NEW YORK STATE BAR ASSOCIATION
TAX SECTION

REPORT ON DISTRIBUTIONS FOLLOWING TAX-FREE REORGANIZATIONS

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DISTRIBUTIONS FOLLOWING TAX-FREE REORGANIZATIONS

I. Introduction

This report[1] of the New York State Bar Association Tax Section has been prepared in response to (i) Treasury's 2003-2004 Priority Guidance Plan listing a project dealing with "transfers of assets after putative reorganizations"[2] and (ii) an Internal Revenue Service ("IRS") request to hear outside views on asset distributions following reorganizations.[3] On March 2, 2004, the Department of the Treasury ("Treasury") and the IRS issued proposed regulations[4] (the "2004 Proposed Regulations") that provide guidance relating to the effect of certain asset and stock transfers on the qualification of certain transactions as tax-free reorganizations under section 368 of the Internal Revenue Code of 1986, as amended (the "Code").[5] Those regulations, amending the final regulations issued in 1998 (the "1998 Regulations"),[6] focus on the treatment of contributions of acquired assets or stock after tax-free reorganizations. The 1998 Regulations and guidance that preceded them reflect the IRS's and

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1 The principal author of this report was Gary Mandel, with substantial assistance from Noah Beck. Significant comments were received from William Cavanagh, Kathleen Ferrell, Karen Gilbreath, Seth Rosen, Michael Schler and Lewis Steinberg.

2 2003 TNT 143-7 (Jul. 24, 2003).

3 At an American Bar Association Section of Taxation meeting in Chicago in 2003, IRS Chief Counsel representatives discussed highlights of the 2003-2004 business plan. William D. Alexander, Associate Chief Counsel (Corporate), indicated that the IRS would like to hear outside views on the extent to which acquiring companies can distribute assets after reorganizations. 2003 TNT 179-6 (Sept. 13, 2003).

4 See REG-265579-02, 69 Fed. Reg. 9771 (March 2, 2004).

5 Unless otherwise specified, all section references are to the Code.

6 See T.D. 8760, 63 Fed. Reg. 4174 (Jan. 28, 1998).

Treasury's continued efforts to provide taxpayers with flexibility to transfer assets and stock following tax-free reorganizations.

Stock and asset transfers following reorganizations were severely limited as a result of two Supreme Court cases from the 1930s, Groman v. Commissioner and Helvering v. Bashford.[7] These cases came to stand for the principle that, in the absence of contrary authority, stock of a parent corporation does not provide the requisite continuity of interest for a tax-free reorganization unless the parent, and not its subsidiary, ultimately acquires the target's assets.[8] In addition, taxpayers had to contend with the well-established principle that for tax purposes, transactions are evaluated based on their substance rather than their form. While this concept would seem to have diminished relevance in an area driven by highly technical and formalistic requirements, courts did not hesitate to apply it, as embodied in the step transaction doctrine, to deny tax-free treatment to otherwise tax-free reorganizations. The specter of integrating post-reorganization transfers was particularly ominous given the stakes, i.e., shareholder-level and, in asset acquisitions, corporate-level taxation of transactions that were otherwise entirely tax-free. Over time, however, particularly in the area of asset and stock contributions following reorganizations, there have been significant legislative, regulatory and administrative developments, largely curtailing the effect of Groman-Bashford and the breadth of post-reorganization restructurings to which the step transaction doctrine would apply.

As part of its project to draft regulations that provide guidance relating to the effect of asset and stock transfers on the qualification of certain transactions as tax-free

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7 Groman v. Commissioner, 302 U.S. 82 (1937); Helvering v. Bashford, 302 U.S. 454 (1938).

8 These cases affected both direct acquisitions by a subsidiary in exchange for its parent stock, as well as acquisitions by a parent corporation followed by a contribution of the acquired assets to its subsidiary pursuant to the plan of reorganization.

reorganizations, we encourage Treasury and the IRS to draft regulations that provide guidance regarding asset and stock distributions or "push-ups" following tax-free reorganizations.[9] We believe that the rules and guidance in the drop-down area that have significantly expanded the flexibility afforded taxpayers to deploy acquired assets and stock in accordance with their business needs should be extended to permit push-ups of assets or stock following tax-free reorganizations.[10] We have limited our recommendations to permitting post-reorganization distributions up to the issuing corporation, but no further, because we believe such distributions are consistent with the general requirements for tax-free treatment, especially in light of the substantial flexibility that has been afforded asset and stock contributions following reorganizations.[11]

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9 Our recommendation is not intended to limit or change existing law regarding continuity of proprietary interest which does allow for certain distributions following reorganizations. See Rev. Rul. 62-138, 1962-2 C.B. 95 (permitting multiple spin-offs tax-free); Rev. Rul. 84-30, 1988-1 C.B. 187 (permitting stock of the acquiring corporation in a "C" reorganization to be distributed through the acquired corporation's 100 percent corporate shareholder to its 100 percent corporate shareholder); Rev. Rul. 95-69, 1995-2 C.B. 38 (permitting partnership's distribution of stock received in a reorganization to its partners in accordance with their interests in the partnership).

10 The paradigmatic transaction is a triangular asset or stock acquisition followed by a distribution of some of the assets or stock acquired or held by the target to the parent of the acquirer, which is also the issuer of stock in the reorganization. We believe that based on the rules that are currently in place, contributions to controlled subsidiaries following such distributions should likewise be permitted.

11 We note that our recommendations are narrowly focused in this respect, given that in stock acquisitions and triangular asset acquisitions, stock or assets of the target (or the surviving corporation) can be distributed at most once before they are held by the issuing corporation. In triangular "B" reorganizations, there is the potential for two asset distributions before the assets are held by the issuing corporation.

We are further limiting our recommendations to distributions of assets that do not constitute "substantially all"[12] of the assets acquired. We recognize that regulations blessing any distributions short of complete liquidations would permit maximum flexibility within the parameters of current published guidance.[13] However, we believe a *per se* rule allowing distributions of less than "substantially all" of the acquired assets provides adequate protections for taxpayers. Establishing the threshold at "substantially all" dovetails with formal distinctions inherent in section 368,[14] and is well within the bounds of published guidance and generally consistent with private guidance and Chief Counsel's views as expressed in the General Counsel Memoranda ("G.C.M.'s") discussed later in this report.

Allowing distributions within a chain of corporations up to the issuer is consistent with the notions of continuity of proprietary interest and continuity of business enterprise ("COBE"), and we believe extending the protection currently afforded drop-downs to push-ups is consistent with the policies underlying other requirements for tax-free reorganizations (such as the "substantially all" test of certain asset acquisitions and the "control immediately after" test for tax-free acquisitions of stock). We believe that the interplay between our recommendations and the rules currently permitting drop-downs should allow corporations to transfer assets and stock

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12 The IRS's present safe-harbor ruling position is that "substantially all" of a target's assets means 90% of the fair market value of its net assets and 70% of the fair market value of its gross assets. Rev. Proc. 77-37, 1977-2 C.B. 586.

13 Revenue Rulings 67-274 (stock for stock acquisition followed by liquidation of target is tested as a "C" reorganization) and 72-405 (forward triangular merger followed by liquidation of surviving entity is tested as a "C" reorganization) analyze an acquisition followed by a distribution of all of the acquired assets in complete liquidation as a direct asset acquisition by parent.

14 In other words, any transaction that was recast as a result of a distribution of assets would *ipso facto* satisfy the "substantially all" requirement of a direct "C" reorganization (although it might fail to qualify as a "C" for other reasons).

not only within a single chain of corporations, but across chains of corporations to sister corporations. Implementing our recommendations would provide taxpayers with the necessary flexibility to deploy assets within their corporate group in an efficient manner. Moreover, we believe that the existence of regulations in any form would promote certainty that is beneficial to both the Government (i.e., by avoiding situations wherein the Government would have to argue against inconsistent positions taken by parties to the reorganization) and taxpayers in an area in which clear guidance is virtually non-existent. Our specific recommendations are summarized below:

> (1) As a general matter we believe the qualification of a transaction as a tax-free reorganization should not be altered by distributions (or subsequent contributions) of stock or less than "substantially all" of the assets acquired. We believe the principles that allow for transfers of acquired assets or stock by way of contributions should similarly apply to distributions up a chain of corporations to the issuing corporation. This is consistent with the policy goals underlying tax-free reorganizations and with the trend of the IRS and Treasury to respect the form of transactions which constitute tax-free reorganizations when followed by contributions of stock or assets.
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> (2) In order to implement our recommendation above, we believe that Treasury regulation § 1.368-2(k) should be amended to allow for any post-reorganization distribution (and subsequent contributions) of the stock or less than "substantially all" of the assets acquired within the "qualified group" as defined in the COBE Regulations. This change would harmonize the COBE rules, which currently allow for distributions following reorganizations, with Treasury Regulations § 1.368-2(k), which currently only permits drop-downs following reorganizations.
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> (3) We considered the effect of our recommendations on Revenue Ruling 70-107 (ruling that split liability assumption in a triangular "C" reorganization runs afoul of the solely for voting stock requirement). We note that Chief Counsel has on more than one occasion called into question the continuing vitality of such ruling. While we would welcome a reconsideration of Revenue Ruling 70-107 from a policy perspective, we believe that implementing our general recommendations above would simply require limiting such ruling to its particular facts.

II. Background

As business transactions have evolved in both sophistication and complexity, so too have the tax-free reorganization rules. The objective behind these rules is to allow taxpayers to combine businesses under modified corporate form without requiring the corporations or their shareholders to recognize gain or loss.[15] The Code contains a set of formalistic rules set forth in seven defined categories (plus two subsidiary merger alternatives) allowing for such combinations. While each statutory provision reflects a substantive policy objective on the part of the drafters, adherence to form is paramount in tax-free reorganizations. If a transaction does not meet the explicit requirements of any particular reorganization provision, a taxpayer may not claim tax-free treatment based on adherence to the underlying policies represented by such provisions.

The approach taken by Congress has been to add categories of transactions to the statute, each with its own unique requirements, to ensure that the transaction represents a readjustment of a continuing interest in a reorganized business and not a sale. The Code sets forth the types of reorganizations in paragraphs under section 368(a)(1) and each type is known or referred to by its corresponding paragraph letter:

> (1) An "A" reorganization is viewed as the most flexible type of reorganization as the statute simply requires "a statutory merger or consolidation";
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> (2) A "B" reorganization is a stock acquisition, which can take the form of a two-company transaction wherein one company acquires the stock of another company, or a three-company transaction (triangular transaction) wherein a subsidiary acquires another company for stock of the subsidiary's parent corporation. "B" reorganizations are somewhat rigid as compared to the other reorganizations in that the only consideration

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[15] H.R. Rep. No. 83-1337, A134 (1954).

allowed is voting stock (no cash). In addition, "B" reorganizations require the acquiring company to acquire control[16] of the target corporation;

(3) A "C" reorganization is an asset acquisition. The statute provides that (i) the acquisition must be of "substantially all" of the assets of the target corporation, (ii) the target must liquidate, and (iii) up to 20% of the consideration can be other than voting stock. (For purposes of the 20% test if any part of the consideration is cash then target liabilities count as consideration other than voting stock.) The statute allows for two company and triangular "C" reorganizations;

(4) A "D" reorganization is an asset acquisition among related companies. The statute requires an acquisition of "substantially all" of the assets, followed by a liquidation of the target.[17] The statute does not provide for triangular "D" reorganizations.

(5) An "E" reorganization is described in the statute as a recapitalization. An "E" reorganization is essentially a transaction involving a change in the capital structure of a single corporation.

(6) An "F" reorganization is described in the statute as a change in identity, form, or place of organization of one corporation.

(7) A "G" reorganization involves a restructuring of a corporation under the jurisdiction of a court under Title 11 (i.e., bankruptcy).

(8) The statute also provides for forward (an "(a)(2)(D)" reorganization) and reverse (an "(a)(2)(E)" reorganization) subsidiary mergers. In a reverse triangular merger, only 20% of the consideration can be other than voting stock (and there is no need to include liability assumptions as is the case with "C" reorganizations). In a reverse subsidiary merger, the surviving entity must "hold" "substantially all" of the assets of both merged companies. In a forward subsidiary merger the surviving entity must acquire "substantially all" of the assets of the target corporation.

Technical compliance with the detailed rules of Section 368 can be a challenge in and of itself; however, satisfying the statutory requirements is merely the first step for a business

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16 Control is determined under section 368(c) and requires ownership of stock possessing at least 80 percent of the total combined voting power of all class of voting stock and the ownership of at least 80 percent of the total number of shares of each class of outstanding non-voting stock. Rev. Rul. 59-259, 1959-2 C.B. 115.

17 These requirements are not found explicitly in the statute authorizing the "D" reorganization, but are found in section 354(b)(1).

combination to qualify as a tax-free reorganization. Regulatory and judicial requirements including "continuity of interest," "continuity of business enterprise" and "business purpose" must also be satisfied before tax-free treatment is afforded a corporate reorganization. Furthermore, even if a transaction literally complies with these statutory and regulatory requirements, taxpayers must consider the impact of the step transaction doctrine on putative reorganizations which, when integrated with a later restructuring, may produce unfavorable results -- namely a taxable transaction.[18]

III. Developments in the Area of Asset and Stock Drop-Downs

In light of the Groman and Bashford decisions, as well as the ever-present step transaction doctrine, taxpayers had to face the possibility that asset and stock drop-downs following reorganizations would jeopardize the tax-free status of such transactions. In light of the practicalities and complexity of corporate restructurings, the lack of flexibility and substantial uncertainty in this area posed a major obstacle for taxpayers who sought to reorganize their businesses in a tax-efficient manner. However, since 1954, Congress, and subsequently Treasury and the IRS has provided much needed guidance in this area allowing taxpayers significant leeway to restructure their businesses following tax-free reorganizations. This Section III summarizes some of the major legal developments responsible for providing taxpayers with this additional flexibility.

A. Section 368(a)(2)(C)

In 1954, Congress enacted two related provisions which expanded the options available to taxpayers in structuring and transferring assets after certain asset acquisitions. One provision

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[18] Since the IRS no longer rules on these transactions (except to resolve certain "significant sub-issues"), in practice, virtually all putative reorganizations require (typically as a

was an amendment to section 368(a)(1)(C) that essentially added to section 368(a) a new type of reorganization, i.e., a triangular "C" reorganization.[19] The other provision was section 368(a)(2)(C), which was designed to protect certain transactions that would otherwise qualify for one of the statutorily-mandated reorganization provisions from being disqualified by virtue of certain asset or stock movements which followed such transactions.[20] Section 368(a)(2)(C) was an important step in removing a major impediment to allowing taxpayers to take advantage of the benefits that the tax-free reorganization provisions were designed to provide. Despite certain patent drawbacks,[21] the 1954 amendments to section 368(a)(1)(C) and 368(a)(2)(C) represented a

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closing condition to the transaction) that the parties receive opinions of counsel that the transaction qualify as a tax-free reorganization. See Rev. Proc. 2001-3, 2001-1 C.B. 111.

19 As currently enacted, a "C" reorganization consists of "the acquisition by one corporation, in exchange solely for all or a part of the its voting stock *(or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation)*, of "substantially all" of the properties of another corporation..." (emphasis added).

20 As currently enacted, section 368(a)(2)(C) states that "a transaction otherwise qualifying under paragraph (1)(A), (1)(B), or (1)(C) shall not be disqualified by reason of the fact that part or all of the assets or stock which were acquired in the transaction are transferred to a corporation controlled by the corporation acquiring such assets or stock. A similar rule shall apply to a transaction otherwise qualifying under paragraph (1)(G) where the requirements of subparagraphs (A) and (B) of section 354(b)(1) are met with respect to the acquisition of assets."

21 Even as currently drafted, the statute is limited in at least three important respects. First, section 368(a)(2)(C) pertains only to certain reorganizations, particularly, "A," "B," "C," and certain "G" reorganizations. Second, the statute only explicitly permits the drop-down of "acquired" stock or assets after an otherwise tax-free reorganization. Accordingly, stock transfers following asset acquisitions and asset transfers following stock acquisitions do not as a technical matter come under the protection of 368(a)(2)(C). Third, the statute by its terms permits only a single drop-down of acquired stock or assets after an otherwise tax-free reorganization; But see Rev. Rul. 64-73, 1964-1 C.B. 142 (permitting successive drop-downs under Section 368(a)(2)(C)); Rev. Rul. 68-261, 1968-1 C.B. 147 (permitting drop-down under section 368(a)(2)(C) into multiple wholly owned subsidiaries of the acquirer); Rev. Rul. 72-576, 1972-2 C.B. 217 (permitting drop-down of assets following a forward subsidiary merger); PLRs 9049006 (Aug. 30, 1990),

significant development toward increased flexibility in corporate restructuring and fit nicely together in granting tax-free treatment to transactions which were either in form or substance triangular asset acquisitions.[22]

B. The 1998 Regulations

On January 3, 1997, the IRS published a notice of proposed rulemaking relating to the implications of transfers of assets and stock after putative reorganizations on the COBE requirements as well as the nebulous Groman-Bashford doctrine of remote continuity of interest (the "COBE Regulations").[23] Treasury generally concluded that, consistent with prior public and private administrative guidance,[24] the corporation acquiring assets in a reorganization need not directly hold such assets or control the businesses associated with such assets. Furthermore, the Government's view in enacting the COBE Regulations was that the policy concerns raised by the transfer of assets or stock by an acquirer after a tax-free reorganization would be adequately addressed by regulations dealing with the concept of continuity of business enterprise and did not think that the regulations needed to separately address the remote continuity of interest doctrine.[25]

9117069 (Nov. 2, 1990), 9719036 (Feb. 7, 1997) (permitting drop-down of stock following a forward subsidiary merger).

22 In 1964, Congress further narrowed the application of the Groman-Bashford doctrine extending 368(a)(2)(C) to stock drop-downs following "B" reorganizations as well as adding parenthetical language to Section 368(a)(1)(B) to permit triangular "B" reorganizations. S. Rep. No. 830, 88th Cong., 2nd Sess. (1964).

23 See REG-252233-96, 62 Fed. Reg. 361 (Jan. 3, 1997).

24 See supra fn. 21.

25 "The IRS and Treasury Department believe the COBE requirements adequately address the issues raised in Groman and Bashford and their progeny. Thus, the final regulations do not separately articulate rules addressing remote continuity of interest." T.D. 8760.

Accordingly, as finalized on January 23, 1998, the COBE Regulations provide that the issuing corporation in a reorganization is deemed to hold all of the businesses and assets of all of the members of the "qualified group."[26] 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 section 368(c) in at least one other corporation, and stock meeting the requirements of section 368(c) in each of the corporations except the issuing corporation is owned directly by one of the other corporations."[27]

Furthermore, in certain cases the issuing corporation is treated as holding the assets and conducting the businesses of certain partnerships that have as a partner a member of the qualified group.[28]

The COBE Regulations only address the requirement of continuity of business enterprise and do not address any other issues concerning the qualification of a transaction as a reorganization. Treas. Reg. § 1.368-1(a) clearly states that other relevant provisions of law must still be considered, including the step transaction doctrine. However, Treas. Reg. § 1.368-2(k), an expansion of 368(a)(2)(C), effectively turns off the application of the step transaction doctrine

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26 Treas. Reg. § 1.368-1(d)(4)(ii).

27 We previously recommended in a report addressing the COBE Regulations proposed in 1997 that the "qualified group" definition be revised to conform generally to the parent-subsidiary controlled group definition of section 1504(a). We still believe that the current definition may cause anomalous results in a minority of situations involving complex ownership structures. However, we will not address that issue in this report. See New York State Bar Association, Tax Section, "Report of the New York State Bar Association (Tax Section) on the Proposed Regulations Addressing the Remote Continuity and Continuity of Business Enterprise Doctrines" (July 24, 1997).

28 See Treas. Reg. § 1.368-1(d)(4)(iii). Prior to the issuance of the 1998 Regulations, the IRS took the position in private guidance and Chief Counsel Memoranda that drop-downs of acquired assets into partnerships could adversely affect continuity of interest. G.C.M 35117 (Nov. 15, 1972); PLR 8302073 (Oct. 13, 1982); G.C.M. 39150 (analyzing PLR 8302073) (March 1, 1984)).

with respect to certain asset and stock drop-downs following otherwise tax-free reorganizations (the "-2(k) Regulations").

Treas. Reg. § 1.368-2(k)(1) states that a transaction otherwise qualifying as an "A," "B," "C," or "G" reorganization will "not be disqualified by reason of the fact that part or all of the acquired assets or stock acquired in the transaction are transferred or *successively transferred* to one or more corporations controlled in each transfer by the transferor corporation."[29] The 1998 Regulations also provide in Treas. Reg. § 1.368-2(k)(2) that a transaction qualifying as an "A" reorganization by virtue of section 368(a)(1)(E) (a reverse subsidiary merger) will not be disqualified by reason of the transfer of the stock of the surviving corporation, or the assets of the surviving or the merged corporation, to one or more corporations controlled in each case by the transferor corporation. The -2(k) Regulations interpret section 368(a)(2)(C) as permissive, rather than as the exclusive means for preserving tax-free reorganization status when assets or stock are transferred after an acquisition. These Regulations, as well as the COBE Regulations, reflect the general approach of the IRS and Treasury to expand upon the technically permissible asset and stock drop-downs following transactions that otherwise qualify as reorganizations.

C. Administrative Guidance Since the 1998 Regulations

Since the promulgation of the COBE and –2(k) Regulations, the IRS has continued its policy of expanding the breadth of permissible drop-downs following tax-free reorganizations. In Revenue Ruling 2001-24,[30] the IRS addressed the circumstances of a stock drop-down following a transaction that otherwise qualified as an "A" reorganization by virtue of section 368(a)(2)(D). The issue was that section 368(a)(2)(C) did not literally apply to such drop-downs

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29 Treas. Reg. § 1.368-2(k) (emphasis added).

30 2001-1 C.B. 1290.

because assets were acquired in the reorganization and, by its terms, section 368(a)(2)(C) applied only to drop-downs of assets and stock acquired in a tax-free reorganization. Reasoning that section 368(a)(2)(C) was permissive rather than exclusive, and based on the legislative history supporting analogous treatment of forward and reverse subsidiary mergers,[31] the IRS held that the post-merger transfer of the acquiring corporation's stock to another subsidiary controlled by the issuing corporation did not cause the acquisition to fail to qualify as a tax-free reorganization.

Similarly, in Revenue Ruling 2002-85,[32] the IRS ruled that an acquiring corporation's transfer of a target corporation's assets to a subsidiary controlled by the acquiring corporation did not prevent the acquisition from qualifying as tax-free under section 368(a)(1)(D). Consistent with its general approach of removing formalistic obstacles to post-reorganization asset and stock movements, the IRS stated that, just as 368(a)(2)(C) should be viewed as permissive, Treas. Reg. § 1.386-2(k) should likewise be viewed as "permissive and not exclusive or restrictive."

E. The 2004 Proposed Regulations

The continuing trend of Treasury and the IRS to accommodate where possible transactions that in substance constitute restructurings of continuing interests in a reorganized business as opposed to sales is further advanced by the 2004 Proposed Regulations. The Preamble to such regulations states that the IRS and Treasury believe that certain transfers of stock and assets to controlled corporations are consistent with tax-free reorganization treatment, even though in some cases the transfers involve a type of reorganization not described in section

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31 See S. Rep. No. 1533, 91st Cong., 2d Sess. 2 (1970) ("...there is no reason why a merger in one direction...should be taxable, when the merger in the other direction, under identical circumstances, is tax-free"); Treas. Reg. § 1.368-2(k)(2) permits drop-downs of stock or assets after reverse subsidiary mergers.

32 2002-2 C.B. 986.

368(a)(2)(C). Specifically, it states that in light of the fact that section 368(a)(2)(C) was intended to be permissive rather than exclusive, asset and stock transfers which are permitted under such rule should be permitted after "all types of reorganizations." Accordingly, the 2004 Proposed Regulations currently propose to amend the -2(k) Regulations to permit subsequent asset and stock drop-downs under any of the reorganization provisions found in section 368(a), and not just those currently enumerated under section 368(a)(2)(C) and the -2(k) Regulations.[33]

IV. Discussion of Asset and Stock Push-Ups Following Reorganizations

As described above, in both legislation and administrative and regulatory guidance, significant attention has been devoted to the treatment of asset and stock drop-downs following reorganizations. There has been far less focus, however, on the treatment of distributions or push-ups of assets and stock following reorganizations. Due to the scant and somewhat inconsistent nature of what limited guidance there is, little certainty exists with respect to such transactions. The following is a discussion of issues relevant to the treatment of push-ups on the qualification of transactions as tax-free reorganizations.

A. "Substantially All"

In order for transactions to qualify as "A" reorganizations by virtue of section 368(a)(2)(D) or 368(a)(2)(E), or "C" reorganizations, there is a requirement that the surviving or acquiring corporation, as the case may be, "acquire" or (in the case of section 368(a)(2)(E)) "hold" "substantially all" of the assets of the transferor corporation. The primary policy underlying the "substantially all" requirement is to ensure that asset reorganization provisions are

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[33] The New York State Bar Association Tax Section will be commenting on the Proposed Regulations in a future report.

used for acquisitive and not divisive transactions, the exclusive ambit of the divisive "D" reorganization.[34]

In Revenue Ruling 88-48, the IRS found that the "substantially all" test was met despite target's sale of 50% of its operating assets immediately prior to the acquisition. In reaching its conclusion, the IRS highlighted that, despite the fact that the acquirer would not retain "substantially all" of the target's "historic assets," the overall transaction was not divisive because the target transferred the proceeds of the initial sale along with its remaining operating assets to the acquirer.[35] In other words, the IRS's focus in determining whether a transaction was truly acquisitive, as opposed to divisive, was on the extent to which the target or target shareholders (or related parties) maintained an interest in the assets of the acquired corporation apart from their indirect interest in the continuing business in the form of the stock of the acquirer.

Revenue Ruling 2001-25 further indicates the IRS's lack of concern with the ultimate location of the relevant assets following the reorganization provided the transaction is not

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34 See S. Rep. No. 1622, 83d Cong., 2d Sess. 274 (1954); Rev. Rul. 88-48, 1988-1 C.B. 117 (permitting target to sell 50% of its operating assets prior to the acquisition provided the proceeds were not retained by target or target's shareholders, but rather transferred to acquirer); G.C.M. 36111 (Dec. 18, 1974); also see section 368(a)(2)(G) (requiring target to distribute the stock and securities received from the acquiring corporation, "as well as its other properties").

35 "In the present situation, 50 percent of the *X* assets acquired by *Y* consisted of cash from the sale of one of *X*'s significant historic businesses. Although *Y* acquired substantially all the assets *X* held at the time of transfer, the prior sale prevented *Y* from acquiring substantially all of *X*'s historic business assets. The transaction here at issue, however, was not divisive. The sale proceeds were not retained by the transferor corporation or its shareholders, but were transferred to the acquiring corporation. Moreover, the prior sale of the historic business assets was to unrelated purchasers, and the *X* shareholders retained no interest, direct or indirect, in these assets. Under these circumstances, the 'substantially all' requirement of section 368(a)(1)(C) was met because all of the assets of *X* were transferred to *Y*." Rev. Rul. 88-48.

divisive in nature. In Revenue Ruling 2001-25, the IRS ruled that the sale to an unrelated corporation by the surviving corporation of 50% of its operating assets following a tax-free reverse subsidiary merger would not cause the transaction to fail the "substantially all" test. In that ruling the IRS took the opportunity to lay to rest a patent ambiguity in section 368(a), namely section 368(a)(2)(E)'s requirement that the surviving corporation "hold", as opposed to "acquire" (the applicable test for "C" and "(a)(2)(D)" reorganizations), "substantially all" of the relevant assets.[36] The IRS ruled that there was no intended distinction between acquiring, for purposes of section 368(a)(1)(C) and (a)(2)(D), and holding, for purposes of section 368(a)(2)(E), and that section 368(a)(2)(E) imposed no requirement that the surviving corporation retain the assets for a certain period of time after the transaction.[37]

In the context of asset acquisitions followed by asset drop-downs, section 368(a)(2)(C) and the -2(k) Regulations make it clear that the drop-down or successive drop-downs do not affect the qualification of the reorganization, and, therefore by implication, satisfaction of the "substantially all" requirement.[38] Neither the statute nor the regulation addresses reorganizations followed by asset distributions. However, in light of the permissive nature of such provisions and the policy underlying the "substantially all" test, we believe asset

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36 See FSA 199945006 (Jul. 23, 1999); PLRs 9238009 (Mar. 13, 1992), 9025080 (Mar. 28, 1990); G.C.M. 35267 at fn. 3 (March 14, 1973).

37 The IRS pointed out that the difference merely stemmed from the fact that in a reverse subsidiary merger the surviving corporation (i.e., target) already owns the assets, whereas in a forward subsidiary merger (as well as a straight asset purchase) the assets are acquired.

38 As discussed above in Section III of this report, this protection was expanded through two revenue rulings to reorganizations not specifically mentioned in section 368(a)(2)(C) or the -2(k) Regulations. See Rev. Rul. 2001-24; Rev. Rul. 2002-85.

distributions up to the issuing corporation should present no obstacle to compliance with such requirement.[39]

We recognize that in the distribution context, unlike that of the above-cited revenue rulings (as well as the drop-down cases), there is no "replacement property" for the acquiring (or surviving) corporation to hold. We believe however, that such distinction is purely a matter of form in the context of a distribution within the corporate group. Chief Counsel came to the same conclusion in G.C.M 36111 (December 18, 1974), which is discussed further below. In analyzing a triangular asset acquisition followed by a distribution of assets to the parent, Chief Counsel stated that the "substantially all" requirement of the Code,

> "at least where the assets are retained by the acquiring corporation, its controlled corporation, *or a corporation controlling it*, refers only to the respective value of the assets transferred by T pursuant to the plan of reorganization and those disposed of by it prior to but as a part of the reorganization."[40]

We agree with Chief Counsel in that G.C.M that in a triangular asset acquisition, it should not matter for purposes of the "substantially all" test whether the acquirer or its parent (or a controlled subsidiary of the parent) ultimately holds the assets of the acquired business, assuming

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[39] Public and private guidance indicates, subject to the possible application of the step transaction doctrine to completely recast the transaction (as discussed further below), that an asset acquisition followed by a distribution within a control group may not run afoul of the "substantially all" requirement. See PLR 9319017 (Feb. 5, 1993) (allowing acquirer to distribute assets in an intra-group merger, but does not state what percentage of the total assets those transferred assets comprised); PLR 8018030 (Mar. 5, 1980) (allowing up to 25 percent of acquired target's assets to be distributed to and sold by parent, but requiring representation that, at time of merger, there was no contract or understanding concerning sale or other disposition of those assets); PLR 7943047 (Jul. 25, 1979) (permitting post-reorganization distribution of 45 percent of target's assets, but indicating that distributed assets were not operating assets); G.C.M. 36111 (Dec. 18, 1974); G.C.M. 39102 (Dec. 21, 1983) (permitting post-reorganization distribution of substantial assets to controlling corporation).

[40] G.C.M. 36111 (emphasis added).

that the basic requisites of a reorganization are satisfied, such as business purpose, continuity of business enterprise, and continuity of interest.[41]

B. Recharacterizing Transactions under the Step Transaction Doctrine

The step transaction doctrine functions to recast a series of transactions consisting of formally separate steps into a single transaction if, in substance, the steps are "integrated, interdependent, and focused toward a particular result."[42] Treas. Reg. § 1.368-1(a) explicitly states that step transaction doctrine must be considered in determining whether a transaction qualifies as a tax-free reorganization. The effect of section 368(a)(2)(C) and Treas. Reg. § 1.368-2(k) is to prevent the application of the step transaction doctrine to putative reorganizations followed by asset or stock drop-downs. Though the IRS has treated the -2(k) Regulations as permissive rather than exclusive, respecting the independent steps of multi-step transactions not covered explicitly by such regulations,[43] there can be no assurance that the IRS will not apply step transaction principles in the case of post-acquisition push-ups of assets or stock. This lack of certainty adds a layer of complexity to a statutory framework with which compliance is already a challenge for taxpayers.

The application of step transaction principles in the context of post-reorganization transactions is illustrated in the oft-cited Revenue Ruling 67-274.[44] Revenue Ruling 67-274 ruled that a transaction that would otherwise have qualified as a good "B" reorganization, when immediately followed by a liquidation of the acquired corporation, is tested as a "C"

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41 Id. We further note that compliance with the "substantially all" test should not be affected by whether the distribution of the assets is taxable or tax-free.

42 Penrod v. Commissioner, 88 T.C. 1415, 1428 (1987); Rev. Rul 79-259, 1979-2 C.B. 156.

43 See Rev. Rul. 2001-24; Rev. Rul. 2002-85.

44 1967-2 C.B. 141.

reorganization.[45] As discussed further below, Revenue Ruling 67-274 is a stark case in that it involved a complete liquidation in which all of the assets of the target were distributed to the acquiring corporation. In contrast, Revenue Ruling 74-35 addresses a "B" reorganization followed by a distribution to the acquiring corporation of 30% of the assets of the target.[46] In that case, the IRS ruled that the distribution did not warrant recasting a portion of the transaction as an acquisition by the acquirer.

Based on the limited guidance that exists and in light of the IRS's tendency to respect the form of tax-free reorganizations even when followed by subsequent asset and stock movements, distributions following reorganizations should generally not result in the denial of tax-free treatment. Unfortunately, however, there is little published guidance dealing with non-liquidating distributions following tax-free reorganizations. Moreover, three conflicting G.C.M.'s[47] issued over a 9-year period, the last in 1983, highlight the lack of clarity regarding how such distributions should be analyzed.

G.C.M 36111 (December 18, 1974), analyzed a private ruling that took the position that a transaction otherwise qualifying as a tax-free forward subsidiary merger would not be recast as a result of a subsequent transfer of 85% of the acquired assets to the issuing corporation (the parent of the acquiring corporation). Chief counsel expressed some doubt as to whether this type of

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45 Also see Rev. Rul. 72-405, 1972-2 C.B. 217 (reaching the same result in the context of a forward subsidiary merger followed by a liquidation).

46 1974-1 C.B. 85.

47 G.C.M.'s are formal written legal opinions prepared by Office of Chief Counsel on substantive and procedural tax issues containing an analysis and conclusion on the particular issues and facts addressed. Although Chief Counsel personnel subsequently use G.C.M.'s as an important research source, they are not to be regarded as a statement of policy or as the position of the service. Generally G.C.M.'s are, however, permissible authority for establishing substantial authority for tax return reporting purposes. See Treas. Reg. § 1.6662-1(d)(3)(iii).

transaction should qualify under section 368(a)(2)(D) in light of the subsequent transfer, but after weighing the competing concerns concluded, on balance, that it was not appropriate to recharacterize the initial reorganization pursuant to step transaction principles. Despite his apprehension, Chief Counsel found merit in the proposition that in order to achieve "analytical symmetry" with section 368(a)(2)(C), and short of a liquidation, the subsidiary should be respected as the acquirer, and the transaction should not be recast as an acquisition by parent followed by a drop-down to its subsidiary.

Five years later, Chief Counsel revisited the issue in G.C.M. 37905 (March 29, 1979), which considered a proposed revenue ruling relating to an acquisition designed to qualify as a triangular "C" reorganization. In that case, subsequent to the initial acquisition, the acquiring subsidiary transferred approximately 90% of the net assets acquired to its parent. Under those facts, Chief Counsel expressed similar step transaction concerns and this time was not swayed by the analogy to section 368(a)(2)(C) and the strict adherence to form advocated in G.C.M. 36111. Instead, the G.C.M. concluded that, absent specific statutory authority to the contrary such as section 368(a)(2)(C) in the context of asset drop-downs, substance over form is always an important factor to be considered. Implicitly taking the view that section 368(a)(2)(C) was not permissive, but rather the exclusive means to avoid recast, Chief Counsel determined that the transaction was more appropriately characterized as an acquisition by the parent of the portion of the assets that were distributed and an acquisition of the remaining assets by the subsidiary in exchange for an assumption of target's liabilities.[48] Adding a layer of ambiguity to his advice, Chief Counsel vaguely concluded that

"[a]lthough the 90 percent "push-up" may or may not constitute "substantially all" of the acquired assets within the meaning of Rev. Proc. 77-37, 1977-2 C.B. 568, depending upon

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[48] The G.C.M. does not mention Revenue Ruling 74-35.

whether the "pushed-up" assets also represent 70 percent of the gross assets of P, we believe the magnitude of this transfer in combination with the provision by X of the entire stock consideration is sufficient to justify treatment of X as the substantive "acquiring" corporation for purposes of section 368(a)(1)(C)."

The result of such recharacterization was that the transaction failed to qualify as a tax-free reorganization due to the requirement of section 368(a)(1)(C), as interpreted by Revenue Ruling 70-107, that "substantially all" of the assets be acquired "solely for voting stock."

Revenue Ruling 70-107 stands for the proposition that based on the literal language of section 368(a)(1)(C), which states in part that in determining whether the exchange is solely for voting stock the assumption *by the acquiring corporation* of a liability of the other shall be disregarded, liabilities assumed by a party other than the acquirer (e.g., under the facts of the Ruling, the parent in a triangular "C" reorganization) will be considered boot.[49] As discussed further below, since G.C.M. 39102, Chief Counsel has questioned the validity of Revenue Ruling 70-107 on more than one occasion.[50] Still, despite the ruling's questionable policy underpinnings, Chief Counsel's decision to recast the transaction in G.C.M. 37905 appears to

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[49] 1970-1 C.B. 78 (emphasis added); because the subsidiary was no longer treated as the acquirer, it was ineligible for the exception to the "solely for voting stock" rule for liabilities assumed by the acquirer.

[50] G.C.M. 39102 points out that Revenue Ruling 70-107's continued vitality is blatantly inconsistent with the legislature's policy objectives in enacting 368(a)(1)(C) as part of a broader legislative package to change the results of the Supreme Court's decision in United States. v. Hendler, 303 U.S. 564 (1938). In Hendler, the Supreme Court ruled that the assumption of liabilities by the acquiring corporation in a tax-free asset acquisition was tantamount to the payment of cash, and thus would violate the "solely for stock or securities" requirement in the predecessor statute to section 368. In Chief Counsel's opinion, the formalistic conclusion reached in Revenue Ruling 70-107 was a vestige of the fact that when section 368(a)(1)(C) was enacted, there were only two-party reorganizations available under section 368. Chief Counsel opined that when Congress introduced three-party "C" reorganizations in 1954 by adding the parenthetical phrase in section 368(a)(1)(C) and by permitting drop-downs under section 368(a)(2)(C), its failure to make the corresponding change to the assumption of liabilities clause in 368(a)(1)(C) was merely an oversight; Also see G.C.M. 34483 (April, 21 1971).

have been largely motivated by its desire to reconcile what seemed like an easy way to sidestep this technical rule.[51]

Four years later Chief Counsel wrestled with the issue again, this time in G.C.M 39102 (December 21, 1983). G.C.M. 39102, in analyzing a proposed revenue ruling, partially confirmed and partially disavowed the overall conclusion reached in G.C.M. 37905. The distribution at issue in G.C.M. 39102 was of a similar magnitude to that of G.C.M. 37905, only G.C.M. 39102 stipulated that "substantially all" of the assets acquired were distributed following the acquisition. However, possibly because the discussion of step transaction principles was more of a prelude to Chief Counsel's main focus in G.C.M. 39102, i.e., the eschewal of Revenue Ruling 70-107,[52] Chief Counsel did not suggest that a distribution of "substantially all" of the

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51 "Furthermore, were we to characterize the subsidiary, X-1, rather than the parent, X, as the 'acquiring' corporation, we would be sanctioning the indirect achievement of that which may not be achieved directly under section 368(a)(1)(C). In determining whether the 'solely for voting stock' requirement of section 368(a)(1)(C) is satisfied, an assumption of the acquired corporation's liabilities by the 'acquiring' corporation is permitted. An assumption of such liabilities by other than the 'acquiring' corporation, however, is prohibited; the result of such an assumption being violation of the 'solely for' requisite and consequent failure of qualification under section 368(a)(1)(C). See Rev. Rul. 70-107, 1970-1 C.B. 78. Thus, the formalistic treatment of X-1 as the 'acquiring' corporation would, in effect, allow contravention of this prohibition by permitting X (the substantive 'acquiring' corporation) to obtain a substantial portion of the acquired corporation's assets as part of the overall plan while X-1 (the substantive non-'acquiring' corporation) assumes all of its liabilities." G.C.M. 37905.

52 In addition to finding that Revenue Ruling 70-107 was inconsistent with legislative intent and undesirable from a policy perspective, G.C.M. 39102 further pointed out that the ruling created an artificial distinction between triangular "C" reorganizations and forward triangular mergers, the latter of which permits split liability assumption. See Treas. Reg. § 1.368-2(b)(2); Rev. Rul. 73-257, 1973-1 C.B. 189 (permitting split liability assumption in a forward subsidiary merger); Treas. Reg. § 1.368-2(j)(4) (permitting split liability assumption in a reverse subsidiary merger).

Additionally, Chief Counsel noted that Revenue Ruling 70-107 was also inconsistent with Revenue Ruling 70-224 which ruled on virtually identical facts that the transaction qualified as a tax-free reorganization. In both rulings the assets of the acquired corporation moved directly to a controlled subsidiary without passing through the hands

acquired assets was a prerequisite to recasting the transaction as a direct asset acquisition.[53] G.C.M. 39102 focused mainly on Revenue Ruling 70-107 and ultimately concluded that such ruling should be revoked and that the transaction should qualify as a good "C" reorganization followed by a drop-down of assets covered by section 368(a)(2)(C).

Revenue Ruling 74-35[54] is the only published guidance that addresses the question of whether step transaction principles will be applied to a reorganization followed by a distribution of assets short of complete liquidation. As discussed above, that ruling analyzed a transaction structured as a "B" reorganization in which one corporation acquired the stock of another corporation solely in exchange for its voting stock, immediately after which the acquired corporation distributed 30% of its assets to the acquirer. Because the acquired corporation distributed only 30% of its properties after the acquisition, the IRS distinguished the transaction from those addressed in Revenue Rulings 67-274 and 72-405, in which acquisitions of stock or subsidiary asset acquisitions followed by liquidations were deemed asset acquisitions by the parent. In Revenue Ruling 74-35, the IRS considered, but ultimately chose not to apply, step transaction principles.

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of its parent. The only difference between the transaction involved in Revenue Ruling 70-224 and the situation presented in Revenue Ruling 70-107 was that the parent corporation was designated by the parties to the reorganization as the one acquiring the properties of the transferor and therefore had "dominion and control" of the acquired assets. Also see Rev. Rul. 64-73, 1964-1 C.B. 142 (holding that a transaction qualifies as a "C" reorganization where the acquiring corporation causes some of the assets of the acquired corporation to be transferred directly to its wholly owned subsidiary).

53 In citing positively to G.C.M. 37950, Chief Counsel in G.C.M. 39102 would seem to have supported recast in both prior G.C.M.'s without regard to whether "substantially all" of the assets were distributed.

54 1974-1 CB 85.

The limited guidance which exists with regard to post-reorganization push-ups indicates that taxpayers must at least consider the application of the step transaction doctrine when structuring a reorganization followed by a significant asset distribution. The only published guidance seems to indicate that the magnitude of a post-reorganization distribution in comparison to the total assets acquired may be relevant (clearly if the distribution is effected by way of a liquidation of the target). The G.C.M.'s, while flirting with a bright-line rule, fail to explicitly suggest a threshold as "safe" below which the status of a transaction as tax-free would be preserved. This uncertainty -- especially in light of the heightened stakes engendered by Revenue Ruling 70-107 -- is an unnecessary obstacle to post-reorganization restructurings. Short of complete liquidation, published and private guidance is consistent with permitting distributions within a chain of corporation up to the issuing corporation following a reorganization. Moreover, we see no policy reason, particularly in light of the continued efforts of the IRS and Treasury to expand upon similar options available to taxpayers in the drop-down context, to limit distributions of stock or less than "substantially all" of the assets acquired following reorganizations. Regulatory guidance establishing that form will be respected, i.e., step transaction doctrine will be turned off for tax-free reorganizations followed by intra-group distributions of stock or less than "substantially all" of the assets acquired (as it is currently for drop-downs), would add much needed certainty to this undeveloped area.

C. Control Immediately After

Section 368(a)(1)(B), one of the more stringent and formalistic reorganization provisions, grants tax-free treatment to certain acquisitions of stock. In order for an acquisition to qualify as a "B" reorganization, among other things, the acquirer must have "control" over the acquired

corporation immediately after the acquisition.[55] While the statutory language of section 368(a)(1)(B) requires such control to exist only "immediately after" the exchange, suggesting that post-acquisition transfers of the acquired stock should not affect this requirement, the IRS has in the past applied step transaction principles in the context of section 351 transactions, for which there is a similar requirement that the transferors have control of the transferee corporation "immediately after the exchange."[56]

A distribution of the acquired stock following a "B" reorganization implicates the control requirement in a triangular "B" reorganization, wherein a subsidiary of the issuing corporation acquires control of the target. In the case of contributions following "B" reorganizations, while direct control is lacking after subsequent drop-downs, section 368(a)(1)(C) and Treas. Reg. § 1.368-2(k) implicitly condone indirect control by automatically preserving otherwise tax-free reorganization status in the event of such contributions. However, because those provisions only explicitly address drop-downs, the IRS could apply step transactions principles to a distribution of target stock to the issuing corporation following a triangular "B" reorganization and accordingly conclude that the acquisition did not meet the control immediately after requirement.[57] On the other hand, as discussed throughout this report, those provisions, which do not apply in the context of section 351, have been interpreted as permissive and not as the exclusive means toward avoiding the application of step transaction principles. Furthermore, even in the context of 351 transactions, there have been developments in the context of stock

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55 See supra fn. 16 for the definition of control for these purposes.

56 See Rev. Rul. 79-194 (Situation 2), 1979-1 C.B. 145; Rev. Rul. 79-70, 1979-1 C.B. 144.

57 Stock held by the parent and subsidiary cannot be aggregated for purposes of satisfying the control test. Rev. Rul. 56-613, 1956-2 C.B. 212.

transfers to related parties in which tax-free treatment was preserved.[58] Nevertheless, while the IRS and Treasury have repeatedly avoided the application of step transaction in this area and related areas, as the law currently stands, it is possible for the IRS to integrate otherwise tax-free triangular "B" reorganizations with subsequent stock distributions to conclude that the control test has not been satisfied. We do not believe allowing distributions of stock raises any greater concern with respect to the control requirement of section 368(a)(1)(B) than is present in the companion case of drop-downs. Moreover, for the reasons stated above, we do not believe such characterization serves any policy objective and would be inconsistent with the Government's recent trend to allow for post-reorganization movement of assets and stock.

D. *Section 381*

Section 381(a)(2) provides the general rule that in non-divisive tax-free asset acquisitions, the acquiring corporation succeeds to the tax attributes of the acquired corporation. In defining the "acquiring corporation" for these purposes, Treas. Reg. § 1.381(a)-1(b)(2)(i) provides that generally the acquiring corporation is that corporation which ultimately acquires all of the assets transferred by the transferor corporation. That regulation goes on to provide that if

> "no one corporation ultimately acquires all of the assets transferred by the transferor corporation, that corporation which directly acquires the assets so transferred shall be the acquiring corporation for purposes of section 381 and the regulations thereunder, even though such corporation ultimately retains none of the assets so transferred."

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[58] See Section 351(c)(1) ("In determining control for purposes of this section, the fact that any corporate transferor distributes part or all of the stock in the corporation which it receives in the exchange to its shareholders shall not be taken into account"); Rev. Rul. 2003-51 (transfer of assets to a corporation in exchange for stock constituting control satisfies the control requirement despite later transfer of such stock to a second corporation simultaneously with the transfer of assets by a third party to the second corporation, when immediately thereafter, the transferor and the third party are in control of the second corporation); Rev. Rul. 84-111, 1984-2 C.B. 88 (permitting partnership to liquidate and transfer target stock to its partners after its transfer of assets to a controlled corporation in a tax-free section 351 transaction).

Based on this definition of the acquiring corporation, if a corporation acquires assets in a tax-free reorganization and subsequently drops such assets down in a manner that qualifies under the COBE and -2(k) Regulations, the initial acquirer will still retain the attributes of the target corporation unless all of the assets acquired are dropped into a single corporation. In other words, if the assets are either dropped into multiple corporations or the initial purchaser relinquishes not all of the assets, such purchaser shall retain the tax attributes of the target. Section 381 does not explicitly address distributions following reorganizations. We believe permitting asset distributions after tax-free reorganizations raises no additional policy issues, and in any case, any such policy concerns should be addressed as part of a separate project (along with any issues arising under section 381 resulting from drop-downs permitted by the 1998 Regulations[59]).

V. Recommendations

A. Issue Regulations Permitting Asset and Stock Push-Ups Following Reorganizations

We recommend that Treasury issue regulations that address the treatment of asset and stock distributions following tax-free reorganizations. We believe these regulations should promote flexibility that is generally consistent with the treatment in this area of asset and stock drop-downs. Redistribution of stock or less than "substantially all" of the assets acquired among members of the issuer controlled group does not implicate the underlying policy goals of section 368 and related provisions. Neither contributions nor distributions involve the transfer of

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[59] We addressed certain such issues in our report following the issuance of such regulations in proposed form. See New York State Bar Association, Tax Section, "Report of the

acquired stock or assets to a "stranger," a factor inconsistent with tax-free treatment.[60] We recognize that post-reorganization transfers of assets or stock to unrelated parties may in certain instances undermine the policies associated with tax-free reorganizations and further appreciate that to the extent such transfers occur after push-up transactions the same concerns would be implicated. Accordingly we have limited our recommendations to distributions of stock and less than "substantially all" of the acquired assets up the chain to, but no further than, the issuer (and more specifically within the "qualified group" as discussed further below).

As discussed above, providing flexibility to transfer assets and stock after tax-free reorganizations within the issuer corporate group is consistent with the principles underlying tax-free reorganizations, and the IRS's interpretation thereof. With regard to the "substantially all" requirement of certain asset reorganizations, the IRS has generally ruled that post-acquisition transfers do not adversely affect the tax-free status of an initial reorganization. That is consistent with the fact that the "substantially all" test was meant to ensure that certain reorganization provisions applied only to acquisitive, non-divisive acquisitions. The concept of a corporate "group" is a commercial reality and is reflected throughout the tax law. Accordingly, we believe regulations in this area should be tailored to explicitly permit intra-group distributions up to the issuer, which are not divisive in any real sense. Furthermore, we see no reason why the "substantially all" test or the control test in "B" reorganizations should ignore continued ownership by a distributee when the COBE Regulations fully acknowledge the continuing

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New York State Bar Association (Tax Section) on the Proposed Regulations Addressing the Remote Continuity and Continuity of Business Enterprise Doctrines" (July 24, 1997).

60 See H.R. Rep. No. 83-1337, A134 (1954); REG-165579-02 (March 1, 2004).

interest represented by a distribution up to the issuing corporation in a subsidiary acquisition.[61] Furthermore, the doctrine of "remote continuity of interest," to the extent it is still valid, is not implicated by asset or stock push-ups, as they actually have the effect of bringing target shareholders closer to the acquired assets or stock.

Providing more freedom in this area will benefit businesses by allowing the acquisition and redeployment of assets as required by natural business exigencies. Moreover, regulations in any form would be beneficial to the Government and taxpayers by avoiding inconsistent positions that could lead to whipsaw potential.[62]

B. Incorporate the Concept of the Qualified Group into the -2(k) Regulations

Consistent with the general trend toward increased flexibility in asset and stock drop-downs following tax-free reorganizations, we welcome the 2004 Proposed Regulations which would expand the -2(k) Regulations to cover all reorganizations and not just those specifically mentioned in Treas. Reg. § 1.368-2(k). Moreover, we recommend that the -2(k) Regulations be expanded to allow for distributions of stock or less than "substantially all" the assets following tax-free reorganizations. In order to accomplish this, we propose harmonizing the -2(k)

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61 The COBE Regulations define the "qualified group" as including the issuing corporation even in a case where assets are acquired by a subsidiary of such corporation. See Treas. Reg. § 1.368-1(d)(4)(ii). Compare Treas. Reg. § 1.368-2(k)(1).

62 We acknowledge that implementing our recommendation will have the effect of permitting push-ups in certain cases in which the "end result" could not otherwise have been achieved. We note however, that this is also true with respect to acquisitions followed by drop-downs in light of the -2(k) Regulations. For example, a foreign subsidiary of a U.S. parent could not acquire directly by merger the assets of a domestic target corporation in exchange for U.S. parent stock in a reorganization qualifying under 368(a)(2)(D), as such provision generally only permits domestic mergers. The effect of such transaction could be accomplished, however, by a merger with the parent under section 368(a)(1)(A) followed by a drop-down of all of the acquired assets. We do not find it troubling that similar opportunities would be presented if the law were explicitly extended to permit distributions following tax-free reorganizations.

Regulations with the COBE Regulations by expanding the group of corporations to which assets may be transferred following a reorganization to the "qualified group" as defined in the COBE Regulations.[63] The COBE Regulations, which are already equipped to accommodate push-ups of assets following reorganizations, treat the issuing corporation in a reorganization as holding all of the businesses and assets of all of the members of the qualified group. As discussed in Section III of this report, a qualified group is defined as one or more chains of corporations connected through stock ownership with the issuing corporation. By defining the qualified group by reference to the issuing corporation, in any reorganization, direct or triangular, the COBE Regulations implicitly endorse push-up transactions. By comparison, the -2(k) Regulations only permit asset and stock contributions down a chain of controlled corporations beginning with the acquiring corporation. If the -2(k) Regulations were modified to incorporate the "qualified group" standard (subject to the caveat that less than "substantially all" of the assets are distributed), taxpayers would be able to rely on such regulations to conclude that push-ups would generally not adversely affect qualification as a tax-free reorganization.

This change would streamline the COBE and -2(k) Regulations by creating a single standard with respect to both testing for continuity of business enterprise and qualification as a tax-free reorganization, as well as with respect to contributions and distributions following reorganizations. We recognize that this would allow for transfers of assets not only within a single chain of corporations, but across chains of corporations (and in certain instances, to partnerships) below the issuing corporation. We see no policy reason why the -2(k) Regulations

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[63] We recognize that this would not only permit distributions, but would also expand upon the drop-downs currently permissible under the -2(k) Regulations, which are limited today to corporations that are controlled by the transferor corporation for purposes of section 368(c).

should not allow for such transfers and think that this would be a positive development in light of the goal of promoting increased flexibility in this area.

C. Revenue Ruling 70-107

As discussed in Part IV of this report, Chief Counsel has acknowledged on more than one occasion that Revenue Ruling 70-107 should be revoked. This conclusion is based on the fact that the ruling is both arbitrary (particularly, in light of the IRS ruling permitting split liability assumption in a forward subsidiary merger),[64] as well as inconsistent with the legislature's intent to combat the negative treatment afforded liability assumption in the Supreme Court's decision in Hendler.

We note that if our recommendations above are followed, the -2(k) Regulations as amended would at least limit the breadth of transactions to which such ruling could be applied to its particular set of facts. Because distributions of less than "substantially all" of the acquired assets would not have any effect on the qualification of otherwise tax-free reorganizations, the IRS could not recast such transactions and invoke the principle of Revenue Ruling 70-107 to deny tax-free treatment. While we would welcome a reconsideration of the underlying policy motives behind Revenue Ruling 70-107,[65] such ruling need not be revoked to allow for push-ups following tax-free reorganizations. That ruling would still literally have effect in an acquisition involving the assumption of liabilities by multiple entities in an acquiring group. More importantly, given that Revenue Ruling 70-107 rests on tenuous policy grounds, it should not be

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64 See Revenue Ruling 73-257, 1973-1 C.B. 289.

65 We have previously advocated the revocation of Revenue Ruling 70-107. See New York State Bar Association, Tax Section, "Report of the New York State Bar Association (Tax Section) on the Proposed Regulations Addressing the Remote Continuity and Continuity of Business Enterprise Doctrines" (July 24, 1997). We maintain this position and believe that the 2004 Proposed Regulations are an opportunity to do so.

seen as an impediment to issuing regulations that allow taxpayers the flexibility to distribute assets to corporations other than those that assumed the related liabilities in an acquisition.