NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON

PROPOSED REGULATIONS §1.312-11: ALLOCATION OF EARNINGS AND PROFITS IN CONNECTION WITH ASSET REORGANIZATIONS

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New York State Bar Association Tax Section

Report on Proposed Regulations §1.312-11: Allocation of Earnings and Profits in Connection with Asset Reorganizations

I. INTRODUCTION

This report ("Report")[1] of the New York State Bar Association Tax Section makes proposals regarding the allocation of earnings and profits ("E&P") in connection with acquisitive asset reorganizations described in section 368 of the Internal Revenue Code of 1986, as amended (the "Code").[2] In all acquisitive asset reorganizations, the target corporation ("Target") must liquidate pursuant to the plan of reorganization, necessitating rules to determine where Target's attributes will reside after the reorganization. Section 381 provides generally that the "acquiring corporation" in an asset reorganization "shall succeed to and take into account, as of the close of the day" of the transfer, all the attributes of Target described in section 381(c), including E&P.[3] If the acquiring corporation in the reorganization transfers the Target assets to a subsidiary, the question is raised as to whether the subsidiary should succeed to the E&P of Target.

The Treasury Department ("Treasury") and Internal Revenue Service (the "Service") recently issued Prop. Reg. §1.312-11, which provides that the E&P of Target moves to a single acquiring corporation and may not be allocated among two or more corporations.[4] For this purpose, the proposed regulations retain the definition of "acquiring corporation" that has existed since the original issuance of regulations under section 381 in 1960 (the "1960 regulations definition"). Consistent with the treatment of other tax attributes, the 1960 regulations definition provides that Target's E&P will be inherited by the corporation that acquires the Target assets directly from Target in the section 368 reorganization (the "Section 368 Acquiring Corporation") or a transferee corporation to which the Section 368 Acquiring Corporation transfers all of Target's assets (the "Single Transferee").

We applaud Treasury and the Service for addressing the ambiguity in current law that has existed for more than fifty years. In general, the rules that address the movement of E&P in the context of an asset reorganization are intended to neutralize the effect of the reorganization on the

[1] The authors of this Report were Karen Gilbreath Sowell, Brian Reed, and Jonathan J. Katz. Significant contributions were made by Michael J. Kliegman, Andrew W. Needham, Michael L. Schler and Eric Solomon. Helpful comments were received from John P. Barrie, Peter J. Connors, Andrew J. Dubroff, Lawrence M. Garrett, Stephen B. Land, Chris Nelson, Richard M. Nugent, David H. Schnabel, David R. Sicular and Gordon Warnke. This Report reflects solely the views of the Tax Section of the NYSBA and not those of the NYSBA Executive Committee or the House of Delegates.

[2] Unless indicated otherwise, all "section" references are to the Code and all "Treas. Reg. §" references are to the Treasury regulations promulgated under the Code, both as in effect on the date of this Report.

[3] Section 381(c)(2).

[4] *See* REG-141268-11 (April 16, 2012).

taxability of future distributions as dividends to the former Target shareholders. By providing that *all* the E&P of Target remains with the Section 368 Acquiring Corporation unless *all* the acquired assets are transferred to a Single Transferee, the proposed regulations seek to ensure that the E&P of the Target remains undivided and generally as close to the former Target shareholders as possible, with certain exceptions. In a purely domestic context, maintaining the E&P of Target at the corporation closest to the former Target shareholders generally prevents distributions of such E&P from escaping shareholder level taxation in a future distribution. In the cross-border context, it seems appropriate that U.S. tax-deferred E&P remain in the foreign entity closest to the water's edge to be taxed in the U.S. upon repatriation. Since the advent of Subpart F and other anti-deferral regimes, however, dividends can flow into the United States directly from foreign entities several tiers below a domestic corporation. Consequently, the electivity of the proposed regulations may result in unwarranted opportunities.

Part II of this Report summarizes our recommendations. Part III of the Report reviews the relevant provisions of the Code and regulations governing the movement of E&P and the case law, legislative history, and commentary that provide insight into the purpose of these provisions. Part IV discusses the additional policy considerations to be considered in determining the proper rules for the allocation of E&P. Part V outlines several approaches for allocating E&P, including the approach proposed by the Service in Prop. Reg. §1.312-11.

II. SUMMARY OF RECOMMENDATIONS

1. *Do not finalize Prop. Reg. §1.312-11.* In order to better implement the policies underlying sections 381 and 312, we recommend that Treasury and Service not finalize Prop. Reg. §1.312-11 in its current form and that the 1960 regulations definition of "acquiring corporation" be reconsidered as it applies to E&P. We do not believe it is appropriate for taxpayers to choose to have the Section 368 Acquiring Corporation inherit the Target E&P by either retaining a single asset or transferring (or causing to be transferred) a single asset to an entity other than the Single Transferee, when all the other assets are transferred to a Single Transferee.

   In particular, with the growth of the U.S. multinational corporation, the tax system has focused on the relationship between the U.S. corporation and its foreign subsidiary. Because a taxpayer may artificially elect whether the Section 368 Acquiring Corporation or the Single Subsidiary will inherit the E&P of the Target, the proposed regulations allow for repatriation planning that should not be available simply because a reorganization has been undertaken. Similarly, in the case of a foreign Section 368 Acquiring Corporation of a domestic Target, electivity in placing E&P may allow for avoidance of U.S. withholding taxes.

2. *Section 368 Acquiring Corporation Proposal.* The rules that determine the appropriate recipient of Target's E&P should be driven by the policy objective of neutralizing the effect of corporate nonrecognition transactions on future shareholder taxability. Moreover, we recognize that any such rules should seek to provide certainty to taxpayers,

eliminate artificial electivity, and be administrable by the Service. As such, we recommend that the Section 368 Acquiring Corporation should succeed to Target's E&P, regardless of any subsequent transfers of the Target assets (the "Section 368 Acquiring Corporation Proposal").

3. *Substantially All Proposal*. Prior to the issuance of Prop. Reg. §1.312-11, commentators had proposed that a corporation that acquires substantially all of Target's assets should succeed to Target's E&P (the "Substantially All Proposal").[5] If Treasury and the Service determine that maintaining a direct relationship between the E&P and the assets that created the E&P is an important policy that should be reflected in the regulations, we believe the corporation that acquires substantially all the assets of Target is the appropriate surrogate for Target and, therefore, recommend that the Substantially All Proposal be adopted.

III. BACKGROUND

A. Asset reorganizations

Section 368 provides for the following types of asset reorganizations:

- a statutory merger or consolidation ("A reorganization");[6]
- the acquisition by one corporation, in exchange for stock of a corporation which is in control of the acquiring corporation, of substantially all of the properties of another corporation by statutory merger or consolidation ("forward triangular merger");[7]
- the acquisition by one corporation, in exchange solely for its voting stock, of substantially all of the properties of another corporation ("C reorganization");[8]
- the acquisition by one corporation, in exchange solely for the voting stock of a corporation which is in control of the acquiring corporation, of substantially all of the properties of another corporation ("triangular C reorganization");[9]
- a transfer by a corporation of substantially all of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred ("D reorganization");[10]

[5] *See* Michael L. Schler, Eric Solomon, Karen Gilbreath Sowell, Jonathan J. Katz, and Gary Scanlon, "Updating the Tax-Free Reorganization Rules: Attributes, Overlaps and More", The Taxes Magazine (March 2012) (hereinafter, the "University of Chicago Proposal").
[6] Section 368(a)(1)(A).
[7] Section 368(a)(1)(A), (a)(2)(D).
[8] Section 368(a)(1)(C).
[9] Section 368(a)(1)(C) (parenthetical language).
[10] Sections 368(a)(1)(D), 354(b)(1)(B).

- a mere change in identity, form, or place of organization of one corporation, however effected ("F reorganization");[11]
- a transfer by a corporation of all or part of its assets to another corporation in a title 11 or similar case ("G reorganization").[12]

To qualify as a C, D, or G reorganization, as well as a forward triangular merger or triangular C reorganization, substantially all of the assets of the Target must be acquired by a single corporation (the "substantially all requirement").[13] An A reorganization does not implicate the substantially all requirement, but requires a transfer of assets pursuant to state or foreign merger statute.[14] An F reorganization involves a reorganization of a single operating company, typically with a newly formed corporation.[15] A G reorganization, in addition to satisfying the substantially all requirement, must be undertaken in a bankruptcy or similar context.

In the context of an A, C, D, F or G reorganization, the corporation that acquires the requisite amount of assets from Target is also the corporation that issues (or is deemed to issue in the case of a D reorganization[16]) its stock (the "issuing corporation") in exchange for the Target assets. In the context of a triangular reorganization (as defined in Treas. Reg. §1.358-6(b)(2)), however, while the "acquiring corporation" acquires the Target assets, the "issuing corporation" is the corporation that controls the acquiring corporation within the meaning of section 368(c).[17]

B. Transfers of assets under section 368(a)(2)(C)

Prior to the 1954 Code, it was believed that a transfer of the Target assets to a subsidiary of the acquiring corporation could violate the common law "continuity" requirements of a reorganization.[18] With the enactment of section 368(a)(2)(C) in 1954, however, a transaction otherwise qualifying as an A, B, or C reorganization would no longer be disqualified by reason of the fact that part or all of the assets or stock which were acquired in the transaction were transferred to a corporation controlled by the corporation acquiring such assets or stock. Beginning in the late 1990s, Treasury and the Service further expanded the scope of permissible asset or stock transfers following other types of reorganizations to include contributions to indirectly controlled subsidiaries, distributions of acquired assets or stock, and transfers to

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[11] Section 368(a)(1)(F).
[12] Section 368(a)(1)(G).
[13] Section 368(a)(1)(C) (acquiring corporation must acquire "substantially all of the properties of another corporation" solely in exchange for voting stock); section 354(b)(1)(A) ("[Section 354(a)] shall not apply to an exchange in pursuance of a plan of reorganization within the meaning of subparagraph (D) or (G) of section 368(a)(1) unless…the corporation to which the assets are transferred acquires substantially all of the assets of the transferor of such assets); section 368(a)(2)(D) (the acquisition by one corporation in exchange for the stock of its parent "of substantially all of the properties of another corporation" can qualify as an A or G reorganization).
[14] Section 368(a)(1)(A).
[15] Section 368(a)(1)(F).
[16] *See* Treas. Reg. §1.368-2(l).
[17] Treas. Reg. §1.368-1(b).
[18] *See Groman v. Comm'r*, 302 U.S. 82 (1937), Ct. D. 1285, C.B. 1937-2, 286; and *Helvering v. Bashford*, 302 U.S. 454 (1938), Ct. D. 1299, C.B. 1938-1, 86.

partnerships.[19] Under current law, therefore, many different corporate entities may house the former assets of the Target in a valid asset reorganization. As a result, there are many more options for which corporation(s) could succeed to Target's E&P than there were in 1954, complicating the policy questions underlying Prop. Reg. §1.312-11.

C. Section 381 acquiring corporation

1. Pre-section 381 case law

Prior to 1954, it was unclear whether the Section 368 Acquiring Corporation succeeded to Target's existing tax attributes.[20] Because no statute addressed this question, the determination was made on a case-by-case basis in the courts.[21] Frequently, as discussed below, the Section 368 Acquiring Corporation was determined to succeed to the tax attributes of Target in a reorganization described in section 112(g)(1)(A) of the Internal Revenue Code of 1939 (the analogue to the modern-day A reorganization), but not other types of reorganizations. This disparity contrasted with the widely held notion that the Section 368 Acquiring Corporation should "step into the shoes" of Target upon any type of asset reorganization.[22] The inconsistency in the case law governing tax attribute carryovers led to significant uncertainty and general confusion among taxpayers.[23]

2. Carryover of attributes other than E&P

Two cases representative of this case law inconsistency are *New Colonial Ice Co. v. Helvering*[24] and *Stanton Brewery, Inc. v. Commissioner*.[25] In *New Colonial Ice*, all the assets and business of Oldco were taken over by Newco in exchange for a stock in Newco, which was distributed by Oldco to its shareholders. The taxpayer argued that Newco should inherit the net operating loss carryovers of Oldco because "for all practical purposes [Newco] was the same entity as [Oldco] and therefore the same taxpayer." The Supreme Court rejected this argument in large part because, as a legal matter, it believed that the two corporations were not identical, but rather

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[19] *See, e.g.,* T.D. 8760 (January 28, 1998) (providing that certain contributions of Target assets to members of the Section 368 Acquiring Corporation's "qualified group" would not cause the reorganization to be disqualified); REG-165579-02 (Mar. 2004) (amendment of Treas. Reg. §1.368-2(k) to conform to Rev. Rul. 2001-24 and Rev. Rul. 2002-85 below); REG-130863-04 (Aug. 2004); T.D. 9361 (Oct. 2007) (expanding the definition of "qualified group" for purposes of Treas. Reg. §1.368-2(k)); T.D. 9396 (May 2008) (providing that Treas. Reg. §1.368-2(k) does not apply to certain transfers to former Target shareholders); Rev. Rul. 2001-24, 2001-1 C.B. 1290 (permitting the parent of the Section 368 Acquiring Corporation to transfer its stock to a subsidiary following a forward triangular merger); Rev. Rul. 2002-85, 2002-2 C.B. 986 (permitting the transfer by the Section 368 Acquiring Corporation to a subsidiary following a D reorganization).

[20] Albert E. Germain, *Carryovers in Corporate Acquisitions*, 15 Tax. L. Rev. 35 (1959).

[21] *See*, *e.g.*, *Comm'r v. Sansome*, 60 F.2d 931 (2d Cir. 1932) and *Campbell v. U.S.*, 144 F.2d 177 (3d Cir. 1944) (discussed *infra).*

[22] *Id.*

[23] *Id.*

[24] 292 U.S. 435 (1934).

[25] 176 F.2d 573 (1949).

were distinct entities because the transfer of the assets and business from one to the other was voluntary and contractual, not by operation of law.[26]

In *Stanton Brewery,*[27] under facts similar to *New Colony*, Oldco transferred its assets and business to Newco by statutory merger. In its analysis, the court described the state of the law at the time:

> The issue as so stated is thus seen to turn upon the nature of merged corporations after a merger. At the outset we find ourselves confronted with one of those questions of legal semantics or categorization which constantly dog the judicial process. For here the decision seems to be sought in terms of which legal entity swallowed the other. Moreover there appears to be the further assumption, on the part of respondent, that necessarily the inactive holding company -- which lost its identity in the other so far at least as its name is concerned -- swallowed the really active part of the enterprise, so that an important privilege of the latter, taxwise, is irrevocably lost. And it seems that, had the converse been true and the swallower originally had the privilege, it would still be retained.[28]

The Service argued that because the legal entity with the relevant tax attribute (Oldco) was eliminated following the merger, the acquiring corporation (Newco) should not inherit it. The court rejected this argument, finding that "the 'resulting corporation' was the union of component corporations into an all-embracing whole which absorbs the rights and privileges, as well as the obligations, of its constituents," and should therefore be entitled to the tax attribute. Distinguishing *New Colony*, the court stated that the corporation resulting from a merger assumed the obligations of Oldco by operation of law. The court further rejected other cases relied upon by the Service because "all the cases cited in its support, and independently stressed by respondent, deal with succession by purchase and contract, rather than by operation of law."[29]

The significance of a state law merger was also found relevant in the context of unamortized bond discount. In *Helvering v. Metropolitan Edison Company,*[30] a wholly-owned subsidiary corporation had issued certain bonds at a discount. Later, the parent corporation absorbed the subsidiary pursuant to the provisions of a Pennsylvania statute authorizing corporate mergers, and the parent subsequently retired the bonds previously issued by the subsidiary and assumed by the parent in connection with the transaction. The Court pointed to an important concession by the Service (the petitioner):

> The petitioner concedes that if there has been a true merger or consolidation whereby the identity of the corporation issuing the bonds continues in the successor and the latter becomes liable for the debts of the former by operation of

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[26] 292 U.S. at 441.
[27] 176 F.2d 573 (2d Cir. 1949).
[28] *Id.* at 574.
[29] *Id.* at 576.
[30] 306 U.S. 522 (1956).

> law, the successor may deduct amortization of discount and expense in respect of bonds issued by its predecessor as well as unamortized discount and expense on any of such bonds retired prior to maturity. The rule is not applicable upon a mere sale by one corporation of all its assets to another which assumes the liabilities of the former.[31]

After examining the transaction in the light of the statutory provisions, the Court ruled that the transfer qualified as a merger within the meaning of the applicable Pennsylvania merger statute. Because the parent corporation became subject to the transferor's liability under the statute by operation of law, the Court concluded that the parent corporation was entitled to claim a deduction for the unamortized bond discount on the bonds of its former subsidiary.[32]

3. Carryover of E&P

The seminal case in the area of E&P succession is *Commissioner v. Sansome*.[33] In *Sansome*, the taxpayer acquired all the stock of Oldco and soon thereafter formed Newco to acquire all of Oldco's assets, subject to all of its liabilities, in exchange for Newco stock. At the time of the reorganization, Oldco had significant E&P. After the reorganization, however, the business became unprofitable and Newco was dissolved two years after its formation. At issue was whether distributions made to the taxpayer in liquidation were "out of the earnings and profits" of Newco and therefore taxable as dividends.[34] The Second Circuit held "as a matter of statutory construction" that Newco inherited the E&P of Oldco.[35] Specifically, the court found it "extremely unlikely that what was not 'recognized' as a sale or disposition for the purpose of fixing gain or loss, should be 'recognized' as changing accumulated profits into capital."[36] Thus, the court concluded that a "corporate reorganization which results in no 'gain or loss' … does not toll the company's life as continued venture … and that what were 'earnings or profits' of the original, or subsidiary, company remain, for purposes of distribution, 'earnings or profits' of the successor, or parent, in liquidation."[37]

In *Campbell v. United States*,[38] in substantial reliance on the above-quoted "continued venture" language, the Third Circuit declined to apply the *Sansome* court's ruling where the shareholders

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[31] 306 U.S. at 526-527.
[32] *See also American Gas & Electric Co. v. Comm'r*, 85 F.2d 527 (2d Cir. 1936); *American Gas & Electric Co. v. U.S.*, 17 F.Supp. 151 (Ct. of Cl. 1936); *New York Central R. Co. v. Comm'r*, 79 F.2d 247 (2d Cir. 1935); *Western Maryland Ry. Co. v. Comm'r*, 33 F.2d 695 (4th Cir. 1929); *Illinois Power & Light Corp. v. Comm'r*, 33 B.T.A. 1189 (B.T.A. 1936); *Connecticut Electric Service Co. v. Comm'r*, 35 B.T.A. 444 (B.T.A. 1937).
[33] 60 F.2d 931 (2d Cir. 1932).
[34] Under section 201(c) of the Revenue Act of 1921, the precursor to section 301(c)(1), liquidating distributions were taxable as dividends to the extent of the E&P of the dissolving corporation. Under current law, liquidating distributions to a noncorporate shareholder are taxable as amounts received in full payment of the stock of the liquidating corporation. *See* section 331(b).
[35] *Sansome*, 60 F.2d 931 at 933.
[36] *Id.*
[37] *Id.*
[38] 144 F.2d 177 (3d. Cir 1944).

of Oldco received only 46 percent of the common and 37 percent of the preferred stock of Newco, with the remaining equity in Newco issued in exchange for an infusion of new capital. The court found lacking the identity of proprietary interest which existed in the *Sansome* case, viewing the introduction of new investors as resulting in an entity sufficiently different from Oldco such that it could not be the successor.[39]

In two other cases, the Supreme Court rejected the identity-of-interest justification for attribute succession. First, in *Commissioner v. S.S. Munter*,[40] the Court held on facts similar to *Campbell* that Newco inherited the E&P of Oldco, at least to the extent that the shareholders of Oldco were not taxed on those earnings under the predecessor to section 356(a)(2). In refusing to follow *Campbell*, the Court reasoned that, regardless of the composition of the acquiring entity in a reorganization, "[t]he congressional purpose to tax all stockholders who receive distributions of corporate earnings and profits cannot be frustrated by any reorganization which leaves earnings and profits undistributed in whole or in part."[41]

Similarly, in *Commissioner v. Phipps*,[42] a parent corporation liquidated its wholly-owned subsidiaries, which, in the aggregate, had E&P deficits in excess of the parent corporation's positive E&P. The shareholders of the parent corporation claimed that a subsequent distribution by the parent qualified as a return of capital because the deficits of the subsidiaries had absorbed and eliminated the parent's E&P. The Service disagreed, arguing that *Sansome* did not apply and that the deficits of the subsidiaries could not be inherited to reduce the E&P of the parent corporation. The Supreme Court sustained the Service in a unanimous decision, concluding that "the Sansome rule is grounded not on a theory of continuity of business enterprise but on the necessity to prevent escape of earnings and profits from taxation."[43]

4. Section 381 and its legislative history

With the enactment of section 381 in 1954, Congress sought to eliminate the confusion and uncertainty regarding the carryover of tax attributes in acquisitive asset reorganizations. At the time of enactment, section 381 governed the carryover of nineteen different tax attributes.[44] In explaining the rationale for section 381, the Senate Finance Committee and the House Committee on Ways and Means expressed similar sentiments. The House Committee on Ways and Means Report stated in relevant part:

> [P]resent practice rests on court-made law which is uncertain and frequently contradictory. Moreover, whether or not the carryover is allowed should be based upon economic realities rather than upon such artificialities as the legal form of the reorganization.

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[39] *Id.* at 180.
[40] 331 U.S. 210 (1947).
[41] *Id.* at 215.
[42] 336 U.S. 410 (1949).
[43] *Id.* at 417.
[44] 26 U.S.C. 381 (1954).

> The bill provides for the carryover of … specific attributes or items from one corporation to another in certain tax-free reorganizations. Under this provision, a corporation which acquires substantially all the property of another corporation in a tax-free transfer is to take into its accounts certain specified items of the distributor or transferor corporation. The principal items are loss carryovers, earnings and profits, and certain elections, such as those relating to LIFO inventory accounting and those relating to the use of the special declining balance depreciation method. No provision is made for the apportionment of such items in the case of split-ups, spin-offs, or other divisive reorganizations.
>
> The new rules enable the successor corporation to step into the "tax shoes" of its predecessor corporation without necessarily conforming to artificial legal requirements which now exist under court-made law. Tax results of reorganizations are thereby made to depend less upon the form of the transaction than upon the economic integration of two or more separate businesses into a unified business enterprise. At the same time the new provision makes it difficult to escape the tax consequences of the law by means of a legal artifice such as liquidation and reincorporation or merger into another corporation.[45]

The legislative history makes clear that Congress intended to eliminate the uncertainty resulting from the lack of statutory guidance in this area. For instance, as discussed above, reorganizations accomplished via a state law merger more often resulted in the carryover of attributes than reorganizations accomplished by contractual agreement. Congress clearly rejected the form by which the integration of the two businesses occurred as relevant to the determination of whether the tax attributes of the Target should carryover in a reorganization.

The statute that was enacted, however, did not clearly establish *which* corporation would succeed to the attributes of Target, a question that became important in light of the contemporaneous enactment of section 368(a)(2)(C). The statute merely provides that the relevant tax attributes carryover to the "acquiring corporation", leaving the definition of that term for future regulations.

[45] H.R. REP. NO. 1337, at 41 (1954). The Senate Finance Committee statements were almost identical. S. REP. NO. 1622, at 52 (1954).

The legislative history suggests that the corporation acquiring substantially all of the assets of Target should succeed to its attributes. Based on the transactional landscape in 1954 and the Code definitions and rules related to reorganizations, as discussed below, the "substantially all" standard sought to ensure that economically similar transactions should be treated similarly, regardless of the particular type of reorganization. For example, to qualify as a C or D reorganization, the Section 368 Acquiring Corporation must acquire substantially all of Target's assets, as opposed to all of the assets in an A reorganization. Because section 381 was designed to apply to all asset reorganizations, Congress probably endorsed the substantially all standard to ensure the same rule applied in all cases. At that time, for example, the Target in a C reorganization was not required to liquidate. If Target's attributes did not travel with substantially all Target assets, the Target attributes would remain with Target, be inherited by the distributee corporation if Target liquidated, or would disappear. Such a result would be in contrast to the results if Target merged into the Section 368 Acquiring Corporation in an A reorganization. In addition, taxpayers were taking the position that a liquidation of Target followed by a reincorporation of substantially all the assets would be respected as such, and would not be characterized as a D reorganization, with the result that Target's assets would be stepped up to fair market value and its tax attributes would disappear. The legislative history cited above suggests Congress did not intend for the order of transaction steps to dictate the recipient of the tax attributes of Target, again suggesting that the purpose of the "substantially all" language was to treat similar transactions similarly.

The legislative history also states that the tax results of a reorganization should be based upon the "economic integration" of the businesses being combined in the reorganization, presumably in furtherance of the goal discussed above. Section 368(a)(2)(C) was enacted at the same time as section 381, affording for the first time the ability to transfer some or all of the assets acquired in an asset reorganization to a controlled subsidiary without running afoul of the common law continuity requirement.[46] Thus, it is unlikely that in the reference to economic integration, Congress was making any statement regarding whether the Target attributes must stay with the Target assets if such assets are transferred after the reorganization.

5. The 1960 regulations

On January 28, 1960, Treasury and the Service issued proposed regulations under section 381,[47] which were finalized on July 12, 1960.[48] These rules remain in effect today.

Treas. Reg. §1.381(a)-1 (i.e., the 1960 regulations definition) provides that a corporation is the "acquiring corporation" and, therefore, succeeds to the tax attributes of Target only if, pursuant to the plan of reorganization, it ultimately acquires, directly or indirectly, *all* of the assets transferred by Target or, if no single corporation acquires *all* of the assets transferred by Target (i.e., the Single Transferee"), then the corporation that directly acquires Target's assets (prior to

[46] *See* Rev. Rul. 64-73, 1964-1 C.B. 142 (subsequent transfer of assets acquired in a C reorganization to a wholly-owned subsidiary of the acquiring corporation will not affect the reorganization).
[47] 25 FR 756 (January 29, 1960).
[48] T.D. 6480 (July 12, 1960).

any subsequent asset transfers) succeeds to its tax attributes (i.e., the Section 368 Acquiring Corporation).[49] In this regard, the 1960 regulations definition of acquiring corporation is independent of the determination of the Section 368 Acquiring Corporation. Thus, if a Single Transferee acquires all of the assets of Target in a transfer pursuant to the plan of reorganization, that corporation succeeds to the attributes of Target even if it is not the Section 368 Acquiring Corporation in the reorganization. Where no one corporation ultimately acquires all of the assets of Target, the Section 368 Acquiring Corporation will succeed to the tax attributes, even if that corporation ultimately retains none of the Target assets.[50]

The 1960 regulations seem like a sensible approach to determining the appropriate location of attributes following an asset reorganization, considering the transactional landscape at the time. The regulations apply whenever Target transfers substantially all of its assets to another corporation, covering all types of asset reorganizations. Further, the regulations recognized that section 368(a)(2)(C) allowed for asset transfers to a directly controlled subsidiary. Thus, if a corporation acquires substantially all of Target's assets in a C reorganization and then transfers all of those assets to a directly controlled subsidiary, the attributes would reside with the subsidiary. This rule could be viewed as consistent with the legislative history language that focused on "substantially all" the assets. In light of the subsequent changes to the reorganization provisions that allow for a variety of post-reorganization asset transfers, and the proliferation of multinational corporations to which the Subpart F regime or withholding regimes apply, we believe the 1960 regulations are no longer appropriate with respect to which corporation should succeed to Target's E&P.

6. Reorganization definitions

In 1954, A reorganizations were the predominant form of reorganization. C reorganizations had been added to the Code to allow for tax-free reorganizations in states that did not have merger statutes or that had merger statutes that were inflexible.[51] To qualify as a C reorganization,

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[49] Treas. Reg. §1.381(a)-1. *See also* Treas. Reg. §1.381(a)-1(b)(2)(ii), *Ex. 1* (Y Corporation, a wholly-owned subsidiary of X Corporation, directly acquires all the assets of Z Corporation solely in exchange for voting stock of X Corporation in a transaction qualifying under section 368(a)(1)(C). Y Corporation is the acquiring corporation for purposes of section 381.).

[50] *Id. See also* Treas. Reg. §1.381(a)-1(b)(2)(ii), Ex. 3 (X Corporation acquires all the assets of Z corporation solely in exchange for the voting stock of X Corporation in a transaction qualifying under section 368(a)(1)(C). Thereafter, pursuant to the plan of reorganization X Corporation transfers one-half of the assets so acquired to Y Corporation, its wholly-owned subsidiary, and retains the other half of such assets. X Corporation is the acquiring corporation for purposes of section 381.), and Ex. 4 (X acquires all the assets of Z in a C reorganization and contributes 50 percent of the Z assets to wholly-owned Y and 50 percent of the assets to wholly-owned M; X is the acquiring corporation for purposes of section 381); CCA 200911010 (July 8, 2008) (A acquires all the assets of T in a D reorganization and contributes 100 percent of the T assets to wholly-owned A1, which in turn contributes 50 percent of the T assets to A2; A1 is the acquiring corporation for purposes of section 381).

[51] *See* S. Rept. No. 558, 73d Cong., 2d Sess., 1939-1 C. B. (Part 2) 586, 598 ("The committee believes that these transactions, when carried out as prescribed in this amendment, are in themselves sufficiently similar to mergers and consolidations as to be entitled to similar treatment."). For example, *see George v. Comm'r*, 26 T.C. 396 (1956)

Target had to transfer substantially all of its assets to the Section 368 Acquiring Corporation. It was not until 1984, however, that the Target in a C reorganization was also required to liquidate after the transfer.[52] Congress amended the C reorganization requirements, in part, because Target could transfer its assets to an acquiring corporation and, pursuant to section 381(a), Target's E&P would move to the Section 368 Acquiring Corporation, leaving Target with the ability to make tax-free distributions to its shareholders from its remaining assets.[53] The 1954 Code also allowed for acquisitive D reorganizations, requiring the transfer of substantially all of Target's assets to a corporation controlled by Target's shareholders or Target and a distribution of stock of the Section 368 Acquiring Corporation. In order to achieve preferable basis results under the law existing at the time, however, taxpayers attempted to avoid D reorganization treatment by undertaking the liquidation of Target as a first step, with the Target shareholder retaining the liquid assets.[54]

7. Post-reorganization transfers of assets – section 368(a)(2)(C)

Also as part of Internal Revenue Code of 1954, Congress enacted section 368(a)(2)(C), providing that certain types of reorganizations (at the time, only A and C reorganizations) are not disqualified as reorganizations if all or a part of the assets of Target are contributed by the Section 368 Acquiring Corporation to a controlled corporation. For this purpose, the Section 368 Acquiring Corporation controls a corporation if it owns at least 80% of all voting stock and 80% of all non-voting stock of that corporation.[55]

(amalgamation of corporations incorporated in two different states could not qualify as an A reorganization because of a state law restriction on consolidating with a "foreign" corporation).

[52] Section 368(a)(2)(G),Tax Reform Act of 1984.

[53] *See, e.g.,* B. Bittker and J. Eustice, *Federal Income Taxation of Corporations and Shareholders,* (7th ed. 2006 & Supp. 2012-2) at 12.24[4] ("Since the transferor's tax history was stripped out by § 381(a)(2), passing over in full to the acquiring corporation, the transferor could continue in existence as a holding company with a clean slate of earnings and profits.").

[54] *See, e.g., Survaunt v. Comm'r*, 5 T.C. 665 (1945), *aff'd and rev'd*, 162 F.2d 753 (8th Cir. 1947) (holding that the liquidation of old company and acquisition of its assets by a new corporation in exchange for delivery of new corporation stock and debentures to old stockholders to allow the stockholders pay off debts was a reorganization rather than a liquidation); *Lewis v. Comm'r*, 176 F.2d 646 (1st Cir. 1949) (holding that a series of transactions undertaken to minimize tax would be treated as a reorganization rather than a liquidation where an old corporation sold two of its three businesses, transferred the remaining business to a new corporation in exchange for the new company's stock, and distributed the stock and proceeds from the sale of the two businesses to its shareholders in liquidation of the first corporation); *Becher v. Comm'r*, 22 T.C. 932 (1954), *aff'd* on other grounds, 221 F.2d 252 (2d Cir. 1955) (holding that a series of transactions constituted a reorganization rather than a liquidation where an old corporation discontinued its business, distributed cash to its shareholders which was contributed to a new corporation to begin a new business, and the old corporation dissolved); *Liddon v. Comm'r*, 22 T.C. 1220 (1954), *rev'd and rem'd*, 230 F.2d 304 (6th Cir. 1956) (holding that a series of transactions constituted a reorganization rather than a liquidation where an old corporation sold some of its assets to a new corporation (with substantial overlapping ownership between the two corporations), and thereafter distributed its remaining assets to its shareholders in liquidation).

[55] Treasury and the Service view the parameters of section 368(a)(2)(C) as nonexclusive. *See, e.g.,* Rev. Rul. 2001-24, 2001-1 C.B. 1290, and Rev. Rul. 2002-85, 2002-2 C.B. 986.

For the first time, the enactment of section 368(a)(2)(C) raised the question of whether Target's tax attributes should reside with the Section 368 Acquiring Corporation or the controlled subsidiary to which the assets were transferred. As discussed above, section 381 simply provides that attributes carry over to the "acquiring corporation", a term not defined in the statute. Given the language in the section 381 legislative history regarding tax attributes carrying over to the corporation that acquires substantially all of Target's assets, it appears the prevailing view at the time of enactment was that the "acquiring corporation" was the corporation that ultimately acquired substantially all of Target's assets. This view was adopted by the Advisory Group Report on Subchapter C,[56] which stated:

> The subsidiary and not the parent would be considered the acquiring corporation for purposes of section 381if it acquires substantially all of the assets transferred in the reorganization either directly from the transferor corporation or upon retransfer from the parent corporation.[57]

The legislative history of section 381 had left open the question of the identity of the "acquiring corporation" when no single corporation acquires substantially all of the assets of the Target. In such a case, the Advisory Group suggested that tax attributes be allocated between the Section 368 Acquiring Corporation and the controlled subsidiary.[58]

D. Section 312

E&P represents the pool of a corporation's economic income that may be used to pay dividends to shareholders without impairing the corporation's capital base. The character of corporate distributions and the consequences of other corporate transactions depend upon whether or not a corporation has E&P and, if so, how much.

Section 312 was enacted as part of the Internal Revenue Code of 1954 to provide mechanical rules for the adjustment of a corporation's E&P pool in connection with certain corporate transactions. These rules and the regulations that interpret them are described below.

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[56] The Advisory Group on Subchapter C was appointed by the House of Representatives Subcommittee on Internal Revenue Taxation on November 28, 1956 to study Subchapter C of the Internal Revenue Code of 1954 and to propose amendments and other changes. The Advisory Group submitted a preliminary report to the Subcommittee on December 24, 1957 and a revised report on December 10, 1958.

[57] Advisory Group Report on Subchapter C at 86 (Dec. 10, 1958).

[58] *Id.* at 87 ("the advisory group believes it is preferable to provide that, in cases where no one corporation owns substantially all the acquired assets, net operating loss carryovers and accumulated earnings and profits should be apportioned between the respective corporations holding a substantial portion of the transferred assets in a manner appropriate to the assets acquired and that the treatment of other tax attributes referred to in subsection (c) should be determined on a rational basis depending on the character of the particular item involved and its relationship to the assets and liabilities owned by the respective corporations, in keeping with the underlying policy of section 381").

1. Allocations of E&P in connection with an asset reorganization pursuant to Treas. Reg. §1.312-11

It has never been clear what happens to the E&P of Target when, in connection with a reorganization, the Section 368 Acquiring Corporation transfers historic Target assets to one or more controlled subsidiaries. The confusion stems from an ambiguous overlap between sections 381 and 312 in this area. As discussed above, the 1960 regulations definition provides that *all* of Target's tax attributes move to either the Section 368 Acquiring Corporation or the Single Transferee. In other words, section 381 does not allow for the allocation of tax attributes (including E&P) if Target's assets are divided among different corporations as a result of asset transfers made in connection with the reorganization.

Despite the fact that the regulations under section 381 do not provide for the possibility of allocating E&P among multiple corporations following a reorganization, the regulations do not foreclose such a possibility. Treas. Reg. §1.381(c)(2)-1(d) provides that, where the assets of the transferor corporation are transferred to one or more corporations controlled by the acquiring corporation, "whether any portion of the earnings and profits received by the acquiring corporation under section 381(c)(2) is allocable to such controlled corporation or corporations shall be determined without regard to section 381. See paragraph (a) of §1.312-11."[59] Treas. Reg. §1.312-11(a) requires "proper adjustment and allocation" of the E&P of the transferor corporation between the transferor and the transferee corporation as a result of certain nonrecognition transactions, including a section 351 transfer which precedes or follows "a reorganization, a transaction under section 302(a) involving a substantial part of the transferor's stock, or a total or partial liquidation."[60] The Service appears to have adopted an administrative position that, in general, it is not appropriate to allocate E&P when a corporation's assets are divided among multiple corporations in connection with an asset reorganization or section 332 liquidation,[61] and Prop. Reg. §1.312-11 confirms this administrative position.

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[59] T.D. 6586 (Dec. 27, 1961).

[60] An earlier version of Treas. Reg. §1.312-11(a) stated that there was to be no allocation or E&P in the case of a transfer of assets from one corporation to another but that the rule "may not apply when such transfer immediately follows or immediately precedes either a reorganization." T.D. 6152 (Dec. 2, 1955). Some commentators have taken the view that, notwithstanding the language of the regulation, Treas. Reg. §1.312-11(a) does not authorize the allocation of E&P in a section 351 transfer following a reorganization. *See* Jasper L. Cummings, Jr., *E&P Allocations and Reorganizations*, 129 Tax Notes 345 (Oct. 18, 2010); *see also Mansfield v. United States*, 141 Ct. Cl. 579 (1958) (under Treas. Reg. §1.312-11(a), before amendment in 1955, the transfer by a corporation of part of its assets to a newly formed subsidiary in return for all the subsidiary's stock does not shift any of the parent's E&P to the subsidiary where the parent remains in existence after the transfer; "[the regulation] is not an absolute requirement for an allocation in all kinds of tax free exchanges. We are of the opinion that the regulation merely requires a "proper" allocation once it is established that an allocation is necessary at all.") For a thorough analysis of this subject, *see* Daniel Halperin, *Carryovers of Earnings and Profits*, 18 Tax L. Rev. 289 (1962-1963); *see also* Jasper L. Cummings, Jr., *E&P Allocations and Reorganizations*, 129 Tax Notes 345 (Oct. 18, 2010).

[61] *See, e.g.,* PLR 201026010 (Dec. 18, 2009); IRS CCA 200911010 (July 8, 2008); PLR 9231068 (Feb. 3, 1992).

2. Section 351 transfers – effect on E&P

Section 351 provides that no gain or loss is recognized on a transfer of property to a corporation solely in exchange for stock of the corporation if immediately after the exchange, the transferor or transferors "control" the transferee corporation.[62] A section 351 exchange, unlike a reorganization under section 368 or a liquidation qualifying under section 332, is not a transaction described in section 381(a). As such, a transfer that qualifies for nonrecognition treatment under section 351(a) does not result in the transferee inheriting any attributes of the corporate transferor, unless all the assets are transferred in a section 351 exchange pursuant to a plan of reorganization.[63]

This rule suggests that it is not important that E&P stays with the assets associated with the generation of the E&P, but shows a preference for maintaining E&P at the highest corporate level.

3. Taxable distributions of assets – effect on E&P

Section 312(a) provides that, unless otherwise provided, on the distribution of property by a corporation with respect to its stock, the E&P of the corporation (to the extent thereof) is decreased by the amount of the distribution (subject to certain adjustments for distributions of built-in gain and built-in loss property).

Section 312(n)(7) limits the amount by which the redeeming corporation reduces its E&P to the redeemed stock's "ratable share" of the E&P.

4. Section 355 distributions – effect on E&P

Section 312(h) generally provides that a proper allocation of E&P must occur in the connection with a section 355 distribution. Treas. Reg. §1.312-10(a) elucidates the meaning of "proper allocation" in the context of a section 355 distribution preceded by a D reorganization, providing that the E&P of the distributing corporation immediately before the transaction is allocated between the distributing corporation and the controlled corporation.[64] In the case of a newly created controlled corporation, the regulations provide the allocation of E&P generally is made in proportion to the fair market value of the business or businesses (and interests in any other properties) retained by the distributing corporation and the business or businesses (and interests in any other properties) of the controlled corporation immediately after the transaction.[65] The regulations also provide that in a "proper case", the E&P allocation may be made between the distributing corporation and the controlled corporation (1) in proportion to the net basis of the

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[62] Section 351(a).
[63] *But see* note 60, *supra*, on the possibility of an allocation of earnings and profits when a section 351 exchange precedes or follows a reorganization or liquidation pursuant to Treas. Reg. §1.312-11(a).
[64] Treas. Reg. §1.312-10(a).
[65] *Id.*

assets transferred and of the assets retained[66] or (2) by such other method as may be appropriate under the facts and circumstances of the case. The regulations do not provide any guidance regarding what a "proper case" would be that would suggest an allocation methodology other than one based on the fair market value of the relative assets. Further, the Service has not provided any administrative guidance in this area.[67]

Treas. Reg. §1.312-10(b) modifies the rule of Treas. Reg. §1.312-10(a) where a section 355 distribution is not preceded by a D reorganization and provides that the E&P of the distributing corporation is decreased by the lesser of the (i) the amount by which the E&P of the distributing corporation would have been decreased if it had transferred the stock of the controlled corporation to a new corporation in a section 355 distribution that involves a D reorganization transaction or (ii) the net worth of the controlled corporation (defined as the sum of the basis of all of the properties plus cash minus all liabilities).

In enacting section 312(h), Congress granted broad discretion to the Secretary in prescribing the detailed method of determining a "proper allocation."[68] Nevertheless, Congress provided that the principles of *Sansome* should be applied to allocate E&P.[69] The sole purpose for making an allocation is to achieve a continuity of shareholder level treatment of future distributions out of a distributing or controlled corporation both before and after the reorganization; fundamentally, the objective of the allocation is to neutralize the effect of divisive reorganizations on future shareholder taxability.[70]

IV. ADDITIONAL POLICY CONSIDERATIONS

In addition to the policies discussed above, we believe the following policies should be considered when designing the rules for determining the location of E&P following an asset reorganization.

A. Interaction with tax basis

Several commentators have observed that there is a parallel relationship between E&P and tax basis.[71] The foundation of this relationship is the basic linear equation of a tax basis balance

[66] For cross border section 355 distributions that involve D reorganizations, Treasury and the Service issued Prop. Reg. §1.367(b)-8 in 2000, which would require that in all cases the allocation of E&P be made based on relative net basis rather than relative fair market value. These proposed regulations have not been finalized to date. *See* REG-116050-99.

[67] In light of the increasing number of section 355 distributions for which the proper allocation of E&P is important, it would be helpful if Treasury and the Service would issue updated guidance in the area. If asked, we would be happy to provide comments on the subject.

[68] *See* S. Rep. No. 1622, 83rd Cong., 2d Sess. 250.

[69] *Id.*

[70] *Id.*

[71] *See, e.g.,* Charles R. Nesson, "Earnings and Profits Discontinuities under the 1954 Code," 77 Harv. L. Rev. 450 (1964); Deborah Bennett, "Earnings and Profits: A Balance Sheet Account?," 86 Taxes 2 (Feb. 2008); and Charles Kingson, "Earnings and Profits Correlate with Tax Basis," 2012 TNT 88-12 (May 7, 2012).

sheet: adjusted basis of net assets equals E&P plus invested capital. Thus, increases and decreases in E&P must result in a corresponding increase or decrease, respectively, in asset basis; otherwise the tax basis balance sheet will become unbalanced.[72]

To illustrate, assume that Target is formed in Year 1 with no capital, earns $300 of taxable income, and pays $100 of tax. At the end of Year 1, Target will have $200 of asset basis (cash), and $200 of E&P. Further assume that at the end of Year 1, the Section 368 Acquiring Corporation acquires all of the assets of Target in a section 368(a)(1) reorganization solely in exchange for stock of the Section 368 Acquiring Corporation. If the Section 368 Acquiring Corporation retains the former Target assets, the Section 368 Acquiring Corporation will succeed to both Target's $200 of asset basis and $200 of E&P,[73] and the Section 368 Acquiring Corporation's tax basis balance sheet as it relates to Target will be balanced ($200 of asset basis, $200 of E&P).

Assume instead that as part of the same plan the Section 368 Acquiring Corporation transfers all of the Target assets to its wholly-owned subsidiary S. In this case, S will succeed to both Target's $200 of asset basis and $200 of E&P, and the Section 368 Acquiring Corporation will have a $200 basis in its S stock.[74] By inheriting Target's $200 of E&P, S effectively "steps into the shoes" of Target and is treated as having earned the $200 of E&P. S's $200 of tax basis in the former Target assets is consistent with this treatment, and S's tax basis balance sheet is balanced ($200 of asset basis, $200 of E&P). Pursuant to section 358, the Section 368 Acquiring Corporation will increase its basis in S by the amount of Target's asset basis, $200, but will have no corresponding adjustment to E&P, apparently resulting in an unbalanced balance sheet. Arguably, if S succeeds to Target's $200 of E&P, the Section 368 Acquiring Corporation cannot also be viewed as having earned that same $200, and therefore nothing has occurred at the Section 368 Acquiring Corporation level that should give rise to asset basis (i.e., no E&P and no invested capital).

If one accepts that a tax basis balance sheet should remain balanced, query whether the rules governing the allocation of E&P should provide for adjustments to E&P and/or asset basis in order to preserve this balance. If Target's E&P is allocated to S, should the Section 368 Acquiring Corporation be required to reduce its basis in its S stock from $200 to $0 to account for such allocation? If this were the case, asset basis and E&P would be equal for both the Section 368 Acquiring Corporation ($0 of asset basis, $0 of E&P) and S ($200 of asset basis, $200 of E&P). Alternatively, if there is no allocation of E&P from the Section 368 Acquiring Corporation to S, the Section 368 Acquiring Corporation's $200 basis in its S stock fits within the framework of the tax basis balance sheet because its $200 of tax basis in its S stock is consistent with its addition of Target's $200 of E&P. In this case, S also has a balanced tax basis balance sheet, with S's $200 basis in its assets corresponding to its $200 of invested capital.

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[72] *See, e.g.,* section 312(a)(3) (on the distribution of property by a corporation with respect to its stock, the E&P of the corporation is decreased by the adjusted basis of the property distributed).

[73] *See* sections 362(b) and 381(a)(2).

[74] *See* section 362(a); Treas. Reg. §1.381(a)-1(b)(2); section 358(a).

Thus, if maintaining a balance between E&P and basis is important, then perhaps the rules governing the allocation of E&P in the context of transfers of assets in connection with a reorganization should ensure these balances are not disturbed.

There are a few recent developments in the area of cross border transactions that seem to recognize the relationship between E&P and tax basis. For example, proposed regulations were issued in 2000 that would allocate E&P between the distributing and controlled corporations in a cross-border section 355 distribution that involves a divisive D reorganization based upon the relative net adjusted bases of the transferred assets and the retained assets.[75] This proposed regulation has not been finalized by the Service and Treasury.[76] As another example, under Treas. Reg. §1.367(b)-3, when a domestic corporation acquires the assets of a foreign corporation in a section 332 liquidation or a section 368(a)(1) reorganization, the domestic corporation is generally required to include in income as a deemed dividend the all E&P amount with respect to its stock in the foreign corporation.[77] Treasury explained that the income inclusion is intended to prevent the conversion of a deferral of tax into a forgiveness of tax and generally ensures that the section 381 carryover basis reflects an after-tax amount. In other words, because E&P gives rise to asset basis, a domestic corporation should not be entitled to such asset basis unless it first includes in income, and pays tax on, the related E&P.

In addition, as discussed above, the E&P allocation rules applicable to section 355 distributions incorporate, to some extent, the relationship between basis and E&P. Specifically, where a D reorganization precedes a section 355 distribution, in the "proper case," E&P is allocated between the distributing and controlled corporation based on the proportion of the net basis of the assets transferred and of the assets retained.[78] Similarly, in a section 355 distribution of a pre-existing controlled corporation, the E&P reduction to the distributing corporation may be limited to the net worth (defined as the sum of the basis of all of the properties plus cash minus all liabilities) of the controlled corporation.[79] The legislative history to section 312(i) (the predecessor to section 312(h) and the underpinnings of Treas. Reg. §1.312-10)) further provided that, "in no case may the earnings and profits of a corporation exceed its total net worth [i.e., the basis of all property less liabilities]."[80]

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[75] Prop. Reg. §1.367(b)-8(b)(iv). REG-116050-99 (Nov. 15, 2000), Fed. Reg. Vol. 65, No. 221, p. 69182.
[76] *See, e.g.,* Dolan et al, U.S. Taxation of International Mergers, Acquisitions and Joint Ventures, supplement 2001-1 (Warren, Gorham & Lamont 1995; Nardi Bress, New Section 367(b) Regulations: Evolutionary, Not Revolutionary, 11 J. Int'l Tax'n 18; Collins et al, "Allocation of E&P in a Spin-Off by a Consolidated Group: New Developments Answer Some Questions But Leave Many Unanswered," PLI Course Handbook, Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings 2005 (No. 6357).
[77] *See* T.D. 8862 (Jan. 24, 2000).
[78] *See* Treas. Reg. §1.312-10(a).
[79] *See* Treas. Reg. §1.312-10(b).
[80] S. Rep. No. 1622, 83d Cong., 2d Sess. 250; 3 U.S. CODE CONG. & AD. NEWS (1954) 4621, 4887-4888). *See also Bennett v. U.S.,* 192 Ct. Cl. 448 (Ct. Cl. 1970) at 464-465 ("it is evident that for purposes of the [net worth] limitation Congress envisioned net worth in its conventional and generally understood balance sheet sense; not the hybrid net worth, based on market value rather than book value of assets, that has been infrequently employed and, when employed, specifically defined.").

The developments in the cross border area, and to a lesser degree the long-standing rules addressing E&P allocations in spin-off transactions, are consistent with an approach that maintains a relationship between E&P and tax basis. Nevertheless, this is not currently a fundamental principle underlying the tax law as it relates to movements of assets and E&P. For example, assume Y corporation, which has $200 of asset basis (cash) and $200 of E&P, acquires the stock of X corporation for $200 in a qualified stock purchase. Further assume that X's assets have a net fair market value of $200 and a $0 basis, and X has no E&P. If following the acquisition X liquidates into Y under section 332, Y would succeed to X's basis in its assets ($0), and X's E&P ($0).[81] In this case, Y would have an unbalanced tax basis balance sheet — asset basis of $0 and E&P of $200 (i.e., its historic E&P). Similar results may occur, for example, in (i) section 368(a)(1) reorganizations where the acquiring corporation issues boot as part of the consideration (e.g., an acquisitive D reorganization using solely cash[82]), (ii) section 304 transactions, (iii) non-dividend equivalent redemptions, (iv) triangular reorganizations and (v) divisive section 368(a)(1)(D) reorganizations.[83] For example, assume that Y, which has $200 of asset basis (cash) and $200 of E&P, instead acquired the stock of X corporation for $200 from Parent, the sole shareholder of Y and X, in a section 304(a)(1) transaction. Further assume that Parent's basis in its X stock is $200. This transaction similarly unbalances Y's tax basis balance sheet – asset basis of $200 (carryover basis in the X stock) and E&P of $0 ($200 of historic E&P less $200 of deemed dividend to Parent). In fact, except for the few transactions that are governed by rules that require a connection between E&P and tax basis, most transactions in which assets move today result in unbalanced balance sheets.

We note that on at least one occasion a court has considered the relationship between E&P and tax basis. In *Bennett*, the Claims Court specifically rejected the taxpayer's argument that E&P was a function of a tax basis balance sheet, stating:

> The short answer to this, as explained at the outset, is that the earnings and profits figure is not an ingredient of a corporation's balance sheet structure. Earnings and profits are neither a corporate resource nor liability. Since, aside from corporate accumulation penalties, the earnings and profits account functions solely as a check valve on the taxable character of shareholder distributions, a balance sheet entry pertaining to it would properly be in the nature of an annotation for stockholder information purposes, not a part of the accounting portrayal of the corporation's own financial condition.[84]

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[81] *See* sections 334(b) and 381(a). *See also* Rev. Rul. 90-95, 1990-2 C.B. 67 (a qualified stock purchase of a target corporation followed by a liquidation of the newly acquired target corporation is respected as a stock acquisition followed by a liquidation rather than a direct asset acquisition).
[82] *See* Treas. Reg. §1.368-2(l).
[83] For further discussion, *see* Charles R. Nesson, "Earnings and Profits Discontinuities under the 1954 Code," 77 Harv. L. Rev. 450 (1964).
[84] *See Bennett v. U.S.,* 192 Ct. Cl. 448, 470 (Ct. Cl. 1970).

In a tax system that generally does not pursue a balance between E&P and tax basis, it is not clear to us that maintaining an equilibrium between E&P and tax basis solely in the context of transfers of assets in connection with a reorganization is a worthwhile pursuit. Nevertheless, we also recognize that harmonizing E&P and tax basis may be a principle to be considered in the income tax system more generally, with a view to addressing the myriad of transactions that implicate the relationship in a consistent manner. Absent a significant change to the tax system as a whole, however, we do not believe this policy should drive the outcome of the current E&P allocation rules.

B. Attributes other than E&P

Section 381 governs many attributes other than E&P, such as net operating loss carryovers, capital loss carryovers, depreciation and accounting methods. Treasury and the Service noted in the preamble to the proposed regulations that one of the goals of the proposed regulations is to harmonize the rules for all of the attributes governed by section 381, but did not explain why such treatment was necessary. The Section 368 Acquiring Corporation Proposal and the Substantially All Proposal would result in a rule for E&P that differs from the rules for other section 381 attributes. We do not believe that E&P must be treated in the same manner as other tax attributes governed by section 381 due to fundamental differences between E&P and those attributes and the different policy objectives at stake.

As noted above, the existence and size of a corporation's E&P pool will determine whether distributions made by the corporation to its shareholders are characterized as dividends or returns of capital and, thus, will determine the tax consequences of those distributions to the shareholders. In contrast, the other tax attributes governed by section 381 are directly relevant to the corporation itself. For example, net operating loss carryovers, capital loss carryovers and depreciation and accounting methods are relevant to the corporation in determining the extent of its own tax liability and other administrative tax return positions and are generally not directly relevant to the taxation of the shareholders of the corporation. Therefore, treating E&P separately from other section 381 attributes is supportable based on the recognition that E&P serves a fundamentally different purpose from those other attributes.

Furthermore, the policies that drive the rules for E&P are different from those that underlie the rules for other attributes. For E&P, the key policy as defined in the seminal *Sansome* case is to neutralize the effect of corporate nonrecognition transactions on future shareholder taxability by preserving E&P at a level close to the ultimate shareholders. For other attributes, the law seems to have focused on identifying the appropriate surrogate for Target after Target dissolves. The Section 368 Acquiring Corporation Proposal will result in E&P remaining at a higher level within corporate chains because the E&P will not move downstream as a result of post acquisition asset transfers. This seems consistent with the *Sansome* policy. On the other hand, it may be more sensible for the other attributes to follow the business if it is transferred to a subsidiary.

If Treasury and the Service determine that for administrability or other reasons it is important for all of Target's section 381 attributes to stay together, the 1960 regulations definition that provides that these attributes will be transferred to a single corporation that acquires all the Target assets could be revisited. It is not clear to us that the electivity provided by the 1960 regulations definition, which provides that Target's attributes are inherited by the Section 368 Acquiring Corporation or a Single Transferee, is particularly problematic for attributes other than E&P. At the same time, however, we do not appreciate why that rule is the optimal rule to govern attributes other than E&P. Therefore, possibly the Section 368 Acquiring Corporation Proposal or the Substantially All Proposal may be appropriate for other attributes as well.

V. POSSIBLE APPROACHES TO E&P ALLOCATION FOR ASSET REORGANIZATIONS

The approaches and proposals described below, other than the approach in Prop. Reg. §1.312-11, will require a modification to the 1960 regulations definition of acquiring corporation solely with respect to E&P.[85] As a result, the adoption of our proposals would result in the Target E&P potentially residing in a different corporation from the corporation that inherits all of the other tax attributes, unless the proposals are adopted for other attributes as well. As discussed above, however, we do not believe all tax attributes must remain together because different policies justify disparate treatment.

A. Prop. Reg. §1.312-11 Approach

The proposed regulations "clarify" that, in a transfer described in section 381(a), only the acquiring corporation, as defined in Treas. Reg. §1.381(a)-1(b)(2), succeeds to the E&P of the distributor or transferor corporation (within the meaning of §1.381(a)-1(a)). No other allocations of E&P are permitted. The rules of the proposed regulations are consistent with the Service's administrative position on these issues.[86]

Because the proposed regulations retain the 1960 regulations definition of acquiring corporation, the determination of which entity inherits Target's E&P - either the Section 368 Acquiring Corporation or a Single Transferee - would continue to be elective for all intents and purposes. For example, if the Section 368 Acquiring Corporation acquires Target assets of $1 billion and then transfers all but a *de minimis* amount of Target's assets to a controlled subsidiary, the "single corporation" rule of the section 381 regulations requires that 100% of the attributes, including all the E&P, remain in the Section 368 Acquiring Corporation.[87] If the Section 368

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[85] For this purpose, we propose to treat all E&P-like attributes (e.g., deficits and taxes) consistently.

[86] In the following rulings, the Service did not allocate E&P as a result of a controlled asset transfer of some (but not all) of the assets of the acquired corporation: PLR 8231030 (May 4, 1982); PLR 9231068 (Feb. 3, 1992); PLR 201026010 (Dec. 18, 2009).

[87] Treas. Reg. §1.381(a)-1(b)(2) provides that the determination of whether a corporation has acquired all of the assets transferred by the transferor corporation is a question of fact to be determined on the basis of all the facts and circumstances.

Acquiring Corporation does not retain the *de minimis* amount of Target's assets, the E&P instead moves to the subsidiary. Alternatively, if the Section 368 Acquiring Corporation transfers all of Target's assets to a subsidiary and the subsidiary then transfers a *de mimimis* amount of assets to its subsidiary, the Section 368 Acquiring Corporation will inherit the E&P. Or if the Section 368 Acquiring Corporation retains none of Target's assets, but instead contributes the assets to two or more subsidiaries, the Section 368 Acquiring Corporation will also succeed to all of the Target's tax attributes. We do not believe that distinctions of this kind should govern the identity of the successor to Target's E&P.

The preamble to the proposed regulations provides the following explanation of the proposal:

> [t]he IRS and Treasury Department believe the proposed rule is appropriate because earnings and profits measures the capacity of a corporation to pay dividends to its shareholders and the corporation that has an interest, directly or indirectly, in all of the target's assets has the dividend-paying capacity that is most comparable to that of the target. Further, the IRS and Treasury Department believe the rules for the allocation of earnings and profits should conform to the rules for the allocation of other tax attributes under section 381.

The preamble recognizes that indirect ownership of the Target's assets supports the Section 368 Acquiring Corporation's dividend paying capacity where the E&P remains at the Section 368 Acquiring Corporation and, therefore, suggests it is not necessary to move E&P to a subsidiary of the Section 368 Acquiring Corporation. The language in the preamble is curious in that it does not explain why the E&P should move to a subsidiary when it acquires all of the Target's assets. The preamble suggests there should remain a connection between the assets that created the E&P and the E&P itself, but does not explain why in only one case (i.e., the transfer of all the acquired assets to a single subsidiary) does Target's E&P move to a corporation other than Section 368 Acquiring Corporation. We can surmise that Treasury believed as a policy matter that a corporation that acquires all the assets of Target the appropriate surrogate for the Target and should therefore succeed to its E&P. If so, it seems the inherent electivity of such a rule is inconsistent with the policy.

The last statement in the preamble is also unclear as section 381 does not involve allocations of attributes and there is no explanation for why all attributes should be treated alike. As discussed above, because E&P is unique in its role of assuring proper treatment of shareholder distributions while the other attributes affect taxable income of the corporation itself, it is not clear what policy is protected by treating all attributes alike.

In light of the flexibility current law now provides to transfer assets to multiple entities in connection with reorganizations, we see little policy reason for retaining the 1960 regulations definition of acquiring corporation as it relates to E&P. As explained at the outset, in order to eliminate artificial electivity and better implement the policies underlying sections 381 and 312, we recommend that Treasury and Service not finalize Prop. Reg. §1.312-11 in its current form. We do not believe the ability to choose whether the Section 368 Acquiring Corporation or a

Single Transferee inherits the Target E&P is appropriate because it may, among other things, allow for inappropriate repatriation planning and U.S. withholding tax avoidance.

Furthermore, the 1960 regulations definition of acquiring corporation in Treas. Reg. §1.381(a)-1(b)(2), which results in the attributes transferring to a Single Transferee only when *all* of the Target assets are transferred to a Single Transferee, raises difficult practical issues in determining whether *all* such assets have in fact been transferred. Any time delay between the acquisition of Target's assets by the Section 368 Acquiring Corporation and the transfer of such assets to a Single Transferee can result in a turnover of Target's inventory, collection of receivables, payment of liabilities, and other changes in Target's business that raise the question of whether the assets transferred to the Single Transferee are the same assets as those acquired by the Section 368 Acquiring Corporation. Consequently, while the current definition may appear to be simple to administer, in actuality it is not. If this rule is retained, Treasury and the Service should provide practical guidance to taxpayers so there can be certainty regarding the location of attributes.

B. Issuing Corporation Approach

Based upon the foregoing, we believe the most important policy goal to protect is to maintain the E&P within the corporation directly owned by the Target shareholders before the reorganization. One approach that would achieve this objective is to treat the issuing corporation as the section 381 acquiring corporation for purposes of E&P (the "Issuing Corporation Approach").

In addition to maintaining E&P within the entity closest to the former shareholders of Target where it can be accessed for future distributions, the Issuing Corporation Approach would also provide consistency on the location of E&P following a reorganization, regardless of form. For example, a reorganization followed by a transfer of the acquired assets to a subsidiary would leave the E&P of the Target within the same corporate entity as in a triangular reorganization. In addition, consistent with the rule that E&P does not move to a subsidiary in connection with a section 351 transfer, the Issuing Corporation Approach would not create a disparity in treatment merely because a reorganization has occurred.

While the Issuing Corporation Approach is the only approach that achieves parity among all transaction forms, the movement of E&P upstream to the issuing corporation from the Section 368 Acquiring Corporation to the issuing corporation in the case of triangular reorganizations creates discontinuities that would need to be addressed. For example, assume foreign Target merges into newly formed foreign Section 368 Acquiring Corporation, with the sole shareholder of foreign Section 368 Acquiring Corporation, a U.S. corporation, issuing its stock, in a transaction qualifying as a section 368(a)(2)(D) reorganization. Under the Issuing Corporation Approach, foreign Target's E&P would be inherited by the U.S. corporation. Absent rules requiring an income inclusion, this result effectively removes foreign Target's E&P from the U.S. tax net by allowing foreign Section 368 Acquiring Corporation to make future distributions to its U.S. shareholder without dividend income in the U.S. This is inapposite of the principles of *Sansome,* which is to neutralize the effect of reorganizations on future shareholder taxability.

Alternatively, if the issuing corporation is foreign and Target and the Section 368 Acquiring Corporation are domestic, the Issuing Corporation Approach could result in the avoidance of withholding taxes absent special rules that impose withholding. We do not believe requiring an income inclusion where E&P is inherited by a U.S. corporation from a foreign corporation is appropriate in the absence of an actual distribution; for the same reason, we do not believe U.S. withholding tax should be imposed if a domestic Target's E&P is inherited by a foreign issuing corporation as a result of a reorganization.

Instead of requiring income inclusions or withholding tax, these discontinuities could be addressed by adopting the Issuing Corporation Approach generally, but providing a special rule where the Section 368 Acquiring Corporation and the issuing corporation are not both foreign or both domestic. There are an increasing number of regulations that modify the general subchapter C rules to address the policy concerns related to cross border transactions.[88] Therefore, if the Issuing Corporation Approach was determined to be appealing for its otherwise consistent treatment, a separate rule for cross border transactions could be considered.

The Issuing Corporation Approach would not relieve the pressure taxpayers and the Service face in resolving the appropriate characterization of a transaction that potentially qualifies as more than one type of reorganization.[89] Because the impact of the proposal depends upon the identification of the issuing corporation, it could heighten the significance of questions related to whether a reorganization could be recharacterized as a triangular reorganization.[90] When an acquiring corporation first acquires the stock of Target and then, pursuant to the same plan, transfers Target to a subsidiary and then Target liquidates, current law is unclear regarding whether that transaction is a section 351 exchange followed by a D reorganization, or whether the transaction should be treated as a triangular C reorganization. In order to determine with certainty whether the first acquiring corporation or the subsidiary would inherit the Target E&P under the Issuing Corporation Approach, this long-standing question would need to be addressed by Treasury and the Service.[91]

For these reasons, the difficult issues introduced by the Issuing Corporation Approach would appear to outweigh its conceptual appeal. Accordingly, we do not recommend that final regulations incorporate this proposal.

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[88] *See, e.g.,* Treas. Reg. §1.367(b)-7 (providing rules governing the manner and extent to which E&P and foreign income taxes carry over in certain foreign-to-foreign transactions); Treas. Reg. §1.367(b)-10 (treating S's purchase of P stock in connection with a triangular reorganization as a section 301 distribution); Treas. Reg. §1.367(b)-13 (special basis and holding period rules applicable to certain triangular reorganizations involving foreign corporations).

[89] *See* NYSBA Tax Section, Report No. 1229, Report on Characterizing "Overlap" Transactions under Subchapter C, January 6, 2011.

[90] *See* Rev. Rul. 78-130, 1978-1 C.B. 114 (P transferred the stock of S1 to S2, and N (a subsidiary of S2) acquired all the assets and liabilities of S1 and S2 liquidated. The Service ruled the transaction was a transfer by S1 of all of its assets and liabilities to N in exchange for S2 stock in a triangular C reorganization). *Compare* PLR 201150021 (respecting the form of the first transfer of stock as a section 351 exchange followed by a D reorganization).

[91] The confusion created by the retention of Rev. Rul. 78-130 in the otherwise form-driven subchapter C warrants reconsideration by Treasury and the Service. If asked, we would be happy to provide comments.

C. Tracing Approach

If there is a strong policy to match E&P with the assets that generated them, tracing E&P to the assets that generated the E&P and allocating the E&P to all corporations that receive those particular Target assets would implement such policy (the "Tracing Approach"). For example, if Target merges into the Section 368 Acquiring Corporation, and the Section 368 Acquiring Corporation then contributes Target's assets among a number of its subsidiaries, a portion of Target's E&P could be allocated to each subsidiary, based on the assets received.

The Tracing Approach has little appeal for two significant reasons. First, it would allow for the creation of additional corporate tiers between the former Target shareholders and the location of Target's E&P, thereby increasing the likelihood that the former Target shareholders will receive distributions that are not out of Target's E&P. Second, given the complexity and amount of historic information regarding earnings and assets that would be required, this proposal would be difficult to administer. In this regard, a similar methodology has been expressly rejected by the Service in the context of E&P allocations in cross border spin-offs. Specifically, the preamble to Prop. Reg. §1.367(b)-8 provides:

> The proposed §1.367(b)-8(b) cross-section rule decreases the earnings and profits of a distributing corporation without regard to the type of income generated by the assets of the controlled corporation. This is consistent with the general assumption in §1.312-10 and the proposed regulations that the earnings and profits of the distributing corporation should be decreased proportionately to reflect the transfer or distribution of assets, rather than by some other measure, such as by determining the earnings and profits attributable to the income generated by assets transferred or distributed (a tracing model) or by decreasing most recently accumulated earnings and profits to the extent of assets transferred or distributed (a dividend model).

For these reasons, we do not recommend that the Tracing Approach be adopted.

D. Allocation Approach

While the Tracing Approach is impractical, it would be possible to allocate E&P among all corporations that receive Target assets in connection with an asset reorganization without tracing the E&P to specific assets or businesses. Instead, E&P could be allocated based on relative fair market values or tax bases of the assets transferred (the "Allocation Approach").

As discussed above, allocating E&P on the basis of relative fair market values is an element of the rules governing section 355 transactions in Treas. Reg. §1. 312-10. The spin-off allocation rules also contemplate that allocation of E&P based on the net basis of assets transferred and retained may be appropriate in certain cases. Because a section 355 distribution is a division of a single corporation into two corporations that are equally close to their shareholders, in order to implement the policies underlying section 312, it is necessary for each corporation to have some amount of the distributing corporation's E&P after the division. In contrast, the transferee of

Target assets following a reorganization generally is a single subsidiary of the Section 368 Acquiring Corporation. Thus, the *Sansome* policy of ensuring that the reorganization does not affect the tax consequences of future distributions to former shareholders of Target is not necessarily furthered by allocating a the Target's E&P among the corporate transferees.

Further, the measure for allocation, fair market value or net basis, does not produce a sensible approach in all cases. An allocation based upon fair market value may make sense in some industries and for some companies, while it would not make sense in others. If a single measure is not required under the Allocation Approach, additional administrative complexity and uncertainty would result. For these reasons, we do not recommend the adoption of an Allocation Approach.

E. Section 368 Acquiring Corporation Proposal

As explained at the outset, we believe the tax system should not provide artificial electivity for determining the appropriate recipient of target's E&P and should treat all taxpayers consistently. In addition, based on the policy underpinnings of section 381 and the rules governing E&P more generally, we believe the most significant policy objective should be to neutralize the effect of corporate nonrecognition transactions on future shareholder taxability. In order to achieve these goals, we recommend that with respect to Target's E&P, the Section 368 Acquiring Corporation should be treated as the section 381 acquiring corporation.

As an initial matter, this approach generally maintains E&P at a corporate level close to the former Target shareholders, allowing the possibility of only a single additional corporate tier in the case of triangular reorganizations. The Section 368 Acquiring Corporation Proposal also avoids the undesirable cross border E&P movements that are possible under the Issuing Corporation Approach (discussed above) and the resulting complexity that would be necessary to address such fact patterns. Rather, the only method for moving E&P cross border would be through a cross border reorganization (e.g., Foreign Target acquired by U.S. Section 368 Acquiring Corporation). The U.S. tax system has a well developed set of rules for addressing, and appropriately taxing, these types of transactions.[92]

In addition, consistent with the rule that E&P does not move to a subsidiary in connection with a section 351 transfer, the Section 368 Acquiring Corporation Proposal would not create a disparity in treatment merely because a reorganization has occurred. Moreover, this proposal provides certainty to taxpayers and is administrable by the Service.

We recognize that maintaining the E&P at the Section 368 Acquiring Corporation allows for transactional electivity between (i) an acquisition of Target's assets by the Section 368 Acquiring Corporation, where P is the Section 368 Acquiring Corporation, followed by a transfer of assets to a subsidiary, S, and (ii) a triangular reorganization in which P is the issuing corporation and S is the Section 368 Acquiring Corporation. In the former case, P would succeed to Target's E&P,

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[92] *See generally* section 367.

and in the latter case, S would succeed to Target's E&P. However, this electivity requires a change to the transaction form, which in subchapter C generally means there will be different tax effects despite the economic similarities.[93] Such electivity stands in stark contrast to the artificial electivity of Treas. Reg. §1.381(a)-1(b) and Prop. Reg. §1.312-11. If Treasury and the Service determine that it is important as a policy matter to treat these transactions in the same manner with respect to E&P, consideration could be given to adding a special rule providing that if the first case would have qualified as a triangular asset reorganization, S would inherit Target's E&P.

F. Substantially All Proposal

If Treasury and the Service view the policy to maintain a direct relationship between E&P and the assets that created the E&P as important, we believe the appropriate surrogate for the Target is the corporation that acquires substantially all of the assets of Target.

While the Substantially All Proposal would import uncertainty surrounding the measurement of "substantially all" the assets, it would generally eliminate the artificial electivity of Treas. Reg. §1.381(a)-1(b) and Prop. Reg. §1.312-11 and better identify the true surrogate for the Target. Special rules would be required to eliminate unwarranted planning opportunities that would result if the E&P is inherited by a subsidiary that acquires substantially all the Target's assets and the Section 368 Acquiring Corporation retains assets to make future distributions with no E&P.[94]

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[93] For example, a reverse triangular merger is treated as a transfer of stock and a forward triangular merger is treated as a transfer of assets for U.S. federal income tax purposes, even though both mergers have similar economic consequences.
[94] For further details of the Substantially All Proposal, *see* University of Chicago Proposal, *see* note 5, *supra*.