Outline of Thoughts on Corporate Distributions

By Robert H. Wellen

Introduction

In his comprehensive article, *Form vs. Substance in the Treatment of Taxable Corporate Distributions,* Jack Cummings argues that the form of a transaction generally does and should govern its tax treatment. In other words, Jack's view is that many business transactions can be accomplished in a variety of ways, and that taxpayers should be able to choose their transaction forms and the resulting tax treatment. More specifically, the Internal Revenue Service and the courts do not and should not recast a corporate transaction and tax it as though something else had happened, unless both (1) the substance of the transaction deviates from the form, and (2) there is a tax policy reason to disregard form.

The last point deserves attention. What kinds of policy reasons are important enough to justify disregarding the form of a transaction? The policy that transactions should be taxed in accordance with their substance is not itself enough, but what policy will be enough?

To answer this question by example, Jack focuses on corporate distributions. He identifies loose ends in this area and makes a number of interlocking proposals to tie them up. Each of the proposals is accompanied by historical, legal and policy analysis, which makes Jack's article a real resource to tax professionals.

The purpose of this outline is to summarize and discuss the most important of Jack's proposals, explain some of their implications and identify possible problems and questions that remain unanswered.

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Defined Terms

The following defined terms are used in this outline:

- "**T**" is the target or acquired corporation in a taxable or tax-free acquisition of assets or stock by A.
- "**A**" is the acquiring corporation in a taxable or tax-free acquisition of the assets or stock of T.
- "**P**" is a corporation that Controls A.
- "**Control**," "**Controls**," "**Controlled**," "**Controlling**" and the like refer to control as defined in Code Sec. 368(c), *i.e., direct* ownership of stock of a corporation with at least 80 percent of its total combined voting power of all classes of stock entitled to vote *and* 80 percent of the total number of shares of all other classes of stock.
- "**E&P**" refers to the earnings and profits of a corporation.
- "**Property**" includes anything that is taxable to the T shareholders when received, Examples are cash, notes issued by any of the parties and operating assets of any of the parties, but not A stock (or, where it could be received tax-free, P stock). Debt "securities" received by a T shareholder in exchange for other debt "securities" are tax-free and are not included. Generally, an assumption of T liabilities is not treated as Property, because the benefit of this assumption accrues to T itself, not to the T shareholders.
- "**Section 304(c) Control**" refers to control as defined in Code Sec. 304(c), *i.e.*, ownership of either (i) stock with at least 50 percent of the total combined voting power of all classes of stock entitled to vote or (ii) at least 50 percent of all classes of stock by value. For this purpose, stock ownership includes both direct and indirect ownership, as well as constructive ownership under the rules of

Code Sec. 304(c)(3) (expanding the constructive stock ownership rules of Code Sec. 318(a)).

- "**Triangular**" transaction or reorganization refers to a transaction in which A acquires the stock or assets of T in exchange for stock of P and Property.
- "**Two-Party**" transaction or reorganization refers to a transaction in which A acquires the stock or assets of T in exchange for A stock and Property. A Two-Party reorganization may involve a transfer of T assets by A to an affiliate under Code Sec. 368(a)(2)(C) or Reg. §1.368-2(k).

Outline of Proposals

I. Property Received by T Shareholders Pursuant to a Plan of Reorganization

A number of Jack's proposals deal with transactions that may qualify as tax-free reorganizations, and specifically with the receipt of Property by shareholders of T in these transactions. The proposals deal with the impact of the Property on the status of the transaction as a reorganization and with the tax treatment to the T shareholders of the Property they receive. Jack's article considers both Two-Party and Triangular transactions.

A. Situations in Which the Proposals Apply[1]

If T shareholders surrender their T stock in exchange for Property, in addition to A stock (in a Triangular transaction, P stock), the status of the transaction as a reorganization may be affected. The various types of reorganizations and their statutory requirements are summarized below. In addition to the statutory requirements, there are other requirements originally imposed by the courts but now codified in regulations. These are continuity of interest (Reg. §1.368-1(e)) and continuity-of-business-enterprise (Reg. §1.368-1(d)).[2]

Although readers of this publication will be familiar with the types of reorganizations, listing them may help some readers understand the impact of Jack's proposals. Others may skip to the description of what is at stake in various types of transactions (Part I.B and Part I.C, below), or even to the description of Jack's proposals themselves (Part I.D, below).

1. Potential Two-Party Asset Acquisition Reorganizations (Type A or Type C). A acquires the assets of T in exchange for A stock and Property, and the A stock and Property are distributed to the T shareholders. If the transaction is to qualify as a reorganization, it must meet either of the following tests:

a. The transaction takes the form of a merger (Reg. §1.368-2(b)) of T into A (Type A reorganization).

b. In a nonmerger asset transfer (Type C reorganization), (i) T transfers "substantially all" of its assets to A; and (ii) the amount of Property A uses as consideration is limited to 20 percent of the total consideration (taking into account also the assumption by A of T's liabilities—*see* definition of "Property," above).[3]

2. Potential Two-Party Stock Acquisition Reorganizations (Type B). A acquires the stock of T in exchange "solely" for A voting stock. If the transaction is to qualify as a reorganization, it must meet both of the following tests:

a. A may not use Property as consideration for the T stock, but T may distribute Property to its shareholders.

b. After the transaction, A must own enough T stock to constitute Control of T.

3. Potential Triangular Asset Acquisition Reorganizations (Triangular Type C or Code Sec. 368(a)(2)(D)). A, a Controlled subsidiary of P, acquires the assets of T in exchange for P stock and Property, and the P stock and Property are distributed to the T shareholders. If the transaction is to qualify as a reorganization, T must transfer substantially all of its assets to A. In addition, the transaction must qualify under either of the following tests:

a. Under Code Sec. 368(a)(2)(D), the transaction takes the form of a merger of T into A.

b. In a nonmerger asset transfer (Triangular Type C reorganization), the amount of Property P may use as consideration is limited to 20 percent of the total consideration, taking into account also the assumption by A of T's liabilities. (*See* definition of "Property," above.)

4. Potential Triangular Stock Acquisition Reorganizations (Triangular Type B). A, a Controlled subsidiary of P, acquires the stock of T in exchange for P stock. If the transaction is to qualify as a reorganization, it must meet both of the following tests:

a. A may not use either any T stock or any Property as consideration for the T stock, but T may distribute Property to its shareholders, either as a *pro rata* distribution or in redemption of T stock.

b. After the transaction, A must own enough T stock to constitute Control of T.

5. Potential Reverse Triangular Merger Reorganizations (Code Sec. 368(a)(2)(E)). Reverse Triangular mergers are hybrid transactions. A Controlled subsidiary of P is merged into T, and T survives as a Controlled

subsidiary of P; the T shareholders receive P stock and Property in exchange for their T stock. In results, these transactions are similar to Two-Party acquisitive stock reorganizations (Type B), described in Part I.A.2, above. Here, however, if the transaction is to qualify as a reorganization, it must meet both of the following tests:

a. The amount of Property P may use as consideration for the T stock is limited, because P must acquire Control of T for P voting stock.

b. Although T may distribute Property to its shareholders, after the merger T must "hold" "substantially all" of its historic assets.

6. Potential Nondivisive Type D Reorganizations. This type of transaction is similar to a Two-Party acquisitive asset reorganization, described in Part I.A.1, above. A acquires T's assets in exchange for A stock and Property, and the A stock and Property are distributed to the T shareholders. Here, however, T and A are related by common stock ownership before the transaction. If the transaction is to qualify as a reorganization, T must transfer substantially all of its assets to A.

7. Potential Recapitalizations (Type E Reorganizations).[4] T shareholders exchange their T stock for T stock with different attributes. T shareholders also may receive Property.

8. Potential Type F Reorganizations. This type of transaction is similar to a nondivisive Type D reorganization, described in Part I.A.6, above. Here, however, T may not have any assets or tax attributes before the transaction, and, after the transaction, the T shareholders must own the stock of A in essentially the same proportions as their pre-transaction ownership of the T stock.[5] One or more T shareholders may receive Property, either in redemption of stock or otherwise.

B. At Stake—Reorganization Requirements

If the T shareholders receive Property, a transaction's status as a reorganization may be affected.

1. Required Transfer by T to A

a. Continuity-of-Business-Enterprise. Does the Property count against the continuity-of-business-enterprise requirement applicable to all reorganizations?

b. Substantially-All. Does the Property count against the "substantially-all" requirement applicable to Type C (Two-Party and Triangular), Code Sec. 368(a)(2)(D), Code Sec. 368(a)(2)(E) and nondivisive Type D reorganizations?

2. Permissible Consideration Received by T Shareholders

a. Continuity-of-Interest. Does the Property count against the continuity-of-interest requirement applicable to Type A (Two-Party), Type B (Two-Party and Triangular), Type C (Two-Party and Triangular), Code Sec. 368(a)(2)(D) and Code Sec. 368(a)(2)(E) reorganizations?[6]

b. Voting Stock As Consideration. Does the Property count against the solely-for-voting-stock requirement applicable to Type B reorganizations (Two-Party and Triangular), the modified solely-for-voting-stock requirement applicable to Type C reorganizations (Two-Party and Triangular) or the control-for-voting-stock requirement applicable to Code Sec. 368(a)(2)(E) reorganizations?

C. At Stake—T Shareholder Treatment in Reorganizations

If the transaction qualifies as a reorganization, Property received by the T shareholders is taxed under a specialized regime.

1. If Property is distributed by T to one or more T shareholders before the actual exchange that makes up the reorganization, is the receipt of Property taxed as part of the reorganization (under Code Sec. 356) or separately (under Code Sec. 301 or Code Sec. 302, depending on whether the Property is distributed *pro rata* or in redemption of T stock)?

2. If Code Sec. 356 applies, it must be determined whether receipt of the Property by the T shareholders is taxed as amount realized in an exchange or as a Code Sec. 301 distribution. Under *D.E. Clark*,[7] this determination is made by treating the Property as paid in redemption of A or P stock hypothetically issued in the reorganization and applying the tests in Code Sec. 302 (including the principles of *Zenz v. Quinlivan*,[8] to that hypothetical redemption.

3. If Code Sec. 356 applies, and, under *Clark*, receipt of the Property is taxed as a Code Sec. 301 distribution, then, under Code Sec. 356(a)(2)—

a. The Property is taxed as a dividend but only to the extent the recipient T shareholder realizes gain in the exchange of its T stock for the A or P stock and Property. (In other words, the *Clark* test determines the character of the gain but not the amount. Under current law, the gain would be taxed to individual T shareholders at the same rate, regardless of whether the character is dividend or capital gain.)

b. The amount of Property taxed as a dividend is further limited by the recipient shareholder's proportionate-share of E&P. Any excess of recognized gain over the shareholder's proportionate share of E&P is taxed as gain under Code Sec. 302(a).

c. Is the amount taxed as a dividend determined by reference to the E&P of T, A, P or some combination (and is the amount of the relevant E&P determined as of before or after the reorganization)?

4. Reg. §1.301-1(l) provides that a Property distribution may be taxed under Code Sec. 301, not Code Sec. 356, "although it takes place at the same time as another transaction if the distribution is in substance a separate transaction whether or not connected in a formal sense."

D. Proposals—Reorganization Requirements

This Part I.D summarizes Jack's proposals relating to how the receipt of Property by T shareholders can affect the status of the transaction as a reorganization.

1. By regulation, Property received by the T shareholders "in pursuance of the plan of reorganization" (as that term is used in Code Sec. 368(a)(2)(G) and in other provisions relating to reorganizations) would be treated as part of the reorganization regardless of the source of the Property (*i.e.*, regardless of whether the Property is or is deemed to be distributed by T or paid by A or P—*see* Part II, below).

a. The proposed test would apply for purposes of determining continuity-of-interest. The source of the Property would not be relevant for this purpose.

b. The proposed test would be used but would not itself determine the results where the source of the Property (T, P or A)[9] must be relevant. That is, Jack has tried to minimize the significance of the source of the Property, but he concludes that sourcing cannot be avoided altogether. When necessary, source would be determined under a special proposed "*Waterman*" test for reorganizations, described in Part II.C.4, below. In reorganizations, source would have to be determined only for purposes of the following requirements:

i. *The Continuity-of-Business-Enterprise Test Applicable to All Acquisitive Reorganizations.* If the source of the Property is T, the Property received by the T shareholders would count against the continuity-of-business-enterprise test. If the source of the Property is A or P, it would have no impact on the continuity-of-business-enterprise test.

ii. *The Substantially-All Test Applicable to Type C Reorganizations (Two-Party and Triangular), Code Sec. 368(a)(2)(D) Reorganizations and Code Sec. 368(a)(2)(E) Reorganizations.* Again, if T is the source of the Property, the Property received by the T shareholders would count against the substantially-all test. If the source of the Property is A or P, however, the Property would have no impact on the substantially-all test.

iii. *The Solely-for-Voting-Stock Test (Applicable to Type B Reorganizations and in Modified Form To Type C Reorganizations) and the Control-for-Voting-Stock Test (Applicable to Code Sec. 368(a)(2)(E) Reorganizations).* If the source of the Property is A or P, the Property received by the T shareholders would count against these tests. If the source of the Property is T, the Property would have no impact on these tests.

2. By regulation, for purposes of the reorganization requirements listed in Part I.B, above, distributions of Property by T made in pursuance of the plan of reorganization would be treated as consideration received by the T shareholders in the reorganization. The only exceptions would be as follows:

a. Property received by the T shareholders pursuant to a potential Type B reorganization but sourced to T, not to P or A, under the proposed *Waterman* test applicable to reorganizations (*see* Part II.C.2, below), would be treated as distributed by T in a separate transaction for all purposes. The reason for this special treatment is that there can be no Code Sec. 356(a) Property in a Type B reorganization.

b. Property received by the T shareholders in pursuance of a plan of potential Code Sec. 368(a)(2)(E) reorganization but sourced to T, not to P or A, under the proposed *Waterman* test for reorganizations (*see* Part II.C.2, below), would be treated as follows:

i. The distribution would be treated as separate from the reorganization for purposes of the control-for-voting-stock test. That is, the Property would not count against this test.

ii. The distribution would be treated as made by T in pursuance of the plan of potential reorganization for purposes of the substantially-all test. That is, the Property would count against this test.

E. Proposals—T Shareholder Treatment

This Part I.E summarizes the proposals relating to how receipt of Property by the T shareholders in a reorganization is taxed to the recipients.

1. By clarification of Reg. §1.301-1(l), Property subject to Code Sec. 356(a) and treated as a Code Sec. 301 distribution under the *Clark* test would be treated as a Code Sec. 301 distribution by P or A for all purposes. The effect of this proposal would be as follows:

a. The dividend-within-gain limitation (Part I.C.3.a, above) would be repealed.

b. The proportionate E&P limitation (Part I.C.3.b, above) on treating gain recognized as a dividend would be repealed.

c. If Property is distributed in a Type F reorganization followed by a related acquisitive reorganization (*see* Proposed Reg. §1.368-2(m)(3)), the Property would be treated as distributed in pursuance of the plan of the acquisitive reorganization (not the Type F reorganization). If the *Clark* test, as applied to the acquisitive reorganization (again, not the Type F reorganization), results in Code Sec. 301 distribution treatment, Code Sec. 301 would apply to all the Property, as described in Part I.E.1.a and Part I.E.1.b, above.

2. By regulation, the Reg. §1.301-1(l) would apply only in the situation described in Part I.E.1, above, and specified other situations.

a. A distribution would be taxable as a dividend under Reg. §1.301-1(l), even if related to a reorganization, if it was not motivated by the reorganization, would have happened anyway and thus was not "in pursuance of" the reorganization plan. An example would be regular, periodic dividends, which would be treated as separate distributions by T for all purposes.

b. Property received by T shareholders from T under the proposed *Waterman* test (*see* Part II.C, below) would be treated as a separate dividend. *See* Part I.D.2.a, above.

c. The principal if not the only other application of Reg. §1.301-1(l) would be to distributions by S corporations of their accumulated adjustments accounts and recovery of basis under Code Sec. 1368 and perhaps distributions by other entities subject to special tax regimes (*e.g.*, cooperatives, RICs and REITs).

i. The Property distribution would be treated as a separate distribution for purposes of determining shareholder consequences of a reorganization.

ii. The Property distribution might not be treated as a separate distribution for purposes of the requirements for tax-free reorganization treatment. That is, Jack acknowledges that he has not plumbed the depths of the issues raised by these types of transactions.

F. Issues and Thoughts Involving the Proposals Relating to Property Received by T Shareholders Pursuant to a Plan of Reorganization

1. Under the proposals, the source of Property received by the T shareholders would be relevant for some purposes (*e.g.*, substantially-all and solely-for-voting stock) but not others (*e.g.*, generally the treatment of the Property to the T shareholders). Determining the source of the Property can be difficult and can produce uncertain tax results. If sourcing is relevant for only limited purposes, source would have to be determined in fewer situations than under current law and practice.

2. If the *Waterman* tests described in Part II.C, below, were adopted, determining the source of the Property would be simpler than under current law. The proposed test for determining the source of the Property would depend on the form of the transaction, however. The test for some transactions would be different from the test for other transactions.

3. Determining whether the T shareholders receive the Property "in pursuance of the plan of reorganization" itself can be a difficult factual issue.

a. Under the proposals, in an acquisitive reorganization where T and A are unrelated before the transaction, a distribution of Property "in pursuance of the plan of reorganization" would include all distributions authorized by the agreement between the parties and would exclude distributions preceding the binding agreement.

b. In transactions between related parties, a binding agreement test could be planned around. Thus, Jack proposes that a test like the judicial test for a "plan of liquidation" be used. Presumably, this test would apply to all related-party reorganizations, not just Type D, Type E and Type F reorganizations. *See* Part III.F.2.c, below.

4. Would a regulation mandating full dividend treatment and repealing the dividend-within-gain rule and the proportionate-E&P rule (both set forth in Code Sec. 356(a)) be valid? Is a statutory change necessary to effect these changes?

5. As a policy matter, can the statutory dividend-within-gain and proportionate-E&P rules of Code Sec. 356(a) be justified as reflecting the hybrid nature of Property received in a reorganization as part-exchange and part-dividend?

a. Is the proposal consistent with *Clark*, which tests for dividend treatment by deeming a redemption of A (or P) stock after the reorganization?

The proposal seems to focus on the status of the recipients of the Property as T shareholders before the reorganization, not their status as A or P shareholders thereafter.

b. Full dividend treatment, as Jack proposes, would be consistent with a reversal of *Clark*, by either by statute or regulation, *i.e.*, to treat the Property received by T shareholders as a distribution by T in deemed redemption of its T stock before the reorganization.

6. The proposals do not address issues related to E&P:

a. If, under *Clark*, receipt of the Property is treated as a Code Sec. 301 distribution to the T shareholders—

i. Should the Property be treated, under Code Sec. 301(c), as a dividend, as a return of capital or as gain by reference to the T's E&P or A's E&P (or, in a Triangular reorganization, P's E&P)?

ii. Should the distribution reduce T's E&P or A's E&P (or, again, in the case of a Triangular reorganization, P's E&P)?

b. In a Two-Party reorganization, it would seem most consistent with *Clark* to use the combined E&P of T and A, after the transaction, as the reference. *See* Code Sec. 381(c)(2). In a Triangular reorganization, it would seem most consistent with Clark to use P's E&P after the transaction as the reference. On the other hand, from an economic standpoint, it seems odd to treat the T shareholders as receiving a dividend from A or P, a corporation in which they have just acquired stock. Here again, a reversal of *Clark* would harmonize the system. *See* Part I.F.5.b, above.

II. Source of Property Distributed to T Shareholders– *Waterman Steamship Corp.*[10]

This Part II deals with whether a purported distribution of Property by T before an acquisition of T stock or assets by A or P should be treated, for tax purposes, as part of the consideration paid by A or P for the T assets or stock. This issue can arise in both tax-free reorganizations and taxable acquisitions.

A. Situations in Which the Proposals Apply

Under current law, the tax treatment of some types of acquisitions turns on whether Property received by the T shareholders had its source in T or in A (or, for Triangular reorganizations, in P). If the proposals were adopted, the source of the Property would continue to be relevant in the following situations (*see also* Part I.D.1.b and Part I.D.2.a, above):

1. T Stock Transfers. T shareholders transfer their T stock to A. Before the stock transfer, T distributes Property to its shareholders. The following Types of transactions are included:

a. Taxable. Stock sales, including reverse cash mergers, with or without Code Sec. 338(g) elections, but excluding stock sales with Code Sec. 338(h)(10) elections.

b. Tax-free:

i. Type B reorganizations (Two-Party and Triangular).

ii. Code Sec. 368(a)(2)(E) reorganizations.

2. T asset transfers and liquidations. T transfers its assets to A in exchange for Property and/or A stock (in a Triangular reorganization, P stock) and liquidates. Before the asset transfer, T distributes Property to the T shareholders. The following Types of transactions are included:

a. Taxable. Asset sales, including forward cash mergers and stock sales with Code Sec. 338(h)(10) elections.

b. Tax-free. Type A reorganizations (both Two-Party and Triangular under Code Sec. 368(a)(2)(D)), Type C reorganizations (both Two-Party and Triangular), nondivisive Type D reorganizations and Type F reorganizations.

3. T stock issuances. Issuances by T of stock to new shareholders for Property and distributions of the Property to its pre-issuance shareholders but not to the new shareholders. (As a variation, T could borrow cash, distribute the cash to its shareholders, then issue new stock and use the proceeds to repay the debt).

B. At Stake

A distribution of Property by T to its shareholders could be treated as a separate distribution by T—a *pro rata* Code Sec. 301 distribution or, if T stock is surrendered, subject to Code Sec. 302. Alternatively, the distributed Property could be treated as a payment *by A or P* to T for the T assets or to the T shareholders in exchange for the T stock.

1. T Stock Transfers

a. Taxable Stock Sale. If the Property distribution is subject to Code Sec. 301, a dividend-received deduction, with no reduction in the shareholders' stock basis, could result (*i.e.*, if a T shareholder is a corporation, and no consolidated return is filed). If the distributed Property is treated as part of the consideration for the T stock, the Property is a fully taxable amount realized on stock sale to A.

b. Potential Type B Reorganization (Two-Party or Triangular). If the Property distribution is not treated as separate from the stock-for-stock exchange, the distribution would prevent the solely-for-voting-stock requirement from being satisfied.[11]

c. Potential Code Sec. 368(a)(2)(E) Reorganization. If the Property distribution is not treated as separate from the merger, the distribution may be treated as a payment by A or P in exchange for the T stock.

i. The deemed payment by P or A could prevent the control-for-voting-stock requirement from being satisfied.

ii. On the other hand, the deemed payment by P or A could eliminate a substantially-all problem.

2. T Asset Transfers and Liquidations

a. Taxable Asset Transfers and Liquidations. If the Property distribution is not treated as separate from the stock sale and liquidation, two recasts are possible:

i. The distributed Property could be treated as fully taxable amount realized on T's asset sale to A and as part of the liquidation proceeds distributed by T to its shareholders (fully taxable to T and, as to the T shareholders, taxable under Code Sec. 331 or tax-free under Code Sec. 332).

ii. The distributed Property could be treated as liquidation proceeds distributed by T out of its own property. Conventional step transaction analysis would determine whether pre-sale distribution is a separate distribution (*pro rata* dividend or Code Sec. 302 redemption) or is integrated into the post-sale liquidation of T. (Note: This recast does not involve re-sourcing the Property from T to A.)

b. Tax-Free T Asset Transfers and Liquidations

i. Potential Two-Party Type A Reorganizations. No sourcing issues arise.

ii. Potential Type C Reorganizations (Two-Party or Triangular). If the Property distribution is not treated as separate from the assets-for-stock exchange and liquidation of T, the distribution may be treated as a payment by P or A for the T assets.

a. The deemed payment by P or A could prevent the modified solely-for-voting-stock requirement from being met.

b. On the other hand, the deemed payment by P or A could eliminate a substantially-all problem.

iii. Potential Code Sec. 368(a)(2)(D) Reorganizations. If the Property distribution is not treated as separate from the merger, the distribution may be treated as a payment by P or A for the T assets and so may eliminate a substantially-all problem. Otherwise, there are no sourcing issues.

3. T stock issuances and distributions. If the Property distribution is not treated as separate from the stock issuance, the distributed Property could be fully taxable amount realized to the T shareholders in a deemed sale of some of their stock to the new shareholders.

C. Proposals

Under the proposals, regulations would be adopted to limit re-sourcing of Property under *Waterman* to specific situations.

1. Taxable Sale of T Stock by T Shareholders. *Waterman* would apply to re-source the distributed Property from T to A, and so treat the Property as part of the amount realized for the T stock, only if either of the following conditions exists:

a. There is a disregardable step, such as the distribution taking the form of a transitory note (as in *Waterman* itself).

b. T could not make the distribution legally, taking into account corporate and regulatory law and T's contractual obligations (*e.g.*, loan covenants) *after the stock transfer*, *i.e.*, taking into account any capital infusions in the acquisition. In this case, the distribution would be re-sourced to A only to the extent the distribution was not legally valid.

2. Taxable Sale of T Assets and Liquidation of T. *Waterman* would apply to recast the Property distribution as amount realized by T in the asset sale, under the same tests as those described in Part II.C.1, above.

3. Issuance of T Stock by T. *Waterman* would apply to recast the stock issuance and Property distribution as a sale of T stock by T shareholders to the new shareholders under the same tests as those described in Part II.C.1, above. The same tests would apply to both *pro rata* distributions and distributions in redemption of T stock (regardless of whether the redemption is taxed to the redeemed shareholder as an exchange or as a Code Sec. 301 distribution). Any net capital infusion resulting from the stock issuance would be taken into account in determining whether the distribution by T is legally valid.

4. Reorganization. A different and more stringent *Waterman* test would apply to Property received by T shareholders in pursuance of a plan of reorganization:

a. *Waterman* would apply to re-source the Property from T to A only if T could not have borrowed the funds to make the Property distribution on its own credit, under the standards described in *Plantation Patterns, Inc.*[12]

b. This *Waterman*/*Plantation Patterns* test would apply to Property distributions in pursuance of a plan of reorganization only for purposes of selected requirements for a reorganization (*see* Part I.B):

i. The requirements that P or A provide proper consideration in a Type B, Type C or Code Sec. 368(a)(2)(E) reorganization (solely-for-voting-stock or control-for-voting-stock)

ii. The substantially-all requirement

iii. The continuity-of-business-enterprise requirement

D. Issues and Thoughts Involving the Source of Property Distributed to T Shareholders

1. Is the general "legality" test for taxable stock acquisitions, asset acquisitions and stock issuances (Part II.C.1, above) too generous or too difficult to administer?

a. Should the test be applied as of immediately *before* (instead of *after*) the acquisition and any related capital infusions? Such a rule would reflect the economics of the distribution and focus on the difference between a distribution and sale proceeds.

b. Even if the legality test applies as of immediately before the transaction, is it feasible to identify and analyze contractual limitations on distributions by T? As an example, a lender to T could waive such a restriction in light of the pending acquisition and capital infusion or in light of other arrangements (*e.g.*, a shareholder guarantee or make-well commitment).

2. In a sale of T stock, privity exists between the T shareholders and A, the person to which the Property is re-sourced. The same is true in a Type B reorganization (and perhaps in a Code Sec. 368(a)(2)(E) reorganization). In an asset sale and liquidation and in a stock issuance and distribution, however, there is no direct transaction between A and the T shareholders. As currently proposed, the test does not take privity into account. Should privity matter in sourcing the Property? For example, the Property could be re-sourced more readily in stock sales than in asset sales, because of privity considerations.

3. Is there a meaningful difference between (a) a "transitory note" that is issued and distributed by T but paid with funds provided by A, as in *Waterman* (an example of a "disregardable step" in Part II.C.1.a) and (b) *e.g.*, a distribution of cash borrowed by T from A? Can the concept of "disregardable step" be defined with precision? If not, would the proposal accomplish its purpose of making the tax consequences of these transactions more predictable?

4. A separate and more stringent test for reorganizations may be justified technically by the statutory "plan of reorganization" concept. There is no similar concept for stock sale, asset sales or stock issuances. On the other hand, does this distinction justify a separate test as a policy matter? For example, would a test like the one described in Part II.D.1.a, above (based on legality as of immediately before the transaction), be appropriate in all circumstances?

5. Would the proposed sourcing test for reorganizations (Part II.C.4, above) be administrable and appropriate as a policy matter? The *Plantation Patterns* issue is highly factual and so is difficult to administer. As examples, how should the *Waterman*/*Plantation Patterns* test apply in the situations below?

a. T borrows cash from A and distributes the cash to its shareholders. T could have borrowed the cash from an unrelated lender but only on more onerous terms than the terms of the borrowing from A (*e.g.*, higher interest rate or more stringent covenants or security interests).

b. T borrows cash from an unrelated lender and distributes the cash to its shareholders. A guarantees the debt or enters into a similar commitment (make-well, stock subscription, *etc.*). Again, T could have borrowed the cash without A's commitment but only on more onerous terms.

6. Would any regulation establishing a more stringent test for reorganizations (Part II.C.4, above) be legally valid? As an example, in a purported Type B reorganization, if the special *Waterman*/*Plantation Patterns* test for reorganizations is flunked, the Property distributed by T to its shareholders would be re-sourced to A. As a result, the transaction could become a taxable stock sale. The less stringent "legality" test (Part II.C.1, above) then would apply so that the Property would be re-sourced back to T. Under this analysis, the transaction would revert to Type B reorganization status. Such a paradox in a regulation may be difficult to defend against judicial challenge.

III. Nondivisive Type D Reorganizations and Liquidation-Reincorporation

A. Situations in Which the Proposals Apply

In all these situations, one or more T shareholders have Code Sec. 304(c) Control of A.

1. T distributes all its assets to its shareholders in a liquidation (or in a state law merger into a corporate shareholder of T), and some or all of the T shareholders transfer some or all the T assets to A in exchange for A stock, Property or a combination thereof.

2. The T shareholders transfer the T stock to A in exchange for A stock, Property or a combination. T then transfers its assets upstream to A in a state law merger or liquidation.

3. T transfers some or all of its assets directly to A in exchange for A stock, Property or a combination. T then distributes all its assets (*i.e.*, any assets retained and the A stock and/or Property received from A) to its shareholders, either in a state law merger (into a corporate T shareholder) or in a liquidation.

B. At Stake

1. Taxable gain on T assets transferred to A. (That is, the transactions described in Part III.A.1 and Part III. A.2, above, may be recast as a direct transfer of assets by T to A, as described in Part III.A.3, above.)

2. Taxable gain on T assets transferred to the T shareholders, not to A. (That is, the transactions described in Part III.A.1 and Part III.A.2, above, may be recast as direct transfers of some assets by T to A, perhaps in a non divisive Type D reorganization, and a distribution of other assets by T to its shareholders subject to Code Secs. 356 and 361(c)—as described in Part III.A.3, above.)

3. If a T shareholder is a Controlling corporate parent of T, the transactions could be tax-free, either under Code Secs. 332 and 351 or under Code Secs. 368(a)(1)(A) or 368(a)(1)(C) and Code Sec. 368(a)(2)(C).[13]

4. Tax consequences to T and its shareholders. If the transaction is treated as a stock redemption or partial liquidation instead of a complete liquidation the theory is that A is a continuation or *alter ego* of T.[14]

C. Proposals Relating to Nondivisive Type D Reorganizations

1. By amendment to Reg. §1.368-1(b), the Treasury should eliminate the apparent exception to the continuity-of-interest requirement for nondivisive Type D reorganizations.

2. By regulation, the normal continuity-of-interest requirement should apply to these transactions, except that, if T and A are under common Section 304(c) Control, the common ownership would satisfy the continuity-of-interest requirement. Thus, where there is such common Section 304(c) Control, all cash Type D reorganizations would qualify under the continuity-of-interest test.

3. The Code Sec. 355 regulations would govern continuity-of-interest in divisive Type D reorganizations as well as in nonreorganization Code Sec. 355 stock distributions.

4. The other general reorganization requirements and specific statutory requirements would remain in effect. *See* Reg. §1.368-2T(l), dealing within these requirements.

a. For example, the requirement under Code Sec. 368(a)(1)(D) that stock or securities of A be distributed to the T shareholders would remain in effect and would not necessarily be satisfied merely by common control as between T and A.

b. The extent to which this rule should be subject to exceptions for "meaningless gesture" and the like (especially where there is significant divergence of direct stock ownership as between T and A) is not dealt with in the proposals.

D. Issues and Thoughts Relating to Nondivisive Type D Reorganizations

1. Is common Code Sec. 304(c) Control the correct test for determining continuity-of-interest? Code Sec. 304(c) embodies broad constructive stock ownership concepts, so that, after the transaction, the former T shareholders may have little or no direct or indirect economic ownership of A.

2. For purposes of determining if T and A are under common Section 304(c) Control, should ownership of T stock be determined after changes in T stock ownership by reason of any redemptions or other non *pro rata* distributions of Property are taken into account? Taking these changes into account would seem appropriate.

E. Proposals Relating to Liquidation-Reincorporation

1. IRS should revise its no-ruling position regarding liquidation-reincorporation[15] to state that reorganization treatment is the principal alternative analysis to complete liquidation.

2. In light of this general principle, the hierarchy for analyzing each of the transactions described in Part III.A, above, would be as follows:

a. If, taking into account any transfer of assets to A, a liquidation or upstream merger of T, in a situation described in Part III.A.1, above, qualifies under Code Sec. 332, such treatment prevails.

b. If Code Sec. 332 (Part III.E.2.a, above) does not apply, and if a liquidation or upstream merger of T, together with a transfer of assets to A (in either order), qualifies as a reorganization (most likely a non divisive Type D reorganization or a Type F reorganization in which A is the acquiring corporation), such treatment prevails.

c. If neither Part III.E.2.a nor Part III.E.2.b applies, and if, taking into account the transfer of assets to A, the upstream transaction itself qualifies as a Type A or Type C reorganization,[16] such treatment prevails.

3. If Part III.E.2.a, Part III.E.2.b or Part III.E.2.c applies, *alter ego* treatment would not be considered. If the transaction does not fit into any of these categories, however, it may be considered whether A is to be treated as an *alter ego* of T. The result would be no "complete liquidation" of T but instead a taxable distribution by T of Property to its shareholders as a *pro rata* dividend, a stock redemption or a partial liquidation. The transfer from T to A would be disregarded.

4. If *alter ego* treatment may be considered, as described in Part III.E.3, above, A will be an *alter ego* of T only if both of the following tests are met:

a. A receives substantially all of T's assets (employing the "substantially-all" definition for nondivisive Type D reorganizations under Code Sec. 354(b)).

b. A is Section 304(c) Controlled by one or more T shareholders who receive a substantial continuity of interest in A in exchange for their investment in T (or in exchange for Property that was received from T in the upstream transaction).

i. These T shareholders need not have Section 304(c) Control of A, just of T.

ii. An all-cash asset sale could not be recast under an *alter ego* theory, although it could qualify as a Type D reorganization, under Reg. §1.368-2T(l).

F. Issues and Thoughts Relating to Liquidation-Reincorporation

1. Should there be a separate test for liquidation-reincorporation outside the Code's reorganization definitions at all? If the definitions of Type D and Type F reorganization are correct, such a separate rule may not be necessary.

2. If a separate test for liquidation-reincorporation is appropriate, should there be a rule to state affirmatively that a liquidation-reincorporation may not result in a taxable transfer of assets from T to A?

a. Such a rule would be analogous to Rev. Rul. 2001-46,[17] which allows a "qualified stock purchase" by A of the T stock, under Code Sec. 338(d)(3), plus an upstream transfer of T's assets to A, to be recast as a direct acquisition of T's assets by A only if the recast asset acquisition would qualify as a reorganization.

b. A similar rule where T and A are related by common stock ownership would add flexibility to business transactions without apparent abuse potential. This situation is a good example of one in which there is no important tax policy for disregarding the form of a transaction.

c. With the recent broadening of the definition of "statutory merger or consolidation" (the touchstone for a type-A reorganization), plus the regulations making Type A reorganizations available to foreign corporations (Reg. §1.368-2(b)), it is easier to qualify transactions as Type A reorganizations. These developments make it less likely that the liquidation-reincorporation doctrine would result in a taxable deemed transfer of T assets from T to A.

3. Should there be a codification of the IRS's advance ruling practice of not applying liquidation-reincorporation *alter ego* analysis to transactions intended to allocate assets in preparation for a spin-off or split-off under Code Sec. 355?

a. Jack's proposed rule for liquidation-reincorporation may achieve this result in many cases without further steps.

b. A spun-off corporation is unlikely to have as its only assets Property received from T. Does this fact eliminate Type F reorganization treatment from this situation as a practical matter?

c. Does a Code Sec. 355 stock distribution prevent any liquidation-reincorporation transaction from qualifying as a separate nondivisive Type D reorganization or from having A treated as an *alter ego*? As an example, suppose T and A are wholly owned subsidiaries of P, a public corporation. T merges upstream into P; P transfers 70 percent of the T's assests to A; P retains the remaining 30 percent of the T's assets but distributes the A stock to its public shareholders under Code Sec. 355. *See* the analytical hierarchy set forth in Part III.E.2, above.

i. The transfer of 70 percent of T's assets to A after the upstream merger would prevent the upstream merger from qualifying as a complete liquidation under Code Sec. 332.

ii. If the merger of T into P and P's transfer of T Property to A qualified as a non divisive Type D reorganization, T would be taxed on any built-in gain on the 30 percent of the T assets that P retains. Because of the distribution of the A stock, however, neither T nor its shareholder, P, has Section 304(c) Control of A.

iii. Similarly, because of the distribution of the A stock, P's transfer of 70 percent of the T assets to A would not qualify under Code Sec. 368(a)(2)(C) or Reg. §1.368-2(k) because, after the distribution, P does not Control A. Thus, the upstream merger of T into P does not qualify as an upstream Type C reorganization, because it flunks the "substantially-all" test.

iv. There is no "substantially-all" test, however, for a Type A reorganization. Thus, the upstream merger of T into P could qualify as a Type A reorganization, provided the 30 percent of the T assets that P retains is enough to meet the continuity-of-business-enterprise test.

4. If a liquidation-reincorporation *alter ego* test is to depend on whether T transfers substantially all of its assets to A, a clarification of the substantially-all test, at least for this purpose, should be part of the guidance.

5. Jack's proposed Type D reorganization test and the proposed liquidation-reincorporation test would allow T to elect into fully taxable asset sale treatment with minor variations in transaction form. Are these results appropriate? As examples—

a. T could sell less-than substantially all of its assets to A (directly or indirectly) in a taxable sale, without *alter ego* recast. In other words, the alter ego recast would not apply where the amount of T assets distributed to T shareholders is the greatest in amount.

b. T could transfer all its assets to two or more subsidiaries of a parent corporation that is under common control with T.

Endnotes

1 Divisive transactions under Code Sec. 355 are considered only in limited respects. Neither Code Sec. 351 exchanges nor insolvency reorganizations are considered at all.

2 Because of its technical orientation, this outline does not address the other pervasive and overlapping judicial requirement, referred to as "business purpose" and "substantial economic effect." Nor is the proposed "net value" requirement addressed. Proposed Reg. §1.368-1(f).

3 If the T shareholders receive no Property, A may assume an unlimited amount of T liabilities (except perhaps that T must have some net value, so that some A stock is issued. Proposed Reg. §1.368-2(d)(l)(i) (Mar. 9, 2005)).

4 It is assumed that Code Sec. 1036 does not apply, instead of Code Sec. 368(a)(1)(E).

5 Under proposed regulations, other transactions may occur as part of the same plan as a Type F reorganization without jeopardizing the Type F reorganization itself. Proposed Reg. §1.368-2(m)(3).

6 The continuity-of-interest requirement may also apply to nondivisive Type D reorganizations. *See* Part III, below.

7 *D.E. Clark,* SCt, 89-1 USTC ¶9230, 489 US 726, 109 SCt 1455.

8 *F.R. Zenz v. Quinlivan,* CA-6, 54-2 USTC ¶9445, 213 F2d 914.

9 In a Two-Party transaction, the sourcing issue is as between T and A. In a Triangular transaction, the sourcing issue is generally between T on the one hand and either P or A on the other hand. In such situations, the source of Property or stock, as between P and A, also can be important. *See, e.g.*, Rev. Rul. 70-107, 1970-1 CB 78; Notice 2006-85, IRB 2006-41, 677. These sourcing issues are outside the scope of the proposals.

10 *Waterman Steamship Corp.,* CA-5, 70-2 USTC ¶9514, 430 F2d 1185. *Cert. denied,* 401 US 939, 91 SCt 936.

11 Rev. Rul. 75-360, 1975-2 CB 110.

12 *Plantation Patterns, Inc.,* CA-5, 72-2 USTC ¶9494, 462 F2d 712.

13 Reg. §1.368-2(k) and Rev. Rul. 69-617, 1969-2 CB 57.

14 *Telephone Answering Service Co., Inc.*, 63 TC 423, Dec. 33,000.*Aff'd,* CA-4 (unpublished opinion), Nov. 8, 1976. *Cert. denied,* 431 US 914, 97 SCt 2174.

15 Currently set forth in Rev. Proc. 2006-3, IRB 2006-1, 122; Code Sec. 4.01(23).

16 S*ee* Code Sec. 368(a)(2)(C), Reg. §1.368-2(k) and Rev. Rul. 69-617.

17 Rev. Rul. 2001-46, 2001-2 CB 321.