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Further Liberalization of Requirements for Corporate Reorganization

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Section 368 of the Internal Revenue Code describes various transactions that may qualify as nontaxable corporate reorganizations. One form of reorganization, described in section 368(a)(1)(D) and commonly referred to as a "D" reorganization, involves a transfer by one corporation of all or a part of its assets to another corporation if, after the transfer, (i) the transferor and its shareholders are in control of the corporation to which the assets are transferred and (ii) stock or securities of the corporation receiving the assets are distributed in a transaction qualifying under Code section 354, 355, or 356.

For various reasons described below, it has been unclear whether a transaction otherwise described in section 368(a)(1)(D) would qualify as a D reorganization if, immediately after the initial transfer of assets, the acquiring corporation transferred the assets to a subsidiary controlled by the acquiring corporation.

The IRS has recently ruled, however, that such a transfer will not prevent a transaction from qualifying as a D reorganization. This ruling appears to facilitate consideration of reorganization structures that might previously have been rejected as unduly risky from a tax perspective.

Rev. Rul. 2002-85

In Revenue Ruling 2002-85 (to be published in I.R.B. 2002-52), A, an individual, owned 100% of the stock of two domestic corporations, P and T. P in turn owned all of the stock of S, also a domestic corporation.

Pursuant to a plan and for valid business reasons: (i) T transferred all of its assets to P in exchange for P voting stock and cash constituting, respectively, 70% and 30% of the consideration for the transfer; (ii) T liquidated, distributing its assets (the cash and P stock) to A; and (iii) P subsequently transferred all of the T assets to S in exchange for S stock.

S continued the historic business of T after the transaction, and P retained the stock of S. Setting aside the transfer of the assets of T to S, the transaction qualified as a D reorganization. That transfer, however, raised several potential concerns as to whether the transaction as a whole would meet the requirements established by the statute and by case law for a nontaxable reorganization.

P as Party to Reorganization

One concern was whether the ownership by P of the assets of T on a transitory basis was sufficient to cause P to be "a party to a reorganization" as that term is defined in section 368(b), taking into account Groman v. Commissioner (302 U.S 82 (1937)) and Helvering v. Bashford (302 U.S. 454 (1938)). Those cases concluded that a corporation the stock of which was used as consideration in an acquisition would not be a party to a reorganization where it had not acquired any assets or stock in the transaction, or held stock or assets of the target only momentarily. If, in the ruling, P was not "a party to a reorganization," the exchange by A of T stock for P stock would be taxable.

The ruling noted, however, that the reorganization rules have been changed repeatedly since Groman and Bushford were decided, in a manner that indicates that Congress has rejected the principle for which those cases are often cited to the effect that a post-acquisition transfer of assets, even to a wholly owned subsidiary, may cause a transaction to fail to qualify as a reorganization by reason of the lack of requisite continuity of interest in a party to the reorganization. This "remote continuity" concern arising from the case law is closely related to the statutory requirement that, in the context of the ruling, each of P and T be "a party to a reorganization."

Specifically, in 1954, Congress added section 368(a)(2)(C) to the Code in response to Groman and Bashford. Section 368(a)(2)(C) initially provided that a transaction otherwise qualifying as a statutory merger under section 368(a)(1)(A) (an "A" reorganization), or as an exchange of assets for stock under section 368(a)(1)(C) (a "C" reorganization), would not be disqualified by

reason of the transfer of the assets or stock acquired in the transaction by the acquiring corporation to another corporation controlled by it.

Section 368(a)(2)(C) was subsequently amended to also apply to (i) a transfer of stock acquired in a stock-for-stock reorganization otherwise described in section 368(a)(1)(B) (a "B" reorganization) and (ii) a transfer of assets by a corporation in bankruptcy proceedings in a transaction otherwise within the scope of section 368(a)(1)(G) (a "G" reorganization) that is also described in section 354.

More recently, Reg. section 1.368-2(k) as added in 1998 extended the permissive approach of section 368(a)(2)(C) to successive transfers of assets acquired in a transaction otherwise qualifying as an A, B, C, or G reorganization to one or more controlled corporations, so long as, with respect to each transfer, the corporation acquiring assets was controlled by the transferor, with control being defined by reference to the section 368(c) 80% standard; and to one or more transfers to controlled corporations of the stock of a surviving corporation following a reverse triangular merger described in section 368(a)(2)(E) (in which, typically, a newly formed subsidiary of a corporation (the "controlling corporation") is merged into the target corporation, with the target corporation surviving and the shareholders of the target corporation receiving stock of the controlling corporation).

Thereafter, the IRS held in Rev. Rul. 2001-24 (2001-1 C.B. 1290) that, in a forward triangular merger (where the target corporation is merged into a newly formed subsidiary of the controlling corporation) otherwise qualifying under section 368(a)(2)(D), the transfer of the stock of the surviving corporation to another subsidiary of the controlling corporation would not prevent the acquiring corporation from being treated as a party to the reorganization.

The IRS further observed, in Rev. Rul. 2002-85, that the differences between asset reorganizations under section 368(a)(1)(D) and under sections 368(a)(1)(A) and 368(a)(1)(C) did not warrant a different standard as to the consequences of a post-acquisition dropdown of assets.

The ruling also notes, more generally, that a transfer of acquired assets or stock will not fail to qualify by reason of the remote continuity of interest concern for which Groman and Bashford are often cited, if the transaction satisfies the continuity of business enterprise requirement (discussed below).

Taking all of the above into account, the IRS concluded that the dropdown of assets described in Rev. Rul. 2002-85 would not preclude treatment of the acquiring corporation as a party to a D reorganization.

Acquisition of Substantially All the Assets

Section 354 effectively requires that, in a D reorganization not within the scope of section 355, the corporation to which the assets are transferred acquire substantially all the assets of the target corporation. Rev. Rul. 2002-85 further concluded, based on the reasoning in prior rulings concerning reverse triangular and C reorganizations, that the transfer of assets by P to S should not be viewed as breaching this requirement, because P retained the stock of S that P received in exchange for the assets of T.

The ruling does not indicate, however, whether an otherwise identical transaction would qualify as a D/354 reorganization if P transferred the assets of T to S as a capital contribution without receiving anything in exchange, and the IRS might take the position that such a transaction does not qualify as a D reorganization notwithstanding that the issuance of stock by a wholly owned subsidiary to its parent would have no economic significance.

Continuity of Business Enterprise

The case law and regulations under section 368 also require that, in order for a transaction to qualify as a reorganization, the acquiring corporation must either continue the historic business of the target corporation or use a significant portion of the assets of the target in a business. These requirements are collectively referred to as the continuity of business enterprise requirement.

Under the regulations issued in 1998 that address the continuity of business requirement, this requirement will continue to be met if the business is continued by, or the assets acquired are held by, one or more members of the same "qualified group" as the acquiring corporation. The term "qualified group" as defined in Reg. section 1.368-1(d)(4) includes the acquiring corporation and other corporations controlled by it as determined by reference to the definition of control in section 368(c). Because, in the ruling, S continued the historic business of T, the transaction satisfied the continuity of business enterprise requirement.

Rev. Rul. 2002-85 also declared obsolete an earlier ruling dealing with the tiebreaker rule in section 368(a)(2)(A) to the effect that a transaction "described in" both section 368(a)(1)(C) and section 368(a)(1)(D) will, for almost all purposes under subchapter C of the Code, be treated as described only in section 368(a)(1)(D).

In Rev. Rul. 74-545 (1974-2 C.B. 122), a corporation transferred substantially all of its assets to another corporation for stock and then distributed that stock, but retained other assets, so the transaction could not qualify as a D/354 reorganization (and clearly was not within the scope of section 355) even though it was arguably "described in" section 368(a)(1)(D). In a controversial application of section 368(a)(2)(A), the ruling concluded that under the tiebreaker rule the transaction could not qualify as a reorganization under section 368(a)(1)(C) because it was also "described in" section 368(a)(1)(D), even though the transaction failed to qualify as a D reorganization.

The policy concern underlying Rev. Rul. 74-545, namely, to prevent the use of the C reorganization rules to avoid the D reorganization requirement of a liquidating distribution by the transferor described in section 354, 355, or 356, was resolved through the addition to the Code of section 368(a)(2)(G), which provides that a transaction may qualify as a C reorganization only if the transferor distributes

the stock and other properties it received, as well as its other assets, pursuant to the plan of reorganization. Taking section 368(a)(2)(G) into account, Rev. Rul. 74-545 was found to be obsolete.

Application of Ruling

Rev. Rul. 2002-85 is not limited by its terms to transactions completed after the ruling was issued. The ruling states, however, that the Service will not apply the principles of the ruling to challenge a taxpayer's position that a transaction completed on or before December 9, 2002, or pursuant to an agreement that was binding on that date, was not a D reorganization, if the identified parties treat the transaction as not qualifying as a D reorganization.

The ruling also addresses the satisfaction of certain requirements under Code section 367 by a U.S. shareholder of a target corporation where the shareholder has taken a position consistent with the principles of Rev. Rul. 2002-85 with respect to a transfer in exchange for stock or securities of a foreign acquiring corporation that occurs on or after July 20, 1998, and on or before December 9, 2002.

Observations

Rev. Rul. 2002-85 represents a further diminution, perhaps to the vanishing point, of the vitality of Groman-Bashford principles regarding remote continuity of interest that have long troubled practitioners in the reorgainzation area.

The ruling notes that the Service and Treasury are considering amendment of the regulations under section 368 to reflect the principles of the ruling. This observation may arise from a concern as to whether the Service can prevent, through a ruling, the continued application in the D reorganization area of principles of Supreme Court decisions (i.e., Groman and Bashford) that have not been overturned by legislative changes. Whether the Treasury would clearly have the authority to do this by regulation is a question beyond the scope of this article.

The ruling should facilitate transactions in circumstances where a orporation desires to cause the acquisition by its subsidiary of the assets of a target corporation through a nontaxable reorganization that does not involve a merger, for example, in a situation in which the acquiring corporation is attempting to avoid or minimize exposure to liabilities of the target corporation but the contemplated transaction cannot be effected as a C reorganization.

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