October 29, 2008

Hon. Douglas Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Comments Concerning the Treatment of Stock of the Acquiring Corporation Already Owned by the Target Corporation in a Section 368(a)(1)(D) Reorganization

Dear Commissioner Shulman:

Enclosed are comments concerning the treatment of stock of the acquiring corporation already owned by the target corporation in a section 368(a)(1)(D) reorganization. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,

William J. Wilkins
Chair, Section of Taxation

Enclosure

cc: Hon. Donald L. Korb, Chief Counsel, Internal Revenue Service
Hon. Eric Solomon, Assistant Secretary (Tax Policy), Department of the Treasury
The following comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation (the “Section”) and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Jasper L. Cummings, Jr., of the Section’s Corporate Tax Committee (the “Committee”). Other committee members who participated in the preparation of these Comments included Eric Sensenbrenner, Maury Passman and Julie Divola. The Comments were reviewed by Robert H. Wellen of the Section’s Committee on Government Submissions and by Peter H. Blessing, the Section’s Council Director for the Committee.

Although members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal income tax principles addressed by these Comments, 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: October 29, 2008
Executive Summary

On December 19, 2006, the Department of the Treasury ("Treasury") and the Internal Revenue Service ("Service") published a Notice of Proposed Rule Making and Temporary Regulations in the Federal Register (the "Temporary Regulations") dealing with one aspect of "acquisitive" (as distinguished from "divisive") section 368(a)(1)(D) reorganizations. Specifically, the Temporary Regulations addressed the question of "whether certain acquisitive transactions can qualify as reorganizations described in section 368(a)(1)(D) where no stock of the transferor corporation is issued and distributed in the transaction." The Notice of Proposed Rule Making requested comments on several issues relating to these reorganizations. On April 16, 2008, the Section submitted comments addressing the Temporary Regulations in general.

Section 368(a)(1)(D) requires that either section 354 or section 356 apply to Target’s "distribution" to its shareholders of "stock or securities" of Acquiring. The Temporary Regulations imply that Target must receive the distributed stock of Acquiring upon original issuance by Acquiring. That is, the Temporary Regulations imply that, if Target owns Acquiring stock before the reorganization: (1) if Target distributes such Acquiring stock, and no other stock, to its shareholders, the transaction would not qualify under section 354(b)(1) and therefore would not qualify under section 368(a)(1)(D); (2) such stock would not be considered transferred to Acquiring for purposes of the "substantially all" test; and (3) even if the transaction otherwise qualifies (because Target receives and distributes other Acquiring stock), Target may not distribute such Acquiring stock tax-free in the reorganization.

In these Comments, we analyze the question whether only stock that is actually issued by Acquiring in the reorganization should qualify for favorable treatment. We conclude that such a limitation is unwarranted, and we recommend that the Regulations be revised to make clear that: (1) no such limitation applies; (2) Target’s distribution to its shareholders of previously owned Acquiring stock in pursuance of the plan of reorganization share in the nonrecognition provided by section 361(c), even though Target does not actually receive such stock from Acquiring in exchange for Target assets; and (3) stock of Acquiring previously held by Target “count” as transferred to Acquiring for purposes of the “substantially all” test.

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3 All references to sections herein are to sections of the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise expressly stated herein, and references to Regulations are to the Treasury Regulations issued under the Code.
4 ABA Section of Taxation, Comments on Proposed and Temporary Regulations under Code Section 368(a)(1)(D), available at http://www.abanet.org/tax/pubpolicy/2008/080416commentsonproposedandtemregsundercodesec368a1d.pdf (the "Prior Comments").
5 The application of section 356 to securities exchanges has a special purpose that is not relevant to these Comments; for that reason securities are not discussed further in these Comments.
I. Background

All three of the Code sections that define acquisitive D reorganizations—sections 368(a)(1)(D), 354(b)(1) and 356(a)—require that the Target shareholders receive at least some stock of Acquiring in exchange for their Target stock. None of these provisions, however, explicitly requires that such stock that Target distributes be received by Target from Acquiring; Target might receive other consideration from Acquiring and might distribute Acquiring stock that it already held. By contrast, such receipt is required by the Code definitions of other forms of reorganization: section 368(a)(1)(C) requires that Acquiring voting stock be exchanged for Target assets, and section 368(a)(1)(B) requires that Acquiring voting stock be exchanged (by the shareholders) for Target stock.

The Temporary Regulations were written to address the acquisitive D reorganization case where Acquiring pays for Target’s assets with consideration other than its stock (sometimes referred to as an “all cash D”). Unless Target distributes to its shareholders some “old and cold” Acquiring stock in exchange for some or all of their Target stock, the “all cash D” cannot literally satisfy the section 368(a)(1)(D) requirement of a section 354 or section 356 stock exchange between Target and its shareholders. To create such an exchange, the Temporary Regulations deem a distribution by Target of a nominal share of Acquiring stock. However, the Temporary Regulations also deem an issuance of that stock by Acquiring to Target. Our Prior Comments recommended that the deemed share requirement be eliminated.

As we read the Temporary Regulations, there are two possible interpretations:

- The deemed stock distribution applies only if there is no distribution of Acquiring stock, old or new. This interpretation treats the deemed stock issuance as no more than a completion of the deemed distribution construct. Under this interpretation, the deemed stock distribution would not apply to a transaction in which Target distributes old and cold stock of Acquiring to its shareholders, because that transaction does not lack a stock distribution and qualifies as a D reorganization without a deemed stock distribution.

- The deemed stock issuance and distribution applies even where “old and cold” Acquiring stock is distributed. Under this reading, the Regulations interpret section 354(b)(1)(B) to require an issuance of Acquiring stock in every D reorganization; a distribution of “old and cold” Acquiring stock by Target does not suffice, because, without an issuance of Acquiring stock, the transaction does not satisfy section 354(b)(1)(B) and therefore is not “otherwise described in section 368(a)(1)(D).”

We believe that the first interpretation is the correct one, and that Treasury and the Service should resolve the ambiguity in the Temporary Regulation. Taxpayers need to know, for a variety of transactions, in addition to “all cash Ds,” whether “old and cold” Acquiring stock “counts” for purposes of meeting the section 368(a)(1)(D) distribution requirement. In addition, the ambiguity highlights the latent problem that section 361(c) gain nonrecognition does not literally extend to Target’s distribution of such “old and cold” Acquiring stock. Finally, the stock of Acquiring should “count” for purposes of the “substantially all” test.

**Example.** P owns 50%, and unrelated persons own the remaining 50%, of the stock of both T and A. T owns business properties with significant value and A stock worth more than 30% of the gross fair market value of T’s assets. T conveys all of its property to A, except for the A stock, for cash. T distributes the A stock and the cash to P.

The Temporary Regulations do not deem an issuance and distribution of A stock, because T and A do not have identical ownership. Nevertheless, the transaction appears to qualify as a D reorganization unless (i) the A stock does not count as a distribution for purposes of section 354 and 356, because the stock was not issued by A in the exchange, or (ii) the failure to transfer the old A stock for new A stock prevents a transfer of substantially all of T’s assets. If the transaction does qualify as a D reorganization, one must then address the possibility that T will recognize any gain in its A shares because they were not received from Acquiring, and thus the shares are not “qualified property,” such that section 361(c) would not apply.  

We conclude that, where Target owns Acquiring stock, no issuance of Acquiring stock (actual or deemed) should be required for a D reorganization, because a distribution of “old and cold” Acquiring stock suffices to create a section 354 or 356 exchange. We also conclude that a distribution of such “old and cold” Acquiring stock should not be subject to section 361(c) gain recognition. We believe Treasury and the Service should clarify both of these points, and also should make clear what appears to be the government’s position that the Target stock “counts” for purposes of the “substantially all” test.

**II. The Temporary Regulation**

Temporary Regulation section 1.368-2T(l)(2)(i) provides for the deemed *issuance* and distribution of a nominal share of stock in the case where there is 100% ownership overlap between Target and Acquiring, and section 368(a)(1)(D) is otherwise satisfied “notwithstanding that there is no actual *issuance* of stock of the transferee corporation ….

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7 See Eustice, Section 361 Redux, 44 Tax Notes (TA) 443 (July 24, 1989) (noting this possibility of section 361(c) gain recognition on distribution of old and cold stock of Acquiring).
The preamble to the Temporary Regulations cites Rev. Rul. 70-240\textsuperscript{8} and *James Armour, Inc.*\textsuperscript{9} as the earliest authorities for the deemed issuance theory. Neither these nor any of the predecessor authorities stands for the proposition that Acquiring stock has to be received by the Target in the exchange; rather, these authorities seem to have assumed that a deemed issuance went hand in hand with the deemed distribution, which was really the requirement at issue.\textsuperscript{10}

The Temporary Regulations cite two Code sections in connection with the deemed stock issuance: section 368(a)(1)(D) and section 354(b)(1)(B), but neither section requires an issuance of Acquiring stock. Section 368(a)(1)(D) does not address the consideration that might be received by the Target, only the Target’s distribution to its shareholders (and thus is consistent with distribution of old and cold stock). Section 354(b)(1)(B), adopted in 1954 as part of an effort to carve off and more tightly control divisive reorganizations under section 355, states when section 354, instead of section 355(a)(1), can apply to a section 368(a)(1)(D) reorganization for shareholder stock exchange nonrecognition purposes. The effect of this rule is to force all potential D reorganizations to qualify under section 355 unless (1) the corporation transfers substantially all of its assets (\textit{i.e.,} acquisitive), and (2) “the stock, securities, and other properties received by such transferor, as well as the other properties of such transferor, are distributed in pursuance of the plan of reorganization.” The second requirement appears to be the sole source of the notion that a stock issuance is required.

III. Interpretation of the Statute

\textbf{A. Expressio unius est exlusion alterius Inapplicable}

The expression of one thing (“the stock … received [is] distributed”) sometimes reflects the exclusion of others (such as the distribution of stock not received). Section 354(b)(1)(B) refers to stock received being distributed. We respectfully submit that any interpretation that section 354(b)(1)(B) requires Target to receive Acquiring stock in exchange for its assets, however, should be rejected. It is not a necessary interpretation

\textsuperscript{8} Rev. Rul. 70-240, 1970-1 CB 81.


\textsuperscript{10} According to *Armour*, it is not necessary to say that “in effect” stock was issued, but rather to look for the continuity of the shareholders’ interest in the assets inside their other controlled corporation. *Armour* at 307-308. \textit{See also Ralph C. Wilson, Sr v. Commissioner}., 46 TC 334, 342-344 (1966) (reanalyzing the arguments and concluding again that section 354 and 356 did not require a stock exchange on the facts, without mentioning section 354(b)); Rev. Rul. 70-240 (quoting section 354(b)(1)(A) but not (B) and treating shareholder as receiving Acquiring stock but not treating Target as receiving Acquiring stock). Both Rev. Rul. 70-240 and *Armour* cite as the earliest authority *Liddon v. Commissioner*, 230 F2d 304 (6\textsuperscript{th} Cir. 1956), cert denied, 352 US 824 (1956), \textit{aff’g} 22 TC 1220 (1954). The Tax Court focused entirely on receipt of Acquiring stock by the shareholders and was able to find that such stock was in fact received as part of the overall transaction because the common shareholders had created and received the initial issuance of the stock of Acquiring in order to engage in the reorganization.
of the statute; it is not logically required by the concept of a D reorganization;\textsuperscript{11} it has no support in history of the section; and it does not have consistent support in application. It has no support in prior case law or the Service’s revenue rulings.

B. Code and Legislative History

There are several reasons in the Code itself and in its history that demonstrate why section 354(b)(1)(B) does not require a stock issuance:

- The words of section 354(b)(1)(B) can easily be read to require the stock (\textit{if any}) received by Target must be distributed.

- If one rejects that reading, one could easily reason that the receipt of both stock and securities is required in every D reorganization, which is clearly not the case.

- Where Congress used the identical language and wanted stock to be received in an asset exchange it said so: the identical language appears only in section 368(a)(2)(G)(i) as to type C reorganizations, and section 368(a)(1)(C) explicitly requires that a certain high level of stock consideration be received in the exchange, in contrast with section 368(a)(1)(D), which has no such requirement. (\textit{See} discussion of Rev. Rul. 78-47, 1978-1 C.B. 113, below.)

- Because Congress did not so specify, a more reasonable interpretation is that section 354(b)(1)(B) is intended to emphasize that Congress \textit{really} wants Target to liquidate and hand over all assets to its shareholders; there is evidence that this was the reason for the enactment of section 368(a)(2)(G)(i) in 1984.\textsuperscript{12}

- There is evidence that Congress did not intend to change the law on stock distribution and issuance when it adopted section 354(b)(1)(B) in 1954.\textsuperscript{13}

C. Prior Law Did Not Require Stock Issuance

The predecessor of section 368(a)(1)(D) entered the law in the Revenue Act of 1924 (the “1924 Act”\textsuperscript{14}) to cover the division of an existing corporation (or more precisely to cover a corporation transferring most or all of its assets to another corporation but not

\textsuperscript{11} As discussed below, initially the provision that ultimately authorized the D reorganization covered reincorporations, which commonly could occur by a merger or transfer down to a subsidiary, in which case distribution of the old and cold stock of the subsidiary would be expected.

\textsuperscript{12} \textit{See} Eustice, The Tax Reform Act of 1984, p. 3-31 (WG&L 1984) (stating that the idea came from the Senate Finance Committee’s 1983 subchapter C proposals, which had involved an elective carryover basis regime in which it did not matter what was received for the assets).

\textsuperscript{13} The Senate Report states that the rules for stock and security exchanges were not changed (in contrast with the House proposal) and simply stated the distribution requirement of section 354(b), without elaboration. S. Rep. No. 83-1622, 83rd Cong., 2nd Sess., 1954 U.S.C.C.A.N., 4621, 4903.

liquidating). The Revenue Act already provided nonrecognition for some reincorporations (change of form or identity) and transfers of substantially all of a corporation’s properties to another corporation (addressed in section 202(c)(2) of the Revenue Act of 1921).\textsuperscript{15} The new nonrecognition transactions described in the 1924 Act necessarily would include (1) transactions in which the transferor remained in existence (\textit{i.e.}, did not reincorporate, thus accomplishing a divisive reorganization)\textsuperscript{16} and (2) transactions in which the transferor did not remain in existence but did not transfer substantially all of its assets to one corporation.

At the time this change was made, we assume that Congress must have been considering situations involving the creation of a new subsidiary and the parent’s distribution to its shareholders of stock received in an \textit{exchange} with the new subsidiary.\textsuperscript{17} However, the statute did not require an exchange between the corporations and did not limit itself to new subsidiaries. Section 203(h)(1)(B) of the 1924 Act only required “a \textit{transfer} by a corporation of all or part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred….”\textsuperscript{18}

The control requirement certainly does not require a stock issuance. If anything, this requirement could be read as contemplating pre-existing control of Acquiring by Target’s shareholders (as contrasted with control acquired in a distribution of stock Target received in exchange for its properties). The “party to the reorganization” requirement similarly sheds no light on the issue.\textsuperscript{19}

Other evidence is consistent with the view that the provision does not require a stock issuance. The predecessor of Regulation section 1.368-1(a) stated that a reorganization included “… the change made in a specified way from a business enterprise conducted by a single corporation to the same business enterprise conducted by a parent and a


\textsuperscript{16} See, \textit{e.g.}, United States v. Phellis, 257 U.S. 156 (1921), and Rockefeller v. United States, 257 U.S. 176 (1921).

\textsuperscript{17} At the same time, Congress enacted section 203(c) of the 1924 Act., which allowed shareholder level nonrecognition in a spin-off by virtue of adding a nonrecognition rule that did not require the shareholder to make an exchange. The explanation in the House Report for the 1924 Act is curious. It states that a spin-off would be taxable under existing law whereas a split-up would not cause gain recognition. See H. Rep. No. 68-170, 68th Cong., 1st Sess. 179 (1924). Literally that was true only because the incorporation of two new subsidiaries by the old parent could qualify as nonrecognition exchanges under the primitive view of the predecessor of section 351 that viewed momentary control as sufficient, and between 1918 and 1924 liquidating distributions were treated as dividends and not gains and thus subject only to the surtax and not the normal tax.

\textsuperscript{18} 43 Stat. at 257 (emphasis added).

\textsuperscript{19} See Baar and Morris, Hidden Taxes in Corporate Reorganizations (1935 Foundation Press), p. 139. In the 1924 Act, section 203(h)(2) defined that term as “includ[ing] a corporation resulting from a reorganization and both corporations in the case of a [stock acquisition].” 43 Stat. at 257-258. So long as the asset transfer was a reorganization, the transferee was a party to the reorganization.
subsidiary corporation, ….” This language bears out the view that the D reorganization (both divisive and acquisitive) was originally viewed as a sort of special case application of section 351 in the context where the shareholder was a corporation. The theory seems to have been that this sort of transfer looked like a reorganization because the same persons continued to own the corporate property.  

In their 1935 treatise on reorganizations, Baar (later a Tax Court Judge) and Morris observed that there had been no litigated case in which a transfer to an already-controlled subsidiary was tested as a D reorganization and speculated that the reason was that “everyone concerned felt that the statute was satisfied.” They also observed that the statute did not require any consideration for the exchange; that adjacent provisions referred to exchanges rather than transfers, indicating that Congress knew the difference; and even stated that the asset transfer could be a “gift.”

Shortly thereafter the test case arrived in the form of Isidor Kahn. There a corporation conveyed other assets to its subsidiary and distributed the stock of the subsidiary it had long owned to shareholders and was held to engage in a predecessor of a D reorganization.

IV. Downstream Reorganizations

A scenario of practical importance in which these issues arise involves Target transferring its assets to its controlled subsidiary, Acquiring, and distributing the old and cold stock Acquiring stock to Target’ shareholders. This type of transaction is a subset of the more general downstream reorganization scenario.

Example - Downstream Merger: P owns all the stock of T, which owns all the stock of A, an “old and cold” active corporation. The A stock is more than half but less than all of the assets of T, and T has no liabilities. T merges into A, and A issues new A shares to P in exchange for its T shares. This transaction can qualify as an A reorganization, and as a C or a D reorganization if Z acquires substantially all of the assets of Y.

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20 Reg. 86, Art. 112 (g)-1,(1934 Act).
21 See Baar and Morris, note 15 supra, at p. 90.
22 Id at 91.
23 Id at 92.
24 Isidor Kahn v. Commissioner, 36 BTA 954 (1937), affid sub nom Helvering v. Einhorn, 100 F2d 418 (2nd Cir. 1938) (per curiam).
In this Example, the parties arranged for there to be a formal exchange and reissuance of old A shares for new A shares. Therefore the issue with which we are concerned does not arise. But alternative examples do present a much-discussed related issue that bears on the question whether “old and cold” A stock may be distributed by T in a D reorganization. The related issue is how the old A stock is to be handled for purposes of the “substantially all” test in downstream D and C reorganizations.

It appears that the Service has not completely resolved this issue, but generally ignores the “old and cold” stock in applying the “70/90 test” of the reorganization ruling guidelines, even though it sometimes deems new stock to be issued in exchange for the old stock. However, there is no indication that the deemed stock issuance is designed to satisfy a reading of section 354(b)(1)(B) that requires Z stock to be newly issued.

The Example above is similar to Rev. Rul. 57-465. There, the Service ruled that a merger of foreign corporations (which then could not enjoy a “statutory merger”) qualified as a D reorganization and reasoned that A cannot “acquire” its own stock when it is transferred only for cancellation. The Revenue Ruling resolved the problem this cancellation creates for the “substantially all” requirement by concluding that the transaction qualified where: (1) only one other corporation (A) winds up with T’s assets; (2) T goes out of existence; and (3) the A stock exactly replaces the T stock in the hands of P. That combination of facts allowed the Revenue Ruling to ensure that the transferee can be treated as acquiring substantially all of the assets of Y, not because it did so, but because the transaction was not divisive. That is, the Revenue Ruling was appears to have been policy-driven: it read the “substantially all” requirement of section 354(b)(1)(A) to reflect Congress’ desire to limit the section 354(b) reorganization to nondivisive transactions. Therefore, the Revenue Ruling concluded that the merger was a D reorganization even though Z did not literally acquire substantially all of the assets of Y. A further clarification of this intent as to the “substantially all” test would be worthwhile.

Private letter rulings involving cases where Acquiring received the old Acquiring stock and exchanged new Acquiring stock cite Rev. Rul. 57-465 and apply the “70/90 test” without any modification to address the transfer or non transfer of the “old and cold” A stock. But in the many cases where Target distributed the “old and cold” Acquiring stock, and Acquiring either did or did not issue additional stock in exchange for the

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28 This formulation may derive from Helvering v. Schoellkopf, 100 F 2d 415, 416 (2nd Cir. 1938); see Foster, “Upstairs and Downstairs Mergers,” 3 Tax L. Rev. 215, 222 (1947).
29 See, e.g., PLR 200532011 (April 29, 2005).
remaining Target assets, the rulings apparently needed to employ a more mechanical test for determining “substantially all” than just looking to see if the transaction was divisive. Consequently, the letter rulings tend to state that, in applying the “70/90 test,” they ignore any “old and cold” stock that was not transferred to Acquiring but was distributed.30

But a different issue arose when Target distributed only old and cold Acquiring stock. In these cases the private letter rulings tended to deem the issuance and distribution of additional Acquiring shares in exchange for the assets other than the stock of the Acquiring that were received by Acquiring.31 This limitation appears to indicate that the Service deemed the issuance of the Acquiring shares to fill out the economic construct explaining what was exchanged for what, and not to satisfy a statutory requirement.

The “substantially all” issue also arises when the downstream transaction is treated as a C reorganization, which it can be under Rev. Rul. 78-47.32 In that ruling, Target transferred all of its assets other than its old and cold stock in Acquiring to Acquiring for additional shares. It is difficult to determine from Rev. Rul. 78-47 whether the Service intended that “old and cold” stock be counted for purposes of the “70/90 test.” The holding of Rev. Rul. 78-47 is that the transfer of the “business assets” was the key to qualifying the “substantially all” test. But then the Revenue Ruling states that the “business assets” were exchanged for the old stock and the new stock. Apparently that means the old stock was treated as acquired and reissued, but that meaning is inconsistent with the normal understanding of “business assets,” which would not include the stock. The significance of the treatment of the old stock is also questionable due to the fact that it may have reflected the particulars of the contract that the ruling posited: in lieu of issuing new shares for the old shares the Acquirer would allow the Target to distribute the old shares.33

In light of such uncertainties regarding Rev. Rul. 78-47, it is predictable that the private letter rulings citing to that Revenue Ruling have been inconsistent. Some have cited it in

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30 PLR 7842059 (July 20, 1978) (old stock and new stock distributed); PLR 8612082 (Dec. 30, 1985).
31 We know this because the rulings specifically state that the old stock is not included in the substantially all transfer, and that the constructive issuance is in exchange for substantially all of the assets. Thus the rulings are not saying that the old stock is deemed cancelled and reissued, but that both old and new shares are distributed. See PLR 8603048 (October 21, 1985), PLR 8612082 (Dec. 30, 1985), PLR 8747011 (Aug. 20, 1987), and PLR 8217165 (Jan. 29, 1982). Cf. PLR 9114012 (Jan. 1, 1991), which seems to err in constructing not only an issuance but also an exchange of the “old and cold” stock of survivor for new stock of survivor, on the mistaken reading of section 354(b) as requiring exchange of substantially all rather than acquisition of substantially all, and also a misreading of Rev. Rul. 57-465 as counting rather than ignoring such stock.
33 Y owned five percent of the X stock and the 5% was worth $90. Y also owned $6 cash, $36 land, and owed $6. Therefore Y was worth $126, of which $90 was five shares of X. X and Y agreed that X would acquire Y’s assets for seven X shares, which would be worth $126. But to avoid state transfer tax, X new shares and Y distributed to its shareholders the five old shares and two new shares in liquidation.
ruling that the old stock is ignored for the “70/90 test.” Others state that the old stock counted for “70/90 purposes.” All of these rulings implicitly or explicitly say that the old stock is deemed exchanged for new stock; it is reasonable to treat this as a separate matter from the “substantially all’ test, and as a matter peculiar to the C reorganization which statutorily requires a stock consideration exchange.

Adding to the confusion is the fact that the downstream cases also can be subject to Rev. Rul. 70-223, 1970-1 CB 79, as statutory mergers. Unless Target distributes the subsidiary stock before it merges, an exchange of old stock for new stock inevitably occurs in a merger. But if it does distribute the old stock, there is no “substantially all” rule to worry about. At least one letter ruling appears to have deemed an exchange of Acquiring stock for the assets that did move. There is no explanation for this deeming other than filling out the economic construct to explain what was exchanged for what. This type of transaction also could be a reincorporation under the proposed regulations if the survivor is a newly created corporation.

Thus it appears that in downstream mergers the deeming of new shares where none are issued is not motivated by section 354(b), but rather by an effort to explain the transaction. This point is basic to our recommendations: deeming a transfer of Acquiring shares by Target to Acquiring in exchange for new Acquiring shares that are distributed to the Target shareholders simply explains the transaction. If so, the same construct should be used for purposes of section 354(b), the “substantially all” test, and section 361(c).

V. General Utilities Gain

A Target engaging in a D reorganization must distribute something to its shareholders, because there must be a section 354 or section 356 exchange, even if it is a deemed distribution such as the one deemed by the Temporary Regulations. An essential element of the Code rules making it possible for reorganizations to be free of gain recognition to all parties is section 361(c), which applies to Target’s distribution of property to its shareholders, generally in liquidation (although the liquidation is deemed in the case of a statutory merger). But section 361(c) provides nonrecognition only to the distribution of “qualified property” and defines qualified property to exclude property that Target did

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38 See, e.g., George v. Commissioner, 26 TC 396 (1956), acq. 1956-2 CB 5. In that case, T owned 50% of the stock of S, and both T and S transferred their assets to A in exchange for A stock that was distributed, as applicable, by S to T and its other shareholders and ultimately by T to its shareholders. The Service argued that T did not transfer substantially all of its properties to A, because T did not transfer the S stock to A, on account of the acquisition of S. But the Tax Court found a transfer of substantially all at both levels, because the results met the C reorganization purposes.
not receive from Acquiring in the reorganization. This rule saves the potential for recognition of the General Utilities gain in Target’s properties that are distributed to its shareholders instead of being transferred to Acquiring. This rule appears to leave a distribution of “old and cold” Acquiring stock literally subject to section 1001(c) gain recognition. But the law should not be applied that way, and it appears the Service agrees in practice.

At first glance, it might seem that Target’s gain in old Acquiring stock should be recognized on a “now or never” basis, because the property and its basis do not pass to another taxpayer (Acquiring) so that the gain might be recognized later. Rather, the gain on those shares disappears. However, we know there are at least two other potential proxies for that gain: Target’s shareholders’ stock, which takes an exchanged basis under section 358, and Acquiring’s previously held assets, which takes a transferred basis under section 361. Accordingly, the distribution of “old and cold” stock differs from the distribution of standard boot, as to which the corporate level recognition is paired with shareholder level cost basis. Instead, if the corporation were required to recognize gain on the distribution of the “old and cold” stock, the shareholders would still take a section 358 exchanged basis, which is inconsistent conceptually with the corporate gain recognition.

Moreover, it seems unfair to tax the distribution of “old and cold” Acquiring stock when the gain recognition can be avoided by the meaningless step of exchanging the old stock for identical new Acquiring stock. While Target can often engage in self-help by going through the motions of swapping the Acquiring shares it has held for identical new shares of Acquiring that it distributes, this is not always convenient or even possible as there can be practical reasons why the stock cannot be swapped, or additional costs associated with such a swap. Thus, if this step is overlooked the corporation should not be penalized.

The private letter rulings that cite the downstream reorganization revenue rulings either do not address the issue or explicitly or implicitly rule that Target will not recognize gain on the distribution of the old stock. The pre-1986 rulings would not have addressed section 361(c) because prior to 1987 the job of section 361(c) was handled by section 311, and it did not require that the distributed property be “qualified” property in order to relieve the liquidating corporation of recognition. Unfortunately, section 361(c)(4)

39 PLR 7842059 (July 20, 1978) (D reorganization that differed slightly from Rev. Rul. 57-465 in that the transferring corporation distributed both the old and cold stock and new shares, as in Rev. Rul. 78-47; no ruling on nonrecognition on the distribution of the shares, old or new, contrary to the normal procedure of that time to issue a nonrecognition ruling under the then controlling section 311); PLR 8503052 (Oct. 23, 1984) (“brother-sister” D reorganization in which a stock issuance was deemed even though none occurred; Target did not own any Acquiring stock; section 311 nonrecognition ruling given); PLR 8607104 (Nov. 20, 1985) (old and cold stock distributed but taxpayer represented that new shares were exchanged, which they were not, and ruling stated that old shares counted for substantially all purposes; no nonrecognition ruling on stock distribution); PLR 8747011 (Aug. 20, 1987) (cites both sections 311 and 361(b)(3) for distribution nonrecognition in the case of “old and cold” stock and deemed issued new stock); PLR 9122080 (March 7, 1991) (includes the old stock in substantially all and refers to the new stock being issued for substantially all of the Target assets, which implies that the old stock was exchanged for the new stock, but does not provide a nonrecognition ruling on distribution); PLR 9247019 (Aug. 24, 1992) (nonrecognition on “old Footnote continued on next page.
precludes resort to section 337 for nonrecognition in the case of reorganizations. It is likely that the Service tended to require a stock exchange, or deemed stock exchange in the cases of downstream mergers of pure holding company Targets in order to distinguish the transaction from a liquidation, in contrast to cases in which Target transferred substantial additional assets to Acquiring.

Accordingly, we recommend that for purposes of section 361(c) either “old and cold” Acquiring shares held by Target be deemed to be qualifying property or that they be deemed exchanged for new Acquiring shares immediately before the distributions, which would be qualifying property.

VI. Conclusion

For reasons discussed above, we recommend that the old and cold A stock owned by T should be counted favorably in the substantially all test, regardless of whether it is actually transferred to A or just distributed as part of the reorganization plan. This rule would be consistent with the other two recommendations.

We realize that two of the recommendations of these Comments appear to derive from different sources: (1) the stock issuance recommendation related to the interpretation of section 354(b) derives in part from a close reading of the words of the statute; and (2) the section 361(c) recommendation for nonrecognition on the distribution of “old and cold” Acquiring stock derives from a practical and policy argument. That difference should not undercut the propriety of either recommendation: each stands on its own footing. If Treasury and the Service adopt these recommendations, they may choose to deem a reissuance of “old and cold” Acquiring stock, for purposes of satisfying the literal words of section 361(c), if such a literal satisfaction is found necessary. If so, the Regulations would deem the stock issuance for the right reason, and in the limited case described.

Section 354(b)(1)(B) does not require the issuance of Acquiring stock in a nondivisive D reorganization; Target’s distribution of “old and cold” Acquiring stock should satisfy the exchange requirement of section 368(a)(1)(D) and section 354; and Target should, if necessary, be deemed to exchange the old stock for new Acquiring stock so that it can distribute that stock without recognition as qualified property under section 361(c). In addition, the long-standing treatment of the “old and cold” stock as satisfying the substantially all requirement should be stated more clearly. We recommend that Treasury and the Service revise the Regulations to provide for these results, or alternately affirm these results in a Revenue Ruling.

and cold” and newly received shares, citing Reg. section 361(c)(1) and Rev. Rul. 78-47, which was said to prevent recognition on the distribution of the old and new shares); PLR 9510072 (Dec. 15, 1994) (deems exchange of old shares for new shares, which sets up the nonrecognition, but does not so rule). Note that between 1986 and 1988 section 361 allowed corporate nonrecognition on a distribution of property that the shareholder received tax free under section 354 or 356.