REPORT #823

TAX SECTION

New York State Bar Association

Report on Notice 94-93 ("Inversion Transactions")
and Rev. Proc. 94-7 6 ("Downstream Reorganizations")
January 31, 1995

Table of Contents

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January 31, 1995

Hon. Leslie B. Samuels
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Hon. Margaret M. Richardson
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re: Inversion Transactions and Downstream Reorganizations

Dear Secretary Samuels and Commissioner Richardson:

Enclosed is a Report by the New York State Bar Association Tax Section commenting on issues arising under:

(1) Notice 94-9 3, relating to corporate “inversion transactions” in which a parent corporation (P) becomes a subsidiary of its former subsidiary (S); and

(2) Rev. Proc. 94-76, relating to the combination of P and S where P initially owns stock of S but less than 80% of S.

Both issues relate to the question of whether the failure of P to recognize any appreciation in its S stock at the time of the transaction is inconsistent with the repeal of the General Utilities doctrine.

The Report reaches the following conclusions, among others:

1. If P owns 80% of S, there should generally be no consequences to the inversion transaction as long as P retains S stock with the "correct" value.

2. If P owns 80% of S, and following an inversion transaction P owns less than the "correct" amount of S stock, P should immediately recognize an appropriate portion of the built-in gain in its S stock, but the shareholders of P should be unaffected.

3. If P owns less than 80% of S, and an inversion transaction results in S owning 80% of P, P should be required to immediately recognize the built- in gain in its S stock.

4. Assuming an authority question is favorably resolved (as it should be), if P owns less than 80% of S and P merges into S, or S acquires P assets in a (C) reorganization, P should be required to immediately recognize the built-in gain in its S stock.

5. If P owns less than 80% of S and S merges into P, P should not be required to recognize gain in its S stock.

We acknowledge that our proposed line-drawing between taxable and nontaxable transactions will in some cases put a premium on the form of a transaction, but we believe it is impossible to eliminate all formal distinctions in this area. We believe our proposal fairly balances the competing principles at stake.

We hope the analysis contained in this Report is helpful. Please let us know if we can be of further help in the development of regulations in this area.

Very truly yours,

Michael L. Schler

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NEW YORK STATE BAR ASSOCIATION

TAX SECTION

COMMITTEE ON CORPORATIONS

Report on Notice 94-93 (“Inversion Transactions”)

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NEW YORK STATE BAR ASSOCIATION

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COMMITTEE ON CORPORATIONS

Report on Notice 94-93 (“Inversion Transactions”) and Rev. Proc. 94-7 6 (“Downstream Reorganizations”)[1]

January 31, 1995

I. Introduction

On September 22, 1994, the Internal Revenue Service (the “Service”) issued Notice 94-93, 1994-41 I.R.B. 8, announcing that regulations would be issued concerning the tax consequences of corporate inversions, i.e., transactions that reverse, in whole or in part, the positions of related corporations. The concern expressed in Notice 94-9 3 is that an inversion transaction may improperly create losses or permit the avoidance of income or gain in circumvention of the repeal of the General Utilities doctrine. Notice 94-93 states that the regulations will require the recognition of income or gain, or adjustments to basis, where appropriate to prevent such results.

On December 14, 1994, the Service issued Rev. Proc. 94¬76, 1994-52 I.R.B. 30, in which it announced that, pending a study of the issue, it would no longer issue advance rulings on

[1] This Report was drafted by Steven C. Todrys, Co-Chair of the Committee on Corporations, with the assistance of Stephen B. Land, Pinchas Mendelson (who also derived the formulas in footnote 4) and Yaron Z. Reich. Helpful comments were received from Peter C. Canellos, Charles I. Kingson, Richard O. Loengard, Jr., Richard L. Reinhold and Michael L. Schler

the tax consequences under section 368 or other provisions of the Internal Revenue Code (the "Code") on transactions in which one corporation owns stock in another corporation, the first corporation is not an "80-percent distributee" of the second corporation under section 337(c) and the two corporations are combined. The Service's concern relates to the avoidance of corporate-level tax on the stock of the second corporation owned by the first corporation in light of General Utilities repeal. While not stated, the presumed reason for the exclusion of an "80-percent distributee" from the no-rule policy is that the two corporations could have combined in a tax-free liquidation under sections 332 and 337.

This Report addresses the tax consequences of inversion transactions described in Notice 94-93[2] and the treatment of "downstream" reorganizations in light of the issues raised by Rev. Proc. 94-76.

II. Background

1. Complete Inversions

The focus of Notice 94-93 is the following example, which deals with a "complete" inversion transaction, i.e., one in which a wholly-owned subsidiary becomes the parent corporation of its former parent:

> Example 1: P, a corporation, owns 100% of the stock of S. P's assets, other than its stock of S, have a value of $300. S's assets have a value of $100. P's basis in the stock of S is $85. P's

[2] The Report does not address certain tax issues raised by inversion transactions that involve foreign corporations, such as problems under sections 367 and 1248(i). See Notice 94-46, 1994-18 I.R.B. 7. Those issues were addressed in our "Report on Notice 94-46 Relating to Certain Outbound Stock Transfers," reprinted at 65 Tax Notes 913 (November 14, 1994).

> shareholders exchange all of their stock of P for stock of S, resulting in S being owned partly by P's shareholders and partly by P by reason of its prior ownership of S.

The issue addressed by Notice 94-93 is the determination of the proper percentage of shares of S to be owned by P's shareholders, on the one hand, and P, on the other hand.[3]

In a complete inversion, P's shareholders are largely indifferent to the percentage of shares issued in the transaction, since they economically retain 100% ownership of the P-S group. However, if the S shares owned by P after the inversion transaction have a value that is less than the value of the S shares owned by P prior to the transaction, the Notice concludes that (i) P may be able to recognize an uneconomic loss on a sale of S shares and (ii) S may be able to dispose of P without properly recognizing gain related to P's ownership of S. On the other hand, the Notice suggests that, where the value of P's stock in S is unchanged after the inversion, the potential for these abuses does not exist.

> <u>Example 2</u>: P's shareholders receive 80% of the stock of S in exchange for their P stock, and P retains 20% of the stock of S.

On the facts of Example 1, the Notice concludes that a 20/80 split in the stock ownership of S between P and P's shareholders preserves the $100 pre-inversion value of P's stock in S. This

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[3] There are a number of different variations in the events that can give rise to an inversion transaction. For example, the shareholders of P may transfer their P stock to S in exchange for S stock in a taxable transaction, a section 351 transaction or a B reorganization. Alternatively, P might merge with a subsidiary of S in a section 368(a)(2)(D) or (a)(2)(E) reorganization in which P shareholders receive S stock.

conclusion can be supported in two ways: the sale analysis and the liquidation analysis.[4]

Under the sale analysis (upon which the Notice relies), the question is whether P would be able to sell its stock in S after the inversion to a third party for $100. According to the Notice, this determination would be made without regard to market constraints, such as whether there is an adequate market for S stock, or whether discounts or premiums would apply to the sale of P's S shares. After the inversion transaction, S's assets consist of its own assets of $100 plus 100% of the stock of P (which has $300 of its own assets plus 20% of the S shares). A purchaser of P's S shares should pay $100 for those shares since, after the purchase, P's assets will be worth $400 and, as a result, the value of S will be $500. Thus, the purchaser's 20% interest in S will be worth $100. P's value in its S shares has been preserved.

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[4] The sale and liquidation analyses are only “proofs” of the mathematical determination of the proper cross ownership percentage. The mathematical formula for a complete inversion case is derived from the formula for partial inversions where P's shareholders retain some shares of P (and where, therefore, the percentage of shares of S owned by P is meaningful to P's shareholders). That formula is:

$$P = \frac{(1-q)\ VG}{(1-q)\ VG + Vs}, \text{ where}$$

p = percentage of S stock to be issued to SH
VG = value of P + S
Vs = value of S
q = percentage of P shares retained by SH

In the complete inversion case, q = 0. Setting q to zero in the above formula yields the formula for complete inversions:

$$P = VG / (VG + Vs)$$

An extensive mathematical analysis of cross ownership is contained in Land, “Strange Loops and Tangled Hierarchies,” 49 Tax Law Rev. 53 (1993).

The liquidation analysis tests whether, in a liquidation of P and S, P would receive $100 of distributions in respect of its S stock. This analysis requires an iteration, since amounts distributed to S in liquidation of P are, to the extent of P's ownership in S, redistributed to P, and then back to S and so on. In Example 2, where P owns 20% of S, P initially distributes $300 to S and S distributes $400 to its shareholders, of which 20% ($80) goes to P. P then distributes this $80 to S, which S distributes to its shareholders, of which 20% ($16) returns to P. The iteration that follows is: 16 x .20 = 3.20; 3.20 x .20 = .64; .64 x .20 = .128; .128 x .20 = .0256; .0256 x .20 = .00512; etc. Thus, the total distributed to P in respect of its S stock is $100, again demonstrating that P's value in the S stock is preserved.

> <u>Example 3</u>: P's shareholders receive 90% of the stock of S in exchange for their P stock, and P retains 10% of the stock of S.

In Example 3, P's value in the stock of S has not been preserved. Under the sale analysis, a purchaser will only pay $44.44 for P's stock in S. That price will give S a value of $444.44, of which the purchaser will own 10%. Under the liquidation analysis, P's stock in S is also worth $44.44. P would receive $40 in the initial distribution from S and the iteration that follows is: 40 x .10 = 4.00; 4.00 x .10 = .40; .40 x .10 = .04; etc. The total distributed to P in respect of its S stock would be $44.44.

If the 10/90 split in Example 3 is permitted, (i) P could recognize a loss of $40.56 on a sale of its S stock, despite the fact that prior to the inversion transaction it had a $15 unrealized gain in its S stock and (ii) S could sell P for $344.44, rather than its pre-inversion value of $400, possibly facilitating a split-up of the P-S group at a reduced tax cost. Notice 94-9 3 does not describe in detail the manner in which this problem will be addressed, other than generally through income recognition or basis adjustment.[5]

2. Partial Inversions

Notice 93-94 does not contain an example involving a “partial” inversion transaction, i.e., one in which either P's shareholders transfer less than 100% of the stock of P to S or in which S has minority shareholders prior to the inversion transaction. In either case, the existence of minority shareholders at either P or S should assure that P retains the proper percentage of S stock. Therefore, unless P shareholders own all of S and each transfers a pro rata portion of its P stock to S, a partial inversion generally will not present the same potential for abuse as a complete inversion.

> Example 4: Assume, in Example 1, that there are two shareholders of P, SHI and SH2. SHI transfers 80% of the stock of P to S, and 20% of the stock of P is retained by SH2 after the transaction.[6]

SHI should receive 76.2% of the stock of S in exchange for 80% of the stock of P (leaving 23.8% of S owned by P), and SH2 has an economic stake in assuring that SHI receives no more than that percentage of S stock. Prior to the partial inversion, SH2's stock in P has a value of $80, which must be preserved after the inversion. Since P's assets aside from its stock in S have a value of $300 (in which SH2 owns a 20% interest worth $60), P's

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[5] The Service has recently revoked private letter rulings apparently involving dilutive inversion transactions. PLRs 9502023 and 9502025.

[6] The same analysis will apply if the P shareholders transfer 80% of their stock of P to S, and retain 20% of their P stock, on a pro rata basis.

stock in S must have a value of $100 (in which SH2 would own a 20% interest worth $20) in order to preserve the value in SH2's P stock.

P's 23.8% interest has a $100 value under both the sale and liquidation analyses. Under the sale analysis, a purchaser would pay $100 for P's S stock. The purchase would cause P's assets to have a value of $400, 80% of which ($320) would be attributable to S's stock ownership in P. When added to S's separate assets of $100, the total value of S becomes $420, of which 23.8% equals $100.

Under the liquidation analysis, SH2 would receive $60 (20% of P's separate assets of $300) in the initial distribution from P, with P's remaining assets ($240) distributed to S. Combined with S's separate assets of $100, S distributes $340 to its shareholders, of which 23.8% ($80.92) is returned to P. The iteration that follows in determining the remaining assets distributed to SH2 is: 80.92 x .20 = 16.18; 64.74 x .238 x .20 = 3.08; 12.33 x .238 x .20 = .59; 2.35 x .238 x .20 = .11; etc. Thus, the total distributed to SH2 in respect of its P stock would be $80.

Likewise, valuation issues should not arise where there is a minority interest in S.

> <u>Example 5</u>: Assume, in Example 1, that X owns 20% of S, and P's shareholders transfer 100% of their P stock to S.

P's shareholders should receive 79.166% of the stock of S in exchange for their P stock, leaving P with 16.666% of S and X with 4.166% of S. X will assure that the pre-inversion value of its S stock ($20) is preserved post-inversion. X's interest in the assets of S and P (not taking into account P's stock in S) is $16,666 ($400 x .04166) and, therefore, its interest in the S stock owned by P post-inversion must be $3.33.

Under the sale analysis, a purchaser would pay $80 for the S stock owned by P. The $80 payment would cause the combined assets of P and S to be $480, of which the purchaser would own 16.666% worth $80. X's share of that $80 increment (4.166%) would be $3.33.

Under the liquidation analysis, X would receive $16,666 in the initial distribution by S ($400 x .04166) and $66.67 ($400 x .1666) would be distributed to P. The iteration that follows in determining the remaining assets distributed to X is: 66.67 x .04166 = 2.777; 11.11 x .04166 = .463; 1.85 x .04166 = .077; etc. Thus, the total distributed to X in respect of its S stock would be $20.

3. Alternative Analyses of Inversions

Even if an inversion transaction preserves the value of the S shares owned by P under the sale and liquidation analyses, it has been suggested that the inversion results in a distribution of assets from P. There are two theories for this result.

a. Liquidation Analysis. Note that the inversion substitutes for P's pre-inversion direct interest in S's assets an indirect interest in P's own assets. Thus, P could be viewed as reacquiring (redeeming) its own stock in exchange for a portion of its interest in S. This observation is demonstrated by the liquidation analysis.[7]

Example 4 can be used to illustrate this effect that even a “fair value” inversion is in a sense equivalent to a redemption by P of its stock using S stock. In that example, SH1, the 80% shareholder of P, exchanges its stock of P for 7 6.2% of the stock of S. Following the inversion, SHI has a $94.10 interest in S's separate assets and a $225.90 interest in P's separate assets.[8] This is the same result that would have occurred had P distributed 7 6.2% of the stock of S to SHI in redemption of a portion of SH1's stock in P. In that case, SH1's interest in P would have been reduced by the redemption from 80% to 75.3%.[9] SH1's interest in S's separate assets would be $94.10, comprised of its direct interest of $76.20 and its indirect interest through P of $17.90 (75.3% of $23.80). SH1's interest in P's separate assets would be $225.90 (75.3% of $300).

However, there are significant differences between the inversion and redemption transactions. In the inversion transaction, SHI has stock ownership only in S and its interest

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[7] Under the liquidation analysis, P is treated as receiving distributions in respect of its S stock that include its own assets previously distributed to S.

[8] On a liquidation of S, SHI would receive $7 6.20 of S's separate assets in the initial distribution. S's remaining assets would be distributed to P, and the iteration that follows is: 23.80 x .80 x .762 = 14.51; 4.54 x .80 x .762 = 2.76; .86 x .80 x .762 = .53; .16 x .80 x .762 = .10 etc., resulting in a total of $94.10. On a liquidation of P, S would receive $240 of P's separate assets in the initial distribution, of which $182.88 would be distributed to SHI. The iteration that follows is: 57.12 x .80 x .762 = 34.82; 10.88 x .80 x .762 = 6.63; 2.07 x .80 x .762 = 1.26; .39 x .80 x .7 62 = .24; etc., resulting in a total of $225.90.

[9] SH1's post-redemption percentage interest would be equal to the pre-redemption value of its P stock ($320) minus the value of the S stock distributed ($76.20), $243.80, divided by the post-redemption value of P ($400 minus $76.20), $323.80.

in P's separate assets derives from S's ownership of stock of P. Thus, SHI has subjected its interest in P to the vicissitudes of the business of S, including the claims of its creditors. No such consequence arises in the redemption transaction.

b. Creditor Analysis. The analysis of the relative positions of the creditors of P and S following an inversion transaction has also been cited as support for the proposition that an inversion, even one that preserves value, results in a distribution from P.[10] This analysis is another way of expressing the observation that the inversion substitutes an indirect interest in P's own assets for P's pre-inversion direct interest in S's assets.

> Example 6: Assume that, in Example 1, P has $400 of gross assets and a liability of $100. Prior to the inversion, the $100 indebtedness held by

P's creditor was supported by $500 of assets: $400 of P's separate assets plus $100 representing P's 100% interest in S's separate assets. Even if P retains its correct 20% interest in S post-inversion, the creditor's indebtedness is now arguably supported by only $420 of assets: $400 of P's separate assets

[10] Canellos, "Acquisition of Issuer Securities by a Controlled Entity: Peter Pan Seafoods, May Department Stores, and McDermott," 45 Tax Law. 1 (1991).

plus $20 representing P's 20% interest in S's separate assets.[11] The liquidation analysis is not a comfort to the creditor because, of the $100 P would normally receive through iterations in respect of its stock ownership in S, $80 represents distributions and redistributions of assets already owned by P and, thus, directly subject to the claims of its creditors. Moreover, this amount is offset by $80 of S's separate assets that will be distributed to shareholders other than P and, therefore, will be unavailable to the creditor. While the sale analysis would yield the creditor an additional $100 of assets at P, in that case, the creditor would be relying on an infusion of new equity into the group rather than on its existing assets.

4. Analogy to Notice 89-37

The issue raised by inversion transactions is similar to the problem addressed in Notice 89-37, 1989-1 C.B. 679, and Prop. Treas. Reg. §1.337(d)-3, involving the acquisition by a partnership of stock of a corporate partner. Under Notice 89-37 and the proposed regulations, the corporate partner is treated as having redeemed its share of its stock (or stock of a member of its affiliated group) acquired by the partnership, and recognizes gain to the extent that the deemed redemption is in exchange for

[11] The Canellos article suggests that the assets supporting the indebtedness of P's creditor have actually been diminished by $100, representing the portion of the value of S stock held by P shareholders that is attributable to S's separate assets (i.e., an 80% direct interest in S's assets ($80) plus a 20% indirect interest in S's assets ($20) through the S stock held by P). However, the existence of a creditor of P may prevent further dilution of P's assets. Given a sufficiently large creditor interest, only $80 of S's separate assets would escape the P creditor's claim by distribution to P's former shareholders. In such cases, the $20 of S's assets owned through P will “stop” at P and be seized by the creditor before being distributed by P back to S and then to the former P shareholders (i.e., the P creditor will cut off the iteration described in the discussion of the liquidation analysis).

its interest in appreciated property held by (or contributed by it to) the partnership.

We note that these rules apply even though all values are preserved. The reasons are that (1) under an aggregate theory of partnerships, a deemed stock redemption occurs when the corporate partner receives an economic interest in its own stock, and (2) this approach is necessary to avoid elimination of the gain with respect to the corporate partner's share of the partnership's appreciated property, because such gain will not be preserved in the stock once distributed to the corporate partner.[12] The Tax Section has submitted two reports supporting the deemed redemption rule.[13]

5. Cross Ownership and Downstream Reorganizations

The alternative analyses discussed above raise the question whether P's ownership of S's stock post-inversion has significance for tax purposes, at least to the extent it relates to an indirect interest in P's own assets.[14] One aspect of this issue is whether the preservation of value approach of the Notice has the effect of actually preserving the potential recognition

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12 Technically, the corporate partner's built-in gain in its stock distributed by the partnership will reflect the partner's overall gain on the transaction and the corporate partner will never recognize that gain on a disposition of the stock as a result of section 1032.

13 "Report on Notice 89-37," reprinted at 46 Tax Notes 99 (January 1, 1990); "Report on Proposed Regulations Implementing Notice 89-37" (March 3, 1993).

14 The courts and the Service have recognized cross-owned shares in a number of circumstances. See e.g., Rev. Rul. 80-189, 1980-2 C.B. 106 and Broadview Lumber Co. v. Commissioner, 561 F.2d 698 (7th Cir. 1977), dealing with the treatment of parent shares acquired by a subsidiary in a transaction under section 304(a)(2). See also Land, "Strange Loops and Tangled Hierarchies," supra n. 4, concerning issues raised by cross ownership, such as the dividends received deduction, affiliation under section 1504 and ownership changes under section 382.

of gain with respect to the shares of S owned by P, or whether gain preservation alone as a defense to gain recognition is illusory as it would be in the cases covered by Notice 89-37 and Prop. Treas. Reg. §1.337(d)-3 involving a partnership's ownership of the stock of a corporate partner. An analysis of this issue must address whether preservation of such gain is critical in light of General Utilities repeal.

A corporation recognizes gain on the disposition of stock in another corporation in the same manner as an individual, except in the case of a liquidation where the corporate shareholder owns 80% of the vote and value of the stock of the liquidating corporation. At that point, any gain attributable to the shares can be eliminated without recognition to the corporate shareholder under section 332.[15]

In an inversion transaction where P owns 80% or more of the stock of S, section 332 would have been applicable to eliminate P's gain with respect to the stock of S had S liquidated. Thus, it may not be essential to preserve P's gain in the S stock following an inversion transaction or downstream reorganization. However, in an inversion transaction where P owns less than 80% of S, P's gain in the S stock could not otherwise be eliminated, so it may be important to preserve that gain following an inversion transaction or downstream reorganization. However, as in Notice 89-37, value preservation may not insure gain preservation.

> Example 7: Holdco owns 15% of the stock of XYZ Corp., a publicly-traded, operating company. The XYZ stock is Holdco's sole asset and has a basis of $5 and a value of $100. Holdco's sole shareholder, A, exchanges his Holdco stock for

[15] See Seplow, “Acquisition of Assets of A Subsidiary: Liquidation or Reorganization?,” 73 Harv. L. Rev. 484 (1960).

stock of XYZ Corp. in a transaction intended to qualify as a reorganization under section 368(a)(1)(B) [16]

The exchange in Example 7 does not raise valuation issues since A and XYZ will have negotiated an arms-length price for A's Holdco stock.[17] However, the exchange does result in the same type of cross ownership that follows a complete inversion transaction, i.e., Holdco, now a subsidiary of XYZ, owns stock in XYZ. Moreover, the transaction has the potential to eliminate a corporate-level tax on the $95 appreciation in the XYZ stock owned by Holdco. Holdco will either retain the XYZ stock in perpetuity, or perhaps liquidate into XYZ in a transaction in which the gain on the XYZ stock is not recognized under section 337(a). Meanwhile, A will now directly own stock of XYZ.

Because of the possibility of liquidating Holdco into XYZ on a tax-free basis, the inversion transaction described in Example 7 is similar to a merger of Holdco and XYZ in which the stock of XYZ owned by Holdco is, in fact, eliminated. The question raised by Rev. Proc. 94-7 6 is whether the elimination of the corporate-level tax on the stock of XYZ owned by Holdco in a reorganization transaction (whether a direct merger or an inversion) is inconsistent with General Utilities repeal.

III. Summary of Recommendations

[16] Where Holdco has no assets other than stock of XYZ, issues may be raised concerning whether the inversion satisfies the requirements for a tax-free reorganization, in particular, the requirement of continuity of business enterprise. Example 7 provides a simplified set of facts and is not intended to address those issues.

[17] Presumably, absent other business considerations, A will receive the same number of shares of XYZ as Holdco owns. Those shares will have the same value, but will represent a smaller percentage of the outstanding shares of XYZ post-inversion than Holdco held pre-inversion, taking into account the shares of XYZ that Holdco continues to own post-inversion.

1. Where section 332 would have applied to a liquidation of S and values are preserved under the sale and liquidation analyses, the tax consequences of an inversion transaction should be determined under generally applicable rules, with one modification.

a. Shareholders of P who exchange their P stock for S stock should recognize gain or loss on the exchange unless a nonrecognition provision, such as section 351 or 354, applies.

b. No gain or loss should be recognized by S on the issuance of its stock in exchange for P stock. Section 1032.

c. No gain or loss should be recognized by P because P will not have engaged in any exchange and there is no avoidance of tax under General Utilities repeal.[18]

d. The tax basis of S in the P stock received in the exchange should be equal to the net inside basis of P's assets. This is the rule under current and proposed regulations if (i) P and S file a consolidated return and the inversion is a "group structure change" under Treas. Reg. §1.1502-31, or (ii) the inversion is effected as a "reverse triangular merger" under section 368(a)(2)(E) and basis is determined under new Prop. Treas. Reg. §1.358-6. We recognize that, under current law, S may be entitled under section 362 to a carryover basis in P stock

[18] In some inversion transactions, the number of outstanding shares of S, including those owned by P, may be adjusted, but as long as P owns its proper percentage of the post-inversion S shares, any adjustment in the number of shares owned by P should be subject to nonrecognition under either section 368(a)(1)(E) or 1036. If, after the adjustment, P owns less than its proper percentage of S, a distribution has occurred and the transaction should be treated as discussed below in connection with inversions where value is not preserved.

acquired from P's shareholders in a nonrecognition transaction or to a fair market value basis in P stock acquired in a taxable transaction, but we believe that the use of net inside basis is appropriate to prevent avoidance of General Utilities repeal.

e. P's basis in its S stock will be unchanged. P will recognize gain or loss on a sale of the S stock equal to the difference between its basis and amount realized. P will recognize gain under section 311 on a distribution of the S stock to S. However, under section 337, if S owns at least 80% of P, P will recognize no gain on a distribution of the S stock in a complete liquidation of P.

f. Dividends paid to P on the S stock will be eliminated if consolidated returns are filed. P would be entitled to the 100% dividends received deduction under section 243(a)(3) applicable to “qualifying dividends”, if P and S are members of the same affiliated group.

2. Where the stock of S retained by P post-inversion has a value that is less than the value of the S stock owned by P pre-inversion, the transaction could be treated as if P had (i) initially retained the proper percentage of S stock in the inversion, and then (ii) distributed to S a portion of the S stock equal to the difference between the correct number of shares to be retained by P and those actually retained. As a result, P would recognize gain under section 311 on the deemed distribution to the extent the value of the S shares deemed distributed exceeded their tax basis and S would be treated as receiving a distribution of its own stock under section 301. Under Prop. Treas. Reg. § 1.1502-13(f)(4), S's gain would not be deferred even if P and S filed a consolidated return. Under this

characterization, there would be no tax consequences to the shareholders of P by reason of the improper valuation.

3. Where section 332 would not apply to the liquidation of S prior to the transaction, an inversion transaction should generally result in recognition of gain with respect to the stock of S held by P. However, if S owns less than 80% of the stock of P after the inversion, such gain should be recognized only if, and when, S owns more than 80% of P, or P otherwise combines with S.

4. Assuming an authority question under section 337(d) is favorably resolved, regulations should tax P's built-in gain in the stock of S where (i) P does not initially own 80% of S and (ii) P merges into S or into a corporation controlled by S (or, similarly, S or the controlled corporation acquires the P assets in a (C) reorganization). Taxation of such gain would be consistent with our recommendation in paragraph 3 above on nonaffiliated corporation inversions. However, no gain should be recognized when S merges into P or a subsidiary of P.

IV. Discussion

1. Inversions of Affiliated Corporations Where Value is Preserved

Where section 332 would have applied to a liquidation of S prior to the inversion transaction, the Committee believes that an inversion transaction in which the value of P's stock in S is preserved does not present a potential for circumventing General Utilities repeal. As demonstrated by the examples, (i) P will not be able to sell its S stock and realize an uneconomic loss and (ii) S will not be able to sell its P stock for less than P's pre-inversion value and, thereby, effect a tax-efficient split-up of the P-S group. We recognize that this conclusion puts significant pressure on determining proper values for P and S and that this could lead to difficult valuation controversies between taxpayers and the Service. However, valuation issues exist in many other areas of the tax law and we see no way of avoiding them in analyzing inversion transactions.

We have carefully considered the alternative analyses of inversion transactions discussed above, and whether inversions involving affiliated corporations present the same potential abuse as the partnership transaction attacked by Notice 89-37 and Prop. Treas. Reg. §1.337(d)-3. We note that the partnership abuse arises because, for most purposes, a partnership is treated as an aggregation of its partners. As a result, section 731 would permit stock of a corporate partner to be withdrawn by that partner from the partnership without gain recognition.[19]

In a corporate context, P and S are treated as separate entities and, generally, property cannot be distributed from one corporation to another without gain recognition. The distinction breaks down, however, where S acquires 80% or more of the stock of P, as it would in a complete inversion transaction. In that case, as in the partnership context, the gain inherent in the S stock owned by P can be eliminated by liquidating P under sections 332 and 337(a). Nevertheless, we believe that, where P could have eliminated the gain inherent in the stock of S through a section 332 liquidation prior to the inversion, the inversion should not trigger recognition of gain to P with respect to its

19 Gain may be recognized under section 731(c) if the stock of the corporate partner is a "marketable security."

stock of S merely because the same gain could also be eliminated by a post-inversion liquidation.[20]

As to the P shareholders, we believe that they should be treated as receiving a distribution only if they have separated out value from P. The S stock held by them after the inversion has exactly the same value as the P stock held by them before the inversion. While the P shareholders are "closer" to S's assets after the inversion, they are "further" from P's assets, and have subjected those assets to the intervening claims of S's creditors. Their relative change in position results from their exchange of P stock for S stock, not from any distribution by P. That exchange occurs in a transaction that will either be (i) governed by a nonrecognition provision or (ii) a taxable exchange. After the inversion, the value of their investment continues to be locked within the P-S group. Thus, we do not believe that, in the inversion transaction, the former P shareholders have separated out value from P that should be taxed to them as a dividend.

The one issue that concerns us in affiliated corporation inversion transactions that preserve the value of P's interest in S is the determination of S's basis in the stock of P.

> Example 8: Assume, in Example 1, that SH have a basis of $400 in their stock of P and that the exchange of P stock for S stock occurs in a nonrecognition transaction governed by either section 351 or section 368(a)(1)(B). P has a basis of $40 in its assets.

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[20] In fact, a partial inversion transaction involving affiliated corporations has the potential of eliminating the benefit of section 332, and ultimately permitting gain recognition ont he stock of S owned by P where, for example, S acquires less than 80% of the stock of P.

Applying section 362 to the inversion transaction, S's basis in the stock of P would be $400. As a result, S would be able to sell the stock of P without realizing any gain, even though, prior to the inversion, a sale of P could have been accomplished only by a sale of P's assets at a gain of $360, or by a sale of P's stock by its shareholders following the taxable distribution to them of the stock of S owned by P. Application of the section 362 basis rule, therefore, could result in avoidance of General Utilities repeal.

This basis problem has been dealt with in the consolidated return context by Treas. Reg. §1.1502-31, and in the triangular reorganization context by Prop. Treas. Reg. §1.358-6. Both regulations would require S to determine its basis in the stock of P by reference to P's net basis in its assets.[21]

We believe the policies behind Treas. Reg. §1.1502-31 and Prop. Treas. Reg. §1.358-6 are equally applicable in the inversion context and, therefore, that S's basis in the stock of P should be determined by reference to P's net basis in its assets. Many complete inversion transactions will be covered by the consolidated return or triangular reorganization regulations and, therefore, the net inside basis result will apply. Where neither regulation applies,[22] we believe a special basis rule to that effect should be adopted.

2. Inversions of Affiliated Corporations Where Value is Not Preserved

[21] The regulations under section 358 do not contemplate negative basis except in the consolidated return context, where an excess loss account may be created.

[22] For example, where P and S are not members of a consolidated group and the inversion is not effected by a section 368(a)(2)(E) reorganization.

If, in an inversion transaction, the value of P's stock in S is not preserved, the diminution in value must be accounted for. We have identified three alternative transactions that are economically equivalent to the inversion transaction, and which could be the basis for a tax rule.

First, an inversion transaction could be treated as if (i) it had initially been consummated using the correct values, and (ii) post-inversion, P distributed the excess S shares to S. For example, on the facts of Example 3 (the 10/90 split), P would be treated as having retained 20% of the S stock in the inversion transaction. Thus, for every 90 shares of S stock issued to P shareholders, P would be treated as having retained 22.5 shares (representing 20% of 112.5 total shares) rather than 10 shares (representing 10% of 100 total shares). After the inversion, P would be treated as having distributed a number of shares of S stock to S such that its percentage interest in S was reduced to 10%. On these facts, P would be deemed to have distributed 12.5 out of its 22.5 S shares (or 55.56%) to S, reducing its interest in S to 10%. P would recognize gain of $8.33 under section 311 on the deemed distribution[23] and S would be treated as receiving a $55.56 distribution under section 30l.[24] P's shareholders would not be affected by the deemed distribution.

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[23] Under Prop. Treas. Reg. §1.1502-13(f)(4), the gain recognized by P on the deemed distribution would not be deferred. The result under the existing consolidated return regulations, Treas. Reg. §1.1502-14(c)(1) and 13(f)(1)(vi), is less clear. G.C.M. 39608 (March 8, 1987) holds that the gain would be deferred as long as the distributed shares were held as treasury shares. Since, under this approach, the S shares deemed distributed are eliminated, we believe that gain would not be deferred.

[24] The section 301 distribution would be eliminated if P and S filed consolidated returns and, otherwise, could be a “qualifying dividend” subject to the 100 percent dividends received deduction under section 243 if P and S are members of the same affiliated group.

Second, P could be treated as having distributed stock of S to its shareholders immediately prior to the inversion transaction. In Example 3, the amount of S stock distributed to P shareholders would be $55.56, resulting in recognition of gain to P under section 311 of $8.33 (55.56 - (85 x 55.56%)) and a section 301 distribution to the P shareholders of $55.56. Assuming the deemed distribution of $55.56 of S stock prior to the inversion, P would own $44.44 worth of S stock immediately thereafter, and the proper ownership of P following the inversion transaction would be 10% by P and 90% by P's shareholders.[25]

Third, the diminution in value could be dealt with through basis adjustments. Taking the case to its extreme, if P retains only nominal stock in S post-inversion, the transaction looks very much like a downstream merger of P into S, followed by a drop-down of P's assets into New P. Under this approach, P's shareholders would recognize no gain or loss, P's basis in its assets would carryover to S and then from S to New P, and S's basis in the stock of New P would be equal to the basis of the assets contributed by S to New P (<u>i.e.</u>, P's historic basis in its assets). One difficulty with this approach is how to deal with the basis of P in the stock of S that it retains. Since the S stock is “reacquired” by S in the deemed downstream merger of P, and then reissued to New P, its basis may not technically be determined by reference to P's historic basis in the S stock. Nevertheless, it may be logical to apply a carryover basis rule with respect to the S stock if this approach is adopted. In Example 3, P's basis in the retained S stock would be $37.77,

[25] P's shareholders would contribute to S shares of stock of P now worth $344.44 ($400-55.56, reflecting the deemed distribution of S stock). S has $100 of separate value, resulting in the issuance of 77.5% (344.44/444.44) of the stock of S to the P shareholders in exchange for the contributed P shares. Their remaining 12.5% ownership is derived from their 55.56% interest in S (22.5% x 55.56% = 12.5%). P's ownership of S post-inversion is 10% (44.44/444.44).

representing the same proportion of its pre-inversion basis in its S stock as the value of its post-inversion S shares bears to the value of its pre-inversion S shares (85 x .4444).

We believe that the first approach is the most appropriate characterization of the transaction and that, by taxing P on the appreciation in the S shares deemed distributed, it imposes the corporate-level tax that General Utilities repeal was intended to capture. The second approach, while also imposing a corporate-level tax on the appreciation in the S shares, imposes a shareholder-level tax as well. This second- level tax is not necessary to prevent the avoidance of General Utilities repeal since the shareholders' gain in their P stock has either been (i) shifted to their S stock (which has the same value to them after the inversion as the P stock had before the inversion) or (ii) taxed on the exchange. More fundamentally, the real shifting of value has occurred from P to S, and there has been no shifting of value from P or S to the shareholders. We see no reason to impose a tax analysis adverse to the P shareholders when there is no policy reason to do so, merely because another possible characterization of the steps would do so. We have rejected the third approach, which imposes no tax, because it is inconsistent with the form of the transaction, does not prevent elimination of corporate-level gain on the S stock, and is premised on a constructive reissuance of the S shares eliminated in the hypothetical downstream merger.[26]

3. Inversions of Nonaffiliated Corporations

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[26] We recognize, however, that the third approach has appeal in light of our observation that P and S could have combined tax-free under section 332.

The inversion transactions discussed above (other than Example 7) deal with cases in which P owns at least 80% of S before the transaction. Where, as in Example 7, the corporations are not so affiliated prior to the inversion transaction, the issue presented is whether gain inherent in stock of the acquiring corporation ("XYZ") held by the acquired corporation ("Holdco") should be recognized at the time of the inversion.

Such gain could not have been eliminated in a prior liquidation of XYZ under section 332, but could be eliminated in a subsequent liquidation of Holdco into XYZ.

The rationale for gain recognition in an inversion of nonaffiliated corporations is not premised on a misvaluation of the stock of XYZ owned by Holdco since, as discussed above, the arms-length nature of the transaction will insure that the proper consideration is exchanged. Nor would it be premised on whether the transaction qualifies for nonrecognition treatment, since an acquisition by XYZ of Holdco for cash would have the same effect. Rather, gain recognition at the time of the inversion would be justified in light of General Utilities repeal, on the theory that (i) the appreciation in the XYZ stock owned by Holdco must be subject to a corporate-level tax and (ii) the inversion is the last chance for that gain to be taxed in most cases.

In Example 7, while Holdco, after it becomes a subsidiary of XYZ, would recognize gain on the XYZ stock in the case of a sale or distribution of that stock, the gain may be perpetually deferred if Holdco retains the shares, and may be eliminated if Holdco liquidates into XYZ under sections 332 and 337. This is also true in the affiliated corporation inversion case discussed above in which we recommended that P's gain in the S stock not be taxed as long as values are preserved. However, unlike the affiliated corporation case, Holdco's gain in the XYZ stock could not have been eliminated on a pre-inversion liquidation of XYZ. Thus, Example 7 poses the same potential abuse as the partnership transactions covered by Notice 89-37 and Prop. Treas. Reg. §1.337(d)-3. Consistent with our support of the deemed redemption rule in the partnership case, we believe that it would be appropriate in light of General Utilities repeal to tax the gain in the XYZ stock held by Holdco at the time of the inversion.[27]

If, however, XYZ acquires less than 80% of the stock of Holdco, Holdco's gain could not be eliminated by a distribution of the XYZ stock in liquidation since sections 332 and 337 would not apply. Therefore, we recommend that Holdco's built-in gain on its XYZ stock be deferred until the time that XYZ owns, directly or indirectly, 80% of Holdco or the two corporations are otherwise combined and the Holdco stock eliminated.

We note that if XYZ acquires 80% of Holdco and Holdco recognizes gain on its XYZ stock, such stock should be treated as if it were reissued to Holdco at its then fair market value. The generally applicable tax rules should thereafter apply to such stock.[28]

4. Downstream Mergers of Unaffiliated Corporations

[27] This rule would be similar to the regulations under section 108(e)(4) under which the acquisition of stock of a corporation holding indebtedness of the acquiror can trigger income from discharge of indebtedness. Treas. Reg. § 1.108-2(c).

[28] Alternatively, the XYZ shares held by Holdco could be treated as treasury stock of XYZ, with section 1032 applicable to a subsequent sale of those shares.

The inversion in Example 7 is similar in effect to a merger of Holdco into XYZ (or an acquisition by XYZ of Holdco assets in a (C) reorganization). While, in general, corporate-level gain on appreciated assets of Holdco would be preserved in a reorganization because the basis in its assets carries over to XYZ under section 362(b), since the XYZ stock held by Holdco is eliminated in the merger, the gain in the stock is also eliminated. Any new issuance by XYZ of its own stock would be nontaxable under section 1032. As a result, it is consistent with our view of nonaffiliated corporation inversion transactions to tax the gain in the XYZ stock at the time of the merger.

This analogy is particularly appropriate because our reason for taxing the gain in Example 7 was the ability of Holdco to subsequently merge into XYZ and permanently avoid the gain. The downstream reorganization simply combines into one step our concerns about the combination of steps in Example 7. In fact, if downstream reorganizations were not to be taxable, it would be difficult to justify taxing the gain in Example 7.

We recognize that there are a number of arguments for not taxing Holdco on the appreciation in its XYZ stock in a downstream reorganization. First, there is long-standing judicial and published ruling precedent supporting nonrecognition treatment for downstream reorganizations of nonaffiliated corporations.[29] Second, section 361(c)(4) expressly states that sections 311 and subpart B of part II of subchapter C (which includes section 337(d)) do not apply to distributions in reorganizations. Third, the legislative history to the Tax Reform Act of 1986 states that reorganization transactions are not

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[29] Commissioner v. Estate of Gilmore, 130 F.2d 791 (3d Cir. 1942); George v. Commissioner, 26 T.C. 396 (1956), acq., 1956-2 C.B. 5; Rev. Rul. 78-47, 1978-1 C.B. 113.

subject to sections 336 and 337.[30] Fourth, the elimination of gain on the XYZ stock does not result in the tax-free step-up in asset basis at which General Utilities repeal was aimed. Finally, it could be argued that corporate stock should be viewed differently than other assets in analyzing the policies underlying General Utilities repeal. Since gain recognized by a corporation on the disposition of stock in another corporation could be viewed as resulting in a third level of tax on the earnings of the underlying corporation,[31] General Utilities repeal should not require the override of an otherwise applicable nonrecognition provision to tax that gain.

On the other hand, there are substantial arguments that gain on the XYZ stock held by Holdco should be recognized as a result of the downstream reorganization after General Utilities repeal. First, corporate stock is no different than any other asset owned by a corporation, and would be subject to a corporate-level tax if sold by the corporation. Therefore, the elimination of gain on that stock through a downstream reorganization is an avoidance of General Utilities repeal. Second, the rationale for nonrecognition treatment in a reorganization is that the basis of assets carries over to the surviving corporation in a meaningful manner. Since the basis to

[30] H.R. Rep. No. 426, 99th Cong., 1st Sess. 285 (1985); H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess., Vol. II II-199 (1986); General Explanation of the Tax Reform Act of 1986, at 337. For example, the House Report states:

> "The bill provides that the general rule requiring recognition of gain or loss on distributions in liquidation does not apply with respect to any exchange or distribution of property to the extent there is nonrecognition of gain or loss to the distributee under the provisions of the Code relating to corporate reorganizations and distributions."

[31] The first level of tax falls on the underlying corporation, the second level of tax falls on the corporation that sells the stock and the third level of tax falls on the selling corporation's shareholders.

the issuer of its own stock is irrelevant, this rationale for nonrecognition is not satisfied. Third, the downstream reorganization is functionally the equivalent of a distribution under section 311 of Holdco's stock in XYZ, followed by the reorganization, and should be taxed as such. Finally, section 337(d) provides broad regulatory authority to tax corporate-level gain on the stock, it specifically refers to the possibility of regulations overriding Part III (reorganizations), and the legislative history supports its application in the reorganization context.[32]

While there is arguably an internal inconsistency between section 361(c)(4) and section 337(d), there appears to be authority under section 337(d) for the promulgation of regulations taxing Holdco on the built-in gain in its XYZ stock upon a downstream reorganization. Assuming the authority question is favorably resolved, we believe on balance, for the reasons stated above, that regulations should tax Holdco's built in gain in the stock of XYZ where (i) Holdco does not initially own 80% of XYZ and (ii) Holdco merges into XYZ or a corporation controlled by XYZ (or Holdco has its assets acquired by XYZ or a controlled corporation in a (C) reorganization).

If regulations are promulgated under section 337(d) requiring recognition of gain, consideration should be given to the following issues:

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[32] "The conferees expect the Secretary to issue, or to amend, regulations to ensure that the purpose of the new provisions is not circumvented through the use of any other provision, including the consolidated return regulations or the tax-free reorganization provisions of the Code (part III of Subchapter C)."

H. R. Conf. Rep. No. 841, 99th Cong., 2d Sess., Vol. II II-204 (1986).

1. The regulations might consider some de minimis rule in cases where Holdco's ownership of XYZ stock is not significant, either in absolute terms or in relation to Holdco's other assets.

2. Nonrecognition treatment would presumably be permitted if Holdco acquired stock of XYZ from XYZ's shareholders to increase its ownership to 80% prior to the reorganization, although stock acquired by Holdco from XYZ as part of an integrated plan to increase its ownership above 80% should probably be disregarded.

3. The shareholders of Holdco should not recognize gain or loss, assuming the downstream reorganization is otherwise tax-free. A tax should only be imposed at the Holdco level, even if the XYZ shares are deemed distributed by Holdco under section 311 or 336, since it is only the gain at the corporate level that is being eliminated and to which General Utilities repeal is addressed.

4. Holdco should only recognize gain (and not loss) with respect to the XYZ stock, in the same manner as it would on a distribution of XYZ stock under section 311. No gain or loss should be recognized with respect to the remaining assets of Holdco, assuming the downstream reorganization is otherwise tax-free.

5. Treatment of Other Corporate Transactions with Similar Effect

We have concluded above that if Holdco owns less than 80% of XYZ, Holdco's built-in gain in the XYZ stock should be recognized if (1) XYZ acquires at least 80% of the stock of

Holdco in an inversion transaction, or (2) Holdco merges downstream into XYZ (or XYZ acquires Holdco assets in a (C) reorganization). In both cases, requiring gain recognition is consistent with section 337(d) because it taxes the gain at a point that will likely be the last opportunity for taxation in most cases.

There are other corporate transactions with a similar effect to which, however, we believe section 337(d) should not apply. For example, if Holdco were simply to acquire sufficient XYZ stock (in a taxable or tax-free transaction) to bring its ownership up to 80%, Holdco could then liquidate XYZ under section 332 without ever recognizing any gain on its previously owned XYZ shares. We believe this tax-free treatment of an 80% shareholder, despite the disappearance of built-in gain, is so fundamental to the Code that it was not intended to be altered by General Utilities repeal or section 337(d).

Other cases are less clear, however. Suppose, for example, that XYZ is less than 80% owned by Holdco and merges upstream into Holdco in an (A) reorganization, with other XYZ shareholders receiving Holdco stock. Given our proposal that gain be recognized on the XYZ shares held by Holdco when Holdco merges downstream into XYZ, should gain likewise be recognized when XYZ merges upstream into Holdco? In both cases, Holdco's shares in XYZ are eliminated. A similar issue is raised where XYZ merges into a controlled subsidiary of Holdco and the other XYZ shareholders receive Holdco stock.

Taxation of the gain in the upstream merger case would effectively be applying a Bausch & Lomb[33] (i.e., liquidation)

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[33] Bausch & Lomb Optical Co. v. Commissioner, 30 T.C. 602 (1958), aff'd, 267 F.2d 75 (2d Cir. 1959), cert, denied. 361 U.S. 835 (1959).

analysis to a reorganization where the acquiring corporation owns stock of the acquired corporation. Moreover, the sidewise merger was the method used by taxpayers (before amendment to the Code) to avoid the Bausch & Lomb result in an upstream merger.

While we recognize that the effect of an upstream or sidewise merger is similar to a downstream merger (or (C) reorganization) with respect to the XYZ stock owned by Holdco, we do not believe section 337(d) should be applied to tax gain on the XYZ stock on an upstream or sidewise merger. A downstream merger is very similar to a liquidation of Holdco because Holdco disappears, and the shareholders of Holdco end up owning the XYZ stock previously held by Holdco. We therefore believe Holdco's gain on the XYZ stock should be taxed accordingly. In an upstream or sidewise merger, however, XYZ disappears but Holdco remains in existence, and all the assets of the merged corporation (here XYZ) remain in corporate solution. Moreover, since XYZ will generally have substantial assets, there is a greater likelihood that there will be real substance to its corporate disappearance and resulting transfer of assets. In addition, an upstream or sidewise merger will often be significantly different from a downstream merger (or particularly a (C) reorganization) from the point of view of the other shareholders of XYZ, who in the upstream or sidewise merger are acquiring stock in a different corporation with its own history and liabilities. Finally, in an upstream merger Holdco remains in existence owning the assets of XYZ, which is the same result that arises from the acquisition by Holdco of additional XYZ stock to increase its ownership to 80% or more, followed by the liquidation of XYZ. We believe that these differences between a downstream and upstream (or sidewise) reorganization are sufficient to justify a different result under section 337(d), even though Holdco's built-in gain in the XYZ stock may disappear in all these cases.

6. Conclusion

Our proposals draw certain lines between combinations of Holdco and XYZ that either do result or do not result in gain recognition on the XYZ stock held by Holdco. We recognize that certain of these lines may appear to exalt form over substance. However, we begin with the case that Holdco may acquire additional XYZ stock, bringing its ownership to 80%, and permanently avoid gain recognition on its XYZ stock. On the other hand, we believe a downstream merger (or downstream (C) reorganization) will often be sufficiently like a liquidation of Holdco that gain should be recognized on the XYZ stock, and, because we do not believe distinctions should be made among downstream mergers (except in de minimis situations), we believe all such mergers should result in gain recognition on the XYZ stock.

Between these two extremes, we have attempted to draw an admittedly fine line between taxable and nontaxable combinations. We acknowledge that our line may not be satisfactory in all cases, because in many cases the particular form of transaction will be elective. However, we believe it is impossible to eliminate all formal distinctions in this area. We believe our proposal fairly balances the competing principles at stake, and we are unable to propose any solution that, we believe, would better do so.