SUPPLEMENTAL MATERIALS

FOR

CORPORATE TAXATION THROUGH THE LENS OF MERGERS & ACQUISITIONS INCLUDING CROSS-BORDER TRANSACTIONS

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I. CHAPTER 1, INTRODUCTION AND REVIEW OF BASIC CONCEPTS

A. Page 8, New Sec. 1.3.B.1. Check-the-Box Regs Upheld—Littriello

Page 8, New Sec. 1.3.B.1. Add before C the following.:
New Sec. 1.3.B.1. **Check-the-Box Regs Upheld--*Littriello***

Littriello v. United States
United States District Court, Kentucky
2005 U.S. Dist. LEXIS 9813, 2005

JOHN G. HEYBURN II
Kentuckiana Healthcare, LLC (the "Company"), a limited liability company formed under the laws of Kentucky, operated a nursing home in Scottsburg, Indiana, under the trade name Scott County Healthcare Center. It failed to pay withholding and FICA taxes for some of the tax periods ending between 12/2000 and 3/2002. Frank Littriello ("Littriello"), the plaintiff in this case, was the sole member of the Company during the tax periods in question. The IRS notified Littriello of its intent to levy his property to enforce previously filed notices of federal tax liens for the Company's unpaid withholding and FICA taxes. Littriello requested a due process hearing with the IRS Appeals office in Louisville, Kentucky.

The Appeals Office determined that Littriello was individually liable for the Company's unpaid withholding and FICA taxes. It held that under Treas. Reg. § 301.7701-3(b)(1)(iii), a single member limited liability company that did not elect to be treated as a corporation is considered as a disregarded entity for federal tax purposes. As such, its activities are treated in the same manner as a sole proprietorship, division or branch of the owner under Treas. Reg. § 301.7701-3(a). Through this federal action Littriello seeks judicial review and redetermination of that decision.

The real dispute here concerns the validity of the so-called "check-the-box" regulations for corporations and partnerships. Treas. Reg. § 301.7701-1 through 3. Littriello contends that the check-the-box regulations constitute an invalid exercise of the Treasury's authority to issue interpretive regulations under Internal Revenue Code ("IRC") § 7805(a) and are, thus, unenforceable. If the regulations are invalid, then the Company alone is liable for the taxes at issue. The Commissioner argues that the regulations are valid and that as applied here Littriello is individually liable for the Company's tax obligation. Both sides have moved for summary judgment.

The IRS and the Treasury Department proposed the check-the-box regulations in 1996 to simplify entity classification for tax purposes, believing that the prior regulations had become unnecessarily cumbersome, complex and risky for affected entities. The current

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regulations function in a relatively straightforward fashion. The Internal Revenue Code treats business entities differently depending upon whether the business entity is classified as a corporation or a partnership. IRC § 7701(a)(3) defines the term "corporation" to include associations, joint-stock companies, and insurance companies. IRC § 7701(a)(2) defines the term "partnership" to include any syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation. The regulations provide that for the purposes of IRC § 7701(a)(3) any unincorporated business entity that is not a publically traded partnership covered by IRC § 7704 may elect whether or not to be classified as an association. Thus, an unincorporated business entity like the Company can generally elect whether or not to be subject to the corporate tax. A default treatment applies under a variety of. circumstances where a business entity chooses not to be considered a corporation. If an unincorporated business entity with more than one member elects not to be treated as an association, it will be treated for federal tax purposes as a partnership. If an unincorporated business entity with only one member elects not to be treated as an association, it will be treated for federal tax purposes as a disregarded entity and taxed as a sole proprietorship. Treas. Reg. § 301.7701-3(a).

The Court now considers the validity of the check-the-box regulations. *Chevron U.S.A., Inc. v. NRDC* 467 U.S. 837, 81 L. Ed. 2d 694, 104 S. Ct. 2778 (1989), governs the analysis for reviewing agency regulations. The Supreme Court established a two-part analysis:

> When a court reviews an agency's construction of the statute which it administers, it is confronted with two questions. First, always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress. If, however, the court determines Congress has not directly addressed the precise question at issue, the court does not simply impose its own construction on the statute, as would be necessary in the absence of an administrative interpretation. Rather, if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute.

The Court can find no appellate or district court opinions considering the validity of the check-the-box regulations. One Tax Court opinion, *Dover Corp. v. Comm'r,* 122 T.C. 324 (2004), discusses the regulations and notes that "some commentators" had questioned whether they constitute a valid exercise of regulatory authority. Neither party challenged the validity of the regulations in that case.

Under step one of the *Chevron* analysis the Court looks to whether the intent of Congress is clear on the precise issue of business classification for federal tax purposes. * * * [T]he Court concludes that the Commissioner's argument that the statute is ambiguous on this point is more persuasive than Littriello who seeks to impose clarity where the Court

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finds none.

Step two of the *Chevron* analysis requires the Court to decide "whether the agency's answer is based on a permissible construction of the statute." The Treasury promulgated the check-the-box regulations pursuant to its general authority to issue "needful rules and regulations for the enforcement of [the IRC]." IRC § 7701(a). The regulations at issue interpret the definitions sections of the IRC. The classification of a business entity affects how the IRS assesses tax liability.

Littriello argues that the plain meaning of the Internal Revenue Code forecloses the possibility of an elective regime because "taxation as intended by Congress is based on the realistic nature of the business entity." *Pls.' Mot. for Summ. J.* p 8. Littriello's primary evidence in support of this contention appears to be the previous Treasury regulations, effective prior to January 1, 1997. Former Treas. Reg. § 301.7701-2(1960). These regulations, commonly referred to as the Kintner regulations, looked to six corporate characteristics to determine the tax status of a business entity. The Kintner regulations enumerated the factors used by the Supreme Court in *Morrissey v. Commissioner*, 296 U.S. 344, 80 L. Ed. 263, 56 S. Ct. 289, 1936-1 C.B. 264 (1935) to define the characteristics of a pure corporation: (1) associates; (2) an objective to carry on a business and divide the gains there from; (3) continuity of life; (4) centralization of management; (5) liability for corporate debts limited to property; and (6) free transferability of interests. Most every business entity has associates and an objective to carry out a business and profit. Before the check-the-box regulations, any business entity the IRS found to meet three of the remaining four corporate characteristics was classified as a association and taxed as a corporation. Business entities that contained only two of the remaining four where classified and taxed as a partnership. Former Treas. Reg. §301.7701-2(a)(1).

Littriello is correct that under the former regulations the Company might have been classified differently. Of course, under the current regulations, the Company could have elected to be classified differently. Moreover, Congressional intent does not attach to the previous regulations. Indeed, Congress appears only to have spoken on this issue through the existing statutes. The check-the-box regulations are only a more formal version of the informally elective regime under the Kintner regulations. A business entity could pick at will which two corporate characteristics to avoid in order to qualify as a partnership under the Kintner regulations. The importance of the change is that under the current regulations a business entity may elect to be taxed as a corporation without specific reference to its corporate characteristics.

While some reasonable arguments support Littriello's position, the Court ultimately finds them unpersuasive. Under the circumstances, the check-the-box regulations seem to be a reasonable response to the changes in the state law industry of business formation. The rise of the limited liability corporation presents a malleable corporate form incompatible with the definitions of the IRC. The newer regulations allow similar flexibility to the Kintner regulations, with more certainty of results and consequences. Considering the difficulty in defining for federal tax purposes the precise character of

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various state sanctioned business entities, the regulations also seem to provide a flexible permissible construction of the statute.

Littriello advances a number of arguments that the Court finds not sufficiently persuasive to change its basic analysis. * * *

The Court will grant Defendant's motion for summary judgment on the issue of the validity of the check-the-box regulations. * * *

NOTE

In response to a motion to reconsider the court held (2005 U.S. Dist. LEXIS 15950, 2005):

> Plaintiff has moved to reconsider the Court's Memorandum Opinion and its Order dated May 18, 2005, on the grounds that the check-the-box regulations are invalid under *Morrissey v. Commissioner*, 296 U.S. 344, 80 L. Ed. 263, 56 S. Ct. 289, 1936-1 C.B. 264 (1935) as argued in a Law Review article by Professor Gregg D. Polsky of the University of Minnesota Law School. Polsky, "Can Treasury Overrule the Supreme Court?", 84 BU.L.Rev. 185 (2004). Thus, this motion states new grounds for Plaintiff's relief. The Court will consider the argument even though it amounts to a renewed motion rather than a true reconsideration.
>
> When confronted with the question posed by Professor Polsky's title, one would naturally answer, "No." However, that is not precisely the question before this Court nor can it be fairly said that Treasury's check-the-box regulations have such an effect. The Court has reviewed *Morrissey* in its proper context and does not find that it requires invalidating the check-the-box regulations.
>
> Certainly, the check-the-box regulations are the subject of academic and theoretical questioning. Professor Polsky has proposed that the Treasury has gone too far in adopting regulations concerning corporations and other associations. However, it is a theory only that the check-the-box regulations violate the Internal Revenue Code definitions because those definitions were made in effect permanent by *Morrissey*. The Court does not believe that *Morrissey* forever incorporated in all future Treasury regulations a particular definition of an "association." In support of this conclusion, the Court would adopt the discussion contained in the response of the United States.

B. Page 29, New Sec. 1.13. Professional Requirements in Rendering Tax Advice—Circular 230

Page 29, New Sec. 1.13. Add at the end of Sec. 1.12 the following new Section heading:

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New Sec. 1.13. **Professional Requirements in Rendering Tax Advice—Circular 230, The IRS Rules of Practice**

C. Page 29, New Sec. 1.13.A. Sections 10.33 and 10.35 of Circular 230

Page 29, New Sec. 1.13.A Add after the New Sec. 1.13 the following:
New Sec. 1.13.A. **Sections 10.33 and 10.35 of Circular 230**

§10.33 Best practices for tax advisors.
(a) Best practices.--Tax advisors should provide clients with the highest quality representation concerning Federal tax issues by adhering to best practices in providing advice and in preparing or assisting in the preparation of a submission to the Internal Revenue Service. In addition to compliance with the standards of practice provided elsewhere in this part, best practices include the following:
(1) Communicating clearly with the client regarding the terms of the engagement. For example, the advisor should determine the client's expected purpose for and use of the advice and should have a clear understanding with the client regarding the form and scope of the advice or assistance to be rendered.
(2) Establishing the facts, determining which facts are relevant, evaluating the reasonableness of any assumptions or representations, relating the applicable law (including potentially applicable judicial doctrines) to the relevant facts, and arriving at a conclusion supported by the law and the facts.
(3) Advising the client regarding the import of the conclusions reached, including, for example, whether a taxpayer may avoid accuracy-related penalties under the Internal Revenue Code if a taxpayer acts in reliance on the advice.
(4) Acting fairly and with integrity in practice before the Internal Revenue Service.
(b) Procedures to ensure best practices for tax advisors. —Tax advisors with responsibility for overseeing a firm's practice of providing advice concerning Federal tax issues or of preparing or assisting in the preparation of submissions to the Internal Revenue Service should take reasonable steps to ensure that the firm's procedures for all members, associates, and employees are consistent with the best practices set forth in paragraph (a) of this section.
(c) Applicability date. —This section is effective after June 20, 2005.

§10.35. Requirements for covered opinions
(a) A practitioner who provides a covered opinion shall comply with the standards of practice in this section.

(b) Definitions. --For purposes of this subpart --

(1) A practitioner includes any individual described in §10.2(a)(5).

(2) Covered opinion

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(i) In general. --A covered opinion is written advice (including electronic communications) by a practitioner concerning one or more Federal tax issues arising from --

(A) A transaction that is the same as or substantially similar to a transaction that, at the time the advice is rendered, the Internal Revenue Service has determined to be a tax avoidance transaction and identified by published guidance as a listed transaction under 26 C.F.R. §1.6011-4(b)(2);

(B) Any partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, the principal purpose of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code; or

(C) Any partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, a significant purpose of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code if the written advice --

(1) Is a reliance opinion;

(2) Is a marketed opinion;

(3) Is subject to conditions of confidentiality; or

(4) Is subject to contractual protection.

(ii) Excluded advice. --A covered opinion does not include --

(A) Written advice provided to a client during the course of an engagement if a practitioner is reasonably expected to provide subsequent written advice to the client that satisfies the requirements of this section;

(B) Written advice, other than advice described in paragraph (b)(2)(i)(A) of this section (concerning listed transactions) or paragraph (b)(2)(ii)(B) of this section (concerning the principal purpose of avoidance or evasion) that --

(1) Concerns the qualification of a qualified plan;

(2) Is a State or local bond opinion; or

(3) Is included in documents required to be filed with the Securities and Exchange Commission;

(C) Written advice prepared for and provided to a taxpayer, solely for use by that taxpayer, after the taxpayer has filed a tax return with the Internal Revenue Service reflecting the tax benefits of the transaction. The preceding sentence does not apply if the practitioner knows or has reason to know that the written advice will be relied upon by

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the taxpayer to take a position on a tax return (including for these purposes an amended return that claims tax benefits not reported on a previously filed return) filed after the date on which the advice is provided to the taxpayer;

(D) Written advice provided to an employer by a practitioner in that practitioner's capacity as an employee of that employer solely for purposes of determining the tax liability of the employer; or

(E) Written advice that does not resolve a Federal tax issue in the taxpayer's favor, unless the advice reaches a conclusion favorable to the taxpayer at any confidence level (e.g., not frivolous, realistic possibility of success, reasonable basis or substantial authority) with respect to that issue. If written advice concerns more than one Federal tax issue, the advice must comply with the requirements of paragraph (c) of this section with respect to any Federal tax issue not described in the preceding sentence.

(3) A Federal tax issue is a question concerning the Federal tax treatment of an item of income, gain, loss, deduction, or credit, the existence or absence of a taxable transfer of property, or the value of property for Federal tax purposes. For purposes of this subpart, a Federal tax issue is significant if the Internal Revenue Service has a reasonable basis for a successful challenge and its resolution could have a significant impact, whether beneficial or adverse and under any reasonably foreseeable circumstance, on the overall Federal tax treatment of the transaction(s) or matter(s) addressed in the opinion.

(4) Reliance opinion

(i) Written advice is a reliance opinion if the advice concludes at a confidence level of at least more likely than not (a greater than 50 percent likelihood) that one or more significant Federal tax issues would be resolved in the taxpayer's favor.

(ii) For purposes of this section, written advice, other than advice described in paragraph (b)(2)(i)(A) of this section (concerning listed transactions) or paragraph (b)(2)(i)(B) of this section (concerning the principal purpose of avoidance or evasion), is not treated as a reliance opinion if the practitioner prominently discloses in the written advice that it was not intended or written by the practitioner to be used, and that it cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer.

(5) Marketed opinion

(i) Written advice is a marketed opinion if the practitioner knows or has reason to know that the written advice will be used or referred to by a person other than the practitioner (or a person who is a member of, associated with, or employed by the practitioner's firm) in promoting, marketing or recommending a partnership or other entity, investment plan or arrangement to one or more taxpayer(s).

(ii) For purposes of this section, written advice, other than advice described in paragraph (b)(2)(i)(A) of this section (concerning listed transactions) or paragraph (b)(2)(i)(B) of

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this section (concerning the principal purpose of avoidance or evasion), is not treated as a marketed opinion if the practitioner prominently discloses in the written advice that --

(A) The advice was not intended or written by the practitioner to be used, and that it cannot be used by any taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer;

(B) The advice was written to support the promotion or marketing of the transaction(s) or matter(s) addressed by the written advice; and

(C) The taxpayer should seek advice based on the taxpayer’s particular circumstances from an independent tax advisor.

(6) Conditions of confidentiality. --Written advice is subject to conditions of confidentiality if the practitioner imposes on one or more recipients of the written advice a limitation on disclosure of the tax treatment or tax structure of the transaction and the limitation on disclosure protects the confidentiality of that practitioner’s tax strategies, regardless of whether the limitation on disclosure is legally binding. A claim that a transaction is proprietary or exclusive is not a limitation on disclosure if the practitioner confirms to all recipients of the written advice that there is no limitation on disclosure of the tax treatment or tax structure of the transaction that is the subject of the written advice.

(7) Contractual protection. --Written advice is subject to contractual protection if the taxpayer has the right to a full or partial refund of fees paid to the practitioner (or a person who is a member of, associated with, or employed by the practitioner’s firm) if all or a part of the intended tax consequences from the matters addressed in the written advice are not sustained, or if the fees paid to the practitioner (or a person who is a member of, associated with, or employed by the practitioner’s firm) are contingent on the taxpayer’s realization of tax benefits from the transaction. All the facts and circumstances relating to the matters addressed in the written advice will be considered when determining whether a fee is refundable or contingent, including the right to reimbursements of amounts that the parties to a transaction have not designated as fees or any agreement to provide services without reasonable compensation.

(8) Prominently disclosed. --An item is prominently disclosed if it is readily apparent to a reader of the written advice. Whether an item is readily apparent will depend on the facts and circumstances surrounding the written advice including, but not limited to, the sophistication of the taxpayer and the length of the written advice. At a minimum, to be prominently disclosed an item must be set forth in a separate section (and not in a footnote) in a typeface that is the same size or larger than the typeface of any discussion of the facts or law in the written advice.

(9) State or local bond opinion. --A State or local bond opinion is written advice with respect to a Federal tax issue included in any materials delivered to a purchaser of a State or local bond in connection with the issuance of the bond in a public or private offering, including an official statement (if one is prepared), that concerns only the excludability of

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interest on a State or local bond from gross income under section 103 of the Internal Revenue Code, the application of section 55 of the Internal Revenue Code to a State or local bond, the status of a State or local bond as a qualified tax-exempt obligation under section 265(b)(3) of the Internal Revenue Code, the status of a State or local bond as a qualified zone academy bond under section 1397E of the Internal Revenue Code, or any combination of the above.

(10) The principal purpose. --For purposes of this section, the principal purpose of a partnership or other entity, investment plan or arrangement, or other plan or arrangement is the avoidance or evasion of any tax imposed by the Internal Revenue Code if that purpose exceeds any other purpose. The principal purpose of a partnership or other entity, investment plan or arrangement, or other plan or arrangement is not to avoid or evade Federal tax if that partnership, entity, plan or arrangement has as its purpose the claiming of tax benefits in a manner consistent with the statute and Congressional purpose. A partnership, entity, plan or arrangement may have a significant purpose of avoidance or evasion even though it does not have the principal purpose of avoidance or evasion under this paragraph (b)(10).

(c) Requirements for covered opinions. --A practitioner providing a covered opinion must comply with each of the following requirements.

(1) Factual matters

(i) The practitioner must use reasonable efforts to identify and ascertain the facts, which may relate to future events if a transaction is prospective or proposed, and to determine which facts are relevant. The opinion must identify and consider all facts that the practitioner determines to be relevant.

(ii) The practitioner must not base the opinion on any unreasonable factual assumptions (including assumptions as to future events). An unreasonable factual assumption includes a factual assumption that the practitioner knows or should know is incorrect or incomplete. For example, it is unreasonable to assume that a transaction has a business purpose or that a transaction is potentially profitable apart from tax benefits. A factual assumption includes reliance on a projection, financial forecast or appraisal. It is unreasonable for a practitioner to rely on a projection, financial forecast or appraisal if the practitioner knows or should know that the projection, financial forecast or appraisal is incorrect or incomplete or was prepared by a person lacking the skills or qualifications necessary to prepare such projection, financial forecast or appraisal. The opinion must identify in a separate section all factual assumptions relied upon by the practitioner.

(iii) The practitioner must not base the opinion on any unreasonable factual representations, statements or findings of the taxpayer or any other person. An unreasonable factual representation includes a factual representation that the practitioner knows or should know is incorrect or incomplete. For example, a practitioner may not rely on a factual representation that a transaction has a business purpose if the representation does not include a specific description of the business purpose or the

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practitioner knows or should know that the representation is incorrect or incomplete. The opinion must identify in a separate section all factual representations, statements or findings of the taxpayer relied upon by the practitioner.

(2) Relate law to facts

(i) The opinion must relate the applicable law (including potentially applicable judicial doctrines) to the relevant facts.

(ii) The practitioner must not assume the favorable resolution of any significant Federal tax issue except as provided in paragraphs (c)(3)(v) and (d) of this section, or otherwise base an opinion on any unreasonable legal assumptions, representations, or conclusions.

(iii) The opinion must not contain internally inconsistent legal analyses or conclusions.

(3) Evaluation of significant Federal tax issues

(i) In general. --The opinion must consider all significant Federal tax issues except as provided in paragraphs (c)(3)(v) and (d) of this section.

(ii) Conclusion as to each significant Federal tax issue. --The opinion must provide the practitioner's conclusion as to the likelihood that the taxpayer will prevail on the merits with respect to each significant Federal tax issue considered in the opinion. If the practitioner is unable to reach a conclusion with respect to one or more of those issues, the opinion must state that the practitioner is unable to reach a conclusion with respect to those issues. The opinion must describe the reasons for the conclusions, including the facts and analysis supporting the conclusions, or describe the reasons that the practitioner is unable to reach a conclusion as to one or more issues. If the practitioner fails to reach a conclusion at a confidence level of at least more likely than not with respect to one or more significant Federal tax issues considered, the opinion must include the appropriate disclosure(s) required under paragraph (e) of this section.

(iii) Evaluation based on chances of success on the merits. --In evaluating the significant Federal tax issues addressed in the opinion, the practitioner must not take into account the possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be resolved through settlement if raised.

(iv) Marketed opinions. --In the case of a marketed opinion, the opinion must provide the practitioner's conclusion that the taxpayer will prevail on the merits at a confidence level of at least more likely than not with respect to each significant Federal tax issue. If the practitioner is unable to reach a more likely than not conclusion with respect to each significant Federal tax issue, the practitioner must not provide the marketed opinion, but may provide written advice that satisfies the requirements in paragraph (b)(5)(ii) of this section.

(v) Limited scope opinions

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(A) The practitioner may provide an opinion that considers less than all of the significant Federal tax issues if --

(1) The practitioner and the taxpayer agree that the scope of the opinion and the taxpayer's potential reliance on the opinion for purposes of avoiding penalties that may be imposed on the taxpayer are limited to the Federal tax issue(s) addressed in the opinion;

(2) The opinion is not advice described in paragraph (b)(2)(i)(A) of this section (concerning listed transactions), paragraph (b)(2)(i)(B) of this section (concerning the principal purpose of avoidance or evasion) or paragraph (b)(5) of this section (a marketed opinion); and

(3) The opinion includes the appropriate disclosure(s) required under paragraph (e) of this section.

(B) A practitioner may make reasonable assumptions regarding the favorable resolution of a Federal tax issue (an assumed issue) for purposes of providing an opinion on less than all of the significant Federal tax issues as provided in this paragraph (c)(3)(v). The opinion must identify in a separate section all issues for which the practitioner assumed a favorable resolution.

(4) Overall conclusion

(i) The opinion must provide the practitioner's overall conclusion as to the likelihood that the Federal tax treatment of the transaction or matter that is the subject of the opinion is the proper treatment and the reasons for that conclusion. If the practitioner is unable to reach an overall conclusion, the opinion must state that the practitioner is unable to reach an overall conclusion and describe the reasons for the practitioner's inability to reach a conclusion.

(ii) In the case of a marketed opinion, the opinion must provide the practitioner's overall conclusion that the Federal tax treatment of the transaction or matter that is the subject of the opinion is the proper treatment at a confidence level of at least more likely than not.

(d) Competence to provide opinion; reliance on opinions of others

(1) The practitioner must be knowledgeable in all of the aspects of Federal tax law relevant to the opinion being rendered, except that the practitioner may rely on the opinion of another practitioner with respect to one or more significant Federal tax issues, unless the practitioner knows or should know that the opinion of the other practitioner should not be relied on. If a practitioner relies on the opinion of another practitioner, the relying practitioner's opinion must identify the other opinion and set forth the conclusions reached in the other opinion.

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(2) The practitioner must be satisfied that the combined analysis of the opinions, taken as a whole, and the overall conclusion, if any, satisfy the requirements of this section.

(e) Required disclosures. --A covered opinion must contain all of the following disclosures that apply --

(1) Relationship between promoter and practitioner. --An opinion must prominently disclose the existence of --

(i) Any compensation arrangement, such as a referral fee or a fee-sharing arrangement, between the practitioner (or the practitioner's firm or any person who is a member of, associated with, or employed by the practitioner's firm) and any person (other than the client for whom the opinion is prepared) with respect to promoting, marketing or recommending the entity, plan, or arrangement (or a substantially similar arrangement) that is the subject of the opinion; or

(ii) Any referral agreement between the practitioner (or the practitioner's firm or any person who is a member of, associated with, or employed by the practitioner's firm) and a person (other than the client for whom the opinion is prepared) engaged in promoting, marketing or recommending the entity, plan, or arrangement (or a substantially similar arrangement) that is the subject of the opinion.

(2) Marketed opinions. --A marketed opinion must prominently disclose that --

(i) The opinion was written to support the promotion or marketing of the transaction(s) or matter(s) addressed in the opinion; and

(ii) The taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

(3) Limited scope opinions. --A limited scope opinion must prominently disclose that --

(i) The opinion is limited to the one or more Federal tax issues addressed in the opinion;

(ii) Additional issues may exist that could affect the Federal tax treatment of the transaction or matter that is the subject of the opinion and the opinion does not consider or provide a conclusion with respect to any additional issues; and

(iii) With respect to any significant Federal tax issues outside the limited scope of the opinion, the opinion was not written, and cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer.

(4) Opinions that fail to reach a more likely than not conclusion. --An opinion that does not reach a conclusion at a confidence level of at least more likely than not with respect to a significant Federal tax issue must prominently disclose that --

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(i) The opinion does not reach a conclusion at a confidence level of at least more likely than not with respect to one or more significant Federal tax issues addressed by the opinion; and

(ii) With respect to those significant Federal tax issues, the opinion was not written, and cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer.

(5) Advice regarding required disclosures. --In the case of any disclosure required under this section, the practitioner may not provide advice to any person that is contrary to or inconsistent with the required disclosure.

(f) Effect of opinion that meets these standards

(1) In general. --An opinion that meets the requirements of this section satisfies the practitioner's responsibilities under this section, but the persuasiveness of the opinion with regard to the tax issues in question and the taxpayer's good faith reliance on the opinion will be determined separately under applicable provisions of the law and regulations.

(2) Standards for other written advice. --A practitioner who provides written advice that is not a covered opinion for purposes of this section is subject to the requirements of §10.37.

(g) Effective date. --This section applies to written advice that is rendered after June 20, 2005. [Reg. §10.35.]

[As added by T.D. 9165, Dec. 17, 2004 (corrected 4-14-2005), as amended by T.D. 9201, May 18, 2005 and T.D. 9359, Sept. 25, 2007.]

NOTE

To ensure compliance with the legend out requirement in Section 10.35(b)(4)(ii), business lawyers generally are including a legend similar to the following in all email they send:

> **Circular 230 Notice:** In accordance with Treasury Regulations which became applicable to all tax practitioners as of June 20, 2005, please note that any tax advice given herein (and in any attachments) is not intended or written to be used, and cannot be used by any taxpayer, for the purpose of (i) avoiding tax penalties or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

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D. Page 29, New Sec. 1.13.B. Applicability of the "Legend Out" Requirement of Circular 230 in Public Deals

Page 29, New Sec. 1.13.B. Add after the New Sec. 1.13.A the following:
New Sec. 1.13.B. **Applicability of the "Legend Out" Requirement of Circular 230 in Public Deals**

Circular 230 and Opinion Letters for Securities Offerings and M&A Deals
108 Tax Notes 473 (July 25, 2005)

[The following letter from two New York business tax lawyers addresses the impact of the legend out requirement in the context of opinions given in certain SEC registered securities and M&A transactions.]

Letter from Leslie B. Samuels, Cleary, Gottlieb, Steen & Hamilton LLP, and Diana L. Wollman, Sullivan & Cromwell LLP, to:

Messrs. Namorato and Whitlock of the IRS:

Thank you for talking to us on Wednesday June 29, 2005, regarding the correct interpretation of Section 10.35 of Circular 230 as it applies to certain letters and opinions issued in connection with securities offerings and M&A transactions. As we discussed on our call, we are writing to provide a record, for the benefit of ourselves and other affected practitioners, that sets forth our approach to Circular 230. We believe that our approach is a proper, reasonable and common sense way to meet the objectives of Circular 230.

Specifically, as discussed below, we believe that certain letters and opinions that do no more than (i) refer to the disclosure made in the document provided to investors, (ii) confirm the accuracy of the tax disclosure in particular, or (iii) confirm an opinion described in such tax disclosure need not contain the "opt-out legend" if the underlying tax disclosure itself complies with Section 10.35.

We have also discussed our interpretation of Section 10.35 with securities and tax lawyers from a large number of other firms which regularly advise on a substantial volume of capital markets and M&A transactions. We expect that this interpretation will be applied by these firms (and others) to a broad range of capital markets and M&A transactions.

We have focused on offerings of securities and M&A transactions where there is a prospectus, proxy statement or other disclosure document made available to shareholders or prospective investors. If the securities are registered with the Securities and Exchange Commission (the "SEC"), the disclosure document is required to be filed with the SEC; otherwise, the document is not filed with the SEC.

In many cases the disclosure document will include a "tax disclosure" section setting forth the anticipated U.S. Federal income tax consequences to investors or the

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corporation(s) involved. Accordingly, the covered opinion rules of Section 10.35 of Circular 230 would be considered. Where the disclosure document is filed with the SEC, no legend is required in order to comply with Section 10.35 because there is an exception for a tax discussion contained in documents required to be filed with the SEC (assuming, of course, the transaction is not a "listed transaction" or a "principal purpose transaction"). Where the disclosure document is not filed with the SEC, the 3-prong marketing legend will generally be included in the disclosure document in order to ensure compliance with Section 10.35.

In addition, the counsel to the issuer and the underwriters will generally issue one or more letters or, in some cases, an opinion, to the underwriters and the issuer regarding the contents of the underlying offering document. Over the years, the securities bar and capital markets participants have developed standard practices for the wording and delivery of these letters and opinions, which are intended to serve very specific purposes relating to the securities laws and securities markets procedures.

As we indicated on our call, when we discussed with the securities lawyers in our firms and other firms the possibility of adding the Circular 230 legends to these types of letters and opinions, they raised concerns and objections based upon possible securities law implications.

In light of the objectives of Circular 230, we believe that our interpretation of the rules of Section 10.35 as applied to these types of opinions and letters is correct and is a rational and common sense approach to Circular 230.

Specifically, it is our interpretation that the following types of letters or opinions, if issued without the so-called "opt-out legends", would not be considered "covered opinions" subject to the requirements of Section 10.35(c):

1. "10b-5 Letters", "Disclosure Letters" or "Negative Assurances Letters"

These letters are issued to the investment banks distributing the securities in connection with both offerings that are registered with the SEC and offerings that are not registered with the SEC (for example, so-called "Rule 144A offerings"). In many, but not all, cases the underlying disclosure document contains a tax disclosure that addresses the U.S. Federal tax consequence of investing in the securities being offered. The disclosure document may also contain statements regarding U.S. Federal tax matters affecting the issuer of the securities or other corporations involved (for example, that the issuer is entitled to a specific Federal tax credit or that the target corporation will not recognize gain in the merger).

These letters are issued by counsel to the issuer and counsel to the investment banks distributing the securities (which are generally referred to as "underwriters" when the offering is SEC-registered and as "initial purchasers" when the offering is not SEC-registered); and the letters are given a variety of names, such as those set forth above.

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The letters state that the practitioner is not aware of any statement in the disclosure document that is materially false or of any statement omitted from the document that renders it materially misleading. In SEC-registered offerings, the letters also state that the practitioner is unaware of the omission of any statement required by the SEC. These letters are issued to the underwriters (or initial purchasers) in their capacity as such and are intended to assist the recipient of the letter in establishing that it has performed due diligence with respect to the contents of the offering document sufficient to avoid liability under the Federal securities laws. Because these letters are intended to be used solely by the underwriters (or initial purchasers), it is standard practice for these letters to include an explicit statement prohibiting any other person from relying on the letters and prohibiting the recipient from quoting, referring to or furnishing the letter to any purchaser or prospective purchaser of the securities.

Consistent with the purpose and content of these letters, they are never filed with the SEC, even when the underlying disclosure document is SEC-filed.

2. Opinions on the Accuracy of the U.S. Federal Income Tax Disclosure (Often Referred to as "Fair and Accurate Summary" Opinions)

These opinions are issued to the underwriters (and initial purchasers) by counsel to the issuer in both SEC-registered and non-SEC-registered offerings where the underlying disclosure document includes a tax disclosure describing the U.S. Federal income tax consequences to investors of purchasing, holding and selling the securities being offered. These opinions state, in effect, that in counsel's opinion the tax disclosure that appears in the disclosure document is accurate or is a "fair and accurate summary" of the U.S. Federal tax consequences to investors.

These opinions are not filed with the SEC in unregistered offerings and generally are not filed in SEC-registered offerings. In some SEC-registered offerings, primarily where the tax disclosure identifies the tax counsel which advised on the tax consequences, the fair and accurate summary opinion will be filed with the SEC as an exhibit to the registration statement containing the prospectus.

3. Closing Opinions in M&A Transactions Where the Proxy Statement Describes the Closing Opinion

These opinions, issued by counsel to the acquiror and/or the target in M&A transactions, address the U.S. Federal income tax consequences of the transaction where the underlying proxy statement or registration statement includes a tax disclosure describing the U.S. Federal income tax consequences of the transaction. Depending upon the transaction, the tax disclosure in the underlying document may address the treatment of one or more of: the target corporation, the target's shareholders, the acquiror and the acquiror's shareholders. The closing opinion will be issued when the transaction closes, and, in some cases, also issued earlier at the time the proxy statement becomes effective.

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The tax disclosure will either describe what the closing opinion is going to say or will make the same statements that will be made in the closing opinion. For example, sometimes the tax disclosure will state that the closing of the transaction is conditioned upon the parties receiving opinions that the merger will be a tax-free reorganization and then will describe what the tax consequences will be assuming the merger is in fact a tax-free reorganization. In other cases, the tax disclosure will state that the merger will be a tax-free reorganization, that opinions to that effect have been received as of the filing date and that "bring-down" opinions to that effect will be received at closing.

In each case, the closing opinion will either (i) reach the conclusions described, referred to or stated in the tax disclosure or (ii) simply state that the tax disclosure is the firm's opinion or is accurate. In many cases, the closing opinion will not be filed with the SEC, even if the related proxy statement is filed with the SEC.

Each of the three types of letters and opinions described above is incidental to the statements in a disclosure document. Some of these letters simply refer to the disclosure document, which has already been furnished to investors or other transaction participants, and other letters basically confirm the statements previously made to investors in the disclosure document. Accordingly, these letters and opinions do not add anything that would require an opt-out label. Moreover, in the case of the letters and opinions that are never seen by investors, the opt-out legends would serve no purpose and make no sense. We believe that the interpretation and application of Section 10.35 described above is proper and represents a rationale and common sense approach to Circular 230.

We are pleased that we were able to confirm with you our understanding of the meaning of the new Circular 230 rules in this important securities' market context as described above. We look forward to a continuing dialogue with you concerning a reasonable and common sense interpretation of Section 10.35 in light of its purposes.

If you have any questions or would like to discuss this further, please contact either of us. Our contact information is set forth below.

Sincerely

Leslie B. Samuels
Diana L. Wollman

E. Page 29, New Sec. 1.13.C. Section 6694, Understatement of Taxpayer's Liability by Tax Return Preparer

Page 29, New Sec. 1.13.C. Add after the New Sec. 1.13.B the following:

New Sec. 1.13.C. **Section 6694, Understatement of Taxpayer's Liability by Tax Return Preparer**

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Section 6694, Understatement of taxpayer's liability by tax return preparer

(a) Understatement due to unreasonable positions

(1) In general

If a tax return preparer--

(A) prepares any return or claim of refund with respect to which any part of an understatement of liability is due to a position described in paragraph (2), and

(B) knew (or reasonably should have known) of the position,

such tax return preparer shall pay a penalty with respect to each such return or claim in an amount equal to the greater of $1,000 or 50 percent of the income derived (or to be derived) by the tax return preparer with respect to the return or claim.

(2) Unreasonable position

(A) In general

Except as otherwise provided in this paragraph, a position is described in this paragraph unless there is or was substantial authority for the position.

(B) Disclosed positions

If the position was disclosed as provided in section 6662(d)(2)(B)(ii)(I) and is not a position to which subparagraph (C) applies, the position is described in this paragraph unless there is a reasonable basis for the position.

(C) Tax shelters and reportable transactions

If the position is with respect to a tax shelter (as defined in section 6662(d)(2)(C)(ii)) or a reportable transaction to which section 6662A applies, the position is described in this paragraph unless it is reasonable to believe that the position would more likely than not be sustained on its merits.

(3) Reasonable cause exception

No penalty shall be imposed under this subsection if it is shown that there is reasonable cause for the understatement and the tax return preparer acted in good faith.

n2 (b) Understatement due to willful or reckless conduct

(1) In general

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Any tax return preparer who prepares any return or claim for refund with respect to which any part of an understatement of liability is due to a conduct described in paragraph (2) shall pay a penalty with respect to each such return or claim in an amount equal to the greater of--

(A) $5,000, or

(B) 50 percent of the income derived (or to be derived) by the tax return preparer with respect to the return or claim.

(2) Willful or reckless conduct

Conduct described in this paragraph is conduct by the tax return preparer which is--

(A) a willful attempt in any manner to understate the liability for tax on the return or claim, or

(B) a reckless or intentional disregard of rules or regulations.

(3) Reduction in penalty

The amount of any penalty payable by any person by reason of this subsection for any return or claim for refund shall be reduced by the amount of the penalty paid by such person by reason of subsection (a).

n3 (c) Extension of period of collection where preparer pays 15 percent of penalty

(1) In general

If, within 30 days after the day on which notice and demand of any penalty under subsection (a) or (b) is made against any person who is a tax return preparer, such person pays an amount which is not less than 15 percent of the amount of such penalty and files a claim for refund of the amount so paid, no levy or proceeding in court for the collection of the remainder of such penalty shall be made, begun, or prosecuted until the final resolution of a proceeding begun as provided in paragraph (2). Notwithstanding the provisions of section 7421(a), the beginning of such proceeding or levy during the time such prohibition is in force may be enjoined by a proceeding in the proper court. Nothing in this paragraph shall be construed to prohibit any counterclaim for the remainder of such penalty in a proceeding begun as provided in paragraph (2).

n4 (2) Preparer must bring suit in district court to determine his liability for penalty

If, within 30 days after the day on which his claim for refund of any partial payment of any penalty under subsection (a) or (b) is denied (or, if earlier, within 30 days after the expiration of 6 months after the day on which he filed the claim for refund), the tax return

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preparer fails to begin a proceeding in the appropriate United States district court for the determination of his liability for such penalty, paragraph (1) shall cease to apply with respect to such penalty, effective on the day following the close of the applicable 30-day period referred to in this paragraph.

(3) Suspension of running of period of limitations on collection

The running of the period of limitations provided in section 6502 on the collection by levy or by a proceeding in court in respect of any penalty described in paragraph (1) shall be suspended for the period during which the Secretary is prohibited from collecting by levy or a proceeding in court.

(d) Abatement of penalty where taxpayer's liability not understated

If at any time there is a final administrative determination or a final judicial decision that there was no understatement of liability in the case of any return or claim for refund with respect to which a penalty under subsection (a) or (b) has been assessed, such assessment shall be abated, and if any portion of such penalty has been paid the amount so paid shall be refunded to the person who made such payment as an overpayment of tax without regard to any period of limitations which, but for this subsection, would apply to the making of such refund.

n5 (e) Understatement of liability defined

For purposes of this section, the term "understatement of liability" means any understatement of the net amount payable with respect to any tax imposed by this title or any overstatement of the net amount creditable or refundable with respect to any such tax. Except as otherwise provided in subsection (d), the determination of whether or not there is an understatement of liability shall be made without regard to any administrative or judicial action involving the taxpayer.

n6 (f) Cross reference

For definition of tax return preparer, see section 7701(a)(36).

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II. Chapter 2, An Overview of Basic Corporate Tax Principles

A. Page 38, New Sec. 2.2.D.1. Proposed Regulations on Transfers of Built-in-Losses

Page 38, New Sec. 2.2.D.1 Add before Sec. 2.3 the following:
New Sec. 2.2.D.1. **Proposed Regulations on Transfers of Built-in-Losses**

Preamble to Proposed Regulations: Limitations on Transfers of Built-in Losses
RIN 1545-BE58, October 23, 2006

SUMMARY: This document contains proposed regulations under section 362(e)(2) of the Internal Revenue Code of 1986 (Code). The proposed regulations reflect changes made to the law by the American Jobs Creation Act of 2004. These proposed regulations provide guidance regarding the determination of the bases of assets and stock transferred in certain nonrecognition transactions and will affect corporations and large shareholders of corporations, including individuals, partnerships, corporations, and tax-exempt entities. * * *

Background

Prior to 1999, Congress grew concerned that taxpayers were engaging in corporate nonrecognition transactions in order to accelerate and duplicate losses. See S. Rep. No. 201, 106th Cong., 1st Sess. 46-48 (1999). Congress was primarily concerned with the acceleration and duplication of losses through the assumption of liabilities (including liabilities to which assets transferred in a corporate nonrecognition transaction were subject). As a result, in 1999, Congress enacted section 362(d) of the Code to prevent the bases of assets transferred to a corporation from being increased above such assets' aggregate fair market value as a result of a liability assumption. In addition, in 2000, Congress enacted section 358(h) to reduce the basis of stock received in certain corporate nonrecognition transactions, but not below fair market value, by the amount of any liabilities assumed in the transaction.

Following the enactment of sections 362(d) and 358(h), Congress remained concerned that taxpayers were engaging in various tax-motivated transactions to take more than one tax deduction for a single economic loss. Consequently, in the American Jobs Creation Act of 2004 (Public Law 108-357, 188 Stat. 1418), Congress enacted section 362(e), which limits the ability of taxpayers to duplicate net built-in loss in certain nonrecognition transactions.

Section 362(e)(1)(A) provides that if there would be an importation of a net built-in loss in a transaction described in section 362(a) or (b), the basis of certain property acquired in such a transaction shall be its fair market value immediately after the transaction. Section 362(e)(1)(B) provides that property is described in section 362(e)(1) if gain or

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loss with respect to such property is not subject to tax in the hands of the transferor immediately before the transfer, and gain or loss with respect to such property is subject to tax in the hands of the transferee immediately after the transfer. Further, section 362(e)(1)(C) provides that there is an importation of net built-in loss in a transaction if the transferee's aggregate adjusted basis in such property would (but for the application of section 362(e)(1)) exceed the aggregate fair market value of such property immediately after the transaction.

Section 362(e)(2)(A) provides that if property is transferred by a transferor to a transferee in a transaction described in section 362(a) and not described in section 362(e)(1), and if the transferee's aggregate adjusted basis in the transferred property would (but for the application of section 362(e)(2)) exceed its aggregate fair market value immediately after the transfer, then the transferee's aggregate adjusted basis in the transferred property shall not exceed the fair market value of the property immediately after the transfer. Further, section 362(e)(2)(B) provides that this aggregate reduction in the basis of the transferred property shall be allocated among the property in proportion to their respective built-in losses immediately before the transaction. As an alternative to this reduction in the basis of the transferred assets, section 362(e)(2)(C) provides that if the transferor and the transferee both so elect, section 362(e)(2)(A) shall not apply, and the transferor's basis in the stock of the transferee received in exchange for the property that would otherwise be subject to basis reduction under section 362(e)(2)(A) shall not exceed its fair market value.

Since the enactment of section 362(e)(2), the IRS and Treasury Department have been exploring issues concerning the interpretation, scope, and application of the section and have proposed these regulations to address these issues. Additional guidance regarding the application of section 362(e)(2) to transfers between members of a consolidated group and the treatment of transactions that have the effect of importing losses into the U.S. tax system (to which section 362(e)(1) applies) will be addressed in separate guidance projects.

Explanation of Provisions

1. *General Provisions*

In general, these proposed regulations apply to transfers of net built-in loss property within the U.S. tax system in which the Code otherwise would duplicate the net built-in asset loss in the stock of the transferee. Such transfers include exchanges subject to section 351, capital contributions, and transfers of paid-in surplus. However, these proposed regulations do not apply to a transfer where the duplicated loss is imported into the U.S. tax system and the transfer is subject to section 362(e)(1), which addresses certain loss importation transactions. Property is net built-in loss property if the transferee corporation's aggregate basis in the property, but for the application of section 362(e)(2), would exceed the aggregate fair market value of such property immediately after the transfer.

If section 362(e)(2) applies to a transfer, the transferee corporation receives the property with an aggregate basis not exceeding the aggregate fair market value of the property

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immediately after the transfer. The transferee allocates the basis reduction among the transferred loss properties in proportion to the amount of loss in each such property immediately before the transfer.

Taxpayers have questioned the effect of any gain taken into account as a result of the transfer. The IRS and Treasury Department have determined that any gain recognized by the transferor that increases the transferee corporation's basis in the transferred property must be taken into account in order to determine the full amount of loss duplication. Accordingly, these proposed regulations provide that in determining whether the transferred property has a net built-in loss in the hands of the transferee, the bases of such property first must be increased under section 362(a) or (b) for any gain recognized by the transferor on the transfer of the property.

There also have been questions about the application of section 362(e)(2) in the case of multiple transferors. The legislative history to section 362(e)(2) contains some potentially conflicting language that refers to the aggregate adjusted basis of property contributed by a transferor or a control group of which the transferor is a member. See Conf. Rep. No. 108-755, 108th Cong., 2d Sess. 635 (2004). However, because the basis rules in section 362 and section 358 are applied on a transferor-by-transferor basis, applying section 362(e)(2) to an aggregated group of transferors would undermine Congress' intent to prevent loss duplication. Further, section 362(e)(2) specifically refers to property "transferred by a transferor." Accordingly, these proposed regulations clarify that section 362(e)(2) applies separately to each transferor. Thus, each transferor's transfer is measured separately, and the determination of whether that transfer is subject to these provisions is made solely by reference to the property transferred by such transferor. Consequently, the treatment of one transferor is unaffected by the transfer of property by any other transferor for purposes of section 362(e)(2).

In addition, these proposed regulations clarify that, even if part of a transaction is subject to section 362(e)(1), section 362(e)(2) can apply to the portion of the transaction that is not described in section 362(e)(1).

2. *Application of Section 362(e)(2) to Transfers Outside of the U.S. Tax System*

Under general principles of law, the Code applies to all transactions without regard to whether such application has any current U.S. tax consequences. In the case of transfers that are wholly outside the U.S. tax system, section 362(e)(2) applies but does not have relevance unless and until the assets transferred or the stock received in the exchange enter the U.S. tax system. Such assets or stock may subsequently enter the U.S. tax system either directly or indirectly. For example, the assets or stock could directly enter the U.S. tax system through a transfer of all or a portion of such assets or stock to a U.S. person, or as a result of the original transferor or original transferee becoming a U.S. person. Further, the assets or stock could indirectly enter the U.S. tax system, for example, through a transfer of all or a portion of such assets or stock to a CFC, or as a result of the original transferor or original transferee becoming a CFC. However, in many cases the U.S. tax treatment of a transfer that is wholly outside the U.S. tax system will never become relevant. The IRS and Treasury Department recognize that, if a transferor does not anticipate the transfer becoming U.S. tax relevant, it is not likely to undertake the

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valuation and record-keeping that section 362(e)(2) would generally require. If circumstances change at some later date, the administrative burden of reconstructing appropriate records may be substantial.

The IRS and Treasury Department have determined that relief is appropriate when transactions are consummated with no plan or intention to enter the U.S. tax system. Thus, if assets are transferred in a transaction that is potentially subject to section 362(e)(2) more than two years before entering the U.S. tax system, then, solely for purposes of section 362(e)(2), these proposed regulations generally presume that the aggregate fair market value of the transferred assets equals their aggregate adjusted basis in the hands of the transferee immediately after the transfer. This presumption applies only if neither the original transfer nor the later entry of any portion of the assets into the U.S. tax system was undertaken with a view to reducing the U.S. tax liability of any person or duplicating loss by avoiding the application of section 362(e)(2).

If a transfer subject to section 362(e)(2) occurs within the two-year period immediately before becoming U.S. tax relevant, the IRS and Treasury Department do not believe that relief from the administrative burden is either necessary or appropriate. Thus, in such a case, the fair market value presumption does not apply, and section 362(e)(2) applies to the original transfer. The proposed regulations provide the relevant parties a means by which to make an election under section 362(e)(2)(C), if desired, at the time of entry into the U.S. tax system.

3. *General Application of Section 362(e)(2) to Reorganizations*

Taxpayers have questioned whether a transaction described in both sections 362(a) and 362(b) may be subject to section 362(e)(2). The IRS and Treasury Department believe that, if there is a duplication of loss in a transaction described in section 362(a) (and not subject to section 362(e)(1)), Congressional intent requires that the transaction be recognized as described in section 362(a) notwithstanding that it is also described in section 362(b). The proposed regulations clarify that section 362(e)(2) can apply to such transactions.

4. *Exception for Transactions in Which Net Built-in Loss is Eliminated Without Recognition*

In certain transactions, the transferor’s duplicated basis in the transferee stock or securities is eliminated by operation of statute without recognition or benefit. For example, in a transaction meeting the requirements of both sections 351 and 368(a)(1)(D), the transferor ordinarily receives stock with an aggregate basis equal to that of the transferred property. As a result, where the transferred property has a net built-in loss, but for section 362(e)(2), the transferor would receive the transferee stock with an adjusted basis that duplicates the built-in loss in the transferred property. However, if the transferor distributes the transferee stock pursuant to a section 368(a)(1)(D) acquisitive reorganization or pursuant to section 355, no taxpayer will recognize the duplicated loss because the distributee will determine its basis in the transferee stock by reference to its basis in surrendered stock of the transferor.

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The IRS and Treasury Department have concluded that, even if a transaction is described in section 362(e)(2), if there is no duplicated loss that can be recognized, section 362(e)(2) should not apply. Accordingly, these proposed regulations provide that section 362(e)(2) will not apply to transactions to the extent that loss duplication is prevented or eliminated where the transferor distributes the transferee stock and/or securities received in the transaction without recognizing gain or loss, and, upon completion of the transaction, no person holds any asset with a basis determined in whole or in part by reference to the transferor's basis in the transferee stock and/or securities.

5. *Application of Section 362(e)(2) to Transfers in Exchange for Securities*

In certain transactions, net built-in loss also can be duplicated in securities received without the recognition of gain or loss. For example, a U.S. transferor duplicates a net built-in loss when it transfers property with a net built-in loss to a U.S. controlled corporation in exchange for stock and securities and all or part of the securities are retained following the distribution of the stock of the controlled corporation pursuant to section 355. Such a transaction is described in section 362(a) but not section 362(e)(1) and, accordingly, may be subject to section 362(e)(2).

Although the statute is silent about the treatment of securities received in such a property transfer, the IRS and Treasury Department have concluded that Congressional intent would be circumvented if section 362(e)(2) were treated as not applying to both stock and securities received in transactions to which section 362(e)(2) applies. Accordingly, these proposed regulations apply section 362(e)(2) to transfers in exchange for both stock and securities to the extent necessary to eliminate loss duplication.

Because the section applies equally to transfers in exchange for both stock and securities, the IRS and Treasury Department have concluded that taxpayers must be allowed to make an election under section 362(e)(2)(C) for both stock and securities. Accordingly, these proposed regulations allow the transferor and transferee to elect to apply section 362(e)(2)(C) to the transferee stock and securities received in the exchange.

6. *Election to Reduce Stock Basis*

Section 362(e)(2)(C) permits transferors and transferees that engage in transactions to which section 362(e)(2) applies to elect to reduce the transferor's basis in the stock received instead of reducing the transferee corporation's basis in the property transferred. As described in this preamble, section 362(e)(2)(C) provides that if the election is made, section 362(e)(2)(A) shall not apply, and the transferor's basis in the transferee stock received in the exchange shall not exceed its fair market value immediately after the exchange. The statutory language might be interpreted to require the transferor to reduce its basis in the stock received by an amount that is larger than the amount by which the transferee otherwise would have been required to reduce its aggregate basis in the assets under section 362(e)(2)(A). For example, assume a corporation, P, contributes a trade or business to a subsidiary, S, in a transaction to which section 351 applies. The assets of the business have an aggregate adjusted basis of $100 and a value of $90, and the business has $20 of associated contingent liabilities. Even if section 358(h)(2)(A) applies to prevent section 358 from reducing P's basis in the S stock by the amount of the

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contingent liabilities, section 362(e)(2)(C) might be interpreted to limit P's basis in the S stock to $70 (notwithstanding that section 362(e)(2)(A) would only require a $10 reduction in the basis of the assets in the hands of S). Thus, a section 362(e)(2)(C) election might result in a larger basis reduction in the stock than would be required in the assets absent an election.

The IRS and Treasury Department believe that, because section 362(e)(2) is intended to prevent the duplication of net built-in loss in the transferred assets, the amount of basis reduction resulting from an election under section 362(e)(2)(C) should not be any larger than what is necessary to eliminate the duplication of loss in the transferred assets. Therefore, these proposed regulations clarify that the amount of the reduction in the basis of the transferee stock (and securities) as a result of an election to apply section 362(e)(2)(C) is equal to the net built-in loss in the transferred assets in the hands of the transferee. In other words, under the proposed regulations, the amount of the reduction in the basis of the transferee stock (and securities) resulting from such an election equals the amount of the reduction in the basis of the assets required by section 362(e)(2)(A) absent the election.

These proposed regulations also implement Notice 2005-70, 2005-41 IRB 694, see §601.601(d)(2), which instructs taxpayers how to elect to apply section 362(e)(2)(C). These proposed regulations revise and expand upon the procedures in Notice 2005-70 to provide more methods and time periods in which to make the section 362(e)(2)(C) election. Specifically, the regulations expand the classifications of persons who can attach the required election statement to a tax return (including an information return).

The "protective election" referenced in Notice 2005-70 also is included in the proposed regulations because the IRS and Treasury Department anticipate that, at the time of the transaction, taxpayers may not always be able to determine with reasonable certainty whether section 362(e)(2) applies to a transfer.

The IRS and Treasury Department request comments on whether the instructions provided in these proposed regulations adequately address the needs of taxpayers. In particular, the IRS and Treasury Department invite comments regarding whether, alternatively, a separate form should be developed and made available to enable taxpayers to make the section 362(e)(2)(C) election prior to and apart from filing it with a U.S. return.

The basis tracing provisions in §1.358-2 apply to certain transfers to which section 351 and either section 354 or section 356 apply. However, the IRS and Treasury Department believe that the basis tracing provisions in §1.358-2 should not apply to a transfer to which section 362(e)(2) also applies if the transferor and transferee make an election to apply section 362(e)(2)(C). The IRS and Treasury Department believe that the statutory language in section 362(e)(2)(C) and the policy of preventing loss duplication precludes the application of the basis tracing provisions because basis tracing could allow the transferor to hold transferee stock or securities with a basis in excess of fair market value even after a reduction under section 362(e)(2)(C). Accordingly, these proposed regulations provide that the provisions of §1.358-2(a)(2) will not apply to a transaction to which section 362(e)(2) applies if the transferor and transferee elect to apply section

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362(e)(2)(C). The IRS and Treasury Department request comments regarding whether this treatment is appropriate.

7. *Transfers by Partnerships and S Corporations*

The proposed regulations also provide that, where the transferor is a partnership and a section 362(e)(2)(C) election is made, any reduction to the partnership's basis in the transferee stock received is treated as an expenditure of the partnership, as described in section 705(a)(2)(B). The proposed regulations provide a similar rule applicable to transfers by S corporations that elect to apply section 362(e)(2)(C).

The IRS and Treasury Department are further exploring how the provisions of section 362(e)(2) apply to partnerships. The IRS and Treasury Department invite comments on this general issue and specifically invite comments regarding the transfer of a partnership interest in exchange for stock in a section 351 transaction to which section 362(e)(2) applies. For example, individuals A and B contribute cash to form a partnership, PRS. PRS purchases property that subsequently decreases in value. A contributes his PRS interest to a corporation in a transaction that qualifies under section 351. PRS does not make an election under section 754. Comments are invited regarding the interaction of section 362(e)(2) and the partnership provisions under these and similar facts.

8. *Application of Section 336(d) to Property Previously Transferred in a Section 362(e)(2) Transaction*

Commentators have questioned how section 362(e)(2) interacts with other Code sections. Specifically, some have asked how section 362(e)(2) applies when section 336(d) might be implicated. Section 336(d) provides various limitations on a liquidating corporation's ability to recognize loss when it distributes property acquired in a section 351 transaction or as a contribution to capital. The IRS and Treasury Department believe that, generally, sections 336(d) and 362(e)(2) are fully compatible where the parties do not make an election to apply section 362(e)(2)(C). However, where an election has been made, the two sections may operate to deny part or all of an economic loss. The IRS and Treasury Department invite comments regarding this issue.

9. *Application to Section 304 Transactions*

In response to inquiries, the proposed regulations contain an example demonstrating how section 362(e)(2) applies to a section 351 transaction treated as occurring under section 304. The IRS and Treasury Department are considering whether the regulations should deem an election to apply section 362(e)(2)(C) to have been made in section 304 transactions. The IRS and Treasury Department invite comments regarding this issue.

B. Page 40, New Sec. 2.3.C. Illustration of Characterization of Shareholder Advances as Debt or Equity--Indmar

Page 40, New Sec. 2.3.C. Add after Sec. 2.3.B the following:

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New Sec. 2.3.C. **Illustration of Characterization Shareholder Advances as Debt or Equity--*Indmar***

Indmar Products Co., Inc. v. Commissioner
2006 TNT 73-11 (CA. Sixth Cir. 2006)

McKEAGUE, Circuit Judge. Indmar Products Co., Inc. ("Indmar") appeals the decision of the Tax Court to disallow interest deductions the company claimed for tax years 1998-2000 . . . . The interest deductions relate to a number of advances made to Indmar by its majority stockholders over several years. Indmar argued at trial that the advances were legitimate loans made to the company, and thus it could properly deduct the interest payments made on these advances under 26 U.S.C. section 163(a). The Tax Court, following the position taken by the Commissioner of Internal Revenue (the "Commissioner"), disagreed, concluding that the advances were equity contributions and therefore the company could not deduct any purported interest payments on these advances. . . .

Upon review of the record, we conclude that the Tax Court clearly erred in finding the advances were equity. The Tax Court failed to consider several factors used by this court for determining whether advances are debt or equity, ignored relevant evidence, and drew several unsupported inferences from its factual findings. We reverse and find that the stockholder advances were bona fide debt.

BACKGROUND. *Stockholder Advances to Indmar*. Indmar, a Tennessee corporation, is a marine engine manufacturer. In 1973, Richard Rowe, Sr., and Marty Hoffman owned equal shares of Indmar. In 1987, after Hoffman passed away, Richard and his wife, Donna Rowe, together owned 74.44% of Indmar, with their children and children's spouses owning the rest.

By all accounts, Indmar has been a successful company. From 1986 to 2000, Indmar's sales and costs-of-goods sold increased from $ 5m and $ 3.9m to $ 45m and $ 37.7m, respectively. In addition, Indmar's working capital (current assets minus current liabilities) increased from $ 471,386 to $ 3.8m. During this period, Indmar did not declare or pay formal dividends.

Since the 1970s, Indmar's stockholders have advanced funds to it, receiving a 10% annual return in exchange. Hoffman started the practice in the 1970s. Beginning in 1987, the Rowes (as well as their children) began to make advancements on a periodic basis. Indmar treated all of the advances as loans from stockholders in the corporate books and records, and made monthly payments calculated at 10% of the advanced funds. Indmar reported the payments as interest expense deductions on its federal income tax returns. Consistent with Indmar's reporting, the Rowes reported the payments as interest income on their individual income tax returns.

The parties did not initially document the advances with notes or other instruments. Beginning in 1993, the parties executed notes covering all of the advances at issue.

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Specifically, Indmar executed a promissory note in 1993 with Donna Rowe for $ 201,400 (*i.e.*, her outstanding balance). The note was payable on demand and freely transferable, had no maturity date or monthly payment schedule, and had a fixed interest rate of 10%. In 1995, Indmar executed a similar promissory note with Richard Rowe for $ 605,681 (*i.e.*, his outstanding balance). In 1998, when the outstanding transfers totaled $ 1,222,133, Indmar executed two line of credit agreements with the Rowes for $ 1m and $ 750,000. The line of credit agreements provided that the balances were payable on demand and the notes were freely transferable. In addition, the agreements provided a stated interest rate of 10% and had no maturity date or monthly payment schedule. None of the advances were secured.

Repayments of the advances were paid on demand, based on the needs of the stockholders, and not subject to set or predetermined due dates. The record indicates that between 1987 and 2000, the total advance balances ranged from $ 634,000 to $ 1.7m, and Indmar made purported interest payments between $ 45,000 and $ 174,000 each year.

The parties structured the advances as demand loans to give the Rowes flexibility as creditors. Moreover, as demand loans, the advances were treated by the Rowes as short-term debt under Tennessee law, thereby excepting interest payments from a 6% state tax on dividends and interest on long-term debts. Tenn. Code Ann. sections 67-2-101(1)(B)(i), 67-2-102 (2005). Indmar, however, reported the advances as long-term liabilities on its financial statements to avoid violating loan agreements with First Tennessee Bank ("FTB"), its primary creditor, who required a minimum ratio of current assets to current liabilities.

In order to reconcile the treatment and execution of the advances as demand loans versus listing them as long-term debt in its financial reports, Indmar received waivers from the Rowes agreeing to forego repayment on the notes for at least 12 months. From 1989 to 2000, the notes to Indmar's financial statements disclosed that "The stockholders have agreed not to demand payment within the next year," and in 1992 and 1993, the Rowes signed written agreements stating that they would not demand repayment of the advances. Indmar did all of this under the direction of its accountant.

Despite the annual waivers, the Rowes demanded and received numerous partial repayments of the advances. Specifically, in 1994 and 1995, Richard Rowe demanded repayment of $ 15,000 and $ 650,000, respectively, to pay his taxes and purchase a new home. He also demanded repayment of $ 84,948, $ 80,000, $ 25,000, and $ 70,221 from 1997-2000 to pay litigation expenses, boat repairs, and tax expenses. Donna Rowe demanded repayment of $ 180,000 in 1998 for boat repairs. The Rowes made additional advances in 1997 and 1998 of $ 500,000 and $ 300,000, respectively. The balance of notes payable to stockholders on December 31, 2000, totaled $ 1,166,912.

As Indmar was a successful, profitable company, numerous banks sought to lend money to it. FTB worked hard to retain Indmar's business, made funds immediately available upon request, and was willing to lend Indmar 100% of the stockholder advances.

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In its loan agreements with Indmar, FTB required the company to subordinate all transfers, including stockholder advances, to FTB's loans. FTB did not strictly enforce the subordination provision, however, as Indmar repaid -- with FTB's knowledge -- some of the stockholder advancements at the same time FTB loans remained outstanding. As an example, when Richard demanded repayment of $ 650,000 to purchase a new home, Indmar borrowed the entire amount from FTB at 7.5% (the prime lending rate was 8.75%). Indmar secured the loan with inventory, accounts and general intangibles, equipment, and the personal guarantee of the Rowes. Richard Moody, the FTB lending officer who worked with Indmar on the loan, testified that he knew Indmar used the proceeds to repay Richard. Indmar had loans outstanding with FTB at the time.

As stipulated by the parties, the prime lending rate ranged from a low of 6% to a high of 10.5% between 1987-1998. In 1997, Indmar and FTB executed a promissory note for $ 1m that was modified in 1998. The interest rate on the note (7.85%) was below the prime lending rate. Indmar also had a collateralized line of credit with FTB. Similar to the stockholder advances, the bank line of credit was used for short-term working capital. FTB charged the following rates for the secured line of credit:

1995 - 9%
1996 - 8.75%
1997 - 9%
1998 - 8%
1999 - 8.75%
2000 - 9.5%

(rates as of December 31st of each year).

Claimed Deductions at Issue. On its tax returns for 1998-2000, Indmar claimed deductions for the purported interest payments paid on the stockholder advances. The Commissioner issued a notice of deficiency. Indmar filed a petition in the Tax Court challenging the Commissioner's decision. After trial, the Tax Court concluded that the advances did not constitute genuine indebtedness and thus the payments to the stockholders were not deductible. . . . .

LEGAL ANALYSIS. *Determining Whether Advance Is Debt or Equity* . . . The basic question before us is whether the advances made to the company by the stockholders were loans or equity contributions. Under 26 U.S.C. section 163(a), a taxpayer may take a tax deduction for "all interest paid or accrued . . . on indebtedness." There is no similar deduction for dividends paid on equity investments. Thus, if the advances were loans, the 10% payments made by Indmar to the Rowes were "interest" payments, and Indmar could deduct these payments. If, on the other hand, the advances were equity contributions, the 10% payments were constructive dividends, and thus were not deductible.

Over the years, courts have grappled with this seemingly simple question in a wide array of legal and factual contexts. The distinction between debt and equity arises in other areas

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of federal tax law, see, e.g., *Roth Steel Tube Co. v. Comm'r*, 800 F.2d 625, 629-30 (6th Cir. 1986) (addressing the issue in the context of the deductibility of advances as bad debt under 26 U.S.C. section 166(a)(1)), as well as bankruptcy law, see, e.g., *In re AutoStyle Plastics, Inc*., 269 F.3d 726, 750 (6th Cir. 2001). The Second Circuit set out the "classic" definition of debt in *Gilbert v. Commissioner*: "an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income or lack thereof." 248 F.2d 399, 402 (2d Cir. 1957). "While some variation from this formula is not fatal to the taxpayer's effort to have the advance treated as a debt for tax purposes, . . . too great a variation will of course preclude such treatment." *Id.* at 402-03. The question becomes, then, what is "too great a variation"?

To determine whether an advance to a company is debt or equity, courts consider "whether the objective facts establish an intention to create an unconditional obligation to repay the advances." *Roth Steel*, 800 F.2d at 630 (citing *Raymond v. United States*, 511 F.2d 185, 190 (6th Cir. 1975)). In doing so, courts look not only to the form of the transaction, but, more importantly, to its economic substance. *See, e.g., Fin Hay Realty Co. v. United States*, 398 F.2d 694, 697 (3d Cir. 1968) ("The various factors . . . are only aids in answering the ultimate question whether the investment, analyzed in terms of its economic reality, constitutes risk capital entirely subject to the fortunes of the corporate venture or represents a strict debtor-creditor relationship."); *Byerlite Corp. v. Williams*, 286 F.2d 285, 291 (6th Cir. 1960) ("In all cases, the prevailing consideration is that artifice must not be exalted over reality, whether to the advantage of the taxpayer, or to the government.").

The circuit courts have not settled on a single approach to the debt/equity question. We elucidated our approach in *Roth Steel*, setting out eleven non-exclusive factors for courts to consider:

> (1) the names given to the instruments, if any, evidencing the indebtedness; (2) the presence or absence of a fixed maturity date and schedule of payments; (3) the presence or absence of a fixed rate of interest and interest payments; (4) the source of repayments; (5) the adequacy or inadequacy of capitalization; (6) the identity of interest between the creditor and the stockholder; (7) the security, if any, for the advances; (8) the corporation's ability to obtain financing from outside lending institutions; (9) the extent to which the advances were subordinated to the claims of outside creditors; (10) the extent to which the advances were used to acquire capital assets; and (11) the presence or absence of a sinking fund to provide repayments.

800 F.2d at 630. No single factor is controlling; the weight to be given a factor (if any) necessarily depends on the particular circumstances of each case. *Id*.; *see also Universal Castings Corp*., 37 T.C. 107, 114 (1961) ("It is not enough when examining such a

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precedential checklist to test each item for its presence or absence, but it is necessary also to weigh each item."), *aff'd*, 303 F.2d 620 (7th Cir. 1962). In essence, the more a stockholder advance resembles an arm's-length transaction, the more likely it is to be treated as debt. *AutoStyle Plastics*, 269 F.3d at 750. . . .

Roth Steel Factors. After discussing some, but not all, of the *Roth Steel* factors, the Tax Court concluded that the Rowes' advances were equity contributions. Specifically, it found the following factors weighed in favor of equity: (i) Indmar did not pay any formal dividends (although this is not one of the Roth Steel factors); (ii) there was no fixed maturity date or obligation to repay; (iii) repayment came from corporate profits and would not be paid if there were not sufficient profits; (iv) advances were unsecured; (v) there was no sinking fund; and (vi) at the time advances were made, there was no unconditional and legal obligation to repay. The court found that several factors weighed in favor of debt: (i) Indmar reported the advances on its federal income tax returns as interest expenses; (ii) external financing was available; (iii) Indmar was adequately capitalized; (iv) the advances were not subordinated to all creditors; and (v) the Rowes did not make the advances in proportion to their respective equity holdings. The court concluded that the factors favoring equity "certainly outweigh" those favoring debt. *Indmar*, 2005 T.C.M. LEXIS 31, at *15.

As explained below, we find that the Tax Court clearly erred in concluding that the advances were equity contributions rather than bona fide debt. The Tax Court failed to consider several *Roth Steel* factors. It also did not address in its analysis certain uncontroverted testimony and evidence upon which the parties stipulated. Consideration of all of the record evidence in this case leaves us "with the definite and firm conviction that a mistake has been committed." *Holmes*, 184 F.3d at 543.

Fixed Rate of Interest and Interest Payments. The first factor to which we look is whether or not a fixed rate of interest and fixed interest payments accompanied the advances. *Roth Steel*, 800 F.2d at 631. The absence of a fixed interest rate and regular payments indicates equity; conversely, the presence of both evidences debt. . . . In its findings of fact, the Tax Court determined that the advances were made with a 10% annual return rate. The court also found that Indmar made regular monthly interest payments on all of the advances.

The fixed rate of interest and regular interest payments indicate that the advances were bona fide debt. In its analysis, however, the Tax Court took a different view. Rather than analyzing these facts within the *Roth Steel* framework (*i.e.*, as objective indicia of debt or equity), the Tax Court focused instead on why the Rowes made the advancements: it concluded that the Rowes "characterized the cash transfers as debt because they wanted to receive a 10-percent return on their investment and minimize estate taxes." *Indmar*, 2005 T.C.M. LEXIS 31, at *11. Yet, neither of these intentions is inconsistent with characterizing the advances as loans.

For tax purposes, it is generally more important to focus on "what was done," than "why it was done." . . . As long as the interest rate is in line with the risks involved, a healthy

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return on investment can evidence debt. . . .

The record indicates that the 10% rate was not an "exorbitant interest rate" under the circumstances. . . .

Far from proving the Commissioner's position, the existence and consistent payment of a fixed, reasonable interest rate strongly supports the inference that the advances were bona fide loans.

Written Instruments of the Indebtedness. "The absence of notes or other instruments of indebtedness is a strong indication that the advances were capital contributions and not loans." *Roth Steel*, 800 F.2d at 631. In its analysis, the Tax Court found that Indmar "failed to establish that, at the time the transfers were made, it had the requisite unconditional and legal obligation to repay the Rowes (e.g., the transfers were not documented)." *Indmar*, 2005 T.C.M. LEXIS 31, at *15 (emphasis added)./3/

The Tax Court focused on only half the story. For years 1987-1992, the Rowes did make advancements without executing any notes or other instruments. Beginning in 1993, and for all the tax years at issue in this case, the parties executed notes of loans and lines of credit covering all of the advances at issue, as the Tax Court noted in its findings of fact. Yet, in its analysis of the *Roth Steel* factors, the Tax Court was silent as to the subsequent execution of notes. After-the-fact consolidation of prior advances into a single note can indicate that the advances were debt rather than equity contributions. *See, e.g., Dev. Corp. of Am. v. Comm'r*, T.C.M. 1988-127, 1988 T.C.M. LEXIS 155, at *11. The Tax Court erred by focusing on the initial lack of documentation without addressing the subsequent history of executed notes.

Fixed Maturity Date and Schedule of Payments. "The absence of a fixed maturity date and a fixed obligation to repay indicates that the advances were capital contributions and not loans." *Roth Steel*, 800 F.2d at 631. Based on the Rowes' waivers, the Tax Court concluded that there was no fixed maturity date or fixed obligation to repay. While correct, we find that this factor carries little weight in the final analysis. The parties structured the advances as demand loans, which had ascertainable (although not fixed) maturity dates, controlled by the Rowes. *Piedmont Minerals*, 429 F.2d at 563 n.5 ("The absence of a fixed maturity date is a relevant consideration, but it is far from controlling. The maturity of a demand note is always determinable by its holder."). Furthermore, the temporary waiver of payment does not convert debt into equity "since [the stockholders] still expected to be repaid." *AutoStyle Plastics*, 269 F.3d at 751.

Where advances are documented by demand notes with a fixed rate of interest and regular interest payments, the lack of a maturity date and schedule of payments does not strongly favor equity. . . .

The Source of Repayments. "An expectation of repayment solely from corporate earnings is not indicative of bona fide debt regardless of its reasonableness." *Roth Steel*, 800 F.2d at 631 (emphasis added). Repayment can generally come from "only four possible sources . . .: (1) liquidation of assets, (2) profits from the business, (3) cash flow, and (4)

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refinancing with another lender." Bordo Prods., 476 F.2d at 1326 (quoting Plumb, supra, at 526).

The Tax Court found that the "source of repayments" factor favored equity. It relied upon Richard Rowe's testimony that Indmar was expected to make a profit and that repayment "has to come from corporate profits or else the company couldn't pay for it." *Indmar*, 2005 T.C.M. LEXIS 31, at *14. The full colloquy from the testimony, however, is more equivocal . . . .

Here, there is undisputed testimony by Rowe and the FTB lending officer, corroborated by stipulated evidence in the record, that clearly weighs in favor of debt on this factor. Indmar repaid a significant portion of the unpaid advances -- $ 650,000 -- not from profits but by taking on additional debt from FTB. While the interest rate on the FTB loan was lower than 10%, Indmar had to secure the bank loan with inventory, accounts and general intangibles, equipment, and personal guarantees. Thus, Indmar repaid a significant portion of the unsecured stockholder advancements by taking on secured debt from a bank, rather than by taking the funds directly from earnings. This is important evidence that the parties had no expectation that Indmar would repay the advances "solely" from earnings. The Tax Court did not discuss or even cite this evidence in its Roth Steel analysis.

The Extent to Which the Advances Were Used to Acquire Capital Assets. Nor did the Tax Court address whether Indmar used the advances for working capital or capital expenditures. "Use of advances to meet the daily operating needs of the corporation, rather than to purchase capital assets, is indicative of bona fide indebtedness." Roth Steel, 800 F.2d at 632. Richard Rowe testified that Indmar always went to a bank for funds to buy capital equipment. He also testified that all of the advances he made to Indmar were used for working capital, as opposed to capital equipment. This is uncontroverted testimony. The government points, however, to Rowe's testimony that he advanced funds even when Indmar did not "need" the funds, and argues that this somehow cuts against his testimony that the advances were used as working capital.

The government's argument is unpersuasive. We do not find that Rowe's testimony on this subject was "improbable, unreasonable or questionable," especially in the absence of the Tax Court addressing this factor in its analysis. A review of Indmar's financial statements shows that it used all of the funds it received in various ways, including working capital and capital equipment expenditures. Thus, Indmar used the advances it received from the Rowes, even if not immediately upon receipt -- i.e., Indmar identified a "need" for the advances at some point. There is nothing specific in the record, including Indmar's financial statements, that suggests the advances went to purchase capital equipment as opposed to being used for working capital. Accordingly, the government's supposition does not counter Rowe's testimony, and this factor squarely supports a finding of debt.

Sinking Fund. "The failure to establish a sinking fund for repayment is evidence that the advances were capital contributions rather than loans." *Id*. The Tax Court was correct to

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point out that the lack of a sinking fund favors equity. This factor does not, however, deserve significant weight under the circumstances. First, a sinking fund (as a type of reserve) is a form of security for debt, and the Tax Court also counted the general absence of security for the stockholder advances as favoring equity. Second, the presence or absence of a sinking fund is an important consideration when looking at advances made to highly leveraged firms. In that case, the risk of repayment will likely be high on any unsecured loans, so any commercially reasonable lender would require a sinking fund or some other form of security for repayment. Where a company has sound capitalization with outside creditors ready to loan it money (as here), there is less need for a sinking fund. See Bordo Prods., 476 F.2d at 1326.

The Remaining Roth Steel Factors. On the remaining Roth Steel factors, the Tax Court determined that one favored equity (lack of security for the advances) and four favored debt (the company had sufficient external financing available to it; the company was adequately capitalized; the advances were not subordinated to all creditors; and the Rowes did not make the advances in proportion to their respective equity holdings). These findings are well-supported in the record.

Failure to Pay Dividends. The Tax Court included in its discussion of *Roth Steel* a factor not actually cited in that case -- Indmar's failure to pay dividends. . . .

Had the Rowes charged Indmar an exorbitant interest rate, the lack of any formal dividends might have been relevant to showing that the payments were not interest payments, but disguised dividends. As this was not the case, . . ., we do not address further the relevance, if any, of the lack of dividend payments to the debt/equity question presented here.

The Tax Court Committed Clear Error. To summarize, eight of the eleven Roth Steel factors favor debt. The three remaining factors suggest the advances were equity, but, as we explained above, two of the factors -- the absence of a fixed maturity date and schedule of payments and the absence of a sinking fund -- deserve little weight under the facts of this case. Moreover, the non-Roth Steel factor relied upon by the Tax Court -- Indmar's failure to pay dividends -- has questionable relevance to our inquiry. The only factor weighing in favor of equity with any real significance -- the lack of security - does not outweigh all of the other factors in favor of debt.

Accordingly, the trial evidence, when reviewed as a whole, conclusively shows that the Rowes' advances to Indmar were bona fide loans. The Tax Court committed clear error in finding otherwise. . . .

[Concurring and dissenting decisions deleted.]

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C. Page 64, New Sec. 2.8.C. Repeal of Basis Shifting Regulations

Page 64, New Sec. 2.8.C. Add before 2.9 the following:
New Sec. 2.8.C. **Repeal of the Basis Shifting Regulations**

Withdrawal of Proposed Regulations Relating to Redemptions Taxable as Dividends
REG-150313-01, April 19, 2006

SUMMARY: This document withdraws a notice of proposed rulemaking relating to redemptions of stock in which the redemption proceeds are treated as a dividend distribution. The proposed regulations were published on October 18, 2002 (67 FR 64331). After consideration of the comments received, the IRS and Treasury Department have decided to withdraw the proposed regulations.

Background. On October 18, 2002, the IRS and Treasury Department issued proposed regulations providing guidance under sections 302 and 304 of the Internal Revenue Code regarding the treatment of the basis of stock redeemed or treated as redeemed. Section 302 provides that a corporation's redemption of its stock is treated as a distribution in part or full payment in exchange for the stock if the redemption satisfies certain criteria. If the redemption does not satisfy any of these criteria, the redemption is treated as a distribution to which section 301 applies. Under section 301(c)(1), a distribution is first treated as a dividend to the extent of earnings and profits. The remaining portion of a distribution, if any, is applied against and reduces basis of stock, and finally is treated as gain from the sale or exchange of property pursuant to section 301(c)(2) and (3).

Section 304(a)(1) treats the acquisition of stock by a corporation from one or more persons that are in control of both the acquiring and issuing corporation as if the property received for the acquired stock was received in a distribution in redemption of the stock of the acquiring corporation. Accordingly, the proposed section 302 regulations also would apply to these transactions.

Section 302 does not prescribe the treatment of the basis of the redeemed stock if the redemption is treated as a distribution to which section 301 applies. In 1955, the IRS and Treasury Department promulgated §1.302-2(c), which states that "[i]n any case in which an amount received in redemption of stock is treated as a distribution of a dividend, proper adjustment of the basis of the remaining stock will be made with respect to the stock redeemed." The regulation contains three examples illustrating a proper adjustment. In two examples, the redeemed shareholder continues to own stock of the redeeming corporation immediately after the redemption. In those cases, the basis of the redeemed shares shifts to, and increases the basis of the shares still owned by, the redeemed shareholder. In the third example, the redeemed shareholder does not directly own any stock of the redeeming corporation immediately after the redemption. He does, however, constructively own stock of the redeeming corporation immediately after the redemption because of his wife's ownership of stock in the redeeming corporation. The example concludes that the redeemed shareholder's basis in the shares surrendered in the

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redemption shifts to increase his wife's basis in her shares of stock of the redeeming corporation.

The proposed regulations provide that the basis of redeemed stock will not shift to other shares directly owned by the redeemed shareholder or to shares owned by any other person whose ownership is attributed to the redeemed shareholder. Instead, the proposed regulations provide that when section 302(d) applies to a redemption of stock, to the extent the distribution is a dividend under section 301(c)(1), an amount equal to the adjusted basis of the redeemed stock is treated as a loss recognized on the date of the redemption. The loss, generally, would be taken into account either when the facts and circumstances that caused the redemption to be treated as a section 301 distribution no longer exist, or when the redeemed shareholder recognizes a gain on the stock of the redeeming corporation (to the extent of such gain).

The IRS and Treasury Department received many comments regarding the proposed regulations, several of which were critical of the approach of the proposed regulations. Generally, these comments expressed two predominant concerns. First, commentators stated that the approach of the proposed regulations was an unwarranted departure from current law. Second, commentators were concerned that the interaction of the proposed regulations with the consolidated return rules could create the potential for two levels of tax instead of one in certain transactions. After considering all the comments, the IRS and Treasury Department have decided to withdraw the proposed regulations.

The IRS and Treasury Department are continuing to study the approach of the proposed regulations and other approaches on the treatment of the basis of redeemed stock and request further comments. In particular, the IRS and Treasury Department are interested in comments on whether a difference should be drawn between a redemption in which the redeemed shareholder continues to have direct ownership of stock in the redeemed corporation (whether the same class of stock as that redeemed or a different class) and a redemption in which the redeemed shareholder only constructively owns stock in the redeemed corporation. The IRS and Treasury Department are also interested in comments in the following two areas: (i) whether a different approach is warranted for corporations filing consolidated income tax returns; and (ii) whether a different approach is warranted for section 304(a)(1) transactions.

Additionally, the IRS and Treasury Department are studying other basis issues that arise in redemptions that are treated as section 301 distributions. Specifically, the IRS and Treasury Department are studying whether, under section 301(c)(2), basis reduction should be limited to the basis of the shares redeemed or whether it is appropriate to reduce the basis of both the retained and redeemed shares before applying section 301(c)(3). The preamble to TD 9250, 71FR 8802, indicated that the IRS and Treasury Department believe that the better view of current law is that only the basis of the shares redeemed may be recovered under section 301(c)(2). However, the IRS and Treasury Department are considering other approaches. For example, another approach would be to allocate the section 301(c)(2) portion of the distribution pro rata among the redeemed shares and the retained shares. A third approach would be to shift the basis of the shares redeemed to the remaining shares and then reduce the basis of those shares pursuant to section 301(c)(2). The IRS and Treasury Department request comments about these

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approaches or other approaches regarding circumstances in which section 301(c)(2) applies.

D. Page 89, New Sec. 2.12. Proposed Regulations on Allocation and Recovery of Basis

Page 89, New Sec. 2.12. Add at the end of the text the following:
New Sec. 2.12. Proposed Regulations on Allocation and Recovery of Basis

Proposed Regulations on Allocation and Recovery of Basis
REG-143686-07, JANUARY 21, 2009

SUMMARY: This document contains proposed regulations under sections 301, 302, 304, 351, 354, 356, 358, 368, 861, 1001, and 1016 of the Internal Revenue Code (Code). The proposed regulations provide guidance regarding the recovery of stock basis in distributions under section 301 and transactions that are treated as dividends to which section 301 applies, as well as guidance regarding the determination of gain and the basis of stock or securities received in exchange for, or with respect to, stock or securities in certain transactions. The proposed regulations affect shareholders and security holders of corporations. These proposed regulations are necessary to provide such shareholders and security holders with guidance regarding the allocation and recovery of basis on distributions of property. * * *

Background

The primary objective of these proposed regulations is to provide a single model for stock basis recovery by a shareholder that receives a constructive or actual distribution to which section 301 applies and a single model for sale and exchange transactions to which section 302(a) applies, including certain elements of a reorganization exchange. Further to this objective, these proposed regulations define the scope of the exchange that must be analyzed under particular Code provisions, and provide a methodology for determining gain realized under section 356 and stock basis under section 358.

In addition, these proposed regulations respond to comments received by the IRS and Treasury Department regarding the current section 358 regulations, such as suggestions to expand the tracing rules to stock transfers that are subject to section 351 but do not qualify as reorganizations, questions regarding whether (and, if so, to what extent) shareholder elections constitute terms of an exchange, and whether the terms of an exchange control for purposes of qualifying a transaction as a reorganization under section 368. Finally, these proposed regulations include amendments to the section 304 regulations that import the statutory amendments to that section. See section 226 of the Tax Equity and Fiscal Responsibility Act of 1982, Public Law 97 248 (96 Stat. 325, 490) (September 3, 1982), section 712(l) of the Deficit Reduction Act of 1984, Public Law 98 369 (98 Stat. 494, 953 55) (July 18, 1984), section 1875(b) of the Tax Reform Act of 1986, Public Law 99 514 (100 Stat. 2085, 2894) (October 22, 1986), and section 1013 of the Taxpayer Relief Act of 1997, Public Law 105 34 (111 Stat. 788, 918) (August 5,

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1997).

Explanation of Provisions

I. Introduction -- Exchanges and Distributions to Which Sections 301 and 302 Apply

Section 301 provides rules for the treatment of a distribution with respect to stock but does not specify how to identify the shares upon which a distribution is made. Furthermore, the tax law does not provide rules concerning whether a shareholder recovers its stock basis in the aggregate, or alternatively, whether a shareholder is required to recover stock basis share-by-share. Finally, the tax law does not provide specifically that transactions treated as section 301 distributions (i.e., redemptions under section 302(d), certain section 304 transactions, and certain reorganizations) should be subject to the same rules as actual section 301 distributions. In the reorganization context, the Code provides consequences resulting from different types of exchanges, but does not specify whether the exchange is based on a shareholder's aggregate stock holdings, or alternatively, based on particular elements of the overall exchange.

Rules related to stock basis recovery and stock basis determinations have evolved independently over many years on a transactional basis. Ad hoc development of these authorities has lead to the possibility of variant treatment of economically similar transactions to which section 301 or 302(a) applies either directly or through the operation of other Code provisions. Moreover, because there has not been a comprehensive review of these issues, many questions lack definitive answers. Prior guidance attempted to address particular areas of uncertainty within the subject matter of basis recovery and basis identification. Without the benefit of addressing all related issues, however, certain of this prior guidance was needed reconsidered. See REG-150313-01. Other guidance built the framework for basis identification that has encouraged the development of these proposed regulations.

Building on themes developed in section 1.358-2 and comments received from the tax community, this proposal is intended to be a comprehensive approach to stock basis recovery and stock basis identification to produce consistent results among economically similar transactions, regardless of the transaction type or the specific Code provision that results in the application of section 301 or 302(a).

The cornerstone of this proposal is that a share of stock is the basic unit of property that can be disposed of and, accordingly, the results of a transaction should generally derive from the consideration received in respect of that share. This guiding principle has section 1012 as its underpinning and has become fundamental to the tax treatment of shareholders, regardless of the specific nature of a shareholder's exchange. See section 1.358-2 and section 1.367(b)-13. A corollary to this basic premise is that a reorganization exchange is not an event that justifies alteration of a shareholder's tax position beyond what is necessary to reflect the results of the reorganization.

To harmonize the tax treatment of economically similar transactions, these proposed

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regulations adopt a single model for section 301 distributions (dividend equivalent transactions) and a single model for sale or exchange transactions to which section 302(a) applies (non-dividend equivalent transactions), regardless of whether section 301 or section 302(a) applies directly or by reason of section 302(d), 304 or 356.

II. Distributions with Respect to Stock and Dividend Equivalent Transactions

A. Section 301 distributions

Consistent with the fundamental notion that a share of stock is the basic unit of property, the results of a section 301 distribution should derive from the consideration received in respect of each share of stock, notwithstanding designations otherwise. *Johnson v. United States*, 435 F.2d 1257 (4th Cir. 1971). Accordingly, these proposed regulations treat a section 301 distribution as received on a pro rata, share-by-share basis with respect to the class of stock upon which the distribution is made. Thus, a distribution that is not a dividend within the meaning of section 301(c)(1) can result in gain with respect to some shares of a class while other shares have unrecovered basis.

B. Dividend equivalent redemptions

To promote consistency among transactions treated as section 301 distributions under the Code, these proposed regulations apply the same basis recovery rules described above to both dividend equivalent redemptions and certain section 304 transactions. Accordingly, under these proposed regulations, a dividend equivalent redemption results in a pro rata, share-by-share distribution to all shares of the "redeemed class" held by the redeemed shareholder immediately before the redemption. The proposed regulations define the term "redeemed class" to mean all of the shares of that class held by the redeemed shareholder. Similar to an actual section 301 distribution, the proportional approach to basis recovery in dividend equivalent redemptions can produce gain with respect to some shares while other shares have unrecovered basis.

The constructive section 301 distribution is limited to the shares of the redeemed class (instead of constructing a pro rata distribution among all shares of various classes held by the redeemed shareholder) because different classes of stock have distinct legal entitlements that are respected for federal income tax purposes. H.K. Porter Co., 87 T.C. 689 (1986); *Comm'r v. Spaulding Bakeries*, 252 F.2d 693 (2d Cir. 1958). Accordingly, a constructive section 301 distribution is conformed to an actual section 301 distribution by identifying those shares with respect to which an actual section 301 distribution would have been received, and by reducing the basis of only those shares.

i. Basis adjustments in dividend equivalent redemptions if less than all of the shares of a single class held by the taxpayer are redeemed

If less than all of the shares of a class of stock held by the taxpayer are redeemed, the proposed regulations provide that in a hypothetical recapitalization described in section 368(a)(1)(E), the redeemed shareholder is deemed to exchange all its shares in the class,

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including the redeemed shares, for the actual number of shares held after the redemption transaction. The tracing rules of the section 358 regulations apply to preserve the basis of the shares exchanged in the recapitalization in the remaining shares of the redeemed class held by the shareholder. Thus, under these proposed regulations, a dividend equivalent redemption is generally treated in the same manner, and its results are the same as, a section 301 distribution in which no shares were cancelled.

ii Basis recovery in dividend equivalent redemptions in which the taxpayer surrenders all of its shares in a single class

Under current law, if all of the shares of a single class held by a shareholder are redeemed in a dividend equivalent redemption, any unrecovered basis in the redeemed shares is permitted to shift to other shares in certain circumstances. See section 1.302-2(c). The IRS and Treasury Department believe that the shifting of stock basis is inconsistent with the fundamental principle that each share is a separate unit of property, and can lead to inappropriate results. Accordingly, these proposed regulations do not permit the shifting of basis to other shares held (directly or by attribution) by the redeemed shareholder. Instead, the proposed regulations preserve the tax consequences of the unrecovered basis for the redeemed shareholder by treating the amount of the unrecovered basis as a deferred loss of the redeemed shareholder that can be accessed when the conditions of sections 302(b)(1), (2), or (3) are satisfied, or alternatively, when all the shares of the issuing corporation (or its successor) become worthless within the meaning of section 165(g).

C. Dividend equivalent reorganization exchanges

If, pursuant to a reorganization, a shareholder receives qualifying property and boot in exchange for its target corporation stock, the tax consequences of the receipt of the boot under these proposed regulations will depend upon whether the reorganization exchange is dividend equivalent or not. See section III. of this Preamble for a description of the proposed rules that would apply if the reorganization is not dividend equivalent.

In general, the determination of whether an exchange has the effect of the distribution of a dividend for purposes of section 356(a)(2) is determined by examining the effect of the shareholder's "overall exchange." *Commissioner v. Clark*, 489 U.S. 726, 738 (1989). Thus, the key to this determination is the scope of the exchange. For example, if the shareholder exchanges shares of preferred stock solely for boot and shares of common stock solely for qualifying property pursuant to a plan of reorganization, is the determination of whether the exchange of the preferred stock for boot is dividend equivalent based solely on that particular exchange or on the overall exchange of the preferred and common stock for the qualifying property and the boot? The same question would arise with respect to each particular exchange if the shareholder exchanged the preferred and common stock for a combination of qualifying property and boot. The Clark decision examined a reorganization exchange involving a single class of stock, and does not provide guidance in the context of multiple classes of stock.

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In the case of a section 302 redemption, the exchanging shareholder determines dividend equivalency based on all the facts and circumstances. See *Zenz v. Quinlivan*, 213 F.2d 914 (C.A.6 1954). To promote consistency between sale or exchange transactions, these proposed regulations provide that the overall reorganization exchange shall be taken into account in determining whether a particular exchange is dividend equivalent. Thus, a shareholder that exchanges a class of stock solely for boot and another class of stock solely for nonqualifying property shall consider the overall exchange (the exchange of the two classes of stock for boot and qualifying property) in determining whether each particular exchange is dividend equivalent.

If it is determined that a reorganization exchange is dividend equivalent, because different classes of stock have distinct legal entitlements that are respected for federal income tax purposes, the proposed regulations provide that an exchange of a class of stock solely of boot is an exchange to which section 302(d) (and not section 356(a)(2)) applies.

To ensure similar tax treatment of dividend equivalent reorganization exchanges and dividend equivalent redemptions, if the reorganization exchange is dividend equivalent the proposed regulations limit the ability of the exchanging shareholder to specify the terms of the exchange. Specifically, if the shareholder receives more than one class of stock or surrenders one class of stock and securities, the shareholder may specify the terms of the exchange between the classes of stock surrendered (or between one or more classes of stock and securities surrendered), provided the designation is economically reasonable, but not between particular shares of the same class of stock.

As with the redemption of shares of a redeemed class in a dividend equivalent redemption, a shareholder's receipt solely of boot with respect to a class of stock in a reorganization exchange is treated as received pro rata, on a share-by-share basis, with respect to each share in the class -- under the principles of Johnson, the shareholder cannot specify that the boot is received with respect to particular shares within the class. Consequently, such an exchange could result in gain recognition with respect to some shares while other shares in the class could have recovered basis.

In formulating the proposed regulations, the IRS and Treasury Department considered different alternatives. For example, in a dividend equivalent reorganization exchange pursuant to section 356(a)(2), the IRS and Treasury Department considered whether gain realized with respect to a class should be determined in the aggregate (for example, with respect to all shares within a class). Under this approach, no gain would be realized with respect to a class that has a block of built-in gain stock and block of built-in loss stock where the built-in loss is at least equal to the built-in gain. The IRS and Treasury Department rejected such an approach because it would contradict the fundamental principle that a share is a discrete unit of property, and also would compromise the principle that a reorganization exchange is not an event that justifies stock basis averaging. The IRS and Treasury Department also considered eliminating a shareholder's ability to specify the terms of a dividend equivalent reorganization exchange based on the premise that under Johnson, all consideration received in such an exchange should be

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considered received pro rata among all shares, regardless of whether more than one class is surrendered. The IRS and Treasury Department rejected this approach in favor of the approach of the proposed regulations that is analogous to the proposed treatment of dividend equivalent redemptions, under which each share of the redeemed class is treated as receiving a pro rata share of the proceeds, and shares outside of the redeemed class are not treated as receiving any part of the distribution.

D. Special rules related to apportionment of interest and other expenses

Under section 864(e), taxpayers apportion interest expense between statutory and residual groupings on the basis of the relative values of their assets in each grouping. For this purpose, taxpayers may choose to value their assets using either fair market value or tax book value (adjusted basis). The proposed regulations provide that for purposes of apportioning expenses on the basis of the tax book value of assets, the adjusted basis in any remaining shares of the redeemed class owned by the redeemed shareholder, any shares that are not in the redeemed class, or any shares owned by certain affiliated corporations shall be increased by the amount of the unrecovered basis of redeemed shares. Thus, under the proposed regulations, the interest expense allocation and apportionment consequences of a dividend equivalent redemption are the same as an actual section 301 distribution.

E. Section 1059

Section 1059(a) provides that if a corporation receives an extraordinary dividend with respect to any share of stock and such corporation has not held such stock for more than two years before the dividend announcement date, then the corporation's basis in such stock shall be reduced (but not below zero) by the non-taxed portion of such dividends.

Except as provided in regulations, in the case of any redemption of stock which would not have been treated (in whole or in part) as a dividend if any options had not been taken into account under section 318(a)(4), or section 304(a) had not applied, any amount treated as a dividend is treated as an extraordinary dividend, without regard to the taxpayer's holding period in the stock. Section 1059(e)(1)(A)(iii). In the case of these types of redemptions, section 1059(e)(1)(A) (flush language) provides that only the basis of the stock redeemed shall be taken into account under section 1059(a). These proposed regulations do not affect the basis reduction provided for in section 1059(e)(1)(A) if section 1059(e)(1)(A)(iii) otherwise applies. Accordingly, to the extent of an extraordinary dividend described in section 1059(e)(1)(A)(iii), a redeeming shareholder would first reduce basis as prescribed by section 1059(e)(1)(A). These proposed regulations would then apply to the extent the distribution is not a dividend within the meaning of section 301(c)(1).

F. Redemptions of stock held by partnerships, trusts, and S corporations

The treatment of unrecovered basis as a deferred loss raises special issues where the redeemed shareholder is an S corporation, a partnership, or a trust (each a flow-through

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entity). These proposed regulations reserve with respect to the issues relating to redeemed shareholders that are flow-through entities pending further study and comment. The primary issue under study is whether an "outside" basis adjustment that reflects the deferred loss should occur at the time of the dividend equivalent redemption, or alternatively, when there is an inclusion date with respect to the deduction.

In general, a deferred loss is reflected in the outside basis of an interest in a flow-through entity when the deduction can be accessed by the entity. Accordingly, as a general matter, disconformity can exist between inside attributes and outside basis where an inside attribute is a deferred loss. Conversely, a net operating loss of a flow-through entity reduces the outside basis of an interest in the entity in the year that the net operating loss arises.

Although disconformity generally can exist where a flow-through entity has a deferred loss, the IRS and Treasury Department are concerned that deferred losses arising from unrecovered basis presents an opportunity to separate the deferred loss from the dividend income resulting from the redemption. The IRS and Treasury Department question whether such a separation would be appropriate, and believe that treating the deferred loss as a net operating loss in the year of the redemption for basis adjustment purposes may be the better approach. However, the IRS and Treasury Department acknowledge that it may be inappropriate to require the owners of a flow-through entity to reduce outside basis before the deferred loss can be accessed, simply because the owners of the flow-through entity cannot access the deferred loss. The IRS and Treasury Department request comments on this issue.

Flow-through entities also present the question of when it is appropriate to treat an owner of the flow-through entity as the redeemed shareholder, and when it is appropriate to treat the flow-through entity itself as the redeemed shareholder. For example, where the owner completely divests of its interest in the flow-through entity, it may be appropriate to treat the owner as the redeemed shareholder for determining whether the sale of the flow-through entity interest is an inclusion date with respect to that owner. This treatment may be more appropriate if the deferred loss is treated as a net operating loss that already has reduced the outside basis of the entity's owner. Conversely, if the deferred loss is not treated as a net operating loss, it may be more appropriate to treat the flow-through entity as the redeemed shareholder in all cases. The IRS and Treasury Department request comments on this issue.

G. Consolidated groups and basis recovery in dividend equivalent redemptions

The IRS and Treasury Department continue to study the issues raised when a redeemed shareholder with a deferred loss files a consolidated return. The IRS and Treasury Department believe that certain of the concerns raised by REG-150313-01 are addressed in these proposed regulations by the deemed recapitalization mechanic described in section II.B.i. of this Preamble.

III. Redemptions Treated as a Sale or Exchange Pursuant to Section 302(a)

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A. In general

Under current law for redemptions characterized under section 302(a), a shareholder that owns shares of stock with different bases can decide whether to surrender for redemption high basis shares, low basis shares or any combination thereof. See section 1.1012-1(c). Consistent with treating a share as a discrete unit of property, the proposed regulations do not limit this electivity. Additionally, as further discussed below, these proposed regulations affirm the ability of a shareholder to specify the terms of a reorganization exchange where the receipt of boot results in sale or exchange treatment.

B. Reorganization exchanges that result in sale or exchange treatment

If it is determined that the reorganization exchange is not dividend equivalent (as described in section II.C. of this Preamble), section 302(a) will apply to the extent shares are exchanged solely for boot. Just as a shareholder can elect to surrender high basis shares, low basis shares or any combination thereof in a non-dividend equivalent redemption, a shareholder engaging in a reorganization exchange that is not dividend equivalent can specify the receipt solely of boot for a share, provided that the terms of the exchange are economically reasonable. In such case, the shareholder will recognize gain or loss with respect to that share pursuant to section 302(a), and section 356(a)(1) will not apply.

IV. Extension of Tracing Principles to Determine Basis in Certain stock Transfers that are Not Reorganizations, and Other Proposals in Response to Specific Comments

A. Application of tracing principles to certain section 351 exchanges and capital

The current section 358 regulations apply tracing principles to determine the basis of stock received in a section 351 exchange only where the section 351 exchange also qualifies as a reorganization and no liabilities was assumed in the exchange. The principal reason for this limitation is the interaction of the basis tracing rules with the aggregate approach to gain determination under section 357(c). The IRS and Treasury Department continue to study this issue, but have concluded that the resolution of this issue is not necessary to broaden the application of the tracing rules to transfers of stock in section 351 exchanges in which no liabilities are assumed. Thus, for example, in an exchange to which section 351 applies where the transferor transfers two blocks of stock with disparate basis and other property, the separate bases will be preserved under section 358, provided that liabilities are not assumed in the exchange.

In addition, these proposed regulations incorporate the deemed issuance and recapitalization approach of the current section 358 regulations to section 351 exchanges to preserve basis if insufficient shares, or no shares at all, are actually issued in the exchange. These proposed regulations also extend the deemed issuance and recapitalization approach to shareholder capital contributions to which section 118 applies.

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B. Miscellaneous

The IRS and Treasury Department have received a number of comments on the current section 358 regulations. These proposed regulations make a number of clarifying, but nonsubstantive, modifications to the current section 358 regulations. Specifically, the proposed regulations add headings throughout the existing final sections 1.358-1 and 1.358-2 regulations without substantive change. In addition, the proposed regulations address the following comments received with respect to the current section 358 regulations.

Commentators questioned how shareholder elections factor into the terms of the exchange. These proposed regulations include two new examples illustrating the effect of such elections.

Commentators questioned the effect of the terms of an exchange on the determination of whether a transaction qualifies as a reorganization, and therefore is not subject to the general rule of section 1001. These proposed regulations include cross-references in the regulations under sections 368 and 1001 to clarify that, to the extent the terms of the exchange specify that a particular property is received in exchange for a particular property, such terms shall control for purposes of determining whether a transaction qualifies as a reorganization provided such terms are economically reasonable.

Finally, in addition to provisions relating to the determination of basis, these proposed regulations add a rule that addresses certain issues considered in Rev. Rul. 68-55 (1968-1 CB 140). Specifically, consistent with Rev. Rul. 68-55, these regulations provide that, for purposes of determining gain under section 351(b), the fair market value of each category of consideration received in a section 351 exchange is allocated between the transferred assets in based on relative fair market values.

V. Specifically Requested Comments

In addition to the comments requested throughout this Preamble, the IRS and Treasury request comments on the following areas.

The proposed regulations under section 302 do not apply to a redemption of stock described in section 306(c). Pursuant to section 306(a)(2), a redemption of stock described in section 306(c) is treated as a distribution of property to which section 301 applies. Example 2 of section 1.306-1 suggests that the unrecovered basis of redeemed section 306 stock is added to the basis of the stock with respect to which the section 306 stock was distributed. The IRS and Treasury Department request comments on whether such treatment is appropriate or whether an alternative regime should apply when such a section 306(c) redemption is treated as a section 301 distribution.

Comments are also requested regarding whether, after a section 355 pro rata split-up, the controlled corporations are the same as or different from the distributing corporation for

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purposes of determining whether the date of distribution would be an inclusion date for a deferred loss attributable to unrecovered basis.

Finally, the IRS and Treasury Department recognize that the proposed regulations may not address all related issues arising in all cash "D" reorganizations. Specifically, these proposed regulations may heighten the importance of whether the nominal share deemed issued in such a reorganization is received in respect of particular shares surrendered by the exchanging shareholder. The IRS and Treasury Department request comments with respect to this issue. * * *

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III.CHAPTER 3, INTRODUCTION TO TAXABLE AND TAX-FREE MERGERS AND ACQUISITIONS

A. Page 114, New Sec. 3.5. 2009 Domestic No Ruling Areas Related to M&A

Page 114, New Sec. 3.5. Add at the end of the text the following:
New Sec. 3.5. **Domestic No Ruling Areas Related to M&A**

Revenue Procedure 2009-3
Domestic Areas [Related to M&A] For Which Rulings, Determination Letters Will Not Be Issued
I.R.B. 2009-107

[In many instances tax attorneys and accountants will want to ask the IRS for a "private letter ruling" on a particular transaction. The ruling will set out the manner in which the IRS will treat the transaction and is binding on the IRS as long as all of the facts have been correctly disclosed. Each year the IRS issues a Rev. Proc. setting forth areas in which it will not issue private letter rulings. Set out below are excerpts from Rev. Proc. 2009-3, which sets out the "no rulings" areas for 2009 that are related to M&A transactions. In dealing with any issue it is important to ascertain if the issue is set out in the current "no ruling" Rev. Proc.]

SECTION 1. PURPOSE AND NATURE OF CHANGES

.01 The purpose of this revenue procedure is to update Rev. Proc. 2008-3, 2008-1 C.B. 110, by providing a revised list of those areas of the Internal Revenue Code under the jurisdiction of the Associate Chief Counsel (Corporate), the Associate Chief Counsel (Financial Institutions and Products), the Associate Chief Counsel (Income Tax and Accounting), the Associate Chief Counsel (Passthroughs and Special Industries), the Associate Chief Counsel (Procedure and Administration), and the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities) relating to issues on which the Internal Revenue Service will not issue letter rulings or determination letters. For a list of areas under the jurisdiction of the Associate Chief Counsel (International) relating to international issues on which the Service will not issue letter rulings or determination letters, see Rev. Proc. 2009-7, this Bulletin. For a list of areas under the jurisdiction of the Commissioner, Tax Exempt and Government Entities Division relating to issues, plans or plan amendments on which the Service will not issue letter rulings and determination letters, see, respectively, section 8 of Rev. Proc. 2009-4 (this Bulletin) and section 3.02 of Rev. Proc. 2009-6 (this Bulletin).

.02 Changes. * * *

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SECTION 2. BACKGROUND AND SCOPE OF APPLICATION

.01 Background.

Whenever appropriate in the interest of sound tax administration, it is the policy of the Service to answer inquiries of individuals and organizations regarding their status for tax purposes and the tax effects of their acts or transactions, prior to the filing of returns or reports that are required by the revenue laws.

There are, however, certain areas in which, because of the inherently factual nature of the problems involved, or for other reasons, the Service will not issue rulings or determination letters. These areas are set forth in four sections of this revenue procedure. Section 3 reflects those areas in which rulings and determinations will not be issued. Section 4 sets forth those areas in which they will not ordinarily be issued. “Not ordinarily” means that unique and compelling reasons must be demonstrated to justify the issuance of a ruling or determination letter. Those sections reflect a number of specific questions and problems as well as general areas. Section 5 lists specific areas for which the Service is temporarily not issuing rulings and determinations because those matters are under study. Finally, section 6 of this revenue procedure lists specific areas where the Service will not ordinarily issue rulings because the Service has provided automatic approval procedures for these matters.

See Rev. Proc. 2009-1 (this Bulletin) particularly section 6 captioned “Under What Circumstances Does The Service Not Issue Letter Rulings Or Determination Letters?” for general instructions and other situations in which the Service will not or ordinarily will not issue letter rulings or determination letters.

With respect to the items listed, revenue rulings or revenue procedures may be published in the Internal Revenue Bulletin from time to time to provide general guidelines regarding the position of the Service.

Additions or deletions to this revenue procedure as well as restatements of items listed will be made by modification of this revenue procedure. Changes will be published as they occur throughout the year and will be incorporated annually in a new revenue procedure published as the third revenue procedure of the year. These lists should not be considered all-inclusive. Decisions not to rule on individual cases (as contrasted with those that present significant pattern issues) are not reported in this revenue procedure and will not be added to subsequent revisions.

.02 Scope of Application.

This revenue procedure does not preclude the submission of requests for technical advice to the National Office from other offices of the Service.

.03 No-Rule Issues Part of Larger Transactions.

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If it is impossible for the Service to determine the tax consequences of a larger transaction without knowing the resolution of an issue on which the Service will not issue rulings and determinations under this revenue procedure involving a part of the transaction or a related transaction, the taxpayer must state in the request to the best of the taxpayer's knowledge and belief the tax consequences of the no-rule issue. The Service's ruling or determination letter will state that the Service did not consider, and no opinion is expressed upon, that issue. In appropriate cases the Service may decline to issue rulings or determinations on such larger transactions due to the relevance of the no-rule issue, despite the taxpayer's representation.

SECTION 3. AREAS IN WHICH RULINGS OR DETERMINATION LETTERS WILL NOT BE ISSUED

.01 Specific questions and problems. * * *

(31) Section 302.-Distributions in Redemption of Stock.-Whether § 302 (b) applies when the consideration given in redemption by a corporation consists entirely or partly of its notes payable, and the shareholder's stock is held in escrow or as security for payment of the notes with the possibility that the stock may or will be returned to the shareholder in the future, upon the happening of specific defaults by the corporation.

(32) Section 302.-Distributions in Redemption of Stock.-Whether § 302 (b) applies when the consideration given in redemption by a corporation in exchange for a shareholder's stock consists entirely or partly of the corporation's promise to pay an amount based on, or contingent on, future earnings of the corporation, when the promise to pay is contingent on working capital being maintained at a certain level, or any other similar contingency.

(33) Section 302.-Distributions in Redemption of Stock.-Whether § 302 (b) applies to a redemption of stock, if after the redemption the distributing corporation uses property that is owned by the shareholder from whom the stock is redeemed and the payments by the corporation for the use of the property are dependent upon the corporation's future earnings or are subordinate to the claims of the corporation's general creditors. Payments for the use of property will not be considered to be dependent upon future earnings merely because they are based on a fixed percentage of receipts or sales.

(34) Section 302.-Distributions in Redemption of Stock.-Whether the acquisition or disposition of stock described in § 302 (c) (2) (B) has, or does not have, as one of its principal purposes the avoidance of Federal income taxes within the meaning of that section, unless the facts and circumstances are materially identical to those set forth in Rev. Rul. 85-19, 1985-1 C.B. 94; Rev. Rul. 79-67, 1979-1 C.B. 128; Rev. Rul. 77-293, 1977-2 C.B. 91; Rev. Rul. 57-387, 1957-2 C.B. 225; Rev. Rul. 56-584, 1956-2 C.B. 179; or Rev. Rul. 56-556,1956-2 C.B. 177.

(35) Section 302 (b) (4) and (e).-Redemption from Noncorporate Shareholder in Partial

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Liquidation; Partial Liquidation Defined.-The amount of working capital attributable to a business or portion of a business terminated that may be distributed in partial liquidation.

(36) Section 312.-Effect on Earnings and Profits.-The determination of the amount of earnings and profits of a corporation.

(37) Sections 331, 453, and 1239.-The Tax Effects of Installment Sales of Property Between Entities with Common Ownership.-The tax effects of a transaction in which there is a transfer of property by a corporation to a partnership or other noncorporate entity (or the transfer of stock to such entity followed by a liquidation of the corporation) when more than a nominal amount of the stock of such corporation and the capital or beneficial interests in the purchasing entity (that is, more than 20 percent in value) is owned by the same persons, and the consideration to be received by the selling corporation or the selling shareholders includes an installment obligation of the purchasing entity.

(38) Sections 332, 351, 368 (a) (1) (A), (B), (C), (E) and (F), and 1036.-Complete Liquidations of Subsidiaries; Transfer to Corporation Controlled by Transferor; Definitions Relating to Corporate Reorganizations; and Stock for Stock of Same Corporation.-Whether a transaction qualifies under § 332, § 351 or § 1036 for nonrecognition treatment, or whether it constitutes a corporate reorganization within the meaning of § 368 (a) (1) (A) (including a transaction that qualifies under § 368 (a) (1) (A) by reason of § 368 (a) (2) (D) or § 368 (a) (2) (E)), § 368 (a) (1) (B), § 368 (a) (1) (C), § 368 (a) (1) (E) or § 368 (a) (1) (F), and whether various consequences (such as nonrecognition and basis) result from the application of that section, unless the Service determines that there is a significant issue that must be resolved in order to decide those matters. If the Service determines that there is a significant issue, and to the extent the transaction is not described in another no-rule section, the Service will rule on the entire transaction, and not just the significant issue. Notwithstanding the preceding paragraph, the Service will rule on the application of § 351 to a controlled corporation when the transaction is undertaken prior to the distribution of the stock of the controlled corporation in a transaction qualifying under § 355.

SIGNIFICANT ISSUE: A significant issue is an issue of law that meets the three following tests: (1) the issue is not clearly and adequately addressed by a statute, regulation, decision of a court, tax treaty, revenue ruling, revenue procedure, notice, or other authority published in the Internal Revenue Bulletin; (2) the resolution of the issue is not essentially free from doubt; and (3) the issue is legally significant and germane to determining the major tax consequences of the transaction. An issue of law will be considered not clearly and adequately addressed by the authorities above, and its resolution will not be essentially free from doubt when, because of concern over a legal issue (as opposed to a factual issue), taxpayer’s counsel is unable to render an unqualified opinion on what the tax consequences of the transaction will be.

OBTAINING A RULING: To obtain a ruling on a transaction involving a significant issue, the taxpayer must in its ruling request explain the significance of the issue, set forth

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the authorities most closely related to the issue, and explain why the issue is not resolved by these authorities.

(39) Section 351.-See section 3.01 (38), above.

(40) Section 358.-Basis to Distributees.-The acceptability of an estimation procedure or the acceptability of a specific sampling procedure to determine the basis of stock acquired by an acquiring corporation in a reorganization described in § 368 (a) (1) (B).

(41) Section 368.-See section 3.01 (38), above. * * *

(73) Section 7701.-Definitions.-The classification of an instrument that has certain voting and liquidation rights in an issuing corporation but whose dividend rights are determined by reference to the earnings of a segregated portion of the issuing corporation's assets, including assets held by a subsidiary.

(74) Section 7701.-See section 3.01 (8), above.

(75) Section 7704.-Certain Publicly Traded Partnerships Treated as Corporations.- Whether interests in a partnership that are not traded on an established securities market (within the meaning of § 7704 (b) and § 1.7704-1 (b)) are readily tradable on a secondary market or the substantial equivalent thereof under § 1.7704-1 (c) (1) of the Procedure and Administration Regulations.

.02 General Areas.

(1) The results of transactions that lack a *bona fide* business purpose or have as their principal purpose the reduction of Federal taxes.

(2) A matter upon which a court decision adverse to the Government has been handed down and the question of following the decision or litigating further has not yet been resolved.

(3) A matter involving alternate plans of proposed transactions or involving hypothetical situations.

(4) Whether under Subtitle F (Procedure and Administration) reasonable cause, due diligence, good faith, clear and convincing evidence, or other similar terms that require a factual determination exist. * * *

SECTION 4. AREAS IN WHICH RULINGS OR DETERMINATION LETTERS WILL NOT ORDINARILY BE ISSUED

.01 Specific questions and problems. (1) Sections 38, 39, 46, and 48.-General Business Credit; Carryback and Carryforward of Unused Credits; Amount of Credit; Energy

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Credit; Reforestation Credit.-Application of these sections where the formal ownership of property is in a party other than the taxpayer, except when title is held merely as security.
* * *

(20) Section 302.-Distributions in Redemption of Stock.-The tax effect of the redemption of stock for notes, when the payments on the notes are to be made over a period in excess of 15 years from the date of issuance of such notes.

(21) Section 302 (b) (4) and (e).-Redemption from Noncorporate Shareholder in Partial Liquidation; Partial Liquidation Defined.-Whether a distribution will qualify as a distribution in partial liquidation under § 302 (b) (4) and (e) (1) (A), unless it results in a 20 percent or greater reduction in (i) gross revenue, (ii) net fair market value of assets, and (iii) employees. (Partial liquidations that qualify as § 302 (e) (2) business terminations are not subject to this provision.)

(22) Sections 302 (b) (4) and (e), 331, 332, and 346 (a).-Effects on Recipients of Distributions in Corporate Liquidations.-The tax effect of the liquidation of a corporation preceded or followed by the transfer of all or a part of the business assets to another corporation (1) that is the alter ego of the liquidating corporation, and (2) which, directly or indirectly, is owned more than 20 percent in value by persons holding directly or indirectly more than 20 percent in value of the liquidating corporation's stock. For purposes of this section, ownership will be determined by application of the constructive ownership rules of § 318 (a) as modified by § 304 (c) (3).

(23) Section 306.-Dispositions of Certain Stock.-Whether the distribution or disposition or redemption of "section 306 stock" in a closely held corporation is in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes within the meaning of § 306 (b) (4).

(24) Sections 331 and 332.-See section 4.01 (22), above.

(25) Sections 331 and 346 (a).-Gain or Loss to Shareholders in Corporate Liquidations.-The tax effect of the liquidation of a corporation by a series of distributions, when the distributions in liquidation are to be made over a period in excess of 3 years from the adoption of the plan of liquidation.

(26) Section 346 (a).-See sections 4.01 (22) and (25), above.

(27) Section 351.-Transfer to Corporation Controlled by Transferor.-Whether § 351 applies to the transfer of an interest in real property by a cooperative housing corporation (as described in § 216 (b) (1)) to a corporation in exchange for stock or securities of the transferee corporation, if the transferee engages in commercial activity with respect to the real property interest transferred.

(28) Section 355.-Distribution of Stock and Securities of a Controlled Corporation.-Whether the active business requirement of § 355 (b) is met when, within the 5-year

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period described in § 355 (b) (2) (B), a distributing corporation acquired control of a controlled corporation as a result of the distributing corporation transferring cash or other liquid or inactive assets to the controlled corporation in a transaction in which gain or loss was not recognized as a result of the transfer meeting the requirements of § 351 (a) or § 368 (a) (1) (D). * * *

(42) Section 1362.-Election; Revocation; Termination.-All situations in which the Service has provided an automatic approval procedure or administrative procedure for an S corporation to obtain relief for late S corporation, qualified subchapter S subsidiary, qualified subchapter S trust, or electing small business trust elections. *See* Rev. Proc. 2003-43, 2003-1 C.B. 998; Rev. Proc. 2004-48, 2004-2 C.B. 172; Rev. Proc. 2004-49, 2004-2 C.B. 210; and Rev. Proc. 2007-62, 2007-41 I.R.B. 786. (For instructions on how to seek this relief, see the preceding revenue procedures.)

(43) Section 1502.-Regulations.-Whether a parent cooperative housing corporation (as defined in § 216 (b) (1)) will be permitted to file a consolidated income tax return with its transferee subsidiary, if the transferee engages in commercial activity with respect to the real property interest transferred to it by the parent. * * *

.02 General areas.

(1) Any matter in which the determination requested is primarily one of fact, *e.g.*, market value of property, or whether an interest in a corporation is to be treated as stock or indebtedness.

(2) Situations where the requested ruling deals with only part of an integrated transaction. Generally, a letter ruling will not be issued on only part of an integrated transaction. If, however, a part of a transaction falls under a no-rule area, a letter ruling on other parts of the transaction may be issued. Before preparing the letter ruling request, a taxpayer should call the Office of the Associate Chief Counsel having jurisdiction for the matters on which the taxpayer is seeking a letter ruling to discuss whether a letter ruling will be issued on part of the transaction. To determine which division has jurisdiction over a particular issue see section 3 of Rev. Proc. 2009-1 (this Bulletin). For a list of telephone numbers for the different divisions, see section 10.07 of Rev. Proc. 2009-1.

(3) Situations where two or more items or sub-methods of accounting are interrelated. If two or more items or sub-methods of accounting are interrelated, ordinarily a letter ruling will not be issued on a change in accounting method involving only one of the items or sub-methods.

(4) The tax effect of any transaction to be consummated at some indefinite future time.

(5) Any matter dealing with the question of whether property is held primarily for sale to customers in the ordinary course of a trade or business.

(6) The tax effect of a transaction if any part of the transaction is involved in litigation

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among the parties affected by the transaction, except for transactions involving bankruptcy reorganizations.

(7) (a) Situations where the taxpayer or a related party is domiciled or organized in a foreign jurisdiction with which the United States does not have an effective mechanism for obtaining tax information with respect to civil tax examinations and criminal tax investigations, which would preclude the Service from obtaining information located in such jurisdiction that is relevant to the analysis or examination of the tax issues involved in the ruling request.

(b) The provisions of subsection (a) above shall not apply if the taxpayer or affected related party (i) consents to the disclosure of all relevant information requested by the Service in processing the ruling request or in the course of an examination in order to verify the accuracy of the representations made and to otherwise analyze or examine the tax issues involved in the ruling request, and (ii) waives all claims to protection of bank or commercial secrecy laws in the foreign jurisdiction with respect to the information requested by the Service. In the event the taxpayer's or related party's consent to disclose relevant information or to waive protection of bank or commercial secrecy is determined by the Service to be ineffective or of no force and effect, then the Service may retroactively rescind any ruling rendered in reliance on such consent. * * *

(9) Except as otherwise provided in this revenue procedure (*e.g.*, under section 3.01 (38), where the Service already is ruling on a significant issue in the same transaction), a letter ruling will not ordinarily be issued with respect to an issue that is clearly and adequately addressed by statute, regulations, decisions of a court, revenue rulings, revenue procedures, notices, or other authority published in the Internal Revenue Bulletin. However, the Service may in its discretion determine to issue a ruling on such an issue if the Service otherwise is issuing a ruling on another issue arising in the same transaction. * * *

SECTION 5. AREAS UNDER STUDY IN WHICH RULINGS OR DETERMINATION LETTERS WILL NOT BE ISSUED UNTIL THE SERVICE RESOLVES THE ISSUE THROUGH PUBLICATION OF A REVENUE RULING, REVENUE PROCEDURE, REGULATIONS OR OTHERWISE * * *

.06 Sections 302 and 304.-Certain Redemptions.-Treatment of basis in a §§ 302/304 redemption. See Announcement 2006-30, 2006-1 C.B. 879.

.07 Sections 351, 358 and 362 (a).-Transfers to Corporation Controlled by Transferors; Basis to Distributees; Basis to Corporations.-The issues described as being under study in Rev. Rul. 2006-2, 2006-1 C.B. 261. * * *

.11 Section 1361.-Definition of a Small Business Corporation.-Whether a State law limited partnership electing under § 301.7701-3 to be classified as an association taxable

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as a corporation has more than one class of stock for purposes of § 1361 (b) (1) (D). The Service will treat any request for a ruling on whether a State law limited partnership is eligible to elect S corporation status as a request for a ruling on whether the partnership complies with § 1361 (b) (1) (D).

.12 Section 1502.-See section 5.05, above. * * *

SECTION 6. AREAS COVERED BY AUTOMATIC APPROVAL PROCEDURES IN WHICH RULINGS WILL NOT ORDINARILY BE ISSUED

.01 Section 338.-Certain Stock Purchases Treated as Asset Acquisitions.-All requests for an extension of time under § 301.9100-3 within which to make an election under § 338 (g) or (h) (10) where the Service has provided an administrative procedure to seek an extension. See Rev. Proc. 2003-33, 2003-1 C.B. 803 (extension automatically granted to certain persons required to file Form 8023 to make a valid section 338 election that have not filed Form 8023 by its due date). * * *

.05 Section 704 (c).-Contributed Property.-Requests from Qualified Master Feeder Structures, as described in section 4.02 of Rev. Proc. 2001-36, 2001-1 C.B. 1326, for permission to aggregate built-in gains and losses from contributed qualified financial assets for purposes of making § 704 (c) and reverse § 704 (c) allocations.

.06 Section 1362.-Election; Revocation; Termination.-All situations in which an S corporation qualifies for automatic late S corporation relief under Rev. Proc. 97-48, 1997-2 C.B. 521.

.07 Sections 1502, 1504, and 1552.-Regulations; Definitions; Earnings and Profits.-All requests for waivers or consents on consolidated return issues where the Service has provided an administrative procedure for obtaining waivers or consents on consolidated return issues. See Rev. Proc. 2002-32, 2002-1 C.B. 959, as modified by Rev. Proc. 2006-21, 2006-1 C.B. 1050 (certain corporations seeking reconsolidation within the 5-year period specified in § 1504 (a) (3) (A)); Rev. Proc. 90-39, 1990-2 C.B. 365, as modified by Rev. Proc. 2006-21, and as clarified by Rev. Proc. 90-39A, 1990-2 C.B. 367 (certain affiliated groups of corporations seeking, for earnings and profits determinations, to make an election or a change in their method of allocating the group's consolidated Federal income tax liability); and Rev. Proc. 89-56, 1989-2 C.B. 643, as modified by Rev. Proc. 2006-21 (certain affiliated groups of corporations seeking to file a consolidated return where member(s) of the group use a 52-53 week taxable year).

SECTION 7. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 2008-3, 2008-1 C.B. 110, and Rev. Proc. 2008-61, 2008-42 I.R.B. 934, are superseded. * * *

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B. Page 114, New Sec. 3.6. Expedited Treatment for Certain Reorganization and Spin-off Private Letter Rulings

Page 114, New Sec. 3.6. Add after New Sec. 3.5 the following:
New Sec. 3.6. **Expedited Treatment for Certain Reorganization and Spin-off Private Letter Rulings**

Revenue Procedure 2005-68, Currently Reflected in Revenue Procedure 2009-1
2005-41 I.R.B. 694, and 2009-1 I.R.B. 1

SECTION 1. PURPOSE

This revenue procedure amplifies Rev. Proc. 2005-1, 2005-1 I.R.B. 1, which explains how the Service provides advice to taxpayers on issues under the jurisdiction of the Associate Chief Counsel (Corporate), the Associate Chief Counsel (Financial Institutions and Products), the Associate Chief Counsel (Income Tax and Accounting), the Associate Chief Counsel (International), the Associate Chief Counsel (Passthroughs and Special Industries), the Associate Chief Counsel (Procedure and Administration), and the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities).

This revenue procedure also amplifies Rev. Proc. 2005-3, 2005-1 I.R.B. 118, which sets forth the areas of the Internal Revenue Code under the jurisdiction of the Associate Chief Counsel (Corporate), the Associate Chief Counsel (Financial Institutions and Products), the Associate Chief Counsel (Income Tax and Accounting), the Associate Chief Counsel (Passthroughs and Special Industries), the Associate Chief Counsel (Procedure and Administration), and the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities) relating to issues on which the Internal Revenue Service will not issue letter rulings or determination letters.

SECTION 2. BACKGROUND

.01 Current Procedures

Section 7 of Rev. Proc. 2005-1 provides general instructions for requesting letter rulings and determination letters. Section 7.02(4) of Rev. Proc. 2005-1 states that the Service ordinarily processes requests for letter rulings in order of the date received, and that expedited handling is granted only in rare and unusual cases.

Section 8.05(1) of Rev. Proc. 2005-1 provides that if a ruling request lacks essential information, the branch representative will tell the taxpayer that the request will be closed if the Associate does not receive the information within 21 calendar days from the date the information is requested, unless an extension of time is granted.

Section 3.01 of Rev. Proc. 2005-3 outlines specific questions and problems on which the Internal Revenue Service will not issue rulings or determination letters. Section 3.01(31)

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of Rev. Proc. 2005-3 provides that the Service will not rule on whether a transaction qualifies under § 332, § 351 or § 1036 for nonrecognition treatment, or whether it constitutes a corporate reorganization within the meaning of § 368(a)(1)(A) (including a transaction that qualifies under § 368(a)(1)(A) by reason of § 368(a)(2)(D) or § 368(a)(2)(E)), § 368(a)(1)(B), § 368(a)(1)(C), § 368(a)(1)(E), or § 368(a)(1)(F), and whether various consequences (such as nonrecognition and basis) result from the application of that section, unless the Service determines that there is a significant issue that must be resolved to decide those matters. If the Service determines that there is a significant issue, and to the extent the transaction is not described in another no-rule section, the Service will rule on the entire transaction, and not just the significant issue. Requests for rulings on whether a transaction constitutes an acquisitive corporate reorganization within the meaning of § 368(a)(1)(D) or § 368(a)(1)(G) or whether a transaction constitutes a corporate distribution under § 355 are not subject to the significant issue limitation.

Section 3.01(31) of Rev. Proc. 2005-3 further provides that a significant issue is an issue of law that meets the following tests: (1) the issue is not clearly and adequately addressed by a statute, regulation, decision of a court, tax treaty, revenue ruling, revenue procedure, notice, or other authority published in the Internal Revenue Bulletin; (2) the resolution of the issue is not essentially free from doubt; and (3) the issue is legally significant and germane to determining the major tax consequences of the transaction.

.02 New Procedures

The significant issue limitation set forth above is designed to increase the time available to the Service for processing letter rulings on transactions that involve the most difficult issues. Despite this willingness to rule on these transactions, the Service understands that taxpayers often execute transactions intended to qualify as reorganizations under § 368 that involve significant issues and distributions intended to qualify under § 355 without submitting letter ruling requests. Based on numerous comments from taxpayers and their representatives, the Service has concluded that this practice is attributable, in part, to the length of time typically associated with the letter ruling process.

The Service believes that it can better serve taxpayers and more effectively administer the internal revenue laws by resolving these issues through the private letter ruling program. Accordingly, to encourage taxpayer participation in this program, Section 7.02(4) of Rev. Proc. 2005-1 is amplified to provide expedited treatment for letter rulings on transactions intended to meet the requirements of either § 368 or § 355 for which such treatment is requested pursuant to this revenue procedure, subject to the restrictions of Section 3.01(31) of Rev. Proc. 2005-3. Instead of the typical processing period, the Service will endeavor to complete and issue letter rulings on these transactions within ten weeks from receipt of the request. It is the intention of the Service to process on an expedited basis all letter ruling requests on these transactions, provided the requirements of this revenue procedure are met. If these requirements are not met, the Service will process the letter ruling request in the usual manner. If the transaction involves an issue or issues not entirely within the jurisdiction of the Associate Chief Counsel (Corporate), the ruling

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request will be processed in the usual manner unless each Associate Chief Counsel having jurisdiction over the transaction agrees to process the ruling request on the expedited basis provided herein.

Section 8.05(1) of Rev. Proc. 2005-1 is amplified to provide that if an expedited ruling request lacks essential information, the branch representative will tell the taxpayer that the information must be submitted within 10 calendar days from the date of the request for additional information, unless an extension of time is granted. If the information is not submitted within 10 calendar days (with any extension) but is submitted within 21 calendar days (with any extension), the ruling request will be processed in the usual manner.

This revenue procedure also clarifies the term “significant issue,” as defined in Section 3.01(31) of Rev. Proc. 2005-3, for all transactions to which the significant issue requirement applies, including transactions not being considered on an expedited basis.

This is a pilot program that applies to ruling requests postmarked or, if not mailed, received after September 14, 2005. This pilot program will be evaluated by the Service periodically.

SECTION 3. REQUEST FOR COMMENTS * * *

SECTION 4. PROCEDURE

.01 Rev. Proc. 2005-1 is amplified by adding the following sentence to the first paragraph of section 7.02(4):

Notwithstanding the previous sentence, expedited handling may be available for certain transactions intended to qualify as reorganizations described in § 368 or distributions described in § 355 as provided in Rev. Proc. 2005-68, Section 4.02.

.02 Rev. Proc. 2005-1 is amplified by adding the following paragraphs to section 7.02(4):

EXPEDITED LETTER RULING PROCESS FOR REORGANIZATIONS AND FOR DISTRIBUTIONS UNDER SECTION 355: If a taxpayer requests a letter ruling on whether a transaction constitutes a reorganization under § 368 or a distribution under § 355 and asks for expedited handling pursuant to this provision, the Service will grant expedited handling. If expedited handling is granted, the Service will endeavor to complete and issue the letter ruling subject to Section 3.01(3) of Rev. Proc. 2005-3 within ten weeks after receiving the ruling request. If the transaction involves an issue or issues not entirely within the jurisdiction of the Associate Chief Counsel (Corporate), the letter ruling request will be processed in the usual manner, unless each Associate Chief Counsel having jurisdiction over an issue in the transaction agrees to process the letter ruling request on an expedited basis.

To initiate this process, the taxpayer must (i) state at the top of the first page of the

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request letter: “Expedited Handling is Requested” and (ii) provide the Associate Chief Counsel (Corporate) with a copy of the request letter by facsimile transmission (fax), without attachments, when the formal request is submitted. The fax copy should be sent to (202) 622-7707, Attn: CC:CORP (Expedite). In due course, the taxpayer must also provide the Associate Chief Counsel (Corporate) with a draft ruling letter setting forth the relevant facts, applicable representations, and requested rulings in a manner consistent with the format used by the Associate Chief Counsel (Corporate) in similar cases. See section 7.02(3) of Rev. Proc. 2005-1. In addition, the taxpayer must ensure that the formal submission of its letter ruling request complies with all of the requirements of Rev. Proc. 2005-1 (including the requirements of other applicable guidelines set forth in Appendix E of Rev. Proc. 2005-1). See section 8.05(1) of Rev. Proc. 2005-1 for a modified requirement regarding the submission of additional information. If the taxpayer does not satisfy the requirements of this paragraph, the letter ruling request will not be processed on an expedited basis, but instead will be processed in the usual manner.

.03 Rev. Proc. 2005-1 is also amplified by adding the following paragraph to section 8.05(1):

The Service will not endeavor to process a ruling request on the expedited basis provided by Rev. Proc. 2005-68, Section 4.02, unless the branch representative in Associate Chief Counsel (Corporate) receives all requested additional information within 10 calendar days from the date of the request for such additional information, unless an extension of time is granted. If the information is not provided within 10 calendar days (with any extension) but is provided within 21 calendar days (with any extension), the letter ruling request will cease to be processed on an expedited basis and instead will be processed in the usual manner.

.04 Rev. Proc. 2005-3 is amplified by adding the following sentence as the last sentence in the paragraph entitled “Significant Issue” in section 3.01(31):

An issue of law will be considered not clearly and adequately addressed by the authorities above, and its resolution will not be essentially free from doubt when, because of concern over a legal issue (as opposed to a factual issue), taxpayer’s counsel is unable to render an unqualified opinion on what the tax consequences of the transaction will be.

SECTION 5. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2005-1, 2005-1 I.R.B. 1 and Rev. Proc. 2005-3, 2005-1 I.R.B. 118 are amplified.

SECTION 6. EFFECTIVE DATE

This revenue procedure applies to all ruling requests postmarked or, if not mailed, received after September 14, 2005. * * *

Rev. Proc. 2009-1 contains the following relevant provisions:

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Issues under the jurisdiction of the Associate Chief Counsel (Corporate)

.01 Issues under the jurisdiction of the Associate Chief Counsel (Corporate) include those that involve consolidated returns, corporate acquisitions, reorganizations, liquidations, redemptions, spinoffs, transfers to controlled corporations, distributions to shareholders, corporate bankruptcies, the effect of certain ownership changes on net operating loss carryovers and other tax attributes, debt vs. equity determinations, allocation of income and deductions among taxpayers, acquisitions made to evade or avoid income tax, and certain earnings and profits questions. * * *

Expedited handling

(4) To request expedited handling. The Service ordinarily processes requests for letter rulings and determination letters in order of the date received. Expedited handling means that a request is processed ahead of requests received before it. Expedited handling is granted only in rare and unusual cases, both out of fairness to other taxpayers and because the Service seeks to process all requests as expeditiously as possible and to give appropriate deference to normal business exigencies in all cases not involving expedited handling. Notwithstanding the previous sentence, expedited handling may be available for certain transactions intended to qualify as **reorganizations** described in § 368 or distributions described in § 355, as provided below. * * *

EXPEDITED LETTER RULING PROCESS FOR **REORGANIZATIONS** UNDER § 368 AND FOR DISTRIBUTIONS UNDER § 355: If a taxpayer requests a letter ruling on whether a transaction constitutes a **reorganization** under § 368 or a distribution under § 355 and asks for expedited handling pursuant to this provision, the Service will grant expedited handling. If expedited handling is granted, the Service will endeavor to complete and issue the letter ruling, subject to Section 3.01 (38) of Rev. Proc. 2009-3, within ten weeks after receiving the ruling request. If the transaction involves an issue or issues not entirely within the jurisdiction of the Associate Chief Counsel (Corporate), the letter ruling request will be processed in the usual manner, unless each Associate Chief Counsel having jurisdiction over an issue in the transaction agrees to process the letter ruling request on an expedited basis.

To initiate this process, the taxpayer must (i) state at the top of the first page of the request letter “Expedited Handling is Requested” and (ii) provide the Associate Chief Counsel (Corporate) with a copy of the request letter by fax, without attachments, when the formal request is submitted. The fax copy should be sent to (202) 622-7707, Attn: CC:CORP (Expedite); and receipt should be confirmed shortly after the fax is sent by calling the telephone number for the office of the Associate Chief Counsel (Corporate), which is in section 10.07 (1) (a) of this revenue procedure. In due course, the taxpayer must also provide the Associate Chief Counsel (Corporate) with a draft ruling letter, in the format used by the Associate Chief Counsel (Corporate) in similar cases, which sets forth the relevant facts, applicable representations, and requested rulings. *See* section 7.02 (3) of this revenue procedure. In addition, the taxpayer must ensure that the formal

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submission of its letter ruling request complies with all of the requirements of this revenue procedure, including the requirements of other applicable guidelines set forth in Appendix E of this revenue procedure. *See* section 8.05 (1) of this revenue procedure for a modified requirement regarding the submission of additional information. If the taxpayer does not satisfy the requirements of this paragraph, the letter ruling request will be processed in the usual manner instead of on an expedited basis. **For further information regarding this EXPEDITED LETTER RULING PROCESS FOR REORGANIZATIONS UNDER § 368 AND FOR DISTRIBUTIONS UNDER § 355, call the telephone number provided in section 10.07 (1) (a) of this revenue procedure for pre-submission conferences with the Office of Associate Chief Counsel (Corporate)**. * * *

C. Page 114, New Sec. 3.7. Single Issue Rulings under Section 355

Page 114, New Sec. 3.7. Add after New Sec. 3.6 the following:
New Sec. 3.7. Single Issue Rulings under Section 355

Revenue Procedure 2009-25
2009-24 I.R.B. 1088

SECTION 1. PURPOSE

This revenue procedure describes a new pilot program for letter rulings for certain transactions under the jurisdiction of the Associate Chief Counsel (Corporate). The new program does not diminish the availability of letter rulings under existing programs.

SECTION 2. CHANGES

This revenue procedure amplifies Rev. Proc. 2009-1, 2009-1 I.R.B. 1, which explains how the Internal Revenue Service (Service) provides advice to taxpayers on issues under the jurisdiction of the Associate Chief Counsel (Corporate). This revenue procedure also amplifies Rev. Proc. 2009-3, 2009-1 I.R.B. 107, which sets forth the areas of the Internal Revenue Code (Code) under the jurisdiction of the Associate Chief Counsel (Corporate) relating to issues on which the Service will not issue letter rulings.

SECTION 3. BACKGROUND

.01 Current Procedures

Ordinarily, the Service will not issue a letter ruling on only part of an integrated transaction. Section 6.03 of Rev. Proc. 2009-1; Section 4.02 (2) of Rev. Proc. 2009-3. If, however, a part of a transaction falls under a no-rule area, a letter ruling on other parts of the transaction may be issued. Where it is impossible for the Service to determine the tax

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consequences of a larger transaction without knowing the resolution of an issue on which the Service will not issue rulings under Rev. Proc. 2009-3, and the Service nevertheless rules on the larger transaction, then the taxpayer must state in the request to the best of the taxpayer's knowledge and belief the tax consequences of the no-rule issue. Section 2.03 of Rev. Proc. 2009-3. The Service's ruling letter will state that the Service did not consider, and no opinion is expressed upon, the no-rule issue. In appropriate cases, the Service may decline to issue rulings on such larger transactions due to the relevance of the no-rule issue, despite the taxpayer's representation.

In addition, the Service generally does not issue letter rulings with respect to an issue that is clearly and adequately addressed by statute, regulations, decisions of a court, or authorities published in the Internal Revenue Bulletin. Section 6.11 of Rev. Proc. 2009-1 and section 4.02 (9) of Rev. Proc. 2009-3. Similarly, unless the Service determines that there is a significant issue (as defined in section 3.01 (38) of Rev. Proc. 2009-3), the Service will not issue a ruling on whether a transaction qualifies for nonrecognition treatment under § 332, § 351 (except for certain transfers undertaken before § 355 distributions) or § 1036. Likewise, absent a significant issue, the Service will not issue a ruling as to whether a transaction constitutes a corporate reorganization within the meaning of § 368 (a) (1) (A) (including a transaction that qualifies under § 368 (a) (1) (A) by reason of § 368 (a) (2) (D) or § 368 (a) (2) (E)), § 368 (a) (1) (B), § 368 (a) (1) (C), § 368 (a) (1) (E) or § 368 (a) (1) (F), or as to the various consequences (such as nonrecognition and basis adjustments) that arise as a result of a transaction constituting a corporate reorganization. If the Service determines that there is a significant issue, and to the extent the transaction is not described in another no-rule section, the Service will rule on the entire transaction, and not just the significant issue. Section 3.01 (38) of Rev. Proc. 2009-3.

.02 New Procedures

In order to use Service resources more efficiently and to increase the availability of private letter rulings, this revenue procedure allows taxpayers to request rulings on one or more issues that: (1) are solely under the jurisdiction of the Associate Chief Counsel (Corporate), (2) are significant (as defined in section 3.01 (38) of Rev. Proc. 2009-3), and (3) involve the tax consequences or characterization of a transaction (or part of a transaction) that occurs in the context of a § 355 distribution. Under this program, taxpayers may request and the Service may issue a ruling on part of a transaction rather than on the larger transaction. In addition, taxpayers may request and the Service may issue a ruling on a particular legal issue under a Code section or a section of the Income Tax Regulations (Regulations) rather than a ruling that addresses all aspects of that Code or Regulations section (or any other section). For example, the Service may rule on whether the acquisition of the assets of one corporation by another corporation meets the continuity of business enterprise requirement of § 1.368-1 (d) or is described in § 355 (b) (2) (C) even though the ruling does not address overall qualification of the transaction under § 368 or § 355, respectively, as long as the acquisition occurs in the context of a § 355 distribution. Accordingly, section 6.03 of Rev. Proc. 2009-1 and sections 3.01 (38) and 4.02 (2) of Rev. Proc. 2009-3 are amplified to provide that the Service will issue

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letter rulings regarding such significant issues under the conditions specified herein.

Ruling requests under this revenue procedure must comply with the relevant requirements of any other applicable revenue procedures. See, e.g., Appendix E of Rev. Proc. 2009-1. For example, a request for a § 351 ruling on a transaction that occurs in the context of a § 355 distribution must provide all of the information required by Rev. Proc. 83-59, 1983-2 C.B. 575. However, if the request is solely for a ruling on a significant issue under § 351, the request must provide the information and representations required by Rev. Proc. 83-59 that pertain only to that significant issue. Further, where a taxpayer is requesting a ruling regarding a significant issue under a Code or Regulations section (e.g., § 368 (a) (2) (C)), the taxpayer must provide a representation regarding qualification or characterization of the transaction under such Code or Regulations section (e.g., § 368 (a) (1) (A)) assuming that the Service rules as requested. The Service reserves the right to rule on any other issue in, or part of, the transaction (including ruling adversely) if the Service believes it is in the best interests of tax administration. Cf. section 2.01 of Rev. Proc 2009-3.

All pertinent no-rule policies governing the Service's ruling practice will govern requests for rulings made pursuant to this revenue procedure. See, for example, Rev. Proc. 2003-48, 2003-2 C.B. 86 (no-rule policy regarding business purpose and device issues under § 355, and § 355 (e) plan issues). In addition, the Service will not grant a ruling on a significant non-plan issue or issues under § 355 (e) unless an adverse ruling on such non-plan issue or issues would result in there being a direct or indirect acquisition by one or more persons of stock representing a 50-percent or greater interest in the distributing corporation or the controlled corporation that is part of a plan under § 355 (e). With respect to ruling requests regarding the effect of a redemption under section 355 (e), the Service will entertain such requests under the conditions described in sections 5.09 and 5.10 of this revenue procedure. Rev. Proc. 2009-3 is amplified to reflect these policies.

The Service will, if requested, endeavor to issue letter rulings requested pursuant to this revenue procedure within ten weeks from receipt of the request, provided that the request meets the requirements of sections 7.02 (4) and 8.05 (1) of Rev. Proc. 2009-1 as amplified by this revenue procedure.

The ruling program under this revenue procedure is a pilot program that applies to ruling requests postmarked or, if not mailed, received after May 4, 2009. This pilot program will be evaluated by the Service periodically.

SECTION 4. REQUEST FOR COMMENTS

The Service requests comments regarding the pilot program. Comments should refer to Rev. Proc. 2009-25, and should be submitted to:

Internal Revenue Service

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P. O. Box 7604

Ben Franklin Station

Washington, DC 20044

Attn: CC:PA:RU

Room 5226

or electronically via the Service internet site at:

Notice.Comments@irscounsel.treas.gov (the Service comments e-mail address). All comments will be available for public inspection and copying.

SECTION 5. PROCEDURE

.01 Rev. Proc. 2009-1 is amplified by adding the following paragraphs to section 6.03:

In addition, the Office of the Associate Chief Counsel (Corporate) may issue a letter ruling on part of an integrated transaction without ruling on the larger transaction if the requested ruling addresses one or more issues that: (1) are under the jurisdiction of the Associate Chief Counsel (Corporate), (2) are significant (as defined in section 3.01 (38) of Rev. Proc. 2009-3, this Bulletin), and (3) involve the tax consequences or characterization of a transaction (or part of a transaction) that occurs in the context of a § 355 distribution. The Service may also rule on a particular legal issue under a Code or Regulations section without ruling on all aspects of such Code or Regulations section if the issue meets the three conditions of the preceding sentence.

Before preparing the letter ruling request under this section 6.03, a taxpayer should call the Office of the Associate Chief Counsel (Corporate) at the telephone number provided in section 10.07 (1) (a) of this revenue procedure for pre-submission conferences to discuss with one of the branches whether the Office of the Associate Chief Counsel (Corporate) will issue a letter ruling under this section 6.03. The Service reserves the right to rule on any other aspect of the transaction (including ruling adversely) if the Service believes it is in the best interests of tax administration. Cf. section 2.01 of Rev. Proc. 2009-3.

All requests for a ruling under this section 6.03 must contain the following:

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- (1)

  A narrative description of the transaction that puts the issue in context;

- (2)

  An explanation concerning why the issue is significant within the meaning of section 3.01 (38) of Rev. Proc. 2009-3;

- (3)

  Applicable information from relevant revenue procedures with respect to the significant issue. See Appendix E of this revenue procedure (referring to, inter alia, Rev. Proc. 96-30, 1996-1 C.B. 696, as modified and amplified by Rev. Proc. 2003-48, 2003-2 C.B. 86);

- (4)

  The precise ruling being requested;

- (5)

  Where the taxpayer is requesting a ruling on the tax treatment of part of an integrated transaction, a representation regarding the relevant tax consequences of the larger transaction (to the best knowledge and belief of the taxpayer), assuming that the Service issues the requested ruling; additionally, where the taxpayer is requesting a ruling on a particular legal issue under a Code section or section of the Regulations (e.g., § 1.368-2 (k)), a representation (to the best knowledge and belief of the taxpayer) regarding qualification or characterization of the transaction under such Code or Regulations section (e.g., § 368 (a) (1) (A)), assuming that the Service issues the requested ruling; and

- (6)

  A statement that no rulings outside the jurisdiction of the Associate Chief Counsel (Corporate) are requested.

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If the Service issues a ruling on a significant issue under this procedure, then the letter ruling will state that no opinion is expressed as to the overall tax consequences of the transactions described in the letter ruling or as to any issue or step not specifically addressed by the letter. In addition, letter rulings under this procedure will contain the following (or similar) language at the beginning of the letter:

This Office expresses no opinion as to the overall tax consequences of the transaction(s) described in this letter. Rather, the ruling(s) contained in this letter only address one or more discrete legal issues involved in the transaction.

.02 Rev. Proc. 2009-1 is amplified by replacing the last sentence of the first paragraph of section 7.02 (4) with the following:

Notwithstanding the previous sentence, expedited handling may be available for certain issues under the jurisdiction of the Associate Chief Counsel (Corporate), as provided below.

.03 Rev. Proc. 2009-1 is amplified by replacing the heading and the first sentence of the seventh paragraph of section 7.02 (4) with the following:

EXPEDITED LETTER RULING PROCESS FOR CERTAIN REQUESTS UNDER THE JURISDICTION OF THE ASSOCIATE CHIEF COUNSEL (CORPORATE): If a taxpayer requests a letter ruling on whether a transaction constitutes a reorganization under § 368 or a distribution under § 355, or a letter ruling involving certain significant issues under the jurisdiction of the Associate Chief Counsel (Corporate) as described in section 6.03 of this revenue procedure, and the taxpayer asks for expedited handling pursuant to this provision, the Service will grant expedited handling.

.04 Rev. Proc. 2009-1 is amplified by replacing the last sentence of section 7.02 (4) with the following:

For further information regarding this EXPEDITED LETTER RULING PROCESS FOR CERTAIN REQUESTS UNDER THE JURISDICTION OF THE ASSOCIATE CHIEF COUNSEL (CORPORATE), call the telephone number provided in section 10.07 (1) (a) of this revenue procedure for pre-submission conferences with the Office of Associate Chief Counsel (Corporate).

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.05 Rev. Proc. 2009-1 is amplified by replacing the first sentence of the last paragraph of section 8.05 (1) with the following:

The Service will not endeavor to process on an expedited basis a ruling request regarding reorganizations under § 368, distributions under § 355, or certain significant issues under the jurisdiction of the Associate Chief Counsel (Corporate) as described in section 6.03 of this revenue procedure unless the branch representative in the Office of Associate Chief Counsel (Corporate) receives all requested additional information within 10 calendar days from the date of the request for such additional information, unless an extension of time is granted.

.06 Rev. Proc. 2009-1 is amplified by replacing the first sentence of the third paragraph of section 19 with the following:

The collections of information in this revenue procedure are in sections 5.06, 6.03, 7.01, 7.02, 7.03, 7.04, 7.05, 7.07, 8.02, 8.05, 10.01, 10.06, 10.07, 11.11, 13.02, 15.02, 15.07, 15.08, 15.09, 15.11, paragraph (B) (1) of Appendix A, Appendix C, and Appendix E (subject matter-rate orders; regulatory agency; normalization).

.07 Rev. Proc. 2009-1 is amplified by replacing the second sentence of Appendix C, Item 35 with the following sentence:

Note that certain requests under the jurisdiction of the Associate Chief Counsel (Corporate) may receive expedited treatment without stating a compelling need.

.08 Rev. Proc. 2009-3 is amplified by starting a new paragraph immediately before the last sentence of the first paragraph of section 3.01 (38) and by adding the following sentences at the end of the revised first paragraph in section 3.01 (38):

However, the Service may rule on a significant issue in a transaction that occurs in the context of a § 355 distribution without ruling on the entire transaction. See section 6.03 of Rev. Proc. 2009-1. Before preparing the letter ruling request, a taxpayer should call the Office of the Associate Chief Counsel (Corporate) at (202) 622-7700 to discuss with one of the branches whether the Office of the Associate Chief Counsel (Corporate) will issue a letter ruling only involving that significant issue. The Service reserves the right to rule on any other issue in the transaction (including ruling adversely) if the Service believes it is in the best interests of tax administration. Cf. section 2.01 of this revenue procedure.

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.09 Rev. Proc. 2009-3 is amplified by adding the following paragraph to section 3.01:

Section 355.-Distribution of Stock and Securities of a Controlled Corporation.-Whether the distribution of the stock of a controlled corporation is being carried out for one or more corporate business purposes, whether the transaction is used principally as a device, and whether the distribution and an acquisition are part of a plan under § 355 (e). See Rev. Proc. 2003-48, 2003-2 C.B. 86. Notwithstanding the preceding sentence, the Service may issue a ruling regarding the effect of redemptions under § 355 (e) pending the issuance of temporary or final regulations regarding redemptions under § 355 (e) if an adverse ruling on such question would result in there being a direct or indirect acquisition by one or more persons of stock representing a 50-percent or greater interest in the distributing corporation or the controlled corporation that is part of a plan under § 355 (e).

.10 Rev. Proc. 2009-3 is amplified by adding the following paragraph to section 4.01:

Section 355.-Distribution of Stock and Securities of a Controlled Corporation.-Any issue under § 355 (e) other than whether a distribution and an acquisition are part of a plan (i.e., any non-plan issue). Notwithstanding the preceding sentence, the Service generally will rule on a non-plan issue or issues (e.g., whether a corporation constitutes a predecessor of distributing) if an adverse ruling on such non-plan issue or issues would result in there being a direct or indirect acquisition by one or more persons of stock representing a 50-percent or greater interest in the distributing corporation or the controlled corporation that is part of a plan under § 355 (e).

.11 Rev. Proc. 2009-3 is amplified by adding the following paragraph to section 4.02 (2):

Notwithstanding the previous paragraph, the Office of the Associate Chief Counsel (Corporate) may issue a letter ruling on part of an integrated transaction without ruling on the larger transaction if such transaction occurs in the context of a § 355 distribution. See section 6.03 of Rev. Proc. 2009-1. Before preparing the letter ruling request, a taxpayer should call the Office of the Associate Chief Counsel (Corporate) at (202) 622-7700 to discuss with one of the branches whether the Office of the Associate Chief Counsel (Corporate) will issue a letter ruling only involving part of the transaction. The Service reserves the right to rule on any other part of the transaction (including ruling adversely) if the Service believes it is in the best interests of tax administration. Cf. section 2.01 of this revenue procedure.

SECTION 6. EFFECT ON OTHER REVENUE PROCEDURES

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Rev. Proc. 2009-1, 2009-1 I.R.B. 1, and Rev. Proc. 2009-3, 2009-1 I.R.B. 107, are amplified.

SECTION 7. EFFECTIVE DATE

This revenue procedure is effective May 4, 2009. * * * Top of Form

D. Page 114, New Sec. 3.8. Treasury and IRS Priority Guidance Plan for Corporate Issues-- 2006-2007

Page 114, New Sec. 3.8. Add after the New 3.6 the following:
New Sec. 3.8. **Treasury and IRS Priority Guidance Plan for Corporate Issues—2006-2007**

DEPARTMENT OF THE TREASURY

Washington, DC 20220

August 15, 2006

Department of the Treasury

2006 - 2007 Priority Guidance Plan * * *

We are pleased to announce the release of the 2006 - 2007 Priority Guidance Plan. * * *

The 2006 - 2007 Priority Guidance Plan contains 264 projects to be completed over a twelve-month period, from July 2006 through June 2007. In addition to the items on this year's plan, the Appendix lists the more routine guidance that is published each year. * * * [Readers may want to refer to this plan when considering various issues.]

CONSOLIDATED RETURNS

1. Regulations [*i.e.*, proposed regulations, temporary regulations or final regulations] under section 1502 regarding liquidations under section 332 into multiple members. Proposed regulations were published on February 22, 2004.

2. Regulations revising section 1.1502-13(g) regarding transactions involving obligations of consolidated group members.

3. Regulations under section 1502 regarding excess loss accounts. Temporary regulation section 1.1502-19T was published on January 26, 2006.

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4. Regulations revising sections 1.1502-35 and 1.337(d)-2 regarding treatment of member stock.

5. Regulations regarding the tacking rule for filing life/nonlife consolidated returns. Temporary regulation section 1.1502-47T was published on April 25, 2006.

6. Regulations regarding agency for a consolidated group where the common parent is a foreign entity. Temporary regulation section 1.1502-77T was published on March 14, 2006.

CORPORATIONS AND THEIR SHAREHOLDERS

1. Regulations to facilitate electronic filing and reduce taxpayer burden. Temporary regulations were published on May 30, 2006.

2. Guidance regarding the recovery of basis in redemptions of corporate stock governed by section 301. A notice was published in the Federal Register on April 19, 2006.

3. Regulations enabling elections for certain transactions under section 336(e).

4. Regulations revising section 1.355-3 regarding the active trade or business requirement.

5. Regulations regarding predecessors and successors under section 355(e). Proposed regulations were published on November 22, 2004.

6. Guidance regarding the applicability of section 357(c) to acquisitive reorganizations under section 368(a)(1)(D).

7. Guidance under section 362(e) regarding the importation or duplication of losses. Notice 2005-70 was published on October 11, 2005.

8. Regulations regarding transactions involving the transfer or receipt of no net equity value. Proposed regulations were published on March 10, 2005.

9. Regulations revising section 1.368-2(k) regarding transfers of assets after putative reorganizations. Proposed regulations were published on August 18, 2004.

10. Revision of Rev. Proc. 81-70 providing guidelines for estimating stock basis in reorganizations under section 368(a)(1)(B). Comments regarding these guidelines were requested in Notice 2004-44.

11. Guidance regarding the scope of section 368(a)(1)(D).

12. Regulations under section 368(a)(1)(F). Proposed regulations were published on August 12, 2004.

13. Guidance under section 382, including regulations regarding built-in items under section 382(h)(6). Built-in items under section 382(h)(6) were previously addressed in Notice 2003-65.

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14. Guidance regarding the transfer of treasury stock to a corporation controlled by the transferor. See Rev. Rul. 2006-2, revoking Rev. Rul. 74-503.

15. Revised regulations under section 1561 regarding the allocation of certain tax benefits among related corporations. * * *

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IV. CHAPTER 4, TAXABLE ASSET ACQUISITIONS: INCLUDING THE TREATMENT OF NET OPERATING LOSSES

A. Page 126, New Sec. 4.2.B.4. The All Cash Nondivisive 368(a)(1)(D) Reorganization

Page 126, New Sec. 4.2.B.4. Add before 4.2.C the following:
New Sec. 4.2.B.4. **The All Cash Nondivisive 368(a)(1)(D) Reorganization**

In 2005 the IRS issued Private Letter Ruling 200551018, which held that a sale of assets by a corporation to a second corporation that was substantially controlled by the shareholders of the selling corporation was a taxable sale and not a nondivisive (D) reorganization under Section 368(a)(1)(D). This ruling sparked a debate in the tax bar about the soundness of the principle embodied in the ruling and led to the issuance of Temporary Regulations addressing the issue in December 2006. The private letter ruling, two of the letters from tax lawyers addressing the issue, and the temporary regulations are set out in Sections 4.2.B.4.a-d below.

B. Page 126, New Sec. 4.2.B.4.a. The All Cash (D)—The Private Letter Ruling

Page 126, New Sec. 4.2.B.4.a. Add after New Sec. 4.2.B.4 the following:
New Sec. 4.2.B.4.a.. **The All Cash (D)—The 2005 Private Letter Ruling**

Private Letter Ruling 200551018
PLR 200551018; 2005 PLR LEXIS 1180, September 15, 2005

LEGEND:

A = * * *
B = * * *
C = * * *
D = * * *
E = * * *
x = * * *
SB/SE Official = * * *

Dear * * *:

This responds to your request dated June 21, 2004, and supplemental correspondence, for

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a letter ruling under section 197 of the Internal Revenue Code as to the proper treatment of goodwill when such goodwill is purchased from a related corporation in a transaction to which the anti-churning rules of section 197(f)(9) do not apply.

FACTS

Taxpayer, an S corporation, was incorporated under the laws of the state of * * * in * * * and is engaged in the business of selling store fixtures to retail stores located throughout the United States. Taxpayer began operations during 1994. None of the assets used in the formation of Taxpayer constituted a previous trade or business.

Taxpayer has two 50% shareholders, A and B. Taxpayer's general manager is C. C has no ownership interest in Taxpayer.

Taxpayer will form New Corp, which will be 90% owned by B and 10% by C. Once formed, New Corp will make an election to be treated as an S corporation and will operate in the same locations, industry, and manner that Taxpayer operated. Since B is a 50% shareholder of Taxpayer and will be a 90% shareholder of New Corp, Taxpayer and New Corp are related parties for purposes of section 197(f)(9).

D, who indirectly owns 50% of Taxpayer through A, desires to retire and sever all ties with Taxpayer. E, who owns 50% of Taxpayer through B, desires to continue Taxpayer's business. C desires to obtain an ownership interest in Taxpayer's business. To effectuate these aims, E and C have decided to form New Corp to purchase the assets and assume the liabilities of Taxpayer. New Corp's purchase price will be equal to the fair market value of the Taxpayer's assets, or approximately x, at the time of sale.

New Corp will purchase the Taxpayer's assets by issuing Taxpayer two installment notes. Each installment note will represent 50% of the fair value of the total assets, less the amount of debt assumed. Each note will contain a stated interest rate of %. Both notes will require monthly interest payments over their respective lives. One of the installment notes ("Note 1") will require principal payments during the years * * *, * * *, * * *, * * *, and * * *. The other installment note ("Note 2") will require principal payments during the years * * *, * * *, * * *, and * * *. The portion of the gain on the asset sale that is attributable to the installment notes will be deferred pursuant to section 453, except to the extent of any principal paid during the year of sale and any section 1245 or section 1250 recapture. Any gain attributable to the assumption of liabilities by New Corp will be taxable in the year of sale. Taxpayer will be subject to a tax on built-in gains under section 1374.

Taxpayer will adopt a plan of liquidation prior to the asset sale. Subsequent to the asset sale (and within 12 months of the adoption of the plan of liquidation), Taxpayer will liquidate and distribute Note 1 to A and Note 2 to B. No gain or loss will be recognized by Taxpayer upon the distribution of the installment notes receivable, pursuant to section 453(h), because: (1) the installment obligations will be acquired from the sale of Taxpayer's assets during the 12-month period beginning on the date of adoption of a plan

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of complete liquidation; and (2) the qualifying installment obligations will then be distributed to Taxpayer's shareholders as part of the liquidation.

At the time of the sale, the total fair market value of the Taxpayer's assets, which mainly consist of cash, receivables, prepaid expenses, inventory, and fixed assets, will be significantly higher than the fair value of the assets recorded on Taxpayer's books. This difference will be recorded on the books of New Corp as goodwill (a Class VII asset).

The facts above and their tax consequence are representations by Taxpayer.

RULING REQUEST

New Corp intends to amortize the goodwill at issue over 15 years pursuant to section 197. Accordingly, Taxpayer requests a ruling that, pursuant to section 197, New Corp is entitled to amortize the cost of the goodwill that New Corp acquires as a result of its purchase of Taxpayer's business using the straight-line method and a 15-year recovery period.

LAW AND ANALYSIS

Section 197(a) provides that a taxpayer shall be entitled to an amortization deduction with respect to any amortizable section 197 intangible. The amount of such deduction shall be determined by amortizing the adjusted basis of such intangible ratably over the 15- year period beginning with the month in which the intangible was acquired. Section 197(c) provides that the term "amortizable section 197 intangible" means any section 197 intangible which is acquired by the taxpayer after August 10, 1993, and which is held in connection with the conduct of a trade or business or an activity described in section 212. Section 197(d)(1)(A) defines the term "section 197 intangible" to include goodwill.

Section 197(f)(9) provides, in part, that the term "amortizable section 197 intangible" shall not include goodwill acquired by a taxpayer if such intangible was held or used at any time on or after July 25, 1991, and on or before August 10, 1993, by the taxpayer or a related person. Section 197(f)(9)(C) defines a related person to include those bearing a relationship to such person described in section 267(b), with "20 percent" substituted for "50 percent." Thus, the anti-churning rules apply to goodwill transferred after August 10, 1993, only if the taxpayer or a related person held or used the goodwill at any time from July 25, 1991, to August 10, 1993.

Section 267(b)(11) defines related parties as an S corporation and another S corporation if the same persons own more than 50 percent in value of the outstanding stock of each corporation.

Section 1060(a) provides that in the case of any applicable asset acquisition, the rules of section 1060 are to be utilized to determine both the transferee's basis in the assets transferred and the gain or loss of the transferor with respect to such acquisition.

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Section 1060(c) provides that the term “applicable asset acquisition” means any transfer (whether directly or indirectly) of assets that constitute a trade or business, and with respect to which the transferee’s basis in such assets is determined wholly by reference to the consideration paid for such assets.

Section 1.1060-1(c)(2) of the Income Tax Regulations provides that, to determine the seller’s amount realized for each of the assets sold (and therefore to determine the buyer’s basis for each of the assets acquired), the residual method under sections 1.338-6 and 1.338-7 should be used. Under this method, the purchase price is first allocated to Class I assets (cash and cash equivalents). Then the remaining consideration is allocated to Class II assets in proportion to their fair market value, followed by Class III assets through Class VI assets, respectively, in proportion to their fair value. Finally, any remaining, unallocated portion of the purchase price is then allocated to Class VII assets (goodwill and going concern value).

Taxpayer represents that, based on the consideration paid by New Corp for Taxpayer’s assets and allocating the consideration paid pursuant to section 1060, New Corp will acquire significant goodwill in the transaction. The goodwill acquired is part of the purchase of assets constituting a trade or business. B is a 50% shareholder of Taxpayer and will be a 90% shareholder of New Corp. As a result, Taxpayer and New Corp are related parties for purposes of section 197(f)(9). However, Taxpayer represents that Taxpayer began operations during 1994. Furthermore, Taxpayer represents that none of the assets used in the formation of Taxpayer constituted a previous trade or business. Thus, Taxpayer’s goodwill asset did not exist during the section 197(f)(9) transition period, and the anti-churning rules of section 197(f)(9) do not apply.

Finally, by letter dated * * *, Taxpayer represents that, for purposes of sections 1239 and 453(g), the ruling request at issue does not involve a sale between related persons.

RULING

Based solely on the Taxpayer’s representations and the above stated analysis, New Corp is entitled to amortize the cost of the goodwill that New Corp acquires as a result of its purchase of Taxpayer’s business using the straight-line method and a 15year recovery period, pursuant to section 197. We express no opinion on whether the installment notes are characterized as debt.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative. We are also sending a copy of this letter to the SB/SE Official.

Sincerely,

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Charles B. Ramsey
Branch Chief, Branch 6
(Passthroughs & Special
Industries)

C. Page 126, New Sec. 4.2.B.4.b. The All Cash (D)—The Steptoe & Johnson Letter to the IRS

Page 126, New Sec. 4.2.B.4.b. Add after New Sec. 4.2.B.4.a the following:
New Sec. 4.2.B.4.b. **The All Cash (D)—The Steptoe & Johnson Letter to the IRS**

Letter to IRS from Steptoe & Johnson and Others Raising Issues with PLR 200551018
March 31, 06

March 31, 2006
Via HAND DELIVERY
Mr. William D. Alexander
Associate Chief Counsel (Corporate)
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224
Re: **"D" Reorganizations and PLR 200551018**
Dear Bill.:
Enclosed is a letter regarding section 368(a)(1)(D) and the determination in PLR 200551018 that the transaction in question was not a "D" reorganization. The letter is being submitted on behalf of the named signatories thereto. The letter is not intended to be an exhaustive analysis of "D" reorganizations. Instead, the letter is being submitted in order to facilitate further consideration and discussion of the issues raised by PLR 200551018 and, hopefully, the issuance of additional guidance by the Internal Revenue Service.
We look forward to meeting with you at your convenience to further discuss these issues.
/s/
Mark J. Silverman * * *
Re: **"D" Reorganizations and PLR 200551018**
Dear Mr. Alexander:
We are writing to raise questions about the determination in PLR 200551018 that the transaction in question was not a reorganization under section 368(a)(1)(D). In PLR 200551018, unrelated corporate shareholders A and B each owned 50 percent of the stock of Corporation X ("X"). Corporation C ("C") was unrelated to A and B. B and C formed Newco, with B owning 90 percent of the Newco stock and C owning the remaining 10 percent. X sold all of its assets to Newco in exchange for two installment notes. Immediately thereafter, X liquidated, distributing one note to A and one note to B. PLR

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200551018 held that Newco was entitled to amortize the cost of the goodwill acquired as a result of the purchase of assets from X.

Although not specifically stated or analyzed, this ruling assumed that the transaction did not qualify as a reorganization under section 368(a)(1)(D). Informal conversations with government representatives indicate that this determination represents the reasoned judgment of the Internal Revenue Service (the "Service") that the transaction in question did not qualify as a "D" reorganization. PLR 200551018 does not discuss the reasons for rejecting the application of section 368(a)(1)(D) to the transaction. In turn., the ruling raises questions concerning the viability of past guidance. This letter is intended to identify some of those questions and facilitate further consideration and discussion of these issues by the Service and practitioners.

The Service and the courts have historically held that, under certain circumstances, an actual transfer and distribution of stock either is not required or is deemed to have occurred because an actual transfer and distribution would be a "meaningless gesture." The circumstances where the Service and the courts have so ruled can be divided into three categories: (1) Target and Acquiring are 100% owned by a single party (or multiple parties in the same percentages) *through direct stock ownership* ("Category 1");(2) Target and Acquiring are 100% owned by a single party (or multiple parties in the same percentages) as a result of *taking into account indirect ownership through subsidiaries* ("Category 2"); and (3)Target and Acquiring are 100% owned by a single party as a result of *applying the other attribution rules of section 318* ("Category 3").

PLR 200551018 represents yet a fourth category of transactions because Target and Acquiring are commonly controlled, but do not have 100% common ownership in the same percentages, either actually, indirectly, or through other section 318 attribution ("Category 4"). We understand that PLR 200551018 represents the government's position that the Category 4 transactions do not qualify as "D" reorganizations. What is not clear is the reasoning supporting this conclusion and whether such unstated reasoning implies a change to the government's longstanding view as to the proper treatment of any of the transactions described in Categories 1, 2, and 3.

These four categories of transactions and the historical guidance from the Service and the courts relating to "D" reorganizations where no stock is issued or distributed are reviewed briefly below. This discussion, however, is not intended to be an exhaustive analysis of "D" reorganizations; rather, we hope it will promote meaningful dialogue regarding the issues raised by PLR 200551018 and result in additional guidance from the Service. * * *

D. Page 126, New Sec. 4.2.B.4.c. The All Cash (D)—The Schler Letter to Tax Notes

Page 126, New Sec. 4.2.B.4.c. Add after New Sec. 4.2.B.4.b the following:
New Sec. 4.2.B.4.c. **The All Cash (D)—The Schler Letter to Tax Notes**

Mike Schler, More on the 'All-Cash D' Reorganization

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111 Tax Notes 383 (April 11, 2006)

Mike Schler, To the Editor:

In your April 10, 2006, issue, on p. 241, you reprint a letter (the letter) from a group of distinguished tax lawyers raising questions about LTR 200551018, Doc 2005-25828, 2005 TNT 247- 18. That LTR implicitly holds, in substance, that a cash sale of assets between two corporations, followed by the liquidation of the selling corporation, is not a "D" reorganization. In the ruling, one taxpayer owned 50 percent of the selling corporation and 90 percent of the buying corporation, and the other shareholders were unrelated. Thus, if the buying corporation had issued at least some stock as consideration for the assets, the statutory requirements for a D reorganization would be satisfied. The letter cites the authorities (the preexisting authority) stating that a D reorganization is considered to arise even on a purely cash sale of assets followed by the liquidation of the seller, if the buying and selling corporations are actually or constructively owned 100 percent by the same taxpayers in the same proportions.

The letter states that "one reasonably can conclude" that the transaction in the LTR should be treated in the same manner as in the case of 100 percent common ownership. Under that approach, assuming the correctness of the preexisting authority, whenever an acquisition of assets of the selling corporation for stock of the buying corporation (followed by liquidation of the seller) would be a D reorganization (based on overlapping ownership of the buying and selling corporations), the same should be true if the sole consideration for the assets is cash.

I agree with the letter that all of those cases should be treated in the same way. However, I have long thought that none of them should be treated as a D reorganization and that all of them should be treated as taxable sales of assets. The letter, if anything, further reinforces my views on that point, although I believe that many (if not all) of the authors of the letter would disagree with my conclusion.

The letter acknowledges that section 354 has generally been interpreted to require that at least some stock be issued in a D reorganization. However, as exemplified by Rev. Rul. 70-240, the statutory requirement for the issuance of stock has been excused in at least some cases by the IRS and the courts on the ground that the issuance of stock would be a "meaningless gesture."

The meaningless gesture doctrine in this context is extremely peculiar and illogical for several related reasons. First, the stock is deemed issued for purposes of satisfying the statutory requirement for a D reorganization that the buying corporation issue stock. Nevertheless, the very same "stock" is ignored for purposes of the additional statutory requirement in section 368(a)(1)(D) that the shareholders of the selling corporation be in control of the buying corporation immediately after the sale.

Second, the deemed issuance of stock is considered to arise only when the selling corporation liquidates, not when it stays alive. Thus, the only purpose of the doctrine is to

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qualify a transaction as a D reorganization when it otherwise would not be. Such a doctrine seems ad hoc at best.

Third, an all-cash sale of assets is quite different than the typical case giving rise to a deemed issuance of stock, namely a transfer of assets by a sole shareholder of a corporation to the corporation for no consideration. In the latter case, there is a gap between the consideration transferred by the shareholder and the consideration received, and it is logical to deem an issuance of stock for purposes of section 351. However, if the corporation paid cash equal to the full fair market value of the assets, there would be no disparity in value that required a deemed issuance of stock, and no one would contend that there was a deemed issuance of stock under the "meaningless gesture" doctrine. Indeed, if there were a deemed issuance of stock in that case, the deemed issuance could support the section 351 treatment of another transferor to the same transferee corporation, when section 351 would not otherwise apply to that other transferor. Such a deemed issuance is clearly not the law, even if the other transferor is a wholly owned nonconsolidated subsidiary of the first transferor. There is no more logic to the deemed issuance of stock in the case of a sale of assets between sister corporations, followed by the liquidation of the seller, than there is in the case of a sale of assets between an ongoing parent and a subsidiary corporation.

Fourth, by definition, the stock that would be issued in the meaningless gesture has a zero value. In every other area of subchapter C of which I am aware, if a taxpayer attempted to actually issue stock with a zero value to meet the requirements of some code section concerning the issuance of stock, the attempt would fail. Nevertheless, here the claim goes even further. Not only does the stock have zero value, but it's not even actually issued -- merely "deemed" to be issued. That position seems unique.

Fifth, in the context of a D reorganization, when the buying and selling corporations are directly owned by the same shareholders in the same proportions, the zero-value stock is simply deemed distributed by the selling corporation directly to those shareholders and disappears. However, as the letter amply demonstrates, when the common ownership of the buying and selling corporations is only indirect, or when the common ownership requires family attribution under section 318, the deemed issuance of zero-value stock requires considerable contortions. In those cases, the zero-value stock must be considered to move around a chain of corporations, and/or between family members, until it comes to rest in the proper place and then disappears. The step transaction doctrine is not generally applied to result in a recharacterization that contains more steps than the actual transaction. The recharacterizations here are clear violations of that principle, because the actual transaction is a simple sale of assets for cash.

Sixth, in the fact pattern in the LTR, there is not 100 percent common ownership of the two corporations even after taking into account constructive ownership. In that case, it is impossible to construct a transaction that would cause the stock constructively issued to the selling corporation to end up in the hands of the shareholders of the buying corporation in the correct proportions. Perhaps that is the basis for the result in the LTR.

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Seventh, the letter asks excellent questions as to where to draw the line between the preexisting authority and the facts of the LTR (for example, what is the result if there is only a 2 percent difference in ownership between the buying and selling corporations). The difficulty of drawing those lines further convinces me that the deemed issuance of stock under the meaningless gesture doctrine should be abandoned in all of these cases.

Finally, the letter points out that if the fact pattern in the LTR is not a D reorganization, but would be a D reorganization if the buying corporation paid slightly less cash and issued a small amount of stock, D reorganization status will be elective. That is true, but so what? Virtually every aspect of the statutory reorganization rules is elective. As to D reorganizations in particular, even if the result in the LTR was a D reorganization, that would not end electivity because the parties could easily avoid D reorganization status by not having the selling corporation liquidate. Moreover, the drafters of the letter appear to view taxpayer electivity as a good thing rather than a bad thing because the letter asks the IRS to allow taxpayers to elect to treat the LTR fact pattern as a D reorganization. As a result, I do not believe the electivity arising from the holding of the LTR is a reason to reverse that holding.

I fully recognize the implications (and folly) of responding to a letter signed by 16 very smart tax lawyers, most of whom probably disagree with me. For weeks to come, the pages of Tax Notes are likely to be filled with responses to this letter. I hope those letters will at least begin with the literal language of sections 368(a)(1)(D) and 354(b), and at some point explain the statutory basis and logic for a deemed issuance and deemed cancellation of zero-value stock.

Michael Schler
New York
April 10, 2006

E. Page 126, New Sec. 4.2.B.4.d. The All Cash (D)—The 2006 Temporary Regulations

Page 126, New Sec. 4.2.B.4.d. Add after New Sec. 4.2.B.4.c the following:

New Sec. 4.2.B.4.d. **The All Cash (D)—The 2006 Temporary Regulations**

Preamble to Temporary Regulations, Corporate Reorganizations; Distributions under sections 368(a)(1)(D) and 354(b)(1)(B)
TD 9303, December 19, 2006

SUMMARY: This document contains temporary regulations under section 368 of the Internal Revenue Code of 1986 (Code). The temporary regulations provide guidance regarding the qualification of certain transactions as reorganizations described in section 368(a)(1)(D) where no stock and/or securities of the acquiring corporation is issued and distributed in the transaction. These regulations affect corporations engaging in such

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transactions and their shareholders. The text of the temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in the Proposed Rules section in this issue of the Federal Register.

DATES: *Effective Date*: These regulations are effective on December 19, 2006. * * *

Background. The IRS and Treasury Department have received requests for immediate guidance regarding whether certain acquisitive transactions can qualify as reorganizations described in section 368(a)(1)(D) where no stock of the transferee corporation is issued and distributed in the transaction. Currently, the IRS and Treasury Department are undertaking a broad study of issues related to acquisitive section 368(a)(1)(D) reorganizations. In the interest of efficient tax administration, the IRS and Treasury Department are issuing these temporary regulations to provide the requested certainty for taxpayers regarding these acquisitive transactions pending the broader study of issues. Although these rules also are being proposed in the Proposed Rules section in this issue of the Federal Register, the IRS and Treasury Department contemplate that the proposed rules may change upon completion of this broader study and the comments received.

The Code provides general nonrecognition treatment for reorganizations specifically described in section 368(a). Section 368(a)(1)(D) describes as a reorganization a transfer by a corporation (transferor corporation) of all or a part of its assets to another corporation (transferee corporation) if, immediately after the transfer, the transferor corporation or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the transferee corporation; but only if stock or securities of the controlled corporation are distributed in pursuance of a plan of reorganization in a transaction that qualifies under section 354, 355, or 356.

Section 354(a)(1) provides that no gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization. Section 354(b)(1)(B) provides that section 354(a)(1) shall not apply to an exchange in pursuance of a plan of reorganization described in section 368(a)(1)(D) unless the transferee corporation acquires substantially all of the assets of the transferor corporation, and the stock, securities, and other properties received by such transferor corporation, as well as the other properties of such transferor corporation, are distributed in pursuance of the plan of reorganization.

Further, section 356 provides that if section 354 or 355 would apply to an exchange but for the fact that the property received in the exchange consists not only of property permitted by section 354 or 355 without the recognition of gain or loss but also of other property or money, then the gain, if any, to the recipient shall be recognized, but not in excess of the amount of money and fair market value of such other property. Accordingly, in the case of an acquisitive transaction, there can only be a distribution to which section 354 or 356 applies where the target shareholder(s) receive at least some property permitted to be received by section 354.

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Notwithstanding the requirement in section 368(a)(1)(D) that "stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356", the IRS and the courts have not required the actual issuance and distribution of stock and/or securities of the transferee corporation in circumstances where the same person or persons own all the stock of the transferor corporation and the transferee corporation. In such circumstances, the IRS and the courts have viewed an issuance of stock to be a "meaningless gesture" not mandated by sections 368(a)(1)(D) and 354(b).

In Revenue Ruling 70-240, 1970-1 CB 81 (see §601.601(d)(2) of this chapter), B owned all of the stock of both corporation X and corporation Y. X sold its operating assets to Y for $34x dollars, which represented the fair market value of X's assets. X had $33x of other assets, consisting generally of cash, accounts receivables, and investments in stocks and bonds, so that the assets sold by X to Y constituted approximately 51% of X's total assets. Following the sale to Y, X paid its debts, which amounted to $38x, and then liquidated, distributing $29x to B, while Y continued to conduct the business formerly operated by X. The IRS concluded that "although no actual shares of the stock of Y were distributed to B as a result of the transaction, B is treated as having received Y stock since he already owned all the stock of Y." Accordingly, the IRS held that the sale of the operating assets by X to Y, followed by the liquidation and distribution of X's assets to B, resulted in a reorganization under section 368(a)(1)(D) and a distribution under section 356(a), despite the absence of an actual issuance and distribution of Y stock.

When considering a similar transaction between two corporations owned in identical proportions by a husband and wife, the Tax Court concluded that there was in substance an exchange of stock which meets the requirements of section 354 and 356, and stated, "[t]he issuance of further stock would have been a meaningless gesture, and we cannot conclude that the statute requires such a vain act." *James Armour, Inc. v. Commissioner*, 43 T.C. 295, 307 (1964). *See also Wilson v. Commissioner*, 46 T.C. 334 (1966). The IRS has also applied this meaningless gesture doctrine to circumstances where the transferor corporation and the transferee corporation are wholly owned by a single party directly or indirectly through subsidiaries, or as a result of family attribution pursuant to section 318(a)(1).

However, the application of this meaningless gesture doctrine has generally been limited to situations in which there is identical shareholder identity and proportionality of interest in the transferor corporation and the transferee corporation. For example, in *Warsaw Photographic Associates, Inc. v. Commissioner*, 84 T.C. 21 (1985), there was no issuance of stock by the transferee corporation to the transferor corporation, and the stock ownership in the two corporations was not identical. On the basis of these facts, the Tax Court concluded that the distribution of stock would not be a mere formality and refused to apply the meaningless gesture doctrine. Accordingly, the transaction failed to qualify as a section 368(a)(1)(D) reorganization because there was no distribution of stock of the transferee corporation under sections 368(a)(1)(D) and 354 (b)(1)(B).

Explanation of Provisions. These temporary regulations provide guidance regarding the circumstances in which the distribution requirement under sections 368(a)(1)(D) and 354(b)(1)(B) is deemed satisfied despite the fact that no stock and/or securities are

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actually issued in a transaction otherwise described in section 368(a)(1)(D). In cases where the same person or persons own, directly or indirectly, all of the stock of the transferor and transferee corporations in identical proportions, these temporary regulations provide that the distribution requirement under sections 368(a)(1)(D) and 354(b)(1)(B) will be treated as satisfied even though no stock is actually issued in the transaction. For purposes of determining whether the same person or persons own all of the stock of the transferor and transferee corporations in identical proportions, these temporary regulations provide that an individual and all members of his family that have a relationship described in section 318(a)(1) will be treated as one individual.

The temporary regulations also provide that the distribution requirement under sections 368(a)(1)(D) and 354(b)(1)(B) will be treated as satisfied in the absence of any issuance of stock and/or securities where there is a de minimis variation in shareholder identity or proportionality of ownership in the transferor and transferee corporations. Further, stock described in section 1504(a)(4) is disregarded for purposes of determining whether the same person or persons own all of the stock of the transferor and transferee corporations in identical proportions.

Under these temporary regulations, in each case where it is determined that the same person or persons own all of the stock of the transferor and transferee corporations in identical proportions, a nominal share of stock of the transferee corporation will be deemed issued in addition to the actual consideration exchanged in the transaction. The nominal share of stock in the transferee corporation will then be deemed distributed by the transferor corporation to its shareholders and, in appropriate circumstances, further transferred to the extent necessary to reflect the actual ownership of the transferor and transferee corporations.

These temporary regulations are being issued in response to requests for immediate guidance regarding whether transactions otherwise described in section 368(a)(1)(D) qualify as reorganizations where no stock and/or securities of the transferee corporation are actually issued in the transaction. The IRS and Treasury Department currently are undertaking a broad study of issues related to acquisitive reorganizations, including issues addressed by these temporary regulations. The IRS and Treasury Department are issuing these temporary regulations in order to provide certainty for taxpayers while these issues are under study.

The IRS and Treasury Department believe that these temporary regulations are a reasonable interpretation of section 368(a)(1)(D) and section 354(b)(1)(B) given the history of those provisions and the manner in which they have previously been interpreted by the courts and the IRS. However, no inference should be drawn from these temporary regulations regarding the law prior to the effective date of these temporary regulations. In the Proposed Rules section in this issue of the Federal Register, the IRS and Treasury Department are requesting comments on several issues relating to acquisitive reorganizations described in section 368(a)(1)(D).

In addition, the IRS and Treasury Department note that these temporary regulations do not expressly implement Prop. Reg. §1.368-1(f)(4) (FR 70, 11903-11912), which provides that there must be an exchange of net value except in the case of a transaction

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that would otherwise qualify as a reorganization described in section 368(a)(1)(D), provided that the fair market value of the property transferred to the acquiring corporation by the target corporation exceeds the amount of liabilities of the target corporation immediately before the exchange (including any liabilities cancelled, extinguished, or assumed in connection with the exchange), and the fair market value of the assets of the acquiring corporation equals or exceeds the amount of its liabilities immediately after the exchange. The solvency requirement remains the IRS's and Treasury Department's proposal but the IRS and Treasury Department continue to consider whether this solvency requirement should be applied to the transactions described in these temporary regulations.

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V. CHAPTER 5, TAXABLE STOCK ACQUISITIONS

A. Page 222, Sec. 5.3.D.7. Merger of Target into Sister Sub after Qualified Stock Purchase of Target under §338

Page 222, Change the reference from Sec. 6.2.F.3 to 6.2.E.3. *See also* New Sec. 5.5.B.5, Additional Final Regulations on Effect of Section 338(h)(10) Elections in Multistep Transactions

B. Page 256, New Sec. 5.4.F.5. Private Letter Ruling Dealing with Deductibility of Investment Banker Expenses in M&A

Page 256, New Sec. 5.4.F.5. Add before 5.5 the following:
New Sec. 5.4.F.5. **Private Letter Ruling Dealing with Deductibility of Investment Banker Expenses in M&A**

Private Letter Ruling 200830009
April 11, 2008

LEGEND:

Company = * * *
Acquisition Co. = * * *
Parent = * * *
Intermediate HoldCo = * * *
The Sponsors = * * *
Investor Group = * * *
Financial Advisor A = * * *
Financial Advisor B = * * *
Financial Advisor C = * * *
Legal Counsel = * * *
Other Service Providers = * * *
Financial Service Providers = * * *
Debt Financing Fees = * * *
State X = * * *
Shareholder A = * * *
Date 1 = * * *
Date 2 = * * *
Date 3 = * * *
Date 4 = * * *

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Date 5 = * * *

Dear * * *:

This letter is in reply to your authorized representative's letter dated Date 5, requesting rulings regarding Federal income tax consequences of certain transaction costs incurred in completed transactions. The information submitted for consideration is summarized below.

SUMMARY OF FACTS

Company, a State A corporation, was acquired on Date 1 through a merger transaction. The acquisition was accomplished through the merger of Acquisition Co. with and into Company, with Company being the surviving company (the "Transaction"). As more fully described herein, the exchanging shareholders of Company received cash in the Transaction.

Prior to the Transaction, pursuant to a merger agreement dated and accepted by the Company's Board of Directors on Date 2 (a date prior to Date 1), the Sponsors (a group of private equity funds that coordinated to effectuate the Transaction) created Parent, Intermediate HoldCo, and Acquisition Co.. As a preliminary step in the Transaction, Shareholder A and certain members of the Company management team contributed a portion of their shares in Company and/or cash in a section 351 transaction in exchange for Parent's stock. Following the initial section 351 transaction, Parent was owned by the Sponsors, Shareholder A, and certain members of Company management (collectively referred to as the "Investor Group"). In addition, Acquisition Co. was a subsidiary of Intermediate HoldCo, which in turn is a subsidiary of Parent. As a result of the merger of Acquisition Co. with and into Company, Company became a wholly owned subsidiary of Intermediate HoldCo.

On Date 1, as part of the Transaction, Acquisition Co. (prior to its merger into Company), entered into a secured credit agreement with a group of lenders. Company is required to pay interest under the terms of the senior secured credit agreement, and also paid commitment fees to the lenders. Pursuant to the plan of merger, Company, using funds borrowed by Acquisition Co., paid its old shareholders (except for the transaction involving Shareholder A and certain management) cash in exchange for their interest in Company.

DESCRIPTION OF TYPES OF TRANSACTION COSTS AND SERVICE PROVIDERS

Financing

Following the Company Board of Director's approval of the Transaction on Date 2, Company began, with its advisors, to consider several distinct financing mechanisms. One source of financing was a whole business securitization approach under which the

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Company's assets would have been used for financing the Transaction, referred to as the "securitization financing plan." The plan was considered through Date 3, and then ultimately abandoned when it was determined that the plan would be unduly burdensome to administer. Costs incurred for the securitization financing plan include a portion of Legal Counsel's and of Other Service Providers' fees.

When the securitization plan was abandoned, more traditional forms of financing were pursued. On Date 4, and on several dates after, the Company announced that, in connection with the Transaction, it was commencing certain financing transactions. These transactions consisted of borrowing new senior secured and unsecured indebtedness, the repayment of certain debts, and several other financing vehicles. Under each of these vehicles, Company is required to pay the associated interest, principle, and fees. These fees include all of the Debt Financing Fees, all of the Financial Service Providers' fees, and based upon a detailed review of the relevant documentation, an allocated portion of both Financial Advisor C's and Legal Counsel's fees.

Financial Advice

To maintain its market share, protect against the threat of takeover and maximize competitive opportunity, Company has historically monitored and considered corporate development growth strategies and opportunities, consulting frequently with third-party financial advisors for modeling on alternatives, identification of market trends, obtaining recommendations for future strategic alternatives, access to capital markets, etc. Prior to Date 2, Company had significant discussions and meetings with Financial Advisor A on all of these strategic issues. In addition, a Special Committee also retained Financial Advisor B to provide services related to its role.

Financial Advisor C rendered Services to Acquisition Co. while the Transaction was being considered. All of these financial advisory firms became involved with the Transaction prior to Date 2 and began investigatory due diligence for the Transaction. As the Transaction progressed, Financial Advisor C assisted in the preparation, review and negotiation of the terms and conditions of the debt used to finance the Transaction. As the Transaction proceeded to closing, Financial Advisor C both directly and through various advisors, become involved with negotiating, structuring, and reviewing the merger agreement. Financial Advisor C also assisted with routine business activities, including preparing a post-Transaction business plan for Company.

Legal Advice

Company, Parent, Acquisition Co., and others employed Legal Counsel to perform various services over the course of planning, modeling, investigating, pursuing, and completing the Transaction, including the financing portions of the Transaction.

Accountants, Rating Agencies, Banks, and Others

Company, Parent, Acquisition Co., and others employed other service providers to

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perform various services over the course of planning, modeling, investigating, pursuing, and completing the Transaction, including all the activities necessary to put into place the financing portions of the Transaction.

RULINGS

Based solely on the information submitted, we hold as follows:

ALLOCATION OF TRANSACTION COSTS

Company requests a ruling that the transaction costs may be allocated to either Company or Acquisition Co. based on the entity to whom the services were rendered and/or on whose behalf the services were provided.

Parent arranged a number of transaction services. Each service provider was directly engaged by Company and the services were directly provided to Company.

Acquisition Co. also incurred a variety of transaction costs. These costs included fees for financial advice, legal services, due diligence services, insurance due diligence, and other miscellaneous transaction related services.

During the transaction, expenses were incurred for arranging the debt financing for the transaction. These expenses included rating fees, lender's out of pocket expenditures, and advisory fees. Although these providers may not have been directly engaged by Company, the fees were paid to secure the debt financing.

The Investor Group arranged for the underwriting services for the transaction. Although arranged by the Investor Group, these services were provided on behalf of Company as part of obtaining the debt. Similarly, the Investor Group engaged certain service providers on behalf of Acquisition Co.. These services directly benefited Acquisition Co..

Section 162(a) allows a deduction for ordinary and necessary expenses paid or incurred by the taxpayer in carrying on a trade or business. Whether an expense is deductible under section 162 is ultimately a question of fact. See *Commissioner v. Heininger*, 320 U.S. 467 (1943).

Section 1.263(a)-4 provides, in part, that except as otherwise provided in this section, a taxpayer must capitalize an amount paid to acquire an intangible or an amount paid to facilitate the acquisition of an intangible, whether the taxpayer is the acquirer or the target.

Section 1.263(a)-5 provides, in part, that a taxpayer must capitalize an amount paid to facilitate the acquisition of a trade or business. Similarly, that section provides that the taxpayer must capitalize the costs of a borrowing. Further, section 1.263(a)-5(k) provides that for these purposes, an amount paid to or by a party include an amount paid on behalf of the party.

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Company requests permission to allocate the transaction costs incurred based on the entity to whom the services were rendered and/or on whose behalf the services were provided. Company's position is that this treatment is appropriate because these entities directly and proximately benefited from the services and incurred the economic burden of these services. Company essentially argues that the proper party to be charged with costs incurred in the Transaction may not be readily identifiable because of the structure of the transaction and the many parties involved.

It is well established that where a taxpayer undertakes to pay the obligations of another taxpayer, such payments are not deductible as ordinary or necessary business expenses incurred in the taxpayer's trade or business. See *Interstate Transit Lines v. Commissioner*, 319 U.S. 590 (1943); *Deputy v. du Pont*, 308 U.S. 488 (1940). This is true even where the cost would have been deductible had the taxpayer incurred it. The determination of the appropriate taxpayer is often a question of fact. See Crosby v. United States, 496 F.2d 1384 (5th Cir. 1974).

We conclude Company may allocate transaction costs to either Company or Acquisition Co. based upon the entity to which the services were rendered and/or on whose behalf the services were provided.

ALLOCATION OF LUMP SUM FEES

Company requests a ruling that Acquisition Co. and Company may allocate lump-sum service provider fees between deductible, amortizable, and capitalizable categories based on scope of service provided.

Section 1.263(a)-4(c)(3)(i) provides that a purchaser must capitalize amounts paid to acquire an ownership interest in a corporation. Section 1.263(a)-5 provides rules for the treatment of costs associated with the acquisition of a trade or business. Generally, costs that facilitate the acquisition must be capitalized. Other costs would typically be deductible.

Section 1.263(a)-5(b) provides in part that an amount is paid to facilitate a transaction if the amount is paid in the process of investigating or otherwise pursuing the transaction. Whether an amount is paid in the process of investigation or otherwise pursuing the transaction is determined based on all of the facts and circumstances. Section 1.263(a)-5(e) provides, in part, that except for certain facilitative costs listed in section (e)(2), an amount paid by the taxpayer in the process of investigating or otherwise pursuing a covered transaction facilitates the transaction only if it relates to activities performed on or after the earlier of the date a letter of intent or similar communication is executed or the date on which the material terms of the transaction are authorized or approved by the taxpayer's board of directors. Section 1.263(a)-5(e)(2) provides a list of costs that are inherently facilitative, which are facilitative regardless of when performed.

Section 1.263(a)-5(f) provides detailed rules concerning the supporting documentation

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necessary to establish the portion of any amount paid that is contingent on the successful closing of a covered transaction that is allocable to activities that do not facilitate the transaction. In general, this documentation must consist of supporting records (for example, time records, itemized invoices, or other records) that identify the activities performed, the fee allocable to those activities, the date of performance, and the service provider. This documentation must be completed on or before the due date for the taxpayer's timely filed return (including extensions).

Company cites several cases for the proposition that allocation of transaction costs among various categories of expense is appropriate in the context of an acquisition. Specifically, the taxpayer states that McCrory v United States, 651 F.2d 828 (2d Cir. 1981); *A.E. Staley Manufacturing Co. v. Commissioner*, 119 F.3d 482 (7th Cir. 1997); and Wells Fargo & Co. v. Commissioner, 224 F.2d 874 (8th Cir. 2000) all found that costs are not automatically treated as incident to an acquisition merely because a merger occurred. Instead, these courts have permitted taxpayers to allocate lump-sum fees among various categories of services provided. These allocations are grounded in the origin of the claim doctrine, under which the "origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer, is the controlling basic test of whether the expense is deductible or not." *U.S. v. Gilmore*, 372 U.S. 39, 49 (1963).

With respect to fees that are not contingent upon the successful closing of the transaction, the example provided by Company demonstrates that the proposed allocation is based upon contemporaneous records that memorialize the activity performed, time spent, and the average rate of the party performing the activity. With respect to fees that are contingent upon the successful closing of the transaction, Company states that detailed billing records are not available.

Although section 1.263(a)-5(f) provides detailed rules concerning the necessary documentation, that section does not require time records. Other records may be used to establish an appropriate allocation. A determination as to whether records establish such an allocation is a question to be determined upon examination.

We conclude that Company and Acquisition Co. may allocate lump-sum provider service costs to the services provided.

INVESTIGATORY COSTS

Company has requested a ruling that Company may treat its investigatory due diligence costs as deductible expenses under section 162 and that Acquisition Co. may treat its business advice and investigatory costs associated with the Transaction as amortizable start-up expenditures under section 195.

The costs at issue arise from due diligence and other investigatory services provided Company by several providers, including Financial Advisor A and Financial Advisor B, certain Legal Counsel, and Other Service Providers and provided Acquisition Co. by

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Financial Advisor C and certain Legal Counsel.

Section 162(a) allows a deduction for ordinary and necessary expenses paid or incurred by a taxpayer in carrying on a trade or business. As described above, under section 1.263(a)-5, a taxpayer must capitalize an amount paid to facilitate a transaction. Thus, ordinary and necessary business expenses associated with a covered transaction that are not facilitative are generally deductible.

A taxpayer is permitted to take a deduction where the taxpayer is expanding its active trade or business. *Briarcliff Candy Corp v. Commissioner*, 475 F.2d 775, 787 (2d Cir. 1973); NCNB Corp v. United States, 684 F.2d 285 (4th Cir. 1982). In addition, pre-decisional investigatory costs incurred in a business expansion context are deductible under section 162. Wells Fargo & Co. v. Commissioner, 224 F.3d 874 (8th Cir. 2000).

Section 1.263(a)-5 requires taxpayers to capitalize amounts paid to facilitate an acquisition of a trade or business. Section 1.263(a)-5(e)(1) provides a bright-line rule to determine whether amounts paid in certain covered transaction are facilitative. Section 1.263(a)-5(e)(i) provides that an amount, which is not inherently facilitative, facilitates a transaction only if the amount relates to activities performed on or after the earlier of (i) the date of which a letter of intent, exclusivity agreement, or similar written communication (other than a confidentiality agreement) is executed by representatives of the acquirer and the target; or (ii) the date on which the material terms of the transaction (as tentatively agreed to by the representatives of the acquirer and the target) are authorized or approved by the taxpayer's board of directors (or committee of the board of directors). In addition, section 1.263(a)-5(e)(2) provides that an amount paid in the process of investigating or otherwise pursuing a covered transaction facilitates that transaction if the amount is inherently facilitative, regardless of whether the amount is paid for activities performed prior to the date determined under paragraph (e)(1) of this section.

Section 195(a) provides that, except as otherwise provided in section 195, no deduction is allowed for start-up expenditures.

Section 195(c)(1) defines "start-up expenditure," in part, as any amount (A) paid or incurred in connection with investigating the creation or acquisition of an active trade or business, and (B) which, if paid or incurred in connection with the operation of an existing active trade or business (in the same field as the trade or business referred to in subparagraph (A)), would be allowable as a deduction for the taxable year in which paid or incurred.

Rev. Rul. 99-23, 1991-1 C.B 998, generally provides that expenditures paid or incurred in order to determine whether to enter a new business and which business to enter are investigatory costs that are start-up expenditures under section 195. Conversely, costs incurred in the attempt to acquire a specific business are capital in nature and thus, are not start-up expenditures under section 195.

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Company states that the costs at issue were not facilitative costs under section 1.263-5 because they were incurred in the process of investigating or otherwise pursuing a covered transaction before the earlier of the date a letter of intent or similar communication was executed or the date on which the material terms of the transaction were authorized or approved and were not inherently facilitative costs. Further, Company anticipates the transaction will speed the domestic and international growth of Company's business. Company will continue to take Acquisition Co.'s investigatory costs into account under section 195.

We conclude that Company may deduct, under section 162, the investigatory expenses incurred in investigating the growth of its business that are non facilitative under section 1.263-5. Acquisition Co. may treat similar expenses as investigatory costs that are start-up expenditures under section 195.

COVERED TRANSACTION

Company requests a ruling that the Transaction is a "covered transaction" under section 1.263(a)-5(e)(3).

Company argues that the Transaction is a covered transaction because it is an acquisition that results in Company being a wholly owned subsidiary of Intermediate HoldCo, which is wholly owned by Parent. Thus, Parent, Intermediate HoldCo, and Company are related under section 267(b).

Section 1.263(a)-5 provides, in part, that costs that facilitate a "covered transaction" must be capitalized.

Section 1.263(a)-5(e)(3) provides, in part, that a covered transaction is (i) a taxable acquisition by the taxpayer of assets that constitute a trade or business, (ii) a taxable acquisition of an ownership interest in a business entity if immediately after the transaction, the acquirer and target are related within the meaning of section 267(b) or 707(b), or (iii) a reorganization described in section 368(a)(1)(A), (B), or (C) or certain reorganizations described in section 368(a)(1)(D). Corporations that are members of the same controlled group are considered related for purposes of section 267(b) of the Code.

Section 3.01 of Rev. Proc. 2008-3, 2008-1 I.R.B. 110 (Jan. 7, 2008) provides that the Service will not issue a ruling concerning most corporate reorganizations.

We conclude that the Transaction is a covered transaction within the meaning of section 1.263(a)-5(e)(3).

AMORTIZATION OF COSTS TO FINANCE BORROWING COSTS

Company requests a ruling that the costs incurred to finance the Transaction are eligible for amortization in accordance with section 1.446-5. These costs include a portion of the fees of Financial Advisor C, Legal Counsel, Other Service Providers and Financing

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Service Providers, as well as Debt Financing Fees.

Section 1.446-5 provides rules for allocating debt issuance costs over the term of the debt for which the costs were incurred. The term debt issuance costs means those transaction costs incurred by an issuer of debt (that is, a borrower) that are required to be capitalized under section 1.263(a)-5. If these costs are otherwise deductible, they are deductible by the issuer over the term of the debt as determined under section 1.446-5(b).

Under section 1.446-5(b), solely for the purposes of determining the amount of the debt issuance costs that may be deducted in any period, debt issuance costs are treated as if they adjusted the yield of the debt. To effect this adjustment, the issuer treats the costs as if they decreased the issue price of the debt. See section 1.1273-2 to determine the issue price of the debt instrument. Thus, debt issuance costs increase or create original issue discount and decrease or eliminate bond issuance premium.

Under section 1.446-5(b)(2), any resulting original issue discount is taken into account by the issuer under the rules of section 1.163-7, which generally require the use of a constant yield method (as described in section 1.1272-1) to compute how much original issue discount is deductible for a period. However, see section 1.163-7(b) for special rules that apply in the total original issue discount on the debt is the de minimis.

Under section 1.446-5(b)(3), any remaining bond issuance premium is taken into account by the issuer under the rules of section 1.163-13, which generally require the use of a constant yield method for purposes of allocating bond issuance premium to accrual periods.

We conclude that Company may take into account the properly allocable costs incurred to finance the Transaction in accordance the provisions of section 1.446-5.

LOSS FOR COSTS OF ABANDONED SECURITIZATION PLAN

Company requests a ruling that its costs related to the securitization financing plan are eligible for an abandonment loss in accordance with section 165.

Section 1.263(a)-5(a) requires, in part, the capitalization of costs that facilitate a stock issuance or borrowing.

Section 165 allows a deduction for any loss sustained during the taxable year and not compensated for by insurance or otherwise. Section 1.165(a)-1(b) provides that to be allowed as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and actually sustained during the taxable year. Further, only a bona fide loss may be deducted. Substance and not form governs in determining a loss.

Section 1.165-2(a) provides that a loss is deductible under section 165(a) if it is incurred in a business or in a transaction entered into for profit and arising from the sudden

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termination of the usefulness in such business or transaction of any nondepreciable property, in a case where such business or transaction is discontinued or where such property is permanently discarded from use therein. For example, in Rev. Rul. 73-580, 1973-2 C.B. 86, the taxpayer was permitted a deductible loss under section 165 for otherwise capitalizable merger and acquisition costs when the transaction was abandoned.

If a taxpayer engages in multiple separate and distinct transactions, costs properly allocated to abandoned transactions may be deductible even if other transactions are completed. *Sibley, Lindsay & Curr Co. v. Commissioner*, 15 T.C. 106 (1950), acq. 1951-1 C.B. 3. By contrast, if the proposals are alternatives, only one of which can be completed, no abandonment loss is proper unless the entire transaction is abandoned. The cost of pursuing any alternatives not consummated must be capitalized as part of the cost of the completed transaction. United Dairy Farmers, Inc. v. United States, 267 F.3d 510 (6th Cir. 2001); Nicolazzi v. Commissioner, 79 T.C. 109 (1982).

Company argues that it is entitled to a loss under section 165 because the securitization financing was a separately investigated plan that was never implemented. As a result, Company received no benefit from the plan. In support, Company has represented that the financing plans were not mutually exclusive and that it received no further benefit from the securitization plan financing when the final financing plan was adopted.

The costs at issue are clearly identified and no further benefit was received after adoption of the final financing plan.

We conclude that the costs related to the securitization financing plan are eligible for an abandonment loss in accordance with section 165.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

Company submitted voluminous materials concerning the costs at issue. While this office reviewed the materials submitted, we are not ruling on any particular item allocated or the amount of any of allocation addressed above, which are appropriately determinations subject to examination.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

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Sincerely,

Robert M. Casey
Senior Technical Reviewer,
Branch 3
(Income Tax & Accounting)

C. Page 256, New Sec. 5.4.F.6. Termination Fee Paid by Target in an M&A Transaction Is Deductible—Santa Fe

Page 256, New Sec. 5.4.F.6. Add after New Sec. 5.4.F.5 the following:
New Sec. 5.4.F.6. **Termination Fee Paid by Target in an M&A Transaction is Deductible—*Sante Fe***

Santa Fe Pacific Gold Company v. Commissioner
United States Tax Court, 132 T.C. No. 12 (April 27, 2009)

GOEKE, *Judge*: The issue for decision is whether Santa Fe Pacific Gold Co. (Santa Fe) is entitled to a deduction of $ 65 million for a payment made to Homestake Mining Co. (Homestake) as a result of the termination of a merger agreement between Santa Fe and Homestake (termination fee) for Santa Fe's 1997 tax year. For the reasons stated herein, we find that Santa Fe is entitled to a deduction pursuant to sections 162 and 165. * * *

OPINION * * *

I. *Burden of Proof* * * *

II. *Deductibility vs. Capitalization*

For Federal income tax purposes the principal difference between classifying a payment as a deductible expense or a capital expenditure concerns the timing of the taxpayer's recovery of the cost. As the Supreme Court observed in *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 83-84, 112 S. Ct. 1039, 117 L. Ed. 2d 226 (1992):
The primary effect of characterizing a payment as either a business expense or a capital expenditure concerns the timing of the taxpayer's cost recovery: While business expenses are currently deductible, a capital expenditure usually is amortized and depreciated over the life of the relevant asset, or where no specific asset or useful life can be ascertained, is deducted upon dissolution of the enterprise. * * * Through provisions such as these, the Code endeavors to match expenses with the revenues of the taxable period to which they are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes. * * *

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Section 162(a) allows as a deduction “all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business”. To qualify for a deduction, “an item must (1) be ‘paid or incurred during the taxable year,’ (2) be for ‘carrying on any trade or business,’ (3) be an ‘expense,’ (4) be a ‘necessary’ expense, and (5) be an ‘ordinary’ expense.” *Commissioner v. Lincoln Sav. & Loan Association*, 403 U.S. 345, 352, 91 S. Ct. 1893, 29 L. Ed. 2d 519 (1971). Section 165(a) allows as a deduction “any loss sustained during the taxable year and not compensated for by insurance or otherwise.”

An expense may be ordinary even if it rarely occurs or occurs only once within the lifetime of the taxpayer. *Welch v. Helvering*, *supra* at 114. Although the transaction may be unique to the individual taxpayer, the question is whether the transaction is ordinary in the “life of the group, the community, of which * * * [the taxpayer] is a part.” *Id.* An expense is necessary if it meets “the minimal requirement that the expense be ‘appropriate and helpful’ for ‘the development of the [taxpayer’s] business.’“ *Commissioner v. Tellier*, 383 U.S. 687, 689, 86 S. Ct. 1118, 16 L. Ed. 2d 185 (1966) (quoting *Welch v. Helvering*, *supra* at 113). A deduction is generally allowed for expenses incurred in defending a business and its policies from attack. *INDOPCO, Inc. v. Commissioner*, *supra* at 83; *Commissioner v. Tellier*, *supra*; *Commissioner v. Heininger*, 320 U.S. 467, 64 S. Ct. 249, 88 L. Ed. 171, 1944 C.B. 484 (1943); see also *Locke Manufacturing Cos. v. United States*, 237 F. Supp. 80 (D. Conn. 1964) (permitting corporation to deduct expenses incurred in successful defense to proxy fight). The underlying reasoning in this line of cases is that the expenses were incurred to protect corporate policy and structure, not to acquire a new asset. See, e.g., *United States v. Federated Dept. Stores, Inc.*, 171 Bankr. 603, 610 (S.D. Ohio 1994), affg. *In re Federated Dept. Stores, Inc.*, 135 Bankr. 950 (Bankr. S.D. Ohio 1992).

Section 263(a)(1) generally provides that a deduction is not allowed for “Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.”

The determination of whether an expenditure is deductible under section 162(a) or must be capitalized under section 263(a)(1) is a factual determination. When an expense creates a separate and distinct asset, it usually must be capitalized. See, e.g., *Commissioner v. Lincoln Sav. & Loan Association*, *supra*. When an expense does not create such an asset, the most critical factors to consider in passing on the question of deductibility are the period over which the taxpayer will derive a benefit from the expense and the significance of that benefit. See *INDOPCO, Inc. v. Commissioner*, *supra* at 87-88; *United States v. Miss. Chem. Corp.*, 405 U.S. 298, 310, 92 S. Ct. 908, 31 L. Ed. 2d 217 (1972); *FMR Corp. & Subs. v. Commissioner*, 110 T.C. 402, 417 (1998); *Conn. Mut. Life Ins. Co. v. Commissioner*, 106 T.C. 445, 453 (1996). Expenses must generally be capitalized when they either: (1) Create or enhance a separate and distinct asset, or (2) otherwise generate significant benefits for the taxpayer extending beyond the end of the taxable year. *Metrocorp, Inc. v. Commissioner*, 116 T.C. 211, 222 (2001). Under the required test, capitalization is not always required when an incidental future benefit is generated by an expense. *INDOPCO, Inc. v. Commissioner*, *supra* at 87. “Whether a

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benefit is significant to the taxpayer who incurs the underlying expense rests on the duration and extent of the benefit, and a future benefit that flows incidentally from an expense may not be significant." *Metrocorp, Inc. v. Commissioner, supra* at 222.

A. *INDOPCO, Inc. v. Commissioner*

The Supreme Court considered fees incurred during a friendly business combination in *INDOPCO, Inc. v. Commissioner*, *supra*. The focus of the Supreme Court's opinion was the taxpayer's argument that the fees at issue were deductible because no separate and distinct asset was created. The taxpayer attempted to argue that under the Court's opinion in *Commissioner v. Lincoln Sav. & Loan Association*, *supra*, only fees that led to the creation of a separate and distinct asset were subject to capitalization. The Court rejected the taxpayer's argument. *INDOPCO, Inc. v. Commissioner*, *supra* at 86-87. The Court held that the fees at issue were to be capitalized because they provided for benefits extending past the tax year at issue.

B. *Victory Mkts., Inc. & Subs. v. Commissioner*

In *Victory Mkts., Inc. & Subs. v. Commissioner*, 99 T.C. 648 (1992), we were confronted with facts similar to those of *INDOPCO, Inc. v. Commissioner, supra*. The taxpayer argued that it incurred professional service fees in connection with the acquisition of its stock by an acquirer and claimed that it was entitled to deduct those expenses because, unlike the taxpayers in *INDOPCO, Inc.*, it was acquired in a hostile takeover. We declined to decide whether *INDOPCO, Inc.*, required capitalization of expenses incurred incident to a hostile takeover, however, because we concluded that the nature of the takeover in *Victory Mkts.* was not hostile and that the facts were generally indistinguishable from those in *INDOPCO, Inc.*

C. *United States v. Federated Dept. Stores, Inc.*

United States v. Federated Dept. Stores, Inc., *supra*, addressed breakup fees paid to "white knights" in the aftermath of failed merger attempts undertaken to avoid undesired corporate takeovers. The District Court sustained the bankruptcy court's holdings that deductions were allowable under either section 162 or section 165. The District Court relied on the bankruptcy court's findings that no benefit accrued beyond the year in which the expenditures were made and, on that basis, distinguished *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 112 S. Ct. 1039, 117 L. Ed. 2d 226 (1992). The bankruptcy judge had found explicitly that the provisions for the payment of the breakup fees did not enhance the amounts that the debtors' shareholders actually received in the takeover transactions. The District Court also agreed with the bankruptcy court that the failed merger transactions with white knights were separate transactions from the successful takeovers and thus could be treated as abandoned transactions eligible for a loss deduction under section 165.

D. *Staley I & II*

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In *A.E. Staley Manufacturing Co. & Subs. v. Commissioner*, 105 T.C. 166 (1995) (Staley revd. 119 F.3d 482 (7th Cir. 1997) (Staley II), we were again faced with a situation similar to that of *INDOPCO, Inc.* and *Victory Mkts.* In Staley I, we were asked to consider the proper characterization of fees paid by a corporation to investment bankers shortly before the corporation was acquired. We held that the fees be capitalized rather than deducted under section 162 or 165. We disallowed the deductions on the basis of the Supreme Court's opinion in *INDOPCO, Inc.* We also held that the taxpayer was not allowed to deduct the costs as an abandonment loss. We distinguished the situation in Staley I from that of *Federated Dept. Stores* because unlike the situation in *Federated Dept. Stores*, there was no white knight transaction present in Staley I.

The U.S. Court of Appeals for the Seventh Circuit reversed. The Court of Appeals discussed the law concerning the deductibility of expenses to resist changes in corporate control before *INDOPCO, Inc.*, then stated that *INDOPCO, Inc.* neither abrogated nor even discussed those cases. The Court of Appeals then stated that the issue for decision in determining the deductibility of the fees was "whether the costs incurred * * * are more properly viewed as costs associated with defending a business or as costs associated with facilitating a capital transaction." Staley II, 119 F.3d at 489. The court allowed a deduction in part, remanding to this Court to allocate the costs between those that were incurred to prevent the takeover and those that facilitated the takeover.

III. *Origin of the Claim Doctrine*

The issue of whether expenses are deductible or must be capitalized may be resolved by the origin of the claim test. *Woodward v. Commissioner,* 397 U.S. 572, 90 S. Ct. 1302, 25 L. Ed. 2d 577 (1970); *United States v. Gilmore,* 372 U.S. 39, 83 S. Ct. 623, 9 L. Ed. 2d 570, 1963-1 C.B. 356 (1963). Under this test, the substance of the underlying claim or transaction out of which the expenditure in controversy arose governs whether the item is a deductible expense or a capital expenditure, regardless of the motives of the payor or the consequences that may result from the failure to defeat the claim. See *Woodward v. Commissioner, supra* at 578; *Newark Morning Ledger Co. v. United States*, 539 F.2d 929, 935 (3d Cir. 1976); *Clark Oil & Ref. Corp. v. United States*, 473 F.2d 1217, 1220 (7th Cir. 1973); *Anchor Coupling Co. v. United States,* 427 F.2d 429, 433 (7th Cir. 1970). The origin of the claim test does not involve a "mechanical search for the first in the chain of events" but requires consideration of the issues involved, the nature and objectives of the litigation, the defenses asserted, the purpose for which the amounts claimed as deductions were expended, and all other facts relating to the litigation. *Boagni v. Commissioner,* 59 T.C. 708, 713 (1973). The Supreme Court, in adopting the origin of the claim test, chose in favor of

the view that the origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer, is the controlling basic test of whether the expense was "business" or "personal" and hence whether it is deductible or not under section 23(a)(2). * * *
United States v. Gilmore, supra at 49.

The origin of the claim doctrine can help determine whether the termination fee should be

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deducted or capitalized by determining whether it is more closely tied to the Santa Fe-Homestake deal or the Santa Fe-Newmont deal.

IV. *Petitioner's Arguments*

A. *Significant Benefit*

Petitioner argues that Santa Fe did not receive a significant benefit from payment of the termination fee. First, petitioner argues that payment of the fee reduced Santa Fe's net worth by $ 65 million. Second, petitioner focuses on the effects of the Santa Fe-Newmont merger on Santa Fe. Petitioner points to the removal of Santa Fe's management team, the removal of Santa Fe's board of directors, the abandonment of Santa Fe's 5- and 10-year plans, and the termination of more than half of Santa Fe's employees. Lastly, petitioner argues that Newmont closed a disproportionate number of Santa Fe facilities after the merger was consummated.

B. *Origin of the Claim*

Petitioner argues that the origin of the claim doctrine requires us to find that the origin of the termination fee lies with the Santa Fe-Homestake agreement, and not the Santa Fe-Newmont combination. Petitioner points to the fee's origin in the Santa Fe-Homestake agreement and to the fact that the Santa Fe-Newmont agreement also included its own separate termination fee. Petitioner also points to the fact that the obligation to pay the termination fee arose before Santa Fe's later agreement with Newmont.

Petitioner attempts to rely on *12701 Shaker Blvd Co. v. Commissioner*, 36 T.C. 255 (1961), affd. 312 F.2d 749 (6th Cir. 1963), in support of its argument. In that case the Court determined the deductibility of fees paid by a corporation to retire bonds before issuing new bonds. In rejecting the taxpayer's argument that the fee should be tied to the new bond issue, we stated that the new financing was not so closely tied to the paying off of the old indebtedness that the two transactions cannot properly be deemed as separate and independent transactions. *Id.* at 258. Petitioner analogizes the issue in *Shaker Blvd. Co.* to the present issue.

Petitioner next contends that under *Wells Fargo Co. & Subs. v. Commissioner*, 224 F.3d 874 (8th Cir. 2000), affg. in part and revg. in part *Norwest Corp. & Subs. v. Commissioner*, 112 T.C. 89 (1999), the termination fee is more directly related to the Santa Fe-Homestake agreement than the Santa Fe-Newmont agreement. Therefore, because the fee is only indirectly related to the Santa Fe-Newmont deal, capitalization is not required under the origin of the claim doctrine and the termination fee is deductible.

Petitioner further argues that a finding that Newmont acted in a hostile manner supports its position. Petitioner points to language in Staley II and *United States v. Federated Dept. Stores, Inc.*, 171 Bankr. 603 (S.D. Ohio 1994), where the courts stated that costs incurred to defend a business from attack are deductible. Petitioner contends that these cases, along with respondent's concession that costs incurred to defend a business are

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deductible, resolve the instant proceeding in favor of deductibility.

Lastly, petitioner argues that the termination fee should be deducted because it served to frustrate, rather than facilitate, the merger between Santa Fe and Newmont. In petitioner's view, this finding -- that the fee frustrated Newmont's attempts -- brings the facts of the present case out of the *INDOPCO, Inc.* line of cases and into the Staley II and *Federated Dept. Store* cases.

C. *Petitioner's Experts*

Petitioner put forth two experts. Petitioner's first expert, W. Eugene Seago (Mr. Seago), has worked in the accounting field for more than 30 years and is a professor of accounting at Virginia Polytechnic Institute and State University. Mr. Seago's expert report focused on the termination fee as it related to public accounting principles, including whether inclusion of the fee in Santa Fe's income would fairly represent Santa Fe's income for 1997.

Petitioner's second expert, Gilbert E. Matthews (Mr. Matthews), has more than 45 years of experience in investment banking. Mr. Matthews's report made the following conclusions: (1) That the termination fee frustrated Newmont's attempts to acquire Santa Fe; (2) that Newmont, although first acting friendly, was clearly attempting a hostile takeover; (3) that Santa Fe as an entity did not benefit from the Newmont takeover; and (4) that although short-term shareholders benefited from Newmont's takeover, that benefit did not last for more than a year (i.e., the takeover did not benefit long-term holders of Santa Fe stock).

V. *Respondent's Arguments*

A. *Significant Benefit*

It is respondent's position that the termination fee should be capitalized under section 263(a) and not deducted under section 162(a). Respondent argues that petitioner paid the termination fee in order to enter into the Newmont offer. Respondent argues that Santa Fe was not facing a hostile takeover but instead wanted to overhaul its capital structure. Respondent further argues that Santa Fe's entering into an agreement with Homestake was merely a negotiating tactic aimed at convincing Newmont to increase its offer. Respondent points to Santa Fe's contacting Newmont in September 1996 as the beginning of Santa Fe's search for a business combination. Respondent's expert argues that at that time Santa Fe was "in play" and any action taken afterwards was done to secure the highest possible value for Santa Fe's shareholders.

As evidence of this significant benefit, respondent points to the March 28, 1996, report prepared by S.G. Warburg that advised Santa Fe that Santa Fe would not become a first-tier gold company without "strategic acquisitions, mergers or alliances." Respondent also points to the Santa Fe board's decision of September 26, 1996, to investigate a possible merger with Newmont. In respondent's view this statement is indicative of a decision by

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Santa Fe to proceed with a merger or sale of the company. Respondent also points to statements by the Santa Fe board contained in the March 10, 1997, board minutes and in the April 4, 1997, SEC Form S-4, Joint Proxy Statement. Both documents indicated that the Santa Fe board viewed the merger with Newmont as fair and in the best interests of Santa Fe stockholders:

In the Form S-4, the board of directors indicates that it unanimously concluded that the merger is fair and in the best interests of the Santa Fe shareholders, and accordingly, unanimously approved the merger agreement and unanimously resolve to recommend that the Santa Fe shareholders approve and adopt the merger agreement.

Respondent also points to press releases issued by Santa Fe and Newmont at the time of the merger generally touting the perceived benefits of the merger.

In respondent's view the termination fee was paid in order to enter into an agreement with Newmont and thus led to any benefits gained by entering into the agreement with Newmont. Therefore, the presence of these benefits requires that the termination fee be capitalized under section 263.

B. *Origin of the Claim*

Respondent argues that the origin of the claim doctrine requires the capitalization of the termination fee. Respondent argues that Santa Fe's payment of the termination fee was directly related to the merger with Newmont. Respondent maintains that Santa Fe was actively seeking a business merger.

Respondent points to *Acer Realty Co. v. Commissioner*, 132 F.2d 512, 513 (8th Cir. 1942), affg. 45 B.T.A. 333 (1941), and similar cases. In *Acer Realty Co.*, the Court of Appeals had to determine the deductibility of large salary payments related to a capital transaction. The court found that because the large salaries were directly related to a capital transaction, the salaries were required to be capitalized as part of that transaction. In *Wells Fargo Co. & Subs. v. Commissioner*, 224 F.3d 874 (8th Cir. 2000), however, the Court of Appeals found that salaries paid to employees who worked on a restructuring of the corporation were deductible because they were not extraordinary like the salaries in *Acer Realty Co.* Respondent distinguishes *Wells Fargo* on the grounds that while the salaries in *Wells Fargo* would have been paid whether the subject transactions were entered into or not, the termination fee at issue in the instant case would not have been paid unless Santa Fe entered into a transaction with Newmont. Respondent points to the fact that payment of the termination fee was conditioned on a "Company Takeover Proposal" and argues that this proposal is extraordinary and thus like the salaries in *Acer Realty Co.*

Respondent also argues that petitioner's application of the origin of the claim doctrine is improper because petitioner is simply applying the doctrine in a mechanical way according to which agreement was entered into first. Respondent argues that we have previously rejected this application of the doctrine in *Boagni v. Commissioner*, 59 T.C. at 713. Respondent argues that the Santa Fe-Newmont agreement triggered the termination fee and that the termination fee was paid so Santa Fe could enter into an agreement with

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Newmont. Therefore, the termination fee was directly associated with and facilitated the merger, unlike the salary expenses in *Wells Fargo*.

Respondent also disputes petitioner's claimed reliance on Staley II and *United States v. Federated Dept. Stores, Inc.*, 171 Bankr. 603 (S.D. Ohio 1994). Regarding Staley II, respondent frames the issue in the present case as whether the termination fee facilitated the merger that took place and argues that Staley II in fact requires capitalization of the termination fee. Respondent argues that Santa Fe faced one decision in March 1997: to proceed with Homestake and not pay a fee or proceed with Newmont and pay a fee. Under respondent's view, Santa Fe's decision to proceed with Newmont means that the termination fee became a cost to Santa Fe of fulfilling its overall objective of combining with another large mining company. Therefore, the termination fee "facilitated" the Santa Fe-Newmont merger and should be capitalized.

Respondent argues that *Federated Dept. Stores* is distinguishable. In *Federated Dept. Stores,* the District Court based its holding on the fact that "the subject hostile takeovers could not, and did not provide Federated or Allied with the type of synergy found in INDOPCO." *United States v. Federated Dept. Stores, Inc.*, *supra* at 609. Respondent argues that in the present case, the synergies found in *INDOPCO, Inc.* are present; therefore, *Federated Dept. Stores* does not apply. Respondent also argues that *Federated Dept. Stores* is distinguishable because there the targets engaged in defensive tactics that respondent argues are not present here. The District Court stated that "The bankruptcy court specifically found that the '[d]ebtors engaged in protracted and strenuous defensive tactics when faced, involuntarily, with the threat of Campeau's hostile acquisition.'" *United States v. Federated Dept. Stores, Inc.*, *supra* at 610 (quoting *In re Federated Dept. Stores*, 135 Bankr. at 961). Respondent argues that Santa Fe did not engage in any hostile defenses, even though there were a number of possible defensive tactics at its disposal (such as poison pills or shareholder rights plans).

C. *Respondent's Expert*

Respondent produced one expert witness, William H. Purcell (Mr. Purcell), a senior director at a Washington, D.C. investment banking firm. Mr. Purcell has over 40 years of experience in the investment banking business.

Mr. Purcell made a number of findings in support of respondent's arguments, including: (1) That the Santa Fe-Newmont transaction was not hostile; (2) that Santa Fe put itself into play as of October 1, 1996; and (3) that Santa Fe used the termination fee as a tool to maximize value for Santa Fe's shareholders. In Mr. Purcell's view, Santa Fe entered into an agreement with Homestake because Santa Fe wanted to send a message to Newmont that Newmont would have to raise its bid in order to acquire Santa Fe.

VI. *Analysis*

As discussed above, we must determine whether payment of the termination fee "[generated] significant benefits for * * * [Santa Fe] extending beyond the end of the

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taxable year.” *Metrocorp. Inc. v. Commissioner*, 116 T.C. at 222. As we stated in *Metrocorp*: “Expenses must generally be capitalized when they either: (1) Create or enhance a separate and distinct asset or (2) otherwise generate significant benefits for the taxpayer extending beyond the end of the taxable year.” *Id.* at 221-222. However, we must take care not to interpret every benefit received after payment of the termination fee as being caused by or related to the termination fee.

We note at the outset that this was clearly a hostile takeover of Santa Fe by Newmont. The management, board of directors, and investment bankers of Santa Fe considered Newmont hostile. Although initial contacts between the two entities were informal, Newmont went directly to Santa Fe’s shareholders once it learned that Santa Fe and Homestake had entered into an agreement. The presentations Goldman Sachs made to Newmont executives clearly foresaw a hostile takeover. Mr. Cambre’s letters to the Newmont board anticipated a fight and warned the board that this would lead to higher costs.

Executives of Santa Fe, Newmont, and Homestake all testified credibly that this was a hostile takeover. Further, we find credible petitioner’s expert Mr. Matthews’s conclusion that this was a hostile takeover. Respondent’s expert’s contention that this was a friendly transaction is at odds with the record as a whole and is not credible.

Although the merger was described in terms of “shared synergies”, the only synergy found in the transaction benefited Newmont. By acquiring Santa Fe, Newmont was able to obtain Santa Fe’s land while disregarding most of Santa Fe’s annual expenses. The record makes clear that Newmont was primarily interested in obtaining Santa Fe’s land position, and the only way for Newmont to acquire Santa Fe’s land was to purchase the entire company. Because Newmont was primarily interested in Santa Fe’s land, it quickly terminated Santa Fe’s employees and discarded the business plans of Santa Fe’s management. Although Santa Fe the entity continued to exist on paper, it was nothing more than a shell owning valuable land.

Santa Fe did not reap the types of benefits present in *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 112 S. Ct. 1039, 117 L. Ed. 2d 226 (1992). After the merger was completed, Newmont shut down Santa Fe’s headquarters and let go most of its management. The Supreme Court’s decision in *INDOPCO, Inc.* to require capitalization of the fees at issue therein relied on findings of this Court and the Court of Appeals for the Second Circuit that the expenditures at issue benefited the operations of the taxpayer incurring the fees. Santa Fe’s operations did not benefit from payment of the termination fee.

Santa Fe’s executives testified credibly that Santa Fe did not have as a strategic goal a business merger with any other mining company. Newmont was a hostile acquirer. In attempting to avoid Newmont’s overtures, Santa Fe sought a white knight: Homestake. Santa Fe was defending against an unwanted acquisition in an effort to maintain and protect its growing business. The termination fee was contracted for in an attempt to salvage its business plan and employees through a white knight combination. See *United States v. Federated Dept. Stores, Inc.*, 171 Bankr. at 610.

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The termination fee was intended to protect the Santa Fe-Homestake agreement, to deter competing bids, and to reimburse Homestake for its time and effort in the event that the deal was terminated. Although Santa Fe had structural defenses in place, its major defensive strategy was to engage in a capital transaction with a third party that would prevent Newmont's acquisition. This attempt failed. The record does not support a finding, and we do not find, that paying the termination fee produced any long-term benefit. See *id.* Respondent argues that *Federated Dept. Stores* is distinguishable on the facts because Santa Fe allegedly did not engage in defensive measures; however, the District Court in *Federated Dept. Stores* stated that the targets "engaged in defensive measures -- the white knight proposals with DeBartolo and Macy respectively." *Id.* The white knight transactions in *Federated Dept. Stores* were in fact viewed by the court as defensive measures meant to prevent the respective takeovers. The Santa Fe-Homestake agreement was a defensive measure meant to prevent Newmont's takeover of Santa Fe. The termination fee was a part of the Santa Fe-Homestake agreement and served as a defense against Newmont. Any benefit as a result of incurring the termination fee died along with the Santa Fe-Homestake agreement. Had Santa Fe's shareholders rejected the Santa Fe-Newmont agreement, or had some exigent circumstance arisen that required termination of the Santa Fe-Newmont agreement, Santa Fe would not have recovered the $ 65 million.

Although the fact that National Starch became a subsidiary as a result of its merger was viewed as a benefit supporting capitalization in *INDOPCO, Inc.*, we do not find Santa Fe's becoming a subsidiary to be a significant benefit. In *INDOPCO, Inc.*, National Starch's management viewed becoming a subsidiary as a positive aspect of the acquisition because it relieved National Starch of its shareholder responsibilities. The Supreme Court relied on this change of ownership in support of its decision to require capitalization precisely because the change in ownership structure served to benefit National Starch's operations. In the instant case, Santa Fe did not become a subsidiary which functioned much as Santa Fe had before the merger. Santa Fe no longer functioned as an autonomous business after the merger. Santa Fe viewed Homestake as a potential white knight to avoid just this result. Santa Fe management sought an agreement with Homestake to avoid being absorbed by Newmont, but the results of the Newmont merger confirm the accuracy of their concerns that Santa Fe would lose its operating identity in a merger with Newmont.

As stated above, the record does not support a finding that Santa Fe had as an overarching goal a business combination. The fact that the Santa Fe board had hired investment advisers and knew the state of the industry before initiating contact with Newmont does not mean that Santa Fe had decided on a corporate restructuring. Santa Fe executives testified credibly that Santa Fe's first contact with Newmont was meant to be preventative and meant to enable Santa Fe to remain in control of any investigation and agreement. The Santa Fe-Newmont agreement was not a modified form of the Santa Fe-Homestake agreement. Payment of the termination fee and subsequent signing of the Santa Fe-Newmont agreement was not, in substance, a continuation of the Santa Fe-Homestake agreement in some modified form. The two transactions were separate: (1) A

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white knight transaction; and (2) a hostile takeover. See *United States v. Federated Dept. Stores Inc., supra* at 611.

Santa Fe viewed Newmont's overtures as hostile; and in an attempt to defeat Newmont's takeover, Santa Fe sought out Homestake as a white knight. Because Newmont's offer was higher than Homestake's, the Santa Fe board believed that in order to fulfill its fiduciary duties the board had to terminate its agreement with Homestake and accept Newmont's higher offer. The facts do not support respondent's contention that the termination fee was paid to restructure Santa Fe in hopes of some future benefit. See *id.* The termination fee was paid to Homestake to compensate it for whatever expenses it incurred. See *id.* As the District Court concluded in *Federated Department Stores*: "in the instant case, the white knight mergers were abandoned. Any effect that this merger had on the later merger with Campeau is irrelevant." *Id.* at 611-612.

This Court's holdings in Staley I and *Norwest Corp. & Subs. v. Commissioner*, 112 T.C. 89 (1999), are distinguishable.

In *Norwest Corp. & Subs. v. Commissioner, supra* at 102, we required the taxpayer to capitalize salaries paid to bank executives for work performed in relation to a friendly merger that provided the bank with significant long-term benefits. Because of a change in State banking law, the taxpayer, a small local bank, sought out a merger with a larger national bank. The taxpayer merged with Norwest because doing so would allow the bank to continue operating competitively. After the transaction, the bank remained in operation and offered a wider array of services than the bank had offered previously. *Id.* at 95.

Relying on *INDOPCO, Inc.*, we required capitalization because the disputed expenses "enabled * * * [the taxpayer] to achieve the long-term benefit that it desired from the transaction". *Norwest Corp. & Subs. v. Commissioner, supra* at 100. Although the expenses were not directly related to the benefit, we required capitalization because "the costs were essential to the achievement of that benefit." *Id.* at 102.

In Staley I, as discussed above, we required the taxpayer to capitalize fees paid to investment bankers incident to a takeover. The taxpayer was a producer of food sweeteners and faced a takeover. The taxpayer hired and paid advisers who counseled the taxpayer before the takeover. Ultimately, the board of the taxpayer decided to accept the acquirer's offer. We held that the expenses had to be capitalized because they were incurred incident to the taxpayer's change of ownership, from which it derived significant long-term benefits.

Unlike Staley I, the present case features a white knight -- Homestake. Further, the acquirer in Staley I had long-term plans for the target corporation. Although the acquirer's plans diverged from those of the target's management, they were plans that nonetheless involved the target's operation as an ongoing company. After the takeover, the taxpayer existed and operated as a business. In the present case, Newmont did not have any plans for Santa Fe's continued operation, and Santa Fe did not operate post

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takeover.

In contrast to *Norwest Corp. & Subs.*, the instant transaction was not friendly. Newmont proceeded in a hostile manner once its initial contacts were rebuffed. Newmont's board and management planned for and effected a hostile takeover. Secondly, Santa Fe did not reap the type of benefits present in *Norwest Corp. & Subs.* Santa Fe was not able to operate in an improved manner once the transaction was completed. Santa Fe did not have access to wider services as a result of the merger, and Santa Fe was not able to operate competitively once taken over. Santa Fe, unlike the taxpayer in *Norwest Corp. & Subs.*, effectively ceased to exist.

Both *Norwest Corp. & Subs.* and Staley I focused on corporations whose operations benefited from the respective payments at issue. In the present case, Santa Fe's operations did not improve as a result of payment of the termination fee. As a result of the combination Santa Fe ceased operation. Although the merger was described in terms of synergies between the two companies, the result of the transaction was that Newmont was able to mine Santa Fe's land while cutting any duplicate costs. In *INDOPCO, Inc.* the taxpayer's operations improved because it gained access to National Starch's large distribution network. In *Norwest Corp. & Subs.*, the taxpayer benefited because it was both able to remain in competition in a much more competitive market and able to offer a wider range of services than it had before. In Staley I, the taxpayer benefited because as a result of its combination it moved away from recent strategic expansions into new industries back to its core business lines.

Payment of the termination fee did not lead to significant benefits for Santa Fe extending past the year at issue. Accordingly, petitioner is entitled to deduct the amount of the termination fee pursuant to section 162. In the light of our reasoning as stated above, we do not reach petitioner's argument concerning the origin of the claim doctrine.

VII. *Conclusion*

On the basis of the foregoing, petitioner is entitled to deduct the termination fee pursuant to section 162.

VIII. *Section 165*

Section 165 allows current deductions of any "loss sustained during the taxable year and not compensated for by insurance or otherwise." Section 165 allows a current deduction for costs associated with an abandoned capital transaction. *Sibley, Lindsay & Curr Co. v. Commissioner*, 15 T.C. 106 (1950). These principles have been applied even though the abandoned transaction, if consummated, would be a capital transaction and the associated costs would have to be capitalized. See *Doernbecher Manufacturing Co. v. Commissioner*, 30 B.T.A. 973 (1934), affd. on other grounds 80 F.2d 573 (9th Cir. 1935). The question is whether the subject transaction was actually abandoned. *United States v. Federated Dept. Stores, Inc.*, 171 Bankr. at 611. The loss must be evidenced by a closed and completed transaction, fixed by identifiable events. Sec. 1.165-1(b), (d), Income Tax

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Regs. The regulations also provide that the loss must be bona fide and that substance, not mere form, shall govern in determining a deductible loss. Sec. 1.165-1(b), Income Tax Regs. In *Sibley, Lindsay & Curr Co. v. Commissioner, supra*, the taxpayer's bankers prepared three separate restructuring plans. The taxpayers chose one of the three and attempted to deduct the cost of the other two. This Court allowed a deduction for the cost of the other two restructuring plans because they were separate plans distinct from the restructuring that was carried out. *Id.* at 110.

The District Court in *United States v. Federated Dept. Stores, Inc.*, 171 Bankr. 603 (S.D. Ohio 1994), also found that the taxpayers were entitled to deduct the termination fees pursuant to section 165. The District Court stated that both targets were presented with two mutually exclusive capital transactions: Mergers with the white knights, or mergers with the hostile acquirer. *Id.* at 611. The District Court reasoned that each transaction "must be viewed separately" and went on to state that "Just because a failed capital transaction has some effect on a later successful capital transaction does not prevent a deduction for a loss sustained in the failed transaction." *Id.*

Respondent argues that petitioner is not entitled to claim a deduction for an abandonment loss. As stated above, respondent argues that beginning in October 1996 Santa Fe had as a goal a corporate restructuring. Respondent views the potential Newmont and Homestake deals as two mutually exclusive alternatives, each a part of this goal. Because Santa Fe could merge with only one, and because Santa Fe had to terminate the Santa Fe-Homestake agreement to merge with Newmont, the termination fee should not be allowed as a deduction under section 165 because Santa Fe never abandoned its goal of a combination and in fact satisfied it by merging with Newmont. Respondent argues Santa Fe's goal was a business merger, not that the Homestake and Newmont mergers were two separate transactions. Therefore, because (1) Santa Fe combined with Newmont, (2) the termination fee was paid to facilitate that merger, and (3) because no transaction was abandoned, there was no closed transaction with Homestake.

Respondent argues that caselaw requires the capitalization of fees paid to extricate a party from one contract in order to enter into a more favorable contract as part of an integrated plan or overall objective. Respondent points to a line of cases where costs related to mutually exclusive alternatives that were part of an integrated plan were not allowed as abandonment losses. Respondent further argues that Santa Fe made a voluntary and well-thought-out decision to terminate the Homestake agreement, pay the termination fee, and merge with Newmont.

Petitioner argues that Santa Fe was faced with two separate transactions: (1) A hostile takeover by Newmont; and (2) a white knight transaction with Homestake. Santa Fe management, in petitioner's view, was not engaged in one overarching plan to restructure the company's capital structure. Santa Fe attempted to avoid Newmont's overtures by entering into a deal with Homestake. When Newmont increased its offer, the Santa Fe board had no choice but to abandon the Homestake deal. Therefore, petitioner argues, the termination fee paid to Homestake was part of an abandoned transaction and petitioner is allowed to deduct the termination fee under section 165.

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Petitioner again analogizes the current case to *Federated Dept. Stores.* Respondent argues that *Federated Dept. Stores* does not apply and argues that the key fact underlying the *Federated Dept. Stores* decision -- that neither of the targets in that case had voluntarily terminated their merger agreements in order to engage in a more favorable merger -- is not present here.

We agree with petitioner. The facts in this case do not show that Santa Fe pursued a corporate restructuring. It is clear that the board and management of Santa Fe did not want to be taken over by a large competitor so shortly after the company was spun off from its former parent. Santa Fe viewed Newmont as hostile and entered into a white knight agreement with Homestake in order to prevent Newmont's acquisition. Later, Santa Fe was forced to abandon its agreement with Homestake when it became clear that Newmont's offer had to be accepted. When Newmont raised its bid above that of Homestake and Homestake refused to match it, Santa Fe had no choice. Delaware law required that the board members choose the highest value for their shareholders. This forced Santa Fe to breach the Santa Fe-Homestake agreement and pay the termination fee. At that time, the Santa Fe-Homestake merger was abandoned. The termination fee was paid as a result of that abandonment and was therefore a cost of the abandoned merger with Homestake.

Accordingly, Santa Fe is alternatively entitled to a deduction under section 165. Santa Fe viewed the possible transactions with Homestake and Newmont as separate and distinct. The two possible combinations were not part of an overall plan by Santa Fe to change its capital structure. The Santa Fe-Homestake agreement was a closed and completed transaction that Santa Fe later abandoned when it entered into the Santa Fe-Newmont agreement.

IX. *Conclusion*

On the basis of the foregoing, petitioner is entitled to a deduction of $ 65 million pursuant to sections 162 and 165 for the termination fee paid to Homestake.

Accordingly,

Decision will be entered under Rule 155.

D. Page 280, New Sec. 5.5.B.5. Additional Final Regulations on Effect of Section 338(h)(10) Elections in Multistep Transactions

Page 280, New Sec. 5.5.B.5. Add after Sec. 5.5.B.4 the following:

New Sec. 5.5.B.5. **Additional Final Regulations on Effect of Section 338(h)(10) Elections in Multistep Transactions**

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Preamble to Final Regulations Effect of Elections in Certain Multi-Step Transactions
TD 9271, July 5, 2006

SUMMARY: This document contains final regulations that give effect to section 338(h)(10) elections in certain multi-step transactions. These final regulations are necessary in order to provide taxpayers with guidance regarding the validity of certain elections made under section 338(h)(10). These final regulations affect corporations and their shareholders. * * *

Background. The IRS published temporary regulations (TD 9071) in the Federal Register on July 9, 2003 (68 FR 40766) (the temporary regulations), along with a notice of proposed rulemaking by cross-reference to the temporary regulations (REG-143679-02) (the proposed regulations). These temporary regulations provide, notwithstanding anything to the contrary in §1.338-3(c)(1)(i), a section 338(h)(10) election may be made for T where P's acquisition of T stock, viewed independently, constitutes a qualified stock purchase and, after the stock acquisition, T merges or liquidates into P (or another member of the affiliated group that includes P), whether or not, under relevant provisions of law, including the step transaction doctrine, the acquisition of the T stock and the merger or liquidation of T qualify as a reorganization described in section 368(a). If a section 338(h)(10) election is made in a case where the acquisition of T stock followed by a merger or liquidation of T into P qualifies as a reorganization described in section 368(a), for all Federal tax purposes, P's acquisition of T stock is treated as a qualified stock purchase and is not treated as part of a reorganization described in section 368(a). For rules about the operation of the step transaction doctrine and the relationship between section 338 and the reorganization provisions when a section 338 election is not made, see §1.338-3(d). See also Rev. Rul. 90-95 (1990-2 CB 67). See §601.601(d)(2).

No public hearing regarding the proposed regulations was requested or held. The IRS received written and electronic comments regarding the proposed regulations. After consideration of the comments, the proposed regulations are adopted by this Treasury decision. The most significant comments received with respect to the proposed regulations are discussed in this preamble.

Explanation of Provisions

A. Section 338(g) Elections. Some commentators recommend that the final regulations allow section 338(g) elections, as well as section 338(h)(10) elections, to turn off the step transaction doctrine in a multi-step transaction that constitutes a reorganization under section 368(a). Although a section 338(g) election is made by the purchasing corporation and the shareholders of the target corporation (target) do not consent to the election, one commentator states that the IRS will not be subject to whipsaw if the IRS provides regulations requiring the shareholders of the acquired corporation to treat the transaction

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consistently with the acquiring corporation's election, rather than as a reorganization under section 368(a).

The final regulations do not adopt the commentators' recommendation, and continue to turn off the step transaction doctrine only in the case of section 338(h)(10) elections. Extending the final regulations to section 338(g) elections would allow the acquiring corporation to unilaterally elect to treat the transaction, for all parties, as other than a reorganization under section 368(a). In light of potential whipsaw and other concerns, the final regulations continue to apply only to section 338(h)(10) elections, not section 338(g) elections.

B. Corporate Purchaser Requirement. One commentator suggests that §1.338-3(b) be amended to clarify under what circumstances a corporation will be considered, for tax purposes, to have purchased the stock of target pursuant to section 338(d)(3).

Under §1.338-3(b), an individual cannot make a qualified stock purchase of target. If an individual forms a corporation (new P) to acquire target stock, new P can make a qualified stock purchase of target if new P is considered, for tax purposes, to purchase the target stock. Facts that may indicate that new P does not purchase the target stock include new P's merging downstream into target, liquidating, or otherwise disposing of the target stock following the purported qualified stock purchase.

The IRS and Treasury Department are continuing to study whether any amendments to the portion of the regulations under section 338 related to the corporate purchaser requirement are appropriate.

E. Page 281, New Sec. 5.5.Ca. Preamble to the Proposed Regulations under Section 336(e)

Page 281, New Sec. 5.5.Ca. Add before Sec. 5.5.D the following:
New Sec. 5.5.Ca. **Preamble to the Proposed Regulations under Section 336(e)**

Preamble to Proposed Regulations under Section 336(e)
August 25, 2008

Background and Explanation of Provisions
Section 336(e) of the Internal Revenue Code (Code) authorizes the issuance of regulations under which a corporation (seller) that owns stock in another corporation (target) meeting the requirements of section 1504(a)(2) and sells, exchanges, or distributes all of such stock may make an election to treat the sale, exchange, or distribution of the target stock as a sale of all of target's underlying assets. Section 336(e) was enacted as part of the legislation repealing the General Utilities rule and, like an election under section 338(h)(10), is meant to provide taxpayers relief from a potential multiple taxation at the corporate level of the same economic gain which can result when a transfer of appreciated corporate stock is taxed to a corporation without providing a

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corresponding step-up in the basis of the assets of the corporation. See H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess., Vol. II, 198, 204 (1986), 1986-3 C.B., Vol. 4, 198-207.

A. Scope of the Proposed Regulations

Pursuant to section 336(e), regulations may authorize a section 336(e) election in a broad set of circumstances. The IRS and Treasury Department have limited the scope of these proposed regulations, however, in order to provide guidance to a large number of taxpayers in the most efficient manner possible. These proposed regulations, when finalized, will provide the requirements and mechanics for, and consequences of, treating a stock sale, exchange, or distribution that would not otherwise be eligible for a section 338 election as a deemed asset sale.

The IRS and Treasury Department do not presently intend to authorize the making of section 336(e) elections under all the circumstances described within the statutory grant of authority. However, the IRS and Treasury Department are interested in comments regarding transactions beyond the scope of these proposed regulations for which such elections should be allowed and under what terms and conditions. For example, these proposed regulations do not apply to transactions between related persons. For this purpose, persons are related if stock in a corporation owned by one of the persons would be attributed to the other person under section 318(a), other than section 318(a)(4). See proposed §1.336-1(b)(11). The IRS and Treasury Department continue to study the possibility of making a section 336(e) election available for such transactions. Accordingly, comments are requested regarding dispositions to related persons, including special rules needed to prevent the use of net operating losses to offset liquidation gains, manipulation of earnings and profits, and changes of accounting methods. See H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess., Vol. II at 204 (1986).

Additionally, these proposed regulations do not apply to transactions in which either the seller or the target is a foreign corporation. The IRS and Treasury Department request comments regarding how the rules of the proposed regulations should be modified to take into account the policies of international tax provisions if the proposed regulations were extended to apply to foreign sellers and/or foreign targets. For example, comments are requested regarding: (1) How the principles of section 338(h)(16) should apply; (2) how the foreign tax allocation rule of §1.338-9(d) should apply; (3) the characterization of the gain recognized on the deemed asset disposition for purposes of section 954(c)(1)(B); (4) whether special earnings and profits rules are necessary (see, for example, the rules described in Prop. Treas. Reg. §1.367(b)-8); and (5) how the withholding tax provisions of section 1445 should apply to the deemed asset disposition (if relevant).

The IRS and Treasury Department continue to study issues related to elections made under section 338(g) in the international area. Comments are requested on issues in this area, including the interaction of section 338(h)(16) with sections 902 and 960.

Absent the issuance of further guidance, it is intended that these regulations would provide the exclusive means of making elections under section 336(e). See proposed §1.336-2(a).

B. General Principles

1. General Adoption of Section 338(h)(10) Principles

The legislative history to section 336(e) provides that principles similar to those of section 338(h)(10) should apply in the case of a section 336(e) election. See H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess., Vol. II, at 204 (1986). These proposed regulations

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implement such principles. Accordingly, except to the extent inconsistent with the purposes of section 336(e) or as otherwise described, the results of a section 336(e) election coincide with those of a section 338(h)(10) election. Whenever possible, these proposed regulations rely upon and use the structure and principles established under section 338(h)(10) and the underlying regulations. For example, these regulations refer to principles under the section 338 regulations regarding the allocation of consideration, application of the asset and stock consistency rules, treatment of minority shareholders, and the availability of the section 453 installment method. In other instances, definitions and concepts from section 338 and the underlying regulations have been modified to reflect principles applicable to section 336(e). For example, these proposed regulations generally use the term “disposition” rather than “acquisition or purchase” and the term “sale, exchange, or distribution” instead of “sale.” Thus, a qualified stock disposition is defined as any transaction or series of transactions in which stock meeting the requirements of section 1504(a)(2) of a domestic corporation is either sold, exchanged, or distributed, or any combination thereof, by another domestic corporation in a disposition, within the meaning of proposed §1.336-1(b)(4), during the 12-month disposition period. See proposed §1.336-1(b)(5).

These proposed regulations also provide that a transaction that satisfies the definition of both a qualified stock disposition and a qualified stock purchase (as defined in section 338(d)(3)) generally will be treated only as a qualified stock purchase and thus does not qualify for an election under these regulations. See proposed § 1.336-1(b)(5)(ii)).

2. Requirements for a Section 336(e) Election

Section 336(e) requires that a seller own stock in another corporation meeting the requirements of section 1504(a)(2) and sell, exchange, or distribute all of such stock to qualify for a section 336(e) election. For purposes of these proposed regulations, a seller is a domestic corporation that makes a qualified stock disposition and includes a transferor and a distributor of target stock. See proposed §1.336-1(b)(1). Generally, all members of a seller’s consolidated group are treated as a single seller. See proposed §1.336-2(g)(2). Thus, similar to a section 338(h)(10) election, a section 336(e) election is available to a seller that directly owns stock of target meeting the requirements of section 1504(a)(2) and to sellers which are members of a consolidated group for the taxable year that includes the disposition date that in the aggregate own stock of target meeting the requirements of section 1504(a)(2). Because section 336(e) requires a corporate seller, the election is not available with respect to the stock of an S corporation. See proposed §1.336-1(b)(5). Cf. § 1.338(h)(10)-1(c)(1).

These proposed regulations interpret section 336(e) as requiring only that an amount of stock meeting the requirements of section 1504(a)(2) be disposed of and not that every share of stock owned by the seller be disposed of. Accordingly, the seller, or a member of seller’s consolidated group, may retain a portion of its target stock. See proposed §§1.336-2(b)(1)(v) and 1.336-2(b)(2)(iv). Furthermore, these proposed regulations permit amounts of target stock sold, exchanged, and distributed to be aggregated for purposes of determining whether there has been a qualified stock disposition. For example, a domestic corporation’s sale of 50 percent of target’s stock to an unrelated person and a distribution to its unrelated shareholders of the remaining 50 percent within a 12-month period would constitute a qualified stock disposition. See proposed §1.336-1(b)(5).

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In contrast to section 338, which requires a corporate purchaser, these proposed regulations define a purchaser as any person or persons who receive stock of target in a qualified stock disposition. Accordingly, a section 336(e) election is available for sales, exchanges, or distributions (or a combination thereof) of target stock to both corporate and non-corporate purchasers, provided that the target stock is not sold, exchanged, or distributed to a related person. See proposed §§1.336-1(b)(2) and 1.336-1(b)(4)(i)(C). Any stock sold, exchanged, or distributed to a related party is not considered to be disposed of for purposes of determining whether there has been a qualified stock disposition. See proposed §§1.336-1(b)(4)(i)(C) and 1.336-1(b)(5)(i). Relatedness generally is determined immediately after the sale, exchange, or distribution of target stock occurs (see proposed §§1.336-1(b)(4)(iii), 1.336-1(b)(11), and 1.338-3(b)(3)).

C. Sales or Exchanges of Target Stock

In general, if a seller sells or exchanges target stock in a qualified stock disposition, the treatment of old target, seller, and purchaser are similar to the treatment of old target (old T), S, and P under section 338(h)(10). See §1.338(h)(10)-1. If an election is made under section 336(e), the seller disregards the actual sale or exchange of target stock. Instead, target (old target) is treated as selling all of its assets to an unrelated corporation in a single transaction at the close of the disposition date (the deemed asset disposition). Old target recognizes the deemed disposition tax consequences from the deemed asset disposition before the close of the disposition date while it is a subsidiary of seller. After the deemed asset disposition, old target is then treated as liquidating into seller which in most cases will be treated as a distribution in complete liquidation to which section 332 and section 336 or 337 applies. Additionally, consistent with a section 338 election, the deemed purchase of the assets of old target by new target constitutes a deemed purchase of any subsidiary stock owned by target. Accordingly, a section 336(e) election is available for the deemed purchase of the stock of a target subsidiary if it constitutes a qualified stock disposition. A section 336(e) election generally does not change the tax consequences of the acquisition to a purchaser of target stock.

D. Distributions of Target Stock Not Described in Section 355(d)(2) or (e)(2)

A section 336(e) election can be made for a distribution of target stock, and the legislative history to section 336(e) provides that “[t]he conferees do not intend this election to affect the manner in which a corporation’s distribution to its shareholders will be characterized for purposes of determining the shareholder level income tax consequences.” H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess., Vol. II, at 204 (1986). Accordingly, additional rules are required to address distributions and to ensure that the income tax consequences to a distributee are generally the same as if a section 336(e) election was not made.

Specifically, these proposed regulations provide that if seller (the distributor) distributes old target stock in the qualified stock disposition, seller is deemed to purchase from new target on the disposition date, immediately after the deemed liquidation of old target, the amount of stock distributed in the qualified stock disposition and to have distributed such new target stock to its shareholders. Seller recognizes no gain or loss on the distribution. See proposed §1.336-2(b)(1)(iv). The distributee’s tax consequences generally shall be the same as if it received the target stock pursuant to the underlying distribution. However, the Federal income tax consequences of the deemed asset disposition and liquidation of target may affect the distributee’s income tax consequences. For example,

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if seller distributes the stock of target to its shareholders in a qualified stock disposition for which a section 336(e) election is made, any increase in seller's earnings and profits as a result of old target's deemed asset disposition and liquidation into seller may alter the amount of the distribution to the shareholders constituting a dividend under section 301(c)(1) from the amount that would have resulted if seller recognized gain on the stock distribution. See proposed §1.336-2(c).

If a seller actually distributed stock of a subsidiary or assets under section 301, it generally would be prevented from recognizing any loss. See section 311(a). The IRS and Treasury Department believe that it would be inconsistent with the general treatment of distributions to allow losses to be recognized on the section 336(e) deemed asset disposition to the extent the qualified stock disposition was the result of a stock distribution. Therefore, under these proposed regulations, only a portion of the losses realized on the deemed asset disposition may be recognized. The portion of any realized loss that may be recognized is based on a fraction equal to the value of the target stock sold or exchanged in the qualified stock disposition on or before the disposition date over the total value of target stock disposed of in the qualified stock disposition on or before the disposition date. In the case of a section 336(e) election for a subsidiary of target, for purposes of determining the amount of loss that may be recognized by the subsidiary on the deemed asset disposition, only the percentage of the stock of the target subsidiary deemed sold by target equal to the percentage of the stock of target sold or exchanged is considered to have been sold or exchanged. See proposed §§1.336-2(b)(1)(i)(B)(2) and (3). Thus, losses realized in the deemed asset disposition are not recognized to the extent the qualified stock disposition is attributable to the distribution of target stock.

E. Section 355 Distributions

1. Availability of Section 336(e) Election for Certain Section 355 Distributions

The legislative history to section 336(e) indicates that the election is intended to be available for taxable transactions. Specifically, the Conference Report provides that, "principles similar to those of section 338(h)(10) may be applied to taxable sales or distributions of controlled corporation stock." H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess., Vol. II, at 204 (1986). The legislative history to section 355(e) provides that although there is no adjustment to the basis of stock or assets as a result of the recognition of gain under section 355(e), "[t]here is no intention to limit the otherwise applicable Treasury regulatory authority under section 336(e) of the Code." H.R. Conf. Rep. 220, 105th Cong., 1st Sess., 531-532, footnote 13 (1997), 1997-4 C.B. Vol. 4, 531, 532. Accordingly, these proposed regulations would allow a corporation that would otherwise recognize the full amount of the gain realized with respect to a qualified stock disposition resulting, in whole or in part, from a disposition described in section 355(d)(2) or (e)(2) to make a section 336(e) election. Without a section 336(e) election, such provisions may create a triple layer of taxation, one at the controlled corporation level, one at the distributing corporation level and, ultimately, one at the shareholder level. Allowing a section 336(e) election in these circumstances limits taxation to two layers, one at the controlled corporation level and one at the shareholder level when the controlled corporation stock is disposed of, and thus is consistent with General Utilities repeal.

2. Special Rules for Distributions Described in Section 355(d)(2) or 355(e)(2)

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Generally, a section 336(e) election, like a section 338(h)(10) election, results in a deemed sale of old target's assets followed by a liquidation of old target into seller, which if made in a transaction to which section 381 applied, results in old target's attributes being transferred to the seller. Accordingly, consistent with a taxable asset acquisition, after the transaction new target generally has no tax attributes or earnings and profits, and holds its assets with a cost basis. In contrast, a section 355 distribution is generally tax-free to the distributing corporation's shareholders, even if the transaction is described in section 355(d)(2) or 355(e)(2). Further, following a section 355 distribution, the controlled corporation generally retains tax attributes and earnings and profits. The IRS and Treasury Department believe that, except as necessary to carry out the purposes of section 336(e), the section 355 consequences generally should continue to apply in such a transaction. For example, if the controlled corporation were treated as a new corporation, with no earnings and profits, the controlled corporation may be able to distribute its assets to its shareholders without recognizing any dividend consequences under section 301(c)(1). Therefore, to preserve the consequences of section 355 distributions, the proposed regulations provide special rules.

If a section 336(e) election is made for a distribution of the controlled corporation stock in a transaction described in section 355(d)(2) or 355(e)(2), the controlled corporation is treated as if it sold its assets to an unrelated person in the deemed asset disposition and then it reacquired those assets (sale-to-self treatment). Following the deemed asset disposition, the controlled corporation (old target) is not deemed to liquidate into the distributing corporation (seller). See proposed §1.336-2(b)(2)(i)(A). Instead, the controlled corporation (old target) is treated as acquiring all of its assets from an unrelated person in a single, separate transaction at the close of the disposition date, and then the distributing corporation is treated as distributing the stock of the controlled corporation (old target) to its shareholders. See proposed §1.336-2(b)(2)(ii) and (iii). Because no liquidation of old target into seller is deemed to occur, the controlled corporation (old target) will generally retain the tax attributes it would have had if the section 336(e) election had not been made. The proposed regulations further provide that the controlled corporation (old target) will take the effects of the deemed asset disposition into account and increase or decrease its earnings and profits immediately before allocating earnings and profits pursuant to §1.312-10. See proposed §1.336-2(b)(2)(vi). Finally, the deemed sale and reacquisition of target's assets (and, in the case of a parent-subsidiary chain of corporations making section 336(e) elections, a target subsidiary's assets) pursuant to the deemed asset disposition will not cause the transaction to fail to satisfy the requirements of section 355. See proposed §1.336-2(b)(2)(v).

Similar to a qualified stock disposition resulting from a distribution not involving a transaction described in section 355(d)(2) or (e)(2), old target's losses in the deemed asset disposition will be recognized, but only in relation to the amount of stock sold or exchanged in the qualified stock disposition on or before the disposition date. See §§ 1.336-2(b)(2)(i)(B)(2) and (3).

Notwithstanding the fact that the sale-to-self treatment applies to a distribution of stock described in section 355(d)(2) or (e)(2), if old target has any subsidiaries for which a section 336(e) election is made, the general deemed asset disposition methodology shall apply. Accordingly, old target subsidiary is treated as though it sold all its assets to an unrelated person, new target subsidiary is deemed to purchase all its assets from an

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unrelated person, and old target subsidiary is deemed to liquidate into old target. If the sale-to-self treatment was applied, target subsidiary's attributes would remain with target subsidiary. The IRS and Treasury Department do not believe that taxpayers should have the option of whether the attributes become those of target, by doing an actual sale of target subsidiary's assets followed by a liquidation of target subsidiary, or remain with target subsidiary, by making a section 336(e) election for target subsidiary. Accordingly, the regulations apply the general deemed asset disposition methodology for section 336(e) elections for target subsidiaries in a distribution of target stock described in section 355(d)(2) or (e)(2).

3. Intragroup Sales, Exchanges, or Distributions Prior to External Sales, Exchanges, or Distributions

Generally, if the stock of a target is transferred within an affiliated group and then is further transferred outside the affiliated group, a section 336(e) election is not available for the intragroup transfer because a qualified stock disposition may not be made between related sellers and purchasers. Thus, stock level gain may be recognized on the intragroup transfer. While a section 336(e) election may be available for the external transfer, this election would result in the affiliated group recognizing gain both on target's assets and the target stock, contrary to the intent of these proposed regulations. Comments are requested on how to address this concern. Further, because section 355(f) provides that section 355 does not apply to an intragroup distribution prior to an external distribution described in section 355(e)(2), these comments should address the concerns that section 355(f) is intended to address for distributions described therein.

F. Aggregate Deemed Asset Disposition Price (ADADP) and Adjusted Grossed Up Basis (AGUB)

These proposed regulations create a new term, aggregate deemed asset disposition price (ADADP). These proposed regulations retain the term adjusted grossed up basis (AGUB) as used in section 338. See § 1.338-5. In general, these proposed regulations treat ADADP and AGUB similarly to the way aggregate deemed sale price (ADSP) and AGUB are treated under the section 338 regulations. See proposed §§ 1.336-3 and 1.336-4. Old target recognizes all of the gain realized on the deemed transfer of its assets in exchange for the ADADP and allocates the ADADP among the assets held as of the disposition date (in the same manner as ADSP is allocated under §§1.338-6 and 1.338-7). See proposed §§1.336-2(b)(1)(i) and 1.336-2(b)(2)(i). ADADP is calculated by adding the grossed-up amount realized on the sale, exchange, or distribution of recently disposed target stock and the liabilities of old target. See proposed § 1.336-3(b)(1). These proposed regulations account for the fact that there is no actual amount realized in a distribution of stock by treating the grossed-up amount realized on the sale, exchange, or distribution as including in the amount realized the fair market value of recently disposed target stock distributed in the qualified stock disposition. See proposed §1.336-3(c)(1)(i)(B).

These proposed regulations also create a new term, nonrecently disposed stock. The term nonrecently disposed stock has a similar meaning to the term nonrecently purchased stock in section 338(b)(6)(B). In a transaction for which a section 338 election is made, there is only one purchasing corporation (or an affiliated group treated as a purchasing corporation). Accordingly, in most cases, it should be relatively easy to determine the purchaser's basis in nonrecently purchased stock in order to determine AGUB. However, in a section 336(e) election, there can be multiple purchasers or multiple distributees,

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many of whom may have acquired small amounts of target stock prior to the 12-month disposition period. While a more precise determination of AGUB would require the determination of the basis of all such stockholdings, the IRS and Treasury Department recognize that it would often be impractical to require a seller to determine and track all the purchasers (and distributees) possessing small amounts of nonrecently purchased stock. Generally, purchasers holding at least 10 percent of the total voting power or value of the stock of target should be readily identifiable through mandatory SEC filings and other sources. Thus, in order to balance a desire for precision with a practical application, nonrecently disposed stock is defined as stock in a target corporation which is held on the disposition date by a purchaser or a person related to a purchaser who owns, on the disposition date, with the application of section 318(a), other than section 318(a)(4), at least 10 percent of the total voting power or value of the stock of target, and which is not recently disposed stock. See proposed §1.336-1(b)(17).

In general, proposed §1.336-4 uses the same principles as paragraphs (b) through (g) of §1.338-5 to determine the amount of AGUB for target and the consequences of a gain recognition election. Proposed §1.336-4(b) contains modifications to the principles of §1.338-5 to reflect the principles of section 336(e).

New target is treated as acquiring all of its assets from an unrelated person in a single transaction at the close of the disposition date, but before the deemed liquidation (or, in the case of a transaction described in section 355(d)(2) or (e)(2), before the distribution) in exchange for an amount equal to the AGUB as determined under proposed §1.336-4. New target allocates the consideration deemed paid in the same manner as new target would as described in §§1.338-6 and 1.338-7 in order to determine the basis in each of the transferred assets. See proposed §§1.336-2(b)(1)(ii) and 1.336-2(b)(2)(ii). In the case of a disposition described in section 355(d)(2) or (e)(2), any reference to new target is treated as referring to old target in its capacity as the purchaser of assets pursuant to the section 336(e) election. See proposed §1.336-4(b)(4).

Consistent with the principles of a section 338(h)(10) election, any stock retained by a seller or a member of seller's consolidated group after the 12-month disposition period is treated as acquired by the seller on the day after the disposition date at its fair market value. For this purpose, the fair market value of all the target stock equals the grossed-up amount realized on the sale, exchange, or distribution of recently disposed stock. See proposed §§1.336-2(b)(1)(v) and 1.336-2(b)(2)(iv). A minority shareholder (that is, a shareholder that is neither the seller that disposes of 80 percent of the voting power and value of target stock nor a member of seller's consolidated group) is generally not affected by a section 336(e) election. Accordingly, such a minority shareholder that disposes of its target stock will recognize gain or loss on the stock without regard to the section 336(e) election, and a minority shareholder that retains its target stock retains its basis and holding period in its target stock. See proposed §1.336-2(d).

Under proposed §1.336-4(c), a holder of nonrecently disposed stock may make a gain recognition election, similar to the gain recognition election under section 338, which treats the nonrecently disposed stock as being sold as of the disposition date. The gain recognition election is mandatory if a purchaser owns (after the application of the rules of section 318(a), other than section 318(a)(4)) 80 percent or more of the voting power or value of target stock. See proposed §§1.336-1(b)(15) and 1.336-4(c)(2). Cf. §§1.338(h)(10)-1(d)(1) and 1.338-5(d). Once made, a gain recognition election is

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irrevocable. See proposed §1.336-4(c)(1). The IRS and Treasury Department request comments on whether the rules regarding gain recognition elections in these proposed regulations are appropriate, and whether the gain recognition election rules in regulations promulgated under section 338 should continue to apply. Also, see the “Correction to section 1.338-5” section of this preamble addressing a correction to the definition of the term basis amount, the amount used in determining the purchasing corporation’s gain on the deemed sale of stock pursuant to the gain recognition election and in determining AGUB.

G. Making the Section 336(e) Election

These proposed regulations provide that a section 336(e) election is made by seller attaching a statement to its timely filed Federal income tax return for the taxable year that includes the disposition date. See proposed §1.336-2(h). If the seller is a member of a consolidated group, the statement is filed with the group’s consolidated return.

The IRS and Treasury Department believe that it is appropriate to allow the seller (or the common parent of the seller’s consolidated group) to unilaterally make the section 336(e) election. The IRS and Treasury Department believe that in a distribution of target stock, it would be impractical to require each distributee, who generally will hold relatively small percentages of the target stock, to join in the election. Further, the distributees’ interests should generally be protected because of the distributing corporation’s fiduciary responsibilities to its shareholders. In the case of a sale or exchange, the purchasers should be able to protect their interests in any purchase contract. Comments are requested regarding whether it is appropriate to allow such unilateral section 336(e) elections in all cases.

The information required on a section 336(e) election statement is similar to that required on Form 8023, Elections Under Section 338 for Corporations Making Qualified Stock Purchases. In the case of a gain recognition election, the section 336(e) election statement must include information pertaining to the gain recognition election.

When finalized, these proposed regulations will permit taxpayers to make a protective section 336(e) election if they are unsure of whether a transaction constitutes a qualified stock disposition. If such an election is made, it will not have any effect if the transaction does not constitute a qualified stock disposition but will otherwise be binding and irrevocable. See proposed §1.336-2(j).

H. Correction to §1.338-5

Section 338(b)(3)(A) authorizes regulations under which the purchasing corporation may elect to step up its basis in nonrecently purchased stock (gain recognition election) to a “basis amount.” Under section 338(b)(3)(B), the basis amount is equal to the grossed-up basis of the purchasing corporation’s recently purchased stock multiplied by a fraction, the numerator of which is the percentage of target stock attributable to the purchasing corporation’s nonrecently purchased stock and the denominator of which is 100 percent minus the numerator amount.

Section 1.338-5(d) provides for the above described gain recognition election. Section 1.338-5(d)(3)(ii) provides that the basis amount is equal to the amount in §1.338-5(c)(1) (the purchasing corporation’s basis in recently purchased target stock determined without regard to acquisition costs) multiplied by a fraction, the numerator of which is the percentage of target stock (by value, determined on the acquisition date) attributable to the purchasing corporation’s nonrecently purchased target stock and the denominator of

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which is 100 percent minus the numerator amount. Section 1.338-5(d)(3)(ii) goes on to state, "[t]hus, if target has a single class of outstanding stock, the purchasing corporation's basis in each share of nonrecently purchased target stock after the gain recognition election is equal to the average price per share of the purchasing corporation's recently purchased target stock."

However, unless the purchasing corporation purchases all of the outstanding stock of target (other than the purchasing corporation's nonrecently purchased stock) within the 12-month acquisition period on or before the acquisition date, the formula in the regulations will not result in the purchasing corporation's basis in each share of nonrecently purchased stock equaling the average price of the recently purchased stock. Only if the basis in the recently purchased stock is grossed-up (as provided by the Code) will such result be achieved. In fact, §1.338-5(g), Example 1, paragraph (v), in demonstrating the effect of a gain recognition election, uses the grossed-up basis in the recently purchased stock, not the non-grossed-up basis, consistent with both the Code and the intent of the regulation. Accordingly, § 1.338-5(d)(3)(ii) is corrected to use the grossed-up basis of recently purchased stock in determining the basis amount, rather than the non-grossed-up basis.

I. Proposed Effective/Applicability Date * * *

F. Page 299, New Sec. 5.6.D.15. Preamble to 2008 Final Disallowance of Loss Regulations

Page 299, New Sec. 5.6.D.15. Add before Sec. 5.7 the following:
New Sec. 5.6.D.15.. **Preamble to 2008 Final Disallowance of Loss Regulations**

Preamble to Final Disallowance of Loss Regulations, Unified Rule for Loss on Subsidiary Stock

Treasury Decision 9424, September 10, 2008

SUMMARY:

This document contains final regulations under sections 358, 362 (e) (2), and 1502 of the Internal Revenue Code (Code). The regulations apply to corporations filing consolidated returns, and corporations that enter into certain tax-free reorganizations. The regulations provide rules for determining the tax consequences of a member's transfer (including by deconsolidation and worthlessness) of loss shares of subsidiary stock. In addition, the regulations provide that section 362 (e) (2) generally does not apply to transactions between members of a consolidated group. Finally, the regulations conform or clarify various provisions of the consolidated return regulations, including those relating to

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adjustments to subsidiary stock basis. * * *

Background

On January 23, 2007, the IRS and Treasury Department issued a notice of proposed rulemaking (REG-157711-02, 2007-8 IRB 537, 72 FR 2964) (January 2007 proposal) that included proposed regulations under § 1.1502-36 (Unified Loss Rule). The proposed Unified Loss Rule would implement aspects of the repeal of the General Utilities doctrine and address the duplication of loss by consolidated groups. The proposed Unified Loss Rule consisted of three principal rules that would apply when a member (M) transferred a loss share of stock of a subsidiary (S): a basis redetermination rule (that would reallocate investment adjustments to address both noneconomic and duplicated stock loss), a basis reduction rule (that would address noneconomic stock loss), and an attribute reduction rule (that would address duplicated loss).

In addition, the January 2007 proposal included proposed regulations under §1.1502-13 (e) (4) that would address the application of section 362 (e) (2) to certain intercompany transactions. The January 2007 proposal also included proposed regulations that would make various technical and administrative revisions to other provisions of the consolidated return regulations and to regulations regarding stock basis following certain corporate restructuring transactions.

No public hearing regarding the proposed regulations was requested or held. Written, electronic, and oral comments responding to the notice of proposed rulemaking were received. After consideration of all the comments, these final regulations generally adopt the rules of the proposed regulations other than proposed §1.1502-13 (e) (4) and its related provisions. The significant comments and modifications are discussed in this preamble.

1. The Unified Loss Rule

A. General comments

In general, commentators and practitioners have consistently described the provisions of the proposed Unified Loss Rule as reaching a fair and reasonable systemic balance. They have generally concurred with the major policy decisions reflected in the proposed regulations, including the retention of the loss limitation model, the rejection of a tracing approach, the application of the rule to built-in income, and the systemic prevention of loss duplication. However, commentators and practitioners have also consistently raised concerns regarding both the complexity of the proposed rules and the anticipated difficulty in compiling the data required to implement the proposed rules, especially those relating to transfers of stock of subsidiaries that hold stock in other subsidiaries.

The IRS and Treasury Department recognize that the proposed rules are complex. However, as recognized by commentators and practitioners, the complexity of the rules is a result of the balancing of benefits and burdens arising from the presumptions on which

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the rules are based. The IRS and Treasury Department are concerned, therefore, that simplifying the proposed rules would adversely impact the fundamental fairness the rules are intended to achieve. Nevertheless, careful consideration has been given to all simplifying suggestions, and they have been incorporated wherever possible.

The suggestions regarding the general application and operation of the rule, and the conclusions reached as to each, are set forth in this section A of this preamble. Suggestions relating to individual paragraphs of the Unified Loss Rule and to other regulations in the January 2007 proposal, including proposed §1.1502-13 (e) (4), and the conclusions reached as to each, are set forth in the following sections.

i. Order of application of the Unified Loss Rule and other adjustments

The January 2007 proposal provided that the Unified Loss Rule would apply to a transfer of a share of subsidiary stock if, after giving effect to all applicable rules of law (other than the Unified Loss Rule), the share is a loss share. The provisions of the proposed Unified Loss Rule would then apply sequentially to adjust subsidiary stock basis and attributes. Any adjustments required under the Unified Loss Rule would be given effect immediately before the transfer.

Commentators found the timing rules unclear, particularly as they related to the application of other provisions of the consolidated return regulations that also purport to apply immediately before a transaction. The IRS and Treasury Department have considered this comment and agree that there could be some uncertainty in this respect.

To address this concern, §1.1502-36 (a) (3) (i) of these final regulations provides that the Unified Loss Rule applies when a member transfers a share of subsidiary stock and, after taking into account the effects of all rules of law applicable as of the transfer, even those that would not be given effect until after the transfer, the share is a loss share. Such effects may be attributable to lower-tier dispositions and worthlessness, as well as to the application of the Unified Loss Rule. Although the determination of whether a transferred share is a loss share is made as of the transfer, the Unified Loss Rule as a whole applies, and any adjustments required under the Unified Loss Rule are given effect, immediately before the transfer.

When the Unified Loss Rule applies to a transfer, its individual provisions are each applied in order. Thus, as described in §1.1502-36 (a) (3) (i) of these final regulations, the general rule is that paragraph (b) applies first with respect to a transferred loss share (or shares). Then, if there is still a transfer of a loss share after the application of paragraph (b), paragraph (c) applies to the loss share (or shares). Finally, if there is still a transfer of a loss share after the application of paragraph (c), paragraph (d) applies with respect to that loss share (or shares). Section 1.1502-36 (a) (3) (ii) provides detailed instruction regarding the order in which the individual provisions of the Unified Loss Rule apply if there are transfers at multiple tiers in the same transaction.

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ii. Application of Unified Loss Rule to nondeconsolidating transfers

Several commentators have suggested that the final regulations include an election to defer basis recovery in the case of a nondeconsolidating transfer. Under such an election, a group could avoid applying the Unified Loss Rule to such transfers by shifting the basis of a transferred share (to the extent such basis exceeds the share's value) to other shares held by members. As a result, the group would forego any current loss, but the Unified Loss Rule would continue to be applicable to any subsequent transfer of loss shares of stock of that subsidiary.

The IRS and Treasury Department are concerned that such an election could cause significant administrative complexity. The IRS and Treasury Department are also concerned that such an election could cause substantial distortions that could adversely affect the treatment of subsequent deconsolidating transfers. For example, a basis shift resulting from such an election could significantly increase the disconformity amount of the retained shares, potentially causing a substantial and inappropriate reduction in the basis of the retained shares when they are ultimately transferred. Further, because this relief would only address transfers of minority interests, and the IRS and Treasury Department believe that such transfers reflect a small portion of subsidiary stock dispositions, the IRS and Treasury Department do not believe such a rule would give rise to any significant relief. Accordingly, this suggestion was not adopted.

Other suggestions were made that would apply special rules to nondeconsolidating transfers. The final regulations generally do not adopt special rules for nondeconsolidating transfers. The principal reasons are the complexity a dual system would create and the small number of transactions expected to be affected by such rules. In addition, the IRS and Treasury Department believe that taxpayers will typically be able to restructure nondeconsolidating transfers to avoid the application of the Unified Loss Rule, for example, by issuing subsidiary stock.

iii. Application of Unified Loss Rule to deferred recognition transfers

The proposed regulations provided that all transfers of loss shares of subsidiary stock are immediately subject to the Unified Loss Rule when the stock is transferred, even if any loss recognized on the transfer would be deferred. The IRS and Treasury Department had concluded that the immediate application of the Unified Loss Rule was necessary to prevent the significant administrative burden of retroactively applying the Unified Loss Rule to members' bases in shares of subsidiary stock, and to the subsidiary's attributes, long after a stock sale.

Commentators questioned the need to apply the Unified Loss Rule to a transfer in which any loss that would be recognized would be deferred, citing as a model §1.1502-20 (a)(3) (deferring the application of §1.1502-20, the Loss Disallowance Rule). Commentators also observed that single-entity principles seemed to suggest that an intercompany transfer is not an appropriate time to apply the Unified Loss Rule, urging that it would be

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more appropriate to apply the Unified Loss Rule to such a transfer when the intercompany item is taken into account.

The IRS and Treasury Department have considered these comments and are persuaded that single-entity principles would be furthered, and group income would be more clearly reflected, if the application of the Unified Loss Rule were coordinated with the intercompany transaction provisions in §1.1502-13. Accordingly, under these final regulations, if a member transfers a share of subsidiary stock to another member and any gain or loss on the transfer is deferred under §1.1502-13, the Unified Loss Rule applies to the transfer, or to any subsequent transfer of that share by a member, when the intercompany item is taken into account. At that time, the determination of whether the Unified Loss Rule applies and, if so, the consequences of its application are made by treating the buying and selling members as divisions of a single corporation. The final regulations also provide that appropriate adjustments will be made to intercompany item (s), any member's basis in the subsidiary's share, and/or the subsidiary's attributes in order to further the purposes of both the Unified Loss Rule and the intercompany transaction provisions in §1.1502-13.

Notwithstanding this modification of the treatment of intercompany transfers, the IRS and Treasury Department continue to believe that the deferral of loss recognized on a sale of subsidiary stock should not, in general, defer the application of the Unified Loss Rule. One reason is that postponing the application of the Unified Loss Rule in transfers that are not intercompany transactions would likely make it much more difficult, and in some cases impossible, to obtain the information and make the determinations necessary to apply the rule. Another reason is that such an approach could require subsequent adjustments to attributes outside the consolidated group. Accordingly, these final regulations continue to apply the Unified Loss Rule to non-intercompany transfers of loss shares at the time the stock is transferred, even if any loss recognized on the transfer is subject to deferral.

These final regulations modify the definition of the term transfer to reflect both the general rule that the deferral of loss does not affect the determination of whether stock is transferred and the limited exception for intercompany transactions.

iv. Application of Unified Loss Rule to liquidations under section 332

The proposed Unified Loss Rule provided that the term transfer generally includes transactions in which a member ceases to own subsidiary stock. However, the proposed regulations included an exception for section 381 (a) transactions in which any member acquires assets of the subsidiary, provided that no gain or loss is recognized by member shareholders with respect to the subsidiary's stock. Commentators observed that this exclusion would apply to liquidations in which more than one member owns stock of the subsidiary and that, in such cases, upper-tier distortions could result because the basis redetermination rule would not apply.

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The IRS and Treasury Department agree with this observation and are concerned with the potential for distortion and abuse. Accordingly, under the final regulations, a disposition of subsidiary stock in a liquidation to which section 332 applies is not excepted from the definition of a transfer if more than one member owns stock in the liquidating subsidiary. However, the final regulations provide that, in the case of a multiple-member section 332 liquidation, neither paragraph (c) (the basis reduction rule) nor paragraph (d) (the attribute reduction rule) will apply to the transfer. Thus, if more than one member owns stock in a subsidiary and those members dispose of the subsidiary stock in a section 332 liquidation of the subsidiary, the transaction is subject to the other provisions of the Unified Loss Rule, in particular the basis redetermination rule in §1.1502-36 (b).

v. Basis in lower-tier stock

In formulating the proposed Unified Loss Rule, the IRS and Treasury Department believed that, by using information that taxpayers were otherwise required to create and maintain, the administrative burden on taxpayers would be minimal. However, commentators have uniformly expressed concern that taxpayers will find it costly and time-consuming, if not impossible, to obtain the subsidiary stock basis information needed to apply many of the provisions of the Unified Loss Rule. Particular concern has been expressed regarding the lower-tier subsidiary rules in the proposed basis reduction rule (proposed §1.1502-36 (c)) and the proposed attribute reduction rule (proposed §1.1502-36 (d)). The reasons cited include the widespread practice of determining stock basis only when necessary to determine a person's tax liability, complicated intercompany accounting rules that make stock basis determinations prone to error, and the frequent inability to obtain accurate historical basis information when acquiring companies with lower-tier subsidiaries.

To address this problem, several commentators have suggested modifying the proposed rules to apply solely based on the net inside attributes of lower-tier subsidiaries (the "look-through" approach). Those commentators have argued that information regarding inside attributes is much more regularly and reliably maintained and available than stock basis information.

The IRS and Treasury Department recognize that adopting a look-through approach would not only address the problem of inadequate stock basis data, it would also significantly simplify the application of the rules. However, the IRS and Treasury Department are concerned that a look-through approach could produce inappropriate results for groups transferring S stock if S holds stock of another subsidiary (S1) and S's basis in its S1 stock reflects unrecognized appreciation in S1's assets (built-in gain).

Example. P, the common parent of a consolidated group, transfers $100 to S in exchange for S's sole outstanding share of stock. S purchases the sole outstanding share of S1 stock for $100 when S1 holds one asset with a basis of $0 and a value of $100. S earns $100, increasing P's basis in S to $200. S1's asset declines in value to $0. P sells its S share to

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X, an unrelated person, for $100, recognizing a loss of $100. Under the basis reduction rule as proposed, P's basis in S stock is reduced by the lesser of S's disconformity amount and S's net positive adjustment. S's disconformity amount is $0, the excess of P's $200 basis in the S share over S's net inside attribute amount ($200, the sum of S's $100 cash and its $100 basis in the S1 share, which is not treated as reduced under the tentative reduction rule because there were no investment adjustments applied to the basis of the S1 share). Accordingly, although S had a $100 net positive adjustment, there is no reduction to P's basis in S stock and so P's $100 loss on the S stock is allowed. However, because the stock loss is duplicated in S's attributes, the attribute reduction rule will apply to eliminate S's inside loss.

If a look-through approach were adopted, however, S's basis in its S1 share would be disregarded and S's disconformity amount would be $100 (the excess of P's $200 basis in its S share over S's $100 net inside attribute amount, computed as the sum of S's $100 cash and S1's $0 basis in its asset). As a result, P's basis in its S share would be reduced by $100, the lesser of S's $100 disconformity amount and S's $100 net positive adjustment. Although S would retain its $100 basis in its S1 share, P would recognize no loss on its sale of the S stock. Thus, the selling group would have suffered an economic loss but the loss would be neither recognized nor allowed. Such a result would be contrary to the general rule adopted in the proposed regulations, that stock basis is not presumed noneconomic to the extent there is no disconformity amount or no net positive adjustment amount.

The IRS and Treasury Department recognize that, under the proposed regulations, a very different result follows where it is S1, not S, that earns the $100. In that case, the proposed regulation would treat S's basis in the S1 stock as tentatively reduced by $100 (the lesser of S1's $100 disconformity amount and S1's net positive adjustment). As a result, S would have a disconformity amount of $100 and P's basis in its S share would be reduced by $100 (the lesser of S's $100 disconformity amount and S's $100 net positive adjustment). But the IRS and Treasury Department believe this result is appropriate because S1's disconformity amount evidences that S1 has at least $100 of built-in gain. Further, S1 has a net positive adjustment that evidences the recognition of that built-in gain. Thus, in this case, the facts indicate that S1's income is attributable to the recognition of built-in gain and that, as a result, M's loss on the share of S stock should be treated as noneconomic.

The IRS and Treasury Department recognize that this approach could lead to situations in which the location of an item is manipulated to produce inappropriate results, but believe there are adequate protections against such manipulation. See, for example, section 482 and the various anti-abuse provisions of the consolidated return regulations, including these final regulations.

For all these reasons, the IRS and Treasury Department continue to believe that including lower-tier stock basis in determinations made under the Unified Loss Rule more fully safeguards taxpayers' interests and generally produces more appropriate results.

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Several commentators argued that an elective look-through rule would address the concerns inherent in a mandatory look-through rule, as well as the concerns regarding the availability of stock basis information and the complexity of the proposed rules.

The IRS and Treasury Department agree that an elective approach would mitigate the concerns presented by a mandatory look-through rule, but believe that an elective approach would not provide the desired simplification. The reason is that the decision will affect computations under both the basis reduction rule and the attribute reduction rule, and what may be taxpayer favorable for one rule may be taxpayer unfavorable for the other rule. Thus, the benefit (or burden) of ignoring lower-tier stock basis for the basis reduction rule will need to be weighed against any benefit (or burden) of ignoring lower-tier stock basis for the attribute reduction rule.

The IRS and Treasury Department acknowledge that, in order to simplify compliance, some taxpayers might elect a look-through approach without making detailed alternative computations. However, the IRS and Treasury Department believe that, given the consequences of such an election, the vast majority of taxpayers will compute their tax treatment both with and without a look-through approach before deciding whether to make such an election. Thus, in the vast majority of cases, there would be little or no simplification from an elective look-through approach, and one of the major goals of such a rule would not be achieved.

Moreover, the IRS and Treasury Department believe that taxpayers making both computations will then universally choose the method that produces better results. While taxpayers are free to arrange their affairs so as to legitimately minimize their taxes, a system that will always operate to the disadvantage of one party or the other (in this case, the government) is not properly balanced.

Accordingly, the IRS and Treasury Department believe that a mandatory look-through approach would produce inappropriate results in certain cases, and that an elective look-through approach would fail to achieve a significant amount of simplification and would significantly diminish the balance and fairness of the regulations. The final Unified Loss Rule therefore does not adopt any form of the look-through approach.

Still, the IRS and Treasury Department recognize that determining lower-tier subsidiary stock basis may be difficult for the reasons previously noted. Further, although the need to determine lower-tier subsidiary stock basis is not particular to these regulations, the Unified Loss Rule arguably increases both the frequency and significance of these determinations. Accordingly, the IRS and Treasury Department are considering various proposals that would mitigate these difficulties on a system-wide basis.

One alternative under consideration is a conforming basis election. Under this election, consolidated groups could determine members' bases in shares of subsidiary stock by treating the basis in each share owned by a member as being equal to the share's proportionate interest in the subsidiary's net inside attributes. If such an election were

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made, the determination would presumably be effective for all Federal income tax purposes. Further, because the determination of subsidiary stock basis is not a concern that is unique to the Unified Loss Rule, consideration is being given to allowing the election with respect to all subsidiaries, with no restrictions on consistency or the time for making elections. However, the IRS and Treasury Department are not certain that such a rule would materially simplify the determination of basis because taxpayers are likely to conclude that they must determine stock basis in judging whether to make the election. Further, the IRS and Treasury Department are concerned about the collateral consequences of such a rule.

Accordingly, the IRS and Treasury Department are requesting comments regarding whether such an election would assist taxpayers and whether it would in fact provide any simplification. Additionally, comments are requested regarding what collateral consequences, if any, such an election should or would have, and whether such consequences are appropriate. The issues include, for example, whether such an election would be an appropriate means of eliminating excess loss accounts, whether it could potentially produce inappropriate cross-chain basis shifts, or whether it could inappropriately facilitate the acceleration of losses.

The IRS and Treasury Department also request comments regarding any other method for addressing this issue.

vi. Items taken into account in determining the net inside attribute amount

As a result of various questions and comments received, the IRS and Treasury Department have reconsidered the inclusion of credits in the determination of the net inside attribute amount. Commentators have correctly observed that, at least with respect to credits held at the time of a taxable acquisition of subsidiary stock, credits are economically similar to other valuable attributes and it would be appropriate to take such credits into account in determining the disconformity amount. However, the proper treatment of other credits (that is, credits accruing after the subsidiary stock was acquired) in determining the disconformity amount, and of any credits (whenever accruing) in determining loss duplication, is less clear. Presumably, however, any such methodology would need to be tracing-based, and would therefore be expected to present the significant administrative concerns described in the preamble to the January 2007 proposal. Ultimately, no viable presumptive methodology was identified for determining the proper inclusion of credits, and so no change is made in the final Unified Loss Rule regarding the treatment of credits.

vii. Adjustments for section 362 (e) (2) transactions

As discussed in Section 3 of this preamble, the IRS and Treasury Department have concluded that section 362 (e) (2) should generally not apply to intercompany transactions. However, section 362 (e) (2) will apply to transactions occurring prior to September 17, 2008, if the taxpayer does not elect to apply the rule in the final regulations. In such cases, distortions will result and, thus, adjustments will need to be

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made. The IRS and Treasury Department are also concerned that there are other provisions that could create distortions. Accordingly, the final regulations retain the rule in proposed §1.1502-36 (e) (2) that provided for adjustments to offset the effects of basis reductions required by section 362 (e) (2) with respect to intercompany transactions, and the rule that provided for appropriate adjustments in cases raising similar issues. However, under the final regulations, taxpayers may make appropriate adjustments without a determination from the Commissioner.

viii. Effective/applicability date issues * * *

B. Section 1.1502-36 (b): basis redetermination rule

Commentators generally recognize and concur with the need for a rule that reallocates investment adjustments to address the problems created when shares of stock are held with disparate bases. As illustrated in Sections B.3, B.4, and E of the preamble to the January 2007 proposal, the allocation of investment adjustments under §1.1502-32 can create a noneconomic stock loss on an individual share that would be eliminated under §1.1502-36 (c). Similarly, the allocation of investment adjustments under §1.1502-32 can fail to eliminate a duplicated loss on an individual share. In both cases, however, the allocation creates no net loss if all the shares are taken into account. The basis redetermination rule in §1.1502-36 (b) is designed to address these issues.

Commentators have expressed concern, however, with both the availability of the investment adjustment data required to implement the rule and the complexity of the application of the rule.

The IRS and Treasury Department recognize that the information may be difficult and costly to produce. However, unlike lower-tier subsidiary stock basis information, the information required to implement the basis redetermination rule (specifically, the investment adjustment history of the stock of the subsidiary that is being transferred) is generally information obtained from the group's own tax returns and other records. Groups are therefore, as a general matter, not dependent on other taxpayers for this information.

Furthermore, the IRS and Treasury Department expect that this rule will apply to only a small number of transactions due to the exception for transactions in which members transfer all of their S stock to one or more nonmembers in a fully taxable transaction. Accordingly, it is anticipated that, in most transactions, taxpayers will not be required to redetermine basis. Moreover, in those situations in which it does apply, it accomplishes important objectives for both taxpayers and the government.

Some commentators suggested allowing a member to be treated as having an averaged basis in its shares of S stock if S has only one class of stock outstanding and the member holds all of the S stock. The commentators argue that such an election could significantly reduce the number of taxpayers required to apply the basis redetermination rule. While that might be true, such basis averaging could result in additional complexities and

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distortions. For example, if a portion of the shares were previously transferred in an intercompany transaction and the bases in all of the subsidiary's shares were averaged, it might be difficult to determine the extent to which particular shares reflect the prior intercompany transaction. Further, averaging the basis in the subsidiary's shares could alter the application of section 267 and section 311.

For all these reasons, the final Unified Loss Rule retains the basis redetermination rule without the suggested modifications.

The final regulations do, however, modify the basis redetermination rule to omit the reallocation of positive investment adjustments applied to preferred shares under §1.1502-32. The reason is that §1.1502-32 allocates positive adjustments to preferred shares solely to account for the right to receive distributions. Thus, the positive §1.1502-32 adjustments allocated to preferred shares, like the adjustments for distributions (which were not reallocated under the proposed Unified Loss Rule), are based on economic changes in the shareholder's investment. As a result, they should have no correlation to unrecognized loss reflected in the bases of the shares and so should not be subject to this rule. The final regulations do, however, continue to permit the reallocation of both positive and negative adjustments from common to preferred shares in order to reduce or eliminate any loss on transferred preferred shares and any gain on either transferred or nontransferred preferred shares. The IRS and Treasury Department believe such reallocations are necessary and appropriate to address any reflection of unrecognized gain or loss in preferred shares attributable, for example, to contributions of assets in exchanged for preferred stock.

i. Exceptions to basis redetermination rule

The proposed basis redetermination rule contained two exceptions to its application, the "no potential for redetermination" exception and the "disposition of entire interest" exception.

The proposed "no potential for redetermination" exception provided that basis redetermination is not required if redetermination would not change any member's basis in S stock. Some commentators found this exception confusing; others suggested that it offered no simplification because it would be necessary to apply the basis redetermination rule to determine whether the exception was available. Other commentators thought that it provided a useful safe-harbor. The IRS and Treasury Department have concluded that the rule should be retained, but that it should be revised to state its scope and effect more clearly. Accordingly, under the final regulations, the basis redetermination rule does not apply if members' bases in shares of S common stock are equal (that is, there is no disparity) and members' bases in shares of S preferred stock reflect no gain or loss. The reason is that, under these circumstances, the only effect that a reallocation of investment adjustments could have would be an increase, not a decrease, in basis disparity.

The proposed "disposition of entire interest" exception provided that basis

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redetermination is not required if, within the group's taxable year in which the transfer occurs, all of the shares of S stock held by members are transferred to a nonmember in a one or more fully taxable transactions. This rule differed from the basis reduction netting rule in proposed §1.1502-36 (c) (7) and the net stock loss definition in proposed §1.1502-36 (d) (3) (ii), which only netted among shares transferred in the same transaction. Commentators observed that this difference presents a potential for distortion and abuse if items are taken into account by S between transfers. While this problem exists to a certain extent if a transaction is comprised of steps that are not executed simultaneously, the problem may be significantly exacerbated by a rule that allowed netting among all transactions within a year. Moreover, because the netting rule in the basis reduction rule is intended, in part, to protect taxpayers when the basis redetermination rule is not applied, the IRS and Treasury Department believe that the application of these rules should be coextensive. Accordingly, the final regulations provide that this exception only applies if members dispose of their entire interest in S stock to one or more nonmembers, if all members' shares of S stock become worthless, or if all members' shares of S stock are either worthless or disposed of to one or more nonmembers, in one fully taxable transaction.

Commentators also inquired whether the "disposition of entire interest" exception was mandatory, that is, whether the basis redetermination rule could be applied even if a group disposed of its entire interest in a transaction that qualifies for the exception. The IRS and Treasury Department recognize that taxpayers might choose to apply the basis redetermination rule in such cases in order to reduce gain or avoid the Unified Loss Rule with respect to upper-tier shares. The IRS and Treasury Department do not believe that doing so would be inappropriate, as the premise of the basis redetermination rule is that reallocations made under the rule are appropriate allocations. However, because the IRS and Treasury Department believe that taxpayers will most often not want to apply the basis redetermination rule, the final regulations generally provide that basis is not redetermined when the exception applies, but include an election to apply the basis redetermination rule in such cases.

ii. Manner in which investment adjustments are reallocated

Some commentators observed that the proposed rules were vague regarding the manner in which reallocations were to be made. The IRS and Treasury Department generally agree with this observation, but had concluded that the rule would work best if taxpayers were given considerable flexibility in determining how to make specific reallocations. In recognition of the fact that such an approach would allow differing interpretations, section F.2 of the preamble to the January 2007 proposal stated that the IRS would respect any reasonable method or formula employed in applying the basis redetermination rule.

The IRS and Treasury Department continue to believe that the rule should be as flexible as possible. However, in response to these comments, the specific provisions of the final basis redetermination rule provide some additional guidance (discussed more fully in the next section). But the rule is still intended to be flexible in its application and, therefore,

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the final regulations explicitly provide that the reallocation of an investment adjustment may be made using any reasonable method or formula that is consistent with the basis redetermination rule and furthers the purposes of the Unified Loss Rule. Thus, like the proposed regulations, the final regulations contemplate that more than one result may be reasonable in any specific case.

iii. Decreasing disparity in basis of members' shares

The general operating rules of the proposed basis redetermination rule provided that reallocations are made in a manner that reduces the extent to which there is disparity in members' bases in S stock. The IRS and Treasury Department have received various questions regarding the scope of this rule. Some practitioners read the rule to completely eliminate the loss on transferred shares even if overall disparity were increased. One practitioner suggested that the general rule, in referring only to the manner of redetermination, did not clearly restrict the amount of redetermination that would otherwise be required under the rules.

To address these concerns, each of the specific allocation provisions in the final regulations includes a statement regarding the manner and extent to which allocations are to be made under the provision. In addition, the operating rules generally provide that the overall application of the rule must reduce disparity among members' bases in preferred shares of subsidiary stock (as provided in the applicable reallocation provisions) and among members' bases in common shares of subsidiary stock, to the greatest extent possible.

C. Section 1.1502-36 (c): basis reduction rule

In general, commentators found the general structure of the basis reduction rule and its components (limiting basis reduction to the lesser of the share's disconformity amount and net positive adjustment) to be a reasonable approach to addressing the issue of noneconomic loss. The principal concern expressed was the anticipated difficulty with respect to gathering the information necessary to implement the lower-tier subsidiary rules. Nevertheless, commentators uniformly agreed that basis adjustments from lower-tier subsidiaries must be taken into account in order to identify and address noneconomic stock loss.

The principal suggestion for addressing the lack of readily accessible and reliable information on lower-tier stock basis was to adopt a look-through approach, as discussed in section 1.A.v. of this preamble. For the reasons set forth in that section of this preamble, the final regulations do not adopt this approach. However, as noted, the IRS and Treasury Department continue to request and consider comments on mechanisms for alleviating the difficulty in determining lower-tier subsidiary stock basis.

Commentators and practitioners did suggest a number of other modifications to the basis reduction rule. Those suggestions and the decisions reached are discussed in the following sections.

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i. Treatment of intercompany debt

Several commentators suggested revising the net positive adjustment amount to exclude items related to intercompany debt. The rationale for this suggestion was that, in general, the nature of such amounts makes them more like to capital transactions than the recognition of built-in gain or loss. Thus it is argued that these amounts should be treated like contributions and distributions, which are not included in the net positive adjustment amount.

The IRS and Treasury Department recognize that, in certain circumstances, intercompany debt has some inherent similarity to capital contributions and distributions, at least with respect to the principal amounts of such obligations. However, the IRS and Treasury Department also recognize that there are circumstances in which unrecognized appreciation in intercompany debt can be reflected in stock basis. For example, if a subsidiary receives cash in exchange for newly issued stock when it holds an intercompany obligation, the basis of the newly issued shares will reflect a portion of any unrecognized appreciation in the obligation. Because the consequences of having that unrecognized appreciation reflected in stock basis are no different from the consequences of any other built-in gain, the regulations would have to provide a system to identify and monitor those amounts. Such a system would need to rely on a tracing-based methodology, which the IRS and Treasury Department have rejected for the reasons articulated in the preamble to the January 2007 proposal. Accordingly, the IRS and Treasury Department have concluded that no special rules would be adopted for items related to intercompany debt.

ii. Disconformity amount: net inside attributes

In the proposed regulations, the term net inside attributes was defined as the excess of the sum of S's loss carryovers, deferred deductions, and asset basis over S's liabilities. Although different rules applied to determine basis in lower-tier subsidiary stock, the terms otherwise had the same meaning for purposes of both the basis reduction and attribute reduction rules.

The proposed regulations defined the term loss carryover to mean any net operating or capital loss carryover attributable to S that is or, under the principles of §1.1502-21 would be, carried to S's first taxable year, if any, following the year of the transfer. Thus, if a buyer were to waive a loss carryover under §1.1502-32 (b) (4), the loss would not be carried to S's first taxable year after the transfer, and so it would be excluded from the computation of net inside attributes.

Practitioners agree that this definition is appropriate for purposes of measuring loss duplication, as it prevents attributes that cannot be duplicated from being taken into account in computing S's attribute reduction amount. However, one commentator observed that this definition seemed inappropriate for purposes of measuring S's disconformity amount.

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The IRS and Treasury Department have considered this comment and agree that the definition is inappropriate for computing S's disconformity amount. As discussed in the January 2007 preamble, the disconformity amount was incorporated in the basis reduction rule in order to limit basis reduction to the net amount of a subsidiary's built-in gain. The IRS and Treasury Department believed that, by limiting basis reduction to the amount of net built-in gain, the basis reduction rule would not reduce stock basis by an amount that could not be attributed to the recognition of built-in gain.

However, by adopting a definition of loss carryovers that required such losses to be carried to a separate return year, the rule allowed a waiver of a loss carryover under §1.1502-32 (b) (4) to reduce the amount of a subsidiary's loss carryovers and, as a result, the subsidiary's net inside attributes. That, in turn, caused an increase in the subsidiary's disconformity amount. But, as the commentator observed, any disconformity created by the waiver of a loss carryover would be unrelated to the existence of built-in gain. Thus, this definition of loss carryovers undermined the protection otherwise afforded by the use of the disconformity amount as a limit on basis reduction.

In addition, other commentators found the proposed rule unclear in its reference to losses that would be carried to a separate return year.

To address these concerns, the final regulations provide that the term loss carryovers means those losses that are attributable to the subsidiary, including any losses that would be apportioned to the subsidiary under the principles of §1.1502-21 (b) (2) if the subsidiary had a separate return year. However, because a waiver under §1.1502-32 (b) (4) does affect the extent to which a loss can be duplicated, the final regulations provide that, solely for purposes of applying the attribute reduction rule, a subsidiary's loss carryovers (and therefore its net inside attributes) do not include the amount of any losses waived under §1.1502-32 (b) (4).

D. Section 1.1502-36 (d): the attribute reduction rule

As discussed in the preamble to the January 2007 proposal, the loss duplication component of the Unified Loss Rule addresses loss duplication systemically in order to clearly reflect the income of both the group and its members, including former members. The IRS and Treasury Department view this rule as a necessary and appropriate complement to §1.1502-32 because, together they work to eliminate the duplication of a group item once the group enjoys the benefit of the item, without regard to which of the duplicative items is recognized and allowed first. The IRS and Treasury Department also view this rule as a necessary and appropriate complement to the basis reduction rule because it eliminates S's unrecognized built-in loss to the extent it prevented the identification of S's recognized built-in gain (and thus prevented the reduction of noneconomic stock basis, and noneconomic stock loss). See sections C.3 and C.4.v of the preamble to the January 2007 proposal for a discussion of the interaction between unrecognized built-in loss and recognized built-in gain.

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Commentators generally agreed with the IRS and Treasury Department on the need for, and appropriateness of, the systemic approach to loss duplication. However, like the basis redetermination and basis reduction rules, the attribute reduction rule received considerable commentary regarding the issues of data availability and computational complexity. Commentators and practitioners made several suggestions for technical revisions to the proposed regulations. The IRS and Treasury Department have considered the suggestions received as well as other revisions to the proposed attribute reduction rule. The suggestions and conclusions are discussed in the following sections.

i. Lower-tier subsidiary rules

In general, commentators and practitioners recognize that the rules for measuring and eliminating loss duplication must take into account both the basis in lower-tier subsidiary stock and the attributes of lower-tier subsidiaries in order to be most effective. Nevertheless, as already noted, commentators expressed much concern regarding the administrability of the proposed lower-tier subsidiary rules. Their principal suggestion for addressing this concern was the adoption of a look-through approach that would address loss duplication only by taking lower-tier attributes into account.

The IRS and Treasury Department considered a look-through approach when drafting the January 2007 proposal, but were concerned that such an approach would not adequately address loss duplication. The principal reason for this concern was that loss duplication can reside in the basis of lower-tier subsidiary stock and in the attributes of that lower-tier subsidiary and, moreover, that it can reside in those locations in differing amounts. Therefore, a rule that measures loss duplication solely by reference to lower-tier attributes, or solely by reference to lower-tier stock basis, would permit potentially significant amounts of loss duplication to avoid reduction. To avoid this problem, the IRS and Treasury Department concluded that the loss duplication regulations must measure loss duplication by reference to both.

The IRS and Treasury Department recognized, however, that when duplication is not uniformly reflected in stock basis and attributes, this approach could cause an over-reduction in lower-tier attributes (when loss duplication resides primarily in lower-tier stock basis) or in lower-tier stock basis (when loss duplication resides primarily in lower-tier attributes). To prevent the former result, the conforming limitation on lower-tier attribute reduction limits the application of tiered-down attribute reduction (generally permitting a lower-tier subsidiary's attributes to be reduced only to the extent necessary to conform them to members' bases in that subsidiary's stock, as reduced under this rule). To prevent the latter result, the basis restoration rule reverses reductions to lower-tier stock basis made by the Unified Loss Rule (generally to the extent necessary to conform members' bases in the subsidiary's stock to the subsidiary's net inside attributes, as reduced under this rule).

Thus, these rules work together to protect the government's interests (by addressing the entire potential for loss duplication) and taxpayers' interests (by preventing the over-reduction of either lower-tier stock basis or lower-tier attributes). Accordingly, the IRS

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and Treasury Department continue to believe these rules are essential to the balance and fundamental fairness of the Unified Loss Rule.

Nevertheless, the IRS and Treasury Department recognize that the conforming limitation and basis restoration rules can add considerable complexity to the application of the Unified Loss Rule. To address this concern, commentators have suggested that one or the other of these rules could be omitted to simplify the proposed rule. The IRS and Treasury Department are concerned, however, that eliminating either of these rules would considerably undermine the overall fairness of the regulation. But the IRS and Treasury Department are persuaded that, if a taxpayer determines that the expected benefit of applying these rules is outweighed by the additional complexity, then that taxpayer should be permitted to choose not to apply these rules.

Accordingly, these final regulations continue to measure the potential for loss duplication by taking both stock basis and attributes into account and continue to safeguard against over-reduction of either inside attributes or stock basis by applying both the conforming limitation and the basis restoration rules. However, under the final regulations, taxpayers are permitted to elect not to apply the conforming limitation or the basis restoration rule if they decide the protection afforded by either or both of those rules does not outweigh the burden of applying them.

ii. Attribute reduction amount below five percent of value

Although the fundamental structure of the attribute reduction rule has been retained, the IRS and Treasury Department have determined that it is appropriate to provide an exception to the application of the attribute reduction rule if the attribute reduction amount (that is, the duplicated loss) is small relative to the size of the transaction. This decision reflects a balancing of the need to eliminate duplicated loss and the administrative burden of applying the attribute reduction rule. Accordingly, under these final regulations, taxpayers must still compute their attribute reduction amount, but if the total attribute reduction amount is less than five percent of the aggregate value of the subsidiary shares that are transferred by members in the transaction, the attribute reduction rule does not apply to the transfer.

However, the IRS and Treasury Department also recognize that, in certain circumstances, a taxpayer may prefer to have the attribute reduction rule apply. For example, a group may want to apply the rule in order to reattribute a subsidiary's attributes. Accordingly, the final regulations allow taxpayers to elect to apply the attribute reduction rule notwithstanding that their total attribute reduction amount is less than five percent of the aggregate value of the transferred shares. If this election is made, the attribute reduction rule will apply with respect to the entire attribute reduction amount determined in the transaction, and thus applies with respect to all members transferring shares, and all shares transferred, in the transaction.

iii. Ordering of reduction of recognized losses

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Commentators generally agreed with the decision to reduce recognized losses (net operating loss (NOL) carryovers, capital loss carryovers, and deferred deductions, identified as Category A, Category B, and Category C attributes, respectively) before reducing asset basis, since the former items represent actual, identified losses. The proposed regulations provided that the attribute reduction amount would be first applied to reduce NOL carryovers (from oldest to newest), then capital loss carryovers (from oldest to newest), and then deferred deductions (proportionately). However, several commentators questioned the need for a mandatory order in which these attributes would be reduced. These commentators observed that, because loss duplication is a mathematical determination under the Unified Loss Rule, and because it is difficult (if not impossible) to know which attributes are economically duplicative of a stock loss, the reduction of any item in those categories should be equally appropriate and effective.

The IRS and Treasury Department have reconsidered this issue and agree with the commentators. Accordingly, the final regulations provide that if the attribute reduction amount is less than the total attributes in Category A, Category B, and Category C, the taxpayer may specify the allocation of S's attribute reduction amount among the attributes in those categories.

The final regulations do, however, prescribe a default allocation for the reduction of such attributes that is used to the extent the taxpayer does not specify an allocation. This default allocation differs from the order provided in the proposed rule in that capital loss carryovers (not NOLs) are reduced first. This modification was made in response to a commentator's suggestion, based on the observation that capital loss carryovers have a significantly shorter expiration period and are therefore more likely than NOLs to expire unused. Accordingly, except to the extent a taxpayer elects to specify an allocation, the final regulations first reduce capital loss carryovers (oldest to newest), then NOL carryovers (oldest to newest), and then deferred deductions (proportionately). This change in the order of reduction is intended to minimize the possibility that the attribute reduction rule will reduce attributes in an amount greater than the amount that would ultimately be available for duplicative use.

The final regulations continue to provide that, regardless of the order in which attributes in these categories are reduced, they are reduced in full before any reduction is made to asset basis.

iv. Methodology for reduction of asset basis

Several commentators have suggested simplifying modifications to the manner in which asset basis is reduced under the attribute reduction rule. One is the elimination of the proposed Category D attributes (unrecognized losses on publicly traded property). This category was included in the proposed rule because the IRS and Treasury Department recognized that these amounts represent a readily identifiable loss that could be eliminated before the presumptive reduction of the bases of other assets. This approach prevented the attribute reduction rule from creating or increasing gain in publicly traded assets. However, commentators viewed this rule as increasing the complexity of an

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already complex analysis while providing only a marginal benefit.

The IRS and Treasury Department are persuaded that this extra complexity might not be warranted in this context and that the elimination of this rule would not materially affect the balance otherwise reached by the Unified Loss Rule. Accordingly, the final regulations include publicly traded property in the general asset basis category (now designated Category D).

Another suggestion made by commentators was to apply the attribute reduction amount remaining after reducing Category A, Category B, and Category C attributes to reduce asset basis in the reverse order of the residual method of allocating consideration paid or received in a transaction under section 1060.

The IRS and Treasury Department have concluded that this approach is readily administrable and reflects an appropriate balancing of presumptions regarding the location of duplicated loss. An important consideration is that such a rule reduces basis in purchased goodwill and going concern value before basis in other assets, and the IRS and Treasury Department are persuaded that duplicated loss is generally more likely to be reflected in the bases of such assets. Therefore, the elimination of the basis in those assets first seems particularly appropriate. Further, the IRS and Treasury Department believe that this approach would generally be more administrable than the proposed pro rata reduction of asset basis.

Accordingly, these final regulations adopt this suggestion and generally provide that the attribute reduction amount is applied to reduce the basis of assets in the asset classes specified in §1.338-6 (b) other than Class I (cash and general deposit accounts, other than certificates of deposit held in depository institutions), but in the reverse order from the order specified in that section. Thus, under this reverse residual method, any attribute reduction amount applied to reduce asset basis is generally applied first to reduce any basis of assets in Class VII (proportionately, based on basis instead of value, until all such basis is eliminated). Any remaining attribute reduction amount is then applied in the same manner to reduce the basis of assets in each succeeding lower asset class, other than Class I.

Notwithstanding the general adoption of this allocation methodology for Category D attributes, these final regulations provide that the portion of the attribute reduction amount that is not applied to attributes in Category A, Category B, and Category C, is first allocated between S's basis in any stock of lower-tier subsidiaries (treating all S's shares of any one lower-tier subsidiary as a deemed single share) and the subsidiary's other assets (treating the non-stock Category D assets as one asset). The allocation is made in proportion to S's deemed basis in each single share of lower-tier subsidiary stock and S's basis in the non-stock Category D asset (S's aggregate basis in all of its Category D assets other than subsidiary stock). Only the portion of the attribute reduction amount not allocated to lower-tier subsidiary stock is applied under the reverse residual method. This initial allocation between lower-tier subsidiary stock and other assets is necessary to ensure that, to the extent the attribute reduction amount reflects items attributable to a

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lower-tier subsidiary's stock basis or attributes, the attribute reduction amount is properly directed and applied to those items.

v. Suspension of excess attribute reduction amount

Several commentators and practitioners questioned the need to suspend attribute reduction amounts in excess of reducible attributes and apply those suspended amounts to reduce or eliminate attributes otherwise arising when all or part of the liability is paid or otherwise satisfied, whether by S or another person. The IRS and Treasury Department proposed this rule because the mathematical operation of the formula for computing the attribute reduction amount results in such an excess only if there is a liability or similar item that has reduced economic value but that has not been taken into account for tax purposes (generally a contingent liability).

The IRS and Treasury Department continue to believe that it is inappropriate to permit the duplication of economic losses that have not accrued for tax purposes and, therefore, that this rule is both necessary and appropriate. Accordingly, the rule is retained in the final regulations.

The IRS and Treasury Department recognize that this rule could create an administrative burden that could last for many years and transfer to taxpayers beyond the initial buyer and seller. However, the IRS and Treasury Department believe that the elimination of the special rule for publicly traded property substantially lessens the administrative burden of this rule. The reason is that, under this revised approach in the final regulations, a subsidiary's attribute reduction amount can only exceed reducible assets to the extent of the subsidiary's Class I assets. In such cases, the IRS and Treasury Department do not believe the burden imposed to be unreasonable or, in most cases, substantial. Moreover, a taxpayer believing the rule to be overly burdensome in its situation can readily avoid any suspension of its attribute reduction amount by converting its Class I assets into assets of another class; in that case, the remaining attribute reduction amount will be applied to the bases of those assets and will not give rise to a suspended attribute reduction amount.

The IRS and Treasury Department received a comment that, if the suspended attribute reduction rule is retained, it should be clarified to provide that present value principles are to be taken into account in valuing liabilities. The final regulations do not include an explicit statement on this point because the rule implicitly incorporates present value principles (by limiting the attribute reduction amount to the lesser of the net stock loss and the aggregate inside loss, which are both a function of value).

vi. Election to reduce stock basis and/or reattribute attributes

Several commentators suggested that the final regulations should expressly permit taxpayers to make a protective election to reattribute attributes (other than asset basis) and/or to reduce stock basis (and thereby reduce stock loss) in order to avoid attribute reduction. The IRS and Treasury Department intend these elections to be as flexible as possible. Accordingly, the final regulations explicitly provide that, if the election is made

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and it is ultimately determined that S has no attribute reduction amount, the election will have no effect, or if the election is made for an amount that exceeds S's finally determined attribute reduction amount, the election will have no effect to the extent of that excess.

In addition, the final regulations permit taxpayers to reduce (or not reduce) stock basis, or to reattribute (or not reattribute) attributes, or some combination thereof, in any amount that does not exceed S's attribute reduction amount.

Thus, under the final regulations, taxpayers have considerable flexibility in making this election, and may make a protective election.

Further, in order to protect against inadvertent attribute reduction, these final regulations provide for a deemed stock basis reduction election equal to the net stock loss (taking into account any actual elections under §1.1502-36 (d) (6)) in the case of a transfer in which the stock loss in the transferred shares would otherwise be permanently disallowed (for example under section 311 (a)).

Several commentators also questioned the need for a mandatory order for the reattribution of losses for the same reasons they questioned the need for a mandatory order for the reduction of such attributes. For the reasons discussed in section 1.D.iii. of this preamble, the IRS and Treasury Department agree that a mandatory order of reattribution is not necessary. Thus, under the final regulations, attributes are reattributed in the same amount, order, and category that they would otherwise be reduced under the attribute reduction rule. Accordingly, because the final regulations provide that taxpayers can specify the attributes in Category A, Category B, and Category C to be reduced, taxpayers may similarly specify the attributes in Category A, Category B, and Category C to be reattributed. Similar to the rule regarding the allocation of the attribute reduction amount, to the extent the taxpayer elects to reattribute attributes but does not specify the attributes to be reattributed, any attributes not specifically reattributed will be reattributed in the default amount, order, and category applicable for attribute reduction.

Additionally, the final regulations revise the provisions regarding the election to reattribute attributes to provide for the reattribution of a section 382 limitation. The final regulations also include conforming amendments to the consolidated section 382 rules in §§1.1502-90, 1.1502-91 (h) (2), 1.1502-95 (d), 1.1502-96 (d), and 1.1502-99 (b) (4).

vii. The conforming limitation

As previously discussed, the proposed regulations limited the application of the attribute reduction amount that tiered down to a lower-tier subsidiary in order to prevent an excessive reduction to that subsidiary's attributes. Under this limitation (the conforming limitation), the tier-down attribute reduction amount (when combined with any attribute reduction amount computed with respect to a transfer of the shares of the lower-tier subsidiary) could be applied to reduce a lower-tier subsidiary's attributes only to the extent necessary to conform those attributes to an amount equal to the sum of all

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members' bases in nontransferred shares, and the value of all members' transferred shares, of that subsidiary's stock.

Commentators observed that the conforming limitation could allow duplication to survive the application of the attribute reduction rule when lower-tier stock basis reflects noneconomic basis. The commentators illustrated their observation with the following example:

Example. M forms S with $100 of cash. S has no other assets or operations. S acquired S1 stock for $100 and no section 338 election is made with respect to such acquisition. S1 has one asset (A1) with a basis of $20 and a value of $100. S1 sells A1 for $100. M's basis in its S stock, and S's basis in its S1 stock, both increase by $80 to $180. S1 invests the $100 of proceeds in another asset (A2). A2 subsequently, declines in value to $40. M sells the S stock for $40.

Under the proposed basis reduction rule, M's basis in the S stock is reduced by the lesser of S's $80 net positive adjustment and S's $80 disconformity amount (determined by treating S's $180 basis in the S1 stock as tentatively reduced by $80, the lesser of S1's $80 net positive adjustment and S1's $80 disconformity amount). After the application of the proposed basis reduction rule, M would recognize a $60 loss on the sale of the S stock.

Under the proposed attribute reduction rule, S's attribute reduction amount is $60 (the lesser of the $60 net stock loss, and S's $140 aggregate inside loss), and S would reduce its basis in the S1 stock by $60 to $120. Under the proposed attribute reduction rule, S's $60 attribute reduction amount allocated to the S1 stock becomes an attribute reduction amount of S1. However, under the proposed conforming limitation on tier-down attribute reduction, S1 is not required to reduce its $100 basis in A2 because S1's $100 of attributes do not exceed S's post-reduction $120 basis in the S1 stock. As a result, M's $60 loss continues to be duplicated in both S's basis in the S1 stock and S1's basis in A2.

The IRS and Treasury Department agree that, under these facts, the attribute reduction rule does not eliminate all lower-tier duplication. However, this effect follows directly from policy decisions underlying the Unified Loss Rule, specifically, that it would be a loss limitation rule and that the basis reduction rule would apply only upon a disposition, deconsolidation, or worthlessness of a loss share. Under this approach, as long as a share is held by the same person and is subject to the consolidated return provisions, noneconomic lower-tier subsidiary stock basis is preserved. As a result, subsequent appreciation can permit the stock to be transferred without being subject to the Unified Loss Rule, and the noneconomic stock basis can reduce any gain that would otherwise be recognized. It is the preservation of that noneconomic stock basis that prevents the full elimination of duplicated loss in S1's attributes.

The issue could be addressed in several ways. First, the decision to preserve basis until there is a loss transfer could be reversed. However, the rule would then either reduce

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lower-tier stock basis below value or rely on valuation to limit such basis reduction. The IRS and Treasury Department are concerned that adding a valuation component to this rule would present substantial administrative concerns. More importantly, however, the IRS and Treasury Department do not believe that such an approach adequately protects the balance struck in the regulation as proposed and so are not reconsidering that decision.

Alternatively, the conforming limitation could be revised such that any conforming limit would be reduced by the amount of any tentative reduction to stock basis under the basis reduction rule. In the example set forth by the commentators, this would reduce S1's conforming limitation by $80 (S1's tentative reduction amount), from $120 to $40. As a result, S1's basis in A2 would be reduced to $40. While this would produce an appropriate result with respect to A2, it leaves S's basis in the S1 stock reflecting $80 of disconformity. Accordingly, absent additional adjustments, S's basis in the S1 stock could appear to reflect a noneconomic loss, and so the rule would remain imperfect.

Moreover, the effect of such an approach would be to create a disconformity amount that is not related to built-in gain. Consequently, when the S1 stock is ultimately sold, economic loss could appear noneconomic and, therefore, could be eliminated under the basis reduction rule. Although the Unified Loss Rule affords some protection for this situation in the operating rules (see the discussion in section A.1.vii. of this preamble), the IRS and Treasury Department are concerned that the tracing necessary to make the adjustments to prevent the elimination of economic loss will present substantial administrative difficulty and, in many cases, may not be possible.

Furthermore, in certain circumstances, the proposed conforming limitation on tier-down attribute reduction could prevent an unnecessary reduction in lower-tier inside attributes, for example, when the loss on S stock is attributable to the loss of built-in gain on an asset held by S (other than subsidiary stock).

Based on all of these considerations, the IRS and Treasury Department have decided not to revise this rule in the final regulations, but will continue to consider the issue.

viii. Attribute Reduction in the Case of Certain Dispositions Due to Worthlessness and Where the Subsidiary Ceases to be a Member and Does Not Become a Nonmember

Section 1.1502-35 (f) generally provides that, if a member treats stock of S as worthless under section 165 (taking into account §1.1502-80 (c)) and S continues as a member, or if M recognizes a loss on S stock and on the following day S is not a member and does not have a separate return year following the recognition of the loss, all losses treated as attributable to S under the principles of §1.1502-21 (b) (2) (iv) are treated as expired as of the beginning of the day following the last day of the group's taxable year. This rule was intended to prevent any implication that S's share of the consolidated losses could be treated as remaining part of the consolidated net operating or capital loss carryover after S becomes worthless or is dissolved in a taxable transaction. The IRS and Treasury Department continue to believe that the regulations should explicitly clarify that such losses are removed from the consolidated losses.

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Commentators have observed that, in the specified circumstances, any credits and built-in losses attributable to S should also be eliminated to prevent their use after S either becomes worthless or is dissolved in a taxable transaction. The IRS and Treasury Department agree that, in such cases, S's credits and other attributes should no longer be available to the group.

Accordingly, these final regulations provide a special attribute elimination rule that applies to transfers that result from one of two events. The first is M's transfer of a share of S stock caused solely by M treating the share as worthless under section 165 (taking into account the provisions of §1.1502-80 (c)), if S remains a member of the group and M has a deduction or recognizes a loss with respect to the transfer of the share. The second is M's transfer of a share of S stock caused by S ceasing to be a member, if S has no separate return year and M recognizes a net deduction or loss on its S shares transferred in the transaction. When there is a transfer of S stock in either of these situations, S's net operating loss carryovers, capital loss carryovers, and deferred deductions (including S's share of such consolidated tax attributes) that are not otherwise reduced or reattributed under §1.1502-36 (d), and S's credits (including S's share of consolidated credits), are eliminated. The IRS and Treasury Department do not believe that any special rule is required regarding any built-in loss in assets because excess asset basis should not survive the transactions to which this rule applies.

In considering this rule, the IRS and Treasury Department recognized that the reason for eliminating S's attributes, including credits and deferred deductions, arises from the nature of the specified transactions, not from the amount of the member's basis in the stock transferred in the transaction. Further, as provided in §1.1502-19 (a) (2) (ii), an excess loss account is treated as basis that is a negative amount and a reference to P's basis in S's stock includes a reference to P's excess loss account. Accordingly, the IRS and Treasury Department have concluded that the elimination of S's attributes should occur whenever one of the specified transactions occurs, without regard to the amount of the basis of the transferred share. Under such an approach, the treatment of S's attributes following one of the specified transfers would be consistent irrespective of whether the aggregate basis in the members' shares is a positive number (which produces a net loss or deduction), a negative number (an excess loss account, which produces income or gain under §1.1502-19), or zero (which produces no income, gain, deduction or loss).

Accordingly, these final regulations include a provision in §1.1502-19 that applies to the same two transactions that will result in the complete elimination of S's attributes when members have net loss on S stock. Thus, it will apply when a share of S stock is worthless under section 165, the requirements of §1.1502-19 (c) (1) (iii) are satisfied, members do not have a net deduction or loss on the S stock, and S continues as a member. It will also apply when S ceases to be a member, S has no separate return year, and members recognize an amount that is not a net loss on the subsidiary's stock in the transaction. When it applies, it will eliminate S's net operating loss carryovers, capital loss carryovers, and deferred deductions (including S's share of such consolidated tax attributes), and S's credits (including S's share of consolidated credits).

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Under both the §1.1502-36 and the §1.1502-19 elimination rules, attributes other than consolidated tax attributes (determined as of the event) are eliminated immediately before the event resulting in the application of the rule. Because consolidated tax attributes are first carried to the consolidated return year before being apportioned to a member's first separate return year, the IRS and Treasury Department do not believe that any special timing rule is required regarding the elimination of the portion of any consolidated tax attributes attributable to the member under either of these rules. Mechanically, the elimination of the member's portion of any consolidated tax attributes under either rule can only occur immediately after the close of the group's tax year that includes the event.

To clarify that there is no duplicative adjustment, these final regulations provide that the elimination of these attributes under either rule is not a noncapital, nondeductible expense.

2. Other Sections Addressing Subsidiary Stock Loss: §§1.337 (d)-1, 1.337 (d)-2, 1.1502-20, and 1.1502-35

In general, transfers of loss shares of subsidiary stock on or after September 17, 2008, will be subject to the Unified Loss Rule and not §1.337 (d)-1, §1.337 (d)-2, §1.1502-20, or §1.1502-35. The IRS and Treasury Department do not expect that §1.1502-20 will affect any transactions occurring on or after September 17, 2008. However, because of the binding-commitment transition rule, the IRS and Treasury Department expect there will be some transactions occurring on or after September 17, 2008, that will be subject to §§1.337 (d)-1, 1.337 (d)-2, and 1.1502-35. In addition, dispositions subject to §1.1502-35 will continue to be subject to the loss suspension and anti-loss reimportation rules in §1.1502-35. Accordingly, the IRS and Treasury Department are removing §1.1502-20 and retaining §§1.337 (d)-1, 1.337 (d)-2, and 1.1502-35, subject to certain modifications described below.

Under these final regulations, §§1.337 (d)-1 and 1.337 (d)-2 are modified to state explicitly that they do not apply to transactions subject to the Unified Loss Rule. However, those sections remain otherwise applicable.

Section 1.1502-35 is also modified to state explicitly that it does not apply to transfers subject to the Unified Loss Rule. Although the provisions of §1.1502-35 are largely

unchanged in these final regulations, there are some significant modifications, and those modifications are described in the following paragraphs.

A. Ten-year termination of application of §1.1502-35

Under the final regulations, the loss suspension rule is revised to provide that it ceases to apply ten years after the stock disposition that gave rise to the suspended loss. The purpose of this modification is to conform the loss suspension rule and the anti-loss reimportation rule.

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In addition, the general provisions of §1.1502-35 are revised to apply only to losses allowed within ten years of the date that they are recognized. Thus, if a loss is deferred and taken into account more than ten years after the disposition, or if an exchanged basis asset is sold at a loss more than ten years after the exchanged basis asset is acquired, the section will have no application to the loss. The purpose of this modification is to conform all application of §1.1502-35 to the ten-year rule applicable to loss suspension and anti-loss reimportation.

B. Location of suspended loss

These final regulations modify §1.1502-35 to state explicitly that if M recognized a loss on S stock and the loss was suspended under §1.1502-35 (c), and if M ceases to be a member when S remains a member, then, immediately before M ceases to be a member, P is treated as succeeding to the loss in a transaction to which section 381 (a) applies. Thus, the suspended loss is explicitly preserved for use by the group that disposed of the loss stock, and the location of the loss is specified. However, §1.1502-35 (c) (5) (i) provides that, "[t]o the extent not reduced ... , any loss suspended ... shall be allowed ... on a return filed by the group of which the subsidiary was a member on the date of the disposition of subsidiary stock that gave rise to the suspended loss ... for the taxable year that includes the day before the first date on which the subsidiary ... is not a member of such group or the date the group is allowed a worthless stock loss ...." Further, §1.1502-35 (c) (3) provides that "any loss suspended ... is treated as a noncapital, nondeductible expense of the member that disposes of subsidiary stock, incurred during the taxable year that includes the date of the disposition of stock [that gave rise to the suspended loss]." Accordingly, the IRS and Treasury Department believe these final regulations merely clarify the rule in §1.1502-35.

C. Effect of elimination of reimported item

Under the anti-loss reimportation rule, a reimported item is generally eliminated immediately before it would be taken into account by the group. The regulations provided that the elimination of the item was a noncapital, nondeductible expense under §§1.1502-32 (b) (2) (iii) and 1.1502-32 (b) (3) (iii). A practitioner suggested that this result would inappropriately reduce upper-tier stock basis and, as a result, would either create noneconomic gain or eliminate economic loss. The IRS and Treasury Department considered modifying this provision but have concluded that the elimination of a reimported item is similar to the expiration of a separate return limitation year loss and should be similarly treated. Accordingly, this rule is not modified in the final regulations.

3. The Application of Section 362 (e) (2) to Intercompany Transfers

The proposed regulations included rules for suspending the application of section 362 (e) (2) in the case of transactions between members of a consolidated group. The IRS and Treasury Department had proposed the rule because the interaction of section 362 (e) (2) and the consolidated return provisions (which already address duplication issues) causes significant distortions, administrative burden, and the potential for inappropriate loss

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disallowance and gain creation. In general, the proposed rules were intended to postpone the application of section 362 (e) (2) to an intercompany transaction until the consolidated return provisions could no longer address the loss duplication created in the intercompany transaction.

To implement such a regime, however, complex tracing rules would be necessary to identify the extent to which duplication is eliminated and to continuously monitor the extent to which duplication could continue to be eliminated by the consolidated return provisions. Although the intent was to simplify the application of section 362 (e) (2) in the consolidated return setting and to prevent the adjustments otherwise made under section 362 (e) (2) from causing inappropriate results under the consolidated return provisions, commentators found these rules to be extremely complex and expect them to be extremely burdensome to administer. The IRS and Treasury Department concur with these views.

Commentators offered two suggestions for addressing the concerns raised by the application of section 362 (e) (2) to intercompany transactions.

The first suggestion was to treat intercompany section 362 (e) (2) transactions as taxable transactions to the extent of the net loss in the transferred assets. Thus, the losses would not be duplicated and, because the transfers would be intercompany transactions, §1.1502-13 would police the recognition of the losses. The rationale supporting this approach was that using a familiar regime (specifically, the intercompany transaction provisions of §1.1502-13) would lessen the overall complexity of the provisions as well as the administrative burden placed on taxpayers and the government. Although this approach would be less burdensome than the approach in the proposed regulations, the IRS and Treasury Department are concerned that this approach would still impose an unnecessary administrative burden. Further, unlike either the general application of §1.1502-13 to a nonrecognition transaction or the general application of section 362 (e) (2), this approach would effectively preserve the original location of the net loss in the transferred assets.

The second suggestion was to modify the consolidated return provisions to make section 362 (e) (2) generally inapplicable to intercompany transactions. Commentators stated that applying section 362 (e) (2) to intercompany transactions gives rise to administrative burden and complexity even if the taxable intercompany transaction model were adopted. Further, they argued that applying section 362 (e) (2) to intercompany transactions is unnecessary because the consolidated return regulations (including the Unified Loss Rule) are already structured to address duplication of loss (and gain) within the group (including its members and former members) in a manner and scope that has been determined appropriate in the consolidated return setting, given the competing single and separate entity policy issues. The application of section 362 (e) (2) to intercompany transactions is thus not only generally unnecessary and burdensome, it is disruptive of the balance struck in the various consolidated return provisions, most notably the investment adjustment rules in §1.1502-32 and the Unified Loss Rule in §1.1502-36.

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For these reasons, the IRS and Treasury Department have concluded that section 362 (e) (2) should generally not apply to intercompany transactions. Accordingly, these final regulations add a new paragraph (h) in §1.1502-80, which makes section 362 (e) (2) generally inapplicable to intercompany transactions. The purpose of the provision is to allow the consolidated return provisions to address loss duplication. The IRS and Treasury Department are therefore withdrawing proposed §1.1502-13 (e) (4), which proposed the suspension of the application of section 362 (e) (2) to intercompany transactions.

Notwithstanding the decision to make section 362 (e) (2) generally inapplicable to intercompany transactions, the IRS and Treasury Department are concerned that the inapplicability of section 362 (e) (2) could be used to reach inappropriate results. For example, assume M transfers a loss asset to S in exchange for new shares in a transaction to which section 351 (a) applies, S has an asset with offsetting appreciation, and later M sells only the new shares received in exchange for the loss asset. If S has no aggregate inside loss, the Unified Loss Rule will not require any attribute reduction. Accordingly, if S remains a member, the group could obtain more than a single benefit for its economic loss. The final regulations therefore include an anti-abuse rule that provides for appropriate adjustments to be made to clearly reflect the income of the group if a taxpayer acts with a view to prevent the consolidated return provisions from properly addressing loss duplication. The final regulations also include an example that illustrates both an abusive fact pattern (similar to the one described) and a nonabusive fact pattern (similar to the one described, except that all the stock is sold).

4. Proposed Revisions to the Investment Adjustment Provisions, §1.1502-32

In the January 2007 proposal, the IRS and Treasury Department proposed several modifications to the investment adjustment rules in §1.1502-32. The principal modifications that were proposed related to the treatment of items attributable to property transferred in an intercompany section 362 (e) (2) transaction and to the treatment of items attributable to the application of §1.1502-36 (d).

As discussed in section 3 of this preamble, these final regulations make section 362 (e) (2) generally inapplicable to intercompany transactions. Accordingly, the IRS and Treasury Department are withdrawing proposed §1.1502-32 (c) (1) (ii) (A) (regarding the allocation of items otherwise attributable to intercompany section 362 (e) (2) transactions).

Proposed regulations addressing the treatment of items attributable to the application of §1.1502-36 (d) are finalized as §1.1502-32 (c) (1) (ii). The IRS and Treasury Department have clarified the language of the proposed rule, but have made no substantive change to that rule.

In addition, the proposed regulations made various nonsubstantive modifications to the language of §1.1502-32 that were intended to simplify, clarify, and then conform various

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sections of the regulations. Those proposed changes are adopted without substantive change.

5. Miscellaneous Amendments to Other Regulations

In addition to the various provisions directly related to the treatment of losses on subsidiary stock and to the treatment of intercompany section 362 (e) (2) transactions, the January 2007 proposal included a number of proposed modifications to regulations unrelated to subsidiary stock loss issues. The proposed revisions are described in Section I of the preamble to the January 2007 proposal. These final regulations adopt those proposed regulations without substantive change.

These final regulations also include several additional provisions that are either additional technical corrections to existing regulations or expansions of regulatory modifications proposed in the January 2007 proposal and adopted as final in this Treasury decision.

A. Technical amendment to §1.1502-13 (g) (3) (i) (B) (2)

One commentator suggested an expansion of §1.1502-13 (g) (3) (i) (B) (2), which prevents the application of §1.1502-13 (c) (6) (i) to items of income or gain attributable to the reduction in basis of an intercompany obligation by reason of sections 108 and 1017 and §1.1502-28 (and thereby prevents such items from being excluded from income). The commentator noted that the same rule should be applied to items of income or gain attributable to the reduction in basis of an intercompany obligation by reason of §1.1502-36 (d), in order to prevent the circumvention of the effects of attribute reduction. The IRS and Treasury Department agree that such a revision would be a helpful clarification and that change is incorporated in these final regulations.

B. Amendments to §1.1502-33 (e) “whole-group” exception

In the January 2007 proposal, modifications were proposed to the “whole-group” exceptions in §1.1502-13 (j) (5) (excepting whole-group acquisitions from the general rule that deconsolidations require intercompany items to be taken into account) and §1.1502-19 (c) (3) (excepting whole-group acquisitions from the general rule that deconsolidations require excess loss accounts to be taken into account).

In response to the proposed changes to the whole-group exceptions in §§1.1502-13 and 1.1502-19, commentators suggested that a similar revision would be appropriate for the whole-group exception in §1.1502-33 (e) (2). That rule excepts whole-group acquisitions from the general rule in §1.1502-33 (e) (1) that eliminates a member’s earnings and profits upon deconsolidation. The IRS and Treasury Department agree that the same reasoning supports the modification of all three whole-group exceptions.

Accordingly, these final regulations modify the whole-group exception in all three provisions, §§1.1502-13 (j) (5), 1.1502-19 (c) (3), and 1.1502-33 (e) (2), to allow for their application without regard to whether the acquirer is a member of a consolidated

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group prior to the acquisition. Further, these final regulations provide that taxpayers may elect to apply each of these modified whole-group exceptions retroactively.

C. Anti-duplicative adjustments provisions

The January 2007 proposal included a set of modifications that was intended to simplify several existing provisions by removing all references to the continued applicability of the Code and all of the anti-duplicative adjustment rules, and including such rule in a single paragraph in §1.1502-80. The IRS and Treasury Department believed this change would simplify the regulations, as well as remove any potential for inadvertent omission or negative implication in other provisions where such concepts are or should be applicable.

Commentators questioned whether the removal of the discussion of the anti-duplicative adjustment rule in various sections of the consolidated return regulations would eliminate guidance that is helpful to taxpayers and that establishes certain policy determinations. The IRS and Treasury Department have considered these comments and concluded that it is appropriate to retain the anti-duplicative adjustment rule in the various sections of the consolidated return regulations, but to add a cross reference to the rule in §1.1502-80 (a). To provide additional guidance in §1.1502-80 (a), the final regulations provide that, in determining the application of the anti-duplicative adjustment rule, the purposes of the provisions and single-entity principles are taken into account.

In addition, the final regulations modify the general anti-duplicative adjustment rule in §1.1502-80 to clarify that its principles apply to adjustments, inclusions, and all similar items.

D. Technical correction to text example in §1.1502-75 (d) (1)

A practitioner informed the IRS and Treasury Department that the rationale in the text example in §1.1502-75 (d) (1) needed modification. Section 1.1502-75 (d) (1) provides that a group remains in existence for a tax year if the common parent remains as the common parent and at least one subsidiary that was affiliated with it at the end of the prior year remains affiliated with it at the beginning of the year. It then sets forth an example in which, at the end of 1965, P is the common parent of a group that includes S and, at the beginning of 1966, P is still the common parent of a group that includes S. The example concludes that the group continues through 1966 even though P acquires another subsidiary and S leaves the group.

The practitioner noted that the result is correct, but that the rationale is misleading and appears to be based on a prior formulation of the continuation of the group rule. Accordingly, these final regulations revise the analysis of this text example so that the rationale reflects the current continuation of the group rule.

E. Amendment to the section 358 stock basis rules for certain triangular reorganizations

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In addition to adopting the proposed technical correction to the cross-reference paragraph in §1.358-6 (e), these final regulations add triangular G reorganizations (other than by statutory merger) to the definition of triangular reorganizations in §1.358-6 (b) (2).

F. Request for comments on gain duplication

Finally, in the preamble to the January 2007 proposal, the IRS and Treasury Department requested comments on the need for a provision that would address the gain duplication that occurs when S stock is sold at a gain and that gain is attributable to unrecognized net appreciation in S's assets. The IRS and Treasury Department have not previously addressed this form of gain duplication directly because taxpayers can structure their transactions to avoid duplicative recognition of the gain, for example, by selling assets directly or by electing to have their stock sales treated as assets sales under section 338. While it is believed that taxpayers generally have adequate means to mitigate this problem, comments were requested.

In response, commentators expressed the view that the IRS and Treasury Department underestimate the frequency and extent of gain duplication and overestimate the efficacy of self-help mechanisms.

Some commentators suggested that gain duplication could be addressed through a section 338-like election, pursuant to which gain recognized on subsidiary stock could be allocated to the basis of the subsidiary's assets, at least to the extent necessary to bring the basis of the assets into conformity with the basis of the stock in the buyer's hands. However, those commentators have explicitly stated that they are not urging this or any other particular model. Moreover, the IRS and Treasury Department have been advised that there is disagreement among commentators and practitioners as to whether the additional burden and complexity inherent in such additional rules would be warranted by the potential relief they could provide.

Accordingly, the IRS and Treasury Department will continue to accept comments and consider this issue. * * *

G. Page 337, New Sec. 5.13a. Notice on Intermediary Transaction Tax Shelters

Page 337, New Sec. 5.13a. Add before Sec 5.14 the following:
New Sec. 5.13a. **Notice on Intermediary Transaction Tax Shelters**

Notice on Intermediary Transaction Tax Shelters
Notice 2008-111, 2008 IRB 1299

SECTION 1. PURPOSE AND BACKGROUND

This Notice clarifies Notice 2001-16, 2001-1 C.B. 730, and supersedes Notice 2008-20,

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2008-6 I.R.B. 406, regarding Intermediary Transaction Tax Shelters. Notice 2001-16 identified the Intermediary Transaction Tax Shelter (hereafter, an “Intermediary Transaction”) as a listed transaction under § 1.6011-4 (b) (2) of the Income Tax Regulations. For purposes of this Notice, an Intermediary Transaction is defined in terms of its plan and in terms of more objective components. Under this Notice, a transaction is treated as an Intermediary Transaction with respect to a particular person only if that person engages in the transaction pursuant to the Plan (as defined in sections 2 and 4), the transaction contains the four objective components indicative of an Intermediary Transaction set forth in section 3, and no safe harbor exception in section 5 applies to that person. A transaction may be an Intermediary Transaction with respect to one person and not be an Intermediary Transaction with respect to another person. This Notice does not affect the legal determination of whether a person’s treatment of the transaction is proper or whether such person is liable, at law or in equity, as a transferee of property in respect of the unpaid tax obligation described in section 3.

SECTION 2. DEFINITION OF THE PLAN

An Intermediary Transaction involves a corporation (T) that would have a Federal income tax obligation with respect to the disposition of assets the sale of which would result in taxable gain (Built-in Gain Assets) in a transaction that would afford the acquiror or acquirors (Y) a cost or fair market value basis in the assets. An Intermediary Transaction is structured to cause the tax obligation for the taxable disposition of the Built-in Gain Assets to arise, in connection with the disposition by shareholders of T (X) of all or a controlling interest in T’s stock, under circumstances where the person or persons primarily liable for any Federal income tax obligation with respect to the disposition of the Built-in Gain Assets will not pay that tax (hereafter, the Plan). This plan can be effectuated regardless of the order in which T’s stock or assets are disposed. A transaction is not an Intermediary Transaction for purposes of this Notice if there is neither any X nor any Y engaging in the transaction pursuant to the Plan (as defined in section 4).

SECTION 3. COMPONENTS OF AN INTERMEDIARY TRANSACTION

There are four components of an Intermediary Transaction, and a transaction must have all four components to be the same as or substantially similar to the listed transaction described in Notice 2001-16, even if the transaction is engaged in pursuant to the Plan. The four components are:

- 1.

  A corporation (T) directly or indirectly (e.g., through a pass-through entity or a member of a consolidated group of which T is a member) owns assets the sale of which would result in taxable gain (T’s Built-in Gain Assets) and, as of the Stock Disposition Date (as defined in component two), T (or the consolidated group of which T is a member) has insufficient tax benefits to eliminate or offset such taxable gain (or the tax) in whole. The tax that would result from such sale is

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hereinafter referred to as T's Built-in Tax. However, for purposes of this component, T will not be considered to have any Built-in Tax if, on the Stock Disposition Date, such amount is less than five percent of the value of the T stock disposed of in the Stock Disposition (as defined in component two). In determining whether T's (or the consolidated group's) tax benefits are insufficient for purposes of the first sentence, the following tax benefits shall be excluded: (i) any tax benefits attributable to a listed transaction under § 1.6011-4 (b) (2), and (ii) any tax benefits attributable to built-in loss property acquired within 12 months before any Stock Disposition described in component two, to the extent such built-in losses exceed built-in gains in property acquired in the same transaction(s). All references to T in this notice include successors to T.

- 2.

  At least 80 percent of the T stock (by vote or value) is disposed of by T's shareholder(s) (X), other than in liquidation of T, in one or more related transactions within a 12 month period (Stock Disposition). The first date on which at least 80 percent of the T stock (by vote or value) has been disposed of by X in a Stock Disposition is the Stock Disposition Date.

- 3.

  Either within 12 months before, simultaneously, or within 12 months after the Stock Disposition Date, at least 65 percent (by value) of T's Built-in Gain Assets are disposed of (Sold T Assets) to one or more buyers (Y) in one or more transactions in which gain is recognized with respect to the Sold T Assets. For purposes of this component, transactions in which T disposes of all or part of its assets to either another member of the controlled group of corporations (as defined in § 1563) of which T is a member, or a partnership in which members of such controlled group satisfy the requirements of §1.368-1 (d) (4) (iii) (B), will be disregarded provided there is no plan to dispose of at least 65 percent (by value) of T's Built-in Gain Assets to one or more persons that are not members of such controlled group, or to partnerships not described herein.

- 4.

  At least half of T's Built-in Tax that would otherwise result from the disposition of the Sold T Assets is purportedly offset or avoided or not paid.

SECTION 4. ENGAGING IN THE TRANSACTION PURSUANT TO THE PLAN

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A transaction that has all four components described in section 3 is only an Intermediary Transaction with respect to a person that engages in the transaction pursuant to the Plan. A person engages in the transaction pursuant to the Plan if the person knows or has reason to know the transaction is structured to effectuate the Plan. Additionally, any X that is at least a 5% shareholder of T (by vote or value), or any X that is an officer or director of T, engages in the transaction pursuant to the Plan if any of the following knows or has reason to know the transaction is structured to effectuate the Plan: (i) any officer or director of T; (ii) any of T's advisors engaged by T to advise T or X with respect to the transaction; or (iii) any advisor of that X engaged by that X to advise it with respect to the transaction. For purposes of this section, if T has more than five officers then the term "officer" shall be limited to the chief executive officer of T (or an individual acting in such capacity) and the four highest compensated officers for the taxable year (other than the chief executive officer or an individual acting in such capacity). A person can engage in the transaction pursuant to the Plan even if it does not understand the mechanics of how the tax liability purportedly might be offset or avoided, or the specific financial arrangements, or relationships of other parties or of T after the Stock Disposition.

A person will not be treated as engaging in the transaction pursuant to the Plan merely because it has been offered attractive pricing terms by the opposite party to a transaction.

Thus, a transaction may be an Intermediary Transaction with respect to X but not Y, or with respect to Y but not X, in situations where one party engages in the transaction pursuant to the Plan and the other does not. A transaction may also be an Intermediary Transaction with respect to some but not all Xs and/or some but not all Ys, depending on whether they engage in the transaction pursuant to the Plan. A transaction will not be an Intermediary Transaction with respect to any person that does not engage in the transaction pursuant to the Plan regardless of the amounts reported on any return.

SECTION 5. SAFE HARBOR EXCEPTIONS FOR CERTAIN PERSONS; PARTICIPATION GENERALLY

01. Safe Harbor Exceptions for Certain Persons

A transaction is not an Intermediary Transaction with respect to the following persons under the following circumstances:

- Any X, if the only T stock it disposes of is traded on an established securities market (within the meaning of § 1.453-3 (d) (4)) and prior to the disposition X (including related persons described in section 267 (b) or 707 (b)) did not hold five percent (or more) by vote or value of any class of T stock disposed of by X.
- Any X, T, or M, if, after the acquisition of the T stock, the acquiror of the T stock is the issuer of stock or securities that are publicly traded on an established

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securities market in the United States, or is consolidated for financial reporting purposes with such an issuer.

- Any Y, if the only Sold T Assets it acquires are either (i) securities (as defined in section 475 (c) (2)) that are traded on an established securities market (within the meaning of § 1.453-3 (d) (4)) and represent a less-than-five-percent interest in that class of security, or (ii) assets that are not securities and do not include a trade or business as described in § 1.1060-1 (b) (2).

02. Participation

If one of the foregoing safe harbor exceptions does not apply to a person, that person engaged in a transaction pursuant to the Plan, and the transaction has all four components described in section 3, the determination of whether the person participated in an Intermediary Transaction for purposes of § 1.6011-4 in any given taxable year is made under the general rule in § 1.6011-4 (c) (3) (i) (A).

SECTION 6. EFFECTIVE DATE; DISCLOSURE, LIST MAINTENANCE, AND REGISTRATION REQUIREMENTS; PENALTIES; OTHER CONSIDERATIONS

Transactions that are the same as, or substantially similar to, the transaction described in Notice 2001-16 were identified as “listed transactions” under § 1.6011-4 (b) (2) effective January 19, 2001. Accordingly, this Notice is generally effective January 19, 2001. However, this Notice imposes no requirements with respect to any obligation under § 6011, § 6111, or § 6112 due before December 1, 2008, not otherwise imposed by Notice 2001-16. Because this Notice supersedes Notice 2008-20, any disclosure filed pursuant to Notice 2008-20 will be treated as made pursuant to Notice 2001-16. Independent of their classification as listed transactions, transactions that are the same as, or substantially similar to, the transaction described in Notice 2001-16 may already be subject to the requirements of § 6011, § 6111, or § 6112, or the regulations thereunder.

Persons required to disclose these transactions under § 1.6011-4 and who fail to do so may be subject to the penalty under § 6707A. Persons required to disclose or register these transactions under § 6111 who have failed to do so may be subject to the penalty under § 6707 (a). Persons required to maintain lists of investors under § 6112 who fail to provide such lists when requested by the Service may be subject to the penalty under § 6708 (a). A person that is a tax-exempt entity within the meaning of § 4965 (c), or an entity manager within the meaning of § 4965 (d), may be subject to excise tax, disclosure, filing or payment obligations under § 4965, § 6033 (a) (2), § 6011, and § 6071. Some taxable parties may be subject to disclosure obligations under § 6011 (g) that apply to “prohibited tax shelter transactions” as defined by § 4965 (e) (including listed transactions).

In addition, the Service may impose other penalties on persons involved in this transaction or substantially similar transactions (including an accuracy-related penalty

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under § 6662 or 6662A) and, as applicable, on persons who participate in the promotion or reporting of this transaction or substantially similar transactions (including the return preparer penalty under § 6694, the promoter penalty under § 6700, and the aiding and abetting penalty under § 6701).

Further, under § 6501 (c) (10), the period of limitations on assessment may be extended beyond the general three-year period of limitations for persons required to disclose transactions under § 1.6011-4 who fail to do so. See Rev. Proc. 2005-26, 2005-1 C.B. 965.

The Service and the Treasury Department recognize that some taxpayers may have filed tax returns taking the position that they were entitled to the purported tax benefits of the types of transactions described in Notice 2001-16. These taxpayers should consult with a tax advisor to ensure that their transactions are disclosed properly and to take appropriate corrective action.

SECTION 7. EFFECT ON OTHER DOCUMENTS

Notice 2001-16 is clarified. Notice 2008-20 is superseded.

SECTION 8. REQUEST FOR COMMENTS

The Service and the Treasury Department seek comments regarding the above definitions, components, and safe harbors for the purpose of reflecting more accurately which transactions are the same as or substantially similar to an Intermediary Transaction and which parties are engaging in a transaction pursuant to the Plan.

Comments should be submitted to: Internal Revenue Service, CC:PA:LPD:PR (Notice 2008-111), Room 5203, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Alternatively, comments may be hand delivered Monday through Friday between the hours of 8:00 a.m. and 4:00 p.m. to: CC:PA:LPD:PR (Notice 2008-XX), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Comments may also be submitted electronically, via the following email address: Notice.Comments@irscounsel.treas.gov. Please include "Notice 2008-111" in the subject line of any electronic submissions. All comments received will be open to public inspection and copying.

DRAFTING INFORMATION * * *

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VI. CHAPTER 6, FUNDAMENTAL REORGANIZATION CONCEPTS

A. Page 402, New Sec. 6.2.I.3. Preamble to the Signing Date Final Regulations

Page 402, New Sec. 6.2.I.3. Add before Sec. 6.3 the following:
New Sec. 6.2.I.3. **Preamble to the Signing Date Final Regulations**

Preamble to Treasury Decision 9225
September 15, 2005

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulation.

SUMMARY: This document contains final regulations that provide guidance regarding the satisfaction of the continuity of interest requirement for corporate reorganizations. The final regulations affect corporations and their shareholders.

Background The Internal Revenue Code of 1986 (Code) provides for general nonrecognition treatment for reorganizations described in section 368 of the Code. In addition to complying with the statutory and certain other requirements, to qualify as a reorganization, a transaction generally must satisfy the continuity of interest (COI) requirement. COI requires that, in substance, a substantial part of the value of the proprietary interests in the target corporation be preserved in the reorganization.

On August 10, 2004, the IRS and Treasury Department published a notice of proposed rulemaking (REG-129706-04) in the Federal Register (69 FR 48429) (hereinafter the proposed regulations) identifying certain circumstances in which the determination of whether a proprietary interest in the target corporation is preserved would be made by reference to the value of the issuing corporation’s stock on the day before there is an agreement to effect the potential reorganization. In particular, in cases in which the consideration to be tendered to the target corporation’s shareholders is fixed in a binding contract and includes only stock of the issuing corporation and money, the issuing corporation stock to be exchanged for the proprietary interests in the target corporation would be valued as of the end of the last business day before the first date there is a binding contract to effect the potential reorganization (the signing date rule). Under the proposed regulations, consideration is fixed in a contract if the contract states the number of shares of the issuing corporation and the amount of money, if any, to be exchanged for the proprietary interests in the target corporation. The signing date rule is based on the principle that, in cases in which a binding contract provides for fixed consideration, the target corporation shareholders generally can be viewed as being subject to the economic fortunes of the issuing corporation as of the signing date.

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No public hearing regarding the proposed regulations was requested or held. However, several written and electronic comments regarding the notice of proposed rulemaking were received. After consideration of the comments, the proposed regulations are adopted as revised by this Treasury decision.

Explanation of Provisions. These final regulations retain the general framework of the proposed regulations but make several modifications in response to the comments received. The following sections describe the most significant comments and the extent to which they have been incorporated into these final regulations.

Fixed Consideration. As stated above, the proposed regulations require that the consideration in a contract be fixed in order for the signing date rule to apply. One commentator identified a number of contractual arrangements that do not provide for fixed consideration within the meaning of the proposed regulations, but, nevertheless, are arrangements in which the consideration should be treated as fixed and, therefore, eligible for the signing date rule. In particular, the commentator identified a number of circumstances in which, rather than stating the number of shares and money to be exchanged for target corporation shares, a contract may provide that a certain percentage of target corporation shares will be exchanged for stock of the issuing corporation. One such circumstance is where a merger agreement permits the target corporation some flexibility in issuing its shares between the signing date and effective date of the potential reorganization. Such an issuance may occur, for example, upon the exercise of employee stock options. As a result, the total number of outstanding target corporation shares at the effective time of the merger and, therefore, the total number of shares of the acquiring corporation to be issued in the merger, may not be known when the merger agreement is signed.

In addition, a contract may permit the target corporation shareholders to elect to receive stock (the number of shares of which may be determined pursuant to a collar) and/or money or other property in respect of target corporation stock, but provide that a particular percentage of target corporation shares will be exchanged for stock of the issuing corporation and a particular percentage of target corporation stock will be exchanged for money. In these cases, if either the stock or the cash consideration is oversubscribed, adjustments are made to the consideration to be tendered in respect of the target corporation shares such that the specified percentage of target corporation shares is, in fact, exchanged for stock of the issuing corporation.

The IRS and Treasury Department agree that a contract that provides for either the percentage of the number of shares of each class of target corporation stock, or the percentage by value of the target corporation shares, to be exchanged for issuing corporation stock should be treated as providing for fixed consideration, as long as the target corporation shares to be exchanged for issuing corporation stock and the target corporation shares to be exchanged for consideration other than issuing corporation stock each represents an economically reasonable exchange. Just as in cases in which the contract states the number of shares of the issuing corporation and the amount of money, if any, to be exchanged for the proprietary interests in the target corporation, in these

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cases, the target corporation shareholders generally can be viewed as being subject to the economic fortunes of the issuing corporation as of the signing date. Accordingly, these final regulations include an expanded set of circumstances in which a contract will be treated as providing for fixed consideration.

Contingent Consideration. The fact that a contract provides for contingent consideration will generally prevent a contract from being treated as providing for fixed consideration. One commentator suggested that a contract should not be treated as failing to provide for fixed consideration solely because it provides for contingent consideration that can only increase the proportion of issuing corporation stock to cash to be exchanged for target corporation shares. Where stock of the issuing corporation is the only type of consideration that is subject to a contingency, the delivery of any of the contingent consideration to the target corporation shareholders will enhance the preservation of the target corporation's shareholders' proprietary interests. Therefore, these final regulations provide for a limited exception to the general rule that an arrangement that provides for contingent consideration will not be one to which the signing date rule applies. The exception applies to cases in which the contingent consideration consists solely of stock of the issuing corporation and the execution of the potential reorganization would have resulted in the preservation of a substantial part of the value of the target corporation shareholders' proprietary interests in the target corporation if none of the contingent consideration were delivered to the target corporation shareholders.

The IRS and Treasury Department continue to study whether other arrangements involving contingent consideration should be within the scope of the signing date rule. Among these arrangements are cases in which the contingent consideration consists not only of issuing corporation stock but also of money or other property and cases in which the issuing corporation stock to be issued in respect of target corporation stock is determined pursuant to a collar.

Nature of Consideration. As described above, under the proposed regulations, the signing date rule applies only when the consideration to be provided in respect of target corporation shares includes only stock of the issuing corporation and money. One commentator suggested that the signing date rule should be expanded to apply to transactions in which the non-stock consideration includes property other than money. Under these final regulations, the signing date rule may apply in such cases. Therefore, under these final regulations, the signing date rule may apply, for example, in cases in which proprietary interests in the target corporation are exchanged for stock and securities of the issuing corporation.

Valuation. The "as of the end of the last business day" rule. The proposed regulations require that, if the signing date rule applies, the consideration to be tendered in respect of the target corporation shares surrendered be valued as of the end of the last business day before the first date there is a binding contract to effect the potential reorganization. One comment requested clarification of the meaning of *as of the end of the last business day*. That comment suggested that an average of the high and low trade price on that day should be an acceptable value for this purpose. Alternatively, the comment suggested that

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if a single trade were to determine the value of the issuing corporation stock, the closing price of the issuing corporation stock on the relevant market should be used. The comment further described an approach for identifying the relevant stock market.

In response to these comments, these final regulations remove the requirement that the consideration be valued as of the end of the last business day before the first date that there is a binding contract. Instead, they provide general guidance that the consideration to be exchanged for target corporation shares pursuant to a contract must be valued the day before such contract is a binding contract.

New issuances. The IRS and Treasury Department recognize that the application of the requirement that the consideration to be exchanged for proprietary interests in the target corporation be valued on the last business day before the first date there is a binding contract to effect the potential reorganization may be unclear in cases in which the consideration does not exist prior to the effective date of the reorganization. For example, suppose that, in the potential reorganization, the issuing corporation will issue a new class of its stock in exchange for the shares of the target corporation. The question has arisen as to how to value those to be issued shares under the signing date rule, given that they do not exist on the last business day before the first date that there is a binding contract to effect the potential reorganization. Thus, these final regulations clarify that this new class of stock will be deemed to have been issued on the last business day before the first date there is a binding contract to effect the potential reorganization for purposes of applying the signing date rule.

Escrowed Stock. Pre-closing covenants. The proposed regulations provide that placing part of the stock issued or money paid into escrow to secure customary target representations and warranties will not prevent the consideration in a contract from being fixed. One comment suggested that this rule should be expanded to include consideration placed in escrow to secure target's performance of customary pre-closing covenants (rather than representations and warranties). That commentator stated that there is no reason to distinguish between customary pre-closing covenants, on the one hand, and customary representations and warranties, on the other hand. The IRS and Treasury Department agree. Accordingly, these final regulations extend the rule related to escrows to include consideration placed in escrow to secure target's performance of customary pre-closing covenants.

Effect of escrowed consideration on satisfaction of COI. Some commentators have indicated that certain examples in the proposed regulations suggest that escrowed stock, even if it is forfeited to the issuing corporation, is treated as preserving the target shareholders' proprietary interests in the target corporation. The IRS and Treasury Department believe that escrowed consideration that is forfeited should not be taken into account in determining whether the COI requirement is satisfied. This conclusion reflects the view that the forfeiture of escrowed consideration is in substance a purchase price adjustment. Accordingly, the examples in these final regulations reflect that forfeited stock is not treated as preserving the target corporation shareholders' proprietary interests in the target corporation and forfeited non-stock consideration is not treated as counting

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against the preservation of the target corporation's shareholders' proprietary interest in the target corporation. The IRS and Treasury Department continue to consider the effect on COI of escrowed consideration and contingent consideration.

Revenue Procedure 84-42. One commentator requested clarification regarding the impact of the proposed regulations on Revenue Procedure 84-42 (1984-1 C.B. 521). Rev. Proc. 84-42 includes certain operating rules of the IRS regarding the issuance of letter rulings, including the circumstances in which the placing of stock in escrow will not prevent the IRS from issuing a private letter ruling. The IRS and Treasury Department continue to review the existing revenue procedures relating to reorganizations in light of the numerous regulatory changes since the publication of these procedures and the policy against issuing rulings in the reorganization area unless there is a significant issue, which is reflected in Rev. Proc. 2005-3. Rev. Proc. 84-42 is not amended at this time.

Anti-Dilution Provisions. One comment suggested that consideration in a contract should not be treated as fixed unless the contract includes a customary anti-dilution provision. The commentator posited an example in which the absence of an anti-dilution clause and the occurrence of a stock split with respect to the stock of the issuing corporation prior to the effective date of a potential reorganization results in the value of the consideration received in respect of the target corporation shares being substantially different from its value on the day before the first date there is a binding contract.

The IRS and Treasury Department do not believe that the absence of a customary anti-dilution provision should necessarily preclude the application of the signing date rule as dilution may not, in fact, occur. However, the IRS and Treasury Department are concerned that application of the signing date rule is not appropriate if the contract does not contain an anti-dilution clause relating to the stock of the issuing corporation and the issuing corporation alters its capital structure between the first date there is an otherwise binding contract to effect the potential reorganization and the effective date of the potential reorganization in a manner that materially alters the economic arrangement of the parties to the binding contract. Accordingly, these final regulations provide that, in such cases, the consideration will not be treated as fixed.

Contract modifications. The proposed regulations require that if a term of a binding contract that relates to the amount or type of consideration the target shareholders will receive in a potential reorganization is modified before the closing date of the potential reorganization, and the contract as modified is a binding contract, then the date of the modification shall be treated as the first date there is a binding contract. Thus, such a modification requires that the stock of the issuing corporation be valued as of the end of the last business day before the date of the modification in order to determine whether the transaction satisfies the COI requirement.

One commentator suggested that a contract should not be treated as being modified for this purpose if the modification has the sole effect of increasing the number of shares of the issuing corporation to be received by the target shareholders. The IRS and Treasury Department agree that, because such a modification only enhances the preservation of the

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target corporation's shareholders' proprietary interests, it is not appropriate to value the consideration to be provided to the target corporation shareholders as of the day before the date of the modification rather than as of the day before the date of the original contract, at least in cases in which the transaction would have satisfied the COI requirement under the signing date rule if there had been no modification. Therefore, these final regulations provide that a modification that has the sole effect of providing for the issuance of additional shares of issuing corporation stock to the target corporation shareholders will not be treated as a modification if the execution of the potential reorganization would have resulted in the preservation of a substantial part of the value of the target corporation shareholders' proprietary interest in the target corporation if there had been no modification. In such cases, the determination of whether a proprietary interest in the target corporation has been preserved is made by reference to the value of the consideration as of the last business day before the first date the contract was binding, not the last business day before the modification. The IRS and Treasury Department continue to consider whether this exception should be extended to certain cases in which the modification results in not only additional shares of the issuing corporation to be issued to target corporation shareholders, but also additional money or other property to be transferred to target corporation shareholders.

Application of Principle Illustrated by Examples. One commentator asked whether the principle that the COI requirement is satisfied where 40 percent of the target corporation stock is exchanged for stock in the issuing corporation that is illustrated in the examples of the proposed regulations (which relate to the application of the signing date rule) also applies in cases in which the signing date rule does not apply. The IRS and Treasury Department believe that this principle is equally applicable to cases in which the signing date rule does not apply as it is to cases in which the signing date rule does apply.

Restricted Stock. The IRS and Treasury Department are continuing to consider the appropriate treatment of restricted stock in the determination of whether the COI requirement is satisfied.

B. Page 402, New Sec. 6.2.I.4. Preamble to the Amended Signing Date Final Regulations

Page 402, New Sec. 6.2.I.4. Add after New Sec. 6.2.I.3 the following:
New Sec. 6.2.I.4. **Preamble to the Amended Signing Date Final Regulations**

Preamble to Treasury Decision 9316, Corporate Reorganizations; Guidance on the Measurement of Continuity of Interest
April 16, 2007

SUMMARY: This document contains final and temporary regulations that provide guidance regarding the satisfaction of the continuity of interest requirement for corporate reorganizations. These regulations affect corporations and their shareholders. The text of

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the temporary regulations also serves as the text of the proposed regulations (REG-146247-06) set forth in the notice of proposed rulemaking on this subject in this issue of the Bulletin. * * *

Background and Explanation of Provisions

The Internal Revenue Code of 1986 (Code) provides general nonrecognition treatment for reorganizations described in section 368 of the Code. In addition to complying with the statutory and certain other requirements, to qualify as a reorganization, a transaction generally must satisfy the continuity of interest (COI) requirement. COI requires that, in substance, a substantial part of the value of the proprietary interests in the target corporation be preserved in the reorganization.

On August 10, 2004, the IRS and Treasury Department published a notice of proposed rulemaking (REG-129706-04, 2004-2 C.B. 479) in the **Federal Register** (69 FR 48429) (2004 proposed regulations) identifying certain circumstances in which the determination of whether a proprietary interest in the target corporation is preserved would be made by reference to the value of the issuing corporation's stock on the day before there is an agreement to effect the potential reorganization. On September 16, 2005, the IRS and Treasury Department published final regulations in the **Federal Register** (T.D. 9225, 2005-2 C.B. 716 [70 FR 54631]) (2005 final regulations) which retained the general framework of the 2004 proposed regulations but made several modifications in response to the comments received regarding the proposed regulations. Specifically, the 2005 final regulations provide that in determining whether a proprietary interest in the target corporation is preserved, the consideration to be exchanged for the proprietary interests in the target corporation pursuant to a contract to effect the potential reorganization is valued on the last business day before the first date such contract is a binding contract (the signing date), if the contract provides for fixed consideration (the signing date rule).

After consideration of comments relating to the 2005 final regulations, the IRS and Treasury Department are revising those regulations as set forth in this Treasury decision. These temporary regulations provide guidance for measuring whether the COI requirement is satisfied. The following sections specifically describe the revisions.

A. *Applicability of the Signing Date Rule*

For purposes of determining whether COI is satisfied, the 2005 final regulations require the consideration to be exchanged for the proprietary interests in the target corporation to be valued on the last business day before the first date such contract is a binding contract, if such contract provides for fixed consideration. As noted in the preamble to the 2005 final regulations, the signing date rule is based on the principle that, where a binding contract provides for fixed consideration, the target corporation shareholders can generally be viewed as being subject to the economic fortunes of the issuing corporation as of the signing date. However, if the contract does not provide for fixed consideration, the signing date value of the issuing corporation stock is not relevant for purposes of determining the extent to which a proprietary interest in the target corporation is

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preserved.

These temporary regulations continue to apply the signing date rule where the contract provides for fixed consideration. If the contract does not provide for fixed consideration, the temporary regulations provide that the signing date rule is not applicable. Further, these temporary regulations clarify that where fixed consideration includes other property that is identified by value, that specified value is the value of such other property to be used in determining whether COI is satisfied.

B. *Definition of Fixed Consideration*

As noted above, the temporary regulations provide that the signing date rule only applies to contracts that provide for fixed consideration. These temporary regulations modify the definition of fixed consideration.

The 2005 final regulations provide four circumstances in which a contract will be treated as providing for fixed consideration. Generally, under the 2005 final regulations, a contract provides for fixed consideration if (1) the contract states the number of shares of the issuing corporation plus the amount of money and any other property to be exchanged for all proprietary interests in the target corporation; (2) the contract states the number of shares of the issuing corporation plus the amount of money and any other property to be exchanged for each proprietary interest in the target corporation; (3) the contract states the percentage of proprietary interests in the target corporation to be exchanged for stock of the issuing corporation; or (4) the contract states the percentage of each proprietary interest in the target corporation to be exchanged for stock of the issuing corporation.

These temporary regulations combine the first two circumstances into one sentence that defines fixed consideration. No substantive change to these two definitions of fixed consideration is intended with this amendment.

The target corporation shareholders are generally subject to the economic fortunes of the issuing corporation as of the signing date only if the contract specifies the number of shares of the issuing corporation to be exchanged for all or each proprietary interest in the target corporation. Accordingly, the temporary regulations provide that the signing date rule is applicable in these situations. The IRS and Treasury Department request comments regarding whether it is appropriate to include in the definition of fixed consideration a contract that specifies a fixed percentage of the shares of the issuing corporation to be exchanged for all or each proprietary interest in the target corporation.

The temporary regulations eliminate the third and fourth circumstances described in the 2005 final regulations from the definition of fixed consideration. Because these types of transactions do not specify the number of shares of the issuing corporation to be received in the exchange, the target corporation shareholders are not subject to the economic fortunes of the issuing corporation as of the signing date. These provisions were removed because, in such situations, applying the signing date rule may produce inappropriate results.

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A commentator noted that a transaction in which a fixed percentage of target corporation shares is exchanged for issuing corporation shares could inappropriately be precluded from satisfying COI due to the application of the signing date rule. For example, if the number of the issuing corporation shares to be received by the target corporation shareholders depends on the value of the issuing corporation shares on the closing date, and the issuing corporation shares appreciate significantly between the signing date and the closing date, the signing date rule could prevent a transaction from satisfying COI notwithstanding the fact that a substantial part of the value of the proprietary interests in the target corporation is exchanged for proprietary interests in the issuing corporation.

Further, the temporary regulations continue to treat a contract that provides for a shareholder election between shares of the issuing corporation stock and the money or other property to be exchanged for the proprietary interests in the target corporation as a contract that provides for fixed consideration in the circumstances described below.

C. *Shareholder Elections*

The 2005 final regulations contain a rule generally stating that a contract that permits the target corporation shareholders to elect to receive stock and/or money and/or other property with respect to their target corporation stock will be treated as providing for fixed consideration if the contract also provides the minimum number of shares of the issuing corporation stock and the maximum amount of money or other property to be exchanged for all of the proprietary interests in the target corporation, the minimum percentage of the number of shares of each class of proprietary interests in the target corporation to be exchanged for stock of the issuing corporation, or the minimum percentage (by value) of the proprietary interests in the target corporation to be exchanged for stock of the issuing corporation. The 2005 final regulations further include two special rules prescribing certain assumptions to be made in the determination of whether COI is satisfied in shareholder election cases. For example, in the case in which the contract states the minimum number of shares of the issuing corporation stock and the maximum amount of money or other property to be exchanged for all of the proprietary interests in the target corporation, the determination of whether a proprietary interest in the target corporation is preserved is made by assuming the issuance of the minimum number of shares of each class of stock of the issuing corporation and the maximum amount of money or other property allowable under the contract and without regard to the number of shares of each class of stock of the issuing corporation and the amount of money or other property actually exchanged for proprietary interests in the target corporation.

These temporary regulations treat certain transactions that allow for shareholder elections as providing for fixed consideration regardless of whether the agreement specifies the maximum amount of money or other property, or the minimum amount of issuing corporation stock, to be exchanged in the transaction. As noted above, if the target corporation shareholders can generally be viewed as subject to the economic fortunes of the issuing corporation as of the signing date, it is appropriate to treat the contract as

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providing for fixed consideration and to apply the signing date rule. The IRS and Treasury Department believe that these circumstances exist in cases where the target corporation shareholders may elect to receive issuing corporation stock in exchange for their target corporation stock at an exchange rate based on the value of the issuing corporation stock on the signing date. For example, if the issuing corporation stock has a value of $ 1 per share on the last business date before the first date on which the contract is binding, and the agreement provides that the target corporation shareholders may exchange each share of target corporation stock for either $ 1 or issuing corporation stock (based on the signing date value), the target corporation shareholders that choose to exchange their target corporation stock for stock of the issuing corporation are subject to the economic fortunes of the issuing corporation with respect to such stock as of the signing date. Accordingly, the IRS and Treasury Department believe that it is appropriate in such a case to apply the signing date rule to value the stock of the issuing corporation for purposes of testing whether the transaction satisfies the COI requirement.

Additionally, the IRS and Treasury Department are concerned that the assumptions in the shareholder election rule in the 2005 final regulations may create confusion about whether COI is satisfied based on the delivery of stock that does not in fact preserve the target corporation shareholders' proprietary interest in the target corporation when such result was not intended. For example, the rule might appear to suggest that stock that is redeemed in connection with the potential reorganization will nonetheless be treated as preserving the target corporation shareholders' proprietary interests in the target corporation, although this result would be contrary to Treas. Reg. 1.368-1(e)(1). Further, these assumptions could prevent a transaction from satisfying COI even though a substantial part of the value of the proprietary interests in the target corporation is actually exchanged for proprietary interests in the issuing corporation.

Because of this potential for confusion, and because these assumptions are not relevant to the revised shareholder election provision, the temporary regulations remove the assumptions so that the determination of whether COI is preserved depends on the actual consideration exchanged. Example 9 of the Temporary Regulations has been modified to illustrate the revised rules regarding shareholder elections.

D. *Contract Modifications*

The 2005 final regulations generally provide that a modification of the contract results in a new signing date. However, the 2005 final regulations provide that a modification that has the sole effect of providing for the issuance of additional shares of issuing corporation stock to the target corporation shareholders will not be treated as a modification if the execution of the transaction pursuant to the original agreement would have resulted in the preservation of a substantial part of the value of the target corporation shareholders' proprietary interests in the target corporation if there had been no modification. One commentator suggested that this rule be broadened to include modifications that decrease the money or other property that will be delivered to the target corporation shareholders. These temporary regulations reflect this broadening.

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Further, the IRS and Treasury Department believe that the signing date rule should also apply to provide certainty regarding the value of the issuing corporation stock used for purposes of testing COI if the transaction fails to qualify as a tax-free reorganization. For this reason, the IRS and Treasury Department believe that the exception to the modification rule should also be available for certain types of modifications if the transaction fails to satisfy COI at the time of the execution of the contract. Accordingly, these temporary regulations provide that certain contract modifications will not result in a new signing date if the terms of the original contract would have prevented the transaction from qualifying as a reorganization.

E. *Contingent Consideration*

The 2005 final regulations provide that contingent consideration will generally prevent a contract from being treated as providing for fixed consideration. However, the 2005 final regulations provide for a limited exception to that general rule. The exception applies to cases in which the contingent consideration consists solely of stock of the issuing corporation and the execution of the potential reorganization would have resulted in the preservation of a substantial part of the value of the target corporation shareholders' proprietary interests in the target corporation if none of the contingent consideration was delivered to the target shareholders. The IRS and Treasury Department received a number of comments regarding the effect of contingent consideration on the application of the signing date rule.

A number of commentators suggested that the scope of the exception should be expanded to include cases in which the delivery of the contingent consideration to the target corporation shareholders does not decrease the ratio of the value of the shares of issuing corporation stock to the value of the money or other property (determined as of the last business day before the first date there is a binding contract) to be delivered to the target corporation shareholders relative to the ratio of the value of the shares of the issuing corporation stock to the value of the money or other property (determined as of the last business day before the first date there is a binding contract) to be delivered to the target corporation shareholders if none of the contingent consideration were delivered to the target corporation shareholders. These temporary regulations modify and expand the applicability of the signing date rule to certain transactions that provide for contingent adjustments (*i.e.*, increases or decreases) to the consideration.

As described above, the signing date rule is based on the principle that, where a binding contract provides for fixed consideration, the target corporation shareholders can generally be viewed as being subject to the economic fortunes of the issuing corporation as of the signing date. The IRS and Treasury Department believe that where this principle holds true, the signing date rule should apply regardless of whether the transaction potentially qualifies as a reorganization, and regardless of whether the contract provides for certain contingent adjustments to the otherwise fixed consideration. Accordingly, these temporary regulations provide that, generally, a contract that otherwise qualifies as providing for fixed consideration will be treated as providing for fixed consideration even if it provides for contingent adjustments to the consideration, and regardless of whether

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the transaction would have satisfied COI in the absence of any contingent adjustments. However, if the terms of the contingent adjustments potentially prevent the target corporation shareholders from being subject to the economic fortunes of the issuing corporation as of the signing date, the contract will not be treated as providing for fixed consideration.

Accordingly, these temporary regulations provide that a contract will not be treated as providing for fixed consideration if it provides for contingent adjustments to the consideration that prevent (to any extent) the target shareholders from being subject to the economic benefits and burdens of ownership of the issuing corporation as of the signing date. For example, a contract will not be treated as providing for fixed consideration if it provides for contingent adjustments in the event that the value of the stock of the issuing corporation, the value of the assets of the issuing corporation, or the value of any surrogate for either the value of the stock of the issuing corporation or the assets of the issuing corporation increase or decrease after the last business day before the first date there is a binding contract, or if the terms of the contingent adjustment provide that any increase or decrease in the number of shares of the issuing corporation will be computed using any value of the issuing corporation shares after the last business day before the first date the contract is a binding contract.

F. *Anti-Dilution Provisions*

These temporary regulations also clarify that if the issuing corporation's capital structure is altered and the number of shares of the issuing corporation to be issued to the target corporation shareholders is altered pursuant to a customary anti-dilution clause, the signing date value of the issuing corporation's shares must be adjusted to take this alteration into account.

G. *Other Issues*

The IRS and Treasury Department continue to study other issues related to the determination of whether the COI requirement is satisfied.

Effective Date * * *

C. Page 402, New Sec. 6.2.J. The All Cash Nondivisive 368(a)(1)(D) Reorganization

Page 402, New Sec. 6.2.J. Add after New Sec. 6.2.I.3 the following:
New Sec. 6.2.J. **The All Cash Nondivisive 368(a)(1)(D) Reorganization**

In 2005 the IRS issued Private Letter Ruling 200551018, which held that a sale of assets by a corporation to a second corporation that was substantially controlled by the

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shareholders of the selling corporation was a taxable sale and not a nondivisive (D) reorganization under Section 368(a)(1)(D). This ruling sparked a debate in the tax bar about the soundness of the principle embodied in the ruling and led to the issuance of Temporary Regulations addressing the issue in December 2006. The private letter ruling, two of the letters from tax lawyers addressing the issue, and the temporary regulations are set out in Sections 4.2.B.4.a-d.

D. Page 415, New Sec. 6.3.E. Preamble to Final Regulations Liberalizing Post-Reorganization Transfers

Page 415, New Sec. 6.3.E. Replace the current Sec. 6.3.E the following:
New Sec. 6.3.E. **Preamble to Final Regulations Liberalizing Post-Reorganization Transfers**

Treasury Decision 9396, Final Regulations Clarifying Rules on Stock, Asset Transfers Following Reorganizations
May 9, 2008

SUMMARY: This document contains final regulations that amend TD 9361, titled Transfers of Assets or Stock Following a Reorganization. These final regulations make certain clarifying amendments to the rules regarding the effect of certain transfers of assets or stock on the continuing qualification of transactions as reorganizations under section 368(a). These regulations affect corporations and their shareholders. * * *

Background

As noted in the preamble to TD 9361 (72 FR 60556), section 1.368-1(a) provides that a transaction must be evaluated under all relevant provisions of law, including the step transaction doctrine, in determining whether it qualifies as a reorganization under section 368(a). Section 1.368-2 provides guidance regarding whether a transaction satisfies the explicit statutory requirements of a particular reorganization. Specifically, section 1.368-2(k) provides that a transaction otherwise qualifying as a reorganization will not be disqualified or recharacterized as a result of certain subsequent transfers of assets or stock described therein. The fact that a subsequent transfer of assets or stock is not described in section 1.368-2(k) does not necessarily preclude reorganization qualification, but the overall transaction would then be subject to analysis under the step transaction doctrine.

Section 1.368-2(k), as in effect prior to these final regulations, generally permits one or more post-reorganization transfers (or successive transfers) of assets or stock, provided that the Continuity of Business Enterprise (COBE) requirement is satisfied and the transfer(s) qualify as "distributions" (as described in section 1.368-2(k)(1)(i)) or "other transfers" (as described in section 1.368-2(k)(1)(ii)). These final regulations amend those rules to clarify that a transfer to the former shareholders of the acquired corporation (other than a former shareholder that is also the acquiring corporation) or the surviving

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corporation, as the case may be, is not described in paragraph (k)(1) to the extent it constitutes the receipt by such shareholders of consideration for their proprietary interests in the acquired corporation or the surviving corporation, as the case may be. Any such transfer to the former shareholders following a transaction otherwise qualifying as a reorganization under section 368(a) calls into question whether the underlying transaction satisfies the continuity of interest requirement in Treas. Reg. section 1.368-1(e) as well as certain statutory limitations on permissible consideration (such as the “solely for voting stock” requirement in section 368(a)(1)(B) or (C)). Therefore, such transfers are outside the scope of the safe harbor protection afforded by these final regulations. Nevertheless, the safe harbor of Treas. 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 the surviving corporation, as the case may be, such as certain pro-rata dividend distributions by the acquiring corporation following a reorganization. Moreover, the amendment provides that the limitation on the scope of Treas. Reg. 1.368-2(k) does not apply to transfers to a shareholder that also is the acquiring corporation in the reorganization. Thus, the regulations continue to provide safe harbor protection to certain “upstream” reorganizations followed by a transfer of acquired assets. See, for example, Rev. Rul. 69-617, 1969-2 CB 57.

In addition, these final regulations amend section 1.368-2(k) to clarify that the safe harbor shall not apply to 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, as the case may be, of consideration initially received in the potential reorganization to the issuing corporation or a person related to the issuing corporation (see definition of “related person” in section 1.368-1(e)).

Further, these final regulations revise the title of paragraph (k)(1)(ii) and the requirement in paragraph (k)(1)(ii)(A). These amendments are intended to clarify that a distribution to shareholders is not a transfer described in paragraph (k)(1)(ii) regardless of whether or not it is described in paragraph (k)(1)(i). Additionally, these final regulations amend paragraph (k)(1)(ii)(C) to clarify that a transfer is not described in paragraph (k)(1)(ii) if the acquired corporation, the acquiring corporation, or the surviving corporation, as the case may be, terminates its corporate existence for Federal income tax purposes in connection with the transfer.

Finally, conforming changes are made to the analysis in Examples 1, 6, 7, 8 and 9, and one clarifying change is made to the facts in Example 3.

E. Page 416, New Sec. 6.3.F. Preamble to the Regulations Eliminating Continuity of Interest and of Business Enterprise for E and F Reorganizations

Page 416, New Sec. 6.3.F. Add before Sec. 6.4 the following:

New Sec. 6.3.F. **Preamble to Final Regulations Eliminating Continuity of Interest and of Business Enterprise for E and F Reorganizations**

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Treasury Decision 9182
February 25, 2005

Action: Final regulation.

Summary: This document contains final regulations regarding reorganizations under section 368(a)(1)(E) and section 368(a)(1)(F) of the Internal Revenue Code. The regulations affect corporations and their shareholders.

Background and Explanation of Provisions. On August 12, 2004, the IRS and Treasury Department published a notice of proposed rulemaking (REG-106889-04) in the Federal Register (69 FR 49836) proposing regulations regarding the requirements for a reorganization under section 368(a)(1)(E) and section 368(a)(1)(F) of the Internal Revenue Code (Code). Generally, a transaction must satisfy the continuity of interest and continuity of business enterprise requirements to qualify as a reorganization under section 368(a). The notice proposed amending § 1.368-1(b) to provide that a continuity of interest and a continuity of business enterprise are not required for a transaction to qualify as a reorganization under section 368(a)(1)(E) (E reorganization) or section 368(a)(1)(F) (F reorganization). The notice also proposed amending § 1.368-2 to include rules regarding the requirements for a transaction to qualify as an F reorganization and regarding the effects of an F reorganization.

The IRS and Treasury Department have received oral comments urging that the rule providing that the continuity of interest and continuity of business enterprise requirements do not apply to E and F reorganizations be finalized quickly. For the reasons expressed in the preamble to the proposed regulations, this Treasury decision adopts that rule for transactions on or after February 25, 2005. The IRS and Treasury Department continue to study the other issues addressed in the notice of proposed rulemaking, and welcomes further comment on those issues.

Effect on Other Documents

The following publications are obsolete as of February 25, 2005:

Rev. Rul. 69-516 (1969-2 C.B. 56).

Rev. Rul. 77-415 (1977-2 C.B. 311).

Rev. Rul. 77-479 (1977-2 C.B. 119).

Rev. Rul. 82-34 (1982-1 C.B. 59).

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F. Page 433, New Sec. 6.11.B. Preamble to Final Regulations on Stock Basis under § 358 in Reorganizations and Related Transactions

Page 433, New Sec. 6.11.B. Replace the current Sec. 6.11.B, which contains the preamble to the proposed regulations with the following:

New Sec. 6.11.B. **Preamble to Final Regulations on Stock Basis under § 358 in Reorganizations and Related Transactions**

Final and Temporary Regulations RIN 1545-BC05
January 23, 2006

SUMMARY: This document contains final regulations under section 358 that provide guidance regarding the determination of the basis of stock or securities received in exchange for, or with respect to, stock or securities in certain transactions. This document also contains temporary regulations under section 1502 that govern certain basis determinations and adjustments of subsidiary stock in certain transactions involving members of a consolidated group. The text of the temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in the Proposed Rules section in this issue of the Federal Register. The final and temporary regulations affect shareholders of corporations. * * *

Background. Section 358(a)(1) of the Internal Revenue Code (Code) generally provides that the basis of property received pursuant to an exchange to which section 351, 354, 355, 356, or 361 applies is the same as that of the property exchanged, decreased by the fair market value of any other property (except money) received by the taxpayer, the amount of any money received by the taxpayer, and the amount of loss to the taxpayer which was recognized on such exchange, and increased by the amount which was treated as a dividend, and the amount of gain to the taxpayer which was recognized on such exchange (not including any portion of such gain which was treated as a dividend). Section 358(b)(1) provides that, under regulations prescribed by the Secretary, the basis determined under section 358(a)(1) must be allocated among the properties received in the exchange or distribution.

On May 3, 2004, the IRS and Treasury Department published a notice of proposed rulemaking (REG-116564-03) in the Federal Register (69 FR 24107) that included regulations under section 358 (the proposed regulations) providing guidance regarding the determination of the basis of shares or securities received in a reorganization described in section 368 and a distribution to which section 355 applies. The proposed regulations adopt a tracing method pursuant to which the basis of each share of stock or security received in a reorganization under section 368 is traced to the basis of each surrendered share of stock or security, and each share of stock or security received in a distribution under section 355 is allocated basis from a share of stock or security of the distributing corporation. In the course of developing the proposed regulations, the IRS and Treasury Department considered whether a tracing method or an averaging method

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should be used to determine the basis of stock and securities received in such transactions. The proposed regulations' adoption of the tracing method is based on the view of the IRS and Treasury Department that, in light of the carryover basis rule of section 358, a reorganization is not an event that justifies averaging the bases of exchanged stock or securities that have been purchased at different times and at different prices. Moreover, the adoption of the tracing method reflects the concern of the IRS and Treasury Department that averaging the bases of exchanged blocks of stock or securities may inappropriately limit the ability of taxpayers to arrange their affairs and may afford opportunities for the avoidance of certain provisions of the Code.

Under the proposed regulations, the basis of each share of stock or security received in an exchange to which section 354, 355, or 356 applies is generally the same as the basis of the share or shares of stock or security or securities exchanged therefor. In the case of a distribution to which section 355 applies, the proposed regulations provide that the basis of each share of stock or security of the distributing corporation is allocated between the share of stock or security of the distributing corporation and the share of stock or security received with respect to such share of stock or security of the distributing corporation in proportion to their fair market values.

If a shareholder or security holder is unable to identify which particular share (or portion of a share) of stock or security is exchanged for, or received with respect to, a particular share (or portion of a share) of stock or security, the proposed regulations permit the shareholder or security holder to designate which share or security is received in exchange for, or in respect of, which share or security. Such designation, however, must be consistent with the terms of the exchange or distribution and must be made on or before the first date on which the basis of a share or security received is relevant, for example, the date on which a share or security received is sold, or is transferred in an exchange described in section 351 or section 721 or a reorganization described in section 368.

No public hearing regarding the proposed regulations was requested or held. However, several written and electronic comments regarding the proposed regulations were received. After consideration of the comments, the proposed regulations are adopted as amended by this Treasury decision.

Explanation of Provisions. These final regulations retain the tracing method of the proposed regulations, but make several modifications to the proposed regulations in response to the comments received. The following paragraphs describe the most significant comments received and the extent to which they have been incorporated into these final and temporary regulations.

Allocation of Consideration Received. As described above, in certain cases, the proposed regulations permit a shareholder to designate which share or security is received in exchange for, or with respect to, which share or security, provided that the designation is consistent with the terms of the exchange or distribution. One commentator observed that in certain cases in which more than one class of stock or securities is received in

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exchange for more than one block of stock, more than one designation may be consistent with the terms of the exchange. For example, suppose that A owns two blocks of 100 shares of Corporation X common stock. Each block has a value of $ 100. A has an aggregate basis of $ 50 in one block and an aggregate basis of $ 250 in the other block. Pursuant to the terms of a reorganization, A transfers both blocks in exchange for 100 shares of Corporation Y common stock with a value of $ 100 and 100 shares of Corporation Y preferred stock with a value of $ 100. Under the proposed regulations, A's designation could reflect that each of the Corporation Y common stock and the Corporation Y preferred stock are allocated to the shares exchanged in proportion to their fair market values. Therefore, Corporation Y common stock with a fair market value of $ 50 and Corporation Y preferred stock with a fair market value of $ 50 would be treated as received for each block of Corporation X common stock. Alternatively, A's designation could reflect that the low basis Corporation X shares were exchanged for Corporation Y common stock and the high basis Corporation X shares were exchanged for Corporation Y preferred stock or vice versa. Other designations would also seemingly be permitted under the proposed regulations. The commentator requested clarification regarding whether these designations would, in fact, be permitted.

The IRS and Treasury Department have considered the extent to which taxpayers should be permitted to designate which type of consideration is received in exchange for particular shares of stock or securities when more than one designation is consistent with the terms of the exchange. The IRS and Treasury Department believe that this issue is likely to arise only in cases in which the target corporation is closely held. In these cases, the shareholders will likely have the ability to control the terms of the exchange. These final regulations confirm that, to the extent the terms of the exchange specify which shares of stock or securities are received in exchange for a particular share of stock or security or a particular class of stock or securities, provided that such terms are economically reasonable, such terms will control for purposes of determining the basis of the stock or securities received. In addition, these final regulations provide that, to the extent the terms of the exchange do not specify which shares of stock or securities are received in exchange for a particular share of stock or security or a particular class of stock or securities, a pro rata portion of the shares of stock and securities of each class received is treated as received in exchange for each share of stock and security surrendered, based on the fair market value of the surrendered stock and securities. The final regulations also include similar rules that apply to distributions under section 355.

Allocation of Boot Received. A number of commentators requested guidance regarding the proper method for allocating boot among the stock and securities surrendered in an exchange or the stock and securities with respect to which a distribution is made. An allocation of boot may be necessary to compute the taxpayer's gain recognized in connection with a transaction and, therefore, its basis in stock and securities received. One commentator suggested that a facts and circumstances analysis (presumably one that examines the terms of the exchange) should be used to determine what nonrecognition property received in an exchange is allocable to particular shares or securities surrendered. In cases in which the facts and circumstances do not suggest a particular allocation, the commentator suggested that the boot should be allocated pro rata among the surrendered

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stock and securities. For example, suppose A holds 100 shares of Corporation T common stock and 100 shares of Corporation T preferred stock. The common shares have an aggregate basis of $ 10 and an aggregate fair market value of $ 100 and the preferred shares have an aggregate basis of $ 20 and an aggregate fair market value of $ 100. Corporation T merges with and into Corporation X in a reorganization under section 368. In the reorganization, A exchanges its shares of Corporation T common and preferred stock for 100 shares of Corporation X common stock with an aggregate fair market value of $ 100 and $ 100 of cash. If the cash were allocated proportionately between the common and preferred shares based on their relative values, A would recognize $ 50 of gain on its common shares and $ 50 of gain on its preferred shares. If the cash were allocated solely to the common shares, A would recognize $ 90 of gain. If the cash were allocated solely to the preferred shares, A would recognize $ 80 of gain.

These final regulations adopt rules governing the allocation of boot among stock and securities surrendered (or with respect to which a distribution is made) that are consistent with those rules described above regarding designations of exchanges and distributions when more than one class of stock or securities is received in exchange for, or received with respect to, more than one block of stock. In particular, this Treasury decision includes regulations under section 356 that provide that, for purposes of computing the gain, if any, recognized on an exchange, to the extent the terms of the exchange specify the other property or money that is received in exchange for a particular share of stock or security surrendered, provided that such terms are economically reasonable, such terms control. This position is consistent with the conclusions reached in Revenue Ruling 74-515, 1974-2 C.B. 118 (suggesting that, for purposes of computing gain recognized under section 356 in the context of an exchange the terms of which provided for the exchange of common stock for common stock and preferred stock for cash, the terms of the exchange governed). To the extent the terms of the exchange do not specify the other property or money that is received in exchange for a particular share of stock or security surrendered, a pro rata portion of the other property and money received is treated as received in exchange for each share of stock and security surrendered, based on the fair market value of such surrendered share of stock or security.

The IRS and Treasury Department are aware that there is a question as to the proper treatment of the basis of stock exchanged for boot in the following circumstances. This question arises, in part, as a result of the operation of section 356. Section 356 generally applies if section 354 would apply to an exchange but for the fact that the property received in the exchange consists not only of property permitted by section 354 to be received without the recognition of gain but also of other property or money. Section 356(c) provides that no loss realized from such an exchange may be recognized.

Suppose A holds 100 shares of Corporation T common stock and 100 shares of Corporation T preferred stock. The common shares have an aggregate basis of $ 10 and an aggregate fair market value of $ 100 and the preferred shares have an aggregate basis of $ 150 and an aggregate fair market value of $ 100. Corporation T merges with and into Corporation X in a reorganization under section 368. The terms of the exchange specify that A exchanges its shares of Corporation T common stock for 100 shares of

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Corporation X common stock with an aggregate fair market value of $ 100 and exchanges its shares of Corporation T preferred stock for $ 100 of cash. Under these final regulations, the terms of the exchange control for purposes of determining gain under section 356 and basis under section 358. Under section 356(c), A realizes a gain of $ 90 on the exchange of Corporation T common stock for Corporation X common stock, none of which is recognized under section 356 and A takes an aggregate basis of $ 10 in the shares of Corporation X common stock received in the exchange. However, A realizes a loss of $ 50 on the exchange of Corporation T preferred stock for cash. Therefore, A would not be entitled to recognize any of the loss realized. This conclusion is consistent with Revenue Ruling 74-515. In that ruling, a shareholder surrenders common stock of the target corporation in exchange for common stock of the acquiring corporation and preferred stock of the target corporation in exchange for cash. The ruling concludes that the tax consequences of the shareholder's exchange of preferred shares for cash are governed by section 356 and any loss realized is not recognized by reason of section 356(c).

The IRS and Treasury Department are considering, and request comments regarding, whether regulations should be adopted interpreting section 356 in a manner that would permit a taxpayer, such as A, in the circumstances described above to recognize the loss in these types of fact patterns. If an approach permitting recognition of loss in these cases is not adopted, then an issue arises as to the proper treatment of the basis of the shares with respect to which the loss is realized but not recognized, at least to the extent that such basis exceeds the cash received in respect of such shares. The IRS and Treasury Department request comments on the proper treatment of such basis.

Retained Shares of Stock or Securities in Section 355 Exchanges. As described above, the proposed regulations provide that the basis of each share of stock or security received in an exchange to which section 355 applies is generally the same as the basis of the share or shares of stock or security or securities exchanged therefor. This rule applies even if the exchanging shareholder or security holder retains shares of stock or securities in the distributing corporation. If the shareholder or security shareholder retains shares of stock or securities in the distributing corporation, the basis of those instruments remains unaffected. One commentator suggested that this approach might be viewed as inconsistent with the statutory language of section 358(b)(2).

Section 358(b)(2) generally provides that in allocating basis among the property permitted to be received without the recognition of gain or loss in an exchange to which section 355 applies, there shall be taken into account not only the property so permitted to be received without the recognition of gain or loss, but also the stock or securities (if any) of the distributing corporation that are retained and the allocation of basis must be made among all such properties. Neither the statutory language of section 358(b)(2) nor its legislative history indicates the method of allocation that Congress contemplated when it enacted this provision.

The IRS and Treasury Department believe that the rule of the proposed regulations is a reasonable approach to the implementation of section 358(b)(2). Nonetheless, the IRS

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and Treasury Department did consider alternative approaches.

For example, the IRS and Treasury Department considered adopting an approach that would aggregate the basis of the shares of stock and securities of the distributing corporation owned by a particular shareholder and then would allocate such basis among the shares of stock and securities in the distributing and controlled corporations owned by that shareholder immediately after the distribution based on their fair market values. Such an approach would effectively be an averaging approach for certain types of exchanges, an approach that is inconsistent with the view that a reorganization is not an event that justifies averaging the bases of exchanged stock that had been purchased at different times and at different prices and that would result in the inconsistent treatment of exchanges under section 354, 355, and 356.

The IRS and Treasury Department also considered adopting an approach that would have treated the shareholder or security holder as receiving a distribution of stock or securities on each share of stock or security that it owned in the distributing corporation, followed by a recapitalization of both the distributing and controlled corporations to reflect the shareholders' and security holders' actual stock and security ownership immediately after the transaction. The IRS and Treasury Department, however, were concerned that this approach would be complex and inadministrable, especially in cases in which a shareholder holds stock of the distributing corporation in multiple accounts.

For the reasons described above, these two alternative approaches were rejected. Therefore, these final regulations do not alter the operation of the rules of the proposed regulations in this context.

Stockless Reorganizations. A number of commentators observed that it is not clear how basis should be determined in the case of a reorganization in which no stock is issued. Such a situation may arise in reorganizations involving commonly controlled acquiring and target corporations where the issuance of additional stock of the acquiring corporation would constitute a meaningless gesture. One commentator suggested an approach that would treat the acquiring corporation as issuing an amount of stock equal to the fair market value of the stock surrendered. The basis of that deemed issued stock would have a basis traced from the shares surrendered in the reorganization under the rules that would have applied had the shareholder actually received such stock. Then, the shareholder's stock in the acquiring corporation would be treated as recapitalized. In the recapitalization, the shareholder would be treated as surrendering all of its shares of the acquiring corporation, including those shares owned immediately prior to the reorganization and those shares the shareholder is deemed to receive, in exchange for the shares that the shareholder actually holds immediately after the reorganization. The basis of the shares that the shareholder actually owns would be determined under the rules that would have applied had the recapitalization actually occurred with respect to the shareholder's actual shares and the shares the shareholder is deemed to have received.

For example, suppose P wholly owns S1 and S2. P owns 100 shares of S1, each of which has a basis of $ 1 and was acquired on Date 1, and 100 shares of S2, each of which has a

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basis of $ 2 and was acquired on Date 2. The fair market value of each share of the stock of each of S1 and S2 is $ 1. S1 merges into S2 in a reorganization under section 368(a)(1)(D) in which P does not receive any additional stock of S2. Under the suggested approach, P would be treated as receiving 100 shares of S2, each of which has a fair market value of $ 1. The basis of those additional 100 shares would be determined as if P had actually received those shares. Therefore, each of those shares would have a basis of $ 1. Then, to reflect that P has only 100 shares of S2 stock rather than 200 shares, S2 would be treated as undergoing a reverse stock split in which it exchanges two shares of its stock for one share. The basis of each of the 100 shares would be determined as if the reverse stock split had actually occurred. Therefore, 50 shares of P's S2 stock would each have a basis of $ 2 and would be treated as having been acquired on Date 1 and the remaining 50 shares of P's S2 stock would each have a basis of $ 4 and would be treated as having been acquired on Date 2.

The IRS and Treasury Department believe that the approach suggested is consistent with the general tracing approach of the proposed regulations. Accordingly, these final regulations adopt the suggested approach for cases in which a shareholder of the target corporation receives no property or property with a fair market value less than that of the stock or securities the shareholder surrendered in the transaction.

Single Versus Split Basis Approaches. The proposed regulations provide that if one share of stock or security is received in exchange for, or with respect to, more than one share of stock or security or a fraction of a share of stock or security is received, the basis of the shares of surrendered stock or securities must be allocated to the shares of stock or securities received in a manner that reflects, to the greatest extent possible, that a share of stock or security received is received in exchange for, or with respect to, shares of stock or securities that were acquired on the same date and at the same price. The preamble states that this rule avoids, to the greatest extent possible, creating shares of stock or securities with split holding periods. Several commentators have requested guidance regarding whether a share that reflects the basis of several shares with differing bases has a single, aggregated basis or a split basis. For example, suppose B has two shares of stock of T. One of those shares has a basis of $ 1 and was acquired on Date 1. The other share has a basis of $ 2 and was acquired on Date 2. A, a corporation, acquires the assets of T in a reorganization under section 368(a)(1)(A). In the reorganization, B exchanges its two shares of T stock for one share of A stock. One possibility is that B has a single, undivided $ 3 basis in its share of A stock. Another possibility is that B has a split basis in its share of A stock such that half of the share is treated as having a basis of $ 1 and the other half is treated as having a basis of $ 2.

The IRS and Treasury Department believe that because the single, aggregated basis approach has the effect of averaging the basis of more than one share, it is inconsistent with the tracing regime adopted in these final regulations. Moreover, as suggested in the preamble of the proposed regulations, the IRS and Treasury Department believe that it is possible for a share to have a split holding period. The IRS and Treasury Department believe that the split basis approach is a logical corollary to the split holding period approach. Therefore, these final regulations reflect that a share may have not only a split

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holding period, but also a split basis.

Coordination with Section 1036. Section 1036 provides that no gain or loss is recognized if common stock is exchanged for common stock, or preferred stock is exchanged for preferred stock, in the same corporation. Section 1031 provides rules for determining the basis of the common or preferred stock received in an exchange described in section 1036. One commentator requested clarification regarding whether the basis tracing rules of the proposed regulations apply to transactions governed by both section 1036 and section 354 or 356.

The IRS and Treasury Department believe that those same policies that support the application of a tracing regime in the context of transactions governed solely by section 354 or 356 support the application of a tracing regime in the context of transactions governed by both section 1036, on the one hand, and section 354 or 356, on the other hand. Accordingly, these final regulations provide that the tracing rules apply to determine the basis of a share of stock or security received by a shareholder or security holder in an exchange described in both section 1036, on the one hand, and section 354 or section 356, on the other hand. The IRS and Treasury Department continue to study whether the rules of these final regulations should be adopted in regulations under section 1036 for transactions governed by section 1036, but not section 354 or 356.

Application of Tracing Rules to Section 351 Transactions. Under the proposed regulations, the tracing rules do not apply to an exchange described in section 351, unless such exchange is also described in section 354 or section 356 and certain other requirements are satisfied. One commentator urged the IRS and Treasury Department to consider expanding the tracing regime of the proposed regulations to apply more broadly to exchanges governed by section 351. That commentator suggested that having different regimes apply to the determination of the basis of stock received in a tax- free exchange for stock is undesirable.

The IRS and Treasury Department are continuing to study the possible application of a tracing approach more broadly to exchanges described in section 351. In the meantime, these final regulations retain those limitations on the application of the basis tracing regime to exchanges described in section 351 that were included in the proposed regulations.

Excess Loss Accounts. Section 1.1502-19(d) provides that if a member (P) of a consolidated group has an excess loss account in shares of a class of another member's (S's) stock at the time of a basis adjustment or determination under the Internal Revenue Code with respect to other shares of the same class of S's stock owned by the member, the adjustment or determination is allocated first to equalize and eliminate that member's excess loss account. The rule reflects a policy of permitting the elimination of excess loss accounts. The application of the rule, however, is sensitive to the form of the transaction. For example, if P owns all of the stock of S with an excess loss account of $ 100 and all of the stock of T with a basis of $ 150, and T merges into S in a reorganization under section 368(a)(1)(D) in which P receives additional shares of S stock, under section

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1.1502-19(d), P's excess loss account in its original shares of S stock is first eliminated. Therefore, P's original S shares will have an aggregate basis of $ 0 and P's new S shares will have an aggregate basis of $ 50. If, instead, however, S merges into T in a reorganization under section 368(a)(1)(D) in which P receives additional shares of T stock, because P does not already have T shares that have an excess loss account, section 1.1502-19(d) does not apply. Therefore, P's original T shares will have a basis of $ 150 and P's new T shares will have an excess loss account of $ 100.

The limitation on the application of section 1.1502-19(d) to cases in which a basis adjustment or determination is made with respect to shares of a class of stock of the corporation in which the member holds other shares with an excess loss account effectively makes the rule elective. That is, if the transaction occurs in one direction (in the example above, T merges into S), the rule applies. If the transaction occurs in the other direction (in the example above, S merges into T), the rule does not apply. The IRS and Treasury Department believe that this electivity is undesirable. Therefore, the IRS and Treasury Department believe that it is appropriate to expand the scope of the application of the rule of section 1.1502- 19(d). Accordingly, the temporary regulations included in this Treasury decision add an additional rule to section 1.1502-19 that provides that if a member would otherwise determine shares of a class of S's stock (a new share) to have an excess loss account and such member owns one or more other shares of the same class of S's stock, the basis of such other shares is allocated to eliminate and equalize any excess loss account that would otherwise be in the new shares. Therefore, in the example above where S merges into T in a reorganization under section 368(a)(1)(D) in which P receives additional shares of T stock, the basis of P's original T shares will first be applied to eliminate the excess loss account that P would otherwise have in its new T shares. Therefore, P will have an aggregate basis of $ 50 in its original T shares and an aggregate basis of $ 0 in its new T shares.

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VII. CHAPTER 7, TAX FREE ASSET ACQUISITIONS: THE (A) REORGANIZATION, THE FORWARD SUBSIDIARY MERGER REORGANIZATION, THE STRAIGHT AND TRIANGULAR (C) REORGANIZATION, INCLUDING THE TREATMENT OF NET OPERATING LOSSES

A. Page 484, New Sec. 7.2.J. Preamble to Final Regulations Dealing with Foreign Mergers and Mergers with Disregarded Entities

Page 484, New Sec. 7.2.J. Replace Sec. 7.2.J. with the following:
New Sec. 7.2.J. **Preamble to Final Regulations Dealing with Foreign Mergers and Mergers with Disregarded Entities**

Treasury Decision 9242
January 26, 2006
[*See* Treas Dec 9243, dealing with foreign mergers under § 367 in New Sec. 10.23.A.]

ACTION: Final regulations.
SUMMARY: This document contains final regulations that define the term *statutory merger or consolidation* as that term is used in section 368(a)(1)(A) of the Internal Revenue Code, concerning corporate reorganizations. These final regulations affect corporations engaging in statutory mergers and consolidations, and their shareholders. * * *

Background

The Internal Revenue Code of 1986 (Code) provides for general nonrecognition treatment for reorganizations described in section 368 of the Code. Section 368(a)(1)(A) provides that the term reorganization includes *a statutory merger or consolidation*. On January 24, 2003, the IRS and Treasury Department published temporary regulations (TD 9038) in the Federal Register (68 FR 3384) (the 2003 temporary regulations), along with a notice of proposed rulemaking by cross-reference to the temporary regulations (REG-126485-01) (the 2003 proposed regulations), defining *statutory merger or consolidation*. The 2003 temporary regulations generally provide that a statutory merger or consolidation is a transaction effected pursuant to the laws of the United States or a State or the District of Columbia, in which, as a result of the operation of such laws, all of the assets and liabilities of the target corporation are acquired by the acquiring corporation and the target corporation ceases its separate legal existence for all purposes. Under the 2003 temporary regulations, the merger of a target corporation into a limited liability company that is disregarded as a separate entity from the acquiring corporation for Federal income tax purposes may qualify as a statutory merger or consolidation.

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No public hearing regarding the 2003 proposed regulations was requested or held. Nonetheless, a number of comments were received.

As described above, under the 2003 temporary regulations, a transaction can only qualify as a statutory merger or consolidation if the transaction is effected “pursuant to the laws of the United States, or a State or the District of Columbia.” Given that many foreign jurisdictions have merger or consolidation statutes that operate in material respects like those of the states, on January 5, 2005, the IRS and Treasury Department proposed regulations (the 2005 proposed regulations) containing a revised definition of statutory merger or consolidation that allows transactions effected pursuant to the statutes of a foreign jurisdiction or of a United States possession to qualify as a statutory merger or consolidation (70 FR 746). Simultaneously with the publication of the 2005 proposed regulations, the IRS and Treasury Department published a notice of proposed rulemaking proposing amendments to the regulations under sections 358, 367, and 884 to reflect that, under the 2005 proposed regulations, a transaction involving a foreign entity and a transaction effected pursuant to the laws of a foreign jurisdiction may qualify as a statutory merger or consolidation (the foreign regulations).

Explanation of Provisions

The IRS and Treasury Department have received comments regarding the 2005 proposed regulations and the foreign regulations. This Treasury decision adopts the 2005 proposed regulations as final regulations, with certain technical changes. The foreign regulations are adopted as final regulations in a separate Treasury decision. The following sections describe a number of the most significant comments received with respect to the 2003 proposed regulations and the 2005 proposed regulations and the extent to which they have been adopted in the final regulations.

State Law Conversions

A number of commentators have questioned whether under the 2003 temporary regulations a transaction involving a state law conversion of a corporation into a limited liability company that is disregarded as an entity separate from its owner for Federal income tax purposes can qualify as a statutory merger or consolidation under section 368(a)(1)(A). For example, suppose A, a corporation, acquires all of the stock of T, a corporation, in exchange for consideration 50 percent of which is A voting stock and 50 percent of which is cash. As part of an integrated transaction, immediately after the stock acquisition, T files a form with the secretary of state of its state of organization to convert its form of organization from a corporation to a limited liability company. Some commentators have suggested that the conversion of T into a single member limited liability company disregarded as an entity separate from A should be treated like the merger of T into a pre-existing single member limited liability company that is disregarded as an entity separate from A. In the latter case, the overall transaction may qualify as a statutory merger or consolidation of T into A under the 2003 temporary regulations. Commentators have suggested that there is no policy reason to require T to actually merge into the entity that is disregarded as separate from A for A’s acquisition of the T assets to qualify as a statutory merger or consolidation. Although the conversion does not involve the fusion under state or local law of a target corporation into a pre-existing entity, it is similar to a statutory merger in that it accomplishes simultaneously the transfer for Federal income tax purposes of all of the assets of the target corporation

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to the acquiring corporation and the elimination for Federal income tax purposes of the target corporation as a corporation.

A similar question arises when the target corporation is an eligible entity under §301.7701-3(a), rather than a per se corporation, and the status of the target for Federal income tax purposes is changed through an Entity Classification Election under §301.7701-3 rather than through a conversion under state law. In this case, no action under state or local law effects the transfer of the assets of the target corporation to the acquiring corporation. Nevertheless, the election also accomplishes the simultaneous transfer for Federal income tax purposes of all of the assets of the target corporation to the acquiring corporation and the elimination for Federal income tax purposes of the target corporation as a corporation.

As described above, the 2003 temporary regulations provide that a transaction can only qualify as a statutory merger or consolidation if the target corporation ceases its separate legal existence for all purposes. The final regulations retain this requirement. In a conversion, the target corporation's legal existence does not cease to exist under state law. Its legal existence continues in a different form. Therefore, a stock acquisition of a target corporation followed by the conversion of the target corporation from a corporation to a limited liability company under state law cannot qualify as a statutory merger or consolidation under these final regulations. Consequently, pending further consideration of this issue, these final regulations clarify that such an acquisition cannot qualify as a statutory merger or consolidation.

Nevertheless, the IRS and Treasury Department are considering whether a stock acquisition followed by a conversion of the acquired corporation to an entity disregarded as separate from its corporate owner, and whether a stock acquisition followed by a change in the entity classification of the acquired entity from a corporation to an entity disregarded as separate from its corporate owner, should be permitted to qualify as a statutory merger or consolidation. The IRS and Treasury Department are interested in receiving comments in this regard. In addition, the IRS and Treasury Department are interested in comments regarding what implications, if any, permitting these two-step transactions to qualify as a statutory merger or consolidation would have on Revenue Ruling 67-274 (1967-2 C.B. 141) (ruling that an acquisition of stock of a target corporation followed by a liquidation of the target corporation qualified as a reorganization under section 368(a)(1)(C)) and Revenue Ruling 72-405 (1972-2 C.B. 217) (ruling that a forward triangular merger of a subsidiary of an acquiring corporation followed by a liquidation of the subsidiary qualified as a reorganization under section 368(a)(1)(C)).

Existence and Composition of the Transferee Unit

The 2003 proposed regulations generally require that, in order for a transaction to qualify as a statutory merger or consolidation, all of the assets and liabilities of each member of the transferor combining unit become the assets and liabilities of one or more members of one other combining unit (the transferee unit). For this purpose, a combining unit is a combining entity and all of its disregarded entities and a combining entity is a business entity that is a corporation (as defined in §301.7701-2(b)) that is not a disregarded entity).

As described above, the definition of statutory merger or consolidation allows for the possibility that a merger of a corporation into an entity disregarded as an entity separate from an acquiring corporation could qualify as a statutory merger or consolidation.

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One commentator stated that while it is clear that the existence and composition of the transferor unit are tested only immediately before the transaction and that the existence and composition of the transferee unit are tested immediately after the transaction, it is not clear whether the existence and composition of the transferee unit are also tested immediately prior to the transaction. This ambiguity, the commentator argued, creates uncertainty as to whether the following transaction can qualify as a statutory merger or consolidation: A and T, both corporations, together own all of the membership interests in P, a limited liability company that is treated as a partnership for Federal income tax purposes. T merges into P. In the merger, the shareholders of T exchange their T stock for A stock. As a result of the merger, P becomes an entity that is disregarded as an entity separate from A. If the existence and composition of the transferee unit were tested only after the transaction, the transaction could qualify as a statutory merger or consolidation. However, if the existence and composition of the transferee unit were tested both before and after the transaction, the transaction would not qualify for tax-free treatment because, before the merger, P is not a member of the transferee unit because it is not treated as an entity that is disregarded as an entity separate from A for Federal income tax purposes. The IRS and Treasury Department believe that the transaction described should qualify as a statutory merger or consolidation. Accordingly, these final regulations include an example that illustrates that the existence and composition of the transferee unit is not tested immediately prior to the transaction but instead is only tested immediately after the transaction. Therefore, the merger of T into P may qualify as a statutory merger or consolidation. Moreover, A would be a party to the reorganization, permitting nonrecognition under the operative reorganization provisions of subchapter C of the Code. Treating the merger of T into P as a reorganization raises questions as to the tax consequences of the transaction to the parties, including whether gain or loss may be recognized under the partnership rules of subchapter K as a result of the termination of P. Similar questions are raised in a merger of T directly into A that qualifies as a reorganization where, in the transaction, P becomes disregarded as an entity separate from A for Federal income tax purposes. The IRS and Treasury Department are considering the tax consequences in these cases, including the extent to which the principles of Revenue Ruling 99-6 apply in these situations and, if they do apply, their consequences. The IRS and Treasury Department request comments in this regard.

Consolidations and Amalgamations

Questions have arisen regarding the application of the definition of statutory merger or consolidation to transactions that are effected under state law consolidation statutes and foreign law amalgamation statutes. In a state law consolidation and a foreign law amalgamation, typically, two or more corporations combine and continue in the resulting entity, which is a new corporation that is formed in the consolidation transaction. Some commentators have asked whether a consolidation or an amalgamation can qualify as a statutory merger or consolidation under section 368(a)(1)(A) if effected pursuant to a law that provides that the consolidating or amalgamating corporations continue as one corporation in the resulting corporation. Those commentators are concerned that, because the existence of each of the consolidating corporations or amalgamating corporations continues in the resulting corporation, the requirement that the transferee corporation cease its separate legal existence for all purposes may not be satisfied.

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The IRS and Treasury Department believe that the fact that the existence of the consolidating or amalgamating corporations continues in the resulting corporation will not prevent a consolidation from qualifying as a statutory merger or consolidation under the 2003 temporary regulations. The 2003 temporary regulations require that the separate legal existence of the target corporation ceases. In a consolidation or an amalgamation, even if the governing law provides that the existence of the consolidating or amalgamating entities continues in the resulting corporation, the separate legal existence of the consolidating or amalgamating entities does in fact cease. Therefore, the IRS and Treasury Department do not believe that the fact that the existence of the consolidating or amalgamating entities continues in the resulting corporation prevents a consolidation or an amalgamation from qualifying as a statutory merger or consolidation.

Other commentators have questioned whether a consolidation or amalgamation of two operating corporations can involve a reorganization under section 368(a)(1)(F) with respect to one and a reorganization under section 368(a)(1)(A) with respect to the other. For example, suppose that X and Y, both operating corporations, consolidate pursuant to state law. In the consolidation, X and Y result in Z, a new corporation. The shareholders of X and Y surrender their X and Y stock, respectively, in exchange for Z stock. Some commentators have suggested that the consolidation could be viewed as a transfer by X of its assets and liabilities to Z in a reorganization under section 368(a)(1)(F) followed by a merger of Y into Z in a reorganization under section 368(a)(1)(A). Alternatively, it could be viewed as a transfer by Y of its assets and liabilities to Z in a reorganization under section 368(a)(1)(F) followed by a merger of X into Z in a reorganization under section 368(a)(1)(A). The IRS and Treasury Department intend to further study this issue in connection with their separate study of reorganizations under section 368(a)(1)(F).

Questions have also arisen regarding the application of the definition of statutory merger or consolidation to triangular transactions involving consolidations and amalgamations. For example, suppose that A seeks to acquire both X and Y, each in exchange for consideration that is 50 percent A voting stock and 50 percent cash. Under state law, X and Y consolidate into Z, a corporation that results from the acquisition transaction as a wholly owned subsidiary of A. The IRS and Treasury Department believe that a triangular consolidation or amalgamation should be tested under the reorganization rules as a forward triangular merger of each of the consolidating or amalgamating corporations into a wholly owned subsidiary of the parent corporation. Such a transaction might qualify as a statutory merger or consolidation pursuant to the rules of section 368(a)(2)(D). The IRS and Treasury Department recognize that in triangular consolidations and triangular amalgamations, the corporation the stock of which is used in the transaction (A) does not control the acquiring corporation (Z) immediately before the transaction. Nonetheless, the IRS and Treasury Department do not believe that section 368(a)(2)(D) requires the corporation the stock of which is used in the transaction to control the acquiring corporation immediately prior to the transaction and that such corporation's control of the acquiring corporation immediately after the transaction is sufficient to satisfy that requirement of section 368(a)(2)(D). Therefore, these final regulations include an example that illustrates the application of section 368(a)(2)(D) to a triangular amalgamation. * * *

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B. Page 518, New Sec. 7.4.F.1.aa. Revocation of Rev. Rul. 74-503

Page 518, New Sec. 7.4.F.1.aa. Add before Sec. 7.4.F.1.b the following:
New Sec. 7.4.F.1.aa. **Revocation of Rev. Rul. 74-503**

Revenue Ruling 2006-2 Revoking Revenue Ruling 74-503
IRB 2006-2 (January 9, 2006)

In Rev. Rul. 74-503, 1974-2 C.B. 117, corporation X transferred shares of its treasury stock to corporation Y in exchange for newly issued shares of Y stock. In the exchange, X obtained 80 percent of the only outstanding class of Y stock. Rev. Rul. 74-503 concludes that the basis of the X treasury stock received by Y is zero and the basis of the newly issued Y stock received by X is zero.

Rev. Rul. 74-503 states that X's basis in the Y stock received in the exchange is determined under §362(a) of the Internal Revenue Code. This conclusion is incorrect. Accordingly, Rev. Rul. 74-503, 1974-2 C.B.117, is revoked, effective December 20, 2005. The other conclusions in the ruling, including the conclusions that X's basis in the Y stock received in the exchange and Y's basis in the X stock received in the exchange are zero, are under study.

Under the authority of § 7805(b), the Service will not challenge a position taken prior to December 20, 2005, with respect to a transaction occurring prior to such date, by a taxpayer that reasonably relied on the conclusions in Rev. Rul. 74-503. *See* §601.601(d)(2)(v) of the Statement of Procedural Rules. * * *

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 74-503, 1974-2 C.B. 117, is revoked.

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VIII. CHAPTER 8, TAX-FREE STOCK ACQUISITIONS: THE STRAIGHT AND TRIANGULAR (B) REORGANIZATIONS AND THE REVERSE SUBSIDIARY MERGER REORGANIZATION UNDER § 368(a)(2)(E); INCLUDING TREATMENT OF NET OPERATING LOSSES

A. Page 574, New Sec. 8.2.K. Guidance for Determining Basis in a (B) Reorganization

Page 574, New Sec. 8.2.K. Add before Sec. 8.3 the following:
New Sec. 8.2.K. **Guidance for Determining Basis in a (B) Reorganization**

IRS Notice 2009-4, 2009-2 IRB 1

I. Purpose

The Internal Revenue Service (IRS) is studying various issues that have arisen in connection with the determination of basis in stock that is acquired in reorganizations described in section 368(a)(1)(B) of the Internal Revenue Code and other transferred basis transactions. The IRS intends to issue further guidance on the determination of such basis. This Notice sets forth the substance of the guidance that the IRS currently contemplates issuing and requests comments on the administrability, accuracy, and appropriateness of such guidance.

II. Background

Section 368(a)(1)(B) of the Code provides that the term reorganization includes the acquisition by one corporation (Acquiring) of stock of another corporation (Target) solely in exchange for part or all of the voting stock of either Acquiring or its parent, provided that Acquiring has control of Target immediately after the acquisition (a B reorganization). Under section 362(b), Acquiring's basis in each share of Target stock acquired in the reorganization is determined with reference to the basis of the share in the hands of the transferor shareholder immediately before the reorganization. Section 362(a) provides similar treatment for Target stock received in a section 351 exchange.

Section 1.368-3 of the Income Tax Regulations requires each significant holder and each corporate party to a reorganization to provide certain essential information regarding the reorganization, including the basis of the transferred property, in a statement on or with its return for the year of the reorganization. In general, a significant holder is any shareholder that owns five percent (by vote or value) of a publicly traded corporation or one percent (by vote or value) of a non-publicly traded corporation. Section 1.351-3 of the regulations imposes similar reporting requirements on significant transferors and transferee corporations in section 351 exchanges. In general, a significant transferor is

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any transferor that owns five percent (by vote or value) of a publicly traded corporation or one percent (by vote or value) of a non-publicly traded corporation immediately after the section 351 exchange.

By 1981, the IRS had identified two significant problems encountered by taxpayers in attempting to establish basis in Target stock acquired in a B reorganization. One was that the acquisition of basis information from shareholders surrendering stock of widely held corporations was time consuming, burdensome, and costly. The other was that not all surrendering shareholders were responding to requests for basis information. To facilitate the determination of basis in these cases, the IRS published Rev. Proc. 81-70, 1981-2 C.B. 729, which set forth general guidelines for surveying surrendering shareholders to determine the basis of Target stock acquired in B reorganizations and provided sampling and estimation procedures to address administrative burdens and shareholder nonresponsiveness.

At the time that Rev. Proc. 81-70 was published, most stock was registered stock, that is, the name of the beneficial owner of the stock was recorded by the issuing corporation's stock transfer agent on its books. However, market practices have changed substantially since the publication of Rev. Proc. 81-70. Today, stock of public companies is primarily held in street name, that is, the stock is held by a nominee (typically a clearinghouse or other financial institution holding stock on behalf of their members or customers) and the transfer agent's books list the nominee as the owner of the stock. Often there are several tiers of nominee owners, each subject to confidentiality and other constraints that could bar the release of information. As a result, the identification of the beneficial owners of large portions of public companies, and thus their bases in those interests, is often difficult or impossible to discover. To address this problem, many taxpayers have developed complicated modeling techniques intended to establish Acquiring's allowable basis in shares acquired in a B reorganization.

There is an additional concern that the information necessary to identify the nominee holders dissipates fairly quickly. In particular, the securities positions reports of depositories and clearinghouses, the most reliable means for identifying such holdings, are generally only maintained by the depository or clearinghouse for five to seven years. Thus, unless such information is secured within that time, the identification of nominee holders will be difficult if not impossible if a basis study subsequently becomes necessary. Accordingly, any model adopted to determine basis in nominee held shares must take that concern into account.

The IRS has been studying the issues raised by nominee stock holdings. As part of that study, the IRS issued Notice 2004-44, 2004-2 C.B. 32, requesting comments on both the difficulties encountered in applying, and the need for modification of, the guidelines set forth in Rev. Proc. 81-70. Written and oral comments were received from a number of sources, including taxpayers, practitioners, and IRS examination teams. Based on these comments, the IRS has concluded that the guidelines of Rev. Proc. 81-70 must be expanded to address the issues presented by nominee stock holdings. In addition, the IRS has concluded that basis determinations should be facilitated for small stock holdings and

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intends to adopt rules that simplify basis determination in such cases.

The IRS recognizes that the difficulties in establishing basis in Target stock acquired in B reorganizations can be presented whenever a corporation acquires Target stock in a transaction in which the acquiring corporation's basis in the acquired stock is determined with reference to the transferring shareholder's basis (transferred basis transaction). In addition to B reorganizations, transferred basis transactions include section 351 exchanges (see section 362(a), which provides that the transferee corporation's basis in property received is determined with reference to the transferor's basis in the property). Transferred basis transactions also include reverse triangular mergers that qualify as either a section 351 exchange or a B reorganization if Acquiring elects to determine basis in acquired property under the provisions of section 362(b) (as permitted by section 1.368-6(c)(2)(ii)). Certain triangular reorganizations involving foreign corporations may also be transferred basis transactions. See section 1.367(b)-13. Accordingly, the IRS has concluded that any further guidance in this area will apply not only to B reorganizations, but to all transferred basis transactions in which Target stock is acquired.

III. The Proposed Guidance: an Expansion of Rev. Proc. 81-70

A. Overview

The IRS continues to believe that the theoretically correct method for determining Target stock basis following a B reorganization is a survey of surrendering Target shareholders. The IRS also continues to believe that Rev. Proc. 81-70 provides essential guidance for obtaining Target stock basis information by surveying surrendering Target shareholders and for using sampling and estimation techniques in appropriate cases. Accordingly, those provisions of Rev. Proc. 81-70 will be preserved without material modification in the guidance that the IRS intends to issue. In this Notice, the guidance that the IRS expects to issue is referred to as Expanded Rev. Proc. 81-70.

As noted above, the concerns expressed regarding the determination of basis following a B reorganization are present, at least to some extent, in any transferred basis transaction. Therefore, the provisions of Expanded Rev. Proc. 81-70 will apply to all transferred basis transactions.

To address those concerns, and to simplify the determination of basis for small stock holdings, Expanded Rev. Proc. 81-70 will include several "safe harbor" provisions. Each safe harbor will apply to a specified group of surrendering shareholders and will prescribe a methodology that can be used to determine those shareholders' bases in surrendered stock. An acquiring corporation may use one or more of the safe harbors; Expanded Rev. Proc. 81-70 will not require the use of all the safe harbors.

The principal provisions of Expanded Rev. Proc. 81-70 are described in more detail in the following sections, beginning with generally applicable provisions in Section III.B of this Notice.

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The safe harbor provisions are described in Section III.C (describing a survey method applicable to shares acquired from "reporting shareholders"), Section III.D (describing a certificate method applicable to shares acquired from "registered, non-reporting shareholders"), and Section III.E (describing a basis modeling method applicable to shares acquired from "nominee, non-reporting shareholders").

Section III.F modifies the reporting requirements under sections 1.351-3 and 1.368-3 to take into account the time needed to complete a basis determination following a transferred basis transaction subject to Expanded Rev. Proc. 81-70.

Section III.G provides a safe harbor for taxpayers using a methodology prescribed in Expanded Rev. Proc. 81-70 and states that the IRS will not assert a different basis determination methodology if a taxpayer complies with the provisions of Expanded Rev. Proc. 81-70.

Section III.H expands the issues that may be the subject of a pre-filing agreement to include basis studies completed in accordance with the terms of Expanded Rev. Proc. 81-70.

Finally, Section III.I provides that Rev. Proc. 81-70 will be obsoleted, subject to a transition rule, when Expanded Rev. Proc. 81-70 is issued.

B. Generally Applicable Provisions of Expanded Rev. Proc. 81-70

A determination of basis must be done timely and diligently to satisfy the conditions of any safe harbor under Expanded Rev. Proc. 81-70.

For purposes of Expanded Rev. Proc. 81-70, a determination of basis will be considered timely if it is completed within two years of the later of the date of the transferred basis transaction and the date that Expanded Rev. Proc. 81-70 becomes effective. In addition, a previously completed basis determination will be considered timely if made compliant with the provisions of Expanded Rev. Proc. 81-70 within two years of the date that Expanded Rev. Proc. 81-70 becomes effective.

For purposes of Expanded Rev. Proc. 81-70, an estimate of basis will be considered to have been done diligently if Acquiring made every reasonable effort to obtain best evidence and, to the extent it was unable to obtain such evidence, can demonstrate that the evidence or basis information could not have been reasonably obtained. The fact that the IRS could, or does, obtain basis information using methods not available to Acquiring does not prevent a determination that Acquiring was diligent in its estimate of basis. Further, Acquiring must have made every reasonable effort to identify and adjust for surrendered shares with low bases (relative to Target's average historical trading price) and for surrendered shares with bases lower than the bases of shares bought and sold under normal market conditions. Circumstances in which this can occur include those in which shares are (1) held by investors with a transferred basis, (2) exchanged for

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convertible stock or debt, or (3) exchanged for debt or other property, as in bankruptcy reorganizations.

The provisions of each safe harbor specify the evidence that should be used for the safe harbor. However, all basis determinations are to be based on best evidence and the determination of the source that is the best evidence is made as of the date of the transferred basis transaction. If a basis determination is not made timely and basis information is lost, missing, or disposed of (e.g., pursuant to the Target's, clearinghouse's or financial institution's record retention policy), and such information could have been obtained if Acquiring had sought it on or shortly after the date of the transaction, Acquiring will not satisfy the best evidence requirement.

In any case in which best evidence is not used, the IRS, in its discretion, may nevertheless accept such evidence, subject to appropriate adjustments to reflect the diminished credibility of the evidence used.

Notwithstanding any safe harbor prescribed in Expanded Rev. Proc. 81-70, if Acquiring has or acquires actual knowledge of a surrendering shareholder's actual basis in a share of surrendered Target stock, Acquiring's allowable basis in the share is equal to that surrendering shareholder's basis. Further, if the examining team has or obtains knowledge of a surrendering shareholder's actual basis in surrendered Target stock, Acquiring's allowable basis in that share is the basis identified by the examining team, even if the basis determined by Acquiring differs from that identified by the examining team. Where the basis of a share is known, any estimated or modeled basis amount must be adjusted to eliminate any basis amount attributable to such share.

C. Safe Harbor for Target Stock Surrendered by or on behalf of Reporting Shareholders

Under this safe harbor, the basis of stock surrendered by reporting shareholders must be determined by survey. For purposes of Expanded Rev. Proc. 81-70, a "reporting shareholder" is any surrendering Target shareholder that was a significant transferor, a significant holder, an officer or director of Target, or plan that acquired Target stock for or on behalf of Target employees, such as an employee stock option or pension, immediately before the date of the transferred basis transaction. The term significant transferor has the same meaning as in section 1.351-3 and the term significant holder has the same meaning as in section 1.368-3.

To identify reporting shareholders, Target's books and records, the Master Securityholder Files maintained by the stock transfer agent, and Securities Exchange Commission (SEC) filings, including Schedule 13 series data, may be used.

In general, a survey must be done in accordance with the guidelines set forth in Rev. Proc. 81-70. Thus:

1. The survey should begin with the mailing of an inquiry letter

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to each reporting shareholder, which states the purpose for requesting the basis information for the surrendered stock, explains how basis is determined, and sets forth the importance of responding timely and accurately. After 30 days, one follow-up letter should be sent to non-responding shareholders. Several attempts also should be made to telephone the non-respondent. These telephone contacts should be attempted on different days of the week and times of the day. Acquiring should maintain a log recording each attempted contact.

2. Any survey sent to a reporting shareholder must request all information necessary for proper determination of basis. Such information may include, but is not limited to:

a. Number of shares surrendered in the transferred basis transaction;

b. Dates those shares were acquired;

c. Total cost of those shares, including commission;

d. How the shares were acquired, for example, by gift, stock option, or inheritance, or as consideration in a prior transferred basis transaction;

e. Tax basis and, if different, cost basis;

f. The nominees (as defined in section E) that held the shares on both the date the shares were acquired and the date of the transferred basis transaction; and

g. In a transaction involving foreign corporations where the rules of section 1.367(b)-13 may apply, whether the shareholder is a section 1248 shareholder with respect to the Target corporation.

3. Survey questionnaires should be sent by certified or registered mail.

4. The procedures by which the survey is designed and implemented must be documented and such documentation must be made available to the IRS examination team on request.

Under this safe harbor, Acquiring's basis in shares acquired from the surveyed shareholders will be the basis reported by such shareholders. If Acquiring does not receive a response from a surveyed shareholder, Acquiring may use estimation

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techniques to determine the basis of Target shares surrendered by the nonresponding shareholder. The estimation guidelines in Sec. 3 of Rev. Proc. 81-70 will be incorporated in Expanded Rev. Proc. 81-70.

However, under this safe harbor, if Acquiring does not survey a reporting shareholder, estimation may not be used and the basis of the shares acquired from such shareholder will be deemed to be zero.

D. Safe Harbor for Target Stock Surrendered by or on behalf of Registered, Non-reporting Shareholders

Under this safe harbor, the basis of stock surrendered by registered, non-reporting shareholders must be determined by the certificate method. For purposes of Expanded Rev. Proc. 81-70, a "registered, non-reporting" shareholder is a shareholder that held Target stock in certificated form, but that is not a reporting or nominee shareholder.

To determine basis under this certificate method, Acquiring must obtain or access Target's books and records and, using those books and records, identify all outstanding certificated shares that were surrendered by or on behalf of non-reporting shareholders and the dates that all such shares were issued. Using both public and private stock exchange trading data, Acquiring must then determine the average trading price of the Target shares on the date each certificate was issued. Subject to the limitations described below, Acquiring may treat the basis of each such share as equal to the average trading price on its issuance date.

Notwithstanding the general rule of this safe harbor, if there has been an extraordinary issuance or event, appropriate adjustment must be made to the basis otherwise determined under this safe harbor. For this purpose, an extraordinary issuance or event is any issuance or event that could have caused the basis of a share to be materially different from the average trading price on its issuance date, including but not limited to the following --

1. On or about the date a stock certificate was issued to a surrendering Target shareholder, another certificate held by the same shareholder was cancelled. In such a case, to the extent that the number of shares issued is less than or equal to the number of shares cancelled, the shares will not be valued as of the date the new certificate was issued, but instead as of the date the earlier certificate was issued. If a cancelled certificate was originally issued concurrently with the cancellation of another certificate, the shares would be valued as of the date of the earlier (or earliest) issuance.

2. A share was acquired by a surrendering Target shareholder in a tax-free stock split. In such a case, the share will be assigned

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a split adjusted basis.

3. A share was acquired by a surrendering Target shareholder as
a
result of a stock dividend. In such a case, the share will be assigned a zero basis.

4. A share was acquired by a surrendering Target shareholder in
a
transaction the details of which are known to the corporation either directly or indirectly. In such a case, the basis must be assigned based on all the information obtainable. This may include, but is not limited to, stock issued due to options, convertible stock, employee plans, and convertible debt.

5. A share was acquired by a surrendering Target shareholder in
a
prior tax-free exchange. In such a case, the share will be assigned a basis of zero unless, using Target's books and records, Acquiring can otherwise establish such basis.

Further, the basis otherwise determined with respect to any share of stock under this safe harbor must be reduced by any distributions paid to the surrendering Target shareholder to the extent such distributions were treated as a return of capital under section 301(c)(2).

E. Safe Harbor for Target Stock Surrendered by Nominees on Behalf of Non-reporting Shareholders

Under this safe harbor, the basis of all stock surrendered by nominees on behalf of non-reporting shareholders is determined under the basis modeling method. For purposes of Expanded Rev. Proc. 81-70, the term nominee means the title owner of equity securities settled through a clearing agency registered pursuant to Section 17A of the Securities Exchange Act of 1934, that holds the stock for or on behalf of the beneficial owner of the stock, typically one of the nominee's participating members.

Modeled basis is determined separately for each series of shares and is done in accordance with the following:

1. Establish measuring dates

Acquiring must identify the measuring dates that will be used in constructing the model. Measuring dates must include the date of the initial public offering (IPO), all subsequent public offering dates prior to the first date for which a depository's or clearinghouse's securities positions report (SPR) is available, the first date for which an SPR is available, and the date of the transferred basis transaction. In addition, there must be a number of measuring dates between the first SPR date and the date of the transferred basis

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transaction. It is not necessary that every business day be a measuring date. However, the dates selected should be representative of Target stock trading activity, including dates surrounding periods of significant volatility in share price or trading activity of Target stock. In addition, the number and the dates of all measuring dates should demonstrate good coverage over the entire relevant period. In general, this means at least one measuring date per quarter.

2. Establish nominee starting basis

Each nominee's starting bases in its shares is determined differently depending on whether an SPR is available for the IPO date.

a. If an SPR is available for the IPO Date

Each nominee holding a share of Target stock on the IPO date is treated as having purchased that share for the IPO price or for the fair market value of the share on the IPO date, whichever is less. That deemed purchase price is the nominee's estimated starting basis in the share.

a. If no SPR is available for the IPO Date

Each nominee holding a share of Target stock on the first SPR date is treated as having purchased that share for the share's allocable portion of Target's pre-SPR Public Offering aggregate basis. That deemed purchase price is the nominee's estimated starting basis in the share.

For purposes of this rule, Target's pre-SPR Public Offering aggregate basis is the excess of Target's "public offering basis" over Target's "redeemed share basis." Target's "public offering basis" is equal to the number of shares offered in the IPO multiplied by the lesser of the offering price and the fair market value of shares issued in the offering, plus the amount so computed for each subsequent public offering before the first SPR date (specifically, the number of shares issued in an offering multiplied by the lesser of the offering price and the fair market value of the shares issued in the offering). Target's redeemed share basis is the sum of the bases of all shares redeemed by Target prior to the first SPR date, treating each redeemed share as having been issued in the public offering immediately preceding the redemption of the share.

A share's allocable portion of Target's pre-SPR Public Offering aggregate basis is determined by allocating Target's pre-SPR Public Offering aggregate basis equally among all shares outstanding as of the first SPR date, other than shares that were privately placed.

3. Adjust estimated starting basis

Nominee holdings on the first SPR date are compared to the nominee holdings on the second measuring date. Any nominees not identified on the Initial SPR Date are treated

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as having purchased their shares, and any increase or decrease in the holdings of a previously identified nominee is treated as a purchase or sale of that number of shares, on the second measuring date. Any deemed purchase is considered to have been made for an amount equal to the volume-weighted average of the trading prices for the period between the first and second measuring dates. As of the end of the second measuring date, each nominee's basis in its Target stock holdings is deemed to be equal to its aggregate estimated starting basis in shares held on the first SPR date, increased to reflect the deemed cost basis of any stock purchased, or decreased to reflect a deemed sale of any stock, as appropriate.

Nominee holdings are then compared to nominee holdings at each next successive measuring date to determine the extent to which there are previously unidentified nominee holdings and changes in previously identified nominee holdings. New and increased holdings are treated as purchases, and decreased holdings are treated as sales, of Target stock. Sales are treated as being made either on the first-in, first-out ("FIFO"), the last-in, first-out ("LIFO"), or the average cost ("ACO") method. Acquiring must identify and adopt the single method that best predicts estimated basis across all investors, which will generally be LIFO, FIFO or ACO basis whichever is lower. As of the end of each measuring date, each nominee's holdings are deemed to have a basis equal to its basis on the immediately preceding measuring date, increased to reflect the deemed cost basis of any purchased stock, or decreased to reflect a deemed sale of any stock, as appropriate.

4. Allowable nominee basis

At the end of the last measuring date (the day of the transferred basis transaction), the aggregate of all basis computed for nominee holdings in each class is allocated equally among the shares in the class that were held by nominees. Acquiring's basis in Target shares acquired from nominees on behalf of non-reporting shareholders is deemed to be the basis allocated to such shares under this safe harbor model. Acquiring's basis in Target shares acquired from nominees on behalf of reporting shareholders is the basis in such shares that is established under section C, notwithstanding the allocation made for computational purposes under this basis modeling safe harbor.

F. Reporting Requirements

Corporations acquiring Target stock in a transferred basis transaction shall be treated as satisfying their reporting requirements under sections 1.351-3 and 1.368-3 with respect to the return for the tax year in which the transaction is completed if the corporation includes a statement on or with such return stating that a basis study is pending with respect to the acquired stock. However, in such cases, the acquiring corporation must include complete statements as required under those regulations, with basis amounts determined pursuant to the study, on or with a return for a tax year that is no later than the tax year that includes the date that is two years after the date of the transferred basis transaction. These rules apply without regard to whether basis is determined under any of the Expanded Rev. Proc. 81-70 safe harbors.

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G. Reliance on Expanded Rev. Proc. 81-70 Safe Harbors

If an acquiring corporation complies with the terms of a safe harbor described in Expanded Rev. Proc. 81-70, including those provisions that apply to all safe harbors described in Expanded Rev. Proc. 81-70, the IRS will not assert an alternative method to determine that corporation's allowable basis in stock covered by that safe harbor.

H. Pre-filing Agreements

The determination of whether a basis study is done in compliance with one or more of the Expanded Rev. Proc. 81-70 safe harbors may be the subject of a pre-filing agreement.

I. Effective Date, Effect on Other Documents

Expanded Rev. Proc. 81-70 will be effective for transferred basis transactions on or after the date it is issued. Because Expanded Rev. Proc. 81-70 will incorporate the provisions of Rev. Proc. 81-70 that have continued application, Rev. Proc. 81-70 will be obsoleted for transactions under Expanded Rev. Proc. 81-70.

IV. Interim Use of Safe Harbor Methodologies

Prior to the issuance of Expanded Rev. Proc. 81-70, whether in the form described in this Notice or otherwise, taxpayers may use the methodologies of any safe harbor described in this Notice (taking into account those provisions generally applicable to all of the safe harbors) to determine the basis of Target stock acquired in any transferred basis transaction that occurs prior to the publication of Expanded Rev. Proc. 81-70. In such cases, the timeliness requirement will be deemed satisfied if the study is completed within two years of the later of the date of the transferred basis transaction and January 12, 2009. The IRS will not assert an alternative methodology against a taxpayer that determines basis in accordance with these proposed guidelines.

V. Request for Comments * * *

B. Page 589, New Sec. 8.5.L., Attempting to Squeeze a Cash Sale into a Reverse Subsidiary Merger or (B) Reorganization—Tribune

Page 589, New Sec. 8.5.L. Add before Sec. 8.6 the following:
New Sec. 8.5.L. **Attempting to Squeeze a Cash Sale into a Reverse Subsidiary Merger or (B) Reorganization—*Tribune***

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Tribune Company v. Commissioner
United States Tax Court, 2005 U.S. Tax Ct. LEXIS 28

COHEN, Judge: Respondent determined a deficiency of $ 551,510,819 with respect to petitioner's Federal income tax for 1998. The notice of deficiency recharacterized as taxable two transactions treated by petitioner as tax-free reorganizations. This opinion addresses the so-called Bender transaction only. The principal issues for decision are:

(1) Whether the Bender transaction qualifies as a reorganization under either section 368(a)(1)(A) and (2)(E) or section 368(a)(1)(B) and, if so,

(2) whether section 269 nonetheless dictates that gain be recognized on the Bender transaction.

Unless otherwise indicated, all section references are to the Internal Revenue Code in effect for the year in issue.

FINDINGS OF FACT

Some of the facts have been stipulated, and the stipulated facts are incorporated in our findings by this reference. Petitioner's principal place of business was in Chicago, Illinois, at the time that the petition was filed. Petitioner is a party to this case solely in its capacity as agent and successor of The Times Mirror Co., Inc. (Times Mirror).

Background * * * Before its merger with petitioner, Times Mirror was a Los Angeles-based news and information company. * * *

Times Mirror engaged in the legal publishing business through Bender. TMD, Inc. (TMD), a wholly owned subsidiary of Times Mirror, owned the only class of issued and outstanding stock of Bender until July 31, 1998. * * *

Melone, Sigler, and Walker Gain Access to the "Domestic Sandwich" Structure. On March 24, 1998, three members of E& Y, Martin R. Melone (Melone), Mary Ann Sigler (Sigler), and Kenneth M. Walker (Walker), entered into an agreement entitled "Nondisclosure and Confidentiality Agreement" with Price Waterhouse LLP (PW). At the time that they entered into the Nondisclosure and Confidentiality Agreement with PW, Melone was the "Partner-in-Charge" of E& Y's audit of Times Mirror, Sigler was a tax partner at E& Y, and Walker was an engagement partner at E& Y. The Nondisclosure and Confidentiality Agreement pertained to the following:

> PW has in the course of its business developed a technique for restructuring a corporate group (known within PW as the "Domestic Sandwich") that is confidential to PW and has substantial pecuniary value to PW (the "Proprietary Technique"), which is the subject of this agreement.

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> PW desires to provide to Individuals [Sigler, Melone, and Walker], and Individuals desire to obtain from PW, a full and complete description of the Proprietary Technique to enable Individuals to review the Proprietary Technique and determine whether it [sic] wishes to use the Proprietary Technique.

As a result of entering into the Nondisclosure and Confidentiality Agreement with PW, Melone, Sigler, and Walker gained access to PW's "Domestic Sandwich" structure. * * *

April 24, 1998, Special Meeting of Times Mirror's Board of Directors. A special meeting of Times Mirror's board of directors was convened on April 24, 1998. A document entitled "Mosby Matthew Bender Update" was prepared for this meeting (April Bender update). The April Bender update listed the following as one of Times Mirror's major accomplishments since the March 5, 1998, meeting of Times Mirror's board of directors:

> As part of our effort to minimize the tax liability on the divestiture, we continued to look for tax-efficient structures. A potential approach that is superior to the structures reviewed at last month's Board meeting was brought to us by Price Waterhouse through Goldman Sachs. This approach is proprietary to Price Waterhouse and is subject to a confidentiality agreement. * * *

The April Bender update also included a section entitled "New Tax Minimization Approach" [*i.e.*, the domestic sandwich] that contained the following:

> The Price Waterhouse structure separates ownership and control so that the acquiring company controls Matthew Bender and Times Mirror controls an amount of cash equivalent to Matthew Bender's value, but without having paid a tax for the shift in control.
>
> The steps in this structure * * * involve the creation of a special purpose corporation (referred to as MB Parent * * *) that is owned partly by Times Mirror and partly by the acquiring company. This special purpose corporation is controlled by the acquiring company through its ownership of relatively low value, nonparticipating preferred stock with 80% voting control. MB Parent in turn owns preferred stock and nonvoting common stock in an acquisition subsidiary that will merge with Matthew Bender and a nonvoting interest in a single member limited liability company that holds the cash referred to above. As a result of the merger of Matthew Bender into the acquisition subsidiary, Times Mirror will own all of the common stock and remaining 20% voting power of MB Parent, the special purpose corporation. However, even though Times Mirror will not have voting control

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over MB Parent, it will control the limited liability corporation holding all of the cash by virtue of being the sole (nonequity) manager of the LLC.

The results are as follows:

o Times Mirror will control the LLC, thereby controlling the cash in it and any assets or businesses acquired with such cash.

o Times Mirror and the LLC will be consolidated for financial reporting purposes.

o The acquiring company will control Matthew Bender and will be able to consolidate for financial reporting purposes.

o The merger of Matthew Bender into the acquisition subsidiary in exchange for MB Parent common stock will qualify as a tax-free reorganization for tax purposes (even though such common stock does not carry with it voting control).

o MB Parent, the LLC and Matthew Bender will not be consolidated for tax purposes with either Times Mirror or the acquiring company.

o At some later date and upon mutual agreement, the Matthew Bender and MB Parent preferred stock can be redeemed at face value and the nonvoting common can be redeemed at a formula price, which would leave the acquiring company as the sole owner of Matthew Bender and Times Mirror as the sole, and controlling owner of MB Parent, with the ability to liquidate MB Parent and the LLC without a tax cost. * * *

Adoption of the Merger Agreement. On April 26, 1998, a document entitled "Agreement and Plan of Merger", prepared by GD& C, was presented to representatives of Times Mirror, TMD, Bender, REUS, REBV, MB Parent, and CBM Acquisition Corp. The Agreement and Plan of Merger set forth the terms and details of the Bender transaction. On that same date, the boards of directors of TMD, Bender, REUS, REBV, and MB Parent adopted resolutions that approved each of those corporation's engaging in the Bender transaction.

On April 27, 1998, representatives of Times Mirror, TMD, Bender, REUS, REBV, MB Parent, and MergerSub executed an agreement entitled "Amended and Restated Agreement and Plan of Merger" (the Bender agreement). Through the Bender agreement, MergerSub replaced CBM Acquisition Corp. as a party to the Bender transaction. The Bender agreement superseded the Agreement and Plan of Merger in its entirety.

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The recitals to the Bender agreement stated, in pertinent part, the following:

> WHEREAS, the TM Parties [Times Mirror, TMD, and Bender, collectively], Acquiror [REUS and REBV, collectively], MB Parent [a sub of Acquiror], and CBM Acquisition Corp. [a sub of MB Parent] have entered into an Agreement and Plan of Merger dated as of April 26, 1998 (the "Existing Merger Agreement");
>
> WHEREAS, the TM Parties and the Reed Parties [REUS, REBV, MB Parent, and MergerSub, collectively] desire to amend and restate the Existing Merger Agreement on the terms and subject to the conditions set forth in this Agreement;
>
> WHEREAS, in anticipation of the Merger (as defined in Section 1.1), MB Parent will file a Restated Certificate of Incorporation of MB Parent * * * with the Secretary of State of the State of Delaware;
>
> WHEREAS, in anticipation of the Merger, MergerSub will file a Restated Certificate of Incorporation of MergerSub * * * with the Secretary of State of the State of New York;
>
> WHEREAS, immediately prior to the Effective Time (as defined below), in consideration of an amount in cash equal to $ 1,375,000,000 less the net proceeds received by MergerSub from the MergerSub Debt (as defined below) from REUS and REBV, MergerSub will issue to REUS (i) seven hundred and ninety-two (792) shares of Common Stock, par value $. 01 per share, of MergerSub ("MergerSub Common Stock"), which MergerSub Common Stock will have 16% of the voting power of all of the outstanding shares of capital stock entitled to vote in an election of directors (" Voting Power") and such other designations, preferences, voting powers, rights and qualifications as are set forth in the MergerSub Certificate of Incorporation, (ii) 75% of the authorized shares of Nonvoting Participating Preferred Stock, par value $. 01 per share, of MergerSub (" MergerSub Participating Preferred Stock"), and (iii) 75% of the authorized shares of Voting Preferred Stock, par value $. 01 per share, of MergerSub ("MergerSub Preferred Stock"), which MergerSub Preferred Stock will have 60% of the Voting Power and such other designations, preferences, voting powers, rights and qualifications as are set forth in the MergerSub Certificate of Incorporation and MergerSub will issue to REBV (i) one hundred and ninety-eight (198) shares of MergerSub Common Stock, which MergerSub Common

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Stock will have 4% of the Voting Power and such other designations, preferences, voting powers, rights and qualifications as are set forth in the MergerSub Certificate of Incorporation, (ii) 25% of the authorized shares of MergerSub Participating Preferred Stock, which MergerSub Participating Preferred Stock will have no Voting Power and such other designations, preferences, voting powers, rights and qualifications as are set forth in the MergerSub Certificate of Incorporation and (iii) 25% of the authorized shares of MergerSub Preferred Stock, which MergerSub Preferred Stock will have 20% of the Voting Power and such other designations, preferences, voting powers, rights and qualifications as are set forth in the MergerSub Certificate of Incorporation;

WHEREAS, immediately prior to the Effective Time (as defined in Section 1.3), MergerSub will borrow $ 600,000,000 on terms not inconsistent with the terms set forth in Section 7.8 ("MergerSub Debt") from an affiliate of Acquiror;

WHEREAS, immediately prior to the Effective Time, in consideration for 75% of the authorized and outstanding shares of MergerSub Participating Preferred Stock held by REUS, MB Parent will issue to REUS 75% of the authorized shares of Voting Preferred Stock, par value $. 01 per share, of MB Parent (" MB Parent Preferred Stock"), which MB Parent Preferred Stock will have 60% of the Voting Power and such other designations, preferences, voting powers, rights and qualifications as are set forth in the MB Parent Certificate of Incorporation;

WHEREAS, immediately prior to the Effective Time, in consideration for 25% of the authorized and outstanding shares of MergerSub Preferred Stock and 25% of the authorized and outstanding shares of MergerSub Participating Preferred Stock held by REBV, MB Parent will issue to REBV 25% of the MB Parent Preferred Stock, which MB Parent Preferred Stock will have 20% of the Voting Power and such other designations, preferences, voting powers, rights and qualifications as are set forth in the MB Parent Certificate of Incorporation;

WHEREAS, immediately prior to the Effective Time, in consideration for $ 1,375,000,000, MB Parent will issue to MergerSub 100% of the authorized shares of Common Stock, par value $. 01 per share, of MB Parent ("MB Parent Common Stock"), which MB Parent Common Stock will have 20% of the Voting Power and such other designations, preferences, voting

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powers, rights and qualifications as are set forth in the MB Parent Certificate of Incorporation;

WHEREAS, in anticipation of the Merger, MB Parent will cause Liberty Bell I, LLC, a single-member Delaware limited liability company ("LLC") to be formed under the laws of the State of Delaware prior to the Effective Time by filing with the Secretary of State of the State of Delaware the Certificate of Formation of LLC * * *;

WHEREAS, in anticipation of the Merger, MB Parent, an affiliate of MB Parent and Times Mirror will enter into a Limited Liability Company Agreement of LLC pursuant to which the affiliate of MB Parent shall be appointed the initial manager of LLC and, immediately after the Effective Time, Times Mirror shall be appointed the manager of LLC * * *;

WHEREAS, immediately after the Effective Time, in accordance with the terms of the LLC Agreement, MB Parent will make a contribution to LLC in the amount of $ 1,375,000,000;

In the Bender agreement, Reed and Times Mirror agreed, in pertinent part, to the following:

SECTION 1.1. The Merger. At the Effective Time (as defined in Section 1.3) and upon the terms and subject to the conditions of this Agreement and in accordance with the New York Business Corporation Law * * *, MergerSub shall be merged with and into * * * [Bender] (the "Merger"). Following the Merger, * * * [Bender] shall continue as the surviving corporation (the "Surviving Corporation") and the separate corporate existence of MergerSub shall cease. The Merger is intended to qualify as a tax-free reorganization under Section 368 of the Code.

* * * * * * *

SECTION 1.8. Conversion of Shares.

(a) Merger Consideration. At the Effective Time, each share of common stock, par value $ 100.00 per share, of * * * [Bender] (individually a "Share" and collectively the "Shares") issued and outstanding immediately prior to the Effective Time (other than Shares held in * * * [Bender's] treasury or by any of * * * [Bender's] Subsidiaries), all of which are owned by TMD, shall, by virtue of the Merger and

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> without any action on the part of MergerSub, * * * [Bender] or the holder thereof, be converted into and shall become the right to receive a number of the fully paid and nonassessable shares of MB Parent Common Stock held by MergerSub immediately prior to the Effective Time equal to a fraction, the numerator of which is the number of shares of MB Parent Common Stock held by MergerSub immediately prior to the Effective Time and the denominator of which is the number of Shares outstanding immediately prior to the Effective Time (the "Merger Consideration"). * * *

Melone Drafts Memorandum Regarding the Bender Transaction for E& Y's Files. On or about April 29, 1998, Melone drafted a memorandum entitled "Times Mirror Matthew Bender Sale" for E& Y's files. Melone included the following statements regarding the Bender transaction and Times Mirror's sale of its 50-percent interest in Shepard's in this memorandum:

> Times Mirror has entered into an agreement with Reed Elsevier for the sale of Matthew Bender for $ 1,375,000,000 and the sale of Times Mirror's interest in Shepard's Inc. for $ 225,000,000. The sale of Matthew Bender is structured as a reorganization in which the $ 1,375 million proceeds from the sale will end up in an LLC whose ownership is as shown in the attached chart. Through the various shareholder agreements, certificates of incorporation and the LLC management agreement, Times Mirror has total control over the assets and operations of the LLC and Reed Elsevier has total control over the assets and operations of Matthew Bender. The structure is designed to result in no tax due by Times Mirror on the profit from the sale of Matthew Bender.
>
> * * * * * * *
>
> Consolidation
>
> * * * Times Mirror controls the assets of the LLC through the management agreement, which specifically states that Times Mirror has no fiduciary duty to the holder of Acquisition Parent [MB Parent] and may use its discretion as to the use of the assets. Times Mirror may have the LLC buy its own debt instruments or Times Mirror stock, make business acquisitions or any other transaction to the benefit of Times Mirror. The only limitation is that Times Mirror may not upstream LLC assets to itself.
>
> Times Mirror owns all of the common stock of Acquisition Parent

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> and the 20% vote it carries. The ownership of the common stock provides Times Mirror with 100% of the residual ownership and value of Acquisition Parent following redemption of the preferred stock, which is virtually assured in at least 20 years due to the redemption rights and certain put and call options. The equity value of the preferred stock is limited to its stated (redemption) value and fixed dividend payments.
>
> Times Mirror has the ability to ensure that the Board of Directors of Acquisition Parent may not do anything that may affect the control or viability of the LLC. Certain board actions require the unanimous vote of the Board. These include:
>
> o the incurrence of indebtedness or guarantees of indebtedness of Acquisition Parent
>
> o the sale, transfer or other disposition, pledge or assignment of any portion or all of its LLC interest
>
> o the issuance of any other securities of Acquisition Parent
>
> All of these factors indicate that Times Mirror not only controls the assets of the LLC, but also is the beneficiary of all of the ownership risks and rewards of the LLC. * * *

Execution of MB Parent Stockholders Agreement and the MergerSub Shareholders Agreement. On July 28, 1998, representatives of Times Mirror, TMD, REUS, REBV, and MB Parent executed an agreement entitled "CBM Acquisition Parent Co. Stockholders Agreement" (MB Parent stockholders agreement). Under the terms of the MB Parent stockholders agreement, Times Mirror, TMD, REUS, REBV, and MB Parent agreed, in pertinent part, to the following:

> Section 1. Call Option with Respect to Voting Preferred Stock.
>
> (a) Grant of Call Option. Acquirors [REUS and REBV] hereby grant to TMD an option, exercisable by TMD no earlier than fifteen (15) days after the occurrence of any Call Event (as defined below), to purchase, in the manner provided in Section 1(d), all, but not less than all, of the outstanding shares of [MB Parent] Voting Preferred Stock, at a purchase price per share equal to 100% of the Stated Value thereof on the date of purchase, payable in cash.
>
> (b) Definition of Call Event. A "Call Event" shall mean (i) June 30, 2018, (ii) any voluntary transfer or other disposition by the Company [MB Parent] of all or any portion of

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> the shares of MergerSub Participating Preferred Stock or (iii) any voluntary transfer or other disposition by the Company of all or any portion of the shares of MergerSub Voting Preferred Stock. * * *

[Thus, pursuant to this provision, TMD has the right to acquire from Reed, the Acquiror, all the preferred stock of MB Parent held by Reed. As will be seen below, Reed only holds preferred in MB Parent. After exercising this call right, TMD will control all of the stock of MB Parent, which in turn controls all of the interest in the LLC.]

Also on July 28, 1998, representatives of REUS, REBV, MB Parent, and MergerSub executed an agreement entitled "CBM MergerSub Corp. Shareholders Agreement" (MergerSub shareholders agreement). Under the terms of the MergerSub shareholders agreement, REUS, REBV, MB Parent, and MergerSub agreed, in pertinent part, to the following:

> Section 1. Call Option with Respect to Voting Preferred Stock.
>
> (a) Grant of Call Option. MB Parent hereby grants to Acquirors [REUS and REBV] an option, exercisable by Acquirors on or after July 15, 2018, to purchase, in the manner provided in Section 1(c), all, but not less than all, of the outstanding shares of [MergerSub] [the court is presumably referring to Bender the survivor of the merger with MergerSub] Voting Preferred Stock, at a purchase price per share equal to 100% of the Stated Value thereof on the date of purchase. * * *
>
> Section 3. Call Option with Respect to Participating Preferred Stock.
>
> (a) Grant of Call Option. MB Parent hereby grants to Acquirors an option, exercisable by Acquirors on or after July 15, 2018, to purchase, in the manner provided in Section 3(c), all, but not less than all, of the outstanding shares of [MergerSub] [the court is presumably referring to Bender the survivor of the merger with MergerSub] Participating Preferred Stock, at a purchase price per share equal to the dollar amount derived from the EBITDA Formula (as defined in Section 3(g)(i)(B) of Article V of the Restated Certificate of Incorporation of the Company). * * *

[Thus, pursuant to this provision, Reed has the right to acquire from MB Parent, the parent of Bender, all the voting and participating preferred stock of Bender held by MB Parent. As will be seen below, MB Parent only holds preferred in Bender. After exercising this call right, Reed will control all of the stock of Bender.] * * *

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The Mechanics of the Bender Transaction. The mechanics of the Bender transaction are set forth below. All of the events described in this section occurred on July 31, 1998, in accordance with detailed instructions prepared by GD& C.

A. Capitalization of MergerSub and MB Parent. As the first step in the capitalization of MergerSub, MergerSub borrowed $ 600 million from the Luxembourg branch of Elsevier, S. A., an affiliate of Reed. The Luxembourg branch of Elsevier, S. A., transferred the $ 600 million to a bank account that MergerSub maintained at Citibank (MergerSub Citibank account).

In addition to MergerSub's borrowing $ 600 million from the Luxembourg branch of Elsevier, S. A., REUS and REBV contributed $ 616,562,500 and $ 158,437,500, respectively, to MergerSub. REUS and REBV transferred their respective contributions to MergerSub to the MergerSub Citibank account.

After making their respective contributions to MergerSub, REUS and REBV owned all of the issued and outstanding common stock of MergerSub, all of the voting preferred stock of MergerSub, and all of the participating preferred stock of MergerSub.

After the capitalization of MergerSub was completed, REUS and REBV contributed all of their shares of MergerSub voting preferred stock and MergerSub participating preferred stock to MB Parent in exchange for 100 percent of MB Parent voting preferred stock. As a class, the MB Parent voting preferred stock held by REUS and REBV was entitled to 80 percent of the voting power of MB Parent and had the power to elect four of the five directors of MB Parent.

In addition to REUS and REBV's contributions to MB Parent, MergerSub contributed $ 1.375 billion to MB Parent. In return, MB Parent issued 1,000 shares, i.e., all, of its common stock to MergerSub. The 1,000 shares of MB Parent common stock received by MergerSub were entitled to 20 percent of the voting power of MB Parent. As a class, the MB Parent common stock held by MergerSub had the power to elect one of the five directors of MB Parent. MergerSub transferred the $ 1.375 billion from the MergerSub Citibank account to a bank account that MB Parent maintained at Citibank (MB Parent Citibank account).

After the capitalization transactions described above had been completed, REUS, REBV, and MB Parent together owned all of the issued and outstanding common stock of MergerSub, all of the voting preferred stock of MergerSub, and all of the participating preferred stock of MergerSub. In addition, REUS, REBV, and MergerSub together owned all of the issued and outstanding common stock of MB Parent and all of the voting preferred stock of MB Parent.

B. Merger of MergerSub and Bender. After the capitalization transactions described above had been completed, MergerSub merged with and into Bender under the relevant provisions of the New York Business Corporation Law, with Bender continuing as the surviving corporation. At the time that the merger of MergerSub with and into Bender

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became effective, all outstanding MergerSub stock was converted into Bender stock, in the same number of shares, in the same classes, and with the same voting power, rights, and qualifications as the previously issued MergerSub common stock, Mergersub voting preferred stock, and MergerSub participating preferred stock.

After the merger of MergerSub with and into Bender, REUS, REBV, and TMD held the following interests in MB Parent:

MB Parent Stock	**REUS**	**REBV**	**TMD**
Common stock			
Shares owned	--	--	1,000
Percentage of class owned	--	--	100%
Percentage of vote	--	--	20%
Voting Preferred stock			
Shares owned	3,000	1,000	
Percentage of class	75%	25%	
Percentage of vote	60%	20%	

[Thus, TMD owned all of MB Parent's common stock, which accounted for 20% of the vote, and Reed affiliates owned all of MB Parent's voting preferred stock with 80% of the vote.]

In addition, REUS, REBV, and MB Parent held the following interests in Bender:

Bender Stock	**REUS**	**REBV**	**MB Parent**
Common stock			
Shares owned	792	198	--
Percentage of class	80%	20%	--
Percentage of vote	16%	4%	--
Voting preferred stock			
Shares owned	--	--	3,960
Percentage of class	--	--	100%
Percentage of vote	--	--	80%
Participating preferred stock			
Shares owned	--	--	10
Percentage of class	--	--	100%
Percentage of vote	--	--	--

[Thus, after the merger, Reed affiliates own all of the common stock of Bender with 20% of the vote, and MB Parent owns all of the Voting preferred with 80% of the vote and all of the participating preferred, which is nonvoting. It was key that MB Parent hold 80% of the stock of Bender because under both Sections 368(a)(2)(E) and 368(a)(1)(B), MB

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Parent must be in control (own at least 80% of the vote, *see* § 368(c)) of Bender after the acquisition.]

C. Capitalization of LBI (the LLC). Pursuant to section 9. b. of the LBI LLC agreement, Times Mirror became the manager of LBI immediately following when the merger of MergerSub with and into Bender became effective. * * *

Immediately following Times Mirror's appointment as manager of LBI, MB Parent contributed $ 1.375 billion to LBI. MB Parent transferred the $ 1.375 billion from the MB Parent Citibank account to a bank account that LBI maintained at Citibank (LBI Citibank account). The $ 1.375 billion was then transferred from the LBI Citibank account to a bank account that LBI maintained at Bank of America. Times Mirror maintained its bank accounts at Bank of America as well.

D. Closing. The Bender transaction closed on July 31, 1998. Times Mirror's sale of its 50-percent interest in Shepard's also closed on that date.

From the time that the Bender transaction closed to the time of trial of this case, Bender continued as a going concern in the legal publishing business. The parties have agreed that the merger of MergerSub with and into Bender, with Bender as the surviving corporation, under the terms of the Bender agreement and in accordance with New York Business Corporation Law, satisfied the continuity of business enterprise requirement for qualification as a tax-free reorganization under section 368.

Times Mirror's Management of LBI and the Development of Times Mirror's Investment Strategy Following the Closing of the Bender Transaction

On July 31, 1998, the law firm of Richards, Layton & Finger (RL& F) prepared an opinion regarding LBI for Times Mirror, MB Parent, REUS, and REBV. With respect to the LBI LLC agreement, RL& F was of the opinion that:

> 2. The LLC Agreement constitutes a legal, valid and binding agreement of the Member [MB Parent] and Manager [Times Mirror], and is enforceable against the Member and the Manager, in accordance with its terms.
>
> 3. If properly presented to a Delaware court, a Delaware court applying Delaware law, would conclude that (i) the removal of the Manager shall be only at the request and direction of the Manager and under no other circumstances, including, without limitation, for cause, as provided for in Section 9(b) of the LLC Agreement and (ii) such provision, contained in Section 9(b) of the LLC Agreement, that requires the removal of the Manager to be only at the request and direction of the Manager, constitutes a legal, valid and binding agreement of the Member, and is enforceable against the Member, in accordance with its

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terms.

On September 1, 1998, Times Mirror, acting in its capacity as manager of LBI, approved a purchase agreement into which LBI had entered with Merrill Lynch International on August 17, 1998 (LBI-MLI purchase agreement). Pursuant to the LBI-MLI purchase agreement, LBI agreed to purchase 1.5 million shares of Series A common stock of Times Mirror from Merrill Lynch International for an initial price of approximately $ 92 million.

On September 30, 1998, Times Mirror, acting in its capacity as manager of LBI, approved the change of LBI's name to Eagle New Media Investments, LLC (hereinafter referred to as the LLC).

A meeting of the officers of the LLC was convened on October 5, 1998. As of that date, the officers of the LLC were Unterman; Debra A. Gastler (Gastler), vice president of taxes for Times Mirror; Steven J. Schoch, vice president and treasurer of Times Mirror; William A. Niese (Niese); Kay D. Leyba; Anne M. Bacher; and Udovic. At this meeting, Unterman informed the other LLC officers of plans to invest the LLC's funds in shares of Series A common stock of Times Mirror and in three companies: Northern Lights, Sinanet, and Homeshark. com. * * *

Summary of the LLC's Investment Activity During 1999. During 1999, Times Mirror directed the LLC to purchase (1) approximately 2.1 million shares of Times Mirror common stock for between $ 125 million and $ 135 million; (2) interests in several Internet media companies; (3) Newport Media, Inc., for $ 132 million; (4) Airspace Safety Analysis Corp. and ASAC International, LLC, for $ 14.5 million; and (5) ValuMail, Inc. Times Mirror also directed the LLC to contribute $ 233,252,000 to TMCT II, LLC, an entity formed for the purpose of retiring stock held by the Chandler Trusts. * * *

Times Mirror's and MB Parent's Income Tax Returns for 1998. On September 14, 1999, Gastler signed Times Mirror's Form 1120, U.S. Corporation Income Tax Return, for 1998. Times Mirror did not disclose any information concerning the Bender transaction on this Form 1120 or on any attachments to this Form 1120.

On September 15, 1999, Vera Lang, treasurer of MB Parent, signed MB Parent's Form 1120 for 1998. Attached to MB Parent's Form 1120 for 1998 was Schedule L, Balance Sheet per Books, on which MB Parent reported its total assets. According to the Schedule L, the following amounts comprised MB Parent's total assets as of the end of 1998: (1) $ 1,613,268 of "Other current assets" and (2) $ 1,457,251,204 of "Other investments". Furthermore, the following amounts comprised MB Parent's "Other investments" as of the end of 1998: (1) $ 61,616,016 of "OTHER INVESTMENTS" held by MB Parent; (2) $ 867,197,048 of "OTHER INVESTMENTS" held by the LLC; and (3) $ 528,438,140 of "Marketable securities" held by the LLC. MB Parent also reported the value of its capital stock on this Schedule L. According to the Schedule L, $ 68,750,000 of preferred stock comprised the total value of MB Parent's capital stock as of the end of 1998. MB Parent

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did not report a value for its common stock on this Schedule L. In addition, MB Parent reported its additional paid-in capital on this Schedule L. According to the Schedule L, the value of MB Parent's additional paid-in capital was $ 1.375 billion as of the end of 1998.

The Internal Revenue Service (IRS) began its audit of Times Mirror's Form 1120 for 1998 sometime during February 2000. On March 15, 2000, Gastler signed the cover sheet to a packet of documents that Times Mirror provided to the IRS as part of this audit. Included in this packet of documents was Form 8275, Disclosure Statement, for the period January 1, 1997, through December 31, 1998, for Times Mirror and its subsidiaries. Referenced in an attachment to the Form 8275 were "Statements previously submitted on February 18, 2000, indicating reorganization of Matthew Bender and Company, per IRC Section 368." These statements included the following:

> MATTHEW BENDER & COMPANY
> STATEMENT PURSUANT TO IRC
> REG. 1.368-3
>
> Matthew Bender & Company was disposed of pursuant to an agreement and plan of merger dated April 27, 1998 by and between The Times Mirror Company, TMD Inc, a wholly owned subsidiary of Times Mirror and Reed Elsevier U.S. Holdings Inc., Reed Elsevier Overseas BV, CBM Acquisition Parent Co, MB Parent and CBM MergerSub Corp. The transactions are fully described in the plan of merger attached. The purpose of the transaction was to dispose of Matthew Bender in a transaction that would qualify as reorganization under Section 368 of the Internal Revenue Code of 1986 as amended.

Times Mirror's Financial Reporting Following the Close of the Bender Transaction. On August 13, 1998, Unterman signed Times Mirror's Form 10-Q, Quarterly Report Pursuant To Section 13 or 15(d) of the Securities Exchange Act of 1934, for the company's quarterly period ended June 30, 1998 (August 13, 1998, Form 10-Q). Included in the August 13, 1998, Form 10-Q were condensed consolidated financial statements for Times Mirror, notes to the condensed consolidated financial statements, all of which were unaudited, and management's discussion and analysis of the company's financial condition and the results of the company's operations. The notes to these financial statements contained, in pertinent part, the following comments:

> Note 3 -- Discontinued Operations
>
> The Company signed definitive agreements with Reed Elsevier plc on April 26, 1998 for the disposition of Matthew Bender & Company, Incorporated (Matthew Bender), the Company's legal publisher, in a tax-free reorganization and the sale of Times Mirror's 50% ownership interest in Shepard's. The two

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> transactions were valued at $ 1.65 billion in the aggregate and were completed on July 31, 1998. The disposition of Matthew Bender was accomplished through the merger of an affiliate of Reed Elsevier with and into Matthew Bender with Matthew Bender as the surviving corporation in the merger. As a result of the merger, TMD, Inc., a wholly owned subsidiary of Times Mirror, received all of the issued and outstanding common stock of CBM Acquisition Parent Co. (MB Parent). MB Parent is a holding company that owns controlling voting preferred stock of Matthew Bender with a stated value of $ 61,616,000 and participating stock of Matthew Bender. MB Parent is also the sole member of Liberty Bell I, LLC (Liberty Bell I). Affiliates of Reed Elsevier own voting preferred stock of MB Parent with a stated value of $ 68,750,000 which affords them voting control over MB Parent, subject to certain rights held by Times Mirror with respect to Liberty Bell I. Concurrently with the closing of the merger, the Company became the sole manager of Liberty Bell I and controls its operations and assets. At the time of the merger, the principal asset of Liberty Bell I was $ 1,375,000,000 of cash. The consolidated financial statements of Times Mirror will include the accounts of Liberty Bell I. * * *

IRS Determinations. On August 14, 2002, the IRS sent to petitioner a statutory notice of deficiency with respect to petitioner's Federal income tax for 1998. In the statutory notice of deficiency, the IRS made the following determinations regarding the Bender transaction:

> 1. $ 1,375,000,000 is the amount realized in 1998 under Code section 1001 by TMD in exchange for the 100% common stock interest in MB [Bender].
>
> 2. In 1998, TMD must recognize capital gain in the amount of $ 1,322,035,840, as computed below. * * * TMD's exchange of its 100% common stock interest in MB is ineligible for nonrecognition treatment under Code section 354 because the series of prearranged transactions that included the merger of Bender Mergersub into MB failed to qualify as a "reorganization" under section 368 of the Code.

In addition, the IRS explained the basis for its determinations under the following headings: "A. TMD CASHED OUT ITS INVESTMENT IN MB", "B. TMD FAILED TO EXCHANGE ITS MB COMMON STOCK FOR STOCK OF MB PARENT WORTH AT LEAST $ 1.1 BILLION", and "C. AFTER THE MERGER, POST-MERGER MB, THE SURVIVING CORPORATION FAILED TO HOLD 'SUBSTANTIALLY ALL' OF ITS PROPERTIES AND THE PROPERTIES OF THE

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'MERGED' CORPORATION". Under the last heading, the notice elaborated:

> D. TMD RECEIVED CONSIDERATION OTHER THAN VOTING STOCK.
>
> To qualify as a reorganization under Code section 368(a)(1)(B), only voting stock may be used by the acquiring corporation. The merger of Bender Mergersub into MB could not qualify as a "B" reorganization if TMD received, in exchange for its MB common stock, any consideration other than voting stock (" boot").
>
> In exchange for its MB common stock, TMD received MB Parent common stock and constructively received the rights to manage Eagle I, which it assigned to TM. Immediately after the merger, Eagle I's sole asset was $ 1.375 billion in cash. The provisions of the Eagle I LLC Agreement, coupled with the broad powers granted to the manager, gave TM direct access to and control over the $ 1.375 billion.
>
> The rights to manage Eagle I were not voting stock, had substantial value, and were constructively received by TMD in exchange for its MB common stock. Since TMD received boot in exchange for its interest in MB, the merger of Bender Mergersub into MB failed to qualify as a reorganization under Code section 368(a)(1)(B).

The notice also determined that section 269 applies to deny nonrecognition treatment of the Bender transaction.

During trial of this case, the parties agreed that TMD's adjusted basis in its Bender common stock was $ 78,454,130 as of July 31, 1998, rather than the $ 52,964,160 amount that had been determined by the IRS in the statutory notice of deficiency.

ULTIMATE FINDINGS OF FACT

The primary consideration received by Times Mirror, through TMD, for transferring control over the operations of Bender to Reed was control over $ 1.375 billion paid by Reed, through MB Parent, to the LLC.

The agreements and corporate organization documents entered into by Times Mirror and Reed negated any meaningful fiduciary obligations between Times Mirror and Reed with respect to Times Mirror's control over the cash or Reed's operation of Bender.

The MB Parent common stock held by TMD had a value of less than $ 1.1 billion and less than 80 percent of the $ 1.375 billion paid by Reed.

The Bender transaction effected a sale of Bender by TMD to Reed.

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OPINION

Section 354(a) states the general rule that "No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization." Section 356 requires recognition of gain from an exchange in which property other than that permitted under section 354 (or section 355) (i.e., boot) is received; the gain recognized is not in excess of the sum of money or the fair market value of other property received in the exchange. Section 368 sets forth definitions of corporate reorganizations that qualify for nontax treatment under section 354(a).

Times Mirror and its advisers intended that the Bender transaction qualify as a tax-free "reverse triangular merger" under section 368(a)(1)(A) and (2)(E). As described by petitioner, a reverse triangular merger is a statutory merger in which the merged corporation (MergerSub) merges with and into the target corporation (Bender) in exchange for stock of a corporation (MB Parent), which, immediately prior to the merger, controlled the merged corporation.

Respondent contends that the Bender transaction does not qualify as a reverse triangular merger because TMD received more than qualifying stock of MB Parent and the transaction thus fails to satisfy the "exchange" requirement of section 368(a)(2)(E)(ii), that is: "in the transaction, former shareholders of the surviving corporation exchanged, for an amount of voting stock of the controlling corporation, an amount of stock in the surviving corporation which constitutes control of such corporation." Section 368(c) defines "control" as "the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation." Respondent argues that TMD's gain on the Bender transaction is taxable unless the fair market value of qualifying consideration, the MB Parent common stock, was at least equal in value to a "controlled block" (80 percent) of Bender stock. The parties agree that this requirement means that the MB Parent common stock must have had a value of $ 1.1 billion for the transaction to qualify as a reverse triangular merger.

Alternatively, and in order to assert reliance on certain rulings of respondent, petitioner argues that the Bender transaction qualifies under section 368(a)(1)(B). * * *

Petitioner's alternative position would not require valuation of the MB Parent common stock. It would, however, require us to conclude that Times Mirror's control over the cash in the LLC was not part of the consideration received in the Bender transaction because it was not intended by Times Mirror or Reed to be a "separate asset".

Respondent argues that the Bender transaction did not qualify under section 368(a)(1)(B) because TMD did not exchange its Bender stock solely for voting stock. In addition, respondent argues that petitioner has belatedly changed its theory and should be

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precluded from doing so.

In form, at the conclusion of the Bender transaction, TMD was the holder of MB Parent common stock and no longer owned Bender common stock. Determination of whether the MB Parent common stock had a value of $ 1.1 billion or, in the alternative, whether the sole consideration exchanged for the Bender common stock was the MB Parent common stock requires a factual analysis of the totality of the Bender transaction. Because the same facts lead us to our conclusions on both theories, we do not need to decide whether petitioner is too late in asserting its section 368(a)(1)(B) argument.

Factual Analysis of the Bender Transaction. Not surprisingly, the parties differ significantly in their descriptions of the Bender transaction. While paraphrasing portions of the record, the parties cannot resist characterizing events in a manner consistent with their respective positions. Petitioner emphasizes the formalities of the multicorporate structure, which undeniably was intended and carefully designed to comply with the requirements for a tax-free reorganization under section 368. Petitioner asserts that "respondent erroneously substitutes his version of the Bender transaction for what actually transpired."

Respondent does not deny that there was a business purpose for the Bender transaction, i.e., the desire of Times Mirror to get out of the legal publishing business because of the trends in that market. Pointing to specific aspects and results of the transaction, however, respondent argues:

> All of the unusual features of the Bender Transaction structure, the creation of a dormant intermediary company (MB Parent) and an enslaved LLC (Eagle I), the interlocking tiers of redeemable Bender and MB Parent voting preferred stock that transferred virtually complete control over Bender to Reed, and the provisions of the LLC Agreement, that transferred absolute control over the cash to the manager (TM), were united to a single purpose: segregate and seal off TM's interest in the cash and Reed's interest in Bender, one from the other.
>
> The substance of the Bender Transaction is a swap. TM gave up Bender for the right to control and distribute to itself at will $ 1.375 billion of cash. Reed gave up $ 1.375 billion of cash for ownership and control of Bender. This is hardly the kind of readjustment of continuing interests in property under modified corporate form that marks a real reorganization. * * *

The proposed findings of fact set forth in the briefs of the parties cannot be adopted as our findings because they lack objectivity either by omission or in argumentative descriptions. Rather than attempting to reconcile the parties' characterizations of particular events, we have reviewed the entire record and related in great detail the contemporaneous statements of the parties to the Bender transaction, the contractual

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terms, the subsequent conduct of the parties to the transaction, and the representations of Times Mirror to shareholders and to regulatory bodies. The form of the transaction includes the totality of the contractual arrangements and is not limited to the design, characterization, and labels put on the arrangements by the Times Mirror tax advisers. In analyzing the terms and provisions of the contractual arrangements, we have considered the interpretation of the parties to them, as demonstrated by their conduct.

Times Mirror's View of the Bender Transaction. Times Mirror, for good business reasons, decided to take advantage of the existing trends in legal publishing and the strong desire of Wolters Kluwer and Reed to acquire Times Mirror's interest in Bender and Shepard's. The bidders agreed to the CJV "reorganization" structure promoted by PW and GS and endorsed by GD& C and E& Y because that was the only way they could acquire their target.

Times Mirror was anxious to have the significant proceeds of its divestiture of Bender to spend on repurchasing its own stock and diversifying into other emerging areas. After the proposed structure of the divestiture was presented to the competing bidders, at the board meeting on April 24, 1998, the board of directors was told: [the court quotes from the report discussed in the facts above] * * *

In a memorandum dated April 29, 1998, E& Y recorded the following: [see discussion of the facts]

We cannot improve on the descriptions of the Bender transaction in the above contemporaneous statements of the participants. Little more would be required to conclude that the Bender transaction was, in substance, a sale. The issue in this case, however, is to determine whether the "reorganization" structure satisfies the requirements of sections 354(a) and 368 and precludes taxation of the gain derived from the transaction.

Fiduciary Obligations Among the Parties. In the context of the dispute over the value of the MB Parent common stock received by TMD, as discussed below, petitioner argues that Times Mirror, as manager of the LLC, had fiduciary obligations that precluded unlimited use of the LLC's cash and prevented a conclusion that TMD or Times Mirror realized the proceeds of a sale of Bender. Respondent contends that Times Mirror's only fiduciary obligation under the management agreement was to itself. * * *

[T]he parties understood that they were deliberately negating any fiduciary obligations owed to Reed with respect to the cash or owed to Times Mirror or TMD with respect to Bender operations. * * *

Consideration for the Transfer of Bender to Reed. For purposes of section 368, the basic factual determination to be made is whether, under the contractual arrangements, the consideration received by TMD, the formal "divestor" of Bender, from MB Parent, the formal "divestee", was, as petitioner contends, common stock of MB Parent worth at least $ 1.1 billion or whether, as respondent contends, the consideration received was title

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to the common stock plus effective control over $ 1.375 billion -- the amount paid by Reed in the transaction. Certainly from the standpoint of Times Mirror, control of the funds was the most important asset received. From the standpoint of Reed, control of the Bender operations was the most important asset received. Neither TMD nor MB Parent had officers or employees. TMD had no operations independent of Times Mirror, and MB Parent had no operations independent of Reed. Unterman testified that Times Mirror was appointed manager of the LLC because TMD had no employees and was solely owned by Times Mirror. He further testified:

> Q [Counsel for petitioner] From your perspective as chief financial officer of Times Mirror, was Times Mirror's management authority over the assets of the LLC a separate part of the consideration Times Mirror received for Matthew Bender?
>
> A [Unterman] Not at all. It was all one deal.
>
> Q Could you explain your response, please?
>
> A Well, the economic asset was the cash that was in MB parent, and the LLC was a way of assuring that the cash would be invested in a manner that was parallel of Times Mirror's interests at all times.

Under the combined terms of the management agreement, MB Parent's restated certificate of incorporation, MergerSub's certificate of incorporation, the MB Parent stockholders agreement, and the MergerSub shareholders agreement, all incidents of ownership of the $ 1.375 billion were shifted to Times Mirror as of July 31, 1998.

Examination of the voting, dividend, redemption, and liquidation provisions of the documents, quoted at length in our findings, confirms respondent's view that only Times Mirror had a continuing economic interest in the cash, and only Reed had a continuing economic interest in Bender. The structure of MB Parent and the dividend provisions assured that any dividends paid to MB Parent from the operations of Bender would be paid to Reed as dividends on MB Parent's preferred stock. Moreover, when the structure was ultimately unwound, TMD would own MB Parent and the LLC and Reed would own Bender.

The foregoing factual analysis demonstrates that the consideration received by TMD, as the investment subsidiary of Times Mirror, was not common stock in MB Parent but was control over the cash deposited in the LLC. In relation to the arguments over expert testimony, as discussed below, petitioner asserts that the common stock and the management authority cannot be valued separately because it would have been unthinkable to transfer them separately. But this argument does not aid petitioner's case. Recognizing that no one would separately purchase either the common stock or the management authority confirms respondent's argument that common stock was not the only consideration for the transfer and that the common stock, viewed alone, did not have

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the value necessary for the transaction to qualify under the reorganization provisions of the Internal Revenue Code.

Valuation of MB Parent Common Stock. Petitioner argues that Times Mirror and Reed "conclusively" agreed that the MB Parent common stock was worth $ 1.375 billion. In the context of the entire agreement, however, the description of the consideration in the merger agreement as common stock was merely a recital consistent with the intended tax effect. We have examined the corporate governing documents to determine whether the MB Parent common stock possessed the requisite value for purposes of section 368(c). *Cf. Alumax Inc. v. Commissioner*, 109 T.C. 133, 177-191 (1997), affd. 165 F.3d 822 (11th Cir. 1999).

The factual analysis of the transaction compels the conclusion that the management authority over the cash in the LLC had far more value to Times Mirror than the MB Parent common stock and thus represented the bulk of the consideration. For completeness, we discuss briefly the expert testimony and the context of petitioner's effective concession that the MB common stock and the management authority over the LLC were inseparable, which we conclude establishes that common stock was not the sole consideration for the Bender transaction. * * *

We need not determine actual value of the MB Parent common stock, only proportionate value, i.e., whether the stock represents 80 percent of the total consideration paid by Reed. It is possible to engage in interminable arguments about the reports of the various experts presented by the parties in this case. To do so, however, would serve no useful purpose, because it would not affect the commonsense conclusions that (1) the MB Parent common stock cannot be isolated and treated as the sole consideration transferred to TMD for its divestiture of Bender and (2) the common stock of MB Parent, objectively, had a value less than $ 1.1 billion and less than 80 percent of the $ 1.375 billion paid by Reed.

Pertinent Precedents. Respondent invites us to adopt a broad-based approach and apply the "spirit" of the reorganization provisions in order to deter the type of abuse that respondent perceives the Bender transaction to be. We need not and do not accept respondent's invitation. We are, however, mindful of the precedents and judicial homilies that support respondent's position.

The source of most "substance over form" arguments, of course, is *Gregory v. Helvering*, 293 U.S. 465, 79 L. Ed. 596, 55 S. Ct. 266 (1935). In oft quoted language, the Supreme Court framed the issue as follows:

> The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended. * * *
> [Id. at 469; citations omitted.]

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Gregory involved a purported statutory reorganization and thus is particularly applicable here. Petitioner argues, however, that “In the 70 years since Gregory was decided, no court has applied substance-form principles to override technical compliance supported by business purpose and true economic effect.” Indeed, in Gregory, the Supreme Court disregarded the form of a transaction as having no independent significance. Before elaborating on the application of this principle and “true economic effect” in this case, we acknowledge the so-called progeny of Gregory.

Respondent cites *Minn. Tea Co. v. Helvering,* 302 U.S. 609, 613-614, 82 L. Ed. 474, 58 S. Ct. 393 (1938), in which the Supreme Court stated that “A given result at the end of a straight path is not made a different result because reached by following a devious path. * * * The controlling principle will be found in Gregory v. Helvering”.

Respondent also relies on another “reorganization” case, *West Coast Mktg. Corp. v. Commissioner,* 46 T.C. 32 (1966), in which the sole stockholder and president of the taxpayer corporation desired to dispose of certain land. In order to qualify the disposition as a tax-free reorganization under sections 354(a)(1) and 368(a)(1)(B), a corporation, Manatee, was formed, and the subject land was transferred to Manatee in exchange for stock. The stock of Manatee was then transferred to the acquiring corporation in exchange for its stock. Thereafter, Manatee was liquidated. Citing *Minn. Tea Co. v. Helvering,* supra, and Gregory v. Helvering, supra, this Court acknowledged that the transaction fell literally within the reorganization provisions but held that “the tax consequences must turn upon the substance of the transaction rather than the form in which it was cast.” *West Coast Mktg. Corp. v. Commissioner, supra* at 40. Respondent argues that MB Parent in the instant case is comparable to the intermediary corporation in *West Coast Mktg. Corp.* in that it had no business, no offices, and no employees, and it served no purpose other than to create the form necessary to support a claim for tax-free reorganization treatment.

In addition to cases cited above, respondent relies on the legislative history of the reorganization provisions, various legislative attempts to prevent abuse, and cases discussing continuity of proprietary interest as “the judicial bulwark and backstop for limiting deferral [nonrecognition] to the kinds of transactions that Congress intended should qualify.” *See Pinellas Ice & Cold Storage Co. v. Commissioner,* 287 U.S. 462, 77 L. Ed. 428, 53 S. Ct. 257, 1933-1 C.B. 161 (1933); *Cortland Specialty Co. v. Commissioner,* 60 F.2d 937 (2d Cir. 1932). Petitioner responds with the assertion that “Stock as consideration has always satisfied” the continuity of proprietary interest requirement “even when the stock conveys a highly attenuated economic interest in the acquiring corporation.” Here, however, petitioner is again assuming that stock was the sole consideration for the divestiture of Bender -- an assumption we reject under the facts of this case for the reasons discussed above. Moreover, the interest of the MB Parent common stock held by TMD in the Bender operations is not merely “highly attenuated”; it is expressly negated by the evidence.

Petitioner does not address *Minn. Tea Co*. or *West Coast Mktg. Corp*. Petitioner relies on

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Esmark, Inc. v. Commissioner, 90 T.C. 171 (1988), affd. without published opinion 886 F.2d 1318 (7th Cir. 1989), as demonstrating the limitations on applying substance over form analysis to recast a transaction that, on its face, complies with the formal requirements of a statute. Respondent notes that Esmark, Inc. reaffirmed the notion that a taxpayer's receipt of a substantial amount of cash for its property is the hallmark of a sale. *See id*. at 187.

In *J. E. Seagram Corp. v. Commissioner*, 104 T.C. 75, 94 (1995), the taxpayer, arguing against reorganization treatment in an effort to establish a recognizable loss, relied on the rationale of Esmark, Inc., and this Court responded:

> Esmark Inc. involved a series of related transactions culminating in a tender offer and redemption of a part of the taxpayer's stock in exchange for certain property. The Commissioner, seeking to apply the step transaction doctrine, sought to recharacterize the tender offer/redemption as a sale of assets followed by a self-tender. While it is true that we held that each of the preliminary steps leading to the tender offer/redemption had an independent function, we also held that the form of the overall transaction coincided with its substance, and was to be respected. In the case before us, petitioner would have us respect the independent significance of DuPont's tender offer, but disregard the overall transaction, which included the merger. That result would, of course, be inconsistent as an analogy with the result in Esmark, Inc. We therefore decline petitioner's request that we apply Esmark, Inc. to the facts of this case. [Id. at 94.]

We believe that the *J. E. Seagram Corp*. analysis is helpful in this case. In *J. E. Seagram Corp*. and in *Esmark, Inc*., we declined to give conclusive effect to a single part of a complex integrated transaction, as petitioner would have us do here.

Petitioner relies primarily on two aspects of the documentation to conclude that the Bender transaction qualifies as a tax-free reorganization. The first is the form by which MB Parent common stock flowed to TMD and by which Bender preferred stock flowed to MB Parent. We agree with respondent that this case is more like *West Coast Mktg. Corp*. than like *Esmark, Inc*. There are differences, of course. MB Parent was not intended to be, and has not been, liquidated as promptly as the intermediary in *West Coast Mktg. Corp*. Additionally, MB Parent was putatively formed by the acquirer rather than by the party divesting itself of the property. Given the terms of MB Parent's governing documents and the structure of its several classes of stock, however, it has no more function than the intermediary in *West Coast Mktg. Corp*. By contrast to the facts in *Esmark, Inc*., here there is no uncontrolled participation by persons who are not parties to the contractual arrangement, such as the public shareholders in *Esmark, Inc*., to give substantive economic effect to the existence of MB Parent. To disregard the existence of

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MB Parent is not to ignore any meaningful step in the transfer of Bender from Times Mirror to Reed.

Second, petitioner asserts that “the evidence conclusively establishes that the parties valued the MBP Common at $ 1.375 billion.” Petitioner argues that the agreement of the parties as to value was the result of arm’s-length negotiations between Times Mirror and Reed. The arm’s-length negotiation, however, led to the parties’ agreeing to adopt the form of tax-free reorganization, which required a recital that the common stock was the consideration being exchanged for the Bender stock. That language was consistent with Times Mirror’s tax objectives, which were accepted by Reed when Reed concluded that it could not acquire the Bender stock without agreeing to those terms. While terms negotiated between the parties may produce evidence of value, they are not conclusive. Cf. *Berry Petroleum v. Commissioner*, 104 T.C. 584, 615 (1995), affd. without published opinion on other issues 142 F.3d 442 (9th Cir. 1998). In the instant case, the negotiated terms are overcome by the evidence, as discussed above, that the MB Parent common stock did not have a value of $ 1.375 billion or even 80 percent of that amount.

Once petitioner acknowledges and asserts that the MB Parent common stock cannot be separated from the authority of Times Mirror, the “ultimate claimholder”, to manage the cash in the LLC, the putative 20-percent voting power of the common stock in MB Parent and the bare title of MB Parent in the LLC should be disregarded. MB Parent clearly serves no purpose and performs no function apart from Times Mirror’s attempt to secure the desired tax consequences. In this context, we agree with respondent’s reliance on *Frank Lyon Co. v. United States*, 435 U.S. 561, 573, 55 L. Ed. 2d 550, 98 S. Ct. 1291 (1978), observing that “the simple expedient of drawing up papers” is not controlling for tax purposes when “the objective economic realties are to the contrary.”

As we indicated at the beginning of our factual analysis, our understanding of the Bender transaction gives full effect to all of the contractual terms other than the labels assigned. As we indicated in our discussion of the dispute over valuation of the common stock, we agree that it is unrealistic to separate the common stock in MB Parent from the authority to manage $ 1.375 billion in cash held by Times Mirror through the management agreement. Thus, we are simply looking at the operative terms of the Bender transaction by analyzing the respective rights of the parties to it as interpreted by them before, on, and after July 31, 1998.

The evidence compels the conclusion that Times Mirror intended a sale, assured that it would receive the proceeds of sale for use in its strategic plans, used the proceeds of sale in its strategic plans without limitation attributable to any continuing rights of Reed, and represented to shareholders and to the SEC that it had full rights to the proceeds of sale. None of these actions were inconsistent with the contractual terms. Thus, we need not “substitute respondent’s version” for “what actually transpired.” We deal only with what actually transpired and give effect to the legal documentation of the Bender transaction, with key points emphasized by the terms of the documents and the statements made by Times Mirror representatives about what was accomplished in the Bender transaction.

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In a different but analogous context, the Court of Appeals for the Seventh Circuit has stated:

> The freedom to arrange one's affairs to minimize taxes does not include the right to engage in financial fantasies with the expectation that the Internal Revenue Service and the courts will play along. The Commissioner and the courts are empowered, and in fact duty-bound, to look beyond the contrived forms of transactions to their economic substance and to apply the tax laws accordingly. That is what we have done in this case and that is what taxpayers should expect in the future. * * * [*Saviano v. Commissioner*, 765 F.2d 643, 654 (7th Cir. 1985), affg. 80 T.C. 955 (1983).]

From any perspective, the "true economic effect" (petitioner's words, quoted above) of the Bender transaction was a sale. Because the consideration paid by the buyer, to wit, unfettered control over $ 1.375 billion in cash, passed to the seller from the buyer, the Bender transaction does not qualify as a reorganization under section 368(a)(1)(B), which requires that the exchange be solely for stock. Because the MB Parent common stock lacked control over any assets, its value was negligible in comparison to the $ 1.1 billion value that would be required to qualify the Bender transaction as a tax-free reorganization under section 368(a)(1)(A) and (a)(2)(E). * * *

C. Page 589, New Sec. 8.5.M. Reverse Subsidiary Merger Followed by a Liquidation Is Not a Reorganization

Page 589, New Sec. 8.5.M. Add after New Sec. 8.5.L the following:
New Sec. 8.5.M. **Reverse Subsidiary Merger Followed by a Liquidation is Not a Reorganization**

Revenue Ruling 2008-25
2008-21 I.R.B. 986

ISSUE

What is the proper Federal income tax treatment of the transaction described below?

FACTS

T is a corporation all of the stock of which is owned by individual A. T has 150x dollars worth of assets and 50x dollars of liabilities. P is a corporation that is unrelated to A and T. The value of P's assets, net of liabilities, is 410x dollars. P forms corporation X, a wholly owned subsidiary, for the sole purpose of acquiring all of the stock of T by causing X to merge into T in a statutory merger (the "Acquisition Merger"). In the

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Acquisition Merger, P acquires all of the stock of T, and A exchanges the T stock for 10x dollars in cash and P voting stock worth 90x dollars. Following the Acquisition Merger and as part of an integrated plan that included the Acquisition Merger, T completely liquidates into P (the “Liquidation”). In the Liquidation, T transfers all of its assets to P and P assumes all of T’s liabilities. The Liquidation is not accomplished through a statutory merger. After the Liquidation, P continues to conduct the business previously conducted by T.

LAW

Section 368 (a) (1) (A) of the Internal Revenue Code provides that the term “reorganization” means a statutory merger or consolidation. Section 368 (a) (2) (E) provides that a transaction otherwise qualifying under § 368 (a) (1) (A) shall not be disqualified by reason of the fact that stock of a corporation in control of the merged corporation is used in the transaction, if (i) after the transaction, the corporation surviving the merger holds substantially all of its properties and of the properties of the merged corporation (other than stock of the controlling corporation distributed in the transaction), and (ii) in the transaction, former shareholders of the surviving corporation exchanged, for an amount of voting stock of the controlling corporation, an amount of stock in the surviving corporation which constitutes control of the surviving corporation. Further, §1.368-2 (j) (3) (iii) of the Income Tax Regulations provides that “[i]n applying the ‘substantially all’ test to the merged corporation, assets transferred from the controlling corporation to the merged corporation in pursuance of the plan of reorganization are not taken into account.”

Section 368 (a) (1) (C) provides in part that a reorganization is the acquisition by one corporation, in exchange solely for all or part of its voting stock, of substantially all of the properties of another corporation, but in determining whether the exchange is solely for stock, the assumption by the acquiring corporation of a liability of the other shall be disregarded. Section 368 (a) (2) (B) provides that if one corporation acquires substantially all of the properties of another corporation, the acquisition would qualify under § 368 (a) (1) (C) but for the fact that the acquiring corporation exchanges money or other property in addition to voting stock, and the acquiring corporation acquires, solely for voting stock described in § 368 (a) (1) (C), property of the other corporation having a fair market value which is at least 80 percent of the fair market value of all of the property of the other corporation, then such acquisition shall (subject to § 368 (a) (2) (A)) be treated as qualifying under § 368 (a) (1) (C). Section 368 (a) (2) (B) further provides that solely for purposes of determining whether its requirements are satisfied, the amount of any liabilities assumed by the acquiring corporation shall be treated as money paid for the property.

Section 1.368-1 (a) generally provides that in determining whether a transaction qualifies as a reorganization under § 368 (a), the transaction must be evaluated under relevant provisions of law, including the step transaction doctrine.

Section 1.368-2 (k) provides, in part, that a transaction otherwise qualifying as a

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reorganization under § 368 (a) shall not be disqualified or recharacterized as a result of one or more distributions to shareholders (including distribution (s) that involve the assumption of liabilities) if the requirements of §1.368-1 (d) are satisfied, the property distributed consists of assets of the surviving corporation, and the aggregate of such distributions does not consist of an amount of assets of the surviving corporation (disregarding assets of the merged corporation) that would result in a liquidation of suchcorporation for Federal income tax purposes.

Rev. Rul. 67-274, 1967-2 C.B. 141, holds that an acquiring corporation's acquisition of all of the stock of a target corporation solely in exchange for voting stock of the acquiring corporation, followed by the liquidation of the target corporation as part of the same plan, will be treated as an acquisition by the acquiring corporation of substantially all of the target corporation's assets in a reorganization described in § 368 (a) (1) (C). The ruling explains that, under these circumstances, the stock acquisition and the liquidation are part of the overall plan of reorganization and the two steps may not be considered independently of each other for Federal income tax purposes. See also, Rev. Rul. 72-405, 1972-2 C.B. 217.

Rev. Rul. 2001-46, 2001-2 C.B. 321, holds that, where a newly formed wholly owned subsidiary of an acquiring corporation merged into a target corporation, followed by the merger of the target corporation into the acquiring corporation, the step transaction doctrine is applied to integrate the steps and treat the transaction as a single statutory merger of the target corporation into the acquiring corporation. Noting that the rejection of step integration in Rev. Rul. 90-95, 1990-2 C.B. 67, and § 1.338-3 (d) is based on Congressional intent that § 338 replace any nonstatutory treatment of a stock purchase as an asset purchase under the Kimbell-Diamond doctrine, the Service found that the policy underlying § 338 is not violated by treating the steps as a single statutory merger of the target into the acquiring corporation because such treatment results in a transaction that qualifies as a reorganization in which the acquiring corporation acquires the assets of the target corporation with a carryover basis under § 362, rather than receiving a cost basis in those assets under § 1012. (In *Kimbell-Diamond Milling Co. v. Commissioner*, 14 T.C. 74, *aff'd per curiam*, 187 F.2d 718 (1951), *cert. denied*, 342 U.S. 827, 72 S. Ct. 50, 96 L. Ed. 626 (1951), the court held that the purchase of the stock of a target corporation for the purpose of obtaining its assets through a prompt liquidation should be treated by the purchaser as a purchase of the target corporation's assets with the purchaser receiving a cost basis in the assets.)

Section 338 (a) provides that if a corporation makes a qualified stock purchase and makes an election under that section, then the target corporation (i) shall be treated as having sold all of its assets at the close of the acquisition date at fair market value and (ii) shall be treated as a new corporation which purchased all of its assets as of the beginning of the day after the acquisition date. Section 338 (d) (3) defines a qualified stock purchase as any transaction or series of transactions in which stock (meeting the requirements of § 1504 (a) (2)) of one corporation is acquired by another corporation by purchase during a 12-month acquisition period. Section 338 (h) (3) defines a purchase generally as any acquisition of stock, but excludes acquisitions of stock in exchanges to which § 351, §

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354, § 355, or § 356 applies.

Section 338 was enacted in 1982 and was "intended to replace any nonstatutory treatment of a stock purchase as an asset purchase under the Kimbell-Diamond doctrine." H.R. Conf. Rep. No. 760, 97th Cong, 2d Sess. 536 (1982), 1982-2 C.B. 600, 632. Stock purchase or asset purchase treatment generally turns on whether the purchasing corporation makes or is deemed to make a § 338 election. If the election is made or deemed made, asset purchase treatment results and the basis of the target assets is adjusted to reflect the stock purchase price and other relevant items. If an election is not made or deemed made, the stock purchase treatment generally results. In such a case, the basis of the target assets is not adjusted to reflect the stock purchase price and other relevant items.

Rev. Rul. 90-95 (Situation 2), holds that the merger of a newly formed wholly owned domestic subsidiary into a target corporation with the target corporation shareholders receiving solely cash in exchange for their stock, immediately followed by the merger of the target corporation into the domestic parent of the merged subsidiary, will be treated as a qualified stock purchase of the target corporation followed by a § 332 liquidation of the target corporation. As a result, the parent's basis in the target corporation's assets will be the same as the basis of the assets in the target corporation's hands. The ruling explains that even though "the step-transaction doctrine is properly applied to disregard the existence of the [merged subsidiary]," so that the first step is treated as a stock purchase, the acquisition of the target corporation's stock is accorded independent significance from the subsequent liquidation of the target corporation and, therefore, is treated as a qualified stock purchase regardless of whether a § 338 election is made. Thus, in that case, the step transaction doctrine was not applied to treat the transaction as a direct acquisition by the domestic parent of the assets of the target corporation because such an application would have resulted in treating a stock purchase as an asset purchase, which would be inconsistent with the repeal of the Kimbell-Diamond doctrine and § 338.

Section 1.338-3 (d) incorporates the approach of Rev. Rul. 90-95 into the regulations by requiring the purchasing corporation (or a member of its affiliated group) to treat certain asset transfers following a qualified stock purchase (where no § 338 election is made) independently of the qualified stock purchase. In the example in § 1.338-3 (d) (5), the purchase for cash of 85 percent of the stock of a target corporation, followed by the merger of the target corporation into a wholly owned subsidiary of the purchasing corporation, is treated (other than by certain minority shareholders) as a qualified stock purchase of the stock of the target corporation followed by a § 368 reorganization of the target corporation into the subsidiary. As a result, the subsidiary's basis in the target corporation's assets is the same as the basis of the assets in the target corporation's hands.

ANALYSIS

If the Acquisition Merger and the Liquidation were treated as separate from each other, the Acquisition Merger would be treated as a stock acquisition that qualifies as a reorganization under § 368 (a) (1) (A) by reason of § 368 (a) (2) (E), and the Liquidation

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would qualify under § 332. However, as provided in § 1.368-1 (a), in determining whether a transaction qualifies as a reorganization under § 368 (a), the transaction must be evaluated under relevant provisions of law, including the step transaction doctrine. In this case, because T was completely liquidated, the § 1.368-2 (k) safe harbor exception from the application of the step transaction doctrine does not apply. Accordingly, the Acquisition Merger and the Liquidation may not be considered independently of each other for purposes of determining whether the transaction satisfies the statutory requirements of a reorganization described in § 368 (a) (1) (A) by reason of § 368 (a) (2) (E). As such, this transaction does not qualify as a reorganization described in § 368 (a) (1) (A) by reason of § 368 (a) (2) (E) because, after the transaction, T does not hold substantially all of its properties and the properties of the merged corporation.

In determining whether the transaction is a reorganization, the approach reflected in Rev. Rul. 67-274 and Rev. Rul. 2001-46 is applied to ignore P’s acquisition of the T stock in the Acquisition Merger and to treat the transaction as a direct acquisition by P of T’s assets in exchange for 10x dollars in cash, 90x dollars worth of P voting stock, and the assumption of T’s liabilities.

However, unlike the transactions considered in Rev. Rul. 67-274, 72-405 and 2001-46, a direct acquisition by P of T’s assets in this case does not qualify as a reorganization under § 368 (a). P’s acquisition of T’s assets is not a reorganization described in § 368 (a) (1) (C) because the consideration exchanged is not solely P voting stock and the requirements of § 368 (a) (2) (B) are not satisfied. Section 368 (a) (2) (B) would treat P as acquiring 40 percent of T’s assets for consideration other than P voting stock (liabilities assumed of 50x dollars, plus 1 0x dollars cash). See Rev. Rul. 73-102, 1973-1 C.B. 186 (analyzing the application of § 368 (a) (2) (B)). P’s acquisition of T’s assets is not a reorganization described in § 368 (a) (1) (D) because neither T nor A (nor a combination thereof) was in control of P (within the meaning of § 368 (a) (2) (H) (i)) immediately after the transfer. Additionally, the transaction is not a reorganization under § 368 (a) (1) (A) because T did not merge into P. Accordingly, the overall transaction is not a reorganization under § 368 (a).

Additionally, P’s acquisition of the T stock in the Acquisition Merger is not a transaction to which § 351 applies because A does not control P (within the meaning of § 368 (c)) immediately after the exchange.

Rev. Rul. 90-95 and § 1.338-3 (d) reject the step integration approach reflected in Rev. Rul. 67-274 where the application of that approach would treat the purchase of a target corporation’s stock without a § 338 election followed by the liquidation or merger of the target corporation as the purchase of the target corporation’s assets resulting in a cost basis in the assets under § 1012. Rev. Rul. 90-95 and § 1.338-3 (d) treat the acquisition of the stock of the target corporation as a qualified stock purchase followed by a separate carryover basis transaction in order to preclude any nonstatutory treatment of the steps as an integrated asset purchase.

In this case, further application of the approach reflected in Rev. Rul. 67-274, integrating

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the acquisition of T stock with the liquidation of T, would result in treating the acquisition of T stock as a taxable purchase of T's assets. Such treatment would violate the policy underlying § 338 that a cost basis in acquired assets should not be obtained through the purchase of stock where no § 338 election is made. Accordingly, consistent with the analysis set forth in Rev. Rul. 90-95, the acquisition of the stock of T is treated as a qualified stock purchase by P followed by the liquidation of T into P under § 332.

HOLDING

The transaction is not a reorganization under § 368 (a). The Acquisition Merger is a qualified stock purchase by P of the stock of T under § 338 (d) (3). The Liquidation is a complete liquidation of a controlled subsidiary under § 332.

PROSPECTIVE APPLICATION

The Service will consider the application of § 7805 (b) on a case-by-case basis.

DRAFTING INFORMATION * * *

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IX. CHAPTER 9, SPIN-OFFS UNDER SECTION 355 AND THEIR USE IN ACQUISITIONS

A. Page 609, New Sec. 9.3.B.7. Modification of the Active Trade or Business Test by the 2006 Act

Page 609, New Sec. 9.3.B.7. Add before Sec. 9.3.C the following:
New Sec. 9.3.B.7. **Modification of the Active Trade or Business Test by the 2006 Act. *See* § 355(b)(3)**

AMENDMENTS TO SECTION 355 BY THE TAX INCREASE PREVENTION AND RECONCILIATION ACT OF 2005 ("TIPRA") AND SIGNED INTO LAW ON MAY 10 2006

Act Sec. 202. Modifications to rules relating to taxation of distributions of stock and securities of a controlled corporation

House Committee Report (H.R. REP. NO. 109-304)

Present Law

A corporation generally is required to recognize gain on the distribution of property (including stock of a subsidiary) to its shareholders as if such property had been sold for its fair market value. An exception to this rule applies if the distribution of the stock of a controlled corporation satisfies the requirements of section 355 of the Code. To qualify for tax-free treatment under section 355, both the distributing corporation and the controlled corporation must be engaged immediately after the distribution in the active conduct of a trade or business that has been conducted for at least five years and was not acquired in a taxable transaction during that period.[1] For this purpose, a corporation is engaged in the active conduct of a trade or business only if (1) the corporation is directly engaged in the active conduct of a trade or business, or (2) the corporation is not directly engaged in an active business, but substantially all of its assets consist of stock and securities of a corporation it controls that is engaged in the active conduct of a trade or business.[2]

In determining whether a corporation is directly engaged in an active trade or business that satisfies the requirement, old IRS guidelines for advance ruling purposes required that the value of the gross assets of the trade or business being relied on must ordinarily

1 Section 355(b).

2 Section 355(b)(2)(A).

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constitute at least five percent of the total fair market value of the gross assets of the corporation directly conducting the trade or business.[3] More recently, the IRS has suspended this specific rule in connection with its general administrative practice of moving IRS resources away from advance rulings on factual aspects of section 355 transactions in general.[4]

If the distributing or controlled corporation is not directly engaged in an active trade or business, then the IRS takes the position that the "substantially all" test requires that at least 90 percent of the fair market value of the corporation's gross assets consist of stock and securities of a controlled corporation that is engaged in the active conduct of a trade or business.[5]

Reasons for Change

Prior to a spin-off under section 355 of the Code, corporate groups that have conducted business in separate corporate entities often must undergo elaborate restructurings to place active businesses in the proper entities to satisfy the five-year active business requirement. If the top-tier corporation of a chain that is being spun off or retained is a holding company, then the requirements regarding the activities of its subsidiaries are more stringent than if the top-tier corporation itself engaged in some active business. The Committee believes that it is appropriate to simplify planning for corporate groups that use a holding company structure to engage in distributions that qualify for tax-free treatment under section 355.

Explanation of Provision

Under the bill, the active business test is determined by reference to the relevant affiliated group. For the distributing corporation, the relevant affiliated group consists of the distributing corporation as the common parent and all corporations affiliated with the distributing corporation through stock ownership described in section 1504(a)(1)(B) (regardless of whether the corporations are includible corporations under section 1504(b)), immediately after the distribution. The relevant affiliated group for a controlled corporation is determined in a similar manner (with the controlled corporation as the common parent).

Conference Committee Report (H.R. CONF. REP. NO. 109-455)

Senate Amendment

3 Rev. Proc. 2003-3, sec. 4.01(30), 2003-1 I.R.B. 113.

4 Rev. Proc. 2003-48, 2003-29 I.R.B. 86.

5 Rev. Proc. 96-30, sec. 4.03(5), 1996-1 C.B. 696; Rev. Proc. 77-37, sec. 3.04, 1977-2 C.B. 568.

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The Senate amendment provision is the same as the House bill with respect to the House bill provision described above, except for the date on which that provision sunsets.[6]

* * *

Conference Agreement

The conference agreement includes the House bill and the Senate amendment with modifications.

With respect to the provision that applies the active business test by reference to the relevant affiliated group, the conference agreement provision is the same as the House bill and the Senate amendment except for the date on which the conference agreement provision sunsets.[7]

* * *

Effective Date

The starting effective date of the provision that applies the active business test by reference to the relevant affiliated group is the same as that of the House bill and the Senate amendment provisions. The conference agreement changes the date on which the provision sunsets so that the provision does not apply for distributions (or for acquisitions, dispositions, or other restructurings as relating to continuing qualification of pre-effective date distributions) occurring after December 31, 2010.

* * *

B. Page 609, New Sec. 9.3.B.8. The "Hot Stock" Temporary Regulations

Page 609, New Sec. 9.3.B.8. Add after New Sec. 9.3.B.7 the following:
New Sec. 9.3.B.8. **The "Hot Stock" Temporary Regulations**

Temporary Regulations on Hot Stock
Treasury Decision 9435, December 15, 2008

6 See "Effective date" for the Senate Amendment, infra.

7 See "Effective date" of the conference agreement provision, infra.

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SUMMARY: This document contains final and temporary regulations that provide guidance regarding the distribution of stock of a controlled corporation acquired in a transaction described in section 355(a)(3)(B) of the Internal Revenue Code (Code). This action is necessary in light of amendments to section 355(b). These temporary regulations will affect corporations and their shareholders. The text of these temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in the Proposed Rules section in this issue of the Federal Register. * * *

Background

Section 355 provides the rules for tax-free distributions of the stock of certain controlled corporations. Since 2006 Congress has enacted several amendments to section 355. See sections 202 and 507 of the Tax Increase Prevention and Reconciliation Act of 2005, Public Law 109-222 (120 Stat. 345); Division A, Section 410 of the Tax Relief and Health Care Act of 2006, Public Law 109-432 (120 Stat. 2922, 2963); Section 4(b) of the Tax Technical Corrections Act of 2007, Public Law 110-172 (121 Stat. 2473, 2476) (Technical Corrections). Furthermore, the IRS and Treasury Department have issued proposed section 1.355-3 (72 FR 26012 (May 8, 2007), 2007-23 IRB 1357), which would provide guidance regarding satisfaction of the active trade or business (ATB) requirement of section 355(b).

Section 355(a) provides that, under certain circumstances, a corporation may distribute stock and securities in a corporation it controls to its shareholders and security holders without causing either the distributing corporation (distributing) or its shareholders and security holders to recognize income, gain, or loss. For this purpose, control is defined under section 368(c).

Sections 355(a)(1)(C) and 355(b)(1) generally require that distributing and the controlled corporation (controlled) each be engaged, immediately after the distribution, in the active conduct of a trade or business. Section 355(b)(2)(A) provides that a corporation shall be treated as engaged in the active conduct of a trade or business if and only if it is engaged in the active conduct of a trade or business.

Section 355(b)(2)(B) requires that the trade or business have been actively conducted throughout the five-year period ending on the date of the distribution (pre-distribution period). Section 355(b)(2)(C) provides that the trade or business must not have been acquired in a transaction in which gain or loss was recognized, in whole or in part (taxable transaction or taxable acquisition), within the pre-distribution period. Section 355(b)(2)(D) provides that control of a corporation that (at the time of acquisition of control) was conducting the trade or business must not have been directly or indirectly acquired by any distributee corporation or by distributing during the pre-distribution period in a taxable transaction. For purposes of section 355(b)(2)(D), all distributee corporations that are members of the same affiliated group (as defined in section 1504(a) without regard to section 1504(b)) shall be treated as one distributee corporation.

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Section 355(b)(3)(A) provides that for purposes of determining whether a corporation meets the requirements of section 355(b)(2)(A), all members of such corporation's separate affiliated group (SAG) shall be treated as one corporation. Section 355(b)(3)(B) provides that for purposes of section 355(b)(3), the term SAG means, with respect to any corporation, the affiliated group that would be determined under section 1504(a) if such corporation were the common parent and section 1504(b) did not apply. Section 355(b)(3)(C) provides that if a corporation became a SAG member as a result of one or more taxable transactions, any trade or business conducted by such corporation (at the time that such corporation became such a member) shall be treated for purposes of section 355(b)(2) as acquired in a taxable transaction. Section 355(b)(3)(A) through (C) are collectively referred to in this preamble as the SAG regime. In addition, for purposes of this preamble, the term DSAG means the SAG of which distributing is the common parent, CSAG means the SAG of which controlled is the common parent, and generally the "SAG" of a corporation means the SAG of which such corporation is the common parent. In addition, throughout this preamble, references to DSAG and CSAG include a reference to distributing and controlled, respectively, where such respective corporation is not the common parent of a SAG (for example, such corporation has no subsidiaries).

Section 355(a)(3)(B) provides that for purposes of section 355 (other than section 355(a)(1)(D)) and so much of section 356 as relates to section 355, stock of controlled acquired by distributing by reason of any transaction (i) which occurs within five years of the distribution of such stock, and (ii) which is a taxable transaction, shall not be treated as stock of controlled, but as other property (hot stock rule). Stock treated as other property under section 355(a)(3)(B) is referred to in this preamble as hot stock.

Section 1.355-2(g) (as applied prior to the applicability of these temporary regulations) (former section 1.355-2(g)) provides that for purposes of section 355(a)(1)(A), stock of controlled acquired in a taxable transaction (other than a transaction described in section 1.355-3(b)(4)(iii)) within the pre-distribution period shall not be treated as stock of controlled but shall be treated as "other property." However, for purposes of section 355(a)(1)(D), the stock so acquired is stock of controlled.

Section 355(b)(3)(D) provides that the Secretary shall prescribe such regulations as are necessary or appropriate to carry out the purposes of section 355(b)(3), including regulations that provide for the proper application of section 355(b)(2)(B), (C), and (D), and modify the application of section 355(a)(3)(B), in connection with the application of section 355(b)(3). Pursuant to this grant of authority, these temporary regulations modify the application of section 355(a)(3)(B) in order to harmonize the hot stock rule and section 355(b).

Explanation of Provisions

1. Hot Stock Rule Inapplicable Where Controlled is a DSAG Member

Congress enacted section 355(b)(3) because it was concerned that, prior to a distribution

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under section 355, corporate groups conducting business in separate corporate entities often had to undergo elaborate restructurings to place active businesses in the proper entities to satisfy the ATB requirement. See, for example, H.R. Rep. No. 109-304, at 53, 54 (2005). The effect of section 355(b)(3) is to treat a corporation's SAG as a single corporation for purposes of the ATB requirement. Consistent with this treatment, Congress enacted the Technical Corrections to clarify:

> that if a corporation became a member of a separate affiliated group as a result of one or more transactions in which gain or loss was recognized in whole or in part, any trade or business conducted by such corporation (at the time that such corporation became such a member) is treated for purposes of section 355(b)(2) as acquired in a transaction in which gain or loss was recognized in whole or in part. Accordingly, such an acquisition is subject to the provisions of section 355(b)(2)(C), and may qualify as an expansion of an existing active trade or business conducted by the distributing corporation or the controlled corporation, as the case may be.
>
> The provision clarifies that the Treasury Department shall prescribe regulations that provide for the proper application of sections 355(b)(2)(B), (C), and (D) in the case of any corporation that is tested for active business under the separate affiliated group rule, and that modify the application of section 355(a)(3)(B) in the case of such a corporation in a manner consistent with the purposes of the provision.

153 Cong. Rec. S16057 (daily ed. Dec. 19, 2007) (Joint Committee on Taxation's explanation of H.R. 4839, which explanation was printed in the Congressional Record at the request of Senator Baucus, who stated that the explanation expressed the Senate Finance Committee's understanding of the bill).

Accordingly, the SAG regime affords a group a certain amount of flexibility regarding the satisfaction of the ATB requirement. For example, Congress indicated that, for purposes of section 355(b), in certain circumstances a stock acquisition will be treated in a manner comparable to an asset acquisition and, as such, may constitute an expansion of an existing trade or business. The IRS and Treasury Department have further interpreted the SAG regime to disregard acquisitions of additional stock of a current subsidiary SAG member for purposes of satisfying the ATB requirement. See proposed section 1.355-3(b)(1)(ii).

Although the SAG regime is not applicable for purposes of section 355(a)(3)(B), the Technical Corrections provide a specific grant of regulatory authority indicating that the application of the hot stock rule may be modified to apply in a manner consistent with the SAG regime of section 355(b)(3). Toward that end, these temporary regulations reflect the fundamental conclusion that the hot stock rule should not apply to any acquisition of

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stock of controlled where controlled is a DSAG member at any time after the acquisition (but prior to the distribution of controlled).

Such a conclusion resolves conflicts that would otherwise arise under section 355(a)(3)(B) and section 355(b). For example, suppose distributing acquired all of controlled's stock in a taxable transaction that qualified as an expansion of distributing's existing trade or business under the SAG regime, and later distributed all such stock within five years of the acquisition in an unrelated transaction. The distribution would satisfy the ATB requirement but, absent the rule reflected in these temporary regulations, could otherwise be fully taxable under the hot stock rule. Such a result seems inconsistent with Congressional intent. Similarly, to achieve consistency with the SAG regime, if controlled is a DSAG member and distributing acquires additional controlled stock, such acquisition should be disregarded for purposes of section 355(a)(3)(B).

Therefore, these temporary regulations generally provide that controlled stock acquired by the DSAG within the pre-distribution period in a taxable transaction constitutes hot stock, except if controlled is a DSAG member at any time after the acquisition (but prior to the distribution of controlled). Accordingly, each of Rev. Rul. 76-54 (1976-1 CB 96) and Rev. Rul. 65-286 (1965-2 CB 92) is obsolete.

2. Transfers Among DSAG Members

Consistent with the SAG regime, which treats the DSAG as a single corporation, transfers of controlled stock owned by DSAG members immediately before and immediately after the transfer are disregarded and are not treated as acquisitions for purposes of the hot stock rule. Compare proposed section 1.355-3(b)(1)(ii) (applying a similar rule for purposes of the ATB requirement).

3. Hot Stock Rule Inapplicable to Acquisitions from Certain Affiliates

Former section 1.355-2(g) provided that the hot stock rule did not apply to acquisitions of controlled stock in a transaction described in section 1.355-3(b)(4)(iii) (affiliate exception). In other words, former section 1.355-2(g) generally exempted from the hot stock rule an acquisition of controlled stock by distributing from a member of the affiliated group (as defined in section 1.355-3(b)(4)(iv)) of which distributing was a member. Compare Notice 2007-60, 2007-2 CB 466 (IRS will not challenge applicability of section 1.355-3(b)(4)(iii) to distributions effected on or before date temporary or final regulations modifying section 1.355-3(b)(4)(iii) are published). These temporary regulations retain the affiliate exception of former section 1.355-2(g) (including its treatment of stock described in section 1504(a)(4)). The IRS and Treasury Department, however, continue to study what impact transfers between affiliates should have on the satisfaction of the ATB requirement and the application of the hot stock rule and believe that, when finalized, the rules regarding the ATB requirement and the hot stock rule should generally be applied consistently with respect to transactions between affiliates.

4. Future Guidance Under Section 355(a)(3)(B)

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The IRS and Treasury Department are considering issuing additional guidance under section 355(a)(3)(B), as described in this section 4 of the preamble. Such guidance would be in addition to, rather than in replacement of, these temporary regulations. In the Proposed Rules section in this issue of the Federal Register (REG-150670-07), comments are requested regarding these temporary regulations and the issues described in this preamble.

A. Dunn Trust and Predecessor Issues

Section 355(a)(3)(B) applies to controlled stock acquired by reason of any transaction during the pre-distribution period in which gain or loss is recognized in whole or in part. The primary types of transactions for which the IRS and Treasury Department are considering issuing additional guidance generally involve the effect of indirect acquisitions and the extent to which predecessor rules should apply for purposes of the hot stock rule. Although the IRS and Treasury Department are considering addressing in future guidance the issues arising in transactions described in this section 4.A. of the preamble, no inference should be drawn regarding the present application of section 355(a)(3)(B), including these temporary regulations, to such transactions.

For example, future guidance may address whether, in a situation where a corporation that owns controlled stock joins the DSAG in a taxable transaction, the DSAG is treated as acquiring the controlled stock in a taxable transaction. Compare section 355(b)(3)(B); proposed section 1.355-3(b)(1)(ii) and (b)(4)(i). Similarly, guidance may address the treatment of taxable acquisitions of controlled stock during the pre-distribution period by a corporation that subsequently joins the DSAG in a nontaxable transaction.

The IRS and Treasury Department are also considering issuing additional guidance that treats the DSAG as making any acquisition made by a predecessor of a DSAG member. Compare H.R. Rep. No. 83-2543, at 38 (1954) (Conf. Rep.) ("by reason of" language of section 355(a)(3)(B) encompasses purchase of controlled stock by a corporation that is in control of distributing prior to "downstairs merger" by such purchaser into distributing). For this purpose, a predecessor of a corporation would be a corporation that transfers its assets to such corporation in a transaction to which section 381(a) applies. Such guidance would address the circumstances in which a predecessor of distributing (or predecessor of a DSAG member) effects an acquisition of controlled stock described in section 355(a)(3)(B).

Additionally, if a DSAG acquires stock of a corporation (target) during the pre-distribution period in a taxable transaction and such target is subsequently acquired by controlled in a section 381(a) transaction, the earlier taxable acquisition of target stock may implicate section 355(a)(3)(B). A conceptually similar issue was addressed in Dunn Trust v. Commissioner, 86 T.C. 745 (1986), acq. (1998-1 CB 5 n. 4 (acquiescing in result only)), except that in Dunn Trust the target that was acquired by distributing was not subsequently acquired by controlled in a section 381(a) transaction. Instead, in Dunn Trust, distributing acquired stock of target in a taxable transaction and subsequently

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contributed such target stock (which stock could not have been distributed without violating section 355(a)(3)(B)) to controlled in exchange for controlled stock in a nontaxable transaction. The Tax Court ruled that the controlled stock was not hot stock under section 355(a)(3)(B). Where distributing acquires target stock in a taxable transaction, and the target is subsequently either combined with controlled in a nontaxable section 381(a) transaction or (as in Dunn Trust) acquired by controlled in a nontaxable stock acquisition, the IRS and Treasury Department believe that such acquisitions raise an issue as to whether target or controlled is the "real controlled" for purposes of section 355(a)(3)(B).

Identifying the "real controlled" might be illustrated by the following example. Assume that distributing owns an amount of stock in controlled that constitutes control within the meaning of section 368(c) but which does not meet the requirements of section 1504(a)(2). Controlled, in turn, owns stock of a target subsidiary that satisfies the requirements of section 1504(a)(2). Distributing acquires additional target stock in a taxable transaction, which stock is then contributed to controlled in exchange for additional controlled stock in a transaction to which section 351(a) applies. Assume that neither controlled nor target joins the DSAG after either step. The question under section 355(a)(3)(B) is whether a target whose stock is acquired by the DSAG in a taxable transaction should be treated as the "real controlled", where such additional target stock is subsequently acquired by the actual controlled (or, in some cases, a CSAG member) in a nontaxable transaction. The IRS and Treasury Department are considering issuing guidance that would provide that a target whose stock is acquired by distributing in a taxable transaction may be treated as the "real controlled" for purposes of section 355(a)(3)(B) if, at the time of the distribution, the CSAG cannot satisfy the requirements of section 355(b) without taking into account an ATB conducted by the target at the time the DSAG acquired the stock of the target in the taxable transaction. In other words, section 355(a)(3)(B) could be implicated as a result of an acquisition of target stock if the target is engaged in an ATB at the time the DSAG acquires the target stock in a taxable transaction, the target stock is then acquired by controlled (or, in some cases, a CSAG member) prior to the distribution, and at the time of the distribution of the controlled stock the CSAG is not able to satisfy the requirements of section 355(b) without taking into account an ATB that was being conducted by the target at the time the DSAG acquired the target stock in the taxable transaction.

B. Issuances of controlled stock outside the Dunn Trust or predecessor context

The IRS and Treasury Department are considering additional guidance that would generally provide that issuances of controlled stock by controlled to distributing in a taxable transaction do not give rise to hot stock. For example, such an acquisition may occur where section 357(c) applies (see Rev. Rul. 78-442, (1978-2 CB 143) (distributing transfers a business to wholly-owned controlled, which assumes distributing's liabilities)). As noted in Rev. Rul. 78-442, the IRS and Treasury Department believe that section 355(b)(2)(C) was not intended to apply to such an acquisition of a trade or business by controlled from distributing under the facts of that ruling even if it is a taxable transaction because the acquisition was not from an "outside party". "[F]or the same reasons, section

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355(a)(3)[(B)] . . . is not applicable to the distribution" of controlled stock acquired in such a transaction.

The IRS and Treasury Department request comments regarding the extent to which issuances by controlled of controlled stock to distributing in taxable transactions should not give rise to hot stock, whether distributing must own some minimum percentage in controlled at the time of such issuance in order for such an acquisition to be excepted from section 355(a)(3)(B), and the extent to which such transactions are adequately addressed under section 355(a)(1)(B) (relating to device) and section 355(g) (relating to distributions involving disqualified investment corporations).

C. Redemptions of controlled stock

Finally, the IRS and Treasury Department request comments regarding the effect of redemptions of controlled stock under section 355(a)(3)(B). Generally, if the controlled shares distributed by distributing were not acquired by distributing during the pre-distribution period, such shares cannot be hot stock. Therefore, a redemption by controlled of its stock from unrelated parties generally should not cause any portion of distributing's controlled stock to become hot stock. Such a rule may be distinguishable from the rule under section 355(b)(2)(D). See McLaulin v. Commissioner, 276 F.3d 1269 (11th Cir. 2001) (applying section 355(b)(2)(D) when distributing acquired control of a subsidiary through a redemption of subsidiary stock), and Rev. Rul. 57-144 (1957-1 CB 123) (same).

The distinction can be made based on the different focus of the provisions. Section 355(a)(3)(B) provides that controlled stock "acquired by the distributing corporation" during the pre-distribution period in a taxable transaction is hot stock, and is directed at the property distributed to the distributing shareholders. In a redemption, generally no additional shares of stock are acquired by distributing, and generally no additional value is distributed to the distributing shareholders. In contrast, section 355(b)(2)(D) prohibits the acquisition of "control of a corporation." Control is a requisite status in order for distributing to distribute the stock of controlled to its shareholders under section 355. A redemption can confer this status on distributing without distributing's acquiring any additional shares of stock.

However, for purposes of section 355(a)(3)(B), the IRS and Treasury Department believe that a redemption of controlled stock from a shareholder other than distributing is the equivalent of distributing's purchase of controlled stock from the redeemed shareholder to the extent distributing is the source of funds for the redemption. Further, the IRS and Treasury Department are studying whether there are other situations in which distributing's increased percentage ownership in controlled resulting from redemptions of controlled stock from a shareholder other than distributing should be treated as hot stock.

5. Request for Comments

In the Proposed Rules section in this issue of the Federal Register (REG-150670-07), the

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IRS and Treasury Department are requesting comments regarding these temporary regulations, including comments on whether section 355(a)(3)(B) should use the same definition of taxable transaction as section 355(b), whether the exception for acquisitions from certain affiliates should be the same for both provisions, and the other issues described in this preamble.

Effective/Applicability Date

These temporary regulations are generally applicable for distributions occurring after December 15, 2008. However, unless taxpayers elect otherwise, these temporary regulations do not apply to any distribution occurring after December 15, 2008 that is pursuant to a transaction which is (1) made pursuant to an agreement which was binding on December 15, 2008,and at all times thereafter; (2) described in a ruling request submitted to the IRS on or before such date; or (3) described on or before such date in a public announcement or in a filing with the Securities and Exchange Commission. Furthermore, taxpayers may elect to apply these temporary regulations retroactively to distributions to which section 4(b) of the Technical Corrections applies (generally to distributions occurring after May 17, 2006).

Effect on Other Documents

The following publications are obsolete as of the applicability of these temporary regulations:

Rev. Rul. 76-54 (1976-1 CB 96).

Rev. Rul. 65-286 (1965-2 CB 92). * * *

C. Page 609, New Sec. 9.3.B.9. Treatment of Disqualified Investment Companies under the 2006 Act

Page 609, New Sec. 9.3.B.9. Add after New Sec. 9.3.B.8 the following:
New Sec. 9.3.B.9. **Treatment of Disqualified Investment Companies under the 2006 Act. *See* § 355(g)**

Amendments to Section 355 by the Tax Increase Prevention and Reconciliation Act Of 2005 ("TIPRA") and Signed into Law on May 10 2006

Act Sec. 507. Modifications to rules relating to taxation of distributions of stock and securities of a controlled corporation

Conference Committee Report (H.R. CONF. REP. NO. 109-455)

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Present Law

A corporation generally is required to recognize gain on the distribution of property (including stock of a subsidiary) to its shareholders as if the corporation had sold such property for its fair market value. In addition, the shareholders receiving the distributed property are ordinarily treated as receiving a dividend of the value of the distribution (to the extent of the distributing corporation's earnings and profits), or capital gain in the case of a stock buyback that significantly reduces the shareholder's interest in the parent corporation.

An exception to these rules applies if the distribution of the stock of a controlled corporation satisfies the requirements of section 355 of the Code. If all the requirements are satisfied, there is no tax to the distributing corporation or to the shareholders on the distribution.

One requirement to qualify for tax-free treatment under section 355 is that both the distributing corporation and the controlled corporation must be engaged immediately after the distribution in the active conduct of a trade or business that has been conducted for at least five years and was not acquired in a taxable transaction during that period (the "active business test").[8] For this purpose, a corporation is engaged in the active conduct of a trade or business only if (1) the corporation is directly engaged in the active conduct of a trade or business, or (2) the corporation is not directly engaged in an active business, but substantially all its assets consist of stock and securities of one or more corporations that it controls that are engaged in the active conduct of a trade or business.[9]

In determining whether a corporation is directly engaged in an active trade or business that satisfies the requirement, old IRS guidelines for advance ruling purposes required that the value of the gross assets of the trade or business being relied on must ordinarily constitute at least five percent of the total fair market value of the gross assets of the corporation directly conducting the trade or business.[10] More recently, the IRS has suspended this specific rule in connection with its general administrative practice of moving IRS resources away from advance rulings on factual aspects of section 355 transactions in general.[11]

If the distributing or controlled corporation is not directly engaged in an active trade or business, then the IRS takes the position that the "substantially all" test as applied to that

8 Section 355(b).

9 Section 355(b)(2)(A). The IRS takes the position that the statutory test requires that at least 90 percent of the fair market value of the corporation's gross assets consist of stock and securities of a controlled corporation that is engaged in the active conduct of a trade or business. Rev. Proc. 96-30, sec. 4.03(5), 1996-1 C.B. 696; Rev. Proc. 77-37, sec. 3.04, 1977-2 C.B. 568.

10 Rev. Proc. 2003-3, sec. 4.01(30), 2003-1 I.R.B. 113.

11 Rev. Proc. 2003-48, 2003-29 I.R.B. 86.

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corporation requires that at least 90 percent of the fair market value of the corporation's gross assets consist of stock and securities of a controlled corporation that is engaged in the active conduct of a trade or business.[12]

In determining whether assets are part of a five-year qualifying active business, assets acquired more recently than five years prior to the distribution, in a taxable transaction, are permitted to qualify as five-year "active business" assets if they are considered to have been acquired as part of an expansion of an existing business that does so qualify.[13]

When a corporation holds an interest in a partnership, IRS revenue rulings have allowed an active business of the partnership to count as an active business of a corporate partner in certain circumstances. One such case involved a situation in which the corporation owned at least 20 percent of the partnership, was actively engaged in management of the partnership, and the partnership itself had an active business.[14]

In addition to its active business requirements, section 355 does not apply to any transaction that is a "device" for the distribution of earnings and profits to a shareholder without the payment of tax on a dividend. A transaction is ordinarily not considered a "device" to avoid dividend tax if the distribution would have been treated by the shareholder as a redemption that was a sale or exchange of its stock, rather than as a dividend, if section 355 had not applied. [15]

* * *

Senate Amendment

* * *

In addition, the Senate amendment contains another provision that denies section 355 treatment if either the distributing or distributed corporation is a disqualified investment corporation immediately after the transaction (including any series of related transactions) and any person that did not hold 50 percent or more of the voting power or value of stock of such distributing or controlled corporation immediately before the transaction does hold a such a 50 percent or greater interest immediately after such transaction. The attribution rules of section 318 apply for purposes of this determination.

A disqualified investment corporation is any distributing or controlled corporation if the fair market value of the investment assets of the corporation is 75 percent or more of

12 Rev. Proc. 96-30, sec. 4.03(5), 1996-1 C.B. 696; Rev. Proc. 77-37, sec. 3.04, 1977-2 C.B. 568.

13 Treas. Reg. sec. 1.355-3(b)(ii).

14 Rev. Rul. 92-17, 1002-1 C.B. 142; see also, Rev. Rul. 2002-49, 2002-2 C.B. 50.

15 Treas, Reg, sec, 1.355-2(d)(5)(iv).

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the fair market value of all assets of the corporation. Except as otherwise provided, the term “investment assets” for this purpose means (i) cash, (ii) any stock or securities in a corporation, (iii) any interest in a partnership, (iv) any debt instrument or other evidence of indebtedness; (v) any option, forward or futures contract, notional principal contract, or derivative; (vi) foreign currency, or (vii) any similar asset.

The term “investment assets” does not include any asset which is held for use in the active and regular conduct of (i) a lending or finance business (as defined in section 954(h)(4)); (ii) a banking business through a bank (as defined in section 581), a domestic building and loan association (within the meaning of section 7701(a)(19), or any similar institution specified by the Secretary; or (iii) an insurance business if the conduct of the business is licensed, authorized, or regulated by an applicable insurance regulatory body. These exceptions only apply with respect to any business if substantially all the income of the business is derived from persons who are not related (within the meaning of section 267(b) or 707(b)(1) to the person conducting the business.

The term “investment assets” also does not include any security (as defined in section 475(c)(2)) which is held by a dealer in securities and to which section 475(a) applies.

The term “investment assets” also does not include any stock or securities in, or any debt instrument, evidence of indebtedness, option, forward or futures contract, notional principal contract, or derivative issued by, a corporation which is a 25-percent controlled entity with respect to the distributing or controlled corporation. Instead, the distributing or controlled corporation is treated as owning its ratable share of the assets of any 25-percent controlled entity.

The term 25-percent controlled entity means any corporation with respect to which the corporation in question (distributing or controlled) owns directly or indirectly stock possessing at least 25 percent of voting power and value, excluding stock that is not entitled to vote, is limited and preferred as to dividends and does not participate in corporate growth to any significant extent, has redemption and liquidation rights which do not exceed the issue price of such stock (except for a reasonable redemption or liquidation premium), and is not convertible into another class of stock.

The term “investment assets” also does not include any interest in a partnership, or any debt instrument or other evidence of indebtedness issued by the partnership, if one or more trades or businesses of the partnership are, (or without regard to the 5-year requirement of section 355(b)(2)(B), would be) taken into account by the distributing or controlled corporation, as the case may be, in determining whether the active business test of section 355 is met by such corporation.

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The Treasury department shall provide regulations as may be necessary to carry out, or prevent the avoidance of, the purposes of the provision, including regulations in cases involving related persons, intermediaries, pass-through entities, or other arrangements; and the treatment of assets unrelated to the trade or business of a corporation as investment assets if, prior to the distribution, investment assets were used to acquire such assets. Regulations may also in appropriate cases exclude from the application of the provision a distribution which does not have the character of a redemption and which would be treated as a sale or exchange under section 302, and may modify the application of the attribution rules.

Conference Agreement

The conference agreement includes the House bill and the Senate amendment with modifications.

* * *

With respect to the provision that affects transactions involving disqualified investment corporations, the conference agreement reduces the percentage of investment assets of a corporation that will cause such corporation to be a disqualified investment corporation, from 75 percent (three-quarters) to two-thirds of the fair market value of the corporation's assets, for distributions occurring after one year after the date of enactment.

The conference agreement also reduces from 25 percent to 20 percent the percentage stock ownership in a corporation that will cause such ownership to be disregarded as an investment asset itself, instead requiring "look-through" to the ratable share of the underlying assets of such corporation attributable to such stock ownership.

The conferees wish to clarify that the disqualified investment corporation provision applies when a person directly or indirectly holds 50 percent of either the vote or the value of a company immediately following a distribution, and such person did not hold such 50 percent interest directly or indirectly prior to the distribution. As one example, the provision applies if a person that held 50 percent or more of the vote, but not of the value, of a distributing corporation immediately prior to a transaction in which a controlled corporation that was 100 percent owned by that distributing corporation is distributed, directly or indirectly holds 50 percent of the value of either the distributing or controlled corporation immediately following such transaction.

The conferees further wish to clarify that the enumeration in subsection 355(g)(5)(A) through (C) of specific situations that Treasury regulations may address is not intended to restrict or limit any other situations that Treasury may address under the general authority

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of new section 355(g)(5) to carry out, or prevent the avoidance of, the purposes of the disqualified investment corporation provision.

Effective Date

* * *

The effective date of the provision that affects transactions involving disqualified investment corporations is the same as that of the Senate amendment provision, except for the conference agreement reduction in the amount of investment assets of a corporation that will cause it to be a disqualified investment corporation, from three-quarters to two thirds of the fair market value of all assets of the corporation. The two-thirds test applies for distributions occurring after one year after the date of enactment.

D. Page 652, New Sec.9.6.F.1.e. Preamble to Final Regulations Under Section 355(e)

Page 652, New Sec. 9.6.F.1.e. Add before Sec. 9.6.F.2 the following:
New Sec. 9.6.F.1.e. **Preamble to Final Regulations Under Section 355(e)**

Treasury Decision 9198

April 19, 2005

Summary: This document contains final regulations under section 355(e) of the Internal Revenue Code relating to the recognition of gain on certain distributions of stock or securities of a controlled corporation in connection with an acquisition. Changes to the applicable law were made by the Taxpayer Relief Act of 1997. These regulations affect corporations and are necessary to provide them with guidance needed to comply with those changes. * * *

Background and Explanation of Provisions. This document contains amendments to 26 CFR part 1 under section 355(e) of the Internal Revenue Code (Code). Section 355(e) provides that the stock of a controlled corporation will not be qualified property under section 355(c)(2) or 361(c)(2) if the stock is distributed as "part of a plan (or series of related transactions) pursuant to which 1 or more persons acquire directly or indirectly stock representing a 50-percent or greater interest in the distributing corporation or any controlled corporation."

On April 26, 2002, temporary regulations (TD 8988) (the 2002 temporary regulations) were published in the Federal Register (67 FR 20632). The 2002 temporary regulations provide guidance concerning the interpretation of the phrase "plan (or series of related transactions)." A notice of proposed rulemaking (REG-163892-01) (the 2002 proposed regulations) cross-referencing the 2002 temporary regulations was published in the

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Federal Register for the same day (67 FR 20711).

The 2002 temporary regulations provide that whether a distribution and an acquisition are part of a plan is determined based on all the facts and circumstances and set forth a nonexclusive list of factors that are relevant in making that determination. The 2002 temporary regulations also provide that a distribution and a post-distribution acquisition not involving a public offering can be part of a plan only if there was an agreement, understanding, arrangement, or substantial negotiations regarding the acquisition or a similar acquisition at some time during the two-year period preceding the distribution (the post-distribution acquisition rule). Finally, the 2002 temporary regulations set forth seven safe harbors. The satisfaction of any one of these safe harbors confirms that a distribution and an acquisition are not part of a plan.

No public hearing was requested or held for the 2002 proposed regulations. Written and electronic comments responding to the notice of proposed rulemaking were received. After consideration of the comments, the 2002 proposed regulations are adopted as amended by this Treasury decision, and the corresponding temporary regulations are removed. The more significant comments and revisions are discussed below.

Pre-Distribution Acquisitions Not Involving a Public Offering. The 2002 temporary regulations include a safe harbor, Safe Harbor IV, that may be available for a pre-distribution acquisition. That safe harbor provides that an acquisition and a distribution that occurs more than two years after the acquisition are not part of a plan if there was no agreement, understanding, arrangement, or substantial negotiations concerning the distribution at the time of the acquisition or within six months thereafter. In addition to Safe Harbor IV, the 2002 temporary regulations identify a number of factors that are relevant in determining whether a distribution and a pre-distribution acquisition not involving a public offering are part of a plan. Among the factors tending to show that a distribution and a pre-distribution acquisition not involving a public offering are not part of a plan is the absence of discussions by the distributing corporation (Distributing) or the controlled corporation (Controlled) with the acquirer regarding a distribution during the two-year period before the acquisition (the no-discussions factor). The absence of such discussions, however, will not tend to show that a distribution and an acquisition are not part of a plan if the acquisition occurs after the date of the public announcement of the planned distribution (the public announcement restriction).

Commentators have suggested that, under the 2002 temporary regulations, it is more difficult to establish that a distribution and a pre-distribution acquisition not involving a public offering are not part of a plan than it is to establish that a distribution and a post-distribution acquisition are not part of a plan. This suggestion is based in part on the fact that the 2002 temporary regulations include the post-distribution acquisition rule for post-distribution acquisitions but no analogous rule for pre-distribution acquisitions.

Commentators have proposed extending the availability of Safe Harbor IV by reducing the period between the acquisition and the distribution from two years to one year. They have also suggested adopting a new safe harbor that would be available for acquisitions

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of Distributing that occur before a pro rata distribution. Finally, commentators have suggested that the public announcement restriction on the no-discussions factor be eliminated because a public announcement, as a practical matter, commits Distributing to attempt the distribution and, thus, is strong evidence that the distribution would have occurred regardless of the acquisition.

The IRS and Treasury Department believe that it is desirable to provide for additional bright-line rules for determining whether a distribution and a pre-distribution acquisition not involving a public offering are part of a plan. Accordingly, these final regulations amend Safe Harbor IV, add a new safe harbor for acquisitions of Distributing prior to a pro rata distribution, and amend the no-discussions factor.

Revisions to Safe Harbor IV of the 2002 Temporary Regulations. The IRS and Treasury Department generally believe that if an acquirer had no knowledge of Distributing's intention to effect a distribution and had no intention or ability to cause a distribution, a pre-distribution acquisition and a distribution should not be considered part of a plan, regardless of whether the distribution occurs more than two years after the acquisition. The IRS and Treasury Department, however, are concerned that conditioning the availability of a safe harbor on an absence of knowledge may be inadministrable and lead to uncertainty. Accordingly, these final regulations amend Safe Harbor IV of the 2002 temporary regulations to provide that a distribution and a pre-distribution acquisition not involving a public offering will not be considered part of a plan if the acquisition occurs before the first disclosure event regarding the distribution. The final regulations define a disclosure event as any communication by an officer, director, controlling shareholder, or employee of Distributing, Controlled, or a corporation related to Distributing or Controlled, or an outside advisor of any of those persons (where such advisor makes the communication on behalf of such person), regarding the distribution, or the possibility thereof, to the acquirer or any other person (other than an officer, director, controlling shareholder, or employee of Distributing, Controlled, or a corporation related to Distributing or Controlled, or an outside advisor of any of those persons).

To ensure that Safe Harbor IV of the 2002 temporary regulations is not available for acquisitions by persons who could participate in the decision to effect a distribution, these final regulations provide that Safe Harbor IV is not available for acquisitions by a person that was a controlling shareholder or a ten-percent shareholder of the acquired corporation at any time during the period beginning immediately after the acquisition and ending on the date of the distribution. The safe harbor is also unavailable if the acquisition occurs in connection with a transaction in which the aggregate acquisitions represent 20 percent or more of the stock of the acquired corporation by vote or value.

New Safe Harbor for Acquisitions Before a Pro Rata Distribution. The IRS and Treasury Department believe that acquisitions of Distributing not involving a public offering that occur before a pro rata distribution are not likely to be part of a plan including the distribution where there has been a public announcement of the distribution prior to the acquisition, there were no discussions regarding the acquisition prior to the public announcement, and the acquirer did not have the ability to participate in or influence the

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distribution decision. The facts that the distribution was publicly announced prior to discussions regarding the acquisition and that the acquisition was small in size suggest that the distribution would have occurred regardless of the acquisition. Moreover, the fact that a pre-distribution shareholder of Distributing has the same interest in both Distributing and Controlled, directly or indirectly, both immediately before and immediately after a pro rata distribution reduces the likelihood that the acquisition and the distribution were part of a plan. Accordingly, these final regulations include a new safe harbor, Safe Harbor V, that applies to acquisitions of Distributing not involving a public offering that occur prior to a pro rata distribution. That safe harbor provides that a distribution that is pro rata among the Distributing shareholders and a pre-distribution acquisition of Distributing not involving a public offering will not be considered part of a plan if the acquisition occurs after the date of a public announcement regarding the distribution and there were no discussions by Distributing or Controlled with the acquirer regarding a distribution on or before the date of the first public announcement regarding the distribution. A public announcement regarding the distribution is any communication by Distributing or Controlled regarding Distributing's intention to effect the distribution where the communication is generally available to the public. A public announcement includes, for example, a press release issued by Distributing announcing the distribution. It also includes a conversation between an officer of Distributing and stock analysts in which the officer communicates Distributing's intention to effect a distribution. New Safe Harbor V is intended to apply only to acquisitions by persons that do not have the ability to effect the distribution. Therefore, new Safe Harbor V is unavailable for acquisitions by persons that were controlling shareholders or ten-percent shareholders of Distributing at any time during the period beginning immediately after the acquisition and ending on the date of the distribution. In addition, new Safe Harbor V is unavailable if the acquisition occurs in connection with a transaction in which the aggregate acquisitions represent 20 percent or more of the stock of Distributing by vote or value.

No-Discussions Factor. As discussed above, the IRS and Treasury Department believe that the occurrence of a public announcement of a distribution before the discussion of an acquisition not involving a public offering suggests that the distribution would have occurred regardless of the acquisition. Therefore, these final regulations amend the no-discussions factor to remove the public announcement restriction.

Public Offerings. The 2002 temporary regulations distinguish between acquisitions not involving a public offering and acquisitions involving a public offering. A number of commentators have suggested that it is difficult to apply the 2002 temporary regulations to acquisitions involving public offerings and have requested (1) clarification of the definition of public offering, (2) additional safe harbors for acquisitions involving public offerings, and (3) guidance regarding when an acquisition is similar to a potential acquisition involving a public offering. These final regulations address these requests.

Definition of Public Offering. Questions have arisen regarding whether a public offering includes stock issuances that are not for cash, including stock issuances for assets or stock in tax-free reorganizations. These final regulations define an acquisition involving a public offering as a stock acquisition for cash where the terms of the acquisition are

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established by the acquired corporation (Distributing or Controlled) or the seller with the involvement of one or more investment bankers, and the potential acquirers have no opportunity to negotiate the terms of the acquisition. Under this definition, while an initial public offering and a secondary offering will be treated as public offerings, a private placement involving bilateral discussions and a stock issuance for assets or stock in a tax-free reorganization will not be treated as public offerings.

New Safe Harbor for Public Offerings. These final regulations add new Safe Harbor VI. Under new Safe Harbor VI, a distribution and an acquisition involving a public offering occurring before the distribution will not be considered part of a plan if the acquisition occurs before the first disclosure event regarding the distribution in the case of an acquisition of stock that is not listed on an established market, or before the date of the first public announcement regarding the distribution in the case of an acquisition of stock that is listed on an established market. The new safe harbor is based on the view of the IRS and Treasury Department that a public offering and a distribution are not likely to be part of a plan if the acquirers in the offering are unaware that a distribution will occur.

Similar Acquisitions Involving Public Offerings. In the plan and non-plan factors and a number of safe harbors, the 2002 temporary regulations refer to acquisitions that are similar to the actual acquisition. The 2002 temporary regulations provide that an acquisition involving a public offering may be similar to another acquisition involving a public offering even though there are changes in the terms of the stock, the class of stock being offered, the size of the offering, the timing of the offering, the price of the stock, or the participants in the offering. This provision is intended to ensure that certain changes in the terms of the offering that is intended at the time of the distribution do not prevent the distribution and the offering that actually occurs from being considered part of a plan.

Commentators have requested further guidance regarding when an acquisition will be treated as similar to another acquisition involving a public offering. The IRS and Treasury Department believe, and these final regulations provide, that more than one actual acquisition may be similar to a potential acquisition involving a public offering. However, the IRS and Treasury Department also believe, and these final regulations provide that, if there is an actual acquisition involving a public offering (the first public offering) that is the same as, or similar to, a potential acquisition involving a public offering, then another actual acquisition involving a public offering (the second public offering) cannot be similar to the potential acquisition unless the purpose of the second public offering is similar to that of the potential acquisition and occurs close in time to the first public offering. The final regulations include three new examples that illustrate the application of this rule.

Acquisitions Pursuant to Publicly Offered Options. The IRS and Treasury Department believe that, in certain cases, whether an acquisition that is pursuant to an option and a distribution are part of a plan should be determined pursuant to the rules related to acquisitions involving a public offering. In particular, suppose that, after consulting with its investment banker, Distributing issues options to acquire its stock. The options are marketed and sold through a distribution process that is similar to that utilized in a public

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offering. In these cases, the acquirer may never discuss the acquisition with Distributing. The investment banker, however, will discuss the acquisition with Distributing. Therefore, it seems more appropriate to analyze whether a distribution and an acquisition of stock pursuant to such an option are part of a plan under the rules that apply to acquisitions involving a public offering, rather than the rules that apply to acquisitions not involving a public offering. Accordingly, these final regulations provide that, if an option is issued for cash, the terms of the acquisition of the option and the terms of the option are established by the corporation the stock of which is subject to the option (Distributing or Controlled) or the writer with the involvement of one or more investment bankers, and the potential acquirers of the option have no opportunity to negotiate the terms of the acquisition of the option or the terms of the option, then an acquisition pursuant to that option will be treated as an acquisition involving a public offering occurring after a distribution if the option is exercised after the distribution or an acquisition involving a public offering occurring before the distribution if the option is exercised before the distribution. Otherwise, an acquisition pursuant to an option will be treated as an acquisition not involving a public offering.

Agreement, Understanding, or Arrangement. Throughout the 2002 temporary regulations reference is made to the phrase "agreement, understanding, or arrangement." The 2002 temporary regulations provide that whether an agreement, understanding, or arrangement exists depends on the facts and circumstances. One commentator questioned whether an agreement by a person who does not actively participate in the management of the acquired corporation should be treated as an agreement, understanding, or arrangement. The IRS and Treasury Department believe that the activities of those who have the authority to act on behalf of Distributing or Controlled as well as the activities of the controlling shareholders of Distributing and Controlled are relevant to the determination of whether a distribution and an acquisition are part of a plan. Therefore, these final regulations provide that an agreement, understanding, or arrangement generally requires either (1) an agreement, understanding, or arrangement by one or more officers or directors acting on behalf of Distributing or Controlled, by a controlling shareholder of Distributing or Controlled, or by another person with the implicit or explicit permission of one or more of such persons, with the acquirer or with a person or persons with the implicit or explicit permission of the acquirer; or (2) an agreement, understanding, or arrangement by an acquirer that is a controlling shareholder of Distributing or Controlled immediately after the acquisition that is the subject of the agreement, understanding, or arrangement, or by a person or persons with the implicit or explicit permission of such acquirer, with the transferor or with a person or persons with the implicit or explicit permission of the transferor. These final regulations also make conforming changes to the rules related to when an option will be treated as an agreement, understanding, or arrangement to acquire stock, and the definition of substantial negotiations.

Substantial Negotiations and Discussions. Under the 2002 temporary regulations, the presence or absence of "substantial negotiations" or "discussions" regarding an acquisition or a distribution is relevant to the determination of whether a distribution and an acquisition are part of a plan. The 2002 temporary regulations provide that, in the case of an acquisition other than a public offering, substantial negotiations generally require

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discussions of significant economic terms by one or more officers, directors, or controlling shareholders of Distributing or Controlled, or another person or persons with the implicit or explicit permission of one or more officers, directors, or controlling shareholders of Distributing or Controlled, with the acquirer or a person or persons with the implicit or explicit permission of the acquirer. In addition, the 2002 temporary regulations provide that (i) discussions by Distributing or Controlled generally require discussions by one or more officers, directors, or controlling shareholders of Distributing or Controlled, or another person or persons with the implicit or explicit permission of one or more officers, directors, or controlling shareholders of Distributing or Controlled; and (ii) discussions with the acquirer generally require discussions with the acquirer or a person or persons with the implicit or explicit permission of the acquirer.

Commentators have requested that final regulations clarify that, where the acquirer is a corporation, substantial negotiations and discussions must involve one or more officers, directors, or controlling shareholders of the acquirer, or another person or persons with the implicit or explicit permission of one or more of such officers, directors, or controlling shareholders. These final regulations reflect those clarifications.

Safe Harbor VI of the 2002 Temporary Regulations. Asset Reorganizations Involving Distributing or Controlled. Safe Harbor VI of the 2002 temporary regulations generally provides that if stock of Distributing or Controlled is acquired by a person in connection with such person's performance of services as an employee, director, or independent contractor for Distributing, Controlled, or a related person in a transaction to which section 83 or section 421(a) applies, the acquisition and the distribution will not be considered part of a plan. Questions have arisen regarding whether this safe harbor is available for an acquisition of Distributing or Controlled stock to which section 83 or section 421(a) applies when the acquirer performed services for a corporation other than Distributing, Controlled, or a person related to Distributing or Controlled. For example, assume that X, a corporation unrelated to Distributing and Controlled, grants A, an employee, an incentive stock option in connection with A's performance of services as an employee of X. Before A exercises the option, Distributing acquires the assets of X in a reorganization under section 368(a)(1)(A) and A's incentive stock option to acquire stock of X is substituted within the meaning of § 1.424-1(a) with an incentive stock option to acquire stock of Distributing. Commentators have asked whether Safe Harbor VI of the 2002 temporary regulations applies to A's exercise of the option to acquire stock of Distributing, even though A performed services for X rather than Distributing. These final regulations modify this safe harbor (Safe Harbor VIII of these final regulations) to ensure its availability in this and similar situations.

Disqualifying Dispositions. As described above, Safe Harbor VI of the 2002 temporary regulations may be available for acquisitions of stock in a transaction to which section 421(a) applies. In order to qualify as a transaction to which section 421(a) applies, the acquirer must satisfy the requirements of section 422(a) or section 423(a), including the holding period requirements of section 422(a)(1) or section 423(a)(1). In particular, the acquirer must not dispose of the acquired stock within two years from the date of the granting of the option or within one year after the transfer of such stock to the acquirer.

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The IRS and Treasury Department do not believe that a disposition of stock acquired pursuant to an option that otherwise satisfies the requirements of section 422 or section 423 prior to the period prescribed in section 422(a)(1) or 423(a)(1) evidences that the acquisition of stock pursuant to the option and the distribution are part of a plan. Therefore, these final regulations extend the application of Safe Harbor VI of the 2002 temporary regulations to not only transactions to which section 421(a) applies, but also transactions to which section 421(b) applies.

Safe Harbor VII of the 2002 Temporary Regulations. Safe Harbor VII of the 2002 temporary regulations generally provides that if stock of Distributing or Controlled is acquired by an employer's retirement plan that qualifies under section 401(a) or 403(a), the acquisition and the distribution will not be considered part of a plan. That safe harbor, however, does not apply to the extent that the stock acquired by all of the employer's qualified plans during the four-year period beginning two years before the distribution, in the aggregate, represents ten percent or more of the total combined voting power of all classes of stock entitled to vote, or ten percent or more of the total value of shares of all classes of stock, of the acquired corporation. Questions have arisen regarding whether this safe harbor is available at all if the acquisitions by the employer's retirement plans exceed ten percent of the acquired corporation's stock during the prescribed period.

These final regulations revise Safe Harbor VII of the 2002 temporary regulations (Safe Harbor IX of these final regulations) to clarify that, if the acquisitions by an employer's retirement plan total in excess of ten percent, the safe harbor is available for the first ten percent acquired during the prescribed period. These final regulations also revise this safe harbor to reflect that it is only available for acquisitions by a retirement plan of Distributing, Controlled, or any person that is treated as the same employer as Distributing or Controlled under section 414(b), (c), (m), or (o).

Compensatory Options. The 2002 temporary regulations include special rules that treat an option as an agreement, understanding, or arrangement to acquire the stock subject to the option on the earliest of the date the option was written, transferred, or modified, if on that date the option was more likely than not to be exercised. The 2002 temporary regulations except compensatory options from these rules. For this purpose, a compensatory option is an option to acquire stock in Distributing or Controlled with customary terms and conditions provided to a person in connection with such person's performance of services as an employee, director, or independent contractor for the corporation or a related person (and that is not excessive by reference to the services performed), provided that the transfer of stock pursuant to such option is described in section 421(a) or the option is nontransferable within the meaning of § 1.83-3(d) and does not have a readily ascertainable fair market value as defined in § 1.83-7(b).

The IRS and Treasury Department have become aware that arrangements using compensatory options have been structured to prevent an acquisition of stock from being treated as part of a plan that includes a distribution in avoidance of section 355(e). Accordingly, these final regulations revise the 2002 temporary regulations to treat

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compensatory options as options. * * *

E. Page 652, New Sec.9.6.F.3. Illustration of the Limits of Section 355(e)

Page 652, New Sec. 9.6.F.3. Add before Sec. 9.6.G the following:
New Sec. 9.6.F.3. **Illustration of the Limits of Section 355(e)**

Revenue Ruling 2005-65
2005 IRB LEXIS 362

Issue. Under the facts described below, is a distribution of a controlled corporation by a distributing corporation part of a plan pursuant to which one or more persons acquire stock in the distributing corporation under § 355(e) of the Internal Revenue Code and § 1.355-7 of the Income Tax Regulations?

Facts. Distributing is a publicly traded corporation that conducts a pharmaceuticals business. Controlled, a wholly owned subsidiary of Distributing, conducts a cosmetics business. Distributing does all of the borrowing for both Distributing and Controlled and makes all decisions regarding the allocation of capital spending between the pharmaceuticals and cosmetics businesses. Because Distributing's capital spending in recent years for both the pharmaceuticals and cosmetics businesses has outpaced internally generated cash flow from the businesses, it has had to limit total expenditures to maintain its credit ratings. Although the decisions reached by Distributing's senior management regarding the allocation of capital spending usually favor the pharmaceuticals business due to its higher rate of growth and profit margin, the competition for capital prevents both businesses from consistently pursuing development strategies that the management of each business believes are appropriate.

To eliminate this competition for capital, and in light of the unavailability of nontaxable alternatives, Distributing decides and publicly announces that it intends to distribute all the stock of Controlled pro rata to Distributing's shareholders. It is expected that both businesses will benefit in a real and substantial way from the distribution. This business purpose is a corporate business purpose (within the meaning of § 1.355-2(b)). The distribution is substantially motivated by this business purpose, and not by a business purpose to facilitate an acquisition.

After the announcement but before the distribution, X, a widely held corporation that is engaged in the pharmaceuticals business, and Distributing begin discussions regarding an acquisition. There were no discussions between Distributing or Controlled and X or its shareholders regarding an acquisition or a distribution before the announcement. In addition, Distributing would have been able to continue the successful operation of its pharmaceuticals business without combining with X. During its negotiations with Distributing, X indicates that it favors the distribution. X merges into Distributing

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before the distribution but nothing in the merger agreement requires the distribution.

As a result of the merger, X's former shareholders receive 55 percent of Distributing's stock. In addition, X's chairman of the board and chief executive officer become the chairman of the board and chief executive officer, respectively, of Distributing. Six months after the merger, Distributing distributes the stock of Controlled pro rata in a distribution to which § 355 applies and to which § 355(d) does not apply. At the time of the distribution, the distribution continues to be substantially motivated by the business purpose of eliminating the competition for capital between the pharmaceuticals and cosmetics businesses.

Law. Section 355(c) generally provides that no gain or loss is recognized to the distributing corporation on a distribution of stock in a controlled corporation to which § 355 (or so much of § 356 as relates to § 355) applies and which is not in pursuance of a plan of reorganization. Section 355(e) generally denies nonrecognition treatment under § 355(c) if the distribution is part of a plan (or series of related transactions) (a plan) pursuant to which one or more persons acquire directly or indirectly stock representing a 50-percent or greater interest in the distributing corporation or any controlled corporation.

Section 1.355-7(b)(1) provides that whether a distribution and an acquisition are part of a plan is determined based on all the facts and circumstances, including those set forth in § 1.355-7(b)(3) (plan factors) and (4) (non-plan factors). The weight to be given each of the facts and circumstances depends on the particular case. The determination does not depend on the relative number of plan factors compared to the number of non-plan factors that are present.

Section 1.355-7(b)(3)(iii) provides that, in the case of an acquisition (other than involving a public offering) before a distribution, if at some time during the two-year period ending on the date of the acquisition there were discussions by Distributing or Controlled with the acquirer regarding a distribution, such discussions tend to show that the distribution and the acquisition are part of a plan. The weight to be accorded this fact depends on the nature, extent, and timing of the discussions. In addition, the fact that the acquirer intends to cause a distribution and, immediately after the acquisition, can meaningfully participate in the decision regarding whether to make a distribution, tends to show that the distribution and the acquisition are part of a plan.

Section 1.355-7(b)(4)(iii) provides that, in the case of an acquisition (other than involving a public offering) before a distribution, the absence of discussions by Distributing or Controlled with the acquirer regarding a distribution during the two-year period ending on the date of the earlier to occur of the acquisition or the first public announcement regarding the distribution tends to show that the distribution and the acquisition are not part of a plan. However, this factor does not apply to an acquisition where the acquirer intends to cause a distribution and, immediately after the acquisition, can meaningfully participate in the decision regarding whether to make a distribution.

Section 1.355-7(b)(4)(v) provides that the fact that the distribution was motivated in

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whole or substantial part by a corporate business purpose (within the meaning of § 1.355-2(b)) other than a business purpose to facilitate the acquisition or a similar acquisition tends to show that the distribution and the acquisition are not part of a plan.

Section 1.355-7(b)(4)(vi) provides that the fact that the distribution would have occurred at approximately the same time and in similar form regardless of the acquisition or a similar acquisition tends to show that the distribution and the acquisition are not part of a plan.

Section 1.355-7(h)(6) provides that discussions with the acquirer generally include discussions with persons with the implicit permission of the acquirer.

Section 1.355-7(h)(9) provides that a corporation is treated as having the implicit permission of its shareholders when it engages in discussions.

Analysis. Whether the X shareholders' acquisition of Distributing stock and Distributing's distribution of Controlled are part of a plan depends on all the facts and circumstances, including those described in § 1.355-7(b). The fact that Distributing discussed the distribution with X during the two-year period ending on the date of the acquisition tends to show that the distribution and the acquisition are part of a plan. See § 1.355-7(b)(3)(iii). In addition, X's shareholders may constitute acquirers who intend to cause a distribution and who, immediately after the acquisition, can meaningfully participate (through X's chairman of the board and chief executive officer who become D's chairman of the board and chief executive officer) in the decision regarding whether to distribute Controlled. See id. However, the fact that Distributing publicly announced the distribution before discussions with X regarding both an acquisition and a distribution began suggests that the plan factor in § 1.355-7(b)(3)(iii) should be accorded less weight than it would have been accorded had there been such discussions before the public announcement.

With respect to those factors that tend to show that the distribution and the acquisition are not part of a plan, the absence of discussions by Distributing or Controlled with X or its shareholders during the two-year period ending on the date of the public announcement regarding the distribution would tend to show that the distribution and the acquisition are not part of a plan only if X's shareholders are not acquirers who intend to cause a distribution and who, immediately after the acquisition, can meaningfully participate in the decision regarding whether to distribute Controlled. See § 1.355-7(b)(4)(iii). Because X's chairman of the board and chief executive officer become the chairman and chief executive officer, respectively, of Distributing, X's shareholders may have the ability to meaningfully participate in the decision whether to distribute Controlled. Therefore, the absence of discussions by Distributing or Controlled with X or its shareholders during the two-year period ending on the date of the public announcement regarding the distribution may not tend to show that the distribution and the acquisition are not part of a plan.

Nonetheless, the fact that the distribution was substantially motivated by a corporate business purpose (within the meaning of § 1.355-2(b)) other than a business purpose to

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facilitate the acquisition or a similar acquisition, and the fact that the distribution would have occurred at approximately the same time and in similar form regardless of the acquisition or a similar acquisition, tend to show that the distribution and the acquisition are not part of a plan. See § 1.355-7(b)(4)(v), (vi). The fact that the public announcement of the distribution preceded discussions by Distributing or Controlled with X or its shareholders, and the fact that Distributing's business would have continued to operate successfully even if the merger had not occurred, evidence that the distribution originally was not substantially motivated by a business purpose to facilitate the acquisition or a similar acquisition. Moreover, after the merger, Distributing continued to be substantially motivated by the same corporate business purpose (within the meaning of § 1.355-2(b)) other than a business purpose to facilitate the acquisition or a similar acquisition (§ 1.355-7(b)(4)(v)). In addition, the fact that Distributing decided to distribute Controlled and announced that decision before it began discussions with X regarding the combination suggests that the distribution would have occurred at approximately the same time and in similar form regardless of Distributing's combination with X and the corresponding acquisition of Distributing stock by the X shareholders.

Considering all the facts and circumstances, particularly the fact that the distribution was motivated by a corporate business purpose (within the meaning of § 1.355-2(b)) other than a business purpose to facilitate the acquisition or a similar acquisition, and the fact that the distribution would have occurred at approximately the same time and in similar form regardless of the acquisition or a similar acquisition, the acquisition and distribution are not part of a plan under § 355(e) and § 1.355-7(b).

Holding.Under the facts described above, the acquisition and the distribution are not part of a plan under § 355(e) and § 1.355-7(b).

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X. CHAPTER 10, CROSS BORDER ACQUISITIVE REORGANIZATIONS

A. Page 734, New Sec. 10.18.D. Treasury's Position on "Killer Bs:" News Release and Notice

Page 734, New Sec. 10.18.D. Add before Sec. 10.19 the following:
New Sec. 10.18.D. **Treasury's Position on "Killer Bs:" New Release and Notice**

Treasury News Release on Triangular Reorganizations Involving Foreign Corporations

Treasury and IRS Announce Regulations To Be Issued With Respect to Certain Triangular Reorganizations Under Section 368(a) Involving Foreign Corporations
(September 22, 2006)

The Department of the Treasury today issued a notice that announced that the Treasury Department and the Internal Revenue Service will issue regulations under section 367(b) of the Internal Revenue Code (Code) to address certain triangular reorganizations under section 368(a) involving foreign corporations.

The notice responds to comments and requests for guidance regarding certain triangular reorganizations that are designed to avoid U.S. tax, including tax on the repatriation of a subsidiary's earnings. The notice describes the transactions as involving a parent corporation (P) and a subsidiary corporation (S) where S transfers property to P in exchange for stock of P and then uses the P stock as consideration in an exchange to acquire the stock or assets of another corporation in a triangular reorganization. Taxpayers take the position that S's transfer of property to P for P's stock is treated as the purchase of P stock, and not a distribution from S to P, thereby effecting, in most cases, a tax-free transfer of S's earnings to P without U.S. income tax.

The notice provides that the regulations that will be issued will apply only where P or S (or both) is a foreign corporation. Further, the regulations will make adjustments with respect to P and S such that the property transferred from S to P in exchange for P stock will have the effect of a separate distribution of property from S to P. When issued, the regulations will apply to transactions occurring on or after the date the notice was released for publication. The regulations will not, however, apply to a transaction that was completed on or after the date the notice was released for publication, provided the transaction was entered into pursuant to a written agreement which was binding before the publication of the notice and all times thereafter.

The notice also requests comments with respect to the rules announced in the notice, including appropriate exceptions.

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IRS Notice on Killer "B"s

Treatment Under Section 367(b) of Property Used to Purchase Parent Stock in Certain Triangular Reorganizations

Notice 2006-85, I.R.B 2006-41 (October 10, 2006)

SECTION 1. OVERVIEW

This notice announces that the Internal Revenue Service (IRS) and the Treasury Department (Treasury) will issue regulations under section 367(b) of the Internal Revenue Code that address certain triangular reorganizations under section 368(a) involving one or more foreign corporations. This notice is issued in response to comments and specific requests for guidance regarding certain transactions that are designed to avoid U.S. income tax, including tax on the repatriation of a subsidiary's earnings. The transactions generally involve a subsidiary purchasing its parent's stock for property and then transferring the stock in exchange for the stock or assets of a corporation in a triangular reorganization under section 368(a). In general, and as described below, the regulations issued pursuant to this notice will apply to transactions occurring on or after September 22, 2006.

The IRS and Treasury recently finalized §1.367(b)-4(b)(1)(ii), which may apply to certain (but not all) of the triangular reorganizations described in this notice. That final regulation under section 367(b) appropriately addressed the treatment of the majority of relevant triangular reorganizations. While the IRS and Treasury were aware of the transactions covered by this notice at that time, the decision was made to address these transactions comprehensively in separate guidance.

The following definitions apply for purposes of this notice. A "triangular reorganization" is a forward triangular merger, a triangular C reorganization, a reverse triangular merger, or a triangular B reorganization, as those terms are defined in §1.358-6(b)(2)(i) through (iv), respectively, or a reorganization described in section 368(a)(1)(G) and (a)(2)(D). In addition, P, S, and T are corporations described in §1.358-6(b)(1)(i) through (iii), respectively. Finally, the term "property" means money, securities, and any other property, except that the term does not include stock in S.

SECTION 2. TRANSACTIONS AT ISSUE

The IRS and Treasury are aware that certain taxpayers are engaging in triangular reorganizations involving foreign corporations that result in a tax-advantaged transfer of property from S to P. The transaction is often structured as a triangular B reorganization, but could also be structured as a triangular C reorganization or another type of triangular reorganization. For example, assume P, a domestic corporation, owns 100 percent of S, a foreign corporation, and S1, a domestic corporation. S1 owns 100 percent of T, a foreign corporation. S purchases P stock for either cash or a note, and provides the P stock to S1 in exchange for all the T stock in a triangular B reorganization.

Taxpayers take the position that (i) when P sells its stock to S for cash or a note, P recognizes no gain or loss on the sale under section 1032, (ii) S takes a cost basis in the P shares under section 1012, and (iii) S recognizes no gain under §1.1032-2(c) upon the

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transfer of the P shares immediately thereafter because the basis and fair market value of the shares are equal. Thus, taxpayers take the position that the cash or note used by S to acquire the P stock does not result in a distribution under section 301. Furthermore, taxpayers do not include in income amounts under section 951(a)(1)(B) because S acquires and disposes of the P stock before the close of a quarter of the taxable year, which is the time at which to measure P's share of the average amount of United States property held by S. *See* section 956(a)(1)(A). Finally, under §1.367(b)-4(b)(1)(ii), S1 does not include in income as a deemed dividend the section 1248 amount attributable to the T stock that S1 exchanges.

The IRS and Treasury believe that the taxpayers' characterization of these transactions raises significant policy concerns, particularly when either P or S (or both) is a foreign corporation (regardless of whether T is related to P and S before the transaction). For example, when P is domestic and S is foreign, as in the example described above, the transaction could have the effect of repatriating foreign earnings of S to P without a corresponding dividend to P that would be subject to U.S. income tax. Similarly, where P is foreign and S is domestic, the transaction could have the effect of repatriating S's U.S. earnings to its foreign parent in a manner that is not subject to U.S. withholding tax. This variation of the transaction also raises U.S. earnings stripping issues where S uses a note to purchase all or a portion of the P stock. Moreover, where both P and S are foreign, the transactions may have the effect of avoiding income inclusions to certain U.S. shareholders of P that would be subject to U.S. income tax under the subpart F provisions, absent the application of an exception, such as under section 954(c)(6). In addition, foreign-to-foreign transactions of this type can be used to facilitate the subsequent repatriation of foreign earnings to U.S. shareholders without U.S. income tax.

SECTION 3. BACKGROUND

.01 Triangular reorganizations

Section 368 defines the term "reorganization." Sections 368(a)(1)(B), 368(a)(1)(C), 368(a)(1)(G), 368(a)(2)(D), and 368(a)(2)(E) describe certain reorganizations in which P stock may be used by S as the consideration issued in exchange for T's stock or assets, as applicable.

Section 1032 provides that no gain or loss will be recognized to a corporation on the receipt of money or other property in exchange for stock of such corporation. Section 1.1032-2(b) provides that in the case of a forward triangular merger, a triangular C reorganization, or a triangular B reorganization, P stock provided by P to S, or directly to T or T's shareholders on behalf of S, pursuant to the plan of reorganization is treated as a disposition by P of shares of its own stock. However, §1.1032-2(c) provides that S must recognize gain or loss in the above transactions on its exchange of P stock for T stock or assets if S did not receive the P stock from P pursuant to the plan of reorganization. Section 361 provides that S does not recognize gain or loss on the P stock that it exchanges for T stock in a reverse triangular merger.

Section 361(a) provides that no gain or loss shall be recognized by T if it exchanges property in pursuance of the plan of reorganization solely for stock or

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securities in P. Section 361(c) provides that no gain or loss shall be recognized to T on the distribution to its shareholders of P stock received from P in pursuance of the plan of reorganization.

Section 354 provides that no gain or loss shall be recognized by T shareholders if stock or securities in T are, in pursuance of the plan of reorganization, exchanged solely for stock or securities of P. Section 356 applies to T shareholders in cases where they receive other property in addition to the property permitted to be received under section 354.

Section 358 provides rules for determining the T shareholders' bases in their P stock following triangular reorganizations. Sections 1.358-6 and 1.367(b)-13 provide rules for determining P's basis in its S or T stock, as applicable. If P files a consolidated return with S or T, other basis rules apply. *See* Treas. Reg. §1.1502-30 or 1.1502-31.

.02 Section 367

Section 367(a)(1) provides that if, in connection with any exchange described in section 332, 351, 354, 356, or 361, a United States person transfers property to a foreign corporation, such foreign corporation shall not, for purposes of determining the extent to which gain shall be recognized on such transfer, be considered to be a corporation. The Secretary has broad authority under section 367(a)(2), (3), and (6) to provide that section 367(a)(1) will not apply to certain transfers described therein.

In the case of any exchange described in section 332, 351, 354, 355, 356, or 361 in connection with which there is no transfer of property described in section 367(a)(1), section 367(b)(1) provides that a foreign corporation shall be considered to be a corporation except to the extent provided in regulations prescribed by the Secretary which are necessary or appropriate to prevent the avoidance of Federal income taxes.

Section 367(b)(2) provides that the regulations prescribed pursuant to section 367(b)(1) shall include (but shall not be limited to) regulations dealing with the sale or exchange of stock or securities in a foreign corporation by a United States person, including regulations providing, among other things, the circumstances under which gain is recognized, amounts are included in gross income as a dividend, adjustments are made to earnings and profits, or adjustments are made to basis of stock or securities.

.03 Distributions of property

Section 301(c)(1) provides that a distribution of property by a corporation to its shareholder with respect to its stock is included in the shareholder's gross income to the extent the distribution constitutes a dividend under section 316. Section 316 defines a dividend as a distribution out of a corporation's current and accumulated earnings and profits. To the extent the distribution is not a dividend, the shareholder reduces basis in the distributing corporation's stock, and any amount of the distribution in excess of the shareholder's basis is treated as gain from the sale or exchange of the corporation's stock. *See* section 301(c)(2) and (3).

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Certain transactions that are exchanges in form can be treated as distributions for tax purposes. Section 304 generally provides that when a shareholder transfers stock of a controlled corporation to another controlled corporation in exchange for property, the two legs of the exchange are bifurcated and the receipt of the property by the shareholder is treated as a distribution. Section 304, by its terms, does not apply to the transfer by a shareholder of its own stock to a controlled corporation in exchange for property, even though the economic effect of that transaction is essentially identical.

Other transactions may result in deemed distribution treatment in certain circumstances. For example, a shareholder that exchanges common stock of a corporation for common stock and property pursuant to a recapitalization will be treated as receiving a distribution of property with respect to its stock under section 301 if in substance the distribution is a separate transaction. *See* Treas. Reg. §1.301-1(l); *see also*, *Bazley v. Comm'r*, 331 U.S. 737 (1947).

.04 Distributions involving foreign corporations or foreign shareholders

The treatment of a distribution varies depending upon whether the corporation or shareholder is domestic or foreign. A distribution from a foreign corporation to a shareholder that is a U.S. person resulting in a dividend under sections 301(c)(1) and 316, or gain from the sale or exchange of property under section 301(c)(3), generally is subject to U.S. income tax, with potential offset by foreign tax credits.

A distribution from a domestic corporation to a shareholder that is not a U.S. person resulting in a dividend is generally taxable under section 871 or 881 at a rate of 30 percent, subject to reduction under an applicable treaty, and the domestic corporation is responsible for withholding tax under section 1441 or 1442. To the extent such a distribution results in gain from the sale or exchange of property to the foreign shareholder under section 301(c)(3), such amounts are subject to U.S. income tax under section 897(a) if the distributing corporation had been a United States real property holding corporation (as defined in section 897(c)(2)) within the past five years. In such a case, the gain is subject to U.S. income tax as income effectively connected with the conduct of a trade or business within the United States.

Finally, a distribution from a foreign corporation to a shareholder that is a controlled foreign corporation, within the meaning of section 957, resulting in a dividend or gain from the sale or exchange of property to the foreign shareholder under section 301(c)(3) may also be subject to U.S. income tax. For example, such amounts may constitute subpart F income and therefore result in an income inclusion under section 951(a)(1)(A) to U.S. shareholders, within the meaning of section 951(b), of the controlled foreign corporation, subject to certain exceptions. *See, e.g.*, section 954(c)(6).

SECTION 4. APPLICATION OF SECTION 367(b)

Congress enacted section 367(b) to ensure that international tax considerations are adequately addressed when the subchapter C provisions apply to certain nonrecognition exchanges involving foreign corporations. This provision was necessary because the subchapter C provisions were enacted largely to address transactions involving domestic

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corporations and shareholders that are United States persons. As a result, the subchapter C provisions do not fully account for international tax concerns that arise when the provisions apply to transactions involving foreign corporations or shareholders that are not U.S. persons.

In enacting section 367(b), Congress noted that "it is essential to protect against tax avoidance in transfers to foreign corporations and upon the repatriation of previously untaxed foreign earnings...." H.R. Rep. No. 658, 94th Cong., 1st Sess. 241 (1975). In addition, because determining the proper interaction of the Code's international and subchapter C provisions is "necessarily highly technical," Congress granted the Secretary broad regulatory authority to provide the "necessary or appropriate" rules to prevent the avoidance of Federal income taxes, rather than enacting a more comprehensive statutory regime. *Id*. This broad grant of authority has been exercised on numerous occasions to address a wide range of international policy concerns. *See, e.g.*, Treas. Reg. §§1.367(b)-4(b)(1) (preserving section 1248 amounts), (b)(2) (addressing trafficking in foreign tax credits by use of preferred stock), -5(b)(1)(ii) (ensuring section 311(b) gain is recognized by a domestic corporation when it distributes stock of a controlled foreign corporation to an individual distributee under section 355), and -7 (addressing the carryover of tax attributes in a foreign-to-foreign section 381 transaction).

In a triangular reorganization, the exchange by the T shareholders of their T stock for P stock is described in section 354 or 356. As a result, a triangular reorganization involving a foreign corporation is described in section 367(b) and, therefore, may be subject to regulations issued under the broad regulatory authority granted therein. It is on this basis that regulations will be issued to address the triangular reorganizations covered by this notice.

SECTION 5. REGULATIONS TO BE ISSUED UNDER SECTION 367(b)

The IRS and Treasury will issue regulations under section 367(b) to address certain triangular reorganizations involving foreign corporations. The regulations will apply to triangular reorganizations where P or S (or both) is foreign and, pursuant to the reorganization, S acquires from P, in exchange for property, all or a portion of the P stock that is used to acquire the stock or assets of T (T could be either related or unrelated to P and S before the transaction). In such a case, the regulations under section 367(b) will make adjustments with respect to P and S such that the property transferred from S to P in exchange for P stock will have the effect of a distribution of property from S to P under section 301(c) that is treated as separate from the transfer by P of the P stock to S pursuant to the reorganization. The adjustments will be made notwithstanding the fact that section 1032 otherwise applies to the reorganization. Therefore, the regulations will require, as appropriate, an inclusion in P's gross income as a dividend, a reduction in P's basis in its S or T stock, and the recognition of gain by P from the sale or exchange of property. The regulations will also provide for appropriate corresponding adjustments to be made, such as a reduction of S's earnings and profits as a result of the distribution (consistent with the principles of section 312). The regulations will also address similar transactions in which S acquires the P stock used in the reorganization from a related party that purchased the P stock in a related transaction.

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SECTION 6. EFFECTIVE DATE

In general, the regulations to be issued under section 367(b) that are described in section 5 of this notice will apply to transactions occurring on or after September 22, 2006. The regulations described in this notice will not, however, apply to a transaction that was completed on or after September 22, 2006, provided the transaction was entered into pursuant to a written agreement which was (subject to customary conditions) binding before September 22, 2006 and all times thereafter.

No inference is intended as to the treatment of transactions described herein under current law, and the IRS may, where appropriate, challenge such transactions under applicable provisions or judicial doctrines.

SECTION 7. COMMENTS

The IRS and Treasury request comments on the regulations to be issued under this notice. Specifically, comments are requested as to whether in certain cases it is appropriate to provide an exception from the treatment described in this notice. In addition, comments are requested as to the source and timing of the adjustments to be made with respect to P and S under the regulations to be issued.

The IRS and Treasury also request comments regarding transactions that are not described in section 5 of this notice. For example, comments are requested on transactions where S or P is foreign and S purchases P stock from a person unrelated to P (for example, from the public on the open market), or where S acquires the P stock in a transaction that is unrelated to the triangular reorganization. Finally, the IRS and Treasury request comments on the treatment of transactions similar to those described in this notice that do not qualify as reorganizations (for example, because S issues minimal consideration to T in a transaction that would otherwise qualify as a reorganization under section 368(a)(1)(B)). Any regulations issued to address transactions that are not described in section 5 of this notice will apply prospectively.

B. Page 765, New Sec. 10.23.A. Preamble to Final Regulations Addressing Impact under § 367 of Allowing Foreign Corporation Merger Reorganizations

Page 765, New Sec. 10.23.A. Add before Sec.10.24 the following:

New Sec. 10.23.A.**Preamble to Final Regulations Addressing Impact under § 367 of Allowing Foreign Corporation Merger Reorganizations**

Treasury Decision 9243
January 26, 2006
[*See* Treas Dec 9242, dealing with foreign mergers under § 368 in New Sec. 7.2.J.]

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Summary: This document contains final regulations amending the income tax regulations under various provisions of the Internal Revenue Code (Code) to account for statutory mergers and consolidations under section 368(a)(1)(A) (including such reorganizations described in section 368(a)(2)(D) or (E)) involving one or more foreign corporations. These final regulations are issued concurrently with final regulations (TD 9242) that define a reorganization under section 368(a)(1)(A) to include certain statutory mergers or consolidations effected pursuant to foreign law. This document also contains final regulations under section 6038B which facilitate the electronic filing of Form 926
Background. On January 24, 2003, the IRS and Treasury issued proposed regulations (REG-126485-01, 2003-1 C.B. 542, 68 FR 3477) and temporary regulations (TD 9038, 2003-1 C.B. 524, 68 FR 3384), that would revise the definition of a statutory merger or consolidation under section 368(a)(1)(A). On January 5, 2005, the IRS and Treasury issued proposed regulations (REG-117969-00, 2005-7 I.R.B. 533, 70 FR 746) that would revise the definition of a section 368(a)(1)(A) reorganization to include transactions effected pursuant to foreign law and transactions involving entities organized under foreign law. Final regulations incorporating the temporary regulations and both sets of proposed regulations, as modified to reflect comments, are being published concurrently with this document.

On January 5, 2005, the IRS and Treasury also issued proposed regulations under sections 358, 367 and 884 (the 2005 proposed regulations) that would account for section 368(a)(1)(A) reorganizations involving one or more foreign corporations. The regulations also proposed changes to other aspects of the section 367(a) and (b) regulations that would address additional issues. This document contains final regulations that incorporate the 2005 proposed regulations amending sections 358, 367, and 884.

The public hearing with respect to the 2005 proposed regulations was cancelled because no request to speak was received. However, the IRS and Treasury received several written comments, which arc discussed below.

On December 19, 2003, the IRS and Treasury issued temporary and final regulations (TD 9100, 2004-1 C.B. 297, 68 FR 70701) modifying regulations under section 6038B to eliminate regulatory impediments to the electronic submission of Form 926 “Return by a U.S. Transferor of Property to a Foreign Corporation.” In the same issue of the Federal Register, the IRS and Treasury issued a notice of proposed rulemaking (REG-116664-01, 2004-1 C.B. 319, 68 FR 70747) cross-referencing the temporary regulations under section 6038B. This document contains final regulations incorporating certain provisions of the temporary regulations under section 6038B. No public hearing regarding the notice of proposed rulemaking was requested or held and no comments were received.

Summary of Comments and Explanation of Provisions

Basis and Holding Period Rules

Section 354 exchanges

On May 3, 2004, the IRS and Treasury published a notice of proposed rulemaking (REG-116564-03) in the Federal Register (69 FR 24107) that included regulations under section 358 that would provide guidance regarding the determination of the basis of stock or securities received in either a reorganization described in section 368 (e.g., in a section 354 exchange) or a distribution to which section 355 applies. The proposed section 358 regulations would adopt a tracing regime for determining the basis of each share of stock or security received in an exchange under section 354 (or section 356). Related

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provisions in the 2005 proposed regulations followed that general tracing regime, with modifications. See Prop. Treas. Reg. §1.367(b)-13(b). Comments were received in response to the proposed regulations under section 358. The IRS and Treasury have issued final regulations under section 358 that adopted the section 358 proposed regulations, with modifications to reflect the comments received. See TD 9244.

The final section 358 regulations retained the general tracing regime for determining basis in an exchange under section 354 (or section 356). This tracing regime is consistent with the policies and requirements underlying the international provisions of the Code, including those under section 1248. As a result, these final regulations do not include the rules set forth in §1.367(b)-13(b) of the 2005 proposed regulations that would determine the basis and holding period in stock as a result of certain exchanges under section 354 (or section 356) involving foreign corporations. Instead, the final regulations cross-reference the regulations under section 358 to determine the exchanging shareholder's basis in stock or securities received in an exchange under section 354 (and section 356). Special rules for certain triangular reorganizations are discussed below.

Triangular asset reorganizations

In contrast to the above, the application of the stock basis roles of §1.358-6 in certain triangular asset reorganizations involving foreign corporations does not accurately preserve a shareholder's section 1248 amount (within the meaning of §1.367(b)-2(c)). Therefore, the 2005 proposed regulations would provide special basis and holding period rules for certain triangular asset reorganizations involving foreign corporations that have section 1248 shareholders (within the meaning of §1.367(b)-2(b)). See Prop. Treas. Reg. §1.367(b)-13(c) through (e). These rules would apply to certain reorganizations described in section 368(a)(1)(A) and (a)(2)(D) (forward triangular merger), triangular reorganizations described in section 368(a)(1)(C), and reorganizations described in section 368(a)(1)(A) and (a)(2)(E) (reverse triangular merger).

The 2005 proposed regulations would provide that, in determining the stock basis of the surviving corporation in certain triangular asset reorganizations, the exchanging shareholder's basis in the stock of the target corporation will be taken into account, rather than target corporation's basis in its assets. Further, where applicable, the 2005 proposed regulations would provide for a divided basis and holding period in each share of stock in the surviving corporation to reflect the relevant section 1248 amounts, if any, in the stock of the target corporation and the surviving corporation. If there are two or more blocks of stock in the target corporation with section 1248 amounts, then each share of the surviving corporation would be further divided to account for each block of stock. If two or more blocks of stock are held by one or more shareholders that are not section 1248 shareholders, then shares in these blocks would be aggregated into one divided portion for basis purposes. If none of the shareholders is a section 1248 shareholder, then the asset basis rules of §1.358-6 would apply.

Commentators stated that the application of the special basis rules would cause unjustified complexity. One commentator stated that such complexity arises in cases where the shares of the target corporation are widely held or where section 1248 shareholders hold less than 50 percent of the target corporation. The commentator recommended that if the special basis rules are retained, §1.358-6 should continue to apply where section 1248 shareholders hold less than 50 percent of the stock of the target corporation. The commentator further recommended that the controlling corporation be

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allowed to elect to apply the rules under §1.358-6 in return for all exchanging section 1248 shareholders including in income the section 1248 amounts with respect to their stock. The IRS and Treasury have considered these comments. On balance, the IRS and Treasury have concluded that creating exceptions to the application of the special basis rules (e.g., by election) would create significant uncertainty for the IRS and would not meaningfully reduce administrative complexity. While the IRS and Treasury recognize the complexity of the rules, the IRS and Treasury nevertheless believe it is important to preserve section 1248 amounts and avoid unnecessary income inclusions that might otherwise be required. As a result, the final regulations do not adopt this recommendation. However, the IRS and Treasury will continue to study alternative methods for preserving the section 1248 amounts in such transactions.

One commentator suggested that the IRS and Treasury consider applying the special basis rules to section 368(a) asset reorganizations followed by asset transfers to a corporation controlled (within the meaning of section 368(c)) by the acquiring corporation pursuant to the same transaction (controlled asset transfer), because these transactions are similar to triangular reorganizations under section 368(a)(1)(C) and section 368(a)(1)(A) and (a)(2)(D). If this suggestion were adopted, the basis in the stock of the controlled subsidiary would reflect the basis in the stock of the target corporation and not the basis of the contributed assets. Because the IRS and Treasury are continuing to study the application of section 358 to such transactions, and because such controlled asset transfers may involve only a portion of the acquired assets, this comment is not adopted at this time.

Finally, commentators noted that the special basis rules of §1.367(b)-13(c) of the 2005 proposed regulations would not apply, by their terms, to a forward triangular merger or a triangular section 368(a)(1)(C) reorganization where no shareholder of the target corporation is a section 1248 shareholder, but the parent of the acquiring corporation is either a domestic corporation that is a section 1248 shareholder of the acquiring corporation or a foreign corporation that has a section 1248 shareholder that is also a section 1248 shareholder of the acquiring corporation. This result was not intended, as illustrated by *Example 3* of 81.367(b)-13(e) of the 2005 proposed regulations, which applies the special basis rules of §1.367(b)-13(c) of the 2005 proposed regulations to such a transaction. As a result, the text of the final regulations has been modified to apply the special basis rules to this type of transaction.

Exceptions to the Application of Section 367(a)

Exchanges of stock or securities in certain triangular asset reorganizations

A U.S. person recognizes gain under section 367(a) on the transfer of property to a foreign corporation in an exchange described in section 351,354, 356, or 361, unless an exception applies. Under §1.367(a)-3(a), section 367(a) does not apply if, pursuant to a section 354 exchange, a U.S. person transfers stock of a domestic or foreign corporation "for stock of a foreign corporation" in an asset reorganization described in section 368(a)(1) that is not treated as an indirect stock transfer.

Notwithstanding the language in the current regulations, this exception is intended to apply to any section 354 (or section 356) exchange made pursuant to an asset reorganization under section 368(a)(1) that is not treated as an indirect stock transfer under §1.367(a)-3(d). However, commentators noted that in certain triangular asset reorganizations where a U.S. person transfers stock of a foreign acquired corporation to

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such foreign corporation in a section 354 (or section 356) exchange, but receives stock of the domestic parent of the foreign acquiring corporation pursuant to such exchange, the transfer by the U.S. person might be subject to section 367(a). This would be the case because, under 81.367(a)-3(a), the U.S. person does not receive "stock of a foreign corporation." This result was not intended. Accordingly, the final regulations clarify the application of this rule by removing the phrase "for stock of a foreign corporation." Thus, section 367(a) will not apply to any section 354 (or section 356) exchange of stock or securities of a domestic or foreign corporation pursuant to an asset reorganization under section 368(a)(1), unless the exchange is considered an indirect stock transfer pursuant to §1.367(a)-3(d). A conforming change also is made to the section 6038B reporting rules (see part J. of this preamble).

Exchanges of securities in certain recapitalizations and other reorganizations

Prior to the issuance of the 2005 proposed regulations, several commentators noted that the exception to the application of section 367(a) contained in §1.367(a)-3(a) applied to exchanges of stock, but not exchanges of securities, in section 368(a)(1)(E) reorganizations and certain asset reorganizations. In response, the IRS and Treasury issued Notice 2005-6 (2005-5 I.R.B. 448) concurrently with the 2005 proposed regulations, and announced the plan to amend §1.367(a)-3(a) to apply the exception to exchanges of stock or securities. These final regulations incorporate the rule announced in Notice 2005-6, including the dates of applicability as discussed below in part K.3. of this preamble.

Consistent with these changes, these final regulations also amend the indirect stock transfer rules of §1.367(a)-3(d) to provide that exchanges by a U.S. person of stock or securities of an acquired corporation for stock or securities of the corporation that controls the acquiring corporation in a triangular section 368(a)(1)(B) reorganization will be treated as an indirect transfer of such stock or securities subject to the rules of section 367(a). This amendment conforms the treatment of triangular section 368(a)(1)(B) reorganizations with the other indirect stock transfers described in §1.367(a)-3(d). Although this amendment has a prospective effective date, no inference is intended as to the application of current law to such exchanges.

Other provisions of the section 367 regulations also contain references to exchanges of stock but not to securities. See, e.g., §1.367(a)-8(e)(1)(i). The IRS and Treasury are studying these references and intend to amend these provisions if these omissions are not appropriate.

Concurrent Application of Section 367(a) and (b)

The 2005 proposed regulations would modify the concurrent application of section 367(a) and (b) to exchanges that require the inclusion in income of the exchanging United States shareholder's all earnings and profits amount under section 367(b). The 2005 proposed regulations would provide that the rules of section 367(b), and not section 367(a), apply to such exchanges in cases where the all earnings and profits amount attributable to the stock of an exchanging shareholder is greater than the amount of gain in such stock subject to section 367(a) pursuant to the indirect stock transfer rules. In such a case, the shareholder would be required to include in income as a deemed dividend the all earnings and profits amount pursuant to §1.367(b)-3, without regard to whether the exchanging shareholder files a gain recognition agreement as provided under §§1.367(a)-3(b) and 1.367(a)-8. This change was proposed because the IRS and Treasury determined

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that it was contrary to the policy of section 367(b) to allow a shareholder effectively to elect to be taxed on the lesser amount of gain under section 367(a) simply by failing to file a gain recognition agreement.

Two comments were received with respect to this overlap rule. One commentator questioned, as a general matter, the application of §1.367(b)-3 and the all earnings and profits rule to inbound asset acquisitions and, more specifically, the broadening of the circumstances under the 2005 proposed regulations where a taxpayer would be required to include in income as a deemed dividend the all earnings and profits amount. The commentator suggested an alternative means to taxing the earnings and profits of the foreign acquired corporation, such as reducing the basis of assets brought into the United States to the extent of any previously untaxed earnings and profits. The IRS and Treasury, at this time, do not believe that a comprehensive revision of the all earnings and profits rule is necessary or appropriate. Alternative approaches to the all earnings and profits rule are beyond the scope of this regulation project, because, for example, any such revision would have to take into account recently enacted section 362(e). As a result, this comment is not adopted.

The second comment stated that the overlap rule adds unnecessary complexity to the section 367 regulations, because it is unlikely that a transaction will occur that would invoke the role (i.e., where a foreign acquired corporation transfers its assets to a domestic subsidiary of a foreign parent corporation in a triangular reorganization). The overlap rule in the 2005 proposed regulations was intended to address cases that are affected by this rule. The IRS and Treasury continue to believe that the rule is necessary to preserve the policies of section 367(b), and that the rule as applied in these contexts does not create undue complexity. For this reason, the comment is not adopted.

Triangular Section 368(a)(1)(B) Reorganizations

In a triangular section 368(a)(1)(B) reorganization, if a U.S. person exchanges stock of an acquired corporation for voting stock of a foreign corporation that controls (within the meaning of section 368(c)) the acquiring corporation, the U.S. person is treated as making an indirect transfer of stock of the acquired corporation to the foreign controlling corporation in a transfer subject to section 367(a). §1.367(a)-3(d)(1)(iii). The current regulations do not, however, treat as an indirect stock transfer a triangular section 368(a)(1)(B) reorganization where the acquiring corporation is foreign and the controlling corporation is domestic. The 2005 proposed regulations would extend the indirect stock transfer rules to include triangular section 368(a)(1)(B) reorganizations in which a U.S. person exchanges stock of the acquired corporation for voting stock of a domestic corporation that controls the foreign acquiring corporation. In such a case, the 2005 proposed regulations would provide that a gain recognition agreement filed pursuant to such transaction is triggered if the domestic controlling corporation disposes of the stock of the foreign acquiring corporation, or the foreign acquiring corporation disposes of the stock of the acquired corporation.

Commentators stated that because any built-in gain in the stock of the acquired corporation is reflected in the stock of the foreign acquiring corporation held by the domestic controlling corporation under §1.358-6(c)(3), a gain recognition agreement should not be triggered if the domestic controlling corporation disposes of the stock of the foreign acquiring corporation. The IRS and Treasury agree, in part, with this comment. Accordingly, the final regulations provide that, in certain cases, the disposition

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of the stock of the foreign acquiring corporation is not a triggering event. For example, the gain recognition agreement terminates in such a case if the domestic controlling corporation disposes of the stock of the foreign acquiring corporation in a taxable exchange. See §1.367(a)-8(h)(1).

Identifying the Stock Transferred in Indirect Stock Transfers Involving a Change in Domestic or Foreign Status of the Acquired Corporation

Under the current section 367(a) regulations, if a U.S. person exchanges stock or securities of an acquired corporation for stock or securities of a foreign acquiring corporation in, for example, a section 368(a)(1)(C) reorganization, and the foreign acquiring corporation transfers all or part of the assets of the acquired corporation to a corporation in a controlled asset transfer, the U.S. person is treated, for purposes of section 367(a), as transferring the stock or securities of the acquired corporation to the foreign acquiring corporation to the extent of the assets transferred to the controlled subsidiary. §1.367(a)-3(d)(1)(v); see also §1.367(a)-3(d)(3), assets transferred to the controlled subsidiary. §1.367(a)-3(d)(1)(v); see also §1.367(a)-3(d)(3), *Example 5A*.

A commentator stated that the indirect stock transfer rules should apply to such a transaction based on the status of the controlled subsidiary, rather than the status of the acquired corporation. Under this approach, if the acquired corporation were domestic and the controlled subsidiary were foreign, U.S. persons that exchange stock or securities of the domestic acquired corporation would be treated as having made an indirect stock transfer of stock or securities of a foreign corporation to a foreign corporation subject to §1.367(a)-3(b), rather than of stock or securities of a domestic corporation that would be subject to the more restrictive rules of §1.367(a)-3(c).

The IRS and Treasury agree, in part, with this comment and believe that §1.367(a)-3(c) should not apply to certain indirect stock transfers that occur by reason of transactions involving a subsidiary member of a consolidated group to the extent that the assets of the domestic acquired corporation are ultimately transferred to a foreign corporation. Accordingly, the final regulations provide that where a subsidiary member of a consolidated group transfers its assets to a foreign corporation pursuant to an asset reorganization, and an indirect stock transfer described in §1.367(a)-3(d)(1)(i) (mergers described in section 368(a)(1)(A) and (a)(2)(D) and reorganizations described in section 368(a)(1)(G) and (a)(2)(D)), (iv) (triangular reorganizations described in section 368(a)(1)(C)), or (v) (asset reorganizations followed by a controlled asset transfer) occurs in connection with such transfer, the U.S. persons that exchange stock or securities in the domestic acquired corporation pursuant to section 354 (or section 356) will be treated for purposes of §1.367(a)-3 as having made an indirect transfer of foreign stock or securities subject to the rules of §1.367(a)-3(b) (and not domestic stock or securities subject to §1.367(a)-3(c)). In the case where the foreign acquiring corporation transfers assets in a controlled asset transfer to a foreign corporation, the exception applies only to the extent of the assets transferred to the foreign corporation. Further, the exception does not apply to the extent that the assets of the domestic acquired corporation are ultimately transferred in one or more successive controlled asset transfers to a domestic corporation. Thus, in such a case, the indirect stock transfer remains subject to §1.367(a)-3(c). The rules relating to foreign acquired corporations remain the same as under current law (that is, the indirect stock transfer rules are based on the status of the foreign acquired corporation).

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The IRS and Treasury are studying in a separate project the interaction of section 7874 and §1.367(a)-3(c). In connection with this study, the IRS and Treasury will continue to examine whether the recommended change should also apply to other transactions. The results of this study may be addressed in a future regulations project. At this time, however, the final regulation will continue to apply to other transactions based on the stock that is owned and exchanged by the U.S. person in the transaction (rather than based on stock of the corporation in which the assets of the acquired corporation are ultimately transferred). Comments are requested as to whether the exception, described above, should be expanded to other ownership structures (e.g., where the domestic target corporation is an affiliated but not consolidated group member).

Coordination of the Indirect Stock Transfer Rules and the Asset Transfer Rules

Under the current regulations, when an indirect stock transfer also involves a transfer of assets by a domestic corporation to a foreign corporation, section 367(a) and (d) apply to the domestic corporation's transfer of assets prior to the application of the indirect stock transfer rules. However, section 367(a) and (d) do not apply to the domestic corporation's transfer to the extent that the foreign acquiring corporation re-transfers the assets received in the asset transfer to a controlled domestic corporation, provided that the controlled domestic corporation's basis in the assets is no greater than the basis that the domestic acquired corporation had in such assets.

The 2005 proposed regulations would modify the scope of the coordination rule as it applies to asset reorganizations such that section 367(a) and (d) generally would apply to the domestic corporation's transfer of assets to the foreign corporation, even if the foreign corporation re-transfers all or part of the assets received to a domestic corporation in a controlled asset transfer. However, the 2005 proposed regulations would provide two exceptions to this general rule. The first exception generally would apply if the domestic acquired corporation is controlled (within the meaning of section 368(e)) by 5 or fewer domestic corporations, appropriate basis adjustments as provided in section 367(a)(5) are made to the stock of the foreign acquiring corporation, and any other conditions as provided in regulations under section 367(a)(5) are satisfied.

The second exception would apply if the controlled domestic corporation's basis in the assets is no greater than the domestic acquired corporation's basis in such assets and the following two conditions are satisfied: (1) the indirect transfer of stock of the domestic acquired corporation satisfies the requirements of§1.367(a)-3(c)(1)(i), (ii), and (iv), and (c)(6); and (2) the domestic acquired corporation attaches a statement to its tax return for the taxable year of the transfer. The statement must certify that the domestic acquired corporation will recognize gain (as described below) if the foreign acquiring corporation disposes of any stock of the domestic controlled corporation with a principal purpose of avoiding the U.S. tax that would have been imposed on the domestic acquired corporation had it disposed of the re-transferred assets. The 2005 proposed regulations contain a rebuttable presumption that the disposition of stock has a principal purpose of tax avoidance if the disposition occurs within 2 years of the transfer.

When applicable, under this second exception, the domestic acquired corporation would be required to recognize gain as if, immediately prior to the exchange, it had transferred the re-transferred assets, including any intangible assets, directly to a domestic corporation in an exchange qualifying under section 351, and immediately sold the stock to an unrelated party for its fair market value in a transaction in which it recognizes gain,

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if any (but not loss). The 2005 proposed regulations would provide that the basis that the foreign acquiring corporation has in the stock of the domestic controlled corporation is increased immediately prior to its disposition by the amount of gain recognized by the domestic acquired corporation. However, the basis of the re-transferred assets held by the domestic controlled corporation would not be increased by such gain.

Several comments were received with respect to the second exception. Commentators stated that the final regulations should provide that the amount of gain recognized by the domestic acquired corporation under the second exception should also increase the basis of the re-transferred assets held by the domestic controlled corporation. As stated in the preamble to the 2005 proposed regulations, the IRS and Treasury believe that the concerns raised by the construct that results from a controlled asset transfer to a domestic subsidiary after an outbound asset transfer are analogous to the concerns raised in other divisive transactions where gain is recognized on the stock of a corporation without a corresponding increase in the basis of the assets of such corporation. See section 355(e) and §1.367(e)-2(b)(2)(iii). The tax consequences set forth in the final regulations are intended to be consistent with the tax consequences that result in these other transactions. As a result, the final regulations do not adopt this comment.

Commentators also questioned whether the proposed modification to the coordination rule is necessary in light of the enactment of section 7874 and whether any new limitations to the rule should await an analysis of how section 7874 affects the rules of §1.367(a)-3(c). Because of the divisive concerns present in these types of transactions, the IRS and Treasury believe that the modifications to the coordination rule continue to be necessary and therefore are retained. Nevertheless, the IRS and Treasury are studying the effect of section 7874 on the coordination rule, as well as the direct and indirect transfer of domestic stock under §1.367(a)-3(c). The results of this study may be addressed in a future regulation project.

Finally, in light of the enactment of section 7874, *Example 6D* of §1.367(a)-3(d)(3) of the 2005 proposed regulations has not been retained. Compare §1.367(a)-3(d)(3) *Example 6B.*

Treatment of a Controlled Asset Transfer Following a Section 368(a)(1)(F) Reorganization as an Indirect Stock Transfer

The 2005 proposed regulations would revise §1.367(a)-3(d)(1)(v) so that any non-triangular asset reorganization followed by a controlled asset transfer will be considered an indirect stock transfer under §1.367(a)-3(d)(1).

Commentators stated, however, that a section 368(a)(1)(F) reorganization followed by a controlled asset transfer should not be treated as an indirect stock transfer. According to the commentators, because a section 368(a)(1)(F) reorganization involves only a “single” corporation, it should be treated in effect as a “non-event” for purposes of the indirect stock transfer rules. As a result, the commentators believe that the transaction should be treated as a mere section 351 transfer of assets to the controlled subsidiary and not as an indirect stock transfer.

In response to this comment, the final regulations exclude from the application of the indirect stock transfer rules *same-country 368(a)(1)(F) reorganizations* followed by controlled asset transfers. For this purpose, a same-country section 368(a)(1)(F) reorganization is a reorganization described in section 368(a)(1)(F) in which both the acquired corporation and the acquiring corporation are foreign corporations and are created or organized under the laws of the same foreign country. This would include, for

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example, situations where the foreign corporation changes its name, changes its location within the foreign country, or changes its form within the foreign country. The IRS and Treasury will continue to examine whether other foreign-to-foreign section 368(a)(1)(F) reorganizations followed by controlled asset transfers should be treated as indirect stock transfers, however, as the general treatment of section 368(a)(1)(F) reorganizations is further considered. Outbound reorganizations under section 368(a)(1)(F) followed by controlled asset transfers are treated as indirect stock transfers under the final regulations. See §1.367(a)-1T(f).

Treatment of Reorganizations Described in Section 368(a)(1)(G) and (a)(2)(D) as Indirect Stock Transfers

Section 368(a)(2)(D) provides that the acquisition by one corporation, in exchange for stock of a corporation which is in control of the acquiring corporation, of substantially all the properties of another corporation does not disqualify a transaction from qualifying as a reorganization under section 368(a)(1)(A) or 368(a)(1)(G), provided certain conditions are satisfied.

Section 1.367(a)-3(d)(1)(i) and (iv) of the 2005 proposed regulations would treat certain reorganizations described in section 368(a)(1)(A) and (a)(2)(D), and certain triangular reorganizations described in section 368(a)(1)(C), respectively, as indirect stock transfers. Moreover, section 1.367(a)-3(d)(1)(v) of the 2005 proposed regulations would include certain reorganizations described in section 368(a)(1)(G), followed by controlled asset transfers, as indirect stock transfers. The 2005 proposed regulations would not explicitly treat reorganizations described in section 368(a)(1)(G) and (a)(2)(D) as indirect stock transfers, even though they have the same effect as these other reorganizations. As a result, the final regulations modify §1.367(a)-3(d)(1)(i), and related provisions, to include as indirect stock transfers certain reorganizations described in section 368(a)(1)(G) and (a)(2)(D). Similar modifications are made in other sections of the final regulations to take into account reorganizations described in section 368(a)(1)(G) and (a)(2)(D).

General Operation of Section 367 Regulations and the Effect of Section 7874

Comments were received regarding the scope of certain portions of the section 367 regulations in light of the enactment of section 7874. In response to the potential overlap of these two provisions, the IRS and Treasury are considering possible changes to §1.367(a)-3(c). Comments are requested as to the interaction of section 7874 and §1.367(a)-3(c), as well as to other aspects of the section 367 regulations.

Section 6038B Reporting

Section 6038B provides for reporting by U.S. persons that transfer property to foreign corporations in an exchange described in section 332, 351, 354, 355, 356, or 361. Temporary regulations under section 6038B provide an exception from reporting for certain transactions described in §1.367(a)-3(a). Section 1.367(a)-3(a) provides an exception to section 367(a) for certain exchanges under section 354 or 356 of stock or securities in section 368(a)(l)(E) reorganizations or in asset reorganizations that are not indirect stock transfers. These exceptions from reporting under section 6038B have been amended to conform to the amendments to §1.367(a)-3(a). These exceptions are incorporated in the final regulations. See Part B. of this preamble.

Section 6038B and the regulations thereunder provide for reporting by filing Form 926 "Return by a U.S. Transferor of Property to a Foreign Corporation" and any attachments with the income tax return for the year of the transfer. Temporary regulations under

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section 6038B eliminate the requirement to sign Form 926, thus permitting the electronic filing of the form with the U.S. transferor’s federal income tax return. The temporary regulations provide that Form 926 and any attachments are verified by signing the income tax return with which the form and attachments are filed. These temporary regulations are incorporated in these final regulations, except with respect to certain filings by corporations which will be addressed as part of a larger final regulation dealing with electronic filing. * * *

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XI. CHAPTER 11, USE OF PARTNERSHIPS, INCLUDING LLCs AND S CORPORATIONS IN MERGERS AND ACQUISITIONS

A. Page 779, New Sec. 11.4.G.6. Final Regulations: Adjustment to Net Unrealized Built-in Gain under Section 1374

Page 779, New Sec.11.4.G.6. Add before Sec. 11.5 the following:
New Sec. 11.4.G.6. **Final Regulations: Adjustment to Net Unrealized Built-in Gain under Section 1374**

Preamble To Final Regulations: Adjustment To Net Unrealized Built-In Gain
T.D. 9180; 2005-1 C.B. 714

SUMMARY:

This document contains final regulations under section 1374 that provide for an adjustment to the amount that may be subject to tax under section 1374 in certain cases in which an S corporation acquires assets from a C corporation in an acquisition to which section 1374 (d) (8) applies. These final regulations provide guidance to certain S corporations that acquire assets from a C corporation in a carryover basis transaction.

Background and Explanation of Provisions

This document contains amendments to Income Tax Regulations (26 CFR part 1) under section 1374 of the Internal Revenue Code, relating to the tax imposed on certain recognized built-in gains of S corporations. Section 1374 imposes a tax on an S corporation's net recognized built-in gain attributable to assets that it held on the date it converted from a C corporation to an S corporation for the 10-year period beginning on the first day the corporation is an S corporation and assets that it acquired from a C corporation in a carryover basis transaction for the 10-year period beginning on the day of the acquisition. A separate determination of the amount subject to tax under section 1374 is required for those assets the S corporation held on the date it converted to C status and each pool of assets the S corporation acquired in a carryover basis transaction from a C corporation. The total amount subject to tax under section 1374 for each pool of assets is limited to that pool's net unrealized built-in gain (NUBIG) on the date of the conversion or acquisition.

Under the current rules, if X, a C corporation, elects to be an S corporation when it owns some or all of the stock of Y, a C corporation, and Y subsequently transfers its assets to X

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in a liquidation to which sections 332 and 337 (a) apply or in a reorganization described in section 368 (a), the built-in gain or built-in loss in Y's assets may be wholly or partially reflected twice: once in the NUBIG attributable to the assets X owned on the date of its conversion (including the Y stock) and a second time in the NUBIG attributable to Y's former assets acquired by X in the liquidation of Y. The IRS and Treasury Department recognize that continuing to reflect the built-in gain or the built-in loss in the Y stock at the time of X's conversion after the liquidation or reorganization is inconsistent with the fact that such liquidation or reorganization has the effect of eliminating that built-in gain or built-in loss. Therefore, on June 25, 2004, the IRS and Treasury Department published in the Federal Register (69 FR 35544) a notice of proposed rulemaking (REG-131486-03, 2004-28 I.R.B. 36) that includes regulations proposing an adjustment to the NUBIG in these cases. In particular, the proposed regulations generally provide that, if an S corporation acquires assets of a C corporation in a carryover basis transaction, some or all of the stock of the C corporation from which such assets were acquired was taken into account in the computation of NUBIG for a pool of assets of the S corporation, and some or all of such stock is redeemed or canceled in such transaction, then, subject to certain limitations, such NUBIG is adjusted to eliminate any effect any built-in gain or built-in loss in the redeemed or canceled stock had on the initial computation of NUBIG for that pool of assets. These regulations are proposed to apply for taxable years beginning after the date they are published as final regulations in the Federal Register.

No public hearing was requested or held regarding the proposed regulations. One written comment, however, was received. That comment requested that the proposed regulations be made effective as soon as possible.

These final regulations adopt the proposed regulations without substantive change as final regulations. However, the final regulations do modify the proposed effective date of the regulations. The final regulations apply to section 1374 (d) (8) transactions that occur in taxable years beginning after February 23, 2005. The final regulations also provide that an S corporation may apply the regulations to section 1374 (d) (8) transactions that occur in taxable years beginning on or before February 23, 2005, if the S corporation (and any predecessors or successors) and all affected shareholders file original or amended returns that are consistent with the regulations for taxable years of the S corporation during the recognition period of the pool of assets the NUBIG of which would be adjusted pursuant to the regulations that are not closed as of the first date after February 23, 2005 that the S corporation files an original or amended return.

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XII. CHAPTER 12, INTRODUCTION TO BANKRUPTCY AND RELATED TRANSACTIONS

A. Page 804, New Sec. 12.6.C. Preamble to the Proposed Regulations Addressing "No Net Value" Reorganizations and Other Transactions

Page 804, New Sec. 12.6.C. Add before Sec. 12.7 the following:
New Sec. 12.6.C. **Preamble to the Proposed Regulations Addressing "No Net Value" Reorganizations and Other Transactions**

Preamble to Proposed REG-163314-03
March 11, 2005

Action: Notice of proposed rulemaking.

Summary: This document contains proposed regulations providing guidance regarding corporate formations, reorganizations, and liquidations of insolvent corporations. These regulations provide rules requiring the exchange (or, in the case of section 332, a distribution) of net value for the nonrecognition rules of subchapter C to apply to the transaction. The regulations also provide guidance on determining when and to what extent creditors of a corporation will be treated as proprietors of the corporation in determining whether continuity of interest is preserved in a potential reorganization. Finally, the regulations provide guidance on whether a distribution in cancellation or redemption of less than all of the shares one corporation owns in another corporation satisfies the requirements of section 332. The proposed regulations affect corporations and their shareholders. * * *

General Background. The IRS and the Treasury Department believe that there is a need to provide a comprehensive set of rules addressing the application of the nonrecognition rules of subchapter C of the Internal Revenue Code (Code) to transactions involving insolvent corporations and to other transactions that raise similar issues. The proposed regulations provide three sets of rules, the principal one of which is that the nonrecognition rules of subchapter C do not apply unless there is an exchange (or, in the case of section 332, a distribution) of net value (the "net value requirement"). The proposed regulations also provide guidance on the circumstances in which (and the extent to which) creditors of a corporation will be treated as proprietors of the corporation in determining whether continuity of interest is preserved in a potential reorganization. The proposed regulations further provide guidance on whether a distribution in cancellation or redemption of less than all of the shares one corporation owns in another corporation satisfies the requirements of section 332. Each of these rules is discussed separately in this preamble.

Explanation of Provisions. **Exchange of Net Value Requirement**. *Background*. In

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subchapter C, each of the rules described below that provides for the general nonrecognition of gain or loss refers to a distribution in cancellation or redemption of stock or an exchange for stock. Section 332 provides, in part, that "[n]o gain or loss shall be recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation . . . only if . . . the distribution is by such other corporation in complete cancellation or redemption of all its stock." Section 351 provides, in part, that "[n]o gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation." Section 354 provides, in part, that "[n]o gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are . . . exchanged solely for stock or securities . . . in another corporation a party to the reorganization." Finally, section 361 provides that "[n]o gain or loss shall be recognized to a corporation if such corporation is a party to a reorganization and exchanges property . . . solely for stock or securities in another corporation a party to the reorganization."

The authorities interpreting section 332 have consistently concluded that the language of the statute referring to a distribution in complete cancellation or redemption of stock requires a distribution of net value. Section 1.332-2(b) provides that section 332 applies only if a parent receives at least partial payment for the stock that it owns in the liquidating corporation. Such payment could not occur unless there were a distribution of net value. The courts have focused in numerous cases on the effect of liabilities on the distribution requirement of section 332. In H. G. Hill Stores, Inc. v. Commissioner, 44 B.T.A. 1182 (1941), a subsidiary liquidated and distributed its assets and liabilities to its parent in cancellation of its indebtedness to its parent. The court interpreted the phrase "in complete cancellation or redemption of all its stock" as requiring that a distribution be made to the parent in its capacity as a stockholder in order for section 112(b)(6) (the predecessor of section 332) to apply and, thus, held that section 112(b)(6) did not apply because the parent corporation received payment in its capacity as a creditor and not in its capacity as a stockholder. See also Rev. Ruls. 2003-125 (2003-52 I.R.B. 1243), 70-489 (1970-2 C.B. 53), and 59-296 (1959-2 C.B. 87).

Rev. Rul. 59-296 holds that the principles relevant to liquidations under section 332 also apply to reorganizations under section 368. However, other authorities are not consistent with the approach of Rev. Rul. 59-296. Most notably, in Norman Scott, Inc. v. Commissioner, 48 T.C. 598 (1967), the Tax Court held that a transaction involving an insolvent target corporation qualified as a reorganization under section 368(a)(1)(A). The IRS and the Treasury Department have decided to resolve the uncertainties by generally adopting a net value requirement for each of the described nonrecognition rules in subchapter C. The net value requirement generally requires that there be an exchange of property for stock, or in the case of section 332, a distribution of property in cancellation or redemption of stock. The IRS and the Treasury Department believe that the net value requirement is the appropriate unifying standard because it is more consistent with the statutory framework of subchapter C, case law, and published guidance than any other approach considered. In addition, the IRS and the Treasury Department believe that the net value requirement is the appropriate standard because transactions that fail the requirement, that is, transfers of property in exchange for the assumption of liabilities or

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in satisfaction of liabilities, resemble sales and should not receive nonrecognition treatment.

The IRS and the Treasury Department considered several other approaches to unify and rationalize the nonrecognition rules of subchapter C as they applied to transactions involving insolvent corporations. The IRS and the Treasury Department considered whether there should be special rules for potential nonrecognition transactions between members of a consolidated group. Such rules might disregard the various exchange requirements in the statute because of the single entity principles generally applicable to corporations joining in the filing of a consolidated return. This approach was rejected because there is no consolidated return policy that compels a different set of rules for potential nonrecognition transactions between members of a consolidated group. Cf. section 1.1502-35T(f)(1); Notice 94-49 (1994-1 C.B. 358). The current intercompany transaction rules (in particular those regarding successors in section 1.1502-13(j)) could be modified to extend deferral of gain and loss to additional situations as long as the assets remained in the consolidated group pending later acceleration events that befall the assets or successor entities. However, no such rules are being proposed because the case for treating the transferor and transferee members as a single entity seems weakest when the group's equity investment in the transferor has been eliminated.

The IRS and the Treasury Department also considered whether satisfying the words of the relevant statutory provisions that describe the relationship of the parties to a transaction should be sufficient for applying the nonrecognition rules to a transaction between the parties. This approach would essentially take the position that the words of distribution or exchange in the statute do not state a separate requirement but merely describe the most common form of the transaction to which the provision is intended to apply. For example, under this approach, it would be sufficient for a transaction to qualify as a distribution in complete liquidation under section 332 if the corporation to which assets are transferred owned stock meeting the requirements of section 1504(a)(2) at the time of the transfer. Also, under this approach, it would be sufficient for a transaction to qualify as a transfer under section 351 if a transferor of assets were in control (as defined in section 368(c)) of the corporation to which assets are transferred immediately after the transaction. However, this approach would require distinguishing, when the structure of the statute does not, between parts of a statute that impose requirements and other parts that do not.

Explanation of rules. *Net Value Requirement.* For potential liquidations under section 332, the net value requirement is effected by the partial payment rule in section 1.332-2(b) of the current regulations. The proposed regulations make no modifications to this rule, except, as discussed below, for transactions in which the recipient corporation owns shares of multiple classes of stock in the dissolving corporation. The proposed regulations also make minor changes to other sections of the regulations under section 332 to conform those regulations to changes in the statute.

For potential transactions under section 351, the proposed regulations add section 1.351-1(a)(1)(iii)(A), which requires a surrender of net value and, in paragraph (a)(1)(iii)(B), a

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receipt of net value. This rule is similar to that for potential asset reorganizations, discussed below. The proposed regulations make minor changes to other sections of the regulations under section 351 to conform those regulations to changes in the statute.

For potential reorganizations under section 368, the proposed regulations modify section 1.368-1(b)(1) to add the requirement that there be an exchange of net value. Section 1.368-1(f) of the proposed regulations sets forth the rules for determining whether there is an exchange of net value. These rules require, in paragraph (f)(2)(i) for potential asset reorganizations and paragraph (f)(3)(i) for potential stock reorganizations, a surrender of net value and, in paragraph (f)(2)(ii) for potential asset reorganizations and paragraph (f)(3)(ii) for potential stock reorganizations, a receipt of net value. In a potential asset reorganization (one in which the target corporation would not recognize gain or loss under section 361), the target corporation surrenders net value if the fair market value of the property transferred by it to the acquiring corporation exceeds the sum of the amount of liabilities of the target corporation that are assumed by the acquiring corporation and the amount of any money and the fair market value of any property (other than stock permitted to be received under section 361(a) without the recognition of gain) received by the target corporation. This rule ensures that a target corporation transfers property in exchange for stock. The IRS and the Treasury Department believe that the proposed rule better identifies whether a target corporation transfers property in exchange for stock than a rule that looks to the issuance or failure to issue stock because, when the parties are related, the issuance or failure to issue stock might be meaningless.

In a potential stock reorganization (one which would be described in section 368(a)(1)(B) or section 368(a)(1)(A) by reason of section 368(a)(2)(E)), the rules are modified to reflect the fact that the target corporation remains in existence. A potential reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(E) must satisfy the asset reorganization test for the merger of the controlled corporation into the target corporation (for which test the controlled corporation is treated as the target corporation) and the stock reorganization test for the acquisition of the target corporation.

In a potential asset reorganization, the target corporation receives net value if the fair market value of the assets of the issuing corporation exceeds the amount of its liabilities immediately after the exchange. This rule ensures that the target corporation receives stock (or is deemed to receive stock under the “meaningless gesture” doctrine) having value. This rule is necessary because the IRS and the Treasury Department believe that the receipt of worthless stock in exchange for assets cannot be part of an exchange for stock.

Scope of Net Value Requirement. The proposed regulations provide in section 1.368-1(b)(1) that the net value requirement does not apply to reorganizations under section 368(a)(1)(E) and 368(a)(1)(F). The IRS and the Treasury Department recently issued final regulations (T.D. 9182, 70 FR 9219 (Feb. 25, 2005)) stating that a continuity of business enterprise and a continuity of interest are not required for a transaction to qualify as a reorganization under section 368(a)(1)(E) or (F) because applying the requirements in those contexts is not necessary to protect the policies underlying the reorganization

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provisions. Because the purpose underlying the net value requirement is the same as that underlying the continuity of interest requirement, the IRS and the Treasury Department have similarly concluded that applying the net value requirement to transactions under section 368(a)(1)(E) or (F) is not necessary to protect the policies underlying the reorganization provisions.

The proposed regulations also provide in section 1.368-1(b)(1) and section 1.368-1(f)(4) that the net value requirement does not apply to a limited class of transactions that qualify as reorganizations under section 368(a)(1)(D). That class of transactions are the transactions exemplified by James Armour, Inc. v. Commissioner, 43 T.C. 295 (1964), and Rev. Rul. 70-240 (1970-1 C.B. 81). The IRS and the Treasury Department acknowledge that the conclusions of the described authorities are inconsistent with the principles of the net value requirement. Nevertheless, the IRS and the Treasury Department currently desire to preserve the conclusions of these authorities while they more broadly study issues relating to acquisitive reorganizations under section 368(a)(1)(D), including the continuing vitality of various liquidation-reincorporation authorities after the enactment of the Tax Reform Act of 1986, Public Law 99-514 (100 Stat. 2085 (1986)). Consistent with the described authorities, the exception is limited to acquisitive reorganizations of solvent target corporations. The proposed regulations provide no specific guidance (other than in an example incorporating the facts of Rev. Rul. 70-240 (1980-1 C.B. 81)), other than with regard to the application of the net value requirement, on when a transaction will qualify as a reorganization under section 368(a)(1)(D). In this regard, compare Armour with Warsaw Photographic Associates, Inc. v. Commissioner, 84 T.C. 21 (1985).

Definition of Liabilities. In applying the proposed regulations, taxpayers must determine the amount of liabilities of the target corporation that are assumed by the acquiring corporation. Although the proposed regulations do not define the term liability, the IRS and the Treasury Department intend that the term be interpreted broadly. Thus, for purposes of the proposed regulations, a liability should include any obligation of a taxpayer, whether the obligation is debt for federal income tax purposes or whether the obligation is taken into account for the purpose of any other Code section. Generally, an obligation is something that reduces the net worth of the obligor. The IRS and the Treasury Department have proposed adopting a similar definition of liability for purposes of implementing section 358(h) in subchapter K. See Prop. Reg. section 1.752-1(a)(1)(ii) and Prop. Reg. section 1.752-7(b)(2)(ii) (REG-106736-00, 68 FR 37434 (June 24, 2003), 2003-28 I.R.B. 46).

Amount of Liabilities. The proposed regulations provide no specific guidance on determining the amount of a liability. The IRS and the Treasury Department are currently considering various approaches to determining the amount of a liability. One approach would be to treat the amount of a liability represented by a debt instrument as its adjusted issue price determined under sections 1271 through 1275 of the Code (the OID rules) (perhaps with exceptions for certain contingent payment debt instruments) while treating the amount of other liabilities as the value of such liabilities. Another approach would be to treat the amount of all liabilities as the value of such liabilities. Other approaches could

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borrow in whole or in part from other authorities such as those relevant to the determination of insolvency under section 108(d)(3). One method for valuing liabilities is to determine the amount of cash that a willing assignor would pay to a willing assignee to assume the liability in an arm's-length transaction. Cf. Prop. Reg. section 1.752-7(b)(2)(ii).

In the course of developing these regulations, the IRS and the Treasury Department considered special issues related to the assumption of nonrecourse liabilities in the context of a transaction to which section 332, 351, or 368 might apply. The IRS and the Treasury Department are considering a rule similar to the one in Rev. Rul. 92-53 (1992-2 C.B. 48) that would disregard the amount by which a nonrecourse liability exceeds the fair market value of the property securing the liability when determining the amount of liabilities that are assumed. For example, under such a rule, if an individual transfers an apartment building with a fair market value of $ 175x subject to a nonrecourse obligation of $ 190x and an adjacent lot of land with a fair market value of $ 10x to a corporation, the transferor will have surrendered net value because the fair market value of the assets transferred ($ 175x + $ 10x) exceeds the amount of the liabilities assumed ($ 190x - $ 15x, the amount of the excess nonrecourse indebtedness). Any rule disregarding excess nonrecourse indebtedness would be limited to the application of the net value requirement and would have no relevance for other federal income tax purposes, such as the determination of the amount realized under section 1001. Comments are requested regarding the treatment of nonrecourse indebtedness and the effect of such treatment when both property subject to the nonrecourse indebtedness and other property are transferred.

Assumption of Liabilities. In general, the IRS and the Treasury Department believe that the principles of section 357(d) should be applied to determine whether a liability is assumed when more than one person might bear responsibility for the liability. Comments are requested regarding whether and to what extent the principles of section 357(d) should be incorporated into the regulations.

The IRS and the Treasury Department believe that transfers of assets in satisfaction of liabilities should be treated the same as transfers of assets in exchange for the assumption of liabilities. Accordingly, in determining whether there is a surrender of net value, the proposed regulations treat any obligation of the target corporation for which the acquiring corporation is the obligee as a liability assumed by the acquiring corporation.

In Connection With. The proposed regulations take into account not only liabilities assumed in the exchange, but also liabilities assumed "in connection with" the exchange. The proposed regulations include this rule so that the timing of an acquiring corporation's assumption of a target corporation's liability (or a creditor's discharge of a target corporation's indebtedness), whether before an exchange, in the exchange, or after the exchange, will have the same effect in determining whether there is a surrender of net value in the exchange. The proposed regulations also take into account, in determining whether there is a surrender of net value, money and other nonstock consideration received by the target corporation in connection with the exchange.

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The IRS and the Treasury Department intend that the substance-over-form doctrine and other nonstatutory doctrines be used in addition to the “in connection with” rule in determining whether the purposes and requirements of the net value requirement are satisfied. Cf. Rev. Rul. 68-602 (1968-2 C.B. 135) (holding that a parent corporation’s cancellation of a wholly-owned subsidiary’s indebtedness to it that is an integral part of a liquidation is transitory and, therefore, disregarded).

Section 368(a)(1)(C)

The proposed regulations remove the statement in section 1.368-2(d)(1) that the assumption of liabilities may so alter the character of a transaction as to place the transaction outside the purposes and assumptions of the reorganization provisions. Because the proposed regulations provide more specific guidance regarding when the assumption of liabilities will prevent a transaction from qualifying as a reorganization under section 368(a)(1)(C), the IRS and the Treasury Department believe the statement is unnecessary.

Section 721. The IRS and the Treasury Department recognize that the principles in the proposed rules under section 351 may be applied by analogy to other Code sections that are somewhat parallel in scope and effect, such as section 721, dealing with the contribution of property to a partnership in exchange for a partnership interest. The IRS and the Treasury Department request comments on whether rules similar to the rules of the proposed regulations should be proposed in the context of subchapter K and the considerations that might justify distinguishing the relevant provisions in subchapter K from those provisions that are the subject of these proposed regulations.

Continuity of Interest. *Background*. The Code provides general nonrecognition treatment for reorganizations described in section 368. A transaction must comply with both the statutory requirements of the reorganization provisions and various nonstatutory requirements, including the continuity of interest requirement, to qualify as a reorganization. See section 1.368-1(b). The purpose of the continuity of interest requirement is to ensure that reorganizations are limited to read justments of continuing interests in property under modified corporate form and to prevent transactions that resemble sales from qualifying for nonrecognition of gain or loss available to corporate reorganizations. See sections 1.368-1(b), 1.368-1(e)(1). Continuity of interest requires that a substantial part of the value of the proprietary interests in the target corporation be preserved in the reorganization. See section 1.368-1(e)(1); see also LeTulle v. Scofield, 308 U.S. 415 (1940); Helvering v. Minnesota Tea Co., 296 U.S. 378 (1935); Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462 (1933); Cortland Specialty Co. v. Commissioner, 60 F.2d 937 (2d Cir. 1932), cert. denied, 288 U.S. 599 (1933).

Generally, it is the shareholders who hold the proprietary interests in a corporation. However, when a corporation is in bankruptcy, the corporation’s stock may be worthless and eliminated in the restructuring. In this case, when the corporation engages in a potential reorganization, its creditors may receive acquiring corporation stock in

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exchange for their claims and its shareholders may receive nothing. Thus, without special rules, most potential reorganizations of corporations in bankruptcy would fail the continuity of interest requirement. The Supreme Court addressed this problem in Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179 (1942), in which it held that, for practical purposes, the old continuity of interest in the shareholders shifted to the creditors not later than the time "when the creditors took steps to enforce their demands against the insolvent debtor. In this case, that was the date of the institution of bankruptcy proceedings. From that time on, they had effective command over the property." See also Palm Springs Holding Corp. v. Commissioner, 315 U.S. 185 (1942) (holding that the legal procedure employed by the creditors to obtain effective command over a corporation's property was not material when the corporation was insolvent). Notwithstanding Palm Springs, it is not clear when creditors of an insolvent corporation not in a title 11 or similar case may be considered proprietors for purposes of satisfying the continuity of interest requirement.

In Atlas Oil & Refining Corp. v. Commissioner, 36 T.C. 675 (1961), the court held that only creditors who in fact receive stock in the acquiring corporation, by relation back, can be deemed to have been equity owners at the time of the transfer. The court stated that the fact that a more senior class of creditors may have had "effective command" over the assets in the case will not make them proprietors if they do not in fact exercise their right to receive stock in the acquiring corporation.

In the Bankruptcy Tax Act of 1980, Public Law 96-589 (94 Stat. 3389 (1980)), Congress added section 368(a)(1)(G), providing for a new type of reorganization applicable to corporations in title 11 or similar cases. In the legislative history to that statute, Congress stated its expectation that the courts and the Treasury Department would determine whether the continuity of interest requirement is satisfied in a potential reorganization under section 368(a)(1)(G) by treating as proprietors the most senior class of creditors who received stock, together with all interests equal and junior to them, including shareholders. See S. Rep. No. 1035, 96th Cong., 2d Sess. 36-37 (1980). This formulation is similar to the relation back analysis that the Tax Court used in Atlas Oil.

Explanation of provisions. The proposed regulations add new section 1.368-1(e)(6), which describes the circumstances in which creditors of a corporation generally, and which creditors in particular, will be treated as holding a proprietary interest in a target corporation immediately before a potential reorganization. In general, the proposed rules adopt the standard for reorganizations under section 368(a)(1)(G) recommended in the Senate Finance Committee Report to the Bankruptcy Tax Act of 1980. The proposed regulations also provide that creditors of an insolvent target corporation not in a title 11 or similar case may be treated as holding a proprietary interest in the corporation even though they take no steps to obtain effective command over the corporation's property, other than their agreement to receive stock in the potential reorganization. The proposed regulations, at section 1.368-1(e)(6)(ii), provide specific guidance on how to quantify the proprietary interest of the target corporation so that taxpayers may determine whether a substantial part of the value of the proprietary interests in the target corporation is preserved in the potential reorganization. Because a creditor of a corporation may hold

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claims in more than one class, the proposed regulations generally refer to claims of a particular class of creditors rather than to creditors in a particular class.

The proposed regulations treat claims of the most senior class of creditors to receive a proprietary interest in the issuing corporation and claims of all equal classes of creditors (together, the senior claims) differently from the claims of classes of creditors junior to the senior claims (the junior claims). The proposed regulations treat senior claims as representing, in part, a creditor claim against the corporation, and, in part, a proprietary interest in the corporation. This rule mitigates the adverse effect on continuity of interest of senior creditors seeking payment primarily in nonstock consideration while still taking some payment in shares of stock of the acquiring corporation. The determination of what part of a senior claim is a proprietary interest in the target corporation is made by calculating the average treatment for all senior claims. Thus, the proposed regulations, at section 1.368-1(e)(2)(ii)(B), provide that the value of a proprietary interest in the target corporation represented by a senior claim is determined by multiplying the fair market value of the creditor's claim by a fraction, the numerator of which is the fair market value of the proprietary interests in the issuing corporation that are received in the aggregate in exchange for the senior claims, and the denominator of which is the sum of the amount of money and the fair market value of all other consideration (including the proprietary interests in the issuing corporation) received in the aggregate in exchange for such claims. The effect of this rule is that there is 100 percent continuity of interest if each senior claim is satisfied with the same ratio of stock to nonstock consideration and no junior claim is satisfied with nonstock consideration.

The proposed regulations, at section 1.368-1(e)(6)(ii)(A), provide that the entire amount of a junior claim represents a proprietary interest in the target corporation immediately before the potential reorganization. Thus, the value of the proprietary interest represented by that claim is the fair market value of the claim (which value is generally determined by reference to the amount of money and the fair market value of the consideration received in exchange therefor).

The rules in the proposed regulations are intended to work in conjunction with the current continuity of interest rules. Accordingly, the proposed regulations modify section 1.368-1(e)(1)(ii), relating to the effect on continuity of interest of distributions or redemptions before a potential reorganization, and section 1.368-1(e)(2), relating to the effect on continuity of interest of acquisitions of proprietary interests by persons related to the issuing corporation, to ensure that the purpose of these rules is effected when creditors' claims represent the proprietary interests in the target corporation.

Section 332. *Background*. Section 332 requires that a subsidiary's liquidating distribution to its parent corporation be in complete cancellation or redemption of all its stock. In Spaulding Bakeries, Inc. v. Commissioner, 252 F.2d 693 (2d Cir. 1958), aff'g 27 T.C. 684 (1957), the Second Circuit concluded that for a distribution to be made in cancellation or redemption of "all the stock," payment must be made on each class of stock. See also H.K. Porter Co. v. Commissioner, 87 T.C. 689 (1986).

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Explanation of provisions. The current regulations provide that section 332 applies only to those cases in which the recipient corporation receives at least partial payment for the stock that it owns in the liquidating corporation. The proposed regulations clarify that section 332 applies only to those cases in which the recipient corporation receives at least partial payment for each class of stock that it owns in the liquidating corporation, an interpretation consistent with the Second Circuit's holding in Spaulding Bakeries and the Tax Court's holding in H.K. Porter. The IRS and the Treasury Department have adopted this approach because they believe that it is appropriate for a taxpayer to recognize loss when it fails to receive a distribution on a class of stock in liquidation of its subsidiary. The recipient corporation would recognize such a loss if the distribution qualified as a reorganization.

The proposed regulations also confirm that when the liquidation fails to qualify under section 332 because the recipient corporation did not receive at least partial payment for each class of stock but did receive at least partial payment for at least one class of stock, the transaction may qualify as a corporate reorganization under section 368.

Proposed Effective Date. These proposed regulations will apply to transactions that occur after the date they are published as final regulations in the Federal Register.

B. Page 804, New Sec. 12.6.D. Preamble to the Final Regulations Addressing Creditor Continuity of Interest in Reorganizations

Page 804, New Sec. 12.6.D. Add before Sec. 12.7 the following:

New Sec. 12.6.D. **Preamble to the Final Regulations Addressing Creditor Continuity of Interest in Reorganizations**

Preamble to Final Regulations

Treasury Decision 9434, December 12, 2008

SUMMARY: This document contains final regulations providing guidance regarding when and to what extent creditors of a corporation will be treated as proprietors of the corporation in determining whether continuity of interest ("COI") is preserved in a potential reorganization. These final regulations are necessary to provide clarity to parties engaging in reorganizations of insolvent corporations, both inside and outside of bankruptcy. These final regulations affect corporations, their creditors, and their shareholders. * * *

Background

On March 10, 2005, the IRS and Treasury Department published a notice of proposed rulemaking (REG-163314-03) in the **Federal Register** (70 FR 11903) proposing regulations that would provide guidance regarding the application of the nonrecognition rules of subchapter C of the Internal Revenue Code (Code) to transactions involving insolvent corporations and to other transactions that raise similar issues. No public hearing regarding the proposed regulations was requested or held. The IRS and Treasury

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Department have carefully considered the comments regarding the proposed regulations. The IRS and Treasury Department continue to consider the issues raised and to evaluate the complexity and necessity for valuation under the exchange of net value requirement. In the interim, these final regulations adopt the portion of the proposed regulations that deals with the circumstances in which (and the extent to which) creditors of a corporation will be treated as proprietors of the corporation in determining whether continuity of interest is preserved in a potential reorganization.

Explanation of Provisions

These final regulations provide that, in certain circumstances, stock received by creditors may count for continuity of interest purposes both inside and outside of bankruptcy proceedings. The expansion of the application of the G reorganization rules to reorganizations of insolvent corporations outside of bankruptcy is consistent with Congress' intent to facilitate the rehabilitation of troubled corporations. S. Rep. No 96-1035, 96th Sess. 35 (1980). Accordingly, the final regulations adopt the rules proposed for creditors of an insolvent target corporation outside of a title 11 or similar case in new §1.368-1(e)(6) with only minor modifications and clarifications. The final regulations treat claims of the most senior class of creditors to receive a proprietary interest in the issuing corporation and claims of all equal classes of creditors (together, the senior claims) differently from the claims of classes of creditors junior to the senior claims (the junior claims). The final regulations treat such senior claims as representing proprietary interests in the target corporation. While such senior claims, and all junior claims, are treated as representing a proprietary interest in the target corporation, the determination of the value of proprietary interests in the target corporation represented by the senior claims is made by calculating the average treatment for all senior claims. The final regulations provide that the value of a proprietary interest in the target corporation represented by a senior claim is determined by multiplying the fair market value of the creditor's claim by a fraction, the numerator of which is the fair market value of the proprietary interests in the issuing corporation that are received in the aggregate in exchange for the senior claims, and the denominator of which is the sum of the amount of money and the fair market value of all other consideration (including the proprietary interests in the issuing corporation) received in the aggregate in exchange for such claims. In contrast to the treatment of the senior creditor class that receives stock of the issuing corporation, the value of the proprietary interest in the target corporation represented by a junior claim is the fair market value of the junior claim. The effect of this rule is that there is 100 percent continuity of interest if each senior claim is satisfied with the same ratio of stock to nonstock consideration and no junior claim is satisfied with nonstock consideration.

An example was added to the COI rule in response to a suggestion that the final regulations demonstrate the bifurcation of senior claims when the creditors of the class receive disproportionate amounts of acquiring corporation stock and other property. Also, in response to comments, a rule was added to the final regulations requiring that in the situation where there is only one class of creditors receiving stock, more than a de minimis amount of acquiring corporation stock must be exchanged for the creditors' proprietary interests relative to the total consideration received by the insolvent target corporation, its shareholders, and its creditors, before the stock will be counted for purposes of COI. * * *

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