SELECTED TAX CONSIDERATIONS IN
CORPORATE RESTRUCTURINGS*

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SELECTED TAX CONSIDERATIONS IN CORPORATE RESTRUCTURINGS

Corporate restructurings of U.S. domestic groups can occur for a variety of reasons. A corporate restructuring may be entirely business driven -- after a series of acquisitions, management looks to consolidate operations, eliminating geographic and functional redundancies. In a world without taxes (or tax advisers), management might simply instruct that specific business locations or business units be shut down and their assets and operations “moved” to a sister location or business unit in a different subsidiary chain of the group. Indeed, there may be several subsidiary chains (each acquisition of a target group having been conducted by the parent corporation), and the business units in question may be at varying tiers below the parent corporation. Further complicating matters, business exigencies may suggest cross-chain transfers in multiple directions. Thus, an operating division of a third-tier subsidiary in one chain is destined for a second-tier subsidiary in another chain, whereas all the operating assets of a fourth-tier subsidiary in yet another chain are meant to be consolidated into a second-tier subsidiary in the first chain, and so on. Further, for various regulatory reasons, perhaps certain subgroup holding companies have to be left untouched. In other words, you need a scorecard.
In another case, the restructuring may be driven primarily by business goals but also be motivated by tax planning considerations. Over a period of years, the corporate group may have conducted a series of acquisitions of companies within its industry, each at the time of its acquisition, of necessity, conducting a vertically integrated business with manufacturing, distribution and sales assets and operations. Management has concluded that it would like to restructure the group along functional lines, centralizing all distribution, sales and marketing operations in a single subsidiary and all manufacturing and inventory management in a separate subsidiary. The restructuring also will have the potential for significantly reducing the state income tax liabilities of the group, given the effect that the restructuring will have on apportionment factors and nexus considerations. Finally, of course, a corporate restructuring may occur preliminary to a section 355 corporate separation.1

In such cases, dozens, and perhaps even hundreds, of companies within the domestic group can be affected. And, of course, corporate restructurings can sometimes implicate substantial international tax issues (not explored here).

Strictly from a federal income tax perspective, a corporate restructuring of a domestic affiliated group may not seem likely to trigger substantial amounts of tax. At worst, the thought may be,  

1 Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the “Code”), or the Treasury regulations promulgated thereunder.
the various relocations of assets and operations within the group may generate deferred intercompany gains, and this may be acceptable (if not optimal). However, even in the consolidated return context, the restructuring can have some nasty consequences. For example, if for whatever reason there are deferred intercompany gains embedded in the stock of one or more members of the group, a decision to collapse a chain of subsidiaries through a series of liquidations or mergers could have the consequence of triggering the recognition of the deferred gains.² Likewise, if the basis in the stock of a subsidiary was written down under the attribute reduction rules of section 108, a liquidation of that subsidiary may trigger the recognition of section 1245 recapture income.³ Preservation of stock basis may not always be

² See section 1.1502-13(f)(5) and discussion infra at pages 56 to 59.

³ The preamble to former section 1.1502-28T(b)(4) provides an illustration of this:

[A] member (a higher-tier member) realizes excluded COD income, that is applied to reduce the higher-tier member’s basis in the stock of another member (a lower-tier member) and, as a result, a corresponding reduction to the basis of property of the lower-tier member is made. The following year, the lower-tier member transfers all of its assets to the higher-tier member in a liquidation to which section 332 applies. Under section 1245, recapture on the lower-tier member’s property that is treated as section 1245 property by reason of section 1017(d)(1) is limited to the amount of the gain recognized by the lower-tier member in the liquidation. However, no similar limitation applies to the stock of the lower-tier member that is also treated as section 1245 property. Therefore, [without more] the higher-tier member

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viewed as an important consideration (given that basis generally tiers up under section 1.1502-32), but it can be quite important if,

would be required to include as ordinary income the entire recapture amount with respect to the lower-tier member.

See T.D. 9117 (Mar. 15, 2004). However, the amount of recognition should be limited to the amount of the stock basis reduction that does not result in a corresponding reduction of the tax attributes attributable to the subsidiary. See section 1.1502-28(b)(4) (issued on March 21, 2005 under T.D. 9192 finalizing section 1.1502-28T(b)(4)), revised by T.D. 9442 (Jan. 5, 2009). See also sections 1.1502-13(f)(5); 1017(b)(3)(D), 1017(d) and 1245.

4 Section 1.1502-32 provides rules pertaining to stock basis adjustments reflecting the principle of the consolidated return regulations that P (the owning member) and S (P’s first or lower tier subsidiary) are to be treated as a single entity so that the computation of consolidated taxable income accurately reflects the group’s income (and avoids double counting). For example, the rules operate to prevent items recognized by S from being recognized a second time on P’s disposition of S’s stock by providing for a basis adjustment in S’s stock for S’s taxable income. Under the rules, P’s basis in the stock of S is increased by positive adjustments (generally, to reflect taxable income and tax-exempt income of S) and decreased by negative adjustments (generally, to reflect losses, non capital, nondeductible expenses, and distributions of S). For example, if P forms S with a capital contribution of $100 and S subsequently earns $10 of taxable income causing S’s value to increase by $10, P’s basis in the stock of S will be increased by $10. Thus if P subsequently sells S’s stock for $110, P will not recognize additional income as P’s basis in S’s stock will have been increased to $110. This avoids taxing the same $10 of income twice -- once when earned by S and again when P disposes of S’s stock. Similarly, if S’s income is tax-exempt interest, P’s basis in S’s stock increases so that the tax-exempt income is not indirectly taxed when P disposes of S’s stock. Adjustments are required to be made at the close of the consolidated return year and at any other time when a basis determination becomes necessary (e.g., sale of a subsidiary’s stock, sale of a portion of the subsidiary’s stock that causes a deconsolidation with respect to the remaining shares, or a section 332 liquidation of a lower-tier subsidiary), in some instances even if there is no current tax effect at the time of the transaction. Adjustments must

(continued...)
for example, there have been taxable stock acquisitions in the recent past.

There are the points above, and many more, to think about even in the somewhat forgiving context of the consolidated return regulations. However, there is a parallel analysis that almost undoubtedly will be required -- where the blanket of the consolidated return rules is pulled away -- to ensure that the state tax effects of the federal income tax analysis are accounted for. That is, for the tax planning with respect to the restructuring to be successful, the restructuring must yield acceptable results under the federal income tax laws with and without application of the consolidated return regulations. This is because the notion that “states follow federal” does not always or uniformly extend to the consolidated return regulations regime. Moreover, in a given case, a state may follow the federal statute but as of a specific earlier date (e.g., the Internal Revenue Code, as amended, as of January 1, 2005) or as to most, but not all, matters. So, the federal tax analysis is to proceed on dual tracks and, of course, close coordination and cooperation between the federal and state tax advisers will be important.

be tiered up from the lowest to the highest tier. For example, if P is also a subsidiary, P’s adjustment to S’s stock is taken into account in determining the adjustments to stock of P owned by other members. In addition, when less than all of the subsidiary’s stock is owned or the subsidiary has more than one class of stock, the rules provide a system for allocating the basis adjustments.

5 See Part II. below.
This paper examines some of the provisions inside and outside the consolidated return regulations likely to come into play in connection with a restructuring of a domestic corporate group and explores some of the issues likely to be encountered in the process of developing the reorganization plan. Part I describes some of the key provisions of the section 1502 consolidated return regulations impinging on corporate restructurings and explores some issues that can arise under those provisions. Part II provides an overview of the extent to which the states conform to federal tax principles (including the section 1502 consolidated return regulations). Part III takes up the topic of cross-chain transfers of assets both generally and in the context of “D” reorganizations (this topic actually runs throughout the paper). Part IV examines debt-equity issues associated with intercompany debt and, in particular, the implications to the restructuring plan if there is a risk that intercompany debt could be recharacterized as equity. Finally, Part V offers some concluding thoughts.

This paper will make reference to a hypothetical fact pattern in which P is the common parent of a consolidated return group. P owns 100 percent of the outstanding stock of subsidiaries X, Y and Z; X and Y, in turn, own 100 percent of the outstanding stock of subsidiaries B and S, respectively.

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6 This paper adopts the convention of referring to the various types of reorganizations described in section 368(a) by simple letter designation. For example, a reorganization described in section 368(a)(1)(D) is sometimes referred to simply as a “D” reorganization.
S has manufacturing, sales and services operations. It also holds certain intellectual property that it licenses to other members of the P group.

I. **Principal Provisions of the Consolidated Return Regulations Affecting Corporate Restructurings.**

As relevant to a corporate restructuring, key points of departure, under the consolidated return regulations, from the answers to planning points otherwise provided under the federal income tax rules (though by no means exclusive) are sections 1.1502-80, 1.1502-34 and 1.1502-13.

A. **Section 1.1502-80.** Section 1.1502-80 provides that the Code “shall be applicable to the group to the extent the regulations do not exclude its application,” highlighting that section 381(c) continues to apply in the case of a transaction to
which section 381(a) applies and that sections 269 and 482 apply for consolidated return years.\(^7\) Section 304, by contrast, is turned off in the case of any acquisition of stock of a corporation in an intercompany transaction or to any intercompany item from such a transaction occurring after July 24, 1991.\(^8\) The worthless stock deduction rules and other rules relating to recognition of stock loss otherwise applicable are altered under section 1.1502-80(c) and, by cross-reference, section 1.1502-36.\(^9\) Finally, section 1.1502-80(d) provides that section 357(c) is inapplicable to intercompany transactions among members of the affiliated group for consolidated return years beginning after 1994 (provided neither

\(^7\) Section 1.1502-80(a). Notice of Proposed Rulemaking, 72 Fed. Reg. 2963 (Jan. 24, 2007), proposed certain revisions to section 1.1502-80(a) to consolidate the concept that duplicative adjustments should not be made as a result of consolidated return provisions. However, T.D. 9424 (September 17, 2008) (finalizing the so-called Unified Loss Rule for subsidiary stock) reflects a determination to retain the various iterations of the rule against duplicative adjustments in the various sections of the consolidated return regulations where they appear while at the same time adding new section 1.1502-80(a)(2) (setting forth the rule against duplicative adjustments).

\(^8\) Section 1.1502-80(b). Other provisions turned off by the regulations include section 163(e)(5) and section 1031 (both effective for consolidated return years beginning on or after July 12, 1995) and, subject to an anti-abuse rule, section 362(e)(2) (effective in respect of any intercompany transaction occurring on or after September 17, 2008 or, by taxpayer election, October 22, 2004). See section 1.1502-80(e), (f) and (h).

\(^9\) Final regulations under section 1.1502-80(c) were adopted on July 17, 2007 and amended in September 2008 by T.D. 9424 referred to above. See T.D. 9341 (July 17, 2007) and supra note 7.
the transferor nor the transferee in an intercompany transaction becomes a nonmember as part of the same plan or arrangement).10

B. Section 1.1502-34. Section 1.1502-34 provides, in relevant part, as follows:

For purposes of Sections 1.1502-1 through 1.1502-80, in determining the stock ownership of a member of a group in another corporation

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10 Section 1.1502-80(d) provides the example of a section 351 contribution. P owns all the stock of S and T with bases of $30 and $20, respectively. S has a $30 basis in its assets and $40 in liabilities. S transfers its assets and liabilities to a newly formed subsidiary in a section 351 transaction. Section 357(c) is inapplicable and S’s basis in the subsidiary’s stock is a $10 excess loss account. A second example illustrating the inapplicability of section 357(c) to a merger of S into T in a transaction qualifying as both a non-divisive “D” reorganization and “A” reorganization is moot by reason of the amendment to section 357(c) limiting the applicability of section 357(c), in the case of “D” reorganizations, to divisive reorganizations pursuant to section 355. American Jobs Creation Act of 2004, Pub. L. No. 108-357, sec. 898, 118 Stat. 1418 (2004). Revenue Ruling 2007-8, 2007-1 C.B. 469, makes clear that section 357(c)(1) does not apply to a transaction that qualifies as a non-divisive “D” reorganization or a transaction described in section 368(a)(1)(A) or (C) even though the transaction simultaneously qualifies as a section 351 exchange, explaining that in these cases “the transferor corporation ceases to exist and, therefore, cannot be enriched as a result of the assumption of the liabilities.” Also, because section 357(c)(1) is no longer applicable to such transactions (provided the requirements of section 354(b)(1) are met), it is also no longer applicable to a reorganization under section 368(a)(1)(G) (again, provided the requirements of section 354(b)(1) are satisfied).

Proposed regulations under section 1.1502-80 clarify that a transferee’s assumption of liabilities described in section 357(c)(3)(A) (e.g., a liability that would give rise to a deduction) generally will not reduce the transferor’s basis in the transferee’s stock in the exchange notwithstanding the inapplicability of section 357(c) in the consolidated return context. See Prop. Treas. Reg. § 1.1502-80(d); Notice of Proposed Rulemaking, 66 Fed. Reg. 57021 (Nov. 14, 2001).
(the “issuing corporation”) for purposes of determining the application of section 165(g)(3)(A), 332(b)(1), 333(b), 351(a), 732(f), or 904(f), in a consolidated return year, there shall be included stock owned by all other members of the group in the issuing corporation.

Consider the case where S (see structure chart above) transfers its intellectual property to B for no ostensible return consideration. Does the transfer qualify as a section 351 contribution by reason of the application of section 1.1502-34? It would seem that one can, and perhaps should, treat this transaction as an exchange by S of property for constructive B stock, following which S is in section 368(c) control of B, since pursuant to section 1.1502-34, for purposes of section 351(a), S will be treated as owning the stock of B owned by all other members of the group. That is, in reliance on section 1.1502-34, the stock in B owned by X is treated as owned by S. Of course, outside the consolidated return context there would not appear to be any support for treating the transfer as made in exchange for stock (see Part II below) and if the transfer were to be so treated, the transaction would be a taxable event.11 However, in an actual parent-subsidiary scenario, a transfer of property from parent to subsidiary without more would

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11 In addition, as will be taken up in greater detail in Part II below, those states that “follow federal” in many cases do not apply section 1.1502-34 or the other provisions of the consolidated return regulations.
be treated as a section 351 exchange\textsuperscript{12} and that is what section 1.1502-34 has constructed for federal tax purposes. Or has it?

Revenue Ruling 74-598, 1974-2 C.B. 287, amplified by Rev. Rul. 75-383, 1975-2 C.B. 127, concerned an affiliated group filing a consolidated federal income tax return in which a wholly owned foreign subsidiary (S-1) of one member of the group (P) was to transfer all of its assets to another member of the group (S-2) that did not own any stock of the foreign corporation. The ruling held that section 1.1502-34 applies to attribute stock owned by members of an affiliated group to other members of the group only if the other members actually own some of the stock. The ruling concluded that because S-2 did not actually own any stock of S-1, section 1.1502-34 did not operate to attribute stock ownership to S-2, and thus section 332 of the Code was inapplicable to prevent recognition of gain on the transfer.

In Revenue Ruling 89-46, 1989-1 C.B. 272, the IRS reversed itself on this point, concluding that the earlier ruling was incorrect on this score and noting that “[s]uch an interpretation is not required by the plain language of section 1.1502-34 and would not further the purpose of that section.” The 1989 ruling concludes that Revenue Ruling 74-598 nevertheless was correct in its ultimate conclusion that section 332 of the Code does not apply to S-2’s receipt of property from S-1 as described in that ruling. This is because, although section 1.1502-34 of the regulations applies to satisfy the 80-percent ownership requirement of section 332(b)(1), it does not apply to satisfy the requirement of section 332(b)(2) or (3) that the distribution be in complete cancellation or redemption of the liquidating corporation’s stock. Since S-2 actually owned no stock in S-1, none of the property received by S-2 from S-1 was received in such a distribution.\footnote{Accordingly, Revenue Ruling 89-46 modifies Revenue Ruling 74-598 to hold that the attribution rules of section 1.1502-34 of the regulations apply for the purpose of determining whether a member satisfies the 80-percent ownership requirement of section 332(b)(1) of the Code, regardless of whether the member actually owns stock in the “issuing corporation,” but do not apply for purposes of determining whether the other requirements of section 332 are met. However, the transaction described in Revenue Ruling 74-598 nevertheless qualifies as a section 368 reorganization: with reference to the facts of Revenue Ruling 74-598, Revenue Ruling 75-383, 1975-2 C.B. 127, holds that the transfer of S-1 assets to S-2 qualifies as a “D” reorganization even though S-2 issued no stock in consideration therefor, citing Revenue Ruling 70-240, 1970-1 C.B. 18 (the “all-cash D” reorganization ruling discussed infra at Part III.C.2.). Note the absence of an indication that the transfer of assets also may qualify as a section 351 contribution.}
Under the facts of Revenue Ruling 89-46, X, a member of the P group, transferred property to Y, also a member of the P Group, solely in exchange for a security of Y having a fair market value equal to the fair market value of the property transferred. The ruling notes that the requirements of section 351(a) of the Code, other than the control requirement, are satisfied by the exchange:

Under section 1.1502-34 of the regulations, even though X has no actual stock ownership in Y, X is considered, for purposes of section 351(a), the owner of the Y shares owned by P. Because P owns 100 percent of the stock of Y, X is in control of Y immediately after the exchange. Therefore, section 351(a) applies to the exchange, and X recognizes no gain or loss on the exchange.14

At the time that Revenue Ruling 89-46 was issued, a transfer of property by one or more persons to a corporation “in exchange for stock or securities in such corporation” could qualify for non-recognition treatment under section 351 provided immediately after such transfer such person or persons were in control of the transferee.15 Under the facts of the ruling, X in fact transfers

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14 The ruling notes that, if X were not a member of an affiliated group filing a consolidated income tax return, section 351(a) would not prevent recognition of gain or loss on the transfer of property from X to Y because X did not own at least 80 percent of the Y stock and thus would not be in control of Y immediately after the transaction.

15 Securities have since been eliminated as an acceptable currency for a section 351 exchange. See Omnibus Budget Reconciliation Act of 1989, P.L.101-239, Sec. 7203(a), 103 Stat. 2106 (1989).
property to Y in exchange for securities thereby meeting the literal requirements of section 351 at the time, other than the control requirement, and section 1.1502-34 is relied on solely for purposes of satisfaction of this latter requirement.

Thus, the holding of Revenue Ruling 89-46 as such (the aggregate stock ownership rules of section 1.1502-34 attribute stock owned by a member of the group to other members of the group, regardless of whether the other members actually own any stock in the corporation) does not go so far as to construct an issuance of stock (or, as then applicable, securities) in the exchange. Returning to the hypothetical with which this discussion began (in which S transfers its intellectual property to B for no ostensible return consideration), does one invoke authorities such as Lessinger16 applicable to actual parent-subsidiary contributions to dispense with the necessity of an actual stock issuance under the 351 branch of the meaningless gesture doctrine and on that basis conclude that the transaction is for B stock (with the attendant divergent consequences inside and outside the consolidated return regulations)? Or should the transaction be cast as a deemed distribution of the intellectual property up the chain to P followed by a deemed contribution of the intellectual property down the chain to B or characterized in yet some other manner?17 In truth, an actual issuance of B stock to S would not be meaningless and, indeed, S’s failure to hold B stock under the exchange-

16 See supra note 12.
17 See infra Part III.B.
for-stock construction would require some explanation. (This topic is taken up again in Part III.C. below.) That is, the basic rationale of *Lessinger* and similar authorities really is not applicable. The case under consideration does not involve a shift in ownership of certain of a parent corporation’s assets to its wholly-owned subsidiary such that the parent’s “balance sheet” is unaffected. To the contrary, S’s “balance sheet” has been depleted and B’s enhanced and, consequently the distribution up/contribution down explanation holds some attraction. Yet, if a single share of stock were to be issued by B to S, it would seem S’s transfer of its intellectual property to B would fall within the ambit of section 351 for consolidated return purposes (though, again, not otherwise).18

A similar “cliff effect” can be noted as to the applicability of section 1.1502-34 to a recipient of assets in a distribution intended to qualify as a section 332 liquidation. As Revenue Ruling 89-46 notes on this subject, with reference again to the regulations under section 351 specifically address the case where the stock received by a transferor is not substantially in proportion to the transferor’s interest in the property immediately prior to the transfer (albeit not in the unusual context posited in the text). Section 1.351-1(b) provides that “in appropriate cases the transaction may be treated as if the stock... had been used to make gifts... to pay compensation... or to satisfy obligations of the transferor.” See also Rev. Rul. 73-233, 1973-1 C.B. 179 (contribution by majority shareholder of portion of stock to corporation prior to merger into another corporation to induce minority shareholders to vote for merger disregarded and instead treated as though target shareholders received shares of acquiring corporation to which entitled without regard to prior contribution and as though majority shareholder thereafter transferred portion of his shares to minority shareholders after merger in taxable disposition).

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18 The regulations under section 351 specifically address the case where the stock received by a transferor is not substantially in proportion to the transferor’s interest in the property immediately prior to the transfer (albeit not in the unusual context posited in the text). Section 1.351-1(b) provides that “in appropriate cases the transaction may be treated as if the stock... had been used to make gifts... to pay compensation... or to satisfy obligations of the transferor.” See also Rev. Rul. 73-233, 1973-1 C.B. 179 (contribution by majority shareholder of portion of stock to corporation prior to merger into another corporation to induce minority shareholders to vote for merger disregarded and instead treated as though target shareholders received shares of acquiring corporation to which entitled without regard to prior contribution and as though majority shareholder thereafter transferred portion of his shares to minority shareholders after merger in taxable disposition).
facts of Revenue Ruling 74-598, “[s]ince S-2 actually owned no stock in S-1, none of the property received by S-2 from S-1 was received” in complete cancellation or redemption of the liquidating corporation’s stock as required by section 332(b)(2) and 332(b)(3). It would appear on the facts of the ruling that if S-2 had owned some stock in S-1, although less than 80 percent, the transfer by S-1 of all of its assets to S-2 might have been held to qualify as a section 332 liquidation.19

A further explication of section 1.1502-34 as it pertains to section 332 liquidations is probably in order. Section 1.1502-34 applies “for purposes of determining the application of section . . . 332(b)(1)”20 and, as already discussed, not sections 332(b)(2) and

19 Accord MARTIN D. GINSBURG & JACK S. LEVIN, 2 MERGERS, ACQUISITIONS AND BUYOUTS ¶ 610.9 (Jan. 2009). See section 1.332-2(d) (“[i]f a liquidating corporation distributes all of its property in complete liquidation and if pursuant to the plan for such complete liquidation a corporation owning the specified amount of stock in the liquidating corporation receives property constituting amounts distributed in complete liquidation within the meaning of the Code and also receives other property attributable to shares not owned by it, the transfer of the property to the recipient corporation shall not be treated, by reason of the receipt of such other property, as not being a distribution (or one of a series of distributions) in complete cancellation or redemption of all stock of the liquidating corporation within the meaning of section 332”).

20 The regulation provision elaborates:

Thus, assume that members A, B, and C each own 33 1/3 percent of the stock issued by D. In such case, A, B, and C shall each be treated as meeting the 80-percent stock ownership requirement for purposes of section 332, and no member can elect to have section 333 apply. Furthermore, the special rule for minority shareholders in

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332(b)(3). Section 332(b)(1) provides that a distribution shall be considered to be in complete liquidation, and thus governed by section 332(a) (providing that no gain or loss shall be recognized on the receipt by a corporation of property distributed “in complete liquidation” of another corporation), only if, among other things, “the corporation receiving such property was, on the date of the adoption of the plan of liquidation, and has continued to be at all times until the receipt of the property, the owner of stock (in such other corporation) meeting the requirements of section 1504(a)(2).” Section 1504(a)(2) (pertaining to the definition of “affiliated group”) requires ownership of stock possessing at least 80 percent of the total voting power and value of stock of such corporation (keeping in mind that for this purpose (contrast the section 368(c) “control” definition) the term “stock” does not


Prior to repeal as part of the Tax Reform Act of 1986 (“86 Act”), section 333 generally provided that the gain recognized by qualified electing shareholders of a domestic corporation, upon complete liquidation of the corporation within one calendar month, would be limited to the greater of (1) the shareholder’s ratable share of the corporate earnings and profits or (2) the amount of money and value of certain securities received in the liquidation. The reference above to section 337(d) is to a prior law provision also repealed as part of the 86 Act. Section 337(d) provided for a pro rata gross-up of the amount realized by minority shareholders upon the liquidation of a corporation for the amount of the corporate tax paid, and imputation to (i.e., provision of a tax credit to) the minority shareholders in respect of the corporate tax paid, by the liquidating corporation in connection with sales or exchanges following adoption of its plan of liquidation.
include section 1504(a)(4) preferred stock -- i.e., nonvoting, non-participating, nonconvertible preferred stock with no, or only a reasonable, redemption or liquidation premium).

Section 1.1502-34 therefore acts to treat each member of an affiliated group receiving property in liquidation of another member of the affiliated group as an 80-percent distributee as required for the nonrecognition rule of section 332(a) to apply in connection with such receipt of property but (depending on the facts) subject to the frailties already exposed by Revenue Ruling 89-46.

Compare this to the treatment of the liquidating corporation. Section 337(a) provides that “no gain or loss shall be recognized to the liquidating corporation on the distribution to the 80-percent distributee of any property in a complete liquidation to which section 332 applies” and section 337(b) treats any transfer of property by a liquidating corporation “to the 80-percent distributee” in satisfaction of indebtedness to such distributee “as a distribution to such distributee in liquidation.” For this purpose, however, according to section 337(c), the term “80-percent distributee” means “only the corporation which meets the 80-percent stock ownership requirement specified in section 332(b) [and] the determination of whether any corporation is an 80-percent distributee shall be made without regard to any consolidated return regulation” (emphasis added). A liquidation that fails to come within section 337 on this account will be assessed under section 336 which, with the exception of distributions occurring pursuant to a plan of reorganization, generally
provides for recognition of gain and loss to a liquidating corporation on the distribution of property, as if sold at fair market value to the distributee.

This is not a subtle point (since it is part of the statute). And, of course, the consequences in the consolidated return context will be muted by the deferred intercompany transaction rules.\textsuperscript{21} However, the state income tax impact, in many cases, will be immediate.

Thus, tax practitioners run the risk of extending the reach of section 1.1502-34 beyond its grasp. To cite a final example, even though one often associates section 368(a)(2)(C) with section 351 “push-downs,” it seems clear that section 1.1502-34 does not apply for purposes of section 368(a)(2)(C). Section 368(a)(2)(C) provides, in relevant part, that:

A transaction otherwise qualifying under paragraph (1)(A), (1)(B), or (1)(C) 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

\textsuperscript{21} Assume affiliated group members A, B and C each own 33-1/3 percent of D. D liquidates, distributing built-in gain property. No gain or loss will be recognized by A, B and C for federal income tax purposes. As to D, however, the distribution will be treated as a deferred intercompany sale with the result that recognition of the gain will be deferred until the distributed property leaves the group (among other possible triggering events). See section 1.1502-80(g), added by T.D. 9376 (Jan. 15, 2008) (special rules in case of section 332 liquidation where multiple distributee members applicable to transactions occurring after April 14, 2008).
controlled by the corporation acquiring such assets or stock.\textsuperscript{22}

Section 368(c) defines “control” to mean the ownership of stock possessing at least 80 percent of the total combined power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corpora-

\textsuperscript{22} In 1954, Congress enacted section 368(a)(2)(C) in response to the cases of Groman v. Commissioner, 302 U.S. 82 (1937) and Helvering v. Bashford, 302 U.S. 454 (1938), the seminal “remote continuity” cases that disqualified putative reorganizations under the predecessor to section 368 where the acquisitions of target by acquirer involved shares of acquirer’s parent and the parent corporation was not deemed a “party to the reorganization” such that receipt of its stock could confer target shareholders with the required continuity of interest. See S. REP. NO. 1622, at 273, 275 (1954). As originally enacted, section 368(a)(2)(C) applied only to reorganizations under sections 368(a)(1)(A) and 368(a)(1)(C), but Congress has since amended the statute to apply to other reorganizations. Specifically, Congress amended section 368(a)(2)(C) in 1964 to apply to reorganizations under section 368(a)(1)(B), and, in 1980, to reorganizations under section 368(a)(1)(G).

Revenue Ruling 2001-24, 2001-1 C.B. 1290, and Revenue Ruling 2002-85, 2002-2 C.B. 986, effectively extended the application of section 368(a)(2)(C) to forward triangular mergers under section 368(a)(2)(D) and “D” reorganizations under section 368(a)(1)(D), respectively, each ruling noting that section 368(a)(2)(C) “is a permissive rather than an exclusive or restrictive section.”

Section 1.368-2(k)(1) restates the general rule of section 368(a)(2)(C) but permits the assets or stock acquired in certain types of reorganizations to be successively transferred to one or more corporations if certain conditions are met without disqualified the reorganization. Section 1.368-2(f) provides that, if a transaction otherwise qualifies as a reorganization, a corporation remains a party to the reorganization even though the stock or assets acquired in the reorganization are transferred in a transaction described in section 1.368-2(k). As discussed in the text that follows, recent revisions to the Treasury regulations have further broadened the scope of transfers permitted under section 368(a)(2)(C).
tion. This, of course, is the same definition of “control” that applies for purposes of section 351 but, as noted, that would not appear to be a sufficient basis for inclusion of section 368(a)(2)(C) within the scope of section 1.1502-34.

Thus, prior to certain recent revisions to the regulations under section 1.368-2(k) and section 1.368-1(d) discussed below, certain post-reorganization transfers of assets within the consolidated return group were traps for the unwary that could cause an otherwise tax-free transaction to be treated as taxable. Since section 368(a)(2)(C) is not among the provisions to which section 1.1502-34 refers, a drop down of assets purportedly pursuant to section 368(a)(2)(C) and in fact qualifying under section 351, but solely by reason of section 1.1504-34, could disqualify an otherwise qualifying “A,” “B,” “C” or “G” (and, by relatively recent extension, “D” and forward triangular “A”) reorganization even within the context of the consolidated return regulations. Assume, for example, that P owned 100 percent of the voting common stock of X, and Y owned 100 percent of the non-voting common stock of X (otherwise with reference to the same ownership chart depicted earlier in this paper). Assume that Z, another direct subsidiary of P, merged into P in a transaction qualifying under section 368(a)(1)(A), following which P contributed certain of the

23 See section 351(a).
Z assets to X for additional X voting stock.24 Apart from the

24 See Revenue Ruling 69-617, 1969-2 C.B. 57 (distribution of subsidiary’s assets via merger into parent followed by contribution of certain subsidiary assets to second subsidiary of parent does not qualify as distribution in complete liquidation governed by section 332 but does qualify as reorganization pursuant to section 368(a)(1)(A)). Reorganization treatment on such facts is also supported by section 1.368-2(k)(1) as recently revised, which provides that a transaction otherwise qualifying as a reorganization under section 368(a) will not be disqualified or recharacterized as a result of one or more subsequent transfers (or successive transfers) of assets or stock conforming to the requirements of the provision. See infra note 31.

This newly included language in the regulations generally is viewed as having eliminated the liquidation-reincorporation doctrine historically applicable the case of a parent-subsidiary liquidation followed by a drop-down of the assets of the liquidated subsidiary to another controlled corporation. This is because a putative section 332 liquidation of a subsidiary into its parent followed by a drop is now recognized as a “C” reorganization. Section 368(a)(1)(C) provides that the term “reorganization” includes a transfer by a corporation of substantially all its assets solely for voting stock of the acquiring corporation provided that the transferor liquidates as part of the transaction, distributing the acquiring corporation stock to its shareholders. In a P-S liquidation, S (the transferor) may be deemed to transfer all its assets to P (the acquiring corporation) for P voting stock which S then distributes to its shareholders (P) in liquidation. A key to this is section 1.368-2(d)(4), which provides that the “solely for voting stock” requirement of a “C” reorganization is not prevented where an acquiring corporation had prior ownership of stock of the target corporation. This regulation provision represents a repeal of the “Bausch & Lomb doctrine” pursuant to which “old and cold” stock of a target subsidiary was deemed boot that could ruin a “C” reorganization. (The theory behind the prior treatment was that the assets were acquired by the taxpayer from a subsidiary in a liquidation exchange for the stock of the subsidiary owned by the taxpayer rather than in exchange for the taxpayer's own voting stock, as required by § 368(a)(1)(C).) Thus, the liquidation is also a good “C” reorganization (although, without more, section 332 treatment will take priority). Under the new regulations, a C reorganization will not be disqualified or recharacterized as a result of a subsequent transfer of the target’s assets acquired in the transactions to a subsidiary controlled by the acquiring corporation. Thus, the drop-down following the liquidation (continued...)

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application of section 1.1502-34, P does not possess section 368(c) control of X on these facts for purposes of section 351 (since P does not own X’s non-voting stock) or section 368(a)(2)(C), and section 1.1502-34 alters that outcome for purposes of section 351, but not for purposes of section 368(a)(2)(C). As a result, the drop down of assets described above would have been a disqualifying event under the old rules.

Recent liberalizations under the regulations interpreting section 368(a)(2)(C) now indicate a different answer, although it was not until the release of the revisions to the regulations in their final form in October 2007 that this was indicated. These revisions to the regulations loosen the “qualified group” concept which -- although still predicated on section 368(c) control -- now includes an aggregation concept similar to that found in section 1.1502-34.

To qualify as a reorganization under section 368, a transaction must satisfy the continuity of business enterprise (COBE) precludes qualification as a section 332 liquidation and is what, under the new regulations, renders the transaction a “C” reorganization (or if a merger is involved, as is the case in our example, an “A” reorganization).

25 This problem arising under the “qualified group” approach was sometimes referred to as the “diamond pattern” problem. See e.g., GINSBURG & LEVIN, supra note 19, at ¶ 610.12.1. (Jan. 2009).


27 See discussion infra at pages 27 to 30.
requirement. The COBE requirement is intended to ensure that reorganizations are limited to readjustments of continuing interests in property under modified corporate form. Section 1.368-1(d)(1) provides that COBE requires the issuing corporation (generally the acquiring corporation) in a potential reorganization to either continue the target corporation’s historic business or use a significant portion of the target’s historic business assets in a business. Pursuant to section 1.368-1(d)(4)(i), the issuing corporation is treated as holding all of the businesses and assets of all members of its “qualified group.” Before revision as discussed below, section 1.368-1(d)(4)(ii) defined 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 (except the issuing corporation) is owned directly by one of the other corporations.

In March 2004, the IRS and the Treasury Department issued proposed regulations focusing both on section 368(a)(2)(C) and the regulations thereunder (section 1.368-2(k)) and the COBE rules that, among other things, proposed the amendment of section 1.368-2(k) to extend the principles of section 368(a)(2)(C) “to certain transfers of stock and assets after all types of reorganizations.”

Accordingly, these regulations propose to amend section 1.368-2(k) to provide that a transaction qualifying as a reorganization under section 368(a) will not be disqualified as a result of the 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)

IRS and the Treasury issued additional proposed regulations (Notice of Proposed Rulemaking, 69 Fed. Reg. 51209 (Aug. 18, 2004)), replacing the March 2004 proposed regulations and expanding upon them (i) to address whether a transaction that otherwise qualifies as a reorganization continues to qualify when, pursuant to the plan of reorganization, assets or stock of the acquired corporation is distributed to a corporation or partnership following the reorganization and (ii) to provide guidance on whether a transaction that otherwise qualifies as a reorganization continues to qualify when, pursuant to the plan of reorganization, acquired assets are transferred to a partnership in which the transferor owns an interest. As to the former point, the proposed amendments permitted a subsequent distribution of part or all of the assets or stock acquired as part of a transaction otherwise qualifying as a section 368 reorganization (other than stock of the issuing corporation) if (i) no transferee receives substantially all of the acquired assets, substantially all of the assets of the acquired corporation in a “B” or “(a)(2)(E)” transaction or 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 section 1.368-1(d)(4)(iii); and (iii) the COBE requirements as set forth in section 1.368-1(d) are satisfied. As to the latter point, a transaction otherwise constituting a section 368 reorganization would not be disqualified as a result of a subsequent transfer (or successive transfers) of part or all of the assets or stock of any party to the reorganization (other than stock of the issuing corporation) if the transfer is to one or more corporations controlled in each transfer by the transferor corporation or to a partnership in which the transferor has an ownership interest immediately after the transfer and requirements (ii) and (iii) above are satisfied.

See infra note 32, for a description of the final form of these amendments to the regulations.
the stock of any party to the reorganization other than the issuing corporation.

The preamble to the proposed regulations noted that when the COBE “qualified group” rules were incorporated into the section 368 regulations in 1998, the IRS and the Treasury stated their belief that the COBE requirements adequately address the remote continuity of interest issues raised by Groman and Bashford. The proposed amendment to section 1.368-2(k) aligned the application of section 368(a)(2)(C) with the COBE rules but, of course, like the definition of “qualified group,” was predicated on section 368(c) control.

The 2004 preamble to the proposed regulations further noted that in all the cases considered -- the scope of transfers permissible under the COBE regulations then in effect, and the extension by Revenue Ruling 2001-24 and Revenue Ruling 2002-85 of section 368(a)(2)(C) to forward triangular mergers and “D” reorganizations, respectively -- “the 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.” The preamble noted that “none of the transactions involve the transfer of the acquired stock or assets to a ‘stranger,’ a result inconsistent with reorganization treatment” [citing H.R. Rep. No. 831337, A134 (1954)].

29 See supra note 22.

30 Id.
In October 2007, the IRS finalized the 2004 proposed regulations but with modifications that broadened the “qualified group” definition in the COBE rules to eliminate the so-called “diamond problem” discussed above.\textsuperscript{31} The Preamble to the final regulations states that several commentators had urged that the definition of “qualified group” under section 1.368-1(d)(4)(ii) be expanded to parallel the definition of an affiliated group under section 1504(a). However, the Treasury Department declined to go this far, stating that it “declined to make this change, primarily because the section 368(c) definition of control is a major structural component underlying the statutory framework of the reorganization provisions.” However, the IRS and the Treasury Department recognized that it is consistent with reorganization policy to expand the definition of “qualified group” to permit qualified group members to aggregate their direct stock ownership of a corporation in determining whether they own the requisite

\textsuperscript{31} See T.D. 9361 (Oct. 25, 2007). Section 1.368-2(k)(1), as so revised, provides in part that "]a] transaction otherwise qualifying as a reorganization under section 368(a) shall not be disqualified or recharacterized as a result of one or more subsequent transfers (or successive transfers) of assets or stock, provided that the requirements of section 1.368-1(d) are satisfied and the transfers are described in either paragraph (k)(1)(i) [distributions] or (k)(1)(ii) [other transfers] of this section."
section 368(c) control in such corporation for the corporation to qualify as a member of the qualified group (provided that the issuing corporation owns directly stock meeting the section 368(c) control requirement in at least one other corporation). The IRS and Treasury Department noted that this aggregation concept is similar to the one found in section 1504(a).32

32 In addition, the final regulations permit transfers of stock to a “controlled partnership,” reversing the position the IRS had taken in Example 3 of the former section 1.368-2(k) regulations. The final regulations provide that, for purposes of determining the qualified group, if members of the qualified group own interests in a partnership meeting requirements equivalent to section 368(c) (a section 368(c) controlled partnership) any stock owned by the section 368(c) controlled partnership shall be treated as owned by members of the qualified group. Treas. Reg. § 1.368-1(d)(4)(iii). The Preamble explains that this section 368(c) equivalent control standard was applied to a transfer of stock to a partnership “in order to protect the section 368(c) control requirement applicable to triangular and stock acquisition reorganizations.” See T.D. 9361 supra note 31. Furthermore, solely for purposes of determining whether a lower-tier partnership is a section 368(c) controlled partnership, any interest in a lower-tier partnership that is owned by a section 368(c) controlled partnership shall be treated as owned by members of the qualified group.

The final regulations permit both distributions of stock of the acquired corporation (provided not consisting of all stock of the acquired corporation acquired in the transaction) and other transfers of stock of the acquired corporation, the acquiring corporation, or the surviving corporation, as the case may be, provided the transfer of stock does not cause the corporation to cease to be a member of the COBE qualified group (which now includes controlled partnerships, as described above). In connection with a transfer (other than a distribution) of part or all of the stock or assets of the acquired corporation, the acquiring corporation or the surviving corporation, as the case may be, the corporation in question must not terminate its corporate existence for federal income tax purposes. On the question of post-reorganization asset distributions, the regulations as finalized adopt a liquidation test in favor of the “substantially all” test employed in the proposed regulations (see (continued...))
The definition of “qualified group” now provides that a qualified group is 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 corpora-

supra note 28). That is, the distribution must not consist of an amount of assets of the acquired corporation, the acquiring corporation (disregarding assets held prior to the potential reorganization), or the surviving corporation (disregarding assets of the merged corporation), as the case may be, that would result in a liquidation of such corporation for federal income tax purposes. Cf Rev. Rul. 2008-25, 2008-1 C.B. 986 (complete liquidation of target (T) into parent corporation (P) following P’s acquisition of T for stock and cash in putative reverse triangular merger transaction under section 368(a)(2)(E) precludes application of section 1.368-2(k) safe harbor exception to application of step transaction doctrine and prevents transaction from qualifying as “reorganization” under section 368(a); ruling characterizes transaction as “qualified stock purchase” under section 338 followed by liquidation governed by section 332). Compare Rev. Rul. 2001-46, 2001-2 C.B. 321 (similar facts except T merges into P following acquisition; step transaction doctrine applied to integrate steps and treat transaction as single statutory merger of T into P since treatment results in transaction that qualifies as section 368(a) reorganization and therefore does not violate policy underlying section 338). See also Rev. Rul. 2001-25, 2001-1 C.B. 1291 (T sale of assets for cash following section 368(a)(2)(E) acquisition of T by P does not violate “substantially all the assets” requirement of section 368(a)(2)(E) where T retained cash).

In 2008, the Treasury Department made clarifying changes to section 1.368-2(k) to provide that a transfer to former shareholders of the acquired corporation or the surviving corporation is not described in section 1.368-2(k) to the extent it constitutes the receipt by the shareholders of consideration for their proprietary interests in either corporation. See T.D. 9396 (May 9, 2008). Transfers to former shareholders not in consideration for their proprietary interests (the example of a pro rata dividend is provided) continue to fall within the permission of section 1.368-2 (k).
tions (except the issuing corporation) is owned directly (or indirectly as provided in paragraph (d)(4)(iii)(D) of section 1.368-1 with respect to controlled partnerships)\textsuperscript{33} by one or more of the other corporations. With the addition of the phrase “one or more” at the end of the “qualified group” definition, the Treasury Department and IRS effectively aligned the COBE rules with the aggregation principles in the consolidated return rules.

In the case posited above (P owns the X voting stock but Y owns the X non-voting stock), X is now considered a member of P’s “qualified group” for purposes of the COBE rules. P, the issuing corporation, owns directly stock meeting the requirements of section 368(c) in Y, and stock meeting the requirement of section 368(c) in X is owned directly by P and Y taken together. Therefore, the dropdown of assets by P to X should not preclude the merger of Z into P from qualifying as an “A” reorganization.\textsuperscript{34}

\textsuperscript{33} As discussed at note 32 above, section 1.368-1(d)(4)(iii)(D) now provides for stock to be attributed to members of a qualified group from a controlled partnership.

\textsuperscript{34} See also section 1.368-2(k)(2), Example 9: As background to this example, P is the issuing corporation and T is an unrelated target corporation. All corporations have only one class of stock outstanding. T operates a bakery that supplies delectable pastries and cookies to local retail stores. The acquiring corporate group produces a variety of baked goods for nationwide distribution. P owns all of the stock of S-1 and 80 percent of the stock of S-4, S-1 owns 80 percent of the stock of S-2 and 50 percent of the stock of S-5, S-2 owns 80 percent of the stock of S-3, and S-4 owns the remaining 50 percent of the stock of S-5 (thus, S-5 is owned in a diamond structure). Pursuant to a plan of reorganization, T transfers all of its assets to S-1 in exchange for P stock (which T distributes to its shareholders) and S-1’s assumption of T’s liabilities. In addition, pursuant to the plan, S-1 sells all of the T assets to S-5 for cash (continued...)
The limited authority examining the applicability of section 1.1502-34 in other contexts has not adopted an entirely literal stance as to the scope of the provision but it would be dangerous to extrapolate. In First Chicago Corp. v. Commissioner, the Tax Court held that a member of a section 1504(a) affiliated group was not entitled to aggregate its affiliated members' ownership interests in a foreign corporation in order to meet the 10-percent ownership test for eligibility to claim deemed-paid foreign tax credits under section 902. In so holding, the court considered the literal language of section 902(a) and the provisions of section 1.1502-4 (pertaining to determination of the consolidated foreign tax credit) and section 1.1502-34 to be “in harmony if section 902 is read and interpreted as not permitting equal to the fair market value of those assets. The analysis provides that, under Section 1.368-2(k), the transaction, which otherwise qualifies as a reorganization under section 368(a)(1)(C), is not disqualified by the sale of all of the T assets from S-1 to S-5 because the transfer is not a distribution to shareholders, the transfer consists of part or all of the assets of the acquiring corporation, the acquiring corporation does not terminate its corporate existence for federal income tax purposes in connection with the transfer, and the transaction satisfies the requirements of §1.368-1(d).

35 96 T.C. 421 (1991), aff’d, 135 F.3d 457 (7th Cir. 1998).

36 Revenue Ruling 85-3, 1985-1 C.B. 222, discussed in the case, is to the same effect. Cf. Rev. Rul. 92-86, 1992-2 C.B. 199, modifying and amplifying Rev. Rul. 91-5, 1991-1 C.B. 114 (application of section 902 in context of section 304 transaction to which section 318 applicable; ruling also illustrates application of section 1.1502-34 in context of contribution of stock by affiliated group member to foreign subsidiary considered in exchange for transferee stock pursuant to section 367(c)(2)).
aggregation with respect to the 10-percent requirement.”\textsuperscript{37} The court therefore found it unnecessary to reach the question of whether section 1.1502-34 is exclusive (i.e., aggregation is not available unless specifically referenced). It did so in the face of a revenue ruling and several private letter rulings where aggregation was permitted regarding affiliated members in connection with sections 334 and 338 despite neither of these provisions being specifically referred to in section 1.1502-34.\textsuperscript{38}

\textsuperscript{37} First Chicago Corp., 96 T.C. at 444.


Revenue Ruling 74-441 related to the special basis rules under section 334(b)(2), as then applicable, which provided a special rule for determining the basis of property received by a corporation in certain distributions in complete liquidation of another corporation within the meaning of section 332(b). Section 1.1502-34, of course, provides that, in determining the stock ownership of a member of an affiliated group in the distributing corporation for purposes of determining the application of section 332(b)(1) of the Code, in a consolidated return year, there shall be included stock owned by all other members of the group in the distributing corporation. However, section 1.1502-31(b)(2)(i), as then applicable, provided that the basis of property acquired in a liquidation to which section 332 applies shall be determined as if separate returns were filed. The question thus presented was whether the latter rule precluded the application of the special basis rule of section 334(b)(2), in a case where none of the members of the affiliated group individually own stock in the distributing corporation possessing the requisite 80 percent ownership. The ruling notes that the purpose of section 334(b)(2) is to provide a basis rule for property received in liquidating distributions qualifying under section 332 that meet specified additional conditions.

(continued...)
C. **Section 1.1502-13.** A complete exegesis of section 1.1502-13 (addressing the tax treatment of transactions between affiliated group members) is well beyond the scope of this paper. Set forth below is a discussion of some of the provisions of section 1.1502-13 of particular relevance to section 368 reorganizations within a consolidated return group.\(^3\)

1. **Basic Architecture of Section 1.1502-13.**

In general, section 1.1502-13 adopts a single entity theory for intercompany transactions,\(^4\) including intercompany transactions involving obligations of affiliated members. Notwithstanding that a selling member (S) and a buying member (B) are treated as separate entities for purposes of determining the amount and location of gain or loss (separate entity treatment), the timing, character, source, holding period and other attributes of intercompany items and corresponding items are re-determined as if the

\(^{3}\) The current intercompany transaction rules generally apply only to intercompany transactions occurring in tax years beginning after July 11, 1995. The prior rules generally remain in effect for intercompany transactions that occurred in prior years.

\(^{4}\) An intercompany transaction is a transaction between corporations that are members of the same consolidated group immediately after the transaction. *See* section 1.1502-13(b)(1)(i).
transactions were between divisions of a single corporation (single entity treatment). This is achieved principally through the so-called matching rule and acceleration rule.

Under the matching rule, S takes into account its items of income, gain, loss, or deduction from the intercompany transaction (termed “intercompany items”) as B takes into account its items of income, gain, loss, or deduction from the intercompany transaction (termed “corresponding items”). As B accounts for its corresponding item, S takes into account its intercompany item in an amount equal to the difference between B’s corresponding item and the so-called “recomputed corresponding item.” Recomputed corresponding items are the corresponding items that B would have recognized if S and B were divisions of a single corporation.

Under the acceleration rule intercompany items of income, gain, loss, or deduction that were deferred under the matching rule

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41 As divisions of a single corporation S and B are treated nevertheless as engaging in their actual transactions and owning any actual property in the transaction.

42 Section 1.1502-13(a). These timing rules are treated as an accounting method to be applied by each consolidated group member but not as an accounting method of the group as a whole. See Section 1.1502-13(a)(3)(i).

43 For example, if S sells property with a $70 basis to B for $100, and B later sells the property to a nonmember for $90, B’s corresponding item is its $10 loss, and the recomputed corresponding item is $20 of gain (determined by comparing the $90 sales price with the $70 basis the property would have if S and B were divisions of a single corporation).
are required to be taken into account when it is no longer possible to maintain single entity treatment under the matching rule. An acceleration generally occurs when the selling or buying member leaves the group, or when the purchased property is transferred outside the group.\textsuperscript{44} The acceleration rule requires the selling member (but generally not the buying member) to immediately recognize its intercompany items.\textsuperscript{45}

To the extent that B’s corresponding item offsets S’s intercompany item in amount, the attributes of B’s corresponding item, determined based on both S’s and B’s activities, control the attributes of S’s offsetting intercompany item. However, to the extent that they do not offset in amount, redetermined attributes are allocated to S’s intercompany item and B’s corresponding item using a method that is reasonable under the facts and circumstances.\textsuperscript{46}

2. Treatment of Intercompany Obligations.

In a typical corporate restructuring, debt between combining entities will be extinguished, while other items of intercompany debt will survive the restructuring but shift as intercompany receivables are transferred along with other assets of the target affiliates and intercompany payables are assumed by the acquiring corporations in the group. Of course, all of the steps in

\textsuperscript{44} Section 1.1502-13(d).
\textsuperscript{45} Section 1.1502-13(d)(3), Ex. 1.
\textsuperscript{46} Section 1.1502-13(c)(4).
the restructuring plan generally will be intended to qualify as non-recognition transactions.

The manner in which transactions involving intercompany debt are accounted for inside and outside of the consolidated return rules can be quite different. Outside of the consolidated return context, at the risk of deceptively over-simplifying, the restructuring generally should not trigger any income taxes in relation to the intercompany debt except in those cases where the intercompany debt was issued or acquired or will be settled at a discount.\(^{47}\)

\(^{47}\) In the case of liquidations to which section 332 applies, a parent-creditor may recognize gain or loss with respect to subsidiary debt extinguished as part of the liquidation. However, the debtor (whether parent or subsidiary) will not be required to recognize income from discharge of indebtedness upon the extinguishment of its debt pursuant to the liquidation. See section 1.332-7; Estate of Helen Gilmore, 40 B.T.A. 945 (1939), acq. 1944 C.B. 11 (indebtedness owed by shareholder to liquidating corporation is asset which is part of liquidation proceeds - no reason to first require shareholder to pay off debt and then receive proceeds in liquidation); and Rev. Rul. 74-54, 1974-1 C.B. 76 (indebtedness owed by parent corporation to subsidiary is asset to which section 332 applies and debt is considered distributed and not forgiven). But cf. Rev. Rul. 93-7, 1993-1 C.B. 125 (recognition of gain or loss on distribution of debt by creditor partnership to debtor partner); Chief Couns. Adv. 200040009 (Oct. 6, 2000) (expressing view that liquidation of creditor corporation into debtor corporation causing cancellation of debtor corporation note gives rise to discharge of indebtedness income if fair market value of debt less than adjusted issue price), rebuked by 2000 IRS NSAR 10352 (Sept. 26, 2000) (apparent conflict in dates notwithstanding) (recognizing that position “fraught with litigation hazards” and “contrary to established law and guidance”).

In the context of an asset reorganization involving debt owed by a target corporation to an acquiring corporation extinguished in the exchange, the debtor-transferor generally should be afforded

(continued...)
nonrecognition treatment by sections 357(a) and 361(a), but the creditor-
transferee may recognize gain or loss with respect to the debt as in the
case of a parent-subsidiary liquidation. See Kniffen v. Commissioner,
39 T.C. 553 (1962), acq., 1965-2 C.B. 5 (section 357 applies to preclude
income recognition in regard to liabilities discharged through merger of
debtor corporation into creditor); Edwards Motor Transit Co. v.
Commissioner, 23 T.C.M. (CCH) 1968 (1964) (downstream merger of
debtor corporation into subsidiary creditor corporation results in
extinguishment of outstanding indebtedness with no cancellation of
indebtedness income to debtor); and Rev. Rul. 72-464, 1972-2 C.B. 214
(where corporation purchases unrelated corporation’s debt at discount and
debtor corporation subsequently merges into it, creditor corporation
recognizes gain to extent of discount).

Where the debt extinguished as part of a section 368
reorganization is debt owed by the acquiring corporation to the target,
section 361(a) should preclude recognition of gain or loss on the part of
the target in connection with the receipt of acquiring corporation stock for
its property (including its debt claim against the acquiring corporation)
and the acquiring corporation should not be charged with discharge of
indebtedness income. See Estate of Gilmore, Rev. Rul. 74-54, and the
other authorities cited supra. But see, Boris I. Bittker & James E.
Eustice, I Federal Income Taxation of Corporations &
Shareholders ¶ 12.43[1][b] (indicating that acquiring corporation
whose debt is extinguished in merger must “consider the effect of section
108(e)(8)” (where corporation transfers stock to creditor in exchange for
cancellation of debt) in determining effect of extinguishment of debt via
merger of creditor-target into debtor-acquiring corporation). See also
proposed regulations under related-party debt acquisition rules of section
108(e)(4) issued on March 21, 1991 and accompanying preamble
(indicating, inter alia, that future regulations will prevent elimination of
income on extinguishment of indebtedness in certain nonrecognition
transactions in which debtor acquires its indebtedness from creditor (or
creditor assumes debtor’s indebtedness to creditor) effective for
transactions occurring on or after March 21, 1991), Prop. Treas. Reg. §
319 (clarifying that effective date in aforementioned preamble intended to
apply to nonrecognition transactions only if (i) creditor acquired
indebtedness or became related to debtor in transaction occurring prior to
nonrecognition transaction which would be direct or indirect acquisition
under proposed section 1.108-2 and (ii) debtor did not report discharge of
indebtedness income resulting from creditor’s acquisition of indebtedness
(continued...
Under the consolidated return regulations, the rearrangement of intercompany debt as part of a corporate restructuring generally should not trigger any federal income tax liability but the path leading to this conclusion is distinct, depending on a deemed satisfaction and re-issuance construction not employed on parallel facts outside the consolidated return context. This deemed-satisfaction-reissuance construction generally applies to situations where (1) an intercompany obligation leaves a consolidated group (an “outbound transaction”), (2) a non-intercompany obligation is brought into a consolidated group (an “inbound transaction”) or (3) an intercompany obligation is assigned or extinguished within a consolidated group (an “intra-group transaction”).

The current regulations under section 1.1502-13(g), only very recently promulgated, apply to transactions involving intercompany obligations occurring in consolidated return years or becoming related to debtor); preamble to final regulations adopted under section 108(e)(4) on December 29, 1992 (likewise warning of forthcoming regulations dealing with discharge of indebtedness income in non-recognition transactions), T.D. 8460, 57 Fed. Reg. 61805 (Dec. 29, 1992); and section 1.108-2(f)(3), reserving on “[a]cquisitions of indebtedness in nonrecognition transactions.” Cf. Notice 94-49 (stating in context of proposed revisions to section 1502 intercompany transaction regulations that separate return rules for obligations satisfied, modified, or issued in reorganization or other nonrecognition transaction are under study as part of separate project).

Section 1.1502-13(g)(2)(ii) generally defines an intercompany obligation as an obligation between members of a consolidated group, but only for the period during which the creditor and debtor are members of the group.

See preamble to T.D. 9442 (Dec. 24, 2008).
beginning on or after December 24, 2008. They mark a substantial improvement in clarity over the predecessor version of the regulations and include clear cut exceptions for many types of intra-group transactions that were not clearly outside the application of the prior rules. The new provisions (discussed further below) are best appreciated against the backdrop of the predecessor provisions they only quite recently supplanted.

Section 1.1502-13(g), as currently constituted, simplifies the mechanics of the deemed satisfaction-reissuance with respect to transactions involving intercompany obligations. Under the current regulations, a deemed satisfaction-reissuance of an intercompany obligation occurs whenever there is (1) a “triggering transaction” or (2) an inbound transaction.51

Subject to certain exceptions, a “triggering transaction” generally includes (i) any intra-group transaction in which a member realizes an amount of income or loss with respect to an

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50 See section 1.1502-13(g)(8). The prior regulations pertaining to obligations between members in a consolidated group were issued as final regulations on July 12, 1995 (see T.D. 8597 published in 60 FR 36671). On December 21, 1998, the IRS and Treasury issued a notice of proposed rulemaking which proposed amendments to the prior regulations (see REG-105964-98 published in 63 FR 70354) (the “1998 Proposed Regulations”). However, the 1998 Proposed Regulations were subsequently withdrawn and replaced by a notice of proposed rulemaking published on September 28, 2007 (see REG-107592-00 published in 72 FR 55139) (the “2007 Proposed Regulations”). On December 24, 2008 the 2007 Proposed Regulations were adopted as revised (the “current regulations”).

51 See section 1.1502-13(g)(3) and (5).
intercompany obligation (e.g. a transaction in which a member realizes a bad debt deduction) and (ii) any outbound transaction.\textsuperscript{52}

The following sequence of events is deemed to occur immediately before, and independently of, the triggering transaction: (i) the debtor is deemed to satisfy the obligation for a cash amount equal to the obligation’s fair market value and (ii) the debtor is deemed to immediately reissue the obligation (with a new holding period but otherwise identical terms) to the original creditor for that same cash amount.\textsuperscript{53} The parties are treated as engaging in the triggering transaction thereafter with the new obligation.\textsuperscript{54}

The following example illustrates the events that take place in an outbound transaction (B and S both are members of a consolidated return group):

\begin{itemize}
\item \textbf{Example:} B borrows $100 from S in return for B’s note providing for arm’s length interest and repayment on the fifth anniversary of the loan. After two years, S sells B’s note to an unrelated third party, X, for $70 (reflecting an increase in prevailing market interest rates).
\end{itemize}

\textsuperscript{52} See section 1.1502-13(g)(3)(i)(A).

\textsuperscript{53} Section 1.1502-13(g)(3)(ii)(A). However, the regulations provide that if the creditor realizes an amount that differs from the debt’s fair market value, and the triggering transaction is not an exchange (or deemed exchange) of debt of a member for newly issued debt of a member, then the debt is considered satisfied and reissued for cash in an amount equal to the amount realized.

\textsuperscript{54} See T.D. 9442.
• Because B’s note ceases to be an intercompany obligation, the sale is a “triggering transaction.” Therefore, B’s note is treated as satisfied and reissued for its fair market value of $70 immediately before S’s sale to X. B realizes $30 of discharge of indebtedness income as a result, under section 1.61-12.

• On a separate entity basis, S’s loss on the sale of the note for $70 would be a capital loss under section 1271. However, under the matching rule, the attributes of S’s intercompany item and B’s corresponding item must be redetermined to produce the same effect as if the transaction had occurred between two divisions of a single corporation. The attributes of B’s discharge of indebtedness income control the attributes of S’s loss and S’s loss therefore is treated as an ordinary loss.

• B is treated as reissuing, immediately after the transaction, a new note to S with a $70 issue price, a $100 stated redemption price at maturity and a $70 basis in S’s hands. S is then treated as selling the new note to X for $70 in a transaction in which no gain or loss is recognized. The new note has a $70 issue price and basis and a $100 stated redemption price at maturity. The $30 spread will be treated as original issue discount by X and B under sections 163(e) and 1272.\footnote{See section 1.1502-13(g)(7), Example 2.}

In the case of an inbound transaction, the deemed satisfaction-reissuance transaction is treated as occurring immediately after the obligation becomes an intercompany obligation and the debt is treated as being satisfied as of the acquisition.
date.\textsuperscript{56} The tax consequences of the transaction in which the debt becomes an intercompany obligation must be determined before the deemed satisfaction and reissuance occurs.\textsuperscript{57}

The deemed satisfaction-reissuance transactions are treated as transactions separate and apart from the triggering or inbound transaction.\textsuperscript{58}

As noted in the example discussed above, the matching rule of section 1.1502-13(c) (and, where applicable, the acceleration rule of section 1.1502-13(d)) operates to conform the timing and attributes of the creditor’s and debtor’s respective items to prevent there being any effect on consolidated taxable income.

\textsuperscript{56} Section 1.1502-13(g)(5)(ii)(A). This regulation provides in relevant part that the obligation is treated as having been satisfied by the debtor for cash in an amount determined under the principles of section 1.108-2(f) and then as having been reissued as a new obligation (with a new holding period but otherwise identical terms) for the same amount of cash. Section 1.108-2(f) deals with discharge of indebtedness income realized upon an acquisition of indebtedness by a person related to the debtor. This regulation generally provides that where the holder purchases the indebtedness on or within six months before the acquisition date, the amount of discharge of indebtedness income that the debtor must realize equals the difference between the debtor’s adjusted issue price in the indebtedness and the related party’s adjusted basis in the indebtedness on the acquisition date. If the holder purchases indebtedness more than six months after the acquisition date, the amount of discharge of indebtedness income that the debtor must realize is determined by reference to the fair market value of the indebtedness on the acquisition date.

\textsuperscript{57} Section 1.1502-13(g)(5)(ii)(B).

\textsuperscript{58} See section 1.1502-13(g)(3)(ii)(B) and section 1.1502-13(g)(5)(ii)(B). The deemed satisfaction and reissuance of a member’s debt does not cause the debt to be recharacterized as other than debt for federal income tax purposes.
The effect of the deemed satisfaction and re-issuance rules thus is to eliminate the effect of the intercompany obligation and treat the consolidated group as a single entity while preserving the intercompany obligations and their respective attributes and locations.\textsuperscript{59} Accordingly, any gains and losses from a triggering transaction should be offset within the consolidated return group.\textsuperscript{60} The character of gains and losses realized in the transactions would depend on which member’s attributes control and how the matching rule redetermines these items to produce the same effect as if the transaction had occurred between divisions of a single corporation.\textsuperscript{61}

Under the prior version of the regulations, section 1.1502-13(g) provided, in general, that (i) if a member of a group realized

\textsuperscript{59} See preamble to 2007 Proposed Regulations at 1. B: “For all three types of transactions [outbound, inbound and intragroup], the deemed satisfaction-reissuance model preserves the location of a creditor and debtor member’s items from an intercompany obligation, matches the timing of such items, and ensures that future items of original issue discount or premium between the creditor and debtor will similarly correspond in amount and timing.” See also section 1.1502-13(g)(4)(i) (dealing with timing and attributes with respect to the application of the matching rule and the acceleration rule to transactions involving an intercompany obligation).

\textsuperscript{60} Note that if a state conforms to the federal consolidated return regulations but the composition of the combined return group differs from the composition of the federal consolidated group, it is possible that only one “leg” of a deemed satisfaction and constructive reissuance will be taken into account, with the result that amounts are not offset. See infra Part II.

\textsuperscript{61} See section 1.1502-13(c)(4)(i). See also section 1.1502-13(g)(7), Examples 1 and 2. (Example 2 is illustrated in the text above).
an amount “other than zero”\(^{62}\) of income, gain, deduction or loss, directly or indirectly, from the assignment or extinguishment of all or part of its remaining rights or obligations under an intercompany obligation, the obligation was (for all federal income tax purposes) deemed satisfied and (ii) if the obligation remained outstanding after the assignment, it was treated as reissued for the amount of cash or property received.\(^{63}\) Thus, the obligation was deemed satisfied immediately before the transaction in which the amount was realized\(^{64}\) and, where applicable, as reissued immediately after the transaction.\(^{65}\)

By separating the deemed satisfaction-reissuance transaction from the actual transaction, the current regulations under section 1.1502-13(g) avoid certain unanticipated collateral tax consequences that arguably could potentially have applied under the prior regulations where the deemed satisfaction-reissuance

\(^{62}\) This wording allowed certain taxpayers to take the position under this prior version of section 1.1502-13(g) that the deemed satisfaction-reissuance rule did not apply where the amount realized on disposition of intercompany debt was zero. The 1998 Proposed Regulations sought to address this and make the regulations expressly applicable to all transactions in which any amount is realized -- including zero -- due to the transfer or extinguishment of rights in an intercompany obligation. See Notice of Proposed Rulemaking, 63 Fed. Reg. 70354 (Dec. 21, 1998); Prop. Treas. Reg. § 1.1502-13(g)(3)(i)(A).

\(^{63}\) See prior section 1.1502-13(g)(3)(i),(ii) and (iii).

\(^{64}\) See prior section 1.1502-13(g)(3)(ii). In the liquidation context, this was a departure from the IRS’s position in Rev. Rul. 74-54 and the decision of the court in Estate of Gilmore both finding that there was no satisfaction of the debt prior to extinguishment. See supra note 47.

\(^{65}\) See prior section 1.1502-13(g)(3)(iii).
construct effectively “straddled” the actual transaction. The new regulations also bring clarity as to the timing of realization and recognition of gain and loss with respect to the deemed satisfaction-reissuance transaction.

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66 By clarifying that the deemed transactions are separate from the actual transaction, the current regulations addressed a concern that certain practitioners had expressed regarding the operation of the deemed satisfaction and reissuance rules under the prior regulations. Under the prior regulations, if an intercompany obligation was exchanged for property (including stock), the obligation arising from the deemed reissuance arguably was to be treated as exchanged for the property acquired in the actual exchange. If the property was stock or debt transferred by the issuer in a nonrecognition transaction, the reissuance could result in a zero basis for the stock or debt, followed by a transfer of the stock or debt in a taxable transaction that locks in the zero basis gain. The preamble to the 1998 Proposed Regulations acknowledged that the form of the recast transaction which accompanies a deemed satisfaction and reissuance was ambiguous under the prior regulations and that “under one interpretation of the [then] current regulations there is a potential that the form of the recast jeopardizes the tax-free treatment of common corporate restructuring transactions.” The 1998 Proposed Regulations provided a clarification of the form and timing of the recast applied to transactions subject to the regulations, providing that the initial debt holder is treated as transferring the deemed satisfaction proceeds (rather than the actual debt) to the transferee who then transfers the proceeds to the debtor (i.e., in effect makes a new loan) for the reissued debt. Taxpayers were permitted to rely on the form and timing of the recast transaction as clarified by the 1998 Proposed Regulations for determining the tax treatment of transactions occurring prior to the finalization of the 1998 Proposed Regulations. See PLR 200801006 (Sept. 26, 2007), indicating that a taxpayer may rely on the form and timing of the recast transaction set out in the 1998 Proposed Regulations. See also preambles to 1998 Proposed Regulations and 2007 Proposed Regulations. However, the recast in the 1998 Proposed Regulations was not viewed as an appropriate solution and the 2007 Proposed Regulations replaced it with the modified deemed satisfaction-reissuance construction found in the current regulations.
The current regulations adopt “fair market value” as the benchmark for determining the deemed satisfaction-reissuance amounts.67 Under the prior regulations, it was somewhat ambiguous as to the value at which debt should be deemed to have been satisfied and reissued and this ambiguity was exacerbated in cases where debt was exchanged for property rather than cash.68 Still, the adoption of a fair market value benchmark does not, without more, resolve all difficulties that can be encountered in valuing intercompany obligations and it is anticipated that further

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67 See Section 1.1502-13(g)(3)(ii)(A).

68 The prior regulations provided that, where a creditor member sells intercompany debt for cash, the debt was treated as satisfied by the debtor immediately before the sale for the cash amount and reissued by the debtor to the purchaser as a new debt in an amount equal to the cash, immediately after the sale. However, in the case of a transfer of debt for property (as generally would be the case in a corporate restructuring), the debt was deemed satisfied at the amount for which the new debt was deemed issued and the new debt, in turn, was treated as being issued for property. The prior regulations included a cross-reference, by way of example, to section 1273(b)(3) and section 1274. Thus, apparently, if neither the debt issued nor the property received was publicly traded, the debt generally would be valued on the basis of the present value of the debt using a discount rate equal to the applicable federal rate. However, the Dubroff treatise, to the contrary, states that “[a]lthough unclear, these rules can be interpreted as requiring intercompany obligations to be treated as satisfied at fair market value, except to the extent that a comparable amount is permitted under the Code (e.g., under section 1274) in the related party context, but there are no guidelines for determining fair market value.” ANDREW DUBROFF, ET AL., FEDERAL INCOME TAXATION OF CORPORATIONS FILING CONSOLIDATED RETURNS (2d ed. 2007) ¶ 33.03[2](a) (indicating (in an accompanying footnote) that the reference to section 1274 appears to be solely as a “surrogate” for fair market value).
guidance may be required in this regard. Nonetheless, notwithstanding the “inherent” difficulties involved, the use of fair market value pricing is considered to more accurately preserve the location of each affected consolidated group member’s items from an intercompany obligation and to result in less distortion where the issue price and value of the obligation differ significantly.

Unlike the prior regulations, the current regulations provide more specific guidance on how the deemed satisfaction and re-issuance rules should work in the context of a nonrecognition transaction involving the extinguishment or assumption of debt (as opposed to an assignment for cash or property). Under the current regulations, not all realization events amount to triggering transactions. The current regulations narrow the scope of intragroup and outbound transactions that trigger the deemed satisfaction-reissuance model by providing a number of exceptions to its application. Exceptions generally include (a) certain intercompany exchanges in which neither the debtor nor creditor

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69 According to the preamble to T.D. 9442, “[t]he IRS and the Treasury Department are studying whether it is appropriate to include certain simplifying presumptions in determining value . . . .”


71 The preamble to T.D. 9442 indicates that “[a] deemed satisfaction and reissuance generally is not required for these excepted transactions either because it is not necessary to apply the deemed satisfaction-reissuance model to carry out the purposes of § 1.1502-13(g) or because the burdens associated with valuing the obligation or applying the mechanics of the deemed satisfaction-reissuance model outweigh the benefits achieved by its application.”
recognizes any income, gain, deduction or loss,\textsuperscript{72} (b) taxable inter-
company sales or dispositions of assets by the debtor (other than
solely money) where intercompany obligations are assumed as part
of the transaction,\textsuperscript{73} and (c) outbound transactions where a member

\textsuperscript{72} Section 1.1502-13(g)(3)(i)(B)(1) provides an exception from
the deemed satisfaction-reissuance rule for transactions constituting an
intercompany exchange to which sections 361(a), 332, 337(a) or 351
applies if no amount of income, gain, deduction or loss is recognized.
The requirement that no amount be recognized in the exchange applies to
amounts recognized with respect to all assets. See preamble to T.D.
9442. Section 1.1502-13(g)(7), Example 4, is instructive. In this
example, B borrows $100 from S in return for B’s note bearing interest at
10 percent and later, when interest rates have fallen and B’s note is worth
$130, S transfers B’s note, along with other assets, to Newco for all
Newco’s common stock in a section 351 exchange. Because the
assignment of B’s note is part of a section 351 transaction in which S
recognizes no gain or loss, the transaction is not treated as a triggering
transaction and the deemed satisfaction-reissuance construction does not
apply. If on the same facts S transfers B’s note, along with all its other
assets, to P in a section 332 liquidation, because the assignment of B’s
note is part of a section 332 transaction in which neither S nor B
recognizes gain or loss, the transaction is not treated as a triggering
transaction and the deemed satisfaction-reissuance construction does not
apply. It should be noted that the exception with respect to section 351
exchanges is available for transactions in which an intercompany
obligation is assigned or even assumed. However, this exception is
limited in situations where the transferor or transferee member has a
unique tax attribute (e.g. a SRLY limitation or a dual consolidated loss
subject to limitation, unless the other member is subject to a comparable
limitation -- see section 1.1502-13(g)(7)(ii), Example 8) or special status
(e.g. a bank or life insurance company), where the transferee member
issues preferred stock in the exchange or where the stock of the transferee
member (or the stock of a direct or indirect owner of the transferee
member) is disposed of within a short period after the exchange.

\textsuperscript{73} See section 1.1502-13(g)(3)(i)(B)(2). Section 1.1502-
13(g)(7), Example 5, provides an illustration: B borrows $100 from S in
return for B’s note bearing interest at 10 percent and later, when interest
rates have fallen and B’s note is worth $110, B transfers its Business Z
(value: $95), plus $15 cash, to another member, T, in exchange for T’s

(continued...)

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that is a party to a reorganization exchanges property in pursuance of the plan of reorganization for a newly issued intercompany obligation of another member and distributes such new intercompany obligation to a nonmember shareholder or nonmember creditor pursuant to the plan of reorganization.\(^{74}\)

The extinguishment of an intercompany obligation (either by a creditor assigning all or part of its rights under an intercompany obligation to the debtor or where the reverse occurs), will not be considered a “triggering transaction” provided the adjusted issue price of the extinguished obligation is equal to the creditor’s basis in the obligation, and the debtor’s corresponding item and the creditor’s intercompany item with respect to the obligation offset each other.\(^{75}\) In the event the intercompany obligation that is assumption of all of B’s obligations on the note in a taxable transaction. The terms and conditions of the note remain unchanged and neither B, S nor T recognizes any income, gain, deduction or loss with respect to the note. Because all of B’s obligations on the note are assumed by T as part of the sale of the assets of Business Z, the assumption of B’s obligations on the note is not treated as a triggering transaction and the deemed satisfaction-reissuance construction does not apply.

\(^{74}\) See section 1.1502-13(g)(3)(i)(B)(7).

\(^{75}\) See section 1.1502-13(g)(3)(i)(B)(5) and section 1.1502-13(g)(7), Example 6. For purposes of determining whether the debtor and creditor items offset and the tax consequences of an intra-group extinguishment of debt, sections 108(a), 108(e)(7), 354, and 355(a)(1) do not apply. In addition, the application of Section 351(a) is also turned off if the extinguishment occurs in a transaction in which the creditor transfers the intercompany obligation to the debtor in exchange for stock in the debtor. See section 1.1502-13(g)(4)(i)(C) and (D). In general, section 108(e)(8) provides that when a debtor corporation repays its debt by issuing its stock to its creditor, it is treated as if it satisfied the debt

\(^{\text{continued...}}\)
extinguished is replaced by a new intercompany obligation, the newly issued intercompany obligation must bear an issue price equal to the adjusted issue price and basis of the extinguished obligation (the “routine modification exception”).

Section 1.1502-13(g)(3)(i)(B)(6) provides in relevant part that solely for purposes of the routine modification exception “a newly issued intercompany obligation includes an obligation that is issued (or deemed issued) by a member other than the original debtor if such other member assumes the original debtor’s obligations under the original obligation in a transaction that is described in either paragraph (g)(3)(i)(B)(1) or (g)(3)(i)(B)(2) of section 1.1502-13 and the assumption results in a significant modification of the original obligation under section 1.1001-3(e)(4) and a deemed exchange under section 1.1001-3(b).” See also section 1.1502-13(g)(7), Example 7. Under the prior regulations, the answer appeared to be that where the debt bore adequate stated interest the amount at which the debt was deemed satisfied (and, in the case of an assumption, reissued) was its face value and in other cases one had to resort further to the principles of sections 1273 and 1274 (although those provisions were only referenced as “examples”).
The outbound and inbound transaction categories are subject to a subgroup exception, which generally provides that in an outbound or inbound transaction the deemed satisfaction and reissuance construction will not apply when the creditor and debtor members of an intercompany debt (referred to as members of an “intercompany obligation subgroup”), move from one consolidated return group to another in a transaction where neither debtor nor creditor recognizes any income, gain, deduction or loss with respect to the intercompany obligation and immediately after such transaction the members of the intercompany obligation subgroup form an intercompany subgroup of another consolidated group. The exception recognizes that the built-in items with respect to the intercompany debt will be preserved in the new consolidated return group.

The exceptions to the application of the deemed satisfaction-reissuance construction are themselves subject to certain anti-abuse rules: the tax benefit rule and the off-market

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77 An intercompany obligation subgroup is defined as two or more members, including the creditor and debtor to an intercompany obligation, who are related pursuant to section 1504(a) through an “intercompany obligation subgroup parent.” See sections 1.1502-13(g)(2)(iii) and (iv).

78 See sections 1.1502-13(g)(3)(i)(B)(8) (providing exception for outbound transactions) and 1.1502-13(g)(5)(i)(B)(2) (inbound transactions). See also section 1.1502-13(g)(7)(ii), Example (2)(v).

79 See preamble to 2007 Proposed Regulations at Section 1.G.

80 See section 1.1502-13(g)(3)(i)(C).
issuance rule. These rules are intended to prevent distortions of consolidated taxable income resulting from the shifting of built-in items from intercompany obligations, or from the issuance of obligations at a materially off-market rate of interest through the manipulation of a member’s tax attributes or stock basis. The tax benefit rule generally applies to an intragroup assignment or extinguishment of debt that would ordinarily be exempt from the application of the deemed satisfaction-reissuance construction, if such assignment or extinguishment is undertaken with a view to securing a tax benefit. If the tax benefit rule applies, the intercompany transaction will be treated as a “triggering transaction” and therefore subject to the deemed satisfaction-reissuance construction. The off-market issuance rule generally applies to an intercompany obligation issued at a materially off-
market rate of interest, if issued with a view to securing a tax benefit. If the off-market issuance rule is applicable, the intercompany obligation will be treated as originally issued for fair market value and any difference between the amount of the intercompany loan and fair market value will be treated as transferred between debtor and creditor at the time of issuance.85

3. **Treatment of Transactions Involving Member Stock -- Section 1.1502-13(f).**

Section 1.1502-13(f) provides special rules with respect to intercompany distributions, boot in intercompany reorganizations, acquisitions by a member of its own stock (or options on its stock), triggers for recognition of deferred gains in stock in the case of certain liquidations and other transactions and parent hook stock situations.

**Intercompany Distributions.** Section 1.1502-13(f)(2) provides that an intercompany distribution to which section 301 applies is not included in the gross income of the distributee member but only to the extent there is a corresponding negative adjustment reflected under section 1.1502-32 in the distributee’s

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85 See section 1.1502-13(g)(4)(iii). See also section 1.1502-13(g)(7)(ii), Example 9 (where T is group member with material SRLY loss and common parent, P, borrows $X from T at above-market rate of interest, thereby generating interest income to absorb the SRLY loss, T is treated as acquiring P’s note at premium and difference between note’s fair market value and amount T loaned to P is treated as contribution to T’s capital by P with premium being accounted for as reduction in T’s interest income and P’s interest expense).
basis in the stock of the distributing member. In addition, the distributee’s dividend received deduction under section 243(a)(3) is determined without regard to any intercompany distributions to the extent they are not included in the gross income.

As to the distributing member, in the case of a distribution in kind, the regulations provide that the principles of section 311(b) apply to the distributing member’s loss, as well as gain, from an intercompany distribution of property. For example, the distributing member’s loss is taken into account under the matching rule if the property that was distributed is subsequently sold to a nonmember.

**Boot in Intercompany Reorganizations.** Section 1.1502-13(f)(3) alters the treatment of boot in an intercompany reorganization -- i.e., an intercompany transaction in which the receipt of money or other property (“nonqualifying property”) results in the application of section 356. Nonqualifying property

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86 See *supra* note 4. For example, no amount is included in the distributee’s gross income under section 301(c)(3) from a distribution in excess of the basis of the stock of a subsidiary that results in an excess loss account under section 1.1502-32(a) which is treated as negative basis under section 1.1502-19.

87 See section 1.1502-26(b) (applicability of dividends received deduction to distributions not excluded from gross income, such as distribution from common parent to subsidiary owning stock of common parent).

88 However, section 311(a) continues to apply to distributions to nonmembers (for example, loss is not recognized).

89 The regulations provide the example of a distribution of stock of a lower-tier member to a higher-tier member in an intercompany (continued...)
received as part of such a transaction is treated as received by the member shareholder in a separate transaction governed, for example, by sections 302 and 311 (rather than sections 356 and 361), and generally is taken into account immediately after the transaction.\(^\text{90}\)

**Acquisitions by a Member of its Own Stock.** Under section 1.1502-13(f)(4), if a member acquires its own stock, or an option to buy or sell its own stock, in an intercompany transaction, the selling member’s basis in that stock or option is treated as eliminated for all purposes. As a result, the selling member’s intercompany items from the stock or options generally are taken into account at the point the issuer member acquires the stock or options “unless, for example, [the issuer member] acquires the stock in exchange for successor property within the meaning of paragraph (j)(1) of this section in a nonrecognition transaction.”\(^\text{91}\)

By way of example, the regulations section provides that if a transaction to which section 355 would apply but for the receipt of nonqualifying property. The rules do not apply if a party to the transaction becomes a member or nonmember as part of the same plan or arrangement. For example, if a member of the group merges into a nonmember in a transaction described in section 368(a)(1)(A), section 1.1502-13(f)(3) does not apply.

\(^{90}\) It is treated as taken into account immediately before the transaction if section 355 would apply but for the fact that nonqualifying property is received. See further discussion of the boot rule, infra Part III.C.3. See also discussion, supra note 10 regarding similar bifurcation in recast of transaction involving section 357(c).

\(^{91}\) See discussion of section 1.1502-13(j) successor rules, infra Part I.C.4.
member of the group redeems its stock from another member in a transaction to which section 302(a) applies (i.e., providing for exchange treatment), the selling member’s gain from the transaction is taken into account immediately under the acceleration rule.\textsuperscript{92}

The example illustrates a case where there is immediate gain recognition on a transaction involving member stock even though there was no pre-existing deferred intercompany gain (i.e., “intercompany item”) with respect to the member stock. On the other hand, a nonrecognition transaction involving member stock is not within the ambit of this rule, although certainly recognition of pre-existing deferred intercompany gains in a member’s stock can be triggered by a nonrecognition transaction under certain circumstances as discussed below.

**Triggering Deferred Intercompany Gain in Member Stock.**

Section 1.1502-13(f)(5) provides that “S’s intercompany item from a transfer to B of the stock of another corporation (T) is taken into account under this section in certain circumstances even though the

\textsuperscript{92} In most circumstances section 302(a) would not govern an intercompany redemption. However, section 1.1502-13(f)(7), Example 4, provides an example of such a case: Before becoming a member of the P group, S owns P stock with a $30 basis. In Year 1, P acquires all of the S stock. In Year 3, P redeems the P stock held by S for $100 -- a transaction to which section 302(a) applies. The example states that, because P’s basis in the P stock acquired from S is treated as eliminated, “S’s intercompany item will never be taken into account under the matching rule because P’s basis in the stock does not reflect S’s intercompany item.” The example concludes that, as a consequence, S’s $70 gain is required to be taken into account under the acceleration rule in Year 3.
T stock is never held by a nonmember after the intercompany transaction.” The example offered is a case where S sells all of T’s stock to B at a gain (thus creating a deferred intercompany gain in the T stock), and T subsequently liquidates into B in a separate transaction to which section 332 applies. The liquidation of T will trigger recognition of S’s deferred gain under the matching rule.93 This rule applies only to a transaction in which B’s basis in its T stock is permanently eliminated in a liquidation under section 332 or comparable nonrecognition transaction, including a merger of B

93 The regulations section notes that “[u]nder paragraph (c)(6)(ii) of this section, S’s intercompany gain taken into account as a result of a liquidation under section 332 or a comparable nonrecognition transaction is not redetermined to be excluded from gross income. By the same token, if S has both intercompany income or gain and intercompany deduction or loss attributable to stock of the same corporation having the same material terms, only the income or gain in excess of the deduction or loss is subject to section 1.1502-13(c)(6)(ii).” However, section 1.1502-13T(c)(6)(ii)(C)(1)(i)-(v) (applicable to items taken into account on or after March 7, 2008) provides that notwithstanding the rule set out in section 1.1502-13(c)(6)(ii)(A)(1), intercompany gain on member stock is re-determined to be excluded from gross income to the extent that (1) the gain is the common parent’s (P) intercompany item, (2) immediately before the intercompany gain is taken into account, P holds the member stock with respect to which the intercompany gain was realized, (3) P’s basis in such member stock is eliminated without the recognition of gain or loss (and the eliminated basis is not further reflected in the basis of any successor asset), (4) the group has not and will not derive any federal income tax benefit from the intercompany transaction that gave rise to such intercompany gain or the redetermination of the intercompany gain (including any adjustment to basis in member stock under section 1.1502-32), and (5) the effects of the intercompany transaction have not previously been reflected, directly or indirectly, on the group’s consolidated return. For the purposes of this rule the redetermination of the intercompany gain is not in and of itself considered a federal income tax benefit. See section 1.1502-13T(f)(7)(i), Example 7. See also Priv. Ltr. Rul. 200835012 (Aug. 29, 2008) and Priv. Ltr. Rul. 200850015 (Dec. 12, 2008).
into T under section 368(a), a distribution by B of its T stock in a transaction described in section 355, or a deemed liquidation of T resulting from an election under section 338(h)(10).

Section 1.1502-13(f)(5)(ii) provides elective relief from this gain recognition requirement, provided T was a member of the affiliated group throughout the period beginning with S’s transfer and ending with the completion of the nonrecognition transaction:

If section 332 applies to T’s liquidation into B, and B transfers T’s assets to a new member (new T) in a transaction not otherwise pursuant to the same plan or arrangement as the liquidation, the transfer is nevertheless treated for all Federal income tax purposes as pursuant to the same plan or arrangement as the liquidation. For example, if T liquidates into B, but B forms new T by transferring substantially all of T’s former assets to new T, S’s intercompany gain or loss generally is not taken into account solely as a result of the liquidation if the liquidation and transfer would qualify as a reorganization described in section 368(a). (Under paragraph (j)(1) of this section, B’s stock in new T would be a successor asset to B’s stock in T, and S’s gain would be taken into account based on the new T stock.)

94 The transfer of an asset to new T not otherwise pursuant to the same plan or arrangement as the liquidation is treated as pursuant to the same plan or arrangement only if B transfers it to new T pursuant to a written plan, a copy of which is attached to a timely filed original return (including extensions) for the year of T’s liquidation, and the transfer is completed within 12 months of the filing of that return. Section 1.1502-13(f)(5)(ii)(B)(2). See also section 1.1502-13(f)(5)(ii)(E) (election procedures and requirements).
Similar principles apply in the context of a transaction similar to a section 332 liquidation, such as a downstream merger described in section 368.\(^{95}\)

Finally, section 1.1502-13(f)(6) provides guidance on the treatment of parent hook stock and positions in parent hook stock, referred to in the regulations as “P stock.” The term “P stock” is defined to mean “any stock of the common parent held (directly or indirectly) by another member or any stock of a member (the issuer) that was the common parent if the stock was held (directly or indirectly) by another member while the issuer was the common parent.” The regulations provide that any loss recognized, directly or indirectly, by a member with respect to P stock is permanently disallowed and does not reduce earnings and profits.\(^{96}\) Further, immediately before a share of P stock in which a member has a built-in-loss comes to be held by a nonmember (whether by transfer or termination of the member’s status as a member of the affiliated group) the member’s basis in the share is reduced to the

\(^{95}\) Appropriate adjustments are made to reflect any events occurring before the formation of new T and to reflect any assets not transferred to new T as part of the same plan or arrangement. For example, if B retains an asset in the reorganization, the asset is treated as acquired by new T but distributed to B immediately after the reorganization. See also section 1.1502-13(f)(5)(ii)(C) (addressing treatment of deemed liquidation under section 332 as result of election under section 338(h)(10)); and section 1.1502-13(f)(5)(ii)(D) (addressing treatment of intercompany section 355 distribution of member stock in which there is deferred intercompany gain or loss).

\(^{96}\) See section 1.1502-32(b)(3)(iii)(A) for a corresponding reduction in the basis of the member’s stock.
share’s fair market value immediately before the share is held by the nonmember.97

Special rules are set forth in regard to “qualified dispositions” of P stock in which there is built-in-gain;98 publicly traded P stock as to which a member accounts for gain or loss under the mark-to-market provisions of section 475(a);99 and options, warrants and other positions in P stock.100

4. Tracing Intercompany Items -- the Successor Rules (and Related Provisions) of Section 1.1502-13(j).

Section 1.1502-13(j) provides that (1) any reference to an asset includes, as the context may require, a reference to any other asset the basis of which is determined, directly or indirectly, in whole or in part, by reference to the basis of the first asset and

97 For example, if M owns shares of P stock with a $100x basis and M becomes a nonmember at a time when the P shares have a value of $60x, M’s basis in the P shares is reduced to $60x immediately before M becomes a nonmember. Similarly, if M contributes the P stock to a nonmember in a transaction subject to section 351, M’s basis in the shares is reduced to $60x immediately before the contribution. (See section 1.1502-32(b)(3)(iii)(B) for a corresponding reduction in the basis of M’s stock.) The regulations also address certain cases where a nonmember that owns P stock with a basis in excess of its fair market value becomes a member of the P consolidated group. See section 1.1502-13T(f)(6)(i)(C) and section 1.1502-13T(f)(6)(i)(C)(2).


99 Section 1.1502-13(f)(6)(iii).

100 Section 1.1502-13(f)(6)(iv).
(2) any reference to a *person* includes, as the context may require, a reference to a predecessor or successor. A “predecessor” is a transferor of assets to a transferee (the successor) in a transaction (A) to which section 381(a) applies; (B) in which substantially all of the assets of the transferor are transferred to members in a complete liquidation; (C) in which the successor’s basis in assets is determined (directly or indirectly, in whole or in part) by reference to the basis of the transferor (but the transferee is a successor only with respect to the assets the basis of which is so determined); or (D) which is an intercompany transaction, but only with respect to assets that are being accounted for by the transferor in a prior intercompany transaction.\\footnote{Section 1.1502-13(j)(1) and (2)(i).}

If the assets of a predecessor are acquired by a successor member, the successor succeeds to, and takes into account, the predecessor’s intercompany items. If two or more successor members acquire assets of the predecessor, the successors take into account the predecessor’s intercompany items “in a manner that is consistently applied and reasonably carries out the purposes of [section 1.1502-13(j)] and applicable provisions of law.”\\footnote{Notice of Proposed Rulemaking, 70 Fed. Reg. 8552 (Feb. 22, 2005), proposed certain revisions to section 1.1502-13(j) regarding the manner in which intercompany items of a liquidating member succeeded to, and taken into account, where more than one distributee member acquires assets of the liquidating corporation in complete liquidation. These revisions were withdrawn by T.D. 9376 (January 15, 2008) pending further study by the IRS and the Treasury Department.}
One effect of the successor rules is to multiply the possible occasions for the triggering of recognition of deferred gains. For example, if S sells land at a gain to another member of the group, M, and a number of years later M contributes the land to B in exchange for all of B’s stock in a section 351 transaction, both transactions are intercompany transactions. B is a successor to M, under section 1.1502-13(j)(2), and B’s items from the land are corresponding items. Also, under section 1.1502-13(j)(1), references to the land includes references to M’s stock in B.

Section 1.1502-13(j)(3) provides that if (as in the example above) there are multiple possible triggers (i.e., more than one possible corresponding item that can cause an intercompany item to be taken into account under the matching rule), the intercompany item is taken into account in connection with the corresponding item most consistent with the treatment of members as divisions of a single corporation.103

103 Section 1.1502-13(j)(3) furnishes an example:

For example, if S sells a truck to B, its intercompany gain from the sale is not taken into account by reference to B’s depreciation if the depreciation is capitalized under section 263A as part of B’s cost for a building; instead, S’s gain relating to the capitalized depreciation is taken into account when the building is sold or as it is depreciated. Similarly, if B purchases appreciated land from S and transfers the land to a lower-tier member in exchange for stock, thereby duplicating the basis of the land in the basis of the stock, items with respect to both the stock and the land can cause S’s intercompany gain to be taken into account.

(continued...)
Assume in the above example that, some time following the section 351 contribution of the land by M to B, M sells 20 percent of the B stock to a third party and that, some years later, B sells 20 percent of the land. Both M’s stock in B and B’s land can cause S’s intercompany gain from the original cross-chain sale of land to be taken into account under the matching rule, and consequently both transactions trigger recognition by S of a portion of its gain.104

104 See section 1.1502-13(j)(9), Ex. 1. Section 1.1502-13(j)(9), Examples 6 and 7 also are of particular interest. In Example 6, X had preferred stock described in section 1504(a)(4) outstanding for several years. On January 1 of Year 1, S buys all of X’s common stock for $60, and B buys all of X’s preferred stock for $40. X’s assets have a $0 basis and $100 value. On July 1 of Year 3, X distributes all of its assets to S and B in a complete liquidation. Under section 1.1502-34, section 332 applies to both S and B. Under section 337, X has no gain or loss from its liquidating distribution to S. Under sections 336 and 337(c), X has a $40 gain from its liquidating distribution to B (see discussion supra at pages 18 and 19). B has a $40 basis under section 334(a) in the assets received from X, and S has a $0 basis under section 334(b) in the assets received from X. Under the matching rule, X’s $40 gain from its liquidating distribution to B is not taken into account under this section as a result of the liquidation (and therefore is not yet reflected under sections 1.1502-32 and 1.1502-33). Under the successor person rule of section 1.1502-13(j)(2)(i), S and B are both successors to X. Under section 337(c), X recognizes gain or loss only with respect to the assets distributed to B. Under section 1.1502-13(j)(2)(ii), S succeeds to X’s $40 intercompany gain. The gain will be taken into account by S under the matching and acceleration rules based on subsequent events. The example concludes (continued...)

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...
Finally, section 1.1502-13(j)(4) (addressing multiple or successive intercompany transactions) provides that, if a member’s intercompany item or corresponding item affects the accounting for more than one intercompany transaction, appropriate adjustments are made to treat all of the intercompany transactions as transactions between divisions of a single corporation\(^{105}\) and by noting that the allocation of the intercompany gain to S does not govern the allocation of any other attributes.

In Example 7, X has only common stock outstanding. On January 1 of Year 1, S buys 60% of X’s stock for $60, and B buys 40% of X’s stock for $40. X’s assets have a $0 basis and $100 value. On July 1 of Year 3, X distributes all of its assets to S and B in a complete liquidation. Under section 1.1502-34, section 332 applies to both S and B. Under sections 336 and 337(c), X has a $100 gain from its liquidating distributions to S and B. Under section 334(b), S has a $60 basis in the assets received from X and B has a $40 basis in the assets received from X. Under the matching rule, X’s $100 intercompany gain from its liquidating distributions to S and B is not taken into account as a result of the liquidation (and therefore is not yet reflected under sections 1.1502-32 and 1.1502-33). Under the successor person rule of section 1.1502-13(j)(2)(i), S and B are both successors to X. Under section 1.1502-13(j)(2)(ii), S succeeds to X’s $40 intercompany gain with respect to the assets distributed to B, and B succeeds to X’s $60 intercompany gain with respect to the assets distributed to S. The gain will be taken into account by S and B under the matching and acceleration rules based on subsequent events. Again, the example concludes by noting that the allocation of the intercompany gain does not govern the allocation of any other attributes.

Note that proposed regulations under section 1.1502-13(j) withdrawn in January 2008 would have altered the approach described in the foregoing examples. See Notice of Proposed Rulemaking, supra note 102 and Prop. Treas. Reg. § 1.1502-13(j)(9) Exs. 6 and 7, revising current examples 6 and 7 (as noted, now withdrawn).

\(^{105}\) For example, if S sells property to M, and M sells the property to B, then S, M, and B are treated as divisions of a single corporation for purposes of applying the rules.
similar principles apply with respect to intercompany transactions that are part of the same plan or arrangement.\textsuperscript{106}

\section*{II. \textbf{Federal Tax Planning with State Income Tax Consequences in Mind.}}\textsuperscript{107}

Virtually all states that impose a corporate tax based on net income, and the District of Columbia, begin the calculation of the state income tax base using federal taxable income as the starting point and make certain addition and subtraction modifications to compute state taxable income. Common state modifications to federal taxable income include the add-back of federal depreciation deductions and the dividends received deduction. Such items are added back to federal taxable income because many states have their own specific rules with regard to such deductions. The deductions with respect to such items provided for under a state’s income tax regime typically would be accounted for as subtraction modifications to federal taxable income. As a corollary effect, a company’s tax basis in its assets and stock, for federal and state income tax purposes, will not match.

\textsuperscript{106} For example, if S sells separate properties to different members as part of the same plan or arrangement, all of the participating members are treated as divisions of a single corporation for purposes of determining the attributes (which might also affect timing) of the intercompany items and corresponding items from each of the properties.

\textsuperscript{107} Part II is largely courtesy of the contributions of certain members of the McDermott Will & Emery state and local tax group, who have my thanks.
State tax law is constantly changing as states adopt, reject or modify positions they once took with respect to conformity with the Code. \(^{108}\) To further complicate matters, state tax law is at times muddled and poorly drafted and often does not provide guidance with the same degree of clarity that one encounters in the Code, regulations and rulings and, accordingly, tax issues for which there is a clear federal answer may not have been resolved at the state level.

Among the key issues to consider in incorporating the state income tax effects of a restructuring into the tax planning process are variances among the relevant states from the Code itself and the extent to which the relevant states incorporate the federal consolidated return regulations.

A. Conformity in General.

On the basic question of conformity with the Code, states fall into three general categories: (i) states that incorporate the Code, as amended; (ii) states that incorporate the Code, as amended as of a certain date; and (iii) states that do not specifically incorporate the Code into their income tax laws, but rather have

\(^{108}\) As of April 2009, bills were pending in Alabama, Florida, Maryland, New Mexico, North Carolina, Pennsylvania, and Rhode Island that would alter those states’ combined reporting rules and could impact certain matters such as the carryover and utilization of tax attributes. Mandatory combined filing was just recently enacted in Massachusetts, West Virginia and Wisconsin effective for tax years beginning on or after January 1, 2009. See Mass. Gen. Laws ch. 63, § 32B; W. Va. Code § 11-24-13; Wis. Stat. § 71.255.
their own distinct corporate tax laws that may, on an ad hoc basis, incorporate specific provisions of the Code.

1. States that Broadly Incorporate the Code, as Amended.

Many states incorporate the Code, along with the periodic amendments thereto, into their tax regimes wholesale. As a consequence, changes to the Code automatically become a part of those states’ tax laws. As a general matter, these states adopt a company’s federal taxable income as the starting point for calculating state income tax liability. Thus, transactions that are “tax-free” for federal purposes will also be tax-free for income tax purposes in many states.110

However, even though a state may use federal taxable income as its starting point for computing state taxable income, this fact does not necessarily convey the totality of the information required to evaluate the tax implications of a corporate restructuring in the state. For example, Ohio has incorporated the Code as of December 30, 2008 (technically placing Ohio under heading 2. below), but also has enacted a commercial activity tax (commonly called the “CAT”) that requires a company to compute its Ohio tax

109 These states are Alabama, Alaska, Colorado, Connecticut, the District of Columbia, Illinois, Kansas, Louisiana, Maryland, Massachusetts, Missouri, Nebraska, New Mexico, New York, North Dakota, Oklahoma, Tennessee and Utah.

110 Such transactions may trigger non-income taxes such as state sales, real property transfer, unemployment and ad valorem property taxes, all of which need to be reviewed on a state-by-state basis.
liability based on its Ohio gross receipts – a term broadly defined to include the amount of any debt assumed or forgiven as part of the consideration in a transaction (including a nonrecognition transaction). Consequently, a company with nexus in Ohio that undergoes an intercompany restructuring that qualifies for nonrecognition treatment for federal income tax purposes could incur additional state tax under the CAT in certain circumstances.

2. States that Incorporate the Code as of a Certain Date.

Many other states, like California, have incorporated the Code as of a certain date. As a consequence of incorporating the Code as of that date, recent changes to the Code are not part of those states’ tax laws. For example, pursuant to the American Jobs Creation Act of 2004, the Code was amended effective for transactions entered into on or after October 22, 2004 to eliminate the applicability of section 357(c) to acquisitive “D” reorganizations. However, for a period of almost a year, California was not in sync with these changes. Indeed, although a bill was introduced into the California legislature on January 12, 2005 to incorporate recent

111 Ohio. Rev. Code § 5751.01(F).
112 California broadly adopts the Code as in effect on January 1, 2005, but adopts certain specific Code sections subject to state modifications.
113 These states are Arizona, California, Florida, Georgia, Hawaii, Idaho, Indiana, Iowa, Kentucky, Maine, Michigan, Minnesota, North Carolina, New Hampshire, Ohio, Oregon, South Carolina, Texas, Vermont, Virginia, West Virginia and Wisconsin.
amendments to the Code into California’s tax laws,\textsuperscript{114} the bill did not become law until October 7, 2005. As a consequence, if California taxation was an important consideration, restructuring work during this period had to proceed on the basis that section 357(c) remained as an issue in planning transactions constituting “D” reorganizations.\textsuperscript{115}

3. States that Do Not Specifically Incorporate the Code.

There are also a number of states that do not specifically incorporate the Code and yet calculate “taxable income” using federal taxable income as the starting point of the computation. Certain of these states adopt specific provisions of the Code or have language in their tax laws that is analogous to provisions of the Code, but do not incorporate the Code in any wholesale fashion.\textsuperscript{116} For example, New Jersey has not incorporated the Code, but generally applies section 381. Yet, New Jersey does not

\textsuperscript{114} Assembly Bill No. 115 “Conformity Act of 2005.”

\textsuperscript{115} A similar issue exists today in California under section 355. New section 355(b)(3) treating all members of a “separate affiliated group” as one corporation for purposes of the section 355(b) active business requirement, as added by the Tax Increase Prevention and Reconciliation Act of 2005 (Pub. L. No. 109-222, sec. 202, 120 Stat. 345 (2006), effective May 17, 2006) has yet to be adopted by California. See Cal. Rev. & Tax. Cd. § 17321. In fact, California’s Franchise Tax Board has issued a ruling stating that California has not adopted or conformed to these federal provisions. See Franchise Tax Board Chief Counsel Ruling No. 2007-3 (July 17, 2007).

\textsuperscript{116} These states are Arkansas, Delaware, Mississippi, Montana, New Jersey, Pennsylvania and Rhode Island.
respect the transfer of net operating loss carryovers to a successor entity in a section 368(a) merger. Specifically, New Jersey tax law states that, upon a change in form or reorganization of a corporation, its net operating loss carryovers are lost.\textsuperscript{117} The theory is that the business that generated the loss is no longer in operation or its operations have been altered and its net operating loss carryovers therefore should not be used to benefit a new or different business. New Jersey does not adopt the federal net operating loss provisions, but has its own state net operating loss provision. New Jersey therefore takes the view that, because it does not have a specific provision allowing a transfer of net operating loss carryovers between entities, a corporation’s net operating loss carryovers are lost in a merger and also in the context of a section 332 liquidation or upstream merger of a subsidiary into its parent corporation.

In some states that do not provide by statute for the transfer of net operating loss carryovers in a tax-free reorganization, case law has developed that treats the acquiring corporation as the taxpayer that sustained the loss and, hence, allows it to use the losses if the business that generated the losses is continued after the transaction.\textsuperscript{118}


\textsuperscript{118} See, e.g., Grade A Market, Inc. v. Comm’r of Rev. Servs., 688 A.2d 1364 (Conn. Super. Ct. 1996); Thermatool Corp. v. Dep’t of (\textit{continued...})
B. Conformity to Federal Consolidated Return Principles.

1. Background. With respect to state corporate income tax return filing methodologies, there are several broad types of filing regimes for state income tax purposes:

   (a) Separate Return -- taxpayers must calculate taxable income and file discrete tax returns on a separate entity basis (e.g., New Jersey). Thus, each entity’s activities and items of income, deduction, losses and credits, etc., are reflected on its own separate return. In states that require the filing of a separate return, a group of taxpayers may have the option to elect or may, at the discretion of the department of revenue upon audit, be required to file on a combined basis if certain conditions are satisfied. This is an important difference from the federal rules, under which related corporations cannot be forced to file consolidated returns.

   (b) Consolidated Group Return -- similar to the federal consolidated return, subject to certain ownership requirements and without regard to nexus (e.g., Florida).

   (c) Unitary Combined Return, without regard to Nexus -- provided at least one member of a corporate group has nexus with the taxing state, the corporate group is engaged in conducting a unitary business (as defined below), and the group is under common ownership, the group may be allowed to or may be

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required to report its taxable income on a combined basis (as opposed to on a separate return basis as discussed above), regardless of whether each company in the combined group is doing business in the state (e.g., California). The combined group may be comprised of all members of a unitary group, including foreign affiliates (this would be an example of what is known as “world-wide” combined reporting). Alternatively, the combined group may be comprised of U.S. domestic entities only (an example of “water’s edge” combined reporting).

(d) Unitary, Nexus-only Combined Return -- those corporations engaged in a unitary business that have nexus (i.e., those that are doing business in the state) and that are under common ownership report on a combined basis (e.g., West Virginia).

(e) Pre- or Post-Apportionment Combination -- a group of taxpayers engaged in conducting a unitary business may be required to calculate the combined group’s apportionable income using either a pre- or post-apportionment method. Under a pre-apportionment approach, each group member’s income and apportionment factors are added together before the combined group’s apportioned taxable income is calculated; thus, there is one “taxpayer” which consists of companies within the group that may have income or loss for the year; effectively, income and loss amounts within the group are offset against each other. Under a post-apportionment approach, each entity calculates state taxable income on a separate entity basis and then the results for all such entities are combined, permitting income realized by certain
entities to be offset by losses realized by other entities participating in the combined return.

2. States that Generally Follow the Federal Consolidated Return Rules. Many states that require or permit filers of federal consolidated returns to file in the same manner for state purposes, or permit or require some form of combined return, have adopted the consolidated return provisions under section 1502 and the accompanying regulations. Among other things, such states generally follow the federal treatment of deferred intercompany transactions such that, if a transaction between affiliates does not trigger current taxation on a federal level, the transaction will not trigger current taxation under the laws of these states.

3. Combined Group States. Numerous states that require or permit pre-apportionment or post-apportionment combined returns do not adopt the federal consolidated return rules, but instead have provisions that are similar to the federal consolidated rules. Certain of these states only permit the deferral of income recognition with respect to intercompany transactions for those companies included in the state combined return, such that, if a transaction involves a taxpayer outside the state combined group, the income or gain deferred for federal income tax purposes could be required to be immediately recognized for state income tax purposes, resulting in a current state tax. Consequently, gains (and losses) that are deferred for federal income tax purposes must be tracked so that a double counting for state income tax purposes is avoided. That is, when deferred intercompany gain or loss
eventually is recognized for federal income tax purposes (e.g., upon a disposition of property outside the consolidated return group or the departure of a member from the group), it must be backed out of the calculation of taxable income for state income tax purposes. Otherwise, the same gain or loss would be taken into account twice at the state level, since it would have been recognized at the time of the original transaction that gave rise to deferred gain or loss for federal income tax purposes.

The concept of a combined group as employed by certain states bears similarities to the federal “affiliated group” that is permitted to file a federal consolidated return. However, while many states have certain ownership requirements for filing a combined return that are similar to the federal 80 percent or more common ownership requirement, these states often impose additional or altogether different requirements for filing a combined return. Generally, in states that require unitary combined reporting, certain common ownership requirements must be met and the companies must be engaged in a unitary business (e.g. California and Illinois). (The United States Supreme Court has characterized a unitary business as a group of companies having a business relationship that includes centralized management, functional integration and economies of scale.) In addition, many states have specific rules, established under case law or by statute or under regulatory or administrative provisions, as to what defines a unitary business. For example, under New York's regulations, a unitary business may be present if (a) the activities of a corporation are related to the activities of the other corporations in the group
(including by reason of the acquisition of goods or property or performance of services for other corporations in the group); or (b) the corporation is engaged in the same or related lines of business as other corporations in the group. 119

4 State Modifications to Federal Consolidated Return Rules. Some states selectively adopt certain provisions of the federal consolidated return rules but with significant modifications. For example, unless specifically stated otherwise, California does not follow the federal consolidated return provisions under section 1502. Rather, California incorporates portions of the section 1502 regulations as in effect in March 1997 and liberally modifies them. 120 To illustrate, California tax law has no provisions similar to the investment adjustments rules under sections 1.1502-32 and 1.1502-33 pertaining to stock basis and the computation of earnings and profits, respectively. In addition, California determines the net income of a member of a combined reporting group from its separate books and records. 121 The earnings and profits of each entity included in the combined report are calculated on a separate company

119 20 N.Y.C.R.R. § 6-2.2(b).

120 These modifications result in only certain companies being able to file a “true” consolidated return and most companies having to elect to file a combined return. Cal. Rev. & Tax Cd. ¶¶ 25101; 25102, 23363; Cal. Code Regs. 18 § 25106.5.

121 Cal. Code Regs. Tit. 18, § 25106.5.
basis and do not include the roll-up of earnings and profits of any lower tier subsidiaries. Likewise, a parent corporation’s tax basis in the stock of a unitary subsidiary is not adjusted to reflect undistributed earnings of the subsidiary. Of course, insofar as a state so departs from the federal consolidated return rules, the result can be that certain items of gain, income, loss or deduction taken into account for purposes of calculating federal consolidated taxable income are excluded from the computation of combined taxable income for relevant state income tax purposes.

5. Separate Company Filing States. Separate company states look at tax filers on a company-by-company basis regardless of whether a given company has subsidiaries or affiliates located in the state. Transactions qualifying for federal income tax purposes for non-recognition treatment or tax deferral in reliance on the section 1502 regulations could be taxable on a current basis in separate return states. Thus, among the issues that can arise in states that require separate company returns and do not


124 Generally, these are the states of Alabama, Arkansas, Delaware, District of Columbia, Florida, Georgia, Iowa, Kentucky, Louisiana, Maryland, Missouri, North Carolina, New Jersey, Pennsylvania, Rhodes Island, South Carolina and Tennessee.
adopt the provisions of the federal consolidated return regulations are potentially significant differences in subsidiary stock basis (since subsidiary stock basis computations are made wholly without reference to section 1.1502-32); immediate recognition of gain for state income tax purposes that is deferred for federal consolidated return purposes (including for example, section 311(b) gain realized on a distribution of assets where fair market value exceeds basis); limitations on net operating loss carryovers, capital loss carryovers and other tax attributes that shift to the successor entity in an asset reorganization for federal income tax purposes;¹²⁵ and immediate recognition of gain with regard to distributions in excess of earnings and profits and basis that instead leads to creation of an “excess loss account” for federal consolidated return purposes (any gain recognition generally being deferred until the stock is disposed of by the distributee).

6. Forced Combination. Finally, in many separate return filing states, the commissioner or department of revenue is given broad discretionary authority to force a combined return, or exclude certain entities from a taxpayer’s elective combined return, if it determines that the taxpayer’s chosen filing methodology distorts the taxpayer’s taxable income and combined reporting, or exclusion of certain

¹²⁵ Compare, for example, section 381(c) and section 1.1502-22.
entities from a combined return, is necessary to achieve a clear reflection of income.126

III. THE IMPORTANCE OF BEING EARNEST.127

A. Intragrid Transfers without Tax Planning. By default, group restructurings sometimes proceed under the *laissez faire* plan -- i.e., without tax planning and by all appearances as if we live in a world without taxes (and tax advisers). This approach has some merit from the standpoint of expediency and business efficiency. Indeed, the time and effort that can be required to develop a well thought-out tax plan for the reorganization of the group may be such that business realities simply cannot await the outcome of the effort. This, in turn, can generate an additional

126 For example, under Mississippi tax law, the Commissioner may require “all members of a group of affiliated corporations, whether or not subject to the tax jurisdiction of this state, to file a combined or consolidated Mississippi income tax return if he believes such combined or consolidated return is necessary to clearly and equitably reflect the Mississippi taxable income of the affiliated group, or included member or members thereof.” See Miss. Admin. Code 35.III.8.07(B)(1). Similarly, the New Hampshire Supreme Court in Baxter International Inc. v. New Hampshire, 665 A.2d 350 (N.H. 1995), upheld a state statute providing that the commissioner may “impose the tax as though the entire combined net income of the water's edge combined group was that of one business organization or the commissioner may adjust the tax or income in such other manner as the commissioner shall determine to be equitable if the commissioner determines it to be necessary in order to clearly reflect the net income earned by such organization from business done in this state.” See N.H. Rev. Stat. Ann. § 77-A:6(IV).

127 With apologies to Oscar Wilde.
layer of complexity as the tax advisers struggle with such questions as whether and when a plan of reorganization can be deemed to exist and be in effect or a plan of liquidation be deemed adopted.128 Can the *laissez faire* business combinations and consolidations that have been going on at the direction of senior management be viewed through the prism of an eventual formal plan of reorganization *ex post hoc*?

Assuming the answer is “no” or, indeed, that tax advisers are never brought into the project, of course, a cross-chain transfer of assets occurring as part of a business re-alignment, without more, runs the risk of being treated for income tax purposes as a taxable event.

With reference to the earlier hypothetical, assume that P management has determined that all intellectual property should be consolidated in B. Pursuant to management’s instructions, S transfers its intellectual property to B for no return consideration.

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There would be broad agreement among tax lawyers that the cross-chain transfer of assets described above constitutes a taxable event. The precise contours of the event, however, may be less certain. Three characterizations suggest themselves with varying degrees of weight, depending on the context and assumptions being made: (1) S will be treated as having *sold* the intellectual property to B for an arm’s length consideration (presumably cash), which consideration *perhaps* reverts to B via a constructive distribution up the chain to P and contribution down the chain to B; (2) S will be treated as transferring the intellectual property to B for constructive B stock, which *perhaps* reverts to X, via a constructive distribution up the chain to P and contribution down the chain; or (3) S will be treated as having distributed the intellectual property to P (via Y), which, in turn, contributed the intellectual property down the chain to B.

1. **Analysis Outside the Consolidated Return Regulations.** Outside of the consolidated return context, each of these characterizations may have much the same outcome: S will recognize, on a current basis, any gain realized on the transfer as if the intellectual property was sold. In the first scenario, the transfer is characterized as an exchange for cash and, in the second, an exchange for stock; neither transaction qualifies as a nonrecognition transaction and a constructive dividend of the proceeds from the transaction (in cash or in kind) may be implied. In the third scenario, S is treated as making a section 301 distribution of the
intellectual property up the chain, and the distribution triggers the application of section 311(b).\(^\text{129}\)

Section 311(b) provides, in general, that if a corporation distributes property (other than its own obligation) to a shareholder in a distribution governed by section 301, and the fair market value of the property distributed exceeds its adjusted basis in the hands of the distributing corporation, then gain is to be recognized to the distributing corporation as if the property were sold to the distributee at its fair market value. Section 311(a) precludes the recognition of a loss on the distribution.\(^\text{130}\) Thus, the third-mentioned possible characterization of the cross-chain transfer of assets would trigger recognition of built-in gain in the assets transferred, but not loss.

2. **Analysis under the Consolidated Return Regulations.** The consolidated return regulations, of course, significantly alter the treatment of the cross-chain transfer of assets described above. Under the first possible characterization (deemed transfer for cash), S realizes deferred intercompany gain on the transfer of the assets that will be subject to eventual recognition in

\(^{129}\) S will be treated as distributing the intellectual property to Y which, in turn, will be treated as distributing the intellectual property to P; P will be treated as contributing it via X to B.

\(^{130}\) By cross-reference to section 336(b), in the case of a distribution of appreciated property governed by section 311(b), if any property distributed is subject to a liability or the shareholder assumes a liability of the distributing corporation in connection with the distribution, the fair market value of the property will be treated as not less than the amount of the liability.
accordance with the provisions of section 1.1502-13 but that is not taxable on a current basis. Based on the discussion of section 1.1502-34 above, it seems unlikely that section 1.1502-34 converts the transfer into a section 351 exchange for constructive B stock (the second characterization posited). Of course, assuming *arguendo* that it did, then in order to reconcile that construction with the facts, S, in turn, presumably would be deemed to distribute the constructive B stock up the chain via Y to P (for contribution to X) and, in so doing, to realize a deferred intercompany gain under section 311(b) with respect to the stock. On the contribution by P of the constructive B stock to X, the X stock deemed issued therefor would be a successor asset under section 1.1502-13(j). Although the transaction so viewed would not trigger any current taxation, this could prove important in connection with any future restructuring of the P group. Under the third scenario (deemed distribution of the intellectual property via Y to P and contribution by P via X to B), S triggers deferred intercompany gain under section 311(b) subject to eventual recognition in accordance with the provisions of section 1.1502-13. On the deemed contribution of the intellectual property by P

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131 See discussion *supra* at pages 9 to 15.

132 See *supra* Part I.C.3.

133 Under section 1.1502-13(f)(2)(iii), the principles of section 311(b) apply to the distributing member’s loss, as well as gain, upon an intercompany distribution of property, and, under the matching rule of section 1.1502-13(c), the gain or loss is not taken into account until the property is sold to a nonmember. See section 1.1502-13(f)(7), Example 1. See also *supra* pages 33 to 35.
to X, the stock deemed issued by X therefor is a successor asset as defined under section 1.1502-13(j) and this pattern repeats itself on the deemed contribution by X of the intellectual property to B. \textsuperscript{134} Again, this could prove important in the context of a future restructuring of the group. However, as in the case of the other two scenarios, the transfer of the intellectual property does not trigger a current tax liability for federal income tax purposes given the assumed applicability of the consolidated return rules.

Thus, while it may be that in many instances which among the three possible characterizations of the cross-chain transfer of assets described above applies will not matter (i.e., all three may trigger immediate state income taxation on built-in gain and may imply a constructive dividend), there are possible differences among the three in terms of their implications under the consolidated return regulations.

B. Authorities Addressing Cross-Chain Asset Transfers -- In General.

In general, a transfer of assets (or the use of assets) between entities under common control for less than fair market value will be recast by the courts as a sale for a fair market value purchase price (with attendant adjustments to the amount realized on the sale and the acquirer’s cost basis) that is \textit{potentially} coupled with “triangular dividend” treatment -- i.e., a deemed distribution by the seller of the assets of the discount amount to the common

\textsuperscript{134} See \textit{supra} Part I.C.3.
parent or other controlling entity and a contribution of the discount amount down to the acquirer. As discussed in more detail below, the test that courts generally employ to determine whether triangular dividend treatment should be applied is whether the common parent or other controlling entity has received the primary economic benefit of the cross-chain transaction such that dividend treatment is appropriate. When a triangular dividend is imputed, the tax effect is that the common parent or other controlling entity is taxed on receipt of a constructive dividend from the seller and the parent’s basis in the stock of the acquirer of the assets is increased to reflect its deemed contribution of the constructive dividend amount to the acquirer.

The IRS’s current position on “gratuitous” cross-chain transfers in the brother-sister context can be traced back to

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135 See, e.g., Sparks Nugget v. Commissioner, 458 F.2d 631 (9th Cir. 1972) (nondeductible portion of excessive rental payments by one corporation to another recast as constructive dividend to controlling shareholder of both corporations); George W. Knipe, 24 T.C.M (CCH) 668 (1965), aff’d per curiam sub nom: Equitable Publishing Co. v. Commissioner, 356 F.2d 514 (3d. Cir. 1966) (advertising participation expenses recast as constructive dividends to common shareholder).

136 Sammons v. Commissioner, 472 F.2d 449 (5th Cir. 1972), employed a two-pronged test: (1) the objective prong of whether the common shareholder has direct or indirect control of the transferred funds, and (2) the subjective prong of whether the common shareholder received the primary benefit of the transfer. In application, the first prong is usually satisfied with a showing of a non-arm’s length transfer between affiliated corporations and the two prongs generally collapse into a one-pronged “primary benefit” test. See, e.g., Gulf Oil Corp. v. Commissioner, 89 T.C. 1010, 1029 (1987), aff’d, 914 F.2d 396 (3d. Cir. 1990) (“[a]s is typical in these cases, the critical inquiry is whether the second part of the Sammons test has been met”).
Revenue Ruling 69-630. Under the facts of the ruling, an individual owned all the outstanding stock of two corporations and caused one corporation to sell property to the other corporation at less than an arm’s length price. The IRS adjusted the sale price upward pursuant to section 482. The ruling held that where a section 482 adjustment is made to impute an arm’s length price in a bargain sale between brother-sister corporations, and the transaction has “as one of its principal purposes the avoidance of Federal income tax” so that relief under Revenue Procedure 65-17 is not available, the amount of the allocation is recast as a constructive distribution to the controlling shareholder from the selling corporation followed by a capital contribution to the purchasing corporation.

In Revenue Ruling 78-83, 1978-1 C.B. 79, the IRS adopted a more expansive stance, holding that every transfer of property or services between commonly controlled entities without adequate compensation therefor involves a constructive distribution to the common parent regardless of whether there was a tax-

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138 Revenue Procedure 65-17, 1965-1 C.B. 833, clarified and modified by Rev. Proc. 99-32, 1999-2 C.B. 296, provided relief under section 482 whereby qualifying taxpayers were placed in substantially the same position they would have occupied if an arm’s length consideration had been set in the first instance. Under Revenue Procedure 65-17, the collateral effects of a section 482 reallocation of income, such as imputation of a constructive dividend and capital contribution to explain a shift in income, could be avoided provided a payment was made to correct the original shortfall or overpayment. See Treas. Reg. § 1.482-1(g)(3).
avoidance motive present. Although this analysis has not been followed in the case law, it has been followed in a series of private letter rulings and the IRS has not changed its official position as stated in Revenue Ruling 78-83. Revenue Ruling 78-83 states that the constructive dividend can consist of the property transferred rather than the cash representing the bargain element of a sale, explaining that “a constructive dividend is a diversion of the property, not of the income” and explaining that “[i]ncome is a characterization which tax law attributes to certain receipts of property, whereas a constructive distribution is that of property itself.”

139 In Revenue Ruling 78-83, a foreign subsidiary diverted income to a foreign sister corporation in excess of reasonable compensation for services. The amount in excess of reasonable compensation was determined to be a constructive dividend to the common domestic parent corporation.


141 Indeed, in connection with certain amendments to the section 1441 regulations in 1997, the IRS and the Treasury attempted to improve their odds. See section 1.1441-2(e)(2) (providing that income arising from secondary adjustments under section 482 is considered “paid” for purposes of section 1441 withholding). See also Notice of Proposed Rulemaking, Fed. Reg. 17614 (Apr. 22, 1996) (clarifying the meaning of “payment” for purposes of withholding).

142 This principle was applied in Private Letter Ruling 9419018, supra note 140, which relied on Revenue Ruling 78-83 in recharacterizing a gratuitous cross-chain transfer of certain business assets of one wholly-owned subsidiary (“D2”) to another (“Sub”) as a distribution by D2 of the business assets to the common parent (“Distributing”), followed by contribution of those assets from Distributing to Sub. The ruling held that section 311(b) would apply such that D2 would recognize gain on the

(continued...)

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The courts have been more circumspect than the IRS in evaluating whether non-arm’s length transfers between brother-sister corporations necessarily trigger “triangular dividend” treatment. In the section 482 context, courts have employed the “primary benefit test” referred to above, looking to whether the common parent or other controlling entity received the primary benefit of the transaction such that the substance of the transaction was in fact a distribution up and contribution down of the value of the assets diverted from one subsidiary to another. In R. T. French Co. v. Commissioner,143 a corporation allowed a foreign affiliate to make free use of certain intellectual property and know-how related to the common British parent corporation’s food production and distribution business. The IRS imputed an arm’s length fee between the two affiliates and further argued that a constructive dividend had been paid to the British parent company in the amount of the imputed fee, requiring payment of a withholding tax. The court held that no constructive dividend had been paid, stating that “[i]t can only be inferred that whatever benefits the parent may have received from these arrangements between its subsidiaries were merely derivative in nature, and it is clear . . . that ‘constructive dividend’ treatment is therefore uncalled for.”144

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constructive distribution of any asset to Distributing whose fair market value exceeded its adjusted basis on the date of distribution. See discussion in the text that follows infra at Part III.C.1.

143 60 T.C. 836 (1973).
144 60 T.C. at 856 (emphasis added).
In *White Tool & Machine Co. v. Commissioner*, the court again sided with the IRS as to the need for a section 482 adjustment but declined to construct a triangular dividend on the facts. In *White Tool*, the taxpayer, a profitable corporation, paid excessive rent to two sister companies in a loss position. The IRS argued that the taxpayer’s deduction for rent should be limited to an arm’s length amount and further argued that amounts paid to the sister companies in excess of fair rentals should be recast as constructive dividends from the taxpayer to the common, individual shareholder. The constructive dividend would have had the effect of generating taxable income to the common shareholder under sections 301 and 316. The court upheld the section 482 adjustment but declined to find a constructive dividend, stating that “[a] distribution by a corporation to a brother-sister corporation is deemed a dividend to the common shareholder only if the distribution *directly benefits* the shareholder.”

The IRS issued a nonacquiescence in the *White Tool* decision, reiterating the government’s position, as argued in *White Tool*, that the proper test of whether the finding of a constructive dividend is warranted is whether “the intercorporate transfer serves a demonstrable, legitimate business interest of the transferor.”

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145 41 T.C.M. (CCH) 116 (1980), aff’d, 677 F.2d 528 (6th Cir. 1982).
146 41 T.C.M. at 125 (emphasis added).
147 A.O.D. 1982-077 (Oct 15, 1982). Earlier cases had held that a valid business purpose for the payment, although not controlling, is a significant factor in the “direct benefit” test. See, e.g., *Gilbert v.*
The court in *White Tool* instead had adhered to the “primary benefit” test and applied it to find that the shareholder did not receive any direct benefits from the bargain sale. General Counsel Memorandum 38676 (1981) also criticized *White Tool*, stating that the court had “in effect granted Rev. Proc. 65-17 type treatment (no constructive dividend) in a tax avoidance situation . . .”148

C. Cross-Chain Transfers Qualifying as “D” Reorganizations.

1. In General. The fact pattern posited above (diversion of intellectual property from S to B) was constructed so as to quite evidently fall outside of section 368 reorganization treatment. It involved neither a merger transaction as would be required for an “A” reorganization nor a transfer of substantially all of S’s assets, as would be prerequisite to characterization of the transaction as a “C” or “D” reorganization.149

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148 As noted above, in the section 482 context, constructive dividend treatment may be avoided under certain circumstances pursuant to Revenue Procedure 99-32. See supra note 138. For a more thorough discussion of triangular dividends, see Michael A. Yuhas & James A. Fellows, *Related Corporations and Triangular Dividends: Can the Circle be Squared?*, 73 TAXES 539 (1995); Walter C. Cliff & Benjamin J. Cohen, *Collateral Fictions and Section 482*, 36 TAX LAW. 37 (1982).

149 See section 368(a)(1)(A) and sections 368(a)(1)(C), 368(a)(1)(D) and 354(b)(1)(A).
Assume, instead, S transfers all of its assets to B (ostensibly for no return consideration) except the intellectual property. Is this transaction a “D” reorganization? The answer, without more facts, is “it depends.” Section 368(a)(1)(D) defines a “D” reorganization as follows:

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.\(^{150}\)

Section 354(b), in turn, predicates applicability of section 354 to a putative acquisitive “D” reorganization on (i) the transferee corporation acquiring “substantially all of the assets of the transferor” and (ii) “the stock, securities and other properties received by such transferor, as well as the other properties of such transferor,” being distributed in pursuance of the plan of reorganization.

Thus, returning to the hypothetical, for the transaction to qualify as a “D” reorganization, among other things, S must

\(^{150}\) In the case of a non-divisive “D,” the term “control” has the meaning ascribed to it by section 304(c) -- namely, at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the value of all classes of stock, applying the attribution rules of section 304(c). See section 368(a)(2)(I).
distribute to its shareholders the stock and securities of the acquiring corporation received by it and effectively must completely liquidate as a result of the transaction. If, to the contrary, S remains in existence and continues to hold the intellectual property, “D” reorganization treatment is precluded. In such case, the analysis of the cross-chain transfer presumably proceeds under Section I.B. above. Private Letter Ruling 9419018, noted above,\(^{151}\) is directly analogous. Under the facts of that ruling, preparatory to a section 355 spin-off, a member of Distributing’s U.S. affiliated group, D2, transferred its “Business B” assets to a subsidiary of Controlled for no return consideration (other than assumption of liabilities). The ruling concludes (citing Revenue Ruling 78-83), that D2 will be treated as making a distribution of all its Business B assets, subject to liabilities, to Distributing, and the deemed distribution will be treated as followed by successive contributions by Distributing to Controlled and by Controlled to its subsidiary. The ruling states that D2 will recognize section 311(b) gain in connection with the deemed distribution to Distributing that will be deferred under then-applicable section 1.1502-14T(a).

Returning to the hypothetical, assume instead that S in fact distributes the intellectual property to Y in connection with the complete liquidation of S. Assuming all other relevant requirements under section 368 are satisfied, the transaction will qualify as a “D” reorganization, and this notwithstanding, of course, the fact that B issued no stock or other consideration to S for S’s

\(^{151}\) See supra note 142.
operating businesses. This is a function of the fact that issuance of stock by S will be deemed a “meaningless gesture.” That is, on these facts, B will be treated as issuing B stock to S in consideration of B’s acquisition of S’s operating assets.\footnote{See discussion immediately following.} Note that if, in fact, B had issued stock to S in the transaction, then, following S’s liquidation, Y would hold actual B stock.\footnote{In any event, Y is in “control” of B immediately after the transfer by S of its operating assets to B, in light of the fact that “control” is determined with reference to section 304(c) and, for such purpose, the section 318 attribution rules apply. See section 304(c)(3). However, if it is planned for Y to liquidate following S’s liquidation, arguably neither the transferor (S) nor its shareholder (Y) can be deemed to be in control of B. See infra note 185 and accompanying text.} This, of course, would appear to be meaningful. On the facts above, it would seem Y therefore will be treated as receiving the B stock and then distributing the B stock to P in a taxable distribution governed by sections 301 and 311(b).\footnote{Cf. Ginsburg & Levin, supra note 19, at ¶ 405.1.1.} This topic is taken up further in Section III.C.3. below following an exploration of the meaningless gesture doctrine.

2. The Current Meaning of “Meaningless Gesture.”

As of the first writing of this paper, much had been written in regard to the scope of the meaningless gesture doctrine in the wake of Private Letter Ruling 200551018.\footnote{Priv. Ltr. Rul. 200551018 (Sept. 15, 2005); Attorneys Question Private Letter Ruling and ‘D’ Reorganizations, 2006 Tax Notes Today 64-45 (Apr. 4, 2006); Michael Schler, More on the ‘All-Cash D’ Reorganization, 2006 Tax Notes Today 74-33 (Apr. 18, 2006); (continued...)} And, of course, the
IRS and the Treasury have now addressed the question through the issuance of temporary regulations delineating the circumstances in which the section 354(b)(1)(B) distribution requirement applicable to “D” reorganizations will be treated as satisfied even though no stock or securities are actually issued in a transaction otherwise described in section 368(a)(1)(D) (the “Temporary D Reorg Regulations”).

In Private Letter Ruling 200551018, unrelated corporations, A and B, each owned 50 percent of the stock of X Corp. C (a corporation unrelated to A and B) and B formed Newco. B owned 90 percent of the Newco stock and C owned the remaining 10 percent. XCorp sold all of its assets to Newco in exchange for two installment notes and immediately thereafter XCorp liquidated. In the liquidation, XCorp distributed one installment note to A and one to B. The ruling holds that Newco is entitled to amortize the cost of the goodwill acquired as a result of the purchase of assets from XCorp.


Thus, the ruling tacitly assumed that the transaction did not qualify as a “D” reorganization. A number of practitioners inquired as to the implications of the ruling and were informed by government representatives that this determination represented the reasoned judgment of the IRS that the transaction did not qualify as a “D” reorganization.\footnote{Attorneys Question Private Letter Ruling and ‘D’ Reorganizations, 2006 TAX NOTES TODAY 64-45 (Apr. 4, 2006).} This led to expressions of concern on the part of some as to the reliability of past guidance as well as polite but definite differences of opinion as to the correctness of the private letter ruling.

Section 1.368-2T(l) provided the government’s response.\footnote{The provisions of section 1.368-2T(l) generally apply to transactions occurring on or after March 19, 2007, except that the provisions do not apply to any transaction occurring pursuant to a written agreement which is binding before December 19, 2006, and at all times thereafter. A taxpayer may apply the provisions of the temporary regulations to transactions occurring before March 19, 2007. However, the transferor corporation, the transferee corporation, any direct or indirect transferee of transferred basis property from either of the foregoing, and any shareholder of the transferor or transferee corporation may not apply the provisions of the temporary regulations unless all such taxpayers apply the provisions of the temporary regulations. Section 1.368-2T(l) expires “on or before December 18, 2009.” As of the writing of this paper, no action has been taken with respect to this regulation. See infra note 177 for a brief discussion of recent comments relating to section 1.368-2T(l).} After stating the basic distribution requirement applicable to “D” reorganizations,\footnote{Section 1.368-2T(l)(1).} the Temporary D Reorg Regulations provide that an acquisitive transaction otherwise described in section 368(a)(1)(D) will be treated as satisfying the
requirements of sections 368(a)(1)(D) and 354(b)(1)(B) notwithstanding that there is no actual issuance of stock or securities of the transferee corporation if the same person or persons own, directly or indirectly, all of the stock of the transferor and transferee corporations in identical proportions. The regulations provide that, in such cases, the transferee corporation will be deemed to issue a nominal share of stock\textsuperscript{160} to the transferor corporation in addition to the actual consideration exchanged for the transferor corporation’s assets. The nominal share of stock in the transferee corporation will then be deemed distributed by the transferor corporation to its shareholders and “where appropriate, further transferred through chains of ownership to the extent necessary to reflect the actual ownership of the transferor and transferee corporations.”\textsuperscript{161}

\textsuperscript{160} The use of the word “nominal” rather than “constructive” is unfortunate in this context. See infra Part III.C.3.

\textsuperscript{161} Section 1.368-2T(l)(2)(i). See also Rev. Rul. 73-233 discussed supra at note 18. Section 1.368-2T(l)(2)(ii) provides that ownership of stock will be determined by applying the principles of section 318(a)(2) (without regard to the 50 percent limitation in section 318(a)(2)(C)), and an individual and all members of his family described in section 318(a)(1) will be treated as one individual.

The Temporary D Reorg Regulations inadvertently imperiled triangular reorganizations, since neither a forward triangular merger under section 368(a)(2)(D) nor a triangular “C” reorganization can include any stock of the acquiring corporation as part of the currency of the transaction, whereas the Temporary D Reorg Regulations impute the issuance of such stock. Characterization of the transaction as a forward triangular merger is precluded, “C” treatment gives way to “D” treatment (see section 368(a)(2)(A)) and the parent stock actually issued is rendered “other property” (i.e., boot). On February 28, 2007, the IRS and the Treasury corrected this problem with the issuance of an (continued...)

In response to the issues raised by Private Letter Ruling 200551018, the regulations provide that de minimis variations in ownership are not to be 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.”162 The regulations also provide that stock described in section 1504(a)(4) is not to be taken into account. By way of the examples, a variation in ownership of one percent qualifies as “de minimis”163 but a variance of the degree described in Private Letter Ruling 200551018 does not.164

amendment to the Temporary D Reorg Regulations providing that the deemed issuance of transferee stock rule does not apply if the transaction otherwise qualifies as a triangular reorganization described in section 1.358-6(b)(2) or as a triangular “G” reorganization qualifying under section 368(a)(2)(D). See T.D. 9313, 2007-1 C.B. 805.

162 Section 1.368-2T(l)(2)(iii).

163 Section 1.368-2T(l)(3), Ex. 4.

164 Section 1.368-2T(l)(3), Ex. 6, mirrors the facts of Private Letter Ruling 200551018. The preamble to the temporary regulations notes that the application of the meaningless gesture doctrine “has generally been limited to situations in which there is identical shareholder identity and proportionality of interest in the transferor corporation and the transferee corporation.” The preamble cites Warsaw Photographic Associates, Inc. v. Commissioner, 84 T.C. 21 (1985), as an example of a case where no stock was issued in the transaction and the stock ownership in transferor and transferee was not identical: “On the basis of these facts,” the preamble explains, “the Tax Court concluded that the distribution of stock would not be a mere formality and refused to apply (continued...)
Example 3 of the Temporary D Reorg Regulations both illustrates an “all-cash D” and addresses lower-tier “D” reorganizations.\footnote{Section 1.368-2T(l)(3), Ex. 3.} Under the facts of the example, P owns all of the stock of S1 and S2. S1 owns all of the stock of S3, which owns all of

the meaningless gesture doctrine.” An examination of the case reveals it is of little use in determining “where to draw the line,” since the common ownership of transferor and transferee was limited to twenty percent in that case.

In Warsaw Photographic, certain shareholders of S holding roughly 20\% of S’s stock in the aggregate and none of its preferred stock (“S Minority”), created a new corporation, W. S transferred substantially all of its assets to W for $21,000, assumption by W of certain S liabilities and the distribution by W of shares of W stock to the S Minority in proportion to their shareholdings in W (not holdings in S). The court held that the transaction does not qualify as a reorganization under section 368(a)(1)(D) entitling W to succeed to S’s net operating losses under section 381(a)(2) and giving W a carryover basis (under section 362) in the assets acquired from S. The transfer was held to be more analogous to a sale than a reorganization: while S was treated as receiving stock in W in turn distributed to certain S shareholders, the holder of 80\% of the common stock and all of the preferred stock was excluded from the distribution of the W shares, the shares instead being distributed to S shareholders according to their interests in W (rendering the effect of the issuance and distribution of the W shares meaningless). Morgan, Atlas Tool, and Armour were each distinguished based on the fact that each of those cases involved identical stock ownership of the transferor and acquiring corporations such that an actual distribution of stock of the acquirer would have been a mere formality, whereas on the facts of Warsaw, the interests varied widely. The court noted that in the other cases it was the taxpayer rather than the government arguing against reorganization treatment and those cases worked to prevent a taxpayer from shaping a transaction to secure an unwarranted benefit. In the case at hand, the court determined that, although an actual stock distribution was made, the stock distribution was simply an attempt to fit under the D reorganization rules and had no real value since it effected no change in relative positions of the affected shareholders.

\footnote{Section 1.368-2T(l)(3), Ex. 3.}
the stock of T. S2 owns all of the stock of S4, which owns all of the stock of S. The T stock has a fair market value of $70x. T sells all of its assets to S in exchange for $70x of cash and immediately liquidates. The example provides that, under section 1.368-2T(l)(2)(ii), there is indirect, complete shareholder identity and proportionality of ownership in T and S and, accordingly, the requirements of sections 368(a)(1)(D) and 354(b)(1)(B) are treated as satisfied notwithstanding the fact that no S stock is issued. The example provides that S will be deemed to issue a nominal share of S stock to T in addition to the $70x of cash actually exchanged for the T assets, and T will be deemed to distribute all such consideration to S3. S3 will be deemed to distribute the nominal share of S stock to S1, which, in turn, will be deemed to distribute the nominal share of S stock to P. P will be deemed to transfer the nominal share of S stock to S2, which, in turn, will be deemed to transfer such share of S stock to S4. This is consistent with a number of prior private letter rulings, albeit the rulings involved payment of no or nominal consideration as opposed to the payment of full fair market value cash consideration as assumed in the facts of Example 3. 166

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166 See Priv. Ltr. Rul. 9336029 (June 14, 1993); Priv. Ltr. Rul. 9229026 (Apr. 21, 1992) and Priv. Ltr. Rul. 8911067 (Dec. 22, 1988). As noted, these rulings involved the payment of little or no consideration for the transferor’s assets. The IRS held that stock is deemed to be issued by the acquiring corporation to the transferor and distributed by the transferor as part of its complete liquidation and, in turn, distributed by the immediate parent of the transferor up the chain to the common parent, and then contributed down the chain through any intermediary subsidiaries until reaching the direct owner of the acquiring corporation.

(continued...)
The foundation on which the Temporary D Reorg Regulations rests includes Revenue Ruling 70-240,\textsuperscript{167} the cases of Morgan v. Commissioner,\textsuperscript{168} and Wilson v. Commissioner\textsuperscript{169} on which Revenue Ruling 70-240 relied, and Warsaw Photographic v. Commissioner (discussed above).\textsuperscript{170}

Under the facts of Revenue Ruling 70-240, B owned all the stock of both corporations X and Y. X sold its operating assets

\begin{quote}
In Private Letter Ruling 8911067, the sole consideration received by the transferor was $1 plus the assumption of the transferor’s liabilities, together with stock of the acquiring stock deemed issued in the exchange. In the remaining two rulings, the acquiring corporation assumed the transferor’s liabilities but otherwise paid no consideration apart from a constructive issuance of acquiring corporation stock. These rulings state that the fair market value of the acquiring corporation stock deemed issued in the exchange will be equal to the value of the transferor stock surrendered by the transferor’s shareholder upon liquidation of the transferor. Both Private Letter Ruling 9336029 and Private Letter Ruling 9229026 include a ruling that gain is required to be recognized under section 311(b) in connection with the up-the-chain leg of the “round trip” of the constructive acquiring corporation stock. Private Letter Ruling 8911067 does not but this may be explainable on the basis that the parent of the transferor corporation in that case was a foreign corporation. See discussion infra at pages 105 to 111.
\end{quote}

\textsuperscript{167} 1970-1 C.B. 81.

\textsuperscript{168} 288 F.2d 676 (3d Cir. 1961), cert. denied, 368 U.S. 836 (1961).

\textsuperscript{169} 46 T.C. 334 (1946).

\textsuperscript{170} See supra note 164. The meaningless gesture doctrine arises in other contexts as well. See e.g., Rev. Rul. 90-13, 1990-1 C.B. 65 (distribution can qualify as distribution in partial liquidation even though no stock of distributing corporation actually surrendered if actual surrender on pro rata basis would be meaningless gesture). See also supra note 12.
to Y for cash at a price equal to their full fair market value. X’s
remaining assets (cash, accounts receivable and investments in
stocks and bonds), after satisfaction of X’s debts, were distributed
to B in liquidation of X. Y continued to operate the business
formerly conducted by X, in addition to its own existing business.
The issue addressed by the ruling was whether X’s liquidating
distribution should be treated by B as boot in a reorganization
under section 356 or as long-term gain realized on the liquidation
of X under section 331. The ruling concluded that the transaction
constituted a “D” reorganization and characterized the amount
received by B in connection with the liquidation of X as boot,
taxable under section 356(a).

If, on the facts of Revenue Ruling 70-240, Y had issued
stock to X in addition to the actual cash consideration paid by Y to
X, Y would have “overpaid” for the assets since the ruling stipulates that the cash amount equated to the full fair market value
of the transferred assets. This was not true in the case of Morgan
(where only partial cash consideration was received by the
liquidating corporation for the assets transferred by it to its sister
corporation)\(^{171}\) but was true in the case of Wilson (in form a cash

\(^{171}\) Essentially cash for furniture and fixtures only. 288 F.2d at
678. In Morgan, an individual who was the sole shareholder of two
companies, as well as the president of a mutual fund that worked with
both companies, caused the mutual fund to terminate its contracts with
one of the companies and enter into an identical services contract with the
other. Once the new contract was completed all of the first company’s
assets (including employees, furniture, fixtures and equipment, and
research data) were transferred to the second company for an assumption
of commercial obligations and a small amount of cash, following which
(continued...)

- 100 -
sale of operating assets for a fair market value purchase price to a commonly-controlled corporation followed by a liquidation).\textsuperscript{172}

Seen from a liquidation-reincorporation perspective (in both cases, substantial liquid assets of the transferor corporation were distributed in liquidation), this distinction is not substantively relevant.\textsuperscript{173} The taxpayers in \textit{Wilson} (father and son) had argued for a distinction to be drawn along these lines -- as had the taxpayer in \textit{James Armour, Inc. v. Commissioner},\textsuperscript{174} a case

\begin{flushright}
\textsuperscript{172} In \textit{Wilson}, a father and son each owned 50 percent of the stock of two corporations, both in the insurance business. One of the corporations transferred all of its business to the other in exchange for cash, which the court found to be in an amount equal to the businesses’ full fair market value. After collecting its receivables and selling off certain investment assets, the transferor corporation distributed its assets, consisting of cash and the balance of its investment assets, to its two shareholders in equal portions, and dissolved.

\textsuperscript{173} As stated by the court in \textit{Morgan}:

\begin{quote}
If the transferor’s assets had been transferred to a newly formed corporation in exchange for stock, there is no question that the boot would have been taxable as dividend income. That an existing corporation in which the taxpayer was the sole shareholder was used instead of a newly formed one cannot alter the true nature of the transaction. Here, the issuance of new stock would have been a meaningless gesture since the stock the taxpayer already held represented the total value of all the assets except for the boot.
\end{quote}

288 F.2d at 680.

\textsuperscript{174} 43 T.C. 295 (1964).
involving similar facts decided two years prior to the decision in Wilson -- but without success:

Petitioners herein argue, as did the petitioners in Armour . . ., that a distinction should be drawn between cases like Morgan, where the transferee corporation receives some assets without consideration, and cases like Armour and the instant cases, where the transferee pays fair market value for what it receives. In rejecting such a distinction in Armour, we held . . .[that] the exchange requirements of the statute are met if, when a series of transactions are completed, the stockholders of the old corporation retain their proprietary interest in the same going business, although in another corporate shell. . . .The rule is applicable here, and we follow it. The record clearly shows that petitioners retained their proprietary interest in [transferor’s] “going business,” its group insurance business, in [transferee’s] corporate shell. Consequently, we hold that the exchange requirements of section 354(a) and 356(a) and the distribution requirement of section 368(a)(1)(D) are satisfied.175

While section 1.368-2T(1) embraces the result under Revenue Ruling 70-240 and cases such as Wilson and James Armour, at the same time the IRS and the Treasury are seeking comments on whether the meaningless gesture doctrine is inconsistent with the distribution requirement in sections 368(a)(1)(D) and 354(b)(1)(B), “especially in situations in which the cash consideration received equals the full fair market value of the property transferred such that there is no missing consideration

175 46 T.C. at 344.
for which the nominal share of stock deemed received and distributed could substitute.\footnote{Notice of Proposed Rulemaking (by cross-reference to temporary regulations). On March 10, 2005 the IRS and the Treasury issued proposed regulations under sections 332, 351 and 368 generally setting forth a “net value” requirement for the nonrecognition rules of subchapter C of the Code to apply to a transaction but excepting “D” reorganizations from that requirement. Prop. Treas. Reg. §§ 1.332-2, 1.351-1, 1.368-1, 70 Fed. Reg. 11903 (Mar. 10, 2005). In the Preamble to the recently adopted section 1.368-1(e) regulations (providing rules for when a creditor will be treated as a proprietor of a corporation to determine whether continuity of interest is preserved in potential reorganization transactions), the IRS and Treasury noted that they continue to consider the issues raised by comments they have received with regard to these proposed regulations and to evaluate the complexity and necessity for valuation under the exchange of net value requirement. T.D. 9434 (Dec. 11, 2008).}

In general, the 2005 proposed regulations require a “surrender of net value” and “receipt of net value.” The former is satisfied, in the case of an asset reorganization governed by section 368 if the fair market value of the property transferred by a target corporation to the acquiring corporation exceeds the sum of the amount of liabilities of the target corporation that are assumed by the acquiring corporation and the amount of money and fair market value of any other boot received by the target corporation. This ensures the transaction involves an exchange of property \textit{for stock}. A target corporation \textit{receives} net value in an asset reorganization if the fair market value of the assets of the issuing corporation exceeds its liabilities immediately after the exchange. The preamble to the proposed regulations explains that “[t]his rule ensures that the target corporation receives stock (or is deemed to receive stock under the ‘meaningless gesture’ doctrine) having value [and is] necessary because the IRS and the Treasury Department believes that the receipt of worthless stock for assets cannot be part of an exchange for stock.” Notice of Proposed Rulemaking, 70 Fed. Reg. 11903 (Mar. 10, 2005).

As noted, there is an exception for “D” reorganizations. Proposed section 1.368-1(f)(4) provides that “[t]he requirement that there be an exchange of net value does not apply to a transaction that would otherwise qualify as a reorganization under section 368(a)(1)(D) . . . provided that the fair market value of the property transferred to the acquiring corporation by the target corporation exceeds the amount of

\textit{(continued...)}
The IRS and the Treasury also are seeking comments on the extent, if any, to which the continuity of interest requirement should apply to “D” reorganizations and whether the Temporary D Reorg Regulations should apply when the parties to the reorganization are members of a consolidated return group.\textsuperscript{177}

\textsuperscript{177} Preamble to T.D. 9303. According to T.D. 9303, 2007-1 C.B 379, the IRS and the Treasury Department are undertaking a broad study of issues related to acquisitive “D” reorganizations and contemplate the possibility of changes to the rules upon completion of the broader (\textit{continued...})
3. **Some Observations Regarding Lower-Tier D Reorganizations.** Part III.C.2. includes a discussion of the facts of Example 3 of the Temporary D Reorg Regulations, involving a transaction between two third-tier subsidiaries, T and S.

The continuity of interest requirement is a critical element in determining whether a reorganization qualifies under section 368 regulations. Under the current section 368 regulations, requisite to a reorganization is continuity of the business enterprise “and (except as provided in section 368(a)(1)(D)) a continuity of interest as described in [section 1.368.1(e)].” Section 1.368-1(b). Indeed, the preamble to Treasury Decision 8760 (Jan. 12, 1998) containing the final regulations in which this language was introduced contains language very similar to T.D. 9303 as regards the role of the continuity of interest requirement in “D” reorganizations and in fact states (with reference to section 1.368-1(b)) that “[t]herefore, these final COI regulations do not apply to section 368(a)(1)(D) reorganizations . . . .”

In 2008, the American Bar Association Section of Taxation submitted comments to section 1.368-2(1) and the proposed regulations pursuant to T.D. 9303. See “Comments on Proposed and Temporary Regulations under Code Section 368(a)(1)(D),” American Bar Association Section of Taxation (April 16, 2008) and “Comments Concerning the Treatment of Stock of the Acquiring Corporation Already Owned by the Target Corporation in a Section 368(a)(1)(D) Reorganization,” American Bar Association Section of Taxation (Oct. 28, 2008). Among the ABA’s comments were these: (1) with reference to the deemed stock issuance rules, instead of deeming a stock issuance, the Temporary Regulations should state that the described transactions would be deemed described in section 356, (2) if the nominal share concept remains in the Temporary Regulations, the Temporary Regulations could be clarified to state that the deemed stock issuance rule has no significance other than to meet the distribution rule; and (3) with respect to the specific issues on which the IRS and the Treasury sought input, (i) the meaningless gesture doctrine is consistent with the statutory distribution requirement; (ii) a continuity of interest requirement for acquisitive “D” reorganizations should be retained with reference to, alternatively, section 304 control and traditional concepts of continuity of interest (a specific test is set forth); and (iii) section 1.368-2T should apply to consolidated return groups.
Assume, in that example, that, rather than T selling its assets to S for full fair value cash consideration and then liquidating, T instead transfers its assets to S for no ostensible return consideration and liquidates. Following the thread of Example 3, the transaction on these changed facts continues to qualify as a “D” reorganization, notwithstanding that no S stock is issued. S should be treated as issuing S stock to T (although the notion of it involving issuance of a “nominal” share of S stock does not fit the facts). T will be treated as distributing this S stock to S3 in connection with T’s liquidation. Of course, stopping here, it is apparent that an actual issuance of S stock would not have been meaningless. Following the transfer, S would be jointly owned by

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178 The transferor (T) or its shareholder (S3) is in section 304(c) control of S, giving effect to the application of the section 318 rules, and the S stock received (or deemed received in this case), along with the other properties of T were distributed to S3.
P’s indirect subsidiaries, S3 and S4. However, the regulations section instructs that S3, in turn, will be treated as distributing the S stock to S1, which, in turn, will be treated as distributing the S stock to P. P will be treated as transferring the S stock to S2, which, in turn, will be treated as transferring the S stock to S4.179 This “return trip” of the S stock would appear to be taxable under section 311(b), resulting in a deferred intercompany gain in the stock for federal income tax purposes and an immediate tax outside of the consolidated return regulations.180

On essentially these facts, Private Letter Ruling 9336029 (noted above) concluded that section 311(b) indeed applies to create a deferred intercompany gain. In Private Letter Ruling 9336029, simplifying the facts slightly, Corp P owned both Corp S, which in turn owned Target, and Corp S1, which in turn owned Acquiring.

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179 As noted above, the IRS’s prior letter ruling practice was to the same effect. See supra note 166.

180 Accord Ginsburg & Levin, supra note 19, at ¶ 405.1.1 (as to separate return treatment).
Target transferred substantially all of its assets to Acquiring, “in constructive exchange for shares of Acquiring stock and the assumption by Acquiring of Target’s liabilities,” following which Target liquidated. The Acquiring stock deemed issued to Target and received by Corp S in connection with the liquidation of Target are described as “constructively distributed by Corp S to Corp P . . . and constructively contributed by Corp P to Corp S1.” The ruling holds (at ruling 16) that Corp S will recognize gain upon the deemed distribution of Acquiring stock to Corp P pursuant to section 311(b) that will qualify as deferred intercompany gain under then-applicable section 1.1502-14T. Although the ruling decides this point within the context of the pre-1995 version of the consolidated return regulations, a different answer does not appear to be compelled by the new consolidated return regulations regime.

However, as something of an aside, a letter submitted to IRS Associate Chief Counsel (Corporate), William D. Alexander, on March 31, 2006 regarding Private Letter Ruling 200551018 (the “submission”) suggests that the outcome under Private Letter Ruling 9336029 as regards the applicability of section 311(b) would not pertain under the current consolidated return regulations:

We note that PLR 9336029, described above, involved members of a consolidated group and was issued before the 1995 amendments to the consolidated return regulations. Under the current consolidated return regulations, if P, S, S1,
Acquiring, and Target are members of a consolidated group, the transaction is treated differently and the following events are deemed to occur: (i) Acquiring is treated as issuing its stock to Target in exchange for Target’s assets; (ii) Target is treated as distributing Acquiring stock to S in a liquidation; and (iii) Acquiring is treated as redeeming its stock from S in exchange for cash. See Treas. Reg. section 1.1502-13(f)(3) and (f)(7), ex. 3. This treatment is similar to the analysis in Commissioner v. Clark, 489 U.S. 726 (1989). Clark did not address cross-chain “D” reorganizations such as those discussed in this letter, but did present an analysis in the context of treating cash boot as dividend income or capital gain that is potentially relevant. To date, the Service has not expressly adopted the Clark analysis in the context of cross-chain “D” reorganizations.

As can be seen, for support the submission cites section 1.1502-13(f)(3) and section 1502-13(f)(7), Example 3. Section 1.1502-13(f)(3), which addresses the treatment of boot in corporate reorganizations and section 351 transactions, was discussed briefly in Part I.C.3. The provision reconstructs a transaction involving a mix of actual stock and boot as an all-share transaction and treats the boot paid in the transaction as cash paid in a section 302 redemption of the shares deemed issued in the constructive share issuance.

The example under the regulations that is cited by the submission\textsuperscript{181} describes a transaction in which S transfers all of its

\textsuperscript{181} Section 1.1503-13(f)(7), Ex. 3.
assets to B in exchange for $150 of cash and B stock with a value of $350. S liquidates, distributing to its shareholder, P, the stock and cash it received from B in the transaction. In accordance with section 1502-13(f)(3), the transaction is recast: S is treated as having received B stock with a value of $500 in exchange for its assets and to have distributed the stock to P in liquidation, following which B redeems the constructive B stock for $150 in cash in a redemption governed by section 302.

The submission seems to be suggesting -- at least as one possible approach -- that one can extrapolate from this that a “D” reorganization between lower-tier subsidiaries involving neither stock nor boot (in reliance on the meaningless gesture doctrine) avoids the section 311(b) outcome described in Private Letter Ruling 9336029 (i.e., at least for federal income tax purposes under the consolidated return regulations).182 Thus, with reference to the facts of Private Letter Ruling 9336029, apparently the transaction between Target and Acquiring first would be recast as an all-cash reorganization. Following the lead of section 1.1502-13(f)(3), one then would construct a transfer of the assets of Target solely for stock of Acquiring that Target distributes to S in liquidation and that Acquiring then redeems, in its entirety, for the

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182 The balance of the discussion in the submission immediately following the passage quoted in the text above reverts to the all-cash “D” context (suggesting that the Clark approach embraced by section 1.1502-13(f)(3) may have application outside the consolidated return context in such cases) and does not further explicate the point made in the quoted passage about “D” reorganizations involving largely constructive acquirer stock and little or no cash.
cash deemed paid. Presumably, since the transaction did not in fact involve the payment of any cash, one further must assume that the cash deemed received by S3 (in redemption of constructive Acquiring stock) was then returned to Acquiring by way of a distribution of the (deemed) cash from S to P and capital contribution from P to S1 and from S1 to Acquiring. This characterization (though convoluted to a point where perhaps this was not what the authors intended) seemingly could provide a happy outcome, and there is nothing about it that seems peculiarly the domain of the consolidated return provisions. Thus, perhaps a good result would be provided both for federal income tax purposes (where, otherwise, it would seem that a deferred intercompany gain has been created) and for state income tax purposes (where, otherwise, gain might be recognized on a current basis). However, the Temporary D Reorg Regulations (issued since the submission), of course, would seem to otherwise resolve the question at least in the separate return context (requiring gain recognition under section 311(b)), and it seems far from clear that section 1.1502-13(f)(3) can be relied on for a different answer in the federal consolidated return context.183

183 In an interview with BNA, Inc. published in the BNA Daily Tax Report for March 27, 2007, IRS Associate Chief Counsel (Corporate), William Alexander told BNA that among the unresolved issues associated with the Temporary D Reorg Regulations “‘probably the closest claimant’ for immediate IRS Action involves how the regulations interact with [the] consolidated return regulations.” 58 Daily Tax Rep. G-2 (Mar. 27, 2007). Alexander stated, however, that “[he does not] even see that happening . . . [and is] not persuaded it needs a quick fix.” “My guess,” he stated, “is that we’ll work with what we have.”  

(continued...)
As a planning matter, certainly, unless the relevant tiers above the transferor entity are being collapsed, lower-tier reorganizations historically have been avoided. Indeed, even in a case where upper-tier entities are being collapsed, arguably care must be taken as to the ordering of events. Assume (reverting to the original hypothetical structure employed for purposes of this paper) that S transfers all of its assets to B in exchange for B stock (either actually or constructively) and liquidates, distributing B stock received (or deemed received) to Y. Assume, further, that as part of the same transaction, Y thereafter will liquidate as well. While there may be varying views on the subject, at a minimum there would appear to be a risk that the transaction does not qualify as a “D” reorganization (recognizing, of course, it may qualify under another provision of section 368). This is due to the fact that neither the transferor (S) nor its shareholder (Y) is in control of B immediately after the transaction. While the attribution rules may be relied upon to establish the requisite control, the concern would be that if neither the transferor nor the shareholder survives the transaction there is no entity to which to attribute control for

Among the other unresolved issues identified in the BNA article are the interaction of the rules with the continuity of interest doctrine, how the rules affect the liquidation-reincorporation doctrine and the effect of the no net value guidance project (see supra note 176).

184 See supra note 154 and accompanying text.

185 In at least one instance involving the issuance of a private letter ruling, the IRS expressed this view and ruled on the basis that the transaction was a good “C” reorganization rather than on the basis of qualification as a “D” reorganization.
these purposes. This is an unfortunate foot fault (if in fact it is a foot fault), since had the steps simply been reversed the issue would not seem to present itself. In other words, assume that first Y liquidates into P and thereafter S engages in its “D” reorganization with B. S’s shareholder (P) would be in control of B immediately after the transaction and (assuming all the other requirements under section 368 are satisfied) the transaction would qualify as a “D” reorganization.

As a final observation on the topic of “D” reorganizations, note the result if, on the facts above, S did not liquidate but rather continued to hold the intellectual property. The transfer of its operating businesses to B would not qualify as a section 368 reorganization and presumably, instead, would be treated as involving a section 301 distribution of the operating assets (with attendant consequences under section 311(b)) up the chain to P and contribution down the chain from P to B.\footnote{See supra note 129 and accompanying text. See, in general, supra Part III.B.} If, to the contrary, S were to purport to sell the assets to B for cash or other property, without more, it would appear \textit{that} form of the transaction should be respected. That is, the meaningless gesture principle as articulated in Revenue Ruling 70-240 and related case law would not appear to have sway in such a scenario. This would appear to be explainable by reference to the fundamental role that the liquidation step in the transactions examined in these cases played under subchapter C of the Code as it existed prior to the 1986 Tax
Reform Act repeal of the General Utilities doctrine and the relative motivations of the IRS and taxpayers during that era.187

IV. DEBT-EQUITY ISSUES ASSOCIATED WITH INTERCOMPANY DEBT.

Many large corporate groups have significant intercompany debt on their balance sheets. Certain affiliate loans may be evidenced by promissory notes; however, many will not. Those loans that are evidenced by promissory notes may take the form of demand obligations or may remain outstanding, in point of fact, long after the loan was to have been repaid under the terms of the note. Large intercompany balances may relate to intercompany trade payables that fail to be settled on any regular basis. All excess cash generated by a trading company may be swept to a finance affiliate with the cash sweep being credited as a receivable to the trading company and as a payable to the finance affiliate. No terms may have been established for the cash sweep. Certain members of the group could be in a continuous net-creditor position with ever-increasing receivables balances from affiliates. There may be a Treasury policy only for intercompany transactions involving the finance affiliate as a lender or borrower. Interest may be credited/charged on the books of the companies in some cases and in others not at all. Interest may be imputed for state

187 As well explained by Robert Willens in an article regarding the Temporary D Reorg Regulations published shortly after they were released. See Robert Willens, IRS Clarifies Contours of D Reorganizations, 114 TAX NOTES 227 (Jan. 15, 2007).
income tax purposes in those cases where it is necessary to avoid transfer pricing disputes with the states but not otherwise tracked.

In the normal course of dealing, while not perhaps ideal, in the context of the massive complexities of the business enterprise, the situation described above is not atypical and generally is not, and should not be, viewed as among the larger issues facing the business. However, in the context of developing a plan for restructuring the corporate group, it can present certain challenges.

Among the questions presented are: (i) whether one can assume the intercompany debt will be respected as indebtedness for federal income tax purposes and (ii) if not, whether the purported indebtedness should be presumed recast as equity or the original transactions giving rise to the purported indebtedness should be presumed recast as transactions involving dividends and capital contributions.

A. The Basic Debt-Equity Question.

It is beyond the scope of this paper to provide an extensive description and analysis of the federal income tax law on the debt-equity distinction. In general, the courts assess whether purported intercompany loan transactions “should be treated as loans, as equity, or as dividends”188 with resort to a non-exclusive list of factors, including: (1) whether there is a promissory note or other written agreement denominating a debt; (2) whether there is a

fixed maturity date; (3) the source of payments (e.g., whether there is anticipated cash flow or liquid assets to cover payments); (4) whether the creditor has the right to enforce payment; (5) whether the advance correlates to an increased participation in management of the debtor by the creditor; (6) whether the debt is subordinated; (7) the adequacy of the debtor’s capital structure in relation to the level of debt; (8) an identity of interest between creditor and stockholder; (9) the ability of the debtor to obtain credit from outside sources; (10) the level of risk involved in making the advances; and (11) whether the debtor makes scheduled payments with respect to the debt.\textsuperscript{189}

It would seem clear on the mix of facts portrayed above that in certain cases there may be a meaningful risk that the purported intra-group indebtedness will not be respected as debt for federal income tax purposes. Some of the scenarios that are described present the issue more starkly than others but quite generally debt between related parties invites “close scrutiny”\textsuperscript{190} and in that sense it therefore may be fair to say that none of the purported debt described above is wholly safe from recharacterization.

\textsuperscript{189} See Laidlaw Transportation, Inc. v. Commissioner, 75 T.C.M. (CCH) 2598 (1998); Nestle Holdings, Inc. v. Commissioner, 70 T.C.M. (CCH) 682 (1995) rev’d and remanded on other grounds, 152 F.3d 83 (2d. Cir. 1998).

\textsuperscript{190} Nestle Holdings, 70 T.C.M. (CCH) at 700; see also, Estate of Mixon v. United States, 464 F.2d 394 (5th Cir. 1972) and Peoplefeeders, supra note 188.
B. Possible Recharacterizations of Intercompany Debt.


Putative intercompany loan transactions that do not pass muster under a debt-equity analysis, may simply be recast as a dividend (e.g., a purported loan from subsidiary to parent is characterized as a dividend) or capital contribution (e.g., a purported loan by parent to subsidiary is recharacterized as a contribution to capital). This characterization can attach to cross-chain loans as well as parent-subsidiary loans. Thus, a purported loan from Y to sister company X might be recharacterized as a dividend by Y to P followed by a capital contribution of the amounts in question from P to X.\footnote{Note that, in order to bring cross-chain affiliate loans more clearly within the ambit of section 7872 (which by its terms is limited to corporation-shareholder cases), the proposed regulations under section 7872 would reconstruct a cross-chain affiliate loan as two loans: using the hypothetical fact pattern employed in this paper, a loan from Y to P and a second loan from P to X. Prop. Treas. Reg. § 1.7872-4(g). By analogy, then, if a cross-chain loan is determined to be equity, the first of the two constructive loans can easily be seen to constitute a dividend and the second of the two constructive loans can easily be seen as a capital contribution.} Among the relevant authorities are Peoplefeeders, Inc. and Subsidiaries v. Commissioner,\footnote{77 T.C.M. (CCH) 1349 (1999).} and Rapid Electric Co. v. Commissioner.\footnote{61 T.C. 232 (1973).}
In Peoplefeeders, restaurants owned and operated by Peoplefeeders and by its wholly-owned subsidiary, Square Pan Pizza (“Square Pan”), and by Square Pan’s various subsidiaries swept their cash receipts from their separate bank accounts into an intercompany bank account held under the name of Square Pan. All expenses of the group were paid out of this centralized account. Each year for a period of years, Peoplefeeders paid both operating expenses and certain loan payments to third parties out of the intercompany bank account in amounts exceeding its deposits into the account, effectively drawing against amounts deposited into the intercompany bank account by Square Pan and its subsidiaries. The record failed to reflect how initial cash receipts were recorded (if at all) but did show that entries were made in relation to inflows and outflows from the intercompany account in the form of debits and credits but with no elucidation beyond that. Neither Peoplefeeders nor Square Pan labeled Peoplefeeders’ draws against the intercompany bank account as loans until years later when the minutes from a board of directors’ meeting labeled them as loans. The purported loans were not evidenced by promissory notes and did not provide for interest or other payment terms or repayment dates. The subsidiary ultimately reported the parent’s draws on its cash deposits as uncollectible debts, and claimed a bad debt deduction under section 166, which was disallowed by the IRS on audit.\textsuperscript{194}

\textsuperscript{194} For the taxable year in question (1992), under section 1.1502-14(d) bad debt deductions were allowed upon cancellation of (continued...)}
The taxpayer argued that the parent had intended to repay the draws and that the draws therefore should be respected as giving rise to bona fide debt. In its brief, it referred to the “ebb and flow” of funds into and out of the intercompany bank account which the court dismissed as reflecting the “mere management of funds and cash flow . . . not the establishment of a genuine debt obligation.”195 The government argued that the evidence illustrated that the draws were merely a constructive dividend from the subsidiary to its parent, and the court agreed, noting, among other things, that “because of the absence of fixed maturity dates and repayment terms associated with the payment out of the intercompany bank account of Peoplefeeders’ expenses and loan payments, Square Pan had no means of establishing Peoplefeeders’

worthless debt obligations between affiliated corporate entities even though such entities filed consolidated federal corporate income tax returns. This regulation was generally effective for bad debt deductions claimed prior to July 12, 1995, and was removed for later years by amendments to the regulations as reflected in T.D. 8597, 1995-2 C.B. 147. Relying on the insolvency exception under section 108, Peoplefeeders took the position it was not required to recognize income relating to the cancellation of the debt. Further, on the 1992 consolidated corporate federal income tax return, Peoplefeeders took the position that, under section 108(b), no reduction in any tax attributes (specifically no reduction in the amount of the net operating loss that was claimed on the tax return relating to the claimed bad debt deduction) was required on petitioner’s tax return because the claimed bad debt deduction and the related net operating loss did not “belong to” Peoplefeeders (i.e., on the ground that the claimed bad debt deduction and the related net operating loss constituted attributes not of Peoplefeeders, but only of Square Pan).

195 Peoplefeeders, 77 T.C.M. (CCH) at 1355.
default and no basis for seeking to enforce repayment of alleged debt principal or payment of interest.” 196

In Rapid Electric Co., 197 Rapid Electric Puerto Rico supplied metal containers used in the housing of electrical rectifiers to a U.S. sister company, Rapid Electric New York (the two companies having a common sole shareholder) for incorporation into its manufacturing process. Rapid Electric Puerto Rico accounted for the sales transactions on its books by creating accounts receivable for the outstanding balances owed to it by Rapid Electric New York, which entered a corresponding accounts payable on its books. However, Rapid Electric New York was under some financial strain and did not make significant payments with respect to these sales-on-account and, after a period of several years, the outstanding accounts receivable on the books of Rapid Electric Puerto Rico owing from Rapid Electric New York had grown considerably.

The government argued that the increase in the accounts receivable balance should be treated as a constructive dividend from Rapid Electric Puerto Rico to the common shareholder (and capital contribution to Rapid Electric New York by the common

196 Id. See also Alterman Foods, Inc. v. U.S., 505 F.2d 873 (5th Cir. 1974) (cash advances made to parent corporation by wholly-owned subsidiaries shown on books of both subsidiaries and parent as debts outstanding but on which there were no interest charges, no set maturity, no notes of indebtedness, nor any apparent legal compulsion to repay the amounts outstanding or effort to force repayment held dividends from subsidiaries to parent, not loans).

shareholder). According to the government, the arrangement was a
tax-avoidance device meant to allow the common shareholder to
transfer earnings between its subsidiaries under the disguise of a
commercial transaction without the recognition of dividend
income.

The Tax Court stated that a “distribution by a corporation
can be treated as a dividend to its shareholder if it is made for his
personal benefit or in discharge of his personal obligations,” even
if the funds are not distributed directly to him, applying the share-
holder benefit test articulated in Sammons v. Commissioner noted
above (i.e., transfer of funds between related corporations will
constitute a dividend to a shareholder if it was made primarily for
his benefit and he actually received a direct or tangible benefit).198

However, the court held that the common shareholder did
not receive a constructive dividend because the advances neither
were made for the benefit of the common shareholder nor resulted
in a direct benefit to him. The court took into consideration that
Rapid Electric New York had made numerous payments against its
accounts payable balance (indeed, “to the fullest extent possible”)
and noted that, because of the common ownership of the affiliates,
it was not commercially material that Rapid Electric Puerto Rico
was carrying a significant accounts receivable balance on its
books.199 The court reasoned that this negated any inference that

198 Rapid Electric, 61 T.C. at 239. See supra Part III.B.
199 The court articulated the point in terms of inventory: “Either
Rapid Puerto Rico or Rapid New York had to carry the surplus inventory
(continued...)
the transfer was done for the benefit of the shareholder and concluded that any such benefit that may have occurred was merely derivative in nature: “[w]hether we classify the extension of credit as debt or as some other kind of investment, the working capital which was provided . . . remained in the corporate solution . . . [and] there is no indication that any of it was siphoned off to or for the benefit of [the common shareholder].”

2. Characterization of Cross-Chain Debt as Equity.

If a court considers a purported loan between affiliates to fail to qualify as debt for federal income tax purposes and yet declines to find the purported loan constituted a dividend to the common parent, then it follows that the purported loan constitutes a cross-chain equity interest (“some other kind of investment”) on the part of the “lender” in the “borrower” presumably constituting a form of non-voting stock.

of containers which were manufactured in order that Rapid Puerto Rico might meet its employment commitment to the Puerto Rican government. For all practical purposes, because of the common ownership of both corporations, it was immaterial which carried the surplus.” 61 T.C. at 239 and 240.

200 Rapid Electric, 61 T.C. at 240. See also Ross Glove Co. v. Commissioner, 60 T.C. 569 (1973) (non-interest bearing advances between brother-sister corporations do not constitute constructive dividend to common shareholder; “unnecessary to decide” whether advances were bona fide debt); Rushing v. Commissioner, 52 T.C. 888 (1969) (same). But cf. Davis v. Commissioner, 69 T.C.M. (CCH) 3004 (1995) (purported brother-sister loan evidenced by interest-bearing note with fixed maturity date held to be constructive dividend to shareholder who primarily benefited from transfer where debtor affiliate in poor financial condition such as to be unable to secure third-party loan).
In *Laidlaw Transportation, Inc. et al. v. Commissioner*, the issue for decision was whether advances made to Laidlaw Transportation and certain of its subsidiaries (“Laidlaw US”) by a Dutch affiliate, Laidlaw International Investments B.V. (“LIIBV”), were debt or equity and thus whether Laidlaw US was entitled to deduct payments to LIIBV for the years at issue denominated as interest (totaling over $133 million) as in fact constituting interest. Laidlaw US and LIIBV were under the common control of Laidlaw Transportation, Ltd., a Canadian corporation (“LTL”). The financing structure under examination included, as to certain of the loans in question, a “double dip” feature under which (oversimplifying) LTL would borrow from third party lenders and contribute the proceeds of the borrowings as equity (through an intermediary subsidiary) to LIIBV which would, in turn, loan funds to Laidlaw US. The intercompany lending activities were complicated. During the early years at issue, the loans between LIIBV and Laidlaw US were interest-bearing demand loans, and, in later years, in many instances instead were term loans (and outstanding demand loans were revised to provide for a fixed maturity date). The loan agreements did not have financial ratio covenants or borrowing limits. Some of them called for two loan accounts -- a “principal account” and a “reinvested interest

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201 75 T.C.M.(CCH) 2598 (1998).

202 Thus, the same economic capital would be generating interest deductions in Canada and the United States; Dutch tax on interest income received from Laidlaw US was minimized through the use of a Curacao branch.
account” (the latter to capture roll-over of interest due on the loans). All increases and decreases in loan amounts were entered on a grid promissory note. A substantial stand-alone loan also was made by LIIBV to Laidlaw US to finance an acquisition.203 In general, loan agreements and promissory notes between LIIBV and Laidlaw US included unconditional obligations to pay principal (on a date certain or on demand) and interest, stated that LIIBV’s rights were senior to the rights of the equity holders of the borrowers, did not authorize conversion of the loans into stock of the debtor and permitted LIBV to transfer the advance to third parties without restriction.

On the distinctly negative side, LIIBV repeatedly extended the due date for principal repayments. In fact, no principal payments were made under the loans over a period of several years and most of the loans involved an interest “reinvestment” feature.

The Tax Court tested the LIIBV loans to Laidlaw US against the debt-equity factors enunciated in Estate of Mixon v. United States204 (essentially the factors set forth at the beginning of this Part IV) and concluded that “the advances from LIIBV to petitioners for which petitioners claim to have paid the interest at issue are equity and not debt.”205 Of note was the extent of the court’s attention to considerations of the status and implications of

203 In addition, LTL itself made certain loans to Laidlaw US.
204 464 F.2d 394 (5th Cir. 1972), cited supra note 190.
205 75 T.C.M. (CCH) at 2624.
conduct being (and not being) at arm’s length,\textsuperscript{206} and the criticality, in the related party context, of following the terms that are established with respect to loans among affiliates. Indeed, while the court noted (with reference to \textit{Estate of Mixon}) that “[p]rovision for payment on demand without a fixed maturity date may indicate that an advance is equity,” it seemed more impressed (negatively) by the existence of \textit{term} loans not paid when due, noting that “[p]ostponing maturity dates for prolonged periods suggests that the nominal lender does not intend to require repayment and that the transfers are equity.”\textsuperscript{207}


\textsuperscript{207} \textit{Laidlaw Transp. Inc.}, 75 T.C.M. (CCH) at 2617 and 2618. The Tax Court methodically worked through each of the \textit{Estate of Mixon} factors finding (\textit{inter alia}) a lack of reasonably anticipated cash flow or liquid assets for repayment of advances, evidence of subordination of the advances to outside creditors, evidentiary issues as to the existence of a \textit{bona fide} intent for the advances to be loans (interest “reinvestment,” extensions of due dates, absence of security and restrictive covenants, etc.) and increasing debt to equity ratios (challenging the argument that this necessarily is to be determined with reference to the fair market values (as opposed to book values) of assets).

Of course, there are taxpayer successes in this area as well. See \textit{Nestle Holdings, Inc. v. Commissioner}, 70 T.C.M. (CCH) 682 (1995) (intercompany loans respected as debt where reasonable expectation of repayment existed). Indeed, the court in \textit{Nestle} expresses a somewhat tolerant stance toward related-party debt:

In evaluating the terms of related-party debt, we do not apply a mechanical test of absolute identity between the related-party advances and the debt that actually or hypothetically would have been available . . . , but, instead, we seek to determine whether the terms of the advances were a “patent

\textit{(continued...)}
C. The Implications of Equity Characterization in the Context of a Corporate Restructuring.

While anecdotal evidence suggests that some tax planners may take intercompany debt at its face value in devising a restructuring plan, once one accepts that there is a meaningful (however unclear) risk that some or all of the group’s intercompany indebtedness is susceptible to recharacterization as equity, the lid on Pandora’s Box is removed, not to be restored until the process of resolving all of the various potential implications has been completed.

Recall for example, the hypothetical case in which P owns all of the voting stock of X while Y owns all the non-voting stock of X. Z merges into P, following which P contributes certain of the Z assets to X for additional X voting stock. It was observed that the contribution of assets from P to X qualifies as a section 351 transaction only by reason of section 1.1502-34 and thus the contribution would be taxable in certain states. It is likely that the state income taxes triggered by the nonapplicability of section 351

distortion of what would normally have been available”... We have recognized that “different creditors invariably undertake different degrees of risk and that, where debtor and creditor are related, the lender might understandably offer more lenient terms than could be secured elsewhere.”

alone would provide sufficient reason to structure around this problem. However, as was further observed, far worse, prior to the recent revisions to section 1.368-1(d) and section 1.368-2(k), the contribution of assets from P to Z would have disqualified the merger from qualifying as an “A” reorganization, since the contribution would have failed to conform to section 368(a)(2)(C).208 Assume, on a variation of the facts, Y did not hold non-voting stock in X but rather held X debt subject to some of the frailties discussed above. If this debt were susceptible to characterization as equity, the equity interest presumably would have been treated as non-voting stock and the risk described above would have been present in the restructuring. Happily, in light of the October 2007 revisions to the section 368 regulations, this scenario is now relegated to the historically interesting only.

Again treating the X debt held by Y as equity, assume that X liquidates into P. Assume that a merger is not possible on the facts. Assume further that the X debt owed to Y qua equity represents 30 percent of the value of the X stock. Is P an “80 percent distributee” for purposes of section 337? Here, a favorable answer may be forthcoming. This is because the 80-percent test for this purpose relies on the section 1504(a) test (80 percent by vote and value), which test excludes from consideration section 1504(a)(4) preferred stock. It would seem that, on the assumption the X debt held by Y is really equity, it would be appropriate to characterize it as section 1504(a)(4) non-voting preferred stock. As noted earlier

208 See discussion beginning at page 21, supra.
in the paper, in order for stock to fall within section 1504(a)(4), it must be non-voting, non-convertible, non-participating -- i.e., “straight” -- preferred stock that is limited and preferred as to dividends and does not carry an unreasonable redemption premium. The X debt held by Y may or may not pay any interest and, further, of course, is not denominated preferred stock. However, the principle underlying the exclusion of “straight” preferred stock from the ambit of the section 1504(a) 80-percent test, ironically, no doubt is that “straight” preferred stock is too debt-like to be taken into account in determine the requisite level of affiliation for filing on a consolidated basis. This being so seems clearly to support characterization of the X debt held by Y, if treated as equity, as “straight” preferred stock coming within the operation of section 1504(a)(4). There is an apparent dearth of authority pertaining to the issue, however.

The question is also relevant to determining whether a liquidation qualifies as a section 332 liquidation at all. For a liquidating distribution to be considered a distribution in complete liquidation governed by section 332, the corporation receiving the property in liquidation is required to be, on the date of adoption of the plan of liquidation, and at all times thereafter, the owner of stock satisfying the section 1504(a)(2) 80-percent test. If the X debt held by Y is to be characterized as an equity interest in X, then, outside the consolidated return context, provided this equity interest in X represents more than 20 percent of the value of

209 See discussion supra at pages 15 to 19.
all outstanding X stock, the liquidation of X into P may or may not qualify under section 332, depending on whether Y’s interest in X can be excluded as section 1504(a)(4) preferred stock.

The risk of deemed equity especially can play havoc in the context of a restructuring where, for regulatory or other reasons, it is not possible to employ direct statutory mergers between corporations as the tactic of choice. Assume, for example, that the proposal is for X to merge into a single-member limited liability company owned by P and formed for purposes of the transaction that is intended to qualify as a “disregarded entity” for federal tax purposes.

Unless steps are taken to address X’s putative debt obligation to Y, P’s LLC will assume the obligation pursuant to the merger transaction. If the X debt is in fact equity, the effect of the transaction will be to render the LLC a partnership for federal income tax purposes, which would preclude treatment of the
merger as an “A” reorganization. \(^{210}\) Similar issues arise, of course, if the liquidation is effected through reliance on a conversion statute (i.e., \(X\) converts into a limited liability company intended to qualify as a disregarded entity of \(P\), by election under an applicable state statute such as the Delaware conversion statute). If one or more members of the affiliated group besides \(P\) is deemed to hold an equity interest in \(X\), the effect of the election under the conversion statute again would be to convert \(X\) into a partnership with attendant consequences that are at variance, of course, with the intended consequences.

Assume, with reference to the structure chart employed for purposes of this paper, that beneath \(S\) is subsidiary \(S_1\) and beneath \(S_1\) is subsidiary \(S_2\). Further assume that \(Z\) holds interests in each of \(S\) through \(S_2\) that, though denominated debt, are deemed to represent equity interests for federal income tax purposes.

\(^{210}\) An election could be made under section 7701 to treat the LLC as a corporation for federal income tax purposes and the transaction re-evaluated on that basis. However, the point in the text is the risk of an inadvertent outcome.
Y merges into X, following which S and its subsidiaries S1 and S2 liquidate in turn (mergers not being an option in this case for whatever reason). Under Resorts International Inc. v. Commissioner,\textsuperscript{211} this transaction will be recast as a series of

\textsuperscript{211} 60 T.C. 778, aff'd 511 F.2d 107 (5th Cir. 1975). In Resorts, the taxpayer acquired via statutory merger the assets of the Victor Paint Co., including the stock of dozens of subsidiaries. Shortly after the closing of the merger transaction, the taxpayer caused the majority of these subsidiaries to be liquidated and dissolved. The question before the court was whether the merger and subsequent liquidations should be treated as separate transactions governed by sections 368(a)(1)(A) and 332, respectively, or, as argued by the government, the liquidation of the subsidiaries and initial merger transaction should be considered together. So considered, the government argued, the merger would continue to be governed by section 368(a)(1)(A) “together with simultaneous reorganization between [taxpayer] and each of the dissolved subsidiaries as defined in section 368(a)(1)(C).” The effect of bringing the (continued...)
cross-chain asset transfers that do not fall within the operation of sections 332 and 337.\textsuperscript{212} Thus, beginning with S2 and continuing up the chain to Y, Y and its subsidiaries each in turn will be treated as transferring its assets to X in return for X stock and the assumption of its liabilities and then liquidating. It would appear

\begin{quote}
liquidations within 368(a) would be to bring them within the operation of the loss carryover limitations of then applicable section 382. Indeed, for the years at issue, section 1.382(b)-1 specifically provided that “a series of transactions which purport to be a reorganization qualifying under section 368(a)(1)(B) followed by a liquidation qualifying under section 332, but which in substance comprise a reorganization qualifying under section 368(a)(1)(C) will be considered as [in relevant part, a transfer to which 361(a) rather than section 332 applies]. “The court held for the government finding the principle of the provision equally applicable where the initial transaction is cast in the form of an “A” reorganization rather than a “B” reorganization. See also Priv. Ltr. Rul. 9108062 (Nov. 30, 1990) (statutory merger of target into acquirer followed by statutory merger of target subsidiary into acquirer recharacterized as “C” reorganization between target subsidiary and acquirer followed by “A” reorganization of target into acquirer); Priv. Ltr. Rul. 8802061 (Oct. 20, 1987) (exchange of target stock for acquirer stock followed by liquidation of target recast as “D” reorganization of target); Priv. Ltr. Rul. 8601008 (Aug. 30, 1985) (exchange of target stock for acquirer stock followed by series of liquidations of target subsidiaries into immediate next tier subsidiary parent recast as series of “C” reorganizations); Priv. Ltr. Rul. 7924067 (Mar. 16, 1979) (acquisition of stock of lower tier subsidiaries in “D” reorganization followed by liquidation of those subsidiaries viewed as “C” reorganizations despite no additional stock issuance by acquirer on cancellation of stock of lower-tier subsidiaries). Cf. Rev. Rul. 67-274, 1967-2 C.B. 141.

\textsuperscript{212} Contrast Rev. Rul. 58-422, 1958-2 C.B. 145 (parent seeking to reincorporate in new state and to acquire and operate directly assets and businesses of two wholly-owned subsidiaries effecting same by merger of parent and subsidiaries into new corporation organized by parent with new corporation as sole surviving entity constitutes “F” reorganization (even though also an “A” reorganization) as to parent and section 332 liquidation of two subsidiaries).
that the transfers of assets by S and its subsidiaries may not qualify as “D” reorganizations. In each case, immediately after the transfer, neither the transferee nor its shareholder will be in control of X -- doubly so since (1) the shareholder of each transferee disappears into X, and (2) the control requirement of section 368(a)(1)(D) cannot be satisfied.

Moreover, if Z’s interest in each of the liquidating entities is classified as a form of non-voting stock, X’s assumption of that “liability” of the liquidating entity may be seen as an issuance of non-voting stock of X in the exchange, potentially precluding characterization of the transaction as a “C” reorganization. All is not lost if the “A” statutory merger route is available (e.g., following the merger of Y into X, S and its subsidiaries merge seriatim into X), but, as in the case posited, there may be circumstances in which that option is not available.

Appreciation of the possible issues presented by intercompany debt that has some susceptibility to reclassification as cross-chain equity may lead instinctively to a desire to “clean

213 See discussion, supra at note 185 and accompanying text.

214 See Rev. Rul. 74-605, 1974-2 C.B. 97 (subsidiary cannot have section 304(c) control of parent in light of section 1.318-1(b)(1) prohibition on corporation being considered to own its own stock).

215 See section 368(a)(1)(C) and section 368(a)(2)(B).

216 This notwithstanding Private Letter Ruling 9108062, supra note 186 (characterizing statutory merger of target subsidiary as “C” rather than “A” reorganization), since under the facts of the ruling nothing turned on the distinction, a purported section 332 liquidation can, after all, be effected by statutory merger, and the section 382 regulation at the time implicated “C” reorganization treatment.
things up” on the front end of the restructuring plan. The better instinct, however, may be to work through each piece of intercompany debt in a methodical manner, with an aim to devising a restructuring plan that is immune to the effects of any such reclassification.

Assume, for example, that S has gross assets worth $100x and no liabilities other than an undocumented payable to Z in the amount of $80x. Assume that there is a concern that the debt owed to Z may constitute equity for federal income tax purposes. In an attempt at a draconian solution to debt-equity concerns, S’s debt to Z is reduced to a written obligation taking the form of a short-term promissory note bearing an arm’s-length rate of interest that is intended to better evidence that the payable qualifies as indebtedness for federal income tax purposes. (This same “fix” is installed for all other intercompany indebtedness outstanding among the members of the group.) As part of the same overall plan, S merges into B following which Y liquidates.

As noted above, in light of the fact that neither the transferor (S) nor its shareholder (Y) is in control of the transferee (B) immediately after the transaction, arguably the transaction fails to qualify as a “D” reorganization even if the S payable to Z were to be respected as indebtedness for federal income tax purposes. Assuming, however, that the S payable to Z is not so treated but the replacement note is respected as true debt, the effect of the issuance of the promissory note may be to preclude the transaction from satisfying the requirement applicable to “C” as well as “D” reorganizations that the acquirer (B) acquire substantially all of the
assets of the transferor (S). Finally, for the reasons discussed above, assuming no B stock is issued, the transfer by S of its assets to B would not appear to qualify as a section 351 contribution even for federal income tax purposes, notwithstanding section 1.1502-34. This leaves for consideration possible qualification as an “A” reorganization. The issue regarding qualification as an “A” revolves around the continuity of interest requirement.

Section 1.368-1(e)(1) provides that the purpose of the continuity of interest requirement is “to prevent transactions that resemble sales from qualifying for nonrecognition of gain or loss available to corporate reorganizations.” The requirement is that a substantial part of the value of the proprietary interests in the target corporation be preserved in the reorganization. A transaction in which 40 percent of the consideration paid to target shareholders is

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217 See sections 368(a)(1)(C) and 354(b)(1)(A). Alternatively, the characterization of the exchange by Z of its receivable from S for an S promissory note (subsequently assumed by B) as the redemption of a Z equity interest in S may cause the transaction to fail to qualify as a “C” reorganization if the issuance of the note in redemption of the Z “equity” in S is integrated with the merger transaction and treated as boot in the exchange in excess of the permissible tolerances (under section 368(a)(2)(B)) for a “C” reorganization. See Rev. Rul. 75-360, 1975-2 C.B. 110. (This characterization should not preclude “D” treatment if otherwise available.)

218 See discussion above at pages 14-15.

219 Section 1.368-1(e)(1)(i) states that a proprietary interest in the target corporation is preserved “if, in a potential reorganization, it is exchanged for a proprietary interest in the issuing corporation . . . , it is exchanged by the acquiring corporation for a direct interest in the target corporation enterprise, or it otherwise continues as a proprietary interest in the target corporation.”
stock of the acquiring corporation satisfies the continuity of interest requirement,\textsuperscript{220} whereas a transaction involving only 20 percent acquirer stock does not.\textsuperscript{221} A proprietary interest in the target corporation is not preserved “if, in connection with the potential reorganization, it is acquired by the issuing corporation for consideration other than stock of the issuing corporation, or stock of the issuing corporation furnished in exchange for a proprietary interest in the target corporation in the potential reorganization is redeemed.”\textsuperscript{222}

Likewise, a proprietary interest in the target corporation is not preserved to the extent the consideration received prior to a potential reorganization, either in a redemption of the target corporation stock or in a distribution with respect to the target corporation stock, is treated as other property or money received in

\textsuperscript{220} Section 1.368-1(e)(2)(v), Ex. 1.

\textsuperscript{221} Section 1.368-1(e)(2)(v), Ex. 3.

\textsuperscript{222} Section 1-368-1(e)(1)(i). For purposes of the continuity of interest requirement, a mere disposition of stock of the target corporation prior to a potential reorganization to persons not related (as defined in section 1.368-1(e)(4)) determined without regard to in section 1.368-1(e)(4)(i)(A)) to the target corporation or to persons not related (as defined in section 1.368-1(e)(4)) to the issuing corporation is disregarded and a mere disposition of stock of the issuing corporation received in a potential reorganization to persons not related (as defined in section 1.368-1(e)(4)) to the issuing corporation is disregarded. Section 1.368-1(e)(4)(i) provides that two corporations are related persons if (A) they are members of the same affiliated group as defined in section 1504 (disregarding section 1504(b), or (B) a purchase of the stock of one corporation by another corporation would be treated as a distribution in redemption of the stock of the first corporation under section 304(a)(2) (determined without regard to Sec. 1.1502-80(b)).
the exchange for purposes of section 356 (or would have been if the target shareholder also had received stock of the issuing corporation in exchange for stock owned by the shareholder in the target corporation).223

A literal application of these provisions to the case posited thus would suggest that the transaction may fail to satisfy the continuity of interest requirement. That is, on the facts above, Z’s receipt of a promissory note for its $80x interest in S qua equity may constitute an exchange of stock for boot in the merger to an extent (80 percent) that precludes qualification of the transaction as an “A” reorganization. Yet, section 1.368-1(e)(3) gives some pause. It provides (emphasis added) as follows:

(3) Related person acquisitions.—A proprietary interest in the target corporation is not preserved if, in connection with a potential reorganization, a person related (as defined in paragraph (e)(3) [sic] of this section) to the issuing corporation acquires, with consideration other than a proprietary interest in the issuing corporation, stock of the target corporation or stock of the issuing corporation furnished in exchange for a proprietary interest in the target corporation in the potential reorganization, except to the extent those persons who were the direct or indirect owners of the target corporation prior to the potential reorganization maintain a direct or indirect proprietary interest in the issuing corporation.

223 Section 1.368-1(e)(1(ii)).
Thus, section 1.368-1(e)(3) effectively provides that, to the extent those persons who were the direct or indirect owners of the target prior to the potential reorganization “maintain a direct or indirect proprietary interest in the issuing corporation,” a proprietary interest in the target corporation is preserved even if, in connection with a potential reorganization, a person related to the issuing corporation acquires stock of the target or stock of the issuing corporation issued in exchange for target stock in return for cash or other non-qualifying consideration.

For example, assume that S did not issue a promissory note to Z prior to S’s merger into B. Rather, following the merger, X (B’s parent) acquires Z’s interest in B (the putative S payable assumed by B in the merger that we are treating as equity for purposes of this discussion) for cash or a promissory note. According to section 1.368-1(e)(3), the requisite continuity of proprietary interest is preserved in this case, since P was the indirect owner of all of the S stock prior to the merger and P maintains a 100 percent indirect proprietary interest in B following the merger. There would appear to be no logical basis, then, for suggesting that the earlier case fails to satisfy the continuity of interest requirement, given P’s ultimate ownership of all of the constitutive assets of the affiliated group before and after the merger of S into B, and yet arguably it does.224

224 Nor do analogous authorities serve to resolve the issue. In Revenue Ruling 84-30, 1984-1 C.B. 114, declared obsolete by Rev. Rul. 2003-99, 2003-2 C.B. 388, corporation X owned all of the stock of Y and
Of course, on the other hand, the logical extension of any notion that the transaction described above qualifies as an “A” reorganization is that close to a nearly all-cash merger between commonly controlled affiliates can qualify under section 368(a) outside of the “D” reorganization context, whereas it would seem the all-cash section 368 reorganization normally is thought of as the exclusive province of the all-cash “D.” That is, the implication becomes that the continuity of interest requirement effectively is

Z and Z, in turn, owned all of the stock of N. N transferred substantially all of its assets to Y in exchange for shares of Y voting stock and the assumption by Y of its liabilities and then liquidated, distributing the Y stock received to Z. However, Z immediately distributed the Y stock to X and this presented the issue as to whether continuity of interest was preserved. Section 1.368-1(b) as then in effect required a continuity of interest on the part of those persons who “directly or indirectly” were the owners of the enterprise prior to reorganization. (Section 1.368-1(e)(3) reflects the same principle.) The revenue ruling considered Z to be the clear “indirect” owner of the N enterprise and addressed whether X also qualifies as an indirect owner of the N enterprise, holding that it does since the distribution by Z of the Y stock to X “does not result in a change in X’s aggregate interests,” given the fact that X was the 100 percent parent of Z, which, in turn, owned all of N. Section 1.368-1(e)(7), Ex. 8, is to the same effect. See also Rev. Rul. 62-138, 1962-2 C.B. 955 (successive section 355 distributions of Newco stock representing incorporation of one of two operating divisions satisfies continuity of interest requirement). Along similar lines, Revenue Ruling 95-69, 1995-1 C.B. 440, holds that satisfaction of the continuity interest requirement is not affected by a partnership’s distribution of stock received in a reorganization to its partners in accordance with their interests in the partnership. Under the facts of both rulings, of course, the ultimate owners of the business enterprise are brought into closer proximity to it by way of the reorganization transaction. As noted, these rulings under the predecessor to the current continuity of interest regulations ultimately do not advance an evaluation of the hypothetical case under consideration much (if at all) beyond a consideration of section 1.368-1(e)(3) itself.
read out of the law in the case of intra-group reorganization transactions. The author knows of no authority that goes that far. However, in light of the many liberalizations\textsuperscript{225} to the section 368 rules in recent years -- which taken together, provide considerable leeway as regards movements of assets among members of a “qualified group” -- it seems the better answer is that there should be no continuity of interest problem on the facts posited.

V. CONCLUSION.

Large-scale corporate restructurings generally involve complex and varied issues requiring careful consideration from

\textsuperscript{225} Among these one would count the large-scale revisions to the continuity of interest regulations made in 1998 (see T.D. 8760, 1998-1 C.B. 803), the more recent establishment of the “signing date rule” (see T. D. 9225, 2005-42 I.R.B. 716; REG. 146247-06, 72 Fed. Reg. 12980; the 1998 revisions to sections 1.368-1(d) (relating to the COBE requirement), 1.368-2(f) and 1.368-2(k) (relating to status as a “party to a reorganization” and permitted transfers under section 368(a)(2)(C)); Rev. Rul. 2002-85, 2002-2 C.B. 986 and Rev. Rul. 2001-24, 2001-1 C.B. 1290 (effectively extending application of section 368(a)(2)(C) to “D” reorganizations and forward triangular mergers under section 368(a)(2)(D), respectively); Rev. Rul. 2001-25, 2001-1 C.B. 1291 (“substantially all” test applicable to reverse subsidiary merger under section 368(a)(2)(E) met notwithstanding sale by surviving corporation of half its operating assets for cash that it retains); Rev. Rul. 88-48, 1988-1 C.B. 117 (“substantially all” test applicable to “C” reorganization met even though immediately prior to transfer target sold half its historic business assets for cash and transferred cash to acquirer instead of historic assets); and the 2007 revisions to section 1.368-1(d) (expanding the definition of “qualified group” to allow qualified group members to aggregate their direct stock ownership of a corporation for section 368(c) control purposes) and the revisions to section 1.368-2(k) (expanding permitted subsequent transfers of stock or assets to transactions otherwise qualifying as a reorganization, so long as the COBE requirement is satisfied) finalized by T.D. 9361 (Oct. 25, 2007)).
multiple perspectives: With an eye on the limits to the validity of
the assumption that “states follow federal,” planning must proceed
assuming in the alternative the applicability and non-applicability
of provisions of the Code and consolidated return regulations, and
in close collaboration with state tax advisers. With an eye on the
risk that certain intercompany indebtedness may be susceptible to
recharacterization as equity for federal income tax purposes,
planning must proceed assuming in the alternative that inter-
company indebtedness is and is not respected as debt for federal
income tax purposes (given the stakes involved, even if the risk is
perceived to be relatively small). The issues confronted as part of
that analysis can provide a microcosm of the vast array of highly
technical issues arising under subchapter C of the Code in
connection with the formulation of a plan of reorganization. These
issues run the gamut from the limits of section 1.1502-34 to the
limitations of the “qualified group” concept (albeit, these now have
been substantially relaxed), from the implications of transfers,
assumptions and extinguishments of intercompany debt to securing
that no deferred intercompany gains are triggered by any of the
steps in the plan. Planned (and unplanned) intercompany transfers
of assets can have varying tax effects that may depend on slight
differences in form, and the sequencing of steps, as well as step
transaction considerations (such as highlighted in Resorts
International), can affect the tax consequences of the restructuring.

As to “D” reorganizations, it would appear the drafters of
the Temporary D Reorg Regulations may have had the case of the
“all-cash D” too prominently in mind when formulating the
regulations. While at the time this paper was originally presented there was considerable focus on the “all-cash D” case in the wake of Private Letter Ruling 200551018, additional guidance as to the treatment of net value “D” reorganizations (involving little or no cash or other ostensible consideration apart from an assumption of liabilities and relying on the meaningless gesture doctrine for a constructive issuance of acquirer stock) would be welcome as well. As noted elsewhere, the IRS and the Treasury Department have signaled that a broad study of issues relating to acquisitive “D” reorganizations is in the offing and have indicated the possibility of changes to the rules upon completion of the broader study. Finally, intra-group restructurings involving entities all under the common control of the common parent of a consolidated return group put pressure on the logic of some of the doctrinal requirements for qualification of a transaction as a section 368 reorganization that were developed in the context of transactions involving unrelated parties.

The goal of the tax planner -- while never losing sight of the basic business motivations and objectives that generated the project in the first place -- is to devise a restructuring plan that balances all of the foregoing considerations, as well as numerous practical, structural and regulatory considerations and constraints,

226 See supra notes 177 and 183 and accompanying texts.
and yields a favorable outcome when tested under each. The devil, of course, is in the details.\textsuperscript{227}

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\footnotesize
\textsuperscript{227} This saying is a variation on the original expression “God is in the details” generally attributed to Gustave Flaubert. See Martin H. Manser & Rosalind Fergusson, \textsc{The Facts on File Dictionary of Proverbs} 46 (Facts on File 2002). However, resort to the original saying in this context, no doubt, would have been in questionable taste.
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