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New York State Bar Association

Tax Section

Report on Certain Corporate Reorganization Transactions Followed by "Same-State" Asset Drop-Downs

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Contents

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This report[1] addresses recent statements to the effect that the Internal Revenue Service (the "***IRS***") may be considering whether certain corporate reorganization transactions[2] that have historically been characterized as nonrecognition transactions under section 368 followed by a "same-state" drop down of assets should instead be characterized as nonrealization events coupled with a distribution of assets.[3] Applying this nonrealization approach could result in significantly different amounts of income recognized by corporations and/or their shareholders in certain fact patterns and divergent tax results for equivalent transactions with minor factual differences from one another. As a result, taxpayers could choose their transaction form and elect the desired treatment, creating seemingly unnecessary transactional frictions for no apparent tax policy gains.

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1 The principal authors of this report are William Alexander and Gordon Warnke. Significant contributions in the drafting of this report were also provided by Philip Jaworskyj, Peyton Miller, and Jonathan Neuville. Helpful comments were provided by Peter Connors, Peter Faber, Michael Farber, Lawrence Garrett, Stephen Land, David Miller, Michael Mollerus, Richard Nugent, Deborah Paul, Michael Schler, Jodi Schwartz, Eric Solomon, Karen Sowell, Joseph Toce, and Shun Tosaka. This report reflects solely the views of the Tax Section of the New York State Bar Association (the "***Tax Section***") and not those of its Executive Committee or its House of Delegates.

2 In this report, except where the context otherwise indicates, the terms "reorganization" and "reorganization transactions" and similar phrases mean transactions that in form meet the definitional requirements of one of the types of reorganizations described in section 368(a)(1). References herein to a type of reorganization indicated by a capital letter are references to the type of reorganization described in that lettered subparagraph of section 368(a)(1).

Unless otherwise noted, for purposes of this report, all section references are to sections of the Internal Revenue Code of 1986, as amended (the "***Code***"), and all references to regulations are to the Treasury regulations promulgated under the Code. Also, unless otherwise noted, all corporations and shareholders are U.S. persons and no corporations are members of a consolidated group.

3 *See, e.g.*, Emily L. Foster, *IRS Grapples with General Utilities Issues, Considers Rulings*, 2017 TNT 97-1 (May 22, 2017); Emily L. Foster, *General Utilities Direction Unknown, Work Continues*, 2017 TNT 15-5 (Jan. 25, 2017); Amy S. Elliott, *IRS Declines Ruling on Same-State Upstream Asset Transfer*, 2016 TNT 236-2 (Dec. 8, 2016); Amy S. Elliott, *Momentary Conversions May Be Enough to Deliver Tax-Free Results*, 2016 TNT 214-3 (Nov. 4, 2016). This report generally does not consider the potential implications of applying nonrealization principles to transactions other than in-form reorganizations followed by asset drop-downs, including other types of reorganization transactions or debt modifications resulting from LLC conversions or partnership continuations, or whether considerations other than those discussed in this report might be applicable in those circumstances. As regards debt modifications resulting from LLC conversions, see James M. Peaslee, *Disregarded Entities and Debt Modifications*, 150 Tax Notes 1145 (Mar. 7, 2016). As regards partnership continuations, see Phillip Gall, *Nothing from Something: Partnership Continuations under Code Sec. 708(a)*, 95 TAXES 187 (Mar. 6, 2017).

The particular fact pattern that we understand is under consideration involves a corporation (S) that is treated as liquidating into its parent corporation (P)[4] with a portion of S's assets then treated as being transferred to a newly formed subsidiary of the parent corporation (S1).[5] As we understand it, where S1 is incorporated in the same state as S, the IRS is considering whether S and S1 are in essence the same corporation(s), with the assets of S not contributed to S1 (and so retained by P as a U.S. federal income tax matter) being treated as transferred by S to P in a transaction to which sections 301 and 311 apply. As a result, income or gain (but not loss) may be recognized by both P and S. However, if S1 were to be incorporated in a different state from S, then the transaction would be treated (assuming the other relevant requirements are met) as an "upstream" reorganization of S into P (or, depending on the facts, a section 332 liquidation of S into P), followed by a transfer in a transaction to which section 351 applies by P to S1 of the assets S1 holds at the end of the transaction. In this latter case, no income, gain, or loss would generally be recognized by P, S, or S1. As explained in more detail in Part III, other differences in consequences—such as the location of tax attributes (including NOLs)—could also result.[6]

For the reasons set forth in this report, we believe that any reconsideration that potentially leads to the above divergent results is undesirable as a matter of both tax policy and tax administrability and is not otherwise mandated.

Part I of this report provides a summary of our recommendations. Part II provides some contextual background and analyzes the historical development of the nonrealization doctrine and the reorganization provisions of the Code. In Part III, some corporate reorganization transactions that might potentially raise the nonrealization/reorganization overlap issues addressed in this report are discussed, and the varying consequences that can result from treating the transaction as a reorganization transaction versus a nonrealization event coupled with a separate distribution are explained. Finally, our conclusions are summarized in Part IV.

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[4] This liquidation could take the form of either an actual liquidation of S for corporate purposes or the conversion of S into an entity that is disregarded as separate from P for U.S. federal tax purposes.

[5] This transfer can take the form of either (i) a direct transfer of assets by P to S1, where S is liquidated for corporate purposes in the first step, or (ii) the extraction of assets by P from S after S is converted to a disregarded entity for U.S. federal tax purposes followed by a conversion of S back to an entity (S1) that is treated as a corporation for U.S. federal tax purposes, with the result that S1 is treated as acquiring the S assets not extracted by P.

[6] For example, if the transactions are treated as an upstream reorganization (or a section 332 liquidation) of S into P followed by a section 351 drop-down, S's NOLs would pass to P and would not move to S1 in the drop-down. Conversely, if the transactions are treated as simply a continuation of S, the NOLs would stay at S1. The difference can be particularly important in connection with state taxes because P and S might be filing separate returns in one or more states even though they might be filing consolidated federal returns.

I. SUMMARY OF RECOMMENDATIONS

We believe that the governing legal principles and the administration of the tax law in the cases addressed in this report are best served by applying the tests for nonrealization and nonrecognition in parallel, rather than using distinct standards for each. The two concepts do not demand different applications of step-transaction and substance-over-form principles that would result in different candidates for the same, successor, or acquirer corporations. These principles have been developed thoroughly under the reorganization provisions over a substantial period of time. The contours of the reorganization provisions are well understood by tax practitioners and their application would avoid the creation of unstated exceptions to reorganization guidance implicit in a separate inquiry into realization under different rules. Moreover, we can discern no overriding policy rationale that would dictate a division between the two concepts and we do not believe that the authorities discussed in Part II mandate it. Accordingly, we believe that, absent a change in the reorganization rules under current law, the government should continue to apply the reorganization rules to corporate transactions similar to those discussed herein.

In light of the IRS's recent focus on *General Utilities* issues, we have considered whether the IRS's consideration of nonrealization principles in the example discussed above, and in more detail later in this report, may be driven in part by concerns regarding policing *General Utilities* repeal.[7] The boundaries of *General Utilities* repeal are beyond the purview of this report.[8] However, we believe that if there are concerns, those concerns also arise in other transactions clearly outside the reach of nonrealization (such as a different state reincorporation). Accordingly, relying on nonrealization to police *General Utilities* repeal would seem to be an ineffective remedy.

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7 *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935) (holding that a corporation recognized neither gain nor loss on its distribution of property to its shareholders). Congress began eroding the *General Utilities* doctrine by adding exceptions to the nonrecognition rule of section 311(a), which by 1984 had all but swallowed the rule, and then finally overturned most continuing remnants of the doctrine in 1986. *See* Tax Reform Act of 1969, Pub. L. No. 91-172, § 905(a) (1969) (provided an exception for appreciated property used to redeem stock); Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 223(a) (1982) (further limiting nonrecognition under section 311); Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 54 (1984) (generally requiring gain, but not loss, recognition on property distributions, whether or not redemptive distributions); Tax Reform Act of 1986, Pub. L. No. 99-514, § 631 (1986) (modifying sections 311, 336, 337, and 338).

8 Although the boundaries of *General Utilities* repeal are beyond the purview of this report, we note that there are differences between convert-distribute-reconvert transactions and the "mirror" or "bust-up" transactions described by Congress in connection with *General Utilities* repeal. *See* H.R. Rep. No. 100-391, pt. 2, at 1080-84 (1987). In a convert-distribute-reconvert transaction, unlike in a mirror or bust-up transaction, the shareholder's outside basis in the stock of the subsidiary is eliminated and the attributes of the subsidiary are moved to the shareholder level. The Tax Section recently issued a report that addressed the impact of *General Utilities* repeal on certain putative section 355 transactions. *See* New York State Bar Ass'n Tax Section, *Report on Notice 2015-59 and Revenue Procedure 2015-43 Relating to Substantial Investment Assets, De Minimis Active Trades or Businesses and C-to-RIC Spin-Offs* (Apr. 12, 2016).

To the extent the government believes that the tax consequences from applying the reorganization rules to these transactions are inappropriate or should be different from what is believed to be current law, then the IRS and the Treasury Department should reexamine the current rules and decide whether they want to modify the law. Similarly, if the government believes the transactions discussed in this report present *General Utilities* repeal issues, then the IRS and the Treasury Department should use the authority under section 337(d) to address those issues. We believe that making any modifications determined to be warranted through alteration of the relevant reorganization rules or section 337(d) will permit the IRS and the Treasury Department to address any concerns better than applying a nonrealization/reorganization dichotomy, which could result in dramatically differing consequences based on only minor differences in facts. We have not considered or formed a view on whether current rules should be changed in light of *General Utilities* repeal.

We believe that the reorganization and nonrealization rules can best be harmonized by applying the step transaction rules under Treasury Regulations section 1.368-2(k) (the "***-2(k) regulations***") consistently for purposes of determining both reorganization and nonrealization status. Indeed, as discussed in greater detail in Part III, we think this harmonization is consistent with current law. Under this approach, if the first step (or series of steps) standing alone would result in realization in what is otherwise a reorganization transaction, followed by an asset drop down to which the -2(k) regulations would apply, then the transaction would be governed by the reorganization rules.

Alternatively, if the government does not agree with our recommendation and believes that nonrealization principles should be analyzed by looking at the overall transaction, then we recommend that nonrealization be limited to situations where there is a complete identity of assets at the end of the transaction. We believe that the nonrealization authorities discussed below can be read as applying nonrealization in what is otherwise a reorganization transaction only when there is no change in a corporation's assets or business as part of the transaction, not when assets are in fact removed from the reorganizing corporation as part of the transaction.[9]

Either way, we urge the IRS to resume issuing private letter rulings in this area and otherwise confirm that it will treat the transactions that are the subject of this report as reorganizations followed by asset drop-downs.

[9] As discussed further in Part III, we believe this alternative approach is less preferable than our recommended approach, as it can result in differences in the location of tax attributes based on minimal differences in facts and, at the margin, can cause transactional frictions that would seem to serve little tax policy purpose.

II. BACKGROUND

This Part II reviews the authorities that bear on the concepts of realization and nonrealization and certain other authorities related to the identity of a corporation for U.S. federal income tax purposes. We first discuss a series of early Supreme Court cases that dealt with the concept of realization in reorganization-like transactions that occurred prior to enactment of the reorganization provisions of the Code. We then discuss the enactment of the reorganization provisions in the early part of the twentieth century, which almost entirely ended the Supreme Court's inquiry into the nature of realization. Finally, we discuss relevant authorities arising after enactment of the reorganization provisions that rely on notions of corporate sameness outside of the context of realization to characterize corporate transactions. Although sparse, these authorities span nearly a century and are important to understanding the current landscape and the recommendations made in this report.

A. Before the Reorganization Provisions

The case law giving rise to the IRS's expressed concerns begins with two early Supreme Court cases—*Towne v. Eisner*[10] and *Eisner v. Macomber*[11]—concerning the taxability of stock dividends. Each case held that a stock dividend was not taxable as income. The former case was decided under the Revenue Act of 1913, which provided that net income included dividends, and the latter case was decided under the Revenue Act of 1916, which expressly taxed stock dividends in the amount of their cash value. It is not clear whether *Towne v. Eisner* was decided as a matter of statutory or constitutional interpretation, but *Eisner v. Macomber* made clear the proposition that Congress was constrained under the Sixteenth Amendment from taxing appreciation prior to realization.[12] To the Court, the realization of income from capital required "*gain derived from capital* . . . *not* a gain *accruing to* capital; not a *growth* or *increment* of value *in* the investment; but a gain, a profit, something of exchangeable value, *proceeding from* the property, *severed from* the capital . . . for his *separate* use, benefit and disposal."[13] A stock dividend, "[f]ar from being a realization of profits of the stockholder, . . . tends rather to

[10] 245 U.S. 418 (1918).

[11] 252 U.S. 189 (1920).

[12] Subsequent cases seem to have eroded the conclusion that realization is a constitutional imperative. *See Cottage Savings Ass'n v. Comm'r*, 499 U.S. 556 (1991); *Helvering v. Horst*, 311 U.S. 112, 116 (1940) (realization requirement is "founded on administrative convenience"); *see generally* Jeffrey L. Kwall and Katherine K. Wilbur, *The Outer Limits of Realization: Weiss v. Stearn and Corporate Dilution*, 17 Fla. Tax Rev. 47, 67-77 (2015) [hereinafter "***Kwall & Wilber***"]. The erosion of the realization requirement is also illustrated by subpart F and subchapter S (which tax shareholders regardless of whether they sever profits from their corporation), the check-the-box regime discussed below in Part II.C.6, and mark-to-market provisions such as section 475. *See generally* Gene Magidenko, *Is a Broadly Based Mark-to-Market Tax Unconstitutional?*, 143 Tax Notes 952 (May 26, 2014).

[13] *Eisner v. Macomber*, 252 U.S. at 193.

postpone such realization. . . . The essential and controlling fact is that the stockholder has received nothing out of the company's assets for his separate use and benefit."[14]

For their first five years, the income tax laws contained no provisions offering relief for exchanges of stock in corporate reorganizations. Thus, the determination of whether an exchange of stock in reorganization-like transactions resulted in shareholders' realization of "gain derived from capital" was decided by the Supreme Court in a series of cases under the Revenue Acts of 1913 and 1916. The first of these cases, *United States v. Phellis*,[15] held that a distribution from an existing corporation to its shareholders of stock in a new corporation is income to the shareholders "unless the two companies must be regarded as substantially identical."[16] An existing corporation in that case, which was organized in New Jersey, transferred its business assets to a new corporation, organized in Delaware, in exchange for preferred and common stock of the new Delaware corporation and distributed all the common stock and most of the preferred stock received to its shareholders. The New Jersey corporation remained in existence but did not conduct any business after the stock distribution other than to hold the retained preferred stock of the new Delaware corporation, which was equal in value to the par value of its own common stock, and distribute the dividends received thereon to its own common shareholders. Pointing out, among other things, that the new corporation was formed under the laws of a different state and had a larger authorized capital stock than the old corporation, the Court held that the old corporation's shareholders "received assets of exchangeable and actual value severed from their capital interest in the old company," and therefore realized income taxable under the Revenue Act of 1913.[17] In particular, the Court assigned no significance to the fact that the fair market value of New Jersey corporation stock before the distribution was equal to the sum of the fair market values of the New Jersey corporation stock and the distributed Delaware corporation stock immediately after the distribution.

With one exception, the subsequent cases followed the reasoning and result of *Phellis*. *Rockefeller v. United States*,[18] concerned distributions by two oil companies, each of which contributed its pipeline property to a new subsidiary and spun off the subsidiary stock to its shareholders. As in *Phellis*, the Court held that a distribution from an existing corporation to its shareholders of stock in a new corporation was income to the shareholders. The distribution constituted in the case of each shareholder "a gain in the form of actual exchangeable assets transferred to him from the oil company for his separate use in partial realization of his former indivisible and contingent interest in the corporate surplus."[19] The Court determined that the

[14] *Id.* at 194.

[15] 257 U.S. 156 (1921).

[16] *Phellis*, 257 U.S. at 170.

[17] *Id.*

[18] 257 U.S. 176 (1921).

[19] *Rockefeller*, 257 U.S. at 183-84.

distribution was, therefore, "in substance and effect, not merely in form, a dividend of profits by the corporation, and individual income by the shareholder."[20]

Cullinan v. Walker,[21] involved a different transaction that split the production and pipeline properties of an oil company. A Texas corporation that conducted the two businesses dissolved for purposes of effecting a restructuring. Its trustees in liquidation transferred each business to a separate new Texas corporation in exchange for stock and bonds of the new corporations, and contributed the stock of these two entities to a new Delaware holding company. The trustees then distributed the stock of the Delaware holding company and the bonds of the Texas corporations pro rata among the former shareholders of the dissolved corporation. In holding that the shareholders of the dissolved corporation realized gain on the distribution, the Court observed that the new holding company, unlike the old corporation, was a holding company and was organized in Delaware.[22] The Court did not distinguish between the stock and bonds received as consideration.

In *Weiss v. Stearn*,[23] shareholders of the National Acme Manufacturing Company ("***NAMC***"), an Ohio corporation, contributed their NAMC stock to a depositary company, while another party contributed cash to the depositary company. The contributors then incorporated National Acme Company ("***NAC***"), a new Ohio corporation, which took over all the assets and business of NAMC under the same management, and NAMC was dissolved. In exchange, the depositary company delivered half the NAC stock to the cash contributor and half the NAC stock plus the contributed cash to the former NAMC shareholders. The Court concluded that "[t]he practical result of the things done was a transfer of the old assets and business, *without increase or diminution or material change of general purpose*, to the new corporation, a disposal for cash by each stockholder of half his interest therein, and an exchange of the remainder for new stock representing the same proportionate interest in the enterprise."[24] The transfer of assets to the new corporation was analogized to an increase in the authorized capital of the old corporation and a stock dividend, which would have been nontaxable under *Eisner v. Macomber*. Accordingly, the Court held that the NAMC shareholders realized gain on the shares sold for cash, but not on the exchange of their NAMC stock for NAC stock, because the stockholder did not obtain "a thing really different from what he theretofore had."[25]

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[20] *Id.* at 184.

[21] 262 U.S. 134 (1923).

[22] *See Cullinan*, 262 U.S. at 137.

[23] 265 U.S. 242 (1924).

[24] *Weiss*, 265 U.S. at 252 (emphasis added).

[25] *Id.* at 254.

In *Marr v. United States*,[26] a New Jersey corporation was reincorporated in Delaware by having a new Delaware corporation issue its stock to acquire the stock of the New Jersey corporation, after which the New Jersey corporation transferred all of its assets and liabilities to the Delaware corporation and dissolved. The old New Jersey corporation had outstanding $15 million of 7% voting preferred stock and $15 million of common stock. The shareholders of the New Jersey corporation received one and one-third shares of Delaware corporation 6% nonvoting preferred stock in exchange for each share of New Jersey corporation 7% voting preferred stock and five shares of Delaware corporation common stock in exchange for each share of New Jersey corporation common stock. The Marrs held both common and preferred stock of the old New Jersey corporation. The Court held that the shareholders realized gain on the exchange of shares, because "the new corporation is essentially different from the old."[27] The Court reasoned that a corporation organized in Delaware had inherently different rights and powers from one organized in New Jersey. The Court also noted that the different voting rights, liquidation preference, and coupon on the preferred stock of the Delaware corporation caused both the preferred stock and the common stock of the New Jersey corporation to be essentially different from the preferred stock and the common stock of the Delaware corporation.[28] This was not a case "in which after the distribution the stockholders have the same proportional interest of the same kind in essentially the same corporation."[29] Four of the nine Justices dissented from the majority opinion, including Justice McReynolds, the author of the Court's opinion in *Weiss*, and instead would have followed the holding of *Weiss*, arguing that *Weiss* "did not turn on the relatively unimportant circumstance that the new and old corporations were organized under the laws of the same state."[30]

As the Court noted in *Marr*, "[i]n each of [the previous cases, as in *Marr*], the business enterprise actually conducted remained exactly the same."[31] Viewed together, it appears that under these cases, the restructuring of a corporation across state lines always results in realization. Beyond that, it seems obvious that not all corporations incorporated in a single state would be viewed as the same. An identity of shareholders is not necessarily required, as a new

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[26] 268 U.S. 536 (1925).

[27] *Marr*, 268 U.S. at 540-41.

[28] *Id.* at 541.

[29] The Board of Tax Appeals applied *Weiss* to a 1916 same-state reincorporation where the target had only common stock outstanding and the acquirer issued common and preferred stock proportionately to the target shareholders. *See Brubaker v. Comm'r*, 4 B.T.A. 1171 (1926). However, following *Marr*, the Board of Tax Appeals found a taxable event for the shareholders in a 1917 same-state reincorporation where the target had only common stock outstanding and the acquirer issued common and preferred stock proportionately to the target shareholders and then issued additional preferred stock to the public. *See Kountze v. Comm'r*, 24 B.T.A. 403 (1931).

[30] *Id.* at 542. Justice McReynolds dissented in *Phellis*, *Rockefeller*, and *Marr*, while Justice Brandeis, the author of *Cullinan* and *Weiss*, dissented in *Marr*.

[31] *Id.* at 540.

investor came in in *Weiss*, although shifts in the proportional interests among the historic shareholders or relative to a new class of shareholders may cause realization under *Phellis* and *Marr*.[32] Changes in capital structure may cause realization, as in *Marr*, although the degree of change necessary to cause realization where that is the only change is not clear. Changes in corporate asset composition may also cause realization, per *Cullinan*, even if the underlying assets are the same as an economic matter. Although it is not completely clear that absolute identity of assets is required for nonrealization, such identity was present in each of the pre-reorganization cases in which nonrealization was found (that is, the stock dividend cases, *Weiss*, and *Brubaker*).[33]

All of these cases involved the shareholder-level consequences. None of them involved the consequences to the corporations themselves, even though there were no statutory provisions in the first two Revenue Acts that would have expressly protected the exchange of target assets for acquirer stock.[34] At the corporate level, it is not clear whether capital or governance changes that were meaningful at the shareholder level should be taken into account in the analysis of whether the two corporations were the same.

B. The Reorganization Provisions

The cases from *Phellis* through *Marr* all involved transactions that took place in 1915 and 1916, and all were pending controversies at the time that Congress first adopted statutory relief

[32] Some commentators suggest that *Weiss* was wrongly decided because of the entry of the new shareholder. *See* Kwall & Wilber, *supra* note 12. Taken to its extreme, although an all-cash forward merger into a newly created corporation is generally viewed as an asset sale, perhaps it is conceivable that some form of a same-state version of such a transaction might be viewed as a stock sale under *Weiss*.

[33] Certain post-reorganization authorities, however, have found an acquiring corporation to be the same as a predecessor corporation without reference to the concept of realization or citation to *Weiss*. In some of these authorities, only a portion of the predecessor entity's assets were transferred to the successor. *See, e.g.*, *Casco Products Corp. v. Comm'r*, 49 T.C. 32 (1967); Rev. Rul. 76-429, 1976-2 C.B. 97; *cf. Telephone Answering Serv. Co. v. Comm'r*, 63 T.C. 423 (1974), *aff'd*, 546 F.2d 423, (4th Cir. 1976). In one instance, all of predecessor's assets were transferred to the successor together with additional assets never held by the predecessor. *See* Rev. Rul. 68-349, 1968-2 C.B. 143. Some of these authorities also appear indifferent to the jurisdiction of incorporation. These authorities are discussed at greater length below.

[34] This is rather curious given the size of some of the companies involved (for example, DuPont in *Phellis* and General Motors in *Marr*). As structured, the shareholders would not appear to have been transferees liable for the corporate tax in *Phellis*, *Rockefeller*, or *Marr*. The situation in *Cullinan* is less clear in that regard, but it does not appear that the government asserted any such tax against Mr. Cullinan. The predecessor of section 351 was enacted in 1921, and the predecessor of section 361(a) was enacted in 1924.

In a 1926 Chief Counsel Advice, the IRS applied the results of *Marr* at the corporate level to a similar 1917 transaction of the United Verde Copper Company, giving the acquiring corporation a stepped-up basis for depletion. *See* Exhibit to Brief for Appellant, *Bonney v. Lynch (NY Ct. Apps.)*, N.Y.C. Bar Ass'n, Court of Appeals, v. 42, available on Google eBooks. We can surmise that no corporate tax was paid in 1917 to obtain the higher basis.

for corporate reorganization transactions in the Revenue Act of 1918.[35] Although the design of these statutory provisions has changed slightly over the years, these provisions largely succeeded in ending the line of inquiry into the nature of realization with respect to post-1917 corporate reorganization transactions and displacing it with questions of statutory interpretation.

The Revenue Act of 1918 provided an exception to the general rule that gain was taxable upon the exchange of property for other property "when in connection with the reorganization, merger, or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value."[36] In that case, "no gain or loss shall be deemed to occur from the exchange, and the new stock or securities shall be treated as taking the place of the stock, securities, or property exchanged."[37] The Senate committee report indicated that the provision was added "to negative the assertion of tax in the case of certain purely paper transactions."[38]

Congress revised the income tax laws in the Revenue Act of 1921 to introduce the concept of nonrecognition for various exchanges of property for property.[39] That Act provided that "no gain or loss shall be recognized . . . when in the reorganization of one or more corporations a person receives in place of any stock or securities owned by him, stock or securities in a party to or resulting from such reorganization."[40] The Act defined a "reorganization" to include "a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or of substantially all the properties of another corporation), recapitalization, or mere change to identity, form, or place of organization of a corporation, (however effected)."[41] The committee reports indicated that the Act's amendments, "if adopted, will, by removing a source of grave uncertainty, not only permit business to go forward with the readjustments required by existing conditions but will also considerably increase the revenue by preventing taxpayers from taking colorable losses in wash sales and other fictitious exchanges."[42]

[35] Pub. L. No. 65-254 (1919).

[36] *Id.* at § 202(b).

[37] *Id.*

[38] S. Rep. No. 65-617, at 5-6 (1918).

[39] Revenue Act of 1921, Pub. L. No. 67-98, § 202(c) (1921).

[40] *Id.* at § 202(c)(2). The Revenue Act of 1921 also offered nonrecognition in other situations, including "like kind" exchanges, incorporation transactions, and exchanges where the property received does not have a "readily realizable market value."

[41] *Id.*

[42] H.R. Rep. No. 67-350, at 10 (1921); S Rep. No. 67-275, at 12 (1921).

C. Post-Reorganization Provisions Authorities

1. Treasury Regulations Section 1.1001-1 and *Cottage Savings*

Current section 1001(c) provides that, "[e]xcept as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized."[43] The regulations thereunder provide that, "[e]xcept as otherwise provided in subtitle A of the Code, the gain or loss realized from . . . the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained."[44] The language "differing materially in kind or in extent" can be viewed as the government's attempt to articulate the standard for realization derived from the case law described above.[45]

The Supreme Court applied this standard in *Cottage Savings Association v. Commissioner*.[46] The taxpayer in that case was a financial institution that transferred a 90% participation interest in 252 mortgages to four other savings institutions in exchange for a 90% participation in 305 different mortgages held by those savings institutions. The loans exchanged were secured by single-family homes, mostly in the Cincinnati area, and worth less than their basis. The taxpayer claimed a deductible loss notwithstanding its similar investment posture before and after the exchange. The Court concluded that "[t]he realization requirement is implicit in section 1001(a) of the Code" and that the regulations quoted above "embody a material difference requirement," which "is a reasonable interpretation of section 1001(a)," noting additionally that the regulation is also consistent with *Phellis*, *Weiss*, *Marr*, and *Eisner v. Macomber*.[47] The Court reviewed those cases for guidance as to the meaning of the "material difference" standard, stating:

> Obviously, the distinction in *Phellis* and *Marr* that made the stock in the successor corporations materially different from the stock in the predecessors was minimal. Taken together, *Phellis*, *Marr*, and *Weiss* stand for the principle that properties are "different" in the sense that is "material" to the Internal Revenue Code so long as their respective possessors enjoy legal entitlements that are different in kind or extent. Thus, separate groups of stock are not materially

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[43] Although the concept of "nonrecognition" was introduced in 1921, this formulation of the general rule roughly dates to 1924. *See* Revenue Act of 1924, Pub. L. No. 68-176, § 202(a) (1924).

[44] Treas. Reg. § 1.1001-1(a).

[45] This language originated with the regulations under the Revenue Act of 1934. *See* Treas. Reg. 86, Art. 111-1 (1935). The regulations under section 368 recite the "general rule" requiring recognition of gain or loss upon an exchange of materially different properties and articulate the "purpose of the reorganization provisions" as excepting reorganizations from this rule. *See* Treas. Reg. § 1.368-1(b). Accordingly, these regulations appear to presume that transactions described in section 368(a) will constitute realization events.

[46] 499 U.S. 556 (1991).

[47] *Id.* at 559-62.

> different if they confer "the same proportional interest of the same character in the same corporation." *Marr v. United States*, 268 U.S., at 540, 45 S. Ct., at 577. However, they *are* materially different if they are issued by different corporations, *id.*, at 541, 45 S. Ct., at 597; *United States v. Phellis*, *supra*, 257 U.S., at 173, 42 S. Ct., at 67, or if they confer "differen[t] rights and powers" in the same corporation, *Marr v. United States*, *supra*, 268 U.S., at 541.[48]

The transaction at issue in *Cottage Savings* "easily" satisfied this requirement because the participation interests exchanged were derived from loans made to different obligors and secured by different homes.

2. F Reorganizations

Section 368(a)(1)(F) defines a "reorganization" to include, among other things, "a mere change in identity, form, or place of organization of one corporation, however effected" (an F reorganization). This language is little different from its predecessor text introduced in 1921, quoted above. The language and policies of this statute appear to invite the same inquiry into corporate sameness as that undertaken in the pre-reorganization cases. A corporation that experiences an F reorganization generally is treated for almost all income tax purposes as the same corporation before and after,[49] regardless of whether it becomes a new corporation in a formal sense.

Notwithstanding the similarity in purpose and intention, the F reorganization statute has not been interpreted in a manner wholly consistent with the pre-reorganization case law. *Helvering v. Southwest Consolidated Corp.*,[50] concerns the workout of an insolvent corporation in a state court proceeding in 1934, before recourse to a federal bankruptcy statute was available. Pursuant to a plan of reorganization approved by the Delaware Chancery Court, the creditors' committee formed a new corporation which bid in all the assets of the old corporation at auction. For the most part, the consideration was the stock and warrants of the new corporation, although a few dissenting creditors received cash. The stock was issued to the secured and, to a lesser extent, the unsecured creditors of the old corporation, and the warrants, which had positive value (but were mostly not exercised), to the unsecured creditors and shareholders of the old corporation. The new corporation took the position that the transaction was a reorganization while the government argued that the transaction resulted in a step down in basis. The lower

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[48] *Id.* at 564-65.

[49] At least if it does not enter or leave the United States. The preamble to the proposed F reorganization regulations noted that "an F reorganization is treated for most purposes of the Code as if the reorganized corporation were the same entity as the corporation in existence before the reorganization." REG-106889-04, 69 Fed. Reg. 49836, 49838 (Aug. 12, 2004).

[50] 315 U.S. 194, 202-03 (1942).

courts held that the transaction was a D reorganization on the theory that the creditors were, as an economic matter, the owners of the corporation.

The Supreme Court held for the government that the basis was stepped down. The Court noted that "[t]he primary problem presented . . . is whether the transaction in question qualified as a 'reorganization'." The transaction was not a C reorganization because some creditors received cash and the warrants were not voting stock. It was not a D reorganization because, notwithstanding the predecessor corporation's insolvency, the creditors were not its stockholders. It was not a recapitalization because "[t]here was not that reshuffling of a capital structure within the framework of an existing corporation contemplated by th[at] term." Finally, the Supreme Court noted that "a transaction which shifts the ownership of the proprietary interest in a corporation is hardly a 'mere change in identity, form, or place of organization' within the meaning of [the F reorganization provision]." The Court did not reference any of the pre-reorganization cases and none of them was cited in any of the briefs. The taxpayer's briefs did argue, to no avail, that the transaction was a single-corporation reorganization,[51] in fact, a recapitalization,[52] and that, had the transaction occurred in 1942 instead of 1934, it could and probably would have been accomplished under federal bankruptcy law without the formation of a new corporation.[53]

Recently finalized regulations defining F reorganizations build off that conclusion, as well as the "one corporation" requirement, to formulate the criteria for an F reorganization.[54] Under these regulations, the general conditions (subject to certain minor exceptions) are that: (i) all of the resulting corporation's stock must have been distributed (or deemed distributed) in exchange for the stock of the transferor corporation; (ii) the same person or persons who owned the stock of the transferor corporation immediately before the potential F reorganization must own all the stock of the resulting corporation immediately after in identical proportions, except for changes resulting from corporate distributions or redemptions or recapitalization exchanges; (iii) the resulting corporation may not hold any property or have any tax attributes immediately before the potential F reorganization; (iv) the transferor corporation must completely liquidate, for U.S. federal income tax purposes, in the potential F reorganization; (v) immediately after the potential F reorganization, no corporation other than the resulting corporation may hold property that was held by the transferor corporation immediately before the potential F reorganization, if

[51] "This case involves that type of reorganization where the financial structure of a single corporation is reconstituted. It does not involve that type of reorganization where the properties of two or more corporations are combined." Brief for Respondent, *Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194 (1942), at 7 (Jan. 5, 1942).

[52] *Id.*, at 16-17.

[53] Supplemental Brief for Respondent, *Helvering v. Southwest Consolidated Corp*., 315 U.S. 194 (1942), (Jan. 13, 1942).

[54] Treas. Reg. § 1.368-2(m); T.D. 9739, 80 Fed. Reg. 56904 (Sept. 21, 2015).

such other corporation would, as a result, succeed to the attributes of the transferor corporation under section 381; and (vi) immediately after the potential F reorganization, the resulting corporation may not hold property acquired from a corporation other than the transferor corporation if the resulting corporation would, as a result, succeed to the attributes of such other corporation under section 381.[55] These criteria are generally tested "in a bubble" without regard to "related events that precede or follow the potential F reorganization."[56] The regulations contemplate the co-existence of F reorganizations with recapitalizations under section 368(a)(1)(E) but not with other types of reorganizations.[57]

Although the F reorganization provisions might appear to contemplate a similar inquiry into corporate identity to that in the early nonrealization cases, as interpreted by the regulations, they reach different results. The new regulations do not require an identity of assets but they do forbid the introduction of new shareholders or equity (although not the withdrawal of shareholders or equity). Accordingly, while the transaction in *Marr* would be an F reorganization under today's law, the transaction in *Weiss* might fail to qualify as an F reorganization, because it would have to be recast to negate the problem caused by the introduction of the new shareholder simultaneously with the reincorporation transaction.[58]

Private Letter Ruling 201638004[59] suggests a greater parallelism between *Weiss* and F reorganizations. In that ruling, the owners of X, an LLC treated as a corporation, contributed their X units to Y, a newly formed same-state LLC treated as a corporation, in exchange for all the equity units of Y, after which X elected to become a disregarded entity of Y (the "***drop and check***"). Thereafter, X distributed one business to Y, while continuing to hold another business. Y contributed its X units to Z, a newly formed same-state LLC treated as a corporation, in exchange for Z units that Y spun off to its shareholders (the "***spin-off***"). The IRS ruled that, "[f]or purposes of determining whether [the drop and check], viewed together, result in the realization of gain or loss under section 1001 (*see Weiss v. Stearn*, 265 U.S. 242 (1924)), or a reorganization under section 368(a)(1)(F) (*see* Rev. Rul. 72-206, 1972-1 C.B. 104), [the spin-off]

55 Treas. Reg. § 1.368-2(m)(1).

56 Treas. Reg. § 1.368-2(m)(3)(ii).

57 *See* Treas. Reg. § 1.368-2(m)(3)(iv)(B).

58 The *Weiss* Court (following the lower court's decision) appeared to recast the transaction into a sale of target shares first, followed by the reincorporation. As noted by some commentators, the use of the escrow agent makes it impossible to determine which corporation the new investor purchased stock in or from whom. *See* Kwall & Wilber, *supra* note 12, at 56-57, 62-67. There are several equally plausible views of the transaction. *Cf. Turner Broadcasting System Inc. v. Comm'r*, 111 T.C. 315 (1998) (simultaneous transactions not recast into sequential transactions).

59 (June 16, 2016).

shall be disregarded." This ruling is interesting not merely for citing *Weiss*, but for applying it in a "bubble."[60]

3. Revenue Ruling 68-349

In Revenue Ruling 68-349,[61] corporation Y transferred all of its assets subject to all of its liabilities to newly formed corporation X in exchange solely for X voting stock. Y then liquidated, distributing the X stock to the Y shareholders in exchange for their Y stock. At the same time, individual A transferred appreciated property to X in exchange solely for X voting stock. The ruling holds that because X was formed for the purpose of enabling A to transfer the appreciated assets to X without the recognition of gain, "the organization of X is to be considered under the circumstances to be merely a continuation of corporation Y." As a result, the transfer of assets by A to X did not come within the nonrecognition provisions of section 351, since A was not in control of the continuing entity as provided in section 368(c) of the Code.

The precise meaning of X being "merely a continuation of Y" is not spelled out in the ruling.[62] On the one hand, it might be interpreted to mean that the transaction between X and Y and Y and its shareholders was not a realization event, along the lines of the rationale in *Weiss*. On the other hand, *Weiss* is not cited in the ruling and, unlike in *Weiss*, the entity at the end of the overall transaction (X) had assets in addition to those that were held by the entity (Y) at the beginning of the transaction. The states of incorporation of X and Y are not indicated.[63] Moreover, the ruling goes on to hold that the transfer by Y of all of its assets to X in exchange for X voting stock and the assumption of Y's liabilities "is a reorganization under section 368(a)(1)(F) of the Code and no gain or loss will be *recognized* to Y or its shareholders."[64] This reference to F reorganization treatment and nonrecognition seems at odds with the proposition that X being a continuation of Y was intended to mean that the transactions between X and Y and

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[60] *But see Kountze v. Comm'r*, 24 B.T.A. 403 (1931) (applying *Marr* to find a realization event when a same-state reincorporation was followed by the issuance of additional preferred stock to the public).

[61] 1968-2 C.B. 143.

[62] Interestingly, Revenue Ruling 68-349 was issued shortly after *Casco Products Corporation v. Commissioner*, 49 T.C. 32 (1967) (discussed Part II.C.5 below) was decided. Perhaps the language used in *Casco* that the successor entity was "simply a continuation" of the predecessor entity was the genesis of the "merely a continuation" language used in Revenue Ruling 68-349.

[63] Revenue Ruling 68-349 was distinguished in Revenue Ruling 76-123, 1976-1 C.B. 94. In that ruling, individual A transferred all the stock of corporation X, incorporated in state O, to newly formed corporation Z, incorporated in state P. At the same time, individual B transferred all the stock of corporation Y, incorporated in state P, to Z. X was then liquidated into Z. The ruling holds that the transfer of X to Z followed by the liquidation of X into Z was a reorganization governed by section 368(a)(1)(C) and forming part of an asset transfer to Z that, together with B's transfer of Y to Z, qualified B's transfer for nonrecognition treatment under section 351(a). In not treating Z as being merely a continuation of X, the ruling distinguishes Revenue Ruling 68-349 on the grounds, among others, that Z was incorporated in order to enable X to be reincorporated in a different state.

[64] Emphasis added.

Y and its shareholders were nonrealization events.[65] It appears that the transaction described in the ruling would not be an F reorganization under the new regulations.[66] An IRS spokesperson was reported as saying that the ruling was not designated as obsolete when the regulations were issued "because of what the ruling says about section 351."[67]

4. Revenue Ruling 72-206

In Revenue Ruling 72-206,[68] corporation X changed its name and issued new stock certificates to its shareholders in exchange for the X stock held by them prior to X's change in name. Despite the fact that the ruling gives no indication that X changed its state of incorporation or that the terms of the newly received shares were any different from those of the old shares (other than the different corporate name on the certificate), the ruling states that the transaction qualified as an F reorganization. The ruling holds that, although X is neither an acquiring corporation nor a new corporation as a result of the name change, X is considered to be "a party to a reorganization" within the meaning of section 368(b). Therefore, no gain or loss is recognized to the shareholders of X upon the exchange of their stock under section 354(a).

The ruling applies the nonrecognition provisions for reorganizations in a situation where X is the same corporation before and after. It is not an acquiring corporation—there is no deemed exchange—but it is nevertheless a resulting corporation because a reorganization has occurred, even though its protections appear not to be needed.[69] Arguably, the name change could also be an F reorganization (because it was, literally, a "mere change in identity" as described in the statute) but not a realization event. However, in that case, the reliance on section 354(a) for no gain or loss would seem to be unnecessary.

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[65] As discussed below in the context of Revenue Ruling 72-206, it is conceivable that a transaction could be an F reorganization, because it meets the definitional requirements of section 368(a)(1)(F), but nevertheless still be a nonrealization event. If that were the intended treatment in Revenue Ruling 68-349, however, the explicit reference in the ruling to nonrecognition (versus nonrealization) seems curious.

[66] *See* New York State Bar Ass'n Tax Section, *Report on Final Regulations on Reorganizations under Section 368(a)(1)(F)*, at 18 (June 1, 2016).

[67] Amy S. Elliott, *ABA Meeting: Only Federal Attributes Count for Third F Reorg Requirement*, 2016 TNT 21-8 (Feb. 2, 2016).

[68] 1972-1 C.B. 104.

[69] *Cf.* Priv. Ltr. Rul. 201026010 (Dec. 18, 2009) (citing *Weiss* for the proposition that a corporate name change is not a realization event). Revenue Ruling 72-206 is not cited in Private Letter Ruling 201026010. Unlike in Revenue Ruling 72-206, it is unclear whether any physical exchange of shares occurred in the facts addressed in the private letter ruling and perhaps that was felt to be a distinguishing feature. On the other hand, it would seem odd for realization to turn on whether there was a physical exchange of shares given that a physical exchange occurred in *Weiss* and yet no realization event was found there. *See also* Treas. Reg. § 1.1001-3(a)(1) (making it clear that a realization event can occur with respect to debt instruments without a physical exchange and a physical exchange of debt instruments is not determinative as to whether a realization event has occurred).

5. Other Pathways to Corporate Sameness

Outside of the context of realization, certain cases and revenue rulings have relied on *ad hoc* notions of corporate sameness independent of the reorganization provisions or the old realization cases. F reorganizations allow the resulting corporation to carry its losses back against the income of its predecessor. Several cases found F reorganizations to allow such carrybacks over the objection of the IRS that the transactions shifted the proprietary interests in the target, contrary to *Southwest Consolidated*.[70] However, in one case, the Tax Court found a newly organized corporation to be the same corporation as its predecessor without reference to either the reorganization provisions or the old realization cases, at least for the purpose of the carryback. In *Casco Products Corporation v. Commissioner,*[71] a firm obtained 91% of the stock of a corporation ("***Old Casco***") over eight months in a tender offer. It then organized another corporation ("***New Casco***") in the same state[72] and caused Old Casco to merge into New Casco for the purpose of squeezing out the 9% minority interest, which received cash in the merger. According to the Tax Court:

> [B]oth parties invite us to engage in an interpretative exercise as to the scope of section 368(a)(1)(F). . . . We decline the invitation. . . . There is no question, and indeed, respondent so concedes, that if Old Casco had redeemed the shares of the minority shareholders and had continued in business the loss carryback would clearly be available. As we see it, the circumstances herein should not produce a different result. . . . Taxwise, New Casco was merely a meaningless detour along the highway of redemption of the minority interests in Old Casco. The merger itself, although in form a reorganization, had as its sole purpose the accomplishment of the redemption[.] … Under these circumstances, the merger was a reorganization in form only and should consequently be ignored as such. What took place was a redemption of 9 percent of the Old Casco shares and no more. Under the limited circumstances of this case, we hold that New Casco was simply a continuation of Old Casco and the loss carryback should have been allowed.[73]

Casco is an interesting case in that the court followed its own notions of corporate identity, relying neither on the reorganization rules nor on cases like *Weiss*, using uncharted

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[70] *See, e.g.*, *Aetna Cas. & Sur. Co. v. United States*, 568 F.2d 811 (2d Cir. 1976).

[71] 49 T.C. 32 (1967), *action on dec.*, 1976 WL 39281 (Jan. 22, 1976) (recommending nonacquiescence).

[72] A fact not relied on by the court.

[73] *Casco*, at 36-37. Two years after *Casco*, the IRS issued Revenue Ruling 69-617, 1969-2 C.B. 57 (discussed below), which involves a squeeze-out transaction that is facially very similar to *Casco*.

principles and seeming to place significant weight on the taxpayer's intent.[74] While, the difference between forward and reverse may not seem that great to someone other than a tax lawyer, directionality has generally been accorded significance in the tax law.[75] Under the new F reorganization regulations, the transaction in *Casco* would be an F reorganization, a proposition the IRS disputed in that case.

Liquidation-reincorporation transactions were designed to avoid the formal requirements of a reorganization so that the shareholders could enjoy capital gain on the cash withdrawn from corporate solution and the acquiring corporation could have a stepped-up basis in the assets going forward and none of the tax attributes of the liquidating corporation. Most of those transactions were analyzed by the courts as reorganizations, notwithstanding the features of the transactions intended to render them taxable.[76] However, the Tax Court approached the question differently in *Telephone Answering Service Co., Inc. v. Commissioner* ("***TASCO***").[77] The taxpayer corporation sold one of its subsidiaries to a third party. It then distributed to its shareholders in liquidation the cash proceeds, the stock of its other historic subsidiary, and the stock of a newly formed corporation to which businesses directly conducted by the taxpayer had been transferred.[78] The Court held that the reincorporation of those assets caused the liquidation not to be "complete" within the meaning of then section 337, which relieved the taxpayer of the corporate-level tax on sales before complete liquidations. No reference was made to the reorganization or nonrealization cases, and no attempt was made to present a full picture of the tax consequences to all the parties.

Revenue Ruling 76-429,[79] appears to take *TASCO* a step further. A parent corporation, P, had a wholly owned subsidiary, S1, engaged in two businesses representing 52% and 48%, respectively, of its value. S1 sold the 48% business, distributed the cash proceeds together with

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[74] Several years after *Casco*, in *Yoc Heating Corp. v. Commissioner*, 61 T.C. 168 (1973), the Tax Court examined a similar squeeze-out transaction and found the acquirer different enough to merit a basis step up. The facts were fairly similar to those in Casco except that the squeeze-out was effected by an asset sale rather than a merger, the cash in the squeeze-out transaction came from the corporation that acquired the majority of the target's stock rather than the target, and that corporation always wanted to acquire assets in order to get a step up. The majority opinions in *Casco* and *Yoc Heating* are both by Judge Tannenwald.

[75] *Compare* Rev. Rul. 67-448, 1967-2 C.B. 144 (treating a target corporation's acquisition via a merger of the acquirer's subsidiary into the target as a transfer by the target's shareholders of their stock to the acquirer in exchange for the acquisition consideration), *with* Rev. Rul. 69-6, 1969-1 C.B. 104 (treating a target's acquisition via a merger into the acquiring corporation as the transfer of the target's assets and liabilities to the acquirer in exchange for the acquisition consideration, which then is distributed by the target to its shareholders in liquidation).

[76] *See, e.g., Reef Corp. v. Comm'r*, 368 F.2d 125 (5th Cir. 1966), *cert. denied*, 386 U.S. 1018 (1967); *Davant v. Comm'r*, 366 F.2d 874 (5th Cir. 1966).

[77] 63 T.C. 423 (1974), *aff'd*, 546 F.2d 423 (4th Cir. 1976).

[78] The new corporation was incorporated in the same state as the taxpayer, but that fact was not emphasized by the Tax Court.

[79] 1976-2 C.B. 97.

its remaining business to P, and then dissolved. Two weeks later, P formed a new corporation, S2, in the same state and having the same name as S1, and transferred the business it received from S1 to S2 in exchange for S2 stock. The ruling holds that the transaction was not a complete liquidation under section 332.[80] "[S]ince the transactions in the instant case did not meet the standards of a complete liquidation, the liquidation of S1 and the incorporation of S2 will be disregarded and the two corporations will be considered the same for Federal income tax purposes." The cash distribution was held to effect a partial liquidation.[81]

Revenue Ruling 69-617,[82] poses an interesting contrast to Revenue Ruling 76-429. Corporation P owned more than eighty percent of the stock of corporation S. S was merged into P under state law, with the minority shareholders of S receiving P stock for their S stock. P then transferred all of the S assets and liabilities to its new subsidiary, corporation X. There is no reference to the state of incorporation of S or X. The ruling holds that, "[s]ince the assets of S were immediately transferred by P to X, there was no complete liquidation of S within the meaning of section 332 of the Code. However, the fact that P owned more than eighty percent of the stock of S does not prevent the transfer of the assets of S to P from qualifying as a statutory merger, where such assets are transferred to another subsidiary."[83] The conclusion that the transaction was not a complete liquidation of S is consistent with Revenue Ruling 76-429 and *TASCO*, but the conclusion that P was the acquiring corporation in an A reorganization is not compatible with the conclusion in Revenue Ruling 76-429 that S2 was the same corporation as S1. Revenue Ruling 69-617 is not mentioned in Revenue Ruling 76-429. When Revenue Ruling 76-429 was published, the transaction it describes could not be treated as an upstream C reorganization, which might appear to be the result in that ruling under today's law.[84]

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[80] *But see* 1996 FSA LEXIS 460 (Mar. 14, 1996) (concluding that a Canadian subsidiary's liquidation into its Canadian parent, followed by a transfer of less than substantially all of the liquidated subsidiary's assets to a newly formed subsidiary, should be treated as a section 332 liquidation followed by section 351 exchange). Although the FSA is highly redacted, it seems that, in response to the taxpayer's argument that the transaction should be treated as a partial liquidation pursuant to Revenue Ruling 76-429, the IRS noted that the newly formed subsidiary could not be treated as the same as, or as an "alter ego" of, the Canadian subsidiary because, among other things, (i) the newly formed subsidiary was not a "receptacle for only the assets of" the Canadian subsidiary and (ii) four months elapsed between the liquidation and the transfer of the liquidated subsidiary's assets, during which time the benefits and burdens of ownership of the assets resided with the Canadian parent. The state or country of the newly formed subsidiary was not mentioned. The IRS also noted that the transaction was distinguishable from *TASCO* without providing specific reasoning.

[81] *TASCO* is not cited and would have been pending appeal at the time the ruling was issued.

[82] 1969-2 C.B. 57.

[83] *Cf.* Rev. Rul. 58-93, 1958-1 C.B. 188 (reaching a similar result with respect to a 79% owned subsidiary).

[84] Regulations subsequently overruled *Bausch & Lomb Optical Co. v. Commissioner*, 267 F.2d 75 (2d Cir. 1959), to permit such upstream reorganizations under section 368(a)(1)(C). *See* Treas. Reg. § 1.368-2(d)(4).

6. Treasury Regulations Section 301.7701-3

Section 7701(a) defines the term "partnership" to include "a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of [the Internal Revenue Code], a trust or estate or a corporation," and the term "corporation" to include "associations, joint-stock companies, and insurance companies." Treasury regulations issued in 1996 interpret these terms.[85] Under these regulations (often referred to as the "***check-the-box regime***"), certain types of entities must be treated as corporations, while other "eligible entities" may choose their status as corporations on the one hand or partnerships or disregarded entities on the other hand, and have a default status if they do not elect otherwise. An eligible entity may elect its status as of its inception but may also elect to change its status under certain conditions thereafter.[86] A change in status is afforded tax consequences.[87] Accordingly, a taxable event is deemed to occur even though, from a non-tax perspective, the entity is not in any way different in kind or extent as a result of the election.

7. Treasury Regulations Section 1.368-2(k)

Treasury Regulations section 1.368-2(k) was adopted to resolve uncertainties regarding the proper characterization of transactions in which assets or stock are transferred after a transaction that would satisfy the standards for a reorganization if not for the subsequent transfer. It generally 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, provided that the continuity of business enterprise requirements of Treasury Regulations section 1.368-1(d) are satisfied and the transfer(s) are certain described distributions or other transfers.[88]

Section 368(a)(2)(C) precludes the disqualification of an otherwise qualifying A, B, or C (or certain types of G) reorganization by reason of the transfer of part or all of the acquired assets or stock to a controlled subsidiary of the acquiring corporation. Prior to the -2(k) regulations, Revenue Ruling 69-617, citing section 368(a)(2)(C), had found an upstream reorganization under section 368(a)(1)(A) when corporation S was merged into its controlling shareholder, corporation

[85] *See* Treas. Reg. §§ 301.7701-1, -2, -3.

[86] Treas. Reg. § 301.7701-3(c)(1).

[87] *See* Treas. Reg. § 301.7701-3(g). As noted in the Preamble to the Notice of Proposed Rulemaking, "[t]his provision is intended to ensure that the tax consequences of an elective change will be identical to the consequences that would have occurred if the taxpayer had actually taken the steps described in the . . . regulations." REG-105162-97, 62 Fed. Reg. 55768 (Oct. 28, 1997). Thus, for example, an elective change of status of a limited liability company from corporation to disregarded status is treated as a liquidation. *See* Treas. Reg. § 301.7701-3(g)(1)(ii). So too is a state law conversion of a corporation to a limited liability company that defaults to disregarded status. *See, e.g.*, Treas. Reg. § 1.368-2(m)(4), *Example 11*.

[88] *See* Treas. Reg. § 1.368-2(k)(1).

P, with the S shareholders receiving P stock, even though the assets and liabilities obtained from S were immediately transferred by P to a new wholly owned subsidiary of P. The -2(k) regulations confirm this result and expand the principles of section 368(a)(2)(C) to other situations in which the target's assets or stock are transferred but remain directly or indirectly under the control of the issuer of the equity that is consideration for the putative reorganization. The new F reorganization regulations explicitly acknowledge the priority of an upstream reorganization under the -2(k) regulations over a potential F reorganization.[89]

8. Private Letter Rulings Involving Transitory LLC Conversions

Several private letter rulings have applied the principles of the -2(k) regulations in an environment in which entities can toggle between corporate and noncorporate status as a result of entity classification elections or state law conversions.[90] In Private Letter Ruling 200830003,[91] Parent owned the stock of a domestic subsidiary, Sub 1, that was a holding company. Sub 1 owned the stock of Distributing and other domestic and foreign subsidiaries. Distributing owned all the interests in Controlled, an LLC taxable as a corporation. In the transaction at issue, Sub 1 converted to an LLC under state B law, becoming a disregarded entity (the "***Sub 1 Conversion***"), Sub 1 LLC distributed the stock of Distributing and the other domestic subsidiaries to Parent, Distributing distributed the interests in Controlled to Parent, Controlled elected to be treated as a disregarded entity of Parent, and Sub 1 LLC then converted under the laws of state B into a corporation, now largely holding its foreign subsidiaries. Thus, at the start of the transaction, Parent owned Sub 1, and Sub 1 owned Distributing and its other domestic and foreign subsidiaries, and Distributing owned Controlled. At the end of the transaction, Parent owned Distributing, the assets of Controlled, Sub 1's other former domestic subsidiaries, and New Sub 1. New Sub 1 owned the foreign subsidiaries formerly owned by Sub 1. The redacted ruling does not state that Sub 1 started as a state B corporation—only that the two conversions occurred under state B law—but it is a reasonable guess that Sub 1 and New Sub 1 were both incorporated in state B. The ruling holds that no gain or loss will be recognized by Sub 1 or Parent on the Sub

[89] *See* Treas. Reg. § 1.368-2(m)(1)(v), (3)(iv), (4), *Example 10*; *see also* T.D. 9739, 80 Fed. Reg. 56,904, 56,910 (Sep. 21, 2015) (referring to Revenue Ruling 69-617).

[90] These private letter rulings are not binding with respect to other taxpayers and transactions. As previously noted, we understand that the IRS has recently declined to issue a private letter ruling in a same-state convert-distribute-reconvert case, although we do not know the particular factual details of that case. *See* note 3, *supra*.

[91] (Apr. 25, 2008).

1 Conversion (citing no Code provision),[92] that section 355 applies to the distribution by Distributing of Controlled, that section 332 applies to the liquidation of Controlled into Parent, and that section 351 applies to the conversion of Sub 1 LLC into New Sub 1.

Private Letter Ruling 200952032[93] obtained a similar result in a transaction with a degree of factual complexity. Holdco owned all of S1 and S2. S1 was incorporated in both states X and Y. S2 was incorporated solely in state Y. The assets comprising the state Y operations were held by S1 and S2 as tenants in common ("***TIC***"), though all the income and expenses of the state Y operations were reported by S2. In the transaction: (i) S1 converted under state X law to a single-member LLC ("***S1 LLC***") that was disregarded as an entity separate from Holdco; (ii) S1 LLC transferred its TIC interest to S2 for no consideration; and (iii) S1 LLC then converted back to a corporation ("***New S1***") under state X law. S1's TIC interest was the only asset that actually moved for state law purposes other than through the conversions. The initial conversion of S1 to S1 LLC terminated S1's status as a state Y corporation. When S1 LLC converted back to a corporation, it was incorporated only in state X. The IRS ruled that the initial conversion of S1 to an LLC was an upstream C reorganization, and that the deemed transfer of the TIC interest by Holdco to S2 was governed by section 351, as was the conversion of S1 LLC into New S1.

Private Letter Ruling 201127004[94] reached a similar result without the complexities of dual incorporation. Sub was incorporated in state Y, and Parent wholly owned all the outstanding common and preferred stock of Sub. The preferred stock was redeemable b years following its issuance. Sub was engaged in two businesses, one conducted through an LLC classified as a partnership. Sub converted under state Y law into an LLC, Sub LLC distributed its interest in the partnership LLC to Parent, and then Sub LLC converted back into a state Y corporation ("***New Sub***"). On the effective date of Sub's conversion to an LLC, the terms of Sub's preferred stock were amended to provided that the stock would be redeemable d years following its issuance. This transaction was also held to be an upstream C reorganization followed by a reincorporation of assets into New Sub governed by section 351.

In two other private letter rulings, a subsidiary converted to a disregarded entity and distributed assets to its parent, and then either the distributed assets or the retained assets were contributed (or deemed to be contributed) to a newly formed corporation that apparently was in

[92] In the ruling, it was represented that the assets reincorporated in New Sub 1 would represent less than "d percent of the gross value of Sub 1's assets." The taxpayer made a full set of representations regarding the initial Sub 1 Conversion "should the transaction be treated as a liquidation under § 332" and another full set of representations "should the transaction be treated as a reorganization under § 368(a)(1)(C)." *See also* Priv. Ltr. Rul. 201033018 (Jan. 14, 2010) (wherein the taxpayer only provided representations regarding section 332 treatment but the IRS gave no gain or loss and basis rulings without section cites, possibly on the grounds that the transaction might also have qualified as an upstream C reorganization).

[93] (Sept. 24, 2009).

[94] (Dec. 17, 2010).

in a different state.[95] In each case, the IRS ruled that the transactions were upstream C reorganizations followed by asset drop downs. Because the contributions apparently were into different state corporations, presumably a nonrealization recast was not a possibility.

9. Section 332 Transactions

Congress first introduced the concept of nonrecognition for distributions by a subsidiary corporation to its corporate parent in complete liquidation as part of the Revenue Act of 1935.[96] That Act provided that "no gain or loss shall be recognized upon the receipt by a corporation of property or money distributed in complete or partial liquidation of another corporation, if the corporation receiving such property owns at least 80 per centum of the voting stock of the other corporation."[97] The committee hearings indicated that the Act's amendments were intended to encourage simplification and the elimination of holding company structures.[98]

As discussed above, the -2(k) regulations prevent certain reorganization transactions from being recharacterized as a result of subsequent related steps. But the -2(k) regulations do not affect the determination of whether a transaction qualifies as complete liquidation under section 332 where the predicates of that section are satisfied, taking subsequent related steps into account.[99] Moreover, the F reorganization regulations contain provisions that preclude a liquidation followed by a reincorporation of some assets from qualifying as an F reorganization if the transaction meets the predicates of section 332 taking the reincorporation into account.[100] We are also unaware of any authority that has suggested that such a transaction could be a nonrealization event, even where the reincorporated entity is in the same state as the liquidated entity.

[95] *See* Priv. Ltr. Rul. 201411002 (Dec. 13, 2013) (a State A corporation converted to an LLC, distributed some assets to its shareholder, and the shareholder then contributed the interests in the LLC to a newly formed State C controlled corporation and distributed the controlled corporation in a section 355 distribution); Priv. Ltr. Rul. 201224006 (Mar. 14, 2012) (multi-step conversion of a State A corporation to a State B LLC that was disregarded as an entity separate from its owner, followed by a distribution of assets by the LLC to its parent corporation and a contribution of the assets distributed into a new State B corporation together with a contribution of the assets not distributed (along with other assets) into a second new corporation, which, although unstated in the ruling, was presumably not a State A corporation).

[96] Pub. L. No. 74-407, § 110.

[97] Added as section 112(b)(6) of the Revenue Act of 1934, Pub. L. No. 73-216.

[98] *Hearings before the Committee on Finance*, S. Comm. on Finance, 74th Cong. 51-52 (1935). Following the elimination of consolidated income tax returns in 1933 and the introduction of the principle that intercompany dividends would be taxable, many corporate groups wished to simplify their corporate structures by eliminating subsidiaries but found it too burdensome.

[99] The -2(k) regulations also do not affect (or address) whether a transaction can simultaneously qualify as both a section 332 transaction and an upstream reorganization.

[100] *See* Treas. Reg. § 1.368-2(m)(1)(v).

For example, assume corporation X is wholly owned by corporation Y. X liquidates into Y and as part of the same plan Y transfers 20% of X's assets to newly formed corporation Z. Z is formed in the same state as X. Assume the above transaction otherwise qualifies as a section 332 liquidation of X into Y followed by a transfer of assets by Y to Z in a transaction to which section 351 applies. By virtue of the above liquidation qualifying as a section 332 liquidation, the F reorganization regulations preclude the overall transaction from being treated as an F reorganization of X into Z with the 80% of the X assets held by Y being treated as distributed by X/Z to Y in a distribution to which section 301 applies. Moreover, we are not aware of any authority that would treat the overall transaction as a nonrealization event as regards X, which would produce essentially the same 80% section 301 distribution result that would obtain if the overall transaction were recharacterized as an F reorganization. [101]

III. DISCUSSION

Corporations are legal fictions. Their physical unreality allows us to imagine that one corporation that remains nominally the same has changed enough to become another corporation, or that one corporation that is nominally different is really the same corporation as another. In cases under the first two Revenue Acts, the Supreme Court embarked on a process of sorting out when a corporation remains the same and when it becomes something different. However, five years of transactions was not enough time to develop this law. This is due in part to the limited number of questions presented and in part to the fact that shareholder-level cases actually presented the question of whether stock was the same, a determination for which the corporation being the same was a necessary but not a sufficient condition. Under these cases, we know that corporations incorporated in different states are different. We know that holding companies and operating companies are different, even if the underlying assets are the same. However, we do not know with certainty whether corporations with different assets are always different. Nevertheless, in all the Supreme Court cases that found nonrealization, there was an identity of assets. The exercise begun by the courts before the reorganization provisions were enacted stopped just at the point where the results were starting to look strange.

The Revenue Act of 1918, which intended to prevent the taxation of "paper gains," posed the question differently, but it is essentially the same question. An F reorganization, involving a "mere change," is effectively a transaction in which the corporation ought to be treated as the same corporation, whether or not it is, and the corporation generally is so treated under the Code.

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[101] *Cf.* Treas. Reg. § 1.368-2(m)(4), *Example 9* (finding that a liquidation followed by a reincorporation of 20% of the liquidating entity's assets is a liquidation governed by section 332 and, accordingly, cannot be an F reorganization of the liquidated entity into the recipient entity. No mention is made of the state of incorporation of the recipient entity being different than the state of incorporation of the liquidated entity or of any possibility of the transaction being treated as a nonrealization event with the recipient entity being treated as the same entity as the liquidated entity coupled with a distribution of the 80% of the liquidated entity's assets retained by the shareholders.).

Other types of reorganizations are transactions that do not involve sameness but sufficiently preserve the interests of the former target corporation's shareholders so as to merit some of the benefits of similarity. There is nearly a century of law developing these concepts.

Corporate law has also changed since the Supreme Court decided the early realization cases. For domestic business entities, there were corporations and general partnerships. At one time, Delaware really did offer more powers than other states to its corporations. Today, as a practical matter, notwithstanding anything a state conversion statute might say about the entities being the same, the governance rules for a Delaware corporation and a Delaware LLC may differ more than those for a Delaware corporation and a Maryland corporation. And the check-the-box regime imposes tax consequences in the absence of any non-tax differences.

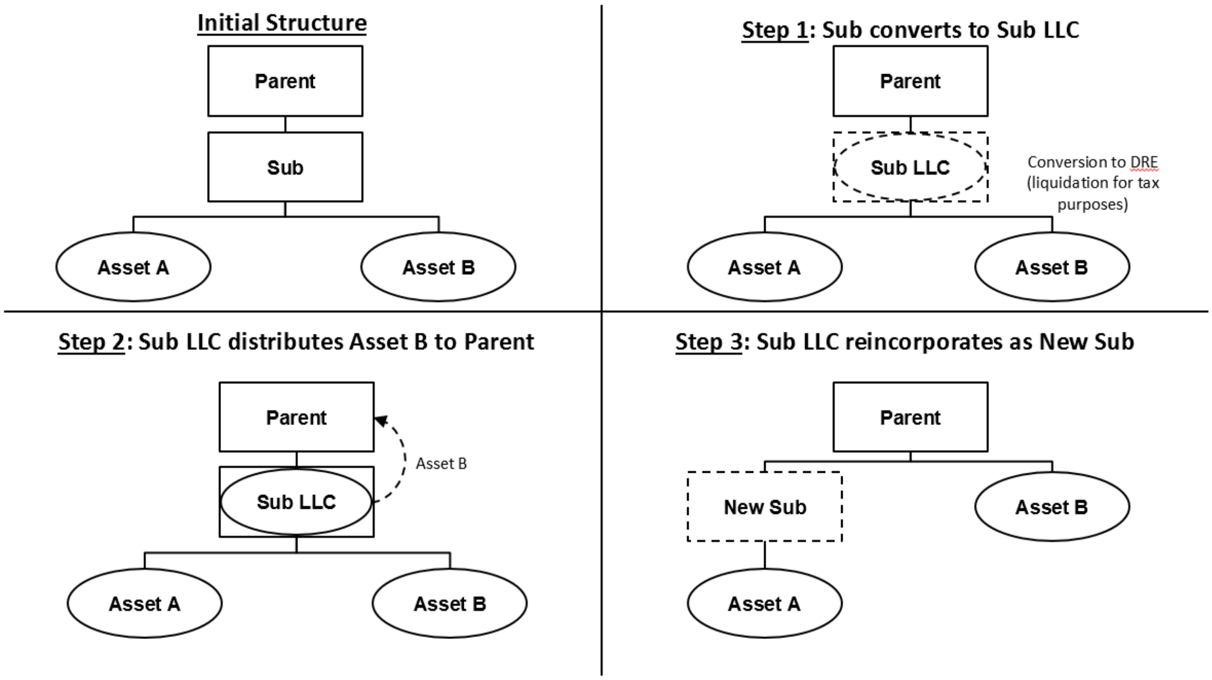
All of this suggests that it would be inadvisable to pick up where the realization cases left off and attempt to develop nonrealization principles in ways apart from the reorganization rules, unless one were convinced that this was otherwise mandated. We discuss approaches for analyzing the realization issue in this light by examining in detail below several transactions involving in-form reorganizations followed (or preceded) by same-state asset drop-downs. These transactions are not the exclusive cases in which the issue of nonrealization versus reorganization treatment may arise. However, they help to delineate the different results that can ensue in the cases addressed depending on which approach is taken as well as permit a more contextual examination of the recommendations made in this report.

1. Conversion, Distribution, Reconversion

The most discussed transaction involving an overlap of the reorganization rules and the nonrealization principles is a situation where a subsidiary corporation converts to an LLC, distributes an asset to its parent, and then reconverts to a corporation.[102]

> ***Example 1.*** Parent directly owns 100% of the stock of Sub, a State X corporation. Parent has a basis of $80 in its Sub stock. Sub owns two assets—Asset A with a basis of $50 and a value of $75 and Asset B with a basis of $30 and a value $50—and has no liabilities. As part of a single plan, Parent and Sub take the following steps. First, Sub converts under State X law to an LLC ("***Sub LLC***"). Second, Sub LLC distributes Asset B to Parent. Third, Sub LLC converts back under State X law to a corporation ("***New Sub***") and continues to hold Asset A.

[102] *See, e.g.*, Priv. Ltr. Rul. 201411002 (Dec. 13, 2013); Priv. Ltr. Rul. 201224006 (Mar. 14, 2012); Priv. Ltr. Rul. 201127004 (Dec. 17, 2010); Priv. Ltr. Rul. 200952032 (Sept. 24, 2009); Priv. Ltr. Rul. 200830003 (Apr. 25, 2008), each briefly discussed in Part II.C.8.



Under the currently understood nonrecognition rules, although the conversion of Sub in step one generally meets the statutory tests of section 332 when looked at in isolation, because a significant portion of the assets deemed distributed by Sub in the deemed liquidation resulting from its conversion to an LLC are, pursuant to the same plan as the liquidation, recontributed by Parent to New Sub in step three, the transactions are likely to be integrated and the first step liquidation is likely to be denied treatment as a complete liquidation under section 332. Nevertheless, under the reorganization provisions, if the first step conversion does not qualify as a complete liquidation under section 332, it may nonetheless potentially qualify for nonrecognition treatment as an upstream C reorganization in which Parent is deemed to have acquired all of Sub's assets in exchange for Parent stock and Sub is deemed to have distributed the Parent stock back to Parent in liquidation. Under the -2(k) regulations, if the first step conversion qualifies as an upstream C reorganization, then it may not be disqualified or recharacterized as a result of Parent's subsequent deemed transfer of Asset B to New Sub in step three, provided that the continuity of business enterprise requirements of Treasury Regulations section 1.368-1(d) are satisfied.[103] The deemed transfer of Asset B to New Sub in step three should qualify as a section 351 exchange because Parent should be treated as transferring Asset B to New Sub solely in deemed exchange for all of New Sub's stock.[104]

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[103] Treas. Reg. § 1.368-2(k)(1). Absent more, we have assumed the continuity of business enterprise requirements would be satisfied. We have also assumed in all the reorganization examples in the report that the other requirements for reorganization treatment (including a valid business purpose) are met.

[104] *See* section 351(a); *cf.* Treas. Reg. § 301.7701-3(g)(1)(iv).

Under this characterization of the transaction in Example 1 as an upstream C reorganization followed by a section 351 exchange, the following U.S. federal income tax consequences would result. As a result of the first step conversion of Sub to an LLC being treated as an upstream C reorganization, no gain or loss would be recognized by Sub or Parent.[105] Parent would take a carryover basis in Asset A of $50 and Asset B of $30, Parent's $80 basis in its Sub stock would be eliminated, and, pursuant to section 381(a), Parent would succeed to Sub's tax attributes. The second step distribution of Asset B by Sub LLC to Parent would have no U.S. federal income tax consequences because, at this point, Sub LLC would be disregarded as an entity separate from Parent. The deemed section 351 exchange resulting from the third step conversion of Sub LLC back to a corporation would result in no gain or loss to New Sub or Parent.[106] Parent would take a $50 basis in its New Sub stock,[107] and New Sub would take a $50 basis in Asset A.[108] Accordingly, as a result of applying the nonrecognition provisions to the transaction in Example 1, (i) Asset B has been moved up one level of the corporate chain to Parent without the recognition of gain by Sub, (ii) Sub's tax attributes have also moved up to Parent, and (iii) Parent's original stock basis in Sub has been eliminated.

In contrast, if the government were to determine that nonrealization principles should apply to the transaction in Example 1, for example because New Sub was reincorporated in the same state as Sub, then the conversion and reconversion of Sub would be ignored for U.S. federal income tax purposes. Instead, the transaction would simply be treated as a taxable distribution of Asset B by Sub to Parent. Sub would recognize $20 of gain under section 311(b) upon the distribution, and Parent would receive a dividends received deduction on the distribution under section 243.[109] To the extent section 1059 applied to the distribution, Parent would reduce its basis in the stock of Sub.[110] Because there would be no section 381(a) transaction, Sub's tax attributes would remain at Sub.

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[105] Sections 354(a)(1); 361(a), (c); 1032(a).

[106] Sections 351(a); 1032(a).

[107] Section 358(a)(1).

[108] Section 362(a).

[109] The applicable dividends received deduction percentage (100% versus 80%) would depend on whether the dividend was a "qualifying dividend" (essentially, paid out of earnings of Sub earned while Sub and Parent were affiliated). Section 243(a), (b). The eligibility of the entire distribution to be treated as a dividend assumes Sub has current or accumulated earnings and profits at least equal to the amount of the distribution and the ability to get any dividends received deduction assumes the requisite holding period is satisfied. *See* Sections 246; 316.

[110] To the extent that Parent and Sub are members of a consolidated group, Sub would recognize $20 of gain under section 311(b) upon the distribution that would be taken into account in accordance with the matching and acceleration rules under Treasury Regulations section 1.1502-13. The distribution of Asset B would be treated as an intercompany distribution and would not be included in Parent's gross income provided that Parent reduces its basis in its Sub stock by the amount of the distribution. *See* Treas. Reg. §§ 1.1502-13(f)(2), -32(b)(3)(v).

We see no reason why the transaction discussed in Example 1 should be treated as a nonrealization transaction coupled with a taxable asset distribution rather than as an upstream reorganization coupled with a nontaxable asset contribution, or in any event why that result should depend on in which state New Sub is incorporated. Rather, if the result of reorganization treatment in Example 1 is felt to be inappropriate, then we believe the appropriate response would be to modify the reorganization rules to provide for what are felt to be the appropriate results in all cases. Not only would this "only reorganization" approach promote consistency, it would obviate the need to delineate further the scope of nonrealization.

We believe that applying nonrealization principles to produce the results discussed above in a transaction that would otherwise be treated as a reorganization under the -2(k) regulations is an incorrect application of current law. Rather, we believe that nonrealization and reorganization principles should be harmonized such that, where the first step (or series of steps) in what would otherwise be a reorganization transaction to which the -2(k) regulations apply is a realization event and the -2(k) regulations apply to disregard other steps, then the reorganization rules should apply to that transaction and the overall transaction should not be recharacterized as a nonrealization event. Our recommended treatment is supported by Revenue Ruling 69-617, discussed in Part II.C.5 above. In that ruling, an upstream merger of a subsidiary into its parent followed by a reincorporation of 100% of the merged subsidiary's assets and liabilities into a newly formed subsidiary was treated as an upstream A reorganization with a subsequent section 351 exchange protected by section 368(a)(2)(C). The ruling does not recast the overall transaction as the new subsidiary being a continuation of the old subsidiary and does not indicate that the state in which new subsidiary was formed was relevant to the holding. As previously discussed, the principles of Revenue Ruling 69-617 have been imbedded in and expanded by the -2(k) regulations. The -2(k) regulations provide that, subject to certain exceptions not relevant to the present example, "a transaction otherwise qualifying as a reorganization under section 368(a) shall not be disqualified or recharacterized as a result of one of more subsequent transfers (or successive transfers) of assets or stock."[111]

Assuming that the first step in Example 1 above qualifies as an upstream C reorganization standing alone, then we believe that the above quoted language from the -2(k) regulations should be interpreted to mean that the subsequent drop down of assets into New Sub should not be taken into account to treat the overall transaction as a nonrealization event coupled with an asset distribution. To do so would obviate reorganization treatment and violate the

[111] Treas. Reg. § 1.368-2(k)(1).

mandate of the "no disqualification or recharacterization" language of those regulations.[112] It would also run contrary to the principles embodied in Revenue Ruling 69-617.

If, contrary to what we believe is the correct application of the -2(k) regulations and of Revenue Ruling 69-617, the government believes that the entire transaction should be examined to see if nonrealization treatment is appropriate, then we believe that nonrealization could and should be limited under the Supreme Court cases discussed above to apply only when there is no change in assets or business as part of the transaction. In other words, applying this recommendation to Example 1, nonrealization should apply only if 100% of Sub's assets, and no other assets, are held by New Sub at the end of the transaction, which is not the case in Example 1. In many cases, this approach would result in no difference in the amount of income, gain, or loss recognized by either Sub or Parent even if the transaction is tested for nonrealization separately before reorganization treatment is applied.

Further narrowing might also be articulated. For example, nonrealization might be further narrowed so as not to apply if there is any change in capital structure[113] or if the recipient entity is a different juridical entity from the liquidating entity under state law,[114] even if no assets are extracted and the recipient corporation is incorporated in the same state as the liquidated corporation. No matter how much the standards for nonrealization are narrowed, however, we believe that applying independent standards for nonrealization in these situations is less preferable than our recommended approach discussed above, as it can result in differences in the

[112] *Cf.* Treas. Reg. § 1.368-2(m)(4), *Example 10* (finding a liquidation followed by a reincorporation of 50% of the liquidating entity's assets was an upstream C reorganization; no mention made of whether the recipient entity was incorporated in a different state than, or the same state as, the liquidating entity). We also believe that the -2(k) regulations are broad enough to overcome any other "corporate sameness" concepts, however articulated, such as the vague articulations of corporate sameness set forth in *Casco*, *TASCO*, and Revenue Ruling 76-429.

[113] *Cf.* Priv. Ltr. Rul. 201127004 (Dec. 17, 2010) (holding that a same-state conversion, distribution, reconversion trans-action was an upstream C reorganization with a section 351 drop in a circumstance where the term of the preferred stock of the converting entity was changed as part of the transaction).

[114] We understand that some in the IRS may be particularly troubled by not applying nonrealization to same-state transactions where the "liquidating" and "recipient" entities are treated as the same juridical entity for state law purposes. Applying a narrow definition of nonrealization but leaving the definition broad enough to cover these cases would help address this concern. *Cf.* Priv. Ltr. Rul. 200315001 (Sept. 19, 2001) (apparently relying on same juridical entity principles in finding that a conversion of a corporation to an LLC did not cause a realization event with respect to the corporation's outstanding indebtedness). On the other hand, the check-the-box regime gives tax effect to transactions that are merely the filing of tax forms and have no effect for state law purposes. Similarly, the mark-to-market rules under section 475 require dealers to recognize gain or loss with respect to any securities that are not inventory or held for investment as if such securities were sold for their fair market value on the last business day of the taxable year, despite the fact that there has been no actual sale, exchange or other disposition of the securities. Accordingly, we do not believe that even same-state, same-juridical-entity cases need be addressed through nonrealization rather than reorganization principles. We also note that *Weiss* applied nonrealization to a situation involving distinct juridical entities.

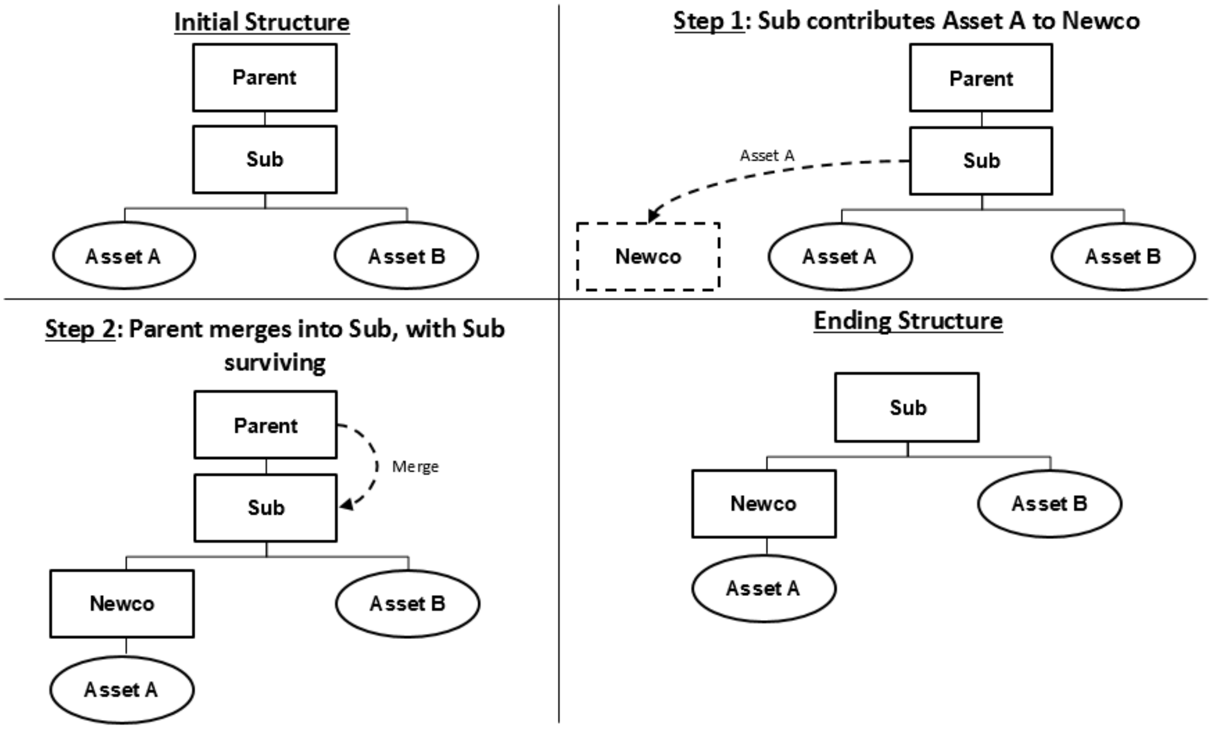
location of tax attributes based on minimal differences in facts.[115] Moreover, at the margin it can cause transactional frictions that would seem to serve little tax policy purpose.[116]

It is instructive to compare the transaction in Example 1 with the following transaction that achieves essentially the same results without an easily constructed nonrealization alternative.

> ***Example 2.*** Parent directly owns 100% of the stock of Sub, a State X corporation. Parent has a basis of $80 in its Sub stock. Sub owns two assets—Asset A with a basis of $50 and a value of $75 and Asset B with a basis of $30 and a value $50—and has no liabilities. As part of a single plan, Parent and Sub take the following steps. First, Sub transfers Asset A to a newly formed State X subsidiary ("***Newco***") in exchange for Newco stock. Second, Parent merges into Sub with Sub surviving.

[115] Regulations addressing the carryover of corporate attributes used to provide that attributes of a predecessor corporation generally were inherited by the acquiring corporation in an acquisitive asset reorganization, but where the acquiring corporation transferred all the assets of the predecessor corporation to another corporation, then that latter corporation was treated as the acquiring corporation and inherited the predecessor corporation's attributes. *See* former Treas. Reg. § 1.381(a)-1(b)(2)(i). That rule was subsequently changed so that the acquiring corporation that inherits the transferor corporation's assets is the corporation that directly acquires the transferor corporation's assets even if that corporation ultimately retains none of the transferred assets. *See* Treas. Reg. § 1.381(a)-1(b)(2)(i). The rationale given for this change was the desire for taxpayer certainty regarding the identity of the acquiring corporation and maintaining earnings and profits at the corporation closest to the transferor corporation's former shareholders in a manner that minimizes electivity (e.g., where most, but not all, of the transferor corporation's assets were transferred by the transferee corporation to another corporation) and administrative burden. *See* T.D. 9700, 79 Fed. Reg. 66616 (Nov. 10, 2014); *see also* New York State Bar Ass'n Tax Section, *Report on Proposed Regulations § 1.312-11: Allocation of Earnings and Profits in Connection with Asset Reorganizations* (Oct. 16, 2012). To permit nonrealization to override reorganization treatment based on small differences in facts, thereby changing the location of tax attributes, would seem at odds with the changes to the attribute-carryover regulations.

[116] In addition, it would provide a surprising gloss on Revenue Ruling 69-617 transactions, as at least certain reincorporations into same-state entities would no longer be afforded upstream A reorganization treatment.



Under the currently understood nonrecognition rules, step one should qualify as a section 351 exchange because Sub transfers Asset A to Newco solely in exchange for all of Newco's stock, and step two should qualify as an A reorganization because Parent merges into Sub and ceases its separate legal existence. Unlike Example 1, this transaction does not rely on the -2(k) regulations to prevent a recharacterization. Nevertheless, it should result in essentially the same U.S. federal income tax consequences as in Example 1. No gain or loss would be recognized by Sub or Newco in the section 351 exchange in step 1.[117] Sub would take a $50 basis in its Newco stock,[118] and Newco would take a $50 basis in Asset A.[119] As a result of the second step merger of Parent into Sub, which should be treated as an A or D reorganization, assuming the predicates of those provisions are met, the tax attributes of both Parent and Sub would wind up in the top tier entity (in this case, Sub), and Parent's stock basis in Sub would be eliminated. No gain or loss would be recognized by Parent or Sub upon the reorganization,[120] and Parent's shareholders would take the same basis in the Sub stock received as they had in the Parent stock exchanged therefor.[121]

[117] Sections 351(a); 1032(a).

[118] Section 358(a)(1).

[119] Section 362(a).

[120] Sections 354(a)(1); 361(a), (c); 1032(a).

[121] Section 358(a)(1).

It is unclear whether or how the government could apply nonrealization principles to this case. It appears that the recharacterization would have to be that Newco is treated as a continuation of Sub, Sub is treated as a continuation of Parent, and Asset B is treated as having been distributed by Newco to Sub. This recharacterization seems at odds with the nonrealization principles discussed above, however, because Sub's corporate existence continues separately from that of Newco.

Alternatively, perhaps a recharacterization could be crafted in which Sub is treated as a successor to Parent and then is treated as distributing Sub shares to former Parent shareholders in exchange for their Parent shares in a taxable transaction. However, this recharacterization would be tantamount to ignoring the merger of Parent into Sub and treating Parent as having distributed the Sub shares to the Parent shareholders in a liquidation. Such a characterization would be at odds with jurisprudence regarding the treatment of "downstream" reorganizations that has stood for decades.[122]

More fundamentally, we believe the difficulty in conceptualizing a nonrealization alternative for Example 2 does not indicate a failure of analytics. Rather it demonstrates that the problem lies with applying a nonrealization alternative to Example 1. The reorganization provisions are a carefully honed, intricate regime that has been molded and crafted over time. To superimpose a nonrealization overlay onto this structure creates substantial uncertainty without any apparent overriding benefit.[123]

2. Contribution, Conversion, Distribution, Reconversion

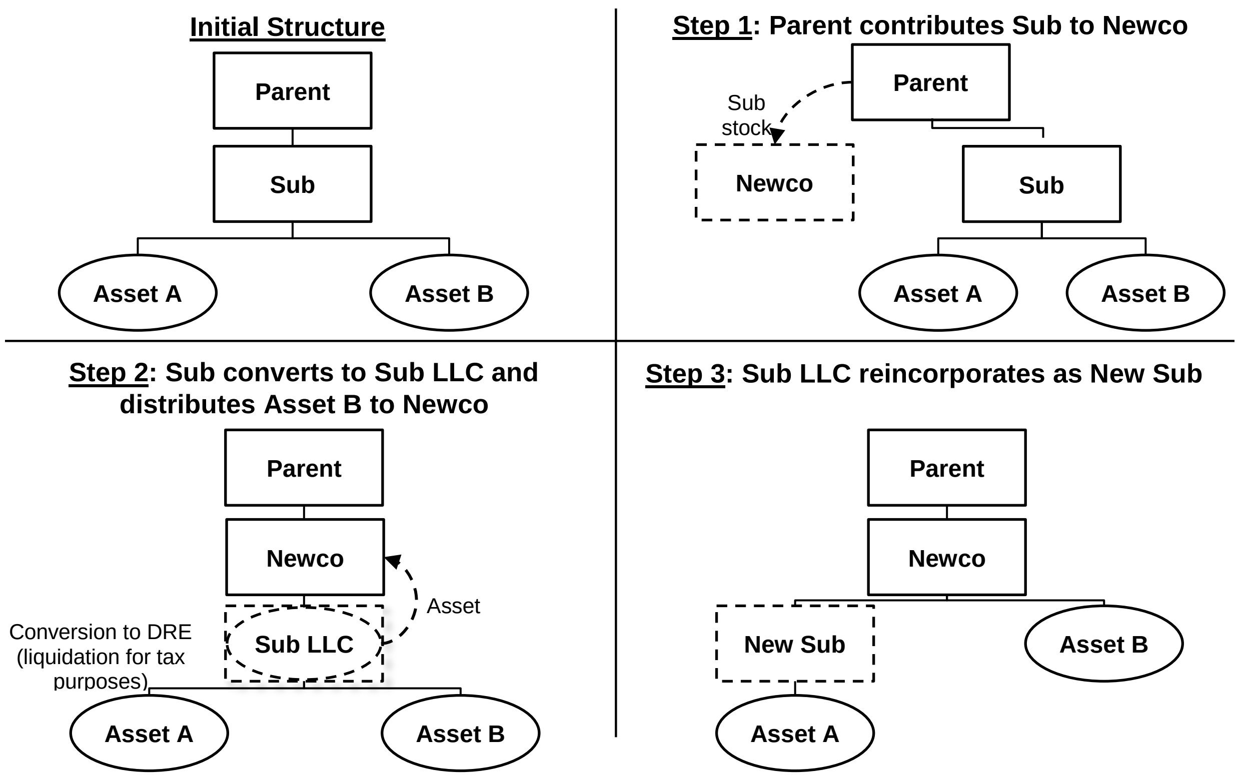
Similar to Example 1, an overlap of the reorganization rules and nonrealization principles can be seen where a parent corporation transfers its subsidiary to a newly formed corporation, the

[122] *See, e.g.*, *Comm'r v. Gilmore's Estate*, 130 F.2d 791 (3d Cir. 1942) (holding that a downstream merger of a parent corporation into its subsidiary is an A reorganization); *Comm'r v. Webster's Estate*, 131 F.2d 426 (5th Cir. 1942) (same); *H. Grady Manning Trust v. Comm'r*, 15 T.C. 930 (1950) (same); *Edwards Motor Transit Co. v. Comm'r*, 20 T.C.M. (CCH) 1968 (same); Rev. Rul. 57-465, 1957-2 C.B. 250 (merger of a foreign, first-tier subsidiary corporation into a foreign, second-tier subsidiary corporation ruled to be a valid downstream D reorganization); New York State Bar Ass'n Tax Section, *Report on Characterizing "Overlap" Transactions under Subchapter C* (Jan. 6, 2011).

[123] Of course, the mere fact that Example 2 produces the same results as Example 1 is not dispositive as to the appropriate treatment of Example 1. In many cases, substantial differences in tax results can arise from small differences in form. For example, even a small amount of nonvoting stock consideration can convert a fully nontaxable B reorganization into a fully taxable stock exchange. However, such differences, like the difference between Examples 1 and 2, further no tax policy goals. A difference in these results accomplishes little other than increasing friction costs in structuring the transaction to achieve the same ends through a different means and occasionally trapping the poorly advised or those in unfortunate regulatory or contractual settings. We believe such differences should be avoided where not otherwise mandated.

subsidiary then converts to an LLC, distributes an asset to the newly formed corporation, and reconverts to a corporation.[124]

> ***Example 3.*** Parent directly owns 100% of the stock in Sub, a State X corporation. Parent has a basis of $80 in its Sub stock. Sub owns two assets—Asset A with a basis of $50 and a value of $75 and Asset B with a basis of $30 and a value $50—and has no liabilities. As part of a single plan, Parent and Sub take the following steps. First, Parent transfers all of its Sub stock to a newly formed State X subsidiary ("***Newco***"). Second, Sub converts under State X law to an LLC ("***Sub LLC***"). Third, Sub LLC distributes Asset B to Newco. Third, Sub LLC converts back under State X law to a corporation ("***New Sub***") and continues to hold Asset A.



Under the currently understood nonrecognition rules, steps one and two of this transaction should qualify as an F reorganization and step three should qualify as a section 351 exchange. Under Treasury Regulations section 1.368-2(m)(3)(ii), a potential F reorganization may occur before, within, or after other transactions that effect more than a mere change, and the related events that precede or follow the potential F reorganization generally will not cause the potential F reorganization to fail to qualify as an F reorganization. Moreover, under Treasury Regulations section 1.368-2(k)(1), if steps one and two qualify as an F reorganization, then it

[124] *See, e.g.*, Priv. Ltr. Rul. 201001002 (Sept. 30, 2009); Priv. Ltr. Rul. 200937005 (June 9, 2009).

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may not be disqualified or recharacterized as a result of Newco's subsequent deemed transfer of Asset B to New Subsidiary in step three, provided that the continuity of business enterprise requirements of Treasury Regulations section 1.368-1(d) are satisfied. Although step two by itself could qualify as an upstream C reorganization, because it would also qualify as an F reorganization together with step one, it should be treated as an F reorganization for all U.S. federal income tax purposes.[125]

As a result of the F reorganization, no gain or loss would be recognized by Parent, Sub, or Newco.[126] Parent would take the same basis in Newco as it had in Sub,[127] and Newco would take the same basis in the Sub assets as Sub had in those assets.[128] Although Newco would succeed to the tax attributes of Sub under section 381(a), they would remain one level below Parent, which is where they started prior to the transaction. The distribution of Asset B by Sub LLC to Newco would have no U.S. federal income tax consequences because, at that point, Sub LLC would be disregarded as an entity separate from Newco. The deemed section 351 exchange resulting from the third step conversion of Sub LLC back to a corporation would result in no gain or loss to New Sub or Newco.[129] Newco would take a $50 basis in its New Sub stock,[130] and New Sub would take a $50 basis in Asset A.[131]

In contrast, if the government were to determine that nonrealization principles should apply to the transaction in Example 3, then similar consequences to those in Example 1 should apply. The conversion and reconversion of Sub likely would be ignored for U.S. federal income tax purposes and, instead, the transaction would likely be treated as if Parent transferred Sub to Newco in a section 351 exchange followed by a taxable distribution of Asset B by Sub to Newco. As a result of the section 351 exchange, no gain or loss would be recognized by Parent or Newco.[132] Parent would take the same basis in the Newco stock as it had in the Sub stock exchanged therefor,[133] and Newco would take a carryover basis in the Sub stock equal to the basis that Parent had in the Sub stock.[134] As in Example 1, Sub would recognize $20 of gain under section 311(b) upon the distribution of Asset B, and Parent would receive a dividends received deduction on the distribution under section 243. To the extent section 1059 applied to

[125] *See* Treas. Reg. § 1.368-2(m)(3)(iv)(B).
[126] Sections 361(a); 1032(a).
[127] Section 358(a)(1).
[128] Section 362(b).
[129] Sections 351(a); 1032(a).
[130] Section 358(a)(1).
[131] Section 362(a).
[132] Sections 351(a); 1032(a).
[133] Section 358(a)(1).
[134] Section 362(a).

the distribution, Parent would reduce its basis in the stock of Sub. Because there would be no section 381(a) transaction, Sub's tax attributes would remain at Sub.

The result of this transaction, however, is not meaningfully different from the result if Sub had merely transferred Asset A to a newly formed subsidiary in a section 351 exchange. Under that form of the transaction, there would clearly be a realization event in which the nonrecognition rules would have prevented Sub from recognizing any gain or loss. As such, as in Example 2, it is difficult to see why nonrealization principles should be applied to override the nonrecognition result that would otherwise be afforded by applying the reorganization rules to the transaction as structured, and that could also be achieved through another means with no meaningful difference in the end non-tax result.

As in Example 1, we believe that the applicable law should be applied to prevent any nonrealization plus a distribution recast. As in Example 1, that recast would violate the "no disqualification or recharacterization" mandate of the -2(k) regulations.[135] These regulations were carefully crafted to provide, among other things, certainty of treatment for transactions within their literal wording. To apply a recast that results in contrary treatment would be directly at odds with the intent and wording of the regulations.

However, as in Example 1, even if the government believes that the entire transaction should be examined to determine whether nonrealization is applicable, we believe that reorganization rather than nonrealization treatment should still ensue on the facts of Example 3. That is, we believe that the Supreme Court cases discussed above can and should be interpreted in this context as not requiring nonrealization, because New Sub does not own all the assets of Sub at the end of the transaction and, accordingly, should not be treated as the same corporation as Sub.

IV. CONCLUSION

For the reasons set forth above, we believe it is inadvisable for the government to seek to apply nonrealization principles in corporation reorganization transactions followed by same-state asset drop-downs to which the -2(k) regulations apply. To do so resurrects many of the

[135] We do not address in this report the appropriate interaction of the "F in a bubble" and nonrealization principles in the case of an F reorganization to which the -2(k) regulations are not applicable. For example, we do not address a situation in which, after an in-form F reorganization of X into Y, assets are dropped down to a Newco incorporated in the same state as X and then Newco is spun off by Y to Y's shareholders and continuity of business enterprise (COBE) is not satisfied as a result of that spin off. In those circumstances, although failure to satisfy COBE would not cause what is otherwise an F reorganization to cease to be treated as an F reorganization, it arguably would prevent the -2(k) regulations from applying. *See* Treas. Reg. § 1.368-2(m)(2) (no COBE required for an F reorganization); Treas. Reg. § 1.368-2(k)(1) (COBE require at end of steps for -2(k) regulations to apply); *cf.* Priv. Ltr. Rul. 201627001 (Jan. 4, 2016) and Priv. Ltr. Rul. 201638004 (June 16, 2016) (discussed in Part II.C.2 above), each involving an F reorganization preceding a spinoff.

uncertainties that the enactment of the reorganization provisions was designed to eliminate. To the extent the government feels that the reorganization provisions are producing inappropriate results, then we believe the preferable approach is to modify the relevant rules rather than create a nonrealization/reorganization dichotomy that results in significantly divergent treatment of economically similar transactions.