Postacquisition Restructuring And Beyond

By George R. Goodman

George R. Goodman is of counsel with Foley & Lardner LLP, Chicago. The views expressed herein are solely those of the author.

This article discusses the recent amendments to the regulations governing restructuring following a tax-free reorganization. It grew out of a presentation on the subject the author gave to the Chicago Tax Club. The article not only discusses the historic backdrop and theoretical underpinnings of the new rules, but also identifies issues and provides practical guidance in structuring transactions to achieve desired results. The article concludes by suggesting that the law still has not gone far enough to facilitate modern transactions.

Table of Contents

If nothing ever changed, there'd be no butterflies.
— Author Unknown

I. Introduction

The Internal Revenue Code confers tax-free treatment on corporate acquisitions only when they are structured to fit within narrow, prescribed patterns. The IRS has recently given acquiring groups additional leeway to reposition assets following the initial acquisition without affecting the initial acquisition's tax-free treatment. This leeway helps facilitate tax-free acquisitions of and by corporate groups that frequently have complex multi-entity, multitier structures by allowing the acquiring group to reposition acquired businesses in the desired entities. While substantial, this leeway is limited, and there is room for the law to develop further.

The article begins by outlining the tax-free reorganization patterns listed in section 368, finding that tax-free acquisitions can be made only by a corporation (P) whose stock is issued to the shareholders of the acquired target corporation (T), or by a first-tier subsidiary of P (S). Thus, to achieve the desired results on a tax-free basis, P or S must first acquire T in exchange for P stock in accordance with one of these patterns, and then move the acquired T stock or assets to the desired locations. This raises step transaction doctrine concerns, as the postacquisition restructuring could, if integrated with the initial acquisition, alter the tax consequences. Integration could cause the transaction to fail as a tax-free reorganization, by taking the transaction outside the section 368 statutory patterns, or causing the nonstatutory continuity of shareholder interest (COSI) or continuity of business enterprise (COBE) requirements to be failed. Integration could also create an overlap issue whereby the initial acquisition would be one type of 368 reorganization while the overall integrated transaction would be another.

Having established the problem posed by narrow tax-free reorganization patterns and the need for postacquisition restructuring, the article reviews the historical development of the law governing this problem. The law was initially very restrictive, but has since become more accommodating. Not only have the statutory section 368 reorganization patterns been expanded to allow greater freedom in structuring initial tax-free acquisitions, a safe harbor has been established under section 368(a)(2)(C) and reg. section 1.368-2(k) within which postacquisition restructuring may be undertaken without affecting the tax treatment of the initial acquisition. The boundaries of the safe harbor continue to be extended, most recently by T.D. 9361, *Doc 2007-23670, 2007 TNT 207-4*.

The article examines the changes made by T.D. 9361 to reg. section 1.368-2 in detail, and it identifies various practical issues, gray areas, and traps for the unwary. The article then analyzes three postacquisition restructuring examples to show how the new safe harbor rules apply, what issues arise, and how best to structure the transactions under the new rules.

The article closes with questions as to whether the law has yet gone far enough to accommodate tax-free combinations of corporate groups. In particular, reg. section 1.368-2(k), as amended by T.D. 9361, requires that some vestige of the initial acquisition structure survive the subsequent restructuring for the restructuring to be covered by the safe harbor and treated as separate from the initial transaction. The article argues that the problems posed by this vestige requirement outweigh the rationale for it and that it should be eliminated. In overlap transactions in which an initial acquisition followed by integrated restructuring would be treated as different types of tax-free 368 reorganizations (depending on whether the step transaction doctrine is applied to integrate the steps), it is argued that taxpayers should be able to designate the treatment. Finally, it is suggested that the statutory section 368 reorganization patterns themselves be further expanded to accommodate initial acquisition structures that directly achieve the results permitted through postacquisition restructuring.

II. Tax-Free Reorganization Patterns Are Narrow

Section 368 prescribes the four basic reorganization patterns for a corporation to acquire another corporation on a tax-free basis, as follows:

- Statutory Merger: Section 368(a)(1)(A) allows P to acquire T by direct merger between P and T, or by triangular merger between S and T.
- Stock Swap: Section 368(a)(1)(B) allows P or S to acquire the stock of T in exchange for solely voting stock of P.
- Asset Acquisition or Constructive Merger: Section 368(a)(1)(C) allows P or S to acquire substantially all the assets of T in exchange generally for solely voting stock of P and the assumption of T's liabilities.
- Common Control Transaction: Section 368(a)(1)(D) allows P to acquire substantially all the assets of T in exchange for stock or securities of P if the former T shareholders have 50 percent control of P immediately after the transaction.

These patterns are all variants of a narrow paradigm. Generally, the assets or stock of T must be acquired by a single corporation — either the issuer of the stock to the T stockholders (i.e., P) or a direct first-tier subsidiary thereof (i.e., S). This narrow paradigm cannot accommodate many real-life transactions in which, for example, P may wish to combine T's business with a second- or lower-tier subsidiary, or disburse T's assets among several P group members, or combine T's assets with a partnership in which P group members are partners. For instance, a merger of T into a second-tier subsidiary of P would be outside the paradigm and therefore taxable.

III. Acquire, Then Reposition

One seemingly promising way to achieve a tax-free reorganization would be for P or S to first acquire T in an initial transaction that fits within one of the prescribed 368 reorganization patterns and then move T, or the T assets, to the desired entities within the P group. This two-step approach, however, raises step transaction concerns.[1] Reg. section 1.368-1(a) specifically cautions that "in determining whether a transaction qualifies as a reorganization under section 368(a), the transaction must be evaluated under relevant provisions of law, including the step transaction doctrine."

In fact, the transactions at issue are typically structured as an initial acquisition that qualifies as a tax-free 368 reorganization, followed by restructuring to get the assets to the desired location in a manner that does not upset that qualification. It is generally assumed here that integration of the restructuring with the initial acquisition would take the entire transaction outside the tax-free reorganization provisions, or cause the transaction to be treated as a different type of reorganization. For example, S acquires the T stock then merges T into another subsidiary of S, so that if integrated, T is treated as merging directly into a second-tier subsidiary of P, which would not qualify as a tax-free reorganization (unless further recast). Thus, the issue is whether the step transaction doctrine applies to integrate the steps.

Integration can be avoided in two ways. First, as discussed below, the Service has turned off the step transaction doctrine as long as the postacquisition restructuring stays within fairly broad safe harbor boundaries. Thus, by staying within the permissible safe harbor boundaries, the restructuring will not affect the initial acquisition's qualification as a reorganization, even if the steps would otherwise be integrated under normal step transaction principles. Second, for restructuring that exceeds those boundaries, preservation of the reorganization qualification of the initial acquisition would require that the restructuring be considered an independent transaction under general step transaction doctrine principles (that is, that the requisite binding contract, mutual interdependence, or end result intent necessary for integration be absent as a factual matter). Those types of restructuring situations may involve having to wait a sufficient period of time or otherwise having facts negating integration.

This article focuses on the safe harbor protections referred to above and generally assumes the postacquisition restructuring at issue would otherwise be stepped together with, and affect, the tax treatment of the initial acquisition. Thus, factual avoidance of integration outside the safe harbor, as described in the second scenario above, is not addressed. This article also does not address postacquisition restructuring following an initial taxable acquisition, because it generally raises no concerns about the need to preserve the tax treatment of the initial acquisition transaction (since it is already taxable) and therefore eliminates constraints on restructuring.

---

[1]*See Minnesota Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938) ("A given result at the end of a straight path is not made a different result because reached by following a devious path"); *Helvering v. Bashford*, 302 U.S. 454 (1938). ("Any direct ownership by [P] of [T] was transitory and without real substance; it was part of a plan which contemplated the immediate transfer of the [T stock and assets] to the new subsidiary" of P.)

IV. Restructuring Implicates Reorg Requirements

Tax-free reorganization qualification generally requires satisfaction of four basic requirements: 1) the transaction must fit within a statutory pattern prescribed in section 368; 2) the transaction must be motivated by a corporate business purpose; 3) the consideration issued to the T shareholders must satisfy the COSI standards; and 4) COBE must be maintained. It is useful to consider briefly how, if at all, postacquisition restructuring may affect each of these requirements.

As to statutory compliance, postacquisition restructuring may cause failure to comply with section 368 if it is integrated with the initial acquisition and takes the transaction (as a whole) outside the statutory pattern the initial acquisition was intended to fall within. Or it could affect the type of section 368 reorganization the transaction falls under. As discussed below, special rules have developed in reg. section 1.368-2(k) to address these concerns. Essentially, reg. section 1.368-2(k) provides a safe harbor against integration of the postacquisition restructuring with the initial acquisition in determining the initial acquisition's qualification as a reorganization, including its compliance with section 368.

Postacquisition restructuring could implicate the COBE requirement if T assets were redeployed in such a way that P was no longer considered to carry on the T business directly or indirectly. A body of principles policing postacquisition restructuring have been developed under the COBE requirement, in reg. section 1.368-1(d).

For COSI, dropping T assets down into lower- and lower-tier subsidiaries of P could attenuate the former T stockholders' continuing interest in T assets through their P stock, potentially implicating the COSI requirement. For example, if the former T shareholders own P stock but the former T assets are not held by P, but by a third-tier subsidiary of P, does the P stock provide the requisite COSI interest, or is it too remote? This issue has played a major role in shaping the law governing postacquisition restructuring, but appears to no longer involve satisfaction of any requirements separate and apart from the COBE requirements of reg. section 1.368-1(d) and the additional constraints in reg. section 1.368-2(k).

Finally, postacquisition restructuring would typically have little bearing on the business purpose requirement. If anything, the desire to reposition assets would be in keeping with bona fide business reasons for acquiring the assets in the first place. Thus, no special rules have arisen concerning the relationship between business purpose and postacquisition restructuring.

In sum, the current framework governing postacquisition restructuring consists of the COBE requirements in reg. section 1.368-1(d), and a safe harbor against application of the step transaction doctrine in reg. section 1.368-2(k). It is useful to review the historical development of the law governing postacquisition restructuring to understand how this framework developed and to appreciate it.

V. Development of the Law

A. The Early Thinking

The foundation for this area of law is the Supreme Court's decision in *Groman v. Commissioner*, 302 U.S. 82 (1937). In that case, P wanted to acquire T and combine it with P's subsidiary, S. A deal was structured whereby S acquired the T stock and then liquidated T into itself. The consideration to the T stockholders included a combination of P stock and S stock. The reorganization statute at the time covered only two-party transactions, not three-party triangular patterns. Therein lay the problem. P sought to wedge its partly triangular structure into the two-party pattern.

The government allowed the T stockholders to receive S stock tax free based on a two-party transaction between S and T (acquisition of T by S for S stock). However, it considered the P stock to be taxable boot. In agreeing with the government, the Supreme Court reasoned that for the P stock to be tax free to the T stockholders, P had to be a party to a reorganization. The parties to the reorganization were S and T. P may have been an enabler or facilitator, but was not itself a party.

Anticipating that approach, the taxpayer further argued that S was essentially just an agent/alter ego of P and that P and S should be viewed together as one corporation. However, the Court respected the separateness of the P and S corporate entities and looked to the purpose of the tax-free reorganization provisions — to confer tax-free treatment on the receipt of stock representing a continuing interest in the acquired corporation's business. The Court considered the P stock to represent an interest in P's own assets; only indirectly, through P's ownership of the S stock as an asset, did the P stock represent an interest in the former T business then held by S. The Court concluded that this was an insufficiently direct link to the former T business, taking the transaction outside the purview of tax-free reorganizations.

In a companion case, *Helvering v. Bashford*, 302 U.S. 454 (1938), the facts were basically the same except that P first acquired the T stock, and in accordance with the plan, transferred the T stock to S, and S then liquidated T into itself. The Court held that P's ownership of the T stock was ''transitory and without real substance,'' so the tax treatment was controlled by *Groman*.

Groman and *Bashford* established what became known as the ''remote continuity doctrine'' — that COSI is satisfied only if P corporation, whose stock is received by the former T stockholders, holds the T assets directly, or the T stock in the case of a 368(a)(1)(B) reorganization. This doctrine remained the law, and it largely precluded triangular acquisitions and postacquisition restructuring (unless not part of the original plan or involving limited assets), until 1954.[2]

[2]Interestingly, although the remote continuity aspect of the cases has largely been overruled, the results of the cases may yet be reflected in the prohibitions or limitations on the use of combinations of both P stock and S stock in triangular reorganizations. *See* section 368(a)(2)(D)(i) (no stock of controlled

(Footnote continued on next page.)

Congress began chipping away at the *Groman-Bashford* remote continuity doctrine in the enactment of the Internal Revenue Code of 1954. Congress changed the C reorganization provision to allow for triangular acquisitions by a controlled subsidiary, and it added section 368(a)(2)(C) to permit a one-level drop-down of acquired assets to a controlled subsidiary following an A or C acquisition. Specifically, new section 368(a)(2)(C) provided that ''a transaction otherwise qualifying under [sections 368(a)(1)(A) or (C)] shall not be disqualified by reason of the fact that part or all of the assets which were acquired in the transaction are transferred to a corporation controlled [within the meaning of section 368(c)] by the corporation acquiring such assets.''

In Rev. Rul. 63-234, 1963-2 C.B. 148, the Service addressed the treatment of a triangular stock-swap acquisition. Although Congress had modified the reorganization statutes to allow for triangular C reorganizations and drop-downs following an A or C reorganization, it did not do so for B transactions. The Service said Gotcha! — ''The rule of the *Groman* and *Bashford* cases is still applicable to reorganizations sought to be brought within the provisions of section 368(a)(1)(B).'' Finding the distinction unwarranted, Congress responded in 1964 by amending sections 368(a)(1)(B) and 368(a)(2)(C) to allow for triangular B reorganizations as well as drop-downs of the acquired T stock to a controlled subsidiary under section 368(a)(2)(C). *See* Revenue Act of 1964, P.L. 88-272; section 218(b)(1).

Undaunted, in 1967 the Service published Rev. Rul. 67-326, 1967-2 C.B. 143 (obsoleted by Rev. Rul. 2003-99, 2003-2 C.B. 388, *Doc 2003-18199, 2003 TNT 164-9*), finding that a forward triangular merger into a controlled subsidiary for parent stock did not qualify for tax-free treatment as an A statutory merger reorganization (although triangular C qualification was allowed). Noting that Congress had amended the ''party to a reorganization'' definition in section 368(b) to include the controlling parent in triangular B and C reorganizations, but had not done so for A transactions, the Service reasoned that the controlling parent in a triangular merger was not a party to the A reorganization, a necessary predicate for application of the nonrecognition provisions. But the Service was rebuffed again when Congress enacted sections 368(a)(2)(D) and (E) in 1968 and 1970 to allow for forward and reverse triangular merger reorganizations under section 368(a)(1)(A), and correspondingly expanded ''the party to a reorganization'' definition to include the controlling parent in such cases. P.L. 90-621, section 1(a), H.R. 18942; P.L. 91-693, section 1(a), H.R. 19562. These amendments brought the section 368 statute where it is today insofar as triangular initial acquisitions and postacquisition restructuring are concerned.

This history shows a mentality early on that the *Groman-Bashford* remote continuity doctrine had continued force and vitality and prevented one from venturing beyond what was specifically authorized by statute. In venturing beyond the statute, one normally had to wait out or otherwise avoid the step transaction doctrine. This mentality and practice persisted until the Service began changing its thinking and administrative practice, starting formally with T.D. 8760, *Doc 98-3827, 98 TNT 16-17*.[3]

B. Toward a More Relaxed Approach

T.D. 8760 was an important step in the direction of a more flexible application and broader scope for the reorganization provisions. It made three basic changes. First, it added reg. section 1.368-1(e), to essentially codify the COSI requirement with specific standards. The biggest change was the elimination of the requirement that T shareholders intend to retain their P shares for some time after the transaction, as had previously been thought necessary to exclude transactions amounting in substance to sales from tax-free reorganization treatment. As amended, reg. section 1.368-1(e) focuses only on the makeup of the consideration issued in the acquisition to

subsidiary may be used); reg. section 1.368-2(c) (''Nor is a transaction a reorganization described in section 368(a)(1)(B) if stock is acquired in exchange for voting stock both of [P] and [S]''); reg. section 1.368-2(d). (''However, if the properties of [T] are acquired in exchange for voting stock of both [P] and [S], the transaction will not constitute a reorganization under section 368(a)(1)(C).'' However, in such case, the limited boot relaxation allowance in 368(a)(2)(B) could perhaps apply.)

[3]To be sure, for some time before T.D. 8760, taxpayers had been applying for and receiving private letter rulings permitting drop-downs beyond what was permitted by section 368(a)(2)(C), reflecting informal evolution in thought leading up to T.D. 8760. *See*, e.g., LTR 8432112 (double drop-down of T assets following downstream A merger), *supplemented*, LTR 8510027; LTR 9041086 (double drop-down of acquired T stock following a section 368(a)(1)(A) and (a)(2)(E) acquisition of T stock); LTR 9536032 (P owned S1 and Interim, S1 owned S2, and S2 owned S3; T merged into Interim, then Interim stock was dropped down to S2, and Interim merged into S3; Service recast transaction as direct acquisition of T assets by P under section 368(a)(1)(C), followed by triple drop-down of former T assets to S3). These rulings were based on Rev. Rul. 64-73, 1964-1 C.B. 142, which in contrast to Rev. Rul. 63-234 and Rev. Rul. 67-326, took a more relaxed attitude toward postacquisition restructuring, stating that ''the specific statutory exceptions to the *Groman-Bashford* doctrine contained in sections 368(a)(1)(C), 368(a)(2)(C), and 368(b) are not intended to exclude a transfer of assets to a wholly-owned subsidiary of a corporation which is controlled by the parent corporation.'' In Rev. Rul. 64-73, the Service allowed a double drop-down by P of less than substantially all the acquired T assets following a C reorganization. However, the significance of this ruling is diminished not only by the fact that it involved only some of the assets, but more importantly, by the fact that the statute itself permits a triangular C acquisition by S followed by a one-tier drop-down of all acquired assets, in which case all the T assets can end up in a second-tier subsidiary of P anyway. *See also* LTR 9620013 (T had merged into P's new first-tier subsidiary A, after which P contributed A stock to another first-tier subsidiary S1; it was then proposed to merge A into S1's other subsidiary S2; the Service ruled that drop-down of A stock to S1, and proposed merger of A into S2, would not prevent the first merger from satisfying COSI and substantially all requirements).

the former T stockholders, and turns off the step transaction doctrine and disregards any subsequent dispositions by T stockholders of the P stock received (unless the disposition is back to P or a person related to P).

Second, T.D. 8760 relaxed the COBE requirements in existing reg. section 1.368-1(d). Before discussing the changes, it is worth questioning why the COBE requirement was retained, given the elimination of the prior COSI requirement that T stockholders retain their P stock for some time. The COBE requirement is often said to be necessary to ensure a continuous link between the former T stockholders and the T business.[4] But if the former T stockholders can or do sell their P shares immediately after the reorganization, the link is unnecessary and may be broken anyway. It seems the COBE requirement has gone beyond ensuring the linkage to the former T stockholders to become a separate business continuity requirement at the corporate level that — unlike COSI — must survive the transaction (including any related post-acquisition restructuring). In contrast to COSI, the step transaction doctrine continues to apply for COBE purposes; an integrated postacquisition disposition by P of T assets beyond what the COBE rules allow will disqualify the initial acquisition as a reorganization for lack of COBE.[5]

T.D. 8760 relaxed the COBE requirement by applying it on a more easily satisfied ''qualified group'' basis. Previously, reg. section 1.368-1(d) required that the acquiring corporation continue T's business (although Rev. Rul. 81-247, 1981-2 C.B. 87, *obsoleted by* Rev. Rul. 2003-99, 2003-2 C.B. 388, permitted drop-downs to directly controlled subsidiaries under section 368(a)(2)(C)). Under T.D. 8760, P is treated as owning the assets and conducting the businesses of all members of its qualified group for COBE purposes. Thus, P meets the COBE requirement if its qualified group does. The term ''qualified group'' was defined as P and its direct and indirect subsidiaries controlled in each instance by its immediate parent under section 368(c). T.D. 8760 also adopted an aggregate or look-through approach to partnerships, under which each partner is treated as owning its share of the partnership assets, and P is treated as conducting the partnership business if qualified group members own a significant interest in the partnership or have active and substantial management functions in the partnership.

Third, T.D. 8760 also added reg. section 1.368-2(k) to implement section 368(a)(2)(C). However, T.D. 8760 exceeded section 368(a)(2)(C) by allowing not only single, but successive drop-downs following A, B, and C reorganizations ''to one or more corporations controlled in each transfer by the transferor corporation.'' Thus, the permissible transferees under reg. section 1.368-2(k) were coextensive with the COBE qualified group members under reg. section 1.368-1(d). In contrast to the aggregate approach to partnerships taken for COBE purposes, however, T.D. 8760 adopted an entity approach to partnerships insofar as other requirements were concerned, such as fitting within the statutory pattern. Thus, reg. section 1.368-2(k), Example 3, concluded that a drop-down of T stock acquired in a purported B reorganization to a partnership owned entirely by controlled subsidiaries disqualified the T stock acquisition from B qualification since the acquiring corporation did not have control of T under 368(c) immediately after the transaction.

The proposed regulations leading to T.D. 8760 had included a prop. reg. section 1.368-1(f) to address the *Groman-Bashford* remote continuity concerns associated with drop-downs to lower-tier qualified group members and partnerships. It provided that those transfers do not violate COSI. However, T.D. 8760 dropped that provision on the grounds that ''the COBE requirements adequately address the issues raised in *Groman* and *Bashford* and their progeny.'' Yet on their face, the reg. section 1.368-1(d) COBE rules address only the COBE requirement and say nothing about COSI. Reg. section 1.368-2(k) would seem more appropriate to cover the remote continuity issue, since, in providing that a transaction otherwise qualifying as a tax-free reorganization shall not be disqualified because of specified drop-downs, it seemingly gives blanket protection against disqualification on any basis, including remote continuity. One could even question the need for the separate reg. section 1.368-1(d) COBE rules on drop-downs, as reg. section 1.368-2(k) would seem to cover the COBE issues as well. Nonetheless, based on T.D. 8760, it appears one is to view the reg. section 1.368-1(d) COBE rules as encompassing the remote continuity doctrine.[6] Indeed, given the lack of any continuing COSI requirement, administration of the remote continuity doctrine on the transaction itself could be seen as the main function of the COBE qualified group rules.

As noted, reg. section 1.368-2(k) permitted drop-downs to occur down any number of tiers of a section 368(c) controlled chain of subsidiaries. Section 368(a)(2)(C) itself permits drop-downs to move down only one tier to a directly controlled subsidiary. The expanded freedom under reg. section 1.368-2(k) represented a marked departure from the old-school view that the *Groman-Bashford* remote continuity doctrine prevented anything beyond what section 368(a)(2)(C) permitted. From then on, it was ''Katy, bar the door!''

The first horse out of the barn was Rev. Rul. 2001-24, 2001-1 C.B. 1290, *Doc 2001-12686, 2001 TNT 87-9*. It permitted P to drop down the stock of its acquiring subsidiary S to another controlled subsidiary following a forward triangular merger of T into S in a section 368(a)(1)(A) and (a)(2)(D) reorganization. This was significant because section 368(a)(2)(D) requires that P be in control of S, and while section 368(a)(2)(C) permits drop-downs of acquired stock or assets, P did not acquire the S stock in the merger (although S was in fact newly formed by P). In allowing the drop-down, the Service

[4]*See* T.D. 7745, 1981-1 C.B. 134 (COBE is a ''necessary corollary to'' to the COSI requirement; without COBE, ''there would be no reason to require T's shareholders to retain a continuing interest in P''); T.D. 9361 (COBE requirements ''adequately preserve the link between the former T shareholder and the T business assets'').

[5]*See* reg. section 1.368-1(d), Example 5.

[6]*See also* T.D. 9361 (reiterating that view).

first reasoned that COBE was maintained under the reg. section 1.368-1(d) qualified group rules. Second, as to whether the transaction fit the statutory pattern, the Service, in keeping with reg. section 1.368-2(k), no longer viewed section 368(a)(2)(C) as setting the boundaries of permissible postacquisition restructuring, finding it to be ''permissive rather than an exclusive or restrictive section.'' Third, since drop-downs following reverse triangular reorganizations under section 368(a)(1)(A) and (a)(2)(E) were allowed, and believing that forward and reverse triangular mergers should be treated similarly, the Service allowed the drop-down in the forward triangular merger as well.

The next development was Rev. Rul. 2002-85, 2002-2 C.B. 986, *Doc 2002-27007, 2002 TNT 237-13*, which permitted a drop-down following a D reorganization, even though section 368(a)(2)(C) allows drop-downs only after A, B, C, and G reorganizations. There, the Service used essentially the same analysis as in Rev. Rul. 2001-24, although it separately addressed remote continuity. First, the drop-down did not violate COBE under the qualified group rules. Second, citing T.D. 8760, the Service considered the *Groman-Bashford* remote continuity issue to be covered by the COBE rules. Third, the Service found both section 368(a)(2)(C) and reg. section 1.368-2(k), neither of which mention section 368(a)(1)(D), to be permissive rather than limiting. Finally, since there was no policy reason to treat a D reorganization different than A and C reorganizations, the Service allowed the post-D reorganization drop-down.

In summary, leading up to T.D. 9361, the Service had long abandoned the notion that postacquisition restructuring was tied to section 368(a)(2)(C), and it exhibited flexibility in allowing some additional restructuring through the regulations and revenue rulings.

VI. T.D. 9361

T.D. 9361 continued the trend of facilitating postacquisition restructuring by amending reg. section 1.368-1(d) to expand the definition of qualified group and amending reg. section 1.368-2(k) to supplant section 368(a)(2)(C) altogether with a much more liberal allowance.

A. COBE Qualified Group Expanded

As amended, reg. section 1.368-1(d) defines qualified group to mean P, at least one subsidiary directly controlled by P, and any other direct or indirect P subsidiaries control of which is held by P and other qualified group members in the aggregate. Thus, subsidiaries that are not directly controlled down each link of a chain, but are controlled by qualified group members in the aggregate (for example, a subsidiary 50 percent of the stock of which is owned by each of P and S), are now permissible transferees.

For purposes of the controlled-group definition, the Service adhered to the section 368(c) definition of control (ownership of voting stock having at least 80 percent of the total voting power and 80 percent of the shares of each class of nonvoting stock), despite commentary suggesting that the Service should look to the affiliation standards in section 1504, at least for affiliated groups filing consolidated returns. The Service reasoned that section 368(c) undergirds the reorganization provisions and therefore should also frame postacquisition restructuring. As a result, the qualified-group definition is in some respects more inclusive than the 1504 affiliated group definition (as when P owns stock with a disproportionately high voting power, giving it 80 percent of the vote but not the value of company's stock, so it is a member of P's qualified group but not P's affiliated group), and in other respects narrower (as when P owns all of a company's common stock but none of its outstanding nonvoting preferred stock described in section 1504(a)(4), so it is a member of P's affiliated group but not its qualified group, if any).

T.D. 9361 also adopted a more liberal, aggregate, or look-through approach to the treatment of postacquisition transfers of stock to partnerships. Although the prior COBE rules generally applied an aggregate or look-through approach to transfers of assets to partnerships, this was not the case for stock. A transfer of more than 20 percent of the stock of S or T to a partnership, even one owned wholly by P and its subsidiaries, would take the company outside the P qualified group. As amended by T.D. 9361, reg. section 1.368-1(d) provides that stock owned by a section 368(c) controlled partnership is treated as owned by the qualified group members owning interests in that partnership. For example, if P acquires the stock of T in a B reorganization, and then transfers all the stock to a 50/50 partnership between P and S, P and S would each be treated as owning 50 percent of the T stock, so T would remain a member of the qualified group.

The term ''section 368(c) controlled partnership'' is defined as a partnership in which members of the qualified group own interests meeting requirements equivalent to section 368(c). The application of section 368(c) concepts and standards to partnerships raises many questions that will need to be addressed, including how voting power is measured, how classes of nonvoting interests are identified, and how percentages of ownership thereof are measured.

B. A New Restructuring Touchstone

T.D. 9631 radically altered reg. section 1.368-2(k). No longer tied to section 368(a)(2)(C), it provides that a transaction otherwise qualifying as a reorganization under section 368 ''shall not be disqualified or recharacterized as a result of one or more subsequent transfers'' as long as (i) COBE is satisfied, and (ii) the restructuring constitutes a distribution under paragraph (k)(1)(i) or another transfer (referred to herein as nondistributive transfer) under (k)(1)(ii). As a result, section 368(a)(2)(C) has largely become a dead letter.

The only additional requirement beyond COBE imposed by reg. section 1.368-2(k) is that the restructuring be a distribution or nondistributive transfer. The ''nondistributive transfer'' and ''distribution'' definitions use the terms ''acquired corporation,'' ''acquiring corporation,'' and ''surviving corporation.'' Definitions for these terms are hard to find, however. Related amendments to the definition of a party to a reorganization in reg. section 1.368-2(f), the examples in amended Treas. reg. section 1.368-2(k), and other subsections in reg. section 1.368-2, appear to supply their intended meanings. It appears that the acquiring corporation is P in a direct reorganization

(A, B, C, D, or G), or P's controlled subsidiary S in a forward triangular reorganization (A, B, C, or G). T is an acquired corporation if acquired in a B reorganization, but a surviving corporation if acquired in a section 368(a)(1)(A) and (a)(2)(E) reverse triangular merger. The apparent distinction between an acquisition of T stock in a B reorganization (in which case T is an acquired corporation) and an acquisition of T stock through a reverse triangular merger (in which case T is a surviving corporation) can apparently make a difference in certain distribution scenarios described below.

1. Nondistributive transfers. Looking first at nondistributive transfers, that category addresses all transfers other than distributions to shareholders. The regulation provides that the property transferred can consist of stock or assets of the acquired corporation, the acquiring corporation, or the surviving corporation. The nondistributive transfers allowance is an extension of the historic drop-down allowance and includes drop-downs and intercompany sales. For example, a cross-chain sale for adequate consideration (other than a redemption of stock), so that it is not a deemed dividend up one chain and down the other, may be a nondistributive transfer. Note that an upstream sale may also be a nondistributive transfer, whereby S acquires the T stock or assets in a triangular transaction and sells the T stock or assets to P.[7]

Two conditions are imposed for a nondistributive transfer to qualify as a covered nondistributive transfer. First, in the case of a transfer of stock, the stock transfer cannot cause the corporation whose stock is transferred to cease being a member of the COBE qualified group. There is some redundancy here — otherwise, the COBE requirement may be failed — but it is possible that sufficient assets have been extracted from the corporation and retained within the qualified group to satisfy COBE. In that case, the corporation's departure from the qualified group on the transfer of its stock would disqualify the stock transfer as a nondistributive transfer, and consideration would have to be given to whether, under general step transaction doctrine principles, the stock transfer disqualifies the reorganization on some ground other than COBE.

Second, the nondistributive transfer cannot terminate the acquired, acquiring, or surviving corporation's existence for federal income tax purposes. While discussed further below, this restriction appears to be based on the view that existence termination is such a major change in the results of the transactions that it cannot be ignored; the step transaction doctrine should be applied and the qualification determined accordingly. For example, if S were to acquire the T stock for P stock in a purported triangular B reorganization as part of a plan, and then immediately merge T into another subsidiary of S (U), the merger would not be a nondistributive transfer since T's existence would terminate. Thus, the transaction would be analyzed under general principles, and if it is characterized as a forward triangular merger of T into U (a second-tier subsidiary of P), it would not come within any tax-free reorganization pattern.

A word of caution is that termination of a corporation's existence for tax purposes can involve some gray areas. A de jure termination of the acquired, acquiring, or surviving corporation's existence through a statutory merger or formal dissolution is usually clear-cut. A conversion to a disregarded limited liability company should also be a clear-cut termination. However, tax existence can also cease under somewhat opaque de facto dissolution principles, and care would need to be taken to avoid that as well.

2. Push-ups. T.D. 9361's allowance of postacquisition distributions, also known as "push-ups," under reg. section 1.368-2(k) is new. Permissible distributions are distributions to shareholders of (1) the assets of the acquired, acquiring, or surviving corporation, or of an interest in an entity received in exchange for those assets in a nondistributive transfer described above, or (2) stock of the acquired corporation.

The specification of the types of assets and stock covered raises some questions. The reference in clause (1) to an interest in an entity received in exchange for assets suggests that generally only distributions of assets owned as of the acquisition date are covered. If subsequently acquired or received or held assets were covered, this reference to interests in transferee entities would seem unnecessary. If this is correct, some type of short-term tracing may be required to ensure ownership of distributed assets as of the acquisition date, and that could prove problematic in the case of fast turnover assets. Moreover, it is not entirely clear what constitutes an interest in an entity. Cash presumably does not, so distribution of cash proceeds received in an intercompany sale of assets to another qualified group member would (apparently) not be a covered distribution. Yet perhaps a short-term negotiable commercial paper-type note might be.

The apparent limitation of stock distributions in clause (2) to stock of the acquired corporation is also somewhat puzzling. Given the apparent definition of acquired corporation as T only if acquired in a B reorganization, it appears that in referring only to stock of the acquired corporation in clause (2), the stock distribution allowance only applies to T stock following a B reorganization. Stock of T acquired in a reverse triangular reorganization, in which case T is a surviving corporation, or stock of a controlled acquiring corporation S in a triangular section 368(a)(1)(A) and (a)(2)(D), (B) or (C) reorganization, does not appear to be covered. The distinction could perhaps be explained based on the fact that the surviving corporation T in a 368(a)(1)(A) and (a)(2)(E) transaction, or the acquiring corporation S in a triangular B or C transaction, will be a first-tier subsidiary of P, so a distribution of T or S stock in those cases would be to the P shareholders, which was intended to be prohibited. By contrast, in a triangular B acquisition by S, the acquired corporation T would be owned by S, so S could distribute the T stock to P. If that is the distinction intended to be drawn, it is

[7]A nondistributive transfer for consideration should permit all the acquired stock or assets to be upstreamed, whereas in a distribution, at least some acquired stock or assets must be retained at the lower level. *See* Push-Ups, *infra*. Query whether part of the acquired assets or stock could be upstreamed in a distribution, with the balance upstreamed in a sale constituting a nondistributive transfer.

subtle to say the least. Nothing in the stock distribution definition excludes a distribution by P of the T stock following a direct B acquisition by P, and subsequent amendments by T.D. 9396, *Doc 2008-10175, 2008 TNT 91-10*, discussed below, specifically address distributions by P to its stockholders and allow them to some extent. Therefore, the apparent limitation of postacquisition stock distributions to B reorganizations seems, if correct, an inexplicable trap for the unwary. It is also unclear how the limitation applies in the case of a reverse triangular merger qualifying as both a section 368(a)(1)(A) and (a)(2)(E) and section 368(a)(1)(B) reorganization.

Two conditions are imposed for a distribution of specified assets or stock to be a covered distribution. First, in the case of a distribution of stock of acquired corporation T, the distribution must not cause T to cease being a member of the qualified group. This limitation appears to be the same as that on transfers of stock in a nondistributive transfer.

Second, in the case of an asset distribution, it must not consist of so much of the assets of the acquired, acquiring, or surviving corporation as would result in a liquidation of that corporation for tax purposes. In the case of a stock distribution, it must not consist of all the acquired corporation stock.[8] For purposes of the asset limitation, assets held by an acquiring corporation or merged corporation in a reverse triangular merger before the reorganization are disregarded. Thus, enough acquired assets or activities must be retained to avoid a tax liquidation.

One concern with a push-up following a section 368(a)(1)(A) and (a)(2)(E) reverse triangular merger reorganization was whether it would violate the requirement in section 368(a)(2)(E)(i) that after the transaction, it holds substantially all of its, and the merged corporation's, properties.[9] Reg. section 1.368-2(k) should resolve this concern. Its blanket protection against reorganization disqualification should clearly preclude any such ''substantially all'' violation by a covered ''distribution.''

Permitted distributions include distributions that involve the assumption of liabilities. In Rev. Rul. 70-107, 1970-1 C.B. 78, a purported triangular C reorganization failed on account of P's assumption of T liabilities along with S. T.D. 9361 cautioned that the new regulations do not change that result, but stated that ''distributions of assets under these final regulations that involve the assumption of liabilities are distinguishable.'' Thus, as long as S first assumes T liabilities, P can then assume those liabilities from S in connection with a distribution of assets from S, without disqualifying the transaction. For this protection to apply, it may be necessary for the assets distributed from S to exceed the liabilities assumed by P, in order for there to be a net distribution.

As originally amended by T.D. 9361, reg. section 1.368-2(k) did not impose further limits on postacquisition distributions beyond those discussed above. Thus, it could be read to cover and protect distributions of T stock or assets by P, including to the former T stockholders. T.D. 9398, *Doc 2008-12858, 2008 TNT 114-10*, amended reg. section 1.368-2(k) to exclude from its protection distributions to the former shareholders of T in consideration for their stock in T.[10] Thus, the effect of those distributions on COSI and any other applicable requirements would need to be considered. However, T.D. 9398 noted that ''the safe harbor of reg. section 1.368-2(k) continues to apply to transfers to the former shareholders that do not constitute consideration for their proprietary interests in the acquired corporation or surviving corporation, as the case may be, such as certain pro rata dividend distributions.''

Some ambiguities exist for certain overlap situations. One situation involves a distribution of stock of a subsidiary of T that is acquired in an asset acquisition of T. Suppose S acquires all of T's assets solely for P voting stock in a triangular C reorganization. Among T's assets are all the shares of X stock, so the transaction also entails S's acquisition of X in a triangular B reorganization. P

---

[8]As originally proposed, REG-130863-04, *Doc 2004-16591, 2004 TNT 159-4*, would have drawn the line for asset distributions at substantially all the acquired assets, and for stock distributions at stock constituting control of the acquired corporation. T.D. 9361 rejected these standards in favor of those adopted on the grounds that the latter were clearer and easier to apply and administer, more consistent with revenue rulings addressing postacquisition liquidations of acquired targets, and more consistent with 368(a)(2)(C)'s allowance of drop-downs of all the acquired assets.

[9]*See* Rev. Rul. 2008-25, 2008-21 IRB 986, *Doc 2008-10249, 2008 TNT 91-13* (complete liquidation of T following reverse triangular merger, which liquidation was not a protected distribution since all T's assets were distributed, disqualified transaction under section 368(a)(1)(A) and (a)(2)(E) because ''after the transaction, T does not hold substantially all of its properties and the properties of the merged corporation''); *compare* Rev. Rul. 2001-25, 2001-1 C.B. 1291, *Doc 2001-12975, 2001 TNT 89-9* (in allowing T to sell assets for cash, which T retained, the Service stated that the section 368(a)(2)(E) ''holds'' requirement imposes no postmerger requirements not applicable under the ''acquires'' requirement in a section 368(a)(1)(A) and (a)(2)(D) transaction).

[10]T.D. 9398 exempts from such exclusion a distribution to a former shareholder of the acquired corporation that is also the acquiring corporation. T.D. 9398 explains that this exemption is intended to cover ''certain 'upstream' reorganizations followed by a transfer of acquired assets. See, for example, Rev. Rul. 69-617, 1969-2 C.B. 57.'' In Rev. Rul. 69-617, P owned between 80 percent and 100 percent of S, and under a plan, S merged upstream into P with the minority S stock converted to P stock, and P then contributed the former S assets to P's new wholly owned subsidiary X. It is difficult to see why the special exemption was considered necessary for that case, or any case for that matter. P's receipt of the S assets in the upstream merger was in the initial merger transaction, not in a postacquisition distribution. The postacquisition restructuring was the simple drop-down to X, which should be covered as a nondistributive transfer.

T.D. 9361 also amended reg. section 1.368-2(k) to exclude from protection ''a transfer by the former shareholders of the acquired corporation (other than a former shareholder that is also the acquiring corporation) or the surviving corporation . . . of consideration initially received in the potential reorganization to the issuing corporation or a person related [thereto].'' The reason behind this exclusion is also difficult to ascertain.

would like to own all the X stock directly. Assuming distribution of the X stock would not constitute a complete liquidation of the acquired T assets, it would be an asset distribution described in reg. section 1.368-2(k)(1)(i)(A)(1). The question is whether it would nonetheless be barred by the not-all-the-acquired-stock limitation in reg. section 1.368-2(k)(1)(i)(B)(2). Perhaps that limitation could be read as corresponding to and limiting only stock distributions under reg. section 1.368-2(k)(1)(i)(A)(2), and that would seem the best reading in terms of the apparent purpose behind the rules, but the regulation is not structured that way. Another possibility would be to argue that section 368(a)(1)(C) trumps 368(a)(1)(B) in such a case, so that X is not an acquired corporation in a B reorganization, but that also is questionable. The overlap may be fairly narrow, but clarification would be helpful in understanding the structure and operation of reg. section 1.368-2(k).

A second overlap situation involves an upstream transfer of all acquired assets or stock, partly as a distribution for stock and partly in exchange for other consideration as a nondistributive transfer. It appears that each transfer would be analyzed separately and would be permitted, as reg. section 1.368-2(k) indicates that combinations of transfers may be covered. In particular, it appears that the not-all-the-acquired-assets-or-stock limitation on distributions would not be violated since some acquired assets on stock would be sold outside the distribution. Clarification of that result would be helpful, however.

VII. Location of T's Tax Attributes

Assuming the postacquisition restructuring does not disqualify tax-free reorganization treatment of the initial acquisition, postacquisition restructuring can raise a number of other tax issues. One is the location of T's tax attributes.

If T has net operating losses or similar items, the location of those attributes within the P group may be important, particularly for state income tax purposes or where the P group does not file consolidated federal income tax returns. Normally, in an asset acquisition, one would want the tax attributes to follow the assets, as that is where the income will likely be generated. If the attributes end up being trapped elsewhere in the P group, they may not be available to offset income generated by those assets.

The location of T's tax attributes is generally governed by reg. section 1.381(a)-1(b)(2). It provides that the T attributes are inherited by the acquiring corporation and that there can be only a single acquiring corporation. The acquiring corporation is identified as follows:

> Generally, in a transaction to which section 381(a)(2) applies, the acquiring corporation is that corporation which, pursuant to the plan of reorganization, ultimately acquires, directly or indirectly, all of the assets transferred by the transferor corporation. If, in a transaction qualifying under section 381(a)(2), no one corporation ultimately acquires all of the assets transferred by the transferor corporation, that corporation which directly acquires the assets so transferred shall be the acquiring corporation for purposes of section 381 and the regulations thereunder, even though such corporation ultimately retains none of the assets so transferred. Whether a corporation has acquired all of the assets transferred by the transferor corporation is a question of fact to be determined on the basis of all the facts and circumstances.[11]

The application of these principles to a transaction involving postacquisition restructuring under reg. section 1.368-2(k) raises an interesting question. Reg. section 1.368-2(k) essentially turns off the step transaction doctrine for postacquisition restructuring, leaving the initial acquisition to stand on its own, at least for reorganization qualification purposes. However, reg. section 1.381(a)-1(b)(2) looks to the corporation that ultimately acquires the assets ''pursuant to the plan of reorganization.'' The question then becomes, in a case in which reg. section 1.368-2(k) applies, whether it also cuts off the postacquisition restructuring from the initial acquisition for purposes of section 381, in effect limiting the plan of reorganization to the initial acquisition steps.

The answer would seem to be no. By its terms, reg. section 1.368-2(k) deals only with the effect of postacquisition restructuring on reorganization qualification, and it does not expressly operate by calling off the step transaction doctrine. Reg. section 1.381(a)-1(b)(2) deals with attribute successorship only after a tax-free reorganization is found. It clearly envisions postacquisition restructuring and clearly indicates that it should be taken into account in attributing attributes. There does not seem to be any great tension here in withholding the step transaction doctrine for the one purpose and applying it for the other. Indeed, in considering whether the step transaction doctrine should apply in a particular case, it is considered good practice to ask whether its application best serves the policies at issue. Here, the policies surrounding reorganization qualification are best served by permitting substantial freedom to then restructure, while the policies associated with attribute attribution are best served by allowing the attributes to follow the assets if they all end up in one entity.

There is a view that section 368(a)(2)(C) does not operate by turning off the step transaction doctrine — that the postacquisition drop-down may be treated as under the plan of reorganization and section 368(a)(2)(C) expressly permits this. Reg. section 1.381(a)-1(b)(2) seems to be based on that approach. However, T.D. 9361 could be viewed as taking a different approach — that the transaction is analyzed by treating the initial acquisition as an independent step. Thus, it would be useful to have confirmation that T.D. 9361 does not affect the analysis or at least the results under section 381.

VIII. Some Practical Applications

Consideration of some basic postacquisition restructuring scenarios helps to grasp the operation of the new rules.

[11]Reg. section 1.381(a)-1(b)(2).

Example 1. Suppose P owns S which in turn owns U, and P wants to acquire T for P stock and combine T with U. T cannot simply be merged into U since the section 368 reorganization patterns do not allow for issuance of grandparent P stock. T could merge into S, with S then contributing all the T assets to U, but that would expose S to T's liabilities, which P may want to avoid. Another option might be for S to acquire the T stock in a triangular B, and then have T merge into U. However, the termination of T's existence on the merger into U would take the transaction outside reg. section 1.368-2(k) (which conditions nondistributive transfer coverage on continuation of T's existence), and assuming the T-U merger is integrated with S's T stock acquisition, the transaction would likely be collapsed into the first option considered above, a taxable forward merger of T into U.

But what would appear to work well is for S to form a new wholly owned, disregarded LLC, have T merge into the LLC, and then merge the LLC into U. The merger of T into the LLC should be treated as a direct merger of T into S under section 368(a)(1)(A) and (a)(2)(D).[12] The merger of the LLC into U should be treated as a contribution by S of all the T assets to U in a nondistributive transfer drop-down. This should not be considered outside the nondistributive transfer protection due to a termination of T's corporate existence, as T's corporate existence for tax purposes terminated on T's merger into LLC in the initial section 368(a)(1)(A) and (a)(2)(D) reorganization, not in connection with the merger of LLC into U. The two mergers should be relatively easy to accomplish (assuming the relevant state laws permit mergers between corporations and LLCs) and would not appear to expose S to T's liabilities. In this case, the T tax attributes should end up in U.[13]

Example 2. Suppose the P group is engaged in two lines of business, A and B. P owns SA, which in turn owns UA, and SB, which in turn owns UB. UA and UB are engaged in businesses A and B, respectively. T is engaged in businesses A and B directly through divisions. P wishes to acquire T and combine its A division with UA, and its B division with UB.

One possibility would be to merge T into SB, and have SB transfer T's division A assets to UA and division B assets to UB. SB's transfer of the division A assets to UA should be a deemed dividend from SB to P, which is covered as a distribution under Treas. reg. section 1.368-2(k), and successive drop-downs of those assets from P to SB, and from SB to UB, which should both be covered nondistributive transfers. SB's drop-down of T's B division assets to UB should be a permitted nondistributive transfer. In this regard, reg. section 1.368-2(k) indicates that it can cover successive, and combinations of, distributions and nondistributive transfers. Thus, the postacquisition restructuring should not disqualify the initial T-SB merger under section 368(a)(1)(A) and (a)(2)(D). However, SB would recognize gain under section 311 on the deemed dividend of T's division A assets to P, to the extent those assets are appreciated. Even if the P group is filing consolidated returns for federal income tax purposes, the gain could be taxable at the state level, and P may wish to avoid creating deferred intercompany gains.

Another approach would be for P to form a new wholly owned disregarded LLC, have T merge into the LLC, have the LLC transfer the A division assets to UA, and then merge the LLC into UB. That should be characterized as a straight A merger of T into P, followed by drop-downs of the division A and B assets to UA and UB, respectively, in covered nondistributive transfers. Aside (possibly) from section 357(c), no gain or loss should arise in connection with the drop-downs. However, one potential problem is that T's tax attributes would end up in P, separate from T's assets.

In fact, aligning T's attributes with the second-tier assets would be difficult. This might be accomplished by converting SA, SB, UA, and UB into disregarded LLCs in tax-free section 332 liquidations. If that were done as part of the transaction before the drop-downs, the drop-downs would be converted into nonevents for federal tax purposes. An intermediate approach that might achieve sufficient matching of assets and attributes (as where the division B assets were likely to produce the most income and use the attributes) would be to adopt the first approach above, whereby T merges into SB, and to convert only UB into a disregarded LLC.

Example 3. Suppose that under a plan, P wishes to acquire T and then transfer all the T assets to a 70/30 joint venture with unrelated Z, P having the 70 percent interest. If M, the joint venture entity, is a corporation, the transfer would be problematic. M would not be a member of P's qualified group, so the COBE requirement of reg. section 1.368-1(d) would not appear to be satisfied.[14] In that case, reg. section 1.368-2(k) would not apply, and the transfer to M would be taken into account.

Perhaps it could be argued that despite reg. section 1.368-1(d), P's 70 percent ownership of M ought to be sufficient for COBE purposes. Support for this could be asserted in the reg. section 1.368-1(d)(1) reference to overall policy and the particular facts and circumstances to resolve particular cases, and to the phraseology of the more specific rules in reg. section 1.368-1(d)(2) and (3), which say only that COBE is satisfied ''if'' certain conditions are met, without saying ''only if'' or specifying what happens if they are not. On the other hand, the examples in reg. section 1.368-1(d)(5) on the whole suggest that if those conditions are not met, solely with reference to the qualified group and partnership rules in reg. section 1.368-1(d)(4), then the COBE requirement of reg. section 1.368-1(d) is not met. To complete the analysis, reg. section 1.368-1(d)(1) seems to say that reorganization treatment applies only if the COBE requirements as stated therein are satisfied, leaving no room for appeals to some other notions of COBE.

But even if one could go outside reg. section 1.368-1(d) to satisfy the COBE requirement, the ghost of *Groman-Bashford* spooks this transaction. If reg. section 1.368-1(d)

---

[12]*See* reg. section 1.368-2(b).

[13]*See* reg. section 1.381(a)-1(b)(2).

[14]*Compare* reg. section 1.368-1(d), Example 15 (COBE requirement of reg. section 1.368-1(d)(1) not satisfied if T stock acquired and contributed to 50-50 partnership).

is not satisfied, nothing prevents the remote continuity doctrine from disqualifying this transaction.

Thus, for the M joint venture to avoid disqualifying the T-P merger from tax-free reorganization treatment, M would have to be classified as a partnership for federal income tax purposes. In that case, P, as 70 percent partner, would be treated as owning 70 percent of the assets formerly owned by T and as conducting the M business formerly conducted by T, thus satisfying COBE. The transfer to M partnership should also be protected as a nondistributive transfer under reg. section 1.368-2(k). Thus, the transfer to M would not affect the T-P merger. This example illustrates that in cases when the acquired assets are, as part of an integrated plan, to be placed in a joint venture less than 80 percent of which is to be owned by P qualified group members, the joint venture must be formed as a tax partnership to preserve the tax-free reorganization treatment of the initial acquisition.

IX. The Next Steps

A. Rethinking the Lines

Postacquisition restructuring can raise two basic issues. The most important is whether it disqualifies the initial acquisition from tax-free section 368 reorganization treatment (disqualification issue). If so, the result can be current taxation of the T stockholders, and if T's assets are transferred, a corporate tax on any gain thereon as well as loss of T's tax attributes. The second issue arises when the initial acquisition on its own qualifies as one type of tax-free reorganization under section 368, but the postacquisition restructuring, if integrated, would transform the overall transaction into another type of tax-free section 368 reorganization (overlap issue). While the results of being treated as a different type of section 368 reorganization are usually not as severe as falling out of section 368 reorganization altogether, the different section 368 reorganization types could present different basis, attribute carryover, tax year, boot treatment, or other differences.

Two provisions of reg. section 1.368-2(k) directed at these issues merit further consideration. Because these provisions and the disqualification and overlap issues interrelate in some respects, it seems expedient to consider them together. The first provision is a set of limits on the extent of restructuring allowed within the nonintegration safe harbor. Reg. section 1.368-2(k)(1)(i)(B) limits protected distributions to less than all the acquired assets or stock, and reg. section 1.368-2(k)(1)(ii)(C) limits protected nondistributive transfers to transactions in which the acquired, acquiring, or surviving corporation remains in existence for tax purposes. In each case, the Service drew a line just short of allowing complete, 100-percent restructuring. Essentially, these limitations require that at least some vestige of the initial acquisition transaction structure remain after completion of the postacquisition restructuring for the initial acquisition to be respected as a separate, stand-alone transaction (hence the limitations shall be referred to as the vestige requirement).

The second provision of reg. section 1.368-2(k) is its prescription that a 368 reorganization transaction shall not be disqualified or recharacterized as a result of subsequent restructuring within its safe harbor. T.D. 9361 added the "or recharacterized" language without explaining it. However, one commentator has provided the following insight:

> We understand that the addition of these two words may be intended to employ a "first to the finish line" approach to the step transaction doctrine under Section 368. Namely, if the first step of a transaction would qualify as a tax-free reorganization, that characterization will control (provided, of course, that the subsequent step is described in the -2(k) rules), even if the integrated transaction would also qualify as a good reorganization.[15]

Under this interpretation, the shall-not-be-disqualified-or-recharacterized prescription turns off the step transaction doctrine not only for purposes of the disqualification issue, but also for purposes of the overlap issue in an overlap situation.

Having set out the basic disqualification and overlap issues and the relevant reg. section 1.368-2(k) provisions, we can examine those provisions further.

Under the vestige requirement, near total restructuring is allowed (with retention of at least some assets, stock, or tax existence, and assuming the other requirements of reg. section 1.368-2(k) are met), but dispose of that last little vestige and the reg. section 1.368-2(k) protection disappears altogether. This vestige requirement poses numerous problems. It creates a "cliff" effect at the edge of the safe harbor, and a trap for the unwary. It also has a "tail wagging dog" aura, in which slight economic differences in postacquisition restructuring can lead to completely different tax treatments. Maintenance of a vestige of the initial acquisition merely to comply with the vestige requirement can be costly or burdensome. Moreover, the parameters of the vestige requirement can be fuzzy, such as whether a de facto dissolution has occurred, or whether retention of a de minimis portion of acquired assets or shares is sufficient. Thus, it seems fair to question the need for the vestige requirement.

The rationale for the vestige requirement was apparently a desire to preserve some existing law on the application of the step transaction doctrine in corporate acquisitions. The general rule has been that the step transaction doctrine applies to determine whether a transaction qualifies as a reorganization.[16] A common application has been that an integrated acquisition by P of the stock of T followed by a complete liquidation of T into P is treated as a direct acquisition by P of the T assets.[17] T.D. 9361 indicates that reg. section 1.368-2(k)(1)(i)(B)(1)'s exclusion of postacquisition distributions of all the acquired assets from reg. section 1.368-2(k)

---

[15]New York State Bar Association Tax Section Report No. 1152 (Apr. 4, 2008), *Doc 2008-7598, 2008 TNT 68-23*.

[16]Reg. section 1.368-1(a).

[17]*See* Rev. Rul. 67-274, 1967-2 C.B. 141 (P's purported acquisition of T stock in a B transaction followed by prearranged liquidation of T into P treated as acquisition by P of T assets in a C reorganization); Rev. Rul. 2004-83, 2004-2 C.B. 157, *Doc 2004-14660, 2004 TNT 138-9* (P's purchase of T stock from

(Footnote continued on next page.)

was to maintain the treatment of those transactions as direct acquisitions by the distributee, in accordance with these rulings.[18] The rationales for reg. section 1.368-2(k)(1)(i)(B)(2)'s exclusion of distributions of all acquired stock, and reg. section 1.368-2(k)(1)(ii)(C)'s exclusion of existence-terminating nondistributive transfers, are less clearly stated, but presumably are similar to, or an extension of, the rationale behind reg. section 1.368-2(k)(1)(i)(B)(1). The common theme of the limitations is that postacquisition restructuring that is so comprehensive as to leave no vestige of the initial acquisition transaction should not be ignored and necessitates characterization of the transaction as a whole.

But the rationale of preserving those prior rulings and treatments does not seem compelling relative to the problems the vestige requirement creates. Moreover, in other contexts, the Service has called off the step transaction doctrine despite a lack of vestige from the initial acquisition. If an initial acquisition of T stock is a qualified stock purchase (QSP) under section 338 when looked at separately, and integration of the initial T stock acquisition with postacquisition restructuring does not produce a tax-free section 368 reorganization, then the step transaction doctrine is called off. The QSP is accorded independent significance from the subsequent restructuring and respected, while P's T stock ownership is treated as old and cold for purposes of determining the tax treatment of the subsequent restructuring. This is so even if T is liquidated or merged upstream into P following P's acquisition of the T stock, leaving no vestige thereof.[19] The step transaction doctrine is withheld in those cases because its application would be inconsistent with the policy of section 338. Integration would result in the acquisition of the T stock being treated as a taxable purchase of T's assets, but in enacting section 338, Congress intended that a cost basis in assets be obtained through a stock purchase only if a section 338 election is made.

Here, the policy behind reg. section 1.368-2(k) is to accommodate postacquisition restructuring. The vestige requirement limits or constrains this policy, for reasons that do not seem compelling. As with the independence accorded a QSP under section 338 regardless of whether a vestige of the QSP survives, an initial tax-free acquisition ought to be respected as a stand-alone reorganization transaction, where it meets all the statutory and nonstatutory requirements for a tax-free reorganization under section 368, and all other requirements of reg. section 1.368-2(k) besides the vestige requirement are met (referred to herein as the cutoff approach).

Regarding the disqualification issue, the cutoff approach would expand reorganization qualification. For example, in Rev. Rul. 2008-25, P acquired the T stock in exchange for cash and P stock in a reverse triangular merger that on its own would qualify as a section 368(a)(1)(A) and (a)(2)(E) reorganization. T then liquidated completely into P (but not by merger into P). In analyzing the transaction, the Service found that the complete liquidation of T was outside the reg. section 1.368-2(k) safe harbor because of violation of the no-distribution-of-all-assets vestige requirement. Thus, for purposes of determining section 368 reorganization qualification, general step transaction doctrine principles applied and caused the transaction to be viewed as a direct acquisition of T's assets by P. As such, it did not qualify (in particular, the cash boot caused it to fail the section 368(a)(1)(C) solely-for-voting-stock requirement). . In sharp contrast, the Service went on to reason that the initial reverse triangular merger would be respected as a separate QSP of T under section 338 and that the liquidation of T would not be integrated therewith to cause it to be disregarded.

Under the cutoff approach (defined to have no vestige requirement), the initial reverse triangular merger acquisition of T would be respected as a separate section 368(a)(1)(A) and (a)(2)(E) reorganization, with the liquidation of T into P qualifying as a separate section 332 liquidation.[20] This seems like a better approach and result. The cutoff approach is far less formalistic in that reorganization qualification does not turn on such formalities as whether T liquidates into P by merger (in which case the transaction would have qualified under current law as a direct 368(a)(1)(A) merger of T into P) or by other means. Indeed, one can envision numerous scenarios in which a given result can be achieved via alternative combinations of an initial acquisition qualifying by itself under 368 and subsequent restructuring, where the subsequent restructuring in one combination is within the reg. section 1.368-2(k) safe harbor and another would be but for the vestige requirement. For example, suppose P wants to acquire T solely for P voting stock and combine it with U, a second-tier subsidiary owned by S. If the transaction were structured as an initial purported triangular B reorganization with S acquiring the T stock, and then a merger of T into U, it could be recast as a taxable direct merger of T into U for P stock (it would violate the no-existence-termination vestige requirement). It is hard to see why this should be so, since the same or nearly the same result could be accomplished within the current reg. section 1.368-2(k) safe harbor, such as by having T first merge into P or S, followed by a

common shareholder followed by prearranged liquidation of T into P treated as acquisition by P of T assets in a D reorganization); *see also* Rev. Rul. 72-405, 1972-2 C.B. 217 (forward triangular merger of T into S followed by prearranged liquidation of S into P treated as acquisition by P of T assets in a C reorganization).

[18]*See also* Rev. Rul. 2001-46, 2001-2 C.B. 321, *Doc 2001-24676, 2001 TNT 186-7* (initial acquisition of T stock via reserve triangular merger of S into T, which on its own would have qualified as a section 368(a)(1)(A) and (a)(2)(E) reorganization, followed by merger of T into P; recast as straight merger of T into P).

[19]*See* Rev. Rul. 2008-25; Rev. Rul. 90-95, 1990-2 C.B. 67; reg. section 1.338-3(c) and (d); *cf.* reg. section 1.338(h)(10)-1(c)(2).

[20]A corollary to disregarding the effect of subsequent transactions on the initial acquisition under the cutoff approach would be that the tax treatment of the subsequent transactions is determined independent of the initial acquisition, as though it were old and cold. It is assumed that the plan of liquidation of T is adopted after P's acquisition.

drop-down of the T assets to U, or by having S acquire the T stock, followed by T's transfer of all its assets to U for U stock and distribution of all but one or a few shares of U stock to S. The minor differences in these transactions should not produce such different tax results.

Moreover, the cutoff approach dovetails nicely with the independence accorded QSPs under section 338. By contrast, current law seems rather haphazard in its application of the step transaction doctrine — applying it for section 368 purposes if the vestige requirement is violated but otherwise not, and not applying it in the QSP context. The result is that in the same transaction, postacquisition restructuring may be integrated for some purposes and treated as separate for others, as illustrated in Rev. Rul. 2008-25. Moreover, the relevant policies and purposes are not unrelated or focused on different or subsidiary aspects of the transaction. While there may be circumstances in which differing integration results are unavoidable, it would seem that they should be minimized, which elimination of the vestige requirement in reg. section 1.368-2(k) would help do.

From a results standpoint, the tax-free section 368(a)(1)(A) and (a)(2)(E) reorganization treatment of the transaction in Rev. Rul. 2008-25 also seems better than taxable QSP treatment. The constituency most affected by the two treatments may be the former T stockholders. But the former T stockholders were not involved in the postacquisition liquidation of T. They participated only in P's initial acquisition of T via reverse triangular merger, and may have believed and intended that it would qualify as a tax-free section 368(a)(1)(A) and (a)(2)(E) reorganization. Perhaps they could argue that under general step transaction doctrine principles, their lack of intent for, and participation in, the postacquisition liquidation of T precludes application of the step transaction doctrine as a factual matter. P's ability to unilaterally change the tax treatment of the initial acquisition (assuming the T stockholders did not contractually prohibit P from doing so), as well as the instances in which the Service could be whipsawed by P, and the former T stockholders take conflicting positions, should be minimized. The vestige requirement tends to exacerbate these problems and should be eliminated.

On the overlap issue, the analysis of the vestige requirement is somewhat different. Two of the revenue rulings cited by T.D. 9361 in support of the vestige requirement, Rev. Rul. 76-274, 1976-2 C.B. 278 and Rev. Rul. 72-405, involved overlap scenarios, in which the step transaction doctrine was applied to integrate the postacquisition restructuring in determining the type of 368 reorganization for which the transaction qualified. Under a first-to-the-finish-line cutoff approach for purposes of the overlap issue based on the "or recharacterized" language in reg. section 1.368-2(k), elimination of the vestige requirement would change the results in those rulings. With no vestige requirement, the postacquisition liquidations in those cases would be disregarded under the reg. section 1.368-2(k) safe harbor in determining the treatment of the initial acquisitions. Thus, in Rev. Rul. 67-274, the initial acquisition of T stock would be treated as a B reorganization, followed by a 332 liquidation of T. The transaction in Rev. Rul. 72-405 would be treated as an initial section 368(a)(1)(A) and (a)(2)(D) acquisition of T by S, followed by a section 332 liquidation of S into P. However, there does not seem to be anything wrong with these treatments.[21] Any differences in tax consequences from section 368(a)(1)(C) treatment under the rulings would seem slight, such as in perhaps using up an additional carryover year in some circumstances.[22]

There may, however, be overlap situations in which material differences in tax consequences may result from application of different section 368 reorganization classifications, and the taxpayers may seek application of the classification based on application of the step transaction doctrine. It would seem appropriate to allow taxpayers in all overlap cases to designate the steps comprising the initial reorganization (taxpayer designation approach). The taxpayer's designation would be respected as long as the designated transaction qualifies as a tax-free reorganization on a stand-alone basis, and any subsequent steps not included in the designated transaction comply with the provisions of reg. section 1.368-2(k) (aside from the vestige requirement, which is assumed deleted). Essentially, the taxpayer designation approach would be a modification of the cutoff approach as applied in overlap situations, where the cutoff approach is applied not on a first-to-the-finish-line basis, but by allowing the taxpayer to choose the point at which the initial reorganization is considered completed and the cutoff is made.

One possible problem with the taxpayer designation approach is that there may be different taxpayers involved in the transaction that may separately report the transaction: P, the former T stockholders, and T. Questions include which taxpayer or taxpayers would make the designation, and whether there would need to be a consistent designation and reporting requirement among different taxpayers. It would not seem unreasonable to establish a requirement of consistent designation and reporting. Default treatment could be imposed when the requirement is not met. However, it might be appropriate to limit the consistency requirement to P, T, and all taxpayers related thereto under a specified relatedness standard, and to exempt from the consistency requirement taxpayers whose tax consequences are the same under the different reorganization types. Another approach might be to allow P to designate the reorganization type and notify T and the former T stockholders thereof, who would generally be required to follow that

[21]*Cf.* Rev. Rul. 2003-51, 2003-1 C.B. 938, *Doc 2003-11263, 2003 TNT 87-16* (step transaction doctrine not applied to series of purported section 351 exchanges, in which the same results could have been achieved under section 351 by reordering steps, thus negating any reason to apply the doctrine).

[22]Elimination of the vestige requirement would not even affect the results in the third ruling cited by T.D. 9361 for the vestige requirement, Rev. Rul. 2004-83. There, P purchased all the T stock from a common shareholder and liquidated T. P's purchase of T stock would not qualify as a section 368 reorganization on a stand-alone basis. Only the entire transaction would qualify, under section 368(a)(1)(D). Since the cutoff approach makes the cutoff only at the point where there is a section 368 reorganization, that approach would yield the same section 368(a)(1)(D) characterization.

designation. In any case, implementation of a taxpayer designation approach would require consideration of these issues.

As for deciding on a default treatment in the absence of a proper taxpayer designation, the first-to-the-finish-line approach would seem most consistent with elimination of the vestige requirement and the discussion above. However, if preservation of Rev. Rul. 67-274 and Rev. Rul. 72-405 were deemed very important, the default treatment could assume application of the step transaction doctrine.

B. Reaching Maturity

Under the current framework, the section 368 patterns prescribing the initial acquisition format are rather narrow, permitting only acquisitions by P or a first-tier subsidiary S. On the other hand, once the initial acquisition takes place, P has substantial freedom to reposition the acquired assets or stock within its qualified group, as long as the limits of reg. section 1.368-2(k) are respected. As argued above, these limits should be further relaxed.

Beyond that, the limitation on initial acquisition structures to the use of parent P stock no longer seems to serve any useful purpose. Given that following a merger of T into P or S, the acquired assets can be dropped down to an nth-tier subsidiary, why not permit T to merge directly into the nth-tier subsidiary in the first place? Or since the T stock can be acquired by P or S and dropped down to an nth-tier subsidiary, why not permit the nth-tier subsidiary to acquire the T stock in the first place? Allowing the use of grandparent or higher-tier parent stock would seem a small step forward, although it would presumably require amendment of section 368.[23]

A much greater advance would be to extend the qualified group rules of reg. section 1.368-1(d) and -2(d) to treat the P qualified group as a single acquiring corporation for generally all reorganization purposes. There would be a tax-free A reorganization where T merges into or with a member of the P qualified group; a B reorganization in which P qualified group members in the aggregate have control of T; a C reorganization in which P qualified group members in the aggregate acquire substantially all the assets of T; or a D reorganization in which P qualified group members in the aggregate acquire substantially all the assets of T. In each case, the other reorganization requirements applicable to that type of reorganization would have to be met (for example, COSI, COBE, and business purpose requirements in all cases; issuance of solely P voting stock in a B transaction; compliance with solely-P-voting-stock and T liquidation requirements in a C transaction; and presence of common control of T and P and compliance with T liquidation requirement in a D transaction).[24] Since the resulting structure could always be accomplished under current law through a direct P level acquisition, followed by tax-free drop-downs, this approach would not really change the scope of the tax-free reorganization provisions.[25] It would, however, allow corporations to accomplish their objectives directly, and that seems useful.

X. Conclusion

The law has come a long way since *Groman* and *Bashford* were decided. Under reg. section 1.368-2(k) as recently amended by T.D. 9361, postacquisition restructuring is generally disregarded in evaluating the reorganization treatment of the initial acquisition if the COBE requirement is satisfied under expanded qualified group principles, and at least some vestige of the initial acquisition structure survives the restructuring. The Service should consider eliminating this vestige requirement, and in overlap situations, allowing taxpayers to designate the steps constituting the initial acquisition and thus the category of section 368 reorganization applicable. Beyond that, consideration should be given to allowing grandparent and higher-tier stock to be issued in the initial acquisitive reorganization itself, and ultimately to treating qualified groups as single acquiring corporations for purposes of the reorganization provisions.

[23]In fact, it may be argued that the Service could write regulations under section 368(a)(1)(A) permitting mergers into lower-tier subsidiaries and designating the top parent P as a party to the reorganization. Section 368(a)(1)(A) itself specifies only that there be a statutory merger, while section 368(b) only enumerates entities included in the term ''a party to a reorganization.'' Inclusion of grandparent or higher-tier parent as a party to a reorganization would be somewhat at odds with *Groman*, but there the Court did not have the benefit of regulations prescribing that treatment. As for section 368(a)(2)(D) and (E), the Service could view those provisions the same as it has section 368(a)(2)(C), as being merely permissive rather than exclusive or limiting. *Compare* S. Rep. No. 1533, 91st Cong. 2d Sess. (1970) (in enacting section 368(a)(2)(D) and (E). Congress believed current law did not permit triangular mergers; Congress did note that ''the Treasury Department has expressed concern that the reorganization provisions need review and modification'').

[24]For mergers of T with a subsidiary of P intended to qualify as an A reorganization, there would be a question whether those mergers should have to satisfy the ''substantially all'' requirements applicable to triangular mergers under section 368(a)(2)(D) and (E). Viewing the qualified group as an acquiring corporation makes the transaction look like a straight horizontal merger, which has no ''substantially all'' requirement.

For all reorganization types, the stock of a P subsidiary (issued together with P stock) would presumably not qualify as tax-free consideration as under current law, although there may be instances when tax-free treatment would not be inappropriate.

[25]This approach may, however, require additional guidance as to the location within the P qualified group of T's tax attributes. For example, reg. section 1.381(a)-1(b)(2) would not address an acquisition by each of two P subsidiaries of half the T assets in a C reorganization.