I. INTRODUCTION[1]

A. Types of Tax-free Reorganizations

Section 368(a)(1) defines the term "reorganization" to mean the following seven forms of transactions:

1. An "A" reorganization -- a statutory merger or consolidation (effected pursuant to the laws of the United States, a State, Territory, or the District of Columbia).

    a. Section 368(a)(1)(A) provides no specific limitation on the kind of consideration that may be issued in the transaction. Sufficient stock will still need to be issued to satisfy the general continuity of interest requirement (see below).

    b. Section 368(a)(2)(D) permits a triangular merger (where shareholders of the merged corporation receive stock in the parent of the surviving corporation) to qualify as a reorganization.

        (1) In this case there is an additional requirement that the acquiring company acquire substantially all of the assets of the target corporation.

        (2) It is not permissible to use a mix of parent stock and acquiring stock.

    c. Section 368(a)(2)(E) permits a reverse triangular merger (where shareholders of the surviving corporation receive stock in the parent of the merged corporation) to qualify as a reorganization.

        (1) Shareholders of the target corporation (the surviving corporation) must exchange at least 80 percent of the

---

[1] Mr. Silverman would like to acknowledge the contributions of Andrew J. Weinstein and Edward L. Froelich, associates at Steptoe & Johnson LLP.

target stock for voting stock of the parent.

(2) It is permissible for boot (which for this purpose would include nonvoting stock) to be used to acquire any remaining target stock.

(3) Following the transaction the surviving company must continue to hold substantially all of its assets as well as the assets of the merged corporation.

2. A "B" reorganization -- the acquisition of stock of the target corporation solely in exchange for voting stock of the acquiring corporation, if immediately after the exchange the acquiring corporation controls the target corporation (within the meaning section 368(c)).

a. The acquisition may also be made using voting stock of the parent of the acquiring corporation. It is not permissible to use a mixture of acquiring corporation stock and parent stock.

b. No consideration other than voting stock may be used.

3. A "C" reorganization -- the acquisition of substantially all of the assets of the target corporation, solely in exchange for voting stock of the acquiring corporation, followed by the liquidation of the target corporation.

a. The acquisition may also be made using voting stock of the parent of the acquiring corporation.

(1) It is generally not permissible to use a mixture of acquiring corporation stock and parent stock.

(2) If sufficient stock of either the acquiring corporation or the parent corporation is used, the transaction may still qualify as a "C"

reorganization with the stock of the other corporation being treated as boot.

b. The "solely for voting stock" requirement will not be violated by the assumption of liabilities by the acquiring corporation.

c. A limited amount of boot may be used. Section 368(a)(2)(B) permits money or property other than voting stock to be exchanged for up to 20 percent of the acquired assets. For this purpose, however, an assumption of liabilities will be treated as a payment of money.

4. A "D" reorganization -- the transfer of assets by a corporation which, immediately after the transaction, is in control of the transferee (or whose shareholders are in control of the transferee), but only if, as part of the plan, stock of the transferee is distributed in a transaction which qualifies under section 354, 355 or 356 (see below).

a. "D" reorganizations may be "divisive" or "acquisitive."

(1) In a divisive "D" reorganization, involving the separation of different businesses conducted by a single corporation, the qualifying distribution is made under section 355.

(2) In an acquisitive "D" reorganization, the qualifying distribution must be made under section 354. In order to qualify under section 354, the acquiring corporation must acquire substantially all of the assets of the target corporation, and the target corporation must liquidate.

b. If a transaction qualifies as both a "C" reorganization and a "D" reorganization it will be treated only as a "D" reorganization. Section 368(a)(2)(A).

5. An "E" reorganization -- a recapitalization.

   A recapitalization is a reorganization involving a single corporation, and has been described as the "reshuffling of a capital structure within an existing corporation." Helvering v. Southwest Consolidated Corp., 315 U.S. 194 (1942); Rev. Rul. 79-287, 1979-2 C.B. 130.

6. An "F" reorganization -- a mere change in form, identity, or place of incorporation of one corporation, however effected.

   a. The statute was amended in 1982 to make explicit that an "F" reorganization was limited to a transaction involving a single corporation. Prior to that time, mergers of commonly controlled corporations had been treated as "F" reorganizations. Estate of Stauffer v. Commissioner, 403 F.2d 611 (9th Cir. 1968); Home Construction Corp. v. United States, 439 F.2d 1165 (5th Cir. 1971); Rev. Rul. 69-185, 1969-1 C.B. 108.

   b. In general, an "F" reorganization does not affect the ownership interest of any party in any way (i.e., there is 100 percent continuity of interest). However, a transaction will not fail to qualify as an "F" reorganization merely because less than one percent of the shareholders dissent to the transaction and receive cash for their shares. Rev. Rul. 78-441, 1978-2 C.B. 152.

7. A "G" reorganization -- the transfer of assets by a corporation to another corporation in a bankruptcy proceeding, but only if as part of the plan, stock of the acquiring corporation is distributed in a transaction which qualifies under section 354, 355 or 356.

   a. Section 368(a)(2)(D) permits the use of parent stock in a "G" reorganization, just as in an "A" reorganization.

   b. As in the case of an acquisitive "D" reorganization, in order for the distribution of acquiror stock to qualify

under section 354, the acquiring corporation must acquire substantially all of the assets of the target corporation, and the target corporation must liquidate.

B. Treatment of Parties to a Reorganization

1. Target Corporation

a. Section 361(a) provides that the target corporation in a reorganization will recognize gain on the receipt of property from the acquiring corporation only to the extent that

(1) Such property does not consist of stock or securities of the acquiring corporation (or, in the case of a triangular reorganization, stock or securities of the parent of the acquiring corporation); and

(2) Such property is not distributed to the target shareholders.

Section 361(b).

b. Pursuant to section 357, the assumption of target liabilities by the acquiring corporation will not be treated as a payment of money or other property except to the extent that

(1) The principal purpose of the assumption is the avoidance of Federal income tax;

(2) The assumption lacks a bona fide business purpose; or

(3) In the case of a "D" reorganization, the amount of liabilities assumed exceeds the basis of the assets transferred to the acquiring corporation.

c. Section 361(c)(2) provides that the target corporation will recognize gain on the distribution to its shareholders of any appreciated property other than

(1) Stock, rights to acquire stock, or debt obligations of the target corporation; or

(2) Stock, rights to acquire stock, or debt obligation of the acquiring corporation (or, in the case of a triangular reorganization, of the parent of the acquiring corporation) received by the target corporation as part of the reorganization.

d. Note the various ways in which gain may be recognized when boot is used.

(1) Suppose that the acquiring corporation transfers appreciated property to the target corporation for its assets, in addition to stock.

(2) The reorganization provisions do not protect the acquiror from recognizing gain on this transaction. Rev. Rul. 72-327, 1972-2 C.B. 197.

(3) The target corporation will receive the boot with a basis equal to fair market value. Section 358(a)(2) (amended in 1990 to apply to section 361 exchanges as well as transactions under sections 351, 354, 355 and 356).

(4) If the property is retained by the target corporation, it must recognize gain to the extent that the total consideration received exceeds the basis of the assets transferred in the reorganization under section 361(a).

(5) Section 361(b)(3) provides that the repayment of target debt with boot obtained from the acquiring corporation will not give rise to gain for the target corporation. This result quite sensibly treats the receipt of boot used to repay target debts equivalently to an assumption of liability under section 357(a).

a) In the context of a divisive reorganization, the former Administration proposed a limit to the amount of property that the distributing corporation can use to repay its creditors under section 361(b)(3) without gain recognition.

b) Under the proposal, the amount will be limited to the amount of the basis of the assets contributed to the controlled corporation. See Joint Committee's Description of Revenue Provisions Contained in the President's Fiscal Year 2001 Budget Proposal, pp. 376-378. There is currently no similar proposal from the current Administration.

(6) Because the boot would be received by the target corporation with a basis equal to fair market value, no gain would be recognized under section 361(c)(2) on a distribution of the property to the target's shareholders or creditors.

(7) Note that, under The Taxpayer Relief Act of 1997 ("TRA 1997"), "nonqualified preferred stock" will be treated as boot for purposes of sections 351, 354, 355, 356, and 368.

e. Under no circumstances will the target corporation recognize a loss in a tax-free reorganization. Section 361(c)(2).

2. Target Shareholders

a. Recognition of Gain or Loss

(1) No loss is recognized by the target shareholders in a tax-free reorganization. Section 354(a).

(2) Gain will be recognized by the target shareholders under section 354(a)(2) to the extent that

a) Property other than stock or securities of the acquiring corporation (or, in the case of a triangular reorganization, of the parent of the acquiring corporation) is received in exchange for stock or securities of the target corporation;

b) Securities are received with a principal amount which exceeds the principal amount of surrendered securities; or

c) Any property (including stock or securities of the acquiring corporation or its parent) is received in exchange for accrued interest on target securities.

It should be noted that results under section 354(a)(2) are governed by the principal amount of securities, rather than by the issue price under OID principles, which has taken the place of principal amount for many purposes of the Code. Cf. Section 305(c); section 483; sections 1272-1274. In 1991, legislation was proposed which would have amended section 354 to take account of OID principals. See H.R. 2777, § 444 (1991). This legislation was never enacted. T.D. 8752, 1998-1 C.B. 611, finalized regulations that treat rights to acquire stock of a corporation that is a party to a reorganization as securities with a zero principal amount. See Regs. §§ 1.354-1(e), 1.355-1(c); 1.356-3(b).

(3) Gain recognized will be taxed at capital gain rates unless it is determined that the receipt of boot in exchange for target stock "has the

effect of the distribution of a dividend." Section 356(a)(2).

a) In Commissioner v. Clark, 489 U.S. 726 (1989), the Supreme Court held that dividend equivalence is determined as if the target shareholder had received only stock of the acquiror (and no boot) as consideration in the reorganization, and then, to the extent the shareholder was deemed to receive more stock than was actually received, such excess stock had been redeemed in exchange for the boot that was actually received.

   i) Prior to Clark, the Internal Revenue Service (the "Service") had attempted to determine dividend equivalency based upon a hypothetical redemption before the reorganization. See 75-83, 1975-1 C.B. 112 (revoked by Rev. Rul. 93-61, 1993-30 I.R.B. 10).

   ii) As explained by the Service in Rev. Rul. 93-62, 1993-2 C.B. 118, the rationale of Clark is to compare the shareholder's percentage ownership of the assets of the target corporation with the percentage ownership which would have resulted had no boot been received.

      a) In the case of a divisive reorganization, the Service reasoned, the relevant comparison involves the shareholder's percentage ownership in all of the assets owned by the

distributing corporation and the controlled corporation.

b) In order to make this comparison, the Service argues one must look at what result would have occurred had the shareholder received boot in a hypothetical redemption of stock of the distributing corporation before the distribution of the stock of the controlled corporation.

b) Whether the hypothetical redemption is equivalent to a dividend is determined under the principles of section 302.

b. Basis of property received in a reorganization

(1) Target shareholders take a fair market value basis in any boot they receive. Section 358(a)(2).

(2) The basis of a target shareholder in stock or securities of the acquiring corporation (or, in the case of a triangular reorganization, of the parent of the acquiring corporation) is equal to the shareholder's basis in the stock and securities surrendered, increased by the amount of any gain recognized in the transaction, and decreased by the amount of boot received. Section 358(a)(1).

3. Acquiring Corporation

a. The acquiring corporation recognizes no gain on the issuance of stock in exchange for target assets or stock. Section 1032.

b. In a reorganization where the acquiring corporation acquires assets of the target corporation (such as an "A" or a "C" reorganization), the basis of the assets acquired is the same as the basis in the hands of the target corporation, increased by the amount of gain recognized by the target corporation. Section 362(b).

(1) In a "B" reorganization, the basis of target stock in the hands of the acquiring corporation is the same as the aggregate amount of such basis in the hands of the target shareholders immediately before the transaction. Id.

(2) In a forward triangular merger under section 368(a)(2)(D), the parent corporation's basis in the stock of the acquiring subsidiary is increased by the net basis of property acquired by the subsidiary (i.e., the basis of property acquired reduced by the amount of liabilities assumed). Reg. § 1.358-6(c)(1).

(3) Similarly, in a reverse triangular merger under section 368(a)(2)(E), the parent corporation's basis in the target corporation after the transaction is equal to the parent's basis in the merged subsidiary plus the net basis of the target corporation's property. Reg. § 1.358-6(c)(2).

Notice that these rules allow an acquiring corporation seeking to acquire a wholly-owned subsidiary to choose the basis it will have by electing to structure the acquisition as a "B" reorganization or as a subsidiary merger (subject to the restrictions which apply to each form of reorganization).

c. Gain recognized by the target shareholders will not increase the basis of the target

assets in the hands of the acquiror. Reg. § 1.358-6(c)(2)(ii).

C. Requirements Common to All Reorganizations

1. Continuity of Interest

a. In order for a transaction to qualify as a reorganization, there must be a direct or indirect continuity of interest ("COI") on the part of the historic shareholders of the target corporation. Reg. § 1.368-1(b).

b. This requirement has its origins in cases dating back to Pinellas Ice & Cold Storage v. Commissioner, 287 U.S. 462 (1933), and Helvering v. Minnesota Tea Co., 296 U.S. 378 (1935). See also Cortland Specialty Co. v. Commissioner, 60 F.2d 937 (2d Cir. 1932).

c. The Service considers the COI requirement as satisfied if, following the transaction, historic shareholders of the target corporation hold stock of the acquiring corporation (as a result of prior ownership of target stock) representing at least 50 percent of the value of the stock of the target corporation. Rev. Proc. 77-37, 1977-2 C.B. 568. Cases have, however, approved reorganizations with significantly lower percentages of stock consideration. See e.g. John A. Nelson Co. v. Helvering, 296 U.S. 374 (1934) (38 percent stock); Helvering v. Minnesota Tea Co., 296 U.S. 378 (1935) (41 percent stock); Miller v. Commissioner, 84 F.2d 415 (6th Cir. 1936) (25 percent stock).

d. Under the law prior to the issuance of the final COI regulations in January 1998 and August 2000, the Service, and to a lesser extent the courts, applied the step-transaction doctrine to determine if the COI requirement was satisfied. Accordingly, transactions occurring before and after sales of stock generally were examined to determine their effect on COI. See, e.g., McDonald's Restaurant of Illinois v.

Commissioner, 688 F.2d 520 (7th Cir. 1982); Superior Coach of Florida v. Commissioner, 80 T.C. 895 (1983); J.E. Seagram Corp. v. Commissioner, 104 T.C. 75 (1995). See also Rev. Proc. 77-37, 1977-2 C.B. 568 (stating that "[s]ales, redemptions, and other dispositions of stock occurring prior or subsequent to the exchange which are part of the plan of reorganization will be considered in determining whether" the continuity of interest requirement is satisfied).

(1) However, dispositions not contemplated at the time of the reorganization transaction generally did not adversely affect the COI requirement. Penrod v. Commissioner, 88 T.C. 1415 (1987). The Service and the courts looked to the facts and circumstances of each transaction in determining whether to apply the step-transaction doctrine.

(2) In McDonald's Restaurant of Illinois, Inc. v. Commissioner, the Seventh Circuit held that a merger failed the continuity of interest requirement where the shareholders of the target corporation sold their acquiring corporation stock soon after the transaction. The Court applied the step-transaction doctrine in determining that the merger and post-transaction sale were interdependent steps and that the target shareholders did not plan to continue as investors at the time of the merger.

(3) In J.E. Seagram Corp. v. Commissioner, 104 T.C. 75 (1995), the Tax Court concluded that sales by public shareholders, prior to a reorganization, that are not part of the plan of reorganization (i.e., in which the acquiring and target corporations are not involved) may be ignored when considering the COI requirement.

a) In that case, Seagram purchased approximately 32% of Conoco's stock for cash pursuant to a tender offer. Subsequently, DuPont purchased approximately 46% of Conoco's stock pursuant to its own tender offer, and Conoco merged into DuPont. In the merger, Seagram exchanged its Conoco stock for DuPont stock.

b) The Tax Court held that the continuity of interest requirement was satisfied, because DuPont acquired Conoco for 54% stock and 46% cash. The Tax Court concluded that Seagram "stepped into the shoes" of 32% of the Conoco shareholders. Accordingly, Seagram's recent purchase of stock did not destroy the COI requirement.

c) Seagram attempted to argue that the transaction was taxable, as it had paid a premium for the Conoco stock, and wanted to deduct its loss upon its exchange of Conoco stock for DuPont stock.

e. In December 1996, the Service issued proposed regulations relating to the affect of post-reorganization transactions by target shareholders on the COI requirement. See Prop. Reg. § 1.368-1(b) and (e), 61 Fed. Reg. 67,512. In January 1998, the Service finalized the proposed regulations, with some changes. In addition, the Service issued temporary and proposed regulations that cover pre-reorganization transactions. Temp. Reg. § 1.368-1T.

(1) The final regulations state that the purpose of the COI requirement is to "prevent transactions that resemble sales from qualifying for nonrecognition of gain or loss available in corporate

reorganizations." Reg. § 1.368-1(e)(1). Thus, the regulations require that "a substantial part of the value of the proprietary interests in the target corporation be preserved in the reorganization."

(2) In the preamble to the final regulations, the Service states that, although cases such as McDonald's focus on whether the target corporation's shareholders "intended on the date of the potential reorganization to sell their [acquiring corporation] stock and the degree, if any, to which [the acquiring corporation] facilitates the sale," the Service and the Treasury Department concluded that "the law as reflected in these cases does not further the principles of reorganization treatment and is difficult for both taxpayers and the IRS to apply consistently. Preamble to T.D. 8760 (Jan. 23, 1998).

(3) Thus, the Service decided to effectively reverse McDonald's, stating that the final regulations will "greatly enhance administrability in this area," and will "prevent 'whipsaw' of the government," such as where the target corporation's shareholders and the acquiring corporation take inconsistent positions as to the taxability of a transaction.

a) Note: The COI regulations do not apply to section 368(a)(1)(D) reorganizations or section 355 transactions. Preamble to T.D. 8760 (Jan. 23, 1998).

(4) Under the final regulations, a "proprietary interest" in the target corporation is preserved if the interest in the target corporation is: (1) exchanged for a proprietary interest in the "issuing" corporation,

(2) exchanged by the acquiring corporation for a direct interest in the target corporation enterprise, or (3) otherwise continued as a proprietary interest in the target corporation. Reg. § 1.368-1(e)(1).

a) The "issuing" corporation is the acquiring corporation, except that in determining whether a reorganization is a triangular reorganization under Reg. § 1.358-6(b)(2), the issuing corporation is the corporation in control of the acquiring corporation. Reg. § 1.368-1(b).

b) For purposes of the COI regulations, any reference to the issuing or target corporation "includes a reference to any successor or predecessor of such corporation, except that the target corporation is not treated as a predecessor of the issuing corporation and the issuing corporation is not treated as a successor of the target corporation." Reg. § 1.368-1(e)(5).

(5) In determining whether a proprietary interest in the target corporation is preserved, all the facts and circumstances are considered. However, no proprietary interest in the target corporation is preserved if "in connection with the potential reorganization, [the proprietary interest] is acquired by the issuing corporation for consideration other than stock of the issuing corporation, or stock of the issuing corporation furnished in exchange for a proprietary interest in the target corporation in the potential reorganization is redeemed." Reg. § 1.368-1(e)(1)(i).

a) In addition, if in connection with the reorganization, stock of the target corporation, or stock of the issuing corporation furnished in exchange for a proprietary interest in the target corporation, is acquired by a person related to the issuing corporation for consideration other than stock of the issuing corporation, the transaction will also fail the COI requirement. Reg. § 1.368-1(e)(2).

b) However, the transaction will not fail the COI requirement by reason of Reg. § 1.368-1(e)(2) if the direct or indirect owners of the target corporation prior to the reorganization maintain a direct or indirect proprietary interest in the issuing corporation.

(6) Thus, some post-reorganization transactions -- namely redemptions -- will cause a reorganization to fail the COI requirement. However, post-reorganization sales of stock will not destroy continuity, as long as such sales are not to the issuing corporation or a party related to the issuing corporation. Thus, as noted above, the final regulations reverse McDonald's.

a) Two corporations are related under the regulations if the corporations are members of the same affiliated group as defined in section 1504, or a purchase of the stock of one corporation by another corporation would be treated as a redemption under section 304(a)(2) (determined without regard to Reg. § 1.1502-80(b)). Reg. § 1.368-1(e)(3).

b) Under section 1504, corporations are members of the same affiliated group if a common parent owns 80% of the vote and value of at least one other member of the group, and one or more of the other corporations in the affiliated group own 80% of the vote and value of each corporation in such group (except the common parent).

c) Corporations are related under the COI regulations if a relationship exists immediately before or immediately after the acquisition. In addition, a corporation (other that the target corporation or a related person) will be treated as related to the issuing corporation if the relationship is created in connection with the reorganization. Related persons do not include individuals or other non-corporate shareholders. See Preamble to T.D. 8760 (Jan. 23, 1998).

d) For purposes of the final regulations, each partner of a partnership will be treated as owning or acquiring any stock owned or acquired by the partnership in accordance with the partner's interest in the partnership (and, correspondingly, treated as furnishing its share of any consideration furnished by the partnership). Reg. § 1.368-1(e)(4).

(7) Under the final regulations, dispositions of stock of the target corporation prior to a reorganization to persons unrelated to the target or issuing corporation is disregarded for purposes of the COI requirement. Reg. § 1.368-1(e)(1). Thus, the regulations

codify the Seagram analysis discussed above.

(8) In addition to the final regulations issued in 1998, the Service also issued temporary and proposed regulations addressing pre-reorganization continuity. See Temp. Reg. § 1.368-1T. Under the former temporary and proposed regulations, a reorganization generally failed the COI requirement if, prior to and in connection with a reorganization, a proprietary interest in the target corporation was redeemed, or prior to and in connection with a reorganization there was an extraordinary distribution made with respect to such proprietary interest. Former Temp. Reg. § 1.368-1T(e)(1)(ii)(A). It is unclear what standards were to be used to determine whether a redemption or an extraordinary distribution is "in connection with a reorganization."

(9) Whether a distribution is extraordinary was considered a facts and circumstances determination. Former Temp. Reg. § 1.368-1T(e)(1)(ii)(A). Note, however, that the treatment of a distribution under section 1059 was not to be taken into account.

(10) A reorganization also failed the COI requirement if, prior to and in connection with a reorganization, a person related to the target corporation acquired target stock, with consideration other than stock of either the target corporation or the issuing corporation. Former Temp. Reg. § 1.368-1T(e)(2)(ii). Two corporations were "related" under the temporary regulations if a purchase of the stock of one corporation by another would be treated as a distribution in redemption of the stock of the first corporation under section 304(a)(2) (determined

without regard to Reg. § 1.1502-80(b)). See Reg. § 1.368-1(e)(3).

(11) Finally, the temporary and proposed regulations did not apply to a distribution of stock by the target corporation under section 355(a) (or so much of section 356 as relates to section 355), except to the extent that the shareholders of the target corporation receive boot to which section 356(a) applies, or the distribution is extraordinary in amount and is a distribution of boot to which section 356(b) applies. Former Temp. Reg. § 1.368-1T(e)(1)(ii)(B).

f. On August 30, 2000, the Service issued final regulations under section 368 providing guidance on the application of the COI requirement to pre-reorganization transactions. See T.D. 8898, 2001-38 I.R.B. 276. These regulations supplement the final, temporary, and proposed COI regulations issued in January 1998. The new final pre-reorganization COI regulations are substantially different from the temporary and proposed pre-reorganization COI regulations issued in 1998. Temp. Treas. Reg. § 1.368-1T was removed.

(1) In summary, the new final pre-reorganization regulations apply the section 356 "boot" rule in determining whether a distribution or redemption prior to a reorganization counts against the COI requirement. Thus, one must determine when section 356 applies to distributions and redemptions prior to reorganizations.

(2) Commentators on the temporary and proposed regulations issued in December 1996 had suggested that the source of funds used by the target corporation to redeem its shareholders should be analyzed in order to determine whether a redemption should adversely affect

the COI requirement. See Preamble to T.D. 8761 (Jan. 23, 1998). The commentators argued that if the acquiring corporation did not directly or indirectly furnish the funds used by the target corporation to redeem its shareholders, COI should not be affected. However, the Service seemed to conclude that since, as a result of the reorganization, the target corporation and acquiring corporation are combined economically, they should be treated as one entity. Thus, cash coming from the target corporation should be treated the same as cash coming from the acquiring corporation. In addition, the Service argued that "a tracing approach would be extremely difficult to administer." Id. Thus, tracing was not adopted in the temporary and proposed regulations, avoiding the "difficult process of identifying the source of payments." Id.

(3) The Service invited comments on "whether the regulations should provide more specific guidance" in the area of extraordinary distributions. Id. One area of particular concern to many taxpayers was whether S corporations should be treated the same as C corporations with respect to the new extraordinary distribution rules. More specifically, commentators asked that the Service make clear the effect of the new rules on S corporations that distribute their Accumulated Adjustments Account ("AAA Account") prior to a reorganization. Under the temporary and proposed regulations, it appears that S corporations are treated the same as C corporations, and that the distribution of an S Corporation's AAA Account prior to a reorganization could be considered an extraordinary distribution. Id. See Preamble to T.D.

8898 (Aug. 30, 2000); Rev. Rul. 71-266, 1971-1 C.B. 262 (ruling that distribution of S corporation's AAA Account prior to reorganization under section 368(a)(1)(C) is not distribution under section 356).

(4) In addition, commentators asked that the Service clarify exactly what the term "extraordinary" means. If the term is given its plain meaning, then any distribution that is not regularly made (i.e., almost any distribution in addition to the corporation's periodic dividends) can be an extraordinary distribution. For example, suppose a corporation ordinarily issues a $10 per share quarterly dividend to its shareholders in cash. If such corporation issues real estate with a fair market value of $10 per share instead of its normal quarterly cash dividend, is that an extraordinary distribution? The total amount of the dividend is the same, but the type of the dividend is different.

(5) In response to these comments, Treasury issued final regulations on August 30, 2000 (T.D. 8898), substantially modifying the temporary and proposed regulations. The final regulations "do not automatically take all pre-reorganization redemptions and extraordinary distributions in connection with [a] reorganization into account for COI purposes." Id.

(6) Under new Treas. Reg. § 1.368-1(e)(1)(ii), the COI requirement will only be violated due to pre-reorganization redemptions of target stock or pre-reorganization distributions with respect to target stock if the amounts received by the target shareholder are treated as boot received from the acquiring corporation in the reorganization for purposes of

section 356. Treas. Reg. § 1.368-1(e)(1)(ii).

a) Interestingly, the COI regulations now seem to provide two different standards, one for pre-reorganization transactions and one for post-reorganization transactions. A post-reorganization transaction generally counts against the COI requirement if it is "in connection with the potential reorganization," while a pre-reorganization transaction generally counts against the COI requirement only if the amounts received by the target shareholder would be treated as boot under section 356.

(7) For purposes of determining whether section 356 applies, the final regulations provide that each target shareholder is deemed to have received some stock of the acquirer in exchange for such shareholder's target stock. Id. This provision is necessary because if a target shareholder receives only cash as a result of a complete redemption of such shareholder's target stock prior to a reorganization, the amount received is generally treated as a redemption under section 302, not as boot under section 356, regardless of whether the redemption and the reorganization are integrated transactions. See Rev. Rul. 74-515, 1974-2 C.B. 118. Thus, without the deemed issuance of stock rule, the redemption would not count against the COI requirement under any circumstance because section 302, not section 356, would apply. With the deemed issuance of stock rule, however, since the target shareholder is treated as receiving cash and stock in exchange

for his target stock, section 356 can apply. Id. Thus, the redemption can count against the COI requirement.

a) Treasury and IRS officials have stressed that the target shareholder is treated as receiving the stock of the acquirer solely for purposes of applying the COI requirement. Thus, since the target shareholder actually received no stock of the acquirer, section 302 applies for purposes of determining the tax treatment of the redemption to the target shareholder. However, even if the target shareholder were treated as receiving some stock of the acquirer in the transaction for purposes of determining the target shareholder's tax treatment upon the redemption, section 302 principles would likely apply anyway. See Commissioner v. Clark, 489 U.S. 726 (1989) (viewing reorganization with boot as stock for stock exchange followed by post-reorganization redemption); Rev. Rul. 93-61, 1993-2 C.B. 118 (same).

b) Treasury and IRS officials have stated that the fact that the target shareholder is deemed to have received stock of the acquirer should have no affect on the determination of whether the redemption is a separate transaction or part of the reorganization.

(8) Neither section 356, nor the legislative history or regulations thereunder, provide guidance as to when amounts received prior to an exchange should be treated as received in the exchange. Thus, one could argue that under the plain language of the

statute, amounts must actually be received in the reorganization in order to be treated as received in the exchange. If this argument prevails, no prereorganization distributions or redemptions will be treated as received in the exchange, and thus no pre-reorganization distributions or redemptions will count against the COI requirement. Treasury and the IRS obviously did not intend this result.

(9) The Preamble to the new final regulations states that in considering whether section 356 applies, "taxpayers should consider all facts, circumstances, and relevant legal authorities." Preamble to T.D. 8898 (Aug. 30, 2000). IRS officials are presently considering whether to issue guidance under section 356. Thus, taxpayers should analyze each transaction under relevant authorities, including authorities under the step-transaction doctrine. The step-transaction doctrine generally steps together two or more transactions if the particular facts and circumstances warrant. If the step-transaction doctrine applies to step a pre-reorganization distribution or redemption together with the reorganization, amounts received by the target shareholders as a result of the distribution or redemption should be treated as received in the exchange, resulting in the application of section 356.

(10) Although the new final pre-reorganization regulations do not provide direct guidance as to the standards that should be used in determining whether section 356 applies to a pre-reorganization distribution or redemption, they do provide an example that seems to focus on the source of

the funds used to pay the target shareholders. See Treas. Reg. § 1.368-1(e)(6), Ex. 9. However, the example may provide more questions than answers.

a) In the example, T has two shareholders, A and B. P wants to acquire the stock of T, but A does not want to own P stock. Thus, T redeems A's shares for cash, and P then acquires all the remaining stock of T from B solely in exchange for P voting stock. The example provides that "[n]o funds have been or will be provided by P" for the redemption.

b) The example in the final regulations concludes that since the cash received by A in the redemption is not treated as boot under section 356, the redemption does not affect the COI requirement. Although it is not entirely clear whether the statement in the example that "[t]he cash received by A in the pre-reorganization redemption is not treated as other property or money under section 356" is a statement of fact or a statement of law, IRS officials have indicated that this statement was intended to reflect the numerous authorities that have concluded that pre-reorganization redemptions followed by a reorganization under section 368(a)(1)(B) where no funds are provided by the acquirer for such redemption are treated as distributions under section 301. See Rev. Rul. 70-172, 1970-1 C.B. 77; Rev. Rul. 69-443, 1969-2 C.B. 54; Rev. Rul. 68-435, 1968-2 C.B. 155; Rev. Rul. 68-285, 1968-1 C.B.

147. See also Rev. Rul. 56-184, 1956-1 C.B. 190; Rev. Rul. 75-360, 1975-2 C.B. 110; McDonald v. Commissioner, 52 T.C. 82 (1969).

c) Query whether the percentage of T stock held by A is relevant to the COI analysis. Would it matter if A held 99% of the stock of T and T redeemed all of A's stock prior to the attempted B reorganization? Because the example does not state the percentage holdings of the two target shareholders, one can infer that such percentages are irrelevant. However, note that a complete redemption of a 99% shareholder would violate the continuity of business enterprise requirement. See Treas. Reg. § 1.368-1(d).

d) On its face, this example simply seems to be following the "source of funds" analysis discussed above in stating that if no cash for the redemption is provided by the acquirer, section 356 will not apply and thus the redemption will not affect the COI requirement. A closer inspection, however, begs the question of how section 356 could possibly apply to the facts in the example even if P provided funds for the redemption. Although not specifically referred to, the reorganization in the example is apparently intended to be a B reorganization. In order to qualify as a B reorganization, P must exchange solely P voting stock (or stock of its parent) for T stock. If P provides the funds for the redemption and the transactions are thus stepped together, P will not be treated as exchanging solely P voting stock

for T stock, and thus the reorganization will not qualify as a valid B reorganization. Therefore, the question of whether section 356 applies will never be reached. If P does not provide the funds for the redemption, the redemption will be treated as a separate transaction and again section 356 will not apply. Thus, it seems that section 356 cannot apply under any circumstance under the facts of the example in the final pre-reorganization COI regulations. As a result, the example provides little help for practitioners.

e) Having determined that the use of section 356 for purposes of the COI requirement is misplaced in the context of B reorganizations, the next question is what is the relevance of COI to B reorganizations (in the context of pre-reorganization transactions) at all? It seems that depending on the source of the funds used to pay target shareholders, an attempted B reorganization will either fail due to the "solely for voting stock" requirement, or succeed because the distribution or redemption is treated as a separate transaction. Is guidance on B reorganizations in the context of pre-reorganization distributions and redemptions even necessary? The Service should clarify the example in the new regulations and the relevance of the COI requirement to B reorganizations in the context of pre-reorganization distributions and redemptions.

(11) Effective date: the final regulations generally only apply to transactions occurring after August 30, 2000, but taxpayers may request a private letter ruling permitting them to apply the final regulations to transactions entered into on or after January 28, 1998. Treas. Reg. § 1.368-1(e)(7). Thus, the 1998 temporary and proposed regulations, including the "extraordinary distribution" rule, should have little continuing applicability.

(12) For a more detailed discussion of the new final COI regulations, see Mark J. Silverman and Andrew J. Weinstein, The New Prereorganization COI Regulations, 28 J. Corp. Tax'n 3 (2001).

2. Continuity of Business Enterprise

a. Continuity of business enterprise ("COBE") focuses on the business conducted by the corporate entity itself, rather than the consideration paid.

b. The regulations provide that, in order to satisfy the continuity of business enterprise requirement, the transferee corporation must either (i) continue a line of the target's historic business (the "historic business test"), or (ii) use a significant portion of the target's historic business assets in any business (whether or not that business was historically conducted by the target)(the "historic asset test"). Reg. § 1.368-1(d)(2). An example in the Regulations suggests that the former requirement will be satisfied if one of three equal-sized lines of business is continued.

c. In January 1997, the Service proposed regulations that addressed the questions of continuity of business enterprise that arise when target assets or target stock are

transferred following a reorganization. See Prop. Reg. § 1.368-1(d) and (f).

d. In January 1998, the Service finalized the COBE regulations, with modest changes. The final regulations apply to transactions occurring after January 28, 1998 -- the date the regulations were published in the Federal Register. Reg. § 1.368-1(d)(1). However, the regulations do not apply to any transaction occurring pursuant to a written agreement which is binding on the date the regulations are published in the Federal Register, and at all times thereafter.

(1) The final regulations permit transfers of target assets or target stock to corporations. The regulations provide that in determining whether the COBE requirement is satisfied, the issuing corporation is treated as holding all of the businesses and assets of all members of the "qualified group." Reg. § 1.368-1(d)(4).

a) The qualified group is defined as one or more chains of corporations connected through stock ownership with the issuing corporation, as long as the issuing corporation owns directly stock having the relationship specified in section 368(c) (i.e., ownership of at least 80% of the voting stock and 80% of each other class of stock) in at least one member of the group, and every member of the group (except the issuing corporation) is controlled (again, using the section 368(c) test) directly by another member of the group. Reg. § 1.368-1(d)(4)(ii).

b) Note: In order to be a member of the qualified group, each corporation (except the issuing corporation) must be controlled directly by one, and only one

other member of the qualified group.

(2) The final regulations also allow transfers of target assets to partnerships. Reg. §§ 1.368-1(f) and (d)(4)(iii). Under the regulations, a partnership is treated as an aggregate for COBE purposes, thereby reversing G.C.M. 35117 (Nov. 15, 1972).

a) However, there are a number of restrictions that apply in determining whether the COBE requirement is met. Under the regulations, partners are treated as owning the target corporation's business assets used in the partnership in accordance with such partner's interest in the partnership. Reg. § 1.368-1(d)(4)(iii). The issuing corporation is treated as conducting a business of the partnership if (1) members of the qualified group, in the aggregate, own a "significant interest" in the partnership business, or (2) one or more members of the qualified group have "active and substantial management functions" as a partner with respect to the partnership business. Reg. § 1.368-1(d)(4)(iii)(B).

b) If a significant historic business of the target corporation is conducted in a partnership, the fact that the issuing corporation is treated as conducting such business tends to establish the requisite continuity, but is not alone sufficient. Reg. § 1.368-1(d)(iii)(C).

(3) The final regulations also provide a safe harbor for transfers to controlled corporations and transfers following

reverse triangular mergers under section 368(a)(2)(E). See Treas. Reg. §§ 1.368-1(f) and (k).

a) Under this safe harbor, a transaction that qualifies as an A, B, C, or G reorganization does not fail the COBE requirement by reason of the fact that "part or all of the acquired assets or stock acquired in the transaction are transferred or successively transferred to one or more corporations controlled in each transfer by the transferor corporation." Reg. § 1.368-1(k)(1). Again, control is determined under section 368(c).

b) Thus, a corporation may transfer assets through as many lower-tiered subsidiaries as it desires, as long as the transferor in each transfer owns at least 80% of the voting power and 80% of each other class of stock in each transferee. Similarly, a reverse triangular merger under section 368(a)(2)(E) does not fail the COBE requirement by reason of the fact that "part or all of the stock of the surviving corporation is transferred or successively transferred to one or more corporations controlled in each transfer by the transferor corporation, or because part or all of the assets of the surviving corporation or the merged corporation are transferred or successively transferred to one or more corporations controlled in each transfer by the transferor corporation." Reg. § 1.368-1(k)(2).

c) Under these rules, the Service apparently will not apply step-

transaction principles to view a section 368(a)(2)(E) reverse triangular merger and subsequent drop of Target stock to a controlled subsidiary of Parent as an invalid merger of Target into a second-tier subsidiary in exchange for grandparent stock. Likewise, step-transaction principles apparently will not be applied to drops of Target stock or assets to second-tier subsidiaries following a triangular "B" reorganization, a triangular "C" reorganization, or a forward triangular merger under section 368(a)(2)(D).). See Rev. Rul. 2001-24, 2001-22 I.R.B. 1 (May 3, 2001) (ruling that COBE requirement is met in forward triangular merger that is followed by drop-down of the acquiring corporation stock to controlled subsidiary; PLR 200124009 (ruling that COBE requirement is met in forward triangular merger that is followed by drop-down of assets from the acquiring subsidiary to its subsidiaries).

3. Business Purpose

a. A transaction lacking a business purpose will fail to qualify as a valid reorganization. Reg. §§ 1.368-1(c), 1.368-2(g); Gregory v. Helvering, 293 U.S. 465 (1935).

b. The contours of the business purpose requirement under section 368 are unclear.

(1) If the sole purpose of a transaction is to minimize federal income taxes, the transaction is unlikely to qualify as a reorganization. See, e.g., Wortham Machinery Co. v. United States, 521 F.2d 160 (10th Cir. 1975) (individual owns all of the stock of two corporations, one of which has

substantial NOL carryforwards; merger of the two corporations, with no intent to combine their operations, and solely to enable the NOLs to be utilized, failed to qualify as a reorganization due to lack of business purpose).

(2) In contrast, if two unrelated corporations determine that, without regard to tax issues, it would be advantageous to combine their operations, such a transaction will satisfy the business purpose requirement.

c. The Service tends to examine the business purpose requirement much more stringently in connection with divisive transactions under section 355 than in acquisitive reorganizations. See Reg. § 1.355-2(b). See also Rev. Proc. 96-30, 1996-1 C.B. 696 (providing guidelines with respect to ruling requests under section 355 involving certain business purposes).

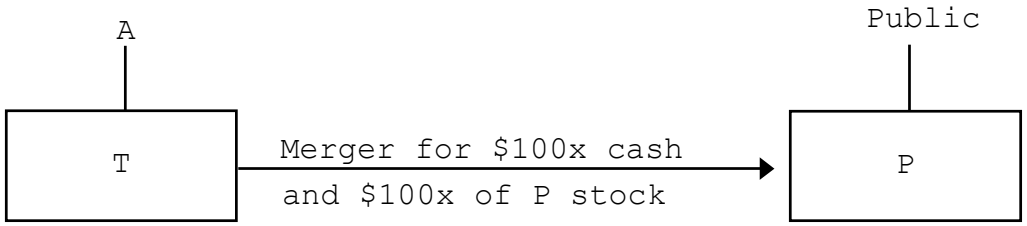
d. The Service takes the position, for ruling purposes, that a business purpose is also required for a transaction described in section 351. See, e.g., Notice 2001-17, 2001-9 I.R.B. 1 (notice of intent to disallow contingent liability tax shelters); FSA 200122022; Rev. Proc. 83-59, 1983-2 C.B. 575. Some courts have agreed. See Caruth v. United States, 688 F. Supp. 1129 (N.D. Tex. 1988), aff'd on another issue, 865 F.2d 644 (5th Cir. 1989); Estate of Kluener v. Commissioner, 154 F.3d 630 (6th Cir. 1998).

II. ISSUES AND EXAMPLES

A. Issues Involving Continuity of Interest

Note: In the following examples, T will be used to represent the target corporation and P will be used to represent the issuing corporation.

1. Example 1 -- Quantitative Continuity



a. Facts: T, a corporation wholly-owned by individual A, enters into an agreement to merge into P, a publicly traded corporation, in exchange for $100x and 100 shares of P stock at a time when P stock is trading at $1x per share.

b. In this example, continuity is satisfied. The Service considers the continuity of interest requirement satisfied if, following the transaction, historic shareholders of the target corporation hold stock of the acquiring corporation (as a result of prior ownership of target stock) representing at least 50% of the value of the stock of the target corporation. Rev. Proc. 77-37, 1977-2 C.B. 568.

(1) Cases have, however, approved reorganizations with significantly lower percentages of stock consideration. See e.g. John A. Nelson Co. v. Helvering, 296 U.S. 374 (1934) (38 percent stock); Helvering v. Minnesota Tea Co., 296 U.S. 378 (1935) (41 percent stock); Miller v. Commissioner, 84 F.2d 415 (6th Cir. 1936) (25 percent stock).

(2) In any event, the use of 50% cash and 50% stock should clearly satisfy the continuity of interest test. Indeed, an example in the final COI regulations explains that continuity is satisfied if the target's historic shareholders receive 50% of the value of the total consideration transferred in the acquisition. Treas. Reg. § 1.368-1(e)(6), Ex.1.

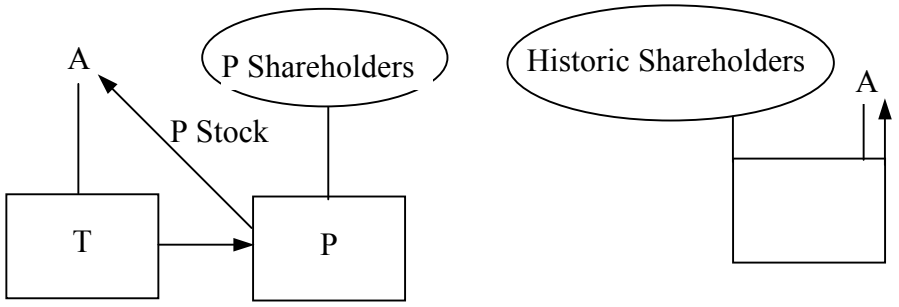
c. Assume that the facts are the same as Example 1, and that the $100x of P stock received by T in the merger represents 40% of the outstanding stock (vote and value) of P. Assume further that immediately following the merger, X, a corporation that owns 45% of the stock (vote and value) of P, purchases all of A's P stock received in the merger.

(1) Under the final regulations, X will be treated as a related person, because it is a member of P's affiliated group under section 1504 immediately after the transaction (i.e., X will own 85% of P's stock immediately after the transaction). Reg. § 1.368-1(e)(3) (stating that corporations are treated as related if relationship exists immediately before or immediately after acquisition of stock involved).

(2) Thus, the transaction will fail the COI requirement. Note, however, that if X were an individual, the related person rules would not apply, and the transaction would pass the COI requirement under the regulations. See Preamble to T.D. 8760 (Jan. 23, 1998).

2. Example 2 -- Contingent Stock

CLOSING EARN-OUT DATE



a. Facts: A owns all of the stock of T Corporation. P, a publicly-traded company, wishes to acquire T in a tax-free transaction. However, the parties are unable to agree on a value for T due to disputes regarding its likely future earnings and significant contingent liabilities. The parties agree that T will merge into P. P will issue $100 million of its stock at closing. If the future earnings of P meet certain targets and contingent liabilities fail to mature, P will issue an additional $25 million of its stock on the second anniversary of the closing date.

b. Issues:

(1) At one point the Service took the position that contingent stock arrangements constituted boot. See Rev. Rul. 57-586, 1957-2 C.B. 249. Thus, in the Service's early view, the use of contingent stock consideration could disqualify a purported "B" reorganization which must be "solely" for acquirer stock. However, after the Service lost several cases on this issue, it changed its position. See Hamrick v. Commissioner, 43 T.C. 21 (1964); Carlberg v. United States, 281 F.2d 507 (8th Cir. 1960).

(2) The Service has since issued guidelines for advance ruling purposes in Rev. Proc. 84-42, 1984-1 C.B. 521, permitting the use of contingent stock if the following requirements are met:

a) All of the stock to be issued in the reorganization will be issued within five years from the date of the initial distribution.

b) There is a valid business reason for not issuing all the stock at the time of the reorganization.

c) The maximum number of shares that may be issued is set forth in the agreement.

d) At least 50% of the maximum number of shares of each class of stock that may eventually be issued is issued in the initial distribution.

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

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

g) With respect to contingent stock arrangements, the right to receive additional stock must either be nonassignable except by operation of law or, if the right is not by its terms nonassignable, not be

evidenced by a negotiable instrument nor readily marketable.

h) With respect to contingent stock arrangements, any stock to be issued must be stock of Acquiror and no non-stock consideration is permitted.

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

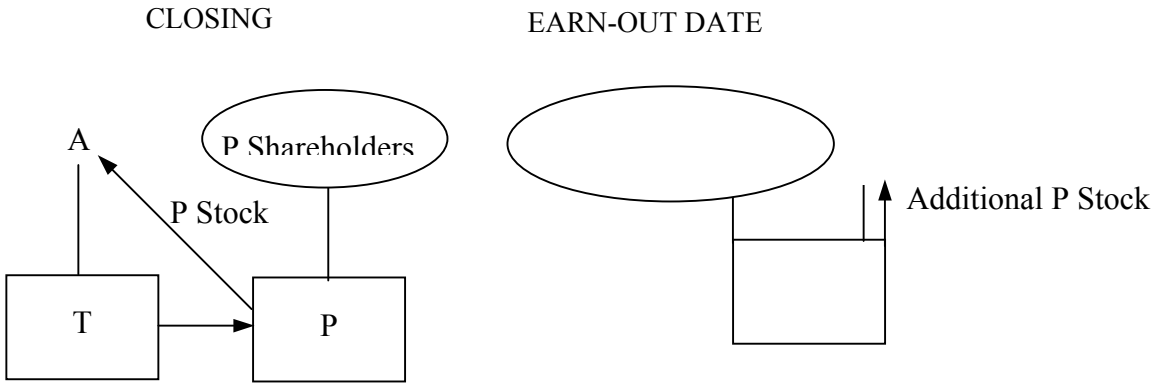
Rev. Proc. 84-42, 1984-1 C.B. 521, amplifying Rev. Proc. 77-37, 1977-2 C.B. 568.

(3) Revenue Procedure 84-42 does not, however, directly address continuity of interest. Nevertheless, it would be anomalous if the contingent stock rights are qualifying stock consideration for purposes of section 356 but fail to provide an adequate "proprietary interest" for continuity of interest purposes. Since the consideration on these facts will consist solely of stock in any event, the requirement should clearly be met. See Carlsberg, supra, (suggesting in dictum that contingent stock certificates do provide continuity). Compare Preamble to the proposed regulations treating stock rights as securities and suggesting such rights do not count towards continuity.

(4) The Service requires, for advance ruling purposes, that continuity be determined as of the "effective time" of the reorganization. See Rev. Proc. 77-37, supra. Almost by definition, this is impossible if the transaction provides for a contingent earn-out thereby deferring receipt of a portion of the consideration. It is unclear whether continuity is satisfied in the above example as a result of the contingent stock being deemed to be outstanding at closing for continuity purposes, or merely because the contingent stock may be ignored. On these facts, however, the distinction is irrelevant.

(5) Assume, however, that the reorganization provides for cash consideration.

3. Example 3 -- Contingent Stock



a. Facts: The facts are as in the previous example except that the consideration is as follows: P will issue $40 million of its stock and $60 million cash at closing. If the earnings of P meet certain targets and contingent liabilities fail to mature, P will issue an additional $25 million of its stock on the second anniversary of the closing date.

	Closing	Earn-Out	Total
Stock	40M (40%)	25M (100%)	65M (52%)
Cash	60M (60%)	-0-	60M (48%)
Aggregate	100M (100%)	25M (100%)	125M (100%)

b. Issues:

(1) If the contingent consideration is counted for continuity purposes, the transaction may qualify as a reorganization. The aggregate consideration in that case would be 52 percent stock and 48 percent cash.

(2) On the other hand, if the contingent consideration is ignored for purposes of continuity, the transaction does not meet the 50 percent threshold established by the Service in Revenue Ruling 77-37, and may be taxable. Given the Service's requirement that continuity be determined as of the effective time, this seems more likely. See Preamble to the proposed regulations under sections 354, 355, and 356 (finalized in 1998) regarding the receipt of rights to acquire stock of a corporation that is a party to a reorganization, 61 Fed. Reg. 67,508 (stating that the proposed rules do not permit rights to acquire stock to be taken into account in determining continuity of shareholder interest).

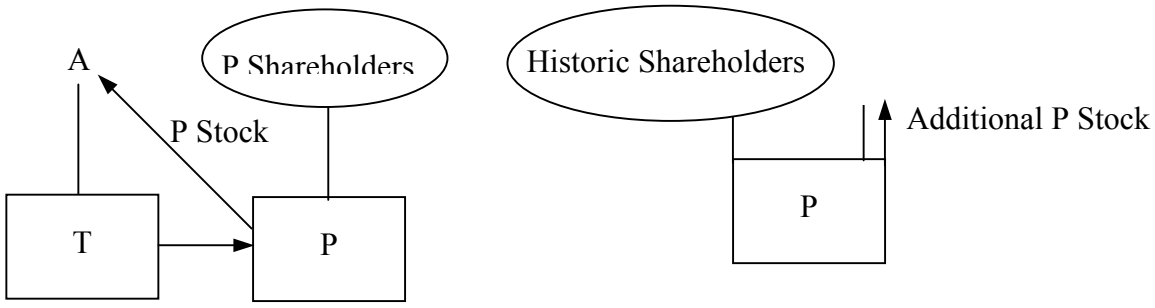
(3) As an alternative to using contingent stock rights, P could issue the contingent stock consideration at closing into escrow. Unless the earnings and other contingencies were satisfied the stock would be returned to P on the second anniversary of closing. Provided (1) that the stock was treated as outstanding on financial statements, (2) the dividends were

accumulated in escrow for ultimate distribution to the T shareholders, and (3) the shareholders were entitled to vote the stock in the interim, the stock should be treated as issued and outstanding in the reorganization and should count for continuity purposes.

(4) What about the converse situation in which stock and cash are issued in the earn-out?

4. Example 4 -- Contingent Earn-out

CLOSING EARN-OUT DATE



a. Facts: The facts are the same as in the previous example, except that the merger consideration is as follows: P initially issues $50 million cash and $50 million stock. (At the time of the merger the P stock is trading at $1000 per share and P issues 50,000 shares). P subsequently must pay an additional $100 million under the Earn-Out in the same proportions. Therefore, P pays $50 million in cash in the Earn-Out (i.e., the same proportion of cash as was issued in the initial transaction). The remaining Earn-Out consideration is provided in the form of P stock. (At the time the Earn-Out consideration is paid, P stock is trading at $5,000 per share. Therefore, P issues 10,000 shares in the Earn-Out.)

	Closing	Earn-Out	Total	Value on Reorg Effective Date
Stock	50,000 shares @ 1,000 = 50M (50%)	10,000 shares @ 5,000 = 50M (50%)	60,000 shares @ 1,000 = 50M (50%) @ 5,000 = 50M (50%)	60,000 shares @ 1,000 = 60M (37.5%)
Cash	50M (50%)	50M (50%)	100M	100M (62.5%)
Aggregate	100M (100%)	100M (100%)	200M	160M

b. Issues:

(1) Although the earn-out does not meet the requirement of Revenue Procedure 84-42 that solely stock be issued in the earn-out, common sense suggests that continuity of interest, at least, should be met. The Service's test requires that 50 percent of the target company's stock by value be exchanged for P stock. See Rev. Proc. 77-37. Taking into account the Earn-Out consideration ultimately paid, T should be viewed as having had a value of $200 million. Assuming T's value is $200 million, only $100 million of value will have been received in cash; thus the remaining 50 percent ($100 million) of the consideration must have been received in the form of qualifying stock consideration.

(2) Nevertheless, the application of the continuity test articulated by the Service in Rev. Proc. 77-37 is unclear. The test states that the determination must be made "as of the effective time of the reorganization." One might argue that this requires all of the P stock to be valued at the trading price as of the effective time. In that case, the aggregate consideration given in the merger would be $100 million cash ($50 million at closing plus $50 million in the Earn-Out) plus 60,000 shares of P stock (50,000 shares at closing plus 10,000 shares in the Earn-Out). For purposes of the continuity of interest test, however, the value of

the 60,000 shares of P stock actually received arguably could be based on the per share value as of the closing (the "effective time"). In that event, the 60,000 shares would be valued at $60 million (60,000 shares times $1,000 per share), in which case the aggregate stock consideration in the Merger would be deemed to be only 37.5 percent. Consequently, continuity could be threatened.

(3) Another question, assuming continuity would otherwise be satisfied, is whether a disposition of earn-out stock may affect continuity. For example, even if A had no plan to dispose of P stock when the deal closed, he may have formed a plan to dispose of stock by the time the earn-out is paid. Should A be required to represent that he will retain the earn-out stock for a specified period following the earn-out payment?

(4) Even if the continuity of interest requirement is met, query whether the contingent right to cash under the earn-out may constitute boot as of the closing. That is, the T shareholders may be required to determine the value of the contingent right and take it into income currently.

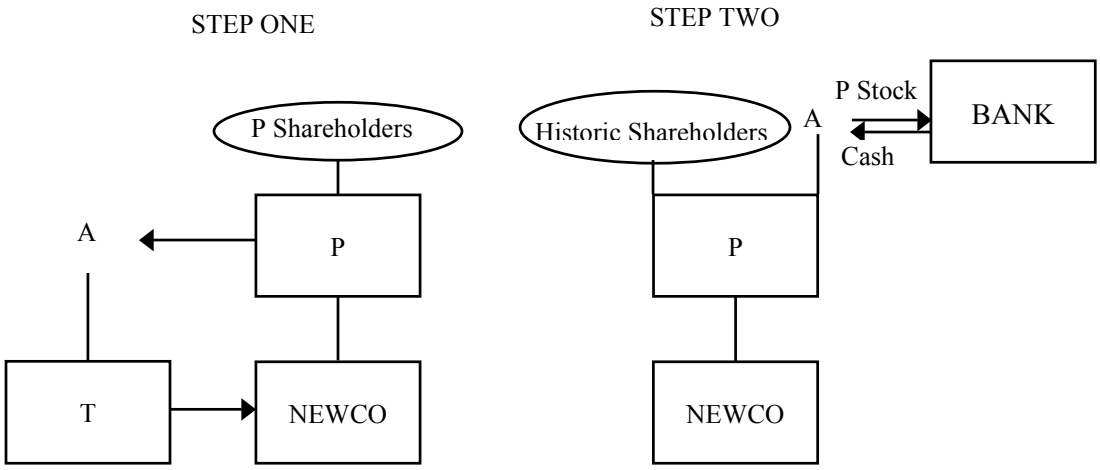
(5) In addition, query whether the transaction could be a contingent payment sale, because there is a contingent right to additional cash.

a) Under section 356 and Commissioner v. Clark, 489 U.S. 726 (1989), when A receives the additional cash, A is treated as having redeemed the stock of P for cash.

b) If the section 302(a) rules are met, the receipt of the boot is taxed as a sale, not a dividend.

If it is taxed as a sale, section 453 should be available.

5. Example 5 -- Post-reorganization Continuity and the Final Regulations



a. Facts: A owns all of the stock of T Corporation. A and P agree that T will be merged into a newly formed subsidiary of P ("Newco") in a transaction intended to qualify as a reorganization under section 368(a)(2)(D). Pursuant to a binding agreement that is already in effect at the time of P's acquisition of T, A agrees to sell the P stock it receives in the transaction to Bank.

b. Is the continuity of interest requirement satisfied?

(1) Under prior law, a prearranged plan to dispose of stock received in the reorganization may have destroyed continuity of interest. See e.g., Rev. Rul. 66-23, 1966-1 C.B. 67; Rev. Proc. 77-37, 1977-2 C.B. 568; Rev. Proc. 86-42, 1986-2 C.B. 722; McDonald's Restaurants of Illinois v. Commissioner, 688 F.2d 520 (7th Cir. 1982); Penrod v. Commissioner, 88 T.C. 1415 (1987); Christian Est. v. Commissioner, 57 T.C.M. 1231 (1989).

(2) In this case, there is a binding commitment to dispose of all of the stock received in the transaction.

(3) Accordingly, continuity would not have been satisfied and the transaction would have been treated as an asset sale under prior law. Thus, A's unilateral action may have subjected T (and thus P) to corporate-level tax.

(4) Many commentators argued that the continuity of interest requirement was intended to look only to the nature of the consideration issued by the acquiring corporation in the transaction. Where, as here, the acquiring corporation has not participated in (or even been aware of) the sale of its stock by the target shareholders, the sale should not destroy continuity. See Rev. Rul. 66-23, 1966-1 C.B. 67.

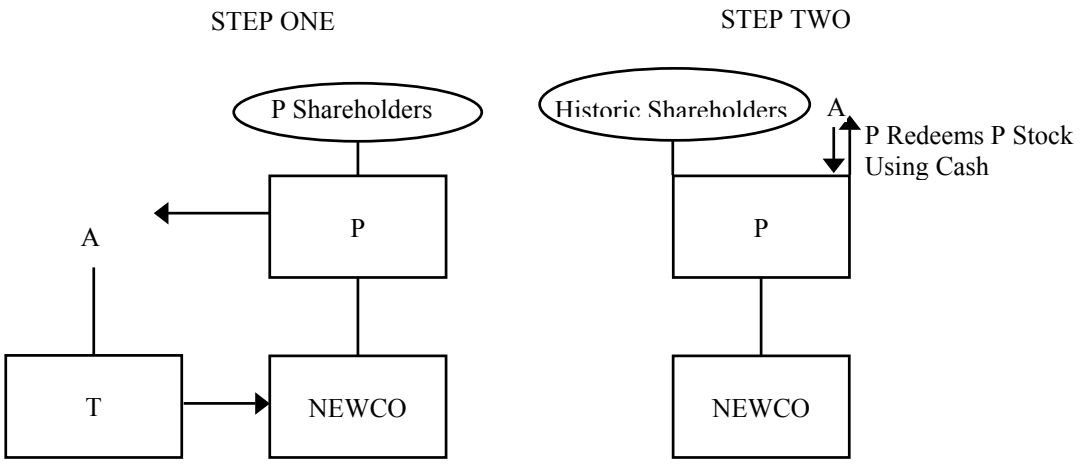
a) The final regulations essentially adopt this position. The regulations state that a mere disposition of stock of the issuing corporation received in a reorganization to persons not related to the issuing corporation is disregarded for purposes of COI. See Treas. Reg. § 1.368-1(e).

b) Thus, under the final COI regulations, continuity would be satisfied in the above example. See Treas. Reg. § 1.368-1(e)(6), Ex. 1.

c) The regulations apply prospectively. Thus, they apply to transactions occurring after January 28, 1998 -- the date the final regulations were published in the Federal Register. See Treas. Reg. § 1.368-1(e)(7). In

addition, the regulations will not apply to "any transaction occurring pursuant to a written agreement which is binding" on January 28, 1998.

6. Example 6 -- Post-reorganization Continuity (Sales to Issuing Corporation)



a. Facts: Assume that the facts are the same as Example 5, except that A has an arrangement to sell the P stock back to P rather than to a third party bank.

b. The final regulations expressly provide that the COI requirement will not be satisfied if the stock of the issuing corporation is redeemed by the issuing corporation from the holders of the proprietary interest in connection with the reorganization. See Treas. Reg. § 1.368-1(e)(1) and (e)(6), Ex. 4. Thus, the transaction will be treated as a sale of the T stock by A to P for cash.

c. Assume that the facts are the same as Example 5, except that P issues redeemable preferred stock (that is not nonqualified preferred stock under sections 351(g)) to A in the reorganization. The stock is redeemable three years after issuance. What if the preferred stock is sinking fund preferred which is redeemed pro-rata over a 20-year period? What if the shareholder has

the right to put the stock to P after two years? In all of these transactions, P may reacquire its stock. Thus, step-transaction principals must be applied to determine if each transaction satisfies the COI requirement.

(1) IRS officials have informally stated that they will analyze whether puttable stock is equity in order to determine whether the COI requirement is satisfied, and, in doing so, will consider whether it is likely that the shareholder will put the stock, i.e., whether the put is deep in the money at the time of the transaction.

d. Assume that the facts are the same as Example 5, except that A has an arrangement to sell the P stock to Newco. Under the final regulations, Newco is a person related to P, and thus the COI requirement is not satisfied. See Treas. Regs. §§ 1.368-1(e)(3)(i) and 1.368-1(e)(6) Ex. 4(iii).

(1) There are situations where the related person rule is not so clear. For example, assume P and T execute a merger agreement and announce plans to merge on 01/01/01. On 01/15/01, X Corporation enters into negotiations with P to acquire all of P's stock for cash. On 03/01/01, P and T merge, and on 04/01/01, X acquires all of P's stock in a reverse subsidiary cash merger, with P's shareholders (which include T's historic shareholders) receiving cash in return for their P stock.

(2) Does the related person rule apply to destroy continuity? If the reverse cash merger is "in connection with" the T/P merger, it seems that X, which is a person related to P following the reverse cash merger, is acquiring the stock of P that P issued to T in the initial merger. Under a technical

reading of the statute, this is a "related person acquisition," and the transaction fails the COI requirement.

(3) Note, however, that in order for the related person rule to apply, the reverse cash merger must be "in connection with" the P/T merger. IRS officials have informally stated that this transaction likely violates the COI requirement.

e. Assume that the facts are the same as Example 5, except A sells all of its P stock received in the merger to an unrelated party ("B"), and shortly thereafter P redeems the stock held by B for cash. Under the final regulations, if the purchase and redemption occur in connection with the reorganization, P has in substance exchanged solely cash for T stock in the merger, and the merger will fail the continuity of interest requirement. Treas. Reg. § 1.368-1(e)(6), Ex. 5.

f. What if P does not redeem the stock held by B, but B pays for the stock purchased from A with proceeds from a bank loan guaranteed by P? Does it matter who the bank is looking to for repayment of the loan? Will the fact that B's interest rate is lower due to P's guarantee affect the outcome? Whether continuity of interest is satisfied in this situation will depend on a facts and circumstances analysis.

g. Assume that the facts are the same as Example 5, except A sells all of its P stock received in the merger to a partnership ("PRS") that is 85% owned by Newco. Under the final regulations, Newco is treated as having acquired 85% of what PRS acquired, and having furnished 85% of the consideration furnished by PRS. Treas. Reg. § 1.368-1(e)(4). Thus, since Newco is related to P under Treas. Reg. § 1.368-1(e)(3)(i), the COI requirement is not satisfied. Treas. Reg. § 1.368-1(e)(6), Ex. 6.

h. Assume that the facts are the same as Example 5, except that, pursuant to an agreement with P to register the P stock, A obtains registration rights and sells its P stock on the open market shortly after the acquisition. Under the final regulations, continuity of interest will be satisfied. Treas. Reg. § 1.368-1(e)(6), Ex. 3.

i. Assume that the facts are the same as Example 5, except that immediately after the merger, P repurchases a small percentage of its stock in the open market, as part of an ongoing stock repurchase program. Under former Example 8 of the 1998 final regulations, if the repurchase program was not created or modified in connection with the reorganization, and the redemptions were a small percentage of the P stock, the COI requirement was satisfied. Treas. Reg. § 1.368-1(e)(6), Former Ex. 8.

(1) The new final COI regulations removed Example 8. The preamble to the regulations states that "Example 8 suggests a more restrictive approach to COI than was intended in this context." See T.D. 8898. Instead, the Service directs taxpayers to Rev. Rul. 99-58, 1999-52 I.R.B. 701, as more appropriate guidance.

(2) In Revenue Ruling 99-58, the Service allowed a pre-existing stock repurchase program to be modified without failing to satisfy the COI requirement. In Rev. Rul. 99-58, T merges into P with the former T shareholders receiving 50% P common stock and 50% cash. In an effort to prevent dilution resulting from the issuance of P stock in the merger, P's pre-existing stock repurchase program is modified to enable P to reacquire a number of its shares equal to the number issued in the merger. The repurchases are made on the open market, through a broker at the prevailing market price, and are

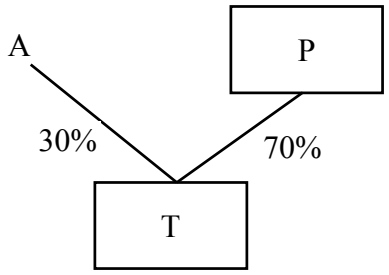
not negotiated with T or T's shareholders. P does not know the identity of a seller of P stock, and former T shareholders who sell their P stock do not know the identity of the buyer. The Service ruled that in these circumstances, the repurchase of P stock on the open market is not "in connection with" the merger, and thus does not affect the satisfaction of the COI requirement. The Service likened the coincidental disposition of stock to P to a disposition to persons not related to P, which has no effect on the COI requirement. See also PLR 199935042 (holding that the post-merger repurchase by the acquiring company of its common stock pursuant to a revised repurchase plan does not affect the satisfaction of the COI requirement).

(3) Apparently, in drafting Example 8, the Service did not consider that P might repurchase a "large" percentage of its stock in a repurchase program. In addition, it was unclear what percentage would be deemed to be "small."

a) It is unclear to what extent the size of the repurchase matters. Query whether, in light of the removal of Example 8, and the approach in Rev. Rul. 99-58, P may, for example, repurchase 90% of its stock in a stock repurchase program.

b) One could argue that this stock repurchase will not violate the COI requirement because it too can be likened to a disposition of stock to a person unrelated to P, a disposition which would have no effect on the COI requirement.

7. Example 7 -- Maintaining Direct or Indirect Interests in the Target Corporation



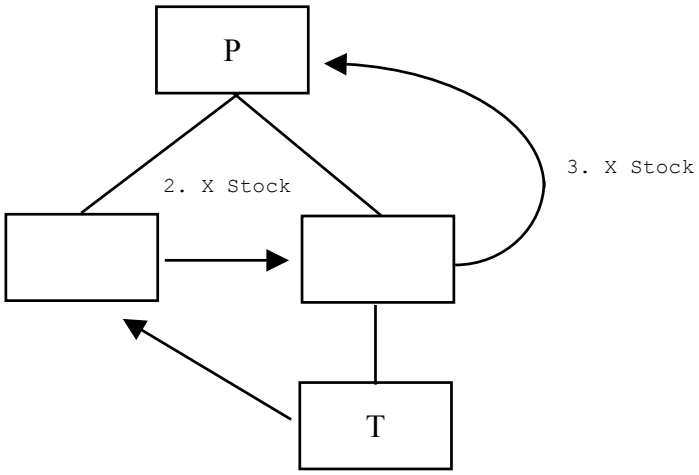
a. Facts: A owns 30% of the stock of T. P owns 70% of the stock of T. T merges into P, and A receives cash in the merger. P's 70% stock ownership was not acquired by P in connection with the acquisition of T's assets.

b. Under the final regulations, the COI requirement is satisfied if the acquiring corporation exchanges a proprietary interest in the target corporation for a direct interest in the target corporation enterprise. Treas. Reg. § 1.368-1(e)(1).

(1) Thus, in the example, the COI requirement is satisfied, because P's proprietary interest in T is exchanged by P for a direct interest in the assets of the target corporation enterprise. Treas. Reg. § 1.368-1(e)(6), Ex. 7.

(2) If, prior to the merger, A had a 60% interest in T, and P had a 40% interest, the transaction would likely fail the COI requirement, and the entire transaction would be taxed.

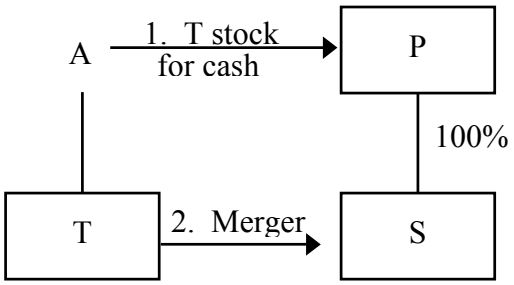
8. Example 8 -- Maintaining Direct or Indirect Interests in the Target Corporation



a. Facts: P owns all the stock of X Corporation and Z Corporation, and Z owns all the stock of T. T merges into X, Z receives X stock in the merger, and immediately thereafter Z distributes the X stock received in the merger to P.

b. Under the final regulations, P is related to X, and the COI requirement is satisfied, because P "was an indirect owner of T prior to the merger who maintains a direct or indirect proprietary interest in [X], preserving a substantial part of the value of the proprietary interest in T." Treas. Reg. § 1.368-1(e)(6), Ex. 8.

9. Example 9 -- *Yoc Heating*



a. Facts: A owns all the stock of T. P owns all of the stock of S Corporation. P

purchases A's T stock for cash. T then merges into S.

b. These facts are similar to the facts of Yoc Heating Corp. v. Commissioner, 61 T.C. 168 (1973), where the Tax Court held that a similar transaction failed to qualify as a reorganization because, applying the step-transaction doctrine, historic shareholder continuity was not present.

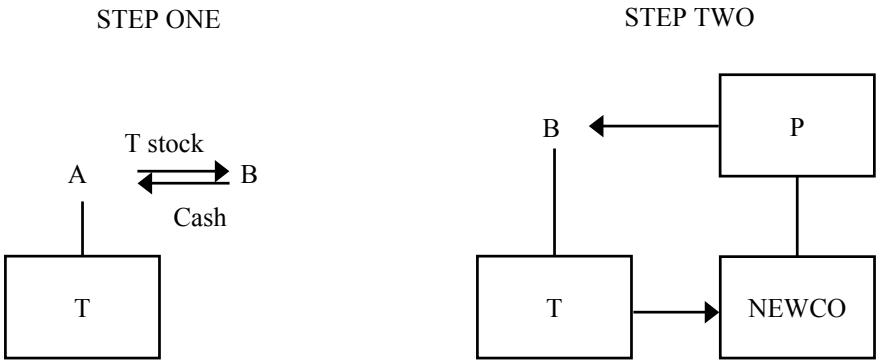
c. The Service has rejected the holding of Yoc Heating and has issued final regulations that treat the COI requirement as satisfied in this case where the acquisition of T stock constitutes a qualified stock purchase under section 338, which eliminates the taint of the change in ownership for COI purposes. See Treas. Reg. § 1.338-3(d)(2). (On February 12, 2001, the Service issued T.D. 8940, 2001-15 I.R.B. 101, supplanting the existing body of temporary section 338 regulations with a new set of final regulations. The new final regulations are similar to the temporary regulations that the Service had issued on January 7, 2000.) See also Treas. Reg. § 1.368-1(e)(6), Ex. 2 (stating that if P does not acquire the T stock in a qualified stock purchase, the transaction fails the COI requirement).

d. The final COI regulations, as amended by T.D. 8783, 1998-2 C.B. 475, do not address whether the above transaction fails the COI requirement as to P, S, and T. Instead, the regulations provide that if P does not acquire the T stock in a qualified stock purchase, the transaction fails the COI requirement. However, if P does acquire the T stock in a qualified stock purchase, Treas. Reg. § 1.338-3(d)(2) should apply, and the COI requirement should be satisfied as to P, S, and Treas. Reg. § 1.368-1(e)(6), Ex. 2. See Treas. Reg. § 1.338-3(d)(2).

e. However, the final COI regulations, as amended by T.D. 8898, 2000-38 I.R.B. 276, do address the effect on COI of a pre-

reorganization stock redemption or distribution with respect to T's stock.

10. Example 10 -- Pre-reorganization Continuity



a. Facts: A owns all of the stock of T Corporation. P wishes to acquire T in exchange for P stock. Pursuant to a binding agreement, A sells its T stock to B so that B rather than A participates in the reorganization. T is merged into a newly formed subsidiary of P (Newco) in a transaction intended to qualify as a reorganization under section 368(a)(2)(D) and B exchanges its recently purchased T stock for P stock.

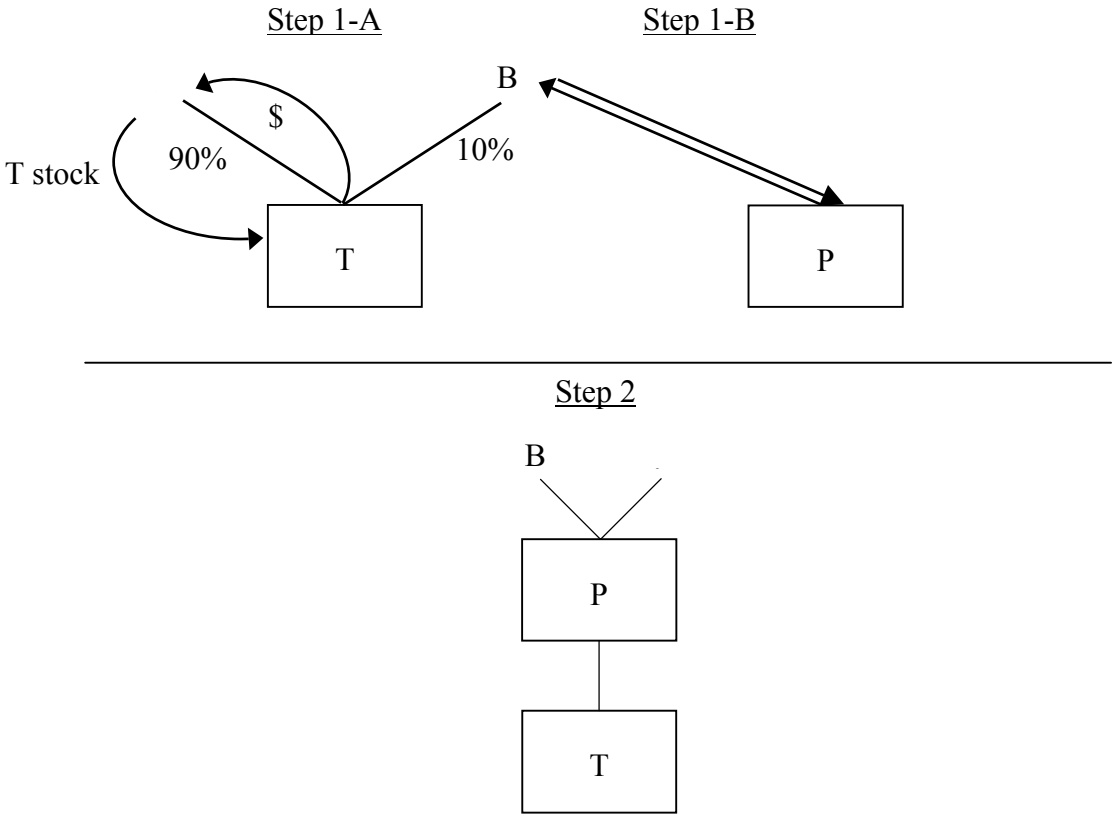
b. Should B be treated as an historic shareholder of T (i.e., is there pre-reorganization continuity)? Under prior law, only consideration received by shareholders whose T stock is "old and cold" was counted in determining whether continuity was satisfied. See Superior Coach of Florida, Inc. v. Commissioner, 80 T.C. 895 (1983); Kass v. Commissioner, 60 T.C. 218 (1973). This prevented taxpayers from circumventing the post-reorganization continuity requirement by cashing out before, rather than after, the reorganization.

c. In this case, the sale to B is pursuant to a binding agreement and presumably B would not be treated as an historic shareholder.

Thus, the transaction, on its face, failed the continuity of interest test under prior law.

d. However, as noted above, the final regulations adopt the Seagram analysis, and state that mere sales of stock prior to a reorganization will not destroy continuity. Thus, this example satisfies the COI requirement under the final regulations.

11. Example 11 -- Pre-reorganization Continuity and Redemption Transactions



a. Facts: T redeems all of the T stock owned by A for $90x. P then acquires all the remaining T stock from B in exchange for P stock in a purported "B" reorganization.

b. Is continuity of interest satisfied? Should P be treated as having purchased the T stock from A for cash?

(1) In Waterman Steamship Corp. v. Commissioner, 430 F.2d 1185 (5th Cir. 1970), a subsidiary ("S") paid a $2.8 million dividend to its parent corporation ("P") shortly before the subsidiary was acquired by a third party ("A") for approximately $700,000 (P's basis in its S stock was $700,000). Because S did not have the funds to pay the dividend, S issued a promissory note to P for the entire $2.8 million. Shortly after the acquisition, A lent $2.8 million to S, and S paid off the promissory note.

(2) Under these facts, the Fifth Circuit held that the $2.8 million dividend was part of the purchase price by A, and that P realized capital gain on the sale in the amount of the dividend.

c. Under prior law, authorities looked to the source of the funds used to redeem A's shares. See, e.g., Waterman Steamship Corp. v. Commissioner, 430 F.2d 1185 (5th Cir. 1970); Casner v. Commissioner, 450 F.2d 379 (5th Cir. 1971); TSN Liquidating Corp. v. United States, 624 F.2d 1328 (5th Cir. 1980); Litton Indus., Inc. v. Commissioner, 89 T.C. 1089 (1987). However, the new temporary and proposed regulations issued in January 1998 simply look to whether there is a redemption prior to and in connection with a reorganization -- regardless of how T obtained the money to redeem A's shares.

d. Under the temporary and proposed COI regulations prior to August 2000, the above transaction failed the COI requirement, because there was a redemption of target stock prior to and in connection with a potential reorganization. Former Temp. Reg. § 1.368-1T(e)(1)(ii)(A).

(1) In addition, if A owned only 70% of the T stock (and B owned 30%), and A redeemed all of its T stock, the preamble to the former temporary

regulations stated that the transaction would have also failed the COI requirement. Preamble to T.D. 8761 (Jan. 23, 1998).

(2) Furthermore, if instead of a redemption by T, a related person of T purchased A's T stock prior to the reorganization, the transaction would likewise have failed the COI requirement. See Former Temp. Reg. § 1.368-1T(e)(6), Ex. 10(ii).

e. However, under the new final regulations issued in August 2000, this transaction will not violate the COI requirement unless the redemption is treated as boot under section 356. Treas. Reg. § 1.368-1(e)(1)(ii).

(1) An example in the regulations with similar facts to this example states that under these facts, "[t]he cash received by A in the prereorganization redemption is not treated as [boot] under section 356" and thus the transaction does not fail the COI requirement. Treas. Reg. § 1.368-1(e)(6), Ex. 9. Thus, it appears from the example in the regulations that pre-reorganization redemptions made with funds not provided by the acquirer will not count against the COI requirement. However, as noted above, Rev. Rul. 71-364 provides that retained assets distributed following a reorganization are treated as boot under section 356 even if no funds are provided by the acquirer. Treasury should clarify that Rev. Rul. 71-364 will not apply to treat pre-reorganization distributions and redemptions as boot under section 356 for purposes of the COI requirement.

f. Assume the same facts as Example 11, except A owns 50% instead of 90% of T, and B owns the other 50% of T. Will A's redemption of all of its T stock for $50x destroy

continuity under the temporary and proposed regulations? Since Treas. Reg. §1.368-1(e)(6), Ex. 1 states that the COI requirement is satisfied if the target's shareholders receive 50% cash and 50% stock in the issuing corporation in the reorganization, this variation of the example should satisfy the COI requirement. See Part II. A. 1., above.

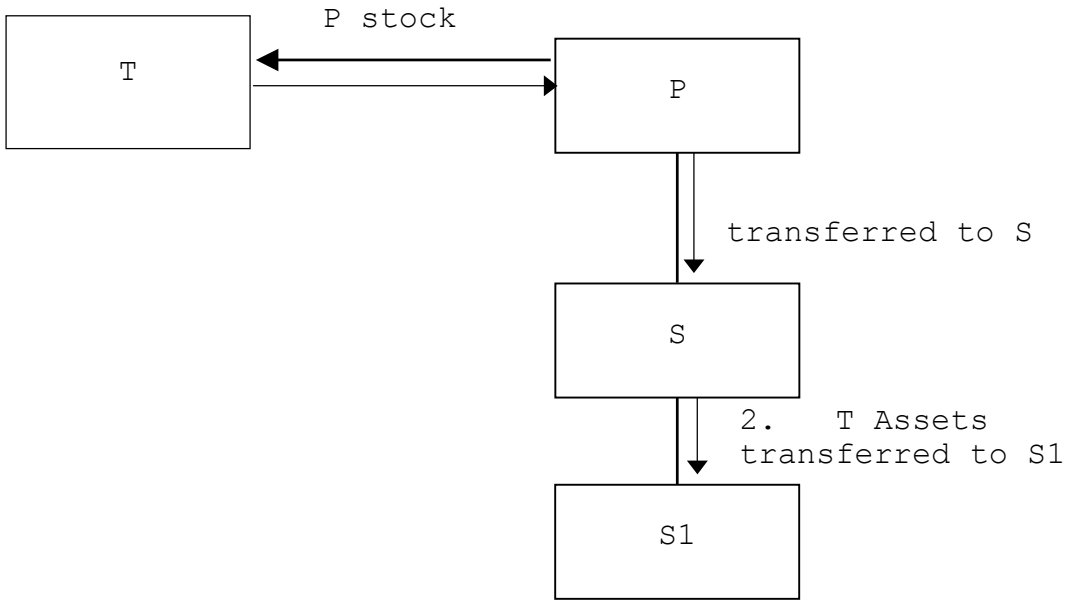
g. Assume the same facts as Example 11, except that instead of redeeming A's target stock, T pays A and B an extraordinary distribution equal to 85% of T's assets.

   a) Under the former temporary and proposed regulations, the COI requirement was not satisfied because T paid A and B an extraordinary distribution, and a substantial part of the value of the proprietary interest of T was not preserved. See Temp. Reg. § 1.368-1T(e)(6), Ex. 11. In other words, A and B were treated as if they had received 85% cash and 15% stock in exchange for their T stock.

   b) However, the transaction should satisfy the COI requirement under the final regulations issued in August 2000, as the "extraordinary distribution" rule was eliminated. T.D. 8898 (August 30, 2000).

B. Issues Involving Continuity of Business Enterprise

1. Example 1 -- Asset Transfers to Corporations



a. Facts: T merges into P and T shareholders exchange their T stock for P stock. P transfers the T assets to S, which immediately transfers them to S1.

b. Is the COBE requirement satisfied?

(1) A transfer of assets to a second-tier subsidiary should not prevent a transaction that otherwise qualifies as a reorganization from meeting the COBE requirement. Section 368(a)(2)(C). See Rev. Rul. 64-73, 1964-1 C.B. 142. See also G.C.M. 30887.

a) Note that the acquiring corporation must be in "control" of the subsidiary in order for the drop-down to be permissible. Section 368(a)(2)(C).

b) Control is defined under section 368(c) as ownership of stock possessing at least 80 percent of

the total combined voting power of all voting stock and at least 80 percent of the total number of shares of all other classes of stock. Section 368(c).

(2) Even drop-downs to third-tier subsidiaries is permissible. See PLRs 9313024 and 9151036. It is also permissible to transfer the assets to multiple subsidiaries. See Rev. Rul. 68-261, 1968-1 C.B. 147.

c. Under the final COBE regulations, the COBE requirement will be satisfied if assets or stock of the target company are transferred among members of the "qualified group." See Treas. Reg. § 1.368-1(d)(4).

(1) The "qualified group" is defined as one or more chains of corporations connected through stock ownership with P, provided that P owns stock meeting the control requirement of section 368(c) in at least one of these corporations, and every member of the group is controlled directly by another member of the group. See Treas. Reg. § 1.368-1(d)(4)(ii).

(2) P, S and S1 constitute a qualified group for this purpose. Accordingly, the COBE requirement is satisfied.

(3) In addition, IRS officials have stated that the new regulations do not alter the result in Rev. Rul. 64-73, supra, which permits an acquirer in a section 368(a)(1)(C) reorganization to direct the target to transfer target assets to one of the acquirer's lower-tier subsidiaries.

d. Assume the same facts as Example 1, except S transfers some of the T assets to each of 10 wholly-owned subsidiaries (S1 through S10). Assume further that no one subsidiary receives a significant portion of T's

historic business assets, but each subsidiary uses T's assets in the operation of its business.

(1) Under the final regulations, this transaction satisfies the COBE requirement. Treas. Reg. § 1.368-1(d)(5), Ex. 6. P is treated as conducting the businesses of S1 through S10, and as holding the historic T assets used in those businesses.

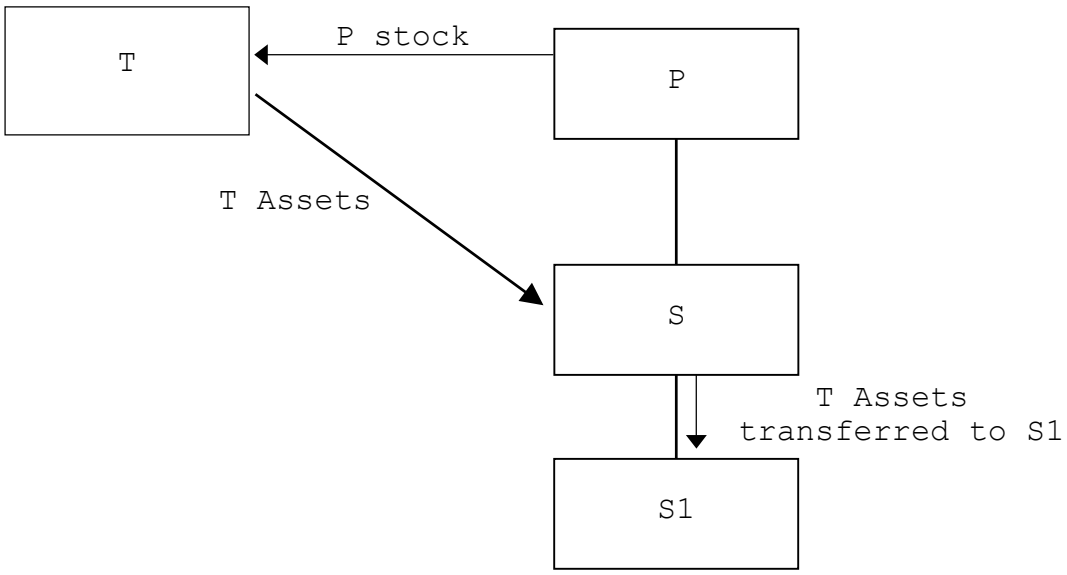
(2) Thus, the COBE requirement is satisfied because, "in the aggregate, the qualified group is using a significant portion of T's historic business assets in a business." Treas. Reg. § 1.368-1(d)(5), Ex. 6.

e. Assume the same facts as Example 1, except that instead of transferring the T assets to S, P sells the T assets to S for cash.

(1) This transaction should satisfy the COBE requirement, because P is treated as holding all of S's assets under Treas. Reg. § 1.368-1(d)(4).

(2) However, we understand that IRS officials are considering whether the COBE requirement is satisfied under these facts.

2. Example 2 -- Safe Harbor



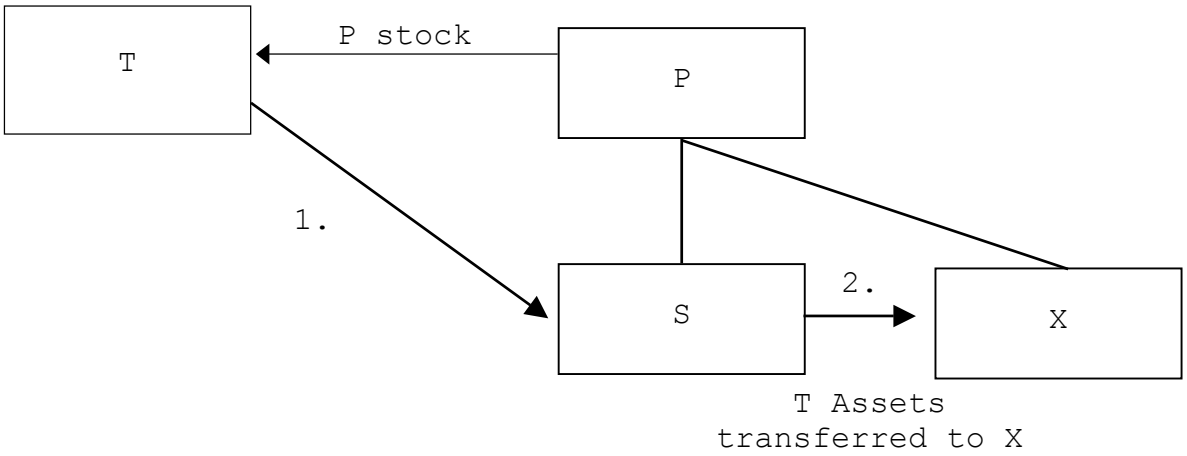
a. Facts: Assume the same facts as Example 1, except that, pursuant to a plan of reorganization, T transfers its assets to S in exchange for P stock (in a triangular "C" reorganization). Shortly thereafter, S transfers the T assets to S1.

b. Treas. Reg. § 1.368-2(k) provides a safe harbor for transactions qualifying as reorganizations where there are successive transfers to corporations controlled by the transferor.

(1) Thus, under these facts, the COBE requirement is satisfied. See Treas. Reg. § 1.368-2(k)(3), Ex. 1.

(2) The same rule would apply, and the COBE requirement would be satisfied, if S had acquired all of the T stock (in a "B" reorganization) rather than the T assets, and then transferred the T stock to S1. See Treas. Reg. § 1.368-2(k)(3), Ex. 2.

3. Example 3 -- Cross-chain Transfers



a. Facts. P owns all the stock of S Corporation and X Corporation. T merges into S (with T's shareholders receiving P stock in exchange for their T shares) in a transaction intended to qualify as a reorganization under sections 368(a)(1)(A) and 368(a)(2)(D). Immediately thereafter, S transfers the T assets to X.

b. Under the final regulations, the issuing corporation is treated as holding all the businesses and assets of all the members of the qualified group. Treas. Reg. § 1.368-1(d)(4)(i). Thus, the COBE requirement is satisfied in this example, because P, S, and X are all members of the same qualified group, and P is treated as owning the assets held by X.

c. What if S had transferred the T assets directly to X's wholly owned subsidiary, Y? Although Treas. Reg. 1.368-1(d) would apply to treat the COBE requirement as satisfied because P, S, X, and Y are all members of the same qualified group, that regulation only applies for purposes of determining whether the COBE requirement is satisfied. The transaction must independently meet the requirements of section 368.

(1) Under the step transaction doctrine, one could view the transaction as a transfer of assets to a second-tier subsidiary (Y) in exchange for "grandparent" (P) stock -- a violation of section 368 (which only allows the receipt of either the acquiring corporation or its parent's stock in a merger). See, e.g., sections 368(a)(1)(A), 368(a)(1)(B), 368(a)(1)(C), 368(a)(2)(D), and 368(a)(2)(E).

(2) Despite the possible application of the step transaction doctrine, we believe that T's merger into S should be a valid reorganization, notwithstanding S's subsequent transfer of T's assets to Y. Cf. Rev. Rul. 2001-24, I.R.B. 2001-22.

d. Assume the same facts as Example 3, except that after T transfers its assets (or the shareholders transfer the T stock) to S, P subsequently transfers its S stock to X.

(1) The safe harbor does not seem to apply to the transfer of the S stock to X, as Treas. Reg. § 1.368-2(k) only applies to transfers of "part or all of the acquired assets or stock acquired in the transaction." Since S stock was not acquired in the transaction, the safe harbor does not seem to apply.

(2) In addition, section 368(a)(2)(C) does not apply because that section also only applies to transfers of the acquired assets or stock. Nevertheless, the Service recently ruled that the COBE requirement is not violated under these facts, because P, S, and X are all members of the same qualified group. See Rev. Rul. 2001-24, I.R.B. 2001-22. The proposed COBE regulations would have applied to transfers of target stock "or transfers of the acquiring corporation's stock

after a T asset acquisition," but such language was removed in the final regulations. See Prop. Reg. § 1.368-1(d)(5)(ii). The Service implied that the transfer of the T stock to S does not contravene the underlying policy of the COBE requirement.

(3) As noted above, Treas. Reg. 1.368-1(d) only applies for purposes of determining whether the COBE requirement is satisfied, and the transaction must independently meet the requirements of section 368. One could analyze this alternative under the step transaction doctrine, and find that it violates the general reorganization rules. One could view the transaction as a merger into a second tier subsidiary (S, after the transfer of its stock to X) in exchange for grandparent (P) stock -- a violation of section 368, which only allows the receipt of either the acquiring corporation or its parent's stock in a merger. See, e.g., sections 368(a)(1)(A), 368(a)(1)(B), 368(a)(1)(C), 368(a)(2)(D), and 368(a)(2)(E).

(4) Notwithstanding the possible application of the step transaction doctrine, however, the Service recently ruled that T's transfer of its assets to S, and P's subsequent drop of S stock to X, is a valid reorganization. See Rev. Rul. 2001-24, I.R.B. 2001-22.

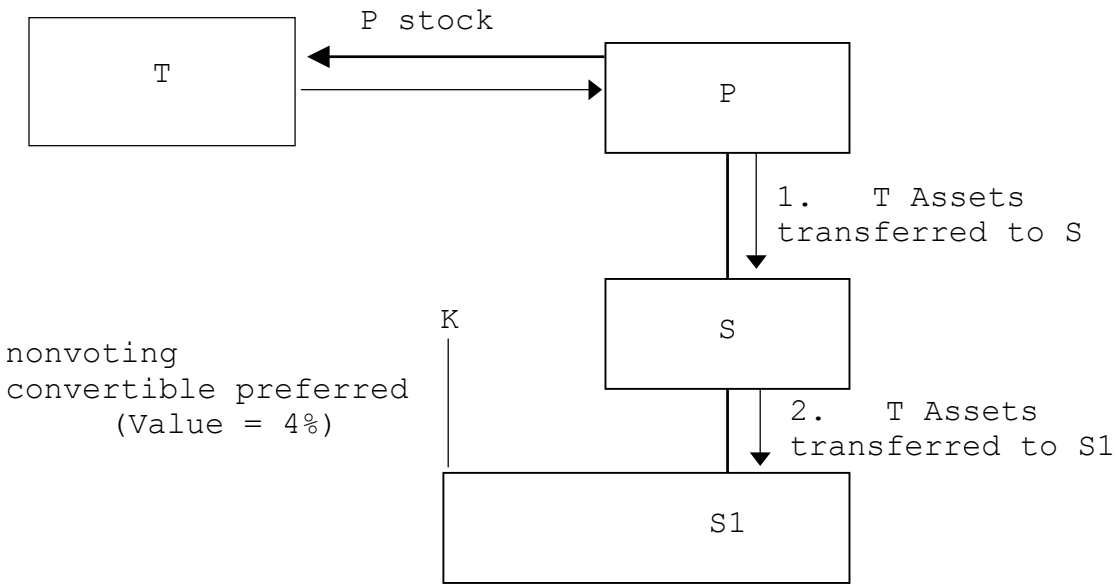
a) In Rev. Rul. 2001-24, the Service stated that it will not recast the transaction under the step transaction doctrine. The Service reasoned that since Treas. Reg. § 1.368-2(k)(2) allows a controlling corporation in a reverse triangular merger under section 368(a)(2)(E) to transfer the stock of the surviving corporation to a

controlled subsidiary, the result should be no different if the transaction is instead structured as a forward triangular merger under section 368(a)(2)(D). Id.

b) The Service further stated that section 368(a)(2)(C), which technically does not apply to the facts in this example, is permissive rather than exclusive, and thus should not preclude the transaction from qualifying as a valid reorganization.

c) Query whether, in light of this statement, taxpayers may transfer assets or stock to a controlled subsidiary following a section 368(a)(1)(D) or section 368(a)(1)(F) reorganization. The Service stated that "forward and reverse triangular mergers should be treated similarly." Rev. Rul. 2001-24, I.R.B. 2001-22.

4. Example 4 -- Continuity Of Business Enterprise



a. Facts: P owns all of the stock of S which owns all of the common stock of S1. Nonvoting convertible preferred stock of S1 is held by a third party but its value is only 4% of S1's total value. In a merger of T into P, the T shareholders exchange their T stock for P stock. Immediately following the merger, P transfers the T assets to S which transfers them to S1.

b. Under the law prior to the issuance of the final COBE regulations, this transaction fails the COBE requirement.

(1) Under section 368(a)(2)(C), transfers to subsidiaries must meet the control test under section 368(c). Under section 368(c), as interpreted by the Service in Rev. Rul. 59-259, 1959-2 C.B. 115, "control" means ownership of at least 80% of the vote and 80% of the total number of shares of each class of nonvoting stock.

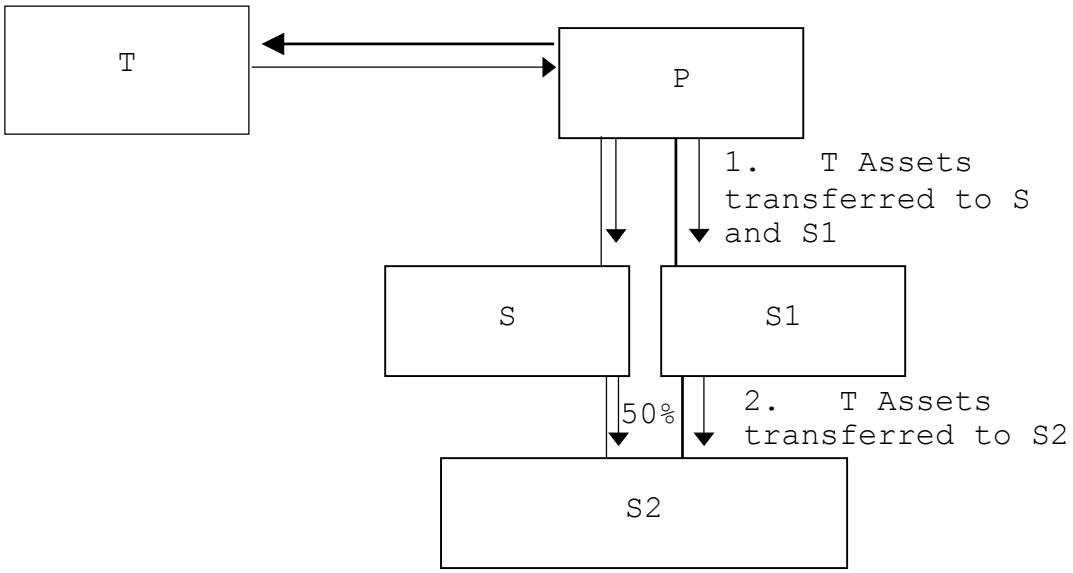
(2) Since the entire class of convertible preferred stock is held by a nonmember, S1 is not "controlled" by S within the meaning of section 368(c).

a) Interestingly, P, S, and S1 can file consolidated returns under sections 1501 and 1504.

b) Under section 1504, affiliation is defined as 80% vote and value, excluding "vanilla preferred" stock.

c. Similarly, the final COBE regulations permit transfers among members of the issuing corporation's (P's) "qualified group" and define the qualified group by reference to section 368(c). See Treas. Reg. § 1.368-1(d)(4). Since S1 is not controlled by S within the meaning of section 368(c), the "qualified group" exception does not apply.

5. Example 5 -- Continuity Of Business Enterprise



a. Facts: P owns all of the stock of S and S1. S and S1 each own 50% of the stock of S2. In a merger of T into P, the T shareholders exchange their T stock for P stock.

Immediately following the merger, P transfers the T assets to S and S1 which transfer them to S2.

b. Under the law prior to the issuance of the final COBE regulations, this transaction fails the COBE requirement.

(1) Under section 368(a)(2)(C), transfers to subsidiaries must meet the control test under section 368(c).

(2) Under section 368(c), as interpreted by the Service in Rev. Rul. 56-613, 1956-2 C.B. 212, there are no constructive ownership or aggregation rules for the control test.

(3) Therefore, S2 is not controlled by either S or S1.

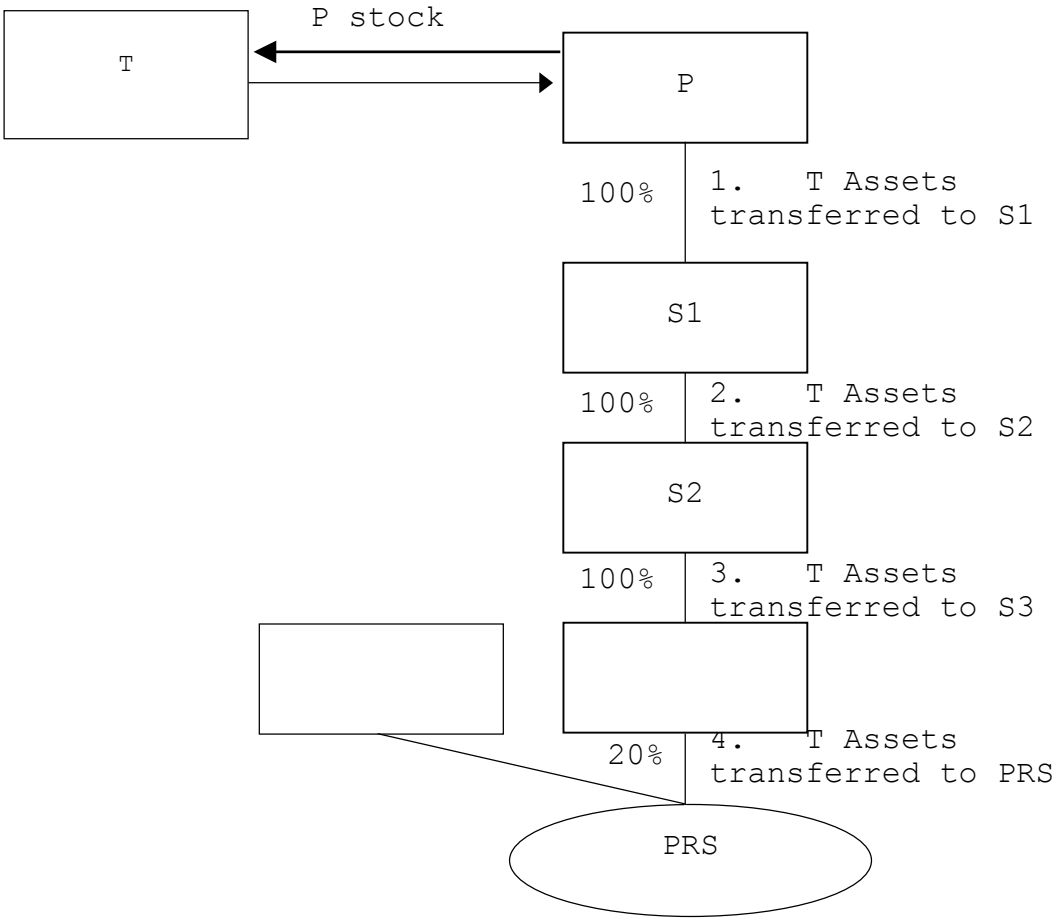
c. Similarly, the final COBE regulations permit transfers among members of the issuing corporation's (P's) "qualified group" and define the qualified group by reference to section 368(c). See Treas. Reg. § 1.368-1(d)(4). S2 is not a member of the qualified group under the regulations because neither S nor S1 has control of S2. Therefore, the "qualified group" exception does not apply.

(1) Commentators had urged Treasury to amend the proposed regulations and adopt a section 1504 test in the final regulations instead of a section 368(c) test. See ABA Members Want COBE Regs Clarified, 97 TNT 90-25 (Jan. 23, 1998). Under section 1504(a)(1), the 80% control test is satisfied if one or more of the other corporations in the affiliated group own 80% of the vote and value of each corporation in such group. At the least, the Commentators suggested that a Treas. Reg. § 1.1502-34 standard (which aggregates stock ownership in consolidated groups) be

adopted in cases where consolidated groups are involved. Id.

(2) However, Treasury decided to keep the section 368(c) test "because section 368 generally determines control by reference to section 368(c) . . . ." Preamble to T.D. 8760 (Jan. 23, 1998).

6. Example 6 -- Transfers to Partnerships



a. Facts: P owns all of the stock of S1, which owns all the stock of S2, which owns all the stock of S3. In a merger of T into P, the T shareholders exchange their T stock for P stock. Immediately following the merger, P transfers the T assets to S1, which transfers the T assets to S2, which transfers the assets to S3. S3 then transfers the assets to a partnership, PRS,

in exchange for a 20% interest in PRS. X Corporation, an unrelated party, transfers cash to PRS in exchange for an 80% interest in PRS. S3, in its capacity as a partner, makes significant business decisions and regularly participates in the overall supervision, direction, and control of the PRS business.

b. Will the transfer of acquired assets to a partnership prevent the transaction from qualifying as a reorganization?

(1) Under prior law (at least in the view of the Service), the transfer of acquired assets to a partnership prevented the transaction from qualifying as a tax-free reorganization. See G.C.M. 35117 (Nov. 15, 1972) (stating that drop-down to partnership following "A" reorganization is not permitted).

(2) In G.C.M. 35117, the Service argued that under the Groman/Bashford doctrine the interest acquired by the corporation was too "remote" to provide the requisite continuity. The Service expressly rejected the taxpayer's argument that the partnership should be viewed as an aggregate rather than an entity for this purpose, and that a partnership is not a qualifying entity under section 368(b).

(3) Thus, the transaction failed remote asset continuity and continuity of business enterprise. But see G.C.M. 39150 (Mar. 1, 1984) (stating that drop-down of a portion of assets or stock to a partnership is permitted as long as COI and COBE are otherwise satisfied).

c. The final regulations reject G.C.M. 35117 and allow transfers to partnerships. Treas. Reg. § 1.368-1(d)(5), Exs. 7-12.

(1) Under these regulations, if the issuing corporation transfers the target's historic business to a partnership in which the issuing corporation has a 20% interest, and the issuing corporation performs active and substantial management functions, the COBE requirement will be satisfied. Treas. Reg. § 1.368-1(d)(5), Ex. 7.

a) It is unclear how corporations are to calculate their partnership interests for purposes of the new regulations.

b) Presumably, one looks to section 704(b), which includes an analysis of the partners' relative contributions to the partnership, the interests of the partners in economic profits and losses, the interests of the partners in cash flow and other non-liquidating distributions, and the rights of the partners to distributions of capital upon liquidation of the partnership. See Treas. Reg. § 1.704-1(b)(3).

(2) Under the above facts, the transaction satisfies the COBE requirement, as P is treated as holding all the assets of S3, and S3 performs active and substantial management functions.

a) Under the regulations, the issuing corporation is treated as conducting the business of the partnership if members of the qualified group (in the aggregate) own a significant interest in the partnership, or members of the qualified group have active and substantial management functions as a partner with respect to the partnership business. Treas. Reg. § 1.368-1(d)(4)(iii)(B).

(3) However, note that if S3 performs active and substantial management functions, but only has a 1% interest in PRS, the transaction will fail the COBE requirement. Treas. Reg. § 1.368-1(d)(5), Ex. 8.

(4) What if S3 has a percentage interest between 1% and 20% in PRS?

a) By stating in the examples to the regulations that a 1% interest is insufficient and a 20% interest is sufficient, the Service seems to be leaving open the question of whether percentage interests between 1% and 20% will be sufficient.

b) Thus, whether the COBE requirement is satisfied in those cases would most likely be a facts and circumstances determination.

(5) In addition to the 20%/active and substantial management function safe harbor, if the issuing corporation has a "significant interest" in the partnership (a 33 1/3% interest is treated as significant), the COBE requirement will also be satisfied, regardless of whether the issuing corporation performs active and substantial management functions. Treas. Reg. § 1.368-1(d)(5), Ex. 9. It is unclear whether interests between 20% and 33 1/3% can qualify as a significant interest, although Example 11 of the regulations seems to assume that a 22 1/3% interest would not qualify as a significant interest. Treas. Reg. § 1.368-1(d)(5), Ex. 11.

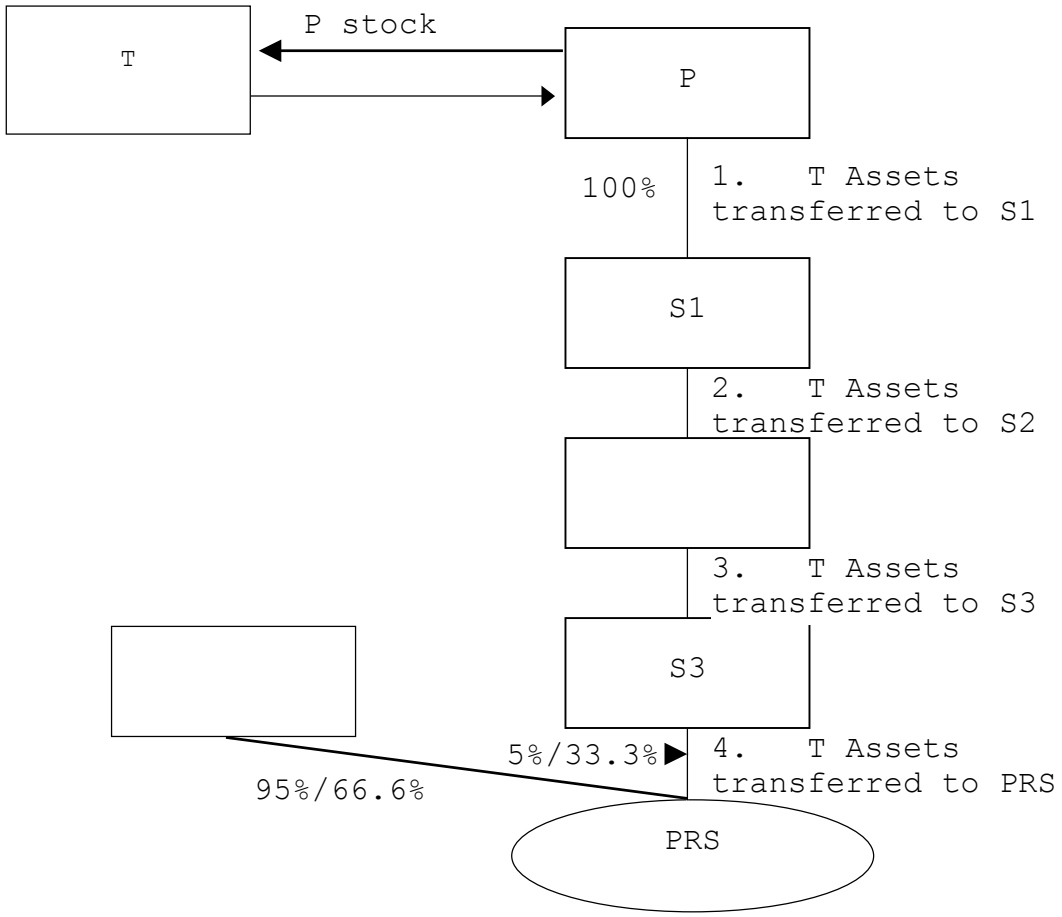
d. Assume that prior to and in connection with a merger with P, T transfers all its assets to a partnership, PRS, and receives a 50% interest in PRS (X, an unrelated party, contributes cash to PRS and holds the other

50% interest). Thus, following the merger, P holds a 50% interest in PRS.

(1) Presumably, the COBE requirement would be satisfied, as P would be treated as owning a significant interest in PRS.

(2) IRS officials have stated that the Service is considering how the COBE requirement applies to these facts.

7. Example 7 -- Transfers to Partnerships

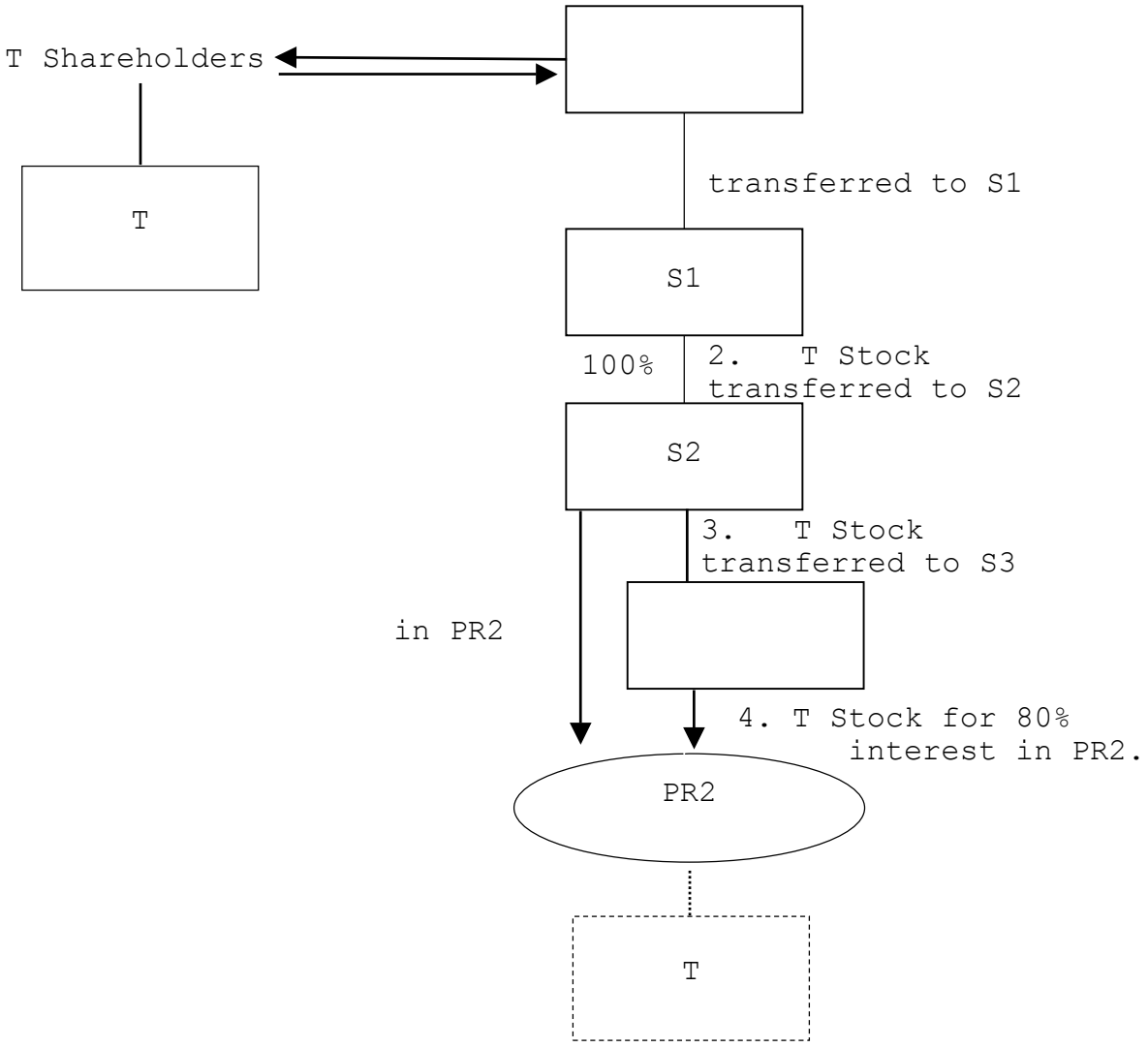


a. Facts: Assume the same facts as Example 6, except S3 owns a 5% interest in PRS and X owns a 95% interest in PRS prior to S3's transfer of T's assets to PRS. Assume further that S3 does not perform active and substantial management functions, and S3's

interest in PRS increases from 5% to 33 1/3% as a result of the transfer.

b. Under the final regulations, S3 is treated as owning 33 1/3% of the T assets, and thus has a significant interest in PRS. Treas. Reg. § 1.368-1(d)(5), Ex. 10. Therefore, the transaction satisfies the COBE requirement.

8. Example 8 -- Transfers of Stock to Partnerships



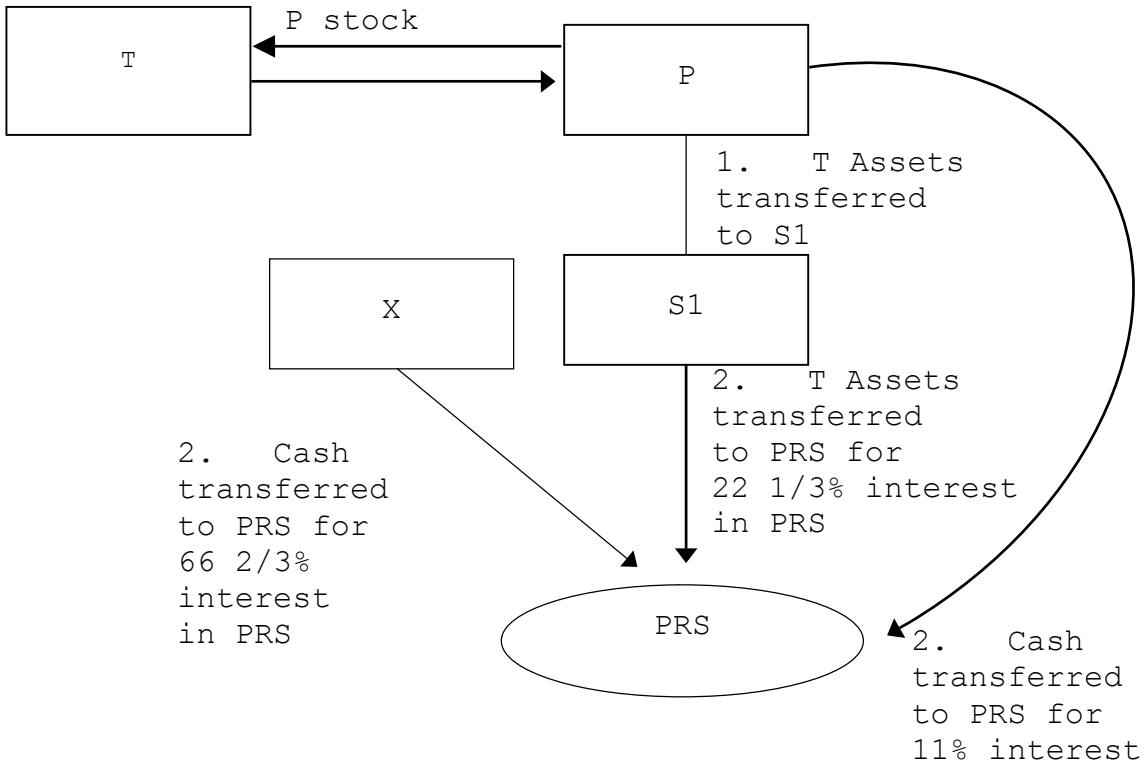
a. Facts: Assume the same facts as Example 6, except (1) P acquires all of T's stock from T's shareholders, instead of its assets, solely in exchange for P stock, (2) the T

stock is transferred down the chain to S1, S2, and then S3, and (3) S3 and S2 form a new partnership, PR2, to which S3 contributes the T stock in exchange for an 80% interest in PR2 and S2 contributes cash in exchange for a 20% interest in PR2.

b. Under these facts, Treas. Reg. § 1.368-2(k) allows the transfer of the T stock to S1, S2, and S3, but does not allow S3's transfer of the T stock to PR2. Treas. Reg. § 1.368-2(k)(3), Ex. 3. The transaction fails the control requirement necessary in section 368(a)(1)(B), because P does not have control of T immediately after the acquisition of the T stock.

c. The general look-through rules in the new COBE regulations do not apply to this transaction because partners are only treated as owning target business assets in accordance with their interests in the partnership if the assets are <u>used in a business of the partnership</u>. The rules do not apply to stock held in a partnership. An example in the regulations states that "the characterization of this transaction must be determined under the relevant provisions of law, including the step transaction doctrine." Treas. Reg. § 1.368-2(k)(3), Ex. 3.

9. Example 9 -- Aggregation of Partnership Interests



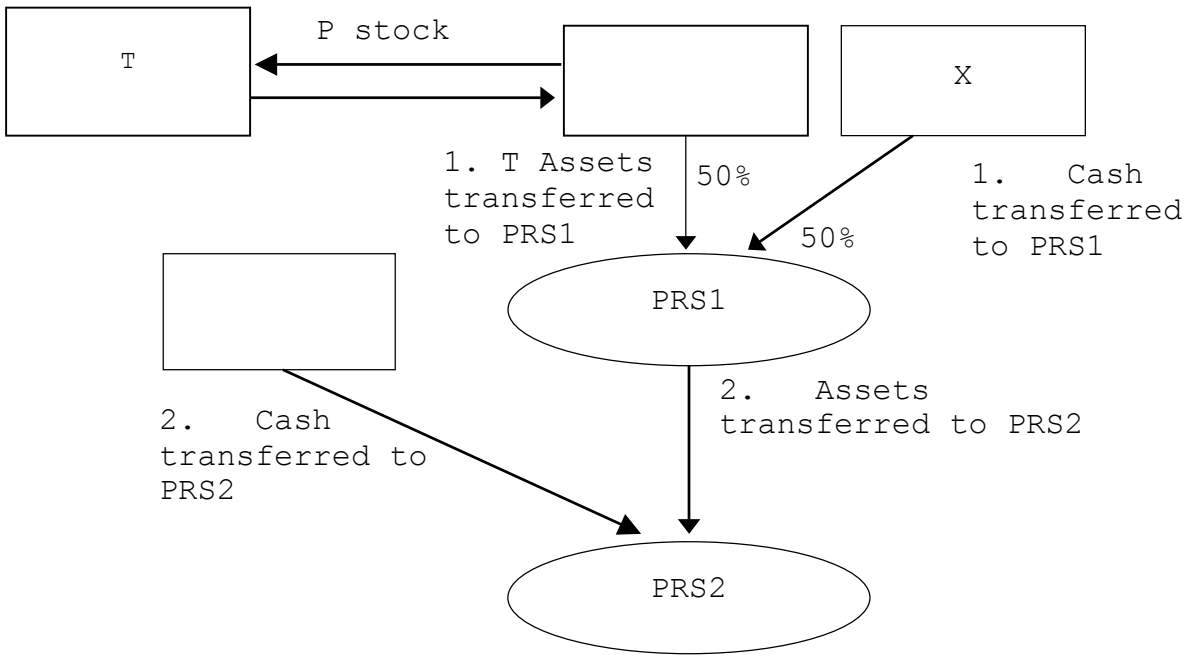
a. Facts: P owns all of the stock of S1. T merges into P. P transfers its T assets to S1, which transfers them to PRS in exchange for a 22 1/3% interest in PRS. PRS uses the historic T assets in its business. P and X each transfer cash to PRS in exchange for partnership interests. P receives an 11% interest in PRS, and X receives a 66 2/3% interest in PRS. No member of P's qualified group performs active and substantial management functions for PRS.

b. As noted in Example 6, if an issuing corporation has a 33 1/3% interest in a partnership, that interest will be a "significant interest," and the COBE requirement will be satisfied, regardless of whether the issuing corporation performs active and substantial management functions.

Are P and S1 aggregated for purposes of the significant interest test?

c. The final regulations state that the interests of all members of the qualified group are aggregated for purposes of the significant interest test. Treas. Reg. § 1.368-1(d)(5), Ex. 11. Thus, P's 11% interest in PRS is aggregated with S1's 22 1/3% interest in PRS, so that the qualified group holds a 33 1/3% interest in PRS. Since P is treated as holding all the assets of all the members of the qualified group, the transaction satisfies the COBE requirement.

10. Example 10 -- Tiered Partnerships



a. Facts: T merges into P solely in exchange for P stock. P transfers all of its T assets to a partnership, PRS1, in exchange for a 50% interest in PRS1. P does not perform active and substantial management functions as a partner in PRS1. X Corporation, an unrelated party, contributes cash in exchange for the remaining 50%

interest in PRS1. PRS1 then transfers the T assets to a second partnership, PRS2, in exchange for a 75% interest in PRS2. PRS2 uses the historic T assets in its business. PRS1 does not perform active and substantial management functions as a partner of PRS2. Y Corporation, an unrelated party, contributes cash in exchange for the remaining 25% interest in PRS2.

b. When there are tiered partnerships, how is the significant interest test applied?

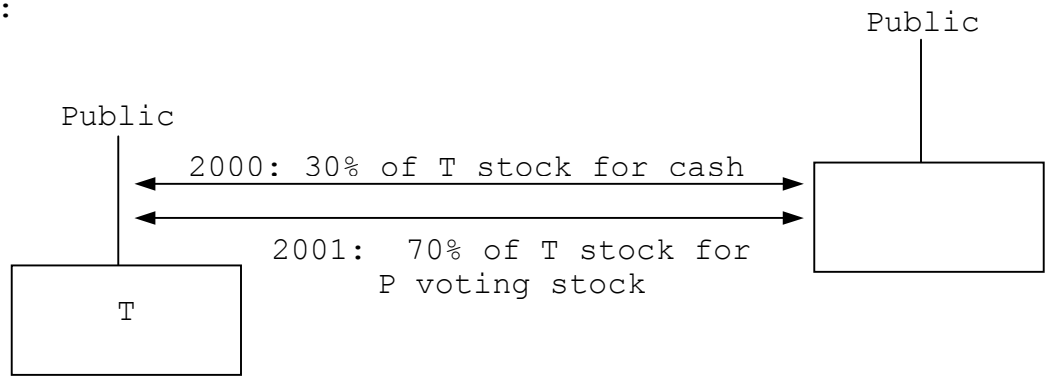
(1) Under the final regulations, P is treated as owning 50% of the assets of PRS1, and PRS1 is treated as owning 75% of the assets of PRS2. Treas. Reg. § 1.368-1(d)(5), Ex. 12.

(2) Thus, P is treated as owning 37 1/2% (i.e., 50% x 75%) of PRS2. As noted in Example 6, if the issuing corporation has a 33 1/3% interest in a partnership, that interest will be a "significant interest," and the COBE requirement will be satisfied, regardless of whether the issuing corporation performs active and substantial management functions. Since P has a 37 1/2% interest in PRS2, the COBE requirement is satisfied.

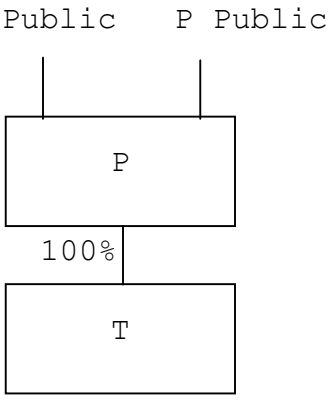
C. Multi-Step Reorganizations

1. Example 1 -- Creeping "B" Reorganization

Before:



After:



a. Facts: In 2000, corporation P purchases 30 percent of the stock of corporation T for cash. In 2001, P offers to exchange P voting common stock for the remaining 70 percent of T stock.

b. Issues:

(1) Must the T shareholders who exchange stock for stock in 2001 recognize gain?

a) If the two separate steps in the transaction are recognized as independent transactions, then the 2001 transaction should qualify as a "B" reorganization. Although P

acquired only 70 percent of the T stock in the exchange, the exchange was solely in exchange for voting stock (so long as the 1999 transaction can be ignored), and P was in control of T within the meaning of section 368(c) immediately after the exchange. Thus, the two statutory requirements of a "B" reorganization would be met. But see American Potash & Chem. Co. v. United States, 399 F.2d 194 (Ct. Cl. 1968).

b) In general, whether two transactions should be "stepped together" will depend upon the facts and circumstances of the transaction.

i) Courts have developed a number of approaches for dealing with step transaction issues. Most prevalent are the binding commitment test, the interdependence test, and the end results test. See McDonald's Restaurants of Illinois, Inc. v. Commissioner, 688 F.2d 520 (7th Cir. 1982). See also FSA 199929013 (applying all three tests in determining whether the continuity of interest requirement under section 355 was satisfied). Cf. True v. United States, 190 F.3d 1165 (10th Cir. 1999)(noting that a transaction needs to satisfy only one of the tests to apply the step transaction doctrine).

ii) Under the binding commitment test, a series of transactions will be stepped

together only if at the time that the first step is commenced there is a binding legal commitment to undertake the subsequent step(s). See, e.g., Commissioner v. Gordon, 391 U.S. 83 (1968); see also FSA 200117020 (applying the binding commitment test to a subsidiary's transfer of parent stock to the parent's employees). This test is the narrowest of the three tests, and may be easily avoided without substantial business risks in transactions where the parties share the same goal of tax-free treatment, or are under common control.

iii) Under the interdependence test, a series of transactions will be stepped together if the steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series. See, e.g., King Enterprises, Inc. v. United States, 418 F.2d 511 (Ct. Cl. 1969); Rev. Rul. 2001-26, 2001-23 I.R.B. 1 (May 11, 2001). This test is similar to the end result test discussed below, in that it focuses on the subjective intent of the parties. However, if any independent purpose is served by an intermediate step it may be sufficient to prevent the application of the step transaction doctrine under the interdependence test where it would not be under the end result test.

iv) Under the end result test, a series of transactions will be stepped together whenever the evidence shows that the parties intent at the outset was to achieve the particular result, and that the separate steps were all entered into as means of achieving that result. See, e.g., Kuper v. Commissioner, 533, F.2d 152 (5th Cir. 1976). This test would result in application of the step transaction doctrine under almost any transaction where the same result could have been achieved in a more direct manner. See also Del Commercial Properties, Inc. v. Commissioner,__ F.3d ___, 2001-2 U.S.T.C. ¶ 50,474 (D.C. Cir. 2001) ("[A] particular step is disregarded for tax purposes if the taxpayer could have achieved its objective more directly, but instead included the step for no other purpose than to avoid U.S. taxes."); FSA 200122007 (noting that courts are seldom rigid in applying the end result test and that courts will look at the intent of the parties and the time interval between steps).

(2) If prior to the 2001 exchange, P sells its 30 percent of the T stock to an unrelated third party and then offers to exchange P common stock for T stock the transaction may be able to qualify as a "B" reorganization, provided that at least 80 percent of the T shareholders accept the offer. Rev. Rul. 72-354, 1972-2 C.B. 216.

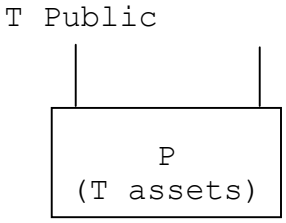
a) However, if there is a tacit agreement between P and the party purchasing the 30 percent interest in T that the exchange offer will be accepted, the Internal Revenue Service ("Service") may argue that P's attempt to "purge" its pre-existing ownership should fail. See Chapman v. Commissioner, 618 F.2d 856 (1st Cir. 1980); Heverly v. Commissioner, 621 F.2d 1227 (3rd Cir. 1980).

b) Query whether this result is correct. Note that if P sells the 30 percent interest in T for cash and then reacquires the same T stock using P stock, P's cash position is the same as if the T stock had originally been acquired for P stock.

2. Example 2 -- Rev. Rul. 67-274

Before:

After:



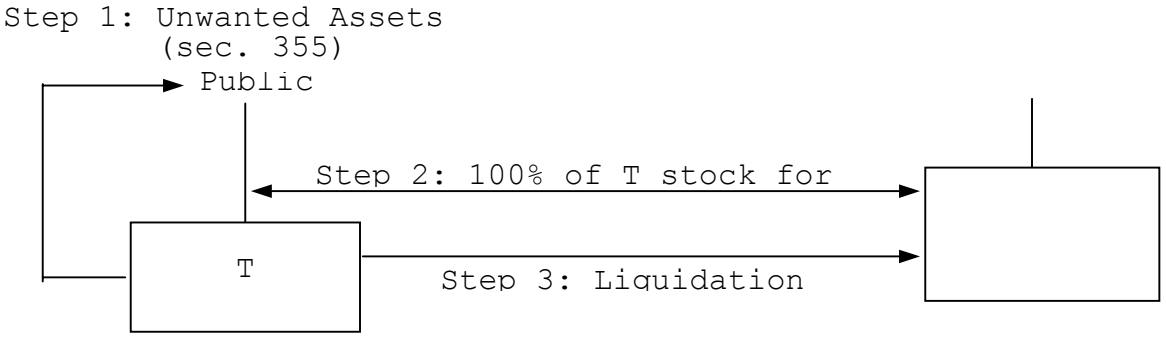
a. Facts: The shareholders of T exchange all of their T stock for voting stock of P. Immediately following the exchange, and as

part of the overall plan, P causes T to liquidate.

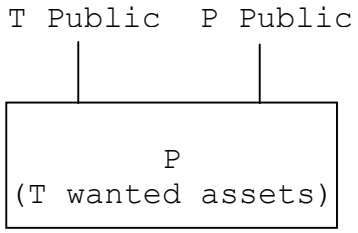
b. Issues: The Service ruled that this transaction should not be treated as a "B" reorganization followed by a liquidation, but instead as a "C" reorganization. Rev. Rul. 67-274, 1967-2 C.B. 141. The rationale for this ruling is that when the transaction is viewed as a whole P has acquired the assets of T in exchange for voting stock.

3. Example 3 -- Rev. Rul. 67-274 (Variation 1: *Elkhorn Coal*)

Before:



After:

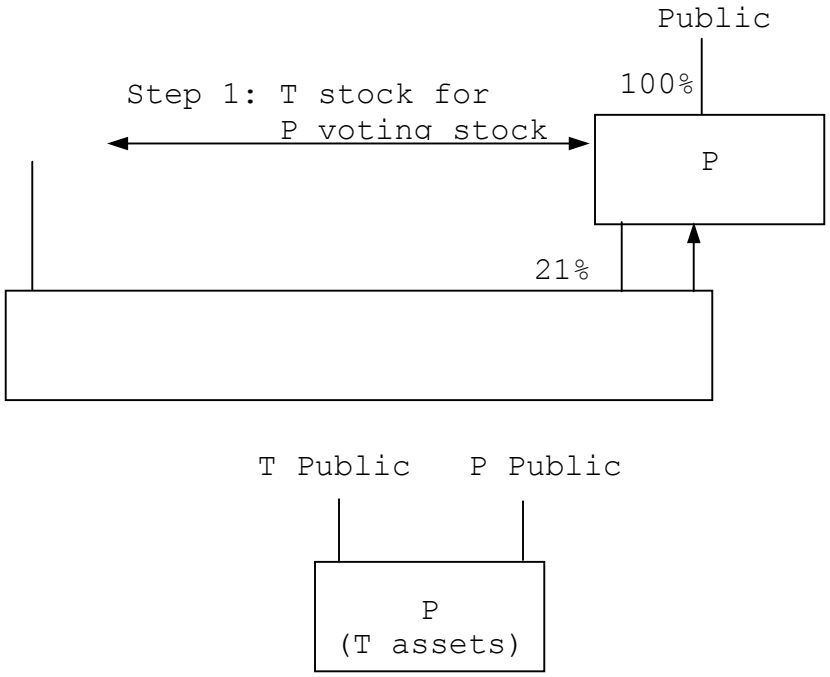


a. Facts: Same facts as Example 2, except that prior to the acquisition by P, T distributes unwanted assets to its shareholders in a tax-free transaction under section 355.

b. Issues: If the transaction is tested as a "C" reorganization under Rev. Rul. 67-274, it would likely fail since P would not be acquiring "substantially all" of T's assets. Helvering v. Elkhorn Coal Co., 95 F.2d 732 (4th Cir.), cert. denied, 305 U.S. 605 (1938).

4. Example 4 -- Rev. Rul. 67-274 (Variation 2: *Bausch & Lomb* and Treas. Reg. § 1.368-2(d)(4)

Before:



a. Facts: Same facts as Example 2, except that prior to the transaction, P owned 21 percent of the stock of T, and T is liquidated into P.

b. Issues:

(1) The recharacterization required by Rev. Rul. 67-274 could transform a tax-free transaction into a taxable transaction under these facts. However, on May 18, 2000, the Service issued final regulations that allow this transaction to qualify as a tax-free reorganization. See T.D. 8885, 65 Fed. Reg. 31805 (May 19, 2000); Treas. Reg. § 1.368-2(d)(4). The final regulations reverse the Service's long-standing position that the "solely for voting stock" requirement of section 368(a)(1)(C) would not be met under these facts. The Service's former position was upheld in Bausch & Lomb Optical Co. v. Commissioner, 267 F.2d

75 (2d Cir.), cert. denied, 361 U.S. 835 (1959). The Second Circuit held in Bausch & Lomb that the transaction did not qualify as a "C" reorganization because P was not viewed as acquiring T's assets solely for P voting stock. Instead a portion of the assets were deemed to be acquired in exchange for the T stock already owned by P. As a result, the transaction was treated as a taxable liquidation with gain being recognized by T, P, and the shareholders of T.

(2) Under the final regulations, an acquiring corporation's preexisting ownership of a portion of a target corporation's stock generally will not prevent the "solely for voting stock" requirement from being satisfied.

(a) In order for section 368(a)(1)(C) to apply, the sum of (i) the money or other property that is distributed to the shareholders of the target corporation other than the acquiring corporation and to the creditors of the target corporation, and (ii) the assumption of all the liabilities of the target corporation (including liabilities to which the properties of the target corporation are subject), cannot exceed 20 percent of the value of all of the properties of the target corporation. See section 368(a)(2)(B); Treas. Reg. § 1.368-2(d)(4).

(b) The final regulations also provide that if, in connection with a potential "C" reorganization, the acquiring corporation acquires the target corporation's stock for consideration other than its own voting stock or its parent's voting stock, such consideration

will be treated as money or other property exchanged by the acquiring corporation for the target corporation's assets. Accordingly, the requirements of section 368(a)(1)(C) will not be satisfied unless the transaction can qualify under the boot relaxation rule of section 368(a)(2)(B), taking into account such money or other property.

(c) The final regulations apply to transactions occurring after December 31, 1999, unless the transaction occurs pursuant to a written agreement that is (subject to customary conditions) binding on that date and at all times thereafter. See Treas. Reg. § 1.368-2(d)(4)(iii). This is consistent with the effective date established by Notice 2000-1, 2000-2 I.R.B. 1 (December 21, 1999) for the proposed regulations. Moreover, according to the Preamble of the final regulations (again, consistent with Notice 2000-1), taxpayers may still request a private letter ruling permitting them to apply the final regulations to transactions occurring on or after June 11, 1999.

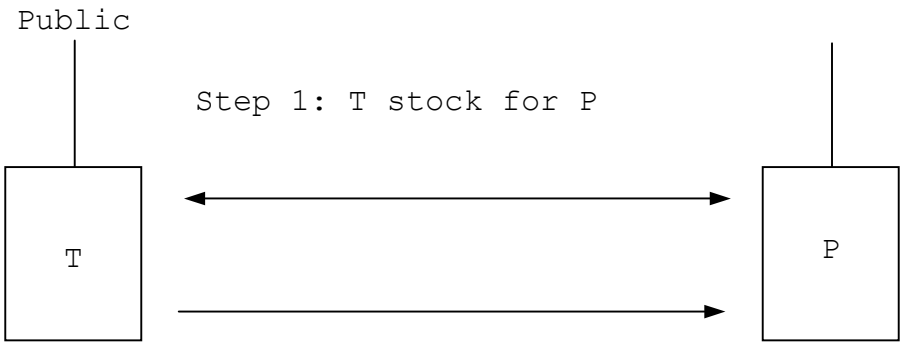
(d) The Preamble also states that the Service and the Treasury Department may reconsider Rev. Rul. 69-294, 1969-1 C.B. 110, in light of the final regulations. Rev. Rul. 69-294 applied the Bausch & Lomb doctrine to disqualify an attempted section 368(a)(1)(B) reorganization that followed a tax-free section 332 liquidation.

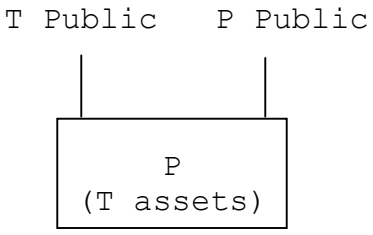
i) In the ruling, X owned all the stock of Y and Y owned 80% of the stock of Z. Y completely liquidated into X. As planned, X then acquired the remaining 20% of the stock of Z in exchange for X voting stock.

ii) The Service ruled that X did not acquire Z through a "B" reorganization. The Service reasoned that X really acquired 80% of the stock of Z in exchange for surrendering Y stock back to Y in liquidation. Thus, X did not acquire 80% stock of Z by exchanging its own stock, and consequently failed the solely for voting stock requirement of section 368(a)(1)(B).

5. Example 5 -- Rev. Rul. 67-274 (Variation 3: Rev. Rul. 90-95)

Before:





a. Facts: Same facts as Example 2, except that the T shareholders receive a mixture of 50 percent stock and 50 percent cash.

b. Issues:

(1) Clearly the use of 50 percent cash consideration will cause the transaction to fail as either a "B" or a "C" reorganization.

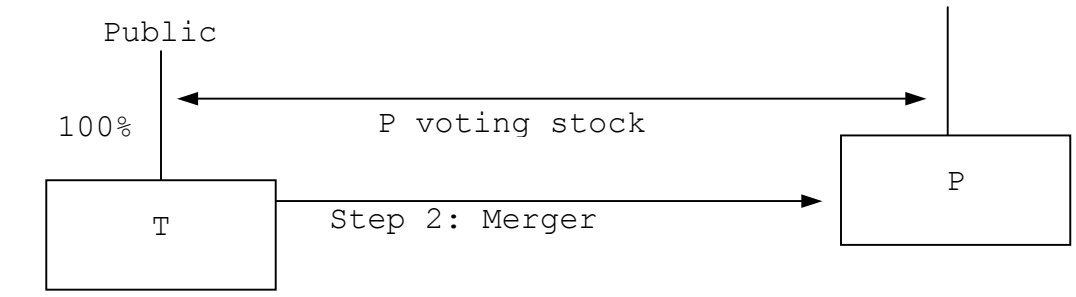
(2) The proper treatment of the transaction, however, is unclear.

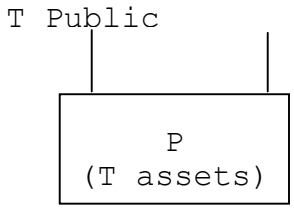
a) Under the theory of Rev. Rul. 67-274, the transaction would be viewed as a direct asset acquisition for stock and cash, failing to qualify as a "C" reorganization because of the presence of boot.

b) In contrast, however, Rev. Rul. 90-95 treats a qualified stock purchase, within the meaning of section 338, followed by a liquidation as two separate transactions, reversing the holding of Kimbell-Diamond Milling Co. v. Commissioner, 14 T.C. 74, aff'd per curiam, 187 F.2d 718 (5th Cir.), cert. denied, 342 U.S. 827 (1951).

c) Presumably where the transaction fails to qualify as a reorganization, the rule of Rev. Rul. 90-95 will take precedence over the analysis of Rev. Rul. 67-274.

6. Example 6 -- Rev. Rul. 67-274 (Variation 4: Upstream Merger)





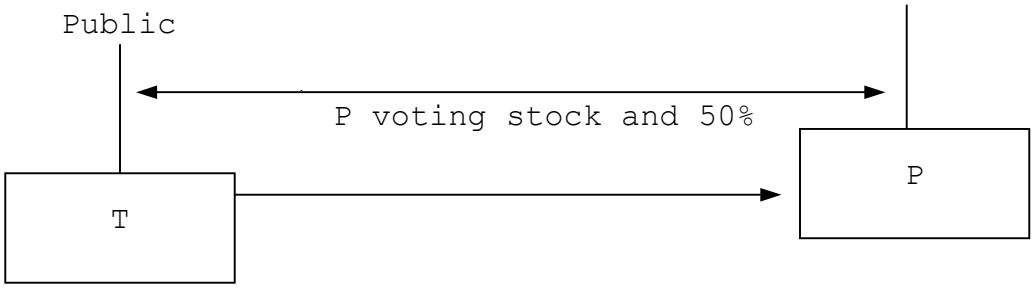
a. Facts: Same facts as Example 2, except that instead of being liquidated, T merges upstream into P.

b. Issues:

(1) Under these facts, one could argue that the transaction should be treated as an "A" reorganization instead of a "C" reorganization.

(2) This treatment was accorded in PLR 9109055 and PLR 8947057 (stock for stock exchange followed by an upstream merger is an "A" reorganization "provided the merger of [target] with and into [acquiror] qualifies as a statutory merger under applicable state law"). See also PLR 200121010 (assuming step transaction doctrine applies, reverse subsidiary merger followed by upstream merger is an "A" reorganization), PLR 200109037 (same), 200105040 (same), 200021032 (same), PLR 200021031 (same), PLR 199945030 (same), PLR 199924038 (same), PLR 9840004 (same), PLR 9836032 (same), PLR 9539018 (same), and PLR 9539018 (same). In an anomalous ruling, the Service reach a different result in PLR 8925087, where a stock for stock exchange after which the acquiror "will liquidate Target by means of a short form merger" was held to be a "C" reorganization.

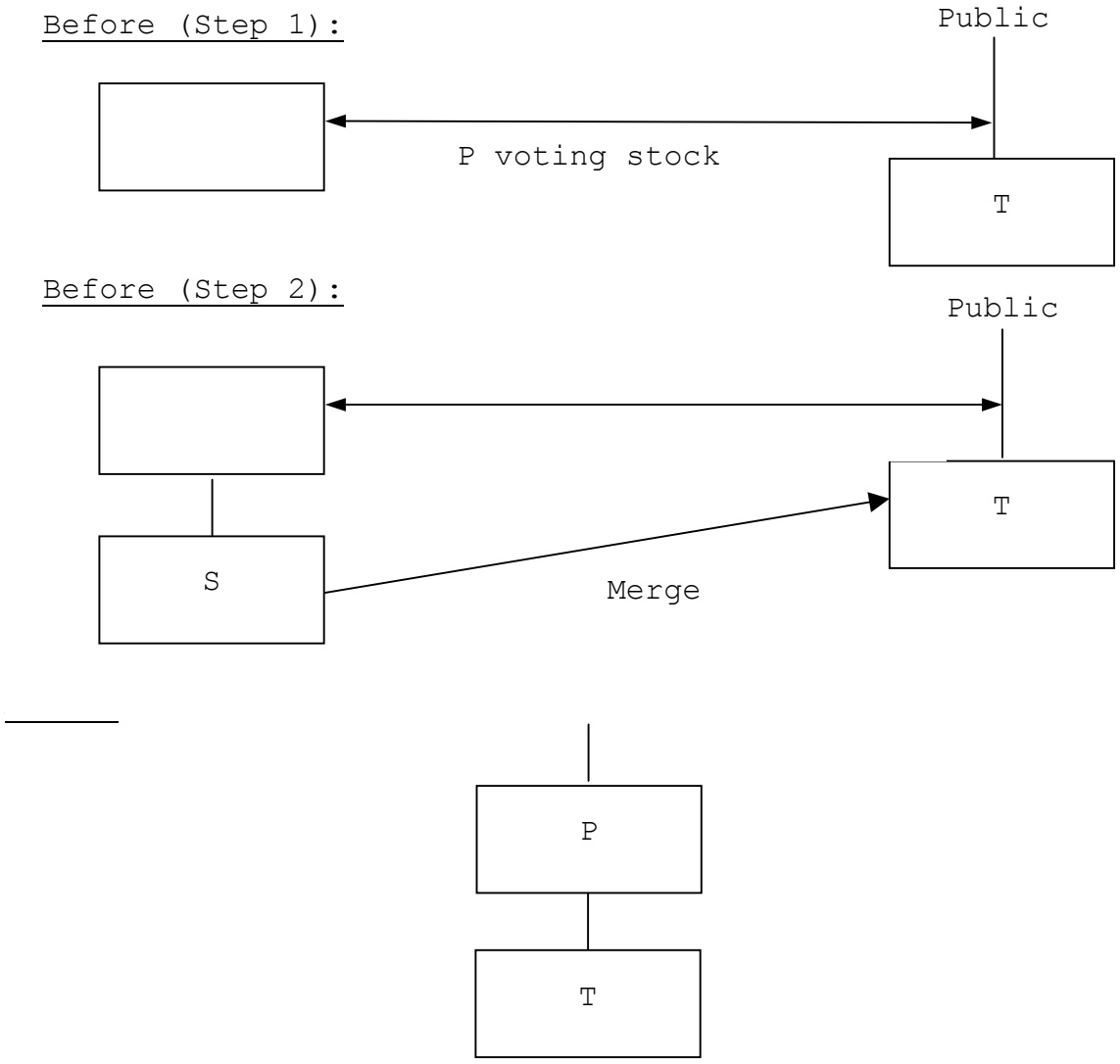
7. Example 7: Rev. Rul. 67-274 (Variation 5: *King Enterprises*)



a. Facts: Same facts as Example 6, except that the consideration used in the merger is 50 percent stock and 50 percent boot.

b. Issues: The transaction could continue to qualify as an "A" reorganization if T is merged into P. See King Enterprises, Inc. v. United States, 418 F.2d 511 (Ct. Cl. 1969). Prior to the issuance of Rev. Rul. 2001-26, 2001-23 I.R.B. 1 (May 11, 2001), commentators questioned whether King Enterprises had any validity following the 1982 amendments to section 338. See Boris I. Bittker & James S. Eustice, Federal Income Taxation of Corporations and Shareholders, ¶ 12.63[2][a] (6th ed. 1994). However, with the issuance of Rev. Rul. 2001-26(see Example 8), the Service seems firmly committed to the step-transaction principles of King Enterprises. See also Brief for the Government, on appeal from the decision of the U.S. Tax Court in Seagram Corp. v. Commissioner, 104 T.C. 75 (1995) (citing King Enterprises with approval).

8. Example 8 – Rev. Rul. 2001-26



a. Facts: P and T are widely held manufacturing corporations organized under the laws of state A. T has only voting common stock outstanding, none of which is owned by P. P seeks to acquire all of T's outstanding stock. For valid business reasons, the acquisition will be effected by a tender offer for at least 51% of T's stock, to be acquired solely for P voting stock, followed by a merger of S, P's newly formed wholly owned subsidiary, into T. Pursuant to the tender offer, P acquires 51% of T's stock from T's shareholders for P voting stock. P

then forms S, which merges into T in a statutory merger under the laws of state A. In the merger, P's S stock is converted into T stock and each of the T shareholders holding the remaining 49 percent of the outstanding T stock exchanges its shares of T stock for a combination of consideration, two-thirds of which is P voting stock and one-third of which is cash.

b. Issues: Assuming (i) that the tender offer and merger are treated as an integrated acquisition by P of all of the T stock, and (ii) that all nonstatutory requirements under sections 368(a)(1)(A) and 368(a)(2)(E), and all statutory requirements under section 368(a)(2)(E) (other than the requirement that P acquire control of T in exchange for its voting stock) are satisfied, the Service ruled in Rev. Rul. 2001-26 that the entire two-step transaction constitutes a tax-free reorganization under sections 368(a)(1)(A) and 368(a)(2)(E). As a result, section 354 and 356 applies to each exchanging shareholder.

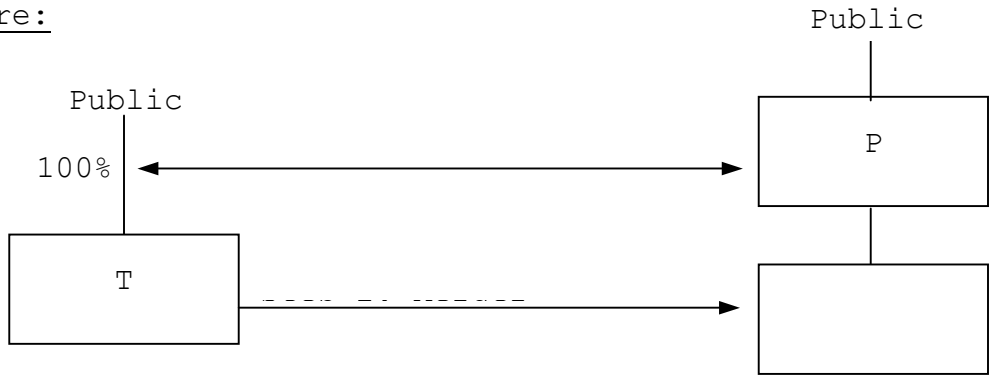
(1) The Service's ruling is based on the holding in King Enterprises that where a merger is the intended result of a pre-merger stock acquisition, the acquiring corporation's acquisition of the target corporation qualifies as an "A" reorganization. The Service reasoned in Rev. Rul. 2001-26 that because the tender offer is integrated with the statutory merger, i.e., the merger is the intended result of the tender offer, the tender offer is treated as part of the subsequent statutory merger for purposes of the reorganization provisions.

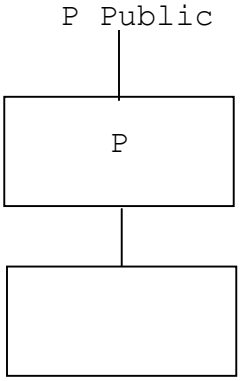
(2) Assume the same facts, except that S initiates the tender offer for T stock and, in the tender offer, acquires 51% of the T stock for P stock provided by P? Under these facts, the Service ruled that the result would be the

same, i.e., that because the merger is the intended result of the tender offer, the tender offer is treated as part of the subsequent statutory merger for purposes of the reorganization provisions, and the transaction constitutes a tax-free reorganization under sections 368(a)(1)(A) and 368(a)(2)(E).

9. Example 9 -- *Yoc Heating*

Before:





a. Facts: P purchases 100 percent of the T stock for cash. Immediately following the stock purchase, P causes T to merge into Sub, a wholly-owned subsidiary of P.

b. Issues:

(1) In Yoc Heating Corp. v. Commissioner, 61 T.C. 168 (1973), the Tax Court held that this transaction failed to qualify as a reorganization because, applying

the step transaction doctrine, historic shareholder continuity is not present.

(2) The Service has rejected the holding of Yoc Heating and has issued final regulations that treat the COI requirement as satisfied in this case where the acquisition of T stock constitutes a qualified stock purchase under section 338, which eliminates the taint of the change in ownership for COI purposes. See Treas. Reg. § 1.338-3(d)(2). (On February 12, 2001, the Service issued T.D. 8940, 2001-15 I.R.B. 101, supplanting the existing body of temporary section 338 regulations with a new set of final regulations. The new final regulations are in general very similar to the temporary regulations that the Service had issued on January 7, 2000.) See also Treas. Reg. § 1.368-1(e)(6), Ex. 2 (stating that if P does not acquire the T stock in a qualified stock purchase, the transaction fails the COI requirement). However, these regulations do not extend tax-free treatment to any minority shareholders. Cf. Kass v. Commissioner, 60 T.C. 218 (1973), aff'd, 491 F.2d 749 (3d Cir. 1974).

(3) As this example and the preceding example illustrate, there appears to be a fundamental inconsistency in the Service's treatment of multi-step acquisitions depending on whether the initial acquisition is a qualified stock purchase, or a tax-free reorganization. It is unclear what rationale, if any, may be used to justify these inconsistent approaches.

(4) In light of Rev. Rul. 90-95 and Treas. Reg. § 1.338-3(d), one can argue that there is no justification for the approach embodied by Rev. Rul. 67-274 and King Enterprises. However, as

noted above, the Service has recently confirmed its belief that King Enterprises is the correct approach. The Service should attempt to develop a consistent treatment of taxable and tax-free transactions in this area.

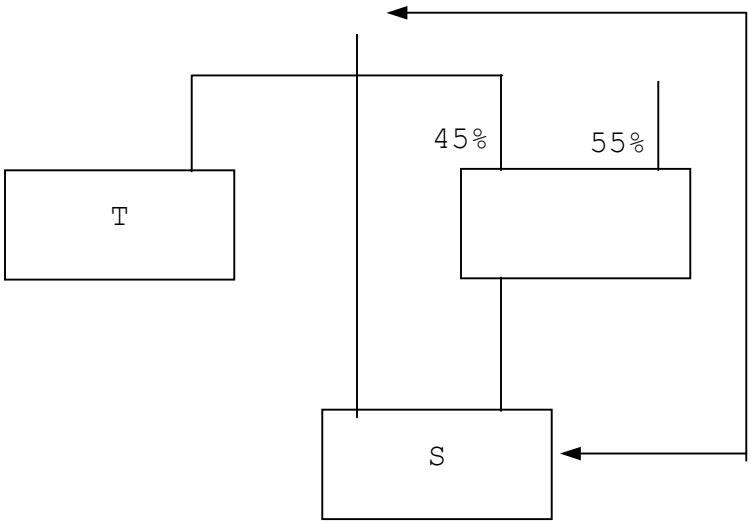
(5) The Service's approach in Rev. Rul. 2001-26 is appropriate. In general, step-transaction principles should apply to determine the nature of the transaction. After the application of these principles, then more specific rules, such as Rev. Rul. 90-95, should be applied (assuming the recharacterized transaction permits such application).

(6) Query however whether the step-transaction doctrine should in all instances be applied first. Assume the same facts as in King Enterprises: P's shareholders acquire 50% of T's stock in exchange for P stock and the remaining 50% of T's stock in exchange for cash. T then merges into P. However, immediately after the merger, P sells T's assets. If step-transaction principles apply, the transaction could be recast as an asset sale rather than a QSP. This recharacterization could have decidely negative tax effects on T. We believe in this circumstance it is inappropriate to apply step-transaction principles because of the dramatic change it causes to the transaction contrary to the parties' intentions. Thus, under the rule of Rev. Rul. 90-95, the transaction should not be recharacterized under the step-transaction doctrine, but viewed as a stock followed by a section 332 liquidation. Cf. Rev. Rul. 2001-24, 2001-22 I.R.B. 1 (May 3, 2001) (ruling that step-transaction principles do not apply in order to maintain parity of

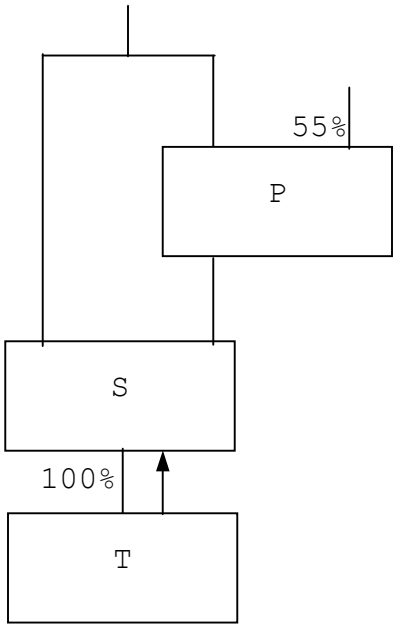
treatment between forward and reverse triangular mergers).

10. Example 10 -- Section 304 or "D" Reorganization

Before:



After:



a. Facts: A owns 100 percent of T, 45 percent of P, and 40 percent of S. P owns the remaining 60 percent of S, and B owns the remaining 55 percent of P. A sells the

stock of T to S for cash. Following the sale, T is liquidated into S.

b. Issues:

(1) The receipt of cash by A must be tested to determine whether it gives rise to ordinary income or capital gain. However, the parameters of the test may vary, depending on whether the form of the transaction is respected.

(2) If the form of the transaction is respected, it must be tested under section 304 to see if A is "in control" of both T and S.

a) For purposes of section 304, "control" is defined as 50 percent stock ownership by vote or by value. Constructive ownership is taken into account by looking through all corporations in which a shareholder has a 5 percent or greater interest.

b) A owns 40 percent of S directly plus 27 percent (60% x 45%) indirectly through P, for a total of 67 percent ownership in S.

c) As section 304 applies to the transaction, the cash is treated as a distribution in redemption of stock that must be tested for dividend equivalence.

d) A's percentage ownership in T is reduced from 100 percent before the transaction to 67 percent after the transaction. See section 304(b). Query whether this results in dividend treatment under section 302.

(3) If the acquisition of T by S, and the subsequent liquidation of T are stepped

together, the transaction would qualify as a "D" reorganization.

a) For purposes of a non-divisive "D" the section 304 rules apply for determining "control." Section 368(a)(2)(H).

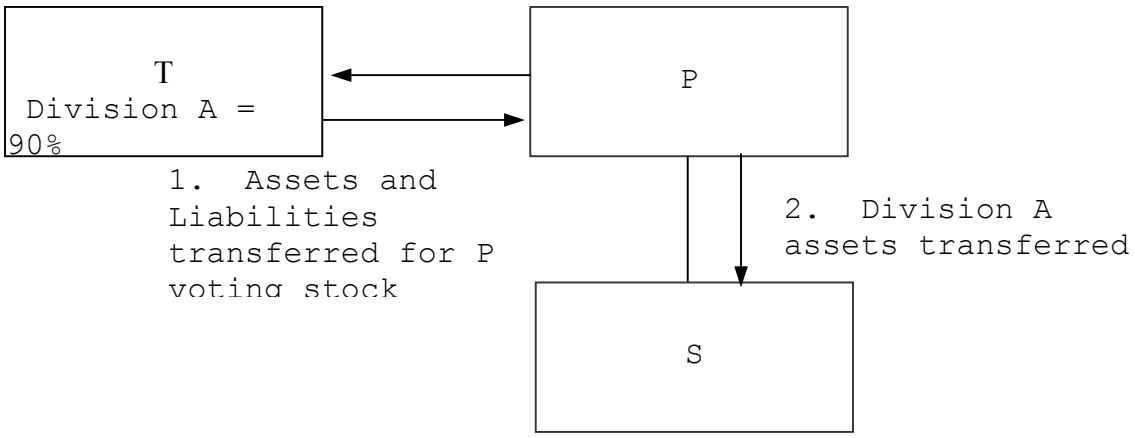
b) However, for purposes of determining dividend equivalence under section 356, the attribution rules of section 318 are not modified so as to take into account constructive ownership through less than 50 percent owned corporations.

i) As a result A's percentage ownership would be reduced from 100 percent to 40 percent.

ii) This would clearly qualify for exchange treatment under section 302.

(4) In different cases, similar transactions have been analyzed as either a sale followed by a liquidation or as a "D" reorganization. See Frederick Steel Co. v. Commissioner, 42 T.C. 13 (1964) (sale and liquidation), rev'd and rem'd on other grounds, 375 F.2d 351 (6th Cir.); Rev. Rul. 77-427, 1977-2 C.B. 100 (same); PLR 9245016 (reorganization); PLR 9111055 (same).

11. Example 11 -- Assumption of Liabilities in Triangular "C" Reorganizations



a. Facts: T corporation operates two divisions, Division A (which represents 90% of the value of T's assets) and Division B (which represents 10% of the value of T's assets). Pursuant to a plan to acquire T, (i) P forms S; (ii) T transfers all of its assets to P in exchange solely for voting common stock of P; (iii) P assumes T's liabilities; (iv) T liquidates, distributing P stock to its shareholders; and (v) pursuant to the plan of reorganization, P contributes the Division A assets to S. Assume that, with the possible exception of the transfer of assets to S, the transaction qualifies as a reorganization under section 368(a)(1)(C).

b. Issue: Whether the subsequent contribution of Division A assets to S affects the treatment of the transaction as a "C" reorganization.

(1) The dropdown should not prevent the transaction from qualifying if it otherwise meets the requirements of section 368(a)(1)(C). See section 368(a)(2)(C) (stating that a transaction otherwise qualifying is not disqualified if assets are transferred to a corporation controlled by the "acquiring" corporation). See also

Treas. Reg. § 1.368-2(k) (stating that a transaction otherwise qualifying as an A, B, C, or G reorganization will not be disqualified by reason of the fact that a part or all of the acquired assets or stock are transferred or successively transferred to one or more corporations controlled in each transfer by the transferor corporation). Thus, P is the "acquiring corporation." Cf. Rev. Rul. 70-224, 1970-1 C.B. 79.

(2) Note, however, that for purposes of determining which corporation succeeds to T's attributes, the "acquiring corporation" may be different.

a) Under section 381, there can be only one "acquiring corporation," which generally will be the corporation that ultimately acquires "all" of the assets pursuant to the plan of reorganization. If no single corporation acquires "all" of the assets, the corporation directly acquiring the assets will be the "acquiring corporation." See Treas. Reg. § 1.381(a)-1(b)(2). But see Treas. Reg. § 1.381-1(b)(3)(ii).

b) In this case, no single corporation will have acquired "all" of the assets, although S will have acquired "substantially all" of the assets. Therefore, P should be the "acquiring" corporation for section 381 purposes and inherit T's attributes. It is possible that the form would be disregarded if all but a "de minimis" portion of the assets were transferred to S.

(3) Now assume that S assumes the liabilities associated with the

Division A assets. To qualify as a "C" reorganization the assets must be acquired solely for voting stock of the "acquiring corporation" (or stock of a corporation in control of the "acquiring corporation").

a) The assumption of liabilities by the "acquiring corporation" is not treated as boot. See section 368(a)(1)(C). However, in this case, P is the "acquiring corporation." Cf. Rev. Rul. 70-224, 1970-1 C.B. 79.

b) The Service has ruled that, where a corporation other than the "acquiring corporation" assumes the liabilities, this may disqualify the transaction. See Rev. Rul. 70-107, 1970-1 C.B. 78. But see G.C.M. 39102 (questioning Rev. Rul. 70-107 and suggesting that any party to the reorganization should be able to assume part or all of the liabilities.) Thus, at least as a technical matter, this raises a concern that S's assumption of liabilities must be viewed as boot.

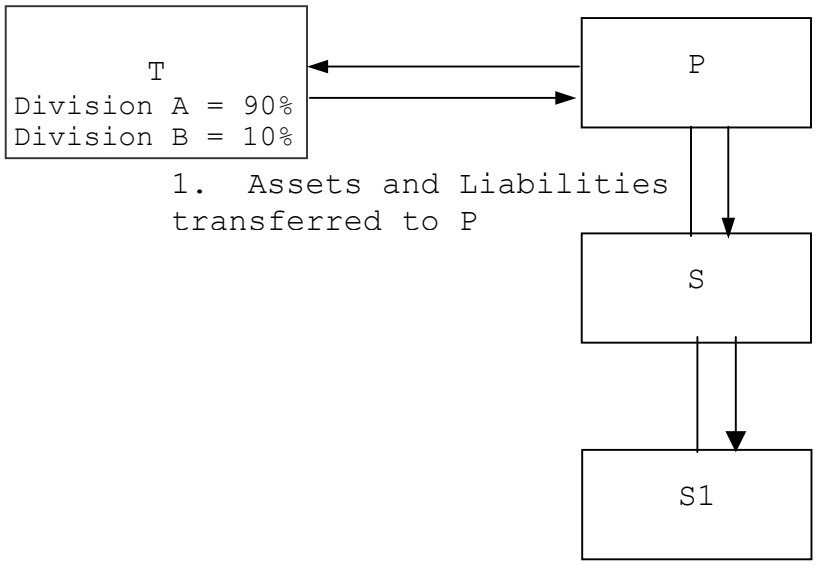
c) However, it seems anomalous to disqualify the transaction on these grounds. Section 351 expressly contemplates the transfer of assets subject to liabilities. See sections 351(h)(1) and 357(a). Furthermore, as discussed below, the Service appears to permit subsidiaries in so-called "cause to be directed" transactions to assume liabilities, even though it treats such transactions as if the assets and liabilities were initially acquired by the parent corporation.

i) The continuity of business enterprise ("COBE") regulations permit transfers of target assets to members of a qualified group; the regulations do not, however, address the issues presented by assumption of liabilities by a party other than the acquiring company in a "C" reorganization.

ii) Note that, if the initial acquisition had been structured as an "(a)(2)(D)" merger of T into S rather than a "C" reorganization, the assumption of liabilities by P, a corporation other than the "acquiring corporation," would have been permitted. See Reg. § 1.368-2(b)(2) (parent may assume liabilities of target in an "(a)(2)(D)" merger).

iii) However, as there is no requirement that an (a)(2)(D) merger be "solely" for voting stock, this would presumably only present an issue if the liabilities assumed by P were sufficiently large to threaten continuity.

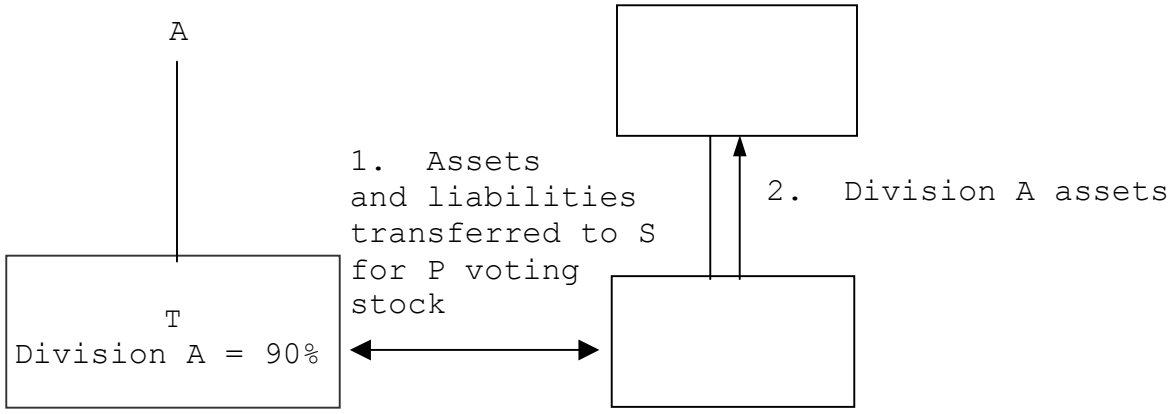
(4) Now assume that the Division A assets are transferred by S to S1, a wholly-owned subsidiary of S.



a) A transfer of assets to a second-tier subsidiary does not prevent a transaction that otherwise qualifies from meeting the requirements of a "C" reorganization. See Reg. § 1.368-2(k); Reg. § 1.368-1(d). See also Rev. Rul. 64-73, 1964-1 C.B. 142; G.C.M. 30887. Indeed, even asset dropdowns to third-tier subsidiaries are permissible. Treas. Reg. §§ 1.368-2(k), 1.368-1(d). See PLRs 9313024 and 9151036. It is also permissible to transfer the assets to multiple controlled subsidiaries. See Treas. Reg. § 1.368-1(d)(5), Example 6; Rev. Rul. 68-261, 1968-1 C.B. 147. These authorities reflect a fairly liberal approach by the Service to post-reorganization dropdowns of acquired assets.

b) Under the COBE regulations, transfers of assets to any member of the "qualified group" will be permitted. See Treas. Reg. § 1.368-1(d).

12. Example 12 -- Asset Push-up After Triangular "C" Reorganization



a. Facts: T corporation operates two divisions, Division A (which represents 90% of the value of T's assets) and Division B (which represents 10% of the value of T's assets). Pursuant to a plan to acquire T, (i) P forms S; (ii) T transfers all of its assets to S in exchange solely for voting common stock of P; (iii) S assumes T's liabilities; (iv) T liquidates, distributing P stock to its shareholders; and (v) pursuant to the plan of reorganization, S distributes the Division A assets to P.

b. Issues: Does the distribution of acquired assets affect the initial acquisition?

(1) Under the COBE regulations, in the context of triangular "C" reorganizations, the corporation in control of the acquiring corporation is treated as the "issuing" corporation. Treas. Reg. § 1.368-1(b). Thus, P is the issuing corporation, and the COBE requirement is satisfied as P holds the Division A assets directly and is treated as holding all the assets of S (i.e., the Division B assets). See Reg. § 1.368-1(d)(4).

a) Prior to the issuance of the COBE regulations in 1998, it was

unclear whether the COBE requirement was satisfied under the above facts. However, the Service had indicated that in the case of pure holding company structures, the business of operating subsidiaries could be attributed to the holding company. See Rev. Rul. 85-197, 1985-2 C.B. 120 and Rev. Rul. 85-198, 1985-2 C.B. 120; see also PLR 9406005.

b) Accordingly, the fact that a portion of the business is subsequently conducted directly by the holding company rather than indirectly would not threaten business continuity on these facts.

(2) It is unclear whether the "solely for voting stock" requirement is met. On similar facts, the Service has ruled that P rather than S will be treated as the "acquiring corporation," in accordance with the substance of the transaction. See G.C.M. 37905; but see G.C.M. 36111.

a) If P is treated as the "acquiring corporation," liabilities assumed by S will be taken into account for purposes of determining whether the acquisition is solely in exchange for voting stock. See section 368(a)(1)(C). Therefore, the transaction may fail to qualify as a "C" reorganization.

b) By contrast, where assets are transferred by the acquiring corporation to a subsidiary, the Service respects the form chosen by the taxpayer, based on the statutory language in section 368(a)(2)(C). See also G.C.M. 39102.

c) Presumably, if P is in substance the "acquiring corporation" and P assumes the Division A liabilities, these liabilities would not be taken into account as boot. However, the transaction may nevertheless fail to qualify as a "C" reorganization if the Division B liabilities assumed by S constitute more than 20 percent of the gross value of the assets acquired (or if P does not assume the Division A liabilities). See section 368(a)(2)(B).

(3) Now assume that, instead of a triangular "C" reorganization," the initial acquisition is structured either as a statutory merger of T into S in exchange for P stock under section 368(a)(2)(D) or a statutory merger of S into T for P stock under section 368(a)(2)(E).

a) In the case of a forward triangular merger, the acquiring corporation must acquire "substantially all" of the assets of the target. See section 368(a)(2)(D).

i) It could be argued that, as a result of the distribution of Division A assets to P, S's transitory acquisition of "substantially all" the assets should be disregarded.

ii) Nevertheless, the Service has ruled that, subject to other applicable limitations such as the COBE requirement, this transaction qualifies as a reorganization under section 368(a)(2)(D). See G.C.M. 36111 (the substantially all requirement looks only to what is transferred by the

transferor rather than what is retained by the transferee). See also PLR 8747038 (permitting assets acquired in an (a)(2)(D) reorganization to be distributed among members of the acquiring consolidated group.) Compare Helvering v. Elkhorn Coal, 95 F.2d 732 (4th Cir. 1937) (where the transferor rather than the transferee distributed property and the transaction was disqualified).

iii) Similar flexibility exists with respect to the assumption of liabilities. See Treas. Reg. § 1.368-2(b)(2) (parent may assume liabilities of target in an "(a)(2)(D)" merger); Rev. Rul. 73-257, 1973-1 C.B. 189 (parent and acquiring subsidiary may both assume such liabilities).

b) In the case of a reverse subsidiary merger, the surviving subsidiary must hold substantially all the assets of the merged subsidiary and its own assets after the transaction. See section 368(a)(2)(E).

i) The Service had indicated that the distribution of acquired assets that caused the surviving subsidiary to hold less than "substantially all" of such assets may disqualify the transaction. See PLRs 9238009, 9025080. See also FSA 199945006 (stating that the assets distributed after a reverse triangular merger pursuant to

plan of reorganization will reduce amount of assets treated as held by target after the merger for purposes of determining whether the surviving subsidiary has held "substantially all" of its own assets and of the merged corporation).

a) Presumably, this view was based on the requirement that the surviving subsidiary "hold" as opposed to "acquire" substantially all the assets.

b) Yet, the dropdown of stock of the surviving subsidiary or the acquired assets to a controlled subsidiary does not violate this requirement. See Treas. Reg. §§ 1.368-2(j)(4), 1.368-1(d).

c) It is unclear why a stricter interpretation of the requirement is appropriate in the case of a push-up of the assets, particularly when the push-up of assets acquired in a forward subsidiary merger is permitted.

ii) However, in Rev. Rul. 2001-25, 2001-22 I.R.B. 1 (May 7, 2001), the Service took the view that there was no difference between "acquires" and "holds." Specifically the Service stated: "The 'holds' requirement of § 368(a)(2)(E) does not

impose requirements on the surviving corporation before and after merger that would not have applied had such corporation transferred its properties to another corporation in a reorganization under § 368(a)(1)(C) or a reorganization under §§ 368(a)(1)(A) and 368(a)(2)(D)." The Service explained that the Code uses the term "holds" rather than "acquisition" because a surviving corporation does not have to "acquire" its own assets.

a) Assume a target corporation sells 50% of its assets to a third-party immediately after a merger, but retains the sales proceeds. In Rev. Rul. 2001-25, the Service held that such a transfer did not violate the substantially all requirement of section 368(a)(2)(E).

b) In Rev. Rul. 2001-25, S, P's newly formed wholly owned subsidiary, merges into T in a statutory merger. In the merger, P exchanges its voting stock for 90% of the T stock, and tenders cash for the remaining 10% of T stock. As part of the merger plan, T sells 50% of its operating assets to X, an unrelated corporation, for cash.

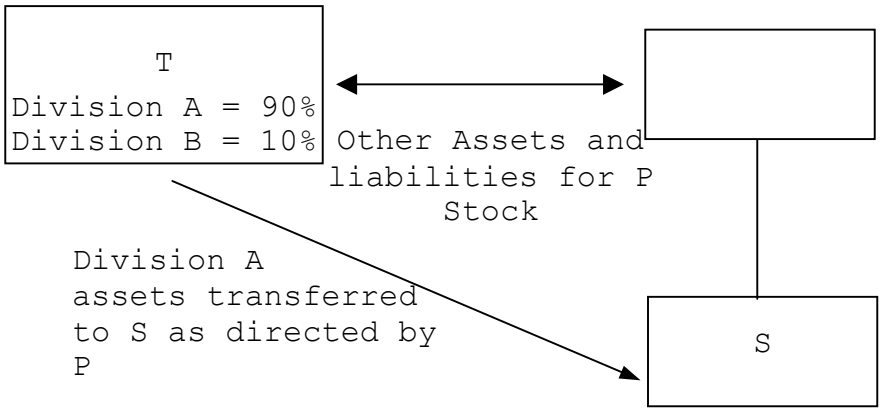
T retains the sales proceeds.

c) The Service reasoned that because T held the sales proceeds and its other operating assets after the sale, it satisfied the requirement under section 368(a)(2)(E) that the surviving corporation hold substantially all of its properties after the transaction.

iii) What if instead of selling 50% of its assets, T distributed those assets to P. Under Rev. Rul. 2001-25, this distribution of assets should not violate the "substantially all" requirement since the "holds" requirement does not impose any requirements beyond those needed for a valid forward triangular merger.

iv) Note that if all the assets of T are distributed, the transaction may be treated as an "over-the-top" triangular reorganization whereby P's basis in T's assets is determined under Treas. Reg. § 1.358-6.

13. Example 13 – "Cause To Be Directed" Transfer



a. Facts: T corporation operates two divisions, Division A (which represents 90% of the value of T's assets) and Division B (which represents 10% of the value of T's assets). Pursuant to a plan to acquire T, (i) P forms S; (ii) T transfers the Division A assets directly to S and the remaining assets to P in exchange solely for voting common stock of P; (iii) P assumes T's liabilities; and (iv) T liquidates distributing P stock to its shareholders.

b. Issues: What is the effect of the direct transfer of Division A assets on the initial acquisition?

(1) The Service will analyze the transaction as if P acquired substantially all the T assets for P stock and immediately thereafter, transferred the Division A assets to S. See Rev. Rul. 64-73, 1964-1 C.B. 142. This analysis is based on the theory that P had "dominion and control" of the assets at all times. See Rev. Rul. 70-224, 1970-1 C.B. 79. Therefore, under section 368(a)(2)(C), the transaction will not cease to qualify as a "C' reorganization as a result of the deemed transfer of assets to S.

(2) Now assume that S assumes some or all of the T liabilities in addition to receiving the Division A assets. One

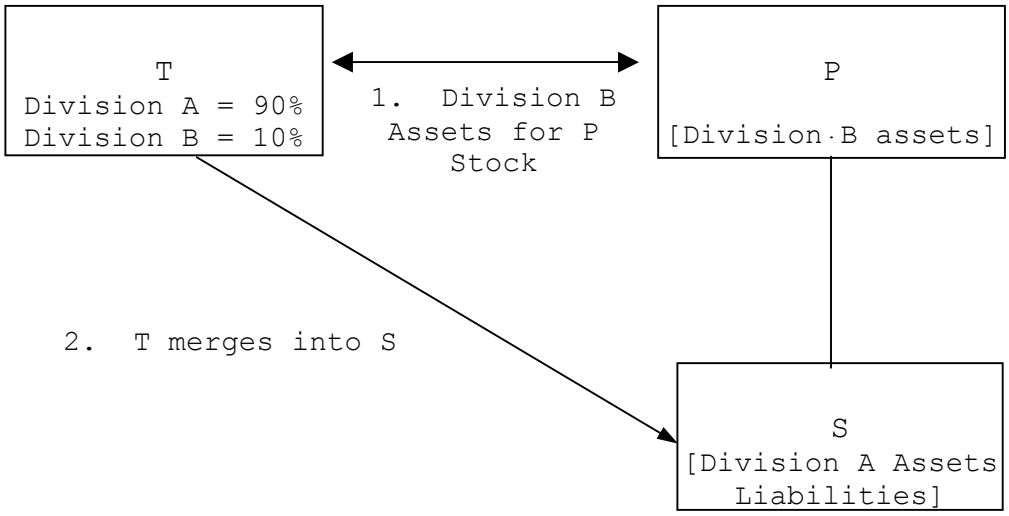
might question whether P is in substance the "acquiring corporation". Cf. G.C.M. 37905.

a) The Service will treat the transaction as an acquisition of assets and liabilities by P followed by a contribution of such assets and some or all of the liabilities to S. See PLRs 9523012, 7942016, 7903110. Thus, notwithstanding G.C.M. 37905 (which determines the "acquiring corporation" in an asset pushup based on the substance of the transaction), in this context the transaction apparently will not be treated as an acquisition by S of the assets and liabilities of T.

b) Although private letter rulings approve cause to be directed transactions (as valid "C" reorganizations) where liabilities are assumed by a corporation other than the acquiror, this transaction could be disqualified by Rev. Rul. 70-107, as discussed in Example 11 above. But see G.C.M. 39102 (questioning Rev. Rul. 70-107).

c) We understand that the Service may be reconsidering its position regarding cause to be directed transactions. If S assumes the liabilities of T, the Service may apply Rev. Rul. 70-107 and treat the liabilities as boot.

(3) What if, instead of directing that T's assets and liabilities be transferred to S, T transfers the Division B assets to P and then (as directed by P) merges into S?



a) The end result of the transaction appears identical to that of the previous transaction. Indeed, the Service has indicated that, on similar facts, it will treat the transaction as an acquisition of T's assets and liabilities by P followed by a dropdown of those assets and liabilities to S. See, e.g., PLRs 9536032, 9526024, 9409033, 9151036.

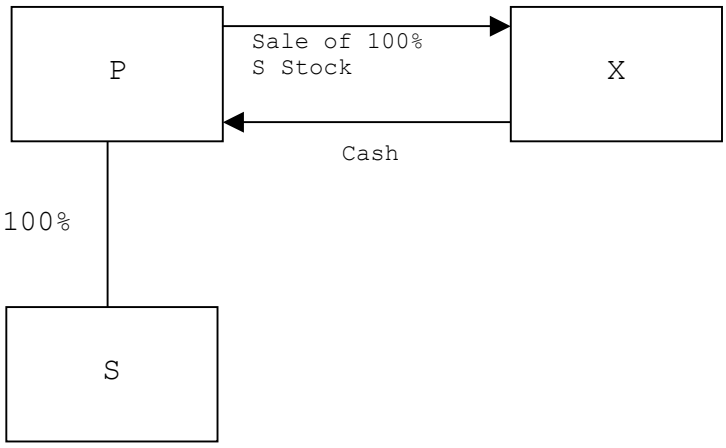
b) Again, the Service appears to disregard the fact that a corporation other than the "acquiring corporation" has assumed liabilities.

c) As noted above, the Service may be reconsidering this position.

c. The Service is currently considering whether the "cause to be directed" doctrine has continuing vitality in light of the new COBE regulations and Treas. Reg. § 1.368-2(k).

D. Recent Issues Involving Qualified Subchapter S Subsidiaries and Limited Liability Companies

1. Example 1 -- Sale of All of QSub Stock: Rev. Rul. 70-140



a. Facts: Corporation P, an S corporation, owns all of the outstanding stock of S, a corporation for which a QSub (qualified subchapter S subsidiary) election has been made. The fair market value of S' assets is $100, and their adjusted basis is $50. P sells all of its S stock to X corporation, an unrelated party, for $100 cash.

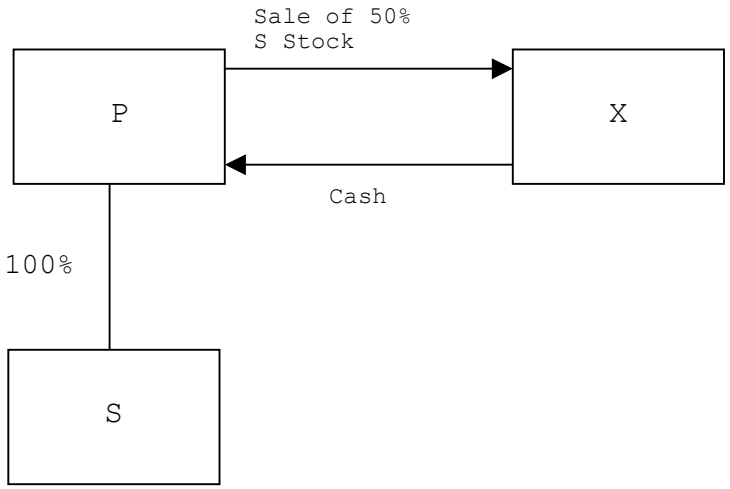
b. Tax Consequences.

(1) New QSub Regulations: Under section 1361(b)(3) and the new QSub regulations, T.D. 8869, 2000-6 I.R.B. 498 (Jan. 20, 2000), a QSub is not treated as a separate corporation, and all assets and liabilities of the QSub are treated as assets and liabilities of its parent corporation. Treas. Reg. § 1.1361-4(a)(1). Upon the sale by P of its S stock, S ceases to be a QSub, and P is treated as if it transferred the S assets to a newly formed corporation, S, and then sold the S stock to X. Treas. Reg. § 1.1361-5(b). Section 351 is not applicable to the transfer of assets to S, because P is

not in control of S immediately after the transfer.

(2) Rev. Rul. 70-140: Under Rev. Rul. 70-140, 1970-1 C.B. 73, the Service will apparently apply the step-transaction doctrine to treat the above transaction as if P sold the assets it was deemed to transfer to S to X. X is then deemed to contribute the assets to S. Thus, P is taxed under section 1001 on the value of the property received (i.e., $100 cash) minus its adjusted basis in the transferred assets. Therefore, P will have $50 of gain.

2. Example 2 -- Sale of Portion of QSub Stock



a. Facts: Same facts as Example 13, except P sells 50% of its S stock to X.

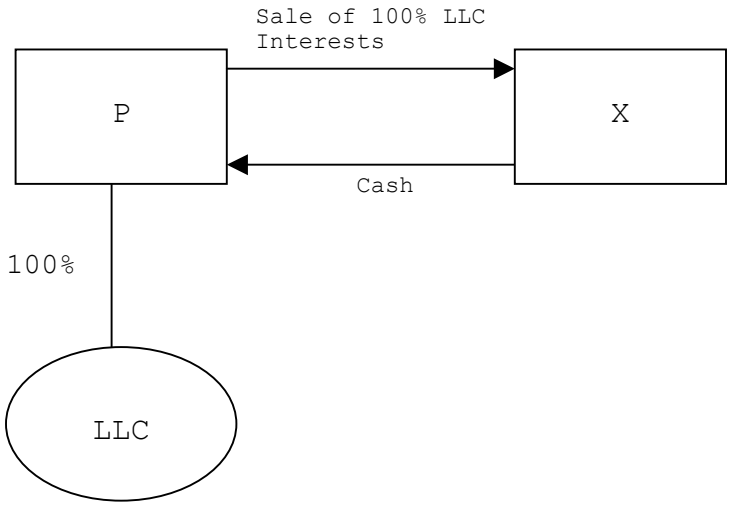
b. Tax Consequences:

(1) As noted in the previous example, upon the sale by P of its S stock, S ceases to be a QSub, and P is treated as if it transferred the S assets to a newly formed corporation, S, and then sold the S stock to X. Treas. Reg. § 1.1361-5(b). Section 351 is not applicable to the transfer of assets to S, because P is not in control of S immediately after the transfer. Thus,

P must recognize all of the gain attributable to the S assets, even though it only sold one-half of its S stock. See Treas. Reg. § 1.1361-5(b)(3), Ex. 1; section 1239. If P had incurred a loss upon the transfer of assets to S, such loss would be subject to the limitations of section 267. Id.

(2) Rev. Rul. 70-140: The Service apparently will not treat this transaction as a sale of assets directly to X.

3. Example 3 -- Sale of All Membership Interests in LLC



a. Facts: Corporation P owns all of the outstanding interests in LLC. LLC does not elect to be classified as a association (i.e., it is treated as a disregarded entity). The fair market value of LLC's assets is $100, and their adjusted basis is $50. P sells all of the outstanding membership interests in LLC to X corporation, an unrelated party, for $100.

b. Tax Consequences:

(1) LLC is disregarded as an entity separate from P. As a result, P is not

treated as owning "interests" in LLC for Federal tax purposes, but rather is treated as owning LLC's assets directly. Thus, the sale of all of the interests in LLC, a disregarded entity, to a single buyer should be treated as a sale of assets by P. Under section 1001, P should recognize gain or loss on the sale, the character of which will depend on the nature of the assets sold.

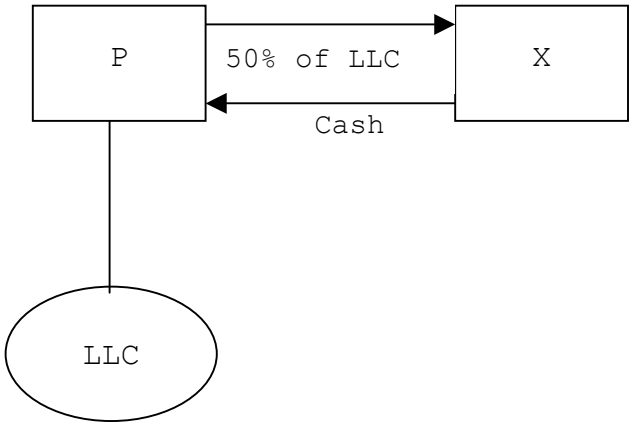
(2) It is not likely that P would be able to change this result by converting LLC into an association taxed as a corporation immediately prior to the sale of the LLC interests to X. The Service will apply step-transaction principles to treat P's sale of the LLC interests as the sale of the LLC's assets. See Rev. Rul. 70-140, 1970-1 C.B. 73.

c. Treatment of Buyer

(1) Because LLC will be owned by a single buyer, X, it will remain a disregarded entity in X's hands. See Treas. Reg. § 301.7701-3(b)(1)(ii). Accordingly, X should be treated as purchasing the assets of LLC directly from P.

(2) What if LLC elects to be taxed as an association immediately after the purchase? If a disregarded entity elects to be treated as an association, the owner is treated as contributing all of the assets and liabilities of the disregarded entity to a newly formed association in exchange for stock of the association. Treas. Reg. § 301.7701-3(g)(1)(iv). Thus, X should be treated as contributing the assets of LLC to a newly formed association in a tax-free section 351 exchange.

4. Example 4 -- Sale of Portion of Membership Interests in LLC



a. Facts: P owns all of the outstanding interests in LLC, which is treated as a disregarded entity for tax purposes. The fair market value of LLC's assets is $100, and their adjusted basis is $50. P sells 50 percent of the outstanding membership interests in LLC to X corporation, an unrelated party, for $50.

b. Tax Consequences: LLC is disregarded as an entity separate from P. As a result, P is not treated as owning "interests" in LLC for Federal tax purposes, but rather is treated as owning LLC's assets directly. Thus, the sale of 50 percent of the interests in LLC, a disregarded entity, to a single buyer should be treated as a sale of 50 percent of the LLC assets by P. P should recognize gain or loss under section 1001, with the character of such gain or loss depending on the character of the assets sold.

c. Deemed Change In Classification - Immediately after the sale, LLC has two owners and, thus, will be treated as a partnership under the default rules of the check-the-box regulations. Treas. Reg. § 301.7701-3(b)(1)(i). Although the tax consequences of this deemed change in

classification are not addressed in the regulations, Rev. Rul. 99-5, 1999-6 I.R.B. 8, provides some guidance. Following Rev. Rul. 99-5, X would be treated as having purchased assets from P and contributed the assets (with their stepped-up basis) to a newly formed partnership under section 721. The other 50 percent of the assets, which would be deemed contributed by P would not receive a stepped-up basis; instead, LLC would take a carryover basis in those assets. Note that under section 704(c), the built-in gain with respect to the assets contributed by P will be allocated to P.

d. Section 197 Anti-Churning Rules – Assume that a portion of the assets held by LLC consisted of goodwill, which was not amortizable under pre-section 197 law. Would LLC be permitted to amortize its goodwill after the sale?

(1) In general, section 197 amortization deductions may not be taken for an asset which was not amortizable under pre-section 197 law, if it is acquired after August 10, 1993, and either (i) the taxpayer or a related person held or used the asset on or after July 25, 1991; (ii) nominal ownership of the intangible changes, but the user of the intangible does not; or (iii) the taxpayer grants the former owner the right to use the asset. See Section 197(f)(1)(A). In addition, under section 197(f)(2), in certain nonrecognition transactions (including section 721 transfers), the transferee is treated as the transferor for purposes of applying section 197.

(2) In the example above, P was treated as owning LLC's goodwill directly, prior to the sale of 50 percent of LLC. Because P's deemed contribution of 50 percent of the goodwill was pursuant to section 721, LLC takes a carryover basis in the goodwill (presumably 0),

which will not be amortizable by LLC. Because X's half of the goodwill was held by P, who is related to LLC under section 197(f)(9)(C), during the prohibited time period, the anti-churning rules will apply to X's transfer of its 50-percent interest. Therefore, LLC's entire basis in its goodwill is nonamortizable. See Treas. Reg. § 1.197-2(k), Ex. 18.

(3) What if P sold more than 80 percent of the LLC membership interests to X? In that case, P is not related to the newly formed partnership within the meaning of section 197(f)(9)(C). Thus, the anti-churning rules should not apply. However, under Treas. Reg. § 1.197-2(h)(6)(ii), the time for testing relationships in the case of a series of related transactions or acquisitions is immediately before the "earliest such acquisition" or immediately after the "last such acquisition" of the intangible.

i) Query whether P is considered related to the newly formed partnership under the final regulation because it was an entity not separate from LLC immediately before the initial acquisition by X.

ii) Note that former Prop. Reg. § 1.197-2(h)(6)(ii) stated that the time for testing relationships was any time during the period beginning immediately before the "earliest acquisition" and ending immediately after the "last acquisition" of the intangible. The Preamble to the Final Regulations explains that the change was necessary to avoid deeming parties related that are only

momentarily related during the acquisition process. See T.D. 8844, 1999-50 I.R.B. 661.

(4) There is a special partnership rule for purposes of determining whether the anti-churning rules apply with respect to any increase in basis of partnership property under section 732(d), 734(b), or 743(b). In such cases, the determinations are to be made at the partner level, and each partner is to be treated as having owned or used such partner's proportionate share of the partnership property. Section 197(f)(9)(E). Thus, if a purchaser acquires an interest in an existing partnership from an unrelated seller, any step-up in basis will be treated as a separate section 197 intangible, and the purchaser will be entitled to amortize its share of the step-up in basis of the partnership intangibles. Treas. Reg. § 1.197-2(g)(3).

a) Query whether the anti-churning rules do not apply to a section 743(b) basis increase if the acquiror already owns a greater than 20% interest in the partnership, and, if the anti-churning rules do not apply, whether such acquiring partner could be allowed to amortize goodwill such partner originally contributed to the partnership.

b) Discussions with Service officials indicate that an acquiring partner that already owns a greater than 20 percent interest in the partnership should be allowed to amortize all goodwill attributable to a section 743(b) adjustment, even if some of that goodwill was originally unamortizable and contributed by such acquiring

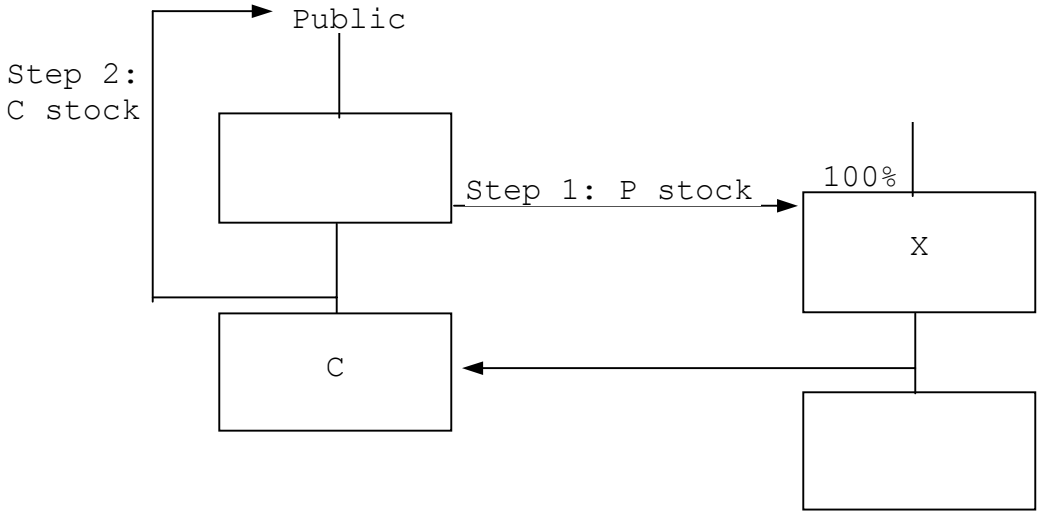
partner to the partnership. However, such discussions also indicate that if the contribution of such unamortizable goodwill and the acquisition that results in the section 743(b) adjustment are part of a series of related transactions, the anti-churning rules will apply to deny amortization with respect to the goodwill contributed by the acquiring partner. It is unclear, however, how the regulations can be read to provide such an exception to the general rule that an acquiring partner may amortize goodwill attributable to a section 743(b) adjustment if such partner is not related to the selling partner.

(5) Assume that, in the example above, LLC was already classified as a partnership for tax purposes (e.g., P contributed the assets of LLC to a newly formed partnership in exchange for partnership interests, and, at the same time, another party contributed property to the newly formed partnership in exchange for nominal partnership interests), and LLC had a section 754 election in effect. If P then sold 50 percent of its partnership interest to X, X's proportionate share of any basis step-up under section 743 should be amortizable.

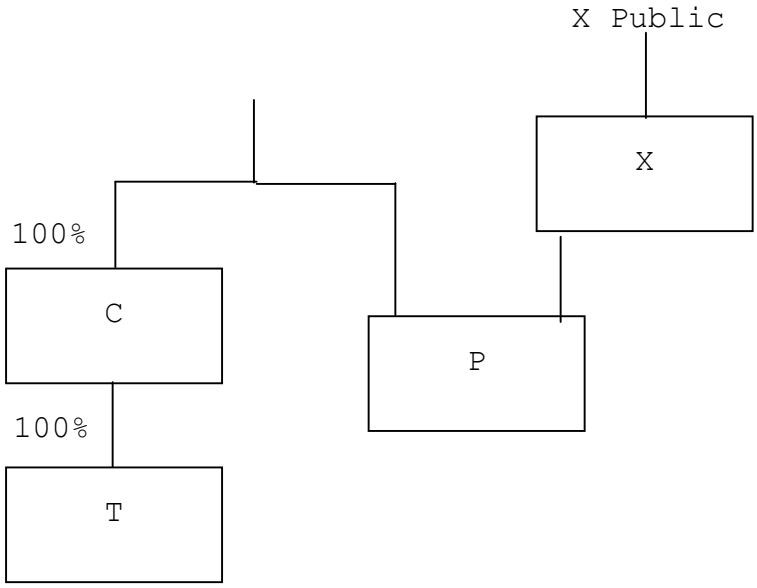
E. Control Issues

1. Example 1 -- Control Issues

Before



After:



a. Facts: C is a wholly-owned subsidiary of P. T is a wholly-owned subsidiary of X. C acquires all of the stock of T in a triangular "B" reorganization using the stock of P. As part of the same transaction, the stock of C (now the parent of T) is then distributed to the historic shareholders of P.

b. Issues:

(1) At the time of the transaction P is in control of C, and thus the statutory requirements of section 368(a)(1)(B) are satisfied.

(2) However, immediately after the transaction P is no longer in control of C. Should this invalidate the "B" reorganization? Note that section 368(a)(1)(B) permits the use of stock of a corporation "which is in control of the acquiring corporation" and does not specifically require the control to exist "immediately after the exchange."

(3) Furthermore, after the transaction, X and its shareholders no longer have any continuing interest in T. Thus, it appears that there should be a complete failure of continuity of interest.

(4) Nevertheless, in PLR 9349011 the Service ruled that this transaction was a valid triangular "B" reorganization, followed by a valid section 355 transaction.

a) In the ruling, X was also a member of the P consolidated group, so that the ultimate shareholders of X and P were the same.

b) Thus, if analyzed using an approach of "remote continuity," it may be reasonable for this transaction to qualify.

c) However, no such analysis was undertaken in the ruling. The issue of continuity of interest was not raised.

(5) Notice that the potential tax costs of failing to achieve reorganization status are much higher here in the case of a triangular reorganization than

would be the case in a direct acquisition of T stock by P.

a) If a direct acquisition failed to qualify as a "B" reorganization, then X (as the sole shareholder of T) would have been required to recognize all of its gain with respect to its T stock. No gain would have been recognized by P or by T.

b) If the triangular acquisition fails to qualify as a "B" reorganization, P could be treated as contributing its stock to C in exchange for C stock followed by C exchanging P stock for T stock. See Rev. Rul. 74-503, 1974-2 C.B. 117.

   i) This would be a fully taxable transaction to C.

   ii) P has no basis in its own stock, hence under section 362, it would appear that C must take a zero basis in the P stock it receives (and that P must take a zero basis in the C stock that it receives).

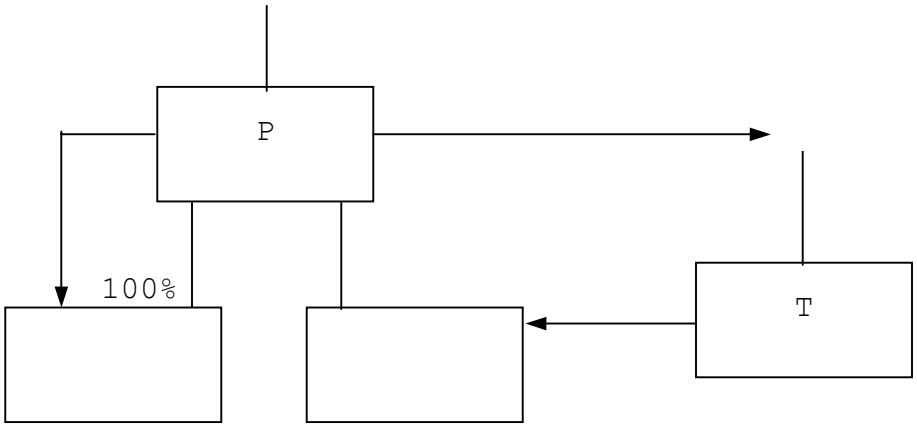
   iii) As a result, C would be required to recognize gain to the extent of the full value of T if the transaction fails to qualify for reorganization treatment.

c) It would appear more reasonable to treat the failed triangular reorganization as if P had exchanged its stock for T stock and then contributed the T stock to C. In this case, assuming that reorganization treatment was unavailable, X would continue to

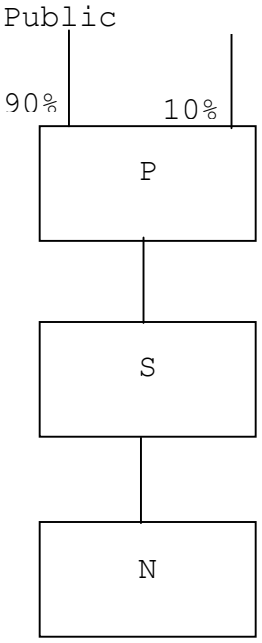
recognize the gain inherent in its T stock, but neither P nor C would be required to recognize any gain.

2. Example 2 -- Control Issues

Before:



After:



a. Facts: P owns 100 percent of the stock of S. P wants to acquire T, a corporation owned 100 percent by individual A, and operate it as a subsidiary of S, but wants to make the acquisition using P stock. P forms N, a wholly-owned subsidiary, and T is merged into N, with A receiving 10 percent

of the stock of P in the transaction. P then contributes stock of N to S.

b. Issues:

(1) The merger of T into N for P stock is a transaction described in section 368(a)(2)(D).

(2) Section 368(a)(2)(C) permits the drop-down of acquired assets in an "A", "C" or "G" reorganization, and the drop-down of acquired stock in a "B" reorganization.

(3) Nothing in the statute or the regulations directly addresses the drop-down of the stock of a surviving corporation in a section 368(a)(2)(D) triangular merger.

(4) Notice that the net effect of this transaction is the acquisition of assets by N in exchange for stock of P, which ends up as its grandparent. If that structure were undertaken directly, the transaction would not qualify as a reorganization under section 368.

(5) However, the Service ruled that this merger is a valid reorganization. Rev. Rul. 2001-24, 2001-22 I.R.B. 1 (May 3, 2001). See also PLRs 9117069 and 9406021.

a) Is there anything wrong with this conclusion?

b) Nearly the same result could be reached through a triangular "B" reorganization followed by a drop-down of the acquired stock, which is explicitly permitted by the statute.

c) Dropdown of target stock acquired in a reverse triangular

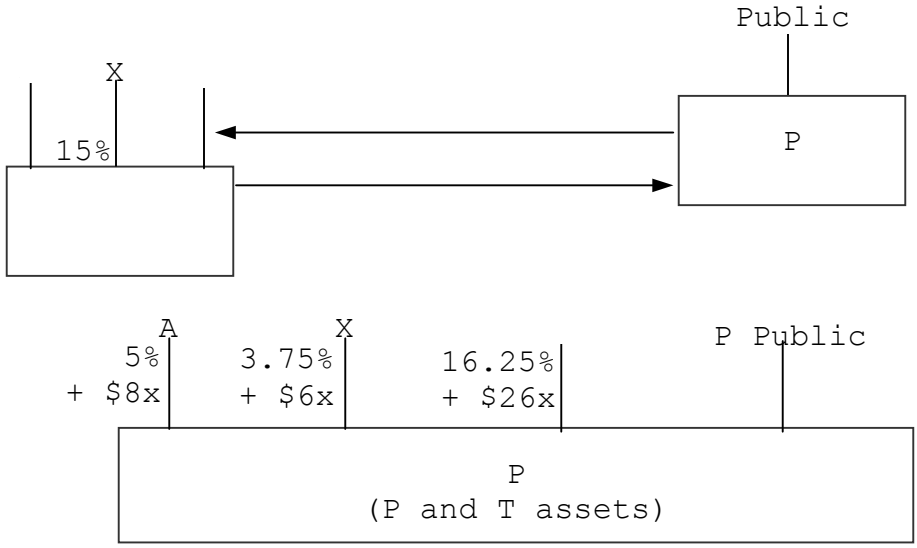
reorganization under section 368(a)(2)(E) is specifically contemplated by the regulations. See Reg. § 1.368-2(j)(4).

(6) See Part II.B.3., above, for a discussion of this transaction in the context of the COBE requirement.

F. Boot in a Reorganization

1. Example 1 -- The *Clark* Test

Before:



a. Facts: T is a publicly traded company with a single class of stock. A, an individual and the founder of T owns 20 percent of T stock; Corporation X owns 15 percent of T stock; and the remaining 65 percent is widely held, with no other shareholder owning more than 5 percent of T stock.

P, a publicly traded corporation with no 5 percent shareholder, proposes to acquire T in a statutory merger. The consideration to be issued to T shareholders will consist of 60 percent common stock and 40 percent cash. The stock to be issued to T shareholders will constitute 25 percent of all P common stock after the transaction.

b. Issues:

(1) Assuming that each T shareholder will receive the same mixture of stock and cash (60 percent-40 percent), how should the cash be treated under section 356(a)?

a) Under Commissioner v. Clark, 439 U.S. 726 (1989) and Rev. Rul. 93-61, the transaction is recast as if only P stock had been transferred to the T shareholders, and then each T shareholder had exchanged 40 percent of the P stock received in exchange for cash.

i) Assume that T was worth $100x. The T shareholders actually received $60x of stock, representing 25 percent of the P stock outstanding after the transaction. Therefore, we know that the historic P shareholders own $180x of P stock. (4 x $60x = $240x; $240x - $60x = $180x).

ii) Had only stock been issued to the T shareholders, they would have received $100x of stock which would have represented approximately 35.7 percent of all P stock outstanding following the transaction. ($100x + $180x = $280x total P stock after the transaction; $100x $280x = 35.7%).

iii) A reduction from 35.7 percent to 25 percent would constitute a substantially disproportionate redemption under section 302(b)(2).

iv) Presumably, the hypothetical redemption of all shareholders is treated as occurring simultaneously, rather than treating any particular shareholder as if he had received only P stock and was redeemed, but as if all other T shareholders received their actual mix of P stock and cash.

v) Note, however, that the actual determination of dividend equivalence is made on a shareholder by shareholder basis, and the results may vary depending on whether the T shareholder owns P stock (actually or constructively) other than the P stock received in the transaction.

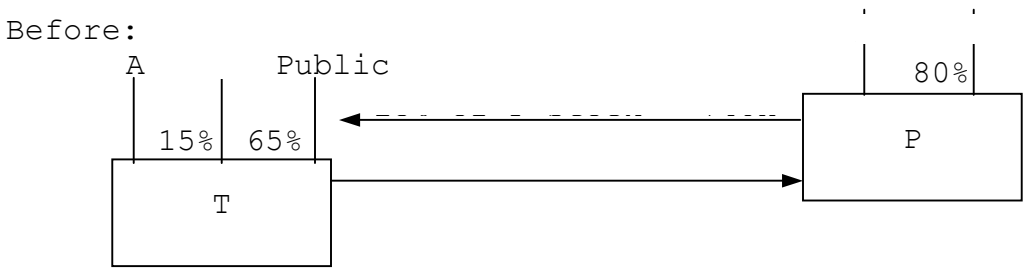
b) Even if the redemption did not satisfy the mechanical test of section 302(b)(2), generally any redemption of stock from a minority shareholder in a public corporation will not be considered equivalent to a dividend under section 302(b)(1). Rev. Rul. 76-385, 1976-2 C.B. 92. See also FSA 1999681 (stating that Rev. Rul. 76-385 continues to represent the Service's position).

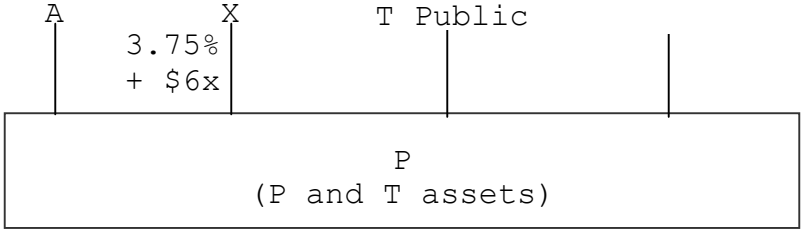
i) This result will not apply, however, if no reduction in the shareholder's interest results from the redemption. Rev. Rul. 81-289, 1981-2 C.B. 82.

ii) It is also possible that a reduction will not be considered meaningful where the shareholder's interest,

although less than 50 percent is substantial compared to the holding of other public shareholders. Cf. GCM 38357; Golconda Mining Corp. v. Commissioner, 58 T.C. 139 (1972) (effective control determinative in applying accumulated earnings tax), rev'd, 507 F.2d 594 (9th Cir. 1974); Himmel v. Commissioner, 338 F.2d 815 (2nd Cir. 1964) (the three factors to consider in determining whether there is a meaningful reduction are voting rights, the right to share in earnings, and the right to share in liquidation proceeds). See also FSA 1999759 (applying Himmel factors to determine that a deemed redemption of stock was a meaningful reduction in a shareholder's interest).

(2) What if, prior to the transaction, A is also a 20 percent shareholder in P?



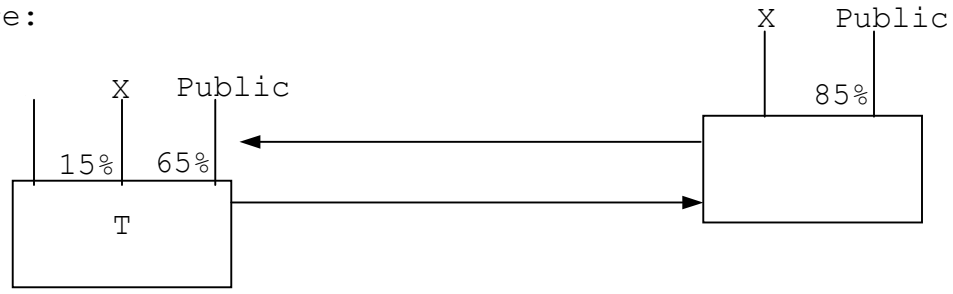


a) In this case, A will be a 20 percent shareholder in P after the transaction, instead of a 5 percent shareholder.

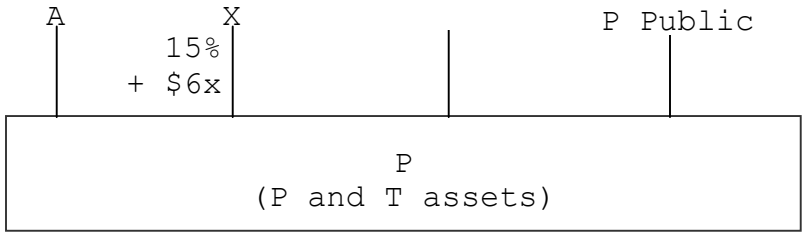
b) Had the T shareholders received only stock in the transaction, A would still have been a 20 percent shareholder in P (since A would have received 20 percent of the stock issued to T shareholders and would continue to own 20 percent of the stock held by historic P shareholders). Thus, a hypothetical redemption of P stock equal to the boot received would not result in any reduction of A's interest in P, and thus the boot must be treated as a dividend under section 356(a)(2), up to the amount of available earnings and profits (see below).

(3) What if, prior to the transaction, Corporation X is a 15 percent shareholder in P?

Before:



After:



a) The analysis is similar to that used above with respect to A's 20 percent interest.

b) Again, a hypothetical redemption of the T shareholders would not result in any reduction of S's interest in P, and thus the boot must be treated as a dividend under section 356(a)(2).

c) Note that, unlike A, X would like for the boot to give rise to dividend treatment, so that X may claim the dividends received deduction under section 243.

(4) Does it matter if T has no earnings and profits? What about P?

a) Section 356(a)(2) provides that if boot has the effect of the distribution of a dividend, it shall be treated as a dividend to the extent of the shareholder's "ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913." (Emphasis added).

i) Note that dividend treatment applies only to the extent of accumulated earnings and profits.

ii) In general, dividends under section 316 may be paid out of either current or accumulated earnings and profits.

b) While the statute does not specifically indicate whether "the corporation" is the target corporation or the acquiring corporation, since dividend treatment is limited to the target

shareholder's share of accumulated earnings and profits, practitioners generally assumed, prior to Clark, that only the earnings and profits of the target corporation were taken into account.

c) Because Clark determines dividend equivalence using a hypothetical redemption of stock of the acquiror following the transaction, it now appears less certain which corporation's earnings and profits are used to determine the amount of a dividend.

i) Immediately following Clark and until mid-1990, the Service continued to issue rulings which looked to the earnings and profits of the target corporation. See, e.g., PLR 8942092; PLR 8936036.

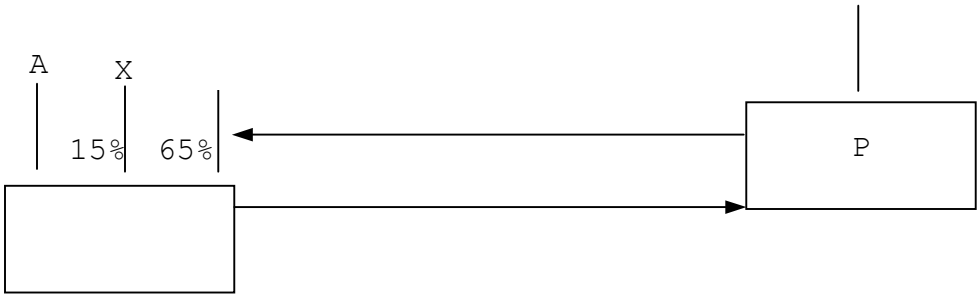
ii) However, the Service subsequently issued rulings which looked instead to the earnings and profits of the acquiring corporation. See PLR 9041086 (reverse triangular merger); PLR 9039029 (merger of two operating corporations into newly-formed shell corporation; in effect both companies earnings and profits were made available).

iii) Some later rulings returned to the initial approach of looking only to the earnings and profits of the target corporation. See PLR 9118025; PLR 9109056.

iv) It remains to be seen what position the Service will ultimately settle on with regard to this issue. It is understood that the issue is under current review.

v) Note that in a section 304 transaction, the earnings and profits of both corporations are available to support dividends.

(5) Is there any change if the transaction is structured as a "cash election merger" (i.e., the merger agreement provides that, with respect to each share of T stock a shareholder may elect to receive stock or cash, so long as the aggregate consideration paid to all T stockholders consists of 60 percent stock and 40 percent cash)?



a) Theoretically, a cash election merger could raise a constructive transfer issue.

b) The T shareholders could be treated as if they received the stock and cash pro rata and then made exchanges between themselves to achieve the desired mix of stock and cash.

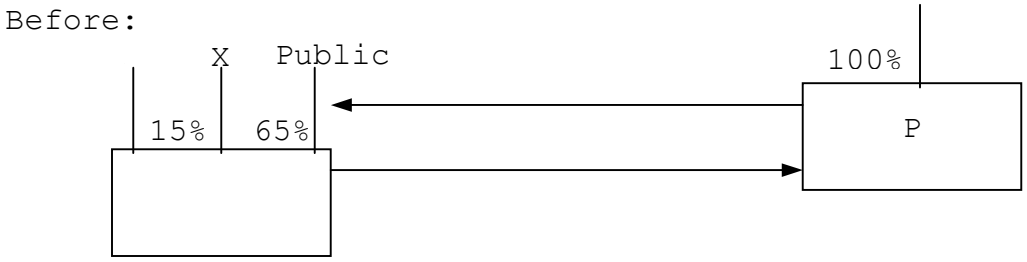
i) This would result in gain recognition even for T shareholders who actually

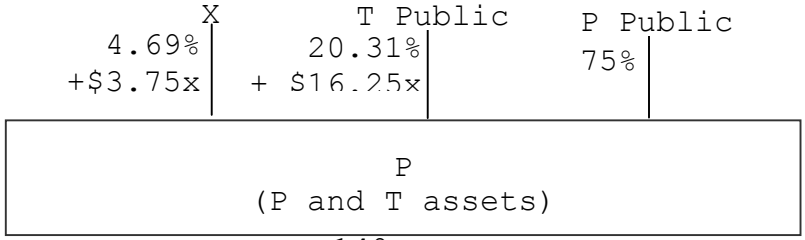
receive no cash in the transaction, since they would be deemed to have received cash and to have used that cash to purchase more stock.

ii) T shareholders receiving more than their pro rata share of cash could recognize less gain under this approach, because it would allow them basis recovery with respect to the deemed exchange between T shareholders where section 356 requires gain to be recognized to the full extent of boot received.

c) However, the Service's position, as evidenced by private rulings, appears to be that shareholders of the target corporation in cash election mergers recognize gain only to the extent, and to the full extent, that they actually receive cash. See, e.g., PLR 9236007; PLR 9135019; PLR 9118025.

(6) How would the transaction be analyzed if A received only cash for his interest, while X and the other T shareholders received cash and boot.





a) In applying the Clark test for dividend equivalence, it is unclear whether A, who receives solely cash, should be treated as part of the hypothetical redemption.

i) By its terms, section 356(a) applies only to target shareholders who receive boot in addition to nonrecognition property.

ii) Regulations under section 354 similarly make clear that an exchange of stock solely for boot is not governed by the reorganization provisions but rather is treated as a redemption under section 302. Reg. § 1.354-1(d)(Ex. 3).

a) Since the redemption is not governed by section 356, presumably Clark does not apply, and hence dividend equivalence is tested only with respect to the target corporation.

b) In this instance, as in most cases this will not matter, since the transaction will constitute a complete termination of A's interest, and hence qualify for exchange treatment under section 302(b)(3).

c) Note, however, that if A had owned stock in both

corporations, or was treated as continuing to own target stock because of attribution under section 318, different results may ensue if the transaction is treated as a redemption from the target corporation or from the acquiring corporation.

iii) It is also unclear whether, in applying the Clark test to target shareholders who receive both cash and stock, target shareholders receiving only cash should be viewed as part of hypothetical redemption, or viewed separately.

a) If A is treated as receiving $20x of stock and redeeming such stock simultaneously with X and the other shareholders of T, X's percentage ownership of P would go from 5.36 percent to 4.69 percent ($15x $280x = 5.36%; recall that in (1), above, it was determined that if T was worth $100x, the total value of P after the merger and prior to the payment of any boot would be $280x).

b) If instead, A's receipt of cash is treated as a separate transaction, X's percentage ownership of P would go from 5.77 percent to 4.69 percent ($15x $260x = 5.77%;

the prior redemption of A would have reduced the total value of P from $280x to $260x).

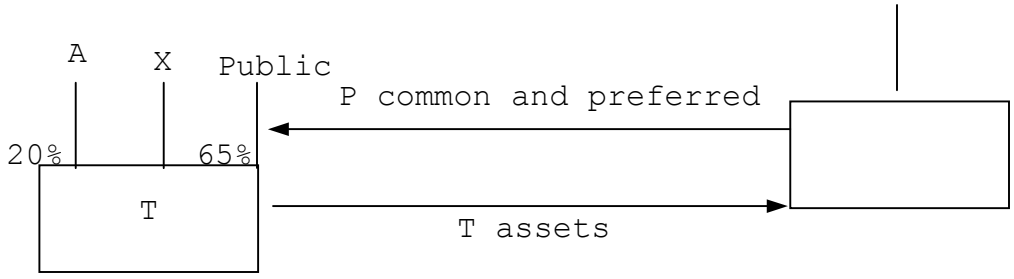
iv) A similar issue arises where a shareholder dissents from a reorganization transaction.

a) Under most state laws, a dissenter is treated as being redeemed by the target corporation prior to the transaction.

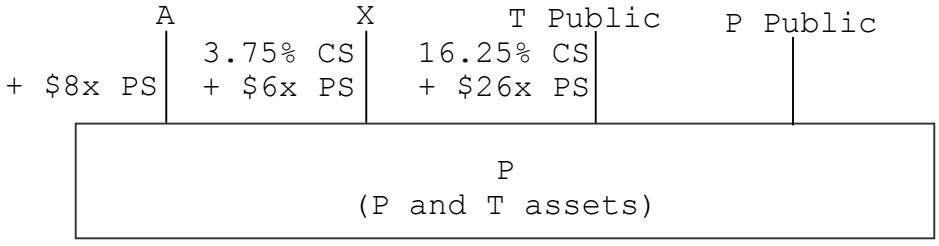
b) Query, however, whether this characterization will control for tax purposes, especially if the acquiring corporation is the source of funds to pay cash to the dissenter.

(7) What if instead of cash, P issued preferred stock?

Before:



After:



a) Under TRA 1997, "nonqualified preferred stock" will be treated as boot for purposes of sections 351, 354, 355, 356, and 368.

i) Nonqualified preferred stock is generally preferred stock for which (1) the holder has the right to require the issuer to redeem or purchase the stock, (2) the issuer is required to redeem or purchase the stock, (3) the issuer has the right to redeem or purchase the stock and, as of the issue date, it is more likely than not that such right will be exercised, or (4) the dividend rate on the stock varies in whole or in part with reference to interest rates, commodity prices, or other similar indices.

ii) "Preferred stock" means stock that is limited and preferred as to dividends and does not participate in corporate growth to any significant extent.

a) The former Administration proposed a clarification to the definition of nonqualified preferred stock for purposes of section 351(g).

b) Under the proposal, the definition of preferred stock would be modified “to ensure that stock for which there is not a real and meaningful

likelihood of actually participating in the earnings and growth of the corporation" is considered to be preferred. See Joint Committee's Description of Revenue Provisions Contained in the President's Fiscal Year 2001 Budget Proposal, pp. 374-75. As of yet, the current Administration has not made a similar proposal.

iii) The conference report to TRA 1997 states that in no event will a conversion privilege into stock of the issuer be automatically considered to constitute participation in corporate growth to any significant extent. Conf. Rep. No. 105-220, 105th Cong., 1st Sess. 545 ("1997 Conference Report").

iv) The first three rules above do not apply if (1) the right cannot be exercised within 20 years of the date the right is issued and is subject to a contingency which makes the likelihood of redemption or purchase remote, (2) the right may be exercised only upon the death, disability, or mental incompetence of the holder, or (3) the right to redeem or purchase is in connection with the performance of services for the issuer and may be exercised only upon the holder's separation from service.

v) Under recently finalized regulations, a right to acquire nonqualified preferred stock received in exchange for stock, or a right to acquire stock, other than nonqualified preferred stock will not be treated as a stock or security. Treas. Reg. § 1.356-6(a). See T.D. 8882, 65 Fed. Reg. 31078 (May 15, 2000) (adopting without modification the temporary and proposed regulations promulgated in T.D. 8753, 1998-1 C.B. 613). In addition, nonqualified preferred stock received in exchange for stock, or a right to acquire stock, other than nonqualified preferred stock will also not be treated as a stock or security. Id.

a) The new regulations do not apply in the case of a recapitalization under section 368(a)(1)(E) of a family-owned corporation. Treas. Reg. § 1.356-6T(b)(1).

b) The new regulations apply to nonqualified preferred stock, or a right to acquire such stock, received in connection with a transaction occurring on or after March 9, 1998. Reg. § 1.356-6(c).

b) If the preferred stock is not "nonqualified preferred stock," the issuance of preferred stock in a reorganization must be tested to

determine if the preferred stock is "section 306 stock."

i) In general, preferred stock received in a reorganization will be section 306 stock if:

a) The transaction is "substantially the same as the receipt of a stock dividend;" or

b) The preferred stock is received in exchange for section 306 stock.

Sections 306(c)(1)(B) and (C).

ii) The disposition, other than in redemption, of section 306 stock generally gives rise to ordinary income (rather than capital gain) to the extent of earnings and profits at the time that the section 306 stock was acquired.

iii) The redemption of section 306 will <u>always</u> be treated as a dividend to the extent of earnings and profits at the time of the redemption.

c) Reg. § 1.306-3(d) provides that preferred stock received in a reorganization will generally be section 306 stock if cash received in lieu of such stock would have been treated as a dividend under section 356(a)(2). The proper application of this "cash in lieu" of test is unclear.

i) For example, note that A receives $8x of preferred stock. Had A instead received $8x of cash, the analysis under section

356(a)(2) and Clark would have been to assume that A had received $8x of stock instead of the $8x of cash, and that such stock had then been redeemed.

ii) For purposes of the section 356(a)(2) analysis, should A be deemed to have received preferred stock (as he actually did), or additional common stock?

iii) The resolution of this issue may have significant consequences.

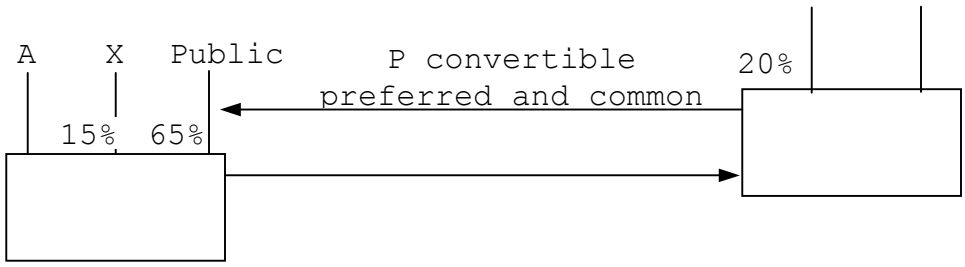
a) Consider, for example, the fact that a hypothetical redemption of preferred stock would never qualify as "substantially disproportionate" under section 302(b)(2) because there would be no reduction in A's ownership of common stock.

b) In contrast, if A were deemed to have received $8x of common stock the redemption would qualify as substantially disproportionate (see (1), above).

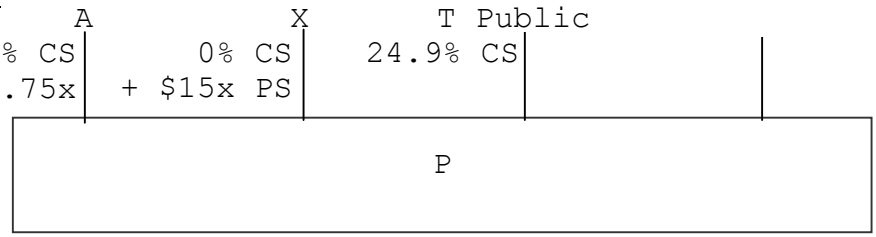
d) More complexities arise with respect to the treatment of preferred stock which is convertible into common stock. See infra for the affect of TRA 1997 on convertible preferred stock.

Suppose again that A owns 20 percent of P, and also that P convertible preferred stock was issued to A and to X in the merger and common stock was issued to T's public shareholders. X does not convert any of the preferred stock received. A converts sufficient preferred stock (in this case $16.25x of preferred stock) so that he continues to own 20 percent of P after the transaction.

Before:



After:



i) If the "cash in lieu" of test were applied simply to the convertible preferred stock received, the purposes of section 306 could be avoided.

a) If the convertible preferred were tested under the "cash in lieu" of test, assuming that section 356(a)(2) were applied using a hypothetical issuance of common stock, one might conclude that A's common stock interest in P had

been sufficiently reduced to avoid making the preferred stock section 306 stock.

b) If all of the T shareholders were treated as receiving only common stock, A would have owned 20 percent of P following the transaction (Recall that P had $180x of stock before the transaction; A owned $36x of that stock and received $20x of the $100x issued in the reorganization; $36x + $20x = $56x; $56x 280x = 20%).

c) If A and X had received only cash in lieu of stock, A would have owned 15 percent of P after the transaction (following the transaction A would own only the $36x of P stock owned before the transaction; $65x additional stock was issued to T's public shareholders; $36x $245x = 15%).

d) Notwithstanding that the receipt of cash in lieu of the convertible preferred stock may have resulted in a substantial decrease in A's common stock interest in P, following the conversion, it is apparent that A's common stock interest in P has

not been reduced at all. Accordingly, the remaining $3.75x of A's preferred stock, after conversion of $16.25x of preferred stock, should be treated as section 306 stock.

ii) Query what the proper result is if A does not convert any stock immediately.

a) Should all of the preferred stock be treated as section 306 stock, because A has the opportunity to keep his common stock ownership at 20 percent?

b) Should none of the preferred stock be treated as section 306 stock, because without conversion A's common stock ownership has decreased to 15 percent (see above)?

c) Should only a portion of the preferred stock be treated as section 306 stock?

iii) The Service generally will rule that convertible preferred stock is <u>not</u> section 306 stock only if the following conditions are met:

a) The shareholders receiving convertible preferred stock receive no common stock in the exchange;

b) The shareholders receiving convertible preferred stock own, in aggregate, less than one percent of P's common stock immediately after the exchange; and

c) The convertible preferred stock is widely held, or it is represented that there will not be any conversion of the stock pursuant to a plan which will result in both preferred stock and common stock being owned by the same exchanging shareholder.

Rev. Proc. 77-37 § 4, 1977-2 C.B. 568.

e) If the preferred stock has a below-market dividend rate, so that its fair market value is less than its redemption price, the holder may be forced to recognize dividend income ratably over time under principles similar to those used for OID purposes. Section 305(c).

i) This inclusion will be required only if the premium exceeds a "de minimis" amount determined under the principles of section 1273(a)(3). See Reg. § 1.305-5(b) (amended by T.D. 8643, Dec. 20, 1995).

ii) For this purpose, the "issue price" of preferred stock is equal to its fair market value at the time that it is issued. See Rev. Rul. 83-

119, 1983-2 C.B. 57; Rev. Rul. 81-190, 1981-2 C.B. 84; Rev. Rul. 76-107, 1976-1 C.B. 89; Rev. Rul. 75-468, 1975-2 C.B. 115; Rev. Rul. 75-179, 1975-1 C.B. 103. See also Prior Reg. § 1.305-5(d) (Ex. 7), before amendment by T.D. 8643.

a) This rule may be sensible in the case of preferred stock issued for cash, or in exchange for common stock in a reorganization. However, unfairness may result to the extent that this rule is applied in a recapitalization.

b) An exchange of preferred stock for preferred stock in a recapitalization, may result in a shareholder accruing "phantom" dividends merely because the fair market value of the stock has decreased due to a downturn in the economic condition of the issuer.

c) Commentators have suggested that no redemption premium should be created in a tax-free recapitalization where old preferred stock is exchanged for new preferred stock. New York State Bar Association Tax Section Corporations Committee, "Report on Regulations to be Issued Implementing the Changes

to Section 305(c) Made by the Revenue Reconciliation Act of 1990," 52 Tax Notes 1199, 1206 (Sep. 2, 1991); Glen A. Kohl, "Selected Issues Involving Preferred Stock, Equity Recapitalizations, and Section 305," 333 PLI Tax Law and Estate Planning Series 769, 824 (1992); James L. Dahlberg and Robert J. Mason, "Section 305(c) After the Budget Reconciliation Act of 1990," 333 PLI Tax Law and Estate Planning Series 859, 871-72 (1992).

d) Note, however, that in the case of OID debt instruments, "phantom OID" is created in a recapitalization; a result mandated by the 1990 repeal of section 1275(a)(4).

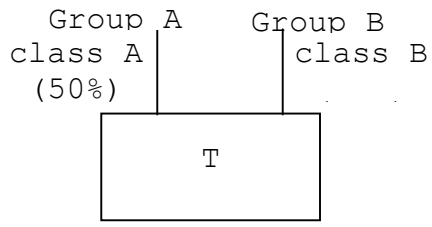
e) Regulations under section 1272 mitigate this result by creating "acquisition premium" which may offset OID inclusions where the holder's basis exceeds the instrument's issue price. Reg. § 1.1272-2.

f) The issuance of similar regulations under section 305(c) would also provide relief to taxpayers, and would not necessitate a change in the manner of computing of issue price.

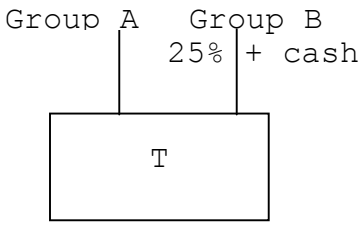
However, the most recent amendments to the section 305(c) regulations did not provide such relief.

2. Example 2 -- Redemption Versus Recapitalization

Before:



After:



a. Facts: T has two outstanding classes of stock, class A, owned entirely by Group A, and class B, owned entirely by Group B. The two classes are identical except that they vote separately as classes. It is decided that Group A should take over the dominant role in the management of T, therefore T is recapitalized so that there is a single class of stock owned 75 percent by Group A and 25 percent by Group B. In the transaction, the Group B shareholders receive cash equal to 25 percent of the value of T, to compensate them for surrendering a portion of their interest in T.

b. Issues:

(1) If the transaction is treated as a recapitalization, the Group B shareholders must recognize any gain inherent in their stock, up to the amount of cash received. Section 356(a)(1). Under Clark, dividend equivalence would be tested using the rules of section 302, but would affect

only the character and not the amount of the gain.

(2) If the transaction is instead viewed as a redemption of 50 percent of their stock by the Group B shareholders prior to the recapitalization, the result could be quite different.

a) If the redemption qualified for exchange treatment under section 302(b), the shareholders would be permitted to offset their basis in the shares surrendered against the cash received.

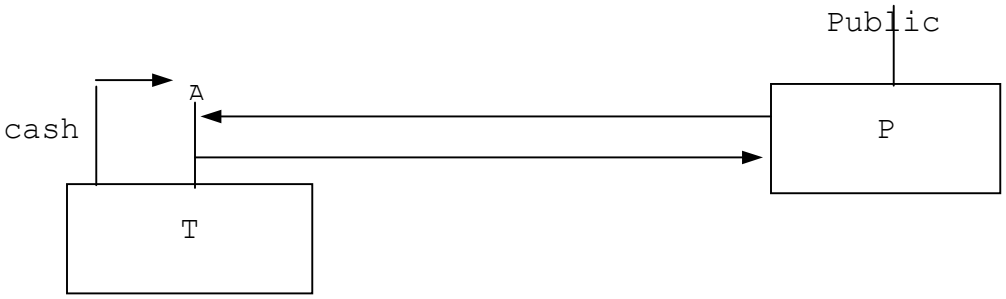
b) In contrast, if the redemption were treated as a dividend, the shareholders would be required to include income to the full extent of cash received (but possibly giving rise to a dividends received deduction in the case of a corporate shareholder), without respect to the amount of gain inherent in the shares surrendered.

(3) In Rev. Rul. 77-415, 1977-2 C.B. 311, the Service ruled that the receipt of securities in exchange for preferred stock constituted a recapitalization under section 368(a)(1)(E).

a) In that case, the surrendering shareholders received no stock in the transaction, and thus their treatment was governed by section 302, rather than by section 356 (see above).

b) So long as a shareholder receives both stock and boot in exchange for the stock he surrenders, it would appear under the reasoning of this ruling, that section 356 should govern rather than section 302.

3. Example 3 -- Pre-reorganization Dividend



a. Facts: A owns 100 percent of the stock of T. P, a publicly traded corporation, wants to acquire all of the stock of T for P stock in a "B" reorganization. Prior to the acquisition, T makes a cash distribution to A.

b. Issues:

(1) Is this a valid "B" reorganization?

a) In general, it is not permissible for there to be any "boot" in a "B" reorganization.

b) The Service has ruled on a number of occasions that the payment of a dividend out of the target corporation's own funds contemporaneously with a stock for stock exchange does not constitute boot, and that the exchange qualifies as a "B" reorganization.

i) In Rev. Rul. 68-435, 1968-2 C.B. 155, the Service approved the payment of a dividend by the target equal to the dividend shareholders would have received from acquiror, where the transaction was delayed because of problems at closing.

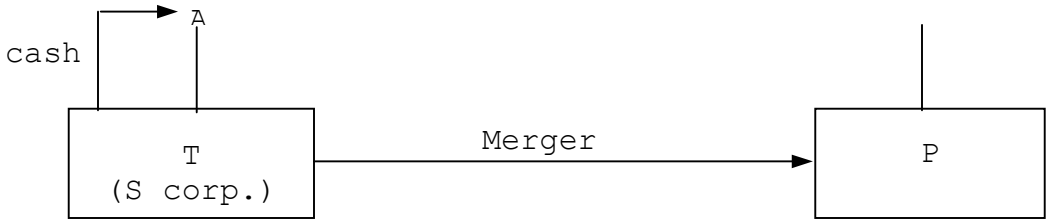
ii) In Rev. Rul. 69-443, 1969-2 C.B. 54, payment of a regular year-end dividend by the target after acquisition to its shareholders of record, where the announcement was made prior to the acquisition was held not to constitute boot.

iii) In Rev. Rul. 70-172, 1970-1 C.B. 77, a taxable distribution of unwanted assets from a target subsidiary to its parent prior to "B" reorganization did not disqualify the transaction.

(2) It is clear, however, that the distribution must be from the target corporation's own funds. If the target borrows money to make the distribution and the borrowing is later repaid with funds provided by the acquiring corporation, the distribution will be treated as boot. See Rev. Rul. 75-360, 1975-2 C.B. 110. See also FSA 19991199 (discussing several of the above-described rulings and noting that the target generally must pay the distribution out of its own funds).

(3) Note that, as discussed above in I. C. f., the new final COI regulations apply the section 356 "boot" rule in determining whether a distribution prior to a reorganization counts against the COI requirement.

c. Now suppose that T is an S corporation, that T is acquired in a merger, rather than a "B" reorganization, and that prior to the acquisition T distributes cash to A equal to T's "AAA" account.



(1) Note that if the distribution of cash is separated from the reorganization, A will receive the cash tax-free under section 1368(c). Instead of paying current tax, A will reduce basis in his T stock with the result that he receives P stock with a lower basis.

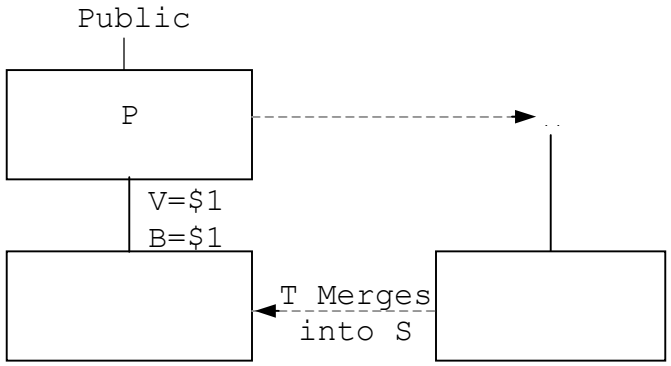
(2) In contrast, if the distribution is treated as boot in the merger, A will have to recognize any gain inherent in his T stock, and will take the P stock with a stepped-up basis.

(3) The same principles should apply in determining whether the distribution is boot or a part of the reorganization that apply for purposes of a "B" reorganization. However, in the case of a merger it is much more difficult to determine the source of funds for the distribution since, immediately following the transaction, the corporations cease to have separate identities.

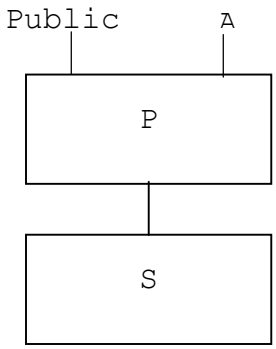
G. Basis Issues In Triangular Reorganizations

1. Example 1 -- Over The Top Model

Before:



After:



a. Facts: P, a public corporation, owns 100% of S. A, an individual owns 100% of T. P forms S with $1 of cash and T merges into S in exchange for P stock.

b. Issue: How is P's basis in the stock of S after the merger to be determined?

(1) While sections 368(a)(2)(D) and 368(a)(2)(E) permit S to acquire T using parent stock, the Code does not provide rules to determine P's basis in its S stock after the merger.

a) If P were viewed solely as having contributed P stock to S in the transaction, P would adjust its basis in S to reflect the basis of the contributed P stock. However, as P has no basis in its own newly-issued stock, P would not adjust its basis in the S stock.

b) Conversely, if P is viewed as having acquired T's assets in a state law merger and contributed the assets to S, P would have a carryover basis in the T assets under section 362(b) and take an equal substituted basis in the S stock deemed received in the dropdown of the T assets under section 358. See generally section 368(a)(2)(C) (permitting a post-reorganization dropdown of assets).

c. In 1995, the Service issued final regulations that determine P's basis in triangular reorganizations using the latter approach (the "over the top" model). See Reg. § 1.358-6.

(1) P's basis is determined as if (i) P acquired the T assets acquired by S (and assumed any liabilities assumed by S or to which the assets were subject) directly from T in a carry-over basis transaction and (ii) P transferred the assets to S in a transaction in which P's basis in the S stock was determined under section 358 (i.e., P takes a substituted basis). See Reg. § 1.358-6(c)(1). Accordingly, P's basis in S is adjusted as if P acquired the T assets with a basis equal to T's basis of $40 and contributed the assets to S. Therefore, P adjusts its basis in S from $1 to $41.

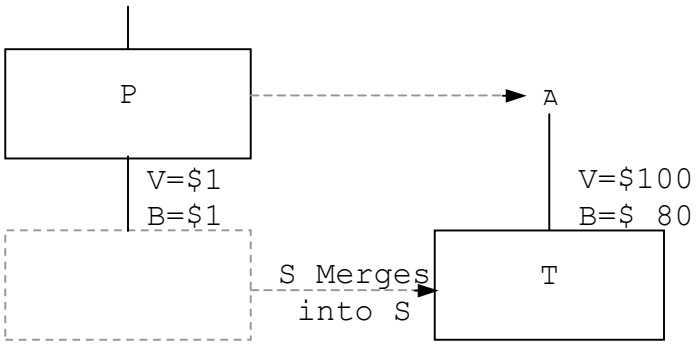
(2) The regulations treat P stock acquired by S pursuant to the plan of

reorganization as issued by P directly to A. Reg. § 1.358-6(b). However, this rule applies solely to qualifying reorganizations and does not resolve the "zero basis" problem that may arise if the intended reorganization fails to qualify for tax-free treatment.

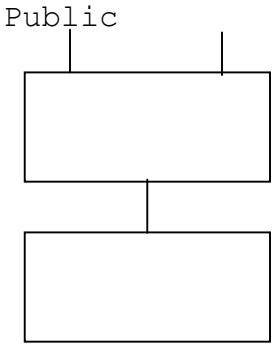
(3) In addition, the rule does not apply to P stock received by S other than pursuant to the plan of reorganization. Reg. § 1.1032-2(c). In other words, S may not use appreciated "old and cold" P stock it already owns in a triangular merger in an attempt to avoid recognizing the gain on such stock.

2. Example 2 -- Stock Basis in Overlapping 368(a)(2)(E) and B Reorganization

Before:



After:



a. Facts: A, an individual owns 100% of T. A's basis in T is $80. T's net basis in its

assets is $40. P seeks to acquire T. P forms a transitory subsidiary S with $1. S is merged into T and A exchanges all of his T stock for P stock.

b. Issues: How is P's basis in its T stock to be determined?

(1) The transaction qualifies under section 368(a)(2)(E) as a reverse triangular merger. Under the regulations issued in 1995, P's basis in T stock in a reverse triangular merger is adjusted as it would be if T had merged into S in a forward triangular merger. Reg. § 1.358-6(c)(2)(i)(A). Reg. § 1.358-6(c)(2)(A). Therefore, P is deemed to acquire T's assets in a merger and contribute the assets to the surviving subsidiary. Accordingly, P's basis in T would be $41.

a) Note, however, that if P acquired less than 100% of T, P would only be permitted to increase its basis in T stock by an allocable portion of T's net asset basis. For example, if A retained 80% of his T stock, P's basis in T would be increased by only $32 (80% x $40).

b) In the case of a reverse triangular merger, P is not treated as having directly issued stock to A. See Reg. § 1.1032-2(c). Instead, nonrecognition on the part of S with respect to the use of P stock in the merger is governed by section 361. Id.

i) This exclusion is presumably premised on the view that a transitory subsidiary used in the reorganization may be ignored and therefore, that P stock must be treated as issued directly to A in any event. However, it is also

possible for a transaction to qualify as an "(a)(2)(E)" reorganization if the subsidiary of the acquiring corporation is "old and cold" and operates a business. In such situations, the "zero basis" issue arguably remains unresolved as the merging subsidiary is not transitory. Nevertheless, under section 361(a), S should not recognize gain.

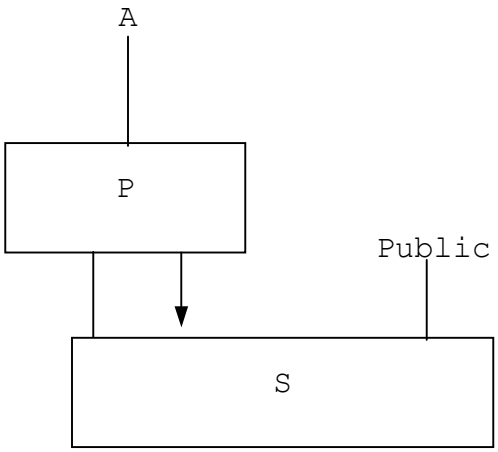
(2) The transaction also qualifies as a "B" reorganization, because S may be disregarded as a transitory entity and P controls T immediately after the acquisition of T for P stock. See Rev. Rul. 67-448, 1967-2 C.B. 144. In a "B" reorganization, P would take A's basis in the T stock rather than T's net asset basis. In the case of such an overlap, the new regulations permit P to elect whichever treatment results in a higher basis. See Reg. § 1.358-6(c)(2)(ii). Presumably, P would elect to increase its $1 basis in S by A's basis of $80 rather than T's net asset basis of $40.

(3) The Preamble to the final regulations states that the "over the top" model applies only to determine basis. Therefore, the model may not apply for purposes of determining P's holding period in T stock. Commentators suggested that this could lead to anomalous results where a reverse triangular merger also qualifies as a "B" reorganization, i.e., if P's basis is determined by T's net asset basis but P's holding period is determined by that of T's shareholders. See N.Y.S.B.A., "Report on Proposed Regulations under sections 358, 1032 and 1502 Concerning Stock Basis

Adjustments in Triangular Reorganizations," reprinted in Tax Notes Today (Sept. 18, 1995). However, this should be a concern only if P intends to sell T stock within a year of the reorganization.

H. Downstream Mergers and Group Inversions After General Utilities

1. Example 1 -- Rev. Rul. 70-223



a. Facts: P, a corporation wholly-owned by A, owns 40 percent of the stock of S. P has no other assets. The other 60 percent of S is owned by the public and traded on a national exchange. In order for A to own stock in a publicly traded corporation, P is merged downstream into S.

b. Issues:

(1) So long as the transaction is structured as a merger under state law, and there is no plan or intent on the part of the A to sell his S stock, the transaction should satisfy the statutory and regulatory requirements for an "A" reorganization. See Rev. Rul. 70-223, 1970-1 C.B. 79.

(2) This transaction is economically equivalent to a liquidation of P.

a) If P were liquidated, however, gain would be recognized by both P and A.

b) However, the Service has ruled that taxpayers may choose the form of their transaction in this situation, and that the tax consequences will be governed by which form is chosen. Rev. Rul. 70-223, supra; TAM 8936003.

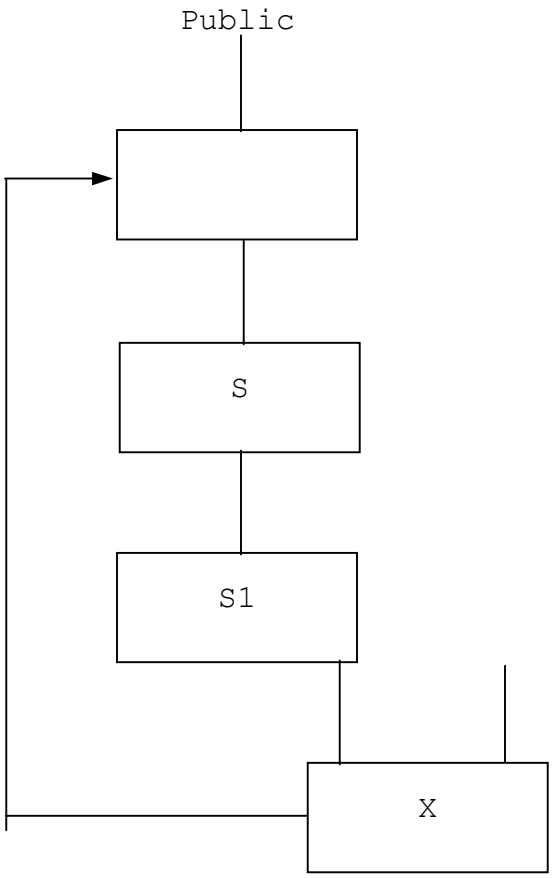
c) In PLR 9104009 the Service reached this same conclusion, but indicated that the issue was being studied in connection with regulations under section 337(d), and that a different result might be reached in the future in order to avoid the circumvention of General Utilities repeal. However, the Service has announced that this study has been abandoned. See Notice 96-6, 1996-1 C.B. 358.

(3) Notice that the S stock owned by P is cancelled in the downstream merger. Should this result in the recognition of gain or loss to P?

a) In general, a reorganization results in the deferral of gain or loss by giving the acquiring corporation a carry-over basis in the assets of the target corporation.

b) Here, however, the S stock is cancelled, so that gain or loss must be recognized currently if it is to be recognized at all.

2. Example 2 -- GCM 39608 Overruled by § 1.1502-13(f)



a. Facts: P, a publicly traded corporation, owns all of the stock of S, which in turn owns all of the stock of S1. S1 owns 80 percent of the stock of X; the other 20 percent is owned by key employees of X. P, S, S1, and X file a consolidated return. In order to give the employees an interest in a publicly traded corporation, X is merged into P, with P stock being issued in exchange for X stock. S1 distributes the P stock it receives in the merger to S, which in turns distributes it to P, where it is held as treasury stock.

b. Issues:

(1) The merger of X into P is a valid "A" reorganization and tax-free.

(2) The distribution of P stock from S1 to S gives rise to gain under section 311(b) which is deferred. See Reg. § 1.1502-13(f)(2)(ii)-(iii).

a) In general, deferred gain is triggered and included in income at the time that the property giving rise to the gain is disposed of outside of the consolidated group. See Reg. § 1.1502-13(c) and (d).

b) In the case of stock, deferred gain is also triggered if the stock is reacquired by the issuing member, whether or not the stock is held as treasury stock after the redemption. Reg. § 1.1502-13(f)(4).

(3) Under prior law, the Service analyzed this transaction and concluded that the deferred gain with respect to the P stock was not triggered upon the distribution of such stock from S to P. See GCM 39608.

a) The stock was not disposed of outside of the group.

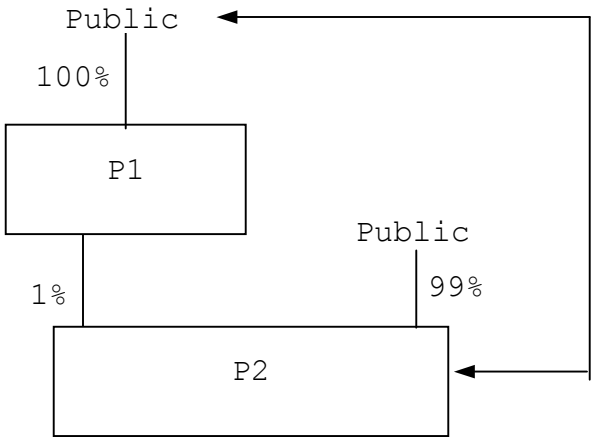
b) Under prior law, deferred gain was triggered if member stock was redeemed. Although the stock was transferred to P, its issuer, the transfer was not a redemption, and hence Prior Reg. § 1.1502-13(f)(1)(vi) does not apply.

(4) GCM 39608 further concluded that the deferred gain would not be triggered so long as the shares received were held as treasury shares and not resold. Thus, this result would not change if

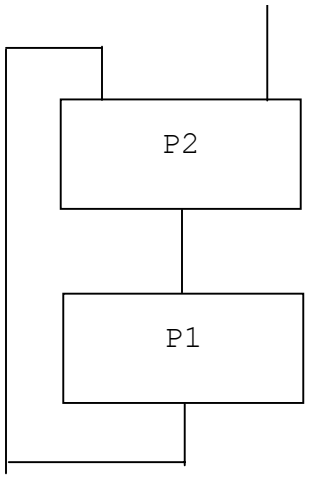
newly issued shares of P stock were sold.

c. The same issue may arise in an acquisition involving corporations which initially were unrelated, other than a portfolio investment by the target in the acquiror.

Before:



After:



P1 and P2 are publicly traded corporations. P1 owns 1 percent of the stock of P2. The P2 stock owned by P1 is substantially appreciated. For valid business purposes unrelated to P1's ownership of P2 stock, P2 wishes to acquire P1's business.

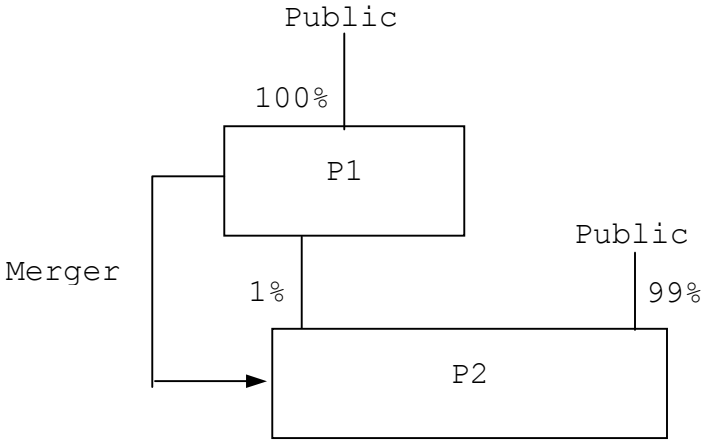
(1) Suppose first that P2 purchases all of P1's stock for cash. An attempt to eliminate P1's minority interest in P2 by distributing the P2 stock as a dividend would create deferred section 311(b) gain that is immediately triggered under Reg. § 1.1502-13(f)(4).

(2) Suppose, instead, that P1 were liquidated into P2.

a) No gain or loss should be recognized pursuant to sections 332 and 337.

b) Since no gain is recognized under the Code, arguably there is no need for deferral under the consolidated return regulations. As a result neither P1 nor P2 should be required to recognize any gain as a result of the transaction.

(3) Finally, suppose that P1 were merged directly into P2.



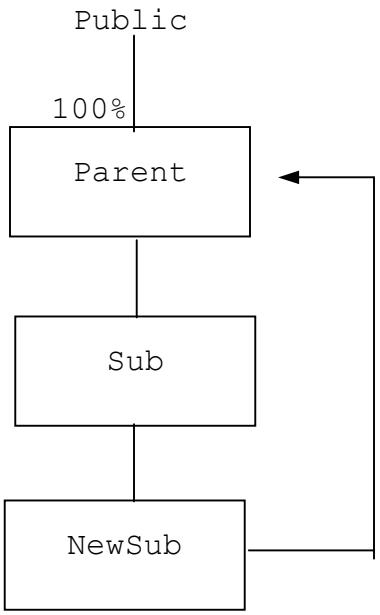
As in the case of the liquidation, no gain or loss should be recognized on this transaction, and nothing in the consolidated return regulations should change this result.

(4) As these examples illustrate, revocation of GCM 39608 by Reg.

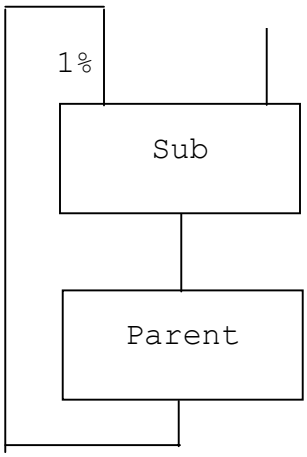
§ 1.1502-13(f)(4) may create a trap for the unwary in situations that involve no tax abuse, and where gain should not be required to be recognized.

3. Example 3 -- Inversion Transaction

Before:



After:



a. Facts: Parent, a publicly traded corporation, owns all of the stock of Sub. Parent has contingent liabilities which may exceed the value of all of its assets, including the stock of Sub. The management

of Parent would therefore prefer that Parent's business be conducted as a subsidiary of Sub, and that Sub's business be conducted as the Parent of the consolidated group. Accordingly, Sub forms NewSub which is merged into Parent in a reverse subsidiary merger under section 368(a)(2)(E), with the shareholders of Parent receiving stock of Sub. After the transaction, 99 percent of all Sub stock is owned by the former shareholders of Parent and 1 percent is owned by Parent.

b. Issues:

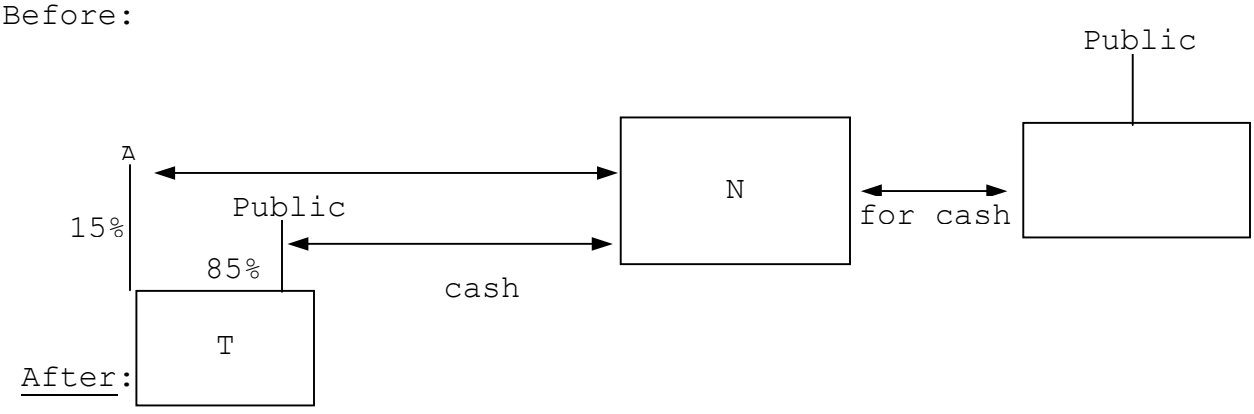
(1) Is this a valid reorganization?

(2) If the Sub stock held by former Parent shareholders after the reorganization has a value in excess of the Parent stock they surrendered in the transaction (due to insulating Sub from the liabilities of Parent), should the transaction be treated as a taxable distribution from Parent to its shareholders?

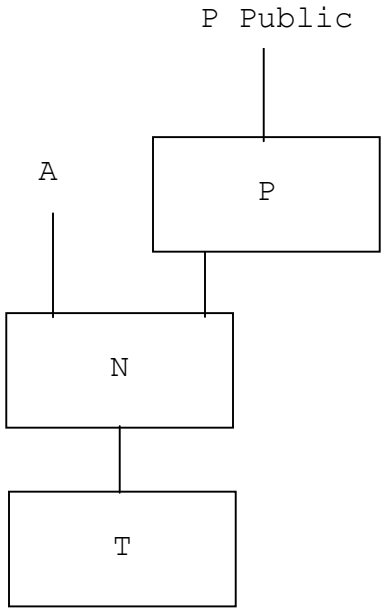
I. Section 351 as an Alternative to Section 368

1. Example 1 -- *National Starch* Variations

Before:



After:



a. Facts: The stock of T is owned 85 percent by the public and 15 percent by a single individual, A. P wants to acquire the stock of T for cash, but A is unwilling to recognize gain. Accordingly, P forms Newco ("N") with a contribution of cash in exchange for all of Newco's common stock. As part of the same transaction, A contributes his T stock to Newco for Newco preferred stock. Newco then purchases the remaining T stock from the public using the cash contributed by P.

b. Issues:

(1) The formation of Newco is a section 351 transaction because P and A, the transferors to Newco, are in control of Newco immediately after the transaction.

a) Rev. Rul. 84-71, 1984-1 C.B. 106 holds that a transfer will qualify as a valid section 351 transaction even if part of a "larger acquisitive transaction" which fails to qualify as a reorganization.

b) In earlier rulings, the Service had argued that where a transfer was part of such an acquisitive transaction, continuity of interest was required to qualify under section 351, just as it is required to qualify under section 368. Rev. Rul. 80-284, 1980-2 C.B. 117, and Rev. Rul. 80-285, 1980-2 C.B. 119 (revoked by Rev. Rul. 84-71).

c) This transaction is similar to the acquisition of National Starch by Unilever and the acquisition of MCA by Matsushita.

(2) Under TRA 1997, "nonqualified preferred stock" will be treated as boot for purposes of sections 351, 354, 355, 356, and 368. See Part II.F. for the definition of nonqualified preferred stock.

a) The conference report to TRA 1997 included an example similar to National Starch.

b) In the example, individual A contributes appreciated property to Xcorp for all the common stock (representing 90 percent of the

value and all the voting power) of Xcorp, and individual B contributes cash for nonqualified preferred stock representing 10 percent of the value of the Xcorp stock.

c) The example concludes that, under the new nonqualified preferred stock rules, B has received boot. However, the preferred stock is still treated as stock for purposes of section 351(a) and 368(c) (unless and until regulations are issued). See 1997 Conference Report, at 545. Thus, the transaction qualifies for non-recognition treatment under section 351. Id.

d) The conference report further states that, if B receives stock in addition to nonqualified preferred stock, B is required to recognize gain only to the extent of the fair market value of the nonqualified preferred stock B receives.

e) Thus, to avoid the new nonqualified preferred stock rules, A in Example 1, above, must generally receive stock that shares in the growth of the corporation. If this is the case, such stock will be treated as stock, as opposed to boot, for purposes of section 351.

i) This stock should also constitute stock under section 1504. Accordingly, A can receive only 20% of the N stock or P and N will not be able to consolidate.

ii) The analysis in this Example 1 assumes that A receives

Newco preferred stock that qualifies as stock for purposes of section 351.

(3) A may be dissatisfied with receiving stock in N instead of publicly traded stock of P.

a) This problem could be solved by waiting for the transaction to become "old and cold" and merging N upstream into P.

b) However, as a minority shareholder A cannot force this merger to occur, and may be unwilling to agree to a transaction which requires the future consent of P before he can acquire publicly traded securities.

(4) In order to address this problem, A could be issued N stock which is convertible into P stock at A's election.

a) Rev. Rul. 69-265, 1969-1 C.B. 109, provides that the treatment of such convertible preferred stock will depend on whether A may convert by presenting the preferred stock directly to P, or whether A must obtain the P stock from N.

b) If A may obtain the P stock directly from P, then that right will be treated as boot received in the original transaction.

c) If, however, A must obtain the P stock from N, the right will be treated as a redemption right inherent in the preferred stock which will not constitute boot in the original transaction.

i) The subsequent exercise of this right, however, would result in a taxable transaction. If P were to contribute P stock to N prior to the exchange, not only would A recognize any gain or loss on the transaction, but N could be forced to recognize gain to the full extent of the value of the P stock.

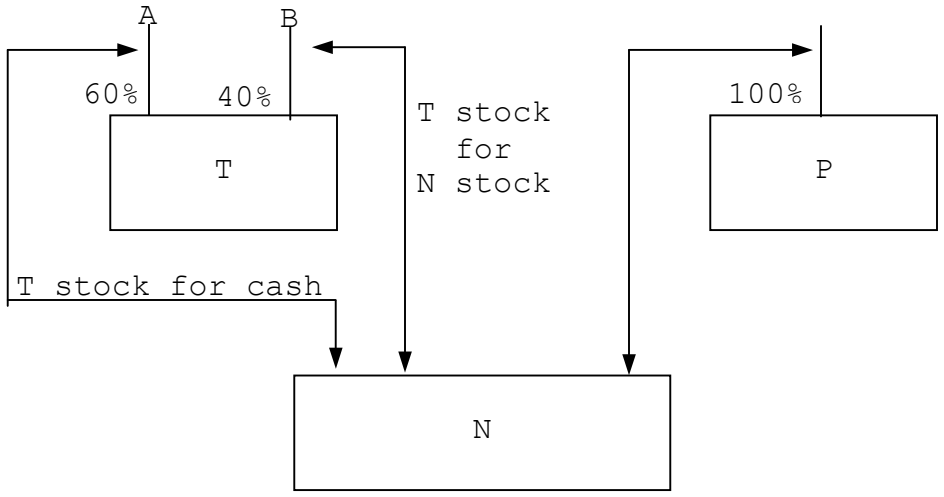
ii) If, instead, A exchanged his N stock for P voting stock in a separate transaction, the exchange would qualify as a "B" reorganization.

iii) Query, however, whether such an exchange would ever be viewed as a truly separate transaction where A has the right to force an exchange by N. Presumably, a principal purpose behind negotiating a separate transaction with P would be to prevent adverse tax consequences, and as such the transaction might well be recast as if A simply exercised his right to acquire P stock from N.

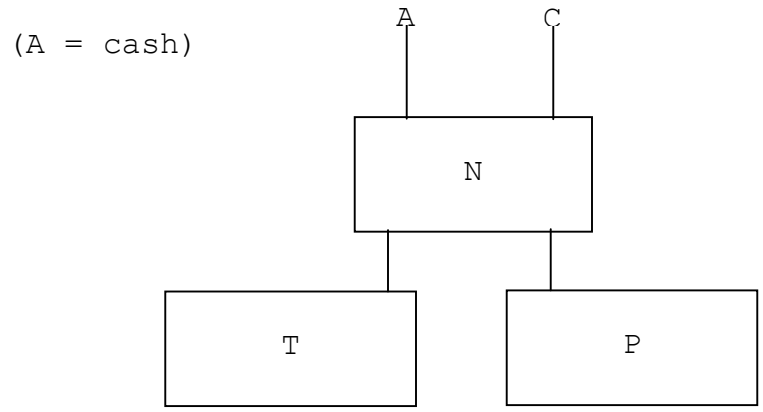
d) Presumably, a right for A to "put" his N stock to P would also be treated as boot under Rev. Rul. 69-265.

2. Example 2 -- Double-winged Section 351 Transaction

Before:



After:



a. Facts: A owns 60 percent of T and B owns 40 percent of T. C owns 100 percent of P. B and C wish to combine the businesses of P and T, and A wants to be cashed out. T is subject to liabilities that could place the P business at risk, so an "A" reorganization is not possible. T recently disposed of a line of business through a tax-free spin-off, thus a subsidiary merger under 368(a)(2)(D) or 368(a)(2)(E) is not possible (because the "substantially all" requirement would not be satisfied). The presence of 60

percent boot makes a "B", "C", or reverse triangular merger impossible.

Accordingly, the following transaction is consummated. C contributes his P stock and cash to N in exchange for N stock, B contributes her T stock to N in exchange for N stock, and A transfers his T stock to N for cash.

b. Issues:

(1) This transaction constitutes a "double-winged" section 351 transaction, in that the shareholders of both operating companies contribute their stock to the newly-formed holding company.

(2) The control requirement of section 351 is met in any double-winged acquisition, because transferors will always be in control of the newly-formed holding company regardless of the relative sizes of the companies and regardless of how much boot is received in the transaction.

(3) If P or T is a public corporation, the exchange requirement of section 351 may also be satisfied by a reverse subsidiary merger that does not qualify under section 368(a)(2)(E) (see, e.g., PLR 9031009, PLR 8912024), or by a statutory share exchange under state law (see PLR 9031009, PLR 8321037).

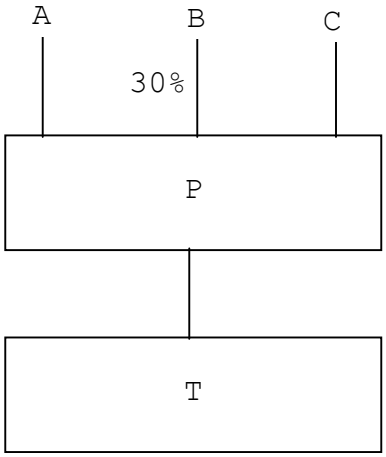
(4) A reverse subsidiary merger that does qualify under section 368(a)(2)(E) will not be governed by section 351, but will nonetheless be treated as a transfer in exchange for stock in determining if the control requirement of section 351 is met in a double-winged acquisition (see PLR 9143025); But see 200125007 (analyzing reorganization as either a reverse subsidiary merger under section 368(a)(2)(E) or a double-winged stock

and asset acquisition under section 351 and reaching the same conclusions under either construct as to section 384 and section 482 issues).

3. Example 3 -- Section 304 Versus 356 Treatment

Before:

After:



a. Facts: T is owned 40 percent by A and 60 percent by B. P is owned 40 percent by A and 60 percent by C. P proposes to acquire T in a tax-free reorganization using a mix of 80 percent stock and 20 percent cash. The stock to be issued will represent 50 percent of the outstanding stock of P.

b. Issues:

(1) Suppose first that the transaction is structured as a reverse triangular merger under section 368(a)(2)(E).

a) A's and B's receipt of cash must be analyzed under section

356(a)(2) in order to determine if it constitutes a dividend or capital gain.

b) Under Clark, it is clear that A will be treated as receiving a dividend. B may qualify for exchange treatment.

i) Assume that P was worth $100x before the transaction and had outstanding 100 shares.

a) A actually received 40 shares of P stock (in addition to the 40 shares he already owned), and $10x of cash.

b) B actually received 60 shares of P stock, and $15x of cash.

c) A total of 200 shares of P stock were outstanding after the transaction.

ii) If A and B had received solely stock, A would have received 50 shares and B would have received 75 shares. A total of 225 shares of P would have been outstanding after the transaction.

a) Thus the hypothetical redemption under Clark would have taken A from 40 percent ownership (90 225 = 40%) to 40 percent (80 200 = 40%).

b) B would have gone from 33 percent (75 225 = 33%) to 30 percent (60 200 = 30%).

(2) Now suppose that A and B simply contribute their T stock to P in exchange for the stock and cash.

a) The exchange of stock for stock and cash does not constitute a reorganization under section 368, but it is a valid section 351 transaction.

b) Section 356 does not apply to section 351 transactions which are not also reorganizations.

c) Rather, the receipt of property in a section 351 transaction is treated as a potential dividend only if section 304 applies.

i) Section 304 applies only if the transferor of stock of the issuing corporation (here T) owns at least 50 percent (by vote or value) of both the issuing corporation and the acquiring corporation (here P).

ii) Since A owns only 40 percent of T and P, section 304 does not apply, and A is not treated as receiving a dividend. Nor does section 304 apply to B, since B had no interest in P prior to the transaction. Accordingly, A and B recognize gain to the extent of boot received under section 351.

iii) If, however, A were a 60 percent shareholder in each corporation section 304 would apply, and A would be treated as receiving the cash in redemption of his T stock.

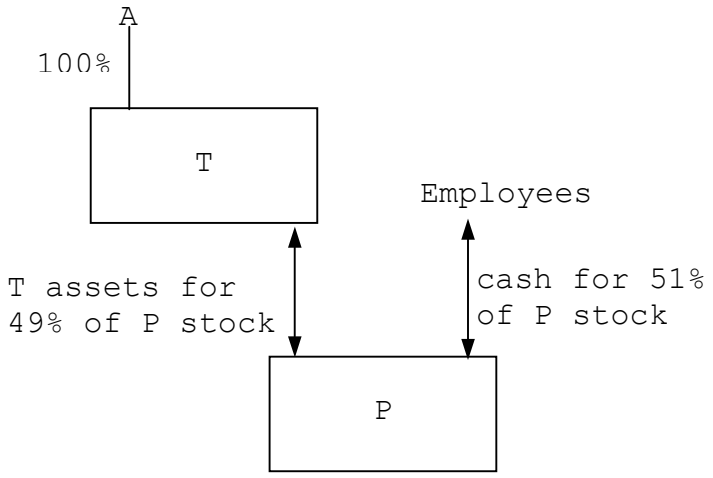
a) A would have held a 60 percent direct interest in T immediately before the transaction.

b) A would continue to hold a 60 percent interest in T, indirectly through being a 60 percent shareholder in P, immediately after the transaction.

c) Accordingly, the cash received by A would be treated as a dividend to the full extent of P's and T's earnings and profits. Section 304(b)(2).

d) Whether structured as a reverse triangular merger or as a section 351 transaction, the parties will be forced to recognize gain up to the full amount of boot received. No basis recovery is allowed either under section 351 or section 356.

4. Example 4 -- Preserving NOLs



a. Facts: T, a corporation wholly-owned by A, has significant NOL carryforwards. A is

considering causing T to abandon its current business and to begin a new business which A expects will generate significant income which will be offset by T's NOLs. The employees of T do not want it to abandon its current business and are willing to contribute cash in exchange for a 51 percent interest in the business. A is willing to grant the employees this interest in the business, but does not want them to share in T's NOLs or for those NOLs to be limited under section 382.

Accordingly, it is agreed that the employees of T will contribute cash to P, a newly-formed corporation, in exchange for 51 percent of the P stock. T will contribute the assets used in its business to P in exchange for 49 percent of the T stock.

b. Issues:

(1) If the transaction were to qualify as a "C" reorganization, P would succeed to T's NOLs, and the NOLs would be limited under section 382.

(2) However, as a result of the failure of T to liquidate, distributing the P stock to A, the transaction does not qualify as a "C" reorganization. Section 368(a)(2)(G).

a) Notice that Section 368(a)(2)(G)(ii) grants the Service discretion to waive the requirement of a liquidation in a "C" reorganization.

i) The legislative history of the 1984 Act, which added section 368(a)(2)(G), indicates that this discretion is intended to grant relief to taxpayers where liquidation would be a "substantial hardship." H.R.

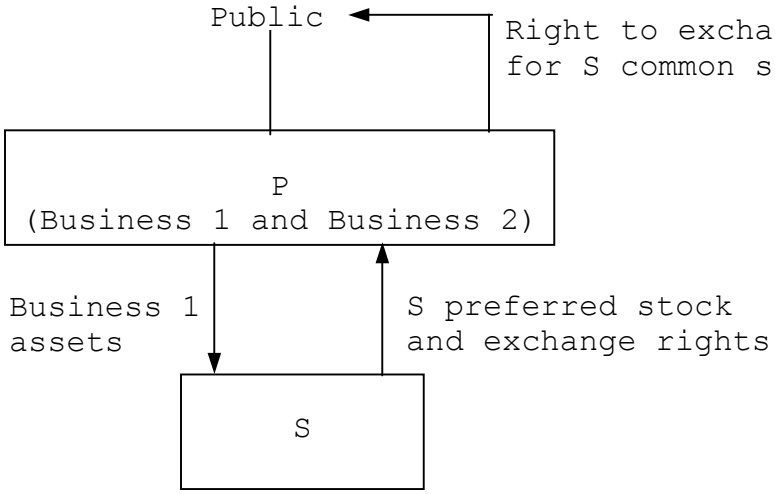
Conf. Rep. No. 861, 98th Cong., 2d Sess. 846 (1984).

ii) Rev. Proc. 89-50, 1989-2 C.B. 631, provides that the Service will rule that a reorganization qualifies as a "C" reorganization notwithstanding that there is not a liquidation of the target corporation if it is represented (1) that the target will retain only its corporate charter and those assets necessary to satisfy state law minimum capital requirements, and (2) that as soon as practicable, and in no event later than 12 months from the date of the acquisition, the target corporation will be sold to an unrelated purchaser or dissolved under state law.

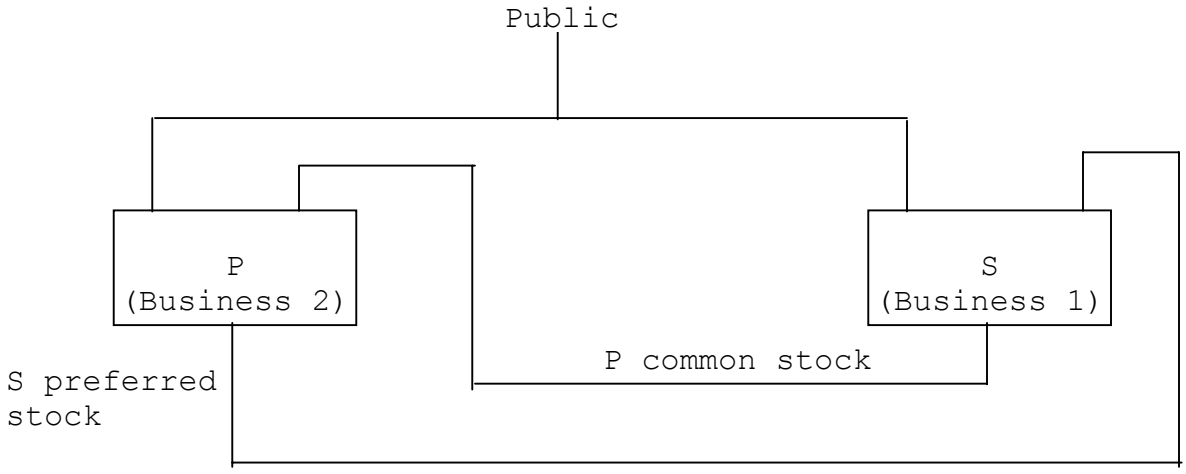
b) Query whether the Service can also use its discretion under section 368(a)(2)(G)(ii) to create a "C" reorganization where the taxpayer intended for the transaction not to qualify.

5. Example 5 -- Synthetic Spin-off

Before:



After:



a. Facts: P, a publicly traded corporation, conducts two businesses. P wishes to separate the two businesses into separate publicly-traded corporations. Business 1, however, has been conducted for less than five years. P forms a new controlled corporation, S with a contribution of its Business 1 assets. In return, S issues preferred stock and rights to exchange P common stock for S common stock of equal value. P retains the preferred stock and distributes the exchange rights to its shareholders, some or all of whom exercise

the rights and exchange a portion of their P stock for S stock.

b. Issues:

(1) If the form of the transaction is respected, only minimal tax will result to P and its shareholders.

a) The receipt of the exchange rights by P upon the formation of S should be treated either as a tax-free stock dividend under section 305(a) (by virtue of section 305(d) which includes rights to acquire stock as "stock" for purposes of section 305) or as the receipt of boot under section 351(b).

i) If the receipt of the exchange rights is treated as a section 305 distribution, P will recognize gain on the distribution of the exchange rights to its shareholders under section 311(b) to the extent that the fair market value exceeds the basis.

ii) If the receipt of the exchange rights is treated as the receipt of boot under section 351(b), there will be no additional gain to P upon the distribution to its shareholders.

iii) The P shareholders receive a dividend equal to the fair market value of the exchange rights (assuming that P has earnings and profits of that amount).

iv) In either case, the gain recognized by P and its shareholders should be

negligible, because the exchange rights distributed to the shareholders provided only the right to exchange stock of P for stock of S with an equal value. Accordingly, the fair market value of the rights should be negligible.

b) With respect to the exchange of P stock for S stock pursuant to the exchange rights, the shareholders would argue that it should properly be treated as a tax-free section 351 transaction, because it is part of the overall plan in which P transfers assets to S.

(2) In 1991, TCI formed Liberty Media and distributed exchange rights to its shareholders in much the manner described above. It is understood that counsel for TCI opined that the exchange by the TCI shareholders of their TCI stock for Liberty Mutual stock would qualify under section 351.

(3) The transaction is not, however, without risk.

a) The Service could argue that in substance P actually distributed stock of S to its shareholders. This deemed distribution would fail to qualify under section 355 with the result that (1) P would be taxed on any gain inherent in the S stock distributed to its shareholders, and (2) the receipt of the S stock would be a dividend to the shareholders to the full extent of the value of the S stock (assuming that P had earnings and profits of that amount).

b) Even if the form of the transaction were respected, the

Service could argue that P's contribution of its assets to S and the P shareholders' contribution of P stock should not be viewed as part of a single section 351 transaction. Under this theory, tax would be imposed upon the shareholders at the time of the exchange of stock.

(4) Following the transaction, the shareholders' interests in P and S are effectively separated (although the ownership of S stock by P and P stock by S results in some continued linkage between the companies).

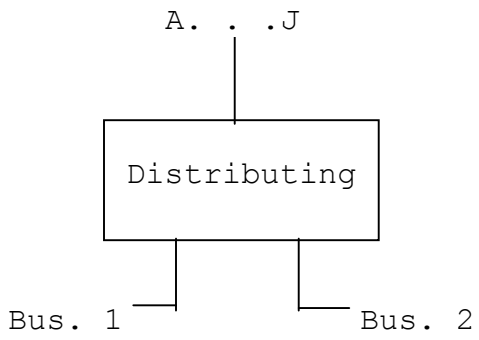
a) This gives the shareholders the ability to trade the stocks separately, taking into account the performance of the separate companies, much as would occur following a tax-free separation.

b) Unlike a "D" reorganization, however, the circular stock ownership between P and S results in duplication of built-in gain rather than an elimination of built-in gain.

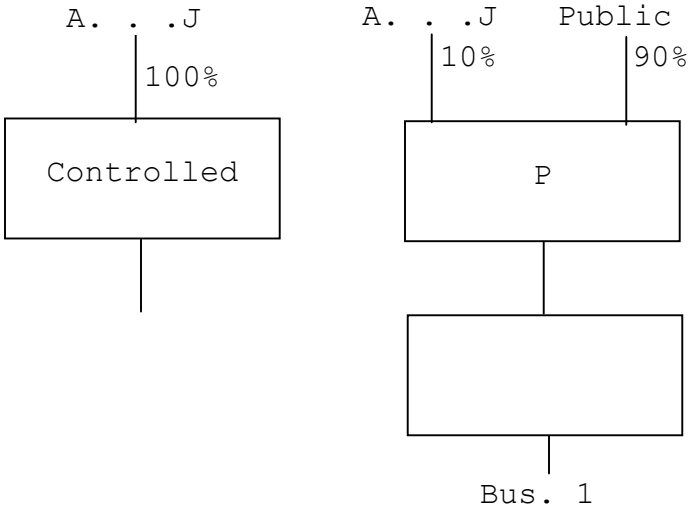
J. Issues Specific to "D" Reorganizations

1. Example 1 -- Morris Trust Variations (prior to legislative change in Taxpayer Relief Act of 1997)

Before:



After:



a. Facts: Ten individuals own all of the stock of Distributing. Distributing conducts two qualifying five-year businesses, Business 1 and Business 2. P, a public corporation, wants to acquire Business 1, but not Business 2. P is willing to issue 10 percent of its outstanding stock in exchange for Business 1. Distributing's shareholders are willing to dispose of Business 1 for P stock.

The parties agree on the following transaction: (i) Distributing will contribute Business 2 a newly-formed subsidiary, Controlled; (ii) Distributing will distribute the stock of Controlled to its shareholders pro rata; (iii) the shareholders of Distributing will transfer their Distributing stock to P in exchange for P voting stock.

b. Issues:

(1) The distribution of unwanted assets to facilitate the merger of the distributing corporation constitutes a valid business purpose for a spin-off. Mary Archer W. Morris Trust, 42 T.C. 779 (1964), aff'd 367 F.2d 794 (4th Cir. 1966), acq. Rev. Rul. 68-603, 1968-2 C.B. 148. But see TRA 1997, discussed in Example 2, infra.

(2) Continuity of interest will be satisfied even though the Distributing shareholders will own less than a 50 percent interest in the assets of Distributing. Id.

(3) Notice that the subsequent acquisition of Distributing must be of a form that does not have a "substantially all" requirement. Accordingly, a "C" reorganization, a triangular merger under section 368(a)(2)(D), or a reverse triangular merger under section 368(a)(2)(E) will not be available.

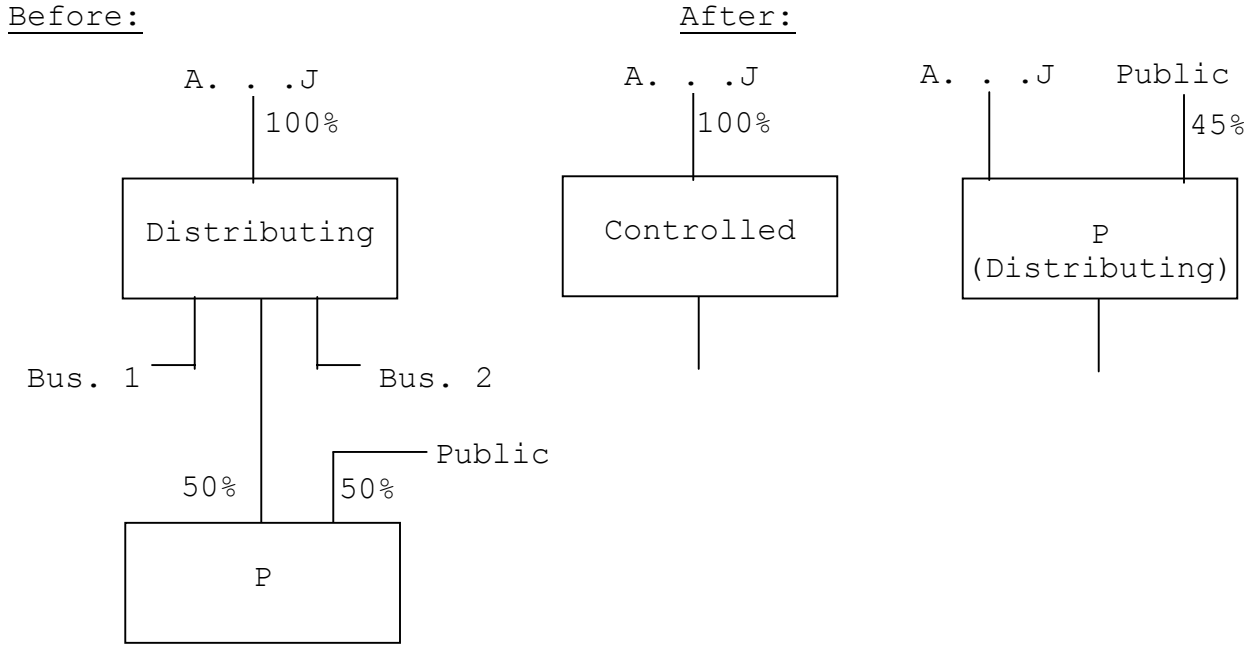
(4) If Controlled were a pre-existing subsidiary which already conducts Business 1 and after the spin-off, the shareholders exchange their Controlled stock for P stock, it is unclear whether the business purpose requirement would be satisfied. Unless P were unwilling for Distributing to be a 10 percent shareholder, the same objective could be achieved without the distribution of Controlled stock, simply by having Distributing exchange the Controlled stock for P stock.

(5) Consider the following variation of a Morris Trust transaction.

a) In addition to conducting two qualifying five year businesses, Distributing owns 50 percent of P. It is decided that Distributing

should merge into P, but that first Business 2 should be distributed to the distributing shareholders.

b) This structure was used in the merger of Affiliated Publications into McCaw Cellular, following the spin-off of Boston Globe.



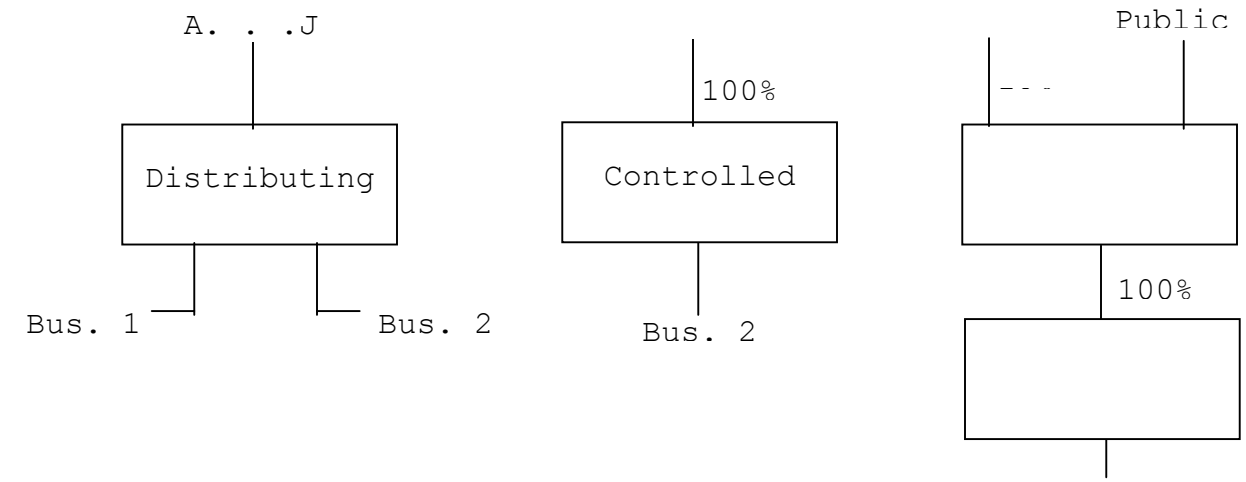
(6) If the business retained by Distributing is small compared to the business distributed to the shareholders and the value of the P stock received, this transaction has much the same effect as a distribution of P stock to the shareholders of Distributing.

i) By structuring the transaction as a merger, P stock may be disposed of without recognizing any corporate level tax.

ii) The shareholders, upon an eventual disposition of P

stock will also be entitled to basis recovery, where a sale by Distributing and distribution of the proceeds would have resulted in dividend income to the extent of Distributing's earnings and profits.

2. Example 2 -- Morris Trust Legislation: TRA 1997



a. Facts: Ten individuals (A . . . J) own all of the stock of Distributing. Distributing conducts two qualifying five-year businesses, Business 1 and Business 2. P, a public corporation, wants to acquire Business 1, but not Business 2. P is willing to issue 10 percent of its outstanding stock in exchange for Business 1. Distributing's shareholders are willing to dispose of Business 1 for P stock.

The parties agree on the following transaction: (i) Distributing will contribute Business 2 to a newly formed subsidiary, Controlled; (ii) Distributing will distribute the stock of Controlled to its shareholders pro rata; (iii) Distributing will merge into P and the Distributing shareholders will transfer

their Distributing stock to P in exchange for P voting stock.

b. Issues:

(1) Under Example 1 above, this transaction would be tax-free to C, D, and A...J, due to the Tax Court's holding in Morris Trust.

(2) However, TRA 1997, signed into law on August 5, 1997, effectively eliminated all Morris Trust transactions where a person acquires stock representing at least 50 percent of the value of C or D.

(3) Under the Act, if there is a section 355 distribution which is part of a plan pursuant to which a person acquires stock representing at least a 50 percent interest in the distributing corporation or controlled corporation, the distributing corporation would recognize gain. There is no gain at the shareholder level. The Act creates a rebuttable presumption that any acquisition occurring two years before or after a section 355 distribution is part of a plan including such distribution.

a) Gain is recognized in the amount that the distributing corporation would have recognized had it sold its controlled corporation stock for its fair market value on the date of the distribution.

b) Any gain recognized is treated as long-term capital gain.

c) In determining whether a person holds stock or securities in a corporation, the section 318(a)(2) attribution rules generally apply.

(4) On January 2, 2001, the Service issued new proposed regulations under section 355(e) which provide guidance as to what constitutes a plan or series of related transactions. Prop. Reg. § 1.355-7, REG-107566-00, 66 F. R. 66-76. With the issuance of the new proposed regulations, the Service withdrew the proposed regulations that it had issued on August 19, 1999. See Former Prop. Treas. Reg. § 1.355-7, 1999-36 I.R.B. 392. The Service recently promulgated the new proposed regulations as temporary regulations in T.D. 8960, 2001 TNT 150-6, effective August 3, 2001.

a) The temporary regulations are identical to the current proposed regulations, except that the temporary regulations reserve section 1.355-7(e)(6) (suspending the running of any time period prescribed in the regulations during which there is a substantial diminution of risk of loss under the principles of section 355(d)(6)(B)) and Example 7 (concluding that multiple acquisitions of target companies using Distributing stock were part of a plan, regardless of whether targets were identified at the time of the spin-off, where purpose for the spin-off was to make such acquisitions).

b) The temporary regulations were issued in response to numerous comments that immediate guidance was needed.

c) The temporary regulations, like the prior proposed regulations, generally treat the test of whether a plan exists as a subjective one that ultimately depends on the intent and

expectations of the relevant parties. However, in adopting the new proposed regulations, the Service rejected the overly broad approach of the original proposed regulations.

i) The preamble to the original proposed regulations noted that Congress intended the phrase "plan (or series of related transactions)" to be interpreted broadly.

ii) The Service pointed to two specific indications of this intent. First, in contrast to section 355(d), which utilizes the concept of "a person" and applies certain aggregation rules to treat related persons and persons acting in concert as one person, section 355(e) adopted a more expansive approach by referring simply to "one or more persons."

iii) Second, the Conference Report provides that public offerings of a sufficient size could trigger section 355(e).

iv) This suggests that there does not need to be an identified acquirer on the date of the distribution and that the intent of the acquirer is not necessarily relevant in determining whether there is a plan.

v) The proposed regulations relied on a variety of factors to determine whether a plan exists, including the timing of the transactions,

the business purpose for the distribution, the likelihood of an acquisition, the intent of the parties, the existence of agreements, understandings, arrangements, or substantial negotiations, and the causal connection between the distribution and the acquisition.

vi) The 2001 proposed (and new temporary) regulations adopt a facts-and-circumstances approach, which is consistent with the statute. The 2001 proposed regulations contain six safe harbors that, when applicable, obviate the need to perform the facts-and-circumstances analysis. If the safe harbors are not satisfied, the 2001 proposed regulations contained a list of nonexclusive factors to consider in determining whether or not there is a plan. Finally, the 2001 proposed regulations deleted the prior proposed regulations' references to a clear and convincing standard of proof. See Mark J. Silverman & Lisa M. Zarlenga, The New Proposed Section 355(e) Regulations - A Vast Improvement, 53 Tax Exec. 5 (2001).

(5) The Act provides exceptions for certain acquisitions. The legislation does not apply to:

a) The acquisition of stock in the controlled corporation by the distributing corporation;

b) The acquisition of stock in a controlled corporation by reason of holding stock in the distributing corporation;

c) The acquisition of stock in any successor corporation of the distributing corporation or controlled corporation by reason of holding stock in such distributing or controlled corporation; and

d) The acquisition of stock if shareholders (owning directly or indirectly 50% or more of either the distributing or controlled corporation before the acquisition) own indirectly 50% or more in such distributing or controlled corporation after such acquisition.

i) In 1998, this fourth exception was amended. See the Internal Revenue Service Restructuring and Reform Act of 1998 (the "Reform Act").

ii) The exception now provides that the legislation does not apply to the acquisition of stock in the distributing corporation or any controlled corporation to the extent that the percentage of stock owned directly or indirectly in such corporation by each person owning stock in such corporation immediately before the acquisition does not decrease.

(6) The Act also provides that a plan (or series of related transactions) will not cause gain recognition under the new Morris Trust rule if, immediately after the completion of the plan or

transaction, the distributing and controlled corporations are members of the same affiliated group.

a) For example, assume P corporation owns all the stock of S corporation, and S owns all the stock of S1 corporation, and all three corporations are members of the same affiliated group. Assume further that P merges into unrelated X corporation, in a transaction where X's former shareholders own 50% or more of the surviving X corporation.

b) If, as part of the merger, S1 distributes S to X in a transaction that otherwise qualifies under section 355, the transaction is not treated as one that requires gain recognition, if S and S1 are members of the same affiliated group following the transaction. See H.R. Conf. Rep. No. 105-220, 105th Cong., 1st Sess. 532 ("Conference Report").

(7) In addition, the Conference Report clarifies that an acquisition does not require gain if the same persons own 50% or more, directly or indirectly, of both the acquired and the acquiring corporation before and after the acquisition and distribution, as long as the stock owned prior to the acquisition was not acquired as part of a plan to acquire a 50% or greater interest in either the distributing or controlled corporation. See Conference Report, at 532-33.

(8) The Act further provide that, except as provided in regulations, if a successor corporation in an A, C, or D Reorganization acquires the assets of the distributing or any controlled corporation, the shareholders

(immediately before the acquisition) of the successor corporation are treated as if they acquired stock in the corporation whose assets were acquired.

(9) In addition, prior to a legislative change in 1998, the Act changed the test for determining control immediately after a distribution in a section 355 transaction. Under the Act, shareholders receiving stock in a controlled corporation by reason of holding stock in the distributing corporation are treated as in control of the controlled corporation immediately after the distribution if they hold stock representing at least a 50% interest in the vote and value of such controlled corporation.

a) Under prior law, control for these purposes was defined as 80% of the voting power of all classes of stock entitled to vote, and 80% of each other class of stock.

b) The Act does not change the requirement that the distributing corporation distribute 80% of the voting power and 80% of each other class of stock of the controlled corporation in the transaction.

c) The Senate Report on S. 949 (the Senate precursor to TRA 1997) notes that the 80% control requirement "would not impose additional restrictions on post-distribution restructurings of the controlled corporation if such restrictions would not apply to the distributing corporation." S. Rep. 105-33, 105th Cong., 1st Sess., at 142.

d) In 1998, the Reform Act replaced the new 50% control test with a provision that states that if the

requirements of section 355 are met, the fact that the shareholders of the distributing corporation dispose of part or all of their controlled corporation stock will not be taken into account for purposes of determining whether the transaction qualifies under section 368(a)(1)(D). Section 368(a)(2)(H)(ii). In addition, a provision of the Tax and Trade Relief Extension Act of 1998 provides that the fact that the controlled corporation issues additional stock will not be taken into account for purposes of determining whether the transaction qualifies under section 368(a)(1)(D). Section 368(a)(2)(H)(ii). Thus, the 80% control test in section 368(c) again applies to divisive section 368(a)(1)(D) transactions.

(10) The Act does not apply to a distribution pursuant to a title 11 or similar case.

(11) The Act applies to distributions after April 16, 1997, unless such distribution is:

a) made pursuant to an agreement which was binding on the effective date and at all times thereafter;

b) described in a ruling request submitted to the Service on or before the effective date; or

c) described on or before the effective date in a public announcement or in a filing with the Securities and Exchange Commission required solely by reason of the distribution.

The above exceptions only apply if the agreement, etc. identifies the acquirer of the distributing or controlled corporation, whichever is applicable. Note that a contract that is binding under State law, but is not written, still may be eligible for transition relief. See Conference Report, at 536-37.

(12) The Act further authorizes the IRS to prescribe regulations necessary to carry out the purposes of the legislation, including regulations:

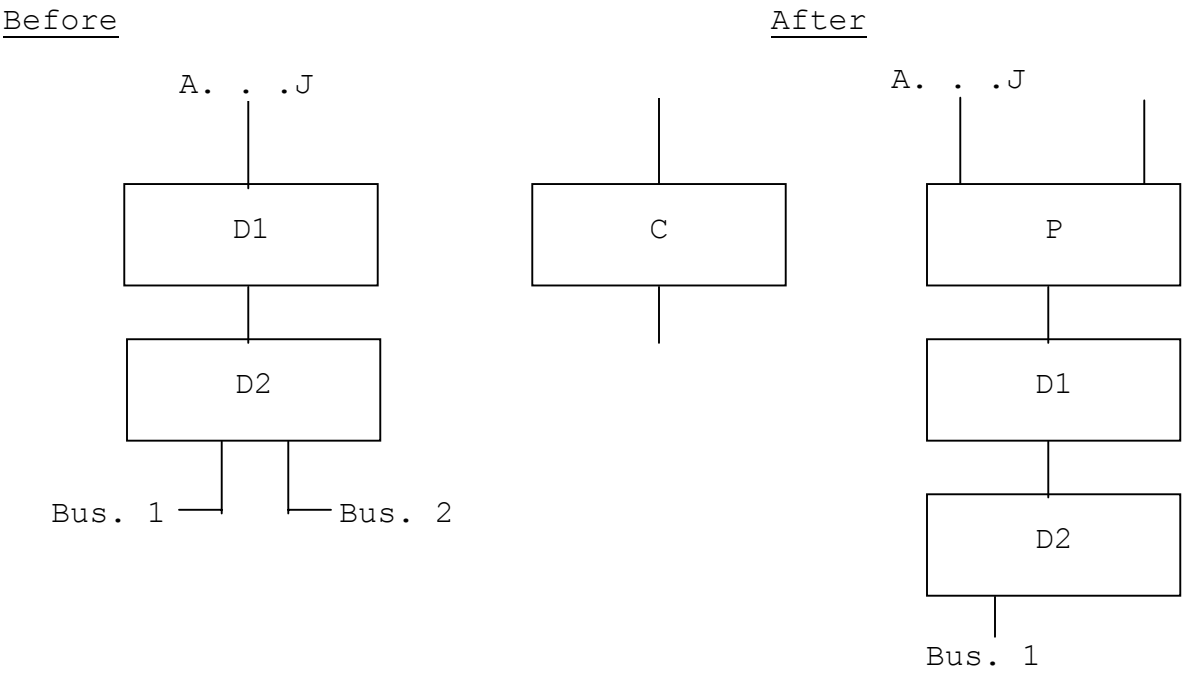
a) providing rules where there is more than one controlled corporation;

b) treating two or more distributions as one distribution; and

c) providing rules similar to the substantial diminution of risk rules of section 355(d)(6) where appropriate for purposes of the legislation.

(13) Although disguised sale transactions such as the Viacom/TCI deal referred to below were thought to be the intended target of any new legislation, the intent of the Act is to eliminate all future Morris Trust transactions, except those where the acquirer acquires less than a 50 percent interest in the distributing or controlled corporation.

3. Example 3 -- Intragroup Spin-off / Morris Trust Legislation: TRA 1997



a. Facts: Ten individuals (A . . . J) own all of the stock of D1. D1 owns all of the stock of D2. D2 conducts two qualifying five-year businesses, Business 1 and Business 2. The parties want to separate Business 2 from Business 1 for business reasons, and sell D1.

The parties agree on the following transaction: (i) D2 will contribute Business 2 to a newly formed subsidiary, Controlled; (ii) D2 will distribute the stock of Controlled to D1, its sole shareholder; (iii) D1 will then distribute the stock of Controlled to its shareholders pro rata, (iv) P, an unrelated party, will then acquire D1.

b. Issues:

(1) Under section 355, this transaction would be tax-free to D1, D2, C, and A . . . J.

(2) However, TRA 1997 eliminates the use of section 355 for intragroup spin-offs that are part of a Morris Trust type transaction, except as provided in regulations.

(3) Under the Act, intragroup spins are generally not taxed (but are subject to the issuance of regulations under section 358). However, the Act states that section 355 will not apply to distributions of stock from one member of an affiliated group to another member if the distribution is part of a "Morris Trust" transaction.

a) Thus, in the example, D2 will recognize deferred intercompany gain as if it had sold C stock on the date of the distribution (and such gain will be triggered into income upon the spin of C outside the group).

b) Furthermore, D1 will recognize gain as if D1 had sold its C stock on the date of the distribution, due to the Morris Trust rule outlined in Example 2. The amount of gain should only be the amount of gain accrued on D1's C stock while it held C directly.

c) The total amount of tax would be the same if, instead of P acquiring D1, P acquired C.

d) Variation on Example: Assume that D2 distributed C to D1, D1 distributed D2 to A...J, and P acquired D1. If P's shareholders own 50% or more of the stock of the new merged corporation, D2 will again recognize deferred intercompany gain as if it had sold C stock on the date of the distribution, under the intragroup spin rule. In addition, D1

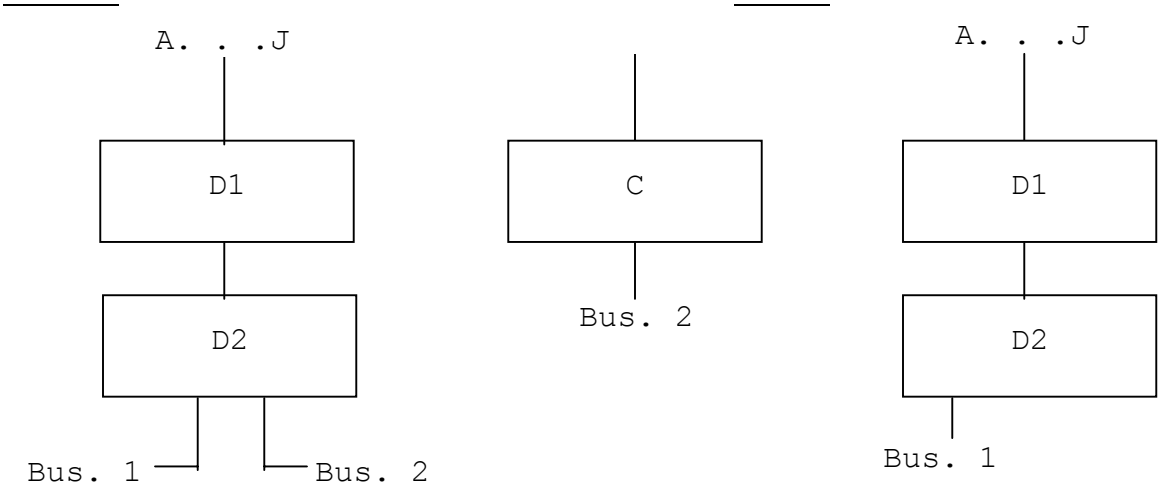
recognizes gain as if D1 sold its D2 stock on the date of the distribution, under the Morris Trust rule outlined in Example 2. See Conference Report, at 534.

(4) In addition, the Act clarifies that all the Morris Trust provisions apply in determining whether the intragroup spin provisions apply. For example, an intragroup spin-off in connection with a transaction that does not cause gain recognition under the Morris Trust provisions outlined in Example 2 due to exceptions in such provisions, is not subject to the intragroup spin-off rules. See Conference Report, at 534.

(5) The Act further allows Treasury to provide adjustments (under section 358) to the adjusted basis of stock in the case of intragroup distributions to which section 355 applies, in order to appropriately reflect the proper treatment of such distributions. See Example 4 for an analysis of Treasury's new authority.

c. The Act generally applies to distributions made after April 16, 1997, with the transition rules referred to in Example 2.

4. Example 4 -- Intragroup Spin-offs Without Morris Trust Transactions: TRA 1997



a. Facts: Ten individuals (A . . . J) own all of the stock of D1. D1 owns all of the stock of D2. D2 conducts two qualifying five-year businesses, Business 1 and Business 2. The parties want to separate Business 2 from Business 1 for business reasons. The parties agree on the following transaction: (i) D2 will contribute Business 2 to a newly formed subsidiary, Controlled; (ii) D2 will distribute the stock of Controlled to D1, its sole shareholder; and (iii) D1 will then distribute the stock of Controlled to its shareholders pro rata.

b. Issues:

(1) If the above transaction satisfies all the requirements of section 355, it will be tax free. TRA 1997 did not change the tax-free status of the above transaction.

(2) However, the Act allows Treasury to provide adjustments (under section 358) to the adjusted basis of stock in the case of intragroup distributions to which section 355 applies, in order to appropriately reflect the proper

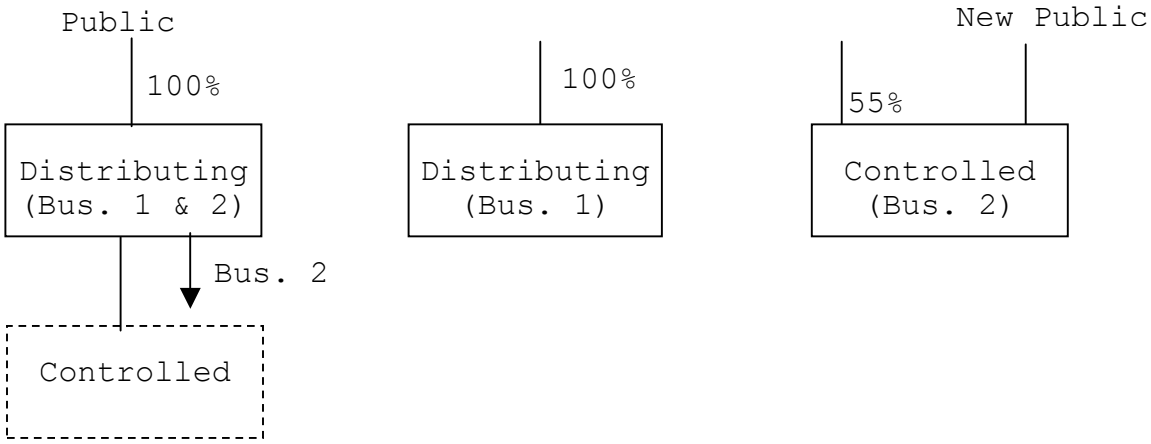
treatment of such distributions. Treasury's authority to provide adjustments under the Act is limited to adjustments to the adjusted basis of stock which is in a corporation that is a member of an affiliated group and is held by another member of such group.

a) The Conference Report to TRA 1997 notes two concerns that it hopes regulations will address: (1) the possibility that corporations can eliminate excess loss accounts in lower tier subsidiaries, and (2) the possibility that corporations can manipulate allocation rules, and increase its stock basis relative to asset basis in one corporation, while correspondingly decreasing its stock basis relative to asset basis in another corporation. See Conference Report, at 535-36.

b) The conferees "expect that any Treasury regulation will be applied prospectively, except in cases to prevent abuse." Conference Report, at 537.

5. Example 5 -- IPO By Controlled

Before: After:



a. Facts: Distributing is a publicly-traded corporation engaged in Business 1 and Business 2. Distributing wants to raise funds for use in Business 2. Accordingly, Distributing contributes Business 2 to a newly formed corporation, Controlled, and distributes the stock of Controlled to its shareholders pro rata. Following the spin-off Controlled raises needed capital through an IPO of 45 percent of its stock.

b. Issues:

(1) The contribution of Business 2 into Controlled is a "D" reorganization, which requires the Distributing shareholders to be in control of Controlled "immediately after" the transaction.

(2) In this situation, up to 20 percent of the Controlled stock could be offered in the IPO. The sale of more than 20 percent would not cause the transaction to fail the control requirement of a "D" reorganization. A provision of the Tax and Trade Relief Extension Act of 1998 provides that the fact that the controlled corporation issues additional stock will not be taken into account for purposes of determining

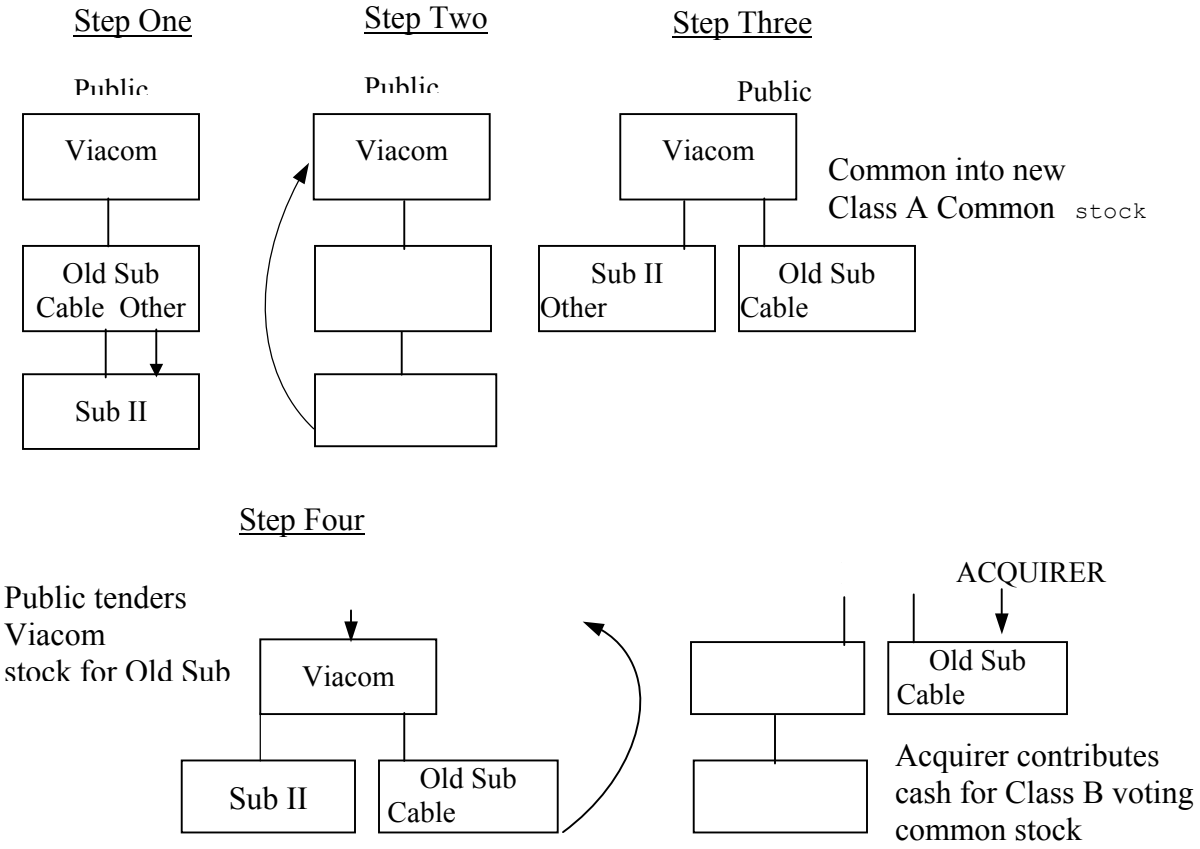
whether the transaction qualifies under section 368(a)(1)(D). Code section 368(a)(2)(H)(ii).

(3) This transaction may also qualify as a section 351 and section 355 transaction. See Treas. Reg. § 1.351-1(a)(3) (stating that if a person acquires stock of a corporation from an underwriter in exchange for cash in a qualified underwriting transaction, for section 351 purposes the person who acquires stock from the underwriter is treated as transferring cash directly to the corporation in exchange for stock of the corporation and the underwriter is disregarded). See also Rev. Rul. 78-294, 1978-2 C.B. 141 (treating public who bought shares from Underwriter as transferors for purposes of section 351 control test), obsoleted by T.D. 8665, 1996-1 C.B. 35 (enacting Treas. Reg. § 1.351-1(a)(3)). Note: The Service in Rev. Rul. 98-27, 1998-1 C.B. 1159, recently stated that it will no longer apply the step-transaction doctrine for purposes of determining "whether the distributed corporation was a controlled corporation immediately before the distribution under section 355(a) solely because of any postdistribution acquisition or restructuring of the distributed corporation, whether prearranged or not." Thus, the Service would apparently not treat the above transaction as if the public offering had occurred prior to the spin-off, in which case the distribution would have failed because Distributing would not have distributed stock constituting control of Controlled. See, e.g., Rev. Proc. 96-39, 1996-2 C.B. 300, Rev. Rul. 73-246, 1973-1 C.B. 181, and Rev. Rul. 70-225, 1970-1 C.B. 80, obsoleted by Rev. Rul. 98-44, 1998-C.B 315.

a) In Rev. Rul. 62-138, the Service treated the dropdown of assets and subsequent distributions as a section 351 transaction (not a "D" reorganization) followed by a section 355 transaction (presumably to avoid the "D" reorganization control issue).

b) However, in PLR 9236007, and PLR 9141029, "D" reorganizations, followed by multiple spin-offs were approved.

6. Example 6 -- Viacom



a. Facts:

(1) Through its wholly-owned subsidiary, Old Sub, Viacom conducts a cable business and other businesses. Old Sub owns all of the stock of Sub II which is engaged in the other businesses. Viacom wishes to dispose of the cable

business (but not its other businesses) to Acquirer on a tax-free basis.

(2) Old Sub contributes its other businesses to Sub II. Sub II assumes substantially all of Old Sub's debt. Old Sub distributes Sub II to Viacom in a section 355 spin-off.

(3) Old Sub is recapitalized -- Viacom exchanges its common stock for new Class A common stock that will automatically convert to nonvoting preferred stock upon Acquirer's investment in Old Sub (described below). The Old Sub preferred stock will be convertible by the holder and callable by the issuer into stock of Acquirer after five years.

(4) Viacom offers to exchange not less than all of its Old Sub stock upon tender of Viacom stock by the Viacom public shareholders. When sufficient shareholders accept the tender offer, Viacom distributes its Old Sub stock to the public in a section 355 distribution.

(5) Acquirer contributes a substantial amount of cash to Old Sub in exchange for newly issued Class B voting common stock. This causes the Class A common stock held by the public to convert to nonvoting preferred stock.

(6) In a recent private ruling on substantially these facts, the Service held that both the distribution of Sub II and the distribution of Old Sub qualified as tax free under section 355. See PLR 9637043 (June 17, 1996). But see Examples 2 - 4, supra, for an explanation of TRA 1997, which effectively eliminates tax-free Morris Trust transactions and intragroup spins related to such transactions.

b. Issues:

(1) If the form is respected, Acquirer effectively would receive control and substantially all of the upside potential of Viacom's cable business in a tax-free transaction.

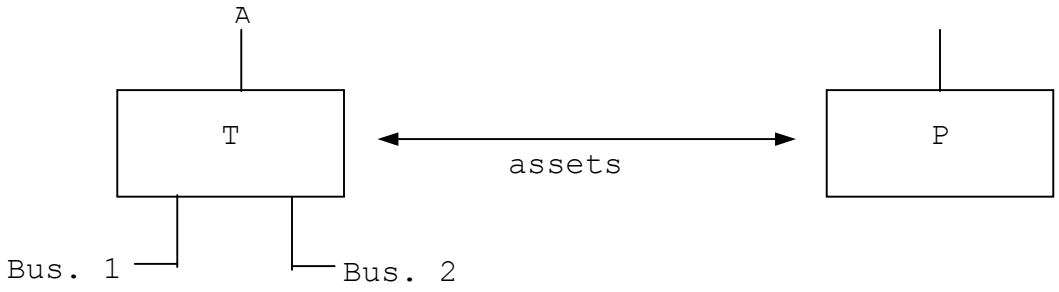
(2) In Revenue Ruling 75-406, the Service respected a section 355 distribution followed by a merger of the distributed corporation when the merger was approved by a separate vote of the public shareholders. However, the Service clarified Revenue Ruling 75-406 in Rev. Rul. 96-30, 1996-1 C.B. 696, stating that the result in Rev. Rul 75-406 turns on the fact that the subsequent merger had not been prearranged by the distributing corporation -- i.e., the result was not based merely on the separate shareholder vote. Assuming Acquirer's investment in Old Sub is prearranged, it appears that the transactions would be viewed as part of plan under Rev. Rul. 96-30.

(3) Rev. Rul. 98-27, supra, renders obsolete Rev. Rul. 96-30 and Rev. Rul. 75-406. The Service in Rev. Rul. 98-27 states that it will no longer apply the step-transaction doctrine for purposes of determining "whether the distributed corporation was a controlled corporation immediately before the distribution under section 355(a) solely because of any postdistribution acquisition or restructuring of the distributed corporation, whether prearranged or not." As a result, Rev. Rul. 98-27 renders obsolete Rev. Rul. 96-30 and Rev. Rul. 75-406. Note, however, that any such postdistribution acquisition or restructuring could result in a corporate-level tax under section 355(e).

(4) Because Old Sub is a preexisting subsidiary, the transaction is not a "D" reorganization. Therefore, Viacom must distribute control of Old Sub but the public shareholders are not required to retain control. See section 355(a)(1)(D). Thus, the disposition of control as a result of Acquirer's investment does not necessarily preclude tax-free treatment.

K. The "Substantially All" Requirement

1. Example 1 -- Disposition of A Division



a. Facts: T, a corporation wholly-owned by individual A, conducts two businesses, Business 1 and Business 2. P, a publicly traded corporation wants to acquire and conduct Business 1. P is not interested in Business 2. P insists that the transaction be structured as an exchange of T's assets for P stock, with P assuming only certain enumerated liabilities of T.

b. Issues:

Under which of the following circumstances will the "substantially all" requirement of a "C" reorganization be satisfied?

(1) Prior the acquisition by P, T forms a new subsidiary, C, with a contribution of Business 2 and distributes the stock of C to A.

a) The Service will take into account any disposition of assets prior to

the transaction, including tax-free spin-offs under section 355. Rev. Proc. 77-37, § 3.02, 1977-2 C.B. 568. See also Helvering v. Elkhorn Coal Co., 95 F.2d 732 (4th Cir.), cert. denied, 305 U.S. 605 (1938).

(2) Prior to the acquisition by P, T sells Business 2 to an unrelated third party, X, for cash.

a) In Rev. Rul. 88-48, 1988-1 C.B. 117, the Service held that the substantially all requirement was met where an unwanted business was sold for cash prior to a "C" reorganization and the cash proceeds were among the assets acquired in the transaction.

b) If, however, the cash proceeds of the sale are distributed to A the sale would cause the reorganization to fail the substantially all requirement.

c) In Rev. Rul. 74-457, 1974-2 C.B. 122, the Service ruled that the payments of regular quarterly dividends would not be taken into account in determining if the substantially all requirement was met.

i) Query what result, therefore, if T is an S corporation and distributes just enough cash for A to pay A's tax liability arising from the sale of Business 2?

ii) In general, the retention of assets to pay corporate liabilities will not cause a reorganization to fail the substantially all requirement. See e.g., Western

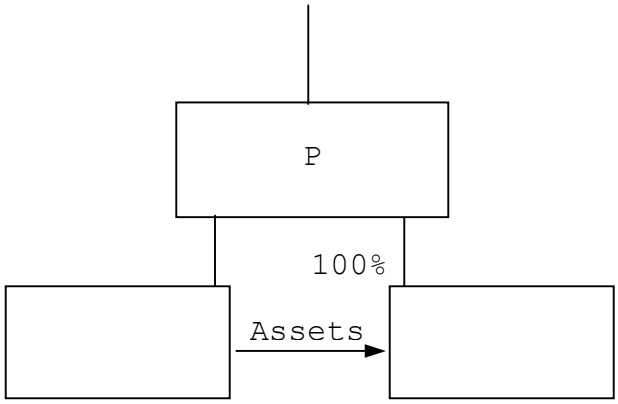
Indus. Co. v. Helvering, 82 F.2d 461 (D.C. Cir. 1936); Smith v. Commissioner, 34 B.T.A. 702 (1936).

iii) If a C corporation could retain assets to pay its tax liabilities upon a sale of assets, it would appear reasonable for an S corporation to be allowed to retain assets to distribute to its shareholder for the same purpose.

d) What if following the transaction, P sells the Business 2 assets in a taxable transaction? Does it matter if the proceeds are distributed to the P shareholders as a dividend?

L. Reorganizations Within a Consolidated Group

1. Example 1 -- Asset Transfer



a. Facts: P, a publicly traded corporation, is the parent of a consolidated group consisting of P, S1 and S2. For valid business purposes, S1 transfers a portion of its assets to S2, and receives no consideration in the transaction.

b. Issues:

(1) How should the transaction be characterized?

a) S1 distributed its assets to P, which in turn contributed the assets to S2?

b) S1 contributed the assets to S2 in return for stock of S2 which S1 then distributed to P?

c) S1 sold the assets to S2 in return for cash which it distributed to P, which in turn contributed the cash to S2?

d) Does it make any difference if S2 received cash in the transaction?

(2) Since each of the recharacterizations described in (1), above, are equally effective manners in which to effect the transaction, taxpayers should structure a transaction so that the form of the transaction leads to the desired tax result.

a) If it is preferable for deferred gain or loss to be created with respect to the transferred assets, the transaction should be structured in accordance with (1)(a) or (1)(c).

b) If instead, it is preferable for deferred gain to be created with respect to the stock of S2, the transaction should be structured in accordance with (1)(b).

i) Note that under prior law, a distribution of depreciated stock in a member of the group did not create deferred loss. Rather the stock took a carry-over basis. Prior

Reg. § 1.1502-31(b). See S. Rep. No. 445, 100th Cong., 2d Sess. 62 n.31 (1988) (result not changed by amendment to section 301(d)).

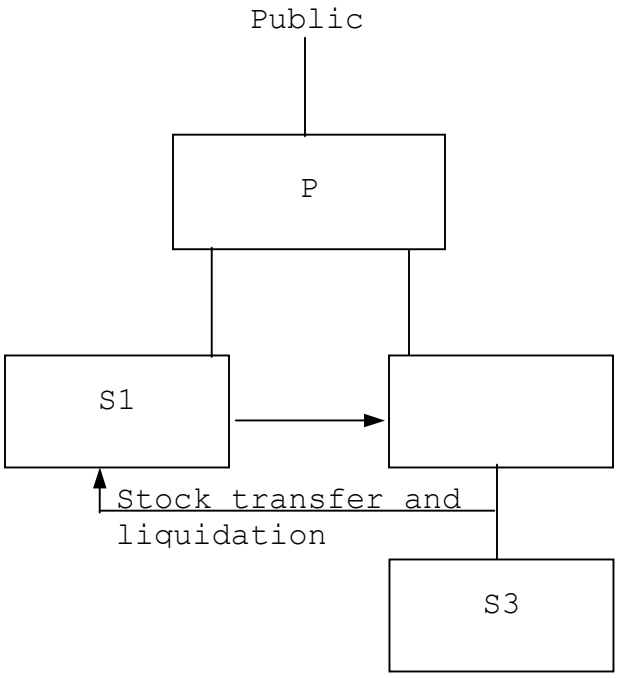
ii) The final regulations require the creation of deferred loss on the distribution of depreciated stock in a member of the group. See Reg. § 1.1502-13(f)(2)(iii) and -13(f)(7), Ex. 4(d).

c) It may also be desirable to structure the transaction as described in (1)(b) if the transferred assets have built-in gain and S2 has losses which are subject to the SRLY rules, and hence cannot be offset with income from other members of the consolidated group.

i) S2 will take the gain assets with a carry-over basis.

ii) As a result, upon a subsequent sale of the assets, the gain will be taxed to S2 and may be used to offset SRLY losses.

2. Example 2 -- Stock Sale and Liquidation



a. Facts: P, a publicly traded corporation, is the parent of a consolidated group consisting of P, S1 and S2 (wholly-owned subsidiaries of P), and S3 (a wholly-owned subsidiary of S2). For valid business purposes, S2 sells the stock of S3 to S1 for $100x. After the transaction, S3 is liquidated into S1.

b. Issues:

(1) The Service has concluded in private letter rulings that this transaction should be treated as a "D" reorganization with boot. See, e.g., PLR 9127023; PLR 9111055; PLR 8952041; PLR 8911067.

a) In accordance with this characterization, S3 is treated as if it transferred its assets to S1 in return for S1 stock and cash, followed by a distribution of the S1 stock and cash to S2, and a

further distribution of the S1 stock from S2 to P.

b) The Service apparently feels that the fact that S3 received no S1 stock can be ignored, because it would be a "meaningless gesture" for such stock to be issued to S3 and transferred to S2 and then to P. See also PLR 8416004; PLR 7848063.

c) Query how the analysis might change if S2 had a minority shareholder. The minority shareholder would be entitled to receive any distribution out of S2, and hence the "meaningless gesture" analysis would no longer apply.

(2) Treatment of the transaction as a "D" reorganization raises a number of collateral issues.

a) The transfer of $100x cash will be treated as boot in a reorganization. Since S2 will continue to own 100 percent of S3 under the attribution rules of section 318, all of the boot will be treated as a dividend, to the extent of gain and to the extent of available earnings and profits. Query whether the available earnings and profits are those of S1, S3, or both. (See II.C.1.4, above).

b) To the extent that the boot gives rise to dividend treatment, the dividends would be excluded for purposes of computing consolidated taxable income. Reg. § 1.1502-13(f)(2)(ii). However, in Rev. Rul. 72-298, 1972-1 C.B. 355, the receipt of boot in a intercompany reorganization was held not to

constitute a dividend, and hence did not increase the earnings and profits of the recipient. See also GCM 34652.

(3) Regulations treat the receipt of boot in an intercompany reorganization as a transaction separate from the reorganization. Reg. § 1.1502-13(f)(3).

a) This approach would appear to require that an intercompany sale be respected as such, and not recast as a reorganization, since the boot received would constitute full value for the stock sold.

b) As a result, deferred gain would be created with respect to the stock of S3. The liquidation of S3 would appear to trigger that deferred gain, with the result that the P group would be required to pay tax on that gain immediately, despite the fact that no stock or assets would have left the group. See Reg. § 1.1502-13(f)(5).

i) The regulations provide that deferred gain will be triggered on an intercompany sale of stock followed by a liquidation under section 332 "in a separate transaction." Id.

ii) However, the regulations permit S2 to avoid triggering the deferred gain if S1 transfers to New S3 substantially all of S3's assets and elects to treat the transaction as pursuant to the same plan as the liquidation. See Reg. § 1.1502-13(f)(5)(ii)(B).

PRACTISING LAW INSTITUTE
TAX STRATEGIES FOR CORPORATE ACQUISITIONS,
DISPOSITIONS, SPIN-OFFS, JOINT VENTURES,
FINANCINGS, REORGANIZATIONS AND
RESTRUCTURINGS 2001

CURRENT DEVELOPMENTS IN TAX-FREE CORPORATE REORGANIZATIONS

August 2001

Mark J. Silverman
Steptoe & Johnson LLP
Washington, D.C

TABLE OF CONTENTS