New York State Bar Association
Tax Section

Report on Proposed and Temporary Regulations Regarding All-Cash Acquisitive D Reorganizations

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INTRODUCTION

This Report[1] of the New York State Bar Association Tax Section comments on identical proposed[2] and temporary regulations[3] (respectively, the "Proposed Regulations" and the "Temporary Regulations," and together the "Regulations") that address the qualification and treatment of certain acquisitive transactions as reorganizations under section 368(a)(1)(D) ("acquisitive D reorganizations") where there is no actual issuance of stock and/or securities of the acquiring corporation. In general, the Regulations provide that a transaction otherwise described in section 368(a)(1)(D) but for the lack of any stock consideration may qualify as an acquisitive D reorganization, *provided the same persons own, directly or indirectly, all of the stock of both the transferor and acquiring corporations in identical proportions*.[4] The Regulations provide that in such cases, the acquiring corporation is *deemed* to issue a nominal share of stock to the transferor corporation.

We commend the Internal Revenue Service (the "Service") and the Department of Treasury ("Treasury") for promulgating the Regulations in response to taxpayer requests for guidance and clarification in this area.[5] Given the significant stakes involved—taxable versus tax-free treatment of asset sale transactions—this guidance was much needed.

The Report's conclusions can be summarized as follows:

1. We agree with the Regulations that all-cash transactions meeting the requirements of the Regulations are properly categorized as acquisitive D reorganizations, notwithstanding that there is no actual issuance of stock and/or securities of the acquiring corporation. This treatment is appropriate given (i) the long-standing case law precedent and guidance from the Service regarding the issuance of stock when it would be a "meaningless gesture," and (ii) that such transactions more closely resemble the restructuring of an on-

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[1] This Report is the joint work product of the Committee on Reorganizations, the Committee on Corporations, and Committee on Outbound Foreign Activities of U.S. Taxpayers. The principal author of the Report is Gary B. Mandel. Substantial contributions were made by Noah Beck and Drew Purcell. Helpful comments were received from John Barrie, Kim Blanchard, Peter Blessing, Ralph Gerra, Edward Gonzalez, Charles Kingson, Erika Nijenhuis, Yaron Reich, Michael Schler, David Sicular, and Eric Sloan. Except as otherwise indicated, all references herein to sections are to sections of the Internal Revenue Code of 1986, as amended (the "Code"), or to Treasury regulations promulgated thereunder.
[2] Prop. Treas. Reg. § 1.368-2(*l*).
[3] Temp. Treas. Reg. § 1.368-2T(*l*).
[4] Temp. Treas. Reg. § 1.368-2T(*l*)(i). For convenience, parallel citations to the Proposed Regulations are omitted.
[5] T.D. 9303, 2007-1 C.B. 379.

going enterprise, rather than a disposition, a fact supporting reorganization as opposed to sale treatment. Moreover, reorganization treatment would generally result in characterizing any gain as a dividend as opposed to capital gain under the boot-dividend rule, which appropriately reflects the fact that these transactions resemble extractions of cash from a continuing investment.

2. The Regulations appropriately mandate reorganization treatment even where the cash consideration received by the transferor corporation equals the full fair market value of the property transferred, such that any shares deemed issued as consideration would have zero or nominal value. We agree with this approach as it does not place undue weight on valuation in determining the tax treatment of related-party transactions.

3. The deemed issued share construct as implemented by the Regulations may eliminate any concerns about possible basis shifting. However, the deemed issued share approach of the Regulations could subject taxpayers to adverse and unintended consequences. We believe that the merits of preventing basis shifting in acquisitive D reorganizations should be considered and determined as part of Treasury's continuing and evolving efforts in the proposed basis allocation regulations[6] and that the Regulations should be finalized in the interim in revised form in order to address the problems we discuss below. Once the more general rules have been issued, the Regulations can be revised to conform to them.

   We have identified two ways in which Treasury could address these problems. First, the deemed issuance construct set forth in the Regulations could be discarded in favor of an approach whereby the statutory requirements of a D reorganization are simply deemed satisfied without the fiction of a nominal share. Alternatively, the deemed issued approach could be retained and any unintended problems created by such construct could be mitigated through targeted rules.

In light of the fact that the Temporary Regulations are scheduled to sunset on December 18, 2009, the scope of this Report is deliberately narrow and does not address broader issues that arise with respect to D reorganizations and on which Treasury has requested comments.[7] We believe that there is a substantial benefit to Treasury, the Service, and taxpayers in avoiding the uncertainty that would result from allowing the Temporary Regulations to sunset without permanent guidance, and that a comprehensive study of those issues is not necessary to promulgate final regulations in some form prior to the expiration of the Temporary Regulations.

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[6] *See* 74 Fed. Reg. 3509 (Jan. 21, 2009).

[7] The preamble to the Proposed Regulations requested comments on the role of the continuity of interest requirement and various liquidation-reincorporation authorities in the D reorganization area. 71 Fed. Reg. 75,898 (Dec. 19, 2006). We believe that those issues as well as other related issues, for example, whether it is appropriate to extend the Regulations to situations where ownership of the transferor and acquiring corporations is similar but not identical, merit further consideration but should not delay the promulgation of final regulations. In addition, this Report is not meant to address the cash received in an acquisitive D reorganization involving identical common ownership to section 356's boot-within-gain limitation. It may be appropriate to treat the cash received as a distribution subject to section 301 in its entirety, as may be the case with single company reorganizations. *See, e.g.*, Treas. Reg. § 1.301-1(*l*); *Bazley v. Commissioner*, 331 U.S. 737 (1947).

I. BACKGROUND

A. Statutory Provisions Relating to Acquisitive D Reorganizations

Subject to certain other requirements, section 368(a)(1)(D) governs the sale of all or a part of the assets of one corporation ("Target") to another corporation ("Acquiring") if immediately after the transfer Target, or one of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of Acquiring; but only if, in pursuance of the plan, *stock or securities of Acquiring are distributed in a transaction which qualifies under section 354 or 356*.[8]

Other statutory provisions impose additional requirements for treatment as an acquisitive D reorganization. In general, section 354(a)(1) provides that no gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another party to the reorganization. Section 354(b)(1) provides that section 354(a) shall not apply to an exchange governed by section 368(a)(1)(D) unless two additional requirements are met. First, Acquiring must acquire "substantially all" of Target's assets.[9] Second, *the stock, securities, and other properties received by Target, as well as the other properties of Target, must be distributed in pursuance of the plan of reorganization* (along with section 368(a)(1)(D)'s distribution language, the "distribution requirement").[10]

The Service and courts have for over forty years consistently concluded that an actual issuance and distribution of Acquiring stock is not necessary to satisfy the statutory distribution requirement where the same persons own all of the stock of Target and Acquiring in identical proportions,[11] concluding that such an issuance would constitute a "meaningless gesture."[12] The Service has also applied the meaningless gesture doctrine to circumstances where Target and Acquiring are wholly owned by a single party indirectly through subsidiaries,[13] or as a result of family attribution.[14] Moreover, the Service and courts have found the distribution requirement satisfied without an actual issuance even in circumstances where Acquiring has paid fair market value for Target's assets.[15] Despite the consistency of the Service's and courts' pronouncements and decisions, the treatment of acquisitive D reorganizations in which no Acquiring stock is

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[8] A transaction may also qualify as a divisive D reorganization if stock or securities of Acquiring are distributed in a transaction which qualifies under section 355. I.R.C. § 368(a)(1)(D).

[9] I.R.C. § 354(b)(1)(A).

[10] I.R.C. § 354(b)(1)(B).

[11] *See* Rev. Rul. 2004-83, 2004 C.B. 157; Rev. Rul. 75-383, 1975-2 C.B. 127; Rev. Rul. 70-240, 1970-1 C.B. 81; *American Manufacturing Co. v. Comm'r*, 55 T.C. 204 (1970); *Atlas Tool Co. v. Comm'r*, 614 F.2d 860 (3d Cir. 1980); *Wilson v. Comm'r*, 46 T.C. 334 (1966); *James Armour, Inc. v. Comm'r*, 43 T.C. 295 (1964).

[12] Rev. Rul. 70-240, 1970-1 C.B. 81; *Wilson*, 46 T.C. at 344; *James Armour*, 43 T.C. at 307. We are not aware of any rulings or court decisions to the contrary.

[13] *See* I.R.S. Priv. Ltr. Rul. 9229026 (Apr. 21, 1992); I.R.S. Priv. Ltr. Rul. 9336029 (June 14, 1993) I.R.S. Priv. Ltr. Rul. 8911067 (Dec. 22, 1988).

[14] T.D. 9303, 2007-1 C.B. 379; *see also* I.R.S. Field Serv. Adv. 200117008 (Apr. 30, 2001); I.R.S. Tech. Adv. Mem. 8402001 (Aug. 16, 1983); I.R.S. Priv. Ltr. Rul. 9111055 (Dec. 19, 1990).

[15] *See* Rev. Rul. 70-240, 1970-1 C.B. 81; *Wilson*, 46 T.C. at 344; *James Armour*, 43 T.C. at 308. We are not aware of any rulings or court decisions to the contrary.

issued and the collateral consequences of such transactions remain the subject of ongoing discussions among practitioners, the Service, and Treasury.[16]

B. The Regulations

The Regulations address the issue of when an acquisitive transaction otherwise described in section 368(a)(1)(D) will be treated as a D reorganization where there is no actual issuance of stock and/or securities of Acquiring. The preamble to the Temporary Regulations[17] noted that the Service and Treasury were issuing the Temporary Regulations to provide taxpayers with certainty regarding treatment of acquisitive transactions where Acquiring issued no actual stock (so-called "all-cash" transactions). The preamble noted that the final form of the Regulations may change upon completion of a broader study of issues pertaining to acquisitive D reorganizations. Since broader guidance has not yet been proposed and the Temporary Regulations are set to expire this year, we believe that finalizing the Regulations in some form prior to the completion of a more comprehensive study is appropriate and worthwhile in light of taxpayers' need for certainty in entering into relevant transactions.

The Regulations provide that a transaction otherwise described in section 368(a)(1)(D) will be treated as satisfying the requirements of sections 368(a)(1)(D) and 354(b)(1)(B)—i.e., the distribution requirement—even though there is no actual issuance of Acquiring stock and/or securities, if the same persons own, directly or indirectly, all of the stock of Target and Acquiring in identical proportions.[18] The Regulations therefore adopt the long-standing view of the Service and courts that, in cases of identical common ownership, the actual issuance of Acquiring stock would be a meaningless gesture and its absence should not bar characterization as a D reorganization.

The Regulations provide that in cases where no share is actually issued but the identical common ownership requirement is met, Acquiring will be deemed to issue a nominal share of stock to Target in addition to the actual consideration exchanged for Target's assets.[19] The deemed issued share will then be deemed distributed by Target to its shareholders and, where appropriate, further transferred through chains of ownership to the extent necessary to reflect the

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[16] *See, e.g.*, Letter from Mark J. Silverman et. al. to William D. Alexander, Associate Chief Counsel (Corporate), Internal Revenue Service, 2006 TNT 64-45 (Mar. 31, 2006); T.D. 9303, 2007-1 C.B. 379; 71 Fed. Reg. 75,898 (Dec. 19, 2006).

[17] T.D. 9303, 2007-1 C.B. 379.

[18] Temp. Treas. Reg. § 1.368-2T(*l*)(2)(i). The Regulations contain four operating rules for determining when there is identical common ownership of Target and Acquiring. First, the ownership of stock is determined by applying section 318(a)(2) attribution rules, without regard to the limitation that attributes ownership of a stock held by a corporation to a shareholder only if the shareholder owns 50% or more of the value of the corporation. Second, an individual and all members of the individual's family described in section 318(a)(1) are treated as one individual. Third, stock described in section 1504(a)(4)—nonconvertible, nonvoting, nonparticipating preferred stock—is not taken into account. Finally, the Regulations provide that the identical common ownership requirement will be met notwithstanding a *de minimis* variation in shareholder identity or proportionality of ownership.

[19] *Id.*.

actual ownership of Target and Acquiring.[20] This last provision would apply if either Target or Acquiring is a lower-tier subsidiary.[21]

Notably, the examples in the Regulations all involve cases where Acquiring pays Target the full fair market value for its assets in cash.[22] Thus, a nominal share is still deemed issued even though there is no "room" to impute the presence of additional share consideration.

Treasury amended the Regulations to allay concerns that the deemed issuance of a nominal share could affect the qualification of related party triangular asset acquisitions as reorganizations.[23] The deemed issuance would have caused certain transactions intended to be triangular reorganizations described in section 368(a)(1)(C) ("C reorganizations") to also be described in section 368(a)(1)(D). Since the transaction would have met the requirements for both C and D reorganizations, section 368(a)(2)(A) would have treated the transaction as an acquisitive D reorganization. Such a classification would have undermined the desired nonrecognition treatment, since the stock of the corporation controlling Acquiring would have been treated as boot and only the deemed issued share in Acquiring would have qualified as nonrecognition property. In addition, transactions intended to be forward triangular mergers described in sections 368(a)(1)(A) and 368(a)(2)(D) would have failed to qualify as such because of the deemed issuance: the latter provision requires that no stock of Acquiring be used in the transaction.

In order to ensure that the deemed issuance would not disrupt these transactions' treatment as triangular reorganizations, the amended Regulations now provide that a transaction otherwise described in Treasury regulations section 1.358-6(b)(2) or section 368(a)(1)(G) by reason of section 368(a)(2)(D) will not treated as a D reorganization.[24] We agree with this clarification and commend the Service and Treasury for moving swiftly to address this unintended byproduct of the Regulations.

II. ALL-CASH ACQUISITIVE D REORGANIZATIONS

A. Reorganization Versus Disposition

We agree with the Regulations' fundamental principle that the sale of substantially all of Target's assets to Acquiring followed by Target's liquidation should be treated as a D reorganization where there is identical ownership of both Target and Acquiring. This is consistent with the policy underpinnings of reorganization treatment that gain or loss should not be recognized because of mere changes in form when the taxpayer's investment remains in corporate solution or when "a formal distribution, directly or through exchange of securities, represents merely a new form of the previous participation in an enterprise involving no change

[20] *Id.*
[21] *See* Temp. Treas. Reg. § 1.368-2T(*l*)(3), ex. 3 (describing deemed distributions and contributions where both Target and Acquiring are third-tier subsidiaries of P, which indirectly owns all the stock in both).
[22] Temp. Treas. Reg. § 1.368-2T(*l*)(3).
[23] T.D. 9313, 2007-1 C.B. 805.
[24] Temp. Treas. Reg. § 1.368-2T(*l*)(2)(iv).

of substance in the rights and relations of interested parties one to another or to the corporate assets."[25]

Moreover, in all-cash acquisitive D reorganizations where there is identity of ownership, any gain realized will be taxed as a dividend under section 356(a)(2),[26] which appropriately reflects the fact that these transactions more closely resemble extractions of cash from an on-going enterprise as opposed to dispositions.[27] In contrast, no comparable route is available to recharacterize the amounts received by Target shareholders as a dividend if the transaction is characterized as a taxable asset sale and liquidation.[28]

B. Technical Requirements Met Through Meaningless Gesture Doctrine

The Service and courts have relied on the so-called meaningless gesture doctrine to conclude that the distribution requirement is satisfied where Target and Acquiring are owned by the same persons in identical proportions, notwithstanding that Acquiring does not actually issue any stock.[29] For example, in considering an asset sale between two corporations owned in identical proportions by a husband and wife, the Tax Court in *James Armour* concluded there was in substance an exchange of stock that met the distribution requirement.[30] The court stated that the identical common ownership of the two corporations meant that "[t]he issuance of further stock would have been a meaningless gesture, and we cannot conclude that the statute requires such a vain act."[31] This is merely one example of many instances in which the Service

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[25] *Bazley v. Comm'r*, 331 U.S. 737 (1947); BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 12.01[3]. While it is true that since the repeal of *General Utilities* taxpayers will generally prefer reorganization treatment to sale treatment with respect to internal transactions, it is still the case that granting taxable sale treatment with respect to such transactions may open the door to potentially inappropriate results. For example, Target may have expiring net operating losses (NOLs) that could offset the gain from the internal sale allowing Target to refresh its amortizable basis without paying tax or relinquishing beneficial ownership of the applicable assets.

[26] In *Clark v. Commissioner*, 489 U.S. 726 (1989), the Supreme Court held that dividend-equivalence under section 356(a)(2) is determined by hypothesizing that all consideration received in the reorganization is nonrecognition property and such nonrecognition property is subsequently redeemed for cash (in an amount equal to the boot in the transaction) under section 302. In an all-cash acquisitive D reorganization where there is identical ownership between Target and Acquiring, the Acquiring shareholders will own the same percentage ownership stake in Acquiring both before and after *Clark*'s hypothetical redemption. Accordingly, any gain recognized in the reorganization because of the receipt of boot should be taxed as a dividend to the extent of the shareholder's ratable share of earnings and profits.

[27] Although the stakes of reaching dividend-equivalent reorganization treatment have changed for individuals because of the current parity between dividends and capital gains rates, character distinctions are still relevant.

[28] Section 304 would not apply to a transaction structured as a sale of assets. Although important differences in treatment apply to section 304 stock purchases and asset purchases qualifying as acquisitive D reorganizations, treating all-cash transactions described in the Regulations as taxable asset sales would only increase the dissonance between the treatment of related-party stock purchases and asset purchases. This discontinuity would be especially inappropriate in light of congressional efforts to conform sections 304 and 368(a)(1)(D). *See* BITTKER & EUSTICE, *supra* note 25, at ¶ 12.26[6] (describing congressional efforts to conform the definition of control in both provisions).

[29] *See, e.g.*, Rev. Rul. 70-240, 1970-1 C.B. 81; *Wilson v. Comm'r*, 46 T.C. 334, 344 (1966); *James Armour, Inc. v. Comm'r*, 43 T.C. 295, 307 (1964).

[30] *James Armour*, 43 T.C. at 307.

[31] *Id.*

has applied the meaningless gesture doctrine to circumstances where Target and Acquiring are wholly owned by a single person through subsidiaries, [32] or as a result of family attribution.[33]

The Service and Treasury requested comments on the applicability of the meaningless gesture doctrine to the distribution requirement.[34] In line with court decisions applying the meaningless gesture doctrine, we believe that the distribution requirement is an appropriate context in which to apply the meaningless gesture doctrine. The meaningless gesture doctrine arose in response to taxpayer attempts to circumvent the acquisitive D reorganization rules in liquidation-reincorporation transactions. The Service and the courts sensibly elevated substance over form to find that such taxpayers should not receive sale treatment (and the concomitant benefits under the *General Utilities* doctrine) merely because a nominal amount of stock was not issued in the transaction. Similarly, the doctrine's rationale should apply with equal force to taxpayers that desire reorganization treatment but do not want an actual issuance of stock for reasons of simplicity, to avoid contract or local law restrictions, or otherwise.

We note that the Tax Court's decision in *Warsaw Photographic Associates, Inc. v. Commissioner*[35] is sometimes cited as representing contrary authority in this area of the law.[36] However, this decision should not be read to require an actual issuance of stock in cases where there is identical common ownership of Target of Acquiring. The court concluded that the distribution requirement was not satisfied where the shareholders of Acquiring had only a 20% stake in Target, and the Acquiring shares issued in the transaction were issued directly to the Acquiring shareholders and not to Target.[37] The court explicitly distinguished the circumstances in *Warsaw* from those cases that had applied the meaningless gesture doctrine, noting that "in the instant case, the stock ownership of petitioner [Acquiring] and Studios [Target] were not identical. . . . Thus, the instant case does not qualify for the one exception that the courts have created regarding the stock transfer and distribution rule."[38] Accordingly, *Warsaw* left the meaningless gesture fully intact and unaltered (at least with respect to transactions involving identical ownership, the sole focus of this Report).

C. Meaningless Gesture Doctrine and Transfers for Fair Market Value Consideration

The preamble to the Proposed Regulations specifically requested comments on the applicability of the meaningless gesture doctrine to "situations in which the cash consideration received equals the full fair market value of the property transferred such that there is no missing consideration for which the nominal share of stock deemed received and distributed should substitute."[39] Consistent with the approach taken by the Regulations, we believe the meaningless gesture doctrine should apply in situations where Acquiring pays Target cash equal

[32] *See* I.R.S. Priv. Ltr. Rul. 9336029 (June 14, 1993); I.R.S. Priv. Ltr. Rul. 9229026 (Apr. 21, 1992); I.R.S. Priv. Ltr. Rul. 8911067 (Dec. 22, 1988).
[33] T.D. 9303, 2007-1 C.B. 379; *see also* I.R.S. Field Serv. Adv. 200117008 (Apr. 30, 2001); I.R.S. Priv. Ltr. Rul. 9111055 (Dec. 19, 1990); I.R.S. Tech. Adv. Mem. 8402001 (Aug. 16, 1983).
[34] Notice of Proposed Rulemaking, 71 Fed. Reg. 75,898, 75,899 (Dec. 19, 2006).
[35] 84 T.C. 21 (1985).
[36] *See, e.g.*, BITTKER & EUSTICE, *supra* note 25, at ¶ 12.26[3] n.339.
[37] *Id.* at 36-37.
[38] *Id.* at 37.
[39] 71 Fed. Reg. 75, 898, 75,899 (Dec. 19, 2006).

to the fair market value of the Target assets transferred (less assumed liabilities). Long-standing case law and Service guidance both support this conclusion, as do policy and administrability concerns.

In *James Armour, Inc. v. Commissioner*, the Tax Court unambiguously held that the meaningless gesture doctrine should apply even where there was a fair market value exchange between Target and Acquiring.[40] The Tax Court concluded that the fair market value exchange should not defeat the conclusion that "*the exchange requirements are met if, when a series of transactions is completed, the stockholders of the old corporation retain their proprietary interest in the same going business, although in another corporate shell*."[41] Under the court's rationale, the meaningless gesture doctrine should apply and the distribution requirement should be treated as satisfied whenever the sale of substantially all of Target's assets and its liquidation resembles a cash extraction from a business accompanied by a change in corporate ownership that preserves the Target shareholders' interest in that business. The Tax Court reaffirmed its treatment of fair market value exchanges two years later in *Wilson v. Commissioner*.[42] The Service indicated its agreement with this approach in Revenue Ruling 70-240.[43]

A conclusion that the meaningless gesture doctrine does not apply where Acquiring pays fair market value for Target's assets would raise policy and administrability concerns. First, it would allow taxpayers to avoid dividend-equivalent reorganization treatment by claiming that the asset transfer is a fair market value exchange. This would undermine the Code's emphasis on taxing extractions of cash as dividends and denying adjustments to basis when Target shareholders continue to hold their proprietary interest in the Target business.

In addition, as a practical matter, an approach that did not apply the meaningless gesture doctrine to fair market value exchanges would unduly elevate the importance of valuation in determining the tax treatment of transactions. Attaching such significance to valuation would undoubtedly lead to uncertainty and abuse given the imprecise nature of valuation in related-party transactions. As noted previously by commentators, "valuations are always within a range" and thus "'room' for nominal consideration should always exist."[44] Moreover, such a formalistic distinction does not justify the inefficiency and waste of resources that would be required by essentially mandating a valuation in connection with internal reorganizations.

Thus, the Regulations' treatment of the distribution requirement as satisfied even where Acquiring has paid fair market value for Target's assets increases certainty for taxpayers and the Service, avoids inefficiency, and furthers the underlying policy reasons for applying the acquisitive D reorganization rules to transactions that more closely resemble reorganizations as opposed to dispositions.

[40] 43 T.C. 295, 307-08 (1964).
[41] *Id.* at 308 (emphasis added).
[42] 46 T.C. 334, 344 (1966).
[43] 1970-1 C.B. 81.
[44] Am. Bar Assoc. Sec. of Taxation, Comments on Proposed and Temporary Regulations Under Code Section 368(a)(1)(D) (Apr. 16, 2008), *available at* *H*http://www.abanet.org/tax/pubpolicy/2008/080416Hcommentsonproposedandtemregsundercodesec368a1d.pdf.

D. Treasury Authority to Treat the Distribution Requirement as Satisfied

We believe that Treasury has ample authority to treat the distribution requirement as satisfied in cases where the same persons own, directly or indirectly, all of the stock of Target and Acquiring in identical proportions. Courts interpreting the distribution requirement have consistently concluded that the distribution requirement may be treated as satisfied in cases of identical common ownership.[45] Moreover, this rule is appropriately applied to circumstances where the identical common ownership occurs indirectly or through attribution, especially in light of section 368(a)(2)(H)'s reference to section 304(c)'s definition of control for purposes of acquisitive D reorganizations, a definition that incorporates section 318 attribution.[46] Finally, courts have not limited themselves to finding the distribution requirement satisfied in cases where Acquiring has paid below fair market value for Target's assets.[47]

Treasury has utilized a deemed issuance concept to satisfy statutory exchange requirements in other reorganization provisions. Treasury regulations section 1.368-2(d)(4) impliedly utilizes a deemed issuance concept in allowing upstream reorganizations under section 368(a)(1)(C) to occur, notwithstanding the fact that the consideration received by Target for its assets is not 80% comprised of Acquiring voting stock.[48] The regulations contain the following illustrative example. [49]

> Example 1: Target is 60% owned by Acquiring and 40% owned by X prior to the reorganization. Acquiring purchases all of Target's assets for Acquiring voting stock worth $30 and $10 cash and assumes Target liabilities of $10. The Acquiring voting stock and the $10 cash are distributed to X in liquidation of Target.

In concluding that the 80% solely for voting stock requirement is satisfied, the regulation impliedly deems Acquiring to issue additional voting stock worth $60 to Target, which is then distributed to Acquiring in Target's liquidation.

Moreover, sections 368(a)(1)(D) and 354(b)(1)(B) are somewhat ambiguous as to whether they require an actual issuance and distribution of Acquiring stock. Unlike sections 368(a)(1)(B) and (C), section 368(a)(1)(D) does not specifically address what consideration must be received. Instead, the provision merely requires that Acquiring stock or securities be distributed in a transaction that qualifies under sections 354 or 356. While this may support a conclusion that a distribution of Acquiring stock is necessary, it does not require an issuance since Target may have owned Acquiring stock prior to the reorganization.[50] In addition, section 354(b)(1)(B) provides that "stock, securities, and *other properties* received by such transferor" must be distributed. Since this cannot possibly mean that Target must receive boot, a better

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[45] *American Manufacturing Co. v. Comm'r*, 55 T.C. 204 (1970); *Atlas Tool Co. v. Comm'r*, 614 F.2d 860 (3d Cir. 1980); *Wilson v. Comm'r*, 46 T.C. 334 (1966); *James Armour, Inc. v. Comm'r*, 43 T.C. 295 (1964).
[46] I.R.C. § 304(c)(3).
[47] *Wilson*, 46 T.C. at 344; *James Armour*, 43 T.C. at 308.
[48] *See* I.R.C. § 368(a)(2)(B) (requiring in a C reorganization that Acquiring acquire, solely for voting stock, property of Target which is at least 80% of the fair market value of all of the property of Target).
[49] Treas. Reg. § 1.368-2(d)(4)(ii), ex. 1.
[50] Mark L. Yecies, *The Future of Acquisitive Reorganizations—A Reply to Michael Schultz*, 84 TAXES 137, 138 (2006).

interpretation is that the provision should be read to say "*any* stock, securities, and other properties received" must be distributed in a Target liquidation.[51]

The dual function of section 368(a)(1)(D) as a divisive and acquisitive provision may explain its reference to stock. In a divisive D reorganization, the distribution of the stock issued in the asset transfer is central to the transaction. Congress may have assumed that Acquiring would issue stock in an acquisitive D reorganization as well.[52] Since, unlike in a divisive D reorganization, the stock issuance could be incidental in an acquisitive D reorganization, especially where ownership is identical, undue weight should not be placed on Target's failure to distribute Acquiring stock.

Finally, section 368(a)(2)(H)'s reduced control requirement was intended to expand the class of transactions qualifying as acquisitive D reorganizations in order to combat liquidation-reincorporation transactions.[53] Congress must have believed that an actual issuance of shares was not required in an acquisitive D reorganization, because otherwise the provision would not have been an effective tool against liquidation-reincorporation transactions: taxpayers could effectively elect whether they would be subject to the reorganization treatment.[54] While some degree of electivity may be appropriate in providing taxpayers flexibility in arranging and consummating bona fide transactions,[55] electivity should be policed when its results are at odds with the policies underlying the statutory scheme.

We would further note, relevant to the discussion in Part III below, that we believe Treasury has the authority to treat transactions described in the Regulations as satisfying the distribution requirement without resorting to a deemed issuance construct. In particular, case law applying the meaningless gesture doctrine does not predicate satisfaction of the distribution requirement on the presence of a deemed issuance of stock. In rejecting the taxpayer's argument that Acquiring had paid fair market value for Target's asset, the Tax Court in *James Armour, Inc. v. Commissioner* concluded that a prior case

> was not based upon the reasoning that in effect stock of the transferee corporation was issued to the transferor corporation in exchange for any assets transferred without consideration. Rather, we construe that case as holding that the exchange requirements are met if, *when a series of transactions is completed, the stockholders of the old corporation retain their proprietary interest in the same going business, although in another corporate shell*.[56]

The deemed share is merely a mechanic for applying the reorganization rules to an otherwise all-cash transaction, and we do not think the authority for applying the reorganization rules in such case is predicated on this construct.

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[51] *See id.* at 138.
[52] *Id.* at 138-39.
[53] H.R. REP. 98-861 (1984) (Conf. Rep.), *reprinted in* 1984 U.S.C.C.A.N. 1445, 1535-36.
[54] *See* Yecies, *supra* note 50, at 140.
[55] *See Gregory v. Helvering*, 263 U.S. 465, 466 (1935) ("The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted.").
[56] 43 T.C. 295, 308 (1964) (discussing *Comm'r v. Morgan*, 288 F.2d 676 (3d Cir. 1961)) (emphasis added).

III. TECHNICAL PROBLEMS RAISED BY DEEMED ISSUANCE

The Regulations provide that in cases that qualify as acquisitive D reorganizations where there is no actual issuance of Acquiring stock and/or securities, Acquiring will be deemed to issue a nominal share of stock to Target in addition to the actual consideration exchanged for Target's assets. The nominal share will then be deemed distributed by Target to its shareholders and, where appropriate, further transferred through chains of ownership to the extent necessary to reflect the actual ownership of Target and Acquiring.[57]

We believe that the deemed issuance of the nominal share and the associated transfers to reflect the actual post-reorganization ownership of Acquiring may give rise to certain unintended and/or inappropriate consequences if such share is treated as issued for purposes other than satisfying the distribution requirement. This Part illustrates some of the complications we have identified that may emerge as a result of the deemed issuance construct.

A. Inaccessible Basis in the Deemed Issued Share

The deemed issuance of a nominal share may inappropriately cause a shareholder to have inaccessible tax basis in the deemed issued share.

> Example 2: B, an individual, owns all the stock of Target and Acquiring. B has a basis of $150 in the Target shares. Target sells its assets to Acquiring for $100, their fair market value, and liquidates.

Under section 356(c), B recognizes no loss in the exchange. If the share deemed issued by Acquiring is taken into account for purposes other than the distribution requirement, B will have a basis in such share of $50, B's $150 basis in Target stock reduced by $100 of boot received.[58]

How can B access the $50 basis reflected in the deemed issued share in Acquiring? It might be difficult for B to contend that B has "sold" the nominal share to a third party in a partial sale of Acquiring stock. A lenient view may allow recovery of basis upon B's disposition of B's entire interest in Acquiring, but even this treatment might be questioned. The reality is that the nominal share has no real value; it does not really exist and accordingly no person would purchase it (or for that matter comprehend in a commercial setting what it is). The presence of the deemed issued share may require a taxpayer to take extreme measures and draft the transaction document governing B's sale of Acquiring stock to a third party to claim that an amount has been paid for the deemed issued share. Again, in the context of a commercial transaction between third parties, this may unduly impede the consummation of a transaction or act as a trap for the unwary. Accordingly, any exchanged basis from the Target shares may become trapped in the deemed issued share—temporarily in the best case, perhaps permanently under a harsher view.[59]

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[57] Temp. Treas. Reg. § 1.368-2T(*l*)(2)(i).

[58] I.R.C. § 358(a)(1).

[59] This problem should not arise if the Target shareholder has a built-in gain in the Target stock. If in Example 2 B's basis in the Target stock were instead $25, then B would have $75 of gain treated as a dividend under section 356(a). B's basis in the deemed issued Acquiring share would be $0 (the $25 initial basis plus the $75 treated as a dividend minus the $100 of cash received). I.R.C. § 358(a)(1). Since B will have recovered B's entire basis in the

The deemed issuance and recapitalization rule for determining basis that would generally apply in acquisitive D reorganizations does not apply when Acquiring pays cash equal to the fair market value of Target's assets. [60] In general, the rule results in the common shareholder of Target and Acquiring owning two blocks of Acquiring shares after the transaction: one block with an exchanged basis from the Target shares and one block with an exchanged basis from the Acquiring shares owned prior to the reorganization. The rule would not work in a fair market value exchange because the sizes of the two blocks in an all-cash acquisitive D reorganization are dependent on the magnitude of the "missing" consideration—essentially the difference between the cash Acquiring pays and the fair market value of the Target assets—relative to the value of the Acquiring shares actually owned. Since the deemed issued share exists only for tax purposes following the transaction—rather than being subject to a deemed recapitalization (or otherwise being dealt with under the Regulations)—the deemed issuance construct could act as an impediment to basis recovery.

B. Excess Loss Accounts and Deemed Distribution in a Consolidated Group

The Regulations' requirement that the deemed issued share be transferred through chains of ownership creates technical problems in the consolidated return area.

> Example 3: X owns all of the stock of Y, which in turn owns all of the stock of Target. X also owns all of the stock of Acquiring. The X group is a consolidated group. Y has a $25 basis in Target stock, and X has a $10 basis in Acquiring stock. Target sells its assets to Acquiring for $100, their fair market value, and liquidates.

The Regulations deem Acquiring to issue a nominal share to Target in addition to the $100 of actual proceeds. Thus, Y receives $100 and a deemed issued share of Acquiring stock in exchange for its Target stock in an exchange to which section 356 applies. Treasury regulations section 1.1502-13(f)(3)(i) provides that (f)(3) applies where the receipt of money or other property results in the application of section 356. Treasury regulations section 1.1502-13(f)(3)(ii) provides that for all Federal income tax purposes the nonqualifying property (i.e., the $100) received as part of an intercompany reorganization is treated as received by the shareholder in a separate transaction (in this case immediately after the transaction). So, presumably Y is treated as receiving the deemed issued nominal share of Acquiring stock (under the Regulations) [61] and $100 of Acquiring stock in place of the $100 of boot (under Treasury regulations section 1.1502-13(f)(3)(ii)), and Y's basis in such Acquiring stock is determined under section 358. Y then receives $100 in a deemed redemption (the value of the boot received) of the shares deemed issued in place of the boot under -13(f)(3), and the redemption is treated as a section 301 distribution under section 302(d). Under Treasury regulations section 1.1502-32, Y will have a $75 excess loss account ("ELA") in Acquiring stock ($25 initial basis minus the $100 distribution).

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reorganization in cases where there is built-in gain in the Target stock, the difficulties of recovering basis located in the deemed issued share should not be present.

[60] Treas. Reg. § 1.358-2(a)(2)(iii), (c), ex. 10.

[61] Temp. Treas. Reg. § 1.368-2T(*l*)(2)(i).

Appropriate basis adjustments under Treasury regulations section 1.302-2(c) should follow.[62] The presence of the deemed issued share makes it unclear to which shares the ELA should attach. The ELA could shift to the shares that X actually owns in Acquiring, as it did in Private Letter Ruling 200810015.[63] If the deemed issued share is taken into account for purposes other than satisfying the distribution requirement, Treasury regulations section 1.302-2(c) indicates that the ELA should attach to the deemed issued share since Y owns it.[64] In this case, the Regulations' deemed distribution from Y to X would result in a deferred $75 gain (the share's $0 value over the $75 ELA). This gain would be taken into account if, *inter alia*, Acquiring liquidated or merged into X.[65] This deferred recognition impedes the well-established ability of taxpayers to eliminate or mitigate the consequences of the ELA.

In addition, the deferred gain that may result to Y under the deemed issuance approach in the Regulations creates the potential for gain duplication within the consolidated group. The issue arises as a result of the fact that, while gain is triggered with respect to the stock of Target, there is no corresponding adjustment to the basis of Target's assets. This "problem" also exists in the context of intercompany stock sales that do not qualify as reorganizations, though in such cases there are provisions, notably Treasury regulations section 1.1502-13(f)(5)(ii)(C), which are designed to mitigate this disconformity.[66] In the case of intragroup reorganizations that involve combining two (or more) companies, each of which has its own historic tax basis attributes, the resulting potential for gain duplication does not lend itself to simple mechanical relief.

IV. TREATING THE DISTRIBUTION REQUIREMENT AS SATISFIED

We believe that there are at least two ways in which Treasury could address the adverse and presumably unintended consequences arising from the deemed issuance approach as currently provided by the Regulations. In this regard, we believe that the Regulations could avoid such problems by providing that a transaction described in the Regulations will be treated as satisfying the distribution requirement, without providing for the deemed issuance of a nominal share. It is worth noting that this deemed satisfied approach is not intended to override the deemed issuance of stock that would arise when Acquiring pays less than fair market value

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[62] Treasury regulations section 1.302-2(c) provides examples of proper basis adjustments in cases where an amount received in redemption of stock is treated as a dividend. If fewer than all of a taxpayer's stock actually owned is redeemed, the remaining basis of the redeemed stock shifts to the stock actually owned after the redemption. Treas. Reg. § 1.302-2(c), ex. 1. If all of the taxpayer's stock is redeemed, the remaining basis of the redeemed stock shifts to stock the taxpayer is treated as owning through attribution. Treas. Reg. § 1.302-2(c), ex. 2.

[63] (Mar. 7, 2008). The letter ruling involved a complete redemption by C of all of B's shares in C. C was owned by B and Parent, the common parent of the consolidated group. Parent indirectly owned almost all of B. The letter ruling concluded that B's post-redemption basis in its C shares (which may or may not have included an ELA) would shift to the C stock owned by Parent.

[64] Treas. Reg. § 1.302-2(c), ex. 3.

[65] *See* Am. Bar Assoc. Sec. of Taxation, *supra* note 44, at 10-11 (discussing example). Typically a section 332 liquidation eliminates an ELA, Treas. Reg. § 1.1502-19(b)(2)(i), but the deemed distribution of the deemed issued share prevents elimination once gain has been recognized (and deferred). Taxpayers' flexibility in structuring their affairs is accordingly significantly impaired, and the adverse consequences become a trap for the unwary.

[66] Treasury regulations section 1.1502-13(f)(5)(ii)(C) mitigates gain duplication by treating the deemed liquidation of T in a section 338(h)(10) transaction as a section 331 liquidation solely with respect to B (the member that acquired the T stock in the prior intercompany transaction) and only to the extent of S's (the member that disposed of the T stock in the prior intercompany transaction) net intercompany income or gain with respect to the T stock.

for Target's assets.[67] Alternatively, in Part V of this Report we discuss another approach whereby the deemed issuance approach is generally preserved, and the Regulations are modified to specifically address any unintended consequences that may occur by virtue of such construct.

In this Part IV, we revisit the examples set out above to illustrate how the technical issues raised by deemed issuance discussed above would be resolved if the Regulations adopted a "deemed satisfied" approach in place of the deemed issuance of a nominal share.

A. Inaccessible Basis in the Deemed Issued Share

As discussed in Part III.A above, the deemed issuance rule may give rise to inaccessible basis in the deemed issued nominal share.

> Example 4: B, an individual, owns all of Target and Acquiring. B has a basis of $150 in the Target shares. Target sells its assets to Acquiring for $100, their fair market value, and liquidates.

When the nominal share is deemed issued, B faces uncertainty as to when and whether it may recover its exchanged basis from the Target shares that is located in the deemed issued Acquiring share (i.e., the fictional share).

If no nominal share is deemed issued, B cannot attach the $50 of unrecovered basis in B's Target shares (after section 358(a)(1) has reduced the $150 initial basis by the $100 of boot received) to the deemed issued share. In other words, B cannot have an exchanged basis in an Acquiring share because B has received none (either deemed or actual) in the reorganization.

This of course raises the question of where the unrecovered basis in the Target shares should go. Treasury regulations section 1.358-2(a)(2)(iii)'s deemed issuance and recapitalization rule cannot apply to split the Acquiring shares into two blocks, because B has received property (i.e., the cash) equal in value to the fair market value of the Target stock surrendered ($100).[68] A reasonable approach would be to spread the $50 of remaining basis from the Target shares over the Acquiring shares B actually owns, presumably in a *pro rata* manner. We acknowledge that the deemed issued share construct may allay concerns about the authority for such a basis shift, since the deemed issued share may act as a vessel for the transfer of unrecovered basis from Target stock to Acquiring stock. Nonetheless, we believe that the fiction of a deemed issued share is not necessary to effect the basis shift, and note that this result is similar to the basis shifting that occurs pursuant to Treasury regulations section 1.302-2(c) in the context of redemptions treated as dividends.[69]

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[67] In such case, Treasury regulations section 1.358-2(a)(2)(iii) provides for a deemed issuance and subsequent recapitalization of Acquiring stock. Notably, both the deemed issuance and deemed satisfied approaches result in disparate tax basis results in cases where full fair market value is paid versus those where there is a shortfall given the inability to apply the recapitalization rule where there is no stock deemed issued or such stock has no value. Nevertheless, concerns relating to such distinctions would be greatly mitigated by a rule respecting good faith determinations of fair market value.

[68] *See supra* text accompanying note 60.

[69] *See supra* note 62 (discussing basis shifting under regulation). The rules would work similarly in the context of all-cash transactions where there is identical ownership by virtue of family attribution rules. Assume that in

It is worth noting that this approach could lead to an artificial distinction between cases in which Acquiring actually issues a nominal amount of stock and all-cash transactions, an issue which, from the point of view of basis spreading, is less acute with the deemed share approach. For example, assume that in Example 4 Acquiring instead pays for the Target assets with $99.99 of cash and one share of stock with a fair market value of $.01. The entire $50.01 of exchanged basis from the Target stock (the $150 initial basis minus the $99.99 of boot)[70] would attach to the one Acquiring share actually issued under general principles governing tax basis in reorganizations, whereas, if no share were issued, under the deemed satisfied proposal the basis would be spread across all of B's stock in Acquiring. We acknowledge that formal distinctions such as this should be avoided where possible, though in this case we think this point has somewhat diminished importance. In this regard, as a substantive matter, we would note that a discontinuity exists even if the deemed share approach is retained. Specifically, in the case where a nominal amount of stock is actually issued, in the example above, there would not be the same uncertainty regarding B's ability to recognize the built-in loss in the Acquiring share that is present when a nominal share is deemed issued under the Regulations. Indeed, B will be able to recognize the loss upon the sale of the actually issued stock rather than presumably only upon a complete disposition of all Acquiring stock. Undesirable formal distinctions are therefore present in both approaches, and we believe that there may be the opportunity to ameliorate any technical issues attendant to the deemed satisfied approach as part of Treasury's broader project to finalize comprehensive regulations relating to acquisitive D reorganizations.

B. Excess Loss Accounts and Deemed Distribution in a Consolidated Group

As discussed in Part III.B above, the deemed issuance of the nominal share and the Regulations' requirement that the nominal share be transferred through chains of ownership to reflect the actual ownership of Target and Acquiring may cause ELAs to be recognized in intercompany acquisitive D reorganizations.

> <u>Example 5</u>: X owns all of the stock of Y, which in turn owns all of the stock of Target. X also owns all of the stock of Acquiring. The X group is a consolidated group. Y has a $25 basis in Target stock, and X has a $10 basis in Acquiring stock. Target sells its assets to Acquiring for $100, their fair market value, and liquidates.

If the transaction is treated as satisfying the distribution requirement without the deemed issuance, there is no ambiguity whether the ELA should attach to the deemed issued nominal share or to the Acquiring shares X actually owns. Y receives $100 from Acquiring in exchange for its Target stock in an exchange to which section 356 applies. Treasury regulations

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Example 4, Daughter owns all of the stock of Target and has a $150 basis in the stock, and Father owns all of the stock of Acquiring. In that event, Daughter's $50 of unrecovered basis (her $150 initial basis less the $100 of cash received) would be transferred to Father. It is worth noting that the Regulations are not clear on what the intended result is in such case under the deemed issuance approach, and it is possible that in the context of family attribution, tax basis rules pertaining to gift transfers could be implicated. In particular, although section 1015(a) generally provides that gifted property retains its basis in the hands of the recipient, property with a built-in loss is subject to a step down in basis to fair market value for the purpose of determining loss. If Treasury intends that the tax basis rules applicable to gift transfers are meant to apply in such context (resulting in the disappearance of Daughter's unrecovered basis in the example above), it should clarify such result when the Regulations are finalized or as part of its broader project of addressing basis shifting generally.

[70] I.R.C. § 358(a)(1).

section 1.1502-13(f)(3)(i) provides that (f)(3) applies where the receipt of money or other property results in the application of section 356. Treasury regulations section 1.1502-13(f)(3)(ii) provides that nonqualifying property (i.e., the $100 of boot) received as part of an intercompany reorganization is treated as received by the shareholder in a separate transaction. So, Y is treated as receiving $100 of Acquiring stock in place of the $100 of boot, and Y's basis in the Acquiring stock is determined under section 358. Y then receives a $100 in a deemed redemption (the value of the boot received) of the shares deemed issued in place of the boot under -13(f)(3), and the redemption is treated as a section 301 distribution under section 302(d). Under Treasury regulations section 1.1502-32, Y will have a $75 ELA in Acquiring stock. Appropriate basis adjustments under Treasury regulations sections 1.302-2(c) should follow. Since the nominal share has not been deemed issued under the Regulations, the ELA should attach to the Acquiring shares X actually owns,[71] as it did in Private Letter Ruling 200810015.[72] Because there has been no deferred gain recognition with respect to the ELA, the problem of gain duplication discussed in Part III.B does not arise and the X group will retain the potential for tax planning to eliminate or mitigate the consequences of the ELA.

We acknowledge that discarding the deemed issuance construct results in some basis shifting. This is readily apparent from both Examples 4 and 5, where basis from Target shares shifts to Acquiring shares actually owned by the common shareholder rather than being allocated to a block of shares based on a recapitalization approach or being made subject to a loss deferral rule (the approaches taken in the proposed basis allocation regulations).[73] While these results may in certain circumstances raise basis shifting concerns, we believe that basis shifting in this limited context (i.e., acquisitive D reorganizations with identical common ownership) seems an acceptable compromise at least until there has been further study of basis issues in general and in particular with regard to acquisitive D reorganizations.[74] In addition, basis shifting concerns may be somewhat attenuated in the consolidated group. The consolidated return regulations already contemplate approaches that look at basis in the aggregate.[75] In this regard, the unified loss rule[76] provides additional protection if basis shifting results in improper recognition of losses.[77]

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[71] *See* Am. Bar Assoc. Sec. of Taxation, *supra* note 44, at 10-11 (discussing example).
[72] (Mar. 7, 2008); *accord* Treas. Reg. § 1.302-2(c), ex. 2. Recognition of the ELA that results from the deemed issuance could be avoided if the consolidated return regulations provided that acquisitive D reorganization treatment would not apply within the consolidated group. This would harmonize the rules applicable to intercompany stock purchases and intercompany asset purchases, since regulations already turn off section 304 in the consolidated group to avoid inappropriate adjustments to basis. Treas. Reg. § 1.1502-80(b); T.D. 8402, 1992-1 C.B. 302.
[73] Prop. Treas. Reg. §§ 1.302-5; 1.358-2(d).
[74] The Regulations' approach may need to be considered in light of other developments as well, such as the administration's proposed repeal of the boot-within-gain limitation in certain international reorganizations. Dep't of Treasury, General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals, at 35 (May 2009), available at www.ustreas.gov/offices/tax-policy/library/grnbk09.pdf.
[75] The ELA basis redetermination rules, for example, require that investment adjustments be allocated to equalize and eliminate ELAs when a member owns existing S shares with different bases. Treas. Reg. § 1.1502-19(d)(1). If a member receives new S shares with an ELA, the basis of S's other shares is allocated to eliminate and equalize any ELA that would be present in the new S shares. Treas. Reg. § 1.1502-19(d)(2).
[76] Treas. Reg. § 1.1502-36.
[77] If the deemed issuance construct is retained, however, adjustments will need to be made to avoid gain duplication as a result of any deferred gain recognition from an intercompany distribution of the deemed issued share. *See supra* note 66 and accompanying text.

If the spreading of basis that would occur under the approach described above is ultimately determined to be inconsistent with Treasury's final view as to how basis allocation should operate in acquisitive D reorganizations, we would note that the proposed basis allocation regulations already contain provisions that could be adapted to handle the issue of basis under the deemed satisfied approach. In particular, under the proposed section 302 regulations, if all shares in a class held by a shareholder are redeemed, an amount equal to the remaining basis of the redeemed stock is treated as a deferred loss that is generally taken into account when the shareholder's other stock ownership (direct or indirect) has declined below a certain threshold.[78] An analogous concept could be adopted for all-cash D reorganizations whereby the inclusion date for the loss corresponding to the remaining basis in Target shares is determined by reference to Acquiring stock owned (directly or indirectly) by the Target shareholder. The loss deferral regime would avoid any potential for basis shifting and would give taxpayers a method for determining when their remaining basis in Target would be recognized.

V. MODIFYING THE DEEMED ISSUED SHARE CONSTRUCT

Although we believe Treasury has authority to deem the statutory distribution requirements satisfied without the deemed issuance of a nominal share,[79] adopting the deemed issuance approach with targeted modifications to address any unintended consequences may avoid any potential concerns regarding the authority for the deemed satisfied approach. Since the Regulations provide taxpayers with much needed guidance and should be finalized in some form, this Part examines an alternative approach that would allow Treasury to retain the deemed issued share construct while mitigating some of its flaws.

Treasury could promulgate targeted rules that alleviate the problems that have been identified with the deemed issued construct. We note that Treasury has already employed such an approach in amending the Regulations to address concerns about the deemed issuance's effect on transactions intended to qualify as triangular reorganizations.[80] Under this approach, we would recommend that the problem of inaccessible unrecovered basis from built-in loss Target stock discussed in Part III.A be addressed by providing that unrecovered basis in Target stock attach to Acquiring stock that the Target shareholder actually or constructively owns (applying the constructive ownership rules set forth in the Regulations) rather than to the deemed issued share.[81] Having a special rule that sets forth the treatment of unrecovered basis in transactions described in the Regulations would prevent the deemed issued share from acting as an impediment to basis recovery. Moreover, it would also provide taxpayers with greater certainty than would be present under the deemed satisfied approach, since the deemed satisfied approach would not specify what the proper result should be. It is worth noting that such a rule would still permit the artificial distinctions that may arise under the deemed satisfied approach where a

[78] Prop. Treas. Reg. § 1.302-5(a)(3)(i), 4(A).
[79] *See supra* note 56 and the accompanying text for the relevant authorities in support of the deemed satisfied approach. In particular we believe that the meaningless gesture doctrine provides support for either a deemed satisfied approach or a deemed issuance approach. *See James Armour, Inc. v. Comm'r*, 43 T.C. 295, 308 (1964).
[80] T.D. 9313, 2007-1 C.B. 805.
[81] *See supra* note 69 and the accompanying text.

taxpayer can choose between having Acquiring actually issue a nominal amount of stock or instead rely on the Regulations to deem the distribution requirement satisfied.[82]

Similarly, in order to avoid creating deferred gain upon the distribution of a deemed issued share with an ELA, a special rule in the consolidated return regulations could reference the Regulations and provide that any ELA that would otherwise attach to Acquiring stock will instead reduce the basis of Acquiring stock constructively owned by the Target shareholder. We note that Treasury has recently promulgated an amendment of limited scope to the consolidated return regulations in order to address an unintended byproduct of a change to the reorganization regulations.[83] It seems appropriate for Treasury to offer similar relief from the effects of the deemed issuance since the deemed issuance is a generally applicable rule that interacts negatively with -13(f)(3)'s turn off of section 356 in the consolidated group, a rule that is specifically tailored to address intercompany reorganizations.

As an alternative to crafting narrowly tailored rules to address undesirable consequences of the deemed issuance, Treasury could simply provide that the deemed issuance has no consequences for purposes other than satisfying the distribution requirement. This approach has the benefit of satisfying the distribution requirement while avoiding any unintended problems associated with a deemed issuance.

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[82] *See supra* text accompanying note 70.

[83] Treasury promulgated Treasury regulations section 1.1502-13T(f)(5)(ii)(B) to correct for a conflict between old -13(f)(5)(ii)(B) and Treasury regulations section 1.368-2(k). *See* T.D. 9458 (Sept. 4, 2009). Old -13(f)(5)(ii)(B) allowed a taxpayer to make an election to avoid deferred gain on an intercompany stock sale following the liquidation of the transferred subsidiary, provided the assets of the liquidated old subsidiary were transferred to a new subsidiary. Old -13(f)(5)(ii)(B) provided that liquidation and transfer would be integrated, and "*if* the liquidation and transfer would qualify as reorganization described in section 368(a)" then the successor asset rule could apply since the basis of the old subsidiary would continue to be reflected in the basis of the new subsidiary. Accordingly, deferral of gain could continue. Treasury regulations section 1.368-2(k), however, characterized such a liquidation and reincorporation as an upstream C reorganization followed by a drop down of assets into the new subsidiary. This characterization would have prevented application of the successor asset rule. In order to enable the deferral of gain under the election, temporary Treasury regulations section 1.1502-13T(f)(5)(ii)(B) now provides that the liquidation and reincorporation is treated as a cross chain reorganization.