October 6, 2014

The Honorable John Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Comments Regarding Sourcing of Earnings and Profits for Boot in Reorganizations

Dear Commissioner Koskinen:

Enclosed please find comments regarding the sourcing of earnings and profits for boot in reorganizations (“Comments”). These Comments are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

The Section would be pleased to discuss the Comments with you or your staff if that would be helpful.

Sincerely,

Armando Gomez
Chair, Section of Taxation

Enclosure

cc: Hon. Mark J. Mazur, Assistant Secretary of the Treasury (Tax Policy)
    Emily S. McMahon, Deputy Assistant Secretary of the Treasury (Tax Policy)
    Lisa Zarlinga, Tax Legislative Counsel, Department of the Treasury
    Hon. William J. Wilkins, Chief Counsel, Internal Revenue Service
    William D. Alexander, Associate Chief Counsel (Corporate), Internal Revenue Service
The following comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation 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. Substantive contributions were made by Devon M. Bodoh, Philip J. Levine, and Michael L. Schler. The Comments were reviewed by Julie Hogan Rodgers, Chair of the Corporate Tax Committee, and Martin Huck, immediate past Chair of the Corporate Tax Committee. The Comments were further reviewed by Robert H. Wellen, of the Section’s Committee on Government Submissions, Julie Divola, the Council Director for the Corporate Tax Committee, and Peter H. Blessing, the Section’s Vice Chair of Government Relations.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal 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 6, 2014
EXECUTIVE SUMMARY

The following comments (“Comments”) consider regulations the Department of the Treasury (“Treasury”) might adopt to identify the corporation to which section 356(a)(2) refers (“... ratable share of the undistributed earnings and profits of the corporation ...”).\(^1\) We understand the current position of the Internal Revenue Service (“Service”) to be that normally “the corporation” is the acquired corporation, but that the positive earnings and profits (“E&P”) of the surviving corporation are also taken into account in acquisitive “D” reorganizations involving identical ownership of both the target and the surviving corporations.\(^2\)

We have considered a number of alternative approaches (each of which might require an ordering rule) to determine when pooling is appropriate, principally the following:

- Regulations might adopt the current Service position and perhaps extend pooling to cases where there is a *de minimis* variation from identical shareholder ownership.
- The E&P of both corporations might be pooled for all acquisitive “D” reorganizations, regardless of common ownership.
- The Clark\(^3\) construct might be extended to treat the section 356 boot as distributed in a post-reorganization section 302 redemption, which, if treated as a section 301 distribution, would utilize pooled E&P.

If the Treasury pursued the Clark alternative, it would have to create a special rule moving the E&P of the target to the acquiring parent in a triangular reorganization for purposes of the section 356 dividend. Indeed, the triangular reorganization question comes up even today under the existing Service policy. If A owns all of X and Y; X merges into a subsidiary of Y; and A gets boot, the question can arise as to the source of the E&P. This is a question that the regulations need to answer even if the narrow current policy on taking into account the E&P of the acquiring corporation does not change.

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\(^1\) References to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise indicated.

\(^2\) In these Comments, the taking into account of the positive E&P of both corporations is sometimes referred to as “pooling.” The possible treatment of deficits in current or accumulated E&P of the target corporation or the acquiring corporation is beyond the scope of these Comments. *See* Reg. § 1.381(c)(2)-1.

DISCUSSION

I. Historical Background

The dividend within gain rule of section 356(a) imposes a limitation on income recognition in reorganizations that appears by modern standards to be arbitrary. That limitation presents its own problems, which are beyond the scope of these Comments. In any event, when the gain is treated as a dividend, the corporation whose E&P is distributed must be identified.

The history of section 356(a) shows that, to the extent Congress had any intention, it was for the target’s E&P to characterize the dividend. But decades ago at least one appellate court and the Service decided that they were not entirely constrained by such intention, and they took account of the acquiring corporation’s E&P in cases where there was an exact overlap of shareholders.

Section 356(a) came into the Revenue Act with its dividend within gain rule in 1924. The 1924 congressional reports show that Congress was concerned with reincorporations that attempted to obscure dividends as gains on the liquidation of the original corporation, and Congress did not discuss acquisitive reorganizations in the committee reports. H.R. Rep. 179, 68th Cong., 1st Sess., S. Rep. 398, 68th Cong., 1st Sess., 1939-1 C.B., Part 2, 251-252, 277. However, the earliest commentator on the dividend within gain rule also described the application of the rule to an acquisitive reorganization in terms of a liquidating distribution by the target, preceded by a dividend distribution of the boot from the target’s E&P. Roswell MaGill, Notes on the Revenue Act of 1924 - Income Tax Provisions – Part II, 3 Nat'l Income Tax Mag 60 (1925). That shows that the commentator would determine whether the boot was dividend-like by looking at the pre-reorganization ownership of the target.

These two examples and early understanding of what the boot within gain rule was about indicate that it can be explained this way: most reorganizations were “C” and “D” asset reorganizations in which the target usually liquidated and the target shareholders got a liquidating distribution that was not taxed to the extent of the qualifying stock and securities consideration. It made sense to tax the liquidating exchange as one would tax sale gain, from the shareholders’ viewpoint, with an adjustment being made for dividend like boot. No one had any idea how to determine dividend like boot except in the base case of reincorporation where all of the boot could be dividend like. But the idea that the boot could be treated as a pre-reorganization distribution from target shows that all of the focus was on the target shareholders’ relationship to the target E&P.

The failure to tag all of the boot as dividend, particularly in the reincorporation cases, would not have seemed illogical to Congress in 1924, because section 302 did not exist. Therefore, redemptions did not hold the potential to be taxed as dividends either, but were taxed as sales (actually as partial liquidations). “Therefore, when Congress wanted to get at abusive redemptions in 1924 it may have assumed the worst it could do was to convert the character of the gain to dividend. This had the result, in 1924, of making the recharacterized income subject to the surtax, which was the only tax on dividends received by individuals. In addition, the predecessor of section 356(a) was part of the generic rule taxing otherwise nontaxable exchanges (including the predecessor of section 1031) to the extent of the lesser of gain realized or boot received. That also probably forced a common approach as to the limitation to gain realized. Finally, Congress did not seem to anticipate that the gain limit would actually apply in the abusive cases it aimed at.” See Cummings, Form vs. Substance in the Treatment of Taxable Corporate Distributions, 85 Taxes 3 (March 2007). The sole example in the legislative reports involved more gain than dividend.
Davant v. Commissioner involved a “D” or “F” reorganization of two corporations owned by the same shareholders in which the boot physically came from both corporations.⁵ The Fifth Circuit held that the E&P of both corporations should determine the boot dividend for these reasons: (1) Bazley v. Commissioner, which is now reflected in Regulation section 1.301-1(l), stands for the view that sometimes a dividend has occurred that can be taxed separately from a reorganization;⁶ (2) “the corporation” to which section 356(a)(2) refers is the distributing corporation that is controlled by the corporate shareholders, which on these facts is both corporations where there is complete identity of ownership; and (3) the reorganization was also an “F” reorganization.⁷

The other courts of appeals and the Tax Court did not follow Davant, although the Tax Court felt compelled to follow it in a case appealable to the 5th Circuit in which the shareholders owned 94.44% and 98% of the corporations.⁸ Rev. Rul. 70-240 applies Davant to a one shareholder 100% ownership overlap “D” reorganization. The Office of Chief Counsel has favorably cited Davant as recently as 2010, along with Rev. Rul. 70-240.⁹

Thus, the law supports pooling in “D” reorganizations where there is 100% ownership overlap of the two corporations, with some flexibility in the authorities allowing de minimis variation from 100% overlap of stock ownership. We note that a similar standard for nearly identical cross ownership could be that of Regulation section 1.368-2(l)(2)(iii), which provides that:

De minimis variations in ownership and certain stock not taken into account. For purposes of paragraph (l)(2)(i) of this section, the same person or persons will be treated as owning, directly or indirectly, all of the stock of the transferor and transferee corporations in identical proportions notwithstanding the fact that there is a de minimis variation in shareholder identity or proportionality of ownership.

There are several other issues, which we have not evaluated, in addition to de minimis variations, which would have to be considered if such a test were adopted, including whether pure preferred stock should be taken into account, and the extent to which ownership attribution and/or aggregation should be employed.

II. The Issue

There currently is uncertainty about when, if ever, the E&P of the acquiring corporation is counted for determination of the amount of dividend within gain under

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⁵ 366 F. 2d 874 (5th Cir. 1966), cert. denied, 386 U.S. 1022, reh. denied, 389 U.S. 893 (1967).
⁶ 331 U.S. 737 (1947).
⁸ Simon v. Commissioner, T.C.M. (CCH) 269, 1982 T.C.M. (P-H) ¶ 82,008.
⁹ CCA 201032035 (Aug. 13, 2010).
section 356(a) in reorganizations other than the one corporation reorganizations under sections 368(a)(1)(E) and (F).

This uncertainty allows electivity that taxpayers and practitioners use in practice. For example, if a target corporation reorganizes into a corporation with E&P, and the stock of the two corporations is owned, directly or indirectly, by the same persons, the shareholders may rely on case law to take the position that only the E&P of target determines the dividend within gain,\textsuperscript{10} despite the holding of Rev. Rul. 70-240\textsuperscript{11} to the contrary. Alternatively, on the same facts, a different taxpayer might look to the E&P of both the target and acquiring corporations, relying on Rev. Rul. 70-240. As another example, commonly controlled corporations with substantial divergence in stock ownership could reorganize, and the shareholders might claim that the E&P of both corporations should be counted. As yet another example, corporations with identical stock ownership might cause some divergence of stock holding to occur in advance of a reorganization, so as to not have identical ownership, and thus claim that the E&P of acquiring does not count even under the Service’s ruling position.

We are not aware of any particular problematic domestic transaction that might be perceived to be abusing the current rules, except to the extent taxpayers have their choice of tax treatment on identical facts. In general, we do not believe that there is a clearly identifiable pro-taxpayer or pro-government answer to the question, because of the differing interests in different types of taxpayers in receiving dividends or not. It may be argued that electivity by form is not per se abusive or a problem for the tax system. However, it could be said that the pro-government answer is to have a single fixed answer to eliminate taxpayer electivity.

We observe that most perceived reorganization abuses in the foreign context have been independently addressed by regulations under subpart F or section 367 or other parts of the Code, which alter the normal operation of subchapter C. We assume that the same approach could be taken here. We do not believe that the subchapter C rules should be altered to accommodate any such foreign concerns, including concerns about cross border ownership of domestic reorganizing corporations.

We believe, in the purely domestic context, that the issue of electivity is problematic only to the extent of distributions that are substantively dividends from the combined corporations (albeit within gain) but normally are not taxed as such due to insufficient E&P in the target. We believe that such cases occur in practice. However, we recognize that there could be questions about the Treasury’s power to enforce a regulation without a statutory change, aside from enforcing the current Service position.

\textsuperscript{10} See American Manufacturing Co. v. Commissioner, 55 T.C. 204 (1970).

\textsuperscript{11} 1970-1 C.B. 81.
III. Statutory Constraints

A threshold question is whether the reference to “the corporation” in section 356(a) limits the E&P to that of the target corporation. Davant rejected this argument and the Service adopted the Davant view in 1970, a position the Service has maintained ever since. It would be a very late date to decide that the Davant interpretation is beyond the scope of reasonable statutory interpretation.⁶ The Tax Court at least once has applied Davant in a case not involving 100% shareholder overlap. Although some believe that Davant and the revenue ruling are special cases because they involve 100% shareholder overlap, that fact does not resolve the statutory problem.

Either “the corporation” means the reorganizing target corporation, or it means some other corporation (i.e., a combination of the two corporations). As a matter of strict literal interpretation, looking to the E&P of a single corporation, either the target or the pooled E&P of the survivor makes more sense than interpreting the statute to refer to two corporations as they existed prior to the reorganization (which Davant seemed to do). The Treasury has proposed to amend Regulation section 1.381(a)-1(b)(2) to make clear that only the acquiring corporation receives the target’s E&P. That proposal could make the interpretation that “the corporation” means the surviving corporation more acceptable, subject to a decision on how to deal with triangular reorganizations, as discussed below.

However, we do not have a consensus view on how far the Davant approach or a pooling approach ought to be pushed by the Treasury in regulations, or on how far pooling could be pushed without a statutory change. Some of our members believe that a statutory change would be required to consider the acquirer’s separate E&P outside “D” reorganizations, and some believe a statutory change would be required to go beyond “D” reorganizations with a Regulation section 1.368-2(l) ownership overlap.

IV. The Alternative Solutions

There are at least eight possible alternatives to reduce current uncertainties, all of which require a regulation and some may require a statutory change. Following is a summary of these alternatives:

1. Only Target E&P. Adopt a regulation that abandons the possibility that the E&P of the acquiring corporation can be considered in characterizing a boot dividend. We reject this alternative because it would turn back almost half a century of law that the government has enforced and because that law has a sound basis in

⁶ Although a regulation based on an approach similar to Rev. Rul. 70-240 (even one allowing small variations of ownership) would represent an important step towards eliminating uncertainty and electivity, there still might be an issue of validity, particularly in the Third Circuit. See Atlas Tool Co. v. Commissioner, 614 F.2d 860 (3d Cir. 1980).

⁷ Cf. Wells Fargo & Co. v. United States, 114 AFTR 2d 2014-5021 (Fed. Cl. 2014) (interest netting applies to target and acquiring corporation in a merger because the target corporation becomes the acquiring corporation).
policy. Moreover, such a regulation might not be valid in the 5th Circuit if a taxpayer wanted to use the acquiring corporation’s E&P in a *Davant*-like situation.

2. **70-240 With *De Minimis* Rule.** Adopt a regulation that embodies Rev. Rul. 70-240, particularly if some cases of *de minimis* variations from 100% stock ownership overlap were also covered, as by using the test in Regulation section 1.368-2(l). To prevent electivity the regulation would state that it described the sole case in which the acquiring corporation’s E&P could be used (perhaps coupled with an anti-avoidance rule and/or a cross-reference to Regulation section 1.301-1(l)). We do not oppose this alternative, but that does not mean it is the preferred alternative.

3. **Expanded 70-240.** Adopt a regulation that expands the principle of Rev. Rul. 70-240 to some broader set of cases in which the target shareholders as a group have some degree of control of the acquiring corporation prior to the reorganization. This approach might use the “D” reorganization definition to define such cases. However, that definition does not well describe a situation of common control because it requires only that some of target’s shareholders control the survivor, not that those shareholders controlled both corporations before the reorganization, as in section 304 (subject to the continuity requirement). This approach would have the advantage of describing a known set of cases, but without a good policy reason for selecting it. Aside from using the “D” reorganization definition, any other definition of prior control would require making up a common ownership threshold out of whole cloth, which seems inappropriate.

4. **Broader Expanded 70-240.** Adopt a regulation that expands the principle of Rev. Rul. 70-240 to some broader set of cases (besides *de minimis* variation) based on some other principle besides control. We would reject this alternative.

5. **Clarified 1.301-1(l).** Adopt a regulation that makes clear that the rule in Reg. section 1.301-1(l) (which now applies to reorganizations generally and is not limited to the examples of “E” and “F” reorganizations) can more generally be applied for the purpose of accessing the E&P of the acquiring corporation. This is not a preferred alternative.

6. **Anti-Abuse Rule.** Adopt a regulation with some sort of anti-abuse rule aimed at a category of cases with which Treasury is concerned. We would reject this alternative because we cannot identify the abusive cases and we believe the rule selected should be adopted as a matter of principle and not as an anti-abuse rule.

7. **Tracing.** Adopt a regulation that traces boot to the E&P of the corporation that provided the boot. We would reject this alternative because it would be unadministrable and manipulative given the fungibility of cash. The Treasury has similarly decided against a tracing regime in the unified loss rule in the consolidated return regulations.
8. **Clark.** The *Clark* construct might be extended to treat the boot as distributed in a post-reorganization section 302 redemption, which if treated as a section 301 distribution would utilize pooled E&P. Triangular reorganizations would have to be specially addressed. Such a regulation would have the virtue of creating consistent construct. However, some members of the working group question the validity of such a regulation, and others believe that extending the *Clark* construct to determine E&P would not be appropriate as a policy matter.

As noted, we do not believe that alternatives 1, 6 or 7 are viable, for the reasons stated. Following is a discussion of the other five alternative solutions.

V. **Discussion of Alternatives 2, 3, 4 and 5**

We believe that Clarified 1.301-1(l) (No. 5) is a possibility but would tend to undermine the clear, if anachronistic, Congressional policy of limiting the dividend to gain. We are aware of legislative proposals to change the dividend within gain limitation and we believe it would be imprudent for Treasury to attempt to do so by regulation at this time.

Expanded 70-240 and Broadly Expanded 70-240 (Nos. 3 and 4) are possible, and can be distinguished from Rev. Rul. 70-240 with *De Minimis* Rule (No. 2) by searching for some principled expansion of Rev. Rul. 70-240 and the *Davant* principle, as discussed below. We discuss the more drastic Clark approach (No. 8) separately.

As already stated, codifying Rev. Rul. 70-240 With *De Minimis* Rule (No. 2), is a viable possibility. It is easy enough to expand Rev. Rul. 70-240 to cover stock ownership that is either identical or substantially identical. In effect the *Simon* Tax Court Memo opinion did this. The Regulation section 1.368-2(l) test could be applied. However, No. 2 would not fully apply the policy that is implied in the *Davant* opinion, which is a policy of identifying dividends based on the shareholder group’s ability to control the paying corporation. The target shareholders as a group obviously have the power to control a dividend payment from target. At some level of stock ownership presumably down to 50% of the vote, they also have the power to control a dividend payment by the acquirer.

Such a control standard appears in section 304(c)(1), which defines control as at least 50% of vote or value. The section 304 exchange is often an alternative to the reorganizations at issue here. Expanding control to go down to a deadlock line and to include either value or vote is consistent with several instances in the Code in which Congress has deemed it dangerous to rely solely on vote, but rather looked to the economic interests as well.\(^\text{14}\)

If Expanded 70-240 (No. 3) were adopted, the more difficult questions are (1) whether the control of acquiring should be measured pre-reorganization or post-

\(^{14}\text{See, e.g., I.R.C. §§ 172(h)(3)(B), 355(d)-(e).}\)
reorganization, and (2) whether the control should be measured based on the target shareholders as a group or shareholder by shareholder.

Pre-existing control seems to be a more natural approach. Section 304 uses preexisting control on a shareholder by shareholder basis. In contrast, section 368(a)(1)(D), which is often the type of reorganization at issue in the cases producing a boot dividend, is based on post-reorganization control held by some group of the target shareholders (who may or may not control the target before the reorganization). The Clark construct (No. 8, discussed below) is based on post-reorganization stock ownership of the specific shareholder, looking not directly to control of either corporation but to section 302 principles for determining when a distribution is like a dividend.

The shareholder by shareholder approach can seem inappropriate if prior control of acquiring is required for dividend treatment of boot.

Example 1. A owns 40% of X and of Y. B owns 60% of X and of Y. X merges into Y and both shareholders receive boot. Under a shareholder by shareholder approach, A does not control Y before the merger and so would not count Y’s E&P, despite the fact that A and B would count Y’s E&P under Rev. Rul. 70-240.

Conversely, the group control approach could seem unfair, but in almost all cases a smaller shareholder of the target will not have dividend treatment and thus will not be affected by a rule that makes the acquiror’s E&P available. As a consequence, a control group approach becomes in effect a shareholder by shareholder approach.

Example 2. A owns 20% of X. B owns 80% of X and all of Y. X merges into Y and both shareholders receive the same pro rata mix of stock and boot. The post-merger shareholders of X as a group control both corporations, but A had no prior relationship with Y’s E&P. Using pre-reorganization control to force A into dividend treatment seems unfair, but for the fact that mathematically A will not have to face the issue because it will suffer at least a small decline in ownership in the deemed redemption and will not have occasion to be taxed on Y’s E&P. Therefore, as a practical matter, a group approach is likely to be a shareholder by shareholder approach.

There is no good reason, aside from certainty, to select a common control definition, like that of section 304, and the validity of a regulation adopting such a rule seems questionable. As noted section 368(a)(1)(D) does not literally require common control in the target shareholder group. No other definition of common control has been suggested.

On balance, we prefer not to base the use of the acquirer’s E&P to characterize the boot dividend on any level of prior control of acquiring by the target shareholders as a group or individually, as contrasted with the current position of the Service (No. 2). Thus any other approach would need to be based on some rationale other than prior control of both corporations, which we admit is the rationale on which Davant seems to have been based. We have identified only one alternative—the Clark construct (No. 8) with which we are not in agreement.
VI. Discussion of Alternative 8: The Clark Construct

The major alternative approach that post-dates Davant is embodied in Commissioner v. Clark.\footnote{489 U.S. 726 (1989).} That decision in effect created a new way of determining when boot in a reorganization is dividend like, by positing that the target shareholder received only stock and then the acquiring corporation redeemed part of it, with the redemption characterized as an exchange or a distribution under section 302. The Service has embraced the Clark test, as it must.\footnote{Rev. Rul. 93-61, 1993-2 C.B. 118.}

A natural, though by no means inevitable, extension of Clark would be to conclude that if the distribution occurs post-reorganization when the target shareholder is deemed to be a shareholder of acquiring, then the combined E&P of the two corporations should be counted. In effect it would apply mostly to “D” reorganizations, but would not necessarily be so limited.

The Supreme Court has directed that this construct be used for the purpose of determining the character of the distribution. That character, when it is a dividend, is closely related to the amount of the relevant E&P. It would be a seemingly natural extension of the Clark construct to determine the E&P as that of the surviving corporation that would combine the E&P of the target except in triangular reorganizations (discussed below). However, we acknowledge that the tax world was somewhat surprised by the Clark construct. It is wholly a creation of the Supreme Court, and there is no inherent reason the Court would have intended it to extend beyond the issue addressed of dividend equivalence.

Under the Clark construct, boot is not treated as a dividend in the vast majority of true acquisitive reorganizations. In general, for Clark to construct dividend treatment, the former target shareholders must be the owner, directly or by attribution, of a significant amount of the surviving corporation’s stock after the deemed redemption. In such cases these shareholders presumably have post-reorganization control over the corporation’s E&P and it seems appropriate to base the dividend amount on the surviving corporation’s E&P.

If the Clark construct were adopted there can be odd cases in which, for example, a small shareholder experiences a slight increase in ownership of the acquiror and would have dividend treatment without control of any corporation. However, this case does not necessarily prove that the Clark construct could not work. Rather, it is simply another application of the oddity of the “teeny to tiny” ruling that forces such a shareholder into dividend treatment.\footnote{See Rev. Rul. 81-289, 1981-2 C.B. 82.}

Some think that applying the Clark construct would be consistent with a general policy of the Treasury to determine the ancillary effects of deemed transactions as if they
actually occurred. It also could be said to be based on the statute, which requires a determination whether the boot is dividend-like, and the Supreme Court’s direction that that be done based on a deemed post reorganization redemption. However, some members of our drafting group do not believe that such consistency would justify a valid regulation. Similarly the Clark approach would create some parallelism with section 304 treatment, which looks to the E&P of both corporations. But pooling the E&P of both corporations required an amendment to section 304.

Finally, some members believe that pooling E&P should not be extended beyond the “F” reorganization and the acquisitive “D” reorganization where there is complete shareholder overlap (i.e., 70-240 With De Minimis Rule (No. 2) or 70-240 Expanded (No. 3).

If adopted, the Clark approach could work this way in various cases.

**Example 3.** A owns 40% of X and Y. B owns 60% of X and Y. X merges into Y, and each shareholder receives 50% boot and 50% stock. They would be deemed to receive only stock of Y, half of which would be considered redeemed. Each would treat its boot as a dividend to the extent of the E&P of both corporations, subject to some ordering rule (assuming an ordering might still be needed for pooled E&P for some purposes).

**Example 4.** A owns 20% (worth $20) of X. B owns 80% (worth $80) of X and all of Y worth $100. X merges into Y, and both shareholders receive 50% boot and 50% stock. A would be deemed to receive 10% of the Y stock, and then be redeemed down to about 7% in a taxable exchange, while B would go up from 90% to 93%, reporting a dividend based on the E&P of both corporations.

**Example 5.** Same as Example 4 but Y merges into X. B’s boot dividend would be measured by the E&P of Y under current law, but by the E&P of both corporations under the Clark construct. Assuming A also exchanges old X shares for new X shares and receives boot, evidently A would be treated as engaging in a recapitalization separate from the merger, and the boot would be taxed as exchange proceeds. This Example shows that reversing the direction of the merger in this type of case would not change the result under the Clark construct, but could change it with respect to B under current law.

**Example 6.** A owns 95% of X and all of Y. X has E&P and Y has none. Y merges into X and boot is paid with the X stock exchanged for A’s Y stock. Under current law, the boot presumably is all exchange proceeds to A but only due to Y’s lack of E&P. Under the Clark construct, the same amount of boot would be dividend to the extent of A’s gain, subject to the pro rata share rule of section 356, regardless of the direction of the merger.19

**Example 7.** Same facts as Example 6 except Y has another small shareholder that is cashed out in the reorganization, but retains a small pre-existing ownership interest in X. Section 356 does not apply to that shareholder and its treatment is not affected by the Clark construct.

**VII. Triangular Reorganizations**

If any rule were adopted to count the acquiring corporation’s E&P and were not limited to acquisitive “D” reorganizations, the rule would have to address triangular

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18 See, e.g., Reg. § 1.338-1(a)(2).
19 Possibly Reg. 1.301-1(l) would apply.
reorganizations. “A” and “C” reorganizations can be triangular and can involve boot. The surviving corporation is the subsidiary of the issuing corporation. In such cases, under a Clark approach the relevant combined E&P should be the E&P of both the target and the issuing corporation.

This question comes up even today under the existing Service policy (No. 2) and would come up under any expanded version of Rev. Rul. 70-240 (No. 3 or No. 4). If A owns all of X and Y; X merges into a subsidiary of Y; and A gets Y stock and boot, the question would arise as to the source of the pooled E&P—Y or the merging subsidiary. This is a question that the regulations need to answer even if the narrow current policy on taking into account an acquiring corporation’s E&P does not change.

Clark itself involved a triangular reorganization. On at least two occasions the Service has issued letter rulings stating that the E&P of the parent in a triangular reorganization is counted.

Presumably the issue of sourcing E&P to an acquiring parent has not arisen because most triangular “A” and “C” reorganizations involve corporations that do not involve anywhere near 100% overlap of shareholders (except for upstream and downstream reorganizations), and the Service has not felt comfortable moving beyond Rev. Rul. 70-240. However, logically the E&P of target and acquiring parent should be available, and if an ordering rule were needed then the target’s E&P should be used first. The regulation could deem a distribution of E&P from target’s E&P to parent, in order to pool the E&P in “the corporation” that pays the deemed dividend.

VIII. Ordering and Pro Ration

Section 356 refers to the shareholder’s ratable share of the undistributed earnings and profits of “the corporation.” This should not be hard to apply when only the target corporation’s E&P is considered or under the Clark construct. We assume that under the Clark construct the shareholder would be treated as having a ratable share of the pooled E&P based on its deemed stock ownership in the acquiring corporation before the deemed redemption. But when the independent E&P of the two corporations are considered, there must occur both a proration of each corporation’s E&P to the shareholders, who often would hold differing percentages in the two companies, and a determination of the order (if not ratable) of accessing the corporations’ respective E&P. Also, even under the Clark construct there may be purposes for which an ordering of use of the combined E&P is relevant. We emphasize “may” because this would be unusual, but see, for example, Regulation section 1.243-4(a)(4) and (6).

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20 Reg. § 1.381(a)-1(b)(2)(ii), Ex. (1).
21 LTR 9041086 (reverse triangular); LTR 8523075 (forward subsidiary merger).
The goals of certainty and reducing electivity can be achieved through any of the alternatives that we did not reject for other reasons. However, another kind of uncertainty and electivity could be introduced if the regulation were an overreach of regulatory authority. At a minimum, we believe that the Treasury can craft a regulation based on the principles of Rev. Rul. 70-240 (as slightly expanded to account for *de minimis* ownership variances).