TAX MANAGEMENT PORTFOLIOS™

U.S. INCOME

Corporate Acquisitions — (A), (B), and (C) Reorganizations

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PORTFOLIO DESCRIPTION

Tax Management Portfolio, *Corporate Acquisitions — (A), (B), and (C) Reorganizations*, No. 771-4th, discusses the requirements necessary to qualify a transaction as an "A" Reorganization, "B" Reorganization, "C" Reorganization, Forward Triangular Merger, or Reverse Triangular Merger. In addition to discussing the basic requirements, this Portfolio examines the consequences to the various parties involved in a reorganization, with an emphasis on practical problems and planning techniques.

Throughout this Portfolio, the relative advantages and disadvantages of the various types of acquisitive reorganization are compared. Through that comparison, along with an analysis of the particular facts, a practitioner should be able to make an informed judgment as to which, if any, type of acquisitive reorganization fits the circumstances of the parties.

For additional material with respect to the various means of effecting corporate acquisitions, *see* 770 T.M., *Structuring Corporate Acquisitions — Tax Aspects*, 772 T.M., *Corporate Acquisitions — D Reorganizations*, 759 T.M., *Transfer to Controlled Corporations: Related Problems*, and 788 T.M., *Stock Purchases Treated as Asset Acquisitions — Section 338*.

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DETAILED ANALYSIS

I. Overview

A. *Scope of Portfolio*

This Portfolio discusses the federal income tax aspects of acquisitive reorganizations. The term "reorganization" is a term of art in the tax law, and refers to specified tax-free or partially tax-free transactions described in §368 of the Internal Revenue Code (the "Code")[1] that meet the requirements set forth in the statute, regulations, and case law.[2] Various types of reorganizations are described in §368, including "acquisitive" reorganizations, "divisive" reorganizations, "recapitalizations," changes in corporate charters, and reorganizations in connection with bankruptcies. The acquisitive reorganizations discussed in this Portfolio are those reorganizations commonly used to effect the acquisition by one corporate entity of the stock or assets of another corporate entity.[3]

Note: Other provisions of the Code, such as §351 or §368(a)(1)(D), also may be used to effect tax-free or partially tax-free acquisitions. See 758 T.M., *Transfers to Controlled Corporations: In General*; 759 T.M., *Transfers to Controlled Corporations: Related Problems*; and 772 T.M., *Corporate Acquisitions — D Reorganizations.*

The discussion below also provides general guidance in choosing an acquisition structure that fits the business objectives of the parties to the transaction (e.g., taxable acquisition vs. reorganization, type of reorganization, etc.). For a more detailed discussion of choice of transaction structure, see 770 T.M., *Structuring Corporate Acquisitions — Tax Aspects.*

Note: Before a transaction structure is chosen, the business objectives and constraints of the parties need to be fully understood. For example, the acquisition of a corporation in a regulated industry may require a stock acquisition or a reverse subsidiary merger, regardless of any potential tax advantages of an asset acquisition or a forward merger.

The acquisitive reorganizations discussed in this Portfolio are reorganizations described in:

- §368(a)(1)(A) (the "A" Reorganization);
- §368(a)(1)(A) and §368(a)(2)(D) (the "Forward Triangular Merger");
- §368(a)(1)(C) or the parenthetical language in §368(a)(1)(C) (the "C" Reorganization or the triangular "C" Reorganization);
- §368(a)(1)(B) or the parenthetical language in §368(a)(1)(B) (the "B" Reorganization or the triangular "B" Reorganization); and
- §368(a)(1)(A) and §368(a)(2)(E) (the "Reverse Triangular Merger").

Three threshold questions arise in the choice of a transaction structure:

(1) Do the parties want to effect an asset acquisition or a stock acquisition?

(2) What corporate mechanics are necessary or appropriate for effectuating the acquisition (e.g., outright purchase, merger, or some combination)?

Comment: For example, the acquisition of a widely held corporation or one with potentially recalcitrant shareholders may need to be in the form of a merger.

(3) Should the transaction be structured (and can it be structured) as tax-free or partially tax-free?

Practice Point: Business constraints or objectives usually suggest the appropriate answers to the first two questions. Occasionally (e.g., when the seller insists on all cash consideration or the buyer desires a "step up" in basis), the underlying business deal may also resolve the third question. The tax advisor often plays a crucial role in answering all three questions.

Although it is the taxable or tax-free nature of the acquisition that is most relevant to this Portfolio, a basic description of acquisition structures that includes the criteria relevant to the first two questions is set forth in II., below. For detailed discussion of these questions, see 770 T.M., *Structuring Corporate Acquisitions — Tax Aspects.*

B. *Terminology*

For purposes of this Portfolio, the acquired corporation is referred to as "Target," and the purchasing or acquiring corporation is referred to as "Acquiror." When it is useful to describe the acquiring corporation as a parent corporation or a subsidiary of a parent corporation, the terms "Parent" or "Sub" are used in place of "Acquiror."

C. *Reorganizations Involving Foreign Corporations*

Reorganization transactions that involve a foreign Acquiror or Target are subject to the provisions of §367 and the regulations thereunder. Section 367(a) addresses outbound transfers of assets or stock and attempts to prevent the removal of appreciated property from U.S. taxing jurisdiction before its sale or other disposition.[4] Section 367(b) applies to inbound and foreign-to-foreign transactions and is aimed at preserving the

[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder.

[2] In the reorganization area, the specific rules have evolved from a variety of statutory changes, court decisions, and administrative pronouncements. That evolution often took place in response to specific problems. As a result, form is perhaps more important here than in any other area of the Code.

[3] Divisive reorganizations involve the split of a single corporate entity into two or more corporate entities. Recapitalizations and charter changes generally involve a single corporate entity. Reorganizations undertaken in connection with bankruptcy proceedings may, in certain circumstances, resemble acquisitive reorganizations, but they are not addressed in this Portfolio. For a complete discussion of bankruptcy reorganizations, see 540 T.M., *Bankruptcy and Insolvency Restructurings; Discharge of Indebtedness*, 790 T.M., *Corporate Bankruptcy*, and 791 T.M., *Corporate Bankruptcy — Special Topics.*

[4] H.R. Rep. No. 72-208, at 20 (1932); H.R. Rep. No. 94-658, at 240 (1975).

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ability of the United States to tax, either currently or at a future date, the accumulated earnings and profits of a foreign corporation attributable to the stock of that corporation held by U.S. shareholders.[5] Finally, §367(d) provides a separate regime for the outbound transfer of intangible property to a foreign corporation.

Note: The Tax Cuts and Jobs Act (TCJA)[6] made sweeping changes to the international provisions of the Code including §367. For example, prior to January 1, 2018, outbound transfers of tangible property pursuant to a reorganization were exempt from current gain recognition if the assets were to be used in the conduct of an active trade or business outside the United States. This so-called active trade or business exception in former §367(a)(3) was repealed for transfers occurring after December 31, 2017.[7] Section 367(d) was also amended to explicitly cover outbound transfers of goodwill, going concern value, and workforce-in-place.[8] Finally, while §367(b) was not amended by the TCJA, the TCJA's addition of the transition tax (§965), the provision for global intangible low-taxed income (§951A), and the new dividends received deduction for foreign earnings (§245A) has significantly altered the impact of §367(b) and the regulations thereunder on reorganizations involving foreign corporations.

For a full discussion of the potential application of §367(a), §367(b), and §367(d) to reorganizations, as well as the impact of the TCJA changes, see 6100 T.M., *U.S.-to-Foreign Transfers Under Section 367(a)* (Foreign Income Series), and 6120 T.M., *Transfers Subject to Section 367(b), (d), or (e)* (Foreign Income Series).

[5] S. Rep. No. 94-938, at 261–71 (1976).
[6] Pub. L. No. 115-97.
[7] *See* Pub. L. No. 115-97, §14102(e).
[8] *See* Pub. L. No. 115-97, §14221(a).

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II. Choosing a Transaction Structure

A. *Description of Various Structures*

1. *Asset Acquisitions*

The transaction structures described below are designed to effect the acquisition of the assets of Target by Acquiror.

- Taxable asset sales — Target sells some or all of its assets to Acquiror for cash.
- Taxable forward mergers — Target merges directly into Acquiror or a subsidiary of Acquiror, and the former shareholders of Target receive cash and/or property for their Target stock.[9]
- "A" Reorganizations — Target merges directly into Acquiror (or into a disregarded subsidiary of Acquiror), and the former Target shareholders receive sufficient Acquiror stock for the acquisition to qualify as an "A" Reorganization under §368(a)(1)(A).
- "(a)(2)(D)" Reorganizations or Forward Triangular Mergers — Target merges into Sub (or a disregarded subsidiary of Sub), and the former Target shareholders receive sufficient Parent stock for the transaction to qualify as a Forward Triangular Merger under §368(a)(2)(D).
- "C" Reorganizations or triangular "C" Reorganizations — Target transfers substantially all of its assets to Parent or Sub in exchange for a sufficient amount of Parent stock for the acquisition to qualify as a "C" Reorganization under §368(a)(1)(C). Target then liquidates, distributing the Parent stock (and any other remaining assets) to the Target shareholders.[10]

Note: In asset acquisitions that are accomplished by merger, title to the assets generally is transferred to the surviving corporation by operation of state law.[11]

2. *Stock Acquisitions*

The transaction structures described below are designed to effect the acquisition of the stock of Target by Acquiror.

- Taxable stock sales — Target shareholders sell their stock to Acquiror for cash and/or property. This structure is most commonly used when the stock of Target is closely held and all Target shareholders agree to the sale.
- Taxable reverse subsidiary mergers — Newly formed Sub merges into Target (with Target surviving the merger), the Target shareholders receive cash and/or property in exchange for their Target stock, and Parent becomes the owner of Target.

Note: The IRS has ruled that reverse subsidiary cash mergers are generally treated as stock sales.[12]

Because a favorable vote on the merger by the requisite percentage of Target shareholders binds all Target shareholders to surrender their stock in the merger, this structure is useful if the Target stock is widely held or if Target has recalcitrant minority shareholders.

Note: Dissenting Target shareholders must surrender their Target stock, although they may be entitled to appraisal rights.[13]

- "B" Reorganizations or triangular "B" Reorganizations — Target shareholders transfer their Target stock to Parent or Sub in exchange solely for Parent stock in a transaction qualifying as a "B" Reorganization under §368(a)(1)(B).
- "(a)(2)(E)" Reorganizations or Reverse Triangular Mergers — Sub merges into Target (with Target surviving), and Target shareholders receive sufficient Parent stock in exchange for their Target stock for the transaction to qualify as a Reverse Triangular Merger under §368(a)(2)(E); Parent, as a result, becomes the owner of Target.

Note: As in reverse subsidiary mergers, dissenting Target shareholders may be entitled to appraisal rights and thus receive cash in exchange for their Target stock.

B. *Taxable Acquisitions*

Before deciding to structure a stock or asset acquisition (either by outright purchase or merger) as tax-free, or partially tax-free, the potential results of taxable acquisition structures need to be considered. Although many practitioners tend automatically to believe that tax-free transactions are preferable to taxable transactions, in some circumstances taxable structures may be preferable to tax-free structures (as is illustrated below).

1. *Liquidations and Liquidating Sales*

The Tax Reform Act of 1986[14] repealed the *General Utilities*[15] doctrine, embodied in §336 and §337 of the 1954 Code, which had permitted corporations to avoid corporate-level tax on gain recognized in liquidations and liquidating sales.[16] Under post-1986 Act law, Target generally recognizes gain or loss on a liquidation[17] or liquidating sale[18] equal to the difference between the fair market value of Target's assets and Target's basis in those assets. The Target shareholders also generally recognize gain or loss on the receipt of Target assets in liquidation equal to the difference between the fair market value of those assets and their basis in the Target stock.[19] Thus, the two levels of tax — tax at the corporate level and tax at the shareholder level — are imposed on all liquidation transactions not involving 80%-owned subsidiaries.

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[9] The Internal Revenue Service (IRS) has ruled that forward cash mergers are to be treated as if Target sold its assets to Acquiror and then liquidated, distributing the proceeds of the sale to the Target shareholders. *See, e.g.*, Rev. Rul. 69-6.

[10] As discussed in III.C.6., below, Target generally must liquidate for the transaction to qualify as a "C" Reorganization. §368(a)(2)(G).

[11] *See* III.A.1.b., below.

[12] *See, e.g.*, Rev. Rul. 73-427 and Rev. Rul. 79-273.

[13] *See, e.g.*, Del. Code Ann. tit. 8, §262 (1953).

[14] Pub. L. No. 99-514.

[15] *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935).

[16] Losses also were unrecognized.

[17] §336. But see §337 with respect to certain liquidations of 80%-owned subsidiaries.

[18] §1001.

[19] §331. But see §332 with respect to certain liquidations of 80%-owned subsidiaries.

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2. Taxation of Taxable Asset Transfers

If Target sells its assets to Acquiror for cash, Target recognizes gain or loss on each asset equal to the difference between the amount of cash (or other consideration) paid (including liabilities assumed) allocable to the asset and its basis in the asset.[20] Acquiror takes the assets with an aggregate basis equal to the amount of cash (or other consideration) paid (including liabilities assumed),[21] and spreads that basis among the assets according to their relative fair market values.[22]

Any tax attributes of Target (e.g., net operating loss and capital loss carryforwards (NOLs), earnings and profits (E&P), etc.) are not transferred to Acquiror, but remain with Target, and are extinguished upon its liquidation except when Target is an 80%-owned subsidiary.[23]

Practice Point: If the transaction is a forward cash merger into Parent or Sub, the transaction is nonetheless treated as an asset sale followed by a liquidation of Target.[24]

Practice Point: Recent tax law changes may enhance the value to a purchaser of a taxable asset acquisition. In particular, the Tax Cuts and Jobs Act (TCJA)[25] made certain changes to the rules applicable to bonus depreciation to (i) increase bonus depreciation to 100% and (ii) permit bonus depreciation on qualifying tangible assets acquired through the acquisition of a trade or business.[26]

a. Use of §338 (Including §338(g) and §338(h)(10)) or §336(e)

Section 338 and §336(e) of the Code permit an election to treat certain stock transfers as asset transfers for federal income tax purposes. Even if Acquiror and Target use a stock sale for corporate law purposes, therefore, the parties may elect asset sale treatment for tax purposes.

(1) Section 338(g) Election

A §338(g) election (a "regular §338 election") generally is available to Acquiror whenever Acquiror purchases, within a 12-month period, 80% or more of the stock of an unrelated Target. When a regular §338 election is made by Acquiror, Target is treated as having sold all of its assets to new Target in a taxable transaction that is reported on Target's final return for a taxable period ending at the close of the acquisition date.[27] Thus, Target shareholders recognize gain (or loss) on the sale of their Target stock, and Target recognizes gain (or loss) on the deemed sale of its assets.

Practice Point: This is true even if Target is an S corporation.[28]

Because the present value of the step-up in asset basis cannot, in the absence of available Target NOLs to offset Target's gain recognition, exceed the present tax cost of achieving that step-up, regular §338 elections generally are not used (except in the special circumstances described below).

For a detailed discussion of the §338(g) election, see 788 T.M., *Stock Purchases Treated as Asset Acquisitions — Section 338.*

(2) Section 338(h)(10) Election

A §338(h)(10) election generally is available to Acquiror and the shareholder(s) of Target whenever Acquiror purchases, within a 12-month period, 80% or more of the stock of an unrelated Target, provided that before the purchase Target was one of the following: (1) a member of a group of corporations filing consolidated returns; (2) a member of a §1504(a) affiliated group (whether or not the group files consolidated returns); or (3) an S corporation.[29]

Practice Point: A §338(h)(10) election must be made jointly by Acquiror and the parent of the selling group, and a §338(g) election is required on behalf of Target. A §338(g) election may be treated as a regular §338 election, and thus generate a double tax, in states that do not recognize §338(h)(10).[30]

When a §338(h)(10) election is made by Acquiror and the Target shareholder(s), Target is treated as having sold all of its assets to new Target (which is considered owned by Acquiror) while still owned by the selling affiliated group or S corporation shareholders, and then as liquidated. The tax liability arising from the deemed asset sale is the primary responsibility of Target (or Target's affiliated group if a consolidated return is filed, or Target's shareholders if Target is an S corporation),[31] and no gain (or loss) generally is recognized on the deemed liquidation of Target.[32] The Target shareholders also are not treated as having sold Target stock in a taxable stock sale. A §338(h)(10) election, unlike a regular §338 election, generally requires only a single level of tax — i.e., on the deemed asset sale.

For a detailed discussion of the §338(h)(10) election, see 788 T.M., *Stock Purchases Treated as Asset Acquisitions — Section 338.*

(3) Section 336(e) Election

The regulations under §336 provide an alternative method to achieving a result similar to the §338(h)(10) election, pursuant to which a domestic corporation or S corporation shareholder (Seller) can make a §336(e) election when there is a "qualified stock disposition" (QSD).[33] A QSD generally is any transaction or series of transactions in which stock meeting the requirements of §1504(a)(2) (i.e., 80 percent of a corporation's vote and value) of Target is either sold, exchanged, or distrib-

[20] §1001.
[21] §1012.
[22] §1060. See 533 T.M., *Amortization of Intangibles*, for a detailed discussion of the operation of §1060.
[23] §381.
[24] *See* Rev. Rul. 69-6.
[25] Pub. L. No. 115-97.
[26] *See* §168(k), as amended by the TCJA, Pub. L. No. 115-97, §13201.
[27] Reg. §1.338-10(a)(1). Target's gain or loss was formerly reported on a separate one-day return. Reg. §1.338-10(a)(2) and §1.338-10(a)(3) retain separate one-day schemes for Targets that are part of consolidated groups or that are S corporations.
[28] Reg. §1.338-10(a)(3).
[29] Reg. §1.338(h)(10)-1(c)(1).
[30] See Bloomberg Tax Corporate Income Tax Navigator for a comprehensive chart on how states recognize and treat the §338(h)(10) election.
[31] Reg. §1.338(h)(10)-1(d)(2) and §1.1502-6(a) provide that Target is jointly and severally liable (with the selling group) for the tax if Target is a member of an affiliated group filing a consolidated return.
[32] *See* §331, §332, §1366, §1367.
[33] Reg. §1.336-2(a).

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uted by a domestic corporation or S corporation shareholder during a 12-month period.[34]

The §336(e) election must be made pursuant to a written, binding agreement between the target corporation and the seller or sellers (or, in the case where Target is an S corporation, all of the S corporation shareholders, even those who do not dispose of their target corporation stock) and the due date for making the §336(e) election is generally the due date (including extensions) of the seller's return for the year that includes the disposition date (or, in the case where Target is an S corporation, all of the S corporation shareholders, even those who do not dispose of their target corporation stock) and the due date for making the §336(e) election is generally the due date (including extensions) of the seller's return for the year that includes the disposition date (or in the case where Target is an S corporation, the S corporation's return for such year).[35] An extension of time may be granted to file a §336(e) election under Reg. §301.9100-3.[36]

In contrast to an election under §338, the §336(e) election is available even where there are multiple acquirers, the stock of the target corporation is not acquired by a corporation and the disposition does not take the form of a sale.

Practice Point: Other planning techniques may also be available to effect a stock transfer that is treated as a transfer of assets for U.S. federal income tax purposes. For example, the conversion of a corporation to a limited liability company or the filing of a check-the-box election for an eligible entity prior to a sale of interests to Acquiror, may in certain circumstances, accomplish results similar to a §338 or §336(e) election.

For a detailed discussion of the §336(e) election, see 788 T.M., *Stock Purchases Treated as Asset Acquisitions — Section 338.*

b. Situations in Which Taxable Asset Transfers May Be Desirable

In certain circumstances, the consequences of a taxable asset acquisition may prove favorable to the parties.

(1) NOLs in Target

If Target has sufficient NOLs available to shelter all or a substantial portion of the gain recognized on a sale of assets, a direct asset sale or a regular §338 election (when a §338(h)(10) or §336(e) election is not available) may secure current deductions or future depreciation and amortization deductions at a cost that is less than the present value of such deductions. As a practical matter, the desirability of making a §338(g) election (or structuring a direct asset purchase in place of a taxable stock purchase) requires (i) an analysis of the amount of NOLs available to offset the gain from the transaction (e.g., taking into consideration any limitations on the use of such NOLs) and (ii) a comparative analysis of the present value of the benefits associated with the NOLs and tax credits available post-acquisition versus the present value of the benefits associated with the basis step-up in a §338(g) election.[37]

Practice Point: If Target is a subsidiary in an affiliated group and the NOLs reside in Target, an asset sale or §338(h)(10) or §336(e) election is necessary if the parties wish to use the NOLs in the sale transaction. Target's NOLs are not available to offset any gain recognized by the selling group on the sale of the Target stock. This is the "circular-basis rule."[38]

Practice Point: Recent tax law changes may enhance the value to a purchaser of a taxable asset acquisition. In particular, the Tax Cuts and Jobs Act (TCJA)[39] made certain changes to the rules applicable to bonus depreciation to (i) increase bonus depreciation to 100% and (ii) permit bonus depreciation on qualifying tangible assets acquired through the acquisition of a trade or business.[40]

(2) Purchase from Affiliated Group

Use of an asset purchase or a §338(h)(10) or §336(e) election can permit Acquiror to step up the basis of Target's assets with only a single level of tax for the seller.

(3) S Corporation

Because S corporations generally are treated as pass-through entities, purchases of assets from S corporations typically result in only a single level of tax on any gain, which absent any inside/outside stock basis differential, should be identical in amount to the tax that would be paid on a stock sale. Consequently, if the value of the S corporation's assets exceeds the basis of those assets, an asset sale (or deemed asset sale if a §338(h)(10) or §336(e) election is made) generally is preferable to a stock sale. The character of the gain may differ from that in a stock sale, if the S corporation level asset gain is ordinary in any respect. However, any penalty to the S corporation shareholders that results from a difference in character of the gain or an inside/outside stock basis differential can be ameliorated through an increased purchase price.

Practice Point: If the S corporation is subject to the built-in gain rules of §1374 (or the excess capital gain rules of former §1374), a sale of S corporation assets results in two levels of tax upon the capital gain or the built-in gain. Additionally, not all states recognize S corporations as pass-through entities, leading to a potential double tax on asset sales by S corporations in those states.[41]

3. Taxation of Taxable Stock Transfers

a. Effects on Target and Target Shareholders

If Acquiror purchases the stock of Target from the Target shareholders in a taxable transaction, the Target shareholders recognize gain (or loss) on the difference between the consideration received and their tax basis in their shares of Target stock.[42] Target's basis in its assets remains unchanged, and the Target's tax attributes remain with Target.

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[34] Reg. §1.336-1(b)(6).

[35] Reg. §1.336-2(h).

[36] *See, e.g.*, PLR 201825014 (extension is granted because taxpayers acted reasonably and in good faith by relying on tax professional who failed to make election); PLR 201702024 (same).

[37] For further discussion of §382, see 780 T.M., *Net Operating Losses and Other Tax Attributes — Sections 381, 382, 383, 384, and 269.*

[38] *See* Reg. §1.1502-11(b).

[39] Pub. L. No. 115-97.

[40] *See* §168(k), as amended by the TCJA, Pub. L. No. 115-97, §13201.

[41] For a discussion of S corporations, see 730 T.M., *S Corporations: Formation and Termination*, and 731 T.M., *S Corporations: Corporate Tax Issues.*

[42] §1001.

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Practice Point: Target's ability to use its NOLs and other carryforwards may be limited by §382.[43]

b. Situations in Which Taxable Stock Transfers May Be Desirable

As in the case of asset transfers, a taxable stock transfer may be preferable to a tax-free reorganization in certain circumstances.

(1) NOLs in Seller

If the Target shareholders have NOLs available to shelter gain from the stock sale, a taxable stock transfer may be desirable, especially when Acquiror desires a cost-basis in the stock to shelter gain on an anticipated resale. If Target is a subsidiary in an affiliated group, on the other hand, a §338(h)(10) or §336(e) election is probably preferable because it provides a step-up in asset basis.

(2) Loss on Stock

If the Target shareholders' basis in their stock exceeds the stock's value, the Target shareholders may desire a taxable sale to recognize their loss.

Practice Point: If Target is a subsidiary in an affiliated group, recognition of loss on the stock sale may be subject to the restrictions in Reg. §1.337(d)-2, §1.1502-35, and §1.1502-36. For further discussion, see 757 T.M., *Consolidated Returns — Limitations on Losses.*

If the Target shareholders have NOLs available to shelter gain from the stock sale, a taxable stock transfer may be desirable, especially when Acquiror desires a cost-basis in the stock to shelter gain on an anticipated resale. If Target is a subsidiary in an affiliated group, on the other hand, a §338(h)(10) or §336(e) election is probably preferable because it provides a step-up in asset basis.

(3) Foreign Seller

If the Target shareholders are foreign individuals or a foreign entity, they generally are not subject to U.S. tax on a stock sale unless the sale is effectively connected with the conduct of a U.S. trade or business or Target is a "United States real property holding corporation."[44]

C. Nontaxable Acquisitions

The value of a transaction may be enhanced if it can be structured as tax-free or partially tax-free. Although the requirements for, and structure and consequences of, such transactions are discussed in more detail later in this Portfolio, the basic consequences of tax-free transactions are set forth below.

1. Taxation of Tax-Free Asset Acquisitions

In a tax-free asset acquisition (i.e., an "A" Reorganization, Forward Triangular Merger, or "C" Reorganization), Acquiror generally takes Target's historic tax basis in the transferred assets. Target and its shareholders recognize no gain or loss, except when other property ("boot") is given in addition to qualifying consideration. The Target shareholders generally take a basis in the Acquiror stock received equal to their historic basis in their Target stock.

2. Taxation of Tax-Free Stock Acquisitions

In a tax-free stock transfer (i.e., a "B" Reorganization or a Reverse Triangular Merger), the results are generally the same as those discussed above. However, in a "B" Reorganization, Parent takes a basis in the Target stock equal to the basis the old Target shareholders had in that stock. In a Reverse Triangular Merger, Parent generally takes a basis in the Target stock equal to the net inside basis of Target's assets, but may elect to carry over the Target shareholders' basis if the transaction also qualifies as a "B" Reorganization.

D. General Comparison of Asset and Stock Acquisitions

Nontax considerations are also relevant in deciding whether to structure an acquisition as a stock or asset transaction. Some of these considerations may be so important in a particular transaction that they outweigh the applicable tax considerations.

1. Liabilities

A direct asset purchase permits Acquiror to select by contract which (if any) of the liabilities of Target will become liabilities of Acquiror. Moreover, unless Acquiror specifically assumes contingent or unknown Target liabilities, those liabilities generally remain with Target. The ability to control the amount of assumed liabilities, coupled with the tax benefits of a step-up in asset basis in taxable transactions, makes direct asset purchases the structure of choice for many acquirors.

Practice Point: Acquiror must comply with any applicable bulk-sales laws. Additionally, if Acquiror acquires all of Target's assets, the doctrine of "de facto merger" may apply in certain states and cause Acquiror to become liable for certain types of liabilities, even when Acquiror attempts to exclude those liabilities from the asset purchase.[45]

Asset acquisitions effected by a forward merger present special problems. In a forward merger, assets and liabilities are transferred to the surviving corporation by operation of state law. There is no opportunity to exclude particular liabilities. A cash merger or "A" Reorganization into Acquiror, therefore, exposes Acquiror's assets to the claims of Target's creditors (unless the merger is structured as a merger into a disregarded entity owned by Acquiror, as discussed in more detail below). Acquiror can seek a contractual indemnity from the former Target shareholders, but ultimate liability remains with Acquiror. Therefore, it is unusual for Acquiror to engage in a cash merger or "A" Reorganization directly when a cash merger or Forward Triangular Merger into a newly formed disregarded entity (such as a limited liability company (LLC)) or corporate subsidiary is feasible. If the merger is into a newly formed LLC or corporate subsidiary, the consequences are similar to those of a stock acquisition from a corporate law standpoint (i.e., the assets of the Target business continue to be subject to the claims

[43] For a complete discussion of §382, see 780 T.M., *Net Operating Losses and Other Tax Attributes — Sections 381, 382, 383, 384, and 269.*

[44] §864, §871(b), §897.

[45] *See, e.g., Marks v. Minnesota Mining and Mfg. Co.*, 232 Cal. Rptr. 594 (Cal. Ct. App. 1986).

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of Target's creditors, but Parent's assets are insulated from that liability).

Stock acquisitions generally do not permit Acquiror to selectively exclude liabilities. However, Acquiror's ultimate exposure for those liabilities remains restricted to the value of the Target assets.

2. Unwanted Assets

A direct asset purchase structure permits Acquiror to designate the specific assets it will acquire and to leave the remaining assets with Target.

In an asset purchase effectuated by merger or in an acquisition of Target stock, pre-acquisition distributions or sales by Target are required to rid Target of unwanted assets. In certain tax-free transactions, specifically "C" Reorganizations, Forward Triangular Mergers, and Reverse Triangular Mergers, the "substantially all" requirement may limit Acquiror's ability to selectively acquire assets or, in the case of a merger, cause Target to dispose of unwanted assets. *See* III.C.5., below.

3. Degree of Complexity

Although direct asset acquisitions are often the preferred transaction structure for buyers, especially if a taxable transaction is contemplated, they often present problems. If Target has a substantial number of assets, the transfer of title to the assets can be complex, time-consuming, and costly. Asset acquisitions that are effected by state-law merger, in which title to the assets passes as a matter of law, may avoid this complexity, but, as discussed below, these acquisitions may require third-party consents for transfers of contracts or governmental permits in a merger.

Stock acquisitions, by contrast, are simple to effect and present little, if any, inherent complexity.

4. Legal Restrictions

Two types of legal restrictions may weigh against an asset purchase. First, Target may be a party to contracts or possess certain governmental permits that are nonassignable. In these circumstances, failure to keep Target in place as the owner of the assets can result in either loss of the contracts and permits or substantial additional cost resulting from renegotiations of the contracts and reapplication for the permits. Second, state laws may impose significant transfer taxes (e.g., sales taxes, deed recording taxes) on the asset transfers.

Stock acquisitions seldom invalidate contracts or permits, unless the contracts or permits are dependent upon there being no change in control of Target. Moreover, stock acquisitions generally do not trigger transfer taxes.

5. Financial Accounting

Under U.S. GAAP, subject to exceptions for relatively limited categories of transactions, all business combinations are accounted for using the "acquisition method".[46] A business combination is defined for financial accounting purposes as "a transaction or other event in which an acquiror obtains control of one or more businesses (the acquiree)."[47] The acquisition method generally requires that the acquiror measure and recognize the assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree at their acquisition date fair values.[48]

For a detailed discussion of the financial accounting rules applicable to business combinations, see 5170 T.M., *Business Combinations* (Accounting Policy and Practice Series).

6. Shareholder Approval

A merger of Target into Acquiror generally requires approval of both sets of shareholders. A merger of Sub and Target, however, requires only the approval of Target's shareholders and Parent, and not the shareholders of Parent.

A sale of substantially all of Target's assets generally requires Target shareholder approval. A sale of Target stock, not affected by merger, generally requires no shareholder approval. As a practical matter, however, each Target shareholder must approve the transaction and agree to sell their shares to the Acquiror.

Practice Point: The charters of some corporations may require shareholder votes in special situations. Moreover, stock exchange rules may require listed corporations to obtain shareholder votes in certain circumstances (e.g., when Acquiror, a listed corporation, issues its stock in the acquisition and the stock so issued amounts to 20% or more of the Acquiror's outstanding stock).[49]

7. Securities and Exchange Commission

If Acquiror (or Sub) gives Acquiror stock or securities as consideration to Target or its shareholders, Acquiror must either file a registration statement with the Securities and Exchange Commission (SEC) or qualify for an exception to the rules requiring the filing of a registration statement. Moreover, Acquiror must comply with any state securities laws ("blue-sky laws") relevant to the transaction.

8. Antitrust

Under the Hart-Scott-Rodino Antitrust Improvement Act of 1976, depending upon the type and size of the transaction at issue, Acquiror must notify the Federal Trade Commission (FTC) of its intent to consummate the acquisition and delay the transaction until expiration of the applicable waiting period. This rule is designed to give the FTC time to object to acquisitions that would be exceedingly anticompetitive. Failure to comply with the rule results in a substantial monetary fine that accrues daily until the FTC requirements are satisfied. The requirement applies to both stock acquisitions and asset acquisitions.

[46] *See* ASC 805.

[47] ASC 805-10-15-3.

[48] ASC 805-10-05-4(c). There are exceptions to this recognition and measurement criteria. These exceptions are discussed in detail in 5170 T.M., *Business Combinations* (Accounting Policy and Practice Series).

[49] *See, e.g.*, New York Stock Exchange Listed Company Manual, ¶312.03(c); NASDAQ Stock Market Rule 5635(a)(1).

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E. Summary

The foregoing constitutes only a brief overview of the factors relevant to choosing the form of transaction structure. Assuming that the parties to the transaction and their tax advisors have determined that some sort of tax-free transaction may be desirable, the next issue is which reorganization structure (if any) fits the transaction. The remainder of this Portfolio discusses the requirements for and consequences of the various types of acquisitive reorganizations. Within the discussion of each type of reorganization, reference is made to its particular advantages and disadvantages, so that the general concepts discussed above receive additional elaboration.

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III. Acquisitive Asset Reorganizations

A. The "A" Reorganization

1. General

a. General Description

A transaction defined as a "reorganization" is subject to special treatment under certain provisions of the Code. Under §361 and §357, the corporation transferring assets (i.e., Target) to Acquiror recognizes neither gain nor loss if, pursuant to a plan of reorganization, it receives stock or securities of another corporation that is also a party to the reorganization. Under §354 and §356, shareholders and creditors of Target who, pursuant to a plan of reorganization, exchange their stock or securities for stock or securities of another corporation that is a party to the reorganization recognize no loss and generally recognize gain only to the extent that other property is received. Section 358 and §362(b) provide for substituted basis in these exchanges. Finally, §381 provides that in certain reorganizations Target's tax attributes (e.g., earnings and profits, foreign tax credits, research and development tax credits, net operating losses, etc.) are inherited by Acquiror subject to certain limitations.[50]

Section 368(a)(1) defines "reorganization" to include seven different types of transactions. Adding the Forward and Reverse Triangular Mergers described in §368(a)(2)(D) and §368(a)(2)(E), respectively, there are nine in all (or 13 if triangular reorganizations under §368(a)(1)(B) and §368(a)(1)(C) and Forward or Reverse Triangular Mergers under §368(a)(1)(G) are counted separately). As discussed below, the qualification of a given transaction as a reorganization requires compliance with not only the applicable statutory definition, but also a host of judicial and administrative rules and limitations. Qualification, however, must begin with the statute.

An "A" Reorganization is defined simply as "a statutory merger or consolidation."[51] The regulations provide that a statutory merger or consolidation is "a transaction effected pursuant to the statute or statutes necessary to effect the merger or consolidation."[52]

Practice Point: This definition allows a merger of Target with and into a disregarded entity and also allows cross-border mergers, as discussed in III.A.1.b.(1), below.

b. Statutory Merger or Consolidation

All of the states and many foreign jurisdictions have statutes providing for mergers and consolidations (or amalgamations, in the case of many foreign jurisdictions). A statutory merger or consolidation can be accomplished only by strictly complying with the applicable laws of the domestic or foreign jurisdiction of incorporation of the participating corporations. In a merger, two or more corporations are combined and only one of the combining corporations survives. In a consolidation or an amalgamation, two or more corporations are combined into a newly organized corporation. In each of these transactions, the assets and liabilities of the disappearing corporation(s) are transferred to the surviving corporation by operation of law, and the stock of the surviving corporation is issued to the shareholders of the disappearing corporation(s) in exchange for their stock of the disappearing corporation(s), which is then cancelled by operation of law. The disappearing corporation ceases its legal separate existence for all purposes, and the corporations become one entity by operation of law.[53]

Practice Point: State statutes generally permit the payment of cash in a merger.[54]

In the domestic context, mergers are much more common than consolidations, because it is generally desirable for one of the combining corporations to survive the transaction, whereby the surviving corporation's assets are not transferred and do not implicate any applicable restrictions on assignment. The creation of a new corporation in a consolidation may add to the expense of qualifying to do business or exchanging shares of both disappearing corporations for shares of the surviving corporation. A consolidation probably is most useful when the combining corporations desire a new state of incorporation, whether domestic or foreign or in a jurisdiction in which a merger statute does not exist.

Practice Point: The availability of NOLs of the participating corporations may be affected by the use of a consolidation instead of a merger because all participating corporations in a consolidation have "short" taxable years unless the consolidation takes place on the last day of their respective taxable years.[55]

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[50] The attributes enumerated in §381(c) may be subject to limitation under §381, §382, §383, and §384.

[51] §368(a)(1)(A). The first reorganization statute, enacted in the Revenue Act of 1918, provided that an exchange of stock or securities for other stock or securities was nontaxable if made in connection with a "reorganization, merger or consolidation." Pub. L. No. 65-254, §202(b), 40 Stat. 1057, 1060 (1918). The Revenue Act of 1926 defined "reorganization" as a "merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation)." Pub. L. No. 69-20, §203(h), 44 Stat. 9, 14 (1926). The distinction between "A," "B," and "C" Reorganizations was first made in the Revenue Act of 1934 when an "A" Reorganization became defined as a "statutory merger or consolidation." Pub. L. No. 73-216, §112(g), 48 Stat. 680, 705 (1934). For an illustration of the "A" Reorganization, see *§368(a)(1)(A) — "A" Reorganization*, in the Bloomberg Tax Transactional Diagrams Library.

[52] Reg. §1.368-2(b)(1)(ii). The regulations in effect until January 2003 required that the merger or consolidation be effected pursuant to the applicable *corporate* laws of the United States, a state or territory of the United States, or the District of Columbia. Former Reg. §1.368-2(b)(1) (emphasis added). Noting that many states have revised their laws to offer greater variety of business entities, the IRS and Treasury sought to provide a definition of the term "merger or consolidation" that would allow a merger of Target with and into a disregarded entity (such as a single-member limited liability company (LLC)) of a corporate Acquiror. *See* REG-126485-01, 68 Fed. Reg. 3477 (Jan. 24, 2003). To that end, the 2003 temporary regulations (effective for transactions occurring on or after January 24, 2003) deleted the term "corporate" from the definition of a statutory merger or consolidation. Former Reg. §1.368-2(b)(1). With respect to cross-border transactions, before the 2006 final regulations were issued, practitioners seeking to structure a tax-free reorganization involving a foreign entity were required to consider qualifying the transaction as another form of reorganization (e.g., as a "B" or "C" Reorganization). The IRS issued proposed regulations in January 2005 to expand the definition of the term "merger or consolidation" to include cross-border "A" Reorganizations. REG-117969-00, 70 Fed. Reg. 746 (Jan. 5, 2005), adopted by T.D. 9242, 71 Fed. Reg. 4259 (Jan. 26, 2006).

[53] Reg. §1.368-2(b)(1)(ii).

[54] *See, e.g.*, Del. Code Ann. tit. 8, §251(b) (1953).

[55] *See* VI.D., below.

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The regulations clarify that reorganizations qualifying as Forward Triangular Mergers under §368(a)(2)(D) can be accomplished by merger, consolidation, or amalgamation, whereas reorganizations qualifying as Reverse Triangular Mergers under §368(a)(2)(E) can be accomplished, by definition, only by means of a merger.[56]

(1) Mergers Involving Disregarded Entities

The regulations allow the use of disregarded entities to achieve an "A" Reorganization. These regulations use the concepts of "combining entity" and "combining units." A "combining entity" is a business entity that is a corporation that is not a disregarded entity.[57] A "combining unit" is composed solely of a combining entity and all disregarded entities, if any, the assets of which are treated as owned by the combining entity for federal tax purposes.[58]

Practice Point: The ability to structure an "A" Reorganization as the merger of Target with and into a disregarded wholly-owned subsidiary of Acquiror presents a very desirable transaction and commonly used structure from a practical standpoint. As noted above, the Acquiror typically prefers retaining Target assets in a separate legal entity from a liability protection standpoint. As noted below, the "A" Reorganization is generally preferred to the other types of acquisitive asset reorganizations as it has the greatest flexibility. Accordingly, the merger of Target with and into a disregarded entity of Acquiror can accomplish the business objectives of limiting liability while benefiting from the flexibility afforded to "A" Reorganizations.

To incorporate the combining entity and unit concepts, the regulations provide generally that a statutory merger or consolidation must provide that the following occur simultaneously at the time of the transaction: (1) all of the assets (other than those distributed in the transaction) and liabilities (except to the extent satisfied or discharged in the transaction or are nonrecourse to which assets distributed in the transaction are subject) of each member of one or more combining units (each a Target unit) become the assets and liabilities of one or more members of one other combining unit (the Acquiror unit); and (2) the combining entity of each Target unit ceases its separate legal existence for all purposes.[59]

> *Example:* Target merges into a disregarded LLC wholly owned by Acquiror (together with the LLC, an Acquiror combining unit) under state corporate laws, and Target shareholders receive solely Acquiror stock in exchange for their Target stock. Because the LLC is treated as a disregarded entity under the "check-the-box" regulations,[60] the assets and liabilities of the Target combining entity are viewed as having been transferred directly to the Acquiror combining entity. Under the regulations, this deemed transfer from the Target combining entity to the Acquiror combining entity qualifies as an "A" Reorganization, and is not forced to qualify as a "C" (or "D") Reorganization.[61]
>
> A merger of a Target disregarded entity into an Acquiror combining entity or combining unit does not qualify as a statutory merger and, therefore, does not qualify as an "A" Reorganization, unless the Target disregarded entity's entire Target combining unit is merged into the Acquiror combining unit.[62] If the merger only involves the disregarded entity and not the entire disregarded entity's Target combining unit (i.e., the Target corporation), the transaction fails to qualify as an "A" Reorganization because the transaction results in the continued existence of the Target. Such a transaction is viewed as a division of the assets of Target.

Examples in the regulations clarify the following: (1) a merger into a disregarded entity cannot qualify as an "A" Reorganization if the target shareholders receive interests in the disregarded entity in the transaction (i.e., the disregarded entity must remain a disregarded entity immediately after the merger);[63] and (2) a merger into an entity that was treated as a partnership for federal income tax purposes but becomes a disregarded entity in the transaction can qualify as an "A" Reorganization (because, so long as the surviving entity is disregarded immediately after the transaction, the status as a partnership before the transaction does not prevent the transaction from qualifying as an "A" Reorganization).[64]

(2) Mergers Involving Foreign Entities

The definition of a "statutory merger and consolidation" in the regulations includes mergers involving foreign corporations.[65]

The regulations clarify the application of the "A" Reorganization provisions to foreign law amalgamations. Certain foreign corporate statutes (e.g., those of Canada) that do not provide for a traditional merger (i.e., one corporation merging with and into another corporation, with the second corporation surviving) may provide for an alternative corporate transaction known as an "amalgamation." In the case of an "amalgamation," a new corporation is technically formed, with the two "merging" parties amalgamating with and into the new corporation and with the new corporation surviving. Reg. §1.368-2(b)(1)(iii) *Ex.* 14 clarifies that an amalgamation can qualify as an "A" Reorganization of both amalgamating companies with and into the newly formed entity.[66] In the preamble to the final regulations, the IRS indicated that it is studying the issue of whether or not one of the two amalgamating corporations can be viewed as engaging in an "F" Reorganization into the newly formed entity followed by the other corporation engaging in an "A" Reorganization with and into the newly formed entity.[67] Until further guidance is issued on this subject,

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56 Reg. §1.368-2(b)(1)(iii) *Ex.* 14.

57 Reg. §1.368-2(b)(1)(i)(B).

58 Reg. §1.368-2(b)(1)(i)(C).

59 Reg. §1.368-2(b)(1)(ii).

60 Reg. §301.7701-1, §301.7701-2, §301.7701-3.

61 Reg. §1.368-2(b)(1)(iii) *Ex.* 2. *See also* PLR 201105019 (target's transfer of its assets and liabilities to single member LLC owned by acquirer treated as acquisition by acquirer, citing Reg. §1.368-2(b)(1)(iii) *Ex.* 2).

62 Reg. §1.368-2(b)(1)(iii) *Ex.* 6.

63 Reg. §1.368-2(b)(1)(iii) *Ex.* 7.

64 Reg. §1.368-2(b)(1)(iii) *Ex.* 11.

65 Reg. §1.368-2(b)(1)(ii).

66 *See also* Reg. §1.368-2(b)(1)(iii) *Ex.* 12 (addressing state law consolidation that is similar to foreign law amalgamation).

67 T.D. 9242, 71 Fed. Reg. 4259 (Jan. 26, 2006).

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Reg. §1.368-2(b)(1)(iii) *Ex.* 14 makes clear that the IRS currently views both amalgamating entities as having engaged in an "A" Reorganization with the newly formed and surviving amalgamated entity.

Practice Point: Some foreign jurisdictions provide for a statutory "demerger" in which a corporation divides its businesses into separate corporations. The IRS in private letter rulings has a treated a demerger as a divisive §368(a)(1)(D) reorganization.[68] Such a transaction, however, could not qualify as an "A" Reorganization in light of its divisive nature.

c. Practical Considerations

The two-party "A" Reorganization is more flexible and is subject to fewer pitfalls than any other acquisitive reorganization. Unlike the "C" Reorganization and Forward or Reverse Triangular Merger, there is no "substantially all" requirement.[69] Thus, for example, an "A" Reorganization is generally the preferred vehicle when Target has distributed unwanted assets before the reorganization by means of a spin-off, redemption, or distribution.[70]

Practice Point: Note, however, that any merger of Target into Acquiror following a purported tax-free spin-off of unwanted assets can render the spin-off taxable to Target if the Target shareholders do not acquire at least 50% of the voting power and value of Acquiror's stock.[71]

Unlike a "B" or "C" Reorganization or a Reverse Triangular Merger, there is no requirement that Acquiror issue voting stock, and the required threshold of equity consideration is considerably lower.[72] The particular makeup of the consideration given by Acquiror is limited only by the continuity of interest (COI) doctrine, discussed at V.A., below. Finally, unlike a Reverse Triangular Merger, an "A" Reorganization may be used when Acquiror already owns a substantial interest in Target.

In addition, an "A" Reorganization is generally less expensive and less time-consuming than a "C" Reorganization because Target's assets and liabilities transfer to Acquiror or Acquiror's disregarded entity by operation of law. The main disadvantage in an "A" Reorganization compared to a "C" Reorganization is the inability to pick and choose Target's liabilities to be assumed.

2. Consideration Given by Acquiror

a. No "Solely for Voting Stock" Requirement

In a "B" Reorganization, no consideration may be given by Acquiror for Target's stock other than voting stock of Acquiror or Acquiror's parent.[73] In a "C" Reorganization, in which Acquiror is required to give voting stock of either Acquiror or Acquiror's parent as consideration for at least 80% of the value of Target's assets, there is only slightly more flexibility.[74]

However, in an "A" Reorganization, the only statutory requirement is that the transaction be consummated pursuant to the applicable state federal or foreign laws; there are no statutory limitations on the type of consideration given by Acquiror in a statutory merger or consolidation.[75] The only limitations on the type of consideration are those imposed by the COI doctrine, discussed below. That doctrine requires that a certain minimum percentage of Acquiror's consideration consist of Acquiror stock, but it does not generally matter under the doctrine whether the stock is voting or nonvoting, or common or preferred.[76] Note, however, that certain preferred stock is treated as boot at the shareholder level, but otherwise as stock for purposes of the COI doctrine.[77]

b. Degree of Permissible Boot

As stated above, the only limitations on the type of consideration given by Acquiror in an "A" Reorganization are those imposed by the COI doctrine. As a result, Acquiror may give nonstock consideration (such as securities, cash, and other property) as consideration for Target's assets so long as the COI threshold is met. When nonstock consideration is passed on to Target's shareholders and creditors, Target generally recognizes no gain or loss on its transfer of assets to Acquiror, although Target's shareholders and creditors are generally required to recognize gain (but not loss) to the extent "boot" is received.[78] The important distinction between an "A" Reorganization (or Forward Triangular Merger) and certain other tax-free reorganizations is that the use of nonstock consideration rarely disqualifies a statutory merger or consolidation as an "A" Reorganization at the definitional level,[79] whereas it always disqualifies an attempted "B" Reorganization at the definitional level and, by virtue of the limited practical use of the 20% boot exception in §368(a)(2)(B), almost always disqualifies an attempted "C" Reorganization at the definitional level.

c. Assumption of Liabilities

(1) Limitations at Definitional Level

In an "A" Reorganization, there are no statutory limitations on Acquiror's assumption of Target's liabilities. Indeed, in every statutory merger or consolidation, all of the assets and liabilities of the disappearing corporations pass to Acquiror by operation of law. At some point, however, if Target's liabilities are sufficiently large in relation to its total assets (so that the shareholders' equity interests in Target are very small relative to the creditors' interests), compliance with the COI re-

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[68] *See, e.g.*, PLR 200335008. See also III.A.3., below, discussing a domestic merger that was treated by the IRS in Rev. Rul. 2000-5, as a divisive transaction rather than an "A" Reorganization.

[69] See §368(a)(1)(C), §368(a)(2)(D), §368(a)(2)(E) for the statutory "substantially all" requirement.

[70] *Commissioner v. Morris Trust*, 367 F.2d 794 (4th Cir. 1966); Rev. Rul. 70-172, Rev. Rul. 68-603. *Cf.* Rev. Rul. 78-251 (spin-off preceding "B" Reorganization), Rev. Rul. 70-434 (same).

[71] *See* §355(e).

[72] *See* V.A., below.

[73] §368(a)(1)(B).

[74] §368(a)(1)(C), §368(a)(2)(B).

[75] §368(a)(1)(A); Reg. §1.368-2(b).

[76] *See* V.A., below.

[77] *See* VI.E.1.c., below.

[78] *See* VI., below.

[79] *But see Roebling v. Commissioner*, 143 F.2d 810 (3d Cir. 1944), cert. denied, 323 U.S. 773 (1944) (statutory merger recast as taxable transaction because Target shareholders received only bonds of Acquiror); *Sw. Natural Gas Co. v. Commissioner*, 189 F.2d 332 (5th Cir. 1951), cert. denied, 342 U.S. 860 (1951) (same result when less than 1% of consideration consisted of Acquiror stock).

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quirement may be at risk.[80] If the shareholders are disregarded and the creditors viewed as the equity holders in Target, but the creditors are not given stock of Acquiror sufficient to satisfy the COI requirement, the acquisition may be viewed as a taxable sale of assets in exchange for Acquiror's assumption of Target's liabilities.[81] The IRS has issued regulations providing guidance when creditors of a corporation will be treated as proprietors for purposes of the COI requirement.[82] For further discussion, see V.A.4.c., below.

(2) Potential for Receipt of Boot by Target

Acquiror's assumption of Target liabilities pursuant to an acquisitive asset reorganization is generally not treated as the receipt of money or other property by Target.[83] Acquiror generally is regarded as assuming Target's liabilities for this purpose, whether the liabilities are simply assumed, paid off contemporaneously with the reorganization (either directly by Target or by Target with funds provided by Acquiror),[84] or exchanged for a new debt instrument of Acquiror (even if the instrument contains materially different terms).[85] The fact that a Target liability is owed to Acquiror, moreover, should not preclude an "assumption" of that liability within the meaning of §357(a); Acquiror is viewed as assuming the liability immediately before it is discharged pursuant to the reorganization.[86] However, if Acquiror advances cash to Target in connection with the reorganization, Target may be viewed as simply receiving cash instead of the assumption of a liability[87] (although the cash would generally not cause gain recognition to Target, as a result of §361(b), discussed below).

The general rule of §357(a) is subject to several exceptions. Under §357(b), if the principal purpose of the assumption or payment is either (a) to avoid federal income tax on the exchange or (b) not a bona fide business purpose, then all of the liabilities assumed by Acquiror (even those that do not bear the taint of a tax avoidance or nonbusiness purpose) are treated as boot received by Target.[88]

Practice Point: The specter of §357(b) is more likely to be raised in a §351 exchange than in a §368 reorganization. The transferor in a §351 exchange must recognize realized gain to the extent of any boot received;[89] no provisions analogous to §361 permit the transferor to avoid gain recognition by distributing the boot to its shareholders or creditors.[90] Thus, the consequences to the transferor may differ significantly depending on whether the transferor (i) borrows money, retains the cash, and has the transferee corporation assume or pay the liability or (ii) simply receives an equivalent amount of money from the transferee corporation. Section 357(b) is necessary to prevent the transferor from using the former route for the principal purpose of avoiding gain recognition on the transfer.[91]

In the context of an acquisitive asset reorganization under §361(b)(1), however, Target avoids gain recognition on the receipt of boot if the boot is distributed to Target's shareholders or creditors pursuant to the plan of reorganization. Such a distribution of boot occurs by operation of law in the case of an "A" Reorganization[92] and is required to occur in the case of either a "C" Reorganization[93] or a reorganization under §368(a)(1)(D).[94] Even if Acquiror's assumption of liabilities were treated as the receipt of boot by Target (under §357(b)), Target would seem to have constructively distributed the boot to the creditors of the assumed liabilities. That would be the result if Acquiror paid the assumed liabilities pursuant to the plan of reorganization (whether on, before, or after the date of reorganization).[95] However, whether Acquiror assumes and pays Target's liabilities or merely assumes them with no plan of immediate payment, no tax avoidance is achieved by having Target incur liabilities before the reorganization, retain the cash, and cause Acquiror to assume the liabilities; had Target instead received cash from Acquiror, the result to Target would be the same.[96] Therefore, §357(b) appears to be a dead letter in the context of §368 reorganizations.

[80] Reg. §1.368-2(d)(1) provides that, although an assumption of liabilities may not violate the "solely for voting stock requirement" in a "C" Reorganization, "it may in some cases … so alter the character of the transaction as to place the transaction outside the purposes and assumptions of the reorganization provisions." While the meaning of this regulation is not clear, it presumably has in mind the requirement in Reg. §1.368-1(b) that the holders of Target's stock and securities before the reorganization maintain a COI. Note also that the illustration in Reg. §1.368-2(d)(3) sanctions an assumption of liabilities equal to 50% of Target's assets.

[81] In several reorganizations involving insolvent corporations, when the shareholders were eliminated and the creditors received stock of Acquiror in exchange for their claims, the creditors were considered to have owned Target's proprietary interests for purposes of the COI requirement. *See* V.A.4.c., below.

[82] Reg. §1.368-1(e)(6).

[83] §357(a).

[84] Rev. Rul. 74-477. *See also Kniffen v. Commissioner*, 39 T.C. 553 (1962), *acq.*, 1965-2 C.B. 5 ("[T]he fact of subsequent discharge and the time of discharge appear to be irrelevant in determining the applicability of [§357(a)] so long as the liabilities belong to the transferor at the time of the exchange and the purpose of the assumption is other than the avoidance of Federal income tax as described in section 357(b)"); *Stockton Harbor Indus. Corp. v. Commissioner*, 216 F.2d 638 (9th Cir. 1954) (contemporaneous payment of Target's liabilities did not violate "solely" requirement in "C" Reorganization). *Cf.* Rev. Rul. 79-4 (Acquiror's payment of Target's pre-existing liability to third party via cash contribution to Target was not disregarded for "B" Reorganization purposes because payment was condition of reorganization and guarantor shareholder was viewed as true debtor).

[85] Rev. Rul. 79-155. *See also Helvering v. Taylor*, 128 F.2d 885 (2d Cir. 1942); *New Jersey Mortgage & Title Co. v. Commissioner*, 3 T.C. 1277 (1944).

[86] *Kniffen v. Commissioner*, 39 T.C. 553 (1962), *acq.*, 1965-2 C.B. 5; Rev. Rul. 72-464. For a discussion of the cancellation of debt income consequences to Target, see VI.B.4., below.

[87] Rev. Rul. 72-343.

[88] For a detailed discussion of §357(b), see 782 T.M., *Boot Distributions and Assumption of Liabilities.*

[89] §351(b).

[90] *Cf.* §361(b).

[91] *See, e.g., Drybrough v. Commissioner*, 376 F.2d 350 (6th Cir. 1967), rev'g in part 42 T.C. 1029 (1964); *Simpson v. Commissioner*, 43 T.C. 900, 917 (1965), *acq.*, 1965-2 C.B. 6.

[92] Because Target in an "A" Reorganization does not exist after the reorganization (and, consequently, a physical post-reorganization distribution by Target is impossible), there is some question as to whether §361 even applies. *See* Carlson, *Boot at the Corporate Level in Tax-Free Reorganizations*, 27 Tax L. Rev. 499 (1972). *But see* Rev. Rul. 72-343 (boot at corporate level in "A" Reorganization).

[93] §368(a)(2)(G).

[94] §354(b).

[95] Rev. Rul. 73-102 (Acquiror's assumption and payment of Target's liability to dissenting shareholders is treated as boot constructively received and distributed by Target; therefore, no gain recognition as result of §361(b)(1)(A)).

[96] *Cf.* Rev. Rul. 79-258 (Acquiror's assumption of Target's recently refinanced loan liability in reorganization under §368(a)(1)(D) did not trigger §357(b), because new indebtedness was incurred to pay off old indebtedness and "no untaxed gain or other tax benefit resulted" to Acquiror or Target as result of assumption).

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Another exception to the application of §357(a) may apply if Acquiror assumes certain Target liabilities that arise in the reorganization. In cases and rulings in the "C" Reorganization context (in which the issue is whether assumed liabilities violate the "solely for voting stock" requirement), an assumption of a liability may not be respected as a valid assumption if the nature and amount of the liability are determined and fixed in the reorganization (as distinguished from a pre-existing liability, which does not require the reorganization to acquire certainty).[97] This principle, which originated in *Helvering v. Sw. Consol. Corp.*,[98] has not been raised in the §357(a) context to invalidate an assumption of a liability, probably because §361(b) would apply in any event to liabilities incurred contemporaneously with the transaction. Also in the "C" Reorganization context, the IRS has ruled that Acquiror's assumption or payment of valid reorganization expenses solely and directly related to the reorganization does not violate the "solely for voting stock" requirement even though such liabilities arise in the reorganization.[99] Thus, the only liabilities other than shareholder liabilities (discussed below) that can be challenged in the "A" Reorganization context are those Target liabilities that arise in, but are not directly related to, the reorganization.[100] Again, even if the assumption or payment of these liabilities is considered boot to Target, the constructive distribution of that boot to the payees should preclude gain recognition to Target.

(3) *Potential for Receipt of Boot by Target Shareholders*

Acquiror's assumption of liabilities or expenses owed or incurred by the Target shareholders is treated as boot received by the shareholders.[101] Although the boot does not trigger gain recognition by Target,[102] it triggers gain recognition with respect to the Target shareholders. In the "A" Reorganization context, this boot must be accounted for in measuring the overall COI. In the "B" and "C" Reorganization contexts, the boot violates the "solely for voting stock" requirement.

In determining whether Acquiror's assumption or payment of a liability or expense is boot to the Target shareholders, whether the liability or expense predates the reorganization or is incurred contemporaneously therewith is generally irrelevant. However, Acquiror's payment of certain reorganization expenses of Target, if paid by Acquiror directly to the creditors, is not treated as boot to the Target shareholders even though those shareholders may benefit from the expenses. These expenses include legal and accounting expenses, appraisal fees, valuation consultant fees, administrative costs of Target directly related to the reorganization (such as printing, clerical work, and telephone service), security underwriting and registration fees and expenses, transfer taxes, and transfer agents' fees and expenses.[103] The payment of certain other expenses results in boot to the Target shareholders; these expenses include expenses incurred by Target shareholders for investment or estate planning advice or legal or accounting advice, and stock transfer taxes owed by those shareholders (when such taxes are not also the legal liability of Target).[104]

Acquiror's assumption or payment of a Target liability guaranteed by a Target shareholder will result in boot to the shareholder if the shareholder is regarded as the true debtor under general debt-equity principles (e.g., thin capitalization of Target) and the assumption or payment is a condition for (and therefore a part of) the reorganization.[105] On the other hand, if the guarantor shareholder is not viewed as the true debtor, the release of the shareholder from the guarantee as a result of Acquiror's payment of the liability is considered incidental and separate from the consideration paid in the reorganization.[106]

d. *Application of Step Transaction Principles*

The step transaction doctrine is a judicially developed concept that, stripped to its essentials, is a subset of the more general "substance over form" doctrine.[107] It treats a series of formally separate "steps" as a single transaction if the steps are "in substance integrated, interdependent and focused toward a particular end result."[108] The courts and the IRS have generally recognized separate steps under a step transaction analy-

[97] *See* III.C.2.c., below.

[98] 315 U.S. 194 (1942).

[99] Rev. Rul. 76-365, Rev. Rul. 73-54. In Rev. Rul. 73-54, the IRS ruled that the valid reorganization expenses must be paid by Acquiror directly to the creditors; a transfer of cash to Target for Target's payment of such expenses would violate the "solely" requirement. This distinction should not matter in the "A" Reorganization context, as a result of §361(b); the deemed receipt of cash by Target does not affect the COI analysis unless the cash is paid to shareholders.

[100] For example, Acquiror's payment of the claims of Target's dissenting shareholders is not considered the payment of an assumed liability, but rather is considered cash consideration paid to Target. Rev. Rul. 73-102.

[101] Rev. Rul. 79-4.

[102] Such an assumption at the shareholder level should be considered outside the scope of §357(a) or within the scope of §357(a) but excluded from gain recognition under §361(b). *See* Rev. Rul. 73-102.

[103] Rev. Rul. 76-365 (valuation expenses), Rev. Rul. 75-450, Rev. Rul. 73-54 (various reorganization expenses), Rev. Rul. 67-275 (stock registration expenses).

[104] Rev. Rul. 73-54.

[105] Rev. Rul. 79-4. In ruling that Acquiror's payment of Target's liability was boot and, therefore, disqualified the attempted "B" Reorganization, the IRS relied primarily on the fact that the payment was a condition for the exchange. However, it is clear that Acquiror can assume or pay Target's liabilities in connection with a "B" Reorganization so long as the payment is made to Target's creditors in their capacity as creditors (as opposed to shareholders). Whether the assumption or payment is a condition of the stock-for-stock exchange is not a controlling fact. *See* Rev. Rul. 70-41 (*modified by* Rev. Rul. 98-10); Rev. Rul. 69-142 (*modified and* superseded by Rev. Rul. 98-10). Therefore, although not stated explicitly, the crux of Rev. Rul. 79-4 is that the guarantor shareholder received boot because the shareholder's personal liability was paid off by Acquiror. If, however, the assumption or payment is not a condition of the exchange, the guarantor shareholder who is treated as the true debtor may not have boot in the reorganization but does have income consequences when the assumption or payment is made. The question of whether Acquiror's payment or assumption of Target's liabilities is a condition of the exchange seems peculiarly applicable to an acquisitive stock reorganization, in which distinctions may be made between capital contributions made by Acquiror to Target and the payment of boot. *See* IV.A.2.c., below.

[106] Rev. Rul. 79-89 (emphasizing that Acquiror's payment of Target's liability was not condition of exchange, but noting that liability was bona fide debt of Target).

[107] The source of most "substance-over-form" arguments is *Gregory v. Helvering*, 293 U.S. 465 (1935).

[108] *Penrod v. Commissioner*, 88 T.C. 1415 (1987); *Estate of Christian v. Commissioner*, T.C. Memo 1989-413; Rev. Rul. 79-250, *modified by* Rev. Rul. 96-29. *See also Gss Holdings (Liberty) Inc. v. United States*, 81 F.4th 1378 (Fed. Cir. 2023) (concluding the Claims Court, in analyzing an investment company's financial arrangements, conflated the step transaction and economic substance doctrines in upholding the IRS's treatment of the sale of a note in 2006 and 2007 and subsequent $24 million payment in 2011 as a single transaction, and remanding for determination under the end result test whether the step transaction doctrine applies).

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sis, even if the steps are taken pursuant to an overall plan, if each step is meaningful and has independent economic significance.[109] However, the IRS and the courts have not consistently delineated the particular circumstances in which the step transaction doctrine is applicable. Also, while the doctrine is typically invoked by the IRS, the IRS and the courts permit the taxpayer to rely on the doctrine in appropriate circumstances.

Step transaction principles may be applied to integrate stock purchases (or a Reverse Triangular Merger) with a subsequent forward merger. For example, Acquiror may purchase Target stock directly from the Target shareholders and then merge Target into Acquiror or a subsidiary of Acquiror. If the consideration given in the stock purchase consists of sufficient Acquiror stock for COI purposes, but not enough to qualify the purchase as a "B" Reorganization, it must be determined whether the purchase and merger should be treated as a single tax-free transaction under the step transaction doctrine.[110] If the step transaction is applicable and the two steps are integrated, then the Target shareholders are treated as exchanging their Target stock for Acquiror stock pursuant to an "A" Reorganization (or a Forward Triangular Merger if Target is merged into a regarded controlled subsidiary of Acquiror),[111] and nonrecognition and carryover basis rules apply to Target. If the step transaction doctrine is inapplicable because the initial stock purchase is "old and cold," the initial stock purchase is taxable to the Target shareholders.[112] The step transaction doctrine is less important to the Target shareholders if the aggregate consideration paid by Acquiror in the stock purchase and subsequent merger does not include sufficient Acquiror stock for continuity purposes; the transaction is taxable to the Target shareholders whether Target stock is treated as exchanged in the initial stock purchase or in the subsequent merger.[113] However, its particular application in that case may be very important to Target or Acquiror as it may impact Target's gain or loss recognition and basis consequences.

For additional discussion of the step transaction doctrine, see V.D., below.

3. *No "Substantially All" Requirement*

There is no requirement in an "A" Reorganization that "substantially all" of Target's assets be transferred to Acquiror, as there is in the case of a "C" Reorganization[114] or a Forward Triangular Merger.[115] Thus, if Target spins off unwanted assets or otherwise makes an extraordinary distribution to its shareholders, Target is not prevented from subsequently merging into another corporation as part of an "A" Reorganization.[116] However, it may not be possible for Target to engage subsequently in a "C" Reorganization or Forward or Reverse Triangular Merger without running afoul of the substantially-all requirement.[117] Note also that premerger dispositions may not be of such a magnitude as to violate the continuity of business enterprise (COBE) requirement, which requires that Acquiror either continue Target's historic business or use a significant portion of Target's assets in a trade of business.[118] As noted above, the regulations incorporate a definition of "statutory merger or consolidation" that includes the requirement that all of the assets and liabilities of the Target combining unit become the assets and liabilities of the Acquiror combining unit pursuant to the transaction. The flush language in the regulations and an example in the regulations clarify that this requirement is not intended to limit premerger distributions of assets or to impose a quasi-substantially-all requirement.[119] The language is apparently intended to prevent divisive transactions, as discussed below.

Although §368(a)(1)(A) does not contain a substantially-all requirement, the section cannot be used to accomplish a tax-free divisive transaction. In Rev. Rul. 2000-5, the IRS addressed two transactions qualifying as mergers under state law. In *Situation 1*, Target transferred some of its assets and liabilities to Acquiror, retained the rest of its assets and liabilities, and remained in existence after the transaction; Target's shareholders received stock of Acquiror in exchange for part of their stock in Target, retaining the rest of the Target stock. In *Situation 2*, Target transferred some of its assets and liabilities to each of two acquiring corporations and then liquidated; Target's shareholders received stock in each of the Acquirors in exchange for their Target stock. The IRS ruled that, even though both transactions were state-law mergers, neither qualified as an "A" Reorganization. Under §368(a)(1)(A), the IRS explained, one corporation must acquire the assets of Target by

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[109] *See, e.g.*, *Esmark, Inc. v. Commissioner*, 90 T.C. 171 (1988), aff'd in unpub. opin., 886 F.2d 1318 (7th Cir. 1989) (Mobil's purchase of Esmark stock and Esmark's subsequent redemption of Mobil's stock were respected as separate steps); Rev. Rul. 79-250 (incorporation of several subsidiaries under §351, merger of unrelated corporation into one subsidiary in Forward Triangular Merger, and reincorporation of Parent under §368(a)(1)(F) were respected as separate steps because each transaction was "sufficiently meaningful on its own account, and … not dependent upon the other transaction for its substantiation …").

[110] For a general discussion of the step transaction doctrine and its specific application in the "A" Reorganization context, see V.D.3., below.

[111] *King Enters., Inc. v. United States*, 418 F.2d 511 (Ct. Cl. 1969); Rev. Rul. 2001-46 (acquisition merger of Acquiror's newly formed subsidiary into Target followed by upstream merger of Target into Acquiror was collapsed into single statutory merger of Target into Acquiror qualifying as "A" Reorganization). In *King Enterprises*, Acquiror purchased Target stock for cash, notes, and Acquiror stock, with the stock comprising 51% of the overall consideration. Acquiror subsequently merged Target upstream. Target shareholders claimed that the two transactions were parts of a single plan, resulting in a nontaxable acquisition of their stock in an "A" Reorganization. The court agreed on the basis of the step transaction doctrine. *See also* Rev. Rul. 69-48, (Acquiror's acquisition of 19% of Target stock for cash as integral step in preconceived plan to acquire Target's assets in "C" Reorganization was treated as cash consideration in reorganization).

[112] Because the stock acquisition does not qualify as a "B" Reorganization, the shareholders' gain or loss is recognized under §1001. *See also* Rev. Rul. 90-95.

[113] Rev. Rul. 69-6 (taxable merger treated as if Target sold its assets and then liquidated). If the step transaction treats Target stock as being exchanged in the merger, the shareholders' gain or loss is recognized under §331 rather than §1001.

[114] §368(a)(1)(C).

[115] §368(a)(2)(D).

[116] *Commissioner v. Morris Trust*, 367 F.2d 794 (4th Cir. 1966); Rev. Rul. 70-172, Rev. Rul. 68-603. *Cf.* Rev. Rul. 78-251 (spin-off preceding "B" Reorganization); Rev. Rul. 70-434 (same). However, any merger of Target into Acquiror following a purported tax-free spin-off of unwanted assets can render the spin-off taxable to Target if the Target shareholders do not acquire at least 50% of the voting power and value of Acquiror's stock. *See* §355(e).

[117] *See, e.g.*, *Helvering v. Elkhorn Coal Co.*, 95 F.2d 732 (4th Cir. 1937), cert. denied, 305 U.S. 605 (1938) (tax-free spinoff preceded attempted "C" Reorganization); Rev. Proc. 77-37.

[118] *See* Reg. §1.368-1(d).

[119] Reg. §1.368-2(b)(1)(ii), §1.368-2(b)(1)(iii) *Ex.* 8.

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operation of law and Target must cease to exist. The IRS noted that both transactions were divisive rather than acquisitive: (a) in *Situation 1* because, after the transaction, Target continued in existence, Target and Acquiror held Target's assets and liabilities, and Target's shareholders held stock in both Target and Acquiror; and in *Situation 2* because, after the transaction, both Acquirors held Target's assets and liabilities, and Target's shareholders held stock in each Acquiror. The IRS stated that §355 is the sole section under which a divisive transaction can be tax-free.

Consistent with the holding in Rev. Rul. 2000-5, the regulations provide that a merger of a Target combining entity into a disregarded entity of an Acquiror's combining unit qualifies as an "A" Reorganization, but a merger of a Target disregarded entity into an Acquiror combining entity or unit does not qualify unless the disregarded entity's entire Target combining unit is merged into the Acquiror combining unit (i.e., a potentially divisive transaction involving a disregarded entity does not qualify as an "A" Reorganization).[120]

4. *Effect of Acquiror's Pre-Existing Ownership of Target*

The effect, if any, of Acquiror's pre-existing ownership of Target depends on the extent of Acquiror's interest, whether the acquisition is a qualified stock purchase (and, if not, whether the interest is "old and cold"), and the amount of Acquiror stock used to acquire Target stock and effect the merger.

If Acquiror purchased at least 80% of the voting power and value of Target's stock in a qualified stock purchase (QSP), then any merger of Target into Acquiror following closely thereafter generally is treated as a liquidation under §332 with respect to Acquiror,[121] and as a taxable liquidation with respect to the minority Target shareholders who did not sell their shares in the QSP.[122] However, if the aggregate consideration paid by Acquiror in the QSP includes sufficient Acquiror stock for continuity purposes, then Rev. Rul. 2001-46 (discussed above) treats the merger of Target into Acquiror as an "A" Reorganization for all parties to the transaction.

Practice Point: However, if Acquiror and Target's shareholders agreed to make a §338(h)(10) election,[123] then the transactions are not to be stepped together and any merger of Target into Acquiror following closely thereafter generally is treated as a liquidation under §332 with respect to Acquiror[124] and as a taxable liquidation with respect to the minority Target shareholders who did not sell their shares in the QSP.[125]

If Acquiror's interest is not "old and cold" and either (i) the interest is less than 80% or (ii) Acquiror acquired at least 80% of the voting power and value of Target's stock in a transaction that does not constitute a QSP (e.g., because of the failure to acquire at least 80% over a 12-month period), the situations in which the acquisition and subsequent merger are stepped together are not clear. Rev. Rul. 2001-46 by its terms is limited to situations in which the first step is a QSP. However, the *King Enterprises* doctrine is not so limited, and treats the overall transaction as an "A" Reorganization if the stock consideration is sufficient to meet the COI requirement.[126] If the stock consideration is not sufficient to meet the COI requirement, the better view is to respect the stock purchase and merger as separate transactions; otherwise, an integration of these transactions into a single taxable merger would be inconsistent with the death of the *Kimbell-Diamond* doctrine.

If Acquiror's interest in Target is less than 80% and is "old and cold," the merger of Target into Acquiror qualifies as an "A" Reorganization with respect to all the Target shareholders (including Acquiror) so long as sufficient COI is present. Whether COI is present should be determined by counting Acquiror's interest toward continuity.[127] If Acquiror's interest in Target is greater than 80% and is "old and cold," the merger of Target into Acquiror can qualify as a §332 liquidation with respect to Acquiror[128] and as an "A" Reorganization with respect to all the Target shareholders who receive Acquiror stock in the merger.[129]

5. *Mergers Within Affiliated Groups*

a. *Downstream Merger*

(1) *"A" Reorganization vs. Liquidation*

The downstream merger of a parent into its subsidiary is generally treated as an "A" Reorganization.[130] The courts have rejected the argument that a downstream merger should be treated as if the parent distributed the subsidiary stock to its shareholders in a liquidation under §331 or §332.[131] Whether the parent's principal or only asset is subsidiary stock should not matter, so long as the requirements of a statutory merger are met and COI is satisfied at the parent level.[132] The COBE requirement is considered satisfied even if the parent's only asset is subsidiary stock.[133] In the case of a downstream reorganiza-

[120] Reg. §1.368-2(b)(1)(ii), §1.368-2(b)(1)(iii) *Ex.* 1.

[121] See V.A.4.b.(2), below. For a more detailed discussion on upstream mergers, see III.A.5.b., below.

[122] Reg. §1.338-3(d); Rev. Rul. 90-95, distinguished by Rev. Rul. 2001-46. *See* V.A.4.b.(2), below.

[123] Reg. §1.338(h)(10)-1(c)(2), §1.338(h)(10)-1(e) *Exs.* 11, 12, 13, 14.

[124] See V.A.4.b.(2), below. For a more detailed discussion on upstream mergers, see III.A.5.b., below.

[125] Reg. §1.338-3(d); Rev. Rul. 90-95, distinguished by Rev. Rul. 2001-46. *See* V.A.4.b.(2), below.

[126] *See Sec. Indus. Ins. Co. v. United States*, 702 F.2d 1234 (5th Cir. 1983); *Seagram Corp. v. Commissioner*, 104 T.C. 75 (1995); *Superior Coach of Fla., Inc. v. Commissioner*, 80 T.C. 895 (1983); *Yoc Heating Corp. v. Commissioner*, 61 T.C. 168 (1973); *Kass v. Commissioner*, 60 T.C. 218 (1973), aff'd without opinion, 491 F.2d 749 (3d Cir. 1974). *See* V.A.4.b., below.

[127] Reg. §1.368-1(e)(8) *Ex.* 7; *Kass v. Commissioner*, 60 T.C. 218 (1973), aff'd without opinion, 491 F.2d 749 (3d Cir. 1974); GCM 39404 (Sept. 4, 1985). *See* V.A.4.b., below.

[128] Reg. §1.332-2(d).

[129] Reg. §1.368-1(e)(8) *Ex.* 7; *Kass v. Commissioner*, 60 T.C. 218 (1973), aff'd without opinion, 491 F.2d 749 (3d Cir. 1974); GCM 39404 (Sept. 4, 1985). See V.A.4.c., below.

[130] *Commissioner v. Webster's Estate*, 131 F.2d 426 (5th Cir. 1942); *Commissioner v. Gilmore's Estate*, 130 F.2d 791 (3d Cir. 1942), *acq.*, 1946-2 C.B. 2; *Edwards Motor Transit Co. v. Commissioner*, T.C. Memo 1964-317; Rev. Rul. 70-223.

[131] *See, e.g., Commissioner v. Gilmore's Estate*, 130 F.2d 791.

[132] *See, e.g., Commissioner v. Gilmore's Estate*, 130 F.2d 791. *See also* Rev. Rul. 78-47 ("C" Reorganization upheld when parent's principal asset was stock in subsidiary); Rev. Rul. 70-223 (Acquiror purchased all of Target stock and then merged into Target in valid "A" Reorganization; COI implicitly tested at parent level).

[133] Reg. §1.368-1(d)(1) specifically acknowledges that mergers of holding companies satisfy the COBE requirement depending on the applicable facts and circumstances. Reg. §1.368-1(d)(1) goes on to state that the policy under-

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tion structured as a "C" Reorganization, both the "substantially all" requirement[134] and the "exchange" requirement[135] should be considered satisfied even if Target is a pure holding company without any operating assets. Finally, both the courts and the IRS have either explicitly or implicitly concluded that a downstream reorganization of a holding company with no operating assets satisfies the business purpose requirement applicable to reorganizations.[136] A downstream merger of a parent into a subsidiary should be respected as an "A" Reorganization whether the subsidiary is "old and cold,"[137] has been recently purchased,[138] or has been formed specifically for the merger.[139] Such a transaction may also qualify as a "D" Reorganization.[140]

Assuming there are no impediments under state law, successive downstream mergers (e.g., merger of parent into Sub 1 followed by merger of Sub 1 into Sub 2) should be treated as separate downstream "A" Reorganizations.[141] A merger of a parent company into a second-tier subsidiary controlled by the parent's first-tier subsidiary is treated as a Forward Triangular Merger under §368(a)(2)(D), assuming the applicable requirements are met.[142]

In addition, Reg. §1.368-2(b)(1)(ii)[143] allows the downstream merger of a parent company into a foreign subsidiary. Such a transaction, however, is subject to §367.[144]

Because a downstream reorganization is similar, in substance, to a taxable liquidation of the parent, the IRS may view it as a means of avoiding the repeal of the *General Utilities* doctrine.[145] If the parent owns less than 80% of the subsidiary and, thus, could not effect a tax-free liquidation of the subsidiary under §332, the IRS has more to gain by recharacterizing a downstream merger as a liquidation of the parent. Thus, the level of scrutiny that the IRS applies to downstream reorganizations may differ depending on whether the parent controls the subsidiary within the meaning of §368(c).

While the IRS has treated a downstream transfer of assets from a holding company to its 5%-owned subsidiary as a "C"

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lying the general COBE requirement, "which is to ensure that reorganizations are limited to readjustments of continuing interests in property under modified corporate form," should "[provide] the guidance necessary to make these facts and circumstances determinations." The courts and the IRS have embellished upon this vague concept in a number of authorities. *See Commissioner v. Gilmore's Estate*, 130 F.2d 791 (pure holding company merged into its 51% operating subsidiary; holding company's historic business was business of its operating company); *Commissioner v. Estate of Webster*, 131 F.2d 426 (5th Cir. 1942) (same); *Edwards Motor Transit Co. v. Commissioner*, T.C. Memo 1964-317 (holding company's only asset was stock of its wholly owned subsidiary); Rev. Rul. 85-198 (holding company was considered engaged in business of second-tier subsidiary for COBE purposes); Rev. Rul. 85-197 (holding company, whose sole asset was all of operating subsidiary's stock, merged into subsidiary; IRS treated holding company as engaged in business of its operating subsidiary and concluded that COBE was satisfied when, after downstream merger, operating subsidiary continued to conduct same historic business that it conducted before merger); Rev. Rul. 78-47 (Target was presumably given credit for historic business of corporation in which it owned 5% interest, which represented over two-thirds of Target's value). *See also* PLR 201918015 (downstream reorganization of holding company into disregarded entity owned by operating company qualified as an "A" Reorganization); PLR 201107003 (downstream merger into a partially owned subsidiary qualified as an "A" Reorganization); PLR 200515012 (downstream reorganization of holding company into publicly traded acquiring corporation in which holding company owned less-than-1% stock interest qualified as "C" Reorganization); PLR 9506036 (holding company's transfer of its 14% interest in subsidiary, plus cash, to subsidiary in exchange for subsidiary stock qualified as "C" Reorganization); GCM 32590 (May 20, 1963) (acquisition by one investment trust, in exchange for its voting certificates, of assets of another investment trust qualified as "C" Reorganization in situation in which sole asset of transferor trust consisted of approximately 8.5% of outstanding certificates of acquiring trust and nominal amount of cash).

[134] *George v. Commissioner*, 26 T.C. 396 (1956), *acq.*, 1956-2 C.B. 5 (56% of value of Target's assets consisted of 50% interest in subsidiary; transaction qualified as "C" Reorganization). *See also* Rev. Rul. 78-47 (downstream reorganization satisfied "substantially all" requirement even though 68% of value of Target assets consisted of 5% of stock of Acquiror); PLR 9506036 (holding company's transfer of its 14% interest in subsidiary plus cash to subsidiary in exchange for subsidiary stock qualified as "C" Reorganization). *Cf.* PLR 8221025 (expressing doubt that "substantially all" requirement could be met when Target's only asset was subsidiary stock).

[135] The use of a "C" Reorganization rather than a merger to combine a pure holding company with a subsidiary to facilitate the holding company's transfer of subsidiary stock to the subsidiary in exchange for new subsidiary stock may raise an issue as to whether a transfer of old shares for new shares is an exchange sufficient in substance to qualify the transaction as a "C" Reorganization. It is clear that the merger of a pure holding company into its subsidiary involves an exchange of property for stock even when the holding company does not own a controlling interest in the subsidiary. *Commissioner v. Webster's Estate*, 131 F.2d 426 (5th Cir. 1942) (rejecting IRS's argument that merger of holding company into its 51% subsidiary did not involve transfer of property in exchange for Acquiror stock and, therefore, could not qualify as reorganization; concluding that operating company's capital stock was property in hands of holding company and that IRS's position would prevent pure holding company from ever merging downstream into its operating subsidiary on tax-free basis). The IRS apparently has not raised the issue in the "C" Reorganization context. Rev. Rul. 78-47 (Target, over two-thirds of whose assets was 5% interest in Acquiror, transferred its remaining assets to Acquiror in exchange for new Acquiror stock and then liquidated; Target's existing stock in Acquiror was deemed to be transferred for new stock because, absent such deemed transfer, "substantially all" requirement could not have been met); Rev. Rul. 57-465 (Target, over one-half of whose assets was stock in Acquiror, transferred all of its assets to Acquiror in exchange for new Acquiror stock and then liquidated; absent deemed exchange of existing Acquiror stock for new stock, "substantially all" requirement for "D" Reorganization could not have been met); GCM 32590 (May 20, 1963) (Target, whose sole asset was 8.5% interest in Acquiror, transferred its Acquiror stock to Acquiror for new Acquiror stock and then liquidated; in treating transaction as "C" Reorganization, IRS stated that there is no rationale for treating downstream "C" Reorganizations differently from downstream statutory mergers). *But see Helvering v. Schoelkopf*, 100 F.2d 415 (2d Cir. 1938).

[136] For example, in both *Commissioner v. Gilmore's Estate*, 130 F.2d 791 (3d Cir. 1942), *acq.*, 1946-2 C.B. 2, and *Commissioner v. Webster's Estate*, 131 F.2d 426, a holding company was merged into its 51%-owned subsidiary simply because the shareholders desired to eliminate the holding company. In GCM 32590 (May 20, 1963), which involved a downstream "C" Reorganization when Target owned only 8.5% of the stock of Acquiror, the IRS viewed the elimination of the costs of maintaining a parent holding company as a sufficient business purpose for a downstream "C" Reorganization.

[137] *See, e.g., Commissioner v. Gilmore's Estate*, 130 F.2d 791.

[138] Rev. Rul. 70-223.

[139] *Cf.* Rev. Rul. 77-428.

[140] *See* Rev. Rul. 57-465 (merger of holding company into subsidiary ineligible for "A" Reorganization, but qualified as reorganization under §368(a)(1)(D)).

[141] *See* PLR 9121013 (successive downstream mergers were treated as separate successive "A" Reorganizations, provided the mergers were statutory mergers under applicable state law); PLR 201214013 (successive downstream reorganizations involving an asset transfer and a check-the-box election treated as a "D" Reorganization followed by a merger treated as an "A" Reorganization); *but see* PLR 9628010 (an upstream merger followed by two successive downstream mergers treated as a two separate "D" Reorganizations and one "A" Reorganization with Acquiror). If the state's merger law requires the filing of documents that designate a surviving corporation, successive mergers may not be possible because all participating subsidiaries but the final corporation would be merged out of existence.

[142] Rev. Rul. 77-428.

[143] *See* III.A.1.b.(2), above.

[144] *See* VIII., below.

[145] For a detailed discussion on the *General Utilities* doctrine, see 784 T.M., *Corporate Distributions and Liquidations Under Prior Law*, at XVII.A.

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Reorganization,[146] there presumably is no reason why a downstream merger of that holding company would not have qualified as an "A" Reorganization. However, with the introduction of §337(d)[147] into the Code in 1986, the IRS began taking the position that a downstream merger involving a less-than-80%-owned subsidiary may be subject to §337(d) regulations, when promulgated.[148]

In 1994, the IRS issued a controversial private letter ruling in which Target, a public company, held 14% of the stock of Acquiror, another public company, with an inherent gain of over $1 billion.[149] This stock in Acquiror represented 85% of Target's assets; the balance of Target's assets consisting of cash. Target transferred its stock in Acquiror plus cash to Acquiror in exchange for new Acquiror shares that were identical in type (but fewer in number) to the Acquiror shares held by Target before the transaction. This "haircut" in the number of shares received by Target represented the business purpose of the transaction for Acquiror. Target then liquidated, distributing the newly issued Acquiror shares to its shareholders. The IRS ruled that the transfer of Target's assets to Acquiror, followed by Target's liquidation, was a tax-free "C" Reorganization. This ruling caused a significant amount of controversy because the transaction was economically equivalent to a taxable liquidation of Target. If Target had liquidated instead of effecting a downstream "C" Reorganization, Target would have recognized gain under §336, and Target's shareholders would have recognized gain under §331.

After issuing PLR 9506036, the IRS announced in Rev. Proc. 94-76 that it would no longer issue rulings on downstream reorganizations when Target does not own stock of Acquiror satisfying the control requirement of §368(c) (which requires ownership stock representing at least 80% of the voting power of all classes of stock entitled to vote and 80% of each class of nonvoting stock).[150] The IRS also announced that, based on its authority under §337(d), it was opening a project to issue guidance on when such transfers were taxable. After reviewing the relevant authorities, the IRS announced in Rev. Proc. 96-22 that it was closing the project without issuing guidance on the subject, but that it would continue its no-ruling policy announced in Rev. Proc. 94-76. By 2000, the IRS had relaxed its no-ruling policy on downstream reorganizations. The IRS has since issued several private letter rulings treating downstream reorganizations as qualifying §368(a)(1)(C) reorganizations.[151]

Regardless of the IRS's current position, the repeal of *General Utilities* does not mean that the pre-1986 authorities regarding downstream reorganizations are irrelevant. Even before the *General Utilities* repeal, the liquidation of a subsidiary into a holding company that did not own subsidiary stock satisfying §368(c) control was a taxable transaction with respect to the holding company. The courts and the IRS, however, have consistently concluded that downstream reorganizations of a holding company with a less-than-80%-owned subsidiary may qualify as nontaxable reorganizations. In fact, both the Third Circuit[152] and the Fifth Circuit[153] explicitly recognized that a downstream reorganization of a holding company into a less-than-80%-percent-owned subsidiary qualified as a nontaxable reorganization even though a liquidation of that same subsidiary into the holding company (or a liquidation of the parent holding company in which subsidiary stock is distributed to noncorporate shareholders of the parent) would have been taxable under the pre-1954 Code versions of §331 and §336.

(2) "A" vs. Other Reorganizations

A downstream merger of a parent into an 80%-owned subsidiary generally qualifies as a reorganization under §368(a)(1)(D) in addition to qualifying as an "A" Reorganization.[154] A downstream merger preceded by a cash purchase of the subsidiary's stock also qualifies as a reorganization under §368(a)(1)(A) and §368(a)(1)(D).[155]

Note: Under Reg. §1.1502-80(d), if parent and subsidiary are members of an affiliated group filing a consolidated return, §357(c) is not applicable and thus, in an intragroup §351 exchange, the transferor's basis in the stock of the transferee received would be reduced twice: (1) by liabilities assumed by the transferee, and (2) under Reg. §1.1502-32 when the liability gives rise to a deduction for the transferee.[156] Proposed amendments to Reg. §1.1502-80(d) would clarify, however, that in a §351 transfer between members of a consolidated group, the transferee's assumption of certain liabilities described in §357(c)(3)(A) does not reduce the transferor's basis in the

[146] Rev. Rul. 78-47. *See also* PLR 200747006 (downstream reorganization of holding company into publicly traded acquiring corporation in which holding company owned less than 5% stock interest qualified as reorganization under §368(a)(1)(C)); PLR 200515012 (downstream reorganization of holding company into publicly traded acquiring corporation in which holding company owned less-than-1% stock interest qualified as reorganization under §368(a)(1)(C)).

[147] Section 337(d) states in part, "[t]he Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of [the *General Utilities* repeal], including regulations to ensure that such purposes may not be circumvented through the use of any provision of law or regulations…."

[148] PLR 9752062; PLR 9333046; PLR 9122080.

[149] PLR 9506036.

[150] *See* Rev. Rul. 59-259.

[151] *See* PLR 200747006; PLR 200515012; PLR 200037002; PLR 200037001. For a discussion of procedures for obtaining a ruling, see VIII., below.

[152] *Commissioner v. Gilmore's Estate*, 130 F.2d 791 (3d Cir. 1942), aff'g 44 B.T.A. 881 (1941), *acq.*, 1946-2 C.B. 2.

[153] *Commissioner v. Webster's Estate*, 131 F.2d 426 (5th Cir. 1942).

[154] Section 368(a)(1)(D) imposes two general requirements: (1) a corporation transfers part or all of its assets to a corporation controlled immediately after the transfer by the transferor or its shareholders; and (2) the transferee corporation's stock or securities are distributed in a transaction that qualifies under §354, §355, or §356. If the required distribution is made pursuant to §354(b), the control requirement is determined under §304(c); otherwise, it is determined under §368(c). *See* Rev. Rul. 57-465 (downstream merger of foreign parent into foreign subsidiary qualifies as a reorganization under §368(a)(1)(D)).

[155] *See* Rev. Rul. 70-223. For transactions effected before October 22, 2004, the IRS had ruled that acquisitive "D" Reorganizations were subject to §357(c)(1), which required the transferor corporation to recognize gain if the liabilities assumed by Acquiror (plus liabilities to which the transferred property is subject) exceeded the total adjusted basis of the property transferred. Rev. Rul. 75-161, *obsoleted by* Rev. Rul. 2007-8. However, the 2004 American Jobs Creation Act (Pub. L. No. 108-357, §898(b)) amended §357(c) to limit its application to divisive "D" Reorganizations — i.e., "D" Reorganizations followed by §355 distributions — for transactions on or after October 22, 2004. Rev. Rul. 2007-8 then clarified that the legislative change excludes acquisitive "D" Reorganizations, like "A" Reorganizations, from application of §357(c)(1) even if §351 also applies to the transaction.

[156] *See* Preamble to REG-134420-10, 89 Fed. Reg. 106,884 (Dec. 30, 2024).

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stock received in the transfer.[157] The IRS originally withdrew these proposed amendments, reasoning that duplicative stock basis reduction is prevented through the combination of existing Reg. §1.1502-32(a)(2) and Reg. §1.1502-80(a)(2), but later reproposed the amendments, clarifying that the prior withdrawal was not intended to suggest that a front-end adjustment is required for a single basis reduction for an assumed §357(c)(3)(A) liability.[158]

At one time, it was possible for the downstream merger of a parent that was merely a holding company into a wholly owned subsidiary to qualify as an "F" Reorganization as well as an "A" and "D" Reorganization. However, the 2015 regulations under §368 provide that a transaction does not qualify as an "F" reorganization unless, among other requirements, the resulting corporation (Newco) does not hold any property or have any tax attributes immediately before the potential F reorganization (other than (1) a de minimis amount of assets (and tax attributes related to those assets) held to facilitate its organization or maintain its legal existence or (2) the proceeds of borrowings related to the potential F reorganization).[159] Thus, under the final regulations, the merger of a holding company into an operating subsidiary would not qualify as an "F" reorganization.[160]

b. Upstream Merger

An upstream merger of an 80%-owned subsidiary into its parent is generally treated as a §332 liquidation even if the transaction satisfies the requirements of a reorganization.[161] Thus, the subsidiary recognizes no gain or loss on the transfer of assets to parent,[162] the parent recognizes no gain or loss on the receipt of such assets,[163] and the subsidiary's basis in its assets carries over to the parent.[164] However, if the merger fails to meet one of the requirements under §332,[165] the transaction may still qualify as a reorganization.

> *Example:* Subsidiary merges into Parent and Parent transfers all or a portion of the Subsidiary's assets to another Subsidiary (i.e., a so-called "liquidation-reincorporation transaction"). The liquidation-reincorporation transaction fails to qualify as a complete liquidation and should be tested as a reorganization.[166] The subsequent drop of Subsidiary's former assets constitutes a §351 exchange and does not prevent the merger from qualifying as an "A" Reorganization pursuant to §368(a)(2)(C).[167] *See* III.C.10.c., below.

The upstream merger of an 80%-owned subsidiary into its parent should be treated as an "A" Reorganization with respect to the minority shareholders if sufficient COI is present.[168] The parent's stock should be counted for purposes of the COI requirement if it is "old and cold"; otherwise, Rev. Rul. 2001-46 may provide for stepping together the multiple steps and treating the transaction as an "A" Reorganization if there is sufficient COI measured solely by reference to the minority shareholders and other "historic shareholders."[169] As discussed above, if the parent acquires the subsidiary in a qualified stock

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[157] Prop. Reg. §1.1502-80(d)(1), REG-134420-10, 89 Fed. Reg. 106,884 (Dec. 30, 2024).

[158] Preamble to REG-134420-10, 89 Fed. Reg. at 106,885. *See* Former Prop. Reg. §1.1502-80(d), REG-137519-01, 66 Fed. Reg. 57,021 (Nov. 14, 2001), *withdrawn by* REG-134420-10, 88 Fed. Reg. 52,057, 52,064 (Aug. 7, 2023).

[159] Reg. §1.368-2(m)(1)(iii).

[160] Reg. §1.368-2(m)(4) *Ex.* 4.

[161] §332(b) (last sentence). The regulations provide that a transaction that qualifies as a complete liquidation and satisfies the requirements of §332 is generally governed by that provision, notwithstanding that the transaction otherwise qualifies as a reorganization under §368. Reg. §1.332-2(d), §1.332-2(e). The example in Reg. §1.332-2(e) describes the merger of a majority-owned subsidiary into its parent corporation. Notwithstanding that the transaction met the requirements for an "A" Reorganization, the example states that the transfer of the subsidiary's assets and liabilities to the parent corporation should be governed by §332. *See American Mfg. Co. v. Commissioner*, 55 T.C. 204, 219–20 (1970) ("The legislative history lends credence to a view that section 332 is intended to cover an area in which the reorganization nonrecognition provisions are inapplicable to a 'statutory merger or consolidation' under section 368(a)(1)(A) that, in substance and effect, is no more than a liquidation of a subsidiary into its parent with all assets going to the parent. Indeed, the regulations under section 332 go further and indicate that the nonrecognition provisions of section 332 take precedence over the reorganization nonrecognition sections, when stock and other property have been exchanged in a parent-subsidiary merger which would result in recognition of 'other property' under the reorganization provisions, but for the fact that section 332 also applied"). *See* PLR 201404004 (statutory merger qualified as a §332 liquidation). For a discussion of the liquidation of subsidiaries under §332, see 784 T.M., *Corporate Liquidations*.

[162] §337.

[163] §332.

[164] §334(b).

[165] In order for a transaction to qualify as a liquidation under §332, the following requirements must be satisfied: (i) the corporation receiving the liquidating distribution ("Parent") must continuously possess §1504(a)(2) ownership of the liquidating corporation ("Subsidiary") from the date the plan of liquidation was adopted through the date the property is received; and the distribution by Subsidiary either (ii) must be in complete cancellation or redemption of all of its stock and the transfer of all its property occurs within the taxable year, or (iii) is one of a series of distributions in complete cancellation or redemption of all of its stock in accordance with a plan of liquidation under which the liquidation is to be completed within three years from the close of the taxable year in which the first distribution was made under such plan. Each class of stock of Subsidiary must receive at least partial payment in the liquidation. *See* §332(a) and §332(b). For a detailed discussion of these requirements, see 784 T.M., *Corporate Liquidations.*

[166] *See* Rev. Rul. 69-617; Reg. §1.368-2(k) (the drop-down of *any portion* of Subsidiary's assets to another Subsidiary will cause the upstream merger to be treated as an "A" Reorganization rather than a §332 liquidation).

[167] *See* Rev. Rul. 69-617; Reg. §1.368-2(k). While Rev. Rul. 69-617 applied the liquidation-reincorporation doctrine to a nontaxable §351 transfer, this doctrine should equally apply to a taxable sale of a liquidating entity's assets to a related subsidiary. Rev. Proc. 90-52, §4.04(4), required a taxpayer seeking a private ruling under §332 to represent that the liquidation of Subsidiary would not be preceded or followed by the reincorporation in, or transfer *or sale to*, a recipient corporation (Recipient) of any of the businesses or assets of Subsidiary, if persons holding, directly or indirectly, more than 20% in value of the Subsidiary stock also hold, directly or indirectly, more than 20% in value of the stock in Recipient. *See also* PLR 201037026 (apparently applying the liquidation-reincorporation doctrine, the IRS ruled that the election by two corporations to be treated as disregarded entities (resulting in deemed liquidations) and the subsequent sale of the entities to related corporations for cash qualify, in each case, as a "Cash D" Reorganization under §368(a)(1)(D) and Reg. §1.368-2(l), by collapsing the liquidation and asset transfers).

[168] *Kass v. Commissioner*, 60 T.C. 218 (1973), aff'd without opinion, 491 F.2d 749 (3d Cir. 1974). *See also* §332(b) (last sentence); Reg. §1.332-2(d), Reg. §1.338-3(d)(5). *See also* III.A.2.d., and III.A.4., above.

[169] *See* III.A.2.d., and III.A.4., above, and V.A.4.b.(2), below; Rev. Rul. 2001-46. *See also* Reg. §1.338(h)(10)-1(c)(2) (step transaction doctrine not applicable if taxpayer makes valid §338(h)(10) election with respect to one step in multi-step transaction if that step, standing alone, is qualified stock purchase), §1.338(h)(10)-1(e) *Exs.* 11–14; Rev. Rul. 2008-25 (taxable reverse subsidiary merger is not integrated with subsequent liquidation (rather than merger) of Target into Parent; first step is viewed as qualified stock purchase, second as liquidation qualifying for §332 treatment).

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purchase, the parent's stock is treated as "old and cold" for purposes of treating a subsequent, prearranged liquidation or merger as an independent transaction, but not for purposes of determining whether the minority shareholders receive tax-free reorganization treatment.[170] The merger is taxable to the minority shareholders under §331 if tax-free reorganization treatment is unavailable.[171]

The upstream merger of a less-than-80%-owned subsidiary into its parent qualifies as an "A" Reorganization with respect to all the Target shareholders (including Acquiror) so long as sufficient COI is present.[172] Note that an upstream merger also qualifies as a reorganization under §368(a)(1)(D) if parent shareholders who also own subsidiary stock are in control of both parent and subsidiary within the meaning of §368(a)(2)(H) and §304(c); Parent's direct ownership of subsidiary stock should not be taken into account for purposes of qualifying the merger as a reorganization under §368(a)(1)(D) because Parent cannot be in control of itself.[173]

c. Brother-Sister ("Sideways") Merger

A merger of one subsidiary into another subsidiary of a common parent (i.e., a "sideways" merger) is generally treated as an "A" Reorganization,[174] and is also treated as a reorganization under §368(a)(1)(D) if the parent owns at least 50% of the acquiring corporation.[175] A sideways merger may also qualify as a reorganization under §368(a)(1)(F) if the acquiring corporation is newly formed for purposes of the acquisition or is otherwise not an operating company, and if only one operating company is involved.[176] In such a case, the operating rules in §381(b) apply.[177]

Practice Point: When a parent recently acquired the merging subsidiary's stock for cash in a transaction that fails to qualify as a qualified stock purchase, it is unclear whether the sideways merger should be respected as a separate transaction or instead be treated as part of a taxable acquisition of such subsidiary's assets.[178] However, as discussed in more detail below, if the merging subsidiary's stock was acquired in a qualified stock purchase under §338, and the consideration paid to the historic shareholders would be sufficient to satisfy the COI requirement, the transactions are integrated as an "A" Reorganization; if the COI requirement is not met, the stock acquisition and merger should be respected as separate acquisitions.

d. Formation of Holding Company

The formation of a holding company is often necessary or useful for business reasons. For example, a banking corporation that is restricted from directly engaging in nonbanking activities, either directly or through a subsidiary, can form a holding company and then cause those activities to be conducted by the holding company or a subsidiary of the holding company. A merger is the most practical means of forming a holding company. The first step is to form two tiers of subsidiaries ("Sub 1" and "Sub 2") below the existing corporation ("X"). X then has two alternatives. X can merge into Sub 2, with X stock exchanged for Sub 1 stock; the transaction is treated as a Forward Triangular Merger under §368(a)(2)(D).[179] As a result of the transaction, X's business becomes the business of Sub 2 and Sub 1 is a holding company of Sub 2. Alternatively, if it is desirable to keep X in existence, Sub 2 can merge into X, with Sub 1's stock in Sub 2 converted into X stock and the X stock held by existing X shareholders converted into Sub 1 stock. This transaction, which makes Sub 1 a holding company of X, is treated as a Reverse Triangular Merger under §368(a)(2)(E).[180]

Another means of forming a holding company is an exchange offer with the shareholders of the existing corporation.

> *Example:* X, an existing corporation, can solicit its shareholders to transfer their X stock to a new corporation in what is treated as a §351 exchange or "B" Reorganization, or possibly both.[181] In an exchange offer, holders of securities in X who exchange those securities for holding company securities pursuant to a §351 exchange may be required to recognize gain or loss,[182] whereas an exchange of those securities for holding company securities pursuant to a "B" Reorganization or a Forward or Reverse Triangular Merger may qualify for nonrecognition treatment.[183]

Practice Point: Whether a holding company is formed by a Forward or Reverse Triangular Merger or by an exchange, the transaction should qualify as a "reverse acquisition" within the meaning of Reg. §1.1502-75(d)(3). Thus, the existing corporation's net operating losses, unused investment credits, foreign tax credits, and capital loss carryovers are not subject to the "separate return limitation year" rules of Reg. §1.1502-21, and its taxable year is used for the filing of the consolidated return.[184]

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[170] Reg. §1.338-3(d)(5). See V.A.4.b.(2), below for a discussion of the effect of a qualified stock purchase on the historic shareholder requirement.

[171] *See, e.g., Kass v. Commissioner*, 60 T.C. 218 (1973), aff'd without opinion, 491 F.2d 749 (3d Cir. 1974).

[172] *See* III.A.2.d., and III.A.4., above.

[173] Rev. Rul. 74-605.

[174] *See, e.g.*, PLR 9105017. *Cf. Superior Coach of Florida, Inc. v. Commissioner*, 80 T.C. 895 (1983) (brother-sister merger failed to qualify for "A" Reorganization treatment due to lack of historic continuity).

[175] §368(a)(2)(H)(i), §304(c). *See* Rev. Rul. 79-289. *See also* PLR 200445016 (merger by Sub 1 into LLC whose sole owner was Sub 2, when both Sub 1 and Sub 2 were wholly owned by common parent, qualified as "D" Reorganization).

[176] Rev. Rul. 79-289; PLR 9038027, PLR 8849017. See the discussion of §368(a)(1)(F) reorganizations in III.A.5.a.(2), above.

[177] *See* Rev. Rul. 87-27, Rev. Rul. 79-289, Rev. Rul. 57-276.

[178] *See* III.A.2.d. and III.A.4., above, and V.A.4.b.(2), below.

[179] Rev. Rul. 78-397. *See also* PLR 200019036.

[180] Rev. Rul. 77-428.

[181] *See, e.g.*, Rev. Rul. 70-433. *Cf.* Rev. Rul. 74-564 (failed Reverse Triangular Merger treated as "B" Reorganization); Rev. Rul. 74-565 (same); PLR 8430093 (failed Reverse Triangular Merger treated as §351 exchange).

[182] Section 351 treats the receipt of securities as boot. *See also* Rev. Rul. 73-472 (transferor of only securities is not member of §351 "control group"). The IRS used to take the position that a bond-for-bond exchange in connection with a "B" Reorganization was governed by §1001. *See* Rev. Rul. 69-142. The IRS eventually changed its view, ruling that a bond-for-bond exchange in connection with a "B" Reorganization is governed by §354 and §356. Rev. Rul. 98-10 (*modifying* Rev. Rul. 78-408, *modifying* Rev. Rul. 70-41, and *superseding* Rev. Rul. 69-142).

[183] *See* VI.E.1.e., below.

[184] *See, e.g.*, PLR 9136027. *See also* Rev. Rul. 72-274 (formation of holding company does not terminate existence of affiliated group for purposes of §243 dividends received deduction).

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e. Corporate Inversions

A merger (Forward or Reverse Triangular Merger) also may be used to place an existing parent corporation beneath an existing subsidiary. Alternatively, the parent shareholders can transfer their parent stock to the subsidiary in a §351 exchange or "B" Reorganization. In each case, the old parent corporation becomes a wholly owned subsidiary of the former subsidiary, and the former subsidiary becomes the new parent. The IRS is concerned about these transactions, known as "corporate inversion" transactions, because they have been used to effectively distribute appreciated assets to shareholders without a corporate level gain, in circumvention of the *General Utilities* repeal.

In Notice 94-93, the IRS warned that regulations would be issued, to be effective for "overly dilutive" inversion transactions occurring on or after September 22, 1994, that would require, as appropriate, (i) an immediate corporate-level gain, or (ii) reductions in basis (or increases in gain upon sale) of the stock of one of the corporations involved. An inversion transaction is considered "overly dilutive" if, as a result of an issuance or transfer of stock or stock rights, there is a reduction in the amount a third party would pay for the stock of one or more corporations involved. While no regulations have been issued, the IRS has applied its position in private letter rulings.[185] Although downstream mergers also have the effect of eliminating the parent's gain on subsidiary stock from potential taxation, the IRS has given no indication that it regards downstream mergers as having the same potential of abusing the repeal of *General Utilities*.[186]

Practice Point: Corporate inversions involving foreign corporations may be subject to §7874. For a full discussion of §7874, see 6105 T.M., *Corporate Inversions* (Foreign Income Series).

6. Consequences of Failure to Qualify as an "A" Reorganization

A merger of Target into Acquiror that fails to qualify as an "A" Reorganization and cannot be characterized as another type of tax-free reorganization is treated as a taxable sale of assets between Target and Acquiror followed by a liquidation of Target.[187] The consequences to Target, the Target shareholders, and Acquiror are described in II.B., above. As previously discussed, a merger may constitute a "C" Reorganization,[188] a reorganization under §368(a)(1)(D),[189] or possibly a reorganization under §368(a)(1)(F).[190]

Practice Point: Note that the COI test in the context of nondivisive §368(a)(1)(D) reorganizations focuses more on the percentage of ownership in the surviving corporation owned by former Target shareholders and less on the quantity of equity consideration involved.[191] For example, a merger involving only 30% equity consideration will most likely fail to qualify as an "A" Reorganization but still constitute a reorganization under §368(a)(1)(D) if the former Target shareholders own, directly or through attribution, at least 50% of Acquiror.[192]

Practice Point: The risk of a taxable sale of assets can be avoided by structuring an "A" Reorganization as a two-step transaction in reliance on Rev. Rul. 2001-46, i.e., a purchase of Target stock by either Acquiror directly or through a merger of Acquiror's wholly owned subsidiary into Target, followed by a merger of Target into Acquiror (or a disregarded wholly-owned subsidiary of Acquiror). This structure is commonly used to achieve the benefits of potential "A" reorganization treatment without assuming the potential risks associated with taxable asset sale treatment if the transaction does not ultimately satisfy the "A" reorganization requirements.[193]

B. The Forward Triangular Merger

1. General

a. General Description

Pursuant to §368(a)(2)(D), a Forward Triangular Merger qualifies as an "A" Reorganization if all of the following tests are met:

- the acquiring corporation (i.e., Sub) uses stock of a corporation in control of the acquiring corporation (i.e., Parent). The control requirement is met if Parent owns at least 80% of Sub's total combined voting power and at least 80% of the total number of shares of all other classes of stock of Sub;[194]
- substantially all of the Target's properties are acquired by Sub;
- the merger of Target into Sub would have qualified under §368(a)(1)(A) had Target merged directly into Parent; and
- no stock of Sub is used in the acquisition.

A Forward Triangular Merger is hybrid category of reorganization with features of both "A" and "C" Reorganizations.

Practice Point: The preamble to the regulations clarifies that a consolidation or foreign law amalgamation transaction can qualify as a §368(a)(2)(D) transaction.[195] The regulations also provide an example in which a foreign amalgamation qualified as a §368(a)(2)(D) transaction.[196]

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[185] *See, e.g.*, PLR 9502023 (relying on Notice 94-93 to revoke PLR 9238009, which involved inversion transaction effected through Reverse Triangular Merger), PLR 9502025 (revoking PLR 8827061).

[186] Robert Willens, *IRS Ruling Offers Fresh Look at Service's View of 'Inversion' Transactions*, 199 DTR J-1 (Oct. 16, 2007).

[187] Rev. Rul. 69-6.

[188] Rev. Rul. 72-405.

[189] Rev. Rul. 78-330, Rev. Rul. 75-161, Rev. Rul. 57-465.

[190] Rev. Rul. 78-287, *obsoleted by* Rev. Rul. 2003-99 (due to 1982 tax law change (Pub. L. No. 97-248)); Rev. Rul. 75-561, *obsoleted by* Rev. Rul. 2003-99 (due to 1982 tax law change (Pub. L. No. 97-248)). However, such a "merger" is limited to a change in identity, form, or place of organization and may involve only one operating company.

[191] *See* V.A.3., below.

[192] Section 368(a)(1)(D) requires that Target or its shareholders be in control of the transferee immediately after the transfer, and control for this purpose is determined under §304(c). §368(a)(2)(H)(i). The IRS has even treated a corporation's sale of assets solely for cash to a related corporation, followed by the liquidation of the selling corporation, as a reorganization under §368(a)(1)(D). PLR 9111055. *See also* Reg. §1.368-2(l).

[193] *See* V.D., below.

[194] *See* §368(c). See also the discussion of the control requirement in IV.A.3., below.

[195] T.D. 9242, 71 Fed. Reg. 4259 (Jan. 26, 2006).

[196] Reg. §1.368-2(b)(1)(iii) *Ex.* 14. For an illustration of the Forward Triangular Merger, see *§368(a)(2)(D) — Forward Triangular Merger*, in the Bloomberg Tax Transactional Diagrams Library.

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b. Practical Considerations

The use of Sub to acquire Target in a Forward Triangular Merger historically offered several advantages over a traditional two-party merger. First, Parent can avoid exposure to the liabilities of Target because Sub absorbs those liabilities by operation of law. Second, the need to obtain approval of the merger by Parent's shareholders may be avoided.[197]

Practice Point: Note, however, that these same advantages can now be achieved through the use of a disregarded entity in an "A" Reorganization without subjecting the transaction to the incremental requirements of a Forward Triangular Merger. See III.A., above, for further discussion.

A Forward Triangular Merger may not be possible when the "substantially all" requirement is a concern. For example, if Target plans to dispose of unwanted assets by means of a spin-off, redemption of some of its stock, or a distribution before or concurrent with the merger, it may be advisable to merge Target directly into Parent with a subsequent drop-down into Sub, or to merge Target directly into a disregarded entity owned by Parent. Note that any subsequent drop-down would be treated as a separate §351 transaction and must run the gamut of §357(b), §357(c), and §362(e).[198]

Practice Point: If the parties desire to issue any Sub stock in addition to Parent stock, a Forward Triangular Merger is not possible. However, the issuance of some Sub stock (in addition to Parent stock) in a merger of Target into Parent should not preclude an "A" Reorganization so long as the continuity of interest (COI) requirement is met by reference to the Parent stock.[199]

c. New or Existing Subsidiary

Section 368(a)(2)(D) applies whether or not Sub is a pre-existing corporation or is formed immediately before the merger, in anticipation of the merger, or after preliminary steps have been taken to merge Target into Sub.[200] However, regardless of whether Sub is old or newly formed, it may not be liquidated immediately after the merger. If it is so liquidated, the transaction must be tested instead as a "C" Reorganization, or potentially as an "A" Reorganization if such liquidation is accomplished by way of an upstream merger.[201]

It also does not matter whether Parent is pre-existing or newly formed.[202] For example, it is common practice to form a holding company by forming two tiers of subsidiaries (Sub 1 owning Sub 2) below the existing corporation (X) and then merge X into Sub 2, exchanging X stock for Sub 1 stock. That transaction may be treated as a Forward Triangular Merger even though Sub 1, which is acting as the Parent, is formed immediately before the merger.[203]

[197] Note that a subsidiary can be a business entity or a disregarded entity (i.e., a single-member LLC). Reg. §1.368-2(b)(1)(i). In either case, Parent can avoid exposure to Target's liabilities for corporate law purposes and avoid the need to obtain approval from the Parent's shareholders.

[198] *See* V.E., below.

[199] This would be an "A" Reorganization, which does not prohibit any specific type of boot paid in the transaction. *See* III.A.2., above.

[200] Reg. §1.368-2(b)(2).

[201] Rev. Rul. 72-405.

[202] Reg. §1.368-2(b)(2).

[203] Rev. Rul. 72-405.

2. Consideration Given by Acquiror

a. No Solely for Voting Stock Requirement

Section 368(a)(2)(D) requires only that "stock" of the Parent be used to effect the acquisition and that no "stock" of the Sub be used. However, stock of the direct controlling parent must be used; stock of a grandparent will not suffice.[204]

The only other restriction on the type of permissible consideration is that Target could have merged into Parent in a transaction qualifying as an "A" Reorganization. Thus, provided the merger of Target into Sub is consummated pursuant to the applicable state, federal, or foreign laws, and no stock other than Parent stock is issued, the only limitations on the type of consideration issued are those that would be imposed by the COI doctrine in an "A" Reorganization.[205] Accordingly, it does not matter whether the Parent stock used in the transaction is voting or nonvoting, or common or preferred.[206] Note, however, that certain preferred stock is treated as boot at the shareholder level, even though it is otherwise regarded as stock for purposes of the COI doctrine.[207]

Practice Point: It should not matter whether the Parent stock is transferred by Sub to the Target shareholders or is simply issued directly by Parent to the Target shareholders, so long as the merger complies with applicable law.[208]

Practice Point: There is no literal requirement that the Parent stock used in the merger be newly issued stock. Parent stock purchased by Sub in the market should qualify as stock consideration for purposes of §368(a)(2)(D). However, because the Forward Triangular Merger is treated as a direct acquisition of assets by Parent followed by a drop-down of those assets solely for purposes of determining Parent's basis in Sub's stock,[209] and this analogy in turn supports the application of §1032 to Sub's issuance of Parent stock,[210] the IRS has stated that Sub may be required to recognize gain or loss on the use of "old and cold" Parent stock.[211] Arguably, Parent stock purchased by Sub pursuant to the plan of reorganization, whether the purchase is from Parent or in the market, should be protected from gain recognition under §1032 (e.g., if the stock appreciates between the purchase date and closing), although some commentators believe otherwise.[212]

b. Prohibition on Use of Subsidiary Stock

Section 368(a)(2)(D) prohibits the use of any Sub stock as consideration in the merger. Thus, if even one share of Sub stock is issued to Target shareholders, the merger does

[204] *See* Rev. Rul. 74-564, Rev. Rul. 74-565 (grandparent stock may not be used in Reverse Triangular Merger). However, the prohibition on the use of grandparent stock is alleviated by Acquiror's ability to drop Sub's assets to a controlled second-tier subsidiary. See discussion of COI and COBE regulations in V.A.5., and V.B., below.

[205] *See* III.A.2.a., above.

[206] *See* III.A.2.a., above.

[207] *See* VI.E.1.c., below.

[208] *See, e.g.*, PLR 8925087.

[209] *See* Reg. §1.358-6(a).

[210] *See* Reg. §1.1032-2(a).

[211] *See* Reg. §1.1032-2(d) *Ex.* 2(b). *See also* Reg. §1.1502-13(f)(6), Reg. §1.1032-3. *Cf.* Rev. Rul. 70-305 (outside of reorganization context, subsidiary recognizes gain or loss on sale of parent stock).

[212] *See* III.B.5.b., below.

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not qualify as a Forward Triangular Merger. Furthermore, the merger does not qualify as a triangular "C" Reorganization because, according to the IRS, the combined use of Parent and Sub stock is prohibited under §368(a)(1)(C).[213] Arguably, however, a merger of Target into Sub should qualify as an "A" Reorganization between Target and Sub if Sub issues enough of its own stock to meet the COI test.[214]

Another question is whether the prohibition on the use of Sub stock can be circumvented by the issuance of Parent stock or Sub (or Parent) bonds that are convertible into Sub stock. The IRS has ruled that when Parent and Sub became jointly liable for Target's debentures in a Forward Triangular Merger, and the debentures are convertible into Sub stock instead of Parent stock if Parent subsequently disposes of Sub stock, Sub stock is not deemed to have been issued in the merger because of the uncertainty of whether Parent will dispose of the Sub stock.[215] Notwithstanding the established rule that convertible debt, stock options, and stock warrants are not stock for tax-free reorganization purposes regardless of the likelihood of exercise,[216] the IRS implied that the debentures might be treated as the equivalent of Sub stock if Parent intended to sell its Sub stock after the merger. Even assuming that a step transaction analysis is appropriate in this context in determining whether conversion rights should be treated as exercised,[217] the critical question is whether the debenture holders intended to convert their debentures into Sub stock.[218]

One final issue relates to targets and acquirors that have outstanding "trust preferred" securities, such as monthly income preferred securities (MIPS), trust originated preferred securities (TOPRS), and qualified improvement preferred securities (QIPS). These securities provide the issuer with tax-deductible interest for tax purposes, while they are often viewed as equity for regulatory purposes. A successful IRS assertion that a particular issuer's trust preferred securities were equity for tax purposes could affect the control requirement or the prohibition on use of subsidiary stock in a triangular reorganization. Although the IRS had originally attacked certain trust preferred securities as constituting equity for tax purposes,[219] subsequent guidance suggests that the IRS has accepted the characterization of these instruments as debt for tax purposes.[220]

c. Degree of Permissible Boot

As discussed in III.A.2.b., above, the only limitations on the degree of nonstock consideration given in the merger, other than the prohibition against the use of Sub stock, are those that would be imposed on an "A" Reorganization. Note, however, that certain preferred stock is treated as boot at the shareholder level.[221] The requirement in §368(a)(2)(D) that the merger could have qualified as an "A" Reorganization if Target had merged directly into Parent means that the general requirements of an "A" Reorganization (e.g., COI, continuity of business enterprise (COBE), and business purpose) must be met in addition to the special requirements of §368(a)(2)(D).[222] Under this requirement, whether a merger of Target into Parent could have been effected under state, federal, or foreign merger laws is irrelevant.[223] Nonstock consideration may be given exclusively by Parent, exclusively by Sub, or by both Parent and Sub.[224]

d. Assumption of Liabilities

There are no statutory limitations on Sub's assumption of Target's liabilities, which occurs by operation of law under the applicable state or federal merger statutes. Considerations relating to the merger of an insolvent or nearly insolvent Target and the potential for the receipt of boot by Target or Target shareholders are the same as those outlined in the "A" Reorganization discussion.[225]

Unlike a triangular "C" Reorganization, in which only Sub may assume Target liabilities,[226] Parent as well as Sub may assume Target liabilities in a Forward Triangular Merger.[227] Moreover, Parent's assumption of Target's liabilities is not generally treated as boot by virtue of §357(a).[228] For example, Parent can assume liability for Target's bonds[229] or it can agree to substitute its stock for stock of Target under an outstanding employee stock option agreement.[230] Parent can even assume Target's liability to cash out dissenting shareholders, possibly avoiding a "substantially all" problem that might arise

[213] Reg. §1.368-2(d)(1).

[214] Any Parent stock issued in such a Target-Sub merger would represent nonqualifying consideration or boot. Indeed, in *Groman v. Commissioner*, 302 U.S. 82 (1937), the Court did find that a reorganization had occurred; it held that the use of parent stock was considered boot only because the parent was not a party to the reorganization.

[215] Rev. Rul. 79-155.

[216] *Gordon v. Commissioner*, 424 F.2d 378 (2d Cir. 1970), cert. denied, 400 U.S. 848 (1970); *Bateman v. Commissioner*, 40 T.C. 408 (1963); Rev. Rul. 70-108, Rev. Rul. 69-91. Note that Reg. §1.356-3(b), issued in 1998, provides that stock warrants and stock options are no longer treated as boot to the target shareholders, although they still are not treated as stock for purposes of determining whether a transaction qualifies as a tax-free reorganization.

[217] *See* GCM 37583 (June 22, 1978) (supporting Rev. Rul. 79-155 and applying step transaction doctrine).

[218] *See Int'l Telephone & Telegraph Corp. v. Commissioner*, 77 T.C. 60 (1981) (conversion of debentures following "C" Reorganization was not considered "part of the reorganization" because debenture holders were not obligated to convert and were not approached by Acquiror to convert, and conversions were not essential to reorganization). This analysis is analogous to the step-transaction analysis in the post-transaction continuity context. *Cf. Commissioner v. Gordon*, 382 F.2d 499 (2d Cir. 1967) (§355 distribution effected through rights distribution). *See* V.A.5., below.

[219] Notice 94-47; Rev. Rul. 94-28.

[220] *See* CCA 200932049 (advising against challenging taxpayer's debt characterization; explaining that holders had creditor rights of "practical significance," that — although conditions would suggest equity if implemented — likelihood of implementation was low, and that long maturity date was not decisive in light of terms of instruments and expectations of marketplace); Wilens, *'Trust Preferred Securities'—The Best of All Worlds?* Daily Tax Rpt. J-1 (Aug. 26, 2009) (discussing how CCA 200932049 stands for proposition that most important consideration in evaluating categorization of "hybrid" instrument is issuer's financial strength); TAM 200606037 (addressing COD consequences upon conversion of securities (TOPRs) to equity), TAM 199910046 (concluding that securities considered in ruling (MIPS) were debt).

[221] *See* VI.E.1.c., below.

[222] Reg. §1.368-2(b)(2).

[223] Reg. §1.368-2(b)(2). *See also* Rev. Rul. 74-297.

[224] Reg. §1.368-2(b)(2).

[225] *See* III.A.2.c., above.

[226] Rev. Rul. 70-107. *Cf.* Reg. §1.368-2(k)(2) *Ex.* 1 (Sub's assumption of Target liabilities, in connection with Target's transfer of all its assets to Sub solely in exchange for Parent stock, qualifies as "C" Reorganization). The preamble to T.D. 9361 distinguishes the facts of this example from those in Rev. Rul. 70-107, and states that T.D. 9361 leaves Rev. Rul. 70-107 intact.

[227] Reg. §1.368-2(b)(2).

[228] Reg. §1.368-2(b)(2).

[229] Rev. Rul. 79-155.

[230] Reg. §1.368-2(b)(2).

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if Target's own funds were used[231] (although such an assumption is regarded as boot for COI purposes).[232]

3. "Substantially All" Requirement

Unlike in a two-party "A" Reorganization, in a Forward Triangular Merger, Sub must acquire substantially all of Target's properties. Congress borrowed this requirement from the "C" Reorganization context to prevent triangular mergers from being used to effect divisive transactions.[233]

The IRS interprets "substantially all" in this context as having the same meaning as it has under §368(a)(1)(C).[234] There may be certain aspects of the "substantially all" requirement in the "C" Reorganization context that are not relevant to a Forward Triangular Merger, but by and large the body of law in that area is useful precedent. For example, a number of rulings and cases in the "C" Reorganization context refer to the percentage or amount of assets that may be retained by Target to pay off liabilities.[235] Of course, in a Forward Triangular Merger, Target is no longer in existence after the reorganization and all of its liabilities are assumed by Sub. Nonetheless, the various percentage limitations developed in the "C" Reorganization context are equally applicable in measuring the impact of post-transaction and pre-transaction asset dispositions on the "substantially all" requirement, which is a concern in both "C" Reorganizations and Forward Triangular Mergers.[236] See III.C.5., below.

4. Effect of Sub's Pre-Existing Ownership of Target

As in the case of a two-party "A" Reorganization, the effect, if any, of Sub's pre-existing ownership of Target depends on the extent of Sub's interest and whether the interest is "old and cold."[237]

For example, if Sub purchased at least 80% of the voting power and value of Target's stock in a qualified stock purchase (QSP), then any merger of Target into Sub following closely thereafter is generally treated as a liquidation under §332 with respect to Sub[238] and as a taxable liquidation with respect to the minority Target shareholders (who did not sell their shares in the QSP).[239] However, if the aggregate consideration paid by Sub in the QSP includes sufficient Parent stock for continuity purposes, then under Rev. Rul. 2001-46 (discussed above), then the stock purchase and merger may be integrated and treated as a Forward Triangular Merger for all parties to the transaction. Note, however, that if Sub and Target's shareholders agreed to make a §338(h)(10) election,[240] then the transactions are not stepped together and any merger of Target into Sub following closely thereafter generally will be treated as a liquidation under §332 with respect to Sub and as a taxable liquidation with respect to the minority Target shareholders who did not sell their shares in the QSP.[241]

If Sub's interest is not "old and cold" and either (i) the interest is less than 80% or (ii) Sub acquired at least 80% of the voting power and value of Target's stock in a transaction that is not a QSP (e.g., because at least 80% was not acquired over a 12-month period), the situations in which the acquisition and subsequent merger will be stepped together are not entirely clear. Rev. Rul. 2001-46 by its terms is limited to situations in which the first step is a qualified stock purchase. However, the *King Enterprises* doctrine is not so limited, and may treat the overall transaction as a Forward Triangular Merger if the stock consideration is sufficient to meet the COI requirement. If the stock consideration is not sufficient to meet the COI requirement, the better view is to respect the stock purchase and merger as separate transactions; otherwise, an integration of these transaction into a single taxable merger is inconsistent with the death of the *Kimbell-Diamond* doctrine.[242] For further discussion, see V.A.4.b.(2), below.

If Sub's interest in Target is less than 80% and is "old and cold," the merger of Target into Sub should qualify as either an "A" Reorganization or as a Forward Triangular Merger so long as sufficient COI is present, which should be determined by counting Sub's interest toward continuity. However, the characterization of the transaction as an "A" Reorganization or as a Forward Triangular Merger and the treatment to the minority shareholders depends on the consideration issued in the merger.[243] If Acquiror's interest in Target is greater than 80% and is "old and cold," the merger of Target into Acquiror can qualify as a §332 liquidation with respect to Acquiror[244] and potentially as a Reorganization with respect to all the Target shareholders, depending on the type of consideration received by each in the merger.[245]

The effect of pre-existing ownership of Target stock by Parent similarly depends on the "old and cold" status of Parent's stock, but generally the extent of that interest has no bearing on the characterization of the merger as a Forward Triangular Merger. On the other hand, if Parent or Parent's shareholders own at least 50% of the voting power or value of Target's shares, then the merger also may qualify as reorganization under §368(a)(1)(D). Even if Parent owns at least 80% of Target, the merger of Target into Sub cannot be recharacterized as a

[231] *Cf.* Rev. Rul. 77-307 (Parent contributed cash to Sub in §368(a)(2)(E) merger to satisfy Target dissenters; payment was disregarded for "substantially all" purposes).

[232] Rev. Rul. 73-102.

[233] *See* H.R. Rep. No. 1902, 90th Cong., 2d Sess. 2–3 (1968); S. Rep. No. 1653, 90th Cong., 2d Sess. 2 (1970).

[234] For a detailed discussion of the "substantially all" requirement in the "C" Reorganization context, see III.C.5., below.

[235] *See* III.C.5.b., below.

[236] *See, e.g.*, Rev. Proc. 77-37, Rev. Proc. 86-42 (for purposes of "substantially all" requirement in §368(a)(1)(C), §368(a)(2)(D), and §368(a)(2)(C), redemptions, distributions, and asset sales are taken into account).

[237] For a discussion of the two-party "A" Reorganization, see III.A.4., above.

[238] *See* V.A.4., below.

[239] Reg. §1.338-3(d); Rev. Rul. 90-95 (distinguished by Rev. Rul. 2001-46). *See* V.A.4.b.(2), below.

[240] Reg. §1.338(h)(10)-1(c)(2), §1.338(h)(10)-1(e) *Exs.* 11–14.

[241] Reg. §1.338-3(d). *See also* Rev. Rul. 2008-25, Rev. Rul. 90-95.

[242] *Kass v. Commissioner*, 60 T.C. 218 (1973), aff'd without opinion, 491 F.2d 749 (3d Cir. 1974); *Yoc Heating Corp. v. Commissioner*, 61 T.C. 168 (1973); *Superior Coach of Fla., Inc. v. Commissioner*, 80 T.C. 895 (1983); *Security Indus. Ins. Co. v. United States*, 702 F.2d 1234 (5th Cir. 1983); *Seagram Corp. v. Commissioner*, 104 T.C. 75 (1995). *See* V.A.4.a., and V.A.4.b., below.

[243] Reg. §1.368-1(e)(7) *Ex.* 7; *Kass v. Commissioner*, 60 T.C. 218 (1973), aff'd without opinion, 491 F.2d 749 (3d Cir. 1974); GCM 39404 (Sept. 4, 1985).

[244] Reg. §1.332-2(d).

[245] Reg. §1.368-1(e)(7) *Ex.* 7; *Kass v. Commissioner*, 60 T.C. 218 (1973), aff'd without opinion, 491 F.2d 749 (3d Cir. 1974); GCM 39404 (Sept. 4, 1985).

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§332 liquidation; liquidation characterization is possible only if Sub directly owned at least 80% of Target. Thus, whether Parent's pre-existing ownership of Target is above or below 80%, the characterization of a merger of Target into Sub depends on the "old and cold" status of Parent's stock or, to the extent such stock is not "old and cold," on the consideration used by Parent to acquire such stock.[246] Of course, if Parent owns 100% of Target, so that no stock of either Parent or Sub is issued in connection with a merger of Target into Sub, the transaction is more likely to be viewed as a two-party "D" Reorganization because, in substance, Sub stock has been issued to the former Target shareholder, Parent.[247] On the other hand, if Parent owns, for example, 90% of Target, and the 10% Target shareholder is issued Parent stock in connection with a merger of Target into Sub, the transaction probably is forced to qualify, if at all, as a Forward Triangular Merger (as opposed to a two-party "A" or "D" Reorganization).

5. *Consequences of Failure to Qualify as Forward Triangular Merger*

a. *Taxable Sale vs. Other Type of Reorganization*

A merger of Target into Sub that fails to qualify as a Forward Triangular Merger and cannot be characterized as another type of tax-free reorganization is generally treated as a taxable sale of assets between Target and Sub followed by a liquidation of Target.[248] Certain consequences to Target, Target shareholders, and Sub are described in II.B., above.

If the merger of Target into Sub fails to comply with, or is not eligible to be governed by, applicable state, federal, or foreign merger laws, the transaction will generally qualify as a tax-free transaction only if it meets the requirements of a triangular "C" Reorganization.[249] The "C" Reorganization rules not only require a higher threshold of equity consideration,[250] but also prohibit the assumption of any liabilities by Parent in a triangular "C" Reorganization.[251] If the triangular merger of Target into Sub qualifies as a merger under state or federal law or similar foreign law,[252] but Sub is subsequently liquidated into Parent as part of an overall plan, the transaction is characterized as a two-party "C" Reorganization between Target and Parent, assuming the applicable requirements are met.[253]

A failed "A" Reorganization may qualify as a reorganization under §368(a)(1)(D) if, immediately after the merger, the former Target shareholders are in "control" of Parent within the meaning of §304(c).[254] It is not clear whether a failed Forward Triangular Merger could qualify as a reorganization under §368(a)(1)(D). In Rev. Rul. 2002-85, the IRS ruled that a drop-down of assets to a subsidiary following a "D" Reorganization does not prevent the transaction from qualifying under §368(a)(1)(D). The regulations have broadened the rules regarding drop-downs following reorganizations (including "D" Reorganizations) in cases in which the transaction adequately preserves the link between the former Target shareholders and the Target business assets.[255] It might be argued in these circumstances that the failed Forward Triangular Merger should be viewed as if Target merged into Parent and then Target's assets were dropped down to Sub.[256]

Practice Point: The risk of a taxable sale of assets can be avoided by structuring a Forward Triangular Merger as a two-step transaction in reliance on Rev. Rul. 2001-46, i.e., a purchase of Target stock by either Sub directly or through a merger of Sub's wholly owned subsidiary into Target, followed by a merger of Target into Sub (or a disregarded wholly-owned subsidiary of Sub). See V.D., below.

b. *Zero Basis Problem*

Reg. §1.1032-2 protects the issuance of Parent stock by Sub in a triangular "B" or "C" Reorganization or a Forward Triangular Merger from gain or loss recognition under §1032, even though §1032 literally applies only to the issuance by a corporation of its own stock.[257] The use of §1032 is unnecessary in the case of a Reverse Triangular Merger, because §361(a) is considered to provide nonrecognition treatment for Sub's use of Parent stock.[258] Nonrecognition treatment under §1032 requires that the Parent stock be "provided by" Parent to Sub, or "directly to" Target or Target's shareholders, "pursuant to the plan of reorganization."[259] To the extent that Sub exchanges — in the triangular reorganization — Parent stock that it did not receive from Parent pursuant to the plan of reorganization, Sub must recognize gain or loss on the exchange of that stock.[260] Arguably, Parent stock purchased by Sub pursuant to the plan of reorganization, whether the purchase is from Parent or in the market, should be protected from gain recognition under §1032 (e.g., if the stock appreciates between the purchase date and closing), although some commentators believe otherwise.[261]

If a merger of Target into Sub fails to qualify as a Forward Triangular Merger or triangular "C" Reorganization (or a pur-

[246] *See* III.A.2.d., and III.A.4., above, and V.A.4.b.(2), below. Note that the historic *Bausch & Lomb* doctrine, which generally did not apply to mergers (Rev. Rul. 58-93), was inapplicable for an additional reason in the case of a triangular merger in which the entity acquiring the assets (i.e., Sub) may be different from the entity owning Target stock (i.e., Parent). *See* Rev. Rul. 57-278 (*Bausch & Lomb* doctrine inapplicable to triangular "C" Reorganization when Parent owned 72% of Target immediately before reorganization).

[247] *Cf.* Rev. Rul. 64-155 (parent's contribution of assets to 100%-owned subsidiary was treated as constructive §351 exchange because issuance of subsidiary stock would be "meaningless gesture").

[248] Rev. Rul. 69-6.

[249] *Cf.* Rev. Rul. 67-326 (forward triangular merger was eligible for qualification as "C" Reorganization before enactment of §368(a)(2)(D)), *obsoleted by* Rev. Rul. 2003-99; Rev. Rul. 57-465 (merger of foreign corporation into another foreign corporation is treated as reorganization under §368(a)(1)(D)).

[250] *See* III.C.2., below.

[251] Rev. Rul. 70-107.

[252] *See* III.A.1., above.

[253] Rev. Rul. 72-405.

[254] *See* §368(a)(2)(H)(i). Several rulings have recharacterized two-party mergers as reorganizations under §368(a)(1)(D). Rev. Rul. 78-330, Rev. Rul. 75-161, Rev. Rul. 57-465.

[255] Reg. §1.368-1(d)(4); Reg. §1.368-2(k).

[256] For an article proposing certain modifications to the statute and regulations to provide greater flexibility in structuring tax-free reorganizations in light of the guidance under Reg. §1.368-2(k), see N.Y. State Bar Ass'n, Tax Section, *Report on Select Issues in Triangular Reorganizations, reprinted in* 2008 TNT 185-18 (Sept. 22, 2008).

[257] Reg. §1.1032-2.

[258] Reg. §1.1032-2.

[259] Reg. §1.1032-2(b).

[260] Reg. §1.1032-2(c).

[261] Cummings & Eustice, *IRS Revises Prop. Reg. on Stock Basis Adjustments in Triangular Reorganizations*, 82 J. Tax'n 324, 326 (1995); *see also* N.Y. State Bar Ass'n, Tax Section, *Report on Zero Basis, reprinted in* 2006 TNT 224–35 (2006).

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ported triangular "B" or "C" Reorganization fails to qualify as such) and the existence of Sub cannot be disregarded as transitory, there is a risk that Sub will be required to recognize gain on the issuance of Parent stock (except as otherwise provided in Reg. §1.1032-3, discussed below).[262]

Reg. §1.1032-3 addresses the disposition of a parent corporation's stock by a subsidiary corporation in an acquisition of cash or other property. The regulation provides for nonrecognition treatment for the subsidiary in the case of a failed reorganization or a taxable acquisition of assets, as well as for grants of stock or options to an employee. The regulation applies to a receipt by a subsidiary of its parent's stock or an option to acquire its parent stock only if, pursuant to a plan to acquire money or other property, (i) the subsidiary corporation acquires stock or a stock option of the parent corporation directly or indirectly in a §351 exchange or as a contribution to capital, (ii) the subsidiary corporation immediately transfers the stock or stock option of the parent corporation to acquire money or other property, and (iii) no party receiving the stock or stock option of the parent corporation has a substituted basis in such stock or stock option as defined in §7701(a)(42) (i.e., does not have either a transferred or exchanged basis in the stock or stock option).[263] In such a case, the subsidiary corporation is deemed to acquire such stock or stock option from the parent corporation for its fair market value with cash contributed to the subsidiary corporation by the parent corporation.[264] As a result of this deemed cash purchase, the subsidiary corporation has a deemed fair market value basis in the issuing corporation's stock and the parent corporation increases its basis in the stock of the subsidiary corporation by such amount.[265] The regulations also provide for nonrecognition treatment in the case of Parent stock or stock options issued to employees of Parent's subsidiary.[266] In light of Reg. §1.1032-3, therefore, no residual zero basis problem should apply to newly issued shares in a failed triangular reorganization.[267] As noted above, however, Reg. §1.1032-3 does not provide any relief from gain recognition by a subsidiary from the issuance of old and cold parent shares in a failed triangular reorganization.

To the extent the Sub's acquisition of Parent's shares does not fall within the scope of Reg. §1.1032-3, it is unclear whether the IRS would press for gain recognition by Sub in a failed triangular reorganization under the zero basis theory. The IRS has ruled in other contexts that parent stock held by a subsidiary is not treasury stock in the hands of a subsidiary, and that such stock has a carryover basis of zero if it was contributed to subsidiary by parent and a cost basis if it was acquired by the subsidiary in the market.[268] Accordingly, a disposition of such stock by the subsidiary could result in gain or loss under §1001.

C. The "C" Reorganization

1. General

a. General Description

A "C" Reorganization is described as the acquisition of "substantially all"[269] of the properties of Target in exchange "solely for voting stock"[270] of Acquiror (or, if Sub is Acquiror, in exchange solely for Parent stock).[271] In the determination of whether the exchange is "solely for voting stock," Acquiror's assumption of Target's liabilities, or the fact that some of Target's properties are subject to liabilities, generally is disregarded.[272] An exception to the "solely" requirement is provided in §368(a)(2)(B), in which Acquiror may transfer boot if at least 80% of the fair market value of Target's properties are acquired solely for voting stock, provided that Target liabilities are counted as boot for this purpose if any cash, property, or other boot is given.[273] Finally, to qualify an asset acquisition as a "C" Reorganization, Target must distribute the stock, securities, and other properties it receives in the reorganization, as well as the other properties it holds, to its shareholders and creditors in pursuance of the plan of reorganization.[274] Other special provisions include §368(a)(2)(C), which permits Acquiror in a "C" Reorganization to drop down Target's assets to a controlled subsidiary, and §368(a)(2)(A), which provides that a transaction described in both §368(a)(1)(C) and §368(a)(1)(D) is treated as described only in §368(a)(1)(D).

The various requirements of a "C" Reorganization have evolved over a number of years. The origins of the "C" Reorga-

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[262] *See* Schler, *Exploring the Boundaries of Section 1032*, 49 Tax Law 543 (1996); Mandel, *Zero Basis: Alive But Not Well*, 74 TAXES 579 (Oct. 1996); Manning, *The Issuer's Paper; Property or What? Zero Basis and Other Income Tax Mysteries*, 39 Tax L. Rev. 159 (1984); Mandel, *The Zero Basis Problem as a Result of the Issuance of Stock or Debt*, 2005 Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings 213 (2005); *see also* N.Y. State Bar Ass'n, Tax Section, *Report on Zero Basis, reprinted in* 2006 TNT 224–35 (2006).

[263] Reg. §1.1032-3(c).

[264] Reg. §1.1032-3(b).

[265] §358(a); Reg. §1.1032-3(e) *Ex.* 1.

[266] Reg. §1.1032-3(e) *Exs.* 4–6.

[267] Before Reg. §1.1032-3 was issued in 2000, Reg. §1.1502-13(f)(6) provided similar protection for members of consolidated groups. Reg. §1.1502-13(f)(6) was amended to apply only to transactions effective before the issuance of Reg. §1.1032-3 in light of the overlap in the provisions. Reg. §1.1502-13(f)(6)(ii), §1.1502-13(f)(6)(v). Proposed amendments to Reg. §1.1502-13(f)(6)(ii) and Reg. §1.1502-13(f)(6)(v) would remove outdated transition rules and references to transactions occurring before May 16, 2000 and July 12, 1995, respectively. REG-134420-10, 88 Fed. Reg. 52,057 (Aug. 7, 2023).

[268] Rev. Rul. 74-503 (*revoked by* Rev. Rul. 2006-2); Rev. Rul. 70-305. §1.1032-2(c) provides that if Sub utilizes Parent's stock in a triangular reorganization that was not contributed to it by Parent as part of the reorganization, Sub recognizes gain or loss on disposition of Parent stock. The IRS revoked Rev. Rul. 74-503 (in Rev. Rul. 2006-2), even though Rev. Rul. 74-503 was seen by many practitioners as the seminal ruling giving rise to concern regarding the zero basis issue for Sub's use of Parent stock. *See* Mandel, *The Zero Basis Problem as a Result of the Issuance of Stock or Debt*, 2005 Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings 213 (2005). Although the IRS did not expressly revoke the zero basis conclusion in Rev. Rul. 74-503, the IRS stated that "the conclusions that X's basis in the Y stock received in the exchange and Y's basis in the X stock received in the exchange are zero, are under study." Rev. Rul. 2006-2. *See also* N.Y. State Bar Ass'n, Tax Section, *Report on Zero Basis*, 2006 TNT 224–35 (2006).

[269] For a discussion of the "substantially all" requirement, see III.C.5., below.

[270] For a discussion of the "solely for voting stock" requirement, see III.C.3., and III.C.4., below.

[271] §368(a)(1)(C). For an illustration of the "C" Reorganization, see *§368(a)(1)(C) — "C" Reorganization*, in the Bloomberg Tax Transactional Diagrams Library.

[272] *See* III.C.2.c., below.

[273] *See* III.C.2.b., below.

[274] §368(a)(2)(G). *See* III.C.6., below.

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nization first appeared in 1926, when a tax-free reorganization was defined as a merger or consolidation "including the acquisition by one corporation…of substantially all of the properties of another corporation."[275] In 1934, Congress restricted the permissible consideration in an acquisition of Target assets or stock (other than a statutory merger or consolidation) to voting stock because it believed that, while tax-free reorganizations should be permitted in situations in which statutory mergers or consolidations were not possible, restrictions designed to prevent tax avoidance were desirable because astute taxpayers had escaped taxation on transactions that were essentially sales by casting them in the form of reorganizations.[276] In 1939, Congress overruled *United States v. Hendler*[277] by permitting Acquiror in a "C" Reorganization to assume liabilities of Target, and the provisions for "B" and "C" Reorganizations were separated.[278] The 20% boot exception was added in 1954 and the distribution requirement was added in 1984.[279]

b. Practical Considerations

From the tax standpoint, a "C" Reorganization is generally less attractive than an "A" Reorganization. Given the amount of liabilities typically assumed in the acquisition of an ongoing business, not to mention the various contingent liabilities which could potentially be taken into account,[280] the 20% "boot" exception to the "solely for voting stock" requirement generally offers little solace to the tax advisor. Even if the tax advisor has a "fix" on the amount of liabilities assumed or the "boot" involved, additional boot may be lurking in a number of well-disguised places, such as contingent or escrowed stock arrangements, employment agreements, and assumptions of shareholder-guaranteed debt.[281]

The "substantially all" and liquidation requirements present additional complications. Unlike a merger, title to Target's assets must be physically transferred to Acquiror, a potentially time-consuming and costly process. A "C" Reorganization, in summary, achieves no tax advantages other than the potential for avoiding the automatic assumption of Target's contingent tax liabilities, which cannot be avoided as easily in a two-party "A" Reorganization.

Practice Point: Acquiror's ability to protect itself from Target's contingent liabilities in a two-party "A" Reorganization has been enhanced by the disregarded entity merger regulations discussed above.

From the nontax standpoint, however, a "C" Reorganization may be necessary or advantageous. First, it may not be possible to merge Target into Acquiror under applicable state, federal, or foreign merger laws,[282] especially when Target possesses a special charter (e.g., when Target is a bank or an insurance company). Second, unlike a merger, a "C" Reorganization offers Acquiror the ability to pick and choose the Target liabilities to be assumed.[283] Third, only the Target shareholders may be entitled to approval and appraisal rights, whereas both Acquiror and Target shareholders usually have these rights in a merger of Target directly with and into the Acquiror.[284]

Practice Point: The ability to avoid Acquiror shareholder approval and appraisal rights in a two-party "A" Reorganization has been enhanced by the disregarded entity merger regulations discussed above.

2. Consideration Given by Acquiror

a. "Solely for Voting Stock" Requirement

Subject to the exception for assumed liabilities in §368(a)(1)(C) and the 20% boot exception in §368(a)(2)(B), the consideration given in a "C" Reorganization must consist solely of voting stock of Acquiror (or if Sub is Acquiror, the voting stock of Parent).[285] Thus, outside of such exceptions, the existence of nonstock consideration, no matter how slight, renders a purported "C" Reorganization taxable. The definition of "voting stock" for this purpose is discussed in III.C.3., below. Note that nonqualified preferred stock is still treated as "stock" for purposes of the "C" Reorganization requirements, even though it is treated as boot at the shareholder level, as discussed in VI.E.1.c., below. The various arrangements or shareholder rights in which the existence of nonstock consideration may arise are discussed in III.C.4., below. The circumstances under which Acquiror's assumption of liabilities may be regarded as boot, other than as a result of §368(a)(2)(B), are discussed in III.C.2.c., below.

b. Degree of Permissible Boot

There are two levels of limitations on the degree of permissible boot in a "C" Reorganization.

First, at the definitional level, the boot given by Acquiror for Target's assets will not prevent the exchange from qualifying as a "C" Reorganization so long as at least 80% of the gross fair market value of all of Target's assets are acquired for voting stock.[286] In applying the 20% boot exception, liabilities assumed by Acquiror (including liabilities to which any asset received by Acquiror is subject) are treated as cash boot, but only if money or other property ("nonliability" boot) is exchanged by Acquiror in the transaction. Thus, if Target's liabilities to be assumed by Acquiror exceed 20% of the gross fair market value of Target's assets, consideration other than Acquiror voting stock may not be exchanged as consideration for Target's assets without invalidating the transaction as a "C" Reorganization. By the same token, if no "nonliability" boot is present, then there is no statutory limit on the amount of Target liabilities that Acquiror can assume in the transaction.

Note that since the boot relaxation rule requires that at least 80% of the gross fair market value of all of Target's assets

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[275] Revenue Act of 1926, §203(h), 44 Stat. 9 (1926).

[276] H.R. Rep. No. 73-704, pt. 2, at 12-14 (1934), 1939-1 C.B. 554, 563–565; S. Rep. No. 73-558, pt. 2, at 16-17 (1934), 1939-1 C.B. 586, 598–599.

[277] 303 U.S. 564 (1938).

[278] Revenue Act of 1939, §213, 53 Stat. 870 (1939).

[279] Tax Reform Act of 1984, Pub. L. No. 98-369, §63 (1984).

[280] *See* III.C.2.c., below.

[281] *See* III.C.4., below.

[282] *See, e.g., George v. Commissioner*, 26 T.C. 396 (1956), *acq.*, 1956-2 C.B. 5.

[283] *See* Willens, *Efforts to Avoid Acquisition of Target's Liabilities Could Signal Renaissance for 'C' Reorganizations*, 155 Daily Tax Rep. J-1 (Aug. 12, 2002).

[284] *See* II.D.6., above.

[285] *See Helvering v. Sw. Consol. Corp.*, 315 U.S. 194 (1942) (in discussing "C" Reorganization rules before enactment of 20% boot exception, Supreme Court stated that "solely leaves no leeway").

[286] §368(a)(2)(B). *See Everett v. United States*, 448 F.2d 357 (10th Cir. 1971); Rev. Rul. 73-102.

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are acquired for voting stock, the retention of any assets by the Target has the effect of further reducing the potential boot permitted in the transaction. For example, if Target has $100 of total assets and transfers $90 of such assets to Acquiror in the exchange, only $10 of the exchanged assets may be acquired for boot because the remaining $80 of such exchanged assets must be acquired for voting stock. In light of the treatment of assumed liabilities and retained assets, the degree of permissible boot in a "C" Reorganization is quite limited.

The second limitation is the continuity of interest (COI) doctrine, which generally applies to all reorganizations.[287]

Even if Acquiror gives the statutorily prescribed consideration and the transaction therefore meets the definition of a "C" Reorganization, the transaction is not a "C" Reorganization if the Target shareholders fail to maintain a requisite COI as a result of a subsequent redemption by Acquiror or a sale of Acquiror stock to related corporations.[288] In addition, even if the assumed liabilities are disregarded under the statutory definition of a "C" Reorganization, the continuity of interest requirement may at some point preclude a "C" Reorganization if Target's liabilities are so large in relation to its total assets that the shareholders' equity interests in Target are very small relative to the creditors' interests.[289]

Comment: Reg. §1.368-2(d)(1) provides that, although an assumption of liabilities may not violate the "solely for voting stock" requirement in a "C" Reorganization, "it may in some cases … so alter the character of the transaction as to place the transaction outside the purposes and assumptions of the reorganization provisions." While the meaning of this regulation is not clear, it presumably has in mind the requirement in Reg. §1.368-1(b) that the holders of Target's stock and securities before the reorganization maintain a COI. The illustration in Reg. §1.368-2(d)(3) approves an assumption of liabilities equal to 50% of Target's assets.

Practice Point: In several reorganizations involving insolvent corporations, when the shareholders were eliminated and the creditors received stock of Acquiror in exchange for their claims, the creditors were considered to have owned Target's proprietary interests for purposes of the COI requirement.[290] If the shareholders are disregarded and the creditors viewed as the equity holders in Target, but the creditors are not given stock of Acquiror sufficient to satisfy the COI requirement, the acquisition may be viewed as a taxable sale of assets in exchange for Acquiror's assumption of Target's liabilities.

c. Assumption of Liabilities

Acquiror's assumption of Target's liabilities presents two separate but related questions. First, will the assumption of liabilities be disregarded for the purposes of the "solely for voting stock" requirement in §368(a)(1)(C)? Second, will the assumption of liabilities come within the general rule of §357(a) and thus avoid treatment as Target's receipt of money or other property for §361 purposes? Generally, a valid "assumption" by Acquiror of what are viewed as "liabilities" of Target for §368(a)(1)(C) purposes should be regarded as a valid assumption for §357(a) purposes, and vice versa, although the question of whether a liability is "fixed and determined in the reorganization" is arguably confined to the §368(a)(1)(C) context.[291] In addition, an assumption of liabilities can theoretically be disregarded for purposes of the "solely" requirement but still be treated as boot for §361 purposes if §357(b) is applicable. However, as previously discussed, §357(b) is unlikely to be invoked in the context of a §368 reorganization by virtue of Target's exemption from gain recognition upon the distribution of boot to its shareholders or creditors.[292]

The liabilities of Target are regarded as "assumed" for §368(a)(1)(C) purposes whether they are simply assumed by Acquiror in the reorganization agreement or are paid off contemporaneously with the reorganization (either directly by Acquiror or by Target with funds provided by Acquiror).[293] Acquiror's issuance of new bonds in exchange for Target's old bonds should be regarded as an "assumption" of a liability for §368(a)(1)(C) purposes, regardless of whether Acquiror's bonds contain materially different terms.[294]

Once an "assumption" has been identified, the next issue is whether the type of "liability" assumed is encompassed by §368(a)(1)(C).

(1) Liabilities Determined and Fixed in the Reorganization

In *Helvering v. Southwest Consolidated Corp.*,[295] the Supreme Court held that Acquiror's assumption of a bank loan incurred by Target to pay off its bondholders was not a valid assumption of liabilities because the requirement to pay the bondholders arose out of the reorganization. Concluding that the assumption of liability amounted to cash consideration for the ex-

[287] Reg. §1.368-1(b). For a detailed discussion of the COI requirement, see V.A., below.

[288] Reg. §1.368-1(e)(2); *Penrod v. Commissioner*, 88 T.C. 1415 (1987); *Estate of Christian v. Commissioner*, T.C. Memo 1989-413.

[289] Reg. §1.368-2(d)(1).

[290] *See, e.g., Helvering v. Ala. Asphaltic Limestone Co.*, 315 U.S. 179 (1942); *Atlas Oil and Refining Corp. v. Commissioner*, 36 T.C. 675 (1961), *acq.*, 1962-2 C.B. 3.

[291] *Helvering v. Sw. Consol. Corp.*, 315 U.S. 194 (1942), rev'g 119 F.2d 561 (5th Cir. 1941).

[292] *See* III.A.2.c., above.

[293] *Everett v. United States*, 448 F.2d 357 (10th Cir. 1971) (assumption of liabilities pursuant to reorganization agreement); *Stockton Harbor Indus. Corp. v. Commissioner*, 216 F.2d 638 (9th Cir. 1954) (contemporaneous payment of Target's liabilities does not violate "solely" requirement in "C" Reorganization). *See also Kniffen v. Commissioner*, 39 T.C. 553 (1962), *acq.*, 1965-2 C.B. 5 (transferor's liability to transferee was extinguished in §351 transaction; liability was regarded as "assumed" for §357(a) purposes because liability could not have been discharged by transferee had it not been first assumed by transferee); *Edwards Motor Transit Co. v. Commissioner*, T.C. Memo 1964-317 (Parent's debt to Sub was extinguished in downstream merger of Parent into Sub; assets transferred to Sub were considered to have "paid" the liability).

[294] Rev. Rul. 79-155; *Southland Ice Co. v. Commissioner*, 5 T.C. 842 (1945), *acq.*, 1946-1 C.B. 4; *N.J. Mortg. & Title Co. v. Commissioner*, 3 T.C. 1277 (1944); *Helvering v. Taylor*, 128 F.2d 885 (2d Cir. 1942), aff'g 43 B.T.A. 563 (1941). *Cf. Stoddard v. Commissioner*, 141 F.2d 76 (2d Cir. 1944), rev'g 47 B.T.A. 584 (1942) (issuance of Acquiror debt in exchange for Target debt was more than "assumption" of liability for §368(a)(1)(C) purposes because secured debt was issued in exchange for previously unsecured debt). The reasoning in *Stoddard* may not represent the current law interpretation of what constitutes an "assumption" of a liability under §368(a)(1)(C). If immediate payment of a debt does not adversely affect the "assumption" of the debt (as in *Stockton*), it would seem surprising that provision of additional security for a scaled-down assumed debt precludes the "assumption" of the debt under §368(a)(1)(C).

[295] 315 U.S. 194 (1942), rev'g 119 F.2d 561 (5th Cir. 1941).

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change, the Supreme Court noted that while the assumed liability had its origins in the obligations of Target, its "nature and amount were determined and fixed in the reorganization." The liability assumed in this case was unique in that the bondholders were transformed to equity owners pursuant to the court-decreed reorganization and the disqualifying debt was incurred to satisfy a proprietary right to dissent arising in the reorganization.

Subsequent cases have limited the holding in *Southwest Consolidated* to its facts. In *Stockton Harbor Indus. Co. v. Commissioner*,[296] the Ninth Circuit upheld the Commissioner's determination that an acquisition qualified as a "C" Reorganization, notwithstanding the fact that Acquiror had paid cash into escrow to pay accrued interest and taxes with respect to Target's real estate. Noting that the liabilities paid by Acquiror were pre-existing obligations that did not require the reorganization to acquire certainty, the court opined: "[W]hen the nature and amount of a debt arising from a pre-existing obligation are determined and fixed prior to the reorganization, the payment of cash to liquidate it is treated as a payment of a liability assumed."[297]

Even though Target's reorganization expenses may be said to be "determined and fixed in the reorganization," the courts for many years permitted Acquiror to pay Target's reorganization expenses without violating the "solely" requirement, provided that payment was made directly to Target's creditors.[298] The IRS upheld this position in Rev. Rul. 73-54, ruling that Acquiror's payment of certain reorganization expenses of Target, if paid by Acquiror directly to the creditors, are not treated as "boot" in a "C" Reorganization even though Target or its shareholders may benefit from such expenses. These expenses were considered related "solely and directly to the reorganization," and included: legal and accounting expenses; appraisal fees; administrative costs of Target directly related to the reorganization such as those incurred for printing, clerical work, telephone and telegraph; security underwriting and registration fees and expenses; transfer taxes and transfer agents' fees and expenses.

Comment: On the other hand, Acquiror's payment or assumption of expenses arising in the reorganization, but which are not "solely and directly related to the reorganization," are treated as "boot" in a "C" Reorganization. These expenses include fees incurred by target shareholders for investment or estate planning advice, or legal or accounting advice, and stock transfer taxes owed by such shareholders (when those taxes are not also the legal liability of Target).[299]

In addition, Acquiror's transfer of cash to Target or its shareholders to enable them to pay expenses arising in the reorganization, even if those expenses are "solely and directly related to the reorganization," are "boot" in a "C" Reorganization.[300]

Comment: Therefore, the scope of *Southwest Consolidated* with respect to the type of liability an Acquiror cannot validly assume under §368(a)(1)(C) is limited to two situations: (1) when Acquiror assumes or pays Target liabilities that are determined and fixed in the reorganization but not "solely and directly related to the reorganization"; and (2) when Acquiror pays Target's expenses that are "solely and directly related to the reorganization," but are paid by means of a cash transfer to Target or its shareholders.

> *Example:* Target's expenses incurred to evaluate five competing acquisition offers were not expenses solely and directly related to the plan of reorganization, but Acquiror's direct payment of these expenses nonetheless constituted a valid assumption of liabilities because the expenses were not determined and fixed in the reorganization.[301] On the other hand, Acquiror's payment of the claims of Target's dissenting shareholders is not considered the payment of an assumed liability for "C" Reorganization purposes, but rather as cash consideration paid to Target.[302]

(2) Interim Financing Advances

Generally, it does not matter whether the liability of Target assumed by Acquiror is owed to third parties or to Acquiror itself.[303] However, the IRS, in Rev. Rul. 72-343, ruled that "interim financing advances" made by Acquiror to Target constituted "boot" received by Target when Target later merged into Acquiror. The IRS concluded that the advances did not create a true debtor-creditor relationship because they did not have to be repaid if the anticipated merger occurred or if it failed to occur through no fault of Target or Acquiror. Accordingly, "[s]ince a debt (liability) did not exist," the extinguishment of the advances in connection with the merger could not be disregarded under §357(a). Target was required to recognize gain because the advances were used to pay creditors rather than shareholders.[304] Section 361(b) has since been amended to permit a Target to avoid gain recognition by transferring "boot" to creditors as well as shareholders.[305]

Practice Point: If, instead of advancing monies to Target prior to the merger, Acquiror had simply agreed to pay certain Target liabilities at the time the merger is consummated, the

[296] 216 F.2d 638 (9th Cir. 1954), cert. denied, 349 U.S. 904 (1955).

[297] 216 F.2d at 646. *See also N.J. Mortg. & Title Co. v. Commissioner*, 3 T.C. 1277 (1944) (Acquiror's assumption and immediate payment of Target's liabilities pursuant to court-approved plan was valid assumption for "C" Reorganization purposes because debts antedated plan and were not changed in nature and amount by plan); GCM 36740 (May 24, 1976).

[298] *See, e.g., Alcazar Hotel, Inc. v. Commissioner*, 1 T.C. 872 (1943), *acq.*, 1943-1 C.B. 1; *Claridge Apartments Co. v. Commissioner*, 1 T.C. 163 (1942), *acq.*, 1947-1 C.B. 2, *aff'd in part and rev'd in part*, 138 F.2d 962 (7th Cir. 1943), rev'd on other grounds, 323 U.S. 141 (1944).

[299] Rev. Rul. 73-54.

[300] Rev. Rul. 73-54.

[301] Rev. Rul. 76-365.

[302] Rev. Rul. 73-102.

[303] *See, e.g., Kniffen v. Commissioner*, 39 T.C. 553 (1962), *acq.*, 1965-2 C.B. 5; Rev. Rul. 72-464 (liabilities of Target assumed by Acquiror in "A" Reorganization included Target bonds owned by Acquiror).

[304] Rev. Rul. 72-343. Note the IRS distinguished *Kniffen v. Commissioner*, 39 T.C. 553 (1962), from the facts under the ruling in that §357(a) was operative in *Kniffen* because a debtor-creditor relationship existed between the transferor-shareholder and his controlled corporation before the §351 exchange.

[305] *See* III.C.6., below. However, the ruling may still create problems in the "C" Reorganization context, in which the "solely" requirement is a concern. Note that there is some question as to whether §361(b) should even apply to "A" Reorganizations because, by virtue of Target's disappearance in the merger, it is impossible to comply with the post-reorganization distribution requirements of §361(b). *See* Carlson, *Boot at the Corporate Level in Tax-Free Reorganizations*, 27 Tax L. Rev. 499, 508 (1972).

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payment of such liabilities would likely have been disregarded for §357(a) purposes.[306]

(3) Contingent Liabilities

Another question is whether a contingent liability is regarded as a "liability" for "C" Reorganization purposes. The treatment of such liabilities as "liabilities" for "C" Reorganization purposes may be advantageous where no "non-liability" boot is present. For example, the IRS ruled that Acquiror's substitution of its stock warrants and options for the outstanding stock warrants and options of Target was an assumption of liability for "C" Reorganization purposes and, consequently, the "solely" requirement was not violated.[307] On the other hand, when "non-liability" boot is present, the 20% boot exception may be exceeded if Acquiror's eventual payment of contingent liabilities is regarded as an assumption of Target's liabilities at the time of the reorganization.

Based on analogies in other contexts, liabilities that are not determinable with reasonable certainty arguably should be ignored. For example, liabilities that have not yet accrued under the "all events test" are not regarded as outstanding liabilities for §752 purposes.[308]

The exclusion of unaccrued liabilities for "C" Reorganization purposes would also be consistent with §381(c)(16), which provides that Acquiror, in certain acquisitive asset reorganizations, steps into the shoes of Target with respect to a deduction for payments made pursuant to an assumed contingent obligation.[309]

Practice Point: Until there is further clarification with respect to the treatment of contingent liabilities, Acquiror should specify in the reorganization agreement the particular Target liabilities that are being assumed. If certain contingent liabilities are assumed by Acquiror, and certain "non-liability" boot is also present, Acquiror may consider limiting its assumption to a specific dollar amount in light of the 20% boot limitation.

Moreover, because the assumption of a deductible liability is not regarded as the type of liability the assumption of which needs the protection of §357(a), it should similarly be ignored for "C" Reorganization purposes.[310]

(4) Liabilities of Target's Shareholders

Acquiror's assumption of liabilities or expenses owed or incurred by Target shareholders constitutes boot to those shareholders, but probably should not be considered an assumption (valid or otherwise) of Target's liabilities for §368(a)(1)(C) or §357(a) purposes. Such an assumption, however, is regarded as boot for purposes of the "solely for voting stock" requirement and the 20% boot exception.[311] Acquiror's assumption of a Target liability owed to a Target shareholder is generally regarded as a valid assumption of liabilities for "C" Reorganization purposes, provided that Acquiror's assumption or payment of that liability is not an indirect payment of boot for the shareholder's stock in Target.[312] Acquiror's assumption or payment of a liability guaranteed by a Target shareholder is generally regarded as a valid assumption of liabilities for "C" Reorganization purposes so long as the guarantor shareholder is not viewed as the true debtor under debt-equity principles.[313]

3. Definition of "Voting Stock"

Critical to qualification as a "C" Reorganization (as well as to transactions structured as "B" Reorganizations and Reverse Triangular Mergers) is whether the consideration issued in the transaction is "voting stock." In order to qualify as voting stock, the consideration issued must be (i) stock (for federal tax purposes) that (ii) carries the required voting rights. Each of these requirements is analyzed below.

a. Definition of "Stock"

Federal income tax law sometimes treats purported debt as stock. However, the parties to a purported "C" Reorganization must issue actual stock and label the consideration as such. Therefore, it is generally not necessary to address circumstances in which instruments denominated as debt are considered stock for federal income tax purposes, except when creditors of an insolvent Target are surrendering their interests for Acquiror stock.[314] Thus, the only potentially troubling issues are (i) whether instruments denominated as "stock" are in fact not stock and (ii) whether other equity-type instruments may constitute stock.

With respect to the latter issue, it is clear that warrants, options, stock rights, and other similar instruments are not stock, nor is convertible debt.[315] More difficult problems of classification arise when the equity interest under examination is an equity interest in a financial institution, such as an interest in a mutual savings bank.[316]

The issue of whether purported stock should be characterized as debt for federal tax purposes has been addressed by only a few courts, and the general trend of the case law in the area suggests that taxpayers seldom need to worry about a court's treatment of stock as debt.[317] The remainder of this discussion,

[306] *See, e.g.*, Rev. Rul. 76-365 (contemporaneous payment of Target's preexisting liabilities is regarded as valid assumption of liabilities for "C" Reorganization purposes).

[307] Rev. Rul. 68-637, *amplified by* Rev. Rul. 98-10 (applying §354 to exchange of warrants or options, provided warrants or options constitute securities under Reg. §1.354-1(e)).

[308] *La Rue v. Commissioner*, 90 T.C. 465 (1988); Rev. Rul. 88-77 *See also* Reg. §1.752-2(b)(4).

[309] Rev. Rul. 83-73 (treating indemnity payments relating back to initial transaction as if they had been contributions to capital of transferor that were made by its shareholders immediately before merger); PLR 200743003 (citing Rev. Rul. 83-73 in ruling that selling group's payment of litigation expenses on behalf of target was contribution to capital of target by group immediately before taxable sale).

[310] *See* §357(c)(3); *Focht v. Commissioner*, 68 T.C. 223 (1977), *acq.*, 1980-2 C.B. 1.

[311] *See* III.A.2.c.(3), above.

[312] *See, e.g.*, Rev. Rul. 78-408, *modified by* Rev. Rul. 98-10; Rev. Rul. 69-142, *modified and superseded by* Rev. Rul. 98-10. *See* III.C.4.l., below (substitution of Acquiror stock warrants and employee stock options for those of Target is valid assumption of liabilities for "C" Reorganization purposes).

[313] *See* III.A.2.c.(3), above.

[314] *See* V.A.4.c., below.

[315] *Helvering v. Sw. Consol. Corp.*, 315 U.S. 194 (1942); Rev. Rul. 79-155, Rev. Rul. 69-91, Rev. Rul. 66-339, Rev. Rul. 64-251. While the §354 regulations treat rights to acquire stock as securities having no principal amount for purposes of §354, §355, and §356, these regulations confirm that rights to acquire stock are not taken into account as stock for purposes of qualifying a transaction as a reorganization.

[316] For a discussion of those issues, see V.A.6., below.

[317] *See, e.g.*, *Zilkha & Sons, Inc. v. Commissioner*, 52 T.C. 607 (1969), *acq.*, 1970-1 C.B. xvi (IRS unsuccessfully argued that stock was debt).

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therefore, assumes that an instrument labeled as stock and constituting stock for state law purposes is, in fact, stock for federal income tax purposes.

b. *Definition of "Voting"*

Only voting stock may be issued as consideration for the Target stock acquired in "B" Reorganizations and, for all practical purposes, for Target assets acquired in "C" Reorganizations. In a Reverse Triangular Merger, voting stock must be issued in exchange for an amount of stock representing control of Target. As stated above, instruments that constitute stock for state law purposes should be treated as stock for federal income tax purposes. Whether such stock is voting stock is a separate, but equally critical, issue.

To be considered voting stock, the stock generally must have the current right to vote in the election of corporate directors.[318] Thus, voting rights with respect to major corporate events, such as mergers, sales of substantial portions of assets, etc., are not by themselves sufficient voting rights to satisfy the voting stock requirement. Whether the stock is common stock or preferred stock is irrelevant; the only issue is whether the stock is, in fact, properly classified as voting stock.[319]

Comment: Many of the authorities in the voting stock area arise outside of the reorganization provisions, and a particularly large amount of the authorities are found in the context of determining whether one corporation is affiliated with another. Affiliation requires, among other things, ownership of 80% of the voting power of the affiliated corporation. [320]

c. *Extent of Voting Rights Required*

Although voting stock must possess the current right to vote in the election of directors, no authority exists regarding the extent of the voting rights required.[321]

As a first principle, voting common stock issued by Acquiror in an acquisition, which voting stock carries identical terms as Acquiror's only class of outstanding voting common stock, should always constitute valid voting stock, regardless of the relative insignificance of the voting rights obtained by the former Target shareholders.

> *Example:* Assume Acquiror has outstanding one million shares of voting common stock (its only class of stock), with each share entitled to one vote. If Acquiror then acquires all of the Target stock solely in exchange for a single share of Acquiror voting common stock,[322] the Acquiror voting common stock issued in the exchange should qualify as voting stock, even though it represents only a single (and presumably inconsequential) vote out of a possible one million and one votes.[323]
>
> The more difficult case arises when Acquiror issues voting stock to the former Target shareholders with voting rights that, on a vote-to-value basis, are less than those of Acquiror's existing voting stock. Suppose, in the example above, that Target is equal in value to Acquiror, but that Acquiror issues to the former Target shareholders 10 shares of a new class of Acquiror voting preferred stock, which has a value equal to one million Acquiror voting common shares and carries one vote per share (i.e., Target shareholders receive 10 shares of stock with one vote per share — high-value/low-vote stock). In this case, the IRS presumably could make a compelling argument that the new class of Acquiror voting preferred stock is, in fact, not voting stock, because its voting rights in relation to its value are insignificant when compared to the voting rights of other classes of Acquiror voting stock.

Practice Point: Deciding whether stock labeled as voting stock should qualify as such really comes down to a matter of instinct and common sense. Provided that the purported voting stock carries voting rights that are not wildly disproportionate to the value of the stock (when compared to the relationship of voting rights to value of other Acquiror voting stock), such stock should be considered voting stock.

d. *Contingent Voting Rights*

Stock generally does not qualify as voting if the voting rights are contingent on future events.

> *Example:* Preferred stock having the right to elect directors only when dividends are in arrears for a specified period

[318] *See Hermes Consol., Inc. v. United States*, 14 Cl. Ct. 398 (1988); Rev. Rul. 71-83 (voting power for §1504(a) purposes is determined without regard to convertibility of nonvoting stock into voting stock). For an interesting (and perhaps unique) departure from this general rule, see *Forrest Hotel Corp. v. Fly*, 112 F. Supp. 782 (S.D. Miss. 1953) (common stock could not vote currently because of dividend arrearage on preferred; common nonetheless was held to be voting stock). *See also* Rev. Rul. 73-28 (Parent issued its voting stock to its first-tier subsidiary in exchange for stock of second-tier subsidiary in "B" Reorganization; Parent stock constituted "voting" stock even though, under state law, it could not be voted in hands of first-tier subsidiary); PLR 9412038 (stock in "large" Dutch company that represented "the greatest level of rights granted to the shareholders" and would be publicly traded after merger was ruled to be voting stock despite fact that shareholders do not have the power to vote for directors of "large" Dutch companies). *But see Alumax Inc. v. Commissioner*, 165 F.3d 822 (11th Cir., 1999) (stock possessing right to elect directors who could cast 80% of board's votes did not possess requisite 80% voting power for purposes of §1504 when substantial restrictions were placed on board's authority); TAM 9452002 (stock possessing right to elect directors who could cast 80% of board's votes did not possess requisite 80% voting power for purposes of §1504 when substantial restrictions were placed on board's authority; National Office focused on lack of actual power stock gave shareholder to participate in corporation's management).

[319] *See, e.g.*, Rev. Rul. 69-126 (for purposes of §1504(a), preferred stock having right to select three of eight directors is voting stock); Rev. Rul. 63-234. See also Willens, *'Neutered' Stock Is Still 'Voting' Stock*, 8 Daily Tax Rpt. J-1 (Jan. 11, 2013), in which PLR 201103032 is interpreted to suggest that the IRS may consider stock to be "voting stock," for purposes of qualifying as "C" Reorganizations, even where transferee did not have the power to freely vote the stock it received from transferor (transferee was relegated to voting its stock in proportion to the votes cast by all of the other shareholders of transferor).

[320] §1504(a).

[321] Although no direct authority exists in the context of a "C" Reorganization, in the context of voting power under §1504, the courts and the IRS have concluded that the mere ability to vote to elect directors of the board is insufficient to satisfy the 80% voting power test of §1504. Rather, §1504 not only requires the power to elect 80% of the board of directors, but also requires that those elected directors have the power and authority to manage the corporation's business. *See Alumax Inc. v. Commissioner*, 165 F.3d 822 (11th Cir. 1999).

[322] In this example, it is assumed that Acquiror is one million times more valuable than Target.

[323] For a similar rule, see the discussion of COI in V.A., below.

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of time is generally not considered voting stock until those rights materialize.[324]

Likewise, when the contingencies have materialized, stock that is generally not voting stock should be characterized as voting stock.[325]

e. Voting Trusts, Etc.

Voting trusts, voting agreements, and other similar arrangements all potentially affect the status of stock as voting stock.

In Rev. Rul. 72-72, the voting stock issued by Acquiror in a purported "B" Reorganization was subject to a five-year, irrevocable proxy in favor of the controlling shareholder of Acquiror. The IRS ruled that the solely for voting stock requirement had been violated, explaining that the facts set forth in the ruling were economically indistinguishable from a case in which the exchanging shareholders initially receive nonvoting stock that automatically converts to voting stock five years later.

Rev. Rul. 72-72 dealt with a very specific set of facts. The use of a voting trust or voting agreement among the Target shareholders following the reorganization should rarely present a problem. Moreover, it is questionable whether the grant of a limited-time proxy to Acquiror itself (rather than its shareholders) should present a problem, especially when Acquiror is widely held.[326]

4. Permissibility of Nonstock Consideration

The voting stock requirements of "C" Reorganizations, "B" Reorganizations, and Reverse Triangular Mergers are extremely strict. In the context of a "B" Reorganization (and, as a practical matter, in the context of most "C" Reorganizations),[327] the use of anything other than voting stock as consideration for Target's stock or assets is fatal to the reorganization.

Over the years, a number of circumstances have come to the attention of the courts and the IRS in which there was some question about whether other consideration was used.[328] These circumstances have led to a patchwork of cases and administrative pronouncements that, without the benefit of a unifying theme, attempt to cover an unlimited number of problems. Some of the more important issues are discussed below.

a. Acquiror's Payment of Reorganization Expenses

Acquiror's payment of reorganization expenses that are "solely and directly" related to the reorganization, and that are not expenses personal to the shareholders of Target (such as personal tax planning or estate planning expenses), does not constitute other property and thus does not violate the solely-for-voting stock requirement.[329] Examples of valid reorganization expenses that may be paid by Acquiror include investment banking fees, legal fees, costs of employing a transfer agent, transfer taxes, and proxy fees, provided these amounts relate generally to the reorganization and are not specific to an individual Target shareholder or group of Target shareholders.[330]

In Rev. Rul. 76-365,[331] the IRS extended Rev. Rul. 73-54 to permit Acquiror's payment of Target's expenses incurred in evaluating Acquiror's acquisition offer. The IRS ruled that the payment of evaluation expenses does not violate the "solely for voting stock" requirement. However, with respect to Acquiror's payment of Target's expenses incurred in the evaluation of other acquisition offers, the IRS ruled that the general reasoning of Rev. Rul. 73-54 does not apply because those expenses were not solely and directly related to the reorganization. Nevertheless, the IRS stated that in the context of a "C" Reorganization, the payment of such expenses represents the assumption of a liability permitted under §368(a)(1)(C) because the expenses were not determined and fixed in the reorganization (thus permitting the transaction to qualify as a "C" Reorganization).[332]

Note: The IRS did not address the application of this portion of the ruling to "B" Reorganizations. However, if the payment represents a mere assumption of a liability of Target by Acquiror (rather than the payment of a shareholder liability), the payment should have no effect on "B" Reorganization treatment.[333]

Practice Point: When the parties are unsure whether certain expenses are Target expenses that are "directly related" to the reorganization or instead may be characterized as expenses personal to the Target shareholders, they can cause the Target shareholders to assume and pay those expenses and then ensure that the Target shareholders receive sufficient Acquiror stock to make them whole for those expenses.

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[324] *See, e.g.*, *Vermont Hydro-Electric Corp. v. Commissioner*, 29 B.T.A. 1006 (1934), *acq.*, XIII-1 C.B. 16 (preferred stock entitling holders to vote upon certain contingencies is nonvoting until contingencies have occurred). *See also Erie Lighting Co. v. Commissioner*, 93 F.2d 883 (1st Cir. 1937) (preferred stock remains nonvoting until it receives current right to elect directors); PLR 8430040 (same). *But see Forrest Hotel Corp. v. Fly*, 112 F. Supp. 782 (S.D. Miss. 1953) (common stock constitutes voting stock, even though no current right to vote due to dividend arrearage). Perhaps the reason for the departure from the general rule in *Forrest Hotel* was the court's perception that either (i) common stock without voting rights (in which the preferred holders have all the voting rights) must be worthless (given the ability of the preferred shareholders to refrain from paying common dividends), in the absence of some reasonable expectation that those voting rights will be restored, or (ii) because the common stock traditionally had voting rights, the absence of those rights for a period of time was different than the mere expectation of voting rights on preferred stock that normally is nonvoting. Consequently, *Forrest Hotel* probably is not good precedent for treating nonvoting preferred stock as voting stock in the absence of the actual occurrence of contingencies that trigger voting rights.

[325] *See, e.g.*, *Pantlind Hotel Co. v. Commissioner*, 23 B.T.A. 1207 (1931) (preferred stock accorded voting rights due to dividend arrearage held to be voting stock); PLR 8534050 (same).

[326] *See* PLR 9436026 (stock received in §368(a)(1)(B) reorganization that also qualified as reverse triangular merger was ruled to be "voting stock" even though subject to voting trust agreements).

[327] See the discussion of the degree of permissible boot in a "C" Reorganization in III.C.2.b., above.

[328] For a discussion of *Tribune Co. v. Commissioner*, 125 T.C. 110 (2005), supplemented by T.C. Memo 2006-12, in which the court found disguised boot in a reorganization, see V.A.3.c., below.

[329] Rev. Rul. 73-54. *See* III.C.2.c., above.

[330] Rev. Rul. 73-54. *See also* PLR 201324003 (acquiring corporation's payment of settlement to target company's former shareholders, to resolve litigation regarding liability for legal contingency fee stemming from lawsuit pending at time that Target was acquired in exchange for acquiring company's stock, will not be considered payment of other than voting stock that would cause acquisition to fail to be valid reorganization under §368(a)(1)(C)).

[331] *See also* Rev. Rul. 75-450 (Acquiror's payment of Target's finder's fee is not boot).

[332] *See* III.C.2., above.

[333] *See* IV.A.2.c., below.

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b. Registration Rights

In certain circumstances, Acquiror's issuance of stock in a reorganization may qualify for an exemption from the registration requirements of federal and state securities laws.[334] The Target shareholders may be willing to accept unregistered stock, provided that Acquiror agrees to register the shares upon the occurrence of certain events. As a practical matter, the Target shareholders often request "tag along" or "piggyback" registration rights, entitling them to request registration (and sale) of their Acquiror stock at the time of a later registration and public offering of newly issued Acquiror stock.[335] As an alternative, the Target shareholders may request "demand" registration rights, which, as the name implies, permit the former Target shareholders to require registration of the Acquiror shares on demand (but generally only after the passage of some minimum period of time and sometimes only after the occurrence of specific events). The grant of future registration rights generally is intended to spare Acquiror the trouble and expense of producing a registration statement solely for the acquisition of Target, and to enable Acquiror to wait until it otherwise planned to issue a registration statement to register the Acquiror stock given to the Target shareholders.

The IRS has ruled that expenses incurred by Acquiror in registering the stock issued in a reorganization do not constitute boot to the Target shareholders.[336] The IRS stated that the costs of registration were, in fact, attributable to Acquiror, in that registration promoted orderly marketing of Acquiror's stock.

c. Stock vs. Debt

As discussed in III.C.3., above, debt convertible into voting stock does not itself constitute voting stock. Such debt, therefore, is other property if issued by Acquiror as consideration for Target stock or assets.[337]

d. Warrants

The regulations under §354, §355, and §356 extend the nonrecognition rules of those sections to certain exchanges involving rights to acquire stock.[338] To provide for nonrecognition treatment, the IRS had to characterize rights to acquire stock (e.g., warrants) as either stock or securities. Because the IRS was constrained by Supreme Court precedent holding that warrants are not stock, it chose to characterize warrants as securities having no principal amount. In reorganizations, this characterization allows for a tax-free exchange of warrants for warrants, warrants for stock, stock for warrants (other than the exchange of solely stock for solely warrants), or securities for warrants, while requiring at least some gain recognition if actual securities are received for warrants.[339] However, it is important to note that warrants are not taken into account as stock for purposes of qualifying a transaction as a reorganization or determining continuity of shareholder interest. Thus, an exchange of Target stock for Acquiror warrants in an attempted "B" Reorganization violates the "solely for voting stock" requirement, and potentially violates such requirement in an attempted "C" reorganization.

e. Fractional Shares

In a "B" Reorganization or a "C" Reorganization, Acquiror may pay cash in lieu of issuing fractional shares, without violating the solely-for-voting-stock requirement, provided that the payment does not represent separately bargained-for consideration and constitutes a mechanical rounding off of the fractions in the exchange.[340] The IRS's position on fractional shares was crystallized by the Fifth Circuit's holding in *Mills v. Commissioner*[341] that cash for fractional shares did not represent boot. In reversing a Tax Court opinion, the Fifth Circuit reasoned that the payments for fractional shares did not represent independent consideration, but a mechanical rounding off for accounting purposes.

In Rev. Rul. 66-365, the IRS also stated that the cash received for fractional shares would be treated as if the shares had been issued and then redeemed, thus treating the payment for fractional shares as a transaction under §302.[342]

f. Redemptions and Dividends

Reorganization-related redemptions and dividends may affect the solely-for-voting-stock requirement, the COI requirement, and the "substantially all" requirement. However, only the "solely for voting stock" aspects are addressed here.[343]

The threshold questions for redemptions and dividends that are reorganization-related are: (1) who makes the payment; and (2) what is the source of the funds for that payment?[344]

As a general rule, provided that Target makes redemption or dividend payments out of its own funds, those payments do not violate the solely-for-voting-stock requirement.

Target may declare a dividend before a "B" Reorganization and pay it after the reorganization.[345] Payments of dividends or redemption payments by Target out of its own funds before the reorganization also are permitted.[346]

Similarly, a tax-free spin-off of an unwanted business, representing 23% of Target's assets, does not invalidate a subsequent "B" Reorganization.[347] However, in Rev. Rul. 75-360, Target declared and paid a dividend before a purported "B" Reorganization. The funds to pay the dividend were borrowed by Target, but Acquiror repaid the loan. The IRS ruled that the div-

[334] Such exemptions generally are only available when Target is privately held. *See* Securities Act of 1933, Pub. L. No. 112-106.

[335] For a discussion of similar rights and the potential step transaction/COI issues they may create, see V.A.5., below.

[336] Rev. Rul. 67-275.

[337] *See, e.g.*, Rev. Rul. 69-91, Rev. Rul. 66-339.

[338] Reg. §1.354-1(e), §1.355-1(c), §1.356-3(b), §1.356-3(c). *See* VI.E.1.c., below.

[339] *See* VI.E.1.d., below.

[340] Rev. Rul. 66-365.

[341] 331 F.2d 321 (5th Cir. 1964), rev'g 39 T.C. 393 (1962).

[342] See PLR 200741015 for an example of the continued applicability of Rev. Rul. 66-365 in this regard. For a discussion of whether such redemptions result in dividend income, see VI.E.2.b., below.

[343] For a discussion of the other aspects, see V.A., and III.C.5., below.

[344] Acquiror's redemptions of its own stock after a reorganization does not affect the solely-for-voting-stock requirement if the redemptions are unrelated to the reorganization. Rev. Rul. 57-114, Rev. Rul. 56-345.

[345] Rev. Rul. 69-443.

[346] Rev. Rul. 70-172, Rev. Rul. 68-435, Rev. Rul. 56-184, Rev. Rul. 55-440; PLR 9041084. Even Target's distribution of excess retained cash to its shareholders in connection with a "C" Reorganization should not violate the "solely" requirement, although the cash will be treated as boot received by the Target shareholders. Rev. Rul. 71-364.

[347] Rev. Rul. 70-434.

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idend constituted other property, thereby invalidating the purported "B" Reorganization.

Practice Point: Perhaps the more difficult issues in this area arise where the redemption or dividend in form comes from Acquiror, but the payment is, in fact, made with funds provided by Target. Although a strong argument can be made that the only relevant inquiry is the source of funds for the payment, the use of Acquiror to make that payment is likely to violate the solely-for-voting-stock requirement.[348]

g. Payments to Dissenters

The analysis of payments to dissenters follows the same lines as the analysis of redemptions and dividends (i.e., the crucial questions are (i) who makes the payment and (ii) out of what funds). In Rev. Rul. 73-102, the IRS ruled that Acquiror's assumption of Target's liabilities to dissenters in connection with a "C" Reorganization constituted other property. The assumption by Acquiror did not qualify as a permitted liability assumption because the liability arose out of the reorganization.

By contrast, Target's payment to dissenting shareholders out of its own funds does not violate the solely-for-voting-stock requirement,[349] regardless of whether the payments are completed before the reorganization. For example, in Rev. Rul. 68-285, Target created and funded an escrow account to pay dissenting Target shareholders in a "B" Reorganization. Even though some of the payments were not made from the escrow until after the transaction, the solely-for-voting-stock requirement was satisfied.

Use of Acquiror's funds to pay dissenting Target shareholders, however, violates the solely-for-voting-stock requirement.[350]

h. Capital Contributions

In the context of a "B" Reorganization, Acquiror's simultaneous contribution of funds to Target in exchange for additional Target stock and acquisition of Target did not violate the solely for voting stock requirement when no part of the funds were distributed to the Target shareholders.[351] Although (i) Target needed the funds for expansion purposes and (ii) the contribution was part of the overall transaction, the purchase of Target stock from Target was not part of the reorganization exchange. Similarly, the solely for voting stock requirement was not violated when Acquiror contributed funds to Target to discharge an indebtedness guaranteed by one of Target's shareholders, particularly because the contribution was not a condition of the exchange and the values of Acquiror stock received by the two Target shareholders were otherwise equal.[352]

In the "C" Reorganization context (and perhaps in the "A" Reorganization context), however, Acquiror's contribution of funds to the capital of Target in connection with the plan of reorganization presumably constitutes boot to Target. Target can avoid recognizing gain in the context of a "C" Reorganization, provided the boot is distributed to the Target shareholders.[353]

i. Contingent or Escrowed Stock

When Target shareholders and Acquiror are unable to agree on the value of the Target stock, the value of the Acquiror stock, or both, it is not unusual for the parties to provide for the initial issuance of a particular number of shares of Acquiror stock in the reorganization, with the issuance of additional Acquiror stock contingent upon the occurrence of specified events (e.g., minimum level of earnings, elimination of contingent liability). Alternatively, Acquiror may issue a new class of Acquiror convertible stock, the conversion ratio of which varies in relation to certain post-reorganization events that reflect on the value of Target or Acquiror at the time of the reorganization.[354]

With contingent stock, the main issue is whether the contingent right to receive additional stock is a separate property right independent of the stock itself. If it is considered separate property, then its value is treated as boot.[355] Both the IRS and the courts agree that contingent stock arrangements are not necessarily other property, although the standards applied by the IRS are somewhat stricter than those found in the case law.[356]

An escrow arrangement can be used under the same circumstances as a contingent stock arrangement (i.e., when the Acquiror stock is physically issued but held in escrow until the occurrence (or nonoccurrence) of certain specified conditions). Another common arrangement is for Acquiror to place into escrow a certain number of shares that are otherwise to be issued in the reorganization, pending confirmation of certain representations and/or warranties made by Target or its shareholders regarding Target's business.

With an escrow, the main issue is whether the escrowed Acquiror shares are considered owned by the recipient shareholders. If they are, then the shares are deemed to have been issued outright, subject to the shareholders' contingent obligation to return the shares.[357] Consequently, no interest is imputed under §483 or §1271 through §1275, and the recipient shareholders are taxed on dividends.[358] The recipient shareholders are generally considered owners of the escrowed shares if they have the rights to vote and receive dividends on such shares.[359] On the other hand, if Acquiror is considered to retain owner-

[348] For a discussion of the consequences of acquisitions of Target stock by affiliates or shareholders of Acquiror, see III.C.7., below.

[349] *See, e.g.*, Rev. Rul. 68-285.

[350] *See, e.g.*, *Turnbow v. Commissioner*, 368 U.S. 337 (1961); Rev. Rul. 75-123, Rev. Rul. 73-427.

[351] Rev. Rul. 72-522. The result is the same in a Reverse Triangular Merger. Reg. §1.368-2(j)(6) *Ex.* 7.

[352] Rev. Rul. 79-89.

[353] §361(c). *Cf.* Rev. Rul. 72-343 (cash "loaned" from Acquiror to Target before "A" Reorganization, with no requirement of repayment if reorganization did not occur, was boot to Target). For a strong criticism of Rev. Rul. 72-343 (and of the concept that there can be corporate level boot in an "A" Reorganization), see Carlson, *Boot at the Corporate Level in Tax-Free Reorganizations*, 27 Tax L. Rev. 499 (1972).

[354] For a discussion of this type of arrangement, see Walter & Strasen, *Contingent and Adjustable Stock in a Public Context*, 65 TAXES 439 (July 1987). *See also* Rev. Rul. 73-205 (preferred stock that was convertible into greater number of shares upon certain conditions did not disqualify "B" Reorganization).

[355] Rev. Rul. 57-586.

[356] The IRS used to take the position that contingent stock arrangements constituted boot. *See* Rev. Rul. 57-586. However, after losing several cases on this issue, the IRS changed its position. *See Hamrick v. Commissioner*, 43 T.C. 21 (1964); *Carlberg v. United States*, 281 F.2d 507 (8th Cir. 1960).

[357] *See* Rev. Rul. 78-376, Rev. Rul. 72-256.

[358] *Feifer v. United States*, 500 F. Supp. 102 (N.D. Ga. 1980); Rev. Rul. 70-120.

[359] *Dev. Corp. of Am. v. Commissioner*, T.C. Memo 1988-127; Rev. Rul. 78-376, Rev. Rul. 76-334.

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ship of the escrowed shares, then whether the escrow arrangement constitutes boot becomes an issue and is analyzed under the rules applicable to contingent stock arrangements and interest may be imputed on the transaction.[360]

For a taxpayer to obtain a favorable ruling from the IRS on a reorganization that includes contingent or escrowed stock, the terms of the contingency or escrow must meet the following ruling guidelines set forth by the IRS in Rev. Proc. 84-42:[361]

1. all of the stock to be issued in the reorganization will be issued within five years from the date of the initial distribution;

2. there is a valid business reason for not issuing all the stock at the time of the reorganization;

3. the maximum number of shares that may be issued is set forth in the agreement;

4. at least 50% of the maximum number of shares of each class of stock that may eventually be issued is issued in the initial distribution;

5. the triggering event for the release of shares from escrow or the issuance of additional shares must not be an event within the control of Target's shareholders and must not be based on the determination of a federal income tax liability related to the reorganization;[362]

6. the formula for calculating the number of Acquiror shares to be issued under the contingency arrangement or released from escrow must be objective and readily ascertainable;

7. with respect to contingent stock arrangements, the right to receive additional stock must either be nonassignable except by operation of law or, if the right is not by its terms nonassignable, must not be evidenced by a negotiable instrument nor readily marketable;

8. with respect to contingent stock arrangements, any stock to be issued must be stock of Acquiror; and

9. with respect to escrow arrangements, any escrowed Acquiror stock must be legally outstanding and shown as such on Acquiror's financial statements, the dividends and voting rights on such shares must rest with the former Target shareholders, and the escrowed shares must not be subject to restrictions that require their return to Acquiror because of death, retirement, or similar events with respect to former Target shareholders.

Practice Point: The business purpose requirement in (2) above should be satisfied in virtually all cases in which the reorganization is the product of arm's-length bargaining between unrelated parties. Some of the other requirements set forth in Rev. Proc. 84-42 may or may not be met and, in any event, seem arbitrary. For example, the logic behind the requirements numbered (1), (3), and (4) above is not readily apparent. Perhaps the rule requiring 50% of the stock to be issued in the initial distribution is related to COI, but the exact nature of that relationship is not explained.

Requirement (7) above is a reiteration of the IRS's position in *Carlberg v. United States*[363] and in Rev. Rul. 66-112.[364] The court in *Carlberg* held that negotiable contingent stock rights were not other property, a position with which the IRS disagrees.[365]

Carlberg did not address whether contingent stock is taken into account for COI purposes. It would appear that if the conditions set forth in Rev. Proc. 84-42 are met, contingent stock not only avoids treatment as boot at the shareholder level but also counts as stock as COI purposes. The problem is that Rev. Proc. 84-42 requires that at least 50% of the stock be issued initially, so it is not clear whether the IRS would count contingent stock as stock for COI purposes.

In addition, it is not clear from Rev. Proc. 84-42 whether escrowed stock that avoids boot treatment at the shareholder level is automatically counted as stock for COI purposes, because the Rev. Proc. 84-42 conditions do not contemplate situations in which counting or not counting the escrowed stock for COI purposes makes a difference. Regulations addressing the proper date for valuation of Acquiror's stock consideration for COI purposes treat escrowed stock in the same manner as Acquiror stock actually issued to the Target shareholders, so long as the escrow is to "secure [T]arget's performance of customary pre-closing covenants or customary target representations and warranties."[366] These regulations also contain an example in which counting the escrowed stock as stock for COI purposes does matter because the stock issued outright to the Target shareholders falls below 40% in overall value of the consideration.[367] The more controversial position in the regulations is that COI is reduced to the extent that the escrowed shares are returned to Acquiror pursuant to the escrow arrangement.[368] The government's position that the return of the escrowed stock adversely affects COI seems inconsistent with its position in Rev. Rul. 76-334.[369]

In a situation in which Target shareholders returned escrowed shares to Acquiror as part of a compromise, and Acquiror paid the Target shareholders an amount of cash equal to one-half the value of the returned shares, the IRS ruled that the cash payment should be treated, not as boot, but rather as an amount paid in redemption of Acquiror shares in a transaction separate from the reorganization.[370] The IRS has also ruled that, when contingent stock is issued pursuant to an agreement to accelerate the issuance of Acquiror shares if Acquiror is itself ac-

[360] *See* Reg. §1.483-4(b) *Ex.* 2; *Carlburg v. United States*, 281 F.2d 507 (8th Cir. 1960); Rev. Rul. 75-237; Rev. Rul. 73-298.

[361] *Amplifying* Rev. Proc. 77-37. Rev. Proc. 85-22 stated that it superseded Rev. Proc. 84-42; however, the IRS still generally seems to follow Rev. Proc. 84-42 in issuing rulings. *See, e.g.*, PLR 200930025, PLR 200835014, PLR 200835013.

[362] The IRS has ruled that, when contingent stock is issued pursuant to an agreement to accelerate the issuance of Acquiror shares if Acquiror is itself acquired, the accelerated issuance of the contingent stock is not other property. Rev. Rul. 75-237.

[363] 281 F.2d 507 (8th Cir. 1960).

[364] *See also* Rev. Rul. 67-90.

[365] 281 F.2d 507 (8th Cir. 1960). *Cf.* Rev. Rul. 66-112, Rev. Rul. 57-586.

[366] Reg. §1.368-1(e)(2)(iii)(D).

[367] Reg. §1.368-1(e)(2)(v) *Ex.* 1.

[368] Reg. §1.368-1(e)(2)(v) *Ex.* 2.

[369] *See* V.A.3.b., below.

[370] Rev. Rul. 76-334. Likewise, in Rev. Rul. 70-120, Acquiror stock placed in escrow to indemnify Acquiror for breach of warranty claims was treated as if it had first been transferred to the Target shareholders.

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quired, the accelerated issuance of the contingent stock is not other property.[371]

It is unclear whether the formula used in determining the amount of additional shares of Acquiror to be issued may be modified after the reorganization without affecting the tax-free status of the reorganization. While there are no cases directly on point, *Hamrick v. Commissioner*[372] involved analogous facts. In *Hamrick*, the taxpayer received shares of a new corporation in a §351 transaction and was to receive additional shares if an invention contributed to the corporation proved successful. The agreement to issue additional shares was modified as the result of a disagreement between the shareholders. The Tax Court found that the receipt of shares after the modification resulted in ordinary income to the taxpayer because they were received in consideration for the taxpayer's surrender of a cause of action rather than pursuant to the reorganization. The reasoning in *Hamrick* is questionable, especially given that the source of the taxpayer's cause of action arose from the original incorporation and the related agreements.

Even if issuance of contingent stock to the former Target shareholders may not represent other property, it does not necessarily follow that all the additional stock may be received tax-free. Before enactment of the 1984 Tax Reform Act, the IRS applied §483 to impute interest when contingent stock was used in a reorganization unless an interest rate at least equal to the test rate was specified or all of the stock was distributed within one year of the reorganization.[373] The courts agreed with this position.[374] Note, however, that the interest imputed on contingent stock does not violate the solely-for-voting-stock requirements of a "B" or "C" Reorganization.[375]

Before regulations were issued in 1996 under §483, it was unclear whether the original issue discount (OID) rules,[376] adopted as part of the 1984 Tax Reform Act, pre-empted §483 with respect to imputing interest on issuances of contingent stock, when contingent stock may be received more than six months after the initial reorganization distribution.[377] In the regulations, the IRS clarified that a contingent stock issuance is a deferred payment subject to §483, and that §1274 does not apply because the right to receive additional shares is not a debt instrument for federal income tax purposes.[378] Under the §483 rules, the contingent stock must be discounted from the date of payment back to the date of the reorganization, using the applicable federal rate. The difference between the fair market value of the contingent shares and discounted present value of those shares represents imputed interest income.

Note: An issue may arise as to whether the corporation's deduction for the imputed interest is subject to §163(l), which denies a corporation a deduction for interest on indebtedness that is payable in stock of the corporation or a related party or equity held by the issuer (or any related party) in any other person.[379] Because §163(l) applies only to "indebtedness" and Reg. §1.483-4(b) provides that "the right to receive the additional shares… is not a debt instrument for federal income tax purposes," the better position is that §163(l) is not applicable.

Additional consequences to Target shareholders from the issuance of contingent or escrowed stock are discussed in VI.E.8.b., below.

j. Purchase of Assets from Target Shareholders

Provided that the amount paid for the assets is not greater than their fair market value, there is no prohibition on purchases of assets (other than Target stock) from Target shareholders by Acquiror or its affiliates.[380] In situations in which Acquiror purchases Target debt instruments and there is a significant overlap among Target shareholders and Target debtholders, Acquiror must take care to ensure that the debt is not purchased for more than fair market value.[381]

k. Employment Agreements

Acquiror may want to retain the services of key employees of Target, some of whom may be shareholders of Target. In many cases, consummation of the transaction is explicitly conditioned upon execution of appropriate employment contracts with the key employees. If amounts to be paid under employment agreements with Target shareholder/employees are in fact for services rendered or to be rendered, those amounts do not constitute boot in the reorganization.[382]

Practice Point: The interaction of §280G (golden parachutes) with the rule stated above is not clear. As a general rule, however, the mere fact that compensation is nondeductible to the payor because it is excessive does not automatically imply that the payment is something other than compensation.[383] In the context of a "C" Reorganization, on the other hand, Acquiror's payment of excess parachute payments probably is an impermissible assumption of a liability arising out of the reorganization.[384]

In *Development Corp. of America v. Commissioner*,[385] Target was acquired in a transaction intended by both parties to qualify as a tax-free "B" Reorganization. Contemporaneous with the acquisition, the controlling shareholder of Target acquired a seat on Acquiror's board of directors pursuant to an oral stock voting agreement. A provision that would have guaranteed him a seat on the board was initially included in the acquisition agreement but was removed due to the concern of

[371] Rev. Rul. 75-237.

[372] *Hamrick v. Commissioner*, 43 T.C. 21 (1964), acq. in result only, 1966-1 C.B. 2, rem'd, 66-1 USTC ¶9322 (4th Cir. 1965).

[373] *See* pre-1994 Reg. §1.483-1(c), §1.483-1(e) *Ex.* 2.

[374] *See, e.g.*, *Jeffers v. United States*, 556 F.2d 986 (Ct. Cl. 1977). *See also* Rev. Rul. 73-298, Rev. Rul. 70-300, *clarified by* Rev. Rul. 72-35.

[375] *See, e.g.*, *Jeffers v. United States*, 556 F.2d 986 (Ct. Cl. 1977). *See also* Rev. Rul. 73-298, Rev. Rul. 70-300, *clarified by* Rev. Rul. 72-35.

[376] §1271–§1275.

[377] For a further discussion of the OID rules and §483, see 181 T.M., *Time Value of Money — Holders of Debt Instruments.*

[378] Reg. §1.483-4(b) *Ex.* 2.

[379] §163(l)(2).

[380] *See, e.g.*, Rev. Rul. 69-142, *modified and superseded by* Rev. Rul. 98-10.

[381] *Cf.* Rev. Rul. 78-408 (exchange of warrants for warrants when overlap existed between shareholders and warrantholders), *modified by* Rev. Rul. 98-10 (applying §354 to exchange of warrants or options, provided that warrants or options constituted securities under Reg. §1.354-1(e)).

[382] *See, e.g.*, Reg. §1.356-5(b); *LeVant v. Commissioner*, 376 F.2d 434 (7th Cir. 1967); Rev. Rul. 77-271 (stock issued for services in connection with a "B" Reorganization was taxable to recipient as ordinary income); Rev. Rul. 68-473.

[383] Reg. §1.162-8.

[384] *See* III.C.2.c., above.

[385] T.C. Memo 1988-127.

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tax advisors that it created a boot distribution hazard. A stock voting agreement was executed in writing seven months after the acquisition. Following an acrimonious liquidation of Target several years later, Acquiror, in order to claim an increased cost basis in the stock of Target, took the position that the acquisition did not qualify as a "B" Reorganization because the acquisition of the seat on the board of directors was part of the acquisition agreement and therefore constituted a boot distribution. The court rejected this argument because it found that both the oral and written stock voting agreements were separate from the acquisition agreement and were supported by mutual consideration between the shareholders involved, and that Acquiror was not a party to the stock voting agreements.

l. Substitution of Acquiror Options for Target Options

The substitution of Acquiror options for outstanding Target compensation-related options generally can be accomplished on a tax-free basis to all parties without affecting the tax-free nature of the underlying reorganization. In the context of an "A" or "C" Reorganization, the substitution of options should be considered as Acquiror's assumption of a permitted liability.[386]

Practice Point: In PLR 9539020, the IRS ruled that Acquiror's assumption of Target's obligations on its outstanding options in an "A" Reorganization would not constitute a taxable event to holders of Target's options. The assumption of Target's options by Parent could be viewed as an impermissible assumption of Target liability by Parent in the context of a triangular "C" Reorganization. This treatment, however, may be avoided by having Sub assume Target's options and agreeing to deliver Parent stock upon exercise. Alternatively, another way to avoid running the risk of potentially having an impermissible assumption of a Target liability by Parent in a triangular "C" Reorganization structure is by structuring the transaction as a "C" Reorganization followed by a §368(a)(2)(C) drop rather than as a triangular "C" Reorganization.

In the context of a "B" Reorganization, the substitution of options should be viewed as occurring outside of the reorganization and, therefore, should not violate the solely-for-voting-stock requirement.[387] The substitution of options also should not result in the recognition of compensation income to the Target shareholder/employees.[388] The deduction upon exercise of the options, however, belongs to Target (or its successor), regardless of the fact that Acquiror stock is used to satisfy the options.[389] Regulations under §354 and §355 on rights to acquire stock have no effect on other statutes or regulations relating to compensation-related options (e.g., §83 and §421–§424 and the regulations thereunder).[390]

Practice Point: If Target employee/optionholders are cashed out in connection with a reorganization, the cash should not constitute boot because it is not paid in exchange for Target stock. In these circumstances, the deduction belongs to Target.[391] At one time the IRS contended that cash payments for options that are unvested but accelerated pursuant to Acquiror's acquisition of Target are nondeductible capital expenditures.[392] Fortunately, the IRS subsequently changed its view.[393]

Practice Point: The conversion of non-statutory options into Acquiror stock in connection with the reorganization results in compensation income to the holder and a deduction to Target unless the stock is restricted under §83, in which case the compensation income and corresponding deduction arise when the restrictions expire (assuming a §83(b) election is not filed).[394] Again, Target's entitlement to a deduction is subject to §280G. The conversion of an incentive stock option directly into Acquiror stock apparently subjects the holder (and correspondingly, Target) to the rules of §83.[395] However, if the holder first exercises the incentive stock option for Target stock, and then exchanges that stock for Acquiror stock in the reorganization, no compensation income (and correspondingly, no deduction to Target) results.[396]

m. Special Stock Rights

(1) Put and Call Rights

When the stock issued in a reorganization contains a right permitting the holder to require redemption of the stock by the issuer, the presence of that right generally does not constitute other property,[397] unless the stock in question is preferred stock and the put right results in the stock being treated as non-qualified preferred stock under §351(g)(2). Note that whether such right is exercisable immediately, or only after the passage of a specified time or the occurrence of a specified event, should not

[386] Rev. Rul. 68-637, *modified by* Rev. Rul. 98-10 (applying §354 to exchange of warrants or options, provided that warrants or options constitute securities under Reg. §1.354-1(e)).

[387] Rev. Rul. 70-269, *amplified by* Rev. Rul. 98-10 (applying §354 to exchange of warrants or options, provided that warrants or options constitute securities under Reg. §1.354-1(e)). *See also* Rev. Rul. 79-100 (when new directors of Target purchased old directors' stock for cash pursuant to option received from Acquiror, "solely" requirement was not violated in "B" Reorganization).

[388] While the §83 regulations dealing with the disposition of non-statutory options and the substitution of restricted property for other restricted property are silent on the substitution of a non-statutory option in connection with a reorganization, the IRS has relied on §83 case law to exempt the substitution of non-statutory options from income recognition. *See Mitchell v. Commissioner*, 590 F.2d 312 (9th Cir. 1979); PLR 9539020, PLR 9031009, PLR 9023092, PLR 8926025; GCM 39399 (Aug. 26, 1985). *Cf.* Reg. §1.83-1(b)(3), §1.83-7; Rev. Rul. 71-80. The substitution of an incentive stock option for a new incentive stock option in connection with a reorganization does not trigger compensation income if the terms of the new option are not more favorable than the old option and certain other conditions are met. §424(a), §424(h).

[389] *See, e.g.*, PLR 9102037. The regulations under §83 and §1032 provide that, when Parent stock is used to compensate an employee of Target, the transaction is recharacterized as a contribution to Target's capital by Parent followed by the payment of compensation by Target. Reg. §1.1032-3 treats this transaction as an initial transfer of cash from Parent to Target, followed by Target's use of that cash to purchase Parent stock. Note that this approach also results in an increase in Parent's basis in Target equal to the value of the Parent stock deemed purchased by Target.

[390] Reg. §1.354-1(e), §1.355-1(c).

[391] Rev. Rul. 73-146; PLR 8834051, PLR 8047123.

[392] *See LBO Industry Program, Restricted Stock Purchase in Mergers & Acquisition*, 51 Tax Notes 412 (Aug. 29, 1991).

[393] Rev. Rul. 94-77; TAM 9641001, TAM 9540003, TAM 9527005.

[394] PLR 9102037.

[395] *See* PLR 9102037. *Cf.* §424(b).

[396] §424(b); PLR 9008028.

[397] Rev. Rul. 69-265 (right to convert Parent stock received in triangular "C" Reorganization into stock of Parent's parent does not constitute other property; Target shareholders presented their Target stock to Parent for conversion). *But see* GCM 37612 (July 21, 1978) (distinguishing Rev. Rul. 69-265; holder had unilateral right to compel cash redemption of preferred stock at fixed price).

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make a difference in the result, provided that no evidence exists of a plan for the put right to be exercised at the time of the reorganization.[398]

Moreover, so long as the put right runs against the issuer of the stock, it should not matter whether the redemption is paid in stock of the issuer's parent or other affiliate or in cash or other property.[399]

If the put right runs, not against the issuer of the stock, but against a third party (whether or not that third party is related to the issuer), the right is deemed to be other property.[400] Optional redemptions of Acquiror stock at Acquiror's option should not be considered other property since the right belongs to Acquiror, not the former Target stockholders. Note, however, that if Acquiror has the right to redeem the stock within the first five years, COI concerns may be implicated because the former Target shareholders may not have unrestricted rights of ownership.[401]

(2) Rescission Rights

The IRS has ruled that when the Acquiror stock issued in the reorganization may be put back to Acquiror upon the occurrence or nonoccurrence of certain events, in exchange for the return of the Target stock to the exchanging shareholders, such a rescission right does not constitute other property.[402] The IRS noted that the rescission rights were an inherent feature of the stock and therefore were not personal to the former Target shareholders. Presumably, if the rescission rights had been merely part of a contractual arrangement, so that a subsequent transferee of the Acquiror stock were not entitled to enforce the rescission right, the result would have been different.[403]

(3) "Poison Pill" Rights

"Poison pill" rights are contingent stock or debt purchase rights that enable the holder to purchase stock (or debt) of the issuing corporation at a substantial discount if a third party acquires more than a stated percentage of the issuing corporation's stock, or to acquire stock (or debt) of Acquiror in the event of a merger of the issuing corporation into Acquiror. Unless and until an acquiror owns the threshold percentage of the issuing corporation's stock, the rights remain attached to the issuing corporation's stock and, thus, may not be separately traded. Poison pills have been issued by many publicly traded corporations as a defensive tactic against attempted hostile takeovers. By allowing existing shareholders to purchase additional discounted shares, the ownership interest of a potential hostile acquirer is diluted. The IRS has ruled that poison pill rights attached to stock issued as consideration in a reorganization are not boot.[404] More importantly, the IRS has ruled publicly that the issuance of generic poison pill rights is a nonevent for federal tax purposes.[405]

5. "Substantially All" Requirement

a. General

Since 1926, when the origins of a "C" Reorganization first appeared, the statute has required that "substantially all of the properties" of Target be acquired by Acquiror.[406] There is no statutory definition of "substantially all." Generally, the determination of "substantially all" is based upon all the facts and circumstances of each case, and, while the percentage of assets transferred is important, other factors are also stressed by the courts.[407] Because of the varied results reached in the cases and IRS rulings, it is probably fair to say that most practitioners are uncomfortable unless the percentage of Target's overall assets transferred to Acquiror is within a few percentage points of the IRS ruling standard, as discussed below.

b. Percentage of Total Assets

(1) Treasury Position

The IRS's substantive position on the "substantially all" requirement is found in Rev. Rul. 57-518, in which Target transferred 70% of its overall assets to Acquiror in a "C" Reorganization and then liquidated. In ruling that "substantially all" of Target's assets were transferred, the IRS focused more on the nature of the properties retained by Target and the purpose of the retention than on any particular percentage of assets transferred. The assets transferred by Target included all of its fixed assets and other properties pertaining to the business and 97% of its inventories. The retained assets consisted of cash, accounts receivable, notes, and 3% of Target's inventory, approximately equal to the amount of Target's retained liabilities. The assets were not retained for the purpose of engaging in any business or for distribution to shareholders.[408] The IRS noted that the "substantially all" requirement would not be met if the liabilities not assumed constituted a large percentage of the gross assets, in which case the transfer of even 100% of the net

[398] See the discussion of post-reorganization continuity in V.A.5., below.

[399] Rev. Rul. 69-265.

[400] Rev. Rul. 69-265 (right to convert Parent stock received in triangular "C" Reorganization into stock of Parent's parent constituted other property; Target's shareholders presented their Target stock directly to Parent's parent for conversion). *Cf.* Rev. Rul. 88-31 (contingent payment right issued together with common stock is considered separate property right because it is separately tradable and its value varies inversely with stock); Rev. Rul. 70-108 (right to purchase additional common stock upon conversion of convertible preferred is considered separate property right).

[401] *See* V.A.5., below.

[402] Rev. Rul. 78-142.

[403] *Cf.* Rev. Rul. 75-33 (right to receive additional dividends was considered attribute of voting preferred stock because it was inseparable from other rights inherent in stock and was not personal to shareholders).

[404] *See, e.g.*, PLR 8925088, PLR 8925087. In PLR 8808081, the IRS had appeared to repudiate the assumption of most practitioners that poison pill rights, before separation, were meaningless for tax purposes. In that ruling, which involved a Reverse Triangular Merger, the IRS ruled that to the extent that the poison pill rights attached to the Acquiror stock had value, that value should be taxed as boot to the former Target shareholders receiving the Acquiror stock in exchange for their Target stock. This ruling caused concern that if universally accepted, it would prohibit "B" and most "C" Reorganizations in which the acquiror's stock had poison pill rights attached. However, the controversy caused by PLR 8808081 is largely of historical interest due to the IRS's subsequent rulings.

[405] Rev. Rul. 90-11. *See also* PLR 9610034 (citing Rev. Rul. 90-11 in ruling that group of affiliated corporations and their shareholders did not recognize gain or loss when they issued or received poison pill rights in §368(a)(1)(D) reorganization), PLR 9120006 (Acquiror stock containing poison pill rights met "solely" requirement for "B" Reorganization).

[406] *See* Revenue Act of 1926, §203, 44 Stat. 9 (1926). *Cf.* §368(a)(1)(C).

[407] *See* Rev. Rul. 57-518.

[408] This ruling was issued before the distribution requirement of §368(a)(2)(G) was enacted. The concern that Target might use retained operating assets to continue its business instead of liquidating is no longer applicable. *See* III.C.6., below.

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assets may not suffice.[409] In the same ruling, the IRS also upheld the validity of a prior ruling[410] in which a transfer of 75% of Target's assets did not meet the "substantially all" requirement because a major part of the 25% retained assets consisted of operating assets not retained for the purpose of liquidating Target's liabilities.

The IRS's advance ruling guidelines provide that the "substantially all" requirement is satisfied if there is a transfer of assets representing at least 90% of the fair market value of the net assets and at least 70% of the fair market value of the gross assets held by Target immediately before the transfer.[411] The 90/70 guideline is not a rule of substantive law, and is not intended to prescribe a minimum threshold for meeting the "substantially all" requirement.[412]

In only one other instance has the IRS addressed the particular percentage of assets transferred, and then only implicitly. In Rev. Rul. 78-47, about 68% of Target's assets consisted of Acquiror stock; the balance was cash and land. To avoid a state stock transfer tax, Target retained its stock in Acquiror and Acquiror issued only the incremental shares necessary to equalize the exchange of Target assets for Acquiror stock. As a technical matter, therefore, Target transferred only 32% of its assets. However, the crux of the ruling is that the formality of Target's transfer of its Acquiror stock to Acquiror was not necessary to meeting the "substantially all" requirement.[413] The ruling does not support the proposition that the IRS would otherwise find a transfer of 32% of Target's assets acceptable.

(2) Case Law Standards

The courts have focused on the percentage of assets transferred only in conjunction with their examination of the type of assets retained (e.g., operating vs. investment assets) and the purpose of the retention. The percentage determined in a given case is generally made after Target's overall assets are reduced by the assets retained to discharge liabilities.[414] This view is consistent with the IRS's position in Rev. Rul. 57-518, in which 70% of the gross assets were transferred, but 100% of the assets in excess of the amount retained to pay liabilities were transferred. For example, in cases in which the purpose of the retention of assets was to make distributions to shareholders or continue business, the courts have held that acquisitions of 68%[415] or 81%[416] of Target's gross assets are insufficient. On the other hand, the transfer of 86% of Target's gross assets has been held sufficient, even though the purpose for the retention was to make distributions to shareholders.[417]

Practice Point: Based on the foregoing, a transfer of anything less than 86% of Target's net assets (i.e., Target's assets in excess of the assets retained to pay liabilities) is venturing into uncharted waters. As noted previously, if the liabilities not assumed constitute a large percentage of Target's gross assets, so that a substantial portion of Target's gross assets are retained, a transfer of the remaining assets, even if it represents a transfer of 100% of the net assets, may not be sufficient to meet the "substantially all" requirement.[418]

Planning Point: In the liquidation-reincorporation area, the IRS has applied the substantially-all test to transfers of lower percentages. Those cases should not be relied upon in the "C" Reorganization context.

c. Assets Considered

The IRS and the courts historically have placed emphasis on whether the assets retained were operating assets or assets not essential to Target's business.[419] Target's retention of operating assets (whether retained by Target for its own use or for distribution to its shareholders) is more likely to violate the "substantially all" requirement than the retention of passive assets such as cash, securities, or accounts receivable.[420]

For purposes of the "substantially all" requirement, Target's properties include intangibles, such as goodwill.[421] In a business in which the primary assets are Target's personnel, such as a consulting business, the term "properties" may also include Target's employees.[422]

d. Dividends or Redemptions

Target's payment of regular, normal dividends to its shareholders does not generally affect the determination of whether "substantially all" of Target's assets were transferred to Acquiror; in other words, the assets used to pay the dividends are not treated as if they were owned by Target immediately before the reorganization.[423] It should not matter whether the dividend is declared and paid after the reorganization agreement is entered into, provided the dividend is paid before the reorganization is consummated.[424] However, if Acquiror pays the dividend after the reorganization is consummated, the cash used to pay the dividend is taken into account in determining whether Target transferred "substantially all" of its properties.[425] On the oth-

[409] For this proposition, the IRS cited *Smith v. Commissioner*, 34 B.T.A. 702 (1936), *acq.*, 1957-2 C.B. 6. For example, if a target having gross assets of $1,000,000 and liabilities of $900,000 transferred only the net assets of $100,000, "the result would probably not come within the intent of Congress in its use of the words 'substantially all.'" Rev. Rul. 57-518.

[410] I.T. 2373, C.B. VI-2 (1927).

[411] Rev. Proc. 77-37, *amplified by* Rev. Proc. 86-42.

[412] Rev. Proc. 77-37, *amplified by* Rev. Proc. 86-42.

[413] *See* III.C.5.h., below.

[414] *See W. Indus. v. Helvering*, 82 F.2d 461 (D.C. Cir. 1936); *Nelson v. United States*, 69 F. Supp. 336 (Ct. Cl. 1947), cert. denied, 331 U.S. 846 (1947); *Corrigan v. Commissioner*, 3 T.C.M. 1013 (1944), aff'd on other grounds, 155 F.2d 164 (6th Cir. 1946); *Smith v. Commissioner*, 34 B.T.A. 702 (1936), *acq.*, 1957-2 C.B. 6.

[415] *See Pillar Rock Packing Co. v. Commissioner*, 90 F.2d 949 (9th Cir. 1937); *Arctic Ice Mach. Co. v. Commissioner*, 23 B.T.A. 1223, modified, 67 F.2d 983 (6th Cir. 1933).

[416] *Nat'l Bank of Commerce of Norfolk v. United States*, 158 F. Supp. 887 (E.D. Va. 1958).

[417] *Commissioner v. First Nat'l Bank of Altoona*, 104 F.2d 865 (3d Cir. 1939), cert. denied, 309 U.S. 691 (1940). *See also Nelson v. United States*, 69 F. Supp. 336 (Ct. Cl. 1947), cert. denied, 331 U.S. 846 (1947).

[418] *See* Reg. §1.368-2(d)(1); *Smith v. Commissioner*, 34 B.T.A. 702 (1936), acq., 1957-2 C.B. 6; Rev. Rul. 57-518.

[419] *See, e.g.*, Rev. Rul. 57-518. *See also* Rev. Rul. 78-47 (Acquiror's acquisition of 32% of gross assets of Target and 33% of net assets of Target qualified as "C" Reorganization when Acquiror acquired 100% of Target's operating assets).

[420] Rev. Rul. 57-518.

[421] *Schuh Trading Co. v. Commissioner*, 95 F.2d 404 (7th Cir. 1938); *Nat'l Bank of Commerce of Norfolk v. United States*, 158 F. Supp. 887 (E.D. Va. 1958).

[422] *See Moffat v. Commissioner*, 363 F.2d 262 (9th Cir. 1966), cert. denied, 386 U.S. 1016 (1967).

[423] Rev. Proc. 77-37, Rev. Rul. 74-457.

[424] Rev. Rul. 74-457.

[425] Rev. Rul. 74-457.

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er hand, extraordinary dividends, regardless of when they are paid, are taken into account for purposes of the "substantially all" requirement if the dividend payment was "part of the plan of reorganization."[426] Further, dividends paid by Target prior to the consummation of the reorganization may be considered extraordinary if they are based on dividends paid by Acquiror with respect to Acquiror's stock.[427]

The use of Target assets to redeem its shareholders or pay dissenters before consummation of the reorganization should be taken into account for "substantially all" purposes if the redemptions or payments are considered "part of the plan of reorganization."[428] Thus, for example, the question of whether a given redemption is taken into account depends on whether the redemption should be integrated with the reorganization under step transaction principles. If stock redemptions or payments to dissenters are funded by Acquiror or paid directly by Acquiror, the assets used to make such redemptions or payments should not be counted as assets owned by Target immediately before the reorganization.[429] However, redemption or dissenting shareholder payments made with funds provided by Acquiror generally violate the solely-for-voting-stock requirement.[430]

Practice Point: The limitation on redemptions and distributions imposed by the IRS in its ruling guidelines refers only to redemptions and distributions made by Target, probably because §368(a)(1)(C) and §368(a)(2)(D) require only that substantially all of Target's properties be "acquired"; there is no requirement, outside of the continuity of business enterprise (COBE) requirement and perhaps §368(a)(2)(E), that those assets be "retained." Except as limited by the COBE requirement and the special requirements, if any, applicable to Reverse Triangular Mergers, it appears that Acquiror is free to distribute a portion of Target's assets to its shareholders as dividend or redemption payments. However, any post-transaction push-up of Target assets likely runs afoul of another limitation in the ruling guidelines relating to dispositions of Target's assets outside the ordinary course of business.[431]

A substantial upstream distribution of Target's assets following the reorganization also may raise a question as to whether Acquiror is actually the acquiring entity for "C" Reorganization purposes.[432]

In addition, if the upstream distribution is made exclusively or disproportionately to former Target shareholders, the step transaction doctrine can treat Target as the distributing corporation for "substantially all" purposes.[433]

e. Spin-Offs of Unwanted Assets

The general purpose of the "substantially all" requirement is to distinguish nondivisive transactions from those that are divisive.[434] Accordingly, if Target spins off unwanted assets (i.e., either a pre-existing subsidiary or a newly formed subsidiary capitalized with the unwanted assets) to its shareholders before a contemplated "C" Reorganization in a qualifying distribution under §355, it may not be possible for Target's transfer of its remaining assets to Acquiror to meet the "substantially all" requirement.[435] Whether the spin-off will be integrated with the purported "C" Reorganization will depend on step transaction principles.[436] If Target spins off unwanted assets in a taxable distribution, the effect of the distribution on the "substantially all" requirement depends on whether the distribution is a regular, normal dividend or is an extraordinary dividend or redemption payment. If it is the latter, and the distribution is stepped together with the reorganization, the assets distributed are counted as assets of Target for determining whether substantially all of Target's assets were transferred to Acquiror.[437]

In Rev. Rul. 2003-79,[438] however, the IRS ruled that it will treat a controlled corporation independently from the distributing corporation in determining whether an acquisition of the controlled corporation satisfies the "substantially all" requirement. In Rev. Rul. 2003-79, Distributing conducted two businesses; Acquiror wanted to acquire one of the businesses (Business X). Distributing transferred Business X to a newly formed subsidiary in exchange for stock and distributed the subsidiary's stock to its shareholders in a §355 spin-off. Acquiror then acquired all of the subsidiary's assets in a purported "C" Reorganization. The IRS stated that only assets held by the subsidiary immediately following the spin-off should be taken into account in determining whether Acquiror acquired substantially all of the subsidiary's assets (i.e., assets held by Distributing immediately before the subsidiary was formed should not be considered). The IRS ruled that Acquiror's acquisition of all of the assets held by the subsidiary immediately after the spin-off satisfies the "substantially all" requirement, even though an acquisition of the same properties from Distributing would have failed the "substantially all" test.

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[426] Rev. Proc. 77-37. The distinction between regular and extraordinary dividends is consistent with the exception for dispositions of assets made in the ordinary course of business. *See* III.C.5.f., below. For a detailed discussion of the meaning of "plan of reorganization," see V.F., below.

[427] *See* Rev. Proc. 77-37 (exception is for "regular, normal distributions"). *Cf.* Rev. Rul. 68-435 (dividends paid by Target prior to consummation of stock-for-stock exchange were not considered "boot" for "B" Reorganization purposes even though the dividends were based on dividends paid by Acquiror on its stock during the interim period).

[428] Rev. Proc. 77-37. For a detailed discussion of the meaning of "plan of reorganization," see V.F., below. *See also* Rev. Rul. 73-102 (amounts paid to dissenters are considered payments in redemption of their target stock).

[429] Rev. Rul. 77-307 (cash contributed by Parent to Sub to be used by Sub to purchase stock of dissenting Target shareholders in Reverse Triangular Merger is not considered in determining whether Target holds substantially all assets held by Sub as well as itself before transaction).

[430] Rev. Rul. 73-102.

[431] *See* III.C.5.f., below.

[432] *See* III.C.5.i., below.

[433] *Cf. Waterman Steamship Corp. v. Commissioner*, 430 F.2d 1185 (5th Cir. 1970), cert. denied, 401 U.S. 939 (1971) (purported dividend paid by Target but funded by Acquiror held to be sales proceeds).

[434] *See* Rev. Rul. 88-48 (Congress intended that transactions that are divisive in nature should be subject to tests under §368(a)(1)(D)).

[435] *See Helvering v. Elkhorn Coal Co.*, 95 F.2d 732 (4th Cir. 1937), cert. denied, 305 U.S. 605 (1938); *Mellon v. Commissioner*, 12 T.C. 90 (1949), *nonacq.*, 1949-2 C.B. 4, *aff'd on other grounds*, 184 F.2d 157 (3d Cir. 1950). *Cf.* Rev. Rul. 58-68 (merger following spin-off of Target constitutes valid "A" Reorganization because there is no substantially all requirement for "A" Reorganizations). Note that Rev. Rul. 58-68 was subsequently revoked by Rev. Rul. 83-114, with respect to the device rules in §355.

[436] *See Helvering v. Elkhorn Coal Co.*, 95 F.2d 732 (4th Cir. 1937), cert. denied, 305 U.S. 605 (1938).

[437] *See* III.C.5.d., above.

[438] *See also* Rev. Rul. 98-27 (IRS will not apply step transaction doctrine to determine whether distributed corporation was controlled corporation immediately before spin-off solely because of any post-distribution acquisition or restructuring of distributing corporation).

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f. Sales of Assets

Unlike a dividend or stock redemption or a spin-off of unwanted assets, a sale of a portion of Target's assets, in and of itself — either before or after the reorganization — does not deplete the aggregate amount of Target's assets. It only changes the makeup of those assets, i.e., the assets sold are replaced with the consideration received on the sale, whether it is cash, notes, or other assets. Provided the sale of assets does not destroy COBE,[439] the nature and amount of the assets sold should have no bearing on the qualification of the reorganization so long as the sales proceeds remain with Target's other assets and are not distributed, either immediately or as part of an overall plan, to either Target shareholders or Acquiror shareholders.[440]

When the IRS previously ruled on the qualification of a "C" Reorganization prior to the no-ruling policy (see VIII.C., below), the IRS ordinarily would not issue a ruling without a representation that Acquiror has no plan or intention to sell or otherwise dispose of any of Target's assets acquired in the transaction except for dispositions made in the "ordinary course of business" or drop-downs made pursuant to §368(a)(2)(C).[441] Placing this limitation on Acquiror rather than Target is curious given the limitation imposed on Target regarding its pre-reorganization distributions and redemptions, as discussed above. In addition, this limitation on asset dispositions, whether it is placed on Acquiror or Target, is in direct conflict with the "substituted asset" theory adopted by the IRS in Rev. Rul. 88-48.

In Rev. Rul. 88-48, Target sold one of its two significant lines of business (constituting 50% of its historic business assets) for cash and then transferred its other line of business together with the cash proceeds to Acquiror in exchange for Acquiror voting stock in a "C" Reorganization, all pursuant to an overall plan. The IRS ruled that because the cash proceeds were not retained by Target or its shareholders but were transferred to Acquiror, the transaction was not divisive. Also, because the sale of the historic business assets was to "unrelated purchasers," the former Target shareholders retained no direct or indirect interest in those assets. Under those circumstances, the IRS ruled, the "substantially all" requirement was met.[442]

The "substituted asset" rationale should protect dispositions made by Acquiror as well as those made by Target. This rationale should also permit Target or Acquiror to lend, lease, or license a portion of Target's properties as part of the reorganization plan without violating the "substantially all" requirement, although caution should be exercised if the person borrowing, leasing, or licensing the properties is related to former Target shareholders. However, a downstream lending, lease, or license of a substantial portion of Target's assets to a noncontrolled subsidiary may be questioned in light of §368(a)(2)(C). An upstream lending, lease, or license of a substantial portion of Target's assets to a shareholder of Acquiror could raise a question as to whether Acquiror is actually the "acquiring" entity for "C" Reorganization purposes.

g. Payment of Reorganization Expenses

The IRS ordinarily does not issue a ruling on the "substantially all" requirement without a representation that the 90/70 guideline is met, and, for that purpose, assets of Target used to pay its reorganization expenses are treated as assets held by Target immediately before the reorganization.[443] This position is inconsistent with the established rule that assets retained by Target to discharge liabilities are excluded when making the "substantially all" determination.[444] There is no reason why Target's obligation to pay its reorganization expenses should be viewed differently for this purpose than any other liability of Target, particularly because the payment of those expenses to third parties does not affect the nondivisive nature of the transaction.

Comment: For purposes of the solely-for-voting-stock requirement, Target's obligation to pay reorganization expenses is not considered a "liability" that may be assumed under the assumption-of-liability exception if the obligation is "determined and fixed in the reorganization." However, Acquiror's payment of those expenses is not considered boot if the expenses are "solely and directly related to the reorganization" and payment is made directly to the Target's creditors.[445]On the other hand, for purposes of the "substantially all" requirement, the purpose of which is to distinguish nondivisive transactions from those that are divisive in nature, it should not matter whether the obligation to pay reorganization expenses predates the reorganization or is determined and fixed in the reorganization, so long as payments are not made to (or for the direct benefit of) Target shareholders.

> *Example:* Assume Target retains $20 cash of its $100 gross assets to discharge a $10 antecedent liability and $10 of reorganization expenses, and then transfers the remaining assets, worth $80, to Acquiror in a "C" Reorganization. The transfer of assets worth $80 exceeds the 70% gross asset requirement (i.e., 70% of $100, or $70), but would fall short of the 90% net asset requirement (i.e., 90% of $90, or $81) if the $10 cash used to pay reorganization expenses were regarded as owned by Target immediately prior to the transfer. On the other hand, if Target's "net assets" (that is, its assets in excess of the amounts retained to pay liabilities) are considered to be worth only $80, then Target will have transferred 100% of its net assets for purposes of the 90/70 guideline.
>
> Acquiror's payment of Target's reorganization expenses should not affect the "substantially all" test with respect to Target, because the payment does not deplete Target's assets.[446] Presumably, this is also true if Acquiror transfers

[439] For a discussion of the COBE requirement, see V.B., below.

[440] The effect of a distribution by Target or Acquiror on the "substantially all" requirement is discussed in III.C.5.d., above.

[441] Rev. Proc. 86-42.

[442] The IRS did not mention the COBE requirement, although the facts of the ruling would clearly meet that requirement. *See* V.B., below. *See also* PLR 8839060 (for purposes of "substantially all" requirement in Reverse Triangular Merger, cash received by Target for sale of its subsidiary would be considered "substituted assets").

[443] Rev. Proc. 86-42.

[444] *See* III.C.5.b., above.

[445] *See* III.C.2.c., above.

[446] *See* Reg. §1.368-2(j)(3)(iii) (money transferred from Parent to Sub to pay "reorganization expenses" in Reverse Triangular Merger is not taken into account for purposes of "substantially all" test). *Cf.* Rev. Rul. 77-307 (money transferred from Parent to Sub to pay Sub's reorganization expenses in Reverse

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cash to Target for the payment of Target's reorganization expenses, although it is advisable to earmark the transferred cash. In light of the solely-for-voting-stock requirement, on the other hand, Acquiror probably should not pay Target's reorganization expenses unless payment is made directly to the creditors.[447]

h. *Simultaneous Acquisition of Affiliated Targets*

In a typical "C" Reorganization, it is not unusual for the assets transferred to Acquiror to include Target's stock in other companies, perhaps even controlled subsidiaries. In such case, the stock owned by Target count as part of Target's assets for purposes of the "substantially all" requirement, and the same nonrecognition and carryover basis rules that apply to the transferred business and other assets of Target also apply to the transferred stock. However, in some circumstances, Acquiror may desire to simultaneously acquire the assets of Target and the assets of one or more of the companies in which Target owns stock.

> *Example:* Assume that Target owns a 50% interest in Sub 1, and that stock interest represents 60% of Target's overall assets. Under the plan of reorganization, Acquiror simultaneously acquires all of the assets and liabilities of Target and Sub 1 in exchange for Acquiror stock, and Target's Sub 1 stock is cancelled as part of the transaction. The Acquiror stock received by Sub 1 is distributed to its shareholders, including Target, and then Sub 1 liquidates. Target distributes the Acquiror stock it receives from Acquiror, together with the Acquiror stock it receives from Sub 1, to its shareholders in a liquidating distribution. The question is whether Target has transferred substantially all its assets to Acquiror when its principal asset, its Sub 1 stock, is not technically transferred to Acquiror.

The Tax Court addressed this issue in *George v. Commissioner*,[448] and concluded, based on facts similar to those above, that the simultaneous acquisitions qualified as two separate "C" Reorganizations, even though Target did not transfer its Sub 1 stock to Acquiror. The rationale was that "[b]oth of the old corporations transferred 100 percent of all the business assets and liabilities held between them."[449]

The IRS has also ruled that the "substantially all" requirement was met when 68% of Target's assets consisted of Acquiror stock.[450] Instead of transferring that stock in the "C" Reorganization, Acquiror issued incremental shares of stock, which, together with the Acquiror stock already held by Target, equalized the exchange of Target assets for Acquiror stock. Citing *George*, the IRS stated that Target transferred "all of its business assets" to Acquiror in exchange for Acquiror stock, consisting of the stock already held by Target and the incremental shares.[451]

Other variations of this issue include (i) simultaneous mergers of Target and Sub 1 into Acquiror,[452] (ii) a merger of Target into Acquiror followed by Acquiror's liquidation of Sub 1, and (iii) acquisition of Target's assets when Target's only asset is Sub 1 stock, followed by liquidation of Target.[453]

For example, in *Resorts International, Inc. v. Commissioner*, [454] the Tax Court held that the acquisition of Target via a merger, followed by the liquidation of Target's subsidiaries, were treated as if Target and each of its subsidiaries were transferred to Acquiror in separate asset reorganizations.[455] Some of these subsidiary liquidations occurred as many as nine months after the Target merger. Nevertheless, the Tax Court found that such liquidations occurred as part of an overall plan and treated the consideration issued in exchange for the assets of the parent corporation as issued, in part, in connection with the deemed asset reorganizations of the subsidiaries.

The IRS has ruled in tiered-entity liquidations, applying a similar step transaction analysis. In PLR 9327010, a publicly traded U.S. corporation ("P") sought to realign its computer manufacturing business, and to avoid withholding taxes. P owned 100 percent of the stock of two foreign corporations, F1 and F3. F1, a holding company, owned 100% of the stock of F2. As part of a series of transactions, P contributed the stock of F1 to F3. Immediately thereafter, F1 liquidated into F3, followed by F2's liquidation into F3. The IRS disregarded the form and ruled that the contribution of F1 into F3, followed by the top-down liquidations, would be treated as a series of "D" Reorganizations. As such, F2 was deemed to transfer "substantially all" of its assets and liabilities to F3 and then liquidate, transferring the F3 stock to F1. Next, F1 was deemed to transfer "substantially all" of its assets to F3 and then liquidate, transferring the F3 stock to P.

i. *Post-Transaction Drop-Downs or Push-Ups of Target Assets*

Any post-transaction drop-down of Target's assets that is within the parameters of §368(a)(2)(C) should not, by definition, violate the "substantially all" requirement. Section 368(a)(2)(C) provides that a transaction that otherwise qualifies as a reorganization is not disqualified simply because part or all of

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Triangular Merger is not taken into account; payment of Target's reorganization expenses was not addressed).

[447] *See* III.C.2.c., above.

[448] 26 T.C. 396 (1956), *acq.*, 1956-2 C.B. 5.

[449] *George v. Commissioner*, 26 T.C. 396 (1956). *See also* Rev. Rul. 68-526 (without citing *George*, IRS treated simultaneous acquisitions of assets and liabilities of Target and its 60%-owned subsidiary in exchange for Acquiror voting stock as two separate "C" Reorganizations); PLR 8601008.

[450] Rev. Rul. 78-47.

[451] Rev. Rul. 78-47.

[452] *See* PLR 9115059, PLR 8221025.

[453] *See* Rev. Rul. 78-47 (downstream reorganization satisfied "substantially all" requirement even though 68% of value of assets of Target consisted of 5% of stock of Acquiror); Rev. Rul. 57-465 (merger of holding company into subsidiary was ineligible for "A" Reorganization, but qualified as reorganization under §368(a)(1)(D); cancellation of holding company's stock in subsidiary pursuant to merger was considered transfer of "substantially all" of holding company's assets). *See also George v. Commissioner*, 26 T.C. 396 (1956), *acq.*, 1956-2 C.B. 5 (56% of value of Target's assets consisted of 50% interest in a subsidiary; Tax Court concluded that transaction qualified as "C" Reorganization); PLR 9506036 (holding company's transfer of its 14% interest in subsidiary plus cash to subsidiary in exchange for subsidiary stock qualified as "C" Reorganization). *But see* PLR 8221025 (expressing doubt as to whether "substantially all" requirement could be met when Target's only asset was subsidiary stock).

[454] 60 T.C. 778 (1973).

[455] The Tax Court treated the transaction treated as "A" Reorganization between Target and Acquiror and as "C" Reorganization between Target's subsidiary and Acquiror.

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the acquired assets are transferred to a controlled subsidiary. Although §368(a)(2)(C) was enacted to address the remote continuity problem presented by the *Groman-Bashford* doctrine,[456] the relief provided by §368(a)(2)(C) should be broad enough to cover "substantially all" problems as well. Drop-downs outside the parameters of §368(a)(2)(C), however, may result in violation of the "substantially all" requirement unless Target acquires a "substituted asset" in return for the drop-down. The COI and COBE regulations clarify that post-transaction drop-downs meeting the COI and COBE requirements are deemed to meet the "substantially all" requirement.[457] See V.B., and V.E., below, for discussions of the COBE regulations and the scope of §368(a)(2)(C) and Reg. §1.368-2(k).

Prior to issuance of the COI and COBE regulations, there was a concern that post-transaction push-ups of Target assets would have an adverse effect on the "substantially all" determination unless Target acquired a "substituted asset" in return for the push-up. Questions were also raised as to whether the COBE requirement was met when the push-up was not to a member of Acquiror's "qualified group,"[458] and whether Acquiror was actually the "acquiring" entity for "C" Reorganization purposes. See V.A. and V.E., below, for a discussion of post-reorganization distributions of assets following issuance of the COI and COBE regulations.

6. *The Complete Distribution Requirement*

A transaction does not qualify as a "C" Reorganization unless Target distributes the stock, securities, and other properties it receives from Acquiror, as well as its other properties, in pursuance of the plan of reorganization.[459] Section 368(a)(2)(G)(i) provides that if Target is liquidated pursuant to the plan of reorganization, any distribution to its creditors in connection with the liquidation is also treated as pursuant to the plan of reorganization.

Practice Point: A literal reading of §368(a)(2)(G) — that the exact assets received must be distributed — seems inconsistent with the §368(a)(2)(G) policy of permitting Target to sell a portion of the Acquiror stock it receives to a third party and use the cash proceeds to pay off a creditor, particularly because Target would recognize gain or loss on such sale. However, in the absence of any helpful authority, it would be inadvisable for Target to dispose of any of the assets received from Acquiror except by way of distribution to shareholders and creditors.

Section 368(a)(2)(G)(i) does not require that the liquidating distributions be made within a specified period of time; it only requires that the distributions be made "in pursuance of the plan of reorganization." However, "Congress anticipated that the distribution will take place reasonably promptly and that [Target] will not engage in the active conduct of a trade or business after the reorganization except to the extent necessary to wind up its affairs."[460] In light of the 12-month deadline imposed by the IRS on the sale of Target's charter when the distribution requirement is waived, as discussed below, it is inadvisable to delay complete liquidation for more than 12 months in a case in which the distribution requirement applies.[461]

The IRS is authorized to waive the distribution requirement, subject to any conditions that it may prescribe.[462] The legislative history indicates that Congress anticipated waivers only in cases in which the distribution requirement would result in substantial hardship and Target and its shareholders treat the undistributed assets as if they had been distributed and then contributed to the capital of a new corporation (i.e., as a liquidation for tax purposes).[463] The loss of a valuable non-transferable charter was considered a substantial hardship resulting from the distribution requirement.[464]

In Rev. Proc. 89-50, the IRS provided certain representations that must be submitted in addition to the standard representations contained in Rev. Proc. 86-42[465] before it "ordinarily" will waive the distribution requirement in a letter ruling request:

> 1. Target will retain only its corporate charter and those assets, if any, necessary to satisfy state law minimum capital requirements to maintain corporate existence (minimum capital).
>
> 2. For purposes of the "substantially all" representation (i.e., the 90/70 guideline), the value of Target's corporate charter and any minimum capital retained by Target will be taken into account as assets of Target held immediately prior to the reorganization.
>
> 3. The sole purpose of Target's maintaining its corporate existence under state law is to isolate Target's charter for resale to an "unrelated purchaser," defined for this purpose as a purchaser that did not own, actually or constructively under §318(a) as modified by §304(c)(3), any Target stock before the reorganization and any Parent or Sub stock after the reorganization.
>
> 4. As soon as practicable, but in no event later than 12 months following the date substantially all of Target's assets are transferred in the reorganization, Target will either be sold to an unrelated purchaser or dissolved under state law. If Target is sold, Target is deemed to distribute, "immediately prior to the sale of Target by its shareholders," the value of its corporate charter and retained minimum capital in a distribution to which §356 and §361(c) apply, and the shareholders are then treated as contributing to the capital of a new target the same assets. The purpose of this deemed distribution is to tax the Target shareholders on the proceeds of the sale of Target under §356 and not under §1001.

Note that the distribution requirement in §368(a)(2)(G)(i) dovetails with the nonrecognition provisions of §361(b) and

[456] A discussion of the *Groman-Bashford* doctrine is included in the Worksheets.

[457] Reg. §1.368-2(k)(2) *Ex.* 1 (drop-down of Target assets following Triangular "C" Reorganization).

[458] *See* V.B., below.

[459] §368(a)(2)(G)(i).

[460] Staff of the J. Comm. on Tax'n, 98th Cong., 2d Sess., *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*," at 189–90 (Comm. Print 1984).

[461] Note that the Senate version of §368(a)(2)(G)(i) imposed a 12-month distribution deadline. S. Prt. 98-169 at 205 (1984). The Conference Committee replaced the 12-month requirement with the "in pursuance of the plan of reorganization" requirement. H.R. Conf. Rep. No. 98-861, at 845–46 (1984).

[462] §368(a)(2)(G)(ii).

[463] H.R. Conf. Rep. No. 98-861, at 845–46 (1984).

[464] S. Prt. 98-169, at 205 (1984).

[465] For a discussion of procedures for obtaining a ruling, see VIII., below.

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§361(c) applicable to all acquisitive asset reorganizations.[466] The distribution of all of Target's properties, including the stock and securities it receives from Acquiror, is required under §368(a)(2)(G)(i) to qualify a transaction as a "C" Reorganization. A distribution by Target of the other property or money received from Acquiror is necessary under §361(b) to avoid gain recognition on the receipt of such items. Under §361(c), no gain or loss is recognized by Target on distributions of "qualified property" (e.g., Acquiror stock or obligations). In each case, distributions must be made "in pursuance of the plan of reorganization" and distributions to creditors "in connection with" the liquidation or reorganization are treated in the same manner as distributions to shareholders.

7. *Effect of Acquiror's Pre-Existing Ownership of Target*

As discussed below, a transaction's ability to qualify as a "C" Reorganization when Acquiror owns shares of Target depends on several factors. First, a determination must be made as to whether the manner in which the Target shares were acquired will impact the COI or solely-for-voting-stock requirement (i.e., whether the Target shares held by Acquiror are "old and cold"). Second, in cases in which the Target shares are not "old and cold" (i.e., when the shares were acquired as part of the overall plan of reorganization), the limitations on the application of the step transaction doctrine need to be considered.

a. *Old and Cold Test*

The effect, if any, of Acquiror's pre-existing ownership of Target first depends on whether Acquiror's interest is "old and cold." If Acquiror's interest is not "old and cold," Acquiror's purchase of the interest that is not "old and cold" is integrated with its issuance of voting stock in a subsequent transaction intended to be "C" Reorganization. Accordingly, if the interest that is not "old and cold" was purchased with consideration other than Acquiror voting stock, the "C" Reorganization is disqualified unless that consideration, together with other boot issued in the subsequent exchange, is not in excess of the 20% boot limitation.[467] Conversely, if the interest that is not "old and cold" was purchased with Acquiror voting stock, the prior purchase would contribute toward the 80% voting stock requirement in the subsequent exchange, which, if it qualified as a "C" Reorganization, would convert the prior purchase into a nontaxable transaction.[468]

The factors to be considered in determining if Acquiror's prior purchase of Target stock is "old and cold" are generally the same as those considered in any step transaction analysis.[469] The IRS has issued several rulings in this context, although, given the limited analysis in these rulings, there is little to be drawn from them. In Rev. Rul. 69-48, Parent adopted a plan for Sub to acquire substantially all of Target's properties. A year later, Parent purchased 19% of Target's stock for cash, and 10 months after that (i.e., 22 months from the date of the plan), Target transferred substantially all its properties to Sub in exchange for Parent voting stock. In ruling that the solely-for-voting-stock requirement was violated in the exchange, the IRS found that the prior cash purchase "was an integral step in a preconceived plan to acquire substantially all of the properties of [Target]."[470]

Although the step transaction doctrine arises in a number of contexts, helpful analogies include cases involving (i) the integration of an acquisition of Target stock in exchange for Acquiror stock and a subsequent merger of Target into Acquiror, for purposes of treating the initial stock acquisition as part of an "A" Reorganization,[471] (ii) the integration of an initial cash purchase by Acquiror of Target stock and a subsequent reorganization or merger between Target and Acquiror, for purposes of determining whether Acquiror is a "historic shareholder" of Target,[472] and (iii) cash purchases by Acquiror of Target stock preceding an attempted "B" Reorganization between Acquiror and Target.[473]

The prior purchase of Target stock by a wholly owned subsidiary of Acquiror is regarded as a purchase by Acquiror itself for purposes of determining whether the interest in Target is "old and cold."[474] In addition, a corporation owning 80% or more of Acquiror stock is considered related to Acquiror.[475] On the other hand, a prior purchase of Target stock by a shareholder of Acquiror, even a 50% shareholder, is not imputed to Acquiror if the shareholder is acting for himself and is under no obligation to transfer the Target stock to Acquiror.[476]

Note: The COI regulations provide that purchases of Target stock by certain corporations related to Acquiror are imputed to Acquiror only for COI purposes. The regulations do not address whether those purchases also violate the solely-for-voting-stock requirement.[477] See V.A.5., below.

Planning Point: If Acquiror desires to purge itself of Target stock that is not "old and cold" to effect a "C" Reorganization, it may do so by unconditionally selling such stock to an unrelated third party, provided the purchaser is free to retain the shares or exchange them in the reorganization and Acquiror

[466] There is some question, however, as to whether §361 even applies in an "A" Reorganization or Forward Triangular Merger. *See* VI.B.1.b., below.

[467] *See, e.g.*, Rev. Rul. 69-48.

[468] *See, e.g.*, *King Enters. Inc. v. United States*, 418 F.2d 511 (Ct. Cl. 1969). *See* V.D., below.

[469] For a general discussion of the step transaction doctrine, see V.D., below.

[470] Rev. Rul. 69-48. *See also* Rev. Rul. 85-138 ("C" Reorganization failed because Acquiror's wholly owned subsidiary had previously purchased for cash stock of Target, thus violating solely-for-voting-stock requirement). In another ruling, involving a triangular "C" Reorganization, Parent's ownership of 72% of Target stock was not taken into account because the stock "had been acquired in a transaction separate from" the Sub's acquisition of Target's assets. Rev. Rul. 69-48 (citing Rev. Rul. 57-278). *See also* Reg. §1.368-2(c) (stock purchased for cash 16 years before attempted "B" Reorganization is regarded as "old and cold").

[471] *King Enters., Inc. v. United States*, 418 F.2d 511 (Ct. Cl. 1969); Rev. Rul. 2001-46. *See* III.A.2.d., above, and V.D., below.

[472] *Security Indus. Ins. Co. v. United States*, 702 F.2d 1234 (5th Cir. 1983); *Seagram Corp. v. Commissioner*, 104 T.C. 75 (1995); *Superior Coach of Fla., Inc. v. Commissioner*, 80 T.C. 895 (1983); *Yoc Heating Corp. v. Commissioner*, 61 T.C. 168 (1973); *Kass v. Commissioner*, 60 T.C. 218 (1973), aff'd without opinion, 491 F.2d 749 (3d Cir. 1974). *See* V.A.4.a., and V.A.4.b., below.

[473] *Reeves v. Commissioner*, 71 T.C. 727 (1979), rev'd and rem'd sub nom. *Chapman v. Commissioner*, 618 F.2d 856 (1st Cir. 1980), cert. dismissed, 451 U.S. 1012 (1981); *Pierson v. United States*, 472 F. Supp. 957 (D. Del. 1979), rev'd and rem'd sub nom. *Heverly v. Commissioner*, 621 F.2d 1227 (3d Cir. 1980). *See* IV.A.2.b., below.

[474] Rev. Rul. 85-138.

[475] Reg. §1.368-1(e)(4), §1.368-1(e)(7) *Ex.* 2.

[476] Rev. Rul. 68-562.

[477] *See* T.D. 8760, 63 Fed. Reg. 4174 (Jan. 28, 1998).

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has no agreement or other arrangement to reacquire the shares if the reorganization does not take place.[478]

b. Newly Acquired Shares Treated as Old and Cold Stock

As discussed in detail in IV.A.4.b., and V.D., below, Reg. §1.338-3 addresses situations in which Acquiror is treated as an old and cold shareholder of Target with respect to certain post-acquisition transactions (such as upstream "C" Reorganizations). Also as discussed above, Rev. Rul. 2001-46 and Rev. Rul. 2008-25 provide guidance on determining when two-step transactions will be integrated for U.S. federal income tax purposes.

c. Repeal of Bausch & Lomb Doctrine — Reg. §1.368-2(d)(4)

Before Reg. §1.368-2(d)(4) was issued in May 2000 (effective for transactions occurring after 1999)[479] even if Acquiror could establish that the Target stock it owned was "old and cold," Acquiror had to contend with the "*Bausch & Lomb*" doctrine. In *Bausch & Lomb Optical Co. v. Commissioner*,[480] Acquiror owned 79% of Target stock on an "old and cold" basis. In an attempted "C" Reorganization, Target transferred its assets to Acquiror in exchange for Acquiror stock. Target then liquidated, distributing the Acquiror stock pro rata to its shareholders, including Acquiror. Both the Tax Court and the Second Circuit held that Acquiror failed to meet the solely-for-voting-stock requirement on the theory that only 21% of Target's assets were acquired in the attempted "C" Reorganization in exchange for Acquiror voting stock. The other 79% of Target's assets were treated as though they had been acquired in consideration for Acquiror's 79% stock interest in Target. In other words, the courts ignored the issuance of Acquiror stock to Target to the extent that stock was returned to Acquiror in its capacity as a shareholder of Target; the transaction, therefore, failed to meet the solely-for-voting-stock requirement.

Under the rationale of *Bausch & Lomb*, Acquiror's holding of a single share of Target stock would have disqualified a "C" Reorganization unless the value of that stock, together with any boot issued in the exchange, was not in excess of the 20% boot limitation.[481]

In 2000, the IRS abolished the *Bausch & Lomb* doctrine by issuing regulations providing that prior ownership of a portion of the stock of Target by Acquiror does not prevent the solely-for-voting-stock requirements in a "C" Reorganization from being satisfied.[482] The IRS believed that, based on the legislative history to §368(a)(1)(C), Congress could not have intended that a transaction would fail to qualify as a "C" Reorganization merely because of Acquiror's ownership of Target stock. Acquiror is simply converting an indirect ownership interest in assets to a direct interest in those assets.[483]

Under Reg. §1.368-2(d)(4)(i), prior ownership of stock of Target by Acquiror will not by itself prevent the solely for voting stock requirement from being satisfied. If Acquiror's stock interest in Target is "old and cold," the boot relaxation rule is applied only with respect to (i) the sum of the money or other property that is distributed in pursuance of the plan of reorganization to the shareholders of Target *other than* Acquiror, (ii) the sum of the money and other property that is distributed in pursuance of the plan of reorganization to the creditors of Target and (iii) all of the liabilities of Target assumed by Acquiror (including liabilities to which the properties of the target corporation are subject). However, to the extent that Acquiror's interest in Target is not "old and cold" and such interest was purchased for consideration other than Acquiror's own voting stock (or voting stock of Acquiror's Parent in a triangular "C" Reorganization), such consideration will be treated, for purposes of the solely for voting stock requirement and the boot relaxation rule, as money or other property exchanged by Acquiror for Target's properties.

> *Example:* Corporation P (P) holds 60% of Target stock that P purchased several years ago in an unrelated transaction. Target has 100 shares of stock outstanding. The other 40% of the Target stock is owned by Corporation X (X), an unrelated corporation. Target has properties with a fair market value of $110 and liabilities of $10. Target transfers all of its properties to P. In exchange, P assumes the $10 of liabilities, and transfers to Target $30 of P voting stock and $10 of cash. Target distributes the P voting stock and $10 of cash to X and liquidates. The transaction satisfies the boot relaxation rule because the sum of $10 of cash paid to X and the assumption by P of $10 of liabilities does not exceed 20% of the $110 value of the properties of Target.[484]

> *Example:* The facts are the same as in the above example, except that P purchased the 60 shares of Target for $60 in cash in connection with the acquisition of Target's assets. The transaction does not satisfy the boot relaxation rule because P is treated as having acquired all of the Target assets for consideration consisting of $70 of cash, $10 of liability assumption and $30 of P voting stock, and the sum of $70 of cash and the assumption by P of $10 of liabilities exceeds 20% of the $110 value of the properties of Target.[485]

8. Triangular "C" Reorganizations

a. General Description

A triangular "C" Reorganization is simply a "C" Reorganization in which Sub acquires substantially all of Target's assets in exchange for Parent stock.[486] In response to the restraints

[478] Rev. Rul. 72-354.

[479] Reg. §1.368-2(d)(4)(iii).

[480] 267 F.2d 75 (2d Cir. 1959), cert. denied, 361 U.S. 835 (1959).

[481] *See* Rev. Rul. 68-526 (Acquiror simultaneously acquired assets of Target and Target's 60%-owned subsidiary in separate "C" Reorganizations; *Bausch & Lomb* did not apply because Acquiror owned no stock in acquired corporations before acquisitions).

[482] *See* Reg. §1.368-2(d)(4).

[483] *See* REG-115086-98, 64 Fed. Reg. 31,770 (June 14, 1999).

[484] Reg. §1.368-2(d)(4)(ii) *Ex.* 1.

[485] Reg. §1.368-2(d)(4)(ii) *Ex.* 2.

[486] Reg. §1.367(b)-10 addresses situations that are subject to rules under §367(b) to prevent certain repatriations of foreign earnings through triangular reorganizations using Parent stock or securities (sometimes referred to as "Killer B" transactions). In Notice 2014-32, the IRS identified transactions designed to exploit the final regulations and announced intended modifications

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imposed by the *Groman-Bashford* doctrine, Congress provided for these reorganizations in 1954 by adding parenthetical language to §368(a)(1) and amending §368(b) to provide that Parent is a party to a triangular "C" Reorganization.[487] The parenthetical language of §368(a)(1)(C) provides that the acquiring corporation may acquire Target's assets "in exchange solely for all or part of the voting stock … of a corporation which is in control of the acquiring corporation."

In addition to the general requirements applicable to any "C" Reorganization, the parties must ensure that Parent owns at least 80% of Sub's total combined voting power and at least 80% of the total number of shares of all other classes of stock of Sub.[488] This control requirement refers only to direct ownership of stock and there are no applicable attribution rules; therefore, stock of a grandparent will not suffice.[489] In addition, the IRS has imposed prohibitions on Parent's assumption of any Target liabilities (and presumably the transfer of any other "boot") and the issuance of any Sub stock, as discussed below.

b. *Practical Considerations*

As compared to a merger, the practical considerations regarding the use of a triangular "C" Reorganization are similar to those discussed in the general "C" Reorganization context.[490] Thus, when a merger is feasible, an "A" Reorganization or a Forward Triangular Merger is generally more attractive than a triangular "C" Reorganization. A triangular "C" Reorganization, like a "C" Reorganization generally, offers the parties the ability to control the particular liabilities assumed and possibly to confine approval and appraisal rights to Target shareholders.[491]

A triangular "C" Reorganization may offer practical advantages over a two-party "C" Reorganization. First, the Target liabilities to be assumed can be isolated at the Sub level. Second, if approval and appraisal rights must be provided to Acquiror shareholders, a triangular "C" Reorganization generally precludes those rights from extending to Parent's shareholders. It should be noted, however, that both of these potential advantages can be addressed in a two-party "C" Reorganization by having Acquiror form a wholly owned LLC to acquire Target's assets. Because an LLC is a disregarded entity for federal income tax purposes, this transaction should be viewed as a two-party "C" Reorganization.[492]

Although the end result of a triangular "C" Reorganization is similar to that of a two-party "C" Reorganization followed by a drop-down of Target's assets and liabilities to Sub, these transactions have significant differences. The drop-down transaction is potentially subject to the "liabilities over basis" rule of §357(c) (as well as §357(b)), whereas a direct transfer of Target's assets and liabilities to Sub in a triangular "C" Reorganization is exempt from §357(c).[493] On the other hand, if it is necessary for Parent to assume any part (or all) of Target's liabilities, and an "A" Reorganization or Forward Triangular Merger is not feasible, a "C" Reorganization at the Parent level (whether or not followed by a drop-down) must be used instead of a triangular "C" Reorganization.[494] Before the COI regulations[495] and COBE regulations[496] were issued, if a principal goal was to lodge Target's assets and liabilities in a second-tier subsidiary of Parent, a triangular "C" Reorganization (or Forward Triangular Merger, if feasible) followed by a single drop-down might have been preferable to a "C" Reorganization at the Parent level followed by a double drop-down, in light of the uncertainties regarding the application of the *Groman-Bashford* doctrine. The COI and COBE regulations permit drop-downs of assets to multiple tiers of controlled subsidiaries following a "C" Reorganization.

c. *Prohibition on Use of Subsidiary Stock*

Section 368(a)(2)(C) requires that Target's assets be acquired "solely" for Acquiror voting stock or, if Acquiror is a Sub, "solely" for Parent voting stock, subject to the exception for assumed liabilities and the 20% boot limitation. Arguably, the issuance of some Sub stock in addition to Parent stock should not disqualify a triangular "C" Reorganization, so long as the Sub stock together with any assumed liabilities and other boot does not exceed the 20% boot limitation.[497] However, the IRS's position is that any mixture of Parent and Sub stock disqualifies either a two-party or a triangular "C" Reorganization.[498] It may nonetheless be possible to issue Parent stock or Sub (or Parent) bonds that are convertible into Sub stock without violating the prohibition on the use of Sub stock.[499]

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to the "Killer B" regulations targeting certain inversion transactions. In Notice 2016-73, the IRS identified additional transactions designed to exploit the final regulations as modified by Notice 2014-32 and announced its intent to issue additional modifications, including the amount of an income inclusion required in certain inbound nonrecognition transactions. In 2024, the IRS and Treasury issued final regulations as announced in Notice 2014-32 and Notice 2016-73, with modifications, relating to the treatment of property used to acquire Parent stock or securities in connection with certain triangular reorganizations involving one or more foreign corporations. T.D. 10004, 89 Fed. Reg. 58,275 (July 18, 2024). Under the final regulations, Reg. §1.367(b)-10 is generally applicable to triangular reorganizations occurring on or after May 17, 2011, obsoleting Notice 2024-32 and Notice 2016-73. For further discussion of the "Killer B" regulations, see 6120 T.M., *Transfers Subject to Section 367(b), (d), or (e)* (Foreign Income Series), and 6100 T.M., *U.S.-to-Foreign Transfers Under Section 367(a)* (Foreign Income Series).

[487] For a discussion of the various legislative responses to the *Groman-Bashford* doctrine, see V.A.6.a., below.

[488] *See* §368(a)(1)(C).

[489] *See* Rev. Rul. 56-613 (Acquiror in "B" Reorganization must acquire direct control of Target; "practical" control is insufficient). *See also* Rev. Rul. 74-565 (grandparent stock may not be used in Reverse Triangular Merger); Rev. Rul. 74-564 (same). However, the prohibition on the use of grandparent stock is alleviated by Acquiror's ability to drop Sub's assets, or even Sub stock itself, to a controlled second-tier subsidiary. *See* §368(a)(2)(C); PLR 8702056, PLR 8635026.

[490] *See* III.C.1.b., above.

[491] *See* III.C.1.b., above.

[492] *See* Reg. §1.368-2(b)(1)(i)(A).

[493] *See* V.E., below.

[494] *See* III.C.8.d., below.

[495] *See* V.A., below.

[496] *See* V.B., below.

[497] Given that there is no specific prohibition as to what type of boot may comprise the 20% boot limitation, Sub stock should be a type of boot permitted to be paid in an otherwise qualifying transaction. Indeed, in *Groman v. Commissioner*, 302 U.S. 82 (1937), the Court did find a reorganization to exist; it held that the use of Parent stock was considered boot only because Parent was not a party to the reorganization.

[498] Reg. §1.368-2(d)(1).

[499] *See* III.B.2.b., above.

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d. Prohibition on Parent's Direct Assumption of Liabilities

Section 368(a)(1)(C) provides that the assumption "by the acquiring corporation" of a liability of Target is disregarded. In Rev. Rul. 70-107, the IRS ruled that the assumption of any Target liabilities by Parent violates the solely-for-voting-stock requirement in a triangular "C" Reorganization because Parent is not the "acquiring corporation." In the facts of the ruling, Sub directly acquired, pursuant to a plan of reorganization intended to qualify as a "C" Reorganization, all of the assets of Target using Parent voting stock previously transferred to Sub. Part of Target's liabilities were assumed by Sub and part by Parent. The IRS ruled that the exchange did not meet the solely-for-voting stock requirement of §368(a)(1)(C) because Parent was not the acquiring corporation and, thus, its assumption of Target's liabilities would not be disregarded.

Although the IRS has not explicitly addressed this point, it is likely that any direct liability assumption by Parent, no matter how small, disqualifies a triangular "C" Reorganization without regard to the 20% boot limitation. Section 368(a)(2)(B) requires that the transaction qualify under §368(a)(1)(C) but for the fact that "money or other property" is exchanged by the "acquiring corporation" in addition to voting stock. Because an assumption of Target liabilities by Parent falls outside of §368(a)(1)(C), and because it is difficult to view such an assumption as an exchange of money or other property by the "acquiring corporation" (i.e., Sub), §368(a)(2)(B) is probably inapplicable.

Practice Point: If Parent desires to assume all of Target's liabilities, but lodge all of Target's assets in Sub, Parent can avoid Rev. Rul. 70-107 by acquiring Target's assets directly in a two-party "C" Reorganization and then dropping the assets down to Sub while retaining the liabilities. Parent could even cause Target's assets to be transferred directly to Sub and still assume all of Target's liabilities as the "acquiring corporation," provided that Parent is designated as the "acquiring corporation" in the reorganization agreement and at all times has "dominion and control" over Target's assets.[500] However, an assumption of Target liabilities by Sub, no matter how small, would similarly disqualify a "C" Reorganization at the Parent level.[501]

Sub can "distribute" to Parent (i.e., have Parent assume) a substantial portion of Target liabilities that Sub has assumed in the "C" Reorganization, without disqualifying the reorganization. Reg. §1.368-2(k)(1)(i) provides that a reorganization is not disqualified by one or more subsequent distributions to shareholders (including distributions that involve the assumption of liabilities) of assets of the acquired, acquiring, or surviving corporation, provided the continuity of business enterprise requirement is satisfied and the distributions do not result in a liquidation of the acquired, acquiring, or surviving corporation (as the case may be) for federal income tax purposes. The regulations clarify that: (1) a transfer to the former shareholders of the acquired corporation (other than a former shareholder that is also the acquiring corporation) or the surviving corporation is not protected by the Reg. §1.368-2(k)(1) safe harbor to the extent it constitutes those shareholders' receipt of consideration for their proprietary interests in the acquired or surviving corporation; and (2) the safe harbor does not apply to a transfer by the former shareholders of the acquired corporation (other than the acquiring corporation) or the surviving corporation of consideration initially received in the potential reorganization to the issuing corporation or a person "related to" the issuing corporation (under the Reg. §1.368-1(e) definition).[502]

> *Example:* Pursuant to a plan of reorganization, Target transfers all of its assets to Sub solely in exchange for Parent stock (which Target distributes to its shareholders) and Sub's assumption of Target's liabilities. Also pursuant to the plan, Sub distributes half of the Target assets to Parent, and Parent assumes half of the Target liabilities. Under Reg. §1.368-2(k), the transaction (which qualifies as a "C" Reorganization) is not disqualified by the distribution of half of Target assets from Sub to Parent or by Parent's assumption of half of the Target liabilities from Sub, because (i) the distribution consists of assets of the acquiring corporation (Sub), (ii) the distribution does not consist of an amount of Sub's assets that would cause Sub to liquidate, and (iii) the transaction satisfies the COBE requirements because all of Target's historic business assets reside within the issuing corporation's "qualified group" (discussed below).[503]

The IRS and Treasury believe the regulations do not implicate the fact pattern in Rev. Rul. 70-107. In other words, a direct assumption by Parent of any portion of Target liabilities in a triangular "C" Reorganization continues to disqualify the reorganization.[504]

Practice Point: Given the harsh consequences of a dual assumption of Target liabilities, the parties should ensure that there are no inadvertent assumptions by the wrong party, particularly in the triangular "C" Reorganization context. For example, if Target has outstanding stock options, substitution of Parent's stock under those options would be regarded as an assumption of a Target liability by Parent.[505] This result can be avoided by requiring Target to issue its own stock to the optionholders before the reorganization in satisfaction of the options. Alternatively, Sub can assume full responsibility for delivery of Parent stock to the optionholders upon the exercise of the options, although Sub may recognize gain upon the exercise of the options if Sub delivers Parent in a transfer that does not qualify under Reg. §1.1032-3.[506] Finally, the transaction could be restructured as a straight "C" Reorganization with an §368(a)(2)(C) drop of Target's assets to Sub (rather than a triangular "C" Reorganization) or a straight "C" Reorganization utilizing a wholly owned LLC subsidiary of Acquiror.

[500] Rev. Rul. 70-224. *See also* PLR 8923046.

[501] *See* GCM 39102 (Dec. 21, 1983); GCM 37905 (Mar. 29, 1979).

[502] Reg. §1.368-2(k)(1).

[503] Reg. §1.368-2(k)(2) *Ex.* 2.

[504] T.D. 9361, 72 Fed. Reg. 60,552 (Oct. 25, 2007).

[505] *Cf.* Reg. §1.368-2(b)(2); Rev. Rul. 68-637, *modified by* Rev. Rul. 98-10.

[506] *Cf.* Rev. Rul. 69-265 (for purposes of "solely for voting stock" requirement in "C" Reorganization, distinction exists between arrangement in which optionholders receive Parent stock directly from Sub and one in which optionholders present their options (i.e., options to convert Sub stock into Parent stock) directly to Parent; latter arrangement was regarded as providing optionholders with "other property").

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e. Zero Basis Problem

The potential zero basis problem facing a failed triangular "C" Reorganization has been discussed in the context of Forward Triangular Mergers.[507]

f. "Stockless" Triangular "C" Reorganizations

A triangular "C" Reorganization may implicate the "solely for voting stock" requirement where Parent has, in addition to its voting stock, non-voting shares that participate meaningfully in corporate growth outstanding at the time of the reorganization, and Parent does not actually issue any new shares in the transaction.

The §358 regulations and the IRS have addressed how to allocate the basis of property contributed in a stockless §351 transfer where the transferee corporation had common and preferred stock outstanding.[508] The IRS interpreted these regulations in FSA 200028004, in which the taxpayer argued that the basis of the contributed property should be allocated entirely to the common stock while the IRS examiner asserted the basis of the contributed property should be allocated between the preferred and the common stock based on the relative tax bases at the time of the contribution.[509] FSA 200028004 states that the relative tax basis allocation asserted by the IRS examiner appeared to be based on the "meaningless gesture" doctrine,[510] and that the application of the meaningless gesture doctrine should be based on the rights attaching to the stock and "whether the issuance or non-issuance of stock makes a difference." FSA 200028004 notes that an allocation of basis to the preferred stock is appropriate only if the contribution meaningfully affects the rights of the preferred shareholders. Under the facts, the only preference the preferred stock had over the common shares was a liquidation preference. FSA 200028004 concluded that since there were otherwise sufficient assets to satisfy this liquidation preference, the basis of the contributed property should be allocated entirely to the common stock.

Practice Point: Query whether the type of analysis used in FSA 200028004 should be applied to the "solely for voting stock" requirement. FSA 200028004 was concerned with how to track basis in the stock of the transferee corporation. In contrast, the "solely for voting stock" requirement is intended to police the amount and the type of consideration received by a shareholder as part of a "C" Reorganization. In the context of a stockless "C" Reorganization, because the shareholder receives no additional consideration, the "solely for voting stock" requirement should not be violated. However, caution is warranted given the lack of authority on point.

9. Application of Step Transaction Principles

a. General

As discussed in V.D., below, Rev. Rul. 2001-46 and Rev. Rul. 2008-25 provide guidance to practitioners in determining when two-step transactions will be integrated for U.S. federal income tax purposes.

b. Recharacterization of Other Reorganizations as "C" Reorganizations

A merger of Target into Acquiror may fail to strictly comply with, or be ineligible to be governed by, the applicable laws. In that case, because the transaction is not eligible for treatment as an "A" Reorganization, it is tested as a "C" Reorganization (or, if applicable, a reorganization under §368(a)(1)(D)).[511] Similarly, a failed merger of Target into Sub is tested as a triangular "C" Reorganization (or, again, if applicable, a reorganization under §368(a)(1)(D)) instead of as a Forward Triangular Merger.[512]

A "B" Reorganization is recharacterized as a "C" Reorganization (assuming, of course, the applicable requirements are met) if Target is liquidated after the acquisition pursuant to a single, integrated plan.[513] Presumably, a triangular "B" Reorganization can be recharacterized as a triangular "C" Reorganization on the same grounds. If Target is merged (as opposed to liquidated) into Acquiror following a "B" Reorganization, the overall transaction should be treated as an "A" Reorganization (or a Forward Triangular Merger if Target is merged into a controlled subsidiary of Acquiror) instead of a "C" Reorganization.[514] A Forward Triangular Merger (and presumably a triangular "C" Reorganization) is recharacterized as a two-party "C" Reorganization (again, assuming the applicable requirements are met) if Sub is liquidated or converted into a limited liability company after the acquisition pursuant to a single, integrated plan.[515] If Target (e.g., in the case of a purported "B"

[507] *See* III.B.5.b., above.

[508] Reg. §1.358-2(a)(2)(iii) (stating that basis should attach to the class of shares "the receipt of which would be consistent with the economic rights associated with each class of stock of the issuing corporation" in a stockless reorganization); FSA 200028004 (Mar. 31, 2000).

[509] Generally, in an exchange to which §351 applies, property is transferred to a corporation and the transferor receives stock of more than one class, the basis of the property transferred must be allocated among all of the stock received in proportion to the fair market values of the stock of each class. Reg. §1.358-2(b)(2).

[510] While an "exchange" is a requirement for reorganizations described in §368(a)(1)(B), §368(a)(1)(C), and §368(a)(1)(D), as well as §351 transfers, the courts and IRS have generally applied nonrecognition treatment, in the wholly-owned context, where the receipt of additional stock would be a "meaningless gesture" because it would not alter the percentage ownership interest of the transferor (or acquiror). *See Estate of Kluener v. Commissioner*, 154 F.3d 630, 634 (6th Cir. 1998) (stating that §351 applies where a shareholder transfers property "to his closely-held corporation to provide it with capital … [and] receives additional stock or, if he already owns the entire corporation, nothing at all"); *Lessinger v. Commissioner*, 85 T.C. 824 (1985), rev'd on other grounds, 872 F.2d 519 (2d Cir. 1989) (holding the receipt of new stock would be a "meaningless gesture" where a sole stockholder transfers property to a wholly owned corporation in a §351 exchange); *Peracchi v. Commissioner*, 143 F.3d 487 (9th Cir. 1998); *Jackson v. Commissioner*, 708 F.2d 1402 (9th Cir. 1983); Rev. Rul. 64-155; *see also* PLR 9551011 (Dec. 22, 1995) (ruling the requirements of a "B" Reorganization were satisfied where a single class of voting stock of each of the acquiring corporation and the target corporation were owned 100% and 95%, respectively, by a shareholder, and the shareholder contributed 100% of its interest in the target corporation to the acquiring corporation in exchange for no consideration); FSA 200221046 (May 24, 2002) (ruling the requirements of a "B" Reorganization were satisfied in an outbound stock transfer from a domestic corporation to its wholly owned foreign subsidiary in exchange for no consideration, stating "issuance of new voting stock would have been a meaningless gesture").

[511] *See* III.A.6., above.

[512] *See* III.B.5.a., above.

[513] Rev. Rul. 67-274. *See also* Rev. Rul. 2001-46; Rev. Rul. 74-35 (treatment of transaction in Rev. Rul. 67-274 as acquisition of assets represents application of *Kimbell-Diamond* principle). *See also* V.D., below.

[514] *See* III.A.2.d., above, and V.D., below.

[515] Rev. Rul. 72-405.

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Reorganization) or Sub (e.g., in the case of a purported Forward Triangular Merger) distributes only a portion of its assets to Parent and remains in existence, the transaction is not collapsed and the distribution is respected as a dividend.[516] If Target is liquidated into Parent after a merger of Parent's wholly owned subsidiary into Target, and Parent's acquisition of Target's assets in the liquidation does not qualify as a reorganization, then the merger and the liquidation are viewed independently.[517]

Recharacterizing a purported "B" Reorganization as a "C" Reorganization may enhance the likelihood that a tax-free reorganization exists, because a "C" Reorganization has limited tolerance for boot while a "B" Reorganization has none.[518] However, the tax-free nature of the transaction may be jeopardized if, by characterizing the purported "B" Reorganization as a "C" Reorganization, concerns unique to the "C" Reorganization arena are brought into play (e.g., the existence of pre-reorganization distributions or redemptions). These transactions may be of no concern in the "B" Reorganization context,[519] but may wreak havoc with the "substantially all" requirement in the "C" Reorganization context.

Recharacterizing a Forward Triangular Merger as a two-party "C" Reorganization only makes it more difficult to characterize the transaction as a tax-free reorganization, because not a single requirement is alleviated and additional ones are imposed (e.g., higher threshold of equity consideration). Recharacterizing a triangular "C" Reorganization as a two-party "C" Reorganization, on the other hand, may be helpful if Parent has assumed any portion of Target's liabilities pursuant to the reorganization;[520] otherwise, the recharacterization has no effect.

10. Overlap with Other Reorganization Provisions

a. Overlap with §368(a)(1)(D)

Under §368(a)(2)(A), a transaction is treated as a reorganization under §368(a)(1)(D) if it is described in both §368(a)(1)(C) and §368(a)(1)(D).[521] Generally, a transaction qualifying as a "C" Reorganization (including a triangular "C" Reorganization) is also described in §368(a)(1)(D) if the former Target shareholders own immediately after the transaction at least 50% of the voting power or value of Acquiror stock (or Sub stock in the case of a triangular merger "C" Reorganization),[522] either directly or constructively. Despite language in §368(a)(1)(D) requiring that Acquiror's stock or securities be distributed in a transaction that "qualifies" under §354, §355, or §356, the IRS believes that a transaction is "described in" §368(a)(1)(D) for purposes of §368(a)(2)(A) if it involves a transfer of assets to a controlled corporation and a distribution of the controlled corporation's stock to the Target shareholders, "regardless of whether such distribution actually qualifies" under §354, §355 or §356.[523] Before the 1984 addition of the distribution requirement in §368(a)(2)(G), a transaction could qualify as a "C" Reorganization but nonetheless be taxable as a result of being "described in," but not eligible to qualify under, §368(a)(1)(D).[524] However, because the distribution requirements in §368(a)(2)(G) and §354(b) are nearly identical, it is unlikely that a transaction "described in" both §368(a)(1)(C) and §368(a)(1)(D) would, under any circumstances, fail to "qualify" under §368(a)(1)(D).

Qualifying as a reorganization under §368(a)(1)(D) instead of as a "C" Reorganization generally enhances the likelihood that a transaction will be tax-free. Because reorganizations under §368(a)(1)(D) focus on the former Target shareholders' percentage of ownership in Acquiror, these reorganizations are not subject to the COI requirement in the same way as other nondivisive reorganizations; in fact, there is no required threshold of equity consideration.[525] Reorganizations under §368(a)(1)(D) are not expressly referenced in §368(a)(2)(C). However, reorganizations described in both §368(a)(1)(D) and §368(a)(1)(C) are treated as "C" Reorganizations for purposes of applying the drop-down provision in §368(a)(2)(C).[526] Furthermore, in Rev. Rul. 2002-85,[527] the IRS ruled that drop-downs may follow "D" Reorganizations.

In Rev. Rul. 2015-10, the IRS clarified the treatment of the so-called "triple-drop-check" transaction that had been the subject of private letter rulings.[528] In that ruling, P owned 100% of LLC, which was treated as a corporation for federal income tax purposes. P also owned 100% of S1, which owned 100% of S2, which in turn owned 100% of S3. P transferred LLC to S1, then S1 transferred LLC to S2, then S2 transferred LLC to S3, and then LLC elected to be treated as a disregarded entity for federal income tax purposes. The IRS ruled P's transfer of LLC to S1 and S1's transfer of LLC to S2 were each §351 transactions, and S2's transfer of LLC to S3 followed by LLC's check-the-box election were treated as a "D" Reorganization.

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[516] Rev. Rul. 74-35 (*Kimbell-Diamond* principle, as used in Rev. Rul. 67-274, does not apply to transfer of less than substantially all of Target's assets).

[517] Rev. Rul. 2008-25. See also the discussion at V.D., below.

[518] *See* IV.A.2.b., below.

[519] *See* IV.A.5., below.

[520] *See* III.C.8.d., above.

[521] Section 368(a)(1)(D) imposes two general requirements: (1) a corporation transfers part or all of its assets to a corporation controlled immediately after the transfer by the transferor or its shareholders; and (2) the transferee corporation's stock or securities are distributed in a transaction which qualifies under §354, §355, or §356. Section 356 applies only if a distribution first qualifies under §354 or §355. Thus, there are only two types of reorganizations under §368(a)(1)(D): nondivisive transactions under §354(b) and divisive transactions under §355. If the distribution is made pursuant to §354(b), the control requirement is determined under §304(c); otherwise, it is determined under §368(c). For a complete discussion of nondivisive and divisive reorganizations under §368(a)(1)(D), see 772 T.M., *Corporate Acquisitions — D Reorganizations*, and 776 T.M., *Corporate Separations*, respectively.

[522] It is unclear whether a failed triangular "C" Reorganization could qualify as a reorganization under §368(a)(1)(D), because the statute literally describes only a two-party reorganization. *See* Rev. Rul. 78-130, *revoked by* Rev. Rul. 2015-9. *See* III.B.5.a., above.

[523] Rev. Rul. 74-545, *obsoleted by* Rev. Rul. 2002-85 (noting enactment of §368(a)(2)(G)).

[524] Rev. Rul. 74-545, *obsoleted by* Rev. Rul. 2002-85 (Target did not distribute all Acquiror stock along with its remaining assets, as required by §354(b); therefore, transaction could not qualify under §368(a)(1)(D) even though it was "described in" that section for purposes of precluding transaction from qualifying under §368(a)(1)(C)).

[525] *See* III.A.6., above, and V.A.3., below. *See also* Reg. §1.368-2(l), T.D. 9475, 74 Fed. Reg. 67,053 (Dec. 18, 2009), generally applicable to transactions occurring after December 19, 2009.

[526] §368(a)(2)(A). *Cf.* PLR 9024004 (reorganization under §368(a)(1)(D) followed by drop-down under §368(a)(2)(C) was viewed as "C" Reorganization for all purposes).

[527] *See also* Reg. §1.368-2(k), as amended by T.D. 9361, 72 Fed. Reg. 60,552 (Oct. 25, 2007) (incorporating Rev. Rul. 2002-85 position).

[528] PLR 201252002, PLR 201150021, PLR 201015002.

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b. Overlap with §351

If the former Target shareholders own directly as much as 80% of Acquiror stock (based on aggregate voting power and number of shares per class)[529] immediately after the transaction, the transaction may constitute a §351 exchange as well as a "C" Reorganization or a reorganization under §368(a)(1)(D). Rev. Rul. 2007-8 clarified that the "liability over basis" rule of §357(c) does not apply to transactions that qualify both as "C" or "D" Reorganizations and as §351 transactions.

Additionally, in such overlap transactions, because either §368(a)(1)(C) or §368(a)(1)(D) would be applicable, Target's tax attributes are inherited by Acquiror under §381(a).[530] The treatment of Target's distribution of Acquiror stock and securities and the exchanges made by the Target shareholders and creditors are determined by the rules applicable to tax-free reorganizations and not §351 exchanges.[531] Note that if Target's transfer of assets to Acquiror does not, by itself, constitute a §351 transaction but does as a "C" Reorganization (or a reorganization under §368(a)(1)(D)),[532] Target may be counted as a transferor for the purpose of qualifying transfers by other transferors under §351, even though Target's transfer is treated solely as a "C" Reorganization (or a reorganization under §368(a)(1)(D)).[533]

c. Liquidation/Reincorporation Transactions

With the repeal of the *Bausch & Lomb* doctrine (discussed in III.C.7.c., above), it is now permissible to have an upstream "C" Reorganization of Subsidiary into Parent, where Subsidiary is actually liquidated into Parent and Subsidiary's assets are dropped down to a controlled subsidiary under §368(a)(2)(C), under the principle of Rev. Rul. 69-617.[534] If there is no drop-down of assets and the liquidation is treated as a §332 liquidation into Parent, the transaction could still be treated as a "C" Reorganization with respect to minority shareholders in Subsidiary who received Parent voting stock.[535]

Unfortunately, since Rev. Rul. 69-617 involved the transfer of 100% of the merged Subsidiary's assets to another controlled subsidiary, it was not always clear that "A" (or "C") Reorganization treatment would prevail if something less than 100% of Subsidiary's assets were transferred to a single controlled subsidiary. Under the historic liquidation/reincorporation case law prior to the repeal of the *General Utilities* doctrine, if "substantially all" of the Subsidiary's assets were dropped down to a single controlled subsidiary, the courts and IRS often treated the transaction as a tax-free "D" Reorganization, with the unincorporated assets treated as a "boot" distribution to Parent.[536] However, if the drop-down involved less than "substantially all" of the Subsidiary's assets, taxpayers generally hoped that that transaction would default to a §332 liquidation followed by a §351 transaction. The problem was that regulations under §331[537] and Rev. Rul. 76-429 suggested that §332 liquidation treatment may not be appropriate if "part" of Subsidiary's assets were reincorporated. In addition, the IRS's ruling policy prior to 2014[538] provided that a private letter ruling ordinarily would not be issued if part or all the liquidated assets were transferred to another corporation (1) that is an "alter ego" of the liquidating corporation, and (2) which, directly or indirectly, is owned at least 20% in value by at least 20% of the former shareholders of the liquidating corporation. This no-ruling position suggested that the IRS believed that the "alter ego" theory in *Telephone Answering Service Co. v. Commissioner*[539] might still prevent a liquidation from qualifying as a liquidation. The IRS finally removed this policy in 2014.[540]

Reg. §1.368-2(k)(1) resolves the foregoing debate in cases where the upstream merger or liquidation occurs first and the reincorporation involves a member of the "qualified group." The regulation provides that "[a] transaction otherwise qualifying as a reorganization under section 368(a) shall not be disqualified or recharacterized as a result of one or more subsequent transfers (or successive transfers) of assets or stock, provided that the requirements of §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." As a result, Reg. §1.368-2(k)(1) effectively *mandates* either "A" Reorganization or "C" Reorganization treatment if (i) upstream merger or liquidation can qualify not only as a liquidation but also an "A" or "C" Reorganization, and (ii) *any portion* of the liquidated assets are transferred to a controlled subsidiary within the "qualified group." Conversely, if there is no drop-down of any portion of the liquidated assets, and the upstream merger or liquidation otherwise meets the requirements of §332, the transaction will be governed by §332.[541]

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[529] The control requirement in §351 is determined by reference to §368(c).

[530] Rev. Rul. 2007-8.

[531] Rev. Rul. 76-123, Rev. Rul. 68-357.

[532] Rev. Rul. 76-123, Rev. Rul. 68-357. *Cf.* Rev. Rul. 84-44 (transfer of assets in Forward Triangular Merger may not be combined with third party's transfer of assets to Parent for purpose of qualifying latter transfer under §351); Rev. Rul. 68-349 (simultaneous transfers were not eligible for §351 when first transfer was made for sole purpose of qualifying second transfer under §351).

[533] Rev. Rul. 76-123, Rev. Rul. 68-357.

[534] Before the repeal of the *Bausch & Lomb* doctrine in 2000, an upstream merger of Subsidiary into Parent followed by a drop-down of the merged Subsidiary's assets into another controlled subsidiary could qualify as an "A" Reorganization (see Rev. Rul. 69-617), whereas an actual liquidation of Subsidiary into Parent followed by a drop-down to another subsidiary could not qualify as a "C" Reorganization. That is because the liquidation violated the "solely for voting stock" requirement, so there was no occasion to address whether an actual liquidation followed by a reincorporation could qualify as a "C" Reorganization followed by a §351 transaction, as opposed to a §332 liquidation followed by a §351 transaction.

[535] *See* III.A.5.b., above.

[536] *See, e.g.*, *Smothers v. United States*, 642 F.2d 894 (5th Cir. 1981).

[537] Reg. §1.331-1(c).

[538] *See, e.g.*, Rev. Proc. 2013-3, §4.01(22).

[539] 63 T.C. 423 (1974). Interpreting a Code provision under pre-1986 law, the Tax Court held that a liquidation followed by a reincorporation of the liquidated entity's assets into an "alter ego" entity did not constitute a liquidation (and, under the facts, such transaction did not qualify as a "D" Reorganization).

[540] Rev. Proc. 2014-3, §1.02(9).

[541] §332(b) (last sentence). The regulations provide that a transaction that qualifies as a complete liquidation and satisfies the requirements of §332 is generally governed by that provision, notwithstanding that the transaction otherwise qualifies as a reorganization under §368. Reg. §1.332-2(d), §1.332-2(e) *Ex.* The example describes the merger of a majority-owned subsidiary into its parent corporation. Notwithstanding that the transaction met the requirements for an "A" Reorganization, the example states that the transfer of the subsidiary's assets and liabilities to the parent corporation should be governed by §332. *See American Mfg. Co. v. Commissioner*, 55 T.C. 204, 219–20 (1970) ("The legislative history lends credence to a view that section 332 is intended to cover an area in which the reorganization nonrecognition provisions are inapplicable to a 'statutory merger or consolidation' under section 368(a)(1)(A) that, in substance and effect, is no more than a liquidation of a subsidiary into its parent with all assets going to the parent. Indeed, the regulations under section 332 go further and indicate that the nonrecognition provisions of

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Example: Subsidiary merges into Parent and Parent transfers all or a portion of the Subsidiary's assets to another Subsidiary (i.e., a so-called "liquidation-reincorporation transaction"). The liquidation-reincorporation transaction fails to qualify as a complete liquidation and should be tested as a reorganization.[542] The subsequent drop of Subsidiary's former assets constitutes a §351 exchange and does not prevent the merger from qualifying as an "A" Reorganization pursuant to §368(a)(2)(C).[543]

If the reincorporation occurs *before* the upstream merger or liquidation, Reg. §1.368-2(k)(1) does not literally apply; however, Rev. Rul. 58-93 suggests that the transaction should be treated as if the upstream merger or liquidation occurs first, followed by the reincorporation. In that ruling, corporation Y, owned 79% by corporation X and 21% by other shareholders, transferred all its assets to a controlled subsidiary, Z, and then merged into X. The IRS ruled that the transaction should be treated as if Y first merged into X, and then X transferred Y's assets to Z in a §368(a)(2)(C) transfer. Recently, however, the IRS has respected the form of this transaction, ruling it to be a drop-down of assets to a controlled subsidiary under §351, followed by a §332 liquidation of the transferor, seemingly in direct opposition to Rev. Rul. 58-93.[544]

If the upstream merger or liquidation does not meet the requirements for a §332 liquidation (e.g., because Parent does not own at least 80% of the combined voting power and at least 80% of the total value of all the stock of Subsidiary on the date that the plan for liquidation is put in place), and there is no drop-down of any portion of the liquidated assets to a controlled subsidiary within the qualified group, there is a question whether that transaction is governed by §331 or by §368 (assuming the requirements of an "A" Reorganization or "C" Reorganization are otherwise met). Unlike the rule in Reg. §1.332-2(d) that effectively says §332 overrides §368 (which is now subject to the rule in Reg. §1.368-2(k)(1) that effectively says §368 governs if there is a drop-down of any portion of the liquidated assets), there is no comparable override rule in §331 or the §331 regulations. Thus, it appears that a §331 liquidation in which there is no drop-down of any portion of the liquidated assets would, under Reg. §1.368-2(k)(1), be treated instead as a §368 reorganization if the requirements of an "A" Reorganization or "C" Reorganization are otherwise met.

Practice Point: A common method for triggering a capital loss in Subsidiary stock is for Parent to sell or otherwise transfer a portion of its Subsidiary stock to another person and then adopt a plan of liquidation for Subsidiary in a transaction treated as a §331 liquidation.[545] To ensure that the transaction will not be treated as a "C" Reorganization which would prevent the capital loss, a sufficient amount of Subsidiary stock should be transferred by Parent so that the assets distributed to Parent in the subsequent liquidation do not constitute "substantially all" of Subsidiary's assets. For what constitutes "substantially all," see III.C.5.b.

D. Corporate Alternative Minimum Tax Consequences

1. In General

The Inflation Reduction Act of 2022[546] amended §55(a) to impose an alternative minimum tax (CAMT) on certain "applicable corporations" effective for taxable years beginning after December 31, 2022.[547] Generally, the alternative minimum tax under §55(a) operates as an additional tax (rather than an "in lieu of" tax) computed on the basis of an applicable corporation's adjusted financial statement income (AFSI).

The CAMT is the excess of (i) an applicable corporation's tentative minimum tax, over (ii) the sum of that corporation's regular tax liability (determined under other applicable provisions of the Code) and its base erosion and anti-abuse tax (BEAT) under §59A.[548] Tentative minimum tax is the excess of (i) 15% of the applicable corporation's AFSI, over (ii) the CAMT foreign tax credit for the taxable year.[549] The term "applicable corporation" generally means any corporation (other than an S corporation, a regulated investment company, or a real estate investment trust) whose average annual AFSI during a prior three-taxable-year period ending with the taxable year of determination exceeds $1 billion.[550] Special income aggregation rules apply for purposes of determining whether a particular corporation is an applicable corporation.[551] For example, if

section 332 take precedence over the reorganization nonrecognition sections, when stock and other property have been exchanged in a parent-subsidiary merger which would result in recognition of 'other property' under the reorganization provisions, but for the fact that section 332 also applied."). *See* PLR 201404004 (statutory merger qualified as a §332 liquidation). For a discussion of the liquidation of subsidiaries under §332, see 784 T.M., *Corporate Liquidations.*

[542] *See* Rev. Rul. 69-617; Reg. §1.368-2(k) (the drop-down of *any portion* of Subsidiary's assets to another Subsidiary will cause the upstream merger to be treated as an "A" Reorganization rather than a §332 liquidation).

[543] *See* Rev. Rul. 69-617; Reg. §1.368-2(k). While Rev. Rul. 69-617 applied the liquidation-reincorporation doctrine to a nontaxable §351 transfer, this doctrine should equally apply to a taxable sale of a liquidating entity's assets to a related subsidiary. Rev. Proc. 90-52, §4.04(4), required a taxpayer seeking a private ruling under §332 to represent that the liquidation of Subsidiary would not be preceded or followed by the reincorporation in, or transfer *or sale to*, a recipient corporation (Recipient) of any of the businesses or assets of Subsidiary, if persons holding, directly or indirectly, more than 20% in value of the Subsidiary stock also hold, directly or indirectly, more than 20% in value of the stock in Recipient. *See also* PLR 201037026 (apparently applying the liquidation-reincorporation doctrine, the IRS ruled that the election by two corporations to be treated as disregarded entities (resulting in deemed liquidations) and the subsequent sale of the entities to related corporations for cash qualify, in each case, as a "Cash D" Reorganization under §368(a)(1)(D) and Reg. §1.368-2(l), by collapsing the liquidation and asset transfers).

[544] PLR 201026010, PLR 200733002.

[545] *Commissioner v. Day & Zimmerman, Inc.*, 151 F.2d 517, 519 (3d Cir. 1945) (discussing legislative recognition of elective feature); *Avco Mfg. Corp. v. Commissioner*, 25 T.C. 975 (1956) (*nonacq*) (sale of small number of shares on New York Stock Exchange caused loss on subsidiary liquidation to be recognized). *aff'd by stipulation*, 57-2 USTC ¶10021 (2nd Cir. 1957); PLR 201014002, PLR 201330004; FSA 200148004.

[546] Pub. L. No. 117-169, §10101.

[547] Pub. L. No. 117-169, §10101(f). Even though the imposition of additional tax under §55(a) does not apply until taxable years beginning after December 31, 2022, the determination of applicable corporation status applies to taxable years beginning after December 31, 2021. Accordingly, a calendar-year corporate taxpayer may become an applicable corporation as of December 31, 2022, but it will not owe tax under §55(a), if any, until its 2023 taxable year.

[548] §55(a).

[549] §55(b)(2)(A), §59(l).

[550] §59(k)(1)(A), §59(k)(1)(B)(i).

[551] *See* §59(k)(1)(D) (providing that the determination of whether a corporation is an applicable corporation for purposes of the CAMT is made based on the AFSI of persons treated as a single employer with such corporation under §52(a) or §52(b)).

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a tested corporation is a member of a "foreign-parented multinational group," as defined in §59(k)(2)(B), its status as an applicable corporation is determined by including the AFSI of all members of the group.[552] Once it is determined that a corporation is an applicable corporation, the 15% tax is applied to the corporation's AFSI, which is generally determined by reference to the corporation's income as reported on its applicable financial statement (AFS),[553] subject to certain adjustments, to determine tentative minimum tax.[554]

Treasury and the IRS published proposed rules related to the CAMT, supplementing interim guidance previously released in the form of four notices.[555] The proposed regulations would clarify and expand the guidance in Notice 2023-7, including guidance on computing AFSI in the context of various corporate recognition and nonrecognition transactions. Generally, the CAMT consequences of corporate transactions would be determined under financial accounting principles unless the CAMT entity qualifies solely for nonrecognition treatment under the relevant Code section.[556] Thus, if a transaction results in the recognition of any amount of gain or loss for regular tax purposes with regard to that CAMT entity (the "cliff effect"), the CAMT entity would apply the relevant financial accounting principles (and not the applicable Code section) to the covered recognition transaction.[557]

For a detailed discussion of the CAMT, including a discussion of the proposed CAMT regulations and other guidance, see 752 T.M., *Corporate Alternative Minimum Tax*, at IX.

2. Effect on Target Corporation

For acquisitive reorganizations other than B reorganizations, the proposed regulations would require the target corporation, when determining AFSI in a covered nonrecognition transaction, to: (1) disregard any FSI resulting from the exchange of target corporation property for acquiror stock; (2) apply §361(a) and §361(b) to the transfer (i.e., the transaction would not result in AFSI to the target corporation); (3) determine the CAMT basis of property received by applying §358, using CAMT basis in lieu of AFS basis; and (4) adjust its CAMT earnings (in lieu of AFS retained earnings) resulting from the transaction by applying §312.[558]

An additional rule would apply if the target corporation purges all "boot" received in the transaction (i.e., the target corporation distributes or transfers all non-qualifying property) and qualifies solely for nonrecognition treatment under §361(c). Under this proposed rule, the target corporation would disregard any FSI resulting from gain or loss with respect to the boot and determine its AFSI by applying §361(c) (i.e., the target corporation would not recognize any AFSI).[559] Thus, the "cliff effect" would be inapplicable.[560]

However, if the target corporation recognizes any gain or loss on the distribution or transfer of the boot to its shareholders or security holders, then the transaction would be a covered recognition transaction, and the target corporation would determine any gain or loss resulting from the distribution or transfer in its AFSI by reference to its CAMT basis (in lieu of AFS basis) in the distributed or transferred property.[561]

3. Effect on Acquiror Corporation

In an acquisitive reorganization that is a covered nonrecognition transaction with respect to the domestic acquiror corporation, the proposed regulations provide that the acquiror corporation would disregard any FSI resulting from the exchange of acquiror corporation stock or other property for target corporation assets, and instead apply §1032(a) in determining AFSI (i.e., the transaction would not result in AFSI to the acquiror corporation.[562] In addition, the acquiror corporation would take a carryover basis in the assets acquired, using CAMT basis in lieu of AFS basis.[563] The acquiror corporation also would be required to (1) adjust CAMT retained earnings (in lieu of AFS retained earnings) resulting from the covered nonrecognition transaction by applying §381(c)(2), [564] and (2) apply §381 to the target corporation's other attributes (i.e., the acquiror corporation succeeds to the target corporation's other attributes).[565]

In contrast, if an acquisitive reorganization is a covered recognition transaction with respect to the acquiror corporation, the transaction would be treated in the same manner as a taxable asset sale.[566] Similarly, if an acquisitive reorganization

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552 *See* §59(k)(2)(A). Once a corporation is determined to be an applicable corporation, that status continues to apply in each succeeding taxable year without a redetermination, unless (1) the corporation has a change of ownership, or (2) the corporation does not meet the AFSI test for a specified number of consecutive taxable years (termination test). *See* §59(k)(1)(C). Treasury and the IRS have proposed a period of five consecutive taxable years for the termination test. *See* Prop. Reg. 1.59-2(h)(2), REG-112129-23, 89 Fed. Reg. 75,062 (Sept. 13, 2024).

553 The AFS of a CAMT entity is the entity's financial statement that has the highest priority. *See* Prop. Reg. §1.56A-2(c) (adopting and adding to the list of financial statements and their priority set forth in 451(b)(3) and Reg. § 1.451-3(a)(5)). A CAMT entity is any entity identified in §7701, other than a disregarded entity. Prop. Reg. §1.56A-1(b)(8).

554 §55(b)(2)(A)(i), §56A(a).

555 REG-112129-23, 89 Fed. Reg. 75,062 (Sept. 13, 2024), *as corrected*, 89 Fed. Reg. 104,909 (Dec. 26, 2024). *See also* Notice 2024-10, Notice 2023-64, *modified by* Notice 2024-10, Notice 2023-20, Notice 2023-7, *modified and clarified by* Notice 2023-64.

556 *See* Preamble to REG-112129-23, 89 Fed. Reg. at 75,093. *See also* Prop. Reg. §1.56A-18(b)(9) (defining a covered nonrecognition transaction as a component transaction that, with regard to a party: (i) qualifies for nonrecognition treatment for regular tax purposes under §305, §311(a), §332, §337, §351, §354, §355, §357, §361, or §1032(a), or a combination of those sections, solely with regard to that party; (ii) is not treated as resulting in the recognition of any amount of gain or loss for regular tax purposes solely with regard to that party; and (iii) is not treated as a covered recognition transaction).

557 *See* Prop. Reg. §1.56A-18(b)(10) (defining a covered recognition transaction as a component transaction consisting of a transfer, sale, contribution, distribution, or other disposition of property that, with regard to a party, does not qualify as a covered nonrecognition transaction solely with regard to the party (and, therefore, could result in the recognition of gain or loss for regular tax purposes to the party)).

558 Prop. Reg. §1.56A-19(c)(1)(i). "CAMT basis" would be defined as the basis of an item for purposes of determining AFSI and, generally, would be the AFS basis of the item, as adjusted under the §56A regulations. Prop. Reg. §1.56A-1(b)(7).

559 Prop. Reg. §1.56A-19(c)(1)(ii).

560 *See* Preamble to REG-112129-23, 89 Fed. Reg. at 75,096.

561 Prop. Reg. §1.56A-19(c)(2).

562 Prop. Reg. §1.56A-19(c)(3)(i).

563 Prop. Reg. §1.56A-19(c)(3)(ii). *See also* §362(b).

564 Prop. Reg. §1.56A-19(c)(3)(iii).

565 Prop. Reg. §1.56A-19(c)(3)(iv).

566 Prop. Reg. §1.56A-19(c)(4)(i), Prop. Reg. §1.56A-18(h). Additional rules are proposed regarding the acquiror corporation parent in covered nonrecognition transactions and covered recognition transactions. Prop. Reg. §1.56A-19(c)(5) and Prop. Reg. §1.56A-19(c)(6), respectively.

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is a covered recognition transaction with respect to a target corporation shareholder or security holder, the transaction would be treated in the same manner as a taxable stock sale or a §351(b) transaction, as appropriate.[567]

4. *Effect on Target Corporation Shareholder or Security Holder in a Covered Nonrecognition Transaction*

Under the proposed regulations, a target corporation shareholder or security holder in a covered nonrecognition transaction would determine AFSI resulting from the transaction by:

- disregarding any resulting gain or loss reflected in its FSI;
- applying §354 or §356, as appropriate; and
- using the distribution amount reflected on its AFS, taking into account the CAMT basis in its target corporation stock.[568]

[567] *See* Preamble to REG-112129-23, 89 Fed. Reg. at 75,096. *See also* Prop. Reg. §1.56A-18(g), which would provide rules for determining the CAMT consequences of stock sales, and 758 T.M., *Transfers to Controlled Corporations: In General*, at IV.J.2.b., for discussion of determining AFSI resulting from a transaction to which §351(b) applies.

[568] Prop. Reg. §1.56A-19(c)(7)(i).

The target shareholder or security holder also would:

- determine the characterization of the distribution of property other than acquiring corporation stock, to the extent applicable, by applying the relevant Code section based on the CAMT earnings (in lieu of earnings and profits) of the target corporation;
- determine its CAMT basis in acquiring corporation stock or securities resulting from the distribution by applying the relevant Code section using the target corporation shareholder's or security holder's CAMT basis in the stock (in lieu of basis for regular tax purposes);
- determine its CAMT basis in property received from the target corporation by applying the relevant Code section, using CAMT basis in lieu of AFS basis; and
- adjust, to the extent applicable, its CAMT current earnings (in lieu of AFS retained earnings) resulting from the distribution by applying §312 based on its AFSI.[569]

[569] Prop. Reg. §1.56A-19(c)(7)(ii)–(v).

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IV. Acquisitive Stock Reorganizations

A. *The "B" Reorganization*

1. *General*

a. *General Description*

A "B" Reorganization is described as the acquisition by Parent (or Sub) of stock of Target in exchange solely for voting stock of Parent if, "immediately after" the exchange, Parent (or Sub) holds stock in Target representing "control" of Target.[570]

Comment: No Sub stock may be used if Parent stock is used in the exchange. Likewise, no Parent stock may be used if Sub stock is used in the exchange.

Practice Point: The "immediately after" requirement presumably means that a pre-existing commitment by Acquiror to dispose of Target stock following the acquisition, so that Acquiror loses control of Target, invalidates the "B" Reorganization.[571]

"Control" is defined as stock possessing 80% of the combined voting power of all stock of Target entitled to vote and 80% of the number of each class of Target stock not entitled to vote.[572] Thus, in a "B" Reorganization, Target remains in existence as a separate corporate entity controlled by Parent (or Sub).

"B" Reorganizations can be accomplished either by a direct exchange of stock by the Target shareholders with Parent (or Sub) in exchange for Parent voting stock, or through a reverse subsidiary merger (i.e., a merger of a newly formed subsidiary of Parent (or Sub) into Target), with the former Target shareholders receiving voting stock of Parent in exchange for their Target stock.[573] "B" Reorganizations involving an acquisition of Target stock by Sub in exchange for Parent stock, either directly or through a merger of a newly formed subsidiary of Sub, are referred to herein as triangular "B" (or parenthetical "B") Reorganizations.

b. *Practical Considerations*

Although a "B" Reorganization requires absolute compliance with the solely-for-voting-stock requirement, there is no requirement that Target hold substantially all of its historic assets following the acquisition. Thus, a "B" Reorganization provides flexibility in acquiring a target that, before the acquisition, distributed unwanted assets to its shareholders.[574] The absence of the "substantially all" requirement also adds flexibility to post-acquisition restructuring.[575]

Practice Point: Note, however, that Acquiror must still satisfy the COBE requirements as described in Reg. §1.368-1(d).

Additionally, because a "B" Reorganization is, in effect, an acquisition of stock of Target, the liabilities of Target remain with Target and do not become liabilities of Acquiror, as they would in an "A" Reorganization and possibly a "C" Reorganization (assuming such reorganizations were not consummated using a wholly owned LLC of Acquiror to hold Target's assets).

Practice Point: If a transaction structured as a reverse subsidiary merger fails to satisfy the requirements of a "B" Reorganization because a modicum of cash was used as consideration, the transaction may nevertheless qualify as a Reverse Triangular Merger under §368(a)(2)(E) if less than 20% of the consideration was comprised of cash and certain other requirements are met. [576]

If a purported "B" Reorganization fails to qualify as any type of tax-free reorganization, the transaction generally is treated as a taxable stock purchase in which the Target shareholders recognize gain or loss on the difference between the value of the Acquiror stock received and their basis in their Target stock.[577] Unlike a failed acquisitive asset reorganization, any inherent gain in Target's assets is not recognized unless a §338 or a §336(e) election is made.[578] Acquiror recognizes no gain on a direct issuance of its stock,[579] but if Sub issues the Parent stock in the exchange, Sub may face the risk of recognizing gain under a zero basis theory.[580]

Additionally, under §368(a)(2)(C), Acquiror (or Sub, in a triangular "B" Reorganization) is free to drop down the Target stock acquired to a controlled corporation.[581]

2. *Consideration Given by Acquiror*

a. *"Solely for Voting Stock" Requirement*

As stated above, one of the requirements of a "B" Reorganization is that the exchange of Target stock must be solely for "voting stock" of Acquiror. The definitional limits of the phrase "solely for voting stock" are the same for "B" Reorganizations as for "C" Reorganizations. For a discussion of these definitional limits, see III.C.3. and III.C.4., above.

There is at least one instance in which the "solely for voting stock" requirement is implicated in the context of a "B" Reorganization and not in a "C" Reorganization. For example, in Rev. Rul. 69-294, X corporation owned all the stock of Y corporation, which in turn owned 80% of Z corporation, with unrelated third parties owning the other 20%. Pursuant to a plan, X caused Y to liquidate under §332, and immediately thereafter X acquired the remaining shares of Z from the minority shareholders using X's voting stock. Reg. §1.332-1 provides

[570] §368(a)(1)(B). For an illustration of the "B" Reorganization, see *§368(a)(1)(B) — "B" Reorganization*, in the Bloomberg Tax Transactional Diagrams Library.

[571] *Cf.* Rev. Rul. 2003-51 (IRS ruled that subsequent transfer pursuant to pre-existing binding arrangement nevertheless satisfies "immediately after" test for §351 when transfer separately qualifies for nonrecognition treatment); Rev. Rul. 70-140 ("immediately after" test in §351 context was not met).

[572] §368(c). For more on the control requirement, see IV.A.3., below.

[573] Rev. Rul. 67-448, Rev. Rul. 56-613. *See, e.g.*, PLR 200941009. For a further discussion of "B" Reorganizations involving Sub or accomplished by merger, see IV.A.6. and IV.A.7., below.

[574] *See* IV.A.5., below.

[575] Compare the effects of the substantially all requirement in "C" Reorganizations, discussed in III.C.5., above.

[576] *See* IV.A.8.b., below.

[577] §1001.

[578] *See* §338(g), §338(h)(10), and §336(e).

[579] §1032. *See Tribune Co. v. Commissioner*, 125 T.C. 110 (2005) (transaction by which parent company divested itself of legal publishing business conducted by subsidiary did not qualify as "B" Reorganization or Reverse Triangular Merger when terms and provisions of contractual documents effected sale).

[580] *See* III.B.5.b., above, and IV.A.6.e., below.

[581] *See* Reg. §1.368-2(k).

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that amounts received by one corporation in complete liquidation of another corporation are treated as in full payment in exchange for stock in such other corporation. As a result, the IRS concluded the transaction failed the "solely for voting stock" requirement for a "B" Reorganization because X acquired 80% of the Z shares in exchange for its Y stock — not the stock of X.[582]

Reg. §1.368-2(d)(4) overturned this result in in the context of a "C" Reorganization. However, the IRS declined to extend this result to "B" Reorganizations. In the preamble to these regulations, the IRS stated that Rev. Rul. 69-294, and by implication "B" Reorganizations, were "beyond the scope of this regulation project, which relates to a 'C' reorganization."[583] The IRS did state that it may reconsider Rev. Rul. 69-294 in future guidance.

b. Degree of Permissible Boot

Two questions arise in connection with boot in a "B" Reorganization. The first is whether, if consideration is used in addition to voting stock and the transaction fails to qualify as a "B" Reorganization, the transaction may nonetheless be tax-free to the extent Target shareholders receive Acquiror voting stock. The second is whether a transaction may qualify as a "B" Reorganization if sufficient Acquiror voting stock is used to acquire stock representing "control" of Target but other consideration is used by Acquiror to acquire the remaining Target stock.

The answer to the first question is well settled. In *Turnbow v. Commissioner*,[584] a case arising under the 1939 Code equivalent of §368(a)(1)(B), the taxpayer transferred all the stock of his wholly owned corporation to the acquiring corporation for voting stock of the acquiring corporation worth approximately $1.2 million plus $3 million in cash. The Tax Court held that, although the exchange did not qualify as a "B" Reorganization, the exchange was taxable to the taxpayer only to the extent of the cash received. In so holding, the Tax Court relied on the 1939 Code predecessor to §356, which provided that if the general nonrecognition provisions of the 1939 Code predecessor to §354 would apply but for the receipt of nonqualifying property, gain had to be recognized only to the extent of the nonqualifying property received.[585]

The Ninth Circuit[586] reversed the Tax Court,[587] and the Supreme Court[588] sustained the Ninth Circuit. Given that the transaction did not qualify as a "B" Reorganization, the Court held that §354 and §356 were inapplicable.

The second question (i.e., whether a valid "B" Reorganization can occur when the Target shareholders receive other consideration for their Target shares in addition to voting stock of Acquiror) has been debated extensively at the lower and circuit court levels but has yet to be resolved by the Supreme Court.[589] However, as discussed below, each of the three circuit courts addressing the issue have held that the definition of a "B" Reorganization prohibits the payment of any consideration other than Parent voting stock to the Target shareholders in exchange for their Target stock.

In *Howard v. Commissioner*,[590] a case decided under the 1939 Code, the Seventh Circuit held that if the acquiring corporation used its voting stock to acquire more than 80% of the stock of Target but acquired additional stock from the Target shareholders for cash, there was no valid "B" Reorganization.

The Third Circuit and the First Circuit considered the issue more than 20 years after *Howard* in hearing appeals of several lower court cases that had arisen from the same transaction. In the transaction before the courts, International Telephone & Telegraph Corporation (ITT) had acquired 6% of the common stock of Hartford Fire Insurance Company for cash from a third party. ITT then acquired an additional 2% of Hartford's common stock on the open market. A little more than a year later, ITT acquired from the shareholders of Hartford, solely in exchange for ITT voting stock, an amount of stock in Hartford representing control of Hartford. The shareholders who exchanged Hartford stock for ITT stock claimed that ITT's acquisition of the controlling interest in Hartford qualified as a "B" Reorganization.

The Commissioner first litigated the issue in the Tax Court[591] and a district court,[592] arguing that the prior cash purchases prohibited a subsequent "B" Reorganization, and lost in both forums. A divided Tax Court held that, while the purchases of the Hartford stock and the subsequent stock-for-stock exchange were part of the same plan by ITT to acquire the stock of Hartford, the prior purchases should be separated from the one in which control of Hartford was acquired in determining whether a valid "B" Reorganization had occurred. The district court held that the presence of boot in a transaction in which control of a Target otherwise is acquired for voting stock of Acquiror does not preclude treatment of the overall transaction as a "B" Reorganization.

The Commissioner's argument, however, was successful on appeal. In reversing and remanding the lower court deci-

[582] In contrast, in Rev. Rul. 69-585, the IRS concluded that the acquiring corporation did not violate the "solely for voting stock" requirement when it acquired the shares of its third-tier subsidiary via a §301 distribution from the second-tier subsidiary. According to Rev. Rul. 69-585, the distribution of shares under §301 was not an impermissible acquisition for purposes of the "solely for voting stock" requirement because the acquiring corporation "did not surrender any property" in the distribution and, therefore, the distribution was not an "exchange." Thus, the IRS appears to have distinguished between acquisitions of target corporation stock in an exchange versus a distribution.

[583] Preamble to T.D. 8885, 65 Fed. Reg. 31,805 (May 19, 2000).

[584] 368 U.S. 337 (1961), aff'g 286 F.2d 669 (9th Cir. 1960), rev'g 32 T.C. 646 (1959).

[585] The Tax Court's decision in *Turnbow* was in accord with *Howard v. Commissioner*, 238 F.2d 943 (7th Cir. 1956), which held that when some exchanging shareholders received solely voting stock and others received cash, the shareholders receiving solely voting stock did not recognize gain.

[586] 286 F.2d 669 (9th Cir. 1960).

[587] 32 T.C. 646 (1959).

[588] 368 U.S. 337 (1961).

[589] *Cf. Helvering v. Sw. Consol. Corp.*, 315 U.S. 194 (1942), reh'g denied, 315 U.S. 829 (1942), reh'g denied, 316 U.S. 710 (1942) (dictum suggesting that solely-for-voting-stock requirement prohibits issuance of any boot). The IRS established its position on this question in Rev. Rul. 75-123 (acquisition of 80% of Target's stock for Acquiror stock did not qualify as "B" Reorganization when Acquiror purchased 20% balance for cash).

[590] 238 F.2d 943 (7th Cir. 1956). Howard was effectively reversed by *Turnbow* on the issue of whether shareholders receiving solely voting stock in a transaction that does not qualify as a tax-free reorganization can receive that stock without recognizing gain.

[591] *Reeves v. Commissioner*, 71 T.C. 727 (1979), rev'd and rem'd sub nom., *Chapman v. Commissioner*, 618 F.2d 856 (1st Cir. 1980), cert. dismissed, 451 U.S. 1012 (1981).

[592] *Pierson v. United States*, 472 F. Supp. 957 (D. Del. 1979), rev'd and rem'd sub nom., *Heverly v. Commissioner*, 621 F.2d 1227 (3d Cir. 1980).

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sions, the First and Third Circuits held that the solely-for-voting-stock requirement precludes the use of any consideration other than voting stock for Target's stock in a "B" Reorganization. The cases were remanded to the lower courts for a determination as to whether the prior cash purchases and the subsequent stock-for-stock exchange were, in fact, part of a single plan of reorganization. Before the Supreme Court could act on the appeals filed by the taxpayers, the Service and ITT reached an agreement that preempted any further litigation.

Practice Point: Given the IRS's litigating position in these cases, the decisions of the First and Third Circuits, and the decision of the Seventh Circuit in *Howard*, most tax practitioners operate on the presumption that the solely-for-voting-stock requirement in a "B" Reorganization absolutely precludes Acquiror from issuing anything other than voting stock in exchange for Target stock.[593] It should be noted, however, that the concept of nonqualified preferred stock presents the possibility that an Acquiror could issue voting stock in a "B" Reorganization that would be treated as boot to the Target shareholder.[594]

Practice Point: Although Acquiror may not use any consideration other than voting stock in exchange for Target stock, Target shareholders may sell their Target stock to third parties before the reorganization or sell to third parties the Acquiror voting stock received in the reorganization, subject to the general continuity of interest (COI) restraints applicable to all reorganizations. For a discussion of COI, see V.A., below.

c. Assumption of Liabilities

Because a "B" Reorganization does not involve a transfer of Target's assets and liabilities, but rather an exchange directly between Target's shareholders and Acquiror with Target remaining in existence, the solely-for-voting-stock requirement is applied only with respect to the consideration passing from Acquiror to Target's shareholders. Accordingly, the statute contains no definitional limits regarding Acquiror's assumption of Target's liabilities. Further, the rules determining whether Acquiror's assumption of Target's liabilities requires Target to recognize gain on the transfer of its assets — specifically §357(a), §357(b), and §361 — are wholly inapplicable to a "B" Reorganization.[595]

Comment: If the stock of Target is virtually worthless, so that the creditors of Target are, in effect, its owners, the validity of the "B" Reorganization may depend upon the consideration given to those creditors.[596]

On the other hand, Acquiror's assumption of liabilities or expenses owed or incurred by Target's shareholders, as opposed to those liabilities of Target itself, generally violates the solely-for-voting-stock requirement.[597] For example, Acquiror's assumption or payment of certain reorganization expenses incurred by Target shareholders violates the "solely" requirement.

Comment: In the context of a "C" Reorganization, the IRS has ruled that Acquiror's payment of certain reorganization expenses, if paid directly to the creditors, will not violate the "solely" requirement. These expenses generally include expenses that are appropriately incurred at the Target level, such as legal and accounting expenses, appraisal fees, and administrative costs.[598] However, Acquiror's assumption or payment of certain reorganization expenses directly attributable to Target's shareholders, such as investment advice or stock transfer taxes that are not also owed by Target, violates the "solely" requirement. This aspect of the ruling is equally applicable to a "B" Reorganization.[599]

In addition, Acquiror's assumption or payment of a Target liability guaranteed by a Target shareholder does violate the "solely" requirement if the shareholder is regarded as the true debtor under general debt-equity principles and the assumption or payment is a condition for (and therefore a part of) the reorganization. In Rev. Rul. 79-4, the IRS held that the solely-for-voting-stock requirement was violated when debt of Target, which debt was guaranteed by the exchanging shareholder, was repaid as a condition of the exchange by Target with funds provided by Acquiror. In contrast is Rev. Rul. 79-89, in which Acquiror contributed funds to Target to enable Target to discharge a debt to a third party, which debt was guaranteed by one of the two former shareholders of Target (but respected as debt of Target under general debt-equity principles). The IRS ruled that, because the contribution was not a condition of the exchange and the fair market values of the Acquiror stock received by each of the two shareholders of Target were equivalent, the contribution and repayment did not constitute additional consideration.[600] The IRS noted that the liability assumed was a bona fide debt of Target, whereas, in Rev. Rul. 79-4, the guarantor-shareholder was the true debtor under general debt-equity principles.[601]

Practice Point: Tax planners should be cautious in structuring a "B" Reorganization in which Target has shareholder guaranteed debt. Based on the rulings cited above, it generally would be inadvisable to enter into any agreement regarding the discharge of shareholder-guaranteed debt if it is possible that the shareholder could be regarded as the true debtor for federal income tax purposes. Moreover, if Target has more than one shareholder and not all the Target shareholders have guaranteed Target debt, a difference in the amount of Acquiror stock given to the guarantor-shareholders may be evidence of disguised boot that could invalidate the "B" Reorganization.

When Acquiror directly assumes or pays Target liabilities owed to Target shareholders, the solely-for-voting-stock requirement is not implicated so long as the Target shareholders are paid (or receive the benefit of Acquiror's assumption) in their capacity as creditors of Target. The IRS, in Rev. Rul.

[593] *See Clark v. Commissioner*, 86 T.C. 138 (1986) (stating that no boot is permitted in "B" Reorganization).

[594] §351(g)(2), §356(e)(1). *See* VI.E.1., below.

[595] For a discussion of these rules in the context of acquisitive asset reorganizations, see III.A.2.c. and III.C.2.c., above.

[596] *Cf.* §368(a)(1)(G); *Helvering v. Ala. Asphaltic Limestone Co.*, 315 U.S. 179 (1942); Rev. Rul. 59-222. *See also* V.A.4., below.

[597] Rev. Rul. 79-4.

[598] Rev. Rul. 73-54.

[599] *See* III.C.4.a., above. *See also* PLR 9508009 (corporation's acquisition of all of Target's stock in exchange for corporation's voting stock and payment of certain personal expenses of Target's shareholders — e.g., investment, estate planning, and accounting advice — did not qualify as "B" Reorganization because, under Rev. Rul. 73-54, corporation's payment of personal expenses violated solely-for-voting-stock requirement).

[600] *Cf.* Rev. Rul. 70-65 (assumption of shareholder's liability as boot).

[601] For a discussion of the relative importance of the "condition of exchange" and "true debtor" aspects of these rulings, see III.A.2.c.(3), above.

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98-10,[602] reversed a position it had taken in Rev. Rul. 69-142, and stated that tax-free treatment under §354(a)(1) applies to the exchange of debentures of the same principal amount, when it occurs as part of a "B" Reorganization, if Target shareholders received exclusively voting stock of Acquiror as consideration and a "substantial proportion" of the Target debentures were held by bondholders who owned no stock in Target. That a substantial proportion of the Target debentures are held by non-Target shareholders "has the effect of ensuring that the value of the debentures" issued by Acquiror "does not constitute indirect nonqualifying consideration for the [Target] stock," the IRS stated. Thus, the debenture exchange — while not part of the stock-for-stock "B" transaction that qualifies for reorganization treatment — meets all of the conditions of §354(a)(1), and, accordingly, any realized gain or loss by the debenture holders is not recognized. The same §354 treatment applies when Target bonds are surrendered in exchange for Acquiror voting stock.[603] Nevertheless, if there is a significant overlap of Target shareholders and Target bondholders, Acquiror must be careful to ensure that Target bonds are not purchased for more than their fair market value and (at least in part) for nonvoting stock consideration (or the excess may be construed as consideration paid for Target stock).[604]

d. Existence of Nonstock Consideration

The circumstances in which Acquiror may be deemed to have issued nonstock consideration in addition to its voting stock in a purported "B" Reorganization are substantially identical to the those in the "C" Reorganization context, discussed in III.C.4., above. The major difference in this area between "B" and "C" Reorganizations involves the assumption of liabilities in connection with a "C" Reorganization. Liability-assumption problems in a "C" Reorganization generally are not present in a "B" Reorganization.

3. The Control Requirement

a. "Control" Defined

For purposes of the reorganization provisions of the Code (and for purposes of §351 and §355), "control" is defined in §368(c) as requiring "the ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation." The IRS interprets the latter part of this phrase to mean 80% of the total number of shares of each of the classes of nonvoting stock of the corporation.[605]

> *Example:* If a corporation has outstanding two classes of nonvoting stock, each with 100 shares, "control" requires ownership of at least 80 shares of each class of nonvoting stock. Ownership of 100 shares of one class and 60 shares of the other would not be sufficient.

The §368(c) definition of "control" is mechanical and artificial. The requirement of obtaining control of each class of nonvoting stock means that Acquiror must acquire stock that may be insignificant relative to the overall value of Target's outstanding stock. In contrast, the concept of "control" used for purposes of determining affiliation and the privilege of filing consolidated returns is determined on the basis of aggregate voting power and value without regard to numbers or classes of shares, and it ignores preferred stock that is nonvoting, nonconvertible, and does not participate in corporate growth to any significant extent.[606]

The §368(c) definition of "control" creates potential traps. For example, if debt is recharacterized for federal tax purposes as stock, it generally is characterized as nonvoting preferred stock. If Target has outstanding debt that, for federal tax purposes, should be considered stock, Acquiror's failure to obtain that debt precludes a valid "B" Reorganization because Acquiror has not acquired 80% of that "class" of preferred stock. If debt held proportionately by Target shareholders is recharacterized as equity, that equity may be considered additional common stock equity. In such cases, failure to acquire the debt does not necessarily preclude a "B" Reorganization, if Acquiror otherwise obtains 80% of the Target common stock.

Although §368(a)(1)(B) requires Acquiror to be in control of Target after the exchange, it is immaterial whether Acquiror was in control of Target before the exchange.[607] Thus, it is possible to have a valid "B" Reorganization when, for example, Acquiror already owns 98% of all classes of Target stock.

The control requirement following a "B" Reorganization must be met by Acquiror alone and cannot be satisfied by Acquiror in conjunction with one or more other related corporations, because attribution rules do not apply to §368(c). Thus, the IRS has ruled that Acquiror's acquisition of 50% of Target's stock, when the remaining 50% was held by Acquiror's wholly owned subsidiary, could not qualify as a "B" Reorganization.[608]

Acquiror may also qualify each one of a series of exchanges as part of a valid "B" Reorganization, provided that (i) all such exchanges take place over a relatively short period of time, such as 12 months, as part of a preconceived plan, (ii) all such exchanges are accomplished in exchange solely for voting stock, and (iii) after the final exchange, Acquiror is in control of Target.[609] The longer the time period separating the exchanges, the less likely it is that Parent can establish that the exchanges were part of a single preconceived plan. The opportunity to aggregate a series of transactions cuts two ways, how-

[602] *Modifying and superseding* Rev. Rul. 69-142, *modifying* Rev. Rul. 70-41.

[603] Rev. Rul. 98-10, *modifying* Rev. Rul. 70-41. In Rev. Rul. 98-10, the IRS stated that §354 applies to the exchange of debentures for stock; such an exchange had been ruled taxable under §1001 in Rev. Rul. 70-41.

[604] Rev. Rul. 78-408, *modified by* Rev. Rul. 98-10.

[605] Rev. Rul. 59-259.

[606] §1504(a)(4). Note that the control requirement in §368(c) is similar to that in the pre-1984 version of §1504(a). Under the latter provision, it was often possible to create two or more classes of voting stock, one with higher voting power relative to equity. *See, e.g.*, TAM 8030007 (IRS respected two classes of common stock for §1504(a) purposes, one with six votes per share and one with one vote per share). *Cf.* PLR 8339020 (class of preferred stock having 80% voting power was not respected for §1504(a) purposes).

[607] Reg. §1.368-2(c).

[608] Rev. Rul. 56-613. *See also Berghash v. Commissioner*, 43 T.C. 743 (1965), aff'd, 361 F.2d 257 (2d Cir. 1966).

[609] Reg. §1.368-2(c).

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ever, in that prior purchases of Target stock for cash may be aggregated with a later stock-for-stock exchange to prohibit the latter exchange from qualifying as a "B" Reorganization.[610]

In *American Potash & Chemical Corp. v. United States*,[611] Acquiror acquired 48% of the outstanding stock of Target in one transaction, and acquired the remaining 52% in a second transaction 14 months later. All of the Target shares were acquired in exchange for Acquiror stock. Note that Acquiror also tendered a nominal amount of cash in lieu of the fractional shares to avoid the distribution of fractional shares that sometimes results from the application of a stock-for-stock exchange ratio. In this situation, the cash did not violate the solely-for-stock requirement provided the cash merely represents a mechanical rounding-off of the fractions resulting from the exchange and is not separately bargained-for consideration.[612] The Claims Court, citing Reg. §1.368-2(c), held that Acquiror must obtain control of Target within a 12-month period for the transaction to qualify as a "B" Reorganization.[613] The government petitioned for reconsideration, and argued that the 12-month period mentioned in the regulations was merely a guideline and not an absolute limitation.[614] On reconsideration, the court held that if a series of stock-for-stock exchanges spanning more than 12 months are to be aggregated as a "B" Reorganization, they must "have been part of a continuing offer to purchase."[615] Having determined that there were two offers over a 14-month period, the court held that a "B" Reorganization had not occurred.

b. Restructuring to Satisfy the Control Requirement

As discussed above, stock in Target held by other members of Acquiror's affiliated group cannot be counted toward the control requirement. If a subsidiary owns some Target stock that Acquiror needs to meet the control requirement, and that stock was not acquired by the subsidiary pursuant to the reorganization, Acquiror's acquisition of the stock in a dividend distribution is regarded as Target stock acquired in exchange for Acquiror voting stock.[616] Presumably, the same would be true if Target stock were owned by a brother-sister company and that stock were distributed as a dividend to the common parent and contributed by the parent to Acquiror. As discussed in IV.A.2.a., however, the IRS has held that where an Acquiror acquired the necessary stock from its subsidiary in a liquidation of the subsidiary, the overall transaction did not qualify as a "B" Reorganization because the Target stock acquired in the liquidation is deemed to have been received in exchange for the subsidiary's stock.[617]

Acquiror is not required to obtain 80% of each class of voting stock, provided 80% of the total voting power is obtained; the class-by-class requirement applies only to classes of nonvoting stock. In Rev. Rul. 76-223,[618] Target recapitalized its nonvoting preferred stock (its only class of stock other than common stock) into voting preferred stock carrying 19% of the total voting power of all Target's stock. Acquiror was then able to effect a "B" Reorganization by acquiring only Target's common stock.

4. Effect of Parent's Pre-Existing Ownership of Target

a. "Old and Cold" Test

Acquiror, at a time when it wants to acquire the remaining Target stock in a "B" Reorganization, may already hold some Target stock that it previously purchased from Target shareholders for cash. As discussed in IV.A.2., above, no consideration for Target stock other than Acquiror voting stock is permitted in a "B" Reorganization. If the prior cash purchases of Target stock are integrated with the later stock-for-stock exchange, those cash purchases have the effect of invalidating the exchange as a "B" Reorganization. In cases in which the cash purchases are integrated, Target stock purchased for cash is sometimes referred to as "hot stock." Purchases of Target stock directly from Target are permitted and are not hot stock, provided that the cash is not distributed to the Target shareholders.[619]

If Target stock purchased by Acquiror is "old and cold" stock (rather than hot stock), however, the subsequent exchange should qualify as a valid "B" Reorganization. The phrase "old and cold" is shorthand for Target stock purchased by Acquiror *not* as part of the plan that includes the subsequent stock-for-stock exchange; prior purchases of old and cold stock should not be integrated with the exchange. The length of time that passes between the stock purchases and the later exchange is one factor to be considered in determining whether the purchased stock is old and cold. The regulations specifically approve a "B" Reorganization following a cash purchase when the exchange occurs 16 years after the cash purchase of Target's stock.[620]

Practice Point: Presumably, 16 years does not represent the minimum amount of time that must pass for purchased stock to become old and cold.

The factors to be considered in determining whether Acquiror's purchase of Target stock is old and cold are generally the same as those in any step transaction analysis. For a further discussion of these factors, see V.D., below.[621]

b. Target Stock Purchased by Acquiror Affiliates, Acquiror Shareholders, or Target

Acquiror cannot avoid the hot stock problem by using one of its subsidiaries to effect a cash purchase of Target stock. In Rev. Rul. 85-139,[622] in a purported "B" Reorganization, Acquiror acquired 90% of Target's stock solely in exchange for

[610] *See* IV.A.4., below.
[611] 399 F.2d 194 (Ct. Cl. 1968).
[612] Rev. Rul. 66-365.
[613] 399 F.2d at 200.
[614] 402 F.2d 1000 (Ct. Cl. 1968).
[615] 402 F.2d at 1001.
[616] Rev. Rul. 69-585.
[617] Rev. Rul. 69-294. Note that in the preamble to regulations issued in 2000 (repealing *Bausch & Lomb*), the IRS announced that it might reconsider this ruling in light of the decision to the extent necessary to be consistent with its revised position regarding upstream "C" Reorganizations. Preamble to T.D. 8885, 65 Fed. Reg. 31,805 (May 19, 2000).
[618] *Cf.* Rev. Rul. 69-407 (recapitalization to satisfy control requirement for §355 distribution); Rev. Rul. 56-117 (same); GCM 34122 (May 8, 1969) (same).
[619] Rev. Rul. 72-522.
[620] Reg. §1.368-2(c).
[621] For a discussion of this issue in the context of "C" Reorganizations, see III.C.7.a., above.
[622] *See also* GCM 39400 (June 7, 1983).

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its voting stock. At the same time, Acquiror caused one of its wholly owned subsidiaries to acquire the remaining 10% of Target's stock for cash. The IRS ruled that the transaction did not qualify as a "B" Reorganization because the acquisition was not effected solely for voting stock.

Rev. Rul. 85-139 is distinguishable from Rev. Rul. 68-562, in which a portion of Target's stock was purchased by an individual 50% shareholder of Acquiror two months before the purported "B" Reorganization. The IRS ruled in Rev. Rul. 68-562 that the purchase did not disqualify the subsequent "B" Reorganization, because the shareholder was acting in his individual capacity in the purchase (not on behalf of Acquiror) and was under no obligation to transfer the stock to Acquiror.

Comment: The COI regulations address the effect of purchases of Target stock by corporations related to Acquiror, but the regulations do not indicate whether the solely-for-voting-stock requirement is satisfied.[623]

Redemptions of Target stock by Target in connection with "B" Reorganizations do not violate the solely-for-voting-stock requirement, provided that the redemptions are not, in fact, funded by Acquiror.[624]

Practice Point: In determining that the redemptions are not, in fact, funded by Acquiror, Acquiror's advisors must be reasonably confident that Target will not require a cash infusion from Acquiror shortly after the reorganization. The need for such a cash infusion may suggest that Target's own funds were insufficient to fund the redemption and that Acquiror provided the needed consideration.[625]

c. Purging Hot Stock

Although Acquiror (or one of its subsidiaries) may own hot stock in Target, that ownership does not absolutely preclude a subsequent "B" Reorganization. If Acquiror desires to purge itself of hot stock to effect a "B" Reorganization, it may do so by unconditionally selling that stock to an unrelated third party before an offer is made to the Target shareholders to acquire their shares for voting shares of Acquiror, provided the purchaser is free to retain the shares or exchange them in the reorganization and Acquiror has no agreement or other arrangement to reacquire the shares if the reorganization does not take place.[626] If Acquiror holds Target stock purchased for cash from Target shareholders, and Acquiror is unsure whether the stock is old and cold, a purge generally is advisable in the absence of business exigencies dictating otherwise.[627]

d. Subsequent Cash Purchases by Acquiror

The hot stock problem is equally applicable when Acquiror initially acquires an amount of stock representing control (but less than 100%) of Target solely for Acquiror voting stock, and Acquiror subsequently, as part of the same plan, purchases Target stock from the remaining Target shareholders for consideration other than Acquiror voting stock. Such a purchase disqualifies the "B" Reorganization status of the prior stock-for-stock exchange, and no purge mechanism is available. Target shareholders who exchange their stock for Acquiror voting stock in a transaction in which Acquiror obtains less than all Target stock thus run a risk that their tax-free treatment will be retroactively invalidated by later Acquiror cash purchases.

5. No "Substantially All" Requirement

Unlike a "C" Reorganization, Forward Triangular Merger or Reverse Triangular Merger, the "B" Reorganization rules do not contain a "substantially all the assets" requirement. Target is therefore free to distribute assets unwanted by Acquiror to the Target shareholders before a "B" Reorganization. Subject to the requirements of §355(e) and assuming certain other requirements are met, the distribution of the stock of a subsidiary of Target to the Target shareholders may qualify for tax-free treatment under §355.[628] If Target has excess cash, it may distribute that cash to Target shareholders as a dividend or in redemption of a portion of their Target stock.[629]

The absence of the "substantially all" requirement also adds flexibility in post-acquisition restructurings. Target is free to push down assets to a controlled subsidiary or to push up assets to Acquiror, without regard to whether those transactions cause Target to hold less than substantially all its assets.[630]

Practice Point: If Target is liquidated into Acquiror following the acquisition, the purported "B" Reorganization may be recharacterized as a "C" Reorganization, thereby bringing the "substantially all" requirement into play. [631] If such liquidation, however, is accomplished through an upstream merger, the purported "B" Reorganization may be recharacterized as an "A" Reorganization which would not implicate the "substantially all" requirement.[632]

6. Triangular "B" Reorganizations

a. Issuance of Parent Stock

If Parent stock is to be used as the consideration in a "B" Reorganization, it must be issued by Parent or a first-tier subsidiary of Parent.[633] Section 368(a)(1)(B) permits the exchange

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[623] Preamble to Reg. §1.368-1(e), T.D. 8760, 63 Fed. Reg. 4174 (Jan. 28, 1998).

[624] Rev. Rul. 75-360, Rev. Rul. 68-285, Rev. Rul. 55-440.

[625] Rev. Rul. 74-565.

[626] Rev. Rul. 72-354. *Cf. Day & Zimmermann, Inc. v. United States*, 151 F.2d 517 (3d Cir. 1945) (sale of stock of subsidiary by Parent to reduce Parent's holdings to less than 80% before liquidation of subsidiary successfully removed liquidation from §332; sale was bona fide).

[627] A purge was accomplished before at least one public transaction. *See Occidental Sale of Hooker Stock Avoids Creeping Reorg.*, 29 J. Tax'n 256 (1968).

[628] For a discussion of §355, see 776 T.M., *Corporate Separations*. *Cf. Helvering v. Elkhorn Coal Co.*, 95 F.2d 732 (4th Cir. 1937) (tax-free spin-off prior to purported "C" Reorganization violated "substantially all" requirement).

[629] Rev. Rul. 68-435, Rev. Rul. 56-184.

[630] *See* Rev. Rul. 74-35 ("B" Reorganization followed by Target's distribution of 30% of its assets to Acquiror is respected as "B" Reorganization followed by separate §301 distribution). *See* PLR 9811024 (Acquiror's exchange of voting stock in exchange for all outstanding stock of Target, followed by §301 distribution to Acquiror of Target subsidiary's stock, was treated as acquisition of Target's stock solely in exchange for Acquiror's voting stock within meaning of §368(a)(1)(B)). For a discussion of how the "substantially all" requirement affects post-acquisition restructurings, see III.C.5.f. and III.C.5.i., above.

[631] *See* III.C.9., above.

[632] *See* Rev. Rul. 2001-46.

[633] *See* Rev. Rul. 56-613. *See also* PLR 9739047 (acquiring corporation issued its stock in exchange for all stock of S corporation target and then contributed some of its voting stock to target, which exchanged it for stock that minority shareholders held in subsidiary of target; acquisition of target and acquisition of 100% control of target subsidiary qualified as "B" Reorganizations).

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to be made solely for voting stock of a corporation that is "in control of" Acquiror. Defined in §368(c), "control" requires direct ownership of Acquiror. Because ownership attribution rules do not apply to §368(c), stock of a grandparent does not suffice. Issuance of Parent stock by a second-tier or lower subsidiary cannot qualify as a "B" Reorganization.[634] However, if it is desirable to lodge the Target stock in a second-tier subsidiary, the parties should consider combining a triangular "B" Reorganization and a drop-down of the Target stock from Sub to Sub's controlled subsidiary pursuant to §368(a)(2)(C).[635]

In Notice 2006-85, the IRS announced that regulations will be issued under §367(b) addressing triangular reorganizations in which Controlling or Controlled is foreign, known as the "Killer B" transaction. The notice indicated that the regulations will treat the transfer of property by Sub to Parent as a §301(c) distribution and as a separate transaction from the underlying tax-free reorganization. The IRS followed up with Notice 2007-48, in which it announced that the anti-Killer B regulations would also cover transactions in which a subsidiary purchases Parent stock from the Parent's shareholders, including purchases from public shareholders.

In 2008, Treasury issued temporary regulations under §367(b) to adopt the approach to Killer B transactions described in Notice 2006-85 and Notice 2007-48.[636] In May 2011, Treasury withdrew the temporary anti-Killer B regulations and replaced them with Reg. §1.367(b)-10.[637] In Notice 2014-32, the IRS identified transactions designed to exploit the final regulations, including regarding the §367(a) and §367(b) priority rules, and announced intended changes to the regulations. In Notice 2016-73, the IRS identified additional transactions designed to exploit the final regulations as modified by Notice 2014-32, including a triangular reorganization followed by a purportedly unrelated inbound nonrecognition transaction to which Reg. §1.367(b)-3 applies, and announced its intent to issue additional regulations modifying the priority rules such that they would not apply to an applicable triangular reorganization involving a foreign corporation.

In 2024, the IRS and Treasury issued final regulations relating to the treatment of property used to acquire Parent stock or securities in connection with certain triangular reorganizations involving one or more foreign corporations.[638]

For further discussion of the "Killer B" regulations, see 6120 T.M., *Transfers Subject to Section 367(b), (d), or (e)*, and 6100 T.M., *U.S.-to-Foreign Transfers Under Section 367(a).*

b. Prohibition on Use of Subsidiary Stock

If Sub voting stock is issued in addition to Parent voting stock, the transaction cannot qualify as a "B" Reorganization.[639] Sub is free to issue either Parent voting stock or Sub voting stock as the sole consideration in a "B" Reorganization, but it cannot issue some of each. For a discussion of the issuance of Parent stock or Sub (or Parent) bonds that are convertible into Sub stock, see III.B.2.b., above.

c. Assumption of Liabilities

Parent, as well as Sub, may assume Target liabilities (e.g., by issuing new bonds in exchange for existing Target bonds) in a triangular "B" Reorganization.[640] The issues raised by Parent's (or Sub's) assumption of Target liabilities are the same in a triangular "B" Reorganization as in a standard "B" Reorganization.

d. Drop-Downs

Following the acquisition, Parent (or Sub) is free to drop down Target stock to one or more controlled, first-tier subsidiaries, or successively drop down Target stock to one or more controlled subsidiaries at the second tier or beyond, providing that each successive transferor is in §368(c) control of each successive transferee.[641]

Regulations allow for the drop-down of Target's assets following a "B" Reorganization and permit a drop-down of Target stock to a partnership, following a "B" Reorganization, providing that the partnership is controlled by members of the qualified group. For a discussion of these COI and COBE regulations, see V.A. and V.B., below.

e. Zero Basis Problem

Although Sub is free to issue Parent voting stock in a "B" Reorganization, the consequences of failure to qualify the transaction as a reorganization are potentially disastrous. In a failed reorganization of this type, not only do the Target shareholders recognize gain or loss, but there is a risk that Sub will be required to recognize gain on the issuance of Parent stock (except as otherwise provided in Reg. §1.1032-3), discussed in III.B.5.b., above.

7. Forced "B" Reorganization

A forced "B" Reorganization (or, as applicable, a forced triangular "B" Reorganization) can result when a newly formed corporation ("Newco"), which may be a subsidiary of either Parent or Sub, merges into Target, with the former Target shareholders receiving Parent voting stock in exchange for their Target stock (i.e., an all-stock reverse subsidiary merger).[642] If Newco is a first-tier subsidiary of Parent, a transaction structured in this manner may also qualify as a §368(a)(2)(E) reorganization if an amount of stock representing control of Target is acquired in the transaction. If Newco is a first-tier subsidiary of Sub and Parent stock is issued in the merger, the transaction does not qualify as a §368(a)(2)(E) reorganization

[634] For an article proposing that the guidance issued under Reg. §1.368-2(k) justifies reconsideration of this requirement by Congress, see N.Y. State Bar Ass'n, Tax Section, *Rpt. on Selected Issues in Triangular Reorganizations*, Rep. No. 1164 (Sept. 22, 2008).

[635] *See* IV.A.6.d., below; Reg. §1.368-2(k); Rev. Rul. 72-576 (Forward Triangular Merger used in combination with drop-down transaction).

[636] T.D. 9400, 73 Fed. Reg. 30,301 (May 27, 2008).

[637] T.D. 9526, 76 Fed. Reg. 28,890 (May 19, 2011).

[638] See, for example, Reg. §1.367(b)-10, T.D. 10004, 89 Fed. Reg. 58,275 (July 18, 2024). The regulations finalized the proposed regulations (REG-117614-14, 88 Fed. Reg. 69,559 (Oct. 6, 2023)) in substantially the same form, obsoleting Notice 2024-32 and Notice 2016-73.

[639] Reg. §1.368-2(c).

[640] For example, see Rev. Rul. 98-10, discussed in IV.A.2.c., above.

[641] Reg. §1.368-2(k). *See, e.g.*, Rev. Rul. 2003-48 (in bank demutualization coupled in integrated plan with "A" and "B" Reorganizations, neither "A" nor "B" Reorganization is disqualified by subsequent transfer of stock to corporations controlled by transferor).

[642] *See* Rev. Rul. 67-448.

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because the Parent stock is considered grandparent stock. [643] Reverse Triangular Mergers also are subject to the "substantially all" requirement.[644]

a. Practical Considerations

Forced "B" Reorganizations provide a merger vehicle for effecting what is, for tax purposes, a stock-for-stock exchange. The forced "B" reorganization therefore is useful when Target either is a widely held corporation or Target has recalcitrant shareholders. Once the merger has been approved by the requisite shareholder vote of Target, all the Target shareholders must either exchange their stock or exercise appraisal rights.

Practice Point: Dissenting Target shareholders who exercise appraisal rights must receive payment for their shares out of Target's funds, not Parent's, to avoid violating the solely-for-voting-stock requirement.[645]

b. A "Newco" is Required

A transaction cannot qualify as a forced "B" Reorganization unless the subsidiary that merges into Target is transitory. A merger involving a nontransitory subsidiary may, however, qualify as a Reverse Triangular Merger.[646] For Newco to be considered transitory, it generally must be formed solely to effectuate the desired transaction and must not carry on any business or engage in any activities other than those necessary to accomplish the transaction.[647]

8. Overlaps with Other Reorganization Provisions

a. Section 351

If the Target shareholders transfer their Target stock to Acquiror solely in exchange for Acquiror voting stock and, after the transfer, the former Target shareholders are in "control" of Acquiror (within the meaning of §368(c)), the transaction is described both in §351 and in §368(a)(1)(B).[648] Which statutory provision is controlling in this circumstance is not clear.

Comment: The relevance of determining which provision controls has been diminished by amendments to §306 and revision of the regulations under §367.

In Rev. Rul. 79-274, the IRS ruled that, for purposes of determining whether certain voting preferred stock in an acquiring corporation that was received in exchange for all of the shares of an acquired corporation constituted "Section 306 stock," the transaction would be characterized as a §368(a)(1)(B) reorganization rather than a §351 exchange so that the voting preferred stock would be treated as §306 stock, even though the preferred stock would not have constituted §306 stock under §351 pursuant to law existing at that time.

In PLR 9520032, the IRS ruled that a transaction that could have been characterized as a triangular reorganization pursuant to §368(a)(1)(B) was a §351 transaction. In the ruling, a corporation (P) owned all the stock of a subsidiary (S). The P shareholders owned all the stock of a Subchapter S corporation (T). The transaction involved three steps: (1) T distributed its entire accumulated adjustments account to its shareholders; (2) P contributed shares of its capital stock to the capital of S; and (3) T shareholders transferred their T stock to S in exchange for the P stock previously transferred to S.

The IRS recharacterized the transaction as a transfer of T stock by its shareholders to P pursuant to §351 in constructive exchange for P stock, followed by a drop-down of the T stock by P to S in constructive exchange for additional shares of S. In support of this conclusion, the IRS cited Rev. Rul. 77-449,[649] in which it had ruled that a "double drop-down" does not violate §351.

Comment: The transaction in PLR 9520032 could also have been characterized as an acquisition of all the T stock by S in exchange for stock of P, in which case it would qualify as a triangular reorganization pursuant to §368(a)(1)(B). The ruling by the IRS in PLR 9520032 makes no mention of the overlap between §351 and §368(a)(1)(B), and simply holds that §351 applies, citing Rev. Rul. 77-449.

b. Reverse Triangular Merger

A forced "B" Reorganization also may qualify as a Reverse Triangular Merger, provided that (i) the "substantially all" requirement is satisfied, (ii) Newco is a first-tier subsidiary of the corporation whose voting stock is used as consideration in the reorganization, and (iii) an amount of stock representing control of Target is obtained in the transaction.[650]

The IRS will rule that a transaction structured as both a Reverse Triangular Merger and a forced "B" Reorganization qualifies under §368(a)(1)(B) if it does not qualify as a Reverse Triangular Merger because of the (i) use of a second-tier subsidiary or (ii) failure to acquire stock representing control of Target in the transaction.[651]

B. The Reverse Triangular Merger

1. General

a. General Description

A Reverse Triangular Merger is described as a merger of Sub into Target in which (i) in the transaction, the former Target shareholders surrender an amount of stock representing control of Target in exchange solely for Parent voting stock, and (ii) after the transaction, Target holds substantially all its properties and substantially all the properties of Sub.[652] Sub may be either transitory or an operating company,[653] although it must

[643] Rev. Rul. 74-564.
[644] §368(a)(2)(E). *See* IV.B.4., below.
[645] *See* III.C.4.g., above.
[646] *See* IV.B., below.
[647] Rev. Rul. 67-448.
[648] Rev. Rul. 79-274. *See also* Rev. Rul. 2003-19.

[649] *See also* Rev. Rul. 2003-19 (receipt by demutualized insurance company's members of holding company interests in exchange for their original interests — after holding company receives all stock of stock company to which original mutual company converted — is both "B" reorganization and §351 transfer, even though holding company subsequently transfers all of its stock in stock company to stock holding company).
[650] §368(a)(2)(E); Reg. §1.368-2(j)(3).
[651] Reg. §1.368-2(j)(6) *Ex.* 4.
[652] §368(a)(2)(E). For an illustration of the Reverse Triangular Merger, see *§368(a)(2)(E) — Reverse Triangular Merger,* in the Bloomberg Tax Transactional Diagrams Library.
[653] Reg. §1.368-2(j)(5).

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be a first-tier subsidiary of Parent.[654] "Control" is defined in §368(c).[655]

The Reverse Triangular Merger is, in many respects, very similar in effect to a "B" Reorganization. After the transaction, Target continues its corporate existence as a stand-alone subsidiary of Parent (although, if Sub was an operating company, Target has acquired the assets and liabilities of Sub). Despite its similarity to a "B" Reorganization, however, the Reverse Triangular Merger is, statutorily, a hybrid "A" Reorganization. This dichotomy between the practical effect of a Reverse Triangular Merger and its place in the statutory scheme sometimes produces surprising results.[656]

b. Practical Considerations

Like a "B" Reorganization, a Reverse Triangular Merger preserves Target's corporate existence, thereby decreasing the risk that the acquisition will invalidate critical Target contracts and permits. Because the liabilities of Target never pass through Parent, Target remains the sole obligor for those liabilities (although, if Sub had been an operating company, its assets are now subject to Target's liabilities, and vice versa). Moreover, because a Reverse Triangular Merger is effected by an actual merger, Parent can assure itself of gaining control of Target.

Because of the "substantially all" requirement, a Reverse Triangular Merger may not be possible if Target has recently spun off or distributed a significant portion of its assets to the Target shareholders. However, unlike in a "B" Reorganization, boot is permissible in a Reverse Triangular Merger (provided an amount of stock representing "control" of Target is acquired solely for Parent voting stock). Reverse Triangular Mergers thus provide a certain amount of flexibility unavailable in a "B" Reorganization, but the "substantially all" requirement brings into play sometimes insurmountable restrictions.

c. Use of New or Existing Subsidiary

As stated above, a Reverse Triangular Merger requires use of a first-tier subsidiary of Parent. The tax consequences of a failed Reverse Triangular Merger, however, may differ depending upon whether a new (and transitory) subsidiary or an existing subsidiary is used to effect the merger.

If Sub is transitory, a failed Reverse Triangular Merger is treated in the same manner as a reverse subsidiary cash merger.[657] The Target shareholders recognize gain on the deemed transfer of their Target stock to Parent, but neither Parent nor Target recognizes gain. If Sub is an existing, nontransitory subsidiary of Parent, however, Sub may recognize gain on its transfer of Parent stock to the Target shareholders on a zero basis theory (except as otherwise provided in Reg. §1.1032-3), unless the transaction is viewed as if Parent issued the stock directly to the Target shareholders.[658]

Also, a failed Reverse Triangular Merger may be characterized as a forced "B" Reorganization only if Sub is transitory. When Sub is transitory, it may be ignored, in which case the merger of Sub into Target is treated as a stock-for-stock exchange between Parent and the shareholders of Target.

Practice Point: For the foregoing reasons, unless business exigencies dictate otherwise, the use of a transitory Sub in a Reverse Triangular Merger generally is recommended.

d. Formation of Holding Company

The Reverse Triangular Merger is the transaction structure most often used for forming a holding company over a corporation whose stock is publicly held. In most transactions, the publicly held corporation (Target) forms Parent (which is to become the new holding company), which in turn forms a transitory subsidiary (Sub). Parent capitalizes Sub with Parent stock. Sub then is merged into Target, with the Target shareholders receiving Parent stock in exchange for their Target stock.[659]

2. Consideration Given by Parent

a. Voting Stock for Control

Although some boot is permitted in a Reverse Triangular Merger, at a minimum the Target shareholders must receive Parent voting stock for an amount of Target stock representing control of Target.[660]

Practice Point: Note that it does not matter whether the Parent stock is transferred by Target to the Target shareholders or is simply issued directly by Parent to the Target shareholders, so long as the merger complies with applicable law.[661]

b. Degree of Permissible Boot

Because the statute provides that former Target shareholders must exchange an amount of stock representing control of Target for voting stock of Parent, there are no restrictions on the issuance of other property for the remaining Target stock.[662] The Target shareholders thus may receive other property from Parent (or Sub) for up to 20% of their Target voting stock and 20% of each class of nonvoting Target stock.[663]

Comment: Note, however, that Parent must acquire 80% of Target's voting stock and 80% of each class of Target's nonvoting stock, on a class-by-class basis, solely for Parent voting stock.

Despite the 20% threshold for boot in a Reverse Triangular Merger, and the exclusion of Target stock redeemed by Target in calculating that threshold, the continuity of interest (COI) requirement common to all acquisitive reorganizations and the "substantially all" requirement applicable to Reverse Triangular Mergers must both be satisfied. These requirements represent other important limitations on the amount of Target stock

[654] Rev. Rul. 74-565, Rev. Rul. 74-564.

[655] *See* IV.A.3., above.

[656] *See, e.g.*, Reg. §1.358-6(c)(2)(i) (Reverse Triangular Merger generally is treated as Forward Triangular Merger for purposes of determining basis of Target stock).

[657] *See* II.B.3., above, for a discussion of the resulting tax treatment.

[658] *See* III.B.5.b., above, for a discussion of the zero basis problem.

[659] For a more detailed discussion of the various methods of forming a holding company, see III.A.5.d., above.

[660] For a discussion of the "control in the transaction" requirement, see IV.B.3., below.

[661] *See, e.g.*, PLR 9125013.

[662] Reg. §1.368-2(j)(6) *Exs.* 1, 2.

[663] Target stock redeemed by Target out of its own funds is not counted in the 20% limitation, nor is it counted for purposes of determining whether Parent has acquired an amount of stock in the transaction representing control of Target. Reg. §1.368-2(j)(3)(i), §1.368-2(j)(6) *Ex.* 2.

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that may be redeemed and/or purchased for cash in connection with a Reverse Triangular Merger.[664]

c. Assumption of Liabilities

Reg. §1.368-2(j)(4) provides that Parent may assume liabilities of Target without affecting the tax-free status of a Reverse Triangular Merger. The assumption of liabilities generally is treated as a contribution to capital of Target by Parent.[665]

Unlike in a "B" Reorganization, an exchange of Target securities for Parent securities in a Reverse Triangular Merger is not a separate transaction outside the reorganization. Instead, the exchange is brought within the reorganization, the securityholders are treated as parties to the reorganization, and the general nonrecognition rule of §354 and the additional property rule of §356 apply.[666]

3. Control in the Transaction

The requirement that a Reverse Triangular Merger take the form of a merger, combined with the requirement that Parent acquire an amount of stock representing control of Target in the transaction, apparently result in a complete prohibition on creeping Reverse Triangular Mergers, at least when the prior acquisitions of Target stock amount to more than 20% of Target's voting stock or any class of Target's nonvoting stock.[667]

Practice Point: Parent's purchase of additional stock in Target from Target in the merger, or Parent's receipt of additional stock of Target in the merger as consideration for Parent's prior interest in Sub, is ignored in calculating whether Parent obtained 80% of each class of Target stock in the merger and, thus, does not affect satisfaction of the "control in the transaction" requirement.[668]

As in the "B" Reorganization context, however, Parent presumably can purge itself of excess holdings of Target stock before a Reverse Triangular Merger by unconditionally selling the excess stock to an unrelated third party without any agreement to repurchase such stock.[669]

Practice Point: There also appears to be no reason why Target cannot engage in recapitalizations or other transactions before the merger to ensure that Parent satisfies the "control in the transaction" requirement, provided that the recapitalizations or other transactions are not merely illusory.[670]

Additionally, in Rev. Rul. 2001-26, the IRS identified two situations in which a series of integrated steps qualifies as a Reverse Triangular Merger even though the Parent or Subsidiary acquires 51% of the Target stock before the merger. In *Situation 1*, Parent and Target are publicly held corporations organized in state X. Target has only voting common stock, none of which is owned by Parent, which wishes to acquire all of Target's outstanding stock. For valid business purposes, the stock acquisition will be accomplished by a tender offer for at least 51% of Target's stock (acquired solely in exchange for Parent's voting stock) followed by a merger of Parent's newly formed subsidiary (Sub) into Target. Parent successfully initiates the tender offer, acquiring 51% of Target's stock. Parent then forms Sub, which merges into Target under the corporate laws of state X. Parent's Sub stock is converted into Target stock and each of Target's shareholders holding the remaining 49% of outstanding Target stock receives a combination of two-thirds Parent voting stock and one-third cash. The same facts apply in *Situation 2*, except that it is Sub that initiates the tender offer and acquires 51% of Target stock in exchange for Parent stock provided by Parent. It is assumed that both situations otherwise meet the statutory and nonstatutory requirements for Reverse Triangular Mergers.

In reviewing both situations, the IRS noted that steps prior to a merger but part of the transaction intended to qualify as a Reverse Triangular Merger should be considered when deciding if the control-for-voting-stock "in the transaction" requirement is met.[671] In both situations, Target's shareholders exchange Target stock in excess of 80% of Target's outstanding stock for Parent stock. Consequently, the integrated transactions in both situations qualify as Reverse Triangular Mergers.

Practice Point: If Target stock owned by Parent or Sub immediately before the merger was acquired in exchange for Parent voting stock in a transaction integrated with the merger, the entire transaction may qualify as a Reverse Triangular Merger.[672]

4. "Substantially All" Requirement

In a Reverse Triangular Merger, Target must hold, after the transaction, "substantially all" the properties of Target and Sub. The definitional limits of the "substantially all" requirement are identical to those applied to Forward Triangular Mergers and "C" Reorganizations.[673] However, in the context of a Reverse Triangular Merger, the "substantially all" requirement applies separately to Target and to Sub.

Practice Point: In a Forward Triangular Merger, the statute requires only that Sub "acquire" substantially all the assets of Target in the merger.[674] On that basis, the IRS has ruled that Sub may distribute a significant portion of the acquired assets to Parent immediately following the merger.[675] By contrast, in a Reverse Triangular Merger, the Code mandates that, after the transaction, Target must hold substantially all the assets of Target and Sub.[676] Reg. §1.368-2(j)(3)(iii) provides that Target may transfer assets under the provisions of Reg. §1.368-2(k) without violating the "hold" requirement.[677]

Pursuant to Rev. Rul. 2001-25, Target, the surviving corporation following a Reverse Triangular Merger, can sell up to 50% of its operating assets to an unrelated party immediately after the merger without violating the substantially all requirement as long as the proceeds of the sale continue to be held by Target.

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664 For a discussion of the COI requirement, see V.A., below.

665 Reg. §1.368-2(j)(4).

666 Reg. §1.368-2(j)(4). Note that §357(b) should not apply to a Reverse Triangular Merger involving a transitory subsidiary.

667 Reg. §1.368-2(j)(3)(i), §1.368-2(j)(6) *Ex.* 4.

668 Reg. §1.368-2(j)(6) *Ex.* 2.

669 *Cf.* Rev. Rul. 72-354. *See* IV.A.4., above.

670 *See* IV.A.3.b., above.

671 Rev. Rul. 2001-26 (referencing Reg. §1.368-2(j)(6) *Ex.* 3).

672 Rev. Rul. 2001-26.

673 Reg. §1.368-2(j)(3)(iii). *See* III.B.3. and III.C.5., above.

674 §368(a)(2)(D).

675 PLR 9319017; GCM 36111 (Dec. 18, 1974).

676 §368(a)(2)(E).

677 For a discussion regarding the scope of §368(a)(2)(C) and Reg. §1.368-2(k), see V.E., below.

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In determining whether the "substantially all" requirement has been satisfied, property contributed from Parent to Sub as part of the plan of reorganization, as well as the Parent stock distributed in the merger, are not taken into account.[678] For example, money transferred from Parent to Sub is not taken into account if it is used to pay consideration to Target shareholders (including dissenting shareholders) or to pay Target creditors or reorganization expenses.[679] However, assets of Target (or pre-existing assets of Sub) distributed to Target shareholders in the transaction are considered property that Target does not hold after the transaction for purposes of the "substantially all" requirement.[680]

5. Overlaps with Other Reorganization Provisions

As discussed in IV.A.8.b., above, a Reverse Triangular Merger also may qualify as a "B" Reorganization. However, unlike a "B" Reorganization, it has not always been clear whether a Reverse Triangular Merger may qualify as a §351 transaction. The IRS at one time had ruled that neither Target nor Target shareholders in a Reverse Triangular Merger are considered transferors of property to Parent for purposes of qualifying another taxpayer's transfer of assets to Parent as a §351 transaction.[681] Apparently the IRS's theory was that, because the form of the reverse merger is respected, the Target shareholders are viewed as transferring their Target stock directly to Target, not to Parent.[682] Thus, if Parent were not considered the transferee, it would not matter for §351 purposes that the former Target shareholders are in control of Parent after the transaction. The IRS ultimately adopted a more sensible position, ruling that a Reverse Triangular Merger can indeed qualify as a §351 transaction for purposes of qualifying another taxpayer's transfer of assets to Parent as tax-free.[683]

Target shareholders in a failed Reverse Triangular Merger are treated as transferors for purposes of qualifying not only their deemed transfer of Target stock to Parent as tax-free under §351, but also any other contemporaneous transfer of property to Parent.[684]

Note: The IRS has treated a Reverse Triangular Merger followed by a merger of Target into Acquiror as a single "A" Reorganization between Acquiror and Target.[685]

[678] Reg. §1.368-2(j)(3)(iii).

[679] Reg. §1.368-2(j)(3)(iii). *But see* Rev. Rul. 77-307 (money transferred from Parent to Sub to pay Sub's reorganization expenses in Reverse Triangular Merger is not taken into account; payment of Target's reorganization expenses is not addressed); Rev. Proc. 86-42 (Target assets used to pay its reorganization expenses are taken into account for purposes of "substantially all" requirement).

[680] Reg. §1.368-2(j)(6) *Ex.* 3.

[681] PLR 8822062.

[682] *Cf.* Rev. Rul. 84-44 (Target shareholders in Forward Triangular Merger are not viewed as transferors for §351 purposes); Rev. Rul. 76-123, Rev. Rul. 68-357.

[683] PLR 9143025. *See also* PLR 200049026 (§351 control requirement met by including in the control group those shareholders transferring target stock in Reverse Triangular Merger involving transferee corporation's transitory subsidiary; transferors to transferee corporation included in same control group).

[684] PLR 8542098, PLR 8430093.

[685] For discussion on this ruling in Rev. Rul. 2001-46, see V.D., below. *Cf.* Rev. Rul. 2008-25 (Reverse Triangular Merger followed by liquidation of Sub was not reorganization of any kind because Parent's acquisition of Target's assets, unlike first step in Rev. Rul. 2001-46, could not qualify as a reorganization).

C. Corporate Alternative Minimum Tax (CAMT) Consequences

1. Acquiror Corporation and Target Corporation Shareholder

As discussed in III.D.1., above, a corporation must determine whether it is an "applicable corporation," that is, whether its adjusted financial statement income (AFSI) exceeds a statutory threshold, for purposes of determining CAMT liability. Generally, proposed regulations provide that the CAMT consequences of corporate transactions would be determined under financial accounting principles (using CAMT inputs) unless the CAMT entity qualifies for nonrecognition treatment.[686]

In the case of a B reorganization, which is a covered nonrecognition transaction, a target corporation shareholder or security holder would be required to:

- determine its AFSI by disregarding any resulting gain or loss reflected in its financial statement income (FSI) and applying the relevant Code section (§354) to the transfer (i.e., no AFSI would be recognized);
- determine its CAMT basis in the stock received from the acquiror corporation by applying the relevant Code section (§358), using CAMT basis (in lieu of applicable financial statement (AFS) basis; and
- adjust its CAMT earnings (in lieu of AFS retained earnings) resulting from the transaction by applying §312.[687]

Analogous rules are proposed for the acquiror corporation in a B reorganization. If an acquiror corporation transfers solely stock to a target corporation shareholder as part of a B reorganization that qualifies the acquiror corporation for nonrecognition treatment under §1032(a), the acquiror corporation would be required to:

- determine its AFSI by disregarding any resulting gain or loss reflected in its FSI and applying §1032(a), or §1032(a) and Reg. § 1.1032-2(b), to the transfer (i.e., no AFSI would be recognized);
- determine its CAMT basis in the stock received from a target corporation shareholder by applying §362, using the CAMT basis (in lieu of AFS basis) of that stock in the hands of the target corporation shareholder; and
- adjust its CAMT retained earnings (in lieu of AFS retained earnings) resulting from the transaction by applying §312.[688]

2. B Reorganization Example

Example:[689] Acquiror and Target are domestic corporations that use the calendar year as the taxable year and are not members of a tax consolidated group. During the taxable year, Acquiror acquires all the stock of Target from X for

[686] *See* Preamble to REG-112129-23, 89 Fed. Reg. 75,062, 75,093 (Sept. 13, 2024).

[687] Prop. Reg. §1.56A-19(b)(1).

[688] Prop. Reg. §1.56A-19(b)(3).

[689] Prop. Reg. §1.56A-19(b)(7)(i) *Ex.* 1.

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100 shares of Acquiror's voting stock in a transaction that qualifies as a B reorganization. At the time of the transaction, (1) X's stock in Target has a CAMT basis of $35x and a fair market value of $100x, and (2) Target has a CAMT basis of $30x in its assets.

Acquiror's acquisition of Target's stock is a covered nonrecognition transaction. In determining AFSI, X disregards any FSI resulting from the exchange of Target stock for Acquiror stock and records $0x of AFSI on the exchange. X's CAMT basis in the Acquiror stock received is $35x, and X must adjust its CAMT retained earnings by the amount of AFSI recognized, or $0x.

Similarly, Acquiror disregards any FSI resulting from the exchange and records $0x of AFSI on the exchange. Acquiror's basis in the Target stock is $35x, and Acquiror must adjust its CAMT retained earnings by the amount of AFSI recognized, or $0x.

Target has no CAMT consequences from the transaction, and Target's $30x of CAMT basis in its assets is unaffected by the transaction.

3. *Acquiror Corporation Parent*

Additional rules are proposed that would apply to an acquiror corporation's parent in covered norecognition transactions and covered recognition transactions. If an acquiror corporation transfers solely stock of the acquiror corporation's parent to a target corporation shareholder as part of a B reorganization that qualifies the acquiror corporation for nonrecognition treatment under §1032(a) and Reg. § 1.1032-2(b) (i.e., a covered nonrecognition transaction), the acquiror corporation's parent would be required to adjust its CAMT basis in its acquiror corporation stock pursuant to the rules for determining stock basis in certain triangular reorganizations (Reg. §1.358-6).[690]

If an acquiror corporation transfers solely stock of the acquiror corporation's parent to a target corporation shareholder as part of a B reorganization that does not satisfy Reg. § 1.1032-2(b) with regard to all acquiror corporation parent stock (i.e., a covered recognition transaction with regard to the parent stock that does not satisfy Reg. § 1.1032-2(b)), the parent corporation would be required to adjust its CAMT basis in its acquiror corporation stock pursuant to Reg. §1.358-6.[691]

In a transaction that does not qualify as a B reorganization, if an acquiror corporation transfers stock of its parent corporation, along with other property, to a target corporation shareholder in exchange for target corporation stock (i.e., a covered recognition transaction), with regard to the parent stock transferred, the parent corporation would be required to adjust its CAMT basis in its acquiror corporation stock pursuant to Reg. § 1.1032-3.[692]

[690] Prop. Reg. §1.56A-19(b)(5).
[691] Prop. Reg. §1.56A-19(b)(6)(i).
[692] Prop. Reg. §1.56A-19(b)(6)(ii).

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V. Requirements and Doctrines Common to All Acquisitive Reorganizations

A. Continuity of Interest Requirement

1. Background and History

One of the most fundamental principles of the tax law is that unrealized appreciation in the value of property should be taxed only when the property is sold or otherwise disposed of.[693] If property is exchanged for other property, a taxable event occurs if the property received is materially different from the property given up.[694] Recognizing that mere changes in the form of corporate holdings should not trigger the recognition of unrealized gain, Congress in 1918 enacted a statute that made an exchange of stock or securities for other stock or securities nontaxable if made in connection with a "reorganization, merger or consolidation."[695]

The statute failed to address the essential question of how to distinguish a reorganization from a taxable transaction. While subsequent reenactments have resolved ambiguities and added more specific requirements, the original task of defining the contours of a reorganization was left almost entirely to the courts.

As discussed below, the early cases differentiated reorganizations from sales by determining whether the Target shareholders continued their interest in Target after the reorganization. The continuity of interest (COI) requirement, as developed in the case law, involves two main aspects: (1) the qualitative aspect, which looks to the nature of the consideration given by Acquiror for Target's stock or assets; and (2) the quantitative aspect, which looks to the relative proportions of continuity-preserving consideration and boot received by the Target shareholders. Other principles have been developed by the courts and the IRS as attempted illuminations of the two general concepts, including (a) the remoteness of the Acquiror stock interest from the actual location of Target assets, (b) the remoteness of the new holder of Acquiror stock from the exchanging Target shareholder, (c) the application of the COI test to the historic Target shareholders, and (d) the continued retention of Acquiror stock by the exchanging Target shareholders.

In several instances Congress has created specific COI requirements, and in other cases Congress has eliminated or alleviated some of the judicial continuity limits. For example, the type of consideration permissible in "B" and "C" Reorganizations and Reverse Triangular Mergers is statutorily prescribed; in "A" Reorganizations and Forward Triangular Mergers, one still looks primarily to the judicial COI doctrine. Section 368(a)(2)(C) (drop-downs), §368(a)(2)(D) (Forward Triangular Merger), and §368(a)(2)(E) (Reverse Triangular Merger) were enacted to override certain judicial continuity doctrines. However, wherever the statute and regulations are silent, some of the judicial principles (e.g., the percentage of equity consideration required, or the *Groman-Bashford* doctrine) may still have application.

[693] *See* §1001(a).

[694] Reg. §1.1001-1(a).

[695] Revenue Act of 1918, §202(b), 40 Stat. 1057, 1060 (1919).

Until 1998, the IRS's regulations on the COI requirements had not changed since 1934. Reg. §1.368-1(b), before its 1998 amendment, merely stated that "requisite to a reorganization under the Code … [is] a continuity of interest therein on the part of those persons who, directly or indirectly, were the owners of the enterprise prior to the reorganization." In addition, the IRS published guidelines for the issuance of advance rulings on certain reorganization issues including the COI requirement,[696] and certain standard representations that must be submitted to obtain a ruling.[697]

2. Nature of Consideration Issued in Transaction

From 1932 to 1942, the courts originated and developed the qualitative and quantitative aspects of the continuity-of-interest doctrine. The qualitative aspect was first addressed in *Cortland Specialty Co. v. Commissioner*,[698] which involved a transfer of substantially all of Target's assets for cash and notes with maturities ranging from two to 14 months. The Second Circuit held that the statutory term "reorganization" presupposes "continuance of business under modified corporate forms" and that "there must be some continuity of interest on the part of the transferor corporation or its shareholders. …"[699] Even if a reorganization had existed, the court stated, short-term notes did not constitute "securities" for purposes of the exemption from gain recognition.

Shortly after *Cortland*, the Supreme Court interpreted the same statute under similar facts in *Pinellas Ice & Storage Co. v. Commissioner*.[700] The Court agreed with the result in *Cortland*, holding that no reorganization existed and stating that "the seller must acquire an interest in the affairs of the purchasing company more definite than that incident to ownership of its short-term purchase money notes."[701]

Then, on the quantitative side, in *Helvering v. Minnesota Tea Co.*,[702] which involved a transfer of substantially all of the Target's assets to Acquiror for approximately 44% cash and 56% Acquiror common stock, the Supreme Court held that the transaction constituted a reorganization because "the seller acquired a definite and substantial interest in the purchaser."[703] Although a large part of the consideration was cash, the Court found it permissible "so long as the taxpayer received an interest in the affairs of the transferee which represented a material part of the value of the transferred assets."[704] Thus, it was now clear that the COI had to be definite and substantial, and had to represent a material part of the consideration received.

In *John A. Nelson Co. v. Helvering*,[705] which the Supreme Court decided along with *Minnesota Tea*, a reorganization was held to exist when the consideration transferred for the Target's assets consisted of 62% cash and 38% nonvoting preferred

[696] Rev. Proc. 77-37.

[697] Rev. Proc. 86-42. For a discussion of the IRS ruling policy, see VIII., below.

[698] 60 F.2d 937 (2d Cir. 1932).

[699] 60 F.2d at 940.

[700] 287 U.S. 462 (1933).

[701] 287 U.S. at 470.

[702] 296 U.S. 378 (1935).

[703] 296 U.S. at 386.

[704] 296 U.S. at 386.

[705] 296 U.S. 374 (1935).

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stock. The preferred stock was held to constitute a "definite and substantial interest in the affairs of the purchasing corporation. …"[706] Participation in the management of the purchaser is not required.[707]

The remaining question was whether the receipt of long-term bonds alone satisfied the COI requirement. The Supreme Court answered this question in *Le Tulle v. Scofield*,[708] which involved a transfer of all of Target's assets for $50,000 in cash and $750,000 in Acquiror bonds with maturities up to 12 years. Acknowledging that the bonds were "securities," the Court held that there was no reorganization because the transfer did not permit the Target shareholders to retain a "proprietary" interest in the enterprise.

These cases set the parameters. The consideration must include some equity, and nonvoting preferred stock is sufficient for this purpose. Generally, subject to the unique rulings and cases involving thrift institutions,[709] no distinctions are made between gradations of equity interests; differences between the equity interest surrendered and the equity interest received (e.g., voting common surrendered for nonvoting preferred) are irrelevant so long as the equity interest received is regarded as equity for tax purposes. Long-term bonds or "securities" do not count as continuity-preserving consideration. Finally, the amount of equity given must pass some minimum threshold — which may be as low as (or perhaps lower than) 38% of the total consideration, based on the Supreme Court's decision in *John A. Nelson Co. v. Helvering*[710] — to be considered material or substantial.

3. *Percentage of Equity Retained by Target Shareholders*

a. *In General*

As discussed above, the quantitative aspect of the continuity-of-interest doctrine, which looks to the relative proportions of continuity-preserving consideration and boot received by the Target shareholders, originated in the early case law. The Target shareholders must acquire a "definite and substantial interest" in Acquiror, and Acquiror stock must represent a "material" part of the consideration transferred.[711] Courts have found reorganizations to exist when the value of the equity portion of the overall consideration given by Acquiror for Target stock or assets has been as low as 25%[712] or 38%.[713] On the other hand, 16% has been held not "tantalizingly high" enough and anything less than 20% has been viewed as "significantly less" COI than the 38% allowed in the *Nelson* case.[714]

Practice Point: Although the cases have accepted a variety of percentages as meeting the continuity threshold, most practitioners are not comfortable with a minimum equity threshold that is less than the 38% allowed in the *Nelson* case.

After years of holding to a 50% minimum equity threshold, the government eventually made it clear that a 40% minimum equity threshold is acceptable. This position was first reflected in COI regulations proposed in 2004 and finalized in 2005. The 2005 final regulations were replaced with temporary regulations effective March 20, 2007, which were finalized on December 19, 2011.[715] Both the 2005 regulations and the 2011 regulations include an example that provided continuity is satisfied if 40% of the consideration paid is in the form of Acquiror stock.[716] In the preamble to the 2005 final regulations, the IRS expressly acknowledged that continuity was satisfied where 40% of the consideration paid was in the form of Acquiror stock.[717] The IRS has also issued private letter rulings in situations in which the continuity level was only 40% (rather than the published standard of 50%).[718]

Several aspects of the quantitative test should be noted. First, the percentage relates to the proportion of equity consideration received by the Target shareholders to the total consideration paid by Acquiror for Target's assets or stock.[719] The percentage interest in Acquiror received overall by the Target shareholders in the acquisitive transaction is generally irrelevant (i.e., a whale can swallow a minnow and the transaction may nevertheless constitute a reorganization). Second, not all of the Target shareholders need to acquire an equity interest in Acquiror. Because the percentage is applied to the aggregate consideration received by the Target shareholders, it is irrelevant that some shareholders receive stock and others receive

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[706] 296 U.S. at 377.

[707] *Miller v. Commissioner*, 84 F.2d 415 (6th Cir. 1936).

[708] 308 U.S. 415 (1940). *See also Roebling v. Commissioner*, 143 F.2d 810 (3d Cir. 1944), cert. denied, 323 U.S. 773 (1944) (99-year bonds did not permit reorganization treatment).

[709] *See* V.A.6., below.

[710] 296 U.S. 374 (1935).

[711] *See, e.g., Helvering v. Minnesota Tea Co.*, 296 U.S. 378 (1935); *John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935).

[712] *Miller v. Commissioner*, 84 F.2d 415 (6th Cir. 1936). In *Miller*, Target stock was acquired for 75% cash and 25% Acquiror stock. In holding that the stock exchange was a "reorganization" under the Revenue Act of 1928, the court stated: "It is idle to say that this is not a substantial part of the value of the thing transferred, or does not constitute a definite and material interest in the affairs of the purchasing company. In the commonly accepted legal sense a substantial interest is something more than a merely nominal interest …."

[713] *John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935). *See also Helvering v. Watts*, 296 U.S. 387 (1935) (45% continuity sufficient).

[714] *Kass v. Commissioner*, 60 T.C. 218, 223–227 (1973), aff'd, 491 F.2d 749 (3d Cir. 1974). *See also Yoc Heating Corp. v. Commissioner*, 61 T.C. 168 (1973) (15% not enough); *Sw. Natural Gas Co. v. Commissioner*, 189 F.2d 332, 335 (5th Cir. 1951), cert. denied, 342 U.S. 860 (1951) (1% insufficient); *Banner Mach. Co. v. Routzahn*, 107 F.2d 147 (6th Cir. 1939), cert. denied, 309 U.S. 676 (1940).

[715] T.D. 9565, 76 Fed. Reg. 78,540 (Dec. 19, 2011); T.D. 9316, 72 Fed. Reg. 12,974 (Mar. 20, 2007).

[716] *See* Reg. §1.368-1(e)(2)(v) *Ex.* 1, T.D. 9565, 76 Fed. Reg. 78,540 (Dec. 19, 2011). *See also* Reg. §1.368-1(e)(2)(v) *Exs.* 6 and 12.

[717] The preamble states: "One commentator asked whether the principle that the COI requirement is satisfied where 40 percent of the target corporation stock is exchanged for stock in the issuing corporation that is illustrated in the examples of the proposed regulations (which relate to the application of the signing date rule) also applies in cases in which the signing date rule does not apply. The IRS and Treasury believe that this principle is equally applicable to cases in which the signing date rule does not apply as it is to cases in which the signing date rule does apply." T.D. 9225, 70 Fed. Reg. 54,631 (Sept. 16, 2005).

[718] *See, e.g.*, PLRs 201438009, 201213001, 200802009, 200709037, and 200613011.

[719] Rev. Rul. 66-224. *See also* Rev. Proc. 77-37. In PLR 200819018, the IRS ruled that Target's cancellation of the shares of missing Target shareholders, which would occur by virtue of the merger itself and not through any action on the part of the shareholders, would not defeat "A" Reorganization treatment. The taxpayer stated that — for purposes of making a representation that at least 40% of the proprietary interest in Target would be exchanged for common stock and would be preserved — stock was not treated as a proprietary interest to the extent that no consideration was exchanged for it.

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cash, so long as one or more Target shareholders receive the requisite continuity-preserving consideration.[720]

Note: For purposes of the quantitative test, warrants, options, stock rights and convertible debt should not be regarded as outstanding Target stock. *See* III.C.3.a., above. Thus, for example, Acquiror's payment of cash to existing option holders in cancellation of their options should not be counted in determining the overall percentage of equity retained by Target shareholders. If an option holder is issued Acquiror stock in connection with the reorganization (either directly or following the exercise of the option for Target stock), the Acquiror stock generally should be counted for purposes of the quantitative test. *See* V.A.4.c., below. In addition, while it is unclear whether contingent stock should be counted as Acquiror stock if and when it is issued, or disregarded altogether, escrowed Acquiror stock should be counted for purposes of the quantitative test so long as the former Target shareholder is regarded as the owner of that stock. *See* III.C.4.i., above, and V.A.3.b., below.

Note: For requests received on or after January 2, 2024, the Associate Chief Counsel (Corporate) has eliminated the "significant issue" practice, under which the IRS would only issue rulings on a significant issue presented in a §368 transaction, rather than a ruling on the entire transaction.[721] The IRS will issue "comfort rulings" on issues under §332, §351, §368, and §1032, and certain issues under §355(e), meaning a ruling will be issued even if the issue is "clearly and adequately addressed" by other published guidance.[722]

b. *Measurement Date for Continuity-of-Interest Requirement*

If a transaction is structured to comply with the COI rule, some difficulty may be encountered if the relative values of Acquiror and Target change significantly between the date on which the deal is struck and the date on which the reorganization is actually consummated. This concern is most likely to be present when one or more public companies are involved in a cash option merger.

> *Example:* Acquiror and Target enter into a cash-option merger agreement at a time when Acquiror stock is trading at $50 a share and Target stock is trading at $25 a share. Target has 4,000 shares outstanding with an aggregate value of $100,000. The agreement provides that holders of Target stock may elect to receive one share of Acquiror stock or $50 cash for every two shares of Target stock, but that no more than 50% of the holders (2,000 shares) may elect to receive cash. Accordingly, based on Acquiror's stock value at the time of entering into the merger agreement, the transaction provided for no more than 50% of the consideration to be paid in cash when the agreement was executed. At the time of the closing, however, assume that Acquiror's stock has fallen to $20 a share but Target's aggregate value is still $100,000. As a result of the ceiling, holders of 2,000 shares of Target stock will receive Acquiror stock worth $20,000, and the holders of the remaining 2,000 shares will receive $50,000 in cash. Thus, the value of Acquiror stock to the total consideration given is 28.5% ($20,000/$70,000).

This example raises the question of whether the relevant measurement date should be the date on which the exchange ratio is set or the date on which the exchange is completed. If the date of the agreement is used, the Acquiror stock represents 50% of the total consideration paid for the Target assets or stock, and the COI requirement is met. In that case, the parties have the assurance that a drop in the value of Acquiror stock between the agreement date and the closing date will not impact the COI requirement. However, if the date of the exchange is used, the Acquiror stock represents only 28.5% of the consideration paid for the Target assets or stock, and the COI requirement is not met.

For many years, the COI threshold (*e.g.*, 40%) was measured based on the closing date values of the consideration paid by Acquiror for the Target assets or stock (the "closing date rule"). Starting in 2004, a series of proposed, final and temporary regulations attempted to address the "fluctuation in value" concern by providing that the COI requirement would be determined by reference to the value of Acquiror's stock on the day before there was a binding agreement, providing the consideration was fixed as of the signing date (the "signing date rule").[723]

Final regulations issued in December 2011 adopted temporary regulations issued in 2007 with only minor changes.[724]

At the same time, in December 2011, the IRS and Treasury proposed a regulation that identified situations, other than those covered by the signing date rule, in which the value of Acquiror stock could be determined based on value other than its actual trading price on the closing date.[725] In, 2019, the IRS withdrew these proposed regulations, stating that current law provides sufficient guidance to taxpayers with respect to the COI requirement, particularly after the issuance of Rev. Proc. 2018-12, as discussed further below.[726]

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[720] Rev. Proc. 77-37; Rev. Rul. 66-224. *See also W. Mass. Theatres, Inc. v. Commissioner*, 236 F.2d 186 (1st Cir. 1956); *Reilly Oil Co. v. Commissioner*, 189 F.2d 382 (5th Cir. 1951); *Miller v. Commissioner*, 84 F.2d 415 (6th Cir. 1936).

[721] Rev. Proc. 2024-3, §1.02; Rev. Proc. 2024-1, §16; Rev. Proc. 2013-32, §5.01(1), *superseded by* Rev. Proc. 2024-3.

[722] Rev. Proc. 2025-1, §6.11.

[723] Former Prop. Reg. §1.368-1(e)(2), §1.368-1(e)(7)(i), §1.368-1(e)(7)(ii), REG-129706-04, 69 Fed. Reg. 48,429 (Aug. 10, 2004). In 2005, the IRS and Treasury finalized the proposed regulations with certain revisions. Former Reg. §1.368-1(e)(2), T.D. 9225, 70 Fed. Reg. 54,631 (Sept. 16, 2005). On March 20, 2007, the IRS removed the 2005 regulations and issued temporary and proposed regulations in their place. Reg. §1.368-1T(e)(2), T.D. 9316, 72 Fed. Reg. 12,974 (Mar. 20, 2007). The 2007 temporary regulations were generally effective for transactions occurring pursuant to binding contracts entered into after September 16, 2005. *See* Reg. §1.368-1T(e)(8)(ii). However, taxpayers could elect to apply the 2005 regulations to transactions pursuant to binding contracts entered into after September 16, 2005, but before March 21, 2007. The 2007 temporary regulations expired on March 19, 2010. In Notice 2010-25, the IRS allowed taxpayers to continue to rely on the expired rules in Reg. §1.368-1T(e)(2) temporarily. However, the target corporation, the issuing corporation, the controlling corporation of the acquiring corporation if stock thereof is provided as consideration in the transaction, and any direct or indirect transferee of transferred basis property from any of the foregoing, were not allowed to apply the provisions of Reg. §1.368-1T(e)(2) unless all such taxpayers elected to apply the provisions.

[724] Reg. §1.368-1(e)(2), T.D. 9565, 76 Fed. Reg. 78,540 (Dec. 19, 2011).

[725] REG-124627-11, Fed. Reg. 78,591 (Dec. 19, 2011).

[726] REG-124627-11, 84 Fed. Reg. 12,169 (Apr. 1, 2019).

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The 2011 final regulations adopt a signing date rule, which provides that the consideration to be exchanged for proprietary interests in Target is valued as of the end of the last business day before the first date on which there is a binding contract for the reorganization, if the consideration that will be given to Target shareholders is fixed in the contract.[727]

These regulations provide that a binding contract is an instrument enforceable under applicable law against the parties to the instrument.[728] In general, if a term of a binding contract that relates to the amount or type of the consideration the target shareholders will receive in a potential reorganization is modified before the closing date of the potential reorganization, the date of the modification is treated as the first date on which there is a binding contract. However, there are a number of special rules for certain situations in which the date of modification is ignored for these purposes.[729]

A contract provides for fixed consideration if it provides the number of shares of each class of stock of the issuing corporation, the amount of money, and the other property (identified either by value or by specific description), if any, to be exchanged in the transaction. A shareholder's election to receive a number of shares of stock of the issuing corporation, money, or other property (or some combination of stock of the issuing corporation, money, or other property) in exchange for all of the shareholder's proprietary interests in the target corporation, or each of the shareholder's proprietary interests in the target corporation, will not prevent a contract from satisfying the definition of fixed consideration if the determination of the number of shares of issuing corporation stock to be provided to the target corporation shareholder is determined using the value of the issuing corporation stock on the last business day before the first date there is a binding contract.[730] This is the case even though the shareholder election may preclude a determination, before the closing date, of the number of shares of each class of the issuing corporation, the amount of money, and the other property (or the combination of shares, money and other property) to be exchanged for each proprietary interest in the target corporation.[731]

> *Example:* On January 3 of Year 1, P and T sign a binding contract, pursuant to which T will be merged with and into P on June 1 of Year 1. On January 2 of Year 1, the value of the P stock and the T stock is $1 per share. Pursuant to the contract, at the shareholders' election, each share of T's 100 shares will be exchanged for cash of $1, or alternatively, P stock. The contract provides that the determination of the number of shares of P stock to be exchanged for a share of T stock is made using the value of the P stock on the last business day before the first date there is a binding contract (that is, $1 per share). The contract further provides that, in the aggregate, 40 shares of P stock and $60 will be delivered, and contains a proration mechanism in the event that either item of consideration is oversubscribed. On the closing date, the value of the P stock is $0.20 per share, and all target shareholders elect to receive cash. Pursuant to the proration provision, each target share is exchanged for $0.60 of cash and $0.08 of P stock. The contract provides for fixed consideration because it provides for the number of shares of P stock and the amount of money to be exchanged for all the proprietary interests in the target corporation and because the number of shares of issuing corporation stock to be provided to the target corporation shareholders is determined using the pre-signing date value of P stock. Accordingly, whether the transaction satisfies the COI requirement is determined by reference to the value of the P stock on January 2 of Year 1. For COI purposes, the T stock is exchanged for $40 of P stock and $60 of cash. Therefore, the transaction preserves a substantial part of the value of the proprietary interest in T, satisfying the COI requirement.[732]

In general, a contract that provides for contingent adjustments to the consideration is treated as providing for fixed consideration if it would satisfy the requirements of fixed consideration without the contingent adjustment provision. An exception to this rule applies, however, if the contract provides for contingent adjustments to the consideration that prevent (to any extent) the target corporation shareholders from being subject to the economic benefits and burdens of ownership of the issuing corporation stock after the last business day before the first date the contract is a binding contract.[733]

The 2011 final regulations also provide that placing part of the consideration to be exchanged for proprietary interests in Target in escrow to secure Target's performance of customary pre-closing covenants or customary target representations and warranties does not prevent a contract from being treated as providing for fixed consideration.[734]

> *Example:* On January 3 of Year 1, Acquiror and Target sign a binding contract pursuant to which Target will be merged with and into Acquiror on June 1 of Year 1. Pursuant to the contract, the Target shareholders will receive 40 Acquiror shares and $60 of cash in exchange for all of the outstanding stock of Target. Twenty of the Acquiror shares, however, will be placed in escrow to secure customary Target representations and warranties. The Acquiror stock is listed on an established market. On January 2 of Year 1, the value of the Acquiror stock is $1 per share. On June 1 of Year 1, Target merges with and into Acquiror pursuant to the terms of the contract. On that date, the value of the Acquiror stock is $0.25 per share. None of the stock placed in escrow is returned to Acquiror. Because the contract provides for the number of shares of Acquiror and the amount of money to be exchanged for all of the proprietary interests in Target, there is a binding contract

[727] Reg. §1.368-1(e)(2)(i).

[728] The presence of a condition outside the parties' control (including, for example, regulatory agency approval) does not prevent an instrument from being a binding contract. Furthermore, the fact that insubstantial terms remain to be negotiated by the parties to the contract, or that customary conditions remain to be satisfied, does not prevent an instrument from being a binding contract. Reg. §1.368-1(e)(2)(ii)(A).

[729] Reg. §1.368-1(e)(2)(ii)(B).

[730] Reg. §1.368-1(e)(2)(iii)(A).

[731] Reg. §1.368-1(e)(2)(iii)(B).

[732] Reg. §1.368-1(e)(2)(v) *Ex.* 9.

[733] Reg. §1.368-1(e)(2)(iii)(C).

[734] Reg. §1.368-1(e)(2)(iii)(D).

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providing for fixed consideration as of January 3 of Year 1. Therefore, whether the transaction satisfies the COI requirement is determined by reference to the value of the Acquiror stock on January 2 of Year 1. Because, for COI purposes, the T stock is exchanged for $40 of P stock and $60 of cash, the transaction satisfies the 40% continuity threshold and satisfies the COI requirement.[735]

Reg. §1.368-1(e)(2)(v) *Ex.* (2)(i), however, is quite troublesome. This example is the same as Reg. §1.368-1(e)(2)(v) *Ex.* (1) except that the 20 Acquiror shares placed in escrow are returned to Acquiror due to Target's breach of a representation. The example concludes that the 40% continuity requirement must be re-evaluated since these escrowed shares were not ultimately issued to the Target shareholders. Thus, even though the events giving rise to the return of the escrowed shares may not have occurred until several years after the merger, Reg. §1.368-1(e)(2)(v) *Ex.* (2)(i) concludes that the 40% continuity test must be retroactively tested based on the $60 of cash and the 20 Acquiror shares that were actually issued to Target shareholders. Accordingly, the 40% continuity test is not met based on these facts.

Reg. §1.368-1(e)(2)(v) *Ex.* (2)(ii) provides a variation on the same facts, except that the escrow was funded based on the 40/60 mix of stock and cash consideration. Thus, the $20 escrow was funded with eight shares of Acquiror stock and $12 of cash. When the consideration in that escrow is removed from the merger consideration, we are left with 32 shares of Acquiror stock and $48 of cash that was agreed to be paid as of the binding contract date. Since 32 shares valued at $1 are 40% of the total $80 of consideration, the continuity test is met.

Interestingly, the foregoing examples do not indicate whether the escrowed shares met all the requirements in Rev. Proc. 84-42 in order for escrowed stock to avoid being treated as boot at the shareholder level. Rev. Proc. 84-42 requires that in order for escrowed stock to be treated as stock owned by the Target shareholders, such shareholders must receive the dividends and voting rights, among other things. *See* III.C.4.i., above. While it is not clear if Rev. Proc. 84-42 says anything about whether escrowed stock is counted as stock for COI purposes, it seems relatively clear that the examples in Reg. §1.368-1(e)(2)(v) confirm that escrowed stock is counted for COI purposes and is not boot at the shareholder level in the first instance, but such stock will subsequently (and retroactively) fail to be counted for COI purposes if it is returned to Acquiror.

For transactions with an effective date on or after January 23, 2018, in determining whether a transaction satisfies the COI requirement under the signing date rule or the closing date rule, the IRS provides safe harbor valuation methods and measuring periods for determining the value of the issuing corporation stock based on either the average of the daily volume weighted average prices, or the average of the average high-low daily prices, or the average of the daily closing prices.[736] The guidance on the measuring periods allows taxpayers to take the average value of stock used in a reorganization over a period of between five and 35 consecutive days.[737] If a transaction satisfies the requirements specified in the guidance, the IRS will not challenge the position that, for purposes of determining whether the COI requirement is satisfied, the value of exchange traded stock is determined under the safe harbor valuation method and measuring period selected by the parties. The safe harbor is available regardless of whether the value of exchange traded stock, as determined under the safe harbor valuation method and the measuring period selected by the parties, satisfies the COI requirement.[738] Rev. Proc. 2018-12 has no effect if the safe harbor does not apply.[739] Moreover, subject to Rev. Proc. 2025-1 and Rev. Proc. 2025-3, the IRS will entertain requests for rulings and determination letters regarding the applicability of the safe harbor and transactions to which the safe harbor does not apply.[740]

c. IRS Challenges to Purported Stock Interest

When determining the mix of consideration received in a reorganization, the IRS may challenge whether a purported stock interest is really a stock interest coupled with a separate property right (i.e., the IRS will look to the entire economic agreement to identify any disguised boot). The IRS has advised that when a taxpayer disposes of a Target in a supposed reorganization transaction, but the stock interest received largely reflects effective ownership of liquid assets equal in value to the Target, the transaction does not qualify as a tax-free reorganization.[741] In *Tribune Co. v. Commissioner*,[742] the IRS asserted that the transaction failed to qualify as a "B" or §368(a)(2)(E) reorganization because a purported stock interest was really a stock interest coupled with other property (in the form of management rights over liquid assets). While this case was not decided on COI grounds, the analysis is instructive for purposes of measuring the amount of equity issued in a purported reorganization.

Tribune Co. v. Commissioner involved a complex set of facts, summarized below. The transaction involved the acquisition of the taxpayer's subsidiary Matthew Bender & Co., Inc. (Bender) by Reed Elsevier (Reed). On July 31, 1998, all of the stock of Bender was acquired from TMD, Inc. (a wholly owned subsidiary of The Times Mirror Co., Inc., a subsidiary of Tribune). To effectuate the acquisition, two wholly owned subsidiaries of Reed (the Reed Subsidiaries) formed MB Parent and Merger Sub as the acquisition vehicles. The Reed Subsidiaries owned voting preferred stock in MB Parent (possessing 80% of the MB Parent vote). MB Parent, in turn, owned voting preferred stock in Merger Sub (possessing 80% of the Merger Sub vote) and participating nonvoting preferred stock in Merger Sub. The Reed Subsidiaries owned all of the common stock in Merger Sub (possessing 20% of the Merger Sub vote). On the date of the merger, MB Parent held cash in the amount of $1.375 billion, and Merger Sub held all of the voting common stock in MB Parent (possessing 20% of the MB Parent vote). On the merger date, Merger Sub merged into Bender, with Bender surviving. As a result, all of the Merger Sub stock

[735] Reg. §1.368-1(e)(2)(v) *Ex.* 1.
[736] Rev. Proc. 2018-12, §4.01.
[737] Rev. Proc. 2018-12, §4.02.
[738] Rev. Proc. 2018-12, §5.
[739] Rev. Proc. 2018-12, §6.02.
[740] Rev. Proc. 2018-12, §6.03.
[741] TAM 200204002.
[742] 125 T.C. 110 (2005), supplemented by T.C. Memo 2006-12.

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was converted into Bender stock, in the same number of shares, in the same classes, and with the same voting power, rights, and qualifications as the Merger Sub common stock, voting preferred stock, and participating nonvoting preferred stock. In addition, TMD, Inc. exchanged its Bender stock for all of the MB Parent common stock owned by Merger Sub (possessing 20% of the MB Parent vote). Immediately following the merger, MB Parent transferred its $1.375 billion of cash to LBI LLC, and Times Mirror became the sole manager of LBI LLC. Thereafter, Times Mirror, in its capacity as manager, directed LBI LLC to make several distributions and purchases.

The issue considered by the Tax Court was whether MB Parent's acquisition of the Bender stock qualified as a reorganization as a "B" or §368(a)(2)(E) reorganization. In form, TMD exchanged all of the Bender stock solely for MB Parent voting stock, and the taxpayer argued that the requirements of nonrecognition were satisfied. The Tax Court explained that the factual determination to be made was whether, under the contractual arrangements, the consideration received by TMD from MB Parent was common stock of MB Parent worth at least $1.1 billion or whether, as the IRS contended, the consideration received was title to the common stock plus effective control over $1.375 billion. Ultimately, the Tax Court concluded that TMD exchanged the Bender stock for a combination of (i) MB Parent common stock plus (ii) separate control over the LBI LLC cash. In other words, the Tax Court viewed the cash management right as boot in the reorganization. The Tax Court concluded further that, because the MB Parent common stock effectively lacked control over any assets (presumably consisting of the $1.375 billion of cash and the Bender stock), the MB Parent common stock had a value of less than $1.1 billion, and §368(a)(2)(E) was not satisfied because control of Bender was not acquired in exchange for MB Parent voting stock.

4. *Historic Shareholder Requirement*

a. *COI Regulations*

The continuity of shareholder interest (COI) regulations permit any or all of the Target shareholders to sell part or all of their Acquiror stock immediately after the reorganization, even pursuant to a binding commitment, without destroying reorganization treatment. These regulations confirm that the focus of the COI requirement is to ensure that Acquiror (or its parent in a triangular reorganization) furnishes sufficient equity consideration to the Target shareholders within the meaning of the historic case law. What the Target shareholders do with the Acquiror stock afterwards no longer affects reorganization treatment, so long as they do not sell that stock back to Acquiror (or a person related to Acquiror) for non-equity consideration pursuant to a plan or arrangement.[743] In addition, the COI regulations address the effect of pre-reorganization dispositions on COI, and adopt the same approach taken by the IRS in *J.E. Seagram Corp. v. Commissioner*.[744] Specifically, a mere disposition of Target stock before a potential reorganization to persons not related to Acquiror is disregarded.[745]

b. *Stock Held by Acquiror*

(1) *General "Old and Cold" Stock and COI Regulations*

The question of whether Target stock owned by Acquiror should be counted for COI purposes has been closely tied to the "historic shareholder" issue. For example, assume Acquiror owns 70% of Target and Target is merged into either Acquiror or a subsidiary of Acquiror, with the 30% minority shareholders receiving cash or Acquiror stock. If Acquiror's stock is counted, there is a 70% continuity without regard to whether the 30% minority shareholders receive cash or stock. If Acquiror's stock is not counted, the level of COI depends not only on whether the 30% minority shareholders receive stock or cash, but also on whether there are other historic shareholders who must be taken into account.

These issues are best illustrated by *Kass v. Commissioner*,[746] in which Acquiror purchased 84% of Target stock for cash and then merged Target into Acquiror, with the 16% minority shareholders receiving Acquiror stock. The court stated that if Acquiror's Target stock were "old and cold," it would be counted as contributing to COI, so that overall continuity would be 100%. However, because of Acquiror's integrated plan to acquire Target's assets, its momentary stock ownership in Target could not be counted. Moreover, the COI had to include all historic shareholders of Target, including those who sold their Target stock to Acquiror for cash, so that overall continuity was only 16%.

At one time the IRS took the position that Acquiror's Target stock could not be counted for continuity, even if that stock was "old and cold." Thus, unless the minority shareholders received sufficient Acquiror stock to pass the COI test on their own, a merger of Target into Acquiror could not qualify as a tax-free reorganization. However, in GCM 39404 (1985), the IRS addressed a situation identical to the example set forth above and concluded that Acquiror's 70% "old and cold" interest should be counted for purposes of qualifying the upstream merger of Target into Acquiror as an "A" Reorganization. The IRS repudiated its earlier position and cited *Kass* as supporting authority.

The final COI regulations confirm that Target stock owned by Acquiror is counted for COI purposes to the extent that the stock was not acquired by Acquiror "in connection with" the reorganization.[747]

(2) *Acquiror's Acquisition of Target Stock Prior to Reorganization*

(a) *Qualified Stock Purchase*

The "historic shareholder" doctrine as set forth in *Kass*, *Yoc Heating*, and other cases is analogous to the *Kimbell-Diamond* doctrine. In *Kimbell-Diamond Milling Co. v. Commissioner*,[748] the court held that Acquiror's purchase of Target stock for the purpose of obtaining Target's assets through a prompt liquidation should be treated as a single taxable acquisition of

[743] Reg. §1.368-1(e)(1)(ii).
[744] 104 T.C. 75 (1995).
[745] Reg. §1.368-1(e)(1), §1.368-1(e)(8) *Ex.* 1(ii).
[746] 60 T.C. 218 (1973), aff'd without opinion, 491 F.2d 749 (3d Cir. 1974).
[747] Reg. §1.368-1(e)(8) *Ex.* 7.
[748] 14 T.C. 74 (1950), aff'd per curiam, 187 F.2d 718 (5th Cir. 1951), cert. denied, 342 U.S. 827 (1951).

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assets. Old §334(b)(2) of the Code was added in 1954 to codify *Kimbell-Diamond*.[749] Congress repealed old §334(b)(2) in 1982 and enacted §338, which was "intended to replace any non-statutory treatment of a stock purchase as an asset purchase under the *Kimbell-Diamond* doctrine."[750] Under §338, in the case of any purchase of at least 80% of Target's stock, by vote and value, within a 12-month period (a "qualified stock purchase"), whether the transaction gives rise to purchase of stock treatment or purchase of assets treatment does not depend on whether Target is liquidated, merged into another corporation, or otherwise disposed of by the purchasing corporation. Rather, it generally turns on whether the purchasing corporation makes a §338 election.

Although it was fairly clear under §338 that a liquidation following a qualified stock purchase would be respected as an independent transaction when a §338 election was made, for some time it was unclear whether the same result would apply when no §338 election was actually made with respect to the qualified stock purchase. Specifically, the issue was whether a qualified stock purchase followed by a liquidation, but with no §338 election, would be treated as a taxable acquisition of assets under the *Kimbell-Diamond* doctrine or the *Yoc Heating* line of cases.[751] In Rev. Rul. 90-95,[752] the IRS clarified that a qualified stock purchase followed by an upstream merger or liquidation is to be governed exclusively by §338, without regard to the *Kimbell-Diamond* doctrine or the *Yoc Heating* line of cases. A qualified stock purchase is to be "accorded independent significance from a subsequent liquidation of the target regardless of whether a Section 338 election is made or deemed made."[753] Essentially, a qualified stock purchase causes Acquiror's recently purchased Target stock to be regarded as "old and cold." Thus, if Target is liquidated or merged into Acquiror following Acquiror's qualified stock purchase of Target stock, the liquidation is tax-free under §332, regardless of whether a §338 election is made.

Following Rev. Rul. 90-95, there continued to be some uncertainty whether a sideways merger of Target into a subsidiary of Acquiror following a qualified stock purchase (for which no §338 election was made) would be treated as an independent transaction or as a taxable asset acquisition under the *Yoc Heating* line of cases. The IRS took the position in private letter rulings, however, that the qualified stock purchase effectively made Acquiror a "historic shareholder" for purposes of determining whether a subsequent sideways merger qualified as an "A" Reorganization.[754] Then, in 1995, the IRS confirmed in regulations that Target stock acquired in a qualified stock purchase counts favorably in determining COI under Reg. §1.368-1(b) for a tax-free reorganization (the "anti-*Yoc Heating* regulations").[755] Specifically, Reg. §1.338-3(d)(2) generally provides that Acquiror's Target stock acquired in the qualified stock purchase represents an interest on the part of a person who was the owner of Target's business enterprise before the transfer that can be continued in a reorganization, for the purpose of determining whether COI is satisfied; thus, Acquiror is regarded as a "historic shareholder."

The anti-*Yoc Heating* regulations apply when Target assets have been transferred to Acquiror or another member of the same affiliated group as Acquiror (the transferee) following a qualified stock purchase of Target stock, and a §338 election has not been made for Target.[756] In addition to treating Acquiror as a historic shareholder of Target, these regulations also treat Acquiror as a shareholder of Target for purposes of determining whether the control requirement of §368(a)(1)(D) is satisfied (i.e., whether, after the transfer, the transferor or its shareholders are in control of the corporation to which the assets were transferred).

The anti-*Yoc Heating* regulations treat Acquiror as a "historic shareholder" only for purposes of determining the tax consequences of Acquiror, Target, and an affiliate of Acquiror that may acquire Target's assets in the reorganization. The historic shareholder requirement and the *Yoc Heating* line of cases are still alive and well for any minority shareholders of Target. Assume that Acquiror acquires 85% of Target stock for cash in a qualified stock purchase, with the remaining 15% of Target owned by Mrs. K. Then, Acquiror causes Target to be merged into Acquiror's subsidiary (Sub), pursuant to which Acquiror's and Mrs. K's Target stock is exchanged for Sub stock. Under these regulations, the merger of Target into Sub is both an "A" Reorganization and a reorganization under §368(a)(1)(D) with respect to Acquiror, Target, and Sub. Therefore, the applicable reorganization provisions (e.g., §354, §358, §361(a), and §362(b)) apply to these parties. However, because Acquiror's purchase of Target stock for cash and the subsequent merger of Target into Sub would be integrated as a taxable acquisition of assets under the *Yoc Heating* line of cases, Mrs. K's exchange of Target stock for Sub stock is not entitled to reorganization treatment, but rather is taxable under §1001.[757]

Planning Point: Assuming Acquiror wants to acquire Target stock for cash and then move Target's business into an affiliate but does not want to risk the "historic shareholder" issue because of minority shareholders in Target who desire tax-free treatment, Acquiror might consider the following: Acquiror contributes its Target stock (if any has already been acquired) and cash to a subsidiary ("Sub"), and the minority Target shareholders desiring tax-free treatment transfer their Target stock to Sub in a §351 transaction.[758] Sub uses the con-

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[749] *See* S. Rep. No. 83-1622 at 257 (1954).

[750] H.R. Conf. Rep. No. 97-760 at 536 (1982), 1982-2 C.B. 600, 632.

[751] *See, e.g.*, PLR 8645041 (declining to rule on treatment of intracompany merger following qualified stock purchase unless §338 election was made). In *Kass v. Commissioner*, 60 T.C. 218 (1973), aff'd without opinion, 491 F.2d 749 (3d Cir. 1974), the post-acquisition upstream merger was treated as an asset purchase under old §334(b)(2), but the court declined to treat the merger as an "A" Reorganization with respect to minority shareholders. In *Yoc Heating Corp. v. Commissioner*, 61 T.C. 168 (1973), on the other hand, the post-acquisition merger of Target into Acquiror's subsidiary was not eligible for §334(b)(2) treatment; the court, nonetheless, treated the merger as a taxable asset acquisition. Consequently, the subsidiary received a stepped-up basis in Target's assets. *See also* Wells, *Does the Asset-Acquisition Doctrine Apply After TRA '86*, 69 J. Tax'n 386 (1988).

[752] *Distinguished by* Rev. Rul. 2001-46.

[753] Rev. Rul. 90-95.

[754] *See, e.g.*, PLR 9317011, PLR 9315019, PLR 9225034, PLR 9213023, PLR 9113022.

[755] Reg. §1.338-3(d)(2), T.D. 8940, 66 Fed. Reg. 9925 (Feb. 13, 2001) (the final redesignation of former Reg. §1.338-2(c)(3), T.D. 8626, 60 Fed. Reg. 54,942 (Oct. 27, 1995)). The anti-*Yoc Heating* regulations originally became effective for transfers of Target assets occurring after October 25, 1995.

[756] Reg. §1.338-3(d)(1).

[757] Reg. §1.338-3(d)(5) *Ex.*

[758] Rev. Rul. 84-71.

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tributed cash to buy the remaining Target stock from the tendering Target shareholders (i.e., those desiring to sell for cash in a taxable stock purchase). Target is then merged or liquidated into Sub, and the parties claim the benefit of Rev. Rul. 90-95 to treat the liquidation as a tax-free transaction under §332.

Planning Point: If Acquiror's goal is simply to combine the businesses of Acquiror and Target following a taxable acquisition of Target stock and there are reasons for not liquidating Target, Acquiror can merge downstream into Target. Because the COI requirement applies only to shareholders of Target,[759] the merger should qualify as an "A" Reorganization.[760] This treatment is supported by Rev. Rul. 70-223,[761] in which Acquiror purchased all of the Target stock within a 12-month period and, within two years of the last purchase, was merged into Target. There were good business reasons for combining the two businesses and it was decided to merge Acquiror into Target (instead of vice versa) because of the recapture tax that would have resulted under old §334(b)(2). The ruling does not suggest that Acquiror's stock interest in Target was "old and cold" or that the requisite COI was provided by Target shareholders. Thus, it is implicit in the ruling that the shareholders of Acquiror provided the COI necessary to qualify the merger as an "A" Reorganization. Accordingly, a downstream reorganization may be considered when structuring transactions with minority Target shareholders who desire tax-free treatment.

Before Rev. Rul. 2001-46 (discussed below) was issued, there remained some question as to whether the anti-*Yoc Heating* regulations took precedence over *King Enterprises, Inc. v. United States*[762] in which a qualified stock purchase was followed by a merger of Target into Acquiror or Acquiror's subsidiary, but the aggregate consideration paid by Acquiror in both transactions included sufficient Acquiror stock for COI purposes. In *King Enterprises*, Acquiror purchased substantially all of the Target's stock for cash, notes, and Acquiror stock; the stock comprised 51% of the overall consideration. Target then merged upstream into Acquiror. The stock purchase and merger were integrated as a single "A" Reorganization. If *King Enterprises* were subject to the anti-*Yoc Heating* regulations, then, under the facts of that case, Acquiror's purchase of Target stock would be a qualified stock purchase (assuming, of course, that the various requirements of §338 were met, e.g., 80% or more of Target's stock was purchased within a 12-month period)[763] and, therefore, should be treated as independent of the subsequent merger. Nevertheless, in the event that Acquiror desires to effect a qualified stock purchase using primarily Acquiror stock as consideration, and then collapse Target into Acquiror or Acquiror's subsidiary, it may be advisable to liquidate (rather than merge) Target to avoid the holding of *King Enterprises*.

The final COI regulations, which include amendments to the anti-*Yoc Heating* regulations, appear to confirm that the anti-*Yoc Heating* regulations take precedence over *King Enterprises* when the initial stock purchase meets the requirements of a qualified stock purchase. The COI regulations provide that an acquisition of Target stock may be linked with later acquisitions of Target's assets under the step transaction principles of *King Enterprises* and *Yoc Heating* for purposes of determining whether a transaction qualifies as a reorganization.[764] However, the amendments to the anti-*Yoc Heating* regulations provide that Acquiror's Target stock acquired in a qualified stock purchase "shall be treated as though it was not acquired in connection with the transfer of [T]arget assets."[765] Moreover, the preamble to the final COI regulations provides that the COI regulations do not address the effect of §338 on corporate transactions.[766] Despite this, in Rev. Rul. 2001-46, the IRS ruled that if, pursuant to an integrated plan, Acquiror's newly formed, wholly owned subsidiary merges into Target, and Target subsequently merges into Acquiror, the transaction is treated as a single statutory merger of Target into Acquiror qualifying as an "A" Reorganization, as in *King Enterprises*. The IRS noted that, absent integration of the two steps, the acquisition of Target's stock would constitute a §338 qualified stock purchase, but asserted that application of the step transaction doctrine does not violate the policy underlying §338, because as a single §368(a)(1)(A) merger, Acquiror receives a carryover basis in Target's assets, not a cost basis.

In response to comments regarding Rev. Rul. 2001-46, however, Treasury issued regulations providing that the step transaction doctrine will not be applied if a taxpayer makes a valid §338(h)(10) election with respect to one step in a multistep transaction, even if the transaction otherwise would qualify as a reorganization, if that step, standing alone, is a qualified stock purchase.[767] Accordingly, a taxpayer can break the application of the step transaction doctrine if the Acquiror and Target shareholders jointly file a valid §338(h)(10) election with respect to the first step stock purchase. The IRS has not issued similar guidance regarding the ability to break the application of the step transaction doctrine by making a valid §338(g) election. In issuing Reg. §1.338(h)(10)-1(c) (in 2006), the IRS expressly noted that a similar rule was not adopted for §338(g) elections because of concerns about potential inconsistent reporting in the case of §338(g) elections (which are unilateral, purchaser-only, elections), as opposed to §338(h)(10) elections, which are bilateral (purchaser-and-seller) elections.[768] Accordingly, until further guidance is issued from the IRS on this issue, it does not appear that taxpayers can break the application of the step transaction doctrine if a taxpayer makes a valid §338(g) election with respect to the first step stock purchase.

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[759] *See, e.g.*, Rev. Proc. 77-37.

[760] *See* III.A.5.a., above.

[761] *See also* TAM 8936003.

[762] 418 F.2d 511 (Ct. Cl. 1969). *See* III.A.2.d., above and V.D., below. In Rev. Rul. 2001-46, the IRS ruled that if, pursuant to an integrated plan, a newly formed, wholly owned subsidiary of Acquiror merges into Target, and Target subsequently merges into Acquiror, the transaction will be treated as a single statutory merger of Target into Acquiror qualifying as an "A" Reorganization, as in *King Enterprises*, rather than as a §338 qualified stock purchase and §332 liquidation.

[763] Section 338(h)(3) defines a "purchase" as any acquisition of stock in which (i) the basis of the stock in the hands of the purchasing corporation is not determined in whole or in part by reference to the adjusted basis of such stock in the hands of the person from whom the stock was acquired, (ii) the stock is not acquired in a transaction to which §351, §354, §355, or §356 apply, and (iii) the stock was not acquired by a related party.

[764] Reg. §1.368-1(a).

[765] T.D. 8760, 63 Fed. Reg. 4174 (Jan. 23, 1998).

[766] Preamble to T.D. 8760, 63 Fed. Reg. 4174 (Jan. 23, 1998).

[767] Reg. §1.338(h)(10)-1(e) *Exs.* 11, 12, 13, 14, T.D. 9271, 71 Fed. Reg. 38,074 (July 5, 2006).

[768] Preamble to T.D. 9271, 71 Fed. Reg. 38,074 (July 5, 2006).

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In Rev. Rul. 2008-25, moreover, the IRS confirmed the distinction between the approaches of Rev. Rul. 2001-46 (requiring application of the step transaction doctrine when merger of Acquiror's subsidiary into Target followed by merger of Target into Acquiror would constitute a tax-free reorganization) and Rev. Rul. 90-95 (rejecting step integration when the result would be a taxable asset purchase on the grounds that Congress intended §338 to replace any non-statutory treatment of stock purchases as assets purchases under the *Kimbell-Diamond* doctrine). Collectively, Rev. Rul. 90-95, Rev. Rul. 2001-46, and Rev. Rul. 2008-25 stand for the proposition that, absent a §338 election, a two-step stock acquisition may be collapsed into an asset acquisition only if the resulting transaction results in a tax-free reorganization.[769]

(b) Non-Qualified Stock Purchase

The anti-*Yoc Heating* regulations obviously do not apply when Acquiror's purchase of stock does not constitute a qualified stock purchase. For example, if Acquiror acquires less than 80% of Target's stock, or acquires 80% or more during a more than 12-month period, and then Target is merged into Acquiror, the historic shareholder requirement and the *Yoc Heating* line of cases may still be applicable. In addition, Rev. Rul. 2001-46 only addresses qualified stock purchases. However, the *King Enterprises* doctrine is not so limited, and may treat the overall transaction as an "A" Reorganization if the stock consideration is sufficient to meet the COI requirement. If the stock consideration is not sufficient to meet the COI requirement, the better view is to respect the stock purchase and merger as separate transactions; otherwise, an integration of these transaction into a single taxable merger would be inconsistent with the death of the *Kimbell-Diamond* doctrine. For example, assume an Acquiror engaged in a nonqualified stock purchase, acquiring 100% of the Target over a 24-month period for cash (80% not acquired in one year) as part of a plan to liquidate Target. If *Kimbell-Diamond* and *Yoc Heating* apply, then the transaction would be recast as a taxable purchase of Target's assets. However, there seems to be little policy basis to justify different treatment in this case as compared to a similar case in which more than 80% of the stock was acquired in a 12-month period. Accordingly, although there is no authority directly on point, it appears the better view is that the *Kimbell-Diamond* doctrine should not apply to the transaction and, thus, the liquidation of Target would not be integrated with the stock acquisition.

In the event that the transaction is taxable, it should be noted that if Acquiror's affiliate and Target are part of Acquiror's consolidated return, any gain required to be recognized by Target in the merger would likely be deferred.[770] However, the treatment of the merger as taxable could have adverse consequences, including loss of favorable depreciation methods, alternative minimum tax implications, possible income and other taxes at the state level, and gain recognition consequences to minority shareholders in Target.

[769] Rev. Rul. 2008-25 is discussed in greater detail below in V.D.

[770] *See* Reg. §1.1502-13(a)(2). *But see* TAM 8837003 (Target is not regarded as member of purchaser's consolidated group when Target is purchased with intention of being merged into another member). The sideways merger may in any event qualify as a §351 transaction. *See* Rev. Rul. 89-46.

(3) Target Stock Acquired in Preceding Reorganization or Exercise of Option

A reorganization or other tax-free transaction in which Target stock is acquired by new shareholders may be followed by a subsequent merger of Target into another corporation.[771] The new Target shareholders may supply the necessary COI to qualify the subsequent merger as a tax-free transaction even though the original reorganization and the subsequent merger occur pursuant to an overall plan. For example, a spin-off of Target before the merger of Target with an unrelated corporation should not prevent the merger from qualifying as an "A" Reorganization. While there may be an issue as to whether the spin-off meets the requirements of §355 or whether the distributing corporation is taxed on the distribution under §355(e),[772] the treatment of the reorganization should not be affected by

[771] *See, e.g.*, Rev. Rul. 96-30, *modifying* Rev. Rul. 75-406, and *obsoleted by* Rev. Rul. 98-27; Rev. Rul. 96-29, *modifying* Rev. Rul. 79-250.

[772] In Rev. Rul. 96-30, *obsoleted by* Rev. Rul. 98-27, a widely held public corporation (Distributing) owned all the stock of an "old and cold" subsidiary (Controlled). Distributing distributed the stock of Controlled pro rata to its shareholders in a transaction meeting the requirements of §355. After the spin-off, Acquiror commenced negotiations with Controlled's management for a merger of Controlled into Acquiror, in which the Controlled stock would be converted into 25% of the stock of Acquiror. Controlled's shareholders voted to approve the merger. The IRS respected the form of the spin-off and subsequent merger because the "substance of the transaction" was a distribution of the Controlled stock followed by an exchange of the Controlled stock for Acquiror stock pursuant to the merger. The IRS suggested that if negotiations with Acquiror for the acquisition of Controlled had begun before the spin-off, the requirement that Distributing distribute control (within the meaning of §368(c)) would not have been met. Rev. Rul. 96-30 modified Rev. Rul. 75-406, in which the IRS had ruled that a merger of Controlled into Acquiror following a spin-off of Controlled did not prevent the spin-off from qualifying as tax-free under §355, in part because the temporary ownership of Controlled stock by the exchanging shareholders was regarded as "real and meaningful" because they were free to vote their Target stock for or against the merger. Following Rev. Rul. 96-30, the IRS adopted a no-ruling policy on spin-offs if, because of some pre-spin-off "negotiations, agreements or arrangements," the Distributing shareholders will reduce their stock ownership in the spun-off corporation to below 80% control. Rev. Proc. 96-39, *superseded by* Rev. Proc. 97-3. Following the enactment of §355(e) in the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, §1012(a), the fate of Rev. Rul. 96-30 was unclear. Section 355(e) taxes the distributing corporation (Distributing) on a spin-off if, pursuant to a plan, 50% or more of the stock of either Distributing or the controlled corporation (Controlled) is acquired by one or more persons. The statute creates a presumption that there was a prohibited plan in place at the time of the spin-off if Distributing or Controlled is acquired within two years before or after the spin-off. Taxpayers may rebut this presumption by showing that the acquisition is unrelated to the spin-off. Note that only Distributing is taxed under §355(e); the Distributing shareholders still receive Controlled stock tax-free if the spin-off otherwise qualifies for tax-free treatment. The IRS reversed its no-ruling policy in Rev. Proc. 97-53, apparently in response to the enactment of §355(e). Also, the legislative history to §355(e) suggests that a prearranged acquisition of Controlled following the spin-off should not prevent the spin-off from qualifying as a tax-free distribution under §355, so long as no more than 49% of Controlled is acquired, on the theory that a prearranged acquisition by Distributing of no more than 49% does not preclude a tax-free distribution of Controlled. H.R. Conf. Rep. No. 105-220 at 131 (1997). In Rev. Rul. 98-27, the IRS ruled that it will not apply *Commissioner v. Court Holding*, 324 U.S. 331 (1945) — or any formulation of the step transaction doctrine — in determining whether the distributed corporation was a controlled corporation immediately before the distribution under §355(a) solely because of any post-distribution acquisition or restructuring of the distributed corporation, whether prearranged or not. Prior to 2024, IRS would ordinarily not issue a ruling on any issue under §355(e) other than whether a distribution and an acquisition are part of a plan (i.e., any non-plan issue). Rev. Proc. 2023-3, §4.01(30). Pursuant to Rev. Proc. 2024-3, IRS will now rule on Section 355(e). For a further discussion of §355(e) and the IRS's current ruling policy, see 776 T.M., *Corporate Separations.*

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the taxable nature of the spin-off. In Rev. Rul. 58-68,[773] a merger following a spin-off of Target constituted an "A" Reorganization even though the spin-off was treated as a taxable distribution. Formerly, it was clear that if Target was a new subsidiary formed shortly before the spin-off distribution or other transaction in which Target stock was acquired, so that the existence of Target was disregarded, the subsequent merger was not likely to be respected as a separate transaction in any event.[774] In Rev. Rul. 98-27, the IRS stated that it would no longer use the step transaction doctrine to determine whether the distributed corporation was a controlled corporation immediately before the distribution under §355(a) solely because of any post-distribution acquisition or restructuring of the distributed corporation, whether prearranged or not.

Other pre-merger acquisitions of Target stock have been respected by the IRS for purposes of qualifying the holder's exchange of Target stock for Acquiror stock in the reorganization as tax-free, including the pre-merger acquisition of Target stock upon the exercise of convertible debt or a stock warrant. The issue of whether the holder's exchange of stock in the reorganization should be respected depends on whether the step transaction doctrine should be applied to disregard the shareholders' temporary, pre-merger ownership of Target shares.[775] Although the "historic shareholder" status of the exchanging holders was not addressed in these authorities, the clear implication is that a holder whose status as a Target shareholder is respected in determining the holder's tax consequences would be regarded as a "historic shareholder" for purposes of qualifying the overall transaction as a tax-free reorganization. This is consistent with the overall approach of the COI regulations, which disregard pre-merger treatment of Target shareholders unless a related-party transaction.[776]

c. Insolvent Target

The COI requirement generally applies only to Target's shareholders, not its creditors. Presumably, COI can be met even when 99% of the aggregate consideration from Acquiror is given to Target's creditors, so long as the 1% consideration issued to Target's shareholders constitutes equity equal to at least 40% (or some lower requisite percentage) of the shareholders' Target stock value. However, when the shareholders' equity interests in Target are very small relative to the creditors' interest, there is a risk that the COI requirement will not be met unless the creditors are counted as equity holders and sufficient equity is issued to the creditors in the reorganization.[777]

Section 368(a)(1)(G), which was added by the Bankruptcy Tax Act of 1980,[778] provides that a "reorganization" includes a transfer by Target of substantially all of its assets to another corporation in a Title 11 or similar case, provided the Target distributes the Acquiror consideration it receives, as well as assets it has retained, pursuant to the plan of reorganization.[779] The legislative history to the Bankruptcy Tax Act of 1980 indicates that the COI test, although generally applicable to a reorganization under §368(a)(1)(G), should be applied more liberally in this context than in other reorganizations.[780] Specifically, the COI test is to reflect the modification of the "absolute priority" rule applicable in bankruptcy, under which shareholders and junior creditors, who previously may have been excluded, may receive stock or other consideration under the bankruptcy plan.[781] The most senior class of creditor to receive stock, along with all junior creditors and even shareholders who receive stock, are counted as equity holders for COI purposes; however, the treatment of any class of creditors as equity holders may not be justified if the shareholders receive any non-equity consideration.[782]

The COI regulations effectively adopt the standards for determining creditor continuity for reorganizations under §368(a)(1)(G) outlined in the legislative history to the Bankruptcy Tax Act of 1980 discussed above. In the preamble to those regulations, the IRS noted that "the expansion of the application of the G reorganization rules to reorganizations of insolvent corporations outside of bankruptcy is consistent with Congress' intent to facilitate the rehabilitation of troubled corporations."[783]

The regulations provide that creditors of an insolvent Target not in a Title 11 or similar case are treated as holding a proprietary interest in the corporation to the extent they receive stock in the reorganization, even if they take no steps to obtain effective command over the corporation's property other than their agreement to receive stock in the potential reorganization. Specifically, the regulations provide that creditors of the most senior class receiving stock (and all junior classes of creditors) of such insolvent Target shall be treated as holding proprietary interests for purposes of measuring COI.[784] Further-

[773] *Revoked by* Rev. Rul. 83-114.

[774] *See, e.g.*, Rev. Rul. 70-225 (Parent's spinoff of recently incorporated subsidiary followed by merger of subsidiary into acquiror was treated as direct transfer of assets by Parent), *modified by* Rev. Rul. 98-27, and *obsoleted by* Rev. Rul. 98-44. For a discussion of the step transaction doctrine, see V.D., below.

[775] *See* GCM 37652 (Aug. 29, 1978) (receipt of Target stock in §351 exchange followed by Forward Triangular Merger of Target into another corporation). *See also* GCM 36040 (Oct. 8, 1974) (preliminary conversion of debentures into stock of Target before "B" Reorganization in which Target stock exchanged for Acquiror stock is given independent economic significance); GCM 36041 (Oct. 8, 1974) (applies rationale of GCM 36040 to exercise of stock warrants of Target immediately before "B" Reorganization). GCM 36040 and GCM 36041 suggest that employees who exercise their stock options before a reorganization should be regarded as historic shareholders. *Cf.* PLR 9105028 (*as revised by* PLR 9132068), PLR 9008028.

[776] Reg. §1.368-1(e)(1)(i), §1.368-1(e)(8) *Ex.* 1.

[777] *See* III.A.2.c.(1) and III.C.2.b., above.

[778] Pub. L. No. 96-589, §4.

[779] §368(a)(1)(G), §354(b). For a detailed discussion of reorganizations under §368(a)(1)(G), see 540 T.M., *Bankruptcy and Insolvency Restructurings; Discharge of Indebtedness.*

[780] H.R. Rep. No. 96-833, 31 (1980); S. Rep. No. 96-1035, 36 (1980).

[781] H.R. Rep. No. 96-833, 31 (1980); S. Rep. No. 96-1035, 36 (1980).

[782] H.R. Rep. No. 96-833, 31 (1980); S. Rep. No. 96-1035, 36 (1980).

[783] Preamble to T.D. 9434.

[784] Reg. §1.368-1(e)(6)(i). Prior to the issuance of these regulations, some courts treated Target's creditors as equity owners for purposes of the COI test when the creditors effectively "stepped into the shoes" of Target's shareholders as a result of a bankruptcy or insolvency proceeding and the shareholders received nothing. *See, e.g.*, *Helvering v. Ala. Asphaltic Limestone Co.*, 315 U.S. 179 (1942); *Atlas Oil & Ref. Corp. v. Commissioner*, 36 T.C. 675 (1961), *acq.*, 1962-2 C.B. 3. Another line of cases regarded creditors as equity holders for COI purposes when the creditors also owned Target stock, whether or not insolvency or bankruptcy proceedings had begun, on the grounds that it was not necessary to determine the capacity in which the Acquiror stock was received. *See, e.g.*, *United States v. Adkins-Phelps, Inc.*, 400 F.2d 737 (8th Cir. 1968); *Norman Scott, Inc. v. Commissioner*, 48 T.C. 598 (1967); *W. Mass. Theatres, Inc. v. Commissioner*, 236 F.2d 186 (1st Cir. 1956).

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more, the regulations provide special rules for measuring the value of the proprietary interests held by the creditors of Target when members of the most senior class of creditors receiving stock also receive other nonstock consideration. In general, to the extent all members of such class of creditors receive a proportionate amount of stock and nonstock consideration, each such creditors interest is bifurcated between a deemed proprietary interest in Target and a non-proprietary interest in Target.[785] The regulations also provide rules for measuring the value of the Target proprietary interest in situations in which creditors in the same class receive differing proportionate amounts of stock and nonstock consideration in the reorganization.[786]

5. *Post-Transaction Continuity*

The COI regulations confirm that the focus of the COI requirement is to ensure that Acquiror (or its parent in a triangular reorganization) furnishes sufficient equity consideration to the Target shareholders within the meaning of the historic case law.[787] What the Target shareholders do with the Acquiror stock afterwards does not affect reorganization treatment, so long as they do not sell such stock back to Acquiror (or a corporation related to Acquiror) for non-equity consideration in connection with the reorganization.[788] Thus, the regulations permit any or all of the Target shareholders to sell part or all of their Acquiror stock immediately after the reorganization, even pursuant to a binding commitment, without destroying reorganization treatment.[789]

The COI regulations provide that all the facts and circumstances are considered in determining whether "proprietary interest in the target corporation is preserved,"[790] i.e., whether Acquiror has in substance furnished sufficient equity consideration.[791]

Acquiror is considered to have furnished non-equity consideration if a person related[792] to Acquiror acquires, with consideration other than Acquiror stock, either Target stock or Acquiror stock furnished in exchange for Target stock in the potential reorganization, except to the extent that the related corporation was a direct or indirect owner of Target before the potential reorganization and maintains a direct or indirect proprietary interest in Acquiror. A corporation is related to Acquiror for this purpose if either (i) the two corporations are members of the same affiliated group as defined in §1504 (without regard to §1504(b)) or (ii) the purchase of stock of one corporation would be treated as a distribution in redemption of stock of the first corporation under §304(a)(2) (determined without regard to Reg. §1.1502-80(b)).[793] A related corporation includes one that is related to Acquiror either before or after the acquisition of the stock involved, or that becomes related in connection with the potential reorganization (other than Target or a corporation related to Target other than because of §1504).[794]

Examples in the COI regulations illustrate that purchases of Target stock for cash by either Acquiror or a related corporation in connection with a potential reorganization count against COI, except to the extent that the purchase results in a qualified stock purchase.[795] Similarly, purchases of Acquiror stock for cash by either Acquiror or a related corporation in connection with a potential reorganization count against COI.[796] Repurchases of a small percentage of Acquiror stock by a publicly traded Acquiror in the open market pursuant to an ongoing stock repurchase program do not count against continuity when the repurchase program was not created or modified in connection with the reorganization.[797] Acquiror is viewed in substance as having redeemed Acquiror stock received by former Target shareholders if any person (whether or not a corporation, e.g., Acquiror's investment banker), in connection with the potential reorganization, purchases Acquiror stock received by the Target shareholders and then, shortly thereafter and in connection with the potential reorganization, Acquiror redeems the stock held by such person for cash.[798]

Another example clarifies that a post-reorganization push-up of Acquiror stock to a corporation related to Acquiror does not count against COI if the related corporation was an indirect owner of Target prior to the reorganization, thus confirming the IRS's position in Rev. Rul. 84-30 [799] In addition, the IRS has clarified that Acquiror's stock in Target is counted for COI purposes if the stock was not acquired in connection with the acquisition of Target's assets, thus confirming the IRS's position in GCM 39404 (discussed in V.A.4.b.(1), above).[800]

The examples in the COI regulations also illustrate that a post-reorganization sale of Acquiror stock by a Target shareholder pursuant to a pre-existing binding contract to sell that stock to an unrelated third party does not violate the COI requirement, so long as the cash was not indirectly furnished by Acquiror.[801] Another example illustrates that the COI requirement is not violated if the Target shareholders receive registration rights pursuant to an agreement with Acquiror to register the Acquiror stock and then sell such stock shortly after the acquisition in the open market.[802]

In addition, the COI regulations address the effect of pre-reorganization dispositions on COI, and adopt the same approach taken by the IRS in *Seagram*. Specifically, a mere dis-

[785] Reg. §1.368-1(e)(6)(ii)(A).

[786] Reg. §1.368-1(e)(8) *Ex.* 10(ii).

[787] Preamble to T.D. 8760, 63 Fed. Reg. 4174 (Jan. 28, 1998). *See* Reg. §1.368-1(e)(1)(i).

[788] Reg. §1.368-1(e)(1)(i).

[789] Reg. §1.368-1(e)(1)(i).

[790] Reg. §1.368-1(e)(1)(i).

[791] Related persons do not include individual or other noncorporate shareholders. Preamble to T.D. 8760, 63 Fed. Reg. at 4174 (Jan. 28, 1998).

[792] Reg. §1.368-1(e)(3).

[793] Reg. §1.368-1(e)(4)(i).

[794] Reg. §1.368-1(e)(4)(ii).

[795] Reg. §1.368-1(e)(8) *Exs.* 2 (purchase by 60% corporate shareholder of Acquiror), 4(ii) (purchase by Acquiror).

[796] Reg. §1.368-1(e)(8) *Ex.* 4(i) (redemption by Acquiror), (iii) (purchase by Acquiror's wholly owned subsidiary).

[797] Rev. Rul. 99-58. The IRS withdrew former Reg. §1.368-1(e)(8) *Ex.* 8 after determining that the example suggested an incorrectly restrictive approach to COI in stock repurchase programs. *See* T.D. 8898, 65 Fed. Reg. 52,909 (Aug. 31, 2000). *See* N.Y. State Bar Ass'n, Tax Section, *Request for Formal Guidance for Stock Buybacks and "North South" Transactions*, Rep. No. 1162 (Aug. 18, 2008), (requesting formal guidance on scope of permissible buy-back programs and impact of revisions made to such programs in connection with acquisitions).

[798] Reg. §1.368-1(e)(8) *Ex.* 5.

[799] Reg. §1.368-1(e)(8) *Ex.* 8.

[800] Reg. §1.368-1(e)(8) *Ex.* 7.

[801] Reg. §1.368-1(e)(8) *Ex.* 1.

[802] Reg. §1.368-1(e)(8) *Ex.* 3.

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position of Target stock before a potential reorganization to persons not related to Acquiror is disregarded.[803]

The COI regulations adopt the aggregate theory with respect to any stock owned or acquired by a partnership. For example if a partnership in which Acquiror's wholly owned subsidiary is an 85% partner purchases, in connection with the potential reorganization, the Acquiror stock received by former Target shareholders, the COI requirement is violated.[804]

In conjunction with the COI regulations, the IRS issued temporary and proposed regulations (since removed) providing that a proprietary interest in Target was not preserved if Target redeemed the interest before, and in connection with, a potential reorganization.[805] A similar result applied to the extent that an extraordinary distribution was made with respect to a proprietary interest in Target before, and in connection with, a potential reorganization.[806] However, the IRS withdrew the temporary and proposed regulations in favor of the more limited test in the COI regulations. The regulations provide that a proprietary interest in Target is not preserved to the extent that the Target shareholder receives consideration before the reorganization (either in redemption of Target stock or as an extraordinary distribution) and this consideration is treated as money or other property under §356 (or would be so treated if the Target shareholder also received Acquiror stock in exchange for a portion of the shareholder's Target stock).[807]

6. *Special Rules for COI for Non-Stock Entities*

a. *General*

A series of rulings and cases involving mergers of thrift institutions have added an interesting gloss on the COI test. While the early cases established that COI requires the receipt of "stock" that represents a "material" part of the consideration given, these cases did not require that the Acquiror stock received by Target shareholders have any particular equity features. Thus, for example, COI existed when holders of a majority of Target common stock exchange that stock pursuant to a merger for nonvoting preferred stock in Acquiror. However, because of the unique capital structure of thrift institutions, the IRS and the courts were forced to scrutinize the equity characteristics of the various interests involved to determine whether a given merger of thrift institutions should qualify as a tax-free reorganization.

Mutual savings banks have no capital stock but are owned by their depositors and borrowers. Savings and loan associations are either similar to mutual savings banks or have some form of capital stock in addition to their depositors and borrowers. Federally chartered savings and loans may be either mutually owned or stock-owned, and state-chartered savings and loans may be either mutually owned or stock-owned depending on the state.[808]

In mutually owned savings and loan associations, the depositors may have exclusive voting rights,[809] may share them with borrowers,[810] or may relinquish them altogether to a board of trustees.[811] They represent, however, the entire equity interests in the association, having the right to share in current earnings and the right to share in assets upon liquidation.[812] As depositors, they have the right to withdraw their investments in cash upon notice to the association.[813] Unlike the depositors, the borrowers have no proprietary interests.

In stock-owned savings and loan associations, the voting rights are typically shared by depositors, borrowers, and stockholders.[814] The stock, usually called "guaranty stock," shares proportionately in the net earnings and assets of the association, subordinate to the claims of creditors.[815] Dividends are paid only after dividends are paid on the depositors' accounts.[816] While guaranty stock does not share in liquidation proceeds until all claims and depositors' accounts have been fully satisfied, it is entitled to all the residual proceeds.[817]

Note: The discussion below is concerned primarily with mergers involving thrift institutions. However, as indicated, a similar analysis applies to reorganizations that are not mergers and to reorganizations involving other non-stock companies, such as mutual life insurance companies.[818]

b. *Mutual-to-Mutual Mergers*

The treatment of a merger of two mutual associations is clear. In Rev. Rul. 69-3, two federally chartered non-stock savings and loan associations were merged, with the depositors of the merged association receiving an amount in the surviving association equal to the same dollar amount evidenced by their passbooks. The IRS noted that, as members of the merged association, they possessed the entire proprietary interests, including the right to vote, the right to share in current earnings, and the right to share in assets upon liquidation. As depositors, they

[803] Reg. §1.368-1(e)(1)(i), §1.368-1(e)(8) *Ex.* 1(ii).

[804] Reg. §1.368-1(e)(4), §1.368-1(e)(8) *Ex.* 6.

[805] Former Reg. §1.368-1T(e)(1)(ii)(A) (T.D. 8761, 63 Fed. Reg. 4183 (Jan. 28, 1998)), *removed by* T.D. 8898, 65 Fed. Reg. 52,909 (Aug. 31, 2000).

[806] Former Reg. §1.368-1T(e)(1)(ii)(A).

[807] Reg. §1.368-1(e)(1)(ii), §1.368-1(e)(8) *Ex.* 9. For a discussion and mild criticism of the regulations, see Wilcox & Gordon, *Tax Treatment of Pre-Reorganization Distributions*, 9 PLI's Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations and Restructurings 915 (2006).

[808] *See generally* Soukup, *The Continuity-of-Proprietary-Interest Doctrine and Thrift Institution Mergers*, 12 J. Corp. Tax'n 141 (1985).

[809] *See, e.g.*, Rev. Rul. 69-6.

[810] *See, e.g.*, *Paulsen v. Commissioner*, 469 U.S. 131 (1985).

[811] *See, e.g.*, Rev. Rul. 78-286.

[812] *See, e.g.*, Rev. Rul. 69-3.

[813] *See, e.g.*, *Paulsen v. Commissioner*, 469 U.S. 131 (1985).

[814] *See, e.g.*, Rev. Rul. 69-646.

[815] Rev. Rul. 69-646.

[816] *See, e.g.*, *Paulsen v. Commissioner*, 469 U.S. 131 (1985).

[817] *Paulsen v. Commissioner*, 469 U.S. 131 (1985).

[818] *See* Rev. Rul. 2003-19 (conversion of mutual insurance companies into stock companies under §368(a)(1)(B), §368(a)(1)(E), and §368(a)(1)(F); holding company membership interests received by mutual company members in "B" Reorganization are proprietary interests treated as voting stock); Rev. Rul. 74-277 (conversion of exempt fraternal beneficiary society into taxable mutual life insurance company); Rev. Rul. 71-233 (merger of mutual life insurance company into stock life insurance company); Rev. Rul. 70-298 (recapitalization of exempt farmers' cooperative is nontaxable under §368(a)(1)(E)). *See also* PLR 9720016 (mergers of two nonprofit, non-stock insurance companies into newly formed corporation satisfied COI requirement; when traditional equity interests do not exist, indicia of equity interest — right to vote, right to pro rata distribution of earnings and surplus, and right to share in liquidation proceeds — are used for purposes of determining whether the COI requirement is satisfied), PLR 9444010 (proprietary interests received by target policy holders in merger of mutual life insurance companies were continuing equity interests for purposes of COI requirement).

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possessed withdrawable deposits that were the equivalent of cash. Despite this dual capacity of the depositors, the merger satisfied the COI requirement because the depositors received "proprietary interests [in the surviving association] equivalent to their equity interests [in the merged association]," particularly because there was no change in their cash deposits.[819]

The same result was reached in Rev. Rul. 78-286[820] in which the facts were identical to those in Rev. Rul. 69-3 except that all voting rights of the merging associations were vested in a self-perpetuating board of trustees. The IRS ruled that COI existed notwithstanding the absence of voting rights, because the depositors — as the only persons entitled by law to participate in the earnings — were the equivalent of shareholders for tax purposes.

The Supreme Court has indicated that mutual-to-mutual mergers should qualify as tax-free reorganizations despite the "predominant cash-equivalent component" of the depositors' interests.[821] This is because the equity interest represented by the share account received in the surviving association — even though it may be small in comparison to the cash-equivalent features of that account — is equivalent to the equity interest represented by the shares surrendered. As the Supreme Court stated, "[t]he fact that identical cash deposits are also exchanged does not affect the equity aspect of the exchange."[822]

c. Mutual-to-Stock Mergers

The merger of a mutual association into a stock association represents an even stronger case for tax-free treatment, because the proprietary interest of the exchanging participants "is not only equivalent before and after the exchange, but it is enhanced."[823] In Rev. Rul. 69-646, the entire equity of the merged state-chartered association was vested in holders of free (savings) shares that, like the share accounts involved in Rev. Rul. 69-3, represented both proprietary interests and withdrawable deposits. Pursuant to a merger, these holders exchanged their free (savings) shares in the merged association for free (savings) shares in the surviving state-chartered association equal to the same dollar amounts reflected in their passbooks. In addition, they received guaranty shares in the surviving association equal to the fair market value of their equity interest in the merged association (i.e., their pro rata interest in the undivided profits and reserves of the merged association). The IRS ruled that the merger satisfied the COI requirement because the substance of the receipt of guaranty shares for the equity interest in the merged association was an equity-for-equity exchange, with the exchange of passbooks representing merely a substitution of one cash deposit for another.

The IRS ruled in Rev. Rul. 80-105[824] that the conversion of a federal mutual savings and loan association to a state stock savings and loan association constituted a reorganization under §368(a)(1)(F). The conversion was accomplished by offering shares of stock on a priority basis to depositors, then to borrowers, and finally to officers, directors, and employees of the association. At the time of conversion, all voting rights not attributable to the stock ceased, and each holder of a savings account at the time of conversion was entitled to a liquidation account representing a proportionate interest in the net worth of the association. These accounts represented a right to receive the depositor's interest before any liquidating distributions could be made to stockholders. These accounts would never be increased, but only decreased to reflect subsequent withdrawals. Even though the depositors' proprietary interest in future growth was shifted to the stockholders, a reorganization under §368(a)(1)(F) took place because (i) the equity interest of the depositor was more "nominal than real" because participation in any liquidation was speculative, (ii) the same savings accounts and loans existed, and (iii) there was an identity of business operations and regulatory requirements.

Comment: The IRS noted that the result would be the same if the conversion from mutual to stock involved federal associations or two state associations.

The IRS has applied a similar analysis to the demutualization of insurance companies. In Rev. Rul. 2003-19, the IRS ruled that the conversion of a mutual life insurance company to a stock insurance company is a reorganization under §368(a)(1)(F) if, under state law, the stock company's corporate existence as a stock insurance company is a continuation of the mutual company's corporate existence as a mutual insurance company. The IRS ruled that such a conversion is also a §368(a)(1)(E) reorganization (i.e., a recapitalization).

Rev. Rul. 2003-19 also addresses the tax results of the following additional transactions: (1) before the conversion, the mutual company (MC) incorporates a mutual insurance holding company (MHC); (2) after the conversion, the members of MC receive membership interests in MHC in exchange for their MC membership interests; and (3) the stock company (SC) issues all of its stock directly to MHC. The IRS ruled that — because MHC acquires SC stock in exchange solely for MHC membership interests and then controls SC — the transfers of SC stock to MHC and of MHC interests to the members together constitute a §368(a)(1)(B) reorganization, *provided* that the COI and COBE requirements are satisfied. The IRS found that the COBE requirement is satisfied because SC continues to offer life insurance products after the transactions. Citing Rev. Rul. 69-3 and *Paulsen v. Commissioner*,[825] the IRS con-

[819] *See also* PLR 200804010 (statutory merger of one mutual life insurance company into another qualified as "A" Reorganization; neither company had capital stock, but each company's proprietary interests were vested in its members).

[820] *See also* PLR 200208017 (mutual-to-mutual reorganization qualifies as "B" Reorganization).

[821] *Paulsen v. Commissioner*, 469 U.S. 131, 142 (1985).

[822] *Paulsen v. Commissioner*, 469 U.S. 131, 142 (1985).

[823] *Paulsen v. Commissioner*, 469 U.S. 131, 142 (1985). This type of exchange is somewhat analogous to a security holder's upgrading of its security interest to equity, pursuant to a reorganization, and, consequently, becoming entitled to nonrecognition treatment. *See, e.g.*, PLR 200115027 (COI requirements under Reg. §1.368-1(b) and §1.368-1(e) were satisfied in series of transactions that merged federally chartered mutual holding company and its mid-tier holding company into mid-tier's federally chartered stock savings bank, and exchanged membership interests for savings bank liquidation account interests), PLR 9602015 (exchange by mutual holding company members of their equity interests in mutual company for interests in subsidiary company's liquidation account satisfied Reg. §1.368-1(b) "continuity of interest" requirement).

[824] *See also* PLR 200051006 (conversion from mutual savings bank to stock company, followed by subsequent mergers, may qualify as "F" Reorganization), PLR 9332030 (depositors in mutual thrifts that were converted into stock thrifts and then merged into commercial banks realized no gain or loss as result of transactions, except for nominal value of interests received in liquidation accounts).

[825] 469 U.S. 131 (1985).

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cluded that MHC's acquisition of SC stock in exchange for MHC membership interests satisfies the COI requirement because the MC members receive MHC membership interests in place of their former MC membership interests. In other words, the MHC membership interests are proprietary interests treated as voting stock.

Rev. Rul. 2003-19 addresses the consequences of an additional, final transaction: after receiving stock from SC, MHC transfers all of its SC stock to a stock holding company (SHC), which MHC previously incorporated, in exchange for SHC voting stock. Citing §368(a)(2)(C) and Reg. §1.368-1(d)(4)(i) and §1.368-2(k), the IRS ruled that MHC's transfer of SC stock to the stock holding company does not prevent the overall acquisition from qualifying as a "B" Reorganization, and that MHC's transfer of its SC stock to SHC is itself a "B" Reorganization because SHC acquires the stock of SC solely in exchange for voting stock and controls SC immediately after the acquisition.[826]

COI in the post-conversion transactions in Rev. Rul. 2003-19 preserves the tax-free result of the original conversion as well. The IRS ruled that, under Reg. §1.368-1(e)(1), the original conversion's characterization as an "E" or "F" Reorganization is not altered by the subsequent change in the direct ownership of the converted company, because the subsequent parts of the transaction satisfy the COI requirement.

d. Stock-to-Mutual Mergers

For years the IRS and the courts were at odds on the treatment of stock to mutual mergers. In Rev. Rul. 69-6, the IRS ruled that a merger of a state-chartered stock association into a federally chartered mutual association was taxable. Although the equity features of an interest in a mutual association were sufficient to qualify a mutual-to-mutual merger in Rev. Rul. 69-3 as tax-free, the IRS ruled they were insufficient when compared to a former interest in a stock association. The courts, on the other hand, held that the COI requirement looks only to whether a proprietary interest is received; the fact that the new interest has relatively more debt-like characteristics than the prior interest is not determinative.[827] However, the Supreme Court's decision in *Paulsen v. Commissioner*[828] significantly changed the landscape.

In *Paulsen*, the Supreme Court held that an exchange of guaranty stock in a state-chartered stock association for passbook accounts and certificates of deposit in a federally chartered mutual association failed to meet the COI requirement because the holder received "essentially cash with an insubstantial equity interest." The Court reached that decision by separately considering the debt and equity characteristics of the interests in the surviving association to determine whether the equity characteristics represented, under the test set forth in *Helvering v. Minnesota Tea*,[829] a "substantial part of the value of the thing transferred."[830] The equity characteristics, including the right to vote and receive dividends, were greatly outweighed by the debt characteristics, which included the right to withdraw the funds after a year, the ability to borrow against those funds, and the fact that the accounts were not subordinated to creditors' claims. The dissenting opinion criticized the majority as having no support for bifurcating the debt and equity characteristics of a hybrid instrument.[831] Although the effect of *Paulsen* on the use of other types of hybrid instruments in reorganizations is not clear, it is noteworthy that the Court regarded the nonvoting preferred stock used in *John A. Nelson Co. v. Helvering*[832] as a "classic ownership [and therefore equity] instrument."[833]

B. Continuity of Business Enterprise Requirement

1. General Rules

The regulations under §368 not only restate the judicial "business purpose" test, but also set forth a "continuity of business enterprise" (COBE) requirement to the effect that a reorganization transaction "must be an ordinary and necessary incident of the conduct of the enterprise and must provide for a continuation of the enterprise."[834] The COBE requirement is fundamental to the notion that tax-free reorganizations merely readjust continuing interest in property.

Pursuant to Reg. §1.368-1(d), COBE generally requires the issuing corporation to either continue Target's historic business or use a signification portion of Target's historic business assets in a business.[835] As defined by Reg. §1.368-1(b), the term "issuing corporation" means the acquiring corporation, except that, in determining whether a reorganization qualifies as a triangular reorganization (as defined in Reg. §1.358-6(b)(2)), the issuing corporation is the corporation in control of the acquiring corporation.

In determining whether the issuing corporation has continued Target's "historic business," generally Target's "historic business" will be the business that Target conducted most recently.[836] With respect to Target's historic business, the fact that the issuing corporation is in the same line of business as Target helps establish continuity but is not, in and of itself, sufficient to satisfy the COBE requirement.[837] If Target has more than one line of business, the issuing corporation need only continue a significant line of business to meet the requirement.[838] Target's "historic business" is not one Target enters into as part of a plan

[826] *See also* Rev. Rul. 2003-48 (in bank demutualization coupled in integrated plan with "A" and "B" Reorganizations, neither "A" nor "B" Reorganization is disqualified by subsequent transfer of stock to corporations controlled by transferor). *See* Reg. §1.368-2(k) (expanding availability of drop-downs under §368(a)(1)(A), §368(a)(1)(B), §368(a)(1)(C), and §368(a)(1)(G) to other reorganizations otherwise qualifying under §368(a)).

[827] *Capital Sav. & Loan Ass'n v. United States*, 607 F.2d 970 (Ct. Cl. 1979); *W. Side Fed. Sav. & Loan Ass'n v. United States*, 494 F.2d 404 (6th Cir. 1974); *Everett v. United States*, 448 F.2d 357 (10th Cir. 1971).

[828] 469 U.S. 131 (1985).

[829] 296 U.S. 378 (1935).

[830] *Paulsen*, 469 U.S. at 140.

[831] *Cf.* Rev. Rul. 69-265 (refusing to treat partnership interest as part debt, part equity). One of the few decisions supporting the bifurcation of a hybrid instrument is *Farley Realty Corp. v. Commissioner*, 279 F.2d 701 (2d Cir. 1960). Note that §385 was amended in 1989 to authorize the issuance of regulations which would provide for bifurcated treatment of hybrid instruments. *See* §385(a). For a detailed discussion of §385(a), see 702 T.M., *Capitalizing a Business Entity: Debt vs. Equity*.

[832] 296 U.S. 374 (1935).

[833] *Paulsen*, 469 U.S. at 140.

[834] Reg. §1.368-1(c).

[835] Reg. §1.368-1(d)(1).

[836] Reg. §1.368-1(d)(2)(i).

[837] Reg. §1.368-1(d)(2)(ii).

[838] Reg. §1.368-1(d)(2)(iii).

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of reorganization.[839] A taxpayer is required to analyze all facts and circumstances in determining the time that a reorganization plan first comes into existence in determining whether a particular line of business is significant.[840]

As an alternative to continuing Target's historic business, the issuing corporation may use a significant portion of Target's "historic business assets" in a business to satisfy the COBE requirement. In determining whether this test is met, Target's historic business assets are the assets that it used in its "historic business" (as defined above), which may include stock and securities and intangible operating assets such as good will, patents, and trademarks, whether or not they have a tax basis.[841] In determining whether the portion of historic business assets used by the issuing corporation is "significant," a taxpayer must analyze the relative importance of the assets to business operations and must consider all additional relevant facts and circumstances, such as the net fair market value of the assets.[842]

A valid reorganization may qualify as tax-free even if the acquiring corporation does not directly carry on the historic Target business or use the historic Target assets in a business.[843] Consistent with this rule, the COBE regulations provide rules under which, in an otherwise qualifying corporate reorganization, the assets and the businesses of the members of a qualified group of corporations are treated as assets and businesses of the issuing corporation.[844] A qualified group is defined as one or more chains of corporations connected through stock ownership with the issuing corporation, but only if the issuing corporation owns directly stock meeting the requirements of §368(c) in at least one other corporation, and stock meeting the requirements of §368(c) in each of the corporations (except the issuing corporation) is owned directly (or indirectly as provided in Reg. §1.368-1(d)(4)(iii)(D) relevant to stock attributed from certain partnerships) by one or more of the other corporations.[845]

For purposes of applying the COBE requirement to the merger of a holding company, the regulations provide for application of a facts and circumstances test.[846] The policy behind the COBE requirement, which pursuant to regulations is to "ensure that reorganizations are limited to readjustments of continuing interests in property under modified corporate form," should be used to guide the facts and circumstances analysis.[847]

With respect to the merger of a holding company into its wholly owned operating subsidiary, the historic business of the parent is considered to be the business of its operating subsidiary. Therefore, after the merger, the subsidiary continues to conduct the parent's historic business.[848]

Planning Point: The ruling leaves open the question, however, of whether the merger of a holding company into a controlled, but less than 100%-owned, operating subsidiary would satisfy the COBE requirement. Note that the IRS has issued several private letter rulings addressing satisfaction of the COBE requirement in downstream reorganizations in which the holding company owns less than 80% of controlled.[849]

In situations in which Target is unrelated to Acquiror but is nonetheless a holding company, so that Target's historic business is conducted indirectly through subsidiaries, the IRS has ruled that the COBE requirement is satisfied if Acquiror sold a first-tier subsidiary of Target for cash and transferred the second-tier subsidiary of Target to one of its wholly owned banking subsidiaries that it then continued to operate indirectly.[850] The second-tier subsidiary was itself considered a significant line of business.

2. Drop-Downs by Acquiror of Target's Assets or Stock

As stated above, the issuing corporation is treated as holding all of the businesses and assets of all of the members of the qualified group.

The "qualified group" definition does not require that any one member of the qualified group continue the historic business or use the historic assets. For example, Acquiror could transfer the acquired assets in an acquisitive asset reorganization to 10 different subsidiaries controlled by Acquiror, each of which uses the assets in a business. Even though no one subsidiary may use a significant portion of Target's historic business assets in a business, the COBE requirement is satisfied because, in the aggregate, the qualified group is using a significant portion of Target's historic business assets in a business.[851] In addition, the "qualified group" definition permits the issuing corporation's control of the historic business or historic assets of Target to be diluted below 80%. For example, Acquiror could transfer the acquired assets in an acquisitive asset reorganization to an 80%-owned first-tier subsidiary ("Sub 1") that, in turn, transfers the assets to its 80%-owned second-tier subsidiary ("Sub 2"). Sub 2 is a member of Acquiror's qualified group because it is controlled directly by Sub 1, which in turn is controlled directly by Acquiror. Thus, even though Acquiror's control of the acquired assets is reduced to a 64% interest, the drop-downs do not violate COBE.

The regulations permit qualified group members to aggregate their direct stock ownership of a corporation in determining whether they own the requisite §368(c) control in the corporation (provided that the issuing corporation owns directly stock meeting such control requirement in at least one other corporation). Thus, in the case of a so-called "diamond structure" — in which Parent owns all of Sub 1 and Sub 2, which in turn each own 50% of Sub 3 — Sub 3 is now a member of Parent's qualified group.

The COBE requirement is satisfied when the issuing corporation (i.e., Parent) transfers Acquiror's stock to another wholly owned subsidiary.[852] The issuing corporation is treated as directly holding the businesses and assets of Acquiror because Acquiror and wholly owned subsidiary are members of issuing corporation's qualified group. Therefore, in Rev. Rul.

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[839] Reg. §1.368-1(d)(2)(iii).
[840] Reg. §1.368-1(d)(2)(iv).
[841] Reg. §1.368-1(d)(3)(ii).
[842] Reg. §1.368-1(d)(3)(iii).
[843] *See* §368(a)(2)(C).
[844] Reg. §1.368-1(d)(4)(i).
[845] Reg. §1.368-1(d)(4)(ii).
[846] Reg. §1.368-1(d)(1).
[847] Reg. §1.368-1(d)(1).
[848] Rev. Rul. 85-197.
[849] See III.A.5., above, for a discussion of downstream reorganizations.
[850] Rev. Rul. 85-198.
[851] Reg. §1.368-1(d)(5) *Ex.* 6.
[852] Rev. Rul. 2001-24. *See also* Reg. §1.368-2(k).

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2001-24, the IRS ruled that because Acquiror continues Target's historic business following the Forward Triangular Merger of Target into Acquiror, the transaction satisfies the COBE requirement of Reg. §1.368-1(d) even though the stock of Acquiror was transferred to a subsidiary of Parent.

The COBE regulations also provide that an intervening partnership does not necessarily prevent a corporation owned by that partnership from being part of a qualified group with the corporations that are partners of the partnership. Specifically, the COBE regulations provide that if members of the qualified group own interests in a partnership that meets requirements equivalent to the "control" definition in §368(c), any stock owned by the partnership is treated as owned by members of the qualified group.[853] This full stock attribution rule effectively treats partnerships in a manner similar to members of the COBE qualified group. Thus, for example, following a reorganization under §368(a)(1)(B), Target remains a member of the qualified group upon a transfer of the Target stock to a partnership in which members of the qualified group own all the interests. Similarly, for example, a wholly owned subsidiary of a partnership in which members of the qualified group own all the interests is a member of the qualified group and, therefore, could acquire part or all of the assets of the Target following a reorganization involving Target and a corporate partner of the partnership.

A corporate member of the qualified group (including the issuing corporation) is treated as owning its proportionate share of any Target business assets held by a partnership in which such member is a partner.[854] Under the general aggregation rule, the issuing corporation is then treated as owning the same Target business assets that any such corporate partner is treated as owning. The issuing corporation is treated as conducting the business (i.e., as opposed to simply owning the assets) of the partnership in which a qualified group member is a partner only if either (i) members of the qualified group, in the aggregate, own an interest in the partnership representing a "significant interest" in that partnership business or (ii) one or members of the qualified group have "active and substantial management functions as a partner with respect to that partnership business."[855] The COBE regulations provide that if a significant historic business is conducted in a partnership, the fact that the issuing corporation is treated as conducting such business under the foregoing rule "tends to establish the requisite continuity, but is not alone sufficient."[856]

The examples in the COBE regulations establish two benchmarks regarding the nature and extent of the partnership interest that the corporate transferor must have to satisfy COBE. First, if the corporate transferor owns at least a 33⅓% interest in the partnership, the traditional one-third COBE test is deemed satisfied. Because a 33⅓% interest is considered "significant," the corporate transferor is treated as conducting Target's historic business, whether or not "active and substantial management functions" are performed.[857] Second, if the corporate transferor owns at least a 20% interest in the partnership (but less than 33⅓%), and performs "active and substantial management functions" for a historic Target business held by the partnership, the COBE requirement is deemed satisfied. While there is no definition of "active and substantial management functions," an example in the COBE regulations states that such functions include "making significant business decisions," and "regularly participating in the overall supervision, direction, and control of the employees" of the business.[858]

The retention of only a 1% interest in a partnership in which the corporate transferor performs active and substantial management functions, on the other hand, is insufficient to satisfy COBE.[859] Other examples illustrate the satisfaction of the 33⅓% benchmark through the aggregation of several qualified group member's interests in the partnership, or through the combination of interests in tiered partnerships.[860]

The "party to a reorganization" and continuity of interest (COI) regulations in Reg. §1.368-2(f) and §1.368-2(k), respectively, are coordinated with the COBE regulations, effectively permitting either downstream transfers or upstream distributions of either Target stock or assets (or stock of Sub in a Forward Triangular Merger or a triangular "B" or "C" Reorganization), with certain limitations, so long as such transfers or distributions meet the COBE requirement. This effectively creates safe harbor protection for the covered "distributions" and "other transfers." Transfers or distributions permitted under Reg. §1.368-2(f) and §1.368-2(k) do not cause a failure to meet the "substantially all" requirement in those reorganizations that have a "substantially all" requirement.

See V.E., below, for further discussion of the effect of Reg. §1.368-2(k) on post-reorganization transfers of acquired stock and assets.

C. Business Purpose Requirement

1. General Rule

Even if the reorganization statute is literally satisfied, there is no tax-free reorganization unless the transaction has a bona fide business purpose. This judicial gloss on the statutory requirements of corporate reorganizations was established in *Gregory v. Helvering*,[861] and is frequently applied by Treasury and the courts to strike down purported reorganizations for which the motive is tax avoidance.[862] This requirement is more

[853] Reg. §1.368-1(d)(4)(iii)(D).

[854] Reg. §1.368-1(d)(4)(iii)(A). *See, e.g.*, PLR 200250023 (statutory merger followed by drop-down of Target's assets to partnership qualifies as "A" Reorganization).

[855] Reg. §1.368-1(d)(4)(iii)(B).

[856] Reg. §1.368-1(d)(4)(iii)(C).

[857] Reg. §1.368-1(d)(5) *Ex.* 10.

[858] Reg. §1.368-1(d)(5) *Ex.* 8. The preamble to the proposed COBE regulations noted that this "active and substantial management" inquiry is tested under Rev. Rul. 92-17, in which a corporate partner's substantial involvement in a partnership's business operations satisfied the §355 "active trade or business" requirement. Further guidance regarding the active trade or business requirement within §355(b)(2) is provided under Rev. Rul. 2002-49, amplifying Rev. Rul. 92-17.

[859] Reg. §1.368-1(d)(5) *Ex.* 9.

[860] Reg. §1.368-1(d)(5) *Exs.* 12 (33⅓% through aggregation), 13 (37½% through tiered partnerships).

[861] 293 U.S. 465 (1935).

[862] *See, e.g.*, *Wortham Mach. Co. v. United States*, 521 F.2d 160 (10th Cir. 1975) (attempted "C" Reorganization failed for lack of business purpose; transferor corporation had ceased operations two years before and had no employees); *Abegg v. Commissioner*, 429 F.2d 1209 (2d Cir. 1970), aff'g 50 T.C. 145 (1968), cert. denied, 400 U.S. 1008 (1971) (inactive personal holding company may conduct sufficient business to have business purpose for reorganiza-

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frequently raised as a concern when the parties to the transaction are related and a collateral tax benefit is to be obtained from the transaction (e.g., an avoidance of the separate return limitation year rules).

2. Treasury Regulations

The regulations refer to the business purpose requirement in three instances. Reg. §1.368-1(b) states, in part:

> The purpose of the reorganization provisions of the Code is to except from the general rule certain specifically described exchanges incident to such readjustments of corporate structures made in one of the particular ways specified in the Code, as are required by business exigencies and which effect only a readjustment of continuing interest in property under modified corporate forms. … [A] sale is nevertheless to be treated as a sale even though the mechanics of a reorganization have been set up.

Reg. §1.368-1(c) states, in part:

> A scheme, which involves an abrupt departure from normal reorganization procedure in connection with a transaction on which the imposition of tax is imminent, such as a mere device that puts on the form of a corporate reorganization as a disguise for concealing its real character, and the object and accomplishment of which is the consummation of a preconceived plan having no business or corporate purpose, is not a plan of reorganization.

Finally, Reg. §1.368-2(g) requires that, to qualify as a tax-free reorganization, a transaction "must be undertaken for reasons germane to the continuance of the business of a corporation a party to the reorganization."

3. Business Purpose of Shareholders

It is not clear if the business purpose must be a corporate business purpose, as opposed to a business purpose of the shareholders. The cases have often referred to the existence or nonexistence of a corporate business purpose. However, there is some indication that a business purpose of the shareholders will suffice.[863]

In Rev. Rul. 74-155, the IRS held that the transfer of assets of a personal holding company (consisting of marketable securities) to a regulated investment company in exchange solely for shares of the investment company qualified as a nontaxable "C" Reorganization. The stated business purposes were the avoidance of local stock transfer taxes on the acquisition of the acquired corporation's portfolio, and greater diversification and better management of the acquired corporation's portfolio.

In *American Bronze Corp. v. Commissioner*,[864] the requisite business purpose existed in the simplification of business records and tax paperwork, and the elimination of duplicate work and expenses in administration and accounting, particularly because — before the merger — the two corporations had conducted the same business and had served essentially the same customers. *American Bronze Corp.* was distinguished in *Laure v. Commissioner*.[865] In *Laure*, the Sixth Circuit concluded that cost savings would have to be substantial to support a business purpose for a reorganization. The court found that the cost savings involved in the case were not substantial when the merging companies were engaged in distinct lines of business and there was little duplication of activity and expenses. Nevertheless, the court held that the preservation of the acquiring company's and the shareholder's goodwill and business reputations constituted a valid business purpose for the merger. Additionally, the assured continuance of air charter and repair services on which the acquiring company was heavily dependent constituted a valid business purpose for the acquisition of its sister corporation, an air service company.

4. Ruling Applications

To the extent a ruling is available, the IRS has stated publicly that ruling requests must include "a complete statement of the business reasons for the transaction."[866] The statement should include evidence that the transaction is logical and sound from a business standpoint, and that tax considerations, if present at all, are secondary.

TAM 8803001[867] illustrates the National Office's view of the business purpose requirement. A profitable corporation distributed its principal asset to a related corporation having a substantial net operating loss in a transaction that satisfied the technical requirements of §368(a)(1)(C). An IRS agent determined that the sole motivation for the transaction was to shelter the income of Target corporation with the net operating losses of Acquiror. The National Office, emphasizing that tax motivation is permissible provided that there is some business purpose for the transaction, concluded that the objectives of enhancing the balance sheet of Acquiror's affiliated group (which improved its prospects of obtaining loans) and infusing operating funds into the group were sufficient business purposes.

D. Step Transaction Doctrine

1. General §338

As discussed in III.A.2.d., above, the step transaction doctrine treats a series of formally separate "steps" as a single transaction if the steps are "in substance integrated, interdependent and focused toward a particular end result."[868] The IRS and courts have generally recognized that separate steps are not disregarded under a step transaction analysis, even if the steps are taken pursuant to an overall plan, if each step is meaning-

tion). *Cf. Laure v. Commissioner*, 653 F.2d 253 (6th Cir. 1981) (distinguishing *Wortham Mach.* by noting substantial assets put to productive use in "A" Reorganization).

[863] *Parshelsky v. Commissioner*, 303 F.2d 14 (2d Cir. 1962); *Lewis v. Commissioner*, 176 F.2d 646 (1st Cir. 1949); *Survaunt v. Commissioner*, 162 F.2d 753 (8th Cir. 1947).

[864] 64 T.C. 1111 (1975).

[865] 653 F.2d 253 (6th Cir. 1981).

[866] *See* Rev. Proc. 2025-1, §7.01(1)(d). See VIII., below, for a discussion of the IRS ruling policy.

[867] TAM 8941004 revoked TAM 8803001 on the grounds that the information submitted regarding the purported business purposes was insufficient for the IRS to reach a conclusion as to whether the taxpayer had met the business purpose requirement. In revoking TAM 8803001, the National Office did not disavow the propositions of law expressed in TAM 8803001.

[868] *Penrod v. Commissioner*, 88 T.C. 1415, 1428 (1987); *Estate of Christian v. Commissioner*, T.C. Memo 1989-413; Rev. Rul. 79-250 modified by Rev. Rul. 96-29.

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ful and has independent economic significance.[869] However, the particular circumstances in which the step transaction doctrine is properly applicable have not been consistently delineated by the IRS or the courts. Also, while the doctrine is typically invoked by the IRS, both the IRS and the courts permit the taxpayer to rely on the doctrine in appropriate circumstances.

Although step transaction principles have been applied to determine whether a subsequent merger should be respected as a separate transaction, the question traditionally has been phrased as whether Acquiror is a "historic shareholder" of Target.[870] In cases in which Acquiror is a historic shareholder of Target, the subsequent merger has been treated as some form of nonrecognition (i.e., carryover-basis) transaction. Otherwise, from Acquiror's and Target's standpoint, the overall transaction must be analyzed carefully to determine whether the transaction should be integrated or respected as two separate transactions.

When Acquiror purchases Target stock in a qualified stock purchase under §338, the IRS generally does not apply step transaction principles to integrate a subsequent merger or liquidation of Target with the stock purchase.[871] That is, a subsequent liquidation or merger of Target into Acquiror is respected as a tax-free liquidation under §332,[872] and a subsequent merger of Target into a subsidiary of Acquiror is respected as an "A" Reorganization (and also a reorganization under §368(a)(1)(D)) regardless of whether a §338 election is made.

In 2001, the IRS issued guidance regarding whether step transaction principles applied to characterize a stock purchase and subsequent merger of Target into Acquiror as an "A" Reorganization when the aggregate consideration paid by Acquiror includes sufficient Acquiror stock for continuity purposes. In Rev. Rul. 2001-46, the IRS ruled that if, pursuant to an integrated plan, Acquiror's newly formed, wholly owned subsidiary merges into Target, and Target subsequently merges into Acquiror, the transaction is treated as a single statutory merger of Target into Acquiror (assuming the integrated transaction qualifies as an "A" Reorganization). The ruling analyzed two different situations. In *Situation 1*, Acquiror — pursuant to an integrated plan — acquired all of the stock of Target in statutory merger of Sub, a newly formed, wholly owned subsidiary of Acquiror, into Target, with Target surviving. Target shareholders received 70% Acquiror voting stock and 30% cash. Following the merger, and as part of the integrated plan, Target merged into Acquiror. In *Situation 2*, the facts were the same except that Target shareholders received solely Acquiror voting stock in the first step, which, if viewed independently, would qualify as Reverse Triangular Merger. The IRS noted that absent the application of the step transaction doctrine, the acquisition of Target stock in *Situation 1* would constitute a §338 qualified stock purchase but asserted that the two steps could be collapsed and treated as a direct acquisition of Target's assets by Acquiror, provided that the integrated steps qualify as a good "A" Reorganization. The IRS noted that in *Situation 2* the qualification of the first step, if viewed independently, as a Reverse Triangular Merger, does not change the result from that reached in *Situation 1* and, thus, the two steps were treated as a single "A" Reorganization. Accordingly, in issuing Rev. Rul. 2001-46, the IRS made it clear that it no longer views the first step (i.e., Acquiror's acquisition of Target stock) as a qualified stock purchase if the integration of the steps qualifies as a good "A" Reorganization.[873]

In response to comments regarding Rev. Rul. 2001-46, however, Treasury issued regulations providing that the step transaction doctrine will not be applied if the Acquiror and Target shareholders jointly file a valid §338(h)(10) election with respect to one step in a multi-step transaction, even if the transaction otherwise would qualify as a reorganization, if that step, standing alone, is a qualified stock purchase.[874] Accordingly, a taxpayer can break the application of the step transaction doctrine if Acquiror and Target shareholders jointly file a valid §338(h)(10) election with respect to the first-step stock purchase. The IRS has not issued similar guidance regarding the ability to break the application of the step transaction doctrine by making a valid §338(g) election. In issuing Reg. §1.338(h)(10)-1(c),[875] the IRS expressly noted that a similar rule was not adopted for §338(g) elections because of the potential for inconsistent reporting in the case of §338(g) elections (which are unilateral — purchaser only — elections), as opposed to §338(h)(10) elections (which are bilateral — purchaser and seller — elections). Accordingly, until further guidance is issued, taxpayers may not break the application of the step transaction doctrine by making valid §338(g) elections with respect to the first-step stock purchase.

Consistent with Rev. Rul. 2001-46, the preamble to T.D. 9242[876] notes that a two-step transaction involving the first-step stock purchase followed by a merger of the target with and into a disregarded entity of the acquiror can qualify as an "A" Reorganization. The preamble and several examples in the regulations clarify, however, that a two-step transaction involving a first-step stock purchase and a second-step conversion of Target to an LLC or check-the-box election cannot qualify as

[869] *See, e.g., Esmark, Inc. v. Commissioner*, 90 T.C. 171 (1988), aff'd in unpub. opin., 886 F.2d 1318 (7th Cir. 1989) (Mobil's purchase of Esmark stock and Esmark's subsequent redemption of Mobil's stock were respected as separate steps); Rev. Rul. 79-250 *modified by* Rev. Rul. 96-29 (incorporation of several subsidiaries under §351, merger of unrelated corporation into one subsidiary in Forward Triangular Merger and reincorporation of Parent under §368(a)(1)(F) were respected as separate steps because each transaction was "sufficiently meaningful on its own account, and … not dependent upon the other transaction for its substantiation …").

[870] *See* V.A.4., above.

[871] *See* Reg. §1.338-3(c)(1); Rev. Rul. 90-95 (*distinguished by* Rev. Rul. 2001-46). *See also* Rev. Rul. 2008-25 (integrated plan involving (i) Parent's acquisition of Target via reverse subsidiary merger, followed by (ii) the complete liquidation of Target into Parent, is properly analyzed under Rev. Rul. 90-95, rather than under Rev. Rul. 67-274 or Rev. Rul. 2001-46, because the integrated transaction did not satisfy the definition of any of the reorganizations described in §368(a)).

[872] Reg. §1.332-2(d). When the requirements for a liquidation are not satisfied, a merger of Target upstream into Acquiror may qualify as an "A" Reorganization. *See also King Enters., Inc. v. United States*, 418 F.2d 511 (Ct. Cl. 1969).

[873] Absent Rev. Rul. 2001-46, the IRS would continue to be whipsawed as it was in *King Enterprises*. The acquiror in that case received a stepped-up basis in Target's assets under former §334(b)(2), while Target's shareholders received tax-free treatment under §368.

[874] Reg. §1.338(h)(10)-1(c)(2), §1.338(h)(10)-1(e) *Exs.* 11, 12, 13, 14, Reg. §1.338(h)(10)-1T(c)(2), §1.338(h)(10)-1T(e) *Exs.* 11, 12, 13, 14.

[875] T.D. 9271, 71 Fed. Reg. 38,074 (July 5, 2006), applicable to stock acquisitions occurring after July 4, 2006.

[876] T.D. 9242, 71 Fed. Reg. 4259 (Jan. 26, 2006).

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an "A" Reorganization.[877] The preamble notes that, although a state law conversion to an LLC or a check-the-box election has similar federal income tax consequences as a merger of Target with and into an LLC, it is also similar to a second-step liquidation of target. The preamble concludes that the IRS will continue to study this issue, but that, until further guidance is issued, such transactions cannot qualify as "A" Reorganizations (although, as discussed, below, these transactions may qualify for tax-free treatment under another reorganization provision, e.g., §368(a)(1)(C)).[878]

In Rev. Rul. 2008-25, the IRS further clarified certain limitations on the step transaction doctrine. In Rev. Rul. 2008-25, Parent acquired the stock of a Target in a reverse subsidiary merger in exchange for cash and stock. Thereafter, and as part of a plan, Target liquidated into Parent rather than merging into Parent as in Rev. Rul. 2001-46. The IRS concluded that the transactions could not be collapsed into a nontaxable reorganization and, thus, treated the transactions as a qualified stock purchase followed by a §332 liquidation.

Comment: Note that because Target was liquidated, the safe harbor protection of Reg. §1.368-2(k) (discussed in V., below) was not available and the first step could not qualify as a §368(a)(2)(E) reorganization. Accordingly, the IRS ruled that the first step was a qualified stock purpose, following the analysis in Rev. Rul. 90-95 (rejecting step integration on grounds that Congress intended for §338 to replace any nonstatutory treatment of stock purchase as asset purchase under *Kimbell-Diamond* doctrine).

The transaction failed to qualify as a (i) "C" Reorganization because the requirements of §368(a)(2)(B) were not satisfied;[879] (ii) "D" Reorganization because neither Target nor Target's shareholder were in control of Parent immediately after the transfer; and (iii) "A" Reorganization because Target did not legally merge into Parent under local law.[880] Collectively, Rev. Rul. 2001-46, Reg. §1.338(h)(10)-1(c), and Rev. Rul. 2008-25 stand for the proposition that, absent a §338(h)(10) election, a two-step stock acquisition should be collapsed into an asset acquisition only if the resulting transaction results in a tax-free reorganization. Otherwise, the transactions are respected as separate (generally as a stock acquisition and liquidation).

Rev. Rul. 2001-46 and Rev. Rul. 2008-25 have several implications. First, the ability to rely on integrating a stock purchase with a subsequent second-step merger (as in Rev. Rul. 2001-46) for purposes of testing the transaction under the reorganization provisions provides planning opportunities in structuring corporate acquisitions. For example, assume that Acquiror wishes to acquire the business of Target with 50% stock and 50% boot. Structuring the transaction as a single-step merger of Target with and into Acquiror (or an LLC wholly owned by Acquiror) would have been the logical transaction structure before Rev. Rul. 2001-46. If the transaction failed to qualify as an "A" Reorganization, Acquiror would inherit a corporate tax liability on the gain inherent in the Target assets (i.e., the risk of taxable forward merger). With the issuance of Rev. Rul. 2001-46, Acquiror is more likely to choose to structure similar transactions as two-step transactions (i.e., typically a first-step reverse subsidiary merger and a second-step forward merger with and into Acquiror (or an LLC wholly by Acquiror)). The benefit of the two-step structure under Rev. Rul. 2001-46 is that a transaction which fails to qualify as an "A" Reorganization on an integrated basis should not be integrated. Assuming the first-step reverse subsidiary merger is a qualified stock purchase, therefore, the transaction should be characterized as a taxable stock purchase followed by a tax-free liquidation.[881] Therefore, the risk of a failed reorganization in this structure is limited to a Target shareholder risk (i.e., one level of taxation), rather than a risk at the Target shareholder and Target corporate level (i.e., two levels of taxation).

A second implication of Rev. Rul. 2001-46 is a trap for the unwary. Assume, as an illustration, that (i) Acquiror intends to purchase Target stock and file a §338(g) election (i.e., Target is a foreign corporation with no U.S. tax presence), (ii) Acquiror intends to pay 40% stock and 60% boot in the transaction, and (iii) for post-merger integration purposes, Acquiror plans to merge or amalgamate the foreign corporation with and into a first-tier foreign subsidiary (either respected as a corporation or treated as a disregarded entity for U.S. federal income tax purposes). If Acquiror fails to modify its integration plan, the transaction should be treated as an integrated §368(a)(1)(A) or §368(a)(2)(D) reorganization, with the result that Acquiror loses the ability to file a §338(g) election because of the application of Rev. Rul. 2001-46.[882] Note, however, that one manner in which Acquiror could modify its plan in this instance to achieve a first-step qualified stock purchase would be to provide for a second-step liquidation (or check-the-box election) rather than a merger or amalgamation. In that instance, the combined transaction would not satisfy the requirements of an "A" Reorganization (no merger or amalgamation) or a "C" Reorganization (due to 60% boot).[883]

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[877] Reg. §1.368-2(b)(1)(iii) *Exs.* 9, 10.

[878] Commentators have suggested that a reverse triangular merger followed by either (i) the merger of Target into a disregarded entity of Acquiror, (ii) the conversion of Target into a disregarded entity of Acquiror, or (iii) a liquidation of Target, pursuant to a single plan, should result in an integrated transaction that qualifies as an "A" Reorganization. Schuck, *Treatment Under Section 368(a)(1)(A) of a Merger or Conversion of the Target Corporation into a Disregarded Entity following a Reverse Triangular Corporate Merger*, 2004 Tax Notes Today 97-40 (May 11, 2004); Swartz, *Multiple Step Acquisitions: Dancing the Tax-Free Tango*, 2005 Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings, 153 (2005). Reg. §1.368-2(b)(1)(iii) *Ex.* 9 clarifies that, pending further guidance, a stock purchase followed by a conversion to an LLC does not satisfy the requirements of an "A" Reorganization. *See* the discussion regarding "C" Reorganizations, below. *See also* PLR 201107003 (multistep transaction proposed by foreign parent corporation to restructure number of its lower-tier entities qualified under §368(a)(1)(A) after steps were integrated).

[879] In the context of a "C" Reorganization, if Target's properties are acquired for money or other property in addition to voting stock, any liabilities assumed by Acquiring will be treated as money for the purposes of determining the total amount of boot used in the exchange. *See* §368(a)(2)(B). In Rev. Rul. 2008-25, the shareholder received $90x of Parent stock and $10x cash. Additionally, Target had $150x of assets and $50x of liabilities. Because Target's shareholder received $10x of cash Target's liabilities were treated as "boot" and the transaction failed the solely for voting stock requirement.

[880] "Control" for purposes of a "D" Reorganization is defined in §304(c) as the ownership of stock possessing at least 50% of the total combined voting power or value of a corporation, taking into account certain expanded constructive ownership rules of §318. *See* §368(a)(2)(H).

[881] Reg. §1.338-3(c); Rev. Rul. 2008-25; Rev. Rul. 90-95.

[882] *See* preamble to T.D. 9271, 71 Fed. Reg. 38,074 (July 5, 2006) (confirming that filing §338(g) election is not permitted if integrated transaction meets requirements of tax-free reorganization).

[883] *See* Rev. Rul. 2008-25.

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Even if it is determined that the circumstances are appropriate for a step transaction analysis, there is no universally accepted set of legal standards for applying the step transaction doctrine to the particular facts. Courts have applied three alternative tests in deciding whether to invoke the step transaction doctrine in a particular transaction, namely the "end result" test, the "mutual interdependence" test, and the "binding commitment" test.[884] Based on the historical Tax Court cases in the post-transaction continuity area and the IRS's most definitive articulation of the issue (before the 1998 regulations discussed above were issued),[885] it would appear that the "mutual interdependence" test is most commonly applied. The "end result" test is usually described as a looser version of the "mutual interdependence" test, and the "binding commitment" test is believed to be appropriate only when the separate steps span several tax years.[886]

2. *Alternative Tests for Applying Step Transaction Doctrine*

a. *Binding Commitment Test*

The "binding commitment" test is the narrowest alternative for applying the step transaction doctrine, and it typically favors the party desiring to have the separate steps respected.[887] The binding commitment test forbids use of the step transaction doctrine unless, at the time the first step is commenced, there is a binding commitment to take the later step.[888] The binding commitment test is generally designed for the characterization of steps that span several tax years and are "not only indeterminable but unfixed for an indefinite and unlimited period in the future, awaiting events that might or might not happen."[889]

In the post-transaction continuity context, the Tax Court has described the binding commitment test as follows:

> The binding commitment test has the advantage of promoting certainty in the tax planning of shareholders. Under such test, the court must make an objective determination as to whether the acquired shareholders were bound by an obligation to sell the shares received in an acquisition. Other factors, such as intent by such shareholders to sell their shares, are not considered. However, there have been objections to that test on the ground that the result is easily manipulable by taxpayers. As the court observed in *King Enterprises, Inc. v. United States*, … "the step transaction doctrine would be a dead letter if restricted to situations where the parties were *bound* to take certain steps."[890]

b. *End Result Test*

While the binding commitment test may represent the most rigid version of the step transaction doctrine, the end result test is the most liberal version. Under this test, the step transaction doctrine is invoked if it appears that a series of formally separate steps are really prearranged parts of a single transaction intended from the beginning to arrive at the ultimate result.[891] The end result test is based upon the actual intent of the taxpayer. Some courts have looked to the results desired by the taxpayer, and have presumed that the taxpayer intended that all transactions that played a part in achieving those results were part of a single transaction.[892] Of course, the results desired by the parties are often difficult to determine, and it is difficult to determine whether particular transactions furthered those results.

In the post-transaction continuity context, the Tax Court has described the end result test as follows:

> The end result test is based upon the actual intent of the parties at the time of the merger. It can be argued that any test which requires a court to make a factual determination as to a party's intent promotes uncertainty and therefore impedes effective tax planning. However, in contrast to the binding commitment test, the end result test is flexible and bases tax consequences on the real substance of the transactions, not on the formalisms chosen by the participants.[893]

c. *Mutual Interdependence Test*

The mutual interdependence test focuses on whether "the steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series."[894] The mutual interdependence test overlaps with the end result test in two respects. First, under both tests, the intent of the parties is important.[895]

Second, as the Tax Court has noted, because the interdependence test requires a court to determine whether the individual steps had independent significance or whether they had meaning only as part of the larger transaction, the court may be called upon — when applying the mutual interdependence test — to determine the end result the parties intended to achieve. Accordingly, the Tax Court has labeled the mutual interdependence test "a variation" of the end result test.[896]

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[884] *Penrod*, 88 T.C. at 1429; *Estate of Christian*, T.C. Memo 1989-413.

[885] *See* Rev. Rul. 79-250, *modified by* Rev. Rul. 96-29.

[886] *McDonald's Rests. of Ill. v. Commissioner*, 688 F.2d 520, 524–525 (7th Cir. 1982).

[887] Taxpayers occasionally use binding commitments for a series of transactions when they seek to have the series integrated for tax purposes.

[888] *See Commissioner v. Gordon*, 391 U.S. 83, 96 (1968); *Redding v. Commissioner*, 630 F.2d 1169, 1178 (7th Cir. 1980), cert. denied, 450 U.S. 913 (1981).

[889] *McDonald's Rests. of Ill. v. Commissioner*, 688 F.2d 520, 525 (7th Cir. 1982) (citing *Gordon*, 391 U.S. at 96).

[890] *Penrod v. Commissioner*, 88 T.C. 1415, 1429 (1987) (emphasis in original) (footnote omitted); *see also Estate of Christian*, T.C. Memo 1989-413.

[891] *Penrod v. Commissioner*, 88 T.C. 1415, 1428 (1987); *Estate of Christian v. Commissioner*, T.C. Memo 1989-413.

[892] *See, e.g., Six Seam Co. v. United States*, 524 F.2d 347 (6th Cir. 1975); *Yamamoto v. Commissioner*, 73 T.C. 946 (1980), aff'd in unpub. opin., 672 F.2d 924 (9th Cir. 1982); *Vest v. Commissioner*, 57 T.C. 128 (1971), aff'd in part and rev'd. in part on other grounds, 481 F.2d 238 (5th Cir. 1973), cert. denied, 414 U.S. 1092 (1973).

[893] *Penrod*, 88 T.C. at 1430; *see also Christian*, T.C. Memo 1989-413.

[894] *Redding v. Commissioner*, 630 F.2d 1169, 1177 (7th Cir. 1980). *See also Assoc. Wholesale Grocers, Inc. v. Commissioner*, 927 F.2d 1517 (10th Cir. 1991); *Kass v. Commissioner*, 60 T.C. 218 (1973), aff'd in unpub. opinion, 491 F.2d 749 (3d Cir. 1974); *Farr v. Commissioner*, 24 T.C. 350 (1955); *Am. Wire Fabrics Corp. v. Commissioner*, 16 T.C. 607 (1951); *Am. Bantam Car Co. v. Commissioner*, 11 T.C. 397 (1948), aff'd 177 F.2d 513 (3d Cir. 1949).

[895] *Estate of Christian v. Commissioner*, T.C. Memo 1989-413.

[896] *Penrod v. Commissioner*, 88 T.C. 1415, 1430 (1987).

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3. Application to "A" Reorganizations

The various circumstances in which the step transaction doctrine has been applied to invalidate or recharacterize an "A" Reorganization include the following:

- The integration of an initial acquisition of Target stock in exchange for Acquiror stock and a subsequent merger of Target into Acquiror or a subsidiary of Acquiror, for purposes of treating the initial stock acquisition as part of an "A" Reorganization.[897]

- The integration of an initial cash purchase of Target stock and a subsequent merger of Target into Acquiror or a subsidiary of Acquiror, for the purpose of determining whether Acquiror is a "historic shareholder" of Target.[898]

- The integration of the initial receipt of Acquiror stock in a reorganization and the subsequent disposition of that stock by the former Target shareholders, for the purposes of determining whether post-transaction continuity of interest exists.[899]

- The integration of Target's drop-down of assets into a controlled subsidiary followed by Target's merger into Acquiror, for the purpose of treating Target as having merged into Acquiror with a subsequent drop-down of assets.[900]

- The integration of the formation of Target and the subsequent merger of Target into Acquiror, for the purpose of treating the transaction as a direct transfer of assets in a "C" Reorganization.[901]

- The integration of a Forward Triangular Merger and the subsequent liquidation of the acquiring subsidiary, for the purpose of recharacterizing a Forward Triangular Merger as a "C" Reorganization.[902]

- The integration of an initial §368(a)(2)(E) merger of Acquiror's subsidiary into Target and a subsequent upstream merger of Target into Acquiror is treated as if Acquiror acquired Target's assets in exchange for Acquiror's stock and Acquiror's assumption of Target's liabilities in an "A" Reorganization.[903]

- The integration of a tender offer for 51% of Target stock initiated by Parent and in exchange for Parent voting stock followed by the merger of Parent's newly formed subsidiary into Target with Target's remaining shareholders receiving a combination of Parent voting stock and cash is treated as the acquisition of 80% or more of Target's stock in exchange for Parent voting stock, satisfying the control-for-voting-stock requirements of §368(a)(2)(E).[904]

- The integration of a tender offer for 51% of Target stock initiated by Parent's newly formed Sub in exchange for Parent voting stock followed by the merger of Sub into Target with Target's remaining shareholders receiving a combination of Parent voting stock and cash is treated as the acquisition of 80% or more of Target's stock in exchange for Parent voting stock, satisfying the control-for-voting-stock requirements of §368(a)(2)(E).[905]

- The integration of a merger of Acquiror's subsidiary into Target and a subsequent upstream merger of Target into Acquiror, for the purpose of recharacterizing a §338 qualified stock purchase and §332 liquidation as an "A" Reorganization.[906]

4. Application to "C" Reorganizations

The various circumstances in which the step transaction doctrine has been applied to invalidate or recharacterize a "C" Reorganization, in addition to several of those discussed above in connection with "A" Reorganizations, include the following:

- The integration of Target's redemption or payment to dissenters with a subsequent reorganization for purposes of the "substantially all" requirement.[907]

- The integration of a spin-off of Target's assets with a subsequent reorganization for purposes of the "substantially all" requirement.[908]

- The integration of an initial cash purchase of Target stock and a subsequent reorganization for purposes of determining whether Acquiror's interest in Target is "old and cold."[909]

5. Application to "B" Reorganizations

The various circumstances in which the step transaction doctrine has been applied to invalidate or recharacterize a "B" Reorganization, in addition to the historic and post-transaction continuity concerns discussed above in connection with "A" Reorganizations, include the following:

- The integration of an initial exchange of Target stock for Acquiror stock and a subsequent liquidation of Target into

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[897] *See* V.D.1., above.

[898] *See* V.A.4., above.

[899] *See* V.A.5., above.

[900] Rev. Rul. 58-93. *See* V.E., below.

[901] Rev. Rul. 70-225 (*modified by* Rev. Rul. 98-27 and *obsoleted by* Rev. Rul. 98-44).

[902] Rev. Rul. 72-405.

[903] *See* Rev. Rul. 2001-46, (integrating (i) merger of Acquiror's newly formed, wholly owned subsidiary into Target and (ii) subsequent merger of Target into Acquiror, and treating transaction as single statutory merger of Target into Acquiror); CCA 200140011 (§368(a)(2)(E) merger of newly created subsidiary into Target and subsequent merger of Subsidiary into Acquiror were treated as statutory merger, as long as individual mergers could be treated as steps in integrated plan under step transaction doctrine); PLR 200038039, PLR 9836032, PLR 9804038. *Cf.* Rev. Rul. 2008-25 (distinguishing facts of Rev. Rul. 2001-46 from transaction consisting of (a) taxable reverse subsidiary merger, followed by (b) complete liquidation of Target into Parent, in which Acquiror's direct acquisition of Target's assets cannot qualify as reorganization of any kind and, thus, cannot be stepped together as reorganization).

[904] Rev. Rul. 2001-26. *See* IV.B.3., above.

[905] Rev. Rul. 2001-26.

[906] Rev. Rul. 2001-46. Taxpayers may avoid this recharacterization by making a valid §338(h)(10) election with respect to the qualified stock purchase, even if the transaction as a whole otherwise would qualify as a reorganization. Reg. §1.338(h)(10)-1(c)(2), §1.338(h)(10)-1(e) *Exs.* 11, 12, 13, 14.

[907] *See* III.C.5.d., above.

[908] *See* III.C.5.e., above.

[909] *See* III.C.7.a., above.

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Acquiror, for purposes of treating the entire transaction as a "C" Reorganization rather than a "B" Reorganization.[910]

• The integration of prior or subsequent cash purchases of Target stock by Acquiror (or its subsidiaries) with an exchange of Target stock for Acquiror stock, for purposes of determining whether Acquiror's interest in Target is "old and cold."[911]

E. Section 368(a)(2)(C): Statutory Limitation on the Step Transaction Doctrine

Issues can arise if Acquiror transfers the stock or assets of a Target to a subsidiary corporation or partnership following reorganization. As noted above, the impact of such a transfer on the COBE requirement must be considered. In addition to a COBE analysis, an analysis of the transfer's impacts on the reorganization's ability to satisfy the statutory requirements of the applicable reorganization provision (i.e., whether the step transaction would apply to cause the subsidiary corporation or partnership to be treated as the acquiror of the stock or assets of the target) is necessary. Section 368(a)(2)(C) was added to the Code in 1954 to provide a framework for "turning off" the step transaction doctrine with respect to qualifying transfers following certain reorganizations. Section 368(a)(2)(C) provides that a transaction otherwise qualifying as a reorganization under §368(a)(1)(A), §368(a)(1)(B), §368(a)(1)(C), or §368(a)(1)(G) is not disqualified by a transfer of part or all of the acquired assets or stock to a corporation controlled by the acquiring corporation.

Reg. §1.368-1(d) permits qualified group members to aggregate their interests for purposes of the §368(c) control test, and to attribute stock owned by a partnership to its corporate partners. The "party to a reorganization" and continuity of interest (COI) provisions in Reg. §1.368-2(f) and §1.368-2(k), respectively, effectively permit either downstream transfers or upstream distributions of either Target stock or assets (or stock of Sub in a Forward Triangular Merger or a triangular "B" or "C" Reorganization), with certain limitations, so long as the transfers or distributions meet the COBE requirement. Transfers or distributions that are permitted under Reg. §1.368-2(f) and §1.368-2(k) do not cause a failure to meet the "substantially all" requirement in those reorganizations that have a "substantially all" requirement.

Reg. §1.368-1(d)(4)(ii), more specifically, permits qualified group members to aggregate their direct stock ownership of a corporation in determining whether they own the requisite §368(c) control in that corporation (provided that the issuing corporation owns directly stock meeting such control requirement in at least one other corporation). Thus, in the case of a "diamond structure," in which P owns all of S1 and S2, which, in turn, each own 50% of S3, S3 is a member of P's qualified group.

The COBE regulations provide that an intervening partnership does not necessarily prevent a corporation owned by that partnership from being part of a qualified group with the corporations that are partners of the partnership. Specifically, Reg. §1.368-1(d)(4)(iii)(D) provides that if members of the qualified group own interests in a "controlled partnership" (i.e., a partnership that meets requirements equivalent to the "control" definition in §368(c)), any stock owned by that partnership is treated as owned by members of the qualified group. This full stock attribution rule effectively treats partnerships in a manner similar to members of the COBE qualified group. For example, following a reorganization under §368(a)(1)(B), Target remains a member of the qualified group upon a transfer of the Target stock to a partnership in which members of the qualified group own all the interests. Similarly, a wholly owned subsidiary of a partnership in which members of the qualified group own all the interests is a member of the qualified group and, therefore, can acquire part or all of the assets of the Target following a reorganization involving Target and a corporate partner of the partnership.[912]

Reg. §1.368-2(k) generally provides that a transaction otherwise qualifying as a reorganization under §368(a) is not disqualified or recharacterized as a result of one or more subsequent transfers (or successive transfers) of assets or stock, provided that the COBE requirement is satisfied and the transfer or transfers qualify as "distributions" or "transfers other than distributions." However, this safe harbor protection does not apply for distributions to shareholders in exchange for their proprietary interest in the acquired or surviving corporation.[913] Such transfers could call into question whether the underlying transaction satisfies the COI requirement as well as the solely for voting stock requirement (if applicable).[914] In addition, the regulations provide that the safe harbor does not apply to certain transfers of consideration originally received by the former shareholders of the acquired or surviving corporation (as the case may be) back to the issuing corporation or a person related to the issuing corporation.[915]

With respect to "distributions" following a reorganization, the regulations provide a safe harbor by stating that a transaction otherwise qualifying as a reorganization is not disqualified or recharacterized as a result of one or more distributions of assets, stock of the acquired corporation, or both, provided the COBE requirement is satisfied and the distributions do not result in a liquidation of the distributing corporation for federal income tax purposes (disregarding, for this purpose, assets held by the acquiring corporation, or the merged corporation in the case of a reorganization under §368(a)(1)(A) by reason of

[910] Rev. Rul. 67-274. *Cf.* Rev. Rul. 2008-25 (when initial exchange is of Target stock for Acquiror stock plus cash, that exchange cannot be integrated with subsequent complete liquidation of Target into Acquiror).

[911] *See* IV.A.4., above.

[912] The 2007 regulations reverse the conclusion of pre-2007 Reg. §1.368-2(k)(3) *Ex.* 3. The IRS and Treasury determined that transfers of stock of a corporation to a "controlled partnership" adequately preserve the link between the former Target shareholders and the Target business assets). Preamble to T.D. 9361, 72 Fed. Reg. 60,552 (Oct. 25, 2007). *See also* Reg. §1.368-2(k)(2) *Ex.* 4, T.D. 9361, 72 Fed. Reg. 60,552 (Oct. 25, 2007).

[913] Reg. §1.368-2(k)(1).

[914] *See* T.D. 9396, 72 Fed. Reg. 26,322 (May 9, 2008). The preamble clarifies that the safe harbor protection continues to apply to post-reorganization distributions not in exchange for a shareholder's proprietary interest (e.g., pro-rata distributions to all surviving corporation shareholders) and distributions in upstream reorganizations. For an example of a post-reorganization distribution treated as a dividend, see PLR 200752014 (post-merger distribution to all acquiring shareholders, including prior target and acquiring shareholders, held to be dividend under §301 and not merger consideration for target shareholders).

[915] Reg. §1.368-2(k)(1).

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§368(a)(2)(E), before the transaction).[916] In the case of distributions of stock of the acquired corporation, the regulations protect the transaction from disqualification or recharacterization if the distributions consist of less than all of the stock of the acquired corporation that was acquired in the transaction and do not cause the acquired corporation to cease to be a member of the qualified group.[917]

With respect to "transfers other than distributions" following a reorganization, the regulations' safe harbor provides that a transaction otherwise qualifying as a reorganization is not disqualified or recharacterized as a result of one or more transfers (that are not distributions) of assets or stock, or both, of the acquired corporation, the acquiring corporation, or the surviving corporation, as the case may be, provided the COBE requirement is satisfied and the acquired corporation, the acquiring corporation, or the surviving corporation, as the case may be, does not terminate its corporate existence in connection with the transfer(s).[918] In the case of transfers of stock of the acquired corporation, the acquiring corporation, or the surviving corporation, as the case may be, the regulations protect the transaction from disqualification or recharacterization only if the transfers do not cause the corporation to cease to be a member of the qualified group.[919]

Acquiror's drop-down of part or all of the acquired assets or stock to a controlled subsidiary (or subsidiaries) is generally not considered a part of the underlying reorganization, but rather is treated as a separate §351 transaction.[920] This follows from the fact that §368(b) (which was amended when §368(a)(2)(C) was enacted to add the acquiring parent as a "party" to the reorganization) does not include the subsidiary as a party to the reorganization. Thus, the acquisition between the acquiring parent and Target is tested as a tax-free reorganization without regard to the subsequent drop-down, even though the drop-down may be part of the reorganization plan. Because the control requirement in §368(a)(2)(C) is identical to the control requirement in §351, a drop-down qualifying under §368(a)(2)(C) automatically qualifies as a §351 transaction.

The first consequence of not treating the subsidiary as a "party to the reorganization" is that any use of subsidiary stock does not count as continuity-preserving consideration.[921] Of course, in a triangular "B" Reorganization, triangular "C" Reorganization, or Forward Triangular Merger, no stock of the controlled subsidiary may be used without disqualifying the entire transaction as a tax-free reorganization.[922] The same is true with respect to a "B" or "C" Reorganization followed by a drop-down, because §368(a)(2)(C) requires that the transaction at the acquiring parent level first qualify as a "B" or "C" Reorganization. However, subsidiary stock can be used in a transaction in which Target is merged into the acquiring parent and Target's assets are then dropped down to the subsidiary, although such stock is treated as "boot" to the Target shareholders because the subsidiary is not a party to the "A" Reorganization.

The second consequence is that the subsidiary's assumption of liabilities in the drop-down transaction must run the gamut of §357(c) (as well as §357(b)) and §362(e) as a result of the application of §351 to the drop-down.[923]

Note: Section 357(c) does not apply to a drop-down transaction if the acquiring parent and subsidiary are members of an affiliated group that files a federal consolidated income tax return. Instead, the excess assumed liabilities over the basis of the transferred assets generally creates an excess loss account (i.e., negative basis) with respect to the subsidiary.[924]

Practice Point: If §357 is potentially applicable to a drop-down transaction (e.g., because the liabilities assumed exceed the basis of the transferred assets) but the parties desire to lodge the assets in a subsidiary of the corporation issuing the stock consideration, the transaction should be structured as a triangular "C" Reorganization or a Forward Triangular Merger, in which case §357 is not implicated. It is not possible to avoid §357 by causing Target to first drop its assets into a controlled subsidiary and merge Target into the acquiring parent, because that transaction would be treated as a merger of Target into the acquiring parent followed by a drop-down of assets to the new subsidiary.[925] Of course, there are other reasons for choosing a triangular reorganization over a parent-level acquisition followed by a drop-down, including less complexity and the avoidance of assumed liabilities at the parent level. On the other hand, if it is necessary for Parent to assume part or all of Target's liabilities, and a merger is not feasible, a "C" Reorganization at the parent level (whether or not followed by a drop-down) must be used instead of a triangular "C" Reorganization.[926]

Note: Section 368(b) treats the acquiring parent as Acquiror even though its ownership of the Target assets or stock may be transitory. Under prior law, the controlled subsidiary receiving Target assets in a drop-down transaction under §368(a)(2)(C) was treated as the "acquiring corporation" for §381 purposes, provided that all of the Target assets transferred to the acquiring parent were ultimately acquired by the subsidiary. If the acquiring parent retained a portion of Target's as-

[916] Reg. §1.368-2(k)(1)(i).

[917] Reg. §1.368-2(k)(1)(i)(A).

[918] Reg. §1.368-2(k)(1)(ii). *See, e.g.*, PLR 200952032 (subsidiary's conversion from corporation to LLC (i) would be treated as exchange of assets for holding company stock followed by distribution in liquidation, qualifying as C reorganization, and (ii) would remain so qualified under §368(a)(2)(C) and Reg. §1.368-2(k) despite subsequent transfer by subsidiary LLC of assets to another subsidiary and reincorporation of subsidiary LLC).

[919] Reg. §1.368-2(k)(1)(ii)(B).

[920] *See* Rev. Rul. 76-188; GCM 37491 (Apr. 10, 1978). If §351 applies to the drop-down transaction, §361 and §362(b) are inapplicable and §362(a) governs the carryover of basis from the acquiring parent to the controlled subsidiary.

[921] Section 354 provides for nonrecognition treatment if the Target shareholders or creditors receive stock or securities in a corporation that is a "party to the reorganization."

[922] §368(a)(1)(B), §368(a)(1)(C), §368(a)(2)(D).

[923] *See* Rev. Rul. 76-188; GCM 37491 (Apr. 10, 1978).

[924] Reg. §1.1502-80(d). A proposed amendment to Reg. §1.1502-80(d) would clarify that in a §351 stock transfer between members of a consolidated group, a transferee's assumption of certain liabilities described in §357(c)(3) will not reduce the transferor's basis in the stock received in the transfer. Prop. Reg. §1.1502-80(d)(1), REG-134420-10, 89 Fed. Reg. 106,884 (Dec. 30, 2024) (reproposing the amendments initially proposed in REG-137519-01, 66 Fed. Reg. 57,021 (Nov. 14, 2001), and withdrawn by REG-134420-10, 88 Fed. Reg. 52,057 (Aug. 7, 2023), confirming the IRS's view that a back-end adjustment is appropriate for a single basis reduction for an assumed §357(c)(3)(A) liability).

[925] Rev. Rul. 58-93.

[926] *See* III.C.8.d., above.

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sets and transferred the remainder to a controlled subsidiary under §368(a)(2)(C), only the acquiring parent was treated as an "acquiring corporation" for §381 purposes.[927] The regulations under §381 were revised and currently treat the corporation that directly acquires the target's assets as the acquiring corporation, even if the acquiring corporation ultimately transfers all of the target's assets.[928]

Note: Final regulations modified the definition of an acquiring corporation for purposes of §381(a)(2) with regard to certain acquisitions of assets. Reg. §1.381(a)-1(b)(2)(i)[929] provides that, in a transaction described in §381(a)(2), the acquiring corporation is the corporation that directly acquires the assets transferred by the transferor corporation, even if the transferee corporation ultimately retains none of the assets transferred. Hence, if a parent corporation receives assets from the transferor corporation in exchange for the parent corporation's stock, and the parent corporation later transfers those assets to its controlled subsidiary pursuant to a plan of reorganization, the parent corporation is the acquiring corporation.

F. *Plan of Reorganization Requirement*

Although the phrase "plan of reorganization" does not appear in the statutory definitions of reorganizations in §368,[930] the operative provisions for nonrecognition treatment to Target and shareholders of Target require that the relevant exchange be made "in pursuance of the plan of reorganization."[931] Thus, at least implicitly, a plan of reorganization must exist before a transaction can qualify as a tax-free reorganization. The courts have not required that the plan of reorganization be evidenced by a formal written document such as a contract or corporate minutes; a plan may be found in the parties' discussions and negotiations.[932]

Under the regulations, each corporation that is a party to the reorganization must adopt the plan of reorganization. Each corporation and "significant holder"[933] that is a party to the reorganization should file required statements for the taxable year within which the reorganization occurred.[934] A "significant holder" is: (1) a holder of stock of the target corporation that receives stock or securities in an exchange described in §354 (or so much of §356 as relates to §354) if, immediately before the exchange, the holder (A) owned at least 5% (by vote or value) of the total outstanding stock of the target corporation if the stock owned by the holder is publicly traded or (B) owned by at least 1% (by vote or value) of the total outstanding stock of the target corporation if the stock owned by such holder is not publicly traded; or (2) a holder of securities of the target corporation that receives stock or securities in an exchange described in §354 (or so much of §356 as relates to §354) if, immediately before the exchange, the holder owned securities in the target corporation with a basis of $1,000,000 or more. The regulations require that all taxpayers who participate in a tax-free exchange in connection with a reorganization retain permanent records containing information regarding the amount, basis, and fair market value of all transferred property, and relevant facts regarding any liabilities assumed or extinguished as part of such reorganization.[935]

To ensure the qualification of a transaction as a tax-free reorganization, the corporate parties should adopt a formal written plan of reorganization and designate it as such.[936]

The phrase "plan of reorganization" serves another function, i.e., to identify the beginning and ending of a reorganization once it has been determined that a tax-free reorganization has occurred. The IRS's attempt to define this function, which has been described by the Tax Court as "imbued with qualities of flexibility and vagueness," is as follows:

> The term "plan of reorganization" has reference to a consummated transaction specifically defined as a reorganization under section 368(a). The term 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 nonrecognition 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). Moreover, the transaction, or series of transactions, embraced in a plan of reorganization must not only come within the specific language of section 368(a), but the readjustments involved in the exchanges or distributions effected in the consummation thereof must be undertaken for reasons germane to the continuance of the business of a corporation a party to the reorganization.[937]

The proper function of the "plan of reorganization" concept should be to determine which transactions form an integral part of a tax-free reorganization. The IRS and the courts generally ask whether a particular transaction is functionally integrated with the reorganization, without regard to time proximity. For example, a distribution by Target to its shareholders is treated as a dividend under §301 to the extent of Target's E&P even though it occurs at the same time and in connection with a tax-free reorganization.[938] As another illustration, the Tax Court has held that conversions of Target's convertible debentures assumed by Acquiror in a "C" Reorganization were not part of the plan of reorganization on the grounds that the debenture holders were not obligated nor encouraged by Acquiror to convert their bonds.[939] On the other hand, an exchange of Target bonds for Acquiror bonds in connection with an "A," "B," or "C" Re-

[927] Former Reg. §1.381(a)-1(b)(2).

[928] Reg. §1.381(a)-1(b)(2)(i).

[929] T.D. 9700, 79 Fed. Reg. 66,616 (Nov. 10, 2014), applicable to transactions occurring on or after November 10, 2014.

[930] Note, however, that §368(a)(1)(D) and §368(a)(1)(G) refer to a distribution of stock or securities "in pursuance of the plan," and §368(a)(2)(G) refers to the distribution required for "C" Reorganizations as one made "in pursuance of the plan of reorganization."

[931] §354(a)(1), §361(a).

[932] *C.T. Inv. Co. v. Commissioner*, 88 F.2d 582 (8th Cir. 1937); *Transp. Prods. Corp. v. Commissioner*, 25 T.C. 853, aff'd per curiam, 239 F.2d 859 (6th Cir. 1956); *Redfield v. Commissioner*, 34 B.T.A. 967 (1936).

[933] Reg. §1.368-3(c)(1).

[934] Reg. §1.368-3(a).

[935] Reg. §1.368-3(d).

[936] In a "B" Reorganization, the Target may not actively participate in the transaction, particularly if the exchange is not accomplished by way of merger, except to the extent required by securities and corporate laws. Nevertheless, for the sake of its shareholders, it is advisable for Target to recognize board approval of the reorganization in its corporate minutes.

[937] Reg. §1.368-2(g).

[938] Rev. Rul. 70-172; Rev. Rul. 68-435; Rev. Rul. 56-184.

[939] *Int'l Tel. & Tel. Corp. v. Commissioner*, 77 T.C. 60 (1981), aff'd, 704 F.2d 252 (2d Cir. 1983).

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organization is considered part of that reorganization.[940] Nevertheless, the term "plan of reorganization" has crept into a number of rulings and cases in which the real issue is whether the step transaction doctrine should be applied to disqualify a tax-free reorganization.[941] In those instances, the term is used (albeit incorrectly) as a label and should not be confused with or regarded as a substitute for the step transaction doctrine.

In *J.E. Seagram Corp. v. Commissioner*,[942] the Tax Court applied the "plan of reorganization" concept in integrating a tender offer and a subsequent merger. In *Seagram*, corporation D entered into an agreement with corporation C under which D would make a tender offer for C stock for cash or for D stock, and then C would merge into D. D accepted tenders of 46% of C's stock for cash, while another corporation (T) accepted tenders of 32% of C's stock for cash pursuant to T's competing tender offer. D then accepted 47.5% of C's stock for D stock, including the 32% of C's stock that T had purchased for cash. D acquired the remaining 6.5% of C stock in exchange for D stock pursuant to the merger of C into D.

T claimed that the exchange of its C stock for D stock was not done in pursuance of a "plan of reorganization" as required by §354 (and that it could therefore recognize the loss on the exchange) because D's tender offer and the subsequent merger were separate and independent transactions. The Tax Court determined that D had an indisputable legal obligation to complete the merger with C after successful completion of the tender offer, notwithstanding the possibility of intervening legal impediments such as minority shareholders' enjoining of the merger (which never happened). The Tax Court concluded that the transactions were integrated and together constituted a "plan of reorganization" under §354.

G. Limitations on Investment Companies

The term "reorganization" does not include a transaction involving two or more investment companies if at least one is considered undiversified.[943] Thus, transactions involving two undiversified investment companies or an undiversified and a diversified investment company are taxable. However, transactions involving two diversified investment companies or an undiversified investment company and an operating company may qualify as tax-free reorganizations.[944]

An "investment company," for these purposes, is a regulated investment company (RIC), a real estate investment trust (REIT), or any corporation 50% or more of whose total assets (excluding cash and cash equivalents) by value consists of stock or securities when 80% or more of those assets are held for investment.[945] In making the 50% and 80% determinations, a parent owning 50% or more of the vote or value of a subsidiary is treated as owning a ratable share of the subsidiary's assets.[946] An investment company is considered undiversified if more than 25% of the value of its assets consists of stock or securities of any one issuer or more than 50% of the value of its assets consists of stock or securities of five or fewer issuers.[947] For that purpose, all members of a controlled group of corporations (within the meaning of §1563(a)) are treated as one issuer. Also for that purpose, a corporation holding stock in a regulated investment company, a real estate investment trust, or a diversified investment company is treated as owning its proportionate share of the assets held by such company or trust.[948]

H. Net Value Requirement — Withdrawal of 2005 Proposed Regulations

In 2017 Treasury and the IRS withdrew proposed regulations issued in 2005 that would have modified Reg. §1.368-1(b)(1) to require an exchange of net value, i.e., both a surrender of net value and a receipt of net value, for certain reorganizations to qualify for nonrecognition treatment.[949] For asset transactions, generally there would have been an exchange of net value if (1) the fair market value of the property transferred by Target to Acquiror exceeds the sum of the amount of liabilities of Target assumed by Acquiror in connection with the exchange and the amount of any money and the fair market value of any other property (other than stock permitted to be received under §361(a) without the recognition of gain) received by Target in connection with the exchange; and (2) the fair market value of the assets of the issuing corporation exceeds the amount of its liabilities immediately after the exchange.[950] For stock transactions, there generally would have been an exchange of net value if (1) the fair market value of the assets of Target exceeds the sum of the amount of Target's liabilities immediately prior to the exchange and the amount of any money and the fair market value of any other property (other than stock permitted to be received under §354 without the recognition of gain and §351(g) nonqualified preferred stock) received by Target's shareholders in connection with the exchange; and (2) the fair market value of the assets of the issuing corporation exceeds the amount of its liabilities immediately after the exchange. [951]

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[940] Rev. Rul. 98-10; Rev. Rul. 79-155.

[941] *See, e.g.*, *Reeves v. Commissioner*, 71 T.C. 727 (1979), rev'd and rem'd sub nom. *Chapman v. Commissioner*, 618 F.2d 856 (1st Cir. 1980), cert. dism'd, 451 U.S. 1012 (1981) (initial cash purchases of Target stock were treated as part of attempted "B" Reorganization); Rev. Proc. 77-37 (sales of Acquiror stock that are "part of the plan of reorganization" are considered in determining whether COI requirement is met).

[942] 104 T.C. 75 (1995).

[943] §368(a)(2)(F).

[944] For a detailed discussion of the investment company limitations under §368(a)(2)(F) as well as §351(e), *see* Wilcox & Shoji, *Investment Company Limitations for Corporations and Partnerships*, 39 Tax Mgmt. Memo., Spec. Ed. 1998-2: Corp. Tax and Bus. Plan. Rev. S-3 (Jan. 19, 1998). *Cf.* PLR 200450018 (transfer of LLC interests and cash to newly formed real estate investment trust (REIT) in exchange for its stock qualifies as §351 exchange and is not transfer to investment company).

[945] §368(a)(2)(F)(iii).

[946] §368(a)(2)(F)(iii).

[947] §368(a)(2)(F)(ii). *See also* PLR 9539011 (§368(a)(2)(F)(ii) diversification requirements were met and mergers of trust funds qualified for nonrecognition under §584), PLR 9510014 (same), PLR 9510013 (same), PLR 9510004 (same).

[948] §368(a)(2)(F)(ii). *See also* PLR 9347022 (reorganization involving holding company and investment company subsidiary was not transaction involving two investment companies because no diversification occurred, and holding company was considered an investment company only because of look-through provisions of §368(a)(2)(F)(iii)).

[949] See REG-163314-03, 70 Fed. Reg. 11,903 (Mar. 10, 2005), withdrawn by REG-139633-08, 82 Fed. Reg. 32,281 (July 13, 2017), where Treasury and the IRS stated that transactions not meeting the net value requirement (i.e., certain transfers of property in exchange for the assumption of liabilities or in satisfaction of liabilities) resembled sales.

[950] Withdrawn Prop. Reg. §1.368-1(f)(2).

[951] Withdrawn Prop. Reg. §1.368-1(f)(3).

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The withdrawal of the proposed regulations has created some uncertainty regarding current law.[952] The guidance withdrawing the proposed regulations states that current law is sufficient to ensure that the reorganization provisions are used to accomplish readjustments of continuing interests in property held in modified corporate form.[953] However, with respect to the reorganization provisions, the IRS and Treasury did not point to specific case law or guidance.

[952] With the withdrawal of the 2005 proposed regulations, taxpayers may look to the prior acquiescence of the decision in *Norman Scott, Inc. v. Commissioner*, 48 T.C. 598 (1967) as representative of the IRS's view. However, *Norman Scott* and its inconsistency with Rev. Rul. 59-296 is not discussed in REG-139633-08. While the preamble to REG-139633-08 cites to Rev. Rul. 59-296, it is only cited as reflecting the IRS's view regarding §332.

[953] See preamble to REG-139633-08. For further discussion of the withdrawal of the proposed regulations, see Allyson Versprille, *IRS Withdraws Parts of Proposed Corporate Reorganization Rules*, 133 Daily Tax Rep. G-7 (July 13, 2017).

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VI. Treatment of Parties to a Reorganization

A. General Requirements

1. Existence of a Reorganization

An acquisitive stock or asset transaction between Acquiror and Target and/or Target's shareholders is generally not accorded tax-free treatment under the Code unless the transaction is described as a "reorganization" under §368.

Practice Point: The general rule is that, absent a specific exception in the Code, gain or loss on the sale or exchange of property must be recognized.[954] An acquisitive transaction that is not described as a reorganization may nonetheless be tax-free if it is described in §351 or §332.

For an acquisitive asset or stock transaction to be described as a "reorganization," it not only must fall within one of the statutory definitions of "reorganization" in §368,[955] but also must comply with a host of judicial and administrative rules and limitations (e.g., continuity of interest (COI), continuity of business enterprise, and business purpose).[956] Once an acquisitive transaction is described as a reorganization, then several operative Code provisions affecting the tax treatment of the various parties are brought into play, namely §354 through §362 and §381. The applicability of these operative provisions in a given transaction depends, however, on three additional statutory requirements: "party to a reorganization," "in pursuance of a plan of reorganization," and "exchange of stock or securities."[957]

2. Party to a Reorganization

Section 354, the operative provision applicable to Target's shareholders and creditors, provides nonrecognition treatment only if Target is a "party to the reorganization" and the corporation whose stock or securities are issued to Target's shareholders or creditors is a "party to the reorganization."[958] Similarly, §361, the operative provision applicable to Target, provides nonrecognition treatment only if Target is "a party to the reorganization" and the corporation whose stock or securities are issued in exchange for Target's property is a "party to the reorganization."[959]

The term "party to a reorganization" includes both the corporation acquiring the property or stock of another (i.e., Acquiror) and the corporation whose property or stock is acquired (i.e., Target).[960] The term also includes the controlling corporation (i.e., Parent) in the case of a triangular "B" Reorganization, triangular "C" Reorganization, Forward Triangular Merger, or Reverse Triangular Merger.[961]

In a transaction otherwise qualifying as a reorganization, a corporation remains a party to the reorganization even if stock or assets are distributed to shareholders or dropped down to subsidiaries after the reorganization.[962]

As a practical matter, the "party to a reorganization" requirement has little effect on its own. For example, the use of grandparent stock in a triangular "B" or "C" Reorganization or in a Forward or Reverse Triangular Merger cannot be received tax-free by Target or its shareholders because the grandparent is not a party to the reorganization. However, wholly apart from that, the use of grandparent stock would violate the requirement in triangular reorganizations that only stock of the Acquiror's direct parent will suffice.[963]

One scenario in which the "party to a reorganization" requirement may have consequences is that in which a reorganization is followed by a drop-down of assets under §368(a)(2)(C) and the controlled subsidiary assumes liabilities in excess of the carryover basis. Because the drop-down is treated not as part of the underlying reorganization (i.e., because the subsidiary is not a party to the reorganization), but rather as a separate §351 transaction, the excess liabilities are subject to §357(c).[964]

3. In Pursuance of the Plan of Reorganization

Section 354 and §361 provide nonrecognition treatment to Target and its shareholders and creditors only if their respective exchanges are made "in pursuance of the plan of reorganization." The plan-of-reorganization requirement is discussed in V.F., above. This requirement serves two functions: (1) to require formal recognition (written or oral) of the reorganization plan; and (2) to determine which transactions are treated as part of the reorganization.[965]

4. Exchange of Stock or Securities

Section 354 provides nonrecognition treatment to a shareholder or security holder of Target only if "stock or securities" in Target are, pursuant to the plan of reorganization, exchanged solely for "stock or securities" in Acquiror. This rule applies whether the exchange is accomplished by operation of law (as in an "A" Reorganization), by a direct exchange with Acquiror (as in a "B" Reorganization), or by a surrender of stock or securities to Target (as in a "C" Reorganization). As discussed, §354 is not operative unless the exchange constitutes a "reorganization," which forces the Target shareholders in the aggregate to receive exclusively stock (in the case of a "B" Reorganization) or some statutorily or judicially prescribed minimum amount of stock consideration (in the case of an "A" or "C" Reorganization). Moreover, even if the exchange as a whole constitutes a reorganization, a particular shareholder exchanging stock for only securities or rights to acquire stock is not covered by §354; instead, the exchange is treated as a redemption and taxed as either an exchange under §302 or a distribution under §301.[966] The exchange of Target securities for Acquiror securities pursuant to an "A," "B," or "C" Reorganization is nontax-

[954] §1001(a).
[955] *See* III., and IV., above.
[956] *See* V., above.
[957] *See, e.g.*, §354(a), §361(a).
[958] §354(a).
[959] §361(a).
[960] §368(b).
[961] §368(b).
[962] §368(b); Reg. §1.368-2(f).
[963] *See* III.B.2.a., III.C.8.a., IV.A.6.a., and IV.A.7., above.
[964] *See* V.E., above.
[965] *See* V.F., above, for a discussion of *J.E. Seagram Corp. v. Commissioner*, 104 T.C. 75 (1995), in which the Tax Court used the plan-of-reorganization requirement to determine which transactions were part of a reorganization.
[966] §354(a)(2)(A)(i); Reg. §1.354-1(d) *Exs.* 3, 4; Rev. Rul. 74-515.

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able, subject to the excess principal amount limitation,[967] as is an exchange of Target securities for Acquiror stock.[968]

Section 361 provides nonrecognition treatment to Target on its transfer of property to Acquiror only if Target receives, pursuant to the plan of reorganization, solely "stock or securities" in Acquiror. By definition, this provision does not apply to Target in a "B" Reorganization or Reverse Triangular Merger because Target transfers no assets in these reorganizations. Section 361 does not address the particular mix of stock and securities received by Target; that issue is addressed at the definitional level of the reorganization.

The Code does not define "stock or securities." The definition has been discussed in the context of "B" and "C" Reorganizations[969] and more generally in the COI context.[970] The authorities on the treatment as stock of instruments such as warrants and poison pill rights for those purposes apply equally to the operative provisions.[971]

Reg. §1.354-1(e) provides that, for purposes of §354, the term "securities" includes stock rights issued by, and rights to acquire the stock of, a party to a reorganization. The issuance of this regulation (in 1998)[972] represented a major change from the prior, long-standing regulatory position that stock rights were not treated as "securities."[973]

The determination of whether a debt instrument constitutes a "security" involves an overall evaluation of the nature of the debt instrument; the term of the instrument is usually regarded as a significant factor.[974] However, many factors are relevant. As the Tax Court stated in the frequently cited case of *Camp Wolters Enterprises, Inc. v. Commissioner*:[975]

> The test as to whether notes are securities is not a mechanical determination of the time period of the notes. Though time is an important factor, the controlling consideration is an overall evaluation of the nature of the debt, degree of participation and continuing interest in the business, the extent of proprietary interest compared with the similarity of the note to cash payment, the purpose of the advances, etc.

The quoted passage, standing alone, sheds little light on whether a particular instrument is a security. It does illustrate, however, that the determination requires a careful consideration of various facts and circumstances, such as the degree of managerial participation,[976] the cash equivalency of the instrument (i.e., ease of convertibility or certainty of collection),[977] and the overall risk of loss.[978] As a general rule, debt instruments payable on demand[979] or with a maturity date of less than five years from issuance are less likely to be classified as securities absent other factors (e.g., risk of nonpayment, degree of potential upside participation),[980] whereas bona fide debt instruments with a maturity of more than five years are likely to be classified as securities.[981] However, in Rev. Rul. 2004-78, the IRS indicated that a debt instrument with a term of less than five years that is issued by Acquiror in exchange for Target securities (which originally had a term of 12 years) may nevertheless be a security for purposes of §354 if the Acquiror's debt instruments bear the same terms (other than interest rate) as the securities of Target.

Note: Although the debt instruments in the ruling, which were issued by Acquiror in an "A" Reorganization in exchange for Target's securities, had two-year terms, the instruments were §354 securities because such instruments were issued in exchange for, and bore the same terms (other than the interest rate) as, Target's securities with an original term of 12 years and, thus, represented a continuation of Target's security holders' investment in Target in substantially the same form.

B. Treatment of Target

1. Nonrecognition of Gain or Loss on Asset Transfer

a. Receipt of Stock or Securities

As discussed in VI.A.4., above, Target is entitled to nonrecognition on its transfer of assets to Acquiror to the extent Target receives "stock or securities" in Acquiror.[982]

b. Receipt of Boot

To the extent Target receives from Acquiror other property or money in addition to stock or securities, Target is required to recognize gain (but not loss) up to the amount of such boot unless Target distributes the boot to its shareholders or creditors "in pursuance of the plan of reorganization."[983] The distribution requirement generally has no independent significance. Target, in the case of an "A" Reorganization or Forward Triangular Merger, disappears by operation of law and, consequently, has

[967] §354(a)(2)(A), §356(d); Rev. Rul. 98-10.

[968] Reg. §1.354-1(a).

[969] *See* III.C.3. and III.C.4., above.

[970] *See* V.A.2., above.

[971] *See* III.C.4.d., and III.C.4.m.(3), above.

[972] T.D. 8752, 63 Fed. Reg. 409 (Jan. 6, 1998).

[973] *See* former Reg. §1.354-1(e) in T.D. 6152 (Dec. 2, 1995).

[974] The term "security" has no relationship to the term "security" as used for purposes of the securities laws.

[975] 22 T.C. 737, 751 (1954), aff'd, 230 F.2d 555 (5th Cir. 1956), cert. denied, 352 U.S. 826 (1956) (purchase money notes due in five equal annual installments between fifth and ninth years after issuance, and actually paid within two years, were securities). Although the question of what constitutes a "security" lost much of its significance in the §351 arena when the section was amended to treat "securities" as boot, the question remains relevant in the reorganization area and, thus, authorities involving §351 are applicable. *See, e.g., Lloyd-Smith v. Commissioner*, 116 F.2d 642 (2d Cir. 1941).

[976] *See, e.g., Dennis v. Commissioner*, 57 T.C. 352 (1971), aff'd, 473 F.2d 274 (5th Cir. 1973) (noteholder was 40% stockholder and president of issuing corporation); *Lagerquist v. Commissioner*, T.C. Memo 1987-185 (noteholder was most substantial minority stockholder of issuing corporation and actively served as one of its directors).

[977] *See, e.g., Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933); *Griffith v. Commissioner*, 73 T.C. 933 (1980).

[978] *Bradshaw v. United States*, 683 F.2d 365 (Ct. Cl. 1982); *D'Angelo Assocs. Inc. v. Commissioner*, 70 T.C. 121 (1978); *Lagerquist v. Commissioner*, T.C. Memo 1987-185.

[979] *Pacific Pub. Serv. Co. v. Commissioner*, 154 F.2d 713 (9th Cir. 1946).

[980] *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933) (four-month note was not security); *Stirn, Inc. v. Commissioner*, 107 F.2d 390 (2d Cir. 1939) (notes to be paid in five years but paid off in 10 months were not securities).

[981] *Dennis v. Commissioner*, 473 F.2d 274 (5th Cir. 1973) (12½-year term notes were securities); *United States v. Hertwig*, 398 F.2d 452 (5th Cir. 1968) (12½-year notes were securities); *Commissioner v. Freund*, 98 F.2d 201 (3d Cir. 1938) (six-year bonds were securities); *Burnham v. Commissioner*, 86 F.2d 776 (7th Cir. 1936) (10 years); Rev. Rul. 59-98 (bonds with average life of 6½ years were securities).

[982] §361(a).

[983] §361(b).

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no opportunity to distribute stock, securities, or other property received from Acquiror. In the case of a Reverse Triangular Merger, Sub (assuming it is an "old and cold" subsidiary that owns property other than Parent's stock) is similarly in no position to distribute Parent stock or securities after the merger.[984]

In the case of a "C" Reorganization, Target is already required, as a prerequisite to the reorganization, to distribute all of its properties, including all stock, securities, and other consideration received from Acquiror, to its shareholders or creditors pursuant to the plan of reorganization.[985] Given the identical language in §368(a)(2)(G) and §361(b), and the absence of any apparent legislative intent to the contrary, these provisions should be regarded as parallel. Except possibly when the distribution requirement is waived for §368(a)(2)(G) purposes,[986] the satisfaction of one should satisfy the other. Because, under §368(a)(2)(G), it is generally advisable to comply with the distribution requirement within 12 months of the reorganization,[987] the same should hold true for §361(b) purposes.

Planning Point: The one scenario in which Target may be unable to avoid gain recognition on its transfer of property to Acquiror is where Target is deemed to receive boot but there is no tangible property to distribute, e.g., where Acquiror assumes Target liabilities to which §357(b) applies but does not pay those liabilities until after the reorganization.[988] As previously discussed, §357(b) is unlikely to apply in those circumstances, even if the assumed liabilities were incurred by Target shortly before or in connection with the reorganization.[989] However, in the event Target has liabilities of a §357(b) character that Acquiror intends to assume, it may be advisable to retire those liabilities in the reorganization, either by Acquiror directly or by Target with funds provided by Acquiror.

Planning Point: There is apparently no requirement in §361(b) that the creditor to whom the distribution is made be "old and cold."

2. *Target's Basis in Stock, Securities, and Property Received*

Target's basis in the stock, securities, and other property received from Acquiror pursuant to the reorganization is determined under §358, which is the same provision used to determine the basis to exchanging Target shareholders and creditors.[990] Under that provision, the basis of any property received by Target other than Acquiror stock or securities is the fair market value of that property on the date of the reorganization.[991] Target's basis in the Acquiror stock or securities it receives is equal to Target's basis in the assets transferred to Acquiror, less the money and the fair market value of other property received and the amount of Target liabilities assumed by Acquiror, plus the amount of any gain recognized by Target on the exchange.[992]

Target's basis in the assets received from Acquiror is generally unimportant because the assets received are, in the case of an "A" Reorganization or Forward Triangular Merger, never acquired by Target (or, if they are deemed acquired, they are deemed immediately distributed), and, in the case of a "C" Reorganization, the assets are required to be distributed to Target's shareholders and creditors. In either case, such a deemed or actual distribution generally does not trigger recognition of gain or loss by Target.[993]

Planning Point: Although the Acquiror stock or securities received by Target have a substituted basis under §358, so that a sale of those assets by Target results in recognized gain or loss, it is inadvisable, at least in the case of a "C" Reorganization where there is a "complete distribution" requirement, for Target to dispose of any assets received from Acquiror except by way of distribution to shareholders and creditors.[994]

3. *Nonrecognition of Gain or Loss on Distributions*

Target will recognize no gain or loss on the distribution of "qualified property" to its shareholders and creditors "in pursuance of the plan of reorganization."[995]

Planning Point: While a distribution of property other than qualified property to the Target's creditors arguably is not precluded from loss recognition in light of the literal language of §361(c)(1) and §361(c)(3), the legislative history indicates an intent to conform these provisions to §311.[996] Under §311, which addresses nonliquidating distributions of property, no loss may be recognized by the distributing corporation; the same, presumably, should be true with respect to any distribution under §361(c).

The term "qualified property" means either (a) Target stock (or rights to acquire Target stock) or obligations or (b) Acquiror stock (or rights to acquire Acquiror stock) or obligations that are received by Target in the reorganization.[997] The term "obligation" presumably includes any debt obligation of Target or Acquiror, whether or not it constitutes a "security." The phrase "in pursuance of the plan of reorganization" should have the same meaning as it has for §368(a)(2)(G) purposes, except possibly when the distribution requirement is waived.[998]

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[984] On these grounds, it has been argued that §361 should have no application in an "A" Reorganization (see Carlson, *Boot at the Corporate Level in Tax-Free Reorganizations*, 27 Tax L. Rev. 499 (1972)); however, under a prior version of §361, which required gain recognition on Target's distributions to creditors, the IRS viewed the Target in an "A" Reorganization as constructively transferring its assets to Acquiror for stock and other consideration and then distributing those items to its shareholders and creditors (Rev. Rul. 72-343 where the IRS held Target's receipt of interim financing advances from Acquiror to repay creditors was considered receipt of boot received in an "A" Reorganization). The IRS has effectively confirmed this view in ruling that a failed "A" Reorganization should be treated as a taxable sale of assets between Target and Acquiror followed by a liquidation of Target. Rev. Rul. 69-6, 1969-1 C.B. 104. In a similar vein, in *TBL Licensing LLC v. Commissioner*, 158 T.C. No. 1 (2022), the Tax Court treated an "outbound F reorganization" as if Target transferred all its assets to Acquiror in exchange for Acquiror stock, and then distributed the Acquiror stock to its shareholder in liquidation.

[985] §368(a)(2)(G). A nondivisive reorganization qualifying under §368(a)(1)(D) is subject to a similar requirement. §354(b), §368(a)(1)(D).

[986] *See* III.C.6., above.

[987] *See* III.C.6., above.

[988] If Acquiror pays the liabilities concurrently with the assumption, Target is viewed as constructively distributing boot it was deemed to have received. *See* Rev. Rul. 73-102.

[989] *See* III.A.2.c.(2), above.

[990] *See* VI.E.5., below.

[991] §358(a)(2).

[992] §358(a)(1), §358(d).

[993] *See* VI.B.3., below.

[994] *See* III.C.6., above.

[995] §361(c)(1), §361(c)(3).

[996] S. Rep. No. 100-445, at 393 (1988).

[997] §361(c)(2)(B).

[998] *See* III.C.6. and VI.B.1.b., above.

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Furthermore, the application of §361(c) to "A" Reorganizations is the same as it is for §361(a) and §361(b) purposes.

Target recognizes gain (but not loss) on distributions of appreciated property other than qualified property (which is either already owned by Target or received by Target from Acquiror, and then distributed to Target's shareholders and creditors).[999] Because Target acquires a fair market value basis in any such property received from Acquiror,[1000] any gain on the distribution of that property is limited to the appreciation (if any) occurring since the date of the reorganization. However, Target's basis in any property already owned by Target that was not received from Acquiror is not affected by the reorganization and, consequently, any gain on the distribution of that property can be substantial.

4. Cancellation of Debt (COD) Income

a. Acquisitive Asset Reorganizations

Assume Target has outstanding bonds with a stated principal amount (or adjusted issue price)[1001] of $1,000 each. Because of interest rate changes, however, the bonds have a fair market value in the bondholder's hands of only $900. Pursuant to the merger of Target into Acquiror, each $1,000 bond is exchanged by the bondholder for $900 worth of Acquiror stock. Target does not recognize gain or loss on the transfer of assets to Acquiror in exchange for Acquiror stock,[1002] nor does Target recognize gain or loss on the distribution of Acquiror stock to its bondholders.[1003] However, it is reasonably clear that Target should recognize $100 of COD income per $1,000 bond, equal to the excess of the bond's $1,000 adjusted issue price over the $900 fair market value of the Acquiror stock.[1004] The absence of direct authority on this point is probably attributable to the fact that bondholders of Target would rarely accept merger consideration at less than stated principal if the Target shareholders are receiving even one dollar of equity in the merger.

Planning Point: The legislative history to the 1988 revisions to §361 provides that the amendments permitting nonrecognition of gain or loss on Target's distribution of qualified property to creditors "are not intended to affect the treatment of any income from the discharge of indebtedness arising in connection with a corporate reorganization."[1005] No authority directly provides for this result in the reorganization context, but Target is arguably in the same position as any other debtor transferring property to a creditor in cancellation of debt. That transaction is generally bifurcated into two components: (1) the difference between the debtor's basis and the fair market value of the transferred property is taxable gain or loss under §1001; and (2) the excess of the canceled debt over the fair market value of the transferred property is COD income.[1006] If the debt canceled is nonrecourse and the creditor had a security interest in Target assets, the entire excess of the canceled debt over Acquiror's carryover basis in the stock received is considered gain rather than COD income and, consequently, all of that gain is entitled to nonrecognition under §361(c).[1007]

If Acquiror is viewed as first assuming Target's liability on the bonds, and then discharging that liability by issuing its stock to the bondholders, Target avoids COD income by reason of §357(a)[1008] but the $100 difference is probably COD income to Acquiror.[1009] Acquiror would be viewed as assuming the tax liabilities of Target in the case of a merger of Target into Acquiror. Generally, it may not matter which entity includes the COD income, unless the losses of one entity — or some exception to the recognition of COD income applicable only to that entity — would not be available to offset the COD income if it were included by the other entity.

Regulations under §108 and §1017 address attribute reductions upon the reorganization of a debtor. If, as a result of a reorganization under §368(a)(1)(A), §368(a)(1)(C), §368(a)(1)(D), §368(a)(1)(F), or §368(a)(1)(G), the distributor or transferor corporation excludes COD income under §108(a), then the acquiring corporation must reduce the tax attributes to which it succeeds.[1010] All of the attributes subject to reduction are listed in §108(b)(2), and include NOL and capital loss carryovers, and basis of property acquired.[1011] For a discussion of the limitations on Acquiror's use of some tax attributes carried over from Target, see 780 T.M., *Net Operating Losses and Other Tax Attributes — Sections 381, 382, 383, 384, and 269.*

If Target's outstanding bonds are assumed by Acquiror in connection with an "A" or "C" Reorganization, the consequences to Target may turn on whether that assumption constitutes an exchange for tax purposes. Whenever a new debt instrument is considered issued in exchange for an old debt instrument, the new debt's issue price must be determined, and, depending on prevailing interest rates and the debt's tradability, that issue price may be below the debt's stated principal amount.[1012] Target's bonds generally should not be considered "exchanged" for Acquiror bonds in an "A" or "C" Reorganization if Acquiror merely assumes those bonds without changing the bond's terms; that is, a mere change of obligor should not be considered a material modification of the bonds.[1013] It does not matter in those circumstances whether Acquiror physically issues new debt instruments to the existing holders. However, if the terms of Target's bonds are changed, the changes — in combination with the addition of an obligor — may result in a deemed exchange.[1014] If the Parent in a Forward Triangular Merger becomes the new obligor, then the existence of an exchange is more likely because an entity other than the "acquiring corporation" (within the meaning of §381) has assumed the debt.[1015]

[999] §361(c)(2).

[1000] §358(a)(2).

[1001] For a definition of "adjusted issue price," see §1272(a)(4) and Reg. §1.1275-1(b).

[1002] §361(b).

[1003] §361(c).

[1004] *Cf.* §108(e)(8) regarding a debtor's transfer of its own stock in satisfaction of debt.

[1005] S. Rep. No. 100-445, at 393 (1988).

[1006] Reg. §1.1001-2; Rev. Rul. 90-16.

[1007] *Cf.* Reg. §1.1001-2(a)(2), §1.1001-2(c) *Ex.* (8); Rev. Rul. 76-111.

[1008] *See* III.A.2.c.(2), above.

[1009] §108(e)(8).

[1010] Reg. §1.108-7(c), §1.1017-1(b)(4). This rule is not limited to reorganizations, but applies to all transactions described in §381(a).

[1011] Reg. §1.108-7(c), §1.1017-1(b)(4).

[1012] §108(e)(10), §1274(c). *See generally* 541 T.M., *Tax Aspects of Restructuring Financially Troubled Businesses.*

[1013] Reg. §1.1001-3(e)(4)(i)(B), §1.1001-3(e)(4)(vi). *See* PLR 200315001.

[1014] Reg. §1.1001-3(e)(4)(i)(B), §1.1001-3(e)(4)(vi).

[1015] Reg. §1.1001-3(e)(4)(i)(B).

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Example 1: Acquiror assumes Target's $1,000 bonds but also changes certain terms. Because of prevailing interest rates or the investment grade of the debt, the new Acquiror bonds will trade publicly at $900 each. If Target's bonds are considered exchanged, Target is treated as having satisfied its $1,000 bonds with new bonds having an issue price of $900 each, resulting in COD income to Target of $100 per $1,000 bond.[1016]

Example 2: Target has outstanding $1,000 bonds that were purchased in a prior, unrelated transaction by Acquiror at $900 each. Pursuant to a merger of Target into Acquiror in which Acquiror assumes all of Target's liabilities, the outstanding bonds are canceled. Under the IRS interpretation of §357(a) and §361(a), Target does not recognize any income on the satisfaction of its indebtedness.[1017] Moreover, §108(e)(4) — which requires a debtor in certain circumstances to recognize COD income if its outstanding debt is acquired by a related party — is not invoked upon the merger because Acquiror's acquisition of Target's assets does not cause Acquiror and Target to become related parties.[1018] However, Acquiror must recognize gain equal to the excess of each Target bond's adjusted price over Acquiror's $900 basis in each such bond.

Planning Point: The apparent rationale for this result is that Target's assets transferred in the merger are applied first to satisfy its indebtedness on the bonds, and the remainder is transferred in exchange for Acquiror stock and other consideration. The IRS treated the result in Rev. Rul. 72-464, as analogous to the result with respect to a subsidiary's indebtedness to its parent in a §332 liquidation.[1019] Although the 1986 Act moved the provisions of §332(c) to §337(b), they are to be interpreted in the same way as under prior law.[1020] If, on the other hand, the debt owed by the subsidiary to the parent exceeds the value of the subsidiary's assets, so that the subsidiary is insolvent, the liquidation does not qualify for §332 treatment. The parent, however, may be entitled to a bad debt deduction upon the liquidation of the subsidiary.[1021]

When Acquiror is indebted to Target, the merger of Target into Acquiror and the consequent cancellation of that indebtedness should not result in COD income to either party. In Rev. Rul. 74-54, the IRS ruled that the cancellation of Parent's note to subsidiary in connection with a §332 liquidation does not result in gain or COD income to Parent or Subsidiary because the note is regarded as an asset in the Subsidiary's hands that is simply distributed in the liquidation. In these circumstances, it should not matter whether the note was issued or purchased at a discount.

Note: However, in a 1991 notice of proposed rulemaking for the proposed regulations under §108(e)(4), the IRS indicated that if a transferee acquires its own indebtedness in a tax-free transaction, the indebtedness should be treated as if it were first acquired by the transferee and then satisfied, requiring the transferee to recognize COD income.[1022] The final regulations issued in 1992, in Reg. § 1.108-2(f)(3), reserved "on the treatment of an acquisition of indebtedness in a nonrecognition transaction, such as the merger of the creditor into a subsidiary of the debtor in a reorganization under Section 368(a)(1)(A),"[1023] and this issue remains reserved.

b. *Acquisitive Stock Reorganizations*

Acquiror's issuance of new bonds for Target's existing bonds in connection with a "B" Reorganization or Reverse Triangular Merger should be treated as an exchange of bonds even when the terms of the Acquiror bonds are substantially identical to the terms of the surrendered Target bonds.[1024] The exchange is nontaxable under §354 if both bonds are considered securities, but otherwise it is taxable.[1025] This result contrasts with those in an "A" or "C" Reorganization, in which Acquiror's assumption of Target's liabilities is not generally regarded as an exchange unless the terms of the liabilities are materially changed.[1026] The apparent reason for this distinction is that the exchange of Target bonds for Acquiror bonds in a "B" Reorganization or Parent bonds in a Reverse Triangular Merger involves a complete substitution of obligor, whereas the new obligor in an acquisitive asset reorganization (Acquiror in an "A" or "C" Reorganization, or Sub in a Forward Triangular Merger) is often merely a continuation of Target (except where Parent becomes a new obligor in a Forward Triangular Merger).[1027] However, even in a "B" Reorganization or Reverse Triangular Merger, an exchange of bonds should not occur if Target's bonds remain outstanding and Acquiror (or Parent) merely supplements Target's outstanding liability through a guarantee or the assumption of joint and several liability.[1028]

If Target's existing debt is acquired by Acquiror in connection with an acquisitive stock reorganization (whether a "B" Reorganization or a Reverse Triangular Merger), either by purchase (e.g., with cash, stock, or other consideration) or by the issuance of new debt in exchange for the old debt, Target may have COD income consequences as a result of §108(e)(4). Section 108(e)(4) provides that, for purposes of determining income from discharge of indebtedness, and to the extent provided in regulations, the acquisition of debt by a person related to the debtor from a person not so related is treated as an acquisition of that debt directly by the debtor.

The legislative history to §108(e)(4) provides a simple example in which a parent corporation purchases for $900 on the

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[1016] *See* §108(e)(10).

[1017] Rev. Rul. 72-464. *See also Edwards Motor Transit Co. v. Commissioner*, T.C. Memo 1964-317.

[1018] §108(e)(4), §267(b), §707(b)(1); Reg. §1.108-2(d)(2).

[1019] *See* Reg. §1.332-7 (if Parent purchases Subsidiary's bonds at discount and receives payment for face amount of bonds upon liquidation of subsidiary, Parent must recognize gain equal to excess of amount paid over Parent's basis in bonds); *Houston Natural Gas Corp. v. Commissioner*, 173 F.2d 461 (5th Cir. 1949) (upon liquidation of Subsidiary, Parent is considered to receive payment equal to face amount of Subsidiary bonds held by Parent).

[1020] Staff of the J. Comm. on Tax'n, 99th Cong., 2d Sess., *General Explanation of the Tax Reform Act of 1986*, 340 (Comm. Print 1987).

[1021] Rev. Rul. 2003-125, *superseding* Rev. Rul. 70-489, *and amplifying* Rev. Rul. 59-296.

[1022] 56 Fed. Reg. 12,135, 12,138 (Mar. 22, 1991).

[1023] T.D. 8460 (Dec. 28, 1992), 57 Fed. Reg. 61,805 at 61,806.

[1024] Reg. §1.1001-3(e)(4).

[1025] *See* VI.E.1.f.(2), below; Rev. Rul. 98-10.

[1026] *See* VI.E.1.e., below.

[1027] *See* VI.B.4.a., above.

[1028] Reg. §1.1001-3(e)(4)(iii). *See also* Rev. Rul. 79-155.

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open market a $1,000 bond issued at par by its wholly owned subsidiary, resulting in $100 of COD income to the subsidiary as if the subsidiary had directly acquired its bond for $900. The legislative history also indicates that the abuse associated with related-party acquisition of debt was that the debtor could effectively eliminate its indebtedness as a "real liability to outside interests" while avoiding the adverse tax consequences that would apply if the debtor had directly acquired the debt.[1029] Final regulations under §108(e)(4) were issued in 1992.[1030]

Section 108(e)(4) does not apply unless the acquisition of outstanding debt is made by a person related to the debtor within the meaning of §267(b) or §707(b)(1) from a person who does not bear such a relationship to the debtor.[1031]

Section 108(e)(4) applies if the debtor's indebtedness is acquired in a direct acquisition or an indirect acquisition.[1032] A direct acquisition includes an acquisition of a debtor's indebtedness from a person who is not related to the debtor by a person who either is already related to the debtor or becomes related to the debtor simultaneously with the debt acquisition.[1033] An indirect acquisition is a transaction in which a holder of outstanding indebtedness becomes related to the debtor, if the holder acquired the indebtedness in anticipation of becoming related to the debtor.[1034] In determining whether debt was acquired by a holder in anticipation of becoming related to the debtor, all relevant facts and circumstances are considered, including: (1) the intent of the parties at the time of the acquisition; (2) the nature of any contacts between the parties before the acquisition; (3) the period of time for which the holder held the debt; and (4) the significance of the debt in proportion to the total assets of the holder group.[1035] In addition, if the holder of the debt acquired the debt less than six months before the date the holder becomes related to the debtor, the holder is treated as having acquired the debt in anticipation of becoming related to the debtor.[1036] If the holder acquires the debt within six to 24 months of becoming related to the debtor or the debt represents more than 25% of the holder group's assets, then the debtor is required to disclose the circumstances of the acquisition on its tax return unless the debtor treats the transaction as an indirect acquisition. This provision appears to be aimed at certain transactions in which a third party would organize a special-purpose subsidiary to acquire outstanding debt and, subsequently, the debtor purchased the stock of the special purpose subsidiary from the third party.[1037]

The amount of cancellation of indebtedness (COD) income realized depends on whether the holder acquired the indebtedness by purchase within six months of the acquisition date. In such a case, the regulations adopt a cost standard and state that COD income is measured by reference to the adjusted basis of the related holder in the indebtedness as of the acquisition date.[1038] In addition, indebtedness is considered acquired by purchase within six months of the acquisition date if the holder acquired the indebtedness as transferred basis property from a person who acquired the indebtedness by purchase on or less than six months before the acquisition date.[1039] If the holder acquired the indebtedness by purchase more than six months before the acquisition date, the amount of COD income realized is measured by reference to the fair market value of the indebtedness on the acquisition date.[1040] The debtor is generally required to recognize the COD income unless the debtor qualifies for the bankruptcy or insolvency exceptions.[1041]

5. Stock Repurchase Excise Tax

The Inflation Reduction Act of 2022 added §4501 imposing a nondeductible excise tax on each "covered corporation" equal to 1% of the corporation's net stock repurchases occurring after December 31, 2022.[1042] A covered corporation is any domestic corporation whose stock is traded on an established securities market within the meaning of §7704(b)(1).[1043] While the scope of what constitutes a "repurchase" for purposes of this new excise tax is broadly defined, there is a statutory exception confirming that the stock repurchase excise tax does not apply to the extent the stock repurchase is part of a §368 reorganization in which no gain or loss is recognized.[1044]

Proposed regulations, issued April 12, 2024, would provide guidance on implementation of the new excise tax, following interim guidance released December 27, 2024, in the form of Notice 2023-2.[1045]

Proposed regulations would provide that in the context of an acquisitive §368 reorganization where Target is a covered corporation, the exchange by Target's shareholders of their Target stock for consideration as part of such reorganization is considered a "repurchase" of such stock by Target for purposes of §4501.[1046] Under the reorganization exception, the proposed regulations would reduce a covered corporation's excise tax base to the extent the Target repurchase is for property permitted to be received without gain or loss recognition under §354 (i.e., for qualifying property, rather than §356 boot).[1047] The result of this approach is that Target may be subject to a 1% ex-

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[1029] H.R. Rep. No. 96-833, at 9 (1980); S. Rep. No. 96-1035, at 10 (1980). Before regulations were issued, the IRS adopted the position that §108(e)(4) was nonetheless currently operative. *See* PLR 8923021, PLR 8922080.

[1030] T.D. 8460 (Dec. 28, 1992).

[1031] For purposes of this rule, two entities that are treated as a single employer under §414(b) or §414(c) are treated as bearing a relationship to each other that is described in §267(b). §108(e)(4)(C). The term "person" includes an individual, partnership, association, or corporation. §7701(a)(1).

[1032] Reg. §1.108-2(a).

[1033] Reg. §1.108-2(b).

[1034] Reg. §1.108-2(c)(1).

[1035] Reg. §1.108-2(c)(2).

[1036] Reg. §1.108-2(c)(3).

[1037] *See* Rev. Rul. 91-47 (similar fact pattern treated in substance as though debtor acquired its debt directly or through related party).

[1038] Reg. §1.108-2(f)(1).

[1039] Reg. §1.108-2(f)(1).

[1040] Reg. §1.108-2(f)(2).

[1041] §108(a).

[1042] §4501(a), §275(a)(6), added and amended by the Inflation Reduction Act of 2022, Pub. L. No. 117-169, §10201 (Aug. 16, 2022).

[1043] §4501(b).

[1044] §4501(e)(1); *see also* §4501(c)(1) (defining "repurchase").

[1045] *See* REG-115710-22, 89 Fed. Reg. 25,980 (Apr. 12, 2024), *obsoleting* Notice 2023-2, generally effective for repurchases, issuances, and provisions of stock of a covered corporation occurring after December 31, 2022. Certain provisions not included in Notice 2023-2 would apply only to repurchases occurring after April 12, 2024.

[1046] *See* Prop. Reg. §58.4501-2(e)(4)(i) (economically similar transaction; Notice 2023-2, Section 3.04(4)(a)(1).

[1047] Prop. Reg. §58.4501-3(c)(1) (statutory exception).

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cise tax on the value of boot received by Target's shareholders in an acquisitive reorganization.[1048]

The proposed regulations would define acquisitive reorganizations to include:

- "A" reorganizations under §368(a)(1)(A), including
  - o A forward triangular merger under §368(a)(2)(D);
  - o A reverse triangular merger under §368(a)(2)(E);
- "C" reorganizations under §368(a)(1)(C);
- "D" reorganizations under §368(a)(1)(D); and
- "G" reorganizations under §368(a)(1)(G).[1049]

Example: Target, a publicly traded corporation, merges into Acquiror in an A reorganization. In the merger, Target's shareholders in the aggregate receive $60X Acquirer stock and $40X cash (i.e. boot), for total merger consideration of $100X. Under the proposed regulations, the Target has repurchased its stock in connection with the reorganization for $100X, $60X of which is considered qualifying property and $40X of which is considered nonqualifying property, thus resulting in the Target's stock repurchase excise base being increased by a net amount of $40X in the year of the merger (i.e., $100X increase for the repurchase, reduced by $60X for the reorganization exception). Absent any other adjustments to Target's stock repurchase excise tax base for other activity occurring during the year of the merger, Target's excise tax for the year of the merger would be 1% of $40X.[1050]

In response to the IRS's request for comments from practitioners regarding the interim guidance provided in Notice 2023-2, numerous comments have been submitted advocating that acquisitive §368 reorganizations should be exempted from §4501 entirely, or alternatively, a broader exception to the §4501 excise tax should be available for such acquisitive reorganizations.[1051] However, the preamble to the proposed regulations provides that Treasury and the IRS take the view that exchange of Target stock occurring as part of an acquisitive reorganization are subject to the stock repurchase excise tax. Further, the preamble explains that "statutory exception would have no effect in the exchange of target corporation stock for non-qualifying property in reorganizations where exempt from the stock repurchase excise tax."[1052] As provided in the preamble, implementation of the statutory exception by reliance on §354 and §356 provides "bright-line" rules that taxpayers can apply and the IRS can administer and enforce with certainty.[1053] That is, every acquisitive reorganization involves a Target redemptive distribution to a Target shareholder to which §354 or §356 is applied.[1054] Until final regulatory guidance is issued and provided that the rules are followed consistently, taxpayers can rely on Prop. Reg. §58.4501-1 through §58.4501-5 for stock repurchases occurring after December 31, 2022, and for stock issuances and provisions occurring during taxable years ending after December 31, 2022. In addition, taxpayers may rely on the interim guidance provided in Notice 2023-2 corresponding to the rules in Prop. Reg. §58.4501-1 through §58.4501-5 with respect to repurchases of stock of a covered corporation occurring after December 31, 2022, and on or before April 12, 2024.[1055] For a full discussion of the stock repurchase excise tax under §4501, including the proposed regulations, see 767 T.M., Redemptions.

C. *Treatment of Acquiror*

1. *Nonrecognition of Gain or Loss on Issuance of Stock or Securities*

a. *Stock — §1032*

Section 1032(a) states: "No gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation." Thus, Acquiror does not recognize gain or loss upon the issuance of its stock in connection with a reorganization.

Although no Code section specifically protects Sub upon the issuance of Parent stock in connection with a reorganization,[1056] the IRS has accepted the principle that Sub recognizes no gain or loss upon the issuance of Parent stock in connection with a reorganization.[1057] Reconciling this result with the general principle that Sub has no basis in Parent stock contributed to Sub is possible on two separate grounds. First, to the extent that triangular acquisitive reorganizations are viewed as direct acquisitions by Parent followed by a drop-down to Sub, the protection of §1032 is available to prevent recognition of gain. Second, it seems inconceivable that Congress would specifically sanction triangular acquisitive reorganizations while, at the same time, intending to tax Sub on the issuance of Parent stock.

Regulations under §1032 generally extend §1032 nonrecognition treatment to Sub on its use of Parent stock in a Forward Triangular Merger, a triangular "C" Reorganization, or a

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[1048] Prop. Reg. §58.4501-1(b)(1) defines an "acquisitive reorganization" to include, among others, an A Reorganization, a Forward Subsidiary Merger, a Reverse Subsidiary Merger and a C Reorganization.

[1049] Prop. Reg. §58.4501-1(b)(1)(i)–§58.4501-1(b)(1)(iv); Notice 2023-2, §3.02(1). "D" and "G" reorganizations must also satisfy the requirements of §354(b)(1). Prop. Reg. §58.4501-1(b)(1)(iii), §58.4501-1(b)(1)(iv).

[1050] *See* Prop. Reg. §58.4501-5(b)(6) *Ex.* 6 (further providing that the issuance of stock by Acquirer in the reorganization in this example would not be considered an issuance for purposes of determining Acquirer's stock repurchase excise tax base for the year of the merger because such stock was part of a transaction to which the qualifying property exception applied in respect of determining Target's stock repurchase excise tax base for the year of the merger); Notice 2023-2, §3.09, *Ex.* 6.

[1051] See NYSBA Report No. 1474 (March 20, 2023); American Bar Association Section of Taxation Comments on Notice 2023-2 (March 20, 2023).

[1052] *See* Preamble to REG-115710-22, 89 Fed. Reg. at 25,999 (Apr. 12, 2024).

[1053] *See* Preamble to REG-115710-22, 89 Fed. Reg. at 25,999 (Apr. 12, 2024).

[1054] *See* Preamble to REG-115710-22, 89 Fed. Reg. at 25,999 (Apr. 12, 2024). As discussed in VI.E., below, the treatment of stockholders and security holders in a reorganization is set forth in §354 and §356. Section 354 provides the rules governing nonrecognition treatment on the receipt of qualifying consideration, and §356 provides the rules for determining the treatment of nonqualifying consideration, i.e., boot.

[1055] *See* Preamble to REG-115710-22. 89 Fed. Reg. at 26,020 (Apr. 24, 2024); Prop. Reg. §58.4501-6.

[1056] If Sub is a transitory first-tier subsidiary of Parent used in a Reverse Triangular Merger or "B" Reorganization effected by merger, Sub may be disregarded and the transaction recharacterized as a direct acquisition by Parent, and thereby protected by §1032. Rev. Rul. 67-448. *See, e.g.*, PLR 200941009.

[1057] *See* Reg. §1.1032-2; Rev. Rul. 57-278.

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triangular "B" Reorganization. Application of §1032 is unnecessary in a Reverse Triangular Merger, because §361(a) is considered to provide nonrecognition treatment for Sub's use of Parent stock. Nonrecognition treatment under §1032 requires that the Parent stock be "provided by" Parent to Sub, or "directly to" Target or Target's shareholders, "pursuant to the plan of reorganization."[1058] To the extent that Sub exchanges in such reorganizations Parent stock that it did not receive from Parent pursuant to the plan of reorganization, Sub must recognize gain or loss on the exchange of that stock.[1059] Parent stock purchased by Sub pursuant to the plan of reorganization, whether the purchase is from Parent or in the market, arguably should be protected from gain recognition under §1032 (e.g., if the stock appreciates between the purchase date and closing), although some commentators believe otherwise.[1060]

Example: Target has assets with an aggregate basis of $60 and fair market value of $100 and no liabilities. Sub is an operating company with substantial assets and has been in existence for several years. Sub also owns Parent stock with a $20 adjusted basis and $30 fair market value. Sub acquired Parent stock in an unrelated transaction several years before the reorganization. Pursuant to a plan of reorganization, Parent transfers additional Parent stock worth $70 to Sub and Target merges into Sub. In the merger, Target shareholders receive $100 of Parent stock ($70 of Parent stock provided by Parent and $30 of Parent stock provided by Sub). The transaction is a reorganization to which §368(a)(1)(A) and §368(a)(2)(D) applies. The $70 of Parent stock provided by Parent pursuant to the plan of reorganization is treated as disposed of by Parent for Target assets acquired by Sub in the merger. Consequently, neither Parent nor Sub has taxable gain or deductible loss on the exchange of those shares. However, Sub recognizes $10 of gain on the exchange of its old and cold Parent stock used in the reorganization because Sub did not receive Parent stock from Parent pursuant to the plan of reorganization.[1061]

b. Securities

The issuance of securities in connection with an acquisitive reorganization should not result in the recognition of gain or loss to Acquiror, because issuance of one's own debt for property is not a taxable event. In the context of a triangular reorganization, recharacterization of the transaction as the issuance of debt for property by Parent[1062] followed by a drop-down to Sub, avoids recognition of "zero basis" gain by Sub.

[1058] Reg. §1.1032-2.

[1059] *See* Reg. §1.1032-2(c).

[1060] Cummings & Eustice, *IRS Revises Proposed Reg. on Stock Basis Adjustments in Triangular Reorganizations*, 82 J. Tax'n 324, 326 (1995) (noting that Parent stock acquired in open market by Sub with funds provided to Sub by Parent pursuant to plan of reorganization is viewed as provided by Parent, while Parent stock acquired by Sub pursuant to plan of reorganization, but with funds obtained outside plan, is not treated as provided by Parent). For a discussion of the consequences of a failed triangular reorganization, see III.B.5.b., above.

[1061] Reg. §1.1032-2(d) *Ex.* 2. *See* Reg. §1.358-6(d) for the effect on Parent's basis in its Sub stock.

[1062] *See, e.g.*, Reg. §1.1032-2(b).

Comment: Note that acquiror's ability to recognize a loss may be limited under other Code sections, such as §267 and §1091.

c. Other Property — §1001

If, in addition to transferring its stock, securities, or debt that does not qualify as a security, Acquiror transfers other property (e.g., personalty or realty) in the reorganization, Acquiror recognizes gain or loss[1063] equal to the difference between the value of such other property and Acquiror's basis in that property.[1064]

2. Acquiror's Basis in Target's Assets in an Acquisitive Asset Reorganization

a. Section 362(b)

Section 362(b) provides a mechanical guide for determining the basis of Target's assets transferred to Acquiror in "A" and "C" Reorganizations. The basis generally is the same as Target's basis, increased by any gain recognized by Target in the exchange.[1065] The increase in asset basis results only from gain recognized by Target.[1066] No increase in basis results from gain recognized by the former Target shareholders,[1067] and no increase in basis results from Acquiror's payment of boot.

The general rule, however, is limited in certain situations. Section 362(e)(1)[1068] imposes basis limitations on certain transactions (including "A" and "C" Reorganizations) involving the transfer or importation of certain assets with a net built-in loss. Section 362(e)(1) is triggered if gain or loss with respect to the property is not subject to U.S. income tax in the hands of a transferor immediately before the transfer but gain or loss with respect to the property is subject to U.S. income tax in the hands of the transferee immediately after the transaction[1069] and the aggregate adjusted basis of the property transferred exceeds the aggregate fair market value of the property.[1070] If §362(e)(1) applies, then the basis of the property transferred is limited to its fair market value.[1071]

The Conference Committee Report suggests that the provision is aimed primarily at transactions in which foreign corporations import loss property into the U.S. in a tax-free incorporation or reorganization.[1072] However, the statutory language

[1063] Rev. Rul. 72-327.

[1064] §1001.

[1065] §362(b); Reg. §1.362-1. Treasury and the IRS intend to issue proposed regulations providing that in certain transactions in which a domestic corporation acquires the stock of a controlled foreign corporation (CFC) from another CFC in an asset reorganization, the acquiring corporation's basis in the acquired CFC stock will, for purposes of §362(b), include basis adjustments made by the transferor CFC under §961(c). *See* Notice 2024-16.

[1066] *See, e.g.*, Rev. Rul. 72-343 (Target had boot gain in "A" Reorganization).

[1067] *See* §362(b), which permits Acquiror to add to its basis in assets any gain recognized by the transferor. Here, the transferor is Target, not the Target's shareholders. For example, in Rev. Rul. 72-327, gain realized by Target shareholders upon receipt of boot in an "A" Reorganization did not increase Acquiror's basis in Target's assets.

[1068] A similar basis limitation rule — §362(e)(2) — was adopted for transfers of built-in loss property under §351.

[1069] §362(e)(1)(B).

[1070] §362(e)(1)(C).

[1071] §362(e)(1)(A).

[1072] H.R. Conf. Rep. No. 108-755 (2004).

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of §362(e)(1) does not distinguish foreign from domestic tax-exempt transferors, and it appears that the basis limitation rule applies to any transaction in which the transferor is a tax-exempt entity.[1073]

Section 362(e)(2) provides another limitation rule for transfers of built-in loss property under §351, by limiting the ability of taxpayers to duplicate net losses in certain nonrecognition transactions.[1074] In particular, §362(e)(2) provides that if property that is transferred in a §351 transaction that is not described in §362(e)(1), and the transferee's aggregate basis in that property would (but for §362(e)(2)) exceed the property's fair market value, then the transferee's aggregate basis in the transferred property shall not exceed the fair market value. Final regulations clarify that §362(e)(2) applies to §351–§368 overlap transactions to the extent the transactions result in the duplication of net built-in-loss.[1075] Such a concern generally is not present, however, in acquisitive asset reorganizations; stock and securities received in acquisitive asset reorganizations are generally distributed to the Target shareholders, and their bases are not determined by reference to Target's basis in its assets.[1076] The issue is more likely to arise in a §351–§368(a)(1)(B) overlap transaction.[1077]

b. Treatment of Assumed Liabilities

Acquiror's assumption of Target's liabilities has no effect on the basis of the assets acquired from Target. However, under §381(c)(16), Acquiror's assumption of Target's liabilities that, after the acquisition, require payments that would have been deductible had they been made by Target, gives rise to a deduction to Acquiror when paid by Acquiror, as if Acquiror were Target. This is in contrast to a taxable acquisition of assets, in which Acquiror's assumption and payment of pre-existing Target liabilities results only in an increase in Acquiror's basis in Target's assets, rather than a deductible expense.[1078]

c. Holding Period

Acquiror's holding period in the assets acquired from Target includes the holding period for that property in the hands of Target.[1079]

3. Parent's Basis in Subsidiary Stock in Triangular Acquisitive Asset Reorganizations

Regulations under §358 and §1502 generally follow the "over-the-top" model for determining Acquiror's basis in the stock of Target as a result of certain triangular reorganizations. In a Forward Triangular Merger or a triangular "C" Reorganization, the over-the-top method treats the transaction solely for basis purposes as if Acquiror directly acquired the assets from Target in a reorganization, in which basis was determined under §362(b), and then dropped down the assets to Sub in a §351 transaction in which basis was determined under §358.[1080]

Note: The basis and holding period rules for corporations engaging in transactions effected pursuant to the statutes of a foreign jurisdiction are contained in Reg. §1.367(b)-13(c) and §1.367(b)-13(d). For further discussion of these rules, see 6100 T.M., *U.S.-to-Foreign Transfers Under Section 367(a)* (Foreign Income Series).

Regulations provide that §357(c) does not apply to Parent's deemed drop-down of assets in the over-the-top model (even though §357(c) does apply to an actual drop-down by Parent of assets it acquires in a reorganization).[1081] In this case, no positive adjustment is made to Parent's stock basis in Sub.[1082]

Although Parent must reduce its basis in its Target stock by the fair market value of the consideration not provided by Parent in the reorganization, the §358 regulations provide that any such negative adjustment may not exceed the positive adjustment resulting from the over-the-top rule.[1083] Note that the reduction in Parent's stock basis in Sub for consideration not furnished by Parent does not apply to Target liabilities assumed by Sub or to Target liabilities to which the Target assets are subject. Adjustments for liabilities are made under §358, subject to the special rule that §357(c) does not apply.[1084] This basis reduction rule does apply to the extent that Sub is required to recognize gain or loss under Reg. §1.1032-1(c) for using Parent stock that Parent did not provide pursuant to the plan of reorganization.[1085] Also, any gain or loss realized by Sub on the use of assets not provided by Parent is generally recognized under §1001.[1086]

If Parent, Sub, and Target, as applicable, are members of the same consolidated group following the triangular reorganization, the special rules limiting the application of §357(c) and net negative adjustments are not applicable.[1087] Thus, the negative adjustments to Parent's stock basis in Sub for liabilities and consideration not provided by Parent may result in a negative basis (referred to as an "excess loss account" in Reg. §1.1502-19).[1088]

As noted above, §362(e)(1) (addressing the importation of built-in-losses) and §362(e)(2) (addressing the duplication of built-in losses in §351–§368 overlap transactions) imposes potential limitations on the §362(b) basis rules. With respect to §362(e)(1) and §362(e)(2), however, issues specific to triangular reorganizations arise. To the extent either §362(e)(1) or §362(e)(2) reduces Sub's basis in Target's assets, Parent's basis in Sub's shares is also presumably reduced under the over-the-top model. Moreover, assuming neither §362(e)(1)

[1073] Reg. §1.362-3(b), (c). *See also* Reg. §1.362-3(d)(2) (look-through rule for pass-through entities).

[1074] Section 362(e)(2) does not apply to an intercompany transaction (i.e., a transaction between corporations that are members of the same consolidated group immediately after the transaction) occurring after September 16, 2008. Taxpayers may elect to apply the exclusion to intercompany transactions occurring after October 21, 2004. Reg. §1.1502-80(h).

[1075] Reg. §1.362-4(h) *Ex.* 3.

[1076] *See* Reg. §1.362-4(h) *Ex.* 4.

[1077] *See* Reg. §1.362-4(h) *Ex.* 2.

[1078] *See, e.g., Webb Co. v. Commissioner*, 708 F.2d 1254 (7th Cir. 1983); *Pac. Transp. Co. v. Commissioner*, 483 F.2d 209 (9th Cir. 1973), cert. denied, 415 U.S. 948 (1974).

[1079] §1223(2).

[1080] *See* Reg. §1.358-6(c)(1)(i).

[1081] Reg. §1.358-6(c)(1)(ii).

[1082] Reg. §1.358-6(c)(1)(ii).

[1083] Reg. §1.358-6(c)(1)(ii), §1.358-6(d)(2).

[1084] *See* Reg. §1.358-6(c)(1)(ii).

[1085] *See* Reg. §1.358-6(d)(1).

[1086] Reg. §1.358-6(d)(3) *Exs.* (c), (d).

[1087] *See* Reg. §1.1502-30(b)(1).

[1088] *See* Reg. §1.1502-30(b)(3).

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nor §362(e)(2) applies to the transaction (i.e., the transaction is neither an importation transaction nor a §351–§368 overlap transaction), it is unclear whether the over-the-top fiction in Reg. §1.358-6 implicates §362(e)(2). In other words, it is unclear whether a built-in loss in Target's assets can be duplicated in Parent's basis in Sub's stock. These provisions have the same effect as if Parent had transferred the Target assets to Sub in a transaction described in §362(a), but — because the property is not actually transferred to Sub in a transaction described in §362(a) — §362(e)(2) does not appear to apply.

4. *Acquiror's Basis in Target Stock in Acquisitive Stock Reorganizations*

a. *"B" Reorganization*

Just as it does in an asset reorganization, §362(b) provides a mechanical guide for determining Acquiror's basis in Target stock following a "B" Reorganization (or triangular "B" Reorganization). Acquiror's basis in the Target stock is the same as the basis of the former Target shareholders in the Target stock, unless the basis limitation rule of §362(e)(1) applies.[1089] While §362(b) also provides an adjustment for any gain recognized by the transferor, such an adjustment generally has no application because it is not possible for the Target shareholders to recognize gain in a "B" Reorganization. However, in the event that the Target shareholders receive voting nonqualified preferred stock, so that gain recognition at the shareholder level is possible, an adjustment to Acquiror's basis in Target stock is made for any gain recognized by the Target shareholders.

Obtaining basis information from existing Target shareholders is often difficult, and may be impossible when Target stock is widely held.

Rev. Proc. 2011-35, provides procedures that an acquiring corporation may use to establish basis in the stock of a target corporation when it acquires the target stock in a transferred basis transaction.[1090]

Comment: Rev. Proc. 2011-42, purports to provide overriding guidance on the use and evaluation of statistical samples and sampling estimates. Rev. Proc. 2011-42 states, specifically, that the IRS will use criteria set forth in section 4 of the revenue procedure to determine whether to accept an estimate as adequate substantiation for a return position, and, even then, only if the IRS has already permitted the taxpayer to use statistical sampling for that purpose. Rev. Proc. 2011-42 does not purport to modify or amplify Rev. Proc. 2011-35, but it mentions Rev. Proc. 2011-35 as an example of IRS published guidance that provides for the use of statistical sampling. Rev. Proc. 2011-42, §2 also states:

> If statistical sampling is determined to be appropriate under prior published guidance or under this revenue procedure, a taxpayer may use only the statistical sampling procedures set forth in this revenue procedure. Thus, any published guidance in effect prior to the effective date of this revenue procedure [Aug. 19, 2011] that permits statistical sampling is modified and amplified by this revenue procedure.

Because Rev. Proc. 2011-35 is prior published guidance, but not explicitly affected by Rev. Proc. 2011-42, the effect of Rev. Proc. 2011-42 on Rev. Proc. 2011-35 is not clear.

Rev. Proc. 2011-35 describes four methodologies that taxpayers may use to determine basis in stock acquired in a transferred basis transaction. Rev. Proc. 2011-35 provides procedures for surveying surrendering Target shareholders to establish basis in the shares surrendered by or on behalf of such shareholders.[1091] These procedures apply to all surveys, whether done with respect to all acquired shares, with respect to a sample of acquired shares under the statistical sampling procedures described in §4.02, or with respect to shares that are surrendered by or on behalf of reporting shareholders when basis is estimated under §4.03 or §4.04. Rev. Proc. 2011-35, §4.01, also clarifies that if a shareholder surveyed in accordance with Rev. Proc. 2011-35, §4.01, fails to respond to Acquiror's request for basis information within 30 days of Acquiror's second follow-up attempt, Acquiror may determine its basis in a share or shares surrendered by or on behalf of the shareholder using such other procedures in the revenue procedure as are applicable.

When the administrative cost of surveying all surrendering shareholders is unreasonably high, the revenue procedure provides procedures for the use of standard statistical sampling techniques to establish basis.[1092] Factors that determine whether administrative cost is unreasonably high include the time, burden, and financial cost of conducting a full survey.[1093]

Planning Point: Note that the administrative cost of surveying every surrendering Target shareholder is presumed unreasonably high if, immediately before the transaction, Target stock was traded on an established securities market.

Finally, Rev. Proc. 2011-35 provides two estimation techniques that may be used in lieu of a full survey or statistical sampling when specified criteria are satisfied.[1094] The revenue procedure clarifies that taxpayers may use one or more of these methodologies in any combination. Additionally, the IRS explains that if a taxpayer cannot or does not use the methodologies prescribed in the revenue procedure, basis in acquired Target shares may be established by such other methodologies as agreed by the IRS and Acquiror.

As noted above, §362(e)(1) (addressing the importation of built-in losses) and §362(e)(2) (addressing the duplication of built-in losses in §351–§368 overlap transactions) imposes potential limitations on the §362(b) basis rules.[1095]

[1089] *See* VI.C.2.a., above.

[1090] Rev. Proc. 2011-35 adopted the surveying and statistical sampling guidelines previously issued in Rev. Proc. 81-70, but updated and revised them to take current market practices into account. Rev. Proc. 2011-35 also adopted the safe harbor methodologies described in Notice 2009-4, but modified them to reflect the comments received, particularly regarding the need for a model that uses data more readily accessible to acquiring corporations. Finally, the revenue procedure expanded the applicability of these provisions by permitting their use in any transferred basis transaction. Rev. Proc. 2011-35 is effective with respect to transferred basis transactions completed on or after June 20, 2011.

[1091] Rev. Proc. 2011-35, §4.01.

[1092] Rev. Proc. 2011-35, §4.02.

[1093] Rev. Proc. 2011-35, §4.02.

[1094] Rev. Proc. 2011-35, §4.03, §4.04.

[1095] *See* VI.C.3., above, for further discussion.

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b. Triangular "B" Reorganization

In a triangular "B" Reorganization, the §358 regulations follow an "over-the-top" model similar to the model for forward triangular reorganizations, except that Parent is treated as acquiring Target stock rather than Target assets.[1096] Thus, Parent's basis in its Sub's stock is treated as if Parent acquired Target stock directly in a transaction in which the basis was determined under §362(b) and Parent then contributed Target stock to Sub in a transaction in which the basis was determined under §358. The same limitations on the application of §357(c) and net negative adjustments apply.[1097] In the consolidated group context, Parent's stock basis in Sub generally is determined in the same manner as in the §358 regulations.[1098] However, in the event that the transaction results in a group structure change, the consolidated return regulations require that Parent's stock basis in Sub be determined as if the transaction were structured as a Forward Triangular Merger.[1099]

Again, §362(e)(1) and §362(e)(2) impose potential limitations on the §362(b) basis rules.[1100]

c. Reverse Triangular Merger

Before the §358 regulations were issued, there was much controversy over whether stock or asset basis should be used to determine Parent's stock basis in Target in a Reverse Triangular Merger. Many commentators stated that stock basis was the more appropriate measure because no assets were transferred as part of the merger transaction. Others opined that asset basis was the more appropriate measure because a Reverse Triangular Merger is, in fact, an "A" Reorganization and, in any event, calculation of the former Target shareholders' basis could be difficult without resorting to statistical sampling.

The §358 regulations adopt a middle ground. Reg. §1.358-6(c)(2)(i) states the general rule: Parent's basis in stock is adjusted as if Target had merged into Sub in a Forward Triangular Merger. The basis must be further adjusted downward if less than all of Target's stock is acquired, in proportion to the percentage of Target stock not acquired. However, if a Reverse Triangular Merger also qualifies as a forced "B" Reorganization or a §351 transfer (or both),[1101] Reg. §1.358-6(c)(2)(ii) allows a Parent to choose either an asset basis or a stock basis for Target stock. If a Reverse Triangular Merger also qualifies as a §351 transfer, but not as a "B" Reorganization because of the payment of boot,[1102] Parent is entitled to adjust its basis in the Target stock for any gain recognized by the Target shareholders.[1103] Such an adjustment is possible even when the Reverse Triangular Merger also qualifies as a "B" Reorganization, in the event that the Target shareholders receive voting nonqualified preferred stock.

Again, the same limitations on the application of §357(c) and net negative adjustments apply, and in the consolidated group context, Parent's stock basis in Sub generally is determined in the same manner as the final §358 regulations.[1104] Also, in the event that the transaction results in a group structure change, the consolidated return regulations require that Parent's stock basis in Sub be determined as if the transaction were structured as a Forward Triangular Merger.[1105]

Another issue that the regulations resolved concerned preexisting ownership of Target stock by Parent. For purposes only of determining basis (and not whether a transaction qualifies as a Reverse Triangular Merger), a Parent may treat its Target stock as either acquired in the reorganization or not.[1106] No explicit election is required because, as Treasury admitted in the preamble to the §358 regulations, it is assumed that Parent will select the higher basis.[1107]

See VI.C.3., above, for a discussion of the limitations imposed by §362(e)(1) and §362(e)(2) on the §362(b) basis rules.

D. Carryovers of Target Attributes

Two considerations are relevant in analyzing carryovers of tax attributes in connection with acquisitive reorganizations. The first, discussed below, is which attributes survive the reorganization. The second is what limitations, if any, apply to use of the surviving tax attributes. Among the relevant limitations are §269, §382, §384, and the separate return limitation year (SRLY) rules of Reg. §1.1502-21. Those limitations are mentioned where relevant, but a complete discussion of them is beyond the scope of this Portfolio. For more information regarding §382, §383, and §384, see 780 T.M., *Net Operating Losses and Other Tax Attributes — Sections 381, 382, 383, 384, and 269.* For more information about the SRLY rules, see 757 T.M., *Consolidated Returns — Limitations on Losses.*

1. Acquisitive Asset Reorganization

Section 381(a)(2) provides the statutory authority for the carryover of Target's tax attributes in connection with an "A" Reorganization, Forward Triangular Merger, or "C" Reorganization.[1108]

The specific tax attributes carried over to the transferee corporation include Target's net operating and capital loss carryforwards and Target's E&P. Note, however, that the IRS does not view the specific attributes listed in §381(c) as an exclusive list.[1109] For example, the IRS has ruled that Acquiror succeeds to the foreign tax credits of Target as a result of an

[1096] Reg. §1.358-6(c)(3).

[1097] Reg. §1.358-6(c)(1)(ii), §1.358-6(d)(2).

[1098] Reg. §1.1502-30(b)(1).

[1099] For group structure changes that occur after April 26, 2004 (and, if the group elects, before that date in consolidated return years beginning on or after January 1, 1995), the basis of stock acquired in a transaction in which gain or loss was recognized in whole reflects the cost of the acquired stock. *See* Reg. §1.1502-31(b)(2), §1.1502-31(d)(2)(ii), §1.1502-31(g), as amended by T.D. 9122, 69 Fed. Reg. 22,399 (Apr. 26, 2004).

[1100] See VI.C.3., above.

[1101] *See* Rev. Proc. 81-70.

[1102] See IV.B.5., above.

[1103] *See* §362(b).

[1104] Reg. §1.1502-30(b)(1).

[1105] Reg. §1.1502-31.

[1106] Reg. §1.358-6(c)(2)(i)(C).

[1107] Preamble to T.D. 8648, 60 Fed. Reg. 66,077 (Dec. 21, 1995).

[1108] Section 381(a)(2) presumably also provides for the carryover of Sub's tax attributes when Sub is merged into Target as part of a Reverse Triangular Merger.

[1109] Reg. §1.381(a)-1(b)(3). *See also Wells Fargo & Co. v. United States*, 119 Fed. Cl. 27 (Fed. Cl. 2014), amending 117 Fed. Cl. 30 (Fed. Cl. 2014), aff'd, No. 2015-5059 (Fed. Cir. June 29, 2016) (tax interest, including interest netting under §6621(d), is not a tax attribute limited by §381(a)).

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"A" Reorganization, although foreign tax credits are not listed in §381(c).[1110]

The regulations provide that only one corporation may inherit the tax attributes of Target for purposes of §381, and that corporation shall be the corporation that, pursuant to the plan of reorganization, directly acquires Target's assets even if that corporation ultimately retains none of such assets.[1111] Thus, Sub, and not Parent, inherits the tax attributes of Target in a Forward Triangular Merger or triangular "C" Reorganization.[1112] The regulations modify the definition of the acquiring corporation to provide that in a transaction to which §381(a)(2) applies, the acquiring corporation is the corporation that, pursuant to a plan of reorganization, directly acquires the assets transferred by the transferor corporation, even if that corporation retains none of the transferred assets.[1113]

Section 381(b) contains special operating rules for transactions described in §381(a).[1114] Section 381(b) provides that Target's tax year ends on the date of the "transfer," i.e., the date of the merger in the case of an "A" Reorganization or Forward Triangular Merger[1115] and the date upon which Target's assets are transferred to Acquiror in the case of a "C" Reorganization. A federal income tax return for the short taxable year of Target ending on the date of transfer is due within 3½ months from the end of the month that contains the date of transfer.[1116] This short taxable year counts as a full year for purposes of limitations on carryforwards.

Planning Point: If the taxable year limitations on carryforwards are relevant, it is preferable to structure the transaction so that the corporation with the carryforwards is the acquiror.

Section 381(b)(3) provides that Acquiror may not carry back a loss incurred after the reorganization to a taxable year of Target. Where the reorganization is an "A" Reorganization, the amount of Acquiror income for the year including the reorganization that may be offset by Target net operating loss carryforwards is limited by a formula restricting the income of Acquiror that may be sheltered to a pro rata amount of Acquiror's total income for the year, based on the number of days in Acquiror's taxable year preceding and following the reorganization.[1117]

Regulations clarify that in a §381(a) transaction ending in a year in which Target excludes COD income under §108(a), any tax attributes to which Acquiror succeeds and the basis of property acquired in the transaction shall reflect the attribute reductions required under §108 and §1017.[1118]

2. *Acquisitive Stock Reorganization*

a. *Tax Years and the SRLY Rules*

"B" Reorganizations and Reverse Triangular Mergers (at least with respect to Target) are outside the scope of §381(a). However, because these acquisitive reorganizations are virtually identical to stock purchases (in that Target's corporate existence is preserved), §381 is not needed to preserve Target's tax attributes.

If Target becomes a member of a consolidated group, or when Target was a member of such a group before the reorganization, Target's tax year generally ends as of the date of the reorganization.[1119] Moreover, subject to the §382 overlap rule, when Target joins a consolidated group, the SRLY rules provide that Target's loss carryforwards generally may be used only to offset future income of Target, and may not be used to offset future income of Acquiror or other members of Acquiror's affiliated group.[1120]

b. *Reverse Acquisitions*

A "reverse acquisition" (which is a consolidated return concept) is a reorganization in which the former Target shareholders receive more than 50% (by value) of Acquiror's stock in exchange for their Target stock.[1121] In a reverse acquisition, Target's affiliated group is treated as remaining in existence, and the SRLY rules are applied to the loss carryforwards of Acquiror's affiliated group.[1122] Likewise, it is the taxable year of Acquiror that closes as a result of the transaction, and the new affiliated group, with Acquiror as the common parent, continues Target's tax year.[1123] The consolidated return regulations contain special rules that apply to tax attributes in reverse acquisitions.[1124]

3. *Section 382 — General*

Although §381 provides specific rules for preservation of tax attributes, and the survival of Target in "B" Reorganizations and Reverse Triangular Mergers leaves Target's tax attributes in place, §382 may substantially diminish the usefulness of Target's (and perhaps Acquiror's) loss and credit carryforwards.

In general, §382 provides that when there has been an "ownership change" of a corporation with loss carryforwards (a "loss corporation"), the loss corporation's ability to use its loss carryforwards against subsequently generated income is

[1110] Rev. Rul. 80-144.

[1111] Reg. §1.381(a)-1(b)(2).

[1112] Reg. §1.381(a)-1(b)(2).

[1113] Reg. §1.381(a)-1(b)(2)(i), effective for transactions occurring on or after November 10, 2014. Under prior law, the controlled subsidiary receiving Target assets in a drop-down transaction under §368(a)(2)(C) was treated as the "acquiring corporation" for §381 purposes, provided that all of the Target assets transferred to the acquiring parent were ultimately acquired by the subsidiary. If the acquiring parent retained a portion of Target's assets and transferred the remainder to a controlled subsidiary under §368(a)(2)(C), only the acquiring parent was treated as an "acquiring corporation" for §381 purposes. Former Reg. §1.381(a)-1(b)(2).

[1114] Other than transactions qualifying as a reorganization under §368(a)(1)(F).

[1115] Likewise, in the case of a Reverse Triangular Merger, Sub's tax year ends on the date of the merger.

[1116] §6072(a), applicable to returns for tax years beginning after Dec. 31, 2015. For tax years beginning before 2016, corporations had to file by the 15th day of the third month of the year immediately following the last day of the tax year being reported. *See* §6072(b), as in effect prior to amendment by Pub. L. No. 114-41. *See* Rev. Rul. 71-129 (a dissolved corporation must file its return and pay the tax due thereon for the short period on or before the fifteenth day of the third full month following the dissolution). *See also* Reg. §1.1502-76(c) for due dates for Target's separate short-year return in the consolidated return context.

[1117] §381(c)(1)(B); Reg. §1.381(c)(1)-1(d).

[1118] Reg. §1.1017-1(b)(4).

[1119] Reg. §1.1502-76(b)(1)(ii). *See also* Reg. §1.1502-76(c) for due dates for Target's separate short-year return in the consolidated return context.

[1120] Reg. §1.1502-21(c)(1).

[1121] Reg. §1.1502-75(d)(3).

[1122] Reg. §1.1502-75(d)(3).

[1123] Reg. §1.1502-75(d)(3)(v).

[1124] *See, e.g.,* Reg. §1.1502-31, Reg. §1.1502-33. For further discussion, see 757 T.M., *Consolidated Returns — Limitations on Losses.*

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restricted.[1125] That restriction is an annual limitation on use of loss carryforwards, equal to the product of the value of the loss corporation's stock on the date of the ownership change and the long-term tax-exempt interest rate on that date.[1126]

An ownership change occurs if, within a three-year "testing period," the percentage of stock of the loss corporation held by "5-percent" shareholders has increased by more than 50% over the lowest percentage of stock held by such shareholders during the three-year period.[1127]

An acquisitive reorganization can trigger an ownership change both with respect to Target, and with respect to Acquiror, because stock of both entities is implicated in the transaction. The regulations under §382 provide extensive rules for the section's application both to acquisitive asset reorganizations and acquisitive stock reorganizations.[1128]

Note: For discussion of relief from the §382 limitation provided in response to the 2008 and 2009 economic crisis by §382(n) and administrative guidance, see 780 T.M., *Net Operating Losses and Other Tax Attributes — Sections 381, 382, 383, 384, and 269.*

Note: In response to the 2020 coronavirus pandemic, the CARES Act provides that any loan made or guaranteed by Treasury is treated as indebtedness and authorizes the IRS to issue guidance which provides that the acquisition of warrants, stock options, common or preferred stock or other equity by the Treasury does not result in an ownership change for purposes of §382.[1129] To date such regulations have not been issued.

In addition to §382 and §383, §384 limits the use of Target losses to shelter post-reorganization Acquiror gains and Acquiror losses to shelter post-reorganization Target gains.[1130]

E. Treatment of Target Shareholders and Security Holders

1. Receipt of Stock or Securities by Target Shareholders and Security Holders

a. General

Section 354(a)(1) states the general rule that Target shareholders and security holders do not recognize gain or loss on their exchange of (i) Target stock for Acquiror stock, (ii) Target securities for Acquiror stock, or (iii) Target securities for Acquiror securities. Section 356 provides generally for the treatment of Target shareholders and security holders upon their receipt of "other property." For a discussion of items that may constitute "other property," see III.C.4., above. Note, however, that the dividend equivalency test of §356(a)(2) applies only to exchanging Target shareholders; no portion of any gain recognized by an exchanging Target security holder with respect to its Target securities will be treated as a dividend.[1131]

b. Treatment of Securities Received

The definition of "security" is discussed in VI.A.4., above. Section 354 applies to Acquiror securities received, only to the extent that their principal amount does not exceed the principal amount of Target securities surrendered. Many practitioners believe that the original issue discount provisions, and perhaps economic reality, dictate that "principal" should equal the adjusted issue price of a debt instrument. However, because Congress has had ample opportunity to address the problem and has yet to do so, "principal" arguably should be given its conventional meaning (i.e., the stated face amount due at maturity).[1132] The fair market value of any excess principal amount is treated as other property under §356(d)(2).

c. Treatment of Nonqualified Preferred Stock

Certain preferred stock instruments that are relatively secure instruments resembling debt are treated as taxable "boot" for purposes of determining shareholder-level consequences in a corporate formation, reorganization, or spin-off.[1133]

"Preferred stock" is stock that is limited and preferred as to dividends and does not participate in corporate growth to any significant extent.[1134] Stock is not deemed to participate in corporate growth to any significant extent (and, thus, is classified as preferred stock) unless there is a real and meaningful likelihood of the shareholder actually participating in the earnings and growth of the corporation.[1135] "Nonqualified preferred stock" is preferred stock with respect to which, at the time of issuance, any of the following apply:

(1) the shareholder has the right to require the issuer to redeem the stock;[1136]

[1125] Section 383 applies similar rules to credit carryforwards.

[1126] §382(b)(1). This limitation may be increased by built-in gains or decreased by built-in losses of the loss corporation under §382(h) and Notice 2003-65. For further discussion, see 780 T.M., *Net Operating Losses and Other Tax Attributes — Sections 381, 382, 383, 384, and 269.*

[1127] §382(g)(1).

[1128] *See, e.g.*, Reg. §1.382-2T(e)(2)(i).

[1129] *See* Pub. L. No. 116-136, §4003. For further discussion, see 780 T.M., *Net Operating Losses and Other Tax Attributes — Sections 381, 382, 383, 384, and 269.*

[1130] For further discussion of §382, §383, and §384, see 780 T.M., *Net Operating Losses and Other Tax Attributes — Sections 381, 382, 383, 384, and 269.*

[1131] *See* Rev. Rul. 71-427 (ruling that §356(a)(2) does not apply to exchanging bondholders in reorganization under §368(a)(1)(E)).

[1132] §354(a)(2). The legislative history of the Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, relating to the repeal of §1275(a)(4) stated that the repeal "does not change the present-law rules of §354, §355 or §356 regarding the amount of gain or loss recognized or not recognized in a reorganization," thus indicating that the traditional meaning of "principal amount" has not been altered by the original issue discount provisions. H.R. Rep. No. 101881, at 354 (1990). *Cf.* FSA 200146013 (suggesting that term "principal amount," as used in §356, does not necessarily refer to face amount of securities, but rather to amounts that tax law treats as principal for interest income and deduction purposes (i.e., issue price of new debt and adjusted issue price of old debt)).

[1133] *See* §351(g), §354(a)(2)(C), §355(a)(3)(D), §356(e).

[1134] §351(g)(3)(A). *See, e.g.*, *Gerdau Macsteel Inc. v. Commissioner*, 139 T.C. No. 5 (2012) (transferee corporation had no accumulated earnings (and was not expected to have earnings within five to seven years when stock was most likely to be redeemed) and stock was entitled to receive fixed payout on redemption purportedly based on cost savings).

[1135] §351(g)(3)(A). This "real and meaningful" participation requirement stems from Congress's concern that taxpayers were attempting to avoid characterization of an instrument as nonqualified preferred stock by including illusory participation rights. *See* H.R. Rep. No. 108-755 (2004). Under §351(g)(3)(A), if there is not a real and meaningful likelihood that dividends beyond any limitation or preference will actually be paid, the possibility of such payments is disregarded in determining whether stock is limited and preferred as to dividends.

[1136] §351(g)(2)(A)(i).

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(2) the issuer or a related person (within the meaning of §267(b) or §707(b)) is required to redeem the stock;[1137]

(3) the issuer or a related person has the right to redeem the stock and it is more likely than not that this right will be exercised;[1138] or

(4) the dividend rate on the stock varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or other similar indices.[1139]

The last item (4) applies regardless of whether the varying rate is provided as an express term of the stock (e.g., in adjustable rate stock) or as a practical result of other aspects of the stock (e.g., in auction rate stock).[1140]

Items (1), (2), and (3) apply only if the right or obligation may be exercised within 20 years of issuance and is not subject to a contingency that renders the likelihood of redemption or purchase remote.[1141] A right or obligation is disregarded for purposes of items (1), (2), and (3) if (i) no publicly traded corporations (including any related corporations that are publicly traded) are involved and exercise can occur only upon the holder's death, disability, or mental incompetency, or (ii) stock is received as compensation and the right or obligation may be exercised only upon separation from service.[1142]

In a §351 transaction, nonqualified preferred stock is boot regardless of the property transferred in exchange (e.g., even other nonqualified preferred stock).[1143] However, in a reorganization or spin-off, nonqualified preferred stock is boot only if received in exchange for stock other than nonqualified preferred stock.[1144] Thus, the receipt of nonqualified preferred stock in a reorganization in exchange for debt securities or other nonqualified preferred stock generally is nontaxable.[1145] In a case in which both §351 and §354 apply to a transaction, §354 generally applies for purposes of the nonqualified preferred stock rules. The exchange of nonqualified preferred stock for common stock in connection with a corporate formation, reorganization, or spin-off is not taxable because nonqualified preferred stock is not received in the exchange.[1146]

Recapitalizations of "family-owned corporations" are not subject to the rules regarding nonqualified preferred stock.[1147] A "family-owned corporation" is any corporation if at least 50% of the total voting power and value of the stock of the corporation is owned by members of the same family for five years preceding the recapitalization.[1148] In addition, a recapitalization does not qualify for the exception if the same family does not own 50% of the total voting power and value of the stock throughout the three-year period following the recapitalization.[1149]

Legislative history clarifies that a conversion feature (e.g., a conversion into common stock) does not automatically constitute "a right to participate in corporate growth to a significant extent" for purposes of the "preferred stock" definition.[1150] Such stock must be tested under the definition of "preferred stock" without regard to the conversion privilege. A conversion right into stock of a corporation other than the issuer (e.g., the parent corporation of the issuer) does not qualify as significant participation in corporate growth.[1151] Note that this sensible approach (i.e., taking into account a conversion feature in determining the degree of participation in corporate growth) is inconsistent with the approach adopted by the IRS under §305.[1152]

Comment: Preferred stock that is convertible at a normal market premium (e.g., no more than a 20% "up") should effectively participate in corporate growth. However, in transactions in which the terms of the preferred stock stray from market norms, the tax treatment is less certain.

Nonqualified preferred stock generally is treated as boot only at the shareholder level, and — pending regulations — is considered stock for other tax purposes, including for purposes of determining whether an overall transaction qualifies as a partially tax-free incorporation or reorganization. The Treasury has authority to prescribe the treatment of nonqualified preferred stock under other provisions of the Code (e.g., §304, §306, §318, and §368(c)).[1153] Thus, unless regulations provide otherwise, nonqualified preferred stock that has voting rights is treated as "voting stock" for purposes of qualifying a transaction as a "B" or "C" Reorganization or Reverse Triangular Merger, and as "stock" for purposes of qualifying a transaction as an "A" Reorganization or Forward Triangular Merger, even though the stock may be taxable as boot at the shareholder level.

Reg. §1.356-6 precludes taxpayers from avoiding the rules on nonqualified preferred stock by relying on regulations treating warrants as securities.[1154] Thus, nonqualified preferred stock is not treated as stock or securities, and warrants to acquire nonqualified preferred stock are not treated as stock or securities, for purposes of §354, §355, and §356 if received in exchange for stock other than nonqualified preferred stock or warrants to acquire stock other than nonqualified preferred stock, but instead are treated as "boot."

[1137] §351(g)(2)(A)(ii). *See* PLR 200440003 (preferred stock is not nonqualified preferred stock if licensure agreements make it unlikely that corporation will redeem shares and no agreement grants redemption rights or requires redemption), PLR 200440004 (same).

[1138] §351(g)(2)(A)(iii).

[1139] §351(g)(2)(A)(iv).

[1140] H.R. Rep. No. 105-220, at 545 (1997).

[1141] §351(g)(2)(B).

[1142] §351(g)(2)(C).

[1143] §351(g)(1)(A).

[1144] §354(a)(2)(C)(i), §355(a)(3)(D), §356(e)(2).

[1145] *See* J. Comm. on Tax'n, *General Explanation of Tax Legislation Enacted in 1997*, 105th Cong., 1st Sess. 212 (1997).

[1146] *See* J. Comm. on Tax'n, *General Explanation of Tax Legislation Enacted in 1997*, 105th Cong., 1st Sess. 212 (1997).

[1147] §354(a)(2)(C)(ii).

[1148] §354(a)(2)(C)(ii)(II) (reference to §447(d)(2)(C), repealed by the 2017 tax act, Pub. L. No. 115-97, §13102(a)(5)(C)(i), effective for tax years beginning after 2017). For former §447(d) purposes, members of the same family were determined by reference to the definition in §447(e), repealed by Pub. L. No. 115-97, §13102(a)(5)(C)(i), effective for taxable years beginning after December 31, 2017.

[1149] §354(a)(2)(C)(ii)(II) (reference to former §447(d)(2)(C)).

[1150] H.R. Rep. No. 105-220, at 545 (1997).

[1151] H.R. Rep. No. 105-220, at 545 (1997).

[1152] Reg. §1.305-5(a) (noting that determination of whether stock is preferred for purposes of §305 shall be made without regard to any right to convert such stock into another class of corporation's stock).

[1153] §351(g)(4).

[1154] Reg. §1.356-6.

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d. Treatment of Stock Warrants

The regulations under §354, §355, and §356 extend the nonrecognition rules of these sections to certain exchanges involving rights to acquire stock.[1155] To provide for nonrecognition treatment, the IRS and Treasury had to characterize rights to acquire stock (e.g., warrants) as either stock or securities. Because the IRS and Treasury were constrained by the Supreme Court's precedent holding that warrants are not stock,[1156] it chose to characterize warrants as securities having no principal amount.[1157] In reorganizations, this characterization allows for a tax-free exchange of warrants for warrants, warrants for stock, stock for warrants, or securities for warrants, while requiring at least some gain recognition if actual securities are received in exchange for warrants.[1158] For example, subject to the discussion immediately below, an exchange of stock for warrants is nontaxable because the warrants, although securities, are deemed to have no principal amount,[1159] while the exchange of a warrant for a debt security is taxable because the security received has a principal amount in excess of the principal amount of the security surrendered.[1160]

Note, however, that if stock (but not Target warrants or other Target securities) is exchanged solely for warrants, the exchange is not covered by §354. Instead, it is treated as a redemption and taxed as either an exchange under §302 or a distribution under §301.[1161]

It is important to note that warrants are not taken into account as stock for purposes of qualifying a transaction as a reorganization or determining continuity of shareholder interest.[1162] Thus, if Target stock is exchanged for Acquiror warrants in an attempted "B" Reorganization, the "solely for voting stock" requirement is violated.

These regulations have no effect on other statutes or regulations relating to compensation-related options (e.g., §83 and §421–§424 and the regulations thereunder). *See* III.C.4.k., above.

e. Receipt Solely of Securities or Other Property by Shareholders

For §356(a)(1) to apply to an exchanging Target shareholder, that shareholder must receive some property qualifying under §354.[1163] If an exchanging Target shareholder receives solely securities or warrants (while exchanging no securities or warrants) or other property, no qualifying property is received.[1164] The exchange is then treated as a redemption and taxed either as a distribution under §301 or an exchange under §302.[1165] The "boot within gain" rule of §356(a)(1) does not apply in that situation, and the entire fair market value of the property received is, in certain circumstances, a dividend to the exchanging Target shareholder.[1166] Avoiding this result is as simple as ensuring that each former Target shareholder receives at least one share of Acquiror stock. Note, however, that if an exchange of Target stock for boot is not governed by §356(a)(1), any loss realized by the exchanging shareholder may be recognized.

f. Considerations Unique to Target Creditors

(1) Acquisitive Asset Reorganizations

Provided that debt instruments qualifying as securities of Target are exchanged for debt instruments qualifying as securities of Acquiror, §354 and §356 apply to the exchange in the manner above discussed.[1167]

Exchanges of Target securities for debt instruments of Acquiror that do not qualify as securities fall outside of §354 and are governed by §1001.[1168]

(2) Acquisitive Stock Reorganizations

If Target securities are exchanged for Acquiror securities in a Reverse Triangular Merger, §354 and §356 operate as they would in an acquisitive asset reorganization.[1169] Until 1998, the IRS took the position that exchanges of Target securities for Acquiror stock or securities in connection with a "B" Reorganization were not governed by §354 and §356, but fell outside the reorganization and were governed by §1001.[1170] The IRS changed its view in Rev. Rul. 98-10, ruling that a bond-for-bond exchange in connection with a "B" Reorganization is governed by §354 and §356.

(3) Accrued Interest

If a Target security holder receives Acquiror stock or securities attributable to accrued but unpaid interest on the Target securities, the stock or securities received are outside the scope of §354 and §356.[1171] In effect, this rule requires the recognition of interest income only for cash basis taxpayers holding instruments not subject to the current accrual of original issue discount.[1172]

If the exchanging security holder had previously accrued interest income on the Target securities, and that accrued but unpaid interest is not provided for in the exchange, the holder is entitled to recognize a loss notwithstanding the general pro-

[1155] Reg. §1.354-1(d), §1.355-1(c), §1.356-3(b), §1.356-3(c).
[1156] *Helvering v. Sw. Consol. Corp.*, 315 U.S. 194 (1942).
[1157] Reg. §1.354-1(e).
[1158] Reg. §1.354-1(a)(2).
[1159] Reg. §1.354-1(e).
[1160] §354(a)(2).
[1161] §354(a)(2)(A)(ii); Reg. §1.354-1(d) *Exs.* 3, 4.
[1162] *See* preamble to REG-249819-96, 61 Fed. Reg. 67,508 (Dec. 23, 1996).
[1163] §356(a)(1)(B).
[1164] Note, however, that Reg. §1.368-2(l) provides that a transaction otherwise described in §368(a)(1)(D) is treated as satisfying the requirements of §368(a)(1)(D) and §354(b)(1)(B) even if no stock or securities of the transferee corporation are issued, provided the same person or persons directly or indirectly own all of stock of the transferor and transferee corporations in identical proportions). *See also* Rev. Rul. 70-240 (in context of all-cash "D" Reorganization, §356(a)(1) applies even though exchanging target shareholder did not receive any qualifying property).
[1165] *See* §354(a)(2)(A)(ii); Reg. §1.354-1(d) *Exs.* 3, 4, §1.356-3(b), §1.356-3(c) *Ex.* 7; Rev. Rul. 74-515.
[1166] *See* 782 T.M., *Boot Distributions and Assumption of Liabilities. Cf.* Rev. Rul. 2004-83 ("boot within gain" rule applies to all-cash "D" Reorganization); Rev. Rul. 70-240 (same).
[1167] *See, e.g.*, Rev. Rul. 79-155.
[1168] §354(a)(1), §1001.
[1169] Reg. §1.368-2(j)(4).
[1170] *See* Rev. Rul. 70-41 (*modified by* Rev. Rul. 98-10); Rev. Rul. 69-142 (*modified and* superseded by Rev. Rul. 98-10).
[1171] §354(a)(2)(B).
[1172] For a discussion of the original issue discount rules, see 181 T.M., *Time Value of Money — Holders of Debt Instruments.*

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hibition against loss recognition in §356(c).[1173] Acquiror, apparently, is free to designate whether or not a portion of the consideration is attributable to accrued but unpaid interest. However, to the extent no consideration is allocated to the accrued but unpaid interest, Target may realize cancellation of indebtedness income unless the interest has not been the subject of a previous deduction and would be deductible if paid[1174] or has been deducted but did not result in a tax benefit.[1175]

(4) Debt Other than "Securities"

If the Target debt exchanged or the Acquiror debt received does not qualify as a "security," gain or loss is recognized to the exchanging creditor upon an exchange of Target debt for Acquiror debt without regard to the "boot within gain" rule of §356(a)(1).[1176]

2. Amount and Character of Recognized Gain

a. "Boot Within Gain" Rule

Once it is determined that an exchange of Target stock or securities for Acquiror stock or securities is covered by §354, the next (and often most important) question is how, and to what extent, the exchanging shareholder or creditor is taxed. Section 356(a)(1) provides that if an exchange is covered by §354, but the recipient also receives other property or money ("boot"), the recipient must recognize gain equal to the lesser of the gain realized or the amount of the boot. This is known as the "boot within gain" rule. If no boot is received, then no portion of the recipient's realized gain is recognized. If boot is received, but the amount of boot is less than the realized gain, the recognized gain is limited to the amount of boot.[1177] If the boot received exceeds the realized gain, then the entire realized gain will be recognized.[1178] Whenever qualifying property is received, no loss is recognized by an exchanging Target shareholder or creditor.[1179]

Planning Point: Section 356 should be contrasted with §302. Under §302, if the redemption is treated as a dividend, the gross amount of the redemption proceeds is treated as a §301 distribution; if the redemption is treated as an exchange, the excess of the amount realized over the shareholder's basis is capital gain. In either case, taxable income is not limited by the amount of "boot."

The amount of an exchanging shareholder's or creditor's "realized" gain, as determined under the principles of §1001, is equal to the excess of the "amount realized" over the recipient's basis in the surrendered stock or securities. The recipient's "amount realized" is equal to the sum of the money and fair market value of stock, securities, and other property received.[1180] However, in the case of debt instruments received by an accrual basis taxpayer, the amount realized with respect to that debt is determined based on the debt's issue price rather than its fair market value.[1181]

When a holder surrenders more than one class of stock or security, or even a single class that has different blocks with different bases, the holder's realized gain or loss must be calculated separately for each block.[1182] It is not proper to total the bases of the various stocks or securities surrendered and simply subtract that from the aggregate amount realized; a realized loss on one block cannot offset a realized gain on another. The parties' allocation of the Acquiror consideration among the stocks or securities surrendered is generally respected if the terms are economically reasonable.[1183] For example, a holder exchanging common stock for Acquiror common stock and preferred stock for cash is entitled to nonrecognition on the common-for-common exchange, but is subject to §356 on the preferred-for-cash exchange.[1184] Holders who own only preferred stock are taxed under §302.[1185]

Boot includes "other property," which includes many of the items referred to as "nonstock consideration" in III.C.4., above. "Other property" may include all types of tangible or intangible property, real or personal. The term also refers to stock or securities issued by a corporation that is not a "party to the reorganization."

"Boot" generally refers to "other property" given by Acquiror in the reorganization. Distributions received from Target in pre-reorganization dividends or redemptions are not regarded as boot and, thus, are neither subject to the "boot within gain" rule nor tested for dividend equivalency under §356(a)(2), provided they are funded by Target and not Acquiror.[1186] To the extent they are funded by Acquiror, they are regarded as boot distributions.[1187] In addition, however, it is important to note that distributions of other property made in connection with an acquisitive asset reorganization are generally treated exclusively as boot distributions, even if the distributions consist in part of Target's retained assets.[1188]

Section 356(d)(1) provides that, except as provided in §356(d)(2), "other property" includes securities of Acquiror. Section 356(d)(2)(A) provides an exception for Acquiror securities that are permitted to be received in a wholly nontaxable

[1173] *See* H.R. Rep. No. 96-833, at 33 (1980); S. Rep. No. 96-1035, at 38 (1980).
[1174] §108(e)(2).
[1175] *See* Rev. Rul. 76-316, Rev. Rul. 67-200.
[1176] *See* §1001.
[1177] §356(a)(1).
[1178] §356(a)(1).
[1179] §356(c).
[1180] §1001(a).
[1181] Rev. Rul. 89-122, Rev. Rul. 79-292. *See also* Reg. §15A.453-1(d)(2)(ii). *Cf.* Reg. §1.1274-2(a).
[1182] Rev. Rul. 68-23. *See, e.g., Tseytin v. Commissioner*, T.C. Memo. 2015-247 (citing Rev. Rul. 68-23 and *Curtis*), *aff'd*, 698 F. App'x 720 (3d Cir. 2017) (holding that when a sale transaction involves "separate unit[s]," each unit's basis must be analyzed and calculated separately).
[1183] Reg. §1.356-1(b); Rev. Rul. 74-515. PLR 201120012 and PLR 201120013 (in merger requiring third-party loan, form of transaction would be respected; cash payment would be respected as made in full to satisfy debt, and issuance of warrants would be respected as made in full to retire common stock held by shareholder).
[1184] Reg. §1.356-1(d) *Ex.* 4.
[1185] Reg. §1.356-1(d) *Ex.* 4. A specific allocation rule applies if the preferred stock surrendered is §306 stock. *See* VI.E.3.b., below.
[1186] *See* III.C.4.f., above.
[1187] For further discussion of pre-reorganization dividends or redemptions as boot, see III.C.4.f., above.
[1188] Rev. Rul. 71-364 (ruling that §356(a) applied to excess cash of Target distributed to Target shareholders in connection with a C reorganization). Note that because §356 can apply to a distribution from Target in an acquisitive asset reorganization, it is a question of fact whether a distribution or redemption funded with Target assets should be treated as made in connection with an acquisitive asset reorganization.

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exchange under §354 (that is, when the securities received are of equal or lower principal amount than the securities surrendered). Section 356(d)(2)(B) provides that when the principal amount of the securities received in a §354 exchange exceeds the principal amount of the securities surrendered, the term "other property" means only the fair market value of such excess. In testing whether boot has been received, only "principal amount" and not "fair market value" is considered. But once it is determined that boot has been received, the amount of that boot is determined by reference to fair market value.[1189] The application of §356(d)(2)(B) is further complicated by confusion regarding the meaning of the term "principal amount."[1190]

b. *Characterization of Shareholder's Gain as Capital or Dividend Income*

(1) *Dividend Equivalency Test*

Section 356(a)(2) provides that if the receipt of boot, in exchange for stock or securities, "has the effect of the distribution of a dividend," then the gain recognized is treated as a dividend to the extent of the recipient's ratable share of undistributed earnings and profits, and the remainder of the recognized gain is capital gain. The statute and the regulations give no guidance on the determination of whether an exchange has the effect of a distribution of a dividend. Section 356(a)(2) does not apply to any gain recognized by Target security holders in the reorganization with respect to their securities.[1191]

Note: Initially, an individual's "qualified dividend income" — generally dividends from domestic corporations and from certain foreign corporations — is taxed as net capital gain rather than as ordinary income. Therefore, the significance of whether boot is dividend or capital gain to the receiving Target individual shareholders is diminished. However, there are instances in which the distinction between dividend and capital treatment may still be important. For example, if Target has numerous shareholders who have held their shares for less than one year but longer than the period of time required to qualify for qualified dividend income, dividend treatment may be preferable.

The courts and the IRS have analogized to the principles of §302 in making dividend equivalency determinations under §356(a)(2).[1192] A more controversial issue, however, was whether the redemption standards of §302 should be applied to acquisitive reorganizations by treating the Target shareholders as having received the boot in a hypothetical redemption by Target immediately before the reorganization (the "pre-reorganization redemption" test) or in a hypothetical redemption by Acquiror of the portion of the Acquiror stock that the Target shareholders would have received if they had not received boot (the "post-reorganization redemption" test). The post-reorganization redemption test was first applied in 1973 in *Wright v. United States*,[1193] but the validity of this test was not established until the 1989 Supreme Court decision in *Commissioner v. Clark*.[1194]

In *Clark*, the taxpayer's wholly owned corporation was merged into a large public corporation in a Forward Triangular Merger. In exchange for all of his stock, the taxpayer received stock in Parent representing a 0.92% interest and substantial cash boot. The Tax Court had found that the receipt of cash boot reduced taxpayer's "potential" holdings in Parent from 1.3% to 0.92%. Both the Tax Court and the Fourth Circuit followed *Wright* and held that the taxpayer's receipt of boot qualified for capital gain treatment because the hypothetical post-reorganization redemption reduced taxpayer's interest from 1.3% to 0.92%, a reduction that met the "substantially disproportionate" test of §302(b)(2).

In a 7-to-2 decision, the Supreme Court agreed with the Tax Court and the Fourth Circuit and adopted the post-reorganization redemption test. The Court based its holding on the language and legislative history of §356 and on the necessity of viewing the reorganization as an integrated transaction. The Court reasoned that the IRS's approach would sever the payment of boot from the context of the reorganization. According to the Court, such a limited view of the transaction is inconsistent with the intent of §356 (i.e., to look at the effect of the entire exchange). The Court concluded that if a taxpayer satisfied the "substantially disproportionate" standards of §302(b)(2) in connection with the deemed post-reorganization redemption, the taxpayer is entitled to capital gain treatment with respect to any boot received. Note that the attribution rules of §318 apply to test the hypothetical post-reorganization redemption for dividend equivalency just as if the redemption were taking place under §302.[1195]

In Rev. Rul. 93-61, the IRS adopted the post-reorganization redemption test and revoked Rev. Rul. 75-83, which had applied the pre-reorganization redemption test.

Note: Any recognized gain of a corporate Target shareholder that is treated as a dividend under §356(a)(2) may qual-

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[1189] Reg. §1.356-3(b) *Exs.* 1, 2, 4, 5, 6. The "fair market value" of a security is not necessarily the same as the "amount realized" with respect to a security. *Cf.* Rev. Rul. 89-122 (amount realized by accrual basis taxpayer in exchange of debt instruments is based on new debt's issue price rather than fair market value).

[1190] *See* VI.E.1.b., above.

[1191] *See* VI.E.1.a., above. Obviously, if a Target security holder also exchanges Target stock in the reorganization, §356(a)(2) can apply to that portion of the exchange.

[1192] *See, e.g.*, *Ross v. United States*, 173 F. Supp. 793 (Ct. Cl. 1959), cert. denied, 361 U.S. 875 (1959); Rev. Rul. 93-62, Rev. Rul. 74-515. Under §302, a shareholder undergoing a sufficient reduction in ownership interest as a result of the transaction is entitled to recognize capital gain or loss on the redemption; a shareholder without a sufficient reduction in interest is treated as having received a §301 distribution. For a detailed discussion of §302, *see* 767 T.M., *Redemptions*. *See also* PLR 201107003 (gain realized by foreign corporation on receipt of stock, cash and boot of affiliated domestic corporation would be recognized, but not in excess of cash and boot received; any gain would not have effect of distribution of dividend and would be treated as gain from exchange of property).

[1193] 482 F.2d 600 (8th Cir. 1973).

[1194] 489 U.S. 726 (1989), aff'g 828 F.2d 221 (4th Cir. 1987), aff'g 86 T.C. 138 (1986). The IRS refused to follow the *Wright* case in Rev. Rul. 75-83 (revoked by Rev. Rul. 93-61), ruling that *Wright* had erred in distinguishing a long line of cases holding that the amount of the dividend is measured by reference to the earnings and profits of the transferor. The Fifth Circuit, in *Shimberg v. United States*, 577 F.2d 283 (5th Cir. 1978), under facts similar to the *Clark* facts, also applied the pre-reorganization redemption test in holding that a controlling shareholder of a closely held corporation received a boot dividend when his corporation merged into a large, publicly held corporation for stock and cash.

[1195] §356(a)(2). Before TEFRA amended §356(a)(2), the IRS had ruled that §318 did not apply for this purpose. Rev. Rul. 74-515.

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ify for the dividends received deduction.[1196] In that case, however, the corporate shareholder may be subject to the extraordinary dividend rules in §1059. *See* 764 T.M., *Current Distributions — Cash and Property*.

(2) Accumulated vs. Current Earnings and Profits

A distribution in connection with a reorganization may be taxable as a dividend under §356(a)(2) only to the extent of the shareholder's "ratable share of the undistributed E&P of the corporation accumulated after February 28, 1913."[1197] Although §356(a)(2), in contrast to §316(a)(2), refers only to "accumulated" E&P and not also to E&P "of the taxable year," several courts have interpreted the phrase in §356(a)(2) to include the current year's E&P.[1198] Another notable difference is that §356(a)(2), unlike §316(a)(2), does not look to the entire pool of E&P to characterize a particular distribution as a dividend, but only to the shareholder's "ratable share."

(3) Whose Earnings and Profits?

Despite *Clark*'s adoption of the post-reorganization redemption test,[1199] the Supreme Court left open the question of whose E&P are to be included in measuring the amount of boot that may be characterized as dividend income. Before *Clark*, it was generally accepted that the words "of the corporation" in §356(a)(2) referred only to Target; that is, particularly in light of the IRS's adoption of the pre-reorganization redemption test, the IRS did not generally attempt to augment Target's E&P by looking to Acquiror's E&P as well.[1200] However, in view of *Clark*, the IRS may contend that the E&P of Acquiror (which, under §381, includes the E&P of Target)[1201] is the appropriate measure for a dividend under §356(a)(2).[1202]

Planning Point: Note, however, that Target's E&P is first reduced by the money or value of any property distributed as boot to the Target shareholders.[1203]

(4) Reduction in E&P for Boot Distributed

Under §312(a) and §312(b), corporations generally reduce their E&P when they distribute property to shareholders. In general, the reduction for the distribution is dollar for dollar to the extent of (1) the amount of money distributed; (2) the principal amount of any obligations distributed; and (3) the adjusted basis of any other property distributed (after netting out the increase in E&P resulting from any inherent gain in such property). However, where a corporation distributes property in a redemption of its stock that is treated as an exchange under §302(a), §312(n)(7) requires the corporation to reduce its E&P only to the extent of the ratable share of the E&P attributable to the stock so redeemed.

When Target makes a distribution to one or more of its shareholders taxable as an exchange under §356(a)(1), the issue arises whether Target should reduce its E&P by the amount of the boot dollar-for-dollar or whether, in light of the *Clark* decision, Target should reduce its E&P only to the extent of the ratable share of the E&P attributable to the stock held by the shareholder receiving the boot in the exchange.

In Rev. Rul. 72-327, the IRS addressed the impact of a distribution of boot taxable under §356 to Target's E&P. The IRS ruled that Target's E&P was reduced by the full amount of the boot distributed to Target's shareholder in an "A" Reorganization, irrespective of whether the boot was taxable as a dividend or capital gain to the shareholder under §356.

While Rev. Rul. 72-327 pre-dates the enactment of §312(n)(7) and the *Clark* decision, nothing in the legislative history of §312(n)(7) suggests that the statute has any application beyond an actual redemption of stock subject to exchange treatment under §302(a). Additionally, following the decision in *Clark*, the IRS did not obsolete Rev. Rul. 72-327; therefore Rev. Rul. 72-327 should remain good law. Thus, *Clark* should not be interpreted as creating a hypothetical redemption of Acquiror's stock for purposes of applying §312(n)(7), and the IRS should not be able to argue that §312(n)(7), which directs a corporation only to reduce its ratable portion of accumulated E&P in the case of a redemption, applies to a boot distribution.

3. Section 306 Stock

a. Receipt of §306 Stock

Preferred stock may be issued by Acquiror in an "A," "B," or "C" Reorganization, and in both Forward and Reverse Triangular Mergers. Voting rights are required in a "B" Reorganization and, subject to limited boot exceptions, in a "C" Reorganization or Reverse Triangular Merger, but are not necessary in an "A" Reorganization or Forward Triangular Merger. In any such reorganization, preferred stock issued by Acquiror, whether the stock is voting or nonvoting, may be treated as "Section 306 stock." Receipt of §306 stock generally has no immediate tax consequences. However, upon the disposition of §306 stock, the proceeds received by the shareholder are treat-

[1196] *King Enters., Inc. v. United States*, 418 F.2d 511 (Ct. Cl. 1969); Rev. Rul. 72-327. A corporate shareholder may be eligible for a dividends received deduction from a domestic corporation that is subject to federal income taxes. §243(a). The amount of the deduction depends on the corporate shareholder's percentage of ownership in the corporation making the dividend distribution. As a general rule, a corporate shareholder may, for tax years beginning after 2017, deduct 50% of dividends received from a domestic corporation subject to federal income taxation. §243(a)(1), *as amended by* the 2017 tax act, Pub. L. No. 115-97, §13002(a). (A 70% deduction is available for corporations with tax years beginning before 2018 under pre-2018 §243(a)(1)). For tax years beginning after 2017, 65% may be deducted if the corporate shareholder owns at least 20% of the stock by vote and value of the corporation. §243(c), *as amended by* the 2017 tax act, Pub. L. No. 115-97, §13002(a). (An 80% deduction is available for corporations with tax years beginning before 2018 under pre-2018 §243(c)). One hundred percent may be deducted for dividends received from a member of the same affiliated group. §243(a)(3).

[1197] §356(a)(2).

[1198] *See Vesper Co. v. Commissioner*, 131 F.2d 200 (8th Cir. 1942); *Armour, Inc. v. Commissioner*, 43 T.C. 295 (1964).

[1199] *Commissioner v. Clark*, 489 U.S. 726 (1989).

[1200] *See, e.g.*, Rev. Rul. 75-83 (*revoked by* Rev. Rul. 93-61). *See also Commissioner v. Owens*, 69 F.2d 597 (5th Cir. 1934); *Ross v. United States*, 173 F. Supp. 793 (Ct. Cl. 1959), cert. denied, 361 U.S. 875 (1959). In one liquidation-reincorporation case, however, the IRS successfully argued that Target's and Acquiror's E&P should be combined for §301 purposes because there was a complete identity of ownership of the corporations. *Davant v. Commissioner*, 366 F.2d 874 (5th Cir. 1966).

[1201] *See* Reg. §1.381(c)(2)-1(c).

[1202] *See, e.g.*, *Davant v. Commissioner*, 366 F.2d 874 (5th Cir. 1966) (treating boot as dividend to extent of Target's E&P and Acquiror's E&P in §368(a)(1)(D) reorganization); PLR 9041086, PLR 9039029. *But see* TAM 200415004 (cash paid to former Target policyholders is boot received as part of merger consideration when Target did not have sufficient capital to pay dividends).

[1203] Rev. Rul. 72-327.

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ed as dividend income if the disposition is a redemption;[1204] if the disposition is a sale, the proceeds are treated in many cases as "qualified dividend income," taxed as net capital gain, and otherwise as ordinary income.[1205] In all cases, no loss is recognized.[1206]

Section 306 is designed to prevent a shareholder from bailing out earnings and profits of a corporation at capital gain rates. In times when there is no significant variance between ordinary income and capital gain rates for corporations,[1207] §306 has diminished importance. Nonetheless, §306 can still have adverse consequences when, for example, capital gain characterization is necessary to use capital losses, when §306 stock is sold for a loss, or when the application of §306 results in a greater amount of taxable income than would be the case under §1001. In times when dividends are taxed *as* capital gain (rather than merely being taxed at the same or similar rates as capital gain),[1208] the importance of §306 is diminished even further. If dividends are included in the computation of the receiving shareholder's net capital gain, the shareholder, presumably, can use more capital losses.

Section 306 stock includes stock other than common stock that is received by a Target shareholder in a reorganization if either: (1) the receipt of cash in lieu of such stock would have been treated as a dividend under §356(a)(2); or (2) the stock is received in exchange for §306 stock.[1209] The application of the "cash in lieu" test to a particular shareholder generally depends on the manner of application of the post-reorganization redemption principle of *Commissioner v. Clark*.[1210] The regulations suggest that in a reorganization in which both common and preferred stock are received for common stock only, the preferred stock is §306 stock.[1211] This is not necessarily the case under *Clark*, however, if the preferred stock (or the cash in lieu of that stock) has sufficient value to avoid dividend characterization under the post-reorganization dividend test. The regulations also suggest that the receipt of preferred stock that is not "substantially different" from preferred stock previously held is not §306 stock, regardless of whether the exchanging shareholder also owns common stock. It is not clear whether this rule applies to reorganizations other than recapitalizations.[1212]

Unfortunately, the receipt of nonqualified preferred stock is not necessarily exempt from the reach of §306. It is possible for nonqualified preferred stock to be taxed upon receipt as boot (i.e., either as dividend income or capital gain, depending on the application of *Clark*), and then result in further dividend income or ordinary income upon a later redemption or disposition. Under §351(g)(4), Treasury has authority to exclude nonqualified preferred stock from §306 treatment.

Even if the receipt of preferred stock in a reorganization is regarded as §306 stock, the subsequent disposition of that stock is not subject to §306 if the IRS is satisfied that both the acquisition and the disposition of the §306 stock did not have as one of its principal purposes the avoidance of federal income tax.[1213] Other dispositions of §306 stock exempt from the reach of §306 include dispositions that terminate the shareholder's interest and nonrecognition dispositions. For a complete discussion of §306 and the reorganization provisions, see 765 T.M., *Stock Rights and Stock Dividends — Sections 305 and 306.*

b. Exchange of §306 Stock

Section 356(f), which is concerned with the treatment of money or other property received in exchange for §306 stock in connection with a reorganization, provides that if §306 stock is surrendered in a §354 exchange and any boot is received for the §306 stock, then, notwithstanding any other provisions of §356, the amount of boot is treated as a §301 distribution. In effect, if Target has either current or accumulated earnings and profits, boot received for the §306 stock represents a taxable dividend to the extent of those earnings and profits, even if the shareholder realizes no actual gain. Any excess is first applied against the cost basis of the §306 stock as a return of capital, and the balance is taxed as capital gain.[1214]

Planning Point: Note, however, that if there are insufficient earnings and profits to support dividend treatment, the recipient shareholder is entitled to apply the boot received for the §306 stock against the stock's basis before gain recognition is required, whereas if the normal §356 rules applied, the shareholder might be required to recognize gain to the extent of the boot.

When a Target shareholder surrenders both §306 stock and non-§306 stock and receives back both qualifying property and boot, the question arises whether the boot is attributable to the §306 stock or to the non-§306 stock. The regulations provide

[1204] §306(a)(2).

[1205] §306(a)(1). Section 306(a)(1)(D) provides that for purposes of §1(h)(11), any amount treated as ordinary income under §306(a)(1) is treated as a dividend received from the corporation. Thus, to the extent that a dividend from §306 stock would be "qualified dividend income," the amount realized upon a sale or other disposition of the §306 stock is included in net capital gain rather than ordinary income. The 2012 ATRA, Pub. L. No. 112-240, §102, made permanent the preferential capital-gain treatment of "qualified dividend income." The 2017 tax act, Pub. L. No. 115-97, §11001(a), retained the top capital gains rate of 20%, but reduced the top individual income tax rate from 39.6% to 37% and increased the income threshold amounts at which of the top individual income tax rate applies. The 20% capital gains rate continues to apply at the same dollar breakpoints (indexed for inflation) that applied for purposes of the pre-2018 top 39.6% tax bracket. Thus, for tax years beginning after 2017, and before 2026, the 20% capital gains rate applies to the qualified dividend income and long-term capital gain of some taxpayers in individual income tax brackets below the top 37% tax bracket.

[1206] §306(a)(1)(C).

[1207] *See* §1 and §11 for the ordinary income and capital gains rates for individuals and corporations, respectively.

[1208] "Qualified dividend income" is taxed to noncorporate taxpayers as net capital gain for taxable years beginning after December 31, 2002. §1(h)(11).

[1209] §306(c)(1)(B).

[1210] 489 U.S. 726 (1989). *See* VI.E.2.b.(1), above. This determination, presumably, is subject to the same uncertainty as to whether Acquiror's E&P is to be counted. *See* Reg. §1.306-3(d) (referring to §356(a)(2)).

[1211] Reg. §1.306-3(d) *Ex.* (1).

[1212] Reg. §1.306-3(d) *Ex.* (2). *See also* Rev. Rul. 88-100, Rev. Rul. 60-1.

[1213] §306(b)(4)(A). In a series of earlier rulings, the IRS had concluded that §306(b)(4) relief was generally available when the §306 stock was issued by a widely held corporation. Rev. Rul. 57-212, Rev. Rul. 57-103, Rev. Rul. 56-116. In Rev. Rul. 89-63, the IRS revoked these rulings on the grounds that §306(b)(4) does not automatically apply to a widely held corporation's issuance of §306 stock. Another exception, in §306(b)(4)(B), requires only that the disposition not have the prohibited purpose. Section 306(b)(4)(B) is a more narrow exception, however, because it is limited to dispositions of §306 stock when there have been prior or simultaneous dispositions of all the common stock on which the §306 stock was issued.

[1214] §301(c)(2), §301(c)(3). As discussed above, boot representing a taxable dividend is also taxed as capital gain. §301(f)(4), §1(h)(11).

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that this is a question of fact to be decided under all the circumstances of each case, but that "ordinarily" the boot received is applied first against any §306 stock.[1215] However, the IRS will respect an allocation of boot to the non-§306 stock if the Target shareholders are not in control of Acquiror and the old §306 stock is exchanged for new preferred stock.[1216]

4. *Application of §305*

a. *Redemption Premiums on Preferred Stock*

Preferred stock often provides for some type of a redemption right. That right may be exercisable by the issuer, the holder, or both, and may be either optional or mandatory. Redemptions at the issuer's option often require payment of some premium over the issue price of the stock. Whenever stock that is considered preferred stock for Section 305 purposes is issued by Acquiror in a reorganization, it is necessary to determine whether the stock has a redemption premium. If it does, then, even though a Target shareholder's receipt of that stock may be nontaxable under §354, the shareholder may be required to recognize income with respect to such stock going forward.

Section 305(c) and regulations promulgated thereunder provide that, generally, the entire amount of a redemption premium on certain preferred stock is treated as being distributed to the holders of such preferred stock on an economic accrual basis over the period that the stock is outstanding (the "Economic Accrual Rule"). A deemed distribution arising by virtue of §305(c) may then be considered an actual distribution on preferred stock triggering application of §305(b)(4). Stock will generally be considered to have a redemption premium for this purpose, if its redemption price at maturity exceeds the issue price by an amount that equals or exceeds the product of: (a) one-quarter of 1% of the redemption price and (b) the number of complete years to maturity (the "OID De Minimis Rule").[1217] Thus, a preferred stock mandatorily redeemable in 10 years has a de minimis amount of 2.5% (one-fourth of 1% times 10 years) of the redemption price. The rules also provide for accrual of any redemption premium in excess of the de minimis amount on a compounded economic accrual basis (as in the OID context).[1218]

Reg. §1.305-5(b)(3) requires constructive distribution treatment with respect to an issuer call only if, based on all of the facts and circumstances as of the issue date, redemption pursuant to the call right is more likely than not to occur. The holder is treated as constructively receiving the premium as a distribution over the period from the issue date to the date on or by which redemption is most likely to occur.[1219]

Even if redemption is likely, however, constructive distribution treatment does not result if the redemption premium is solely in the nature of a penalty for premature redemption.[1220] A penalty for premature redemption is a premium paid as a result of changes in economic or market conditions over which neither the issuer nor the holder has control.[1221] Examples include changes in prevailing dividend rates or in the value of the common stock into which the stock is convertible.

Under a safe harbor in Reg. §1.305-5(b)(3)(ii), constructive distribution treatment does not result from an issuer call if the issuer and the holder are unrelated, no arrangements effectively require the issuer to redeem the stock, and exercise of the option to redeem would not reduce the yield of the stock.

According to the IRS, the tax consequences of the callable preferred stock are intended to reflect the economic expectations of the parties and to afford issuers flexibility to issue stock on terms that reflect their business needs. The regulations are also intended to foreclose corporations from attempting to use issuer calls to create constructive distributions solely for tax planning reasons.

For a detailed discussion of §305, *see* 765 T.M., *Stock Rights and Stock Dividends — Sections 305 and 306.*

b. *Exchange of Preferred Stock*

Under the §305 regulations, an exchange of preferred stock with dividends in arrears for other stock pursuant to a recapitalization may result in a deemed dividend distribution when the fair market value (or liquidation preference, if greater) of the stock received exceeds the issue price of the stock surrendered.[1222] However, this provision would not apply to an acquisitive reorganization. Therefore, the exchange of preferred stock for other stock pursuant to an acquisitive reorganization does not invoke §305 (except to the extent the stock received has a redemption premium, as discussed above).

5. *Basis of Stock or Securities Received by Target Shareholders and Security Holders*

a. *Section 358 — General*

Section 358 provides that Target shareholders or security holders receiving stock or securities in a reorganization exchange retain the same tax basis in their Acquiror stocks or securities received as they had for the Target stock or securities surrendered.[1223]

A more intricate, but mechanical, rule applies if some gain or loss has been recognized; the basis is decreased by any money and the value of any boot received in the exchange and any loss recognized on the exchange, and increased by any gain recognized on the exchange.[1224]

b. *Allocation of Basis*

The applicable rules regarding the allocation of the basis of the stock or securities exchanged is to be allocated to the stock or securities received tax free is set forth in regulations.[1225]

[1215] Reg. §1.356-4.

[1216] Rev. Rul. 76-15 (exchanges of old common for new common and cash, and old preferred for new preferred, were respected). *Cf.* Rev. Rul. 76-14 (allocation of boot to non-§306 stock was not respected because exchange was not negotiated at arms' length between unrelated parties). *See also* Reg. §1.356-1(d) *Ex.* 4.

[1217] §305(c)(1); Reg. §1.305-5(b)(1); §1273(a)(3).

[1218] Reg. §1.305-5(b)(1) referring to §1273(a)).

[1219] *See* Reg. §1.305-5(d) *Ex.* 8.

[1220] Reg. §1.305-5(b)(3).

[1221] Reg. §1.305-5(b)(3).

[1222] Reg. §1.305-7(c).

[1223] This assumes, of course, that §354 applies to the exchange. In the context of a "B" Reorganization, an exchange of securities for securities falls under §1001, thus giving rise to a basis equal to fair market value.

[1224] §358(a)(1).

[1225] §358(b)(1); Reg. §1.358-2.

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A shareholder may have different bases in different shares of stock transferred in a reorganization. For example, the shareholder may transfer, pursuant to the reorganization, 100 shares of stock in Target, 50 of which have a basis of $40 a share and 50 of which have a basis of $10 a share, for 100 shares of stock in Acquiror.

The regulations adopt a tracing method under which the basis of each share of stock or security received in a reorganization under §368 is traced to the basis of each surrendered share of stock or security.[1226]

Under the regulations, the basis of each share of stock or security received in an exchange to which §354 or §356 applies is generally the same as the basis of the share or shares of stock or security or securities exchanged therefor. If a shareholder or security holder is unable to identify which particular share (or portion of a share) of stock or security is exchanged for, or received with respect to, a particular share (or portion of a share) of stock or security, the shareholder or security holder may designate which share or security is received in exchange for, or in respect of, which share or security. This designation, however, must be consistent with the terms of the exchange or distribution and must be made on or before the first date on which the basis of a share or security received is relevant (e.g., the date on which a share or security received is sold).[1227]

The regulations also provide that in the case of an exchange in which the shareholder or security holder receives shares of stock or securities of more than one class, or receives other property or money in addition to shares of stock or securities, then — to the extent the terms of the exchange provide a specific allocation of the consideration received to either a particular share of stock or security or a particular class of stock or securities — the terms control, provided that they are economically reasonable.[1228] To the extent the terms of the exchange do not provide a specific allocation of the consideration received, the consideration (including boot) is allocated pro rata to the surrendered stock and securities, in accordance with relative fair market values for purposes of §358.[1229]

The fact that the regulations permit parties to specifically designate how the consideration that is received is allocated to the stock or securities surrendered is a beneficial development.

> *Example:* Individual J owns 10 shares of Class A stock of corporation X with a basis of $3 per share, and 10 shares of Class B stock of X with a basis of $9 per share. Pursuant to a reorganization, J exchanges all of J's X stock for 10 shares of corporation Y stock and $100 cash. On the date of the exchange, each share of X stock has a value of $10 per share, and each share of Y stock has a value of $10 per share.
>
> If terms of the exchange do not designate an allocation of the Y stock and cash, then it is allocated pro rata to the surrendered stock: The 10 shares of Class A stock are treated as exchanged for five shares of Y stock and $50 cash; and the 10 shares of Class B stock are treated as exchanged for five shares of Y stock and $50 cash. Under §356, J recognizes $50 of gain on the exchange of the Class A stock (i.e., the lesser of $70 gain or $50 boot received) and $10 of gain on the Class B stock (i.e., the lesser of $10 gain or $50 boot received). Under §358(a)(1), J's basis in the five Y shares received in exchange for the Class A stock is $30 (original $30 basis, reduced by $50 of cash, increased by $50 of recognized gain), and J's basis in the five Y shares received in exchange for the Class B stock is $50 (original $90 basis, reduced by $50 of cash, increased by $10 of recognized gain).[1230]
>
> On the other hand, if the terms of the exchange designate that the Y stock is received in exchange for J's Class A stock and the $100 is received in exchange for J's Class B stock, J does not recognize any gain on the exchange of the Class A shares, and only $10 of gain on the exchange of the Class B shares (i.e., the lesser of $10 gain or $100 boot received). Under §358(a)(1), J's basis in the 10 shares of Y stock is be $30. By specifically allocating the boot consideration to the high basis stock, therefore, J can significantly reduce the amount of gain recognized in the exchange.[1231]

Note: In 2009 the IRS proposed regulations that would have curtailed some of the flexibility given to Target shareholders to specify the terms of the exchange, in order to ensure similar tax treatment of dividend equivalent reorganization exchanges and dividend equivalent redemptions. Specifically, if the exchange has the effect of a distribution of a dividend, the Target shareholder could specify the terms of the exchange between the classes of stock surrendered provided the designation is economically reasonable, but not between particular shares of the same class of stock.[1232] In 2019, the 2009 proposed regulations were withdrawn by the IRS.[1233]

The regulations reflect the fact that a single share of stock may have not only a split holding period, but also a split basis. This rule applies when a share of stock or security is received

[1226] Reg. §1.358-1, Reg. §1.358-2. The preamble to T.D. 9244 states that the IRS considered whether a tracing method or an averaging method should be used to determine the basis of stock and securities received in these transactions. The adoption of the tracing method was based on the view that, in light of the carryover basis rule of §358, a reorganization is not an event that justifies the averaging of bases of exchanged stock or securities that have been purchased at different times and at different prices. Moreover, the adoption of the tracing method reflects the concern of the IRS that averaging the bases of exchanged blocks of stock or securities may inappropriately limit the ability of taxpayers to arrange their affairs and may afford opportunities for the avoidance of certain provisions of the Code. The preamble to the final regulations also notes that the specific allocation model raises issues when the stock or security that is surrendered is subject to a loss (i.e., when the shareholder's adjusted basis therein exceeds its fair market value). If, pursuant to the terms of the exchange, loss stock or loss security is exchanged solely for other property or money, the exchanging shareholder or security holder realizes a loss. Section 356(c), however, denies recognition of the loss. The issue noted in the preamble is what happens to the shareholder's or security holder's basis in the surrendered stock or security. The preamble notes that the IRS continues to study the appropriate resolution of this issue.

[1227] Reg. §1.358-2(a)(2)(vii).

[1228] Reg. §1.358-2(a)(2)(ii).

[1229] Reg. §1.358-2(a)(2)(ii).

[1230] Reg. §1.358-2(c) *Ex.* 3.

[1231] Reg. §1.358-2(c) *Ex.* 4. As a comparison, note that taxpayers cannot specifically designate consideration in the context of §351. Rev. Rul. 68-55.

[1232] REG-143686-07, 74 Fed. Reg. 3509 (Jan. 21, 2009).

[1233] REG-143686-07, 84 Fed. Reg. 11,686 (Mar. 28, 2019).

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in exchange for, or with respect to, more than one share of stock or security and the surrendered stock or securities were acquired on different dates or at different prices.[1234]

The regulations do not apply to an exchange to which both §351 and either §354 or §356 apply if, in connection with the exchange: (i) the shareholder or security holder also exchanges property for stock or securities in an exchange to which neither §354 nor §356 applies; (ii) the shareholder or security holder exchanges property for stock or securities in a transaction for which an election to apply §362(e)(2)(C) is in effect; or (iii) liabilities of the shareholder or security holder are assumed.[1235]

6. Holding Period of Stock or Securities Received by Target Shareholders and Security Holders

Under §1223(1), if a Target shareholder or security holder held the Target stock and securities as capital assets, then the Acquiror stock and securities received under §354 will tack the holding period of the Target stock and securities surrendered therefor.

7. Qualified Small Business Stock Status

If a Target shareholder exchanges qualified small business stock for Acquiror Stock in a §368 reorganization (a "QSBS Exchange"), the Target shareholder may be eligible to preserve qualified small business stock status for the Acquiror stock received in the exchange.[1236] If the Acquiror is a qualified small business under §1202(d) at the time of the QSBS Exchange, the Acquiror stock issued in such exchange should be treated as qualified small business stock without limitation; however, if the Acquiror is not a qualified small business under §1202(d) at the time of the QSBS Exchange, the Acquiror stock issued in such exchange should only be treated as qualified small business stock to the extent of the amount of gain that would have been recognized had the QSBS Exchange been a taxable exchange.[1237] For a detailed discussion on qualified small business stock considerations in §368 reorganization, *see* 760 T.M., *Small Business Corporation Stock*.

8. Treatment of Post-Reorganization Consideration

a. Installment Sale Rules

If boot in the form of a non-readily tradable deferred payment obligation of Acquiror is received by a Target shareholder, then, provided the boot is not taxed as a dividend, and provided the Target shares surrendered in exchange therefor were not of a class traded on a securities exchange, the exchanging Target shareholder is permitted to report gain on the installment basis.[1238] For a detailed discussion on reporting gain on the installment method under §453, see 565 T.M., *Installment Sales*.

b. Release of Contingent or Escrowed Stock

If stock is held back by Acquiror to provide for contingent or unknown liabilities, or otherwise "contingent stock" is issued, an unresolved issue is the treatment of the basis of the stock received by, and the basis of the stock held back from, Target's shareholders. If all of the stock to be received is received before the sale of any stock, the issue apparently does not arise.

For advance ruling purposes, the IRS takes the position that the aggregate basis of the shares in Target must be allocated to all of the shares of Acquiror that either have been received or may be received under the contingent payout.[1239] This method for determining basis thus results in a portion of the taxpayer's historic basis being "suspended," in effect being allocated to the maximum number of shares that may be issued under the contingent payout, which produces an inequitable result if the taxpayer sells all or a portion of the shares that the shareholder actually receives before the contingent payout is settled if the maximum number of shares that may be issued under the contingent payout are not received by the taxpayer. In such event, the "suspended" basis would need to be allocated among the remaining shares held by the taxpayer at the time the contingent payout is settled. If the taxpayer does not hold any Acquiror shares at such time, any remaining "suspended" basis at such time would presumably give rise to a loss for such taxpayer.

This problem may be avoided by having Acquiror issue a new class of stock that incorporates the contingency into the conversion feature. The stock should be convertible into a greater number of shares of common stock upon the occurrence of the contingency than it would be in the event that the contingency does not occur.[1240]

Alternatively, the taxpayer can allocate the aggregate basis for the taxpayer's shares in Acquiror to the initial Acquiror stock that the taxpayer receives, and then reallocate this basis each time that the taxpayer receives stock by reason of the contingent payout. In the event that any shares are sold before the completion of the contingent payout period, gain would be determined by using the basis of those shares at the time of the sale. This method of computing basis ensures that the shareholder will not lose basis in the event that all of the contingent shares are not transferred, however, as noted above this alternative method of basis allocation does not comply with the method proscribed by the IRS for advance ruling purposes.

The basis and holding period implications also depend on whether or not separate share certificates are issued for the imputed interest component of the contingent shares, or the contingent shares are paid in a single block of shares. While there are no clear rules in this area, the following approaches seem reasonable based on available authority.

First, if there is no separation of interest and noninterest shares, then the basis of the initial shares (or, under the IRS's position, the basis of the initial shares and the basis initially allocated to contingent shares that may be received) should be reallocated among the initial shares and the newly issued shares (as well as, under the IRS's position, any additional contingent shares yet to be issued).[1241] Basis related to the portion of the contingent shares recognized as imputed interest income should

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[1234] Reg. §1.358-2(a)(2)(i).

[1235] Reg. §1.358-2(a)(2)(viii).

[1236] §1202(h)(4)(A).

[1237] §1202(h)(4)(B).

[1238] §453(f)(6). *See* 782 T.M., *Boot Distributions and Assumption of Liabilities*.

[1239] Rev. Proc. 77-37, §3.03. *See, e.g.*, PLR 8938062. For a discussion of the IRS ruling policy, see VIII., below.

[1240] *See* Rev. Rul. 73-205.

[1241] *See* PLR 8938062.

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only increase the basis of the contingent shares, not the initial shares received in the reorganization.[1242]

The holding period for each of the contingent shares should be split.[1243]

A new holding period should begin on the date that the contingent shares are received for the imputed interest portion. This portion of each of the contingent shares presumably should be determined by dividing the amount characterized as imputed interest by the aggregate fair market value of the contingent shares.[1244] The balance of each contingent share should be tacked to the holding period of the initial shares received in the reorganization.[1245]

Second, if the earn-out is separated into interest and noninterest shares, then the basis of the interest shares should have a basis equal to their fair market value on their issuance date. The taxpayer can immediately sell all or part of those shares (e.g., to pay the taxes imposed on the imputed interest income) without further recognition of gain.[1246] The basis in the initial shares (or, under the IRS's position, the basis of the initial shares and the basis allocated to contingent shares that may be received) should be reallocated among the initial shares and noninterest contingent shares received (as well as, under the IRS's position, any additional contingent shares yet to be issued).[1247]

The holding period for the interest shares should begin on the date of their issuance.[1248] The holding period for the noninterest contingent shares should tack to the holding period of the initial shares received in the reorganization.[1249]

The IRS has ruled that the release of appreciated stock from an escrow fund to satisfy an obligation of the shareholder does not require the shareholder to recognize gain or loss when the shares are released without regard to their fair market value on the release date.[1250] The rationale is that no gain or loss should be recognized where the shareholder has not received any benefit or detriment from any change in value of the escrowed shares. In those circumstances, the shareholder's basis is reallocated among the remaining shares. On the other hand, the IRS has required the recognition of gain on the release of escrowed shares if the number of shares used to satisfy an obligation of the shareholder is based upon the fair market value of the escrowed shares on the release date.[1251]

c. Settlement Proceeds

In *Tribune Publishing Co. v. United States*,[1252] the taxpayer had received Acquiror stock in exchange for its Target stock in an "A" Reorganization in 1969. In 1977, the taxpayer sued Acquiror for securities fraud in connection with the reorganization and, as part of the settlement, received cash plus the right to buy material from Acquiror at a discount over an eight-year period. The court treated the cash as if it were boot received in the original reorganization, because the underlying claim was based on the additional consideration taxpayer would have received in the reorganization had Acquiror not committed securities fraud.[1253]

The court also treated the value of the discounts as boot, but permitted taxpayer to recognize the boot in income over the years in which the discount purchases were made.

The court further held that the taxpayer was not liable for interest on the cash payment from 1969 (the date of the merger) to 1977 (the date of the settlement), pointing out that the settlement proceeds were not voluntarily contracted for in 1969. The court held, however, that interest should be imputed under §483 on the value of the discounts as if they were deferred payments made on the sale of property, and that this interest should run from the date of settlement until the discounts actually were received by the taxpayer.

[1242] *See* PLR 8938062.

[1243] *See* PLR 8938062.

[1244] *See* PLR 8938062. *See also* Rev. Rul. 62-140, *amplified by* Rev. Rul. 85-164.

[1245] §1221(a)(1) (assuming shares are held as capital asset). *See also* Rev. Rul. 62-140, *amplified by* Rev. Rul. 85-164.

[1246] Rev. Rul. 70-300, *clarified by* Rev. Rul. 72-35.

[1247] Rev. Proc. 77-37, §3.03.

[1248] *See* PLR 8938062.

[1249] *See* PLR 8938062.

[1250] Rev. Rul. 76-334, Rev. Rul. 76-42.

[1251] Rev. Rul. 78-376.

[1252] 836 F.2d 1176 (9th Cir. 1988).

[1253] The court did not address the issue of whether the boot should be dividend or capital gain, because the parties had conceded that, if it were boot, it would be a dividend. Moreover, the court did not mention what result its boot determination would have had if the underlying transaction had been a "B" Reorganization.

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VII. Reorganizations Involving S Corporations and Noncorporate Entities

A. General

Although S corporations generally are treated as passthrough entities similar to partnerships, they are treated as corporations for purposes of the reorganization provisions.[1254] The IRS has acknowledged that S corporations may be parties to reorganizations.[1255] Special considerations arise in the application of reorganization provisions to S corporations; a few are discussed below in further detail. For a more complete explanation of S corporations, including their involvement in reorganizations, see 731 T.M., *S Corporations: Corporate Tax Issues.*

B. S Corporation as Acquiror; C Corporation or S Corporation as Target

1. "A" Reorganizations

If a C corporation Target is merged into an S corporation Acquiror in an "A" Reorganization, the transaction itself does not affect the S corporation status of Acquiror, provided that no second class of stock is issued in the transaction and Acquiror ends up with no more than 100 shareholders, all of whom are eligible to hold stock in an S corporation.[1256] The assets acquired from Target in the merger are subject to the built-in gain rules of §1374.[1257]

If an S corporation Target is merged into an S corporation Acquiror in an "A" Reorganization, the Acquiror's status as an S corporation is unaffected, provided that Acquiror continues to have a single class of stock and 100 or less eligible shareholders.[1258]

As discussed in III.A.1.b.(1), above, regulations permit the merger of Target entities into a wholly owned disregarded entity of Acquiror to qualify as an "A" Reorganization. As provided in Reg. §1.368-2(b)(1)(i)(A), a qualified subchapter S subsidiary (QSub) is considered a disregarded entity. Accordingly, a merger of either a C corporation Target or an S corporation Target with and into a QSub (or another disregarded entity) of an S corporation Acquiror, in exchange for S corporation Acquiror's stock, could qualify as an "A" Reorganization.

A C corporation Target's earnings and profits ("E&P") carry over to the S corporation Acquiror pursuant to §381(a)(2) and become taxable to the S corporation Acquiror's shareholders as ordinary dividend income as and when such E&P is treated as distributed to such shareholders pursuant to §1368(c).[1259]

An S corporation Target's accumulated adjustments account ("AAA") carries over to the S corporation Acquiror pursuant to §381(a)(2), and is combined with S corporation Acquiror's AAA account.[1260]

2. "C" Reorganizations

A "C" Reorganization between an S corporation Acquiror and either a C corporation Target or an S corporation Target involves the same or similar tax considerations as an "A" Reorganization.[1261]

3. Acquisitive Stock Reorganizations

An S corporation Acquiror may acquire the stock in a C corporation Target, in exchange for its voting stock, in either a "B" Reorganization or Reverse Triangular Merger. S corporation Acquiror's status as an S corporation is unaffected, provided that Acquiror continues to have a single class of stock and 100 or less eligible shareholders. Target remains a C corporation.[1262]

An S corporation Acquiror may also acquire the stock of an S corporation Target, in exchange for its voting stock, in either a "B" Reorganization or Reverse Triangular Merger. Acquiror's status as an S corporation is unaffected, provided that Acquiror continues to have a single class of stock and 100 or less eligible shareholders. However, unless the Target is treated as a QSub immediately upon its acquisition, it will lose its S corporation status — and therefore will become a C corporation — upon its acquisition, due to S corporation Acquiror being a nonqualifying S corporation shareholder under §1361(b)(1)(B). Further, the QSub election by Acquiror will cause the transaction to be tested under the rules applicable to "C" Reorganizations, and characterization of the transaction as a "B" Reorganization or Reverse Triangular Merger will no longer be possible.[1263] See the discussion of QSubs in 730 T.M., *S Corporations: Formation and Termination.*

C. S Corporation as Target; C Corporation as Acquiror

1. "A" Reorganizations

If an S corporation Target is merged into a C corporation Acquiror (or a disregarded entity of such C corporation Acquiror) in an "A" Reorganization, the S corporation Target disappears in the merger and, thus, its S corporation status ends on the date on which its final taxable year ends.

Planning Point: Acquiror, if it qualifies, may elect S corporation status before the acquisition. By doing so, it ensures that Target's assets will not be subjected to §1374 by virtue of having been held by a C corporation in the event that Acquiror later converts to an S corporation.

It is not entirely clear whether an S corporation Target's AAA carries over to the C corporation Acquiror for purposes of permitting the former S corporation Target shareholders to receive distributions during the post-termination transition period as a tax-free return of basis under §1371(e)(1).[1264] For a discus-

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[1254] See §1371(a), which provides that, except as otherwise provided in the Code, Subchapter C applies to S corporations in all cases in which the application of Subchapter C is not inconsistent with the S corporation provisions.

[1255] GCM 39768 (Dec. 1, 1988).

[1256] Rev. Rul. 69-566.

[1257] These rules are discussed in detail in 731 T.M., *S Corporations: Corporate Tax Issues.*

[1258] Rev. Rul. 79-52.

[1259] *See* §381(c)(2).

[1260] Reg. §1.368-2(d)(2).

[1261] *See* discussion at VII.B.1., above.

[1262] Since 1996, an S corporation has been entitled to own stock of a C corporation without affecting its S corporation status. Small Business Job Protection Act of 1996 (SBA), Pub. L. No. 104-188.

[1263] *See* III.C.9.b. and IV.B.5., above.

[1264] Reg. §1.1377-2(b) provides that a post-termination transition period is created when a C corporation acquires the assets of an S corporation in a §381(a)(2) transaction. However, the preamble for certain recent regulatory changes which included the modification of Reg. §1.1377-2(b), notes that Trea-

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sion of §1371(e)(1), see 730 T.M., *S Corporations: Formation and Termination.*

2. "C" Reorganizations

A "C" Reorganization between an S corporation Target and a C corporation Acquiror involves the same or similar tax considerations as an "A" Reorganization.

Planning Point: As in the case of an "A" Reorganization, Acquiror may wish to make an S election before the acquisition to avoid application of §1374 to Target's assets in the event that Acquiror later converts to an S corporation.

3. Acquisitive Stock Reorganizations

If an S corporation Target is acquired by a C corporation Acquiror in a "B" Reorganization or a Reverse Triangular Merger, the Target will lose its S corporation status upon its acquisition — and therefore will become a C corporation — due to C corporation Acquiror being a nonqualifying S corporation shareholder under §1361(b)(1)(B).

D. Noncorporate Entities

1. Partnerships and Limited Liability Companies Taxable as Corporations

When a noncorporate entity elects to be taxed as a corporation, it generally qualifies as a corporation under any Code provision that designates an entity by that term.[1265] Because of this, a partnership or a limited liability company (LLC) may engage in a tax-free reorganization with a corporation if the partnership or LLC has elected to be taxed as a corporation.[1266]

The question of whether a non-corporate entity that checks the box to be a corporation for U.S. tax purposes can issue "voting stock" in a "B" or "C" Reorganization has been addressed, at least implicitly, in three private letter rulings from 2000.[1267] Each involved a triangular "C" Reorganization where the issuing corporation was an LLC that checked the box to be a corporation for U.S. federal income tax purposes. In each ruling the issuing corporation issued "voting membership interests" in the LLC entity. Without any discussion, the PLRs treated the transactions as triangular "C" Reorganizations, which meant that IRS was treating the voting membership interests as voting stock. There is no reason why the same "voting stock" result would not be applied in the case of a "B" Reorganization or Reverse Triangular Merger.

2. Disregarded Entities

As discussed in more detail in III.A.1.b.(1), above, regulations provide that certain statutory mergers and consolidations of Target corporations with and into disregarded entities (i.e., entities that elect not to be taxable apart from their owners) qualify as "A" Reorganizations.[1268]

It is important to note, however, that the merger of a disregarded entity into an acquiring corporation does not satisfy the requirements under §368(a)(1)(A) because the corporate owner does not merge into the acquiring corporation and the corporate owner does not cease to exist as a result of the merger transaction.[1269]

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sury and the IRS considered the question of whether AAA constitutes a tax item that an acquiring corporation would succeed to or take into account under §381(a) and determined that the issue required further review. *See* preamble to T.D. 9914, 85 Fed. Reg. 66,471 at pg66,474 (Oct. 20, 2020). Note also that Reg. §1.1368-2(d) provides that an AAA transfers from a target S corporation to an acquiring S corporation, but is silent on whether an AAA transfers from a target S corporation to an acquiring C corporation.

[1265] §7701(a)(3).

[1266] Reg. §301.7701-3.

[1267] *See* PLR 200009028 (conversion of state-law corporations to limited liability companies that have elected to be taxed as corporations), PLR 200009026 (same), PLR 200005016 (same).

[1268] Reg. §1.368-2(b).

[1269] Reg. §1.368-2(b)(1)(iii) *Ex.* 6.

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VIII. Obtaining Rulings from the IRS

A. When a Ruling Should Be Sought

Historically, taxpayers had the option to seek rulings addressing an entire transaction that presented a significant issue. In recent years, the IRS's ruling policy reduced the scope of private letter rulings to significant issue rulings.[1270] On January 2, 2024, the IRS announced that it would once again issue "transactional rulings" or "comfort rulings" in respect of §368 reorganization.[1271] For requests received on or after January 2, 2024, the Associate Chief Counsel (Corporate) has eliminated the "significant issue" practice, under which the IRS would only issue rulings on a significant issue presented in a §368 transaction, rather than a ruling on the entire transaction, and the IRS removed certain transactions under §355(e) from the no-rule list.[1272] The IRS will issue "comfort rulings" on issues under §368, and certain issues under §355(e), meaning a ruling will be issued even if the issue is "clearly and adequately addressed" by other published guidance.[1273]

Whether the parties to a reorganization should seek an advance ruling from the IRS with respect to §368 reorganizations depends upon a variety of factors. Given the time required to obtain a private letter ruling from the IRS, parties involved in a time-sensitive transaction may not have the option of requesting an advance ruling. Rulings generally require an average of four to six months from date of filing to date of final response, however, in certain instances expedited processing may be available.

The IRS initiated a "fast-track processing" program, which may provide for the receipt of a private letter ruling in connection with a §368 reorganization within three months if certain conditions are satisfied.[1274] Fast-track processing is generally available for private letter ruling requests solely or primarily under the jurisdiction of the Associate Chief Counsel (Corporate).

There are specific submission requirements to meet, including that taxpayers requesting fast-track processing generally are required to (i) request a pre-submission conference, (ii) provide a draft ruling and agree to provide additional information requested by the IRS within seven days of the request, (iii) follow special procedures for submitting the ruling request, and (iv) provide one or more of the taxpayer's reasons for requesting fast-track processing.[1275] The required pre-submission conference process may result in the branch representative determining that a request is out of scope. Generally, the fast-track process replaces the expedited handling process in Rev. Proc. 2025-1, §7.02(4), with the exception of Reg. §301.9100 relief.[1276]

Private letter ruling requests that involve non-corporate issues or that are not primarily under the Corporate division's jurisdiction (such as those involving financial products, cross-border transactions, or industries with special tax rules) require additional approvals to qualify for fast-track processing.[1277]

In cases in which the timing of a ruling request is acceptable, the factors to be considered in determining whether to seek an advance ruling include:

- the scope and nature of the tax exposure if the transaction fails to qualify as a reorganization (including whether public shareholders will be affected);
- the degree of comfort offered by the tax advisors to the transaction (including the availability of appropriate legal opinions); and
- the presence of issues that place the transaction within the scope of the IRS's "no ruling" policy.[1278]

Advance rulings from the IRS are not necessary (or available) in many cases. Moreover, because the IRS requires the taxpayer to make all factual representations necessary to reach the legal conclusion, the ruling is only as good as the representations behind it. On audit, agents are free to challenge the tax treatment of the transaction if they can show a discrepancy between the representations and subsequent events.

B. Procedure for Requesting a Ruling

The first annual revenue procedure[1279] sets forth detailed procedural rules for the issuance of rulings and determination letters, and outlines generally the information required by the IRS in a ruling request.[1280]

The specific guidelines regarding representations and information that must be included with requests for rulings on tax-free reorganizations are found in Rev. Proc. 77-37[1281] and Rev. Proc. 86-42. A practitioner seeking to file a ruling request in the reorganization area should review revenue procedures, as well as recent private letter rulings covering the type of reorganization at issue. Private letter rulings provide insight into facts or representations required by the IRS and illustrate factors that the IRS considers important.

[1270] Rev. Proc. 2023-1, §6.03, *superseded by* Rev. Proc. 2024-1. *See also* Rev. Proc. 2017-52, relating to requests for rulings on significant issues under §355, *modified by* Rev. Proc. 2024-3, *and* by Rev. Proc. 2024-24 (modifying representations and providing procedures for requesting rulings on delayed distributions and retained controlled stock or securities).

[1271] Rev. Proc. 2024-1, Rev. Proc. 2024-3.

[1272] Rev. Proc. 2024-3, §1.02, *superseding* Rev. Proc. 2023-3, §3.01(60), §4.01(30); Rev. Proc. 2024-1, §16.

[1273] Rev. Proc. 2025-1, §6.11.

[1274] Rev. Proc. 2023-26, making permanent, with some modifications, the fast-track processing pilot program established in Rev. Proc. 2022-10. For further discussion of situations where expedited treatment may still be available, see 621 T.M., *IRS National Office Procedures — Rulings, Closing Arguments.*

[1275] *See* Rev. Proc. 2023-26, §5. Fast-track processing is not available if the letter ruling includes a closing agreement with respect to an issue under the jurisdiction of the Associate Chief Counsel (Corporate) or another Associate office. Rev. Proc. 2023-26, §4.02(2). If a taxpayer requests a specified period for processing of less than 12 weeks, then the taxpayer must demonstrate a business need for requesting fast track processing. Rev. Proc. 2023-26, §5.06(1)(b).

[1276] *See* Rev. Proc. 2023-26, §6.01.

[1277] Rev. Proc. 2023-26, §4.01.

[1278] E.g., an escrow or contingent stock arrangement that does not meet the guidelines of Rev. Proc. 86-42.

[1279] *See, e.g.*, Rev. Proc. 2025-1. See also discussion of Rev. Proc. 2023-26, relating to a fast-track ruling process, in VIII.A., above.

[1280] For further discussion, *see* 621 T.M., *IRS National Office Procedures — Rulings, Closing Agreements.*

[1281] Rev. Proc. 77-37, as *modified by* Rev. Proc. 89-30, and *as amplified by* Rev. Proc. 77-41, Rev. Proc. 83-81, Rev. Proc. 84-42 (superseded, in part, as to no-rule areas by Rev. Proc. 2024-3), Rev. Proc. 86-42, and Rev. Proc. 89-50. For a discussion of areas in which IRS will not issue rulings, see VIII.C., below.

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Note: For requests received on or after January 2, 2024, the Associate Chief Counsel (Corporate) has eliminated the "significant issue" practice, under which the IRS would only issue rulings on a significant issue presented in a §368 transaction, rather than a ruling on the entire transaction, and the IRS removed certain issues under §355(e) from the no-rule list.[1282] The IRS will issue "comfort rulings" on issues under §368, and certain issues under §355(e), meaning a ruling will be issued even if the issue is "clearly and adequately addressed" by other published guidance.[1283]

IRS authority to impose "user fees" on the issuance of private letter rulings is codified at §7528. For a discussion of the user fee program, including the current fee for filing a ruling request, see 621 T.M., *IRS National Office Procedures — Rulings, Closing Agreements.*

C. "No Ruling" Areas

In the third annual revenue procedure, the IRS announces those areas in which ruling letters will not (or ordinarily will not) be issued.[1284] As discussed above, the IRS had previously taken the position that it would generally not rule on whether a transaction constituted a corporate reorganization under §368(a)(1)(A),[1285] §368(a)(1)(B), §368(a)(1)(C), §368(a)(1)(E), or §368(a)(1)(F), and whether various consequences (such as nonrecognition and basis) would result from the application of those sections. Instead, the IRS would rule on one or more significant issues presented in a transaction described by those code sections.[1286] On January 2, 2024, the IRS announced that it would once again issue "transactional rulings" or "comfort rulings" in respect of §368 reorganizations.[1287]

Note: For requests received on or after January 2, 2024, the Associate Chief Counsel (Corporate) has eliminated the "significant issue" practice, under which the IRS would only issue rulings on a significant issue presented in a §368 transaction, rather than a ruling on the entire transaction, and the IRS removed certain transactions under §355(e) from the no-rule list.[1288] The IRS will issue "comfort rulings" on issues under §368, and certain issues under §355(e), meaning a ruling will be issued even if the issue is "clearly and adequately addressed" by other published guidance.[1289]

The third annual revenue procedure does not contain an exhaustive list of the areas in which the IRS will not issue rulings. The IRS is wary of issuing any rulings that are not within the pattern of previous rulings.[1290] For a discussion of current no-ruling areas and full text of the most recent annual Revenue Procedure, see 621 T.M., *IRS National Office Procedures — Rulings, Closing Agreements.*

[1282] Rev. Proc. 2024-3, §1.02, *superseding* Rev. Proc. 2023-3, §3.01(60), §4.01(30); Rev. Proc. 2024-1, §16.

[1283] Rev. Proc. 2025-1, §6.11.

[1284] *See, e.g.*, Rev. Proc. 2024-3.

[1285] Including transactions qualifying under §368(a)(1)(A) by virtue of §368(a)(2)(D) or §368(a)(2)(E).

[1286] *See* Rev. Proc. 2023-3, §3.01(60).

[1287] Rev. Proc. 2024-1 and Rev. Proc. 2024-3.

[1288] Rev. Proc. 2024-3, §1.02, *superseding* Rev. Proc. 2023-3, §3.01(60), §4.01(30); Rev. Proc. 2024-1, §16.

[1289] Rev. Proc. 2025-1, §6.11.

[1290] *See* Chief Counsel Notice 2003-014 (Oct. 17, 2002) (IRS will not take positions in PLRs inconsistent with positions it has taken in published guidance or in proposed regulations, even if there are plans to revoke, change, or clarify positions in public guidance).

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IX. Reporting Requirements

A. General

The regulations require that all taxpayers participating in tax-free exchanges in connection with reorganizations retain permanent records that include information regarding the amount, basis, and fair market value of all transferred property and relevant facts regarding any liabilities assumed or extinguished as part of such reorganization.[1291]

The regulations also require the filing of certain documents and/or information with the federal income tax return for the year in which the exchange took place. The statements and documents vary depending upon whether the taxpayer is: (1) a corporation that is a party to the reorganization; or (2) a taxpayer (other than a corporation that is a party to the reorganization) who received stock or securities and other property upon a tax-free exchange.

B. Corporation a Party to the Reorganization

An exchange must be pursuant to a plan of reorganization to qualify for nonrecognition treatment under the reorganization provisions.[1292] With its return for the taxable year that includes the reorganization, each party to the reorganization must include a statement titled, "STATEMENT PURSUANT TO §1.368-3(a) BY [INSERT NAME AND EMPLOYER IDENTIFICATION NUMBER (IF ANY) OF TAXPAYER], A CORPORATION A PARTY TO A REORGANIZATION."[1293] The statement must include:[1294]

(1) the name and employer identification number (EIN) of the parties to the reorganization;

(2) the date of the reorganization;

(3) the value and basis of the assets, stock, or securities of the target corporation transferred in the transaction, determined immediately before the transfer and aggregated as follows: [1295]

- ○ Importation property transferred in a loss importation transaction (as defined in Reg. §1.362-3(c)(2) and Reg. §1.362-3(c)(3));[1296]
- ○ Loss duplication property (as defined in Reg. §1.362-4(g)(1));[1297]
- ○ Property for which any gain or loss was recognized on the transfer (without regard to whether it is also identified with loss duplication or importation property above);[1298]
- ○ Other property not described above;[1299] and

(4) the date and control number of any private letter ruling addressing the transaction issued by the IRS in connection with the reorganization.

If any corporation a party to the reorganization is a controlled foreign corporation (CFC) under §957, each U.S. shareholder[1300] of the CFC must include the statement in its return.[1301]

If the tax-free exchanges pursuant to the reorganization cover more than one taxable year, the information should be given with the returns for all such years. The IRS, in one instance, contended without success than an otherwise tax-free reorganization should be disqualified solely because the information required by the regulation was not filed.[1302]

C. Other Parties

Certain reporting requirements also apply to taxpayers receiving stock or securities and other property or money upon a tax-free exchange in connection with a corporate reorganization. Each such taxpayer who is a "significant holder,"[1303] other than a corporation a party to the reorganization, must include a statement titled, "STATEMENT PURSUANT TO §1.368-3(b) BY [INSERT NAME AND TAXPAYER IDENTIFICATION NUMBER (IF ANY) OF TAXPAYER], A SIGNIFICANT HOLDER," on or with the holder's return for the taxable year of the exchange. The statement must include:[1304]

(1) the names and employer identification numbers (if any) of all of the parties to the reorganization;

(2) the date of the reorganization; and

(3) the value and basis of all the stock or securities of the target corporation held by the significant holder that is transferred in the transaction and such holder's basis in

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[1291] Reg. §1.368-3(d).
[1292] Reg. §1.368-3(a).
[1293] Reg. §1.368-3(a).
[1294] Reg. §1.368-3(a)(1)–§1.368-3(a)(4).
[1295] Reg. §1.368-3(a)(3).
[1296] Reg. §1.368-3(a)(3)(i).
[1297] Reg. §1.368-3(a)(3)(ii).
[1298] Reg. §1.368-3(a)(3)(iii).
[1299] Reg. §1.368-3(a)(3)(iv). The preamble to the temporary regulations (T.D. 9264, 71 Fed. Reg. 30,591 (May 30, 2006)) stated as follows regarding estimates of fair market value and tax basis: "The IRS and Treasury Department recognize that, in some cases, a taxpayer may not conveniently be able to provide a precise valuation of property exchanged or distributed in a transaction that is not taxable in the current year. In those cases, for the purposes of these statements, the IRS and Treasury Department will accept a taxpayer's good faith estimate of such fair market value. Similarly, the IRS and Treasury Department recognize that there are occasionally situations where a taxpayer may not be able to precisely determine its basis in a taxable year in which that basis would not be relevant to determining the taxpayer's taxable income. As in the case of fair market value, for purposes of these statements, the IRS and Treasury Department will in these situations accept a taxpayer's good faith estimate of such basis." On June 1, 2011, the IRS issued Rev. Proc. 2011-35, providing procedures that an acquiring corporation may use to establish basis in the stock of a target corporation when it acquires the target stock in a transferred basis transaction as described in VI.C.4., above. Rev. Proc. 2011-35 provides that corporations acquiring Target stock in a transferred basis transaction will be treated as satisfying their reporting requirements under Reg. §1.351-3 and §1.368-3 if they include a statement on or with the timely filed original return for the taxable year of the transferred basis transaction that identifies the transferred basis transaction and states that a basis study is pending with respect to the acquired stock. However, to satisfy the requirements of those sections in such cases, the taxpayer must include complete statements as required under those regulations, with basis amounts determined pursuant to the study or otherwise under the revenue procedure, on or with a timely filed original return for a tax year that is no later than the tax year that includes the date that is two years after the date of the transferred basis transaction.
[1300] As defined in §951(b).
[1301] Reg. §1.368-3(a).
[1302] *Wilson v. Commissioner*, T.C. Memo 1961-135.
[1303] Defined as a 5% shareholder of a publicly traded corporation, a 1% shareholder of a private corporation, or a security holder with more than $1,000,000 in securities. Reg. §1.368-3(c)(1).
[1304] Reg. §1.368-3(b).

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that stock or securities, determined immediately before the transfer and aggregated as follows:[1305]

○ Stock and securities with respect to which a §362(e)(2)(C) election is made;[1306]

○ Stock and securities with respect to which a §362(e)(2)(C) election is not made.[1307]

If any significant holder is a CFC under §957, each U.S. shareholder[1308] of the CFC must include the statement in its return.[1309]

If the tax-free exchanges pursuant to the reorganization cover more than one taxable year, the information should be given with the returns for all such years.

D. Liquidations Accompanying Reorganizations

Section 6043(a) requires a corporation to file a return on Form 966 with respect to a liquidation, whether or not any part of the gain or loss realized by the shareholders upon the liquidation is recognized.[1310] A liquidation often accompanies a reorganization exchange; in fact, following the Tax Reform Act of 1984, a liquidation of Target is a necessary component of a "C" Reorganization.[1311]

Form 966 must be filed within 30 days after the corporation adopts "any resolution or plan for or in respect of the dissolution of a corporation or the liquidation of the whole or any part of its capital stock."[1312] The corporation must file Form 966 with the IRS office in which the corporation files its tax return, showing the following data:

(1) name and address of the corporation;

(2) place and date of its incorporation;

(3) date the plan of liquidation was adopted;

(4) place last corporate tax return was filed, and year it covered; and

(5) an attachment containing a certified copy of the plan of liquidation.[1313]

However, a Form 966 is not required for a deemed liquidation resulting from a "check-the-box" election made on Form 8832.[1314]

[1305] Reg. §1.368-3(b)(3).
[1306] Reg. §1.368-3(b)(3)(i).
[1307] Reg. §1.368-3(b)(3)(ii). *See* note above regarding ability to estimate such fair market value and tax basis information.
[1308] As defined in §951(b).
[1309] Reg. §1.368-3(b).
[1310] *See* Reg. §1.6043-1(a).
[1311] §368(a)(2)(G).
[1312] Reg. §1.6043-1(a).
[1313] Reg. §1.6043-1(b)(1). If the plan is amended, a new Form 966 must be filed showing the dates of any amendments to the plan of liquidation.
[1314] *See* the instructions to Form 966.

E. Changes in Control

Section 6043(c) calls for regulations to implement reporting requirements for transactions involving a change in control or in the capital structure of a corporation. The apparent purpose of the reporting rules is to better enable the IRS to audit issues associated with leveraged buyouts and recapitalizations. The statute depends on legislative regulations from Treasury.

Regulations under §6043(c) require information reporting in the event of an acquisition of control or a substantial change in the capital structure of a U.S. corporation, but limit such reporting to transactions in which the reporting corporation or any shareholder was required to recognize gain as a result of the application of §367(a).[1315] The preamble to the 2005 final regulations indicates that the IRS and Treasury continue to consider the extension of the reporting requirements to transactions to which §367(a) does not apply.[1316]

Section 6043A provides for information reporting by an acquiring corporation in any taxable acquisition according to the forms or regulations prescribed by Treasury.[1317]

In Notice 2005-7, the IRS noted that §6043A supplements the information reporting provisions of §6043(c) and §6045 (relating to brokers) and solicited comments regarding the proper coordination of potential information reporting under §6043(c) and §6043A. The preamble to the 2005 regulations[1318] noted that the IRS continues to consider the proper implementation of additional information reporting provided in §6043A and the coordination of reporting requirements under §6043A, §6043(c), and §6045, to transactions not covered by the regulations.

In summary, any information reporting provisions under §6043(c) apply to outbound transactions in which the reporting corporation or any shareholder is required to recognize gain under §367(a). In addition, no regulations have been issued under §6043A. Based on the narrow application of the existing reporting requirements under §6043(c) (i.e., limited to outbound transfers under §367(a)), a further discussion of the specific reporting requirements is not provided in this Portfolio. For a further discussion of the specific reporting requirements, see 6100 T.M., *U.S.-to-Foreign Transfers Under Section 367(a)* (Foreign Income Series).

[1315] Reg. §1.6043-4(c)(1)(v), §1.6043-4(d)(2)(ii).
[1316] Preamble to T.D. 9230, 70 Fed. Reg. 72,376 (Dec. 5, 2005).
[1317] In addition, to the extent provided by Treasury, the reporting requirements provided in §6043A may apply to the acquired corporation and not the acquiring corporation.
[1318] T.D. 9230, 70 Fed. Reg. 72,376 (Dec. 5, 2005).

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X. Tax Treatment of Reorganization Expenses

A. Background

The decision in *INDOPCO, Inc. v. Commissioner*[1319] confirmed the holdings of a line of cases that many expenditures incurred in the course of a negotiated, uncontested acquisition were nondeductible and must be capitalized. For example, expenses incurred by Target in evaluating Acquiror's offer and in negotiating the transaction were ruled to be capital,[1320] and expenses paid by Acquiror in evaluating Target and negotiating the transactions were capital but generally had to be added to the basis of the Target stock or assets acquired in the transaction.[1321]

The *INDOPCO* decision does not stand for the proposition that all expenses incurred in a negotiated acquisition are nondeductible. Expenses incurred in evaluating abandoned transactions could qualify for a current deduction.[1322] Expenses incurred in resisting an unwanted Acquiror also could be deductible, even if a transaction with the unwanted Acquiror ultimately was consummated.[1323]

In January 2004, in order to clarify what were regarded as uncertain issues, Treasury and IRS issued regulations on the tax treatment of transaction costs and other expenditures incurred in stock and asset acquisitions, often referred to as the INDOPCO regulations.[1324] The following is a general overview of the INDOPCO regulations.

B. Reg. §1.263(a)-4 — Amounts Paid to Acquire or Create Intangibles

Reg. §1.263(a)-4 provides that a taxpayer must capitalize amounts paid (i) to acquire an intangible,[1325] (ii) to create an intangible,[1326] (iii) to create or enhance a "separate and distinct intangible asset,"[1327] (iv) to create or enhance a future benefit identified in published guidance as an intangible for which capitalization is required,[1328] and (v) to facilitate an acquisition or creation of an intangible.[1329]

The regulations clarify that an amount "facilitates" the acquisition if it is paid in the process of "investigating or otherwise pursuing the transaction."[1330] The regulations also clarify that an amount paid to determine the value or price of an intangible is an amount paid in the process of investing or otherwise pursuing the transaction. The fact that an amount would (or would not) have been paid "but for" the transaction is relevant but not determinative in evaluating whether an amount is paid to facilitate the transaction.[1331]

To the extent the taxpayer is not related to the entity immediately after the transaction, the treatment of costs incurred to acquire or create an ownership interest in that entity is governed by Reg. §1.263(a)-4.[1332] In other words, if a taxpayer acquires or creates an ownership interest in a corporation, partnership, trust, estate, limited liability company, or other entity and, immediately after the transaction, the taxpayer and that entity are not related within the meaning of §267(b) or §707(b), the ownership interest is considered an "intangible" and is subject to the rules in Reg. §1.263(a)-4(e)(1)(i).

C. Reg. §1.263(a)-5 — Amounts Paid or Incurred to Facilitate an Acquisition of a Trade or Business, a Change in Capital Structure, and Certain Other Transactions

Reg. §1.263(a)-5 applies to amounts paid to facilitate the acquisition of a trade or business regardless of whether the transaction is structured as a stock acquisition or an asset acquisition. In general, a taxpayer must capitalize an "amount paid"[1333] to facilitate each of the following transactions, without regard to whether the transaction is comprised of a single step or a series of steps carried out pursuant to an overall plan:

(1) an acquisition of assets constituting a trade or business;

(2) an acquisition of an ownership interest in an entity conducting a trade or business, but only if, immediately after the transaction, the taxpayer and the entity are related within the meaning of §267(b) or §707(b);[1334]

(3) an acquisition of an ownership interest in the taxpayer (other than an acquisition by the taxpayer of an ownership interest in itself by redemption or otherwise);

(4) a restructuring recapitalization, or reorganization of the capital structure of a business entity (including reorganizations described in §368 and distributions of stock by the taxpayer described in §355);

(5) a transfer described in §351 or §721;

(6) a formation or organization of a disregarded entity;

(7) an acquisition of capital;

(8) a stock issuance;

[1319] 503 U.S. 79 (1992).

[1320] *See, e.g.*, Rev. Rul. 73-580 (compensation paid to Acquiror employees in connection with reorganization must be capitalized).

[1321] *See McCrory Corp. v. United States*, 651 F.2d 828 (2d Cir. 1981); *Nat'l Starch & Chem. Corp.*, T.C. Memo 1986-512.

[1322] *See, e.g., Sibley, Lindsay & Curr Co. v. Commissioner*, 15 T.C. 106 (1950).

[1323] *See United States v. Federated Dep't Stores Inc. (In re Federated Dep't Stores Inc.)*, 171 B.R. 603 (S.D. Ohio 1994) (break-up fees paid to white knight in failed merger defense to hostile takeover were held currently deductible under §162 or §165). *Cf. Welch v. Helvering*, 290 U.S. 111 (1933) (legal fees to defend corporation against lawsuit were ordinary and necessary business expenses).

[1324] *See* Reg. §1.263(a)-4. For a comprehensive discussion of these regulations, *see* 523 T.M., *Deductibility of Legal and Other Professional Fees.*

[1325] Reg. §1.263(a)-4(b)(1)(i).

[1326] Reg. §1.263(a)-4(b)(1)(ii).

[1327] Reg. §1.263(a)-4(b)(1)(iii). A "separate and distinct intangible asset" is a property interest of ascertainable and measurable value that is subject to protection under applicable statute, federal, or foreign law and the possession and control of which is intrinsically capable of being sold, transferred, or pledged separate and apart from a trade or business. Reg. §1.263(a)-4(b)(3)(i).

[1328] Reg. §1.263(a)-4(b)(1)(iv).

[1329] Reg. §1.263(a)-4(b)(1)(v).

[1330] Reg. §1.263(a)-4(e)(1)(i).

[1331] Reg. §1.263(a)-4(e)(1)(i).

[1332] Reg. §1.263(a)-4(c)(1)(i), §1.263(a)-4(d)(2)(i)(A).

[1333] The term "amount paid" means, in the case of an accrual method taxpayer, a liability incurred within the meaning of Reg. §1.446-1(c)(1)(ii). Reg. §1.263(a)-5(h).

[1334] Note that if, immediately after the transaction, the taxpayer and entity are not related, the ownership interest is treated as an "intangible" to which Reg. §1.263(a)-4(a) applies. Reg. §1.263(a)-4(c)(1)(i), §1.263(a)-4(d)(2)(i)(A).

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(9) a borrowing (including an issuance of debt in an acquisition of capital or in a recapitalization); and

(10) the writing of an option.[1335]

An amount is paid to facilitate a transaction if, based upon all the facts and circumstances, it is paid in the process of investigating or otherwise pursuing the transaction.[1336]

Practice Point: The fact that an amount would (or would not) have been paid but for the transaction is relevant but not determinative. For example, an amount paid to determine the value or price of the transaction is an amount paid in the process of investing or otherwise pursuing the transaction, whereas the purchase price paid for Target stock or assets is not an amount paid to facilitate the transaction.[1337]

The regulations provide special rules with respect to bankruptcy reorganization costs. Costs incurred to institute or administer Chapter 11 proceedings generally must be capitalized, but costs incurred to operate the debtor's business during the Chapter 11 proceeding are treated in the same manner as they would have been treated absent the bankruptcy proceeding.[1338]

The regulations also provide special rules for certain types of acquisitive transactions called "covered transactions," to aid in the determination of whether amounts paid in these transactions are facilitative. "Covered transactions" include taxable acquisitions of assets that constitute a trade or business, taxable acquisitions of ownership interests in entities where the Acquiror and Target are related immediately after the acquisition, and "A," "B," "C" and nondivisive "D" Reorganizations.[1339] Amounts paid in the process of investigating or otherwise pursuing a covered transaction are treated as facilitative (and therefore subject to capitalization) if the costs are "inherently facilitative" or were incurred after certain bright-line dates.[1340]

Costs that are "inherently facilitative" are required to be capitalized, whereas other costs, which may facilitate the transaction (but are not inherently facilitative), are required to be capitalized only if they are incurred on or after a certain date.[1341] Amounts are inherently facilitative if they are paid to: (1) secure an appraisal, formal written evaluation, or fairness opinion; (2) structure the transaction (including the negotiation of the structure and the obtaining of tax advice on the structure); (3) prepare and review the documents that effectuate the transaction; (4) obtain regulatory approval for the transaction; (5) obtain shareholder approval for the transaction; or (6) convey property between the parties.[1342] General due diligence costs are not considered inherently facilitative but, rather, are to be analyzed under the bright-line date rule.[1343]

The bright-line date rule states that costs that facilitate the transaction but are not inherently facilitative must be capitalized if they are incurred on or after the earlier of (i) the date on which a letter of intent, exclusivity agreement, or similar written communication is executed by Target and Acquiror or (ii) the date on which the material terms of the transaction are approved by the taxpayer's board of directors or appropriate governing officials.[1344] If board approval is not required, the bright-line date in (ii) is the date on which Acquiror and Target execute a binding written contract reflecting the terms of the transaction.[1345] The term "similar written communication" is not intended to include a confidentiality agreement.[1346] In addition, the board of directors' approval date is not the date on which the board authorizes a committee or management to explore the possibility of a transaction with another party, nor is it intended to be the date on which the board ratifies a shareholder vote in favor of the transaction.[1347]

After the *INDOPCO* decision, there was much discussion about whether costs incurred in defending against a hostile takeover should be treated differently from costs incurred in conjunction with a friendly acquisition.[1348] The IRS and Treasury ultimately determined that amounts paid to ward off a hostile takeover through another capital transaction such as a recapitalization or a merger with a white knight should and would be analyzed under the inherently facilitative and bright line date rules in the regulations. Similarly, other costs that Target incurs in defending against a hostile takeover through other means would not be subject to capitalization under the regulations either because the costs are not inherently facilitative (e.g., costs to seek an injunction) or relate to activities performed before the bright-line date. Accordingly, the regulations do not contain any special rules related to hostile acquisition attempts.[1349]

[1335] Reg. §1.263(a)-5(a).

[1336] Reg. §1.263(a)-5(b).

[1337] Reg. §1.263(a)-5(b)(1).

[1338] Reg. §1.267(a)-5(c)(4). The regulations also provide that a taxpayer is not required to capitalize amounts paid to defend against the commencement of an involuntary bankruptcy proceeding.

[1339] Reg. §1.267(a)-5(e)(3).

[1340] Reg. §1.263(a)-5(e)(1). *See also* PLR 200953014 (due diligence costs, relating to legal, financial, and accounting services provided to corporation in process of investigating merger, incurred before merger was approved and not inherently facilitative, may be deducted under §162). PLR 200953014 also provided that the taxpayer could deduct costs incurred in selling a subsidiary to private investors, potentially including the reimbursed costs of the investors. For further discussion, see Willens, *Deducting 'Going Private' Expenses*, 29 Tax Mgmt. Wkly. Rpt. No. 6, 184 (Feb. 8, 2010) (author noted that, in his experience, this ruling was first of its kind).

[1341] Reg. §1.263(a)-5(a), §1.263(a)-5(e)(2). *See also* FAA 20040302F (Acquiror must capitalize investigatory expenses, including professional fees paid for advice on transaction's structure and tactics, inherently facilitative to acquisition of Target; §195 does not apply to acquisition of ongoing business in same field).

[1342] Reg. §1.263(a)-5(e)(2).

[1343] *See* preamble to T.D. 9107, 69 Fed. Reg. 436 (Jan. 5, 2004). It appears that the IRS may interpret Reg. §1.263(a)-5(e) as allowing the corporations involved in a merger to allocate transaction costs between them. *See, e.g.*, PLR 200830009 (ruling that Target, which survived merger, could allocate transaction costs to either itself or Acquiror, depending on entity to which services were rendered or on behalf of which entity services were provided).

[1344] Reg. §1.263(a)-5(e)(1).

[1345] Reg. §1.263(a)-5(e)(1). *See also* CCA 201234026 (execution of merger agreement setting forth terms of covered transaction and approved by both parties' boards of directors on date of execution establishes the bright-line date for purposes of Reg. §1.263(a)-5(e); inclusion of a "go shop" provision does not change this bright-line date).

[1346] Reg. §1.263(a)-5(e)(1). *See also* preamble to T.D. 9107, 69 Fed. Reg. 436 (Jan. 5, 2004).

[1347] *See* preamble to T.D. 9107, 69 Fed. Reg. 436 (Jan. 5, 2004).

[1348] The 2002 proposed regulations drew such a distinction and would not have required a taxpayer to capitalize transaction costs incurred in defending against a hostile takeover; however, if the acquisition became friendly, the proposed regulations would have required the taxpayer to bifurcate its costs and capitalize those costs incurred in facilitating the friendly acquisition. *See* Prop. Reg. §1.263(a)-4(e)(4)(iii).

[1349] *See* preamble to T.D. 9107, 69 Fed. Reg. 435 (Jan. 5, 2004). *See also* Reg. §1.263(a)-5(l) *Exs.* 11 (hostile takeover), 12 (white knight).

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Under the regulations, the costs of arranging for the borrowing of money facilitate the borrowing itself and do not facilitate another transaction that would require such costs to be capitalized under §263.[1350] Note that §162(k) disallows any deduction for any amount paid or incurred (other than interest expense on associated debt or amounts properly allocable to indebtedness and amortized over the term of such indebtedness) in connection with a corporation's reacquisition of its own stock. Section 162(k) applies to any reacquisition (i.e., any transaction that is in effect an acquisition of previously outstanding stock) regardless of whether the transaction is treated as a redemption, a sale of the stock, a dividend, a reorganization or any other transaction. The Ninth Circuit in *United States v. Kroy (Europe) Ltd. (In re Kroy (Europe) Ltd.)*,[1351] interpreted §162(k) narrowly. In *Kroy*, the IRS disallowed a §162(a) deduction for costs incurred by a corporation (T) to borrow funds that were used to finance a redemption. The costs were composed of fees paid to lenders, investment bankers, and attorneys for services rendered to T. The court determined that for tax purposes there were two separate and independent transactions involved, namely, a borrowing transaction and a redemption transaction, and that §162(k) applied only to the redemption transaction (and not the loan fees). The Tax Court, in *Fort Howard Corp. & Subsidiaries v. Commissioner*,[1352] declined to follow *Kroy*. Due to certain amendments to §162(k),[1353] the Tax Court, in a supplemental opinion, held that the expense disallowance rule of §162(k) does not preclude the target corporation from taking deductions for the amount of costs it incurred that are properly allocable to indebtedness and amortized over the term of such indebtedness.[1354]

The regulations provide special rules for certain costs including costs incurred in connection with the disposition of unwanted assets before an acquisition and termination payments paid to facilitate mutually exclusive transactions.[1355] Amounts paid to facilitate the sale of unwanted assets in preparation for a merger with an acquiring corporation are not required to be capitalized as amounts paid to facilitate the merger.[1356] Furthermore, an amount paid to terminate an agreement to enter into a transaction does not constitute an amount paid to facilitate a second transaction unless the transactions are mutually exclusive.[1357]

A success-based fee paid upon the successful closing of a transaction is generally treated as an amount paid to facilitate the transaction and, thus, subject to capitalization.[1358] However, a portion of the fee may be deductible to the extent the taxpayer maintains sufficient documentation to establish that a portion of the fee is allocable to activities that do not facilitate the transaction.[1359] In Rev. Proc. 2011-29, the IRS provided a safe harbor under which, in lieu of maintaining the documentation that otherwise would be required, a taxpayer may elect to treat 70% of the success-based fee as an amount that does not facilitate the transaction and the remaining 30% portion of the fee must be capitalized as an amount that facilitates the transaction.[1360]

[1350] Reg. §1.263-5(c)(1).

[1351] 27 F.3d 367 (9th Cir. 1994), rev'g 92-2 USTC ¶50,611 (D. Ariz. 1992).

[1352] 103 T.C. 345 (1994).

[1353] *See* §162(k)(2)(A)(ii). For further discussion, see 770 T.M., *Structuring Corporate Acquisitions — Tax Aspects.*

[1354] *Fort Howard Corp. v. Commissioner*, 107 T.C. 187 (1996).

[1355] Reg. §1.263(a)-5(c)(2), §1.263(a)-5(c)(8).

[1356] Reg. §1.263(a)-5(c)(2).

[1357] Reg. §1.263(a)-5(c)(8). *See, e.g.*, TAM 200512021 (advising that termination fee paid by taxpayer to enable it to back out of merger agreement so that it could accept more advantageous merger offer was capital expenditure; advice related to transaction that occurred before December 31, 2003, so Reg. §1.263(a)-5 did not apply; IRS relied on *INDOPCO* in reasoning that termination fee was subject to capitalization because fee was directly related to taxpayer's ability to execute second merger agreement, which conferred significant future benefits upon taxpayer). Although Reg. §1.263(a)-5 did not apply to the transaction, it seems likely that the same result would have occurred had the regulations been applicable. *See* Reg. §1.263(a)-5(l) *Ex*. 13.

[1358] Reg. §1.263(a)-5(f). *See also* CCA 201234027 (nonrefundable milestone payments, creditable to a success-based fee are not, themselves, success-based fees and, therefore, do not qualify for the safe harbor under Rev. Proc. 2011-29).

[1359] Reg. §1.263(a)-5(f). *See also* TAM 201002036 (allocation spreadsheets developed by accounting firm are "other records" under Reg. §1.263(a)-5(f); thus, the examiner must consider spreadsheets in establishing portions of contingent fees as allocable between facilitative or non-facilitative costs); CCA 201008037 (agreeing with TAM 201002036). *But see* CCA 201830011 (letter from an investment banker estimating percentage of time spent on facilitative and non-facilitative activities which includes a caveat stating the letter should not be relied on as the investment banker does not keep time records is not sufficient documentation under Reg. §1.263(a)-5(f)). For further discussion of CCA 201830011, see Willens, *Documentation Doesn't Support Deduction of 'Success-Based' Fee*, 160 Daily Tax Rep. 19 (Aug. 17, 2018).

[1360] Rev. Proc. 2011-29 is effective for success-based fees paid or incurred in taxable years ending on or after April 8, 2011. To make the election, a taxpayer must attach a statement to its return for the taxable year in which the success-based fee is paid or incurred, stating that the taxpayer is electing the safe harbor, identifying the transaction, and stating the fee amounts that are deducted and capitalized. Rev. Proc. 2011-29; *see also* PLR 202335013 (granting extension of time under Reg. §301.9100-1 and §301.9100-3 to make late election where taxpayer's tax preparer was unaware of a contingent fee paid on behalf of taxpayer in relation to a taxable acquisition of taxpayer's stock; contingent fee paid from buyer's sales proceeds was part of the purchase price included in stock cost basis and was received by the selling shareholders, then contributed to taxpayer as a capital contribution), PLR 202224005 (granting extension of time to make late election where required statement was not included with taxpayer's timely filed return due to tax professionals' inadvertent oversight; return otherwise reported success-based fees in accordance with safe harbor and statement's omission was not discovered by IRS). *But see* PLR 202308010 (denying extension of time to make late election because contingent fee paid by subsidiary of target corporation to financial advisor was governed by Reg. §1.263(a)-1(e) rather than Reg. §1.263(a)-5, and was properly capitalized as a cost that reduced the sellers' amount realized on stock sale; subsidiary was ineligible to make the safe-harbor election as the "object" of the sale). For further discussion of Rev. Proc. 2011-29, see Jennifer Kennedy, David Crawford, & Sara Logan, *A Safe Harbor for Success-Based Fees: Is There a Light at the End of the Documentation Tunnel?* 132 DTR J-1 (July 11, 2011). *See also* LB&I-04-0413-002 (Apr. 29, 2013), which states that the IRS will not challenge taxpayer's Rev. Proc. 2011-29 safe harbor treatment of eligible milestone payments made during corporate transactions that incur success-based fees if certain conditions are met.

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Last, certain costs are deemed not to facilitate a transaction and, therefore, are excepted from the capitalization requirement. These amounts include "employee compensation," defined as compensation (including salary, bonuses, and commissions) paid to an employee of the taxpayer, as determined under §3401(c).[1361] Amounts treated as not facilitating a transaction also include overhead.[1362] De minimis transaction costs are also excepted from the capitalization requirement; de minimis costs are costs other than employee compensation and overhead that do not, in the aggregate, exceed $5,000.[1363] De minimis costs do not include commissions paid to facilitate a transaction.[1364]

[1361] Reg. §1.263(a)-5(d)(2).
[1362] Reg. §1.263(a)-5(d)(1).
[1363] Reg. §1.263(a)-5(d)(3)(i).
[1364] Reg. §1.263(a)-5(d)(3)(ii).

The regulations also provide that amounts paid to integrate the business operations of the taxpayer with the business operations of another do not facilitate the transaction.[1365] Such amounts should, therefore, be deductible.

The regulations provide that amounts that are required to be capitalized by Acquiror in a taxable acquisitive transaction are added to either the basis of the acquired assets in an asset transaction or the basis of the acquired stock in a stock transaction.[1366]

[1365] Reg. §1.263(a)-5(c)(6).
[1366] Reg. §1.263(a)-5(g)(2). Note that the IRS and Treasury reserved on the treatment of capitalized costs incurred in connection with a tax-free acquisitive transaction. Reg. §1.263(a)-5(g)(1).

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