February 7, 2005

Hon. Mark W. Everson
Commissioner
Internal Revenue Service
Room 5226
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Comments Regarding Transfers of Assets and Stock Following a Reorganization

Dear Commissioner Everson:

Enclosed are comments on transfers of assets and stock following a reorganization, which were prepared by individual members of the American Bar Associations Section of Taxation’s Committee on Corporate Tax. These comments represent the individual views of those members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or of the Section of Taxation.

Sincerely,

Kenneth W. Gideon
Chair, Section of Taxation

Enclosure

cc: Eric Solomon, Acting Deputy Assistant Secretary for Tax Policy, Treasury
Helen M. Hubbard, Tax Legislative Counsel, Department of Treasury
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Comments Regarding Proposed Regulations Addressing Transfers of Assets and Stock Following a Reorganization

The following comments represent the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

These comments were prepared by individual members of the Committee on Corporate Tax of the Section of Taxation (the “Committee”). Principal responsibility for drafting the report was exercised by Philip J. Levine and Darin A. Zywan. Substantive contributions were made by John Barrie, Jasper L. Cummings, Julie Divola, Stuart J. Offer, Mark J. Silverman, Thomas F. Wessel, R. David Wheat, Philip B. Wright, and Lisa M. Zarlenga. The comments were reviewed by Robert H. Wellen of the Section’s Committee on Government Submissions and by Mark L. Yecies, Council Director for the Committee on Corporate Tax.

Although many of the members of the Section of Taxation who participated in preparing these comments have clients who would be affected by the federal tax principles addressed by these comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these comments.

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Date: February 7, 2005
Comments Regarding Proposed Regulations Addressing Transfers of Assets and Stock Following a Reorganization

I. Executive Summary

A. Overview

On August 18, 2004, the Treasury Department (“Treasury”) and the Internal Revenue Service (the “Service”) published proposed regulations (the “Proposed Regulations”) that relate to the effect of asset and stock transfers on the status of certain transactions as reorganizations under section 368(a) of the Internal Revenue Code of 1986 (the “Code”), as amended. The Proposed Regulations expand earlier proposed regulations, published on March 2, 2004 (the “March 2004 proposed regulations”), providing that a transaction otherwise qualifying as a reorganization will not be disqualified as a result of a transfer or successive transfers to one or more corporations controlled in each transfer by the transferor corporation of part or all of (i) the assets of any party to the reorganization or (ii) the stock of any party to the reorganization other than the issuing corporation. 69 Fed. Reg. 9771 (March 2, 2004). The March 2004 proposed regulations amended Treas. Reg. § 1.368-2(k), the continuity of business enterprise (“COBE”) regulations under Treas. Reg. § 1.368-1(d) and the definition of a party to a reorganization under Treas. Reg. § 1.368-2(f).

On May 26, 2004, members of the Committee submitted comments on the effect of transfers of assets of an acquired corporation to the issuing parent corporation after an acquisition otherwise qualifying as a triangular reorganization. In addition, on July 19, 2004, members of the Committee submitted comments on the March 2004 proposed regulations. Copies of these comments are attached.

The Proposed Regulations expand on the March 2004 proposed regulations by addressing whether a transaction that otherwise qualifies as a reorganization continues to qualify when, pursuant to the plan of reorganization, assets of or shares of stock in the acquired corporation are distributed to certain related corporations or partnerships following the reorganization. Prop. Treas. Reg. §§ 1.368-2(f), (j), and (k), 69 Fed. Reg. 51209 (Aug. 18, 2004). These are our comments on the Proposed Regulations.

B. Summary of Recommendations

We believe that, for the benefit of all concerned, the Proposed Regulations should be issued in final form as quickly as possible. Our recommendations are that Treasury and the Service should (1) provide additional guidance on failing the “substantially all” test, at a minimum in the form of a safe harbor; and (2) apply section 1504(a), rather than section 368(c), to determine membership in a “qualified group,” at least in the consolidated return context.

1 Unless otherwise indicated, all section references are to the Code and the Treasury Regulations thereunder (“Treas. Reg. §”).

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II. Background

To qualify as a reorganization, a transaction must satisfy certain statutory and judicial requirements, including COBE. COBE requires that the issuing corporation either (i) continue the target corporation’s historic business or (ii) use a significant portion of the target corporation’s assets in a business. Treas. Reg. § 1.368-1(d)(2). The term “issuing corporation” generally means the acquiring corporation. In the case of a triangular reorganization, however, the issuing corporation includes the corporation in control of the acquiring corporation. The issuing corporation is treated as holding all the businesses and assets of the members of the qualified group. For this purpose, the qualified group is one or more chains of corporations connected though stock ownership with the issuing corporation, but only if the issuing corporation directly owns stock meeting the requirements of section 368(c) in at least one other corporation, and stock meeting the requirements of section 368(c) in each of the corporations (except the issuing corporation) is owned directly by one of the other corporations.

Section 368(a)(2)(C) provides that a transaction otherwise qualifying as a reorganization under section 368(a)(1)(A), (B), (C), or (G) will not be disqualified by reason of the fact that part or all of the acquired assets or stock are transferred to a corporation controlled by the acquiring corporation. For this purpose, control has the meaning contained in section 368(c). Treasury and the Service have interpreted the terms of section 368(a)(2)(C) as permissive, rather than exclusive or restrictive. Rev. Rul. 2002-85, 2002-2 C.B. 986; Rev. Rul. 2001-24, 2001-1 C.B. 1290.

Under Treas. Reg. § 1.368-2(k), a transaction otherwise qualifying as a reorganization under section 368(a)(1)(A), (B), (C), or (G) (where the requirements of section 354(b)(1)(A) and (B) are met) generally will not be disqualified by reason of the fact that part or all of the acquired assets or stock are transferred to a corporation controlled by the acquiring corporation. For this purpose, a corporation is a controlled corporation if the transferor corporation owns stock of such corporation constituting control within the meaning of section 368(c).

The Proposed Regulations incorporate the March 2004 proposed regulations by extending the principles in Treas. Reg. § 1.368-1(d), -2(f) and (k) to all types of reorganizations. In addition, the Proposed Regulations provide that a transaction otherwise qualifying as a reorganization will not be disqualified as a result of a subsequent distribution of acquired assets or stock if all of the following requirements are satisfied:

(i) No transferee receives (a) “substantially all” of the acquired assets, (b) substantially all of the assets of the acquired or surviving corporation (in a transaction otherwise qualifying as a reorganization under section 368(a)(1)(B) or section 368(a)(1)(A) by reason of section 368(a)(2)(E)), or (c) stock constituting control of the acquired corporation.

(ii) The transferee is either a member of the qualified group or a partnership the business of which is treated as conducted by a member of the qualified group under Treas. Reg. § 1.368-1(d)(4)(iii).
(iii) The COBE requirement is satisfied.

As they had with respect to drop-downs in the March 2004 proposed regulations, Treasury and the Service reasoned that the asset and stock distributions described in the Proposed Regulations are consistent with the policies underlying the reorganization provisions because they effect readjustments of continuing interests in the reorganized business in modified corporate form and do not involve a transfer to a “stranger.” See Treas. Reg. § 1.368-1(b); H.R. Rep. No. 83-1337, A134 (1954).

III. General Comments

We commend the government for issuing the Proposed Regulations. We believe that they reflect sound corporate tax policy and are based on solid technical analysis. In addition, the Proposed Regulations are of considerable practical significance and provide needed flexibility for post-acquisition restructurings. The transfers permitted by the Proposed Regulations result in little or no change in the ultimate ownership of the acquired assets or stock. Thus, there is no policy reason to disqualify a reorganization in such cases. Indeed, from a policy standpoint, it is desirable to prevent acquirers from unilaterally disqualifying a reorganization through transactions resulting in little change in the parties’ circumstances. Such transactions increase the likelihood that the target shareholders and the acquiring corporation might take inconsistent positions thereby creating whipsaw potential.

IV. Specific Suggestions

We believe that, for the benefit of all concerned, the Proposed Regulations should be issued in final form as quickly as possible. Our suggestions are (1) to request additional guidance on the “substantially all” test (at least in the form of a safe harbor that could be incorporated either in the final regulations or in a new project, if the guidance would delay the issuance of final regulations); and (2) to renew our proposal for a different test to determine

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2 As these comments make clear, we welcome the Proposed Regulations. We encourage the Service to examine a related issue as well—whether a forward subsidiary merger followed by an upstream merger of the acquiring subsidiary into its parent must be tested for reorganization status under section 368(a)(1)(C). There is no authority so holding, but Rev. Rul. 67-274, 1967-2 C.B. 141, and Rev. Rul. 72-405, 1972-2 C.B. 217, are consistent with this analysis. If the Service does take this position, it would place significant pressure on the “substantially all” analysis.

This pressure would be alleviated if either (i) the overall transaction were treated as a direct merger of the target into the acquiring parent, as in Rev. Rul. 2001-46, 2001-2 C.B. 321, or (ii) the two mergers were treated as independent transactions, as in Rev. Rul. 90-95, 1990-2 C.B. 67 and Temp. Treas. Reg. § 1.338(b)(10)-1T. Temp. Treas. Reg. § 1.368-2T(b)(1), which treats a merger of the target into a disregarded entity owned by the acquiring corporation as a merger of target into acquiring, suggests that a forward triangular merger followed by an upstream merger also should be treated as a reorganization under section 368(a)(1)(A). Moreover, as stated in Rev. Rul. 2001-24, 2001-1 C.B. 1290, the legislative history of section 368(a)(2)(E) suggests that forward and reverse triangular mergers should be treated similarly. S. Rep. No. 1533, 91st Cong., 2d Sess. 2 (1970).

More generally, some members of the Committee who participated in drafting these comments believe the Service should re-examine Rev. Rul. 67-274 and Rev. Rul. 72-405 in light of changes to section 382 and developments in the law under section 368 since the promulgation of those rulings.
membership in a qualified group, at least in the consolidated return context. Specifically, we suggest the following:

A. Substantially All

In the comments submitted on May 26, 2004, relating to asset distributions following putative reorganizations, the members of the Committee who prepared those comments were divided regarding whether the appropriate test for preventing a recharacterization of a transaction involving a post-acquisition distribution of acquired assets should be based on a “substantially all” or “de facto liquidation” standard. The Proposed Regulations adopt a “substantially all” test for this purpose and provide that the term “substantially all” is to have the same meaning as in section 368(a)(1)(C). We believe that, if this test is adopted in final regulations, further guidance on the meaning of the “substantially all” standard is desirable, perhaps in the form of a safe harbor.

It is striking how little guidance has been provided by the Service on the meaning of the term “substantially all.” The term has been the subject of considerable uncertainty and litigation over the years. The Service has stated that a transfer of assets representing at least 90 percent of the fair market value of the net assets and at least 70 percent of the fair market value of the gross assets held by the transferor corporation immediately prior to the transfer will be considered substantially all of the assets for advance ruling purposes. Rev. Proc. 77-37, 1977-2 C.B. 568. However, in connection with the Proposed Regulations, taxpayers will be interested in failing the “substantially all” test.

There is no guidance (other than case law) on what transfers do not satisfy the “substantially all” test. Accordingly, it would be helpful for the Service to issue guidance on the meaning of the “substantially all” test at least in this context, but ideally in all the contexts in which it arises.

We believe that the establishment of a safe harbor on what is not a transfer of “substantially all” would be beneficial both to taxpayers and the Service, and that such a project could be completed in the near term, either in final regulations or shortly after adoption of final regulations. The obvious safe harbor would be that a transfer would not encompass “substantially all” of the transferor’s assets if it involved less than either 70 percent of the gross

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3 Although there is a substantial body of case law that addresses the quantity and quality of assets that must be transferred in order to satisfy the substantially all requirement, this case law does not provide a clear standard. See, e.g., Brit v. v. Comm’r, 114 F.2d 10 (4th Cir. 1940) (92 percent substantially all); Comm’r v. First Nat’l Bank of Altoona, 104 F.2d (3d Cir. 1939) (92 percent substantially all); Arctic Ice Mach. Co. v. Comm’r, 23 B.T.A. 1223 (1931) (68 percent not substantially all). See also James Armour, Inc. v. Comm’r, 43 T.C. 295 (1965) (51 percent held substantially all where assets necessary to the conduct of an enterprise of the business are not retained); American Mfg. Co. v. Comm’r, 55 T.C. 204 (1970) (20 percent substantially all because all operating assets); Smothers v. United States, 648 F.2d 894 (5th Cir. 1981) (15 percent substantially all because all operating assets acquired). Whether a transaction satisfies the substantially all requirement generally depends on the facts and circumstances, including the amount and nature of the assets that are not transferred, and the purpose for their retention. See Rev. Rul. 57-518, 1957-2 C.B. 253; Boris I. Bittker & James S. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 12.24[2][b] (7th Ed. 2000).

4 Treas. Reg. § 1.337(d)-4 provides that if a taxable corporation transfers “substantially all” of its assets to one or more tax-exempt entities, the taxable corporation must recognize gain or loss on the transferred assets. Thus, in this situation as well, taxpayers will be interested in failing the “substantially all” test.
assets or 90 percent of the net assets acquired in the putative reorganization.\(^5\) To minimize difficult issues, such a safe harbor could apply only to acquisitive reorganizations (not divisive ones) and only for purposes of determining whether the acquisition could continue to qualify as a reorganization despite a post-acquisition asset transfer.\(^6\)

Comprehensive guidance would require an analysis of the history and policies of the “substantially all” requirement, and of the economics of various types of transfers. In particular, the role of corporate obligations (including, but not limited to, “liabilities” in both the financial accounting sense and the tax sense) would have to be examined, together with the nature and quantity of the assets that would have to be transferred. As one example, it would be necessary to determine how transfers of assets subject to liabilities should be measured in connection with a net asset test.\(^7\) We would be happy to discuss those issues with you, in connection with developing either a safe harbor or broader guidance, or both if that would be helpful.

B. COBE and Diamond Transactions

On May 6, 1997, in connection with the initial proposed COBE regulations, members of the Committee recommended that the Service and Treasury apply section 1504(a),\(^8\) rather than section 368(c), in determining the composition of a qualified group.\(^9\) A copy of these comments is attached. We continue to believe that section 1504(a) is a more appropriate standard, and that it would eliminate many anomalies both in the existing regulations and in the Proposed Regulations. These anomalies arise particularly in the context of a “diamond pattern” of stock ownership. For example, assume P owns 100 percent of the stock of S1 and S2, which in turn each own 50 percent of the assets of S3. T is an unrelated corporation. After an acquisition by P of T’s assets in a transaction otherwise qualifying as a reorganization, P transfers the acquired assets equally to S1 and S2, and then S1 and S2 transfer the assets to S3. The transfers by S1 and S2 would not satisfy either COBE or Treas. Reg. § 1.368-2(k), even though all acquired assets would continue to be owned indirectly by P. We do not believe that this result makes sense. In our view, it creates both a trap for the unwary and an opportunity for whipsaw.

As we understand it, Treasury and the Service believe that section 368(a)(2)(C) limits their authority to adopt section 1504(a) as the general standard in this area. Whatever the merits of this concern, it seems clear to us that a section 1504(a) rule can be adopted in the consolidated

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\(^5\) In the case of a reorganization under section 368(a)(1)(B) or (a)(2)(E), the test would be applied to the assets held by target at the time of its acquisition. In either case, we believe the determination should be made without regard to assets distributed before the acquisition.

\(^6\) A simpler alternative would be to adopt a 70 percent of gross assets safe harbor without a net assets test, which would avoid most of the liability issues.

\(^7\) It would be helpful particularly to clarify that a transfer of the acquired assets within the qualified group does not affect whether the initial reorganization transfer satisfies the “substantially all” requirement. It also would be helpful if clarification could be provided on the application of the regulations if the initial transferee of substantially all of the acquired assets then sprinkles those assets to more than one subsequent transferee.

\(^8\) In this context, section 1504(a) would be applied without regard to the exceptions in section 1504(b).

\(^9\) Comments on the Continuity of Interest and Business Enterprise Proposed Regulations, American Bar Association Section of Taxation, May 6, 1997.
return context under the broad regulatory authority of section 1502.\textsuperscript{10} We believe that, in addition to providing a better test for reorganization status, a test based on section 1504(a) in the context of a consolidated group would be more appropriate than a section 368(c) rule, because it would further the single entity principles of the consolidated return regulations.

We would be pleased to meet with you to discuss any of our recommendations if you believe such a meeting would be helpful.

\textsuperscript{10} The breadth of this authority recently has been confirmed in section 844 of the American Jobs Creation Act of 2004, P.L. 108-357.
COMMENTS ON THE CONTINUITY OF INTEREST AND BUSINESS ENTERPRISE PROPOSED REGULATIONS

The following comments are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

These comments were prepared by individual members of the Committees on Corporate Tax and Partnerships of the Section of Taxation. Principal responsibility was exercised by Eric M. Elfman. Substantive contributions were made by Jasper L. Cummings, Jr., J.D. Dell, David A. Miller, Roger M. Ritt, Mark J. Silverman, Benjamin G. Wells and Philip B. Wright. The comments were reviewed by Robert A. Jacobs of the Section’s Committee on Government Submissions and by Stuart J. Offer, Council Director for the Corporate Tax Committee.

Although many of the members of the Section of Taxation who participated in preparing these Comments have clients who would be affected by the federal tax principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: April 28, 1997
EXECUTIVE SUMMARY

On January 2, 1997, the Treasury Department (the "Treasury") and the Internal Revenue Service ("IRS") proposed regulations that generally would clarify the rules for qualification of certain transactions as tax-free reorganizations where the target corporation's stock or assets are transferred by an acquiring corporation to members of the acquired corporation's "qualified group," or its assets are transferred to a partnership. The regulations address issues under both the "remote continuity" doctrine and the continuity of business enterprise ("COBE") doctrine.

We applaud the Treasury and IRS for boldly addressing a long-standing problem in determining whether a transaction qualifies as a tax-free reorganization. The comments that follow are directed to specific portions of the proposed regulations that may present particular problems. However, because these proposed regulations set forth sensible rules relating to the remote continuity and COBE doctrines, we strongly urge the prompt finalization of these rules.

PRINCIPAL RECOMMENDATIONS

This paper makes the following principal comments and recommendations:

1. The regulations should be adopted promptly.

2. The regulations should be applicable to transactions closed after the effective date of the regulations, but subject to a binding contract prior to such effective date.

3. The definition of "qualified group" should be modified to be determined by reference to section 1504(a)(2).¹

4. With respect to the application of the continuity of business enterprise test ("COBE Test") to partnerships, the "other facts and circumstances test" should be clarified with more specific examples.

5. It should be clarified that permitted transfers among members of a qualified group (or to a qualifying partnership) can be either taxable or tax-free (or partially taxable and tax-free).

¹ All statutory references are to the Internal Revenue Code of 1986, as amended, and all references to Treas. Reg. and Prop. Treas. Reg. are to the current and proposed income tax regulations thereunder.

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6. The regulations should permit transfers of assets to a corporation or a partnership prior to the reorganization.

7. Transfer of assets to a partnership owned by multiple members of a qualified group should be permitted under certain circumstances.

8. More guidance is needed with respect to the application of the COBE Test in conjunction with taxable asset sales and multiple and tiered partnerships.

9. It should be clarified that a corporation remains a "party to a reorganization" where there are subsequent transfers of assets or stock permitted by Prop. Treas. Reg. § 1.368-1(d)(5) and (f).

10. The regulations should apply also to "D" and "F" reorganizations.

We recognize that many of these suggestions may take IRS and Treasury considerable time to consider. To that end we urge the prompt finalization of the currently proposed regulations, while at the same time, possibly opening another project to analyze these additional issues in the coming months.
INTRODUCTION

On January 2, 1997, the Treasury and the IRS proposed regulations that generally would clarify the rules for qualification of certain transactions as tax-free reorganizations where the target corporation’s stock or assets are transferred by an acquiring corporation to members of the acquired corporation’s “qualified group,” or its assets are transferred to a partnership. The regulations address issues under both the “remote continuity” doctrine and the COBE doctrine.

Remote Asset Continuity

In Groman v. Commissioner, 302 U.S. 82 (1937), the U.S. Supreme Court held that continuity of interest did not exist to the extent that the selling shareholders received stock of the acquiring corporation’s parent in exchange for their stock in the target corporation.

Although the Court agreed that the transaction qualified as a reorganization and, therefore, the stock of the direct subsidiary acquiring corporation did not give rise to taxable income, the parent corporation was not a party to the reorganization and, therefore, the receipt of its stock by the transferor shareholders was taxable. In a companion case, Helvering v. Bashford, 302 U.S. 454 (1938), the Court held that the remote continuity doctrine established in Groman was applicable where the acquired properties were received by the parent and were then transferred by it to a subsidiary as part of a single plan. This unfortunate development of the remote continuity doctrine reflects an extremely narrow and formal view of that doctrine.

The remote continuity doctrine has been narrowed by Congress over the course of the years. For example, in 1954, Congress enacted section 368(a)(2)(C) which allows (i) the transfer of target assets acquired in a reorganization under section 368(a)(1)(A) or section 368(a)(1)(C) to a controlled corporation or (ii) after amendment in 1964, the transfer of the stock of a target corporation acquired in a section 368(a)(1)(B) reorganization to a controlled corporation. Also, in 1954, Congress amended section 368(a)(1)(C) to permit a triangular C reorganization and, in 1964, amended section 368(a)(1)(B) to permit a triangular B reorganization. In 1968, Congress enacted section 368(a)(2)(D) specifically sanctioning forward subsidiary mergers and, in 1971, Congress enacted section 368(a)(2)(E) allowing reverse subsidiary mergers.

The Treasury and the IRS have issued numerous pronouncements attempting to clarify the extent of the remote continuity doctrine. In several different cases, when the Treasury and the IRS adopted too rigid an interpretation for remote continuity, as indicated above, Congress overturned those interpretations. See, e.g., Rev. Ruls. 63-234, 1963-2 C.B. 148 and 67-326, 1967-2, C.B. 143.

The proposed regulations would specifically permit a transfer of the target stock or target assets among members of a "qualified group" following certain reorganizations. In that regard, the proposed regulations provide that the transfer of target assets or target stock among...
members of a "qualified group" will not violate the continuity of interest requirement in respect of reorganizations otherwise qualifying under sections 368(a)(1)(A), (B), (C) or (G) (meeting the requirements of sections 354(b)(1)(A) and (B)). Thus, target stock or target assets could be transferred among members of a qualified group without affecting the qualification of the transaction as a reorganization. In addition, the proposed regulations provide that continuity of interest is satisfied where target assets (or transfers of target assets following a stock acquisition) are transferred to a partnership in exchange for a partnership interest.

**Continuity of Business Enterprise**

Treas. Reg. § 1.368-1(b) requires that the COBE Test be satisfied in order for a transaction to qualify as a reorganization. The COBE Test requires that the acquiring corporation either (i) continue the target corporation's historic business (business continuity), or (ii) use a significant portion of the target corporation's assets in a business (asset continuity). Treas. Reg. § 1.368-1(d)(2).

The proposed regulations provide the COBE Test continues to be satisfied where there are transfers of target stock (or transfers of target assets after a stock acquisition) or target assets (or transfers of the acquiring corporation's stock after a target asset acquisition) among members of a qualified group in respect of reorganizations otherwise qualifying under sections 368(a)(1)(A), (B), (C) or (G) (meeting the requirements of sections 354(b)(1)(A) and (B)). In addition, the proposed regulations treat a partnership as an aggregate of its partners for purposes of the COBE Test, thereby reversing a prior informal position of the IRS that a partnership should be treated as an entity separate from its partners for this purpose. See, e.g., G.C.M. 35117 (Nov. 15, 1972). Thus, the proposed regulations provide that for purposes of the business continuity prong of the COBE Test, a corporate transferor partner ("PTR") will be treated as conducting a business of a partnership ("PRS") where (i) PTR has active and substantial management functions as a partner with respect to the PRS business, or (ii) PTR's interest in PRS represents a significant interest in the PRS business. For purposes of the asset continuity prong of the COBE Test, (i) PTR will be treated as owning the assets of PRS in accordance with PTR's interest in PRS, and (ii) PTR will be treated as conducting a PRS business if PTR meets either of the requirements for the business continuity prong of the COBE Test described in the previous sentence.

1. **The Proposed Regulations Should Be Adopted Promptly**

We strongly support the thrust of the proposed regulations to limit the uncertain scope of the remote continuity doctrine. In a number of cases, the proposed regulations adopt positions taken by the IRS in private letter rulings. We also support the change in IRS position with respect to the aggregate treatment of partnerships. Because these proposed regulations set forth sensible rules relating to the remote continuity and COBE doctrines, we urge the prompt finalization of these rules.

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2. **The Regulations Should Be Applicable to Transactions Closed After the Effective Date of the Regulations, But Subject to a Binding Contract Prior to Such Effective Date**

The proposed regulations apply only to transactions occurring after the final regulations are published in the Federal Register, except that they also will not apply to any transactions occurring pursuant to a written agreement which is (subject to customary conditions) binding on or before that date. We see no reason why the proposed regulations should not apply to transactions closed after the effective date of the regulations, but which were the subject of a binding contract prior to the effective date of the regulations. Although we believe that in many cases the proposed regulations merely clarify existing law, the preamble to the final regulations should include a statement to the effect that the regulations do not create any inference with respect to transactions governed by the law prior to the regulations.

3. **The Definition of "Qualified Group" Should Be Modified to Be Determined by Reference to Section 1504(a)(2)**

The proposed regulations define a "qualified group" as one or more chains of corporations connected through stock ownership with the issuing corporation, but only if the issuing corporation owns directly stock meeting the requirements of section 368(c) in at least one other corporation, and stock meeting the requirements of section 368(c) in each of the corporations is owned directly by one of the other corporations. Prop. Treas. Reg. § 1.368-1(d)(5)(iii). The "issuing corporation" is defined as the acquiring corporation or, in the case of a triangular reorganization, the controlling corporation. Prop. Treas. Reg. § 1.368-1(d)(5)(iv). Section 368(c) defines "control" as the ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation. In addition, the attribution rules of section 318 are inapplicable for purposes of section 368(c). See Rev. Rul. 56-513, 1956-2 C.B. 212. Thus, a qualified group requires the direct ownership by the issuing corporation or a qualified member of stock satisfying section 368(c).²

**Example 1 -- Direct Ownership:** P owns 100% of the only class of outstanding stock of S and S1 (first tier subsidiaries). S and S1 each own 50% of the only class of outstanding stock of S3 (second tier subsidiary). S and S1 are members of the qualified group but S3 is not, as neither S nor S1 owns a direct interest that constitutes control under section 368(c).

**Example 2 -- Nonvoting Plain Vanilla Preferred Stock:** P owns 100% of the common stock of S. S has outstanding a class of nonvoting preferred stock, which is treated as excludable preferred stock described in section 1504(a)(4), equal to 10% of S's total value.

² Section 368(c) requires the ownership of 80% of the total number of shares of each class of stock. See Rev. Rul. 59-259, 1959-2 C.B. 115.
Because P does not control S within the meaning of section 368(c), S is not a member of the qualified group.

We believe the definition of qualified group as determined by reference to section 368(c) is unnecessarily restrictive and should be defined by reference to section 1504(a)(2). Such a standard minimizes the ability of the acquiring corporation to attempt to avoid reorganization treatment by transferring the acquired stock or assets to a subsidiary that does not meet the control requirements of section 368(c). Adopting a section 1504(a)(2) standard would more closely follow the economic substance of the transaction. Moreover, we believe that the Treasury and IRS have authority to prescribe reasonable interpretative rules relating to the application of the remote continuity requirement and the COBE Test and are not limited by section 368(a)(2)(C) in determining the permissible transfers that satisfy these requirements.

If the Service considers bound by the statutory language of section 368(a)(2)(C), it should consider a special rule in the context of corporations that are members of an affiliated group filing a consolidated return. In such case, a qualified group could be defined as any member of an affiliated group within the meaning of section 1504(a) joining in the filing of a consolidated return. The treatment of members of an affiliated group filing a consolidated return differently than non-consolidated groups has precedent. See, e.g., Treas. Reg. § 1.1502-30 (stock basis after certain triangular reorganizations can create an excess loss account if liabilities assumed exceed the adjusted basis of target assets); Treas. Reg. § 1.1502-80 (sections 304 and 357 not applicable to affiliated group filing consolidated return). Such a rule would permit the transfer of target assets or target stock in both Examples 1 and 2, above, if the groups have elected to file consolidated returns.

As a second alternative for affiliated corporations filing a consolidated return, Treas. Reg. § 1.1502-34 could be amended to include section 368(c). This rule would permit the transfer of target assets or target stock in Example 1 but not Example 2 above. If the change in definition of "qualified group" is made through the consolidated return regulations, retroactive application may be limited by section 1503.

Finally, regardless of which standard is adopted, the regulations should provide that other transfers may be permitted. The preamble to the regulations should clarify that no inference is intended to be created that the transfers permitted by the regulations are the exclusive transfers permitted and that no negative inference is intended with respect to "cause to be directed" or other transactions. See, e.g., Rev. Rul. 64-73, 1964-1 C.B. 142.

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3 Presumably, section 368(c) was selected as the applicable standard because that standard is noted in section 368(a)(2)(C).

4 The acquiring corporation’s ability to unilaterally disqualify the reorganization may result in the target shareholders and acquiring corporation taking inconsistent positions.
4. **With Respect to the Application of the Continuity of Business Enterprise Test to Partnerships, the "Other Facts and Circumstances Test" Should Be Clarified With More Specific Examples**

In describing the application of the COBE Test to asset transfers to partnerships, Prop. Treas. Reg. § 1.368-1(d)(5)(v)(C) states that the fact that an acquiror-partner may be treated as conducting a business of a partnership which acquires target assets tends to establish COBE but is not alone sufficient. Although we understand the reluctance of the IRS to establish a bright-line test, it would be helpful if the regulations were clearer as to what considerations would be important in applying this facts and circumstances test. For example, is it the concern of the IRS that at some level of ownership the interest of a partner is simply too low to satisfy the COBE Test, regardless of the partner's management role? Is the IRS also concerned that the continuing business transferred to the partnership may be so small in relation to the other partnership operations as to lose its significance? Since the examples in the proposed regulations all reach the conclusion that both the remote continuity and COBE Test are satisfied, it is difficult to know what facts and circumstances are the cause for concern.

In the absence of further explication, we expect that the examples in the regulations will be read closely and that taxpayers will seek to extract rules from the examples which may not be intended. Thus, for example, we assume that Prop. Treas. Reg. § 1.368-1(d)(6), Example 9, provides a "safe harbor" for both the remote continuity and COBE Test so long as the transferor-partner has a one-third interest in the partnership, even though the partner has no management responsibility. If this is correct, the regulations should make this clear. Likewise, we assume that Example 8 of the regulations provides a "safe harbor" for the remote continuity and the COBE Test for a partner that performs active and substantial management functions coupled with a 20% interest in the partnership. Neither example suggests any concern about any other facts and circumstances other than active management and ownership percentage which are relevant to the COBE Test or the remote continuity requirement. We believe that the final regulations would be helped by clarifying the language of Prop. Treas. Reg. § 1.368-1(d)(5)(v)(C) in this respect.

5. **It Should Be Clarified That Permitted Transfers Among Members of a Qualified Group (or to a Qualifying Partnership) Can Be Either Taxable or Tax-Free (or Partially Taxable and Tax-Free)**

The proposed regulations do not specify whether subsequent transfers among members of a qualified group (or to a partnership) must be tax-free transfers (or partially tax-free transfers) or whether they can be taxable transfers (in whole or in part) without violating the remote continuity and the COBE Test. The final regulations should clarify that the regulations apply without regard to the form and tax consequences to the acquiring corporation (P) and transferees of the transfers of assets or stock.
Under the proposed regulations, most transfers will probably be tax-free exchanges, either under section 351 (if made to members of the qualified group) or section 721 (if made to a partnership). However, circumstances may arise where the transfer is a taxable transaction. These include the following:

a. Even when a transfer would otherwise qualify under section 351, P might be required to recognize gain under section 357(c) if P and the transferee do not join in a consolidated return.

b. A transfer to a member of the qualified group may not meet the requirements of section 351, particularly when the members of the group do not join in a consolidated return.

c. As a result of the operation of section 752, a transferor may recognize gain upon a transfer to a partnership of assets that are subject to liabilities.

d. The disguised sale rules of section 707(a)(2)(B) may apply, either by design or by inadvertence, to a transfer to a partnership.

e. P may find it desirable to sell the assets to a member of the qualified group or to a partnership if the transferee has unrelated shareholders or partners, if the transferee is separately subject to the jurisdiction of a regulatory agency or for other reasons.

Some of these questions could have arisen under prior law. However, they are more likely to arise in the future, in view of the latitude which the regulations will otherwise afford for transfers of the acquired assets or stock.

The obvious intent of the proposed regulations is to liberally clarify the rules for post-acquisition transfers. It would be in keeping with this intent to make clear that the precise form of transfer is immaterial, as long as the transfer is to a permitted transferee.\footnote{Arguably, this is consistent with the IRS position under current law. In Rev. Rul. 85-198, 1985-2 C.B. 120, 1, a holding company, merged into P. As a result of the merger, P acquired all of the stock of T’s subsidiary, S1. S1 then distributed to P all of the stock of S1’s subsidiary, S2. P transferred the S2 stock to one of its existing subsidiaries and sold the stock of S1 to an unrelated purchaser. The ruling holds that the COBE Test is met, without discussing the tax consequences of the distribution by S1 of the stock of S2 and subsequent contribution by P of that stock to its existing subsidiary.}
If our recommendation is accepted, then it could be implemented by including a statement in the preamble to the final regulations to the effect that the new rules apply without regard to the manner in which the transfer or transfers are made (e.g., in exchange for an equity interest in the transferee or by a sale to the transferee). In addition, Prop. Treas. Reg. § 1.368-1(f)(1)(ii) should be modified to read as follows:

"(ii) Partnerships. Continuity of interest is satisfied even where T assets (or transfers of T assets following a T stock acquisition) are transferred to a partnership of which the transferor or any member of the qualified group is a partner."

The regulations should also add an example where PTR owns a historic 33 1/3 percent interest in PRS and sells target's assets to PRS in exchange for cash. The example should conclude that, because PTR continues to own a 33 1/3 percent interest in target's assets, the transaction satisfies the COBE Test. The example should also make it clear that the COBE Test is satisfied after a sale of target's assets to PRS if PTR owns a 20 percent interest in PRS and conducts active and substantial management functions as a partner with respect to target's business.

6. The Regulations Should Permit Transfers of Assets to a Corporation or a Partnership Prior to the Reorganization

The examples in Prop. Treas. Reg. § 1.368-1(d)(6), relating to the application of the COBE Test, focus exclusively upon transfers occurring after a reorganization. There is no principled distinction between a transfer by target to a corporation or a partnership occurring before (but in connection with) a reorganization and a transfer to a corporation or a partnership occurring after (and in connection with) a reorganization. In fact, the IRS specifically rejected a taxpayer's attempt to distinguish a transfer to a partnership occurring immediately before a purported reorganization from such a transfer occurring immediately after a purported reorganization. G.C.M. 39150 (March 1, 1984), fn 2.

An example should be added to Prop. Treas. Reg. § 1.368-1(d)(6) where T transfers all of its assets to a partnership immediately prior to (and in connection with) a transaction otherwise qualifying as a reorganization in exchange for an interest that will result in a corporate transferor partner being treated as conducting a business of the partnership for purposes of Prop. Treas. Reg. § 1.368-1(d)(5)(v).

7. Transfer of Assets to a Partnership Owned by Multiple Members of a Qualified Group Should Be Permitted Under Certain Circumstances

In general, a transaction will satisfy the COBE Test, notwithstanding a corporate partner's transfer of target's assets to a partnership, provided the partner's interest in the partnership represents a significant interest in the partnership's business or that the partner conducts active and substantial management functions as a partner in the partnership. Prop.
Treas. Reg. § 1.368-1(d)(6), Example 10, provides that a corporate partner's entire interest in the partnership is taken into consideration for purposes of determining whether the COBE Test has been satisfied, even if the partnership owned a portion of that interest prior to the transaction at issue. Accordingly, even a historic interest in the partnership may be taken into account under the proposed regulations.

In addition to the foregoing, Prop. Treas. Reg. § 1.368-1(d)(6), Example 7, provides that the COBE Test is satisfied where the qualified group uses a significant portion of target's historic business assets in a business, even though no one corporation is using a significant portion of target's historic business assets in a business. The proposed regulations, however, do not appear to allow a qualified group to aggregate its interests in the partnership in determining whether the COBE Test has been satisfied. Because the proposed regulations generally aggregate a qualified group for purposes of the COBE Test and because the proposed regulations do not distinguish between a historic interest in the partnership and an interest in the partnership acquired in connection with the plan of reorganization, the proposed regulations should be amended to provide that the qualified group's interest in the partnership should be aggregated for purposes of the COBE Test.

An example should be added to the proposed regulations where a corporate partner transfers target's assets to a partnership in exchange for a 1 percent interest therein. The example should further provide that other members of the corporate partner's qualified group own, in the aggregate, a 32 1/3 percent interest in the partnership. The example should conclude that, because the corporate partner's qualified group maintained a 33 1/3 percent interest in target's assets, the transaction satisfies the COBE Test. The example should also make it clear that activities conducted by the corporate partner and other members of the corporate partner's qualified group that hold interests in the partnership should be aggregated in determining whether the corporate partner conducts active and substantial management functions as a partner. For example, the COBE Test should be satisfied where the corporate partner transfers target's assets to the partnership in exchange for a 19 percent interest as a limited partner if a member of the corporate partner's qualified group holds a 1 percent interest in the partnership as a general partner and conducts active and substantial management functions as a partner in the partnership. This aggregation should apply even if the transferor-partner sells the assets to a partnership in which it is not a partner in a taxable transaction, provided that other members of its qualified group are partners in the partnership to the extent required by the proposed regulations.

8. More Guidance is Needed With Respect to the Application of the COBE Test in Conjunction With Taxable Asset Sales and Multiple and Tiered Partnerships

Prop. Treas. Reg. §1.368-1(d)(5)(v)(A)(2) provides that, for purposes of the continuity of business enterprise requirement, a corporate transferor partner (PTR) will be treated as conducting a business of a partnership (PRS) where PTR's interest in PRS represents a "significant interest" in the PRS business. Prop. Treas. Reg. § 1.368-1(d)(6), Example 9,
indicates that PTR's ownership of a one-third interest in PRS is significant where PTR acquired all of T's assets in a reorganization and transferred, as part of the plan of reorganization, T's assets to a new partnership (PRS) in which PTR owns a one-third interest. Example 9 concludes that PTR is treated as conducting T's historic business because PTR's one-third interest in PRS represents a significant interest in the PRS business. It should be clarified whether it is correct to interpret the proposed regulations to reach the same result if, prior to the reorganization with PTR, T had sold two of its three equal lines of business to a third party for cash and marketable securities, as is the case in Example 1 of the continuity of business enterprise final regulations, Treas. Reg. § 1.368-1(d), or if PRS sold two of T's three lines of business to a third party after the reorganization. In such case, PTR's interest in PRS would represent a significant interest (i.e., one-third) in PRS, even though PTR owns on a look-through basis a smaller interest (i.e., one-ninth) in T's historic business.

Prop. Treas. Reg. § 1.368-1(d)(6), Example 7, addresses the consequences of transfers of assets to multiple members of a qualified group. Prop. Treas. Reg. § 1.368-1(d)(6), Example 7, illustrates that the COBE Test is satisfied where the qualified group uses a significant portion of target's historic business assets in a business even though no one corporation is using a significant portion of target's historic business assets in a business. A similar issue may arise where a corporate partner transfers target's assets to a number of different partnerships for state tax planning or other purposes. Because the proposed regulations provide that the corporate transferor-partner must have a "significant interest in the partnership's business," it appears that a partner who does not have a significant interest in any single partnership cannot aggregate interests in multiple partnerships to satisfy the requirement that it have a "significant interest." A corporate partner, however, should be entitled to aggregate its interests in multiple partnerships with respect to which it conducts active and substantial management functions. In other words, if a corporate partner transfers target's assets to 5 separate partnerships in exchange for a 10 percent general partnership interest in each partnership and conducts active and substantial management functions as a partner with respect to each partnership, the partner should be treated as conducting active and substantial management functions as a partner with respect to the partnership's business for purposes of the COBE Test.

Likewise, the proposed regulations do not address the treatment of multiple transfers down two or more tiers of partnerships. For example, if a corporate partner transfers all of a target's assets to a 33 percent partnership which, in turn, drops the assets to a partnership 33 percent owned by it, do these transfers satisfy the COBE Test? Further, the application of the

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active and substantial management functions test should be clarified with respect to tiered partnerships.

9. It Should Be Clarified That a Corporation Remains a "Party to a Reorganization" Where There Are Subsequent Transfers of Assets or Stock Permitted by Prop. Treas. Reg. § 1.368-1(d)(5) and (f)

Prop. Treas. Reg. § 1.368-2(f) currently provides that a corporation remains a party to a reorganization even though assets are transferred among members of the qualified group as defined in Prop. Treas. Reg. § 1.368-1(d)(5)(iii). Because Prop. Treas. Reg. § 1.368-1(d)(5)(ii) allows for transfers of target stock, in addition to target's assets, Prop. Treas. Reg. § 1.368-2(f) should be amended to provide that a corporation remains a party to a reorganization even though assets or stock are transferred among members of the qualified group. Because the proposed regulations also allow for transfers of assets to partnerships in certain circumstances, Prop. Treas. Reg. § 1.368-2(f) should be amended to provide that a corporation remains a party to a reorganization even though assets are transferred to a partnership, provided that the COBE Test has been satisfied.

The first sentence of Prop. Treas. Reg. § 1.368-2(f) could be amended to provide as follows: "A corporation remains a party to the reorganization even though assets or stock of target are transferred among members of a qualified group as defined in § 1.368-1(d)(5)(iii) and, provided the continuity of business enterprise requirement of § 1.368-1(d) has been satisfied, remains a party to the reorganization even though assets of target are transferred to a partnership."

Finally, the proposed regulations should provide that they do not provide an exclusive definition of a party to a reorganization.

10. The Regulations Should Apply Also to "D" and "F" Reorganizations

Prop. Treas. Reg. § 1.368-1(d)(5)(i) currently provides that the rules of paragraph (d)(5)(i) through (vi) relating the transfer of target's assets or stock to a member of the qualified group or the transfer of target's assets to a partnership apply only to transactions otherwise qualifying as reorganizations under sections 368(a)(1)(A), (B), (C) or (G) (meeting the requirements of sections 354(b)(1)(A) and (B)) ("Covered Reorganizations"). Prop. Treas. Reg. § 1.368-1(f)(1) provides similar limitations applicable to the remote continuity requirement. The preamble to the regulations notes that section 368(a)(2)(C) by its terms does not apply to acquisitive section 368(a)(1)(D) or section 368(a)(1)(F) reorganizations and solicits comments as to whether the rules regarding the transfer of target assets or stock should be extended to these reorganization provisions or to divisive section 368(a)(1)(D) reorganizations ("Excluded Reorganizations").
The preamble implies that the regulations apply only to Covered Reorganizations because section 368(a)(2)(C) by its terms applies only to those reorganizations. The proposed regulations, however, allow transfers of target assets to partnerships in connection with Covered Reorganizations in certain circumstances notwithstanding the fact that section 368(a)(2)(C) by its terms does not apply to transfers to partnerships. The preamble provides that the Treasury and IRS believe it is appropriate to treat a partnership as an aggregate of its partners in analyzing whether a transaction satisfies the continuity of proprietary interest requirement. The regulations also adopt an aggregate approach in determining whether a transaction satisfies the COBE Test. Accordingly, the aggregate view of partnerships, and not section 368(a)(2)(C), provides the support for the portion of the regulations allowing transfers of target assets to a partnership.

The fact that section 368(a)(2)(C) by its terms applies only to Covered Reorganizations is not relevant to the determination whether the regulations should allow for the transfer of target assets to a partnership by a corporate transferor partner in connection with an Excluded Reorganization. In fact, there is no distinction between Covered Reorganizations and Excluded Reorganizations for purposes of determining whether the aggregate or entity view of partnerships should be applied in determining whether a transaction satisfies the continuity of proprietary interest or COBE requirements applicable to reorganizations. Because the Treasury and IRS have appropriately concluded that the aggregate view of partnerships applies for purposes of determining whether a transaction satisfies the continuity of proprietary interest and COBE requirements, the provisions of the regulations sanctioning transfers to a partnership in certain circumstances should be extended to Excluded Reorganizations.

Moreover, we believe that the Treasury and IRS have authority to prescribe reasonable interpretative rules relating to the application of the remote continuity requirement and the COBE Test to Excluded Reorganizations and are not limited by section 368(a)(2)(C) in determining the permissible transfers that satisfy those requirements. Accordingly, the regulations should generally be extended to Excluded Reorganizations as well.
Comments Regarding Transfers of Assets Following Putative Reorganizations

These comments represent the individual views of members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation. These comments were prepared by individual members of the Committee on Corporate Tax of the Section of Taxation. Principal responsibility for drafting the report was exercised by Philip J. Levine, Dana L. Trier, Rachel Kleinberg, and Darin A. Zywan. Substantive contributions were made by John Barrie, Reginald Clark, Jasper L. Cummings, Julie Divola, Milton Hyman, Stuart Offer, William Richardson, Roger Ritt, Michael Schultz, Mark J. Silverman, Thomas F. Wessel, Rose L. Williams, and Philip B. Wright. The comments were reviewed by Robert Wellen of the Section’s Committee on Government Submissions and by Mark Yecies, Incoming Council Director for the Committee on Corporate Tax.

Although many of the members of the Section of Taxation who participated in preparing these comments have clients who would be affected by the federal tax principles addressed by these comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these comments.

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Date: May 26, 2004
Comments Regarding Transfers of Assets Following Putative Reorganizations

I. Executive Summary

A. Overview

The 2003-2004 Priority Guidance Plan published by the Treasury Department ("Treasury") and Internal Revenue Service ("Service") includes, under the caption "Corporations and their shareholders," the following item:

Guidance regarding transfers of assets after putative reorganizations.

We understand that a portion of the project may deal with the transfer of assets of a target corporation from either an acquiring subsidiary corporation or an acquired corporation to its parent after an acquisition (a “push-up”). The joint statement accompanying the Business Plan invites the public to provide comments on projects as guidance is developed throughout the year. We respectfully submit for your consideration our comments and suggestions regarding the U.S. federal income tax treatment of “push-ups.”

These comments focus on whether a “push-up” causes an acquisition otherwise qualifying as one type of triangular reorganization under Section 368 unless no longer to satisfy the applicable requirements or to be recharacterized as a transaction with potentially different tax results, such as an acquisition by the parent of the acquiring subsidiary or parent of the acquired

1 Unless otherwise noted, all citations to sections of the Internal Revenue Code ("Code") are to the Code of 1986, and to sections of the Regulations to the Treasury Regulations thereunder.
subsidiary after its acquisition. In particular, these comments offer suggestions as to how Treasury and the Service might interpret, preferably through regulations, existing provisions of the Code and regulations to provide greater flexibility for such transfers of assets of acquired companies within a corporate group, consistent with the current statutory and regulatory framework.

The discussion will be divided into six parts: (1) an overview of push-ups through several core illustrative transactions described below and the questions raised by such transactions; (2) an overview of the statutory and regulatory background and relevant rulings and similar authorities; (3) a discussion of the appropriate limits of general step transaction principles in this context; (4) an analysis of the application of the statutory “substantially all” test and nonstatutory rules under the continuity of interest and continuity of business enterprise doctrines with respect to the core illustrative transactions; (5) a treatment of certain other major collateral issues raised by push-ups, including liability assumption transfers; and (6) a discussion of the appropriate form of guidance on this issue.

B. Summary of Recommendations

We believe that a “push-up” only should cause a triangular reorganization to be recast as a direct acquisition by the acquiring parent in a limited category of cases. We would follow the long-standing Service position that a pre-planned push-up by actual liquidation of the acquiring

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2 The “triangular” transactions that are the focus of this report include both statutory mergers potentially subject to Sections 368(a)(2)(D) and 368(a)(2)(E) and subsidiary C reorganizations under Section 368(a)(1)(C). As a practical matter, however, similar issues may be raised by other acquisitive transactions. For example, a putative C reorganization by an acquiring corporation for stock of the acquiring corporation followed by a distribution of assets to the acquiring corporation’s shareholders may raise similar issues. Although the tax treatment of such transactions is not the focus of this report, we will discuss issues relating to such transactions in Part VI.
or acquired subsidiary should not be analyzed as a subsidiary acquisition for Section 368 purposes. In that case, qualification of the transaction as a tax-free reorganization would depend upon qualification of the transaction treating the acquiring parent as the acquiror. We were unable to reach a consensus with respect to a case in which all of the principal operating assets of the target were distributed by the acquiring or acquired subsidiary to its parent, but the subsidiary remained in existence. Some of us would treat the parent as the acquiror if “substantially all” of the assets are distributed; others only would treat the parent as the acquiror if the distribution constituted a “de facto liquidation” of the subsidiary. We agreed that, in all other cases involving a push-up, the form of the transaction should be respected.

We believe that our recommendation is consistent with applicable statutory and nonstatutory requirements for a tax-free reorganization. Our comments propose that the recommended approach be included in Treas. Reg. § 1.368-2(k).

II. Issues Relating to Push-Ups

The issues relating to push-ups that are the subject of this report are of considerable practical significance. It is now quite common after consummation of a triangular reorganization for the acquiring group to consider moving a portion of the assets of the target corporation (for example, intellectual property) up to the acquiring parent or to other parts of the group. In a significant number of cases, these post-acquisition transactions will not constitute “drop-downs” covered by the now extensive guidance relating to such transactions, and important step transaction and technical questions are thus raised.
A. Illustrative Transactions

The central issues that are our focus can be usefully analyzed from the perspective of four variations of pre-planned transactions immediately after a putative tax-free reorganization under Sections 368(a)(1)(A) and 368(a)(2)(D). Assume, for illustration purposes, that an unrelated target (“T”) is acquired by the forward merger of T into the newly formed wholly-owned acquisition subsidiary (“S”) of a parent acquiror (“P”) in which the T shareholders receive P voting stock. P and S then enter into one of four alternative preplanned transactions:

(1) The outright liquidation of S into P (“Case 1”);

(2) The distribution of a portion of T’s assets to P in a transaction in which S does not liquidate and after which S retains assets of T constituting all of T’s principal operating assets (i.e., substantially all of T’s assets) (“Case 2”);

(3) The distribution by S of all of the principal operating assets of one of the acquired businesses (i.e., less than substantially all of T’s assets) to P (40-60 percent of the gross assets) in a transaction in which S does not liquidate and after which S retains all of the principal operating assets of the other acquired business (“Case 3”); and

(4) The distribution by S to P of all of T’s principal operating assets (i.e., substantially all of T’s assets) in a transaction in which S does not liquidate and retains some of T’s assets (“Case 4”).

B. Questions Raised By the Illustrative Transactions

The questions posed by these basic transactions can be divided into two broad categories. The first set of questions is whether the transactions can, consistently with the structure of the statute and the existing framework of established step transaction authorities under Subchapter C, be viewed as a transaction with S as the “acquiror” and analyzed on that basis under Section 368(a)(2)(D). As to this question, we propose, for the reasons discussed below, that Case 2 and Case 3 above should be analyzed as a transaction with S as the acquiror. In addition, we propose
that a pre-planned push-up by actual liquidation of the acquiring or acquired subsidiary (Case 1) should not be analyzed as a subsidiary acquisition for Section 368 purposes. Accordingly, in that case, qualification of the transaction as a tax-free reorganization would depend upon qualification of the transaction as if P were the acquiror and would depend upon whether, for example, the requirements of Section 368(a)(1)(C) were met viewing P as the acquiror. As to Case 4, which involves a push-up of substantially all of the T assets but no liquidation of S, we did not reach a consensus. As discussed below, some of us would not treat S as the acquiror if “substantially all” of the assets are distributed to P; others would treat S as the acquiror unless the distribution constituted a “de facto liquidation” of S. In any case in which the transaction was recast to treat P as the acquiror and in which S retains some of the T assets, we propose that the transaction be treated as an acquisition by P with a drop to S of the assets that S in form retains.

The second set of questions raised by these transactions is whether both the technical statutory requirements of the “substantially all” test and the broad nonstatutory concepts relating to the tax-free reorganization rules such as the continuity of interest and continuity of business enterprise rules can be reconciled with Case 2 and Case 3. We conclude for the reasons discussed below that the tax-free treatment of these transactions is not inconsistent with the application of these requirements and concepts.

III. Background

A. Statutory and Regulatory Framework

Section 368 identifies several types of corporate stock and asset transactions as qualifying reorganizations subject to nonrecognition treatment. The Code originally limited the definition
of reorganization to two-party transactions. The Supreme Court, in Groman v. Comm’,r, 302 U.S. 82 (1937), and Helvering v. Bashford, 302 U.S. 454 (1938), held that the reorganization provisions did not permit a direct transfer of target assets to an acquiring subsidiary in exchange for its parent’s stock or a transfer of target assets to an acquiring parent followed by a drop to its subsidiary. Starting in 1954, in response to these decisions, Congress repeatedly has expanded the reorganization definition to permit drops of acquired assets or stock following a reorganization and to permit direct transfers to a subsidiary in exchange for parent stock. With the issuance of Treas. Reg. § 1.368-2(k), the government has, in effect, expanded Section

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4 Groman involved the acquisition of all the stock of target by a newly formed subsidiary of a parent corporation followed by the liquidation of target into the subsidiary for consideration consisting of stock of both the parent and acquiring subsidiary. The Supreme Court determined that the parent corporation was not “a party to a reorganization” and would not look through the parent to measure the target shareholders’ continuity of interest in the acquired assets. The Supreme Court emphasized that the stock in the parent was an interest in parent’s assets, only part of which was the stock of the acquiring subsidiary. Bashford involved the acquisition and consolidation in one subsidiary of the acquiror of the stock and assets of three target corporations, with the target shareholders again getting stock in both the acquiring parent and its subsidiary as consideration. The Supreme Court held that the parent stock did not represent stock with the requisite continuity of interest.

5 Congress enacted Section 368(a)(2)(C) as part of the 1954 Code in an attempt to limit the application of the Groman-Bashford doctrine, which, as noted above, would cause a reorganization to be disqualified on remote asset continuity grounds if the acquired assets or stock of a target were ultimately lodged in a subsidiary of an acquirer. Section 368(a)(2)(C) explicitly provides that a transaction otherwise qualifying under Sections 368(a)(1)(A), (1)(B), (1)(C) and certain transactions under 368(a)(1)(G) shall not be disqualified by reason of the fact that part or all of the assets or stock which were acquired in the transaction are transferred to a corporation controlled by the corporation acquiring such assets or stock.

In 1954, Congress also amended Section 368(a)(1)(C) to permit the use of a parent corporation’s stock in a transaction in which the assets of the target corporation are acquired by a subsidiary which is directly controlled by the parent corporation. In 1964, Congress expanded the scope of Section 368(a)(1)(B), permitting the use of a parent corporation’s stock in a transaction in which the stock of the target corporation is acquired by a subsidiary which is directly controlled by the parent corporation. In 1968, Congress added Section 368(a)(2)(D), which permits the target corporation to merge directly into a subsidiary of the parent corporation with the target shareholders exchanging their target stock for stock of the parent corporation (a “forward triangular” merger). In 1971, Congress added Section 368(a)(2)(E), which permits a subsidiary corporation to merge directly into the target corporation with the target corporation surviving and the target shareholders receiving stock of the subsidiary’s parent corporation (a “reverse triangular” merger). These provisions were added or amended to accommodate transactions that had the effect of a merger, when for some reason a direct statutory merger or consolidation into the parent corporation was not feasible.
368(a)(2)(C) by permitting successive transfers of acquired assets or stock to one or more corporations controlled in each transfer by the transferor corporation. In addition, in two recent revenue rulings, the Service announced its view that the language of Section 368(a)(2)(C) permitting drops of acquired assets or stock is permissive, rather than exclusive or restrictive. Finally, most recently, the Service issued proposed regulations, which would further confirm the liberal treatment of drop-downs evidenced in these pronouncements. Thus, taxpayers now are afforded considerable flexibility in dropping acquired assets or stock following an acquisitive reorganization.

By contrast, the tax law governing “push-ups” is much less developed. In fact, it is striking how little guidance exists regarding the effect of push-ups on reorganization qualification. There are no cases addressing reorganization transactions in which some or all of the acquired assets were transferred to the shareholder of the acquiring corporation following the initial acquisition other than by liquidation or merger; and perhaps in part for that reason, there is no statutory analogue to Section 368(a)(2)(C) in which Congress has explicitly addressed such a transaction. As summarized below, although there are several revenue rulings that could be viewed as generally relevant to the treatment of push-ups under step transaction principles, the

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6 For this purpose, control is defined under Section 368(c) as ownership of stock possessing at least 80 percent of the total combined voting owner of all classes of voting stock plus at least 80 percent of the number of outstanding shares of each class of nonvoting stock of the corporation. Rev. Rul. 59-259, 1959-2 C.B. 115.


most thorough discussion of the issues still relevant today is contained in several General Counsel Memoranda ("GCMs")\(^9\) issued in the 1970’s and 1980’s.

**B. Revenue Rulings**

In two of the classic revenue rulings under Subchapter C, Rev. Rul. 67-274, 1967-2 C.B. 141, and Rev. Rul. 72-405, 1972-2 C.B. 217, the Service considered the tax treatment of a pre-arranged liquidation of the target or acquiring subsidiary on the overall characterization of an acquisitive transaction. While the application of the step transaction doctrine to acquisition transactions has been the subject of several important pronouncements in recent years as a result of statutory changes, the basic concepts applied in these two rulings have remained intact.

In Rev. Rul. 67-274, the acquiring corporation acquired all of the outstanding stock of the target corporation in exchange solely for voting stock of the acquiring corporation. As part of the plan to acquire the target corporation, the target corporation distributed all of its assets to the acquiring corporation in liquidation. The Service concluded that “the two steps may not be considered independently of each other for Federal income tax purposes. . . . The substance of the transaction is an acquisition of assets . . . .” Accordingly, the Service ruled that the transaction qualified as a reorganization described in Section 368(a)(1)(C), rather than Section 368(a)(1)(B).\(^{10}\)

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\(^9\) GCMs are not considered “authority” for certain purposes. Treas. Reg. § 1.6662-3(b)(2) does not list GCMs as “authority” that can be considered in determining whether there is “substantial authority” for the tax treatment of an item.

\(^{10}\) As a consequence of its holding, the Service stated that the rules under Section 382(b) (relating changes of ownership resulting from reorganizations), as then in effect, would apply. The treatment under Section 382, as then in effect, would have been different had the transaction been treated as a reorganization under Section 368(a)(1)(B).
The concept underlying Rev. Rul. 67-274 was extended in Rev. Rul. 72-405 to a liquidation of an acquiring subsidiary rather than the acquired corporation. In that ruling, the target corporation merged into a newly-formed subsidiary of a parent corporation with the target shareholders receiving stock of the parent corporation. As part of a plan that included the reorganization, the newly-formed subsidiary distributed all of its assets in complete liquidation to the parent. After discussing the principles of Rev. Rul. 67-274, the Service determined that the transitory passage of the assets and liabilities of the target corporation through the newly-formed subsidiary would not be accorded independent significance for tax purposes. Accordingly, the Service ruled that the transaction qualified as a reorganization described in Section 368(a)(1)(C), rather than as a reorganization within the meaning of Sections 368(a)(1)(A) and 368(a)(2)(D) followed by a liquidation of the newly-formed subsidiary. These rulings can be viewed as key authorities at the core of a broader line of authority applying step transaction principles to two-step acquisitions of all of a target’s assets.11

There appears, however, to be only one published ruling dealing with the narrower question of the effect of push-ups of a portion of the target assets after the first step of an acquisitive transaction. In Rev. Rul. 74-35, 1974-1 C.B. 85, the acquiring corporation acquired all of the outstanding stock of the target corporation solely in exchange for shares of voting common stock of the acquiring corporation. As part of the plan that included the reorganization, the target corporation made a distribution to the acquiring corporation of appreciated investment

11 See King Enterprises, Inc. v United States, 418 F.2d 511 (Ct. Cl. 1969); Seagram Corp. v. Comm’r, 104 T.C. 95 (1995); Rev. Rul. 2001-46, 2001-2 C.B. 321; Rev. Rul. 2001-26, 2001-1 C.B.1297. If the acquiring subsidiary immediately merges up into P, it is not clear whether the integrated transaction is analyzed under Section 368(a)(1)(A) or 368(a)(1)(C) because T, the target, did not merge directly with P under state law. See PLRs 9644046 (Nov. 1, 1996); 8701028 (Oct., 7, 1986) and 8453046 (Sept. 28, 1984). See generally Ginsburg and Levin, Mergers, Acquisitions and Buyouts, Vol. 2, 8-35 (2003).
assets that represented 30 percent of the target corporation’s total assets. The Service considered whether the transaction should be recast as (1) a constructive sale by the target to the acquiring corporation of the assets “distributed” in exchange for an amount of acquiring corporation stock received of equivalent value, followed by a constructive taxable distribution of such stock by the target corporation to its shareholders, and (2) a concurrent exchange by the target corporation shareholders of their target stock solely for acquiring corporation stock qualifying as a reorganization under Section 368(a)(1)(B). The ruling notes that:

The Kimbell-Diamond principle, as illustrated by Rev. Rul. 67-274, does not support a recast of a portion of a transaction, such as in the instant case, because [the acquiring corporation] does not acquire substantially all the property of [the target corporation]. [The acquiring corporation] continues its stock interest in [the target corporation], which retains all of its operating assets and 70 percent in value of all the assets it owned prior to the transaction.12

Accordingly, the Service ruled that the acquisition qualified as a reorganization within the meaning of Section 368(a)(1)(B) and the subsequent distribution of assets was a distribution of property under Section 301.13

12 In Kimbell-Diamond Milling Co. v. Comm’r, 14 T.C. 74 (1950), aff’d per curiam, 187 F.2d 718 (5th Cir. 1951), one corporation acquired all of the stock of another corporation pursuant to a prearranged plan in which the target corporation then distributed all of its assets to the acquiring corporation in complete liquidation. The court gave effect to the intent, purpose, and result “of this plan such that the acquiring corporation was treated as if it had actually acquired assets rather than stock.” In Rev. Rul. 74-35, the Service viewed Rev. Rul. 67-274 as an application of “the Kimbell-Diamond principle.”

13 Cf. Rev. Rul. 75-521, 1975-2 C.B. 120 (Kimbell-Diamond principles not applied to recast transaction in which parent owned 50 percent of the stock of a subsidiary that was not recently purchased and acquired the remaining 50 percent and immediately liquidated the subsidiary).
C. General Counsel Memoranda

Several GCMs issued during a relatively brief period of time generally contemporaneously with Rev. Rul. 74-35 provide a more detailed analysis by the Service of the issues that must be addressed in determining the tax treatment of a “push-up.” In revealing how the views of the Chief Counsel’s office kept changing over a relatively short time period, these GCMs reflect the difficulty of the issues raised by push-ups. The same issues considered in these GCMs during this period ultimately must be resolved for meaningful guidance on push-ups to be issued today.

The Service’s initial reference to push-ups appears in GCM 35267 (Mar. 14, 1973), in which it was noted that the qualification of a triangular reorganization under Section 368(a)(1)(C) “might be voided on the ground that the acquiring company (the controlled subsidiary) failed to acquire ‘substantially all’ the assets of the acquired company” due to a planned distribution of part of the acquired assets by a controlled subsidiary to its parent in an otherwise qualifying triangular C reorganization. However, this was not the primary focus of the GCM, and the Service acknowledged that the issue had not been considered in depth.14

In GCM 36111 (Dec. 18, 1974), the Service considered whether, as part of a plan of reorganization described in Sections 368(a)(1)(A) and 368(a)(2)(D), the surviving corporation in the merger could transfer a large portion of the acquired assets (80 to 85 percent by value) to its sole corporate shareholder. Respecting the form of the transaction, the GCM determined that the

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14 The facts of GCM 35267 did not involve a push-up after an asset reorganization. The GCM did, however, consider whether a stock for stock transaction otherwise described in Section 368(a)(1)(B) that was followed by a planned intercorporate distribution of assets should be recast for tax purposes. The other portions of the analysis are not relevant to the discussion of push-ups.
push-up was not incompatible with the statutory requirements of Section 368(a)(2)(D) and did not violate the continuity of interest requirement. The GCM noted that the enactment of Section 368(a)(2)(C) was required by reason of the *Groman* and *Bashford* decisions in order to permit drop-downs to a controlled corporation following a reorganization. According to the GCM, no similar special statutory provision was required to permit a push-up to the controlling corporation. Changing its initial view as expressed in GCM 35267, the Service concluded that the “substantially all” requirement of Section 368(a)(2)(D) was not affected by post-acquisition dispositions of the acquired assets.

In our opinion... the “substantially all” requirement... at least where the assets are retained by the acquiring corporation, its controlled corporation, or a corporation controlling it, refers only to the respective value of the assets transferred by [the target corporation] pursuant to the plan of reorganization and those disposed of by it prior to but as a part of the reorganization transaction. ... We therefore believe that the “substantially all” requirement as it exists in [Section] 368(a)(2)(D) again, at least in the context of this case, concerns only preacquisition dispositions.

The Service stated that its “categorical conclusion” in GCM 35267, in which the Service said that a push-up might void a triangular reorganization under Section 368(a)(1)(C), was incorrect. Ultimately the Service concluded that:

the “substantially all” language... expresses a requirement that substantially all of the acquired corporation’s assets be acquired in the reorganization. This requirement, in our opinion, does not mandate that such quantum of assets be retained by the surviving subsidiary corporation assuming that the basic requisites of a reorganization are satisfied... .

However, the Service acknowledged that a push-up:

raises questions as to whether such transaction should be considered to qualify under [Section] 368(a)(1)(A) and (a)(2)(D) because of the large
portion of the acquired corporation’s assets transferred by the acquiring subsidiary to its parent corporation. . . . At this juncture, we simply wish to emphasize that there is some doubt that [Section] 368(a)(2)(D) was intended to facilitate mergers whereby the parent corporation, via a “push-up” arrangement, acquires direct possession of the assets of the target corporation.

Presumably if the transaction were recast as an acquisition by the parent, the requirements of Section 368(a)(1)(C) would have to be satisfied.

In GCM 37905 (Mar. 29, 1979), the Service reconsidered whether the form of a purported triangular reorganization should be respected when approximately 90 percent by value of the acquired assets were transferred to the parent corporation in a push-up. The Service determined that use of the substance-over-form doctrine was appropriate in identifying which entity was the “acquiring” corporation in purported triangular reorganizations under Section 368(a)(2)(D) and parenthetical Section 368(a)(1)(C) that involved a push-up. Because the push-up involved approximately 90 percent of the value of the target corporation’s assets, the Service concluded that the parent was in substance the “acquiring” corporation. Furthermore, citing Rev. Rul. 70-107, 1970-1 C.B. 78, the Service concluded the transaction did not satisfy the “solely for voting stock” requirement of Section 368(a)(1)(C), because the liabilities of the target were assumed by the subsidiary corporation, rather than the parent corporation.\textsuperscript{15}

Later, in GCM 39102 (Dec. 21, 1983), the Service applied a substance-over-form analysis similar to that used in GCM 37905. However, GCM 39102 took the position that Rev. Rul. 70-107 was incorrect and that all parties to a reorganization exchange should be permitted to

\textsuperscript{15} In Rev. Rul. 70-107, 1970-1 C.B. 78, the Service concluded that “solely for voting stock” requirement of Section 368(a)(1)(C) required that only the “acquiring corporation” assume liabilities of the target corporation in the reorganization. See discussion below.
assume the liabilities of the target corporation, reasoning among other things that the failure to provide relief for the assumption of liabilities by the parent of acquirer was a legislative oversight when Congress extended “C” reorganization treatment to triangular C reorganizations and that Rev. Rul. 70-107 imposes an “artificial distinction” between triangular mergers subject to Section 368(a)(2)(D) and “practical” triangular mergers subject to Section 368(a)(1)(C). Accordingly, under GCM 39102 the transaction would qualify as a reorganization under Section 368(a)(1)(C), even though a party other than the acquiring corporation assumed liabilities of the target corporation. The revocation of Rev. Rul. 70-107 was, however, never implemented.

IV. Determination of the Acquiring Corporation; Application of Step Transaction Principles and Consistency with Statutory Framework

The threshold question relating to push-ups, as reflected in the GCMs discussed above, is how to reconcile the application of step transaction principles with treatment of the acquiring subsidiary as the “acquiring” corporation for purposes of technical statutory analysis. In this regard, we believe it important to apply to push-ups an analytical framework generally consistent with otherwise established core step transaction authorities. We believe that these objectives are best satisfied in this context by applying step transaction and substance over form principles to recast the transaction if and only if the putative acquiring corporation (S in our four core illustrative cases) either actually liquidates (or merges) in a pre-planned transaction into its parent (P in our illustrative cases) or distributes virtually all of its assets to P. In the case of a transaction in which S remains in existence, the transaction would be recast as a direct transfer to P followed by a drop of assets to S. In addition, we would apply our analysis equally to a transaction in which S merged with and into T, with T surviving (i.e., a reverse triangular merger), and T’s assets were pushed up to P.
This approach appears to be entirely consistent with the relevant published revenue rulings described above. Rev. Rul. 67-274 and Rev. Rul. 72-405, of course, involved the termination of the existence of S, and we believe that, at this stage of the development of Subchapter C principles, it is appropriate to leave these rulings intact and applicable for purposes of analyzing push-ups. Moreover, as discussed above, Rev. Rul. 74-35 explicitly did not recast a transaction in which less than substantially all of the assets were moved in a preplanned transaction.

We were unable to reach a consensus on which test should be applied to determine whether a transaction should be recast if assets are distributed to P, but S is not liquidated. There was general agreement, however, that the test applied should limit recasts to cases in which virtually all of T’s operating assets had been pushed-up to P.

Some of us favor drawing a line for application of step transaction principles between transfers of assets not constituting substantially all of the assets and those constituting substantially all. It is argued that use of a substantially all test in this context appears consistent with a statutory scheme in which the acquisition of substantially all of the assets by P would be analyzed under Section 368(a)(1)(C) and in which Congress applied a substantially all test in defining a “practical merger.” In this connection, we would not recommend that the Service’s

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16 Several members of the Committee question whether Rev. Rul. 67-274 should continue to govern the application of step transaction doctrine, noting among other things that the issues at stake at the time the revenue ruling was issued (i.e., treatment of the transaction under Section 382) are no longer relevant. These members suggest that the step transaction rules should not be applied to convert a transaction that in form is tax-free into a taxable transaction. (Neither Rev. Rul. 67-274 nor Rev. Rul. 72-405 caused the transactions analyzed to be taxable.) Concerns were also expressed that unilateral actions by the acquiring group should not affect the tax treatment of the target shareholders.

17 The substantially all test is discussed in more detail below.
90/70 ruling safe harbor\textsuperscript{18} should create an absolute standard for applying the step transaction doctrine.\textsuperscript{19} For example, if the acquiring subsidiary retains an active business, we do not believe the transaction should be recast even if the assets transferred up to parent would satisfy the ruling safe harbor.

Others of us are concerned that a substantially all test is potentially overbroad, and argue that use of substantially all as the standard has the disadvantage of importing a test that has been the subject of considerable uncertainty and litigation over the years.\textsuperscript{20} It is recommend that transactions in which S stays in existence should only be recast in the event that S has made a distribution that constitutes a “de facto liquidation.”\textsuperscript{21} Under this approach, recasts would be limited to cases in which S actually liquidated or liquidated in substance and retained only immaterial assets.

We explicitly considered and rejected an approach that would turn off step transaction principles completely and disregard all push-ups. We note in this regard that there appears to be no reason based in legislative history to “turn off” the core historic Subchapter C recast authorities that continue in effect today. Unlike the case with respect to the legislative history of

\textsuperscript{18} The Service has stated that a transfer of assets representing at least 90 percent of the fair market value of the net assets and at least 70 percent of the fair market value of the gross assets held by the transferor corporation immediately prior to the transfer will be considered substantially all of the assets for advance ruling purposes. See Rev. Proc. 77-37, 1977-2 C.B. 568.

\textsuperscript{19} If the substantially all approach is adopted, we believe that a safe harbor would be appropriate.

\textsuperscript{20} See footnote 31 supra. Because of the uncertainty in this area, whether or not substantially all is the standard adopted here, it would be helpful for the Service to issue guidance on the meaning of that test.

\textsuperscript{21} For examples of cases addressing de facto liquidation, see Owens v. Comm’r, 568 F.2d 1233 (6th Cir. 1977), aff’d, 64 T.C. 1 (1975); United States v. Jackson Oldsmobile, Inc., 371 F.2d 808 (5th Cir. 1967); Anbaco-Emig Corp. v. Comm’r, 49 T.C. 100 (1967)(acq.); Lowndes v. United States, 384 F.2d 635 (4th Cir. 1967); Grubbs v. Comm’r, 39 T.C. 42 (1962); Rev. Rul. 61-191, 1961-2 C.B. 251.
Section 338 relating to two-step transactions involving a qualified stock purchase\(^{22}\) and the legislative history of Section 355(e) relating to transactions after a spin-off,\(^{23}\) for example, there is no legislative history indicating a reason to apply a strict form-based analysis in this context. Moreover, as noted above, there is no real equivalent to Section 368(a)(2)(C) with respect to push-ups. Of course, the Service has the authority to “turn off” the step transaction doctrine in appropriate cases without any specific Congressional authorization.\(^{24}\) However, the Service already has applied the step transaction doctrine to push-ups in Rev. Rul. 67-274 and Rev. Rul. 72-405. Thus, we believe the lines we are drawing between Case 2 and Case 3, on the one hand, and Case 1 and Case 4, on the other hand, are most consistent with the existing framework of the authorities under Subchapter C.\(^{25}\)

A somewhat more difficult question is whether Case 3 should be viewed as consistent with the statutory framework. Assume, for example, a case in which exactly 50 percent of the historic assets of T are pushed up by S to P in a preplanned transaction immediately after a putative Section 368(a)(2)(D) triangular reorganization. In such a case, neither P nor S ends up with substantially all T’s assets and in that regard both arguably could be viewed as equal candidates for being viewed as the acquiring corporation for purposes of technical analysis.


\(^{25}\) We also believe that the result should not change if, following a push-up of assets that would be treated as a separate step under our analysis, P were to drop the T assets to a subsidiary in a different chain. Similarly, we believe that our push-up analysis should be applied to direct cross-chain transfers, whether or not consideration is received in the exchange.
The principal question here is whether the existing statutory framework reveals a strong Congressional intent that one and only one corporation be the real acquiror. Note in this regard, for example, that specific statutory provisions, such as Section 368(a)(2)(D)(ii) and the parenthetical clauses of Sections 368(a)(1)(B) and 368(a)(1)(C), seem to indicate a Congressional unwillingness to permit flexibility if and to the extent that the consideration is that of two different acquirors. In a very general way, this could indicate a Congressional unwillingness to sanction transactions as to which there are two strong candidates for being treated as the acquirors and thus successors to target’s attributes. Note in this regard that the changes to the Code after *Groman* and *Bashford* did not actually sanction split consideration.26

We believe, however, that legislative intent is not so clear as to preclude a division of target assets among the acquiring group so long as, in form, one party is the acquiring corporation and the target shareholders only receive stock of the parent of the acquiring corporation. Once those requirements are satisfied and one logical entity to serve as a successor to target has been established, application of existing step transaction principles is, as argued here, not inconsistent with respecting the form so long as the push-up is not of virtually all the target assets acquired. What we are proposing here is also generally consistent with the concepts underlying the drop-down rules. As stated in the preamble to the recent proposed regulations, the question should be whether “. . . in all the situations considered, the transactions in form satisfy the statutory requirements of a reorganization and, in substance, constitute readjustments

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26 We also note that the Section 381 regulations do not divide target attributes among members of the acquiring group. See Treas. Reg. § 1.381(a)-1(b)(2)(ii) (Example 3) and -1(b)(3)(ii).
of continuing interests in the reorganized business in modified corporate form” and “none of the transactions involve the transfer of the acquired . . . assets to a stranger.”

V. Analysis of Push-ups Under Core Statutory and Nonstatutory Requirements

Assuming that, consistent with generally applicable step transaction principles and the existing statutory and regulatory framework, the acquiring subsidiary, S, can be viewed as the acquiror in transactions similar to Case 2 and Case 3, the question remains whether the other core statutory and nonstatutory requirements applicable to triangular acquisitions specifically and tax-free reorganizations generally are satisfied if there is a preplanned push-up. There are several statutory and nonstatutory requirements for qualification as a reorganization that may be implicated by a push-up. Other than direct mergers, all acquisitive asset reorganizations include a requirement that the acquiring corporation acquire “substantially all” of the assets of the target corporation. Reverse triangular acquisitions require that the target “holds” substantially all of

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28 Section 368(a)(1)(C) is defined as:

the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of substantially all of the properties of another corporation, but in determining whether the exchange is solely for stock the assumption by the acquiring corporation of a liability of the other shall be disregarded.

A transaction subject to Section 368(a)(1)(D) is described as:

a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under Section 354, 355, or 356.

For acquisitive reorganizations under Section 368(a)(1)(D), Section 354(b)(1)(A) requires that “the corporation to which the assets are transferred acquires substantially all of the assets of the transferor of such assets.” Section 368(a)(2)(D) provides that:

the acquisition by one corporation, in exchange for stock of a corporation (referred to in this subparagraph as “controlling corporation”) which is in control of the acquiring corporation, of substantially all of the properties of another corporation shall not disqualify a transaction under paragraph (1)(A) or (1)(G) if -- (i) no stock of the acquiring corporation is used in the transaction,
its properties and the properties of the merged corporation following the acquisition. A question arises as to whether it is enough to acquire substantially all of the target corporation’s assets if the acquiring corporation ceases to hold such assets pursuant to a pre-arranged plan to do a push-up. In addition, push-ups must be analyzed with respect to the continuity of interest and continuity of business enterprise requirements.

A. Substantially All

The core issue here relating to the substantially all requirement is the effect on the satisfaction of the requirement of subsequent transfers by the acquiring corporation to its shareholder for no consideration. Analysis of this issue requires a review of the history of the reorganization provisions and the purpose of the substantially all requirement. We believe that the purpose of this requirement is met as long as substantially all of the assets of the target are acquired in the transaction, and the transaction is not “divisive” in relation to the indirect proprietary interests of the target shareholders in the target corporation (i.e., the target

and (ii) in the case of a transaction under paragraph (1)(A), such transaction would have qualified under paragraph (1)(A) had the merger been into the controlling corporation.

29 Section 368(a)(2)(E) provides that: [a] transaction otherwise qualifying under paragraph (1)(A) shall not be disqualified by reason of the fact that stock of a corporation (referred to in this subparagraph as the “controlling corporation”) which before the merger was in control of the merged corporation is used in the transaction, if -- (i) after the transaction, the corporation surviving the merger holds substantially all of its properties and of the properties of the merged corporation (other than stock of the controlling corporation distributed in the transaction); and (ii) in the transaction, former shareholders of the surviving corporation exchanged, for an amount of voting stock of the controlling corporation, an amount of stock in the surviving corporation which constitutes control of such corporation.

The Service recently ruled that the use of the term “holds” in Section 368(a)(2)(E) “does not impose requirements on the surviving corporation before and after the merger that would not have applied had such corporation transferred its properties to another corporation in a reorganization under Section 368(a)(1)(C) or a reorganization under Sections 368(a)(1)(A) and 368(a)(2)(D).” Rev. Rul. 2001-25, 2001-1 C.B. 1291.

30 For a thoughtful discussion of the issues related to the application of the substantially all requirement in the context of distributions both before and after an acquisitive reorganization, see Michael L. Schultz, The Evolution of the Continuity of Interest Test, General Utilities Repeal and the Taxation of Corporate Acquisitions, 80 Taxes 229, 257-59 (2002).
shareholders do not, after the transaction, hold proprietary direct or indirect interests in separate parts of the target business assets). 31

The substantially all requirement arose out of the extension of tax-free reorganization treatment from statutory mergers and consolidations to other “practical” mergers. Congress addressed the effect of a reorganization for the first time in Section 202(b) of the Revenue Act of 1918, providing that no gain or loss would be recognized in connection with a “reorganization, merger, or consolidation of a corporation.” However, Congress did not define the terms “reorganization,” “merger,” or “consolidation.” In 1921, Congress defined a reorganization in Section 202(c)(2) of the Revenue Act of 1921 to include “a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation).” But, again, Congress did not define the terms “reorganization,” “merger,” or “consolidation.”

In 1934, Congress separated the definition of a reorganization into separate provisions. One provision described a “merger or consolidation” of companies, the predecessor to reorganization under the current Section 368(a)(1)(A). The word “statutory” was added to the definition of a reorganization so that the definition “will conform more closely to the general

31 Although there is a substantial body of case law that addresses the quantity and quality of assets that must be transferred in order to satisfy the substantially all requirement, this case law regarding the quantity and quality of assets that must be acquired is beyond the scope of this report. See, e.g., James Armour, Inc. v. Comm’r, 43 T.C. 295 (1965) (51 percent held substantially all where assets necessary to the conduct of an enterprise of the business are not retained); American Mfg. Co. v. Comm’r, 55 T.C. 204 (1970) (20 percent substantially all because all operating assets); Smothers v. United States, 648 F.2d 894 (5th Cir. 1981) (15 percent substantially all because all operating assets acquired). Whether a transaction satisfies the substantially all requirement generally depends on the facts and circumstances, including the amount and nature of the assets that are not transferred, and the purpose for their retention. See Rev. Rul. 57-518, 1957-2 C.B. 253; Boris I. Bittker & James S. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 12.24[2][b] (7th Ed. 2000).
requirements of [state] corporation law," which generally contemplate that a merger constitutes an acquisition of all of the target corporation’s assets by the surviving corporation by operation of law. Accordingly, in this provision, Congress did not include a substantially all requirement for transactions described as a statutory merger or consolidation.

The second provision added in 1934 encompassed an “acquisition by one corporation . . . of substantially all the properties of another corporation,” the predecessor to an asset reorganization under the current Section 368(a)(1)(C). The form of such asset reorganizations is a transfer of assets by the target corporation in exchange for stock of the acquirer. Often referred to as a “practical merger,” Congress imposed a substantially all requirement to ensure that a transfer of assets by a target corporation that was eligible for nonrecognition treatment (i.e., an asset reorganization) resembled a merger or combination of two corporations rather than taxable sales of a portion of the assets of a target corporation. Consistent with this history, in Helvering v. Elkhorn Coal Co., 95 F.2d 732, 735 (4th Cir.), cert. denied, 305 U.S. 605 (1938), the Fourth Circuit held that the substantially all requirement could not be satisfied if the acquisition was preceded by a divisive transaction such that the acquiring corporation did not receive substantially all of the target corporation’s historic assets.

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33 The legislative history surrounding the Revenue Act of 1934 concluded that the “practical merger” provision was designed to permit transactions which are “equivalent to a merger.” See S. Rep. No. 73-558, 73d Cong., 2d Sess. 17 (1934).


35 See also Mellon v. Comm’r, 36 B.T.A. 977 (1937). In Rev. Rul. 2003-79, 2003-29 I.R.B. 80, the Service ruled that, after the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788, 916-17, the substantially all rule of Elkhorn Coal would apply with respect to acquisitions of the distributing corporation following a divisive transaction, but not to acquisitions of a newly-formed controlled corporation following a divisive transaction.
The policy underlying the substantially all test was further buttressed in 1984. Up until that time, there was no requirement in a reorganization under Section 368(a)(1)(C) that the target corporation dissolve following the transfer of its assets to the acquiring corporation. Thus, up to that point in time the substantially all test was the only requirement that would prevent a reorganization under Section 368(a)(1)(C) from being used to effect a divisive transaction without satisfying the requirements of Section 355. In 1984, Congress addressed this issue by amending Section 368 to require that the target corporation in a reorganization described in Section 368(a)(1)(C) liquidate after transferring substantially all its properties.\textsuperscript{36} This amendment was enacted further to ensure that a transfer of assets by a target corporation that was eligible for nonrecognition treatment (i.e., an asset reorganization) resembled a merger or combination of two corporations and that Section 368(a)(1)(C) could not be used to avoid the requirements of Section 355 relating to divisive transactions.\textsuperscript{37}

The legislative history in connection with the amendment is instructive as to the purposes of the substantially all requirement:

Prior to 1934, Federal statutes provided for reorganization treatment only in the case of a transaction qualifying as a merger or consolidation under state law. The C reorganization provisions were added to the Code because uniform merger or consolidation statutes had not been enacted in all states, and the Congress believed that for Federal tax purposes substantially similar transactions should be treated consistently without regard to state law. Thus, the provisions were intended to apply to transactions that are acquisitive in nature and resemble statutory mergers or consolidations.

\textsuperscript{36} Tax Reform Act of 1984, Pub. L. No. 98-369, § 63, 98 Stat. 583, 583 (codified as Section 368(a)(2)(G)).

\textsuperscript{37} The enactment of this statutory change arguably accomplishes the purpose of the substantially all requirement in preventing divisive transactions that do not meet the requirements of Section 355.
Different provisions are intended to apply to divisive transactions. The committee is concerned that since a distribution by the transferor corporation of all its assets is not required in connection with a C reorganization, and after such a reorganization the transferor may be able to engage in an active trade or business and not merely serve as a holding company for its shareholders’ interests in the acquiring corporation, transactions that are somewhat divisive in nature can qualify as reorganizations without qualifying under the provisions generally applicable to divisive transactions.

In addition, as stated above, the C reorganization provisions were intended to apply to transactions that resemble, in substance, statutory mergers or consolidations. In the case of a statutory merger or consolidation, the transferor is liquidated by operation of law. The committee is concerned that substantially similar transactions should be treated consistently for Federal income tax purposes.\(^{38}\)

The role of the substantially all test in assuring that a transaction is not divisive was comprehensively articulated several years later in Rev. Rul. 88-48, 1988-1 C.B. 117, which continues to represent the Service’s most complete discussion of the substantially all requirement in published guidance. In the ruling, a target corporation operated two businesses, each constituting 50 percent of the target corporation’s total historic business assets. Because the acquiring corporation only was interested in acquiring one of the target corporation’s businesses, pursuant to an overall plan, the target corporation sold its entire interest in the unwanted business to third-party purchasers in a taxable transaction. The target corporation then transferred all of its assets, including the cash proceeds from the sale of the unwanted business, to the acquiring corporation in exchange for voting stock of, and the assumption of the target corporation’s liabilities by, the acquiring corporation. Finally, the target corporation distributed the acquiring corporation stock (the sole asset the target corporation held) to the shareholders of the target corporation in complete liquidation. The ruling concluded that the substantially all requirement

was satisfied, despite the target corporation’s sale of 50 percent of its historic business assets to unrelated parties immediately prior to the reorganization.

In reaching its conclusion, the ruling analyzed the purpose of the substantially all requirement stating:

Congress intended that transactions that are divisive in nature not qualify under section 368(a)(1)(C) of the Code, but, instead, be subject to the tests under section 368(a)(1)(D). See S. Rep. No. 1622, 83d Cong., 2d Sess. 274 (1954). The enactment of section 368(a)(2)(G) indicates the continuing interest in furthering this underlying objective of preventing divisive “C” reorganizations.

The ruling also notes the Service’s longstanding position that where some assets are transferred to the acquiring corporation and other assets retained, the transaction may be divisive and so fail to meet the “substantially all” requirement of Section 368(a)(1)(C), citing Rev. Rul. 57-518, 1957-2 C.B. 253. However, the Service determined that the facts presented in the ruling were not divisive stating:

Although [the acquiring corporation] acquired substantially all the assets [the target corporation] held at the time of transfer, the prior sale prevented [the acquiring corporation] from acquiring substantially all of [the acquiring corporation]’s historic business assets. The transaction here at issue, however, was not divisive. The sale proceeds were not retained by the transferor corporation or its shareholders, but were transferred to the acquiring corporation. Moreover, the prior sale of the historic business assets was to unrelated purchasers, and the [the target corporation] shareholders retained no interest, direct or indirect, in these assets. Under these circumstances, the “substantially all” requirement of section 368(a)(1)(C) was met because all of the assets of [the target corporation] were transferred to [the acquiring corporation].

Thus, the Service made clear that the concern of the substantially all requirement was to prevent divisive transactions from qualifying as tax-free reorganizations. In the facts of the
ruling, the transaction was not divisive because the proceeds from the sale of the unwanted assets constituted a substituted asset. A push-up to the parent of an acquiring subsidiary corporation following an acquisitive reorganization of any or all the assets of a target corporation is also not divisive; all the value of target corporation has been acquired and the assets continue to be held indirectly by the target shareholders through a single proprietary interest, stock of the acquiring parent corporation. Thus, the requirement is not violated by a planned distribution of the acquired assets by the acquiring corporation.39

B. Continuity of Interest

Continuity of interest principles clearly should not be viewed as violated by a push-up. Under Treas. Reg. § 1.368-1(e)(1), “[c]ontinuity of interest requires that in substance a substantial part of the value of the proprietary interests in the target corporation be preserved in the reorganization.” The Service has long viewed a transaction in which an indirect owner’s interest in the target corporation becomes more direct as preserving continuity of interest.40 Thus, a push-up should not raise any continuity of interest concerns. In this case, unlike the facts at Groman and Bashford, shareholders of target receiving parent corporation stock retain a more direct interest in the target assets.

39 A push-up through P to its shareholders could under some circumstances be viewed as divisive (e.g., if the assets went principally to former T shareholders). Such transactions are discussed in Part VI of this report.

40 See Treas. Reg. § 1.368-1(e)(7)(Examples 7 and 8); Rev. Rul. 95-69, 1995-2 C.B. 38 (distribution from a limited partnership to its partners of the stock of an acquiring corporation following the merger of the partnership’s wholly-owned corporation into the acquiring corporation does not violate continuity of interest); Rev. Rul. 84-30, 1984-1 C.B. 114 (distribution from a direct owner to its shareholder following a reorganization does not violate continuity of interest); see also Rev. Rul. 76-528, 1976-2 C.B. 103 (continuity of interest requirement for a spin-off not violated when shareholder partnership dissolves before the distribution); Rev. Rul. 62-138, 1962-2 C.B. 95 (continuity of interest requirement of Section 355 satisfied, notwithstanding the transferor corporation’s distribution of the transferee corporation’s stock to its corporate shareholder followed by the corporate shareholder’s distribution of such stock to its shareholders).
C. Continuity of Business Enterprise

Finally, the continuity of business enterprise rules should be easily satisfied with respect to the push-up transactions that are our focus. To satisfy continuity of business enterprise, the “issuing corporation” must either (1) continue the target corporation’s historic business (“business continuity”) or (2) use a significant portion of target’s historic business assets in a business (“asset continuity”). The “issuing corporation” is the acquiring corporation within the meaning of Section 368(a), except that, in determining whether a reorganization qualifies as a triangular reorganization as defined in Treas. Reg. § 1.358-6(b)(2), the issuing corporation is the corporation in control of the acquiring corporation. For purposes of the regulations, the “issuing corporation” is treated as holding all of the businesses and assets of all of the members of the “qualified group.” Accordingly, the continuity of business enterprise requirement can be satisfied indirectly because the regulations in effect treat the qualified group as a single entity.

For continuity of business enterprise purposes, a “qualified group” includes one or more chains of corporations connected through stock ownership with the issuing corporation, but only if the issuing corporation owns directly stock meeting the requirements of Section 368(c) in at least one other corporation, and stock meeting the requirements of Section 368(c) in each of the corporations (except the issuing corporation) is owned directly by one of the other corporations.

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41 Treas. Reg. § 1.368-1(d)(1)-(3).
42 Treas. Reg. § 1.368-1(b).
44 Treas. Reg. § 1.368-1(d)(4)(ii).
Based on the continuity of business enterprise requirements described above, a “push-up” of assets after a reorganization should not violate the continuity of business enterprise requirement provided that the assets are distributed to a shareholder that is a member of a “qualified group” within the meaning of Treas. Reg. § 1.368-1(d)(4)(i). In the context of a triangular reorganization under Sections 368(a)(1)(C), 368(a)(2)(D), and 368(a)(2)(E), the corporation in control of the acquiring corporation is treated as the “issuing” corporation. Thus, the parent company is the issuing corporation in a triangular reorganization and, therefore, a push-up to the parent corporation would not violate continuity of business enterprise. However, it is unclear whether continuity of business enterprise would be satisfied if the pushed-up assets are ultimately distributed to shareholders outside of the “qualified group,” as discussed further below.

VI. Ancillary Issues

Although the core issues relating to push-up transactions would be addressed by guidance relating to the four simple fact situations discussed above, other push-up related issues can also be implicated. Here, we will discuss two such issues: (i) the assumption of liabilities by the parent of the acquiring corporation in connection with the transaction and (ii) the movement of assets above the corporation the stock of which is provided to target stockholders in the transaction.

A. Assumption or Other Transfer of Liabilities

The first ancillary issue potentially raised in connection with push-ups is the effect of the assumption of liabilities by the parent acquirer (P in the four illustrative cases) as part of the overall plan. This issue, like push-ups generally, has an important impact in practice. In this
regard, it is useful analytically to consider two different cases; first, a transaction in which at least a portion of the liabilities of T are directly assumed by P in an acquisition transaction -- for example, an acquisition by S of T assets in a putative C reorganization; and second, one in which, after the merger of T into S or other acquisition by S of T assets, T’s former assets together with associated liabilities are, in a preplanned transaction, moved up to P, which assumes such historic T liabilities or takes the assets subject to such liabilities.

The central authority in this regard is the controversial Rev. Rul. 70-107, which involves a putative C reorganization. In that case, corporation X owned all the stock of corporation Y. Y directly acquired all the assets of corporation Z using voting stock of its parent, X corporation, with part of the liabilities of Z assumed by Y and part by X. The Service held,

\[
\dot{\ldots} \text{in view of the assumption by } X \text{ of some of } Z's \text{ liabilities, the exchange does not meet the ‘solely for voting stock’ requirement of Section 368(a)(1)(C) because that section provides, in part, that in determining whether the exchange is solely for voting stock the assumption by the acquiring corporation of a liability of the other shall be disregarded. Since } X \text{ (the parent of } Y) \text{ is not the acquiring corporation, its assumption shall not be disregarded.}
\]

The first factual variation, in which P directly assumes the liabilities of T in the acquisition, directly implicates Rev. Rul. 70-107. For reasons that include those presented in GCM 39102 summarized above, we believe that there are strong arguments that Rev. Rul. 70-107 should be overruled. However, that issue is beyond the scope of these comments. Thus, we do not address here whether and/or how a direct assumption of a target liability by the parent of an acquiring corporation in a putative triangular C reorganization should affect the treatment of the transaction under the statute.

With respect to the second variation discussed above--the assumption of liabilities by the parent of the acquiring corporation in connection with a push-up of assets to such parent after the
acquisition by the acquiring corporation—we believe that Rev. Rul. 70-107 should not apply and the language of Section 368(a)(1)(C) relating to the assumption of liabilities by S should apply, assuming, as we do in our discussion above, that the acquiring subsidiary S is not liquidated and the amount of the target’s assets pushed-up to P does not cause P to be treated as the acquiror for U.S. federal income tax purposes. In other words, the form of the transaction should be respected; because the form does not involve a direct assumption of liabilities by P and because, for the reasons discussed above, we believe that the form should under these circumstances be respected, there is no reason to apply Rev. Rul. 70-107. In this respect, we are proposing treatment analogous to a drop-down transaction, in which the assumption of liabilities by the nonacquiring corporation would be viewed as a separate transaction. In any event, it should be noted in this regard that this issue is of primary importance with respect to C reorganizations because of the greater flexibility afforded to triangular mergers subject to Sections 368(a)(2)(D) and 368(a)(2)(E).

B.  Push-Ups To Higher Levels

In each of the cases that have been the focus of these comments, which involve triangular reorganizations, the acquired corporation’s assets are being pushed-up to a corporation (P in the illustrative cases) the stock of which was utilized in the transaction and which controls the acquiring subsidiary. In such a case, some of the substantive issues raised by push-ups are relatively easy to resolve. For example, in such a case the push-up will not cause the transaction to be divisive as to the target shareholders; and the target shareholders will, through the proprietary interest in P that they received in the transaction, continue to have a continuity of proprietary interest in the T assets—in fact, one that is more direct than if the assets were not pushed up. Other factual variations raise more difficult issues, however.
Two merit discussion here. First, what if T’s historic assets were distributed first to P and then out of P to P’s shareholders in preplanned transactions. Second, what if S stock were used as the merger consideration so that the transaction were a simple “A” or “C” reorganization, and the historic assets of T were pushed-up to P, the parent or other significant shareholder of S? A variation on this case is a triangular reorganization in which the assets were pushed-up beyond P to P’s parent (e.g., a holding company).

As to the first variation, assume, for example, that after T’s merger into S for the stock of S’s parent, a subsidiary of T, TS, is distributed first by T to P, and then by P to its shareholders including both former T shareholders and historic P shareholders. In addition to complex Section 355(e) issues, two significant policy issues relating to the treatment of the T acquisition under the tax-free reorganization rules are raised by this fact pattern. First, to the extent former T shareholders receive T assets, the transaction could be viewed as divisive under Rev. Rul. 88-48. Second, to the extent shareholders of P other than former T shareholders receive the historic T assets, a continuity of proprietary interest is not retained by former T shareholders in such assets and, in some cases, arguably a continuity of business enterprise is not maintained. For these reasons, we view this case as a more complex case than those that are the focus of this report. Therefore, without further study of these issues, we would not extend relief to these push-up transactions.

As to the second variation, assume that T merges into S in a transaction in which T shareholders get 50 percent S stock and 50 percent cash, and then a substantial portion of T’s historic assets are pushed up to P, the former 100-percent shareholder of S. The principal concern here is that the target shareholders will not, through their stock interest in S, continue to own a proprietary interest in a substantial portion of the former T assets; in other words, the
assets have been moved to a level above the level at which the target shareholders have an equity interest. In a sense, P is a “stranger” to S and T, viewed from the perspective of the former T stockholders. As to this case, depending on the size of the distribution, we believe that, at a minimum, application of the continuity of interest test should be affected. Because P is not a member of the qualified group, continuity of business enterprise also is implicated. Thus, pending further study, we would also not extend relief to this push-up transaction.

It is important to recognize that, while push-ups to higher levels raise fascinating issues particularly to aficionados of Subchapter C, from our experience in practice, these issues rarely if ever arise. We believe further study is required, and should not delay guidance on the important and extremely practical issues that are the focus of this report.

VII. The Nature of Guidance

The final question that we have considered in connection with push-ups is the form of guidance. Because we believe our recommendations are consistent with existing step transaction authorities, a strong argument could be made that the basic guidance we seek could be articulated in a published revenue ruling or series of revenue rulings. However, because difficult issues are raised analogous to those presented by drop-downs and there is no guidance either in the statute, regulations or case law, we believe that the government can best address these issues in regulations. Because Treas. Reg. § 1.368-2(k) in a sense also addresses step transaction issues, we believe that push-ups appropriately could be addressed in those regulations.
COMMENTS ON PROPOSED REGULATIONS ON CONTINUITY OF BUSINESS ENTERPRISE AND CERTAIN RELATED ISSUES UNDER SECTION 368

The following comments are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

These comments were prepared by individual members of the Committee on Corporate Tax of the Section of Taxation. Principal responsibility was exercised by David Wheat. Substantive contributions were made by John Barrie, Jasper Cummings, Mark Silverman, Robert Wellen, Rose Williams and Philip Wright. The Comments were reviewed by Robert Liles of the Section’s Committee on Government Submissions and by Joseph M. Pari, Council Director for the Committee on Corporate Tax.

Although many of the members of the Section of Taxation who participated in preparing these Comments have clients who would be affected by the federal tax principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Overview. On March 1, 2004, the Treasury Department and the Internal Revenue Service (the “IRS”) proposed regulations relating to the effect of asset and stock transfers on the qualification of certain transactions as reorganizations under Section 368(a), including the continuity of business enterprise requirement and the definition of party to a reorganization. Prop. Treas. Reg. §§ 1.368-1(d)(4), -2(f), (k). These are our comments on the proposed regulations.

Background. To qualify as a reorganization under Section 368, a transaction must satisfy certain statutory and judicial requirements, including continuity of business enterprise ("COBE"). COBE requires that the issuing corporation either (i) continue the target corporation’s historic business or (ii) use a significant portion of the target corporation’s assets in a business. Treas. Reg. § 1.368-1(d)(2). The term issuing corporation generally means the acquiring corporation. In the case of a triangular reorganization, however, the issuing corporation includes the corporation in control of the acquiring corporation. In addition, the issuing corporation is treated as holding all of the businesses and assets of the members of the qualified group. For this purpose, the qualified group is one or more chains of corporations connected though stock ownership with the issuing corporation, but only if the issuing corporation owns directly stock meeting the requirements of Section 368(c) in at least one other corporation, and stock meeting the requirements of Section 368(c) in each of the corporations (except the issuing corporation) is owned directly by one of the other corporations.

Section 368(a)(2)(C) provides that a transaction otherwise qualifying as a reorganization under Section 368(a)(1)(A), (B), (C), or (G) will not be disqualified by reason of the fact that part or all of the acquired assets or stock are transferred to a corporation controlled by the acquiring corporation. For this purpose, control has the meaning contained in Section 368(c). Several rulings have concluded that the terms of Section 368(a)(2)(C) are permissive, rather than exclusive or restrictive. Rev. Rul. 2001-24, 2001-1 C.B. 1290; Rev. Rul. 2002-85, 2002-2 C.B. 986. Therefore, transfers of target stock or assets not described in Section 368(a)(2)(C) do not necessarily prevent the transaction from qualifying as a reorganization.

Under Treas. Reg. § 1.368-2(f), the term “party to a reorganization” includes a corporation resulting from a reorganization, and both corporations in a transaction qualifying as a reorganization where one corporation acquires stock or properties of another corporation. This regulation further provides that if a transaction otherwise qualifies as a reorganization, a corporation remains a party to the reorganization even though stock or assets acquired in the reorganization are transferred in a transaction described in Treas. Reg. § 1.368-2(k).
Under Treas. Reg. § 1.368-2(k), generally a transaction otherwise qualifying as a reorganization under Section 368(a)(1)(A), (B), (C), or (G) (where the requirements of Section 354(b)(1)(A) and (B) are met) will not be disqualified by reason of the fact that part or all of the 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. For this purpose, a corporation is a controlled corporation if the transferor corporation owns stock of such corporation constituting control within the meaning of Section 368(c).

The proposed regulations extend the principles described above in Treas. Reg. § 1.368-1(d), -2(f) and (k) to all types of reorganizations. The government reasoned that these transactions, in form, satisfy the statutory requirements of a reorganization and, in substance, constitute readjustments of continuing interests in the reorganized business in modified corporate form. Importantly, none of the transactions protected by the proposed regulations involve the transfer of the acquired stock or assets to a “stranger” which would be inconsistent with reorganization treatment. H.R. Rep. No. 83-1337, A134 (1954).

**General.** We commend the government for issuing these proposed regulations because we believe that they reflect sound corporate tax policy. In many cases, the proposed regulations adopt positions previously taken by the IRS in public and private rulings. Further, as noted in the preamble to the proposed regulations, the permitted asset and stock transfers are not made to a “stranger.” Rather, such transfers result in little or no change in the ultimate ownership of the acquired assets or stock. Thus, there is no policy justification for disqualifying a reorganization in such cases. Indeed, from a policy standpoint, it is desirable to prevent acquirers from unilaterally “busting” a reorganization through transactions resulting in little change in the parties’ circumstances. In the reorganization context, such transactions increase the likelihood that the target shareholders and the acquiring corporation might take inconsistent positions thereby creating whipsaw potential for the government.

Our principal suggestions are in two categories: (1) clarifications consistent with the intended scope of the regulations; and (2) expanding the scope of the regulations to cover additional issues and transactions (perhaps in separate projects).

**Specific Suggestions.** Specifically, we suggest the following:

1. **F Reorganizations.** Clarify, perhaps by example, that transfers of assets to members of a qualified group do not prevent a transaction from qualifying as a reorganization under Section 368(a)(1)(F).
2. **Divisive D Reorganizations.** Clarify, again perhaps by example, that transfers of assets to members of a qualified group do not prevent a transaction from qualifying as a divisive reorganization under Section 368(a)(1)(D).
3. **Active Trade or Business.** Clarify whether Prop. Treas. Reg. § 1.368-2(k) applies for purposes of the post-distribution active trade or business qualification under Section 355. We believe that it should. The purposes behind COBE and the active trade or business requirement are sufficiently similar that the same rules should apply in the context of post-transaction asset transfers.

4. **COBE and Diamond Transactions.** Our only suggestion for actual change affecting the proposed regulations is to reiterate our prior recommendation that the definition of “qualified group” in Treas. Reg. § 1.368-1(d) be modified so that it is determined by reference to Section 1504(a)(2) (perhaps limited to consolidated return situations), rather than Section 368(c).\(^1\) As we have previously stated, a Section 1504(a)(2) standard minimizes the ability of the acquiring corporation to attempt to avoid reorganization treatment by transferring the acquired assets or stock to a subsidiary that does not meet the control requirements of Section 368(c). Adopting a Section 1504(a)(2) standard will more closely follow the economic substance of the transaction. Moreover, we believe that the Treasury and IRS have authority to prescribe reasonable interpretive rules relating to the application of COBE and the remote continuity requirement and are not limited by Section 368(a)(2)(C) in determining the permissible transfers that satisfy these requirements.

5. **Effective Date.** Given the sensible results reached by the proposed regulations, we urge prompt finalization of the regulations. We generally agree with a prospective effective date because certain aspects of the regulations could be viewed as changing current law, and, therefore, a retroactive effective date could upset legitimate tax planning. We note, however, that certain aspects of the proposal adopt positions previously stated in revenue rulings. We understand that the prospective effective date for the regulations does nothing to undermine the effect of those rulings.

We will be pleased to meet with you if that is appropriate.

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\(^1\) *Comments on the Continuity of Interest and Business Enterprise Proposed Regulations*, American Bar Association Section of Taxation, April 28, 1997.