Extreme Makeover: Corporate Tax Edition—Re-thinking Reorganizations

By Richard M. Weber, Jr.

Richard M. Weber provides an overview of the current rules governing acquisitive reorganizations and compares the complexity of the current acquisitive reorganization regime with the complexities of the former entity classification rules.

Internal Revenue Code ("the Code") provisions governing the tax or tax-free treatment of corporate acquisitive reorganizations have morphed and mutated ad hoc over the past 80 years into a dysfunctional house that needs to be knocked down and replaced. It is time that the Code Sec. 368 acquisitive reorganization provisions had a makeover.

Corporate reorganizations are "corporate amalgamations or readjustments" occurring in mergers or acquisitions, corporate divisions or significant changes in capital structure.[1] Acquisitive reorganizations involve mergers, acquisitions and consolidations, and are a subset of the broad category of corporate reorganizations.[2] In a merger, one corporation is absorbed into another corporation. In a consolidation, two corporations come together to form a new corporation.[3] An acquisitive reorganization is a realization event that is taxable under the general recognition rules to the target[4] shareholders[5] and possibly the target corporation.[6] Although acquisitive transactions are clearly realization events, current federal corporate income tax law provides for deferral or postponement of tax on certain types of acquisitions through compliance with statutory and judicial rules.[7]

The basic "A," "B" and "C" acquisitive reorganizations reflect early types of acquisitive transactions used in the business world.[8] The Type A reorganization is a statutory merger[9] or consolidation under state law that usually results in the surviving corporation having all of the liabilities and assets of the target corporation.[10] The Type "B" stock-for-stock acquisition[11] allowed the acquiring corporation to keep the target as a subsidiary, but still has the disadvantage of all the liabilities of the target.[12] The Type "C" stock-for-assets acquisition[13] seemed to avoid the transfer of the target's liabilities.[14]

An acquisitive reorganization, an A, B or C, can be structured to involve a subsidiary of the acquiring corporation in a "triangular" structure. The "triangular" structure is specifically permitted in the Code.[15] Triangular reorganizations are useful because setting the target up as a subsidiary of the acquiring corporation has advantages such as insulation of the acquirer assets from the liabilities of the target, avoiding the requirement of obtaining acquiring corporation shareholder approval before the transaction, and keeping the target business a separate operation.[16] Additional rules must be met for a triangular reorganization and these rules vary based on which of the three acquisitive reorganizations is being used and whether the target or subsidiary survives.[17] These triangular mergers provide a good illustration of how the Code has reacted to changes in the business world with additional layers of complexity.

This article does not attempt to describe all of the rules involved in triangular mergers. It is noteworthy that the Code provides distinct rules for each basic

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type of acquisitive reorganization and for the related triangular reorganizations. These layers of complexity have been added despite the fact that the end result of any acquisitive reorganization, whether in basic or triangular form, is economically equivalent. All acquisitive acquisitions derive justification based on the "mere change in form" policy, so it is useful to consider these as a group. Although the focus of this article is acquisitive reorganizations[18] and the related triangular reorganizations,[19] the same justification for simplification should also be applied to recapitalizations, changes in identify and reorganizations in bankruptcy.[20]

Divisive reorganizations contemplated in Code Sec. 355 and Code Sec. 368(a)(1)(D) are beyond the scope of this article. Divisive reorganizations are reorganizations involving a spin-off, split-off or break up of an existing corporation. Policy concerns of a divisive reorganization are not the same "mere change of form" involved in acquisitive reorganizations. Divisive reorganizations not only present policy concerns different from those presented by acquisitive reorganizations but also involve potential abuses different from those involved in acquisitive reorganizations. A divisive reorganization might be used, for example, to avoid recognition in corporate distributions of property to shareholders. Amended Code Sec. 355 blocked the use of divisive reorganizations as an end run around the repeal of *General Utilities* in Code Sec. 311(b).[21]

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The Problem with Tax Deferred Reorganizations–An Introductory Summary

Achieving tax deferred status for corporate reorganizations involves a great deal of complexity. The complexity results from the combination of the statutory and judicial requirements, the overlaps in the definitions between the types of acquisitive reorganizations, and the various forms in which a transaction may be undertaken.

The corporate reorganization rules have been criticized as "extraordinarily complex, even for the code."[22] Corporate reorganizations have evolved ad hoc,[23] imposing completely different requirements for alternative transaction forms that are economically equivalent. A basic example of this inconsistency is found in the Code Sec. 368(a)(1)(B) prohibition of boot in certain stock purchases while Code Sec. 368(a)(2)(B) allows boot in asset purchases. The cost of compliance with reorganization rules is high. Because of the complexity of the rules and the high stakes involved, taxpayers have historically been reluctant to proceed without an IRS advance ruling or opinion letter from private counsel.[24]

This article provides an overview of the current rules governing acquisitive reorganizations sufficient for the reader to appreciate that these rules are a needless complexity. Tax-deferred reorganizations must be structured not only to fit the goals and constraints of the parties to the transaction but also to comply with statutory definitions and judicial rules that change with almost every contemplated variation in the transaction. The current regime for tax-deferred acquisitive reorganizations is analogous to the entity selection process of the former Reg. §301.7701 for corporation or partnership treatment, in which businesses would go through needless contortions to achieve their desired tax treatment. This article compares the complexity of the current acquisitive reorganization regime with the complexities of the former entity classification rules.

Current rules for tax-deferred acquisitive reorganization treatment are so complex as to discourage use.[25] The current system presents overlaps in definitions which poses the danger that a reorganization may be recast by the IRS as a different type of transaction which will then fail to satisfy the rules of that type of reorganization and result in taxable treatment.[26]

The current tax-deferred reorganization rules have no real benefits. The complexity of the system serves to make work for accountants and lawyers that does not add value for businesses, in much the same way as the former entity classification rules provided work for lawyers and accountants but added no value. Current rules promote the promulgation of more regulations; burden the IRS, taxpayers, lawyers and accountants; and increase requests for private letter rulings[27] while not necessarily encouraging the most economical or efficient alternatives.

Elective Tax Treatment for Acquisitive Reorganizations

There are advantages and disadvantages to taxable and tax-deferred reorganizations. Taxable reorganizations of corporations will involve the disadvantage of the double corporate tax. But with the taxable sale the buyer gets a cost basis.[28] The tax-deferred reorganization will defer recognition of tax through a carryover

basis. If the transaction is a tax-deferred reorganization, the buyer receives a carryover basis in the property received.[29] The buyer recognizes no gain on the purchase, unless the buyer uses appreciated property[30] other than its own stock in the transaction.[31]

I propose to leave the decision whether to have a taxable sale and cost basis for the buyer or tax-deferred acquisitive reorganization in which tax is deferred and basis is carried over to be left up to the parties involved.[32] This would be an opportunity for parties to an acquisitive reorganization to elect tax treatment, similar to the check-the-box rules and the Code Sec. 338 election, while including anti-abuse rules. Patterns for this change are available in the current entity selection system,[33] the Code Sec. 338 election[34] and the 1985 Senate Finance Committee Proposal to allow for an express election for corporate reorganizations.[35] The proposed elective acquisitive reorganization system should incorporate a safety valve to ensure transactions that in economic terms are sales that do not masquerade as tax-deferred reorganizations. Further the corporate reorganization election should be explicitly limited to reorganizations among domestic corporations only, leaving in place Code Sec. 367.

Under this proposed elective regime, the default treatment for qualifying reorganizations should be defaulted to either a tax-deferred or a taxable transaction,[36] with an election to be treated as other than the default.[37] For a valid election to treat the transaction as tax-deferred, all of the corporations that are parties to the transaction must consent to the election,[38] similar to the current Code Sec. 338(h)(10) election.

> The cost of compliance with reorganization rules is high. Because of the complexity of the rules and the high stakes involved, taxpayers have historically been reluctant to proceed without an IRS advance ruling or opinion letter from private counsel.

I. Complexity of a Merger

Merger and acquisition manuals supply lengthy checklists[39] for the business owner, manager and attorney to consider when working on a contemplated merger or acquisition. Numerous business questions must be addressed in considering whether to merge such as financing, securities regulation, management issues and valuation, just to name a few in general terms.

These complexities can be illustrated by comparing a corporate reorganization with personal events that present similar intricacies and concerns, such as marriage or buying a house. Both of these personal events involve a great deal of similar complexities.

The decisions surrounding marriage are similar to the emotional and cultural dynamics to a merger or acquisition.[40] A merger or acquisition must address management and cultural issues; after all, a corporate reorganization is in a sense a marriage of two or more corporations.

Buying a home, especially a starter home, for example, raises questions of the location, the neighborhood, valuation (price), potential for appreciation and availability of financing. A corporate reorganization must address these types of issues on a much larger scale.

Current corporate reorganization rules add an unnecessary layer of complexity on top of the corporate marriage and house buying complexities of the acquisitive reorganization. Without presenting a lengthy review of considerations of a merger or acquisition, the marriage and house buying analogies seek to illustrate the ways in which each party's goals and constraints put pressure on meeting the statutory and judicial tests for a tax-deferred reorganization. Both of these examples bring up similar worries such as whether the decision to merge is a good idea and whether or not the acquisitive reorganization will work. These are meant as an illustration of the interaction of the pressures driving decisions whether to merge or acquire and how to structure the transaction. Specific pressures driving decisions to merge or acquire and the structure of the transaction include financial, securities regulation, business considerations, valuation and tax consequences.

II. Transaction Structures

The transaction structure will be driven by the goals and constraints of the corporations involved. Goals and constraints include insulating the acquiring corporation from unknown or contingent liabilities,[41] preservation of company marks, names, contract rights, licenses and other attributes of either or both parties, obtaining necessary approval from shareholders and third parties such as banks, and effects of minority and dissenting shareholders.[42]

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Forward Merger

In a regular or forward merger, the target corporation would be absorbed into the acquiring corporation and the target would cease to exist.[43] This transaction would involve two parties, the buyer and seller. *See* Diagram 1.

This transaction structure offers no protection to the acquirer for contingent liabilities and may run into contractual problems with company marks, names, contract rights, licenses and other attributes of either corporation.

Reverse Merger

In a reverse merger, the acquiring corporation would be absorbed into the target. *See* Diagram 2. The acquiring corporation would control the combined company with the acquiring corporate entity ceasing to exist. The reverse transaction structure allows the name, contract rights, licenses and other attributes of the target to survive, while at the same time these same attributes of the acquiring corporation may cease to exist. Also, the "reverse" will combine the contingent liabilities of both companies allowing no protection for the acquiring corporation from target corporation contingent liabilities.

Diagram 1.

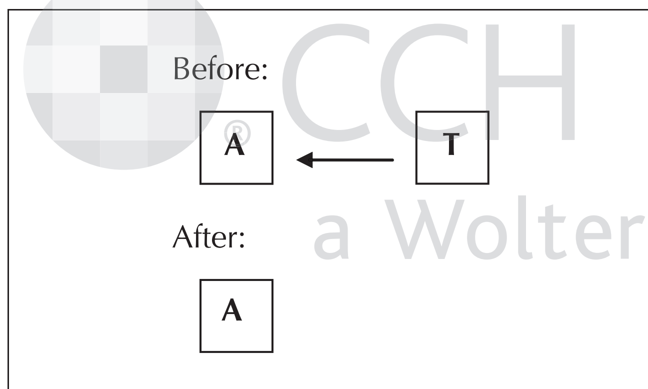
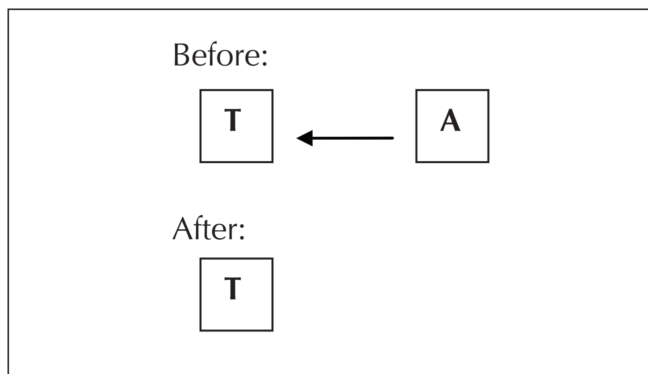


Diagram 2.



Forward Triangular Merger

A triangular merger[44] introduces a third participant, hence the term triangular merger. This transaction structure involves three corporations, the target on the seller side and a parent and subsidiary of the parent on the buyer side of the transaction. Here the subsidiary corporation is the acquirer, but the target or its shareholders receive stock of the subsidiary's parent. In this regular or direct triangular reorganization, the subsidiary is the acquiring and surviving corporation as between the subsidiary and the target.

The forward triangular merger has the benefits of insulating the acquiring corporation from target contingent liabilities. However, the company names of the target will disappear and contract rights, licenses and other attributes of the target may not survive either. *See* Diagram 3.

Reverse Triangular

In the reverse triangular merger, the target corporation is the surviving corporation, the purchasing company's subsidiary is merged directly into the target corporation so the target survives and the subsidiary disappears.[45] The direct triangular merger has the parent's subsidiary acquiring the target. This reverse triangular is in substance the same as the triangular merger. But in form the target survives and not the subsidiary of the acquiring corporation. *See* Diagram 4.

Diagram 3.

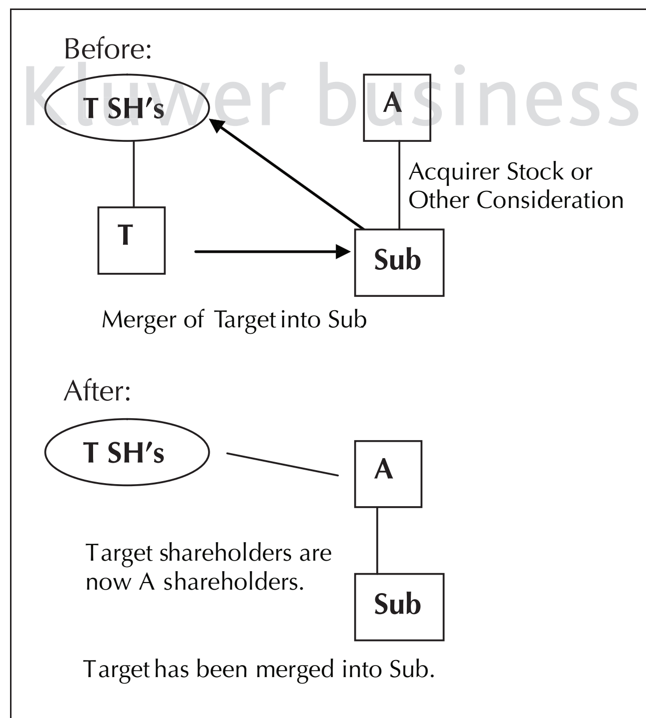


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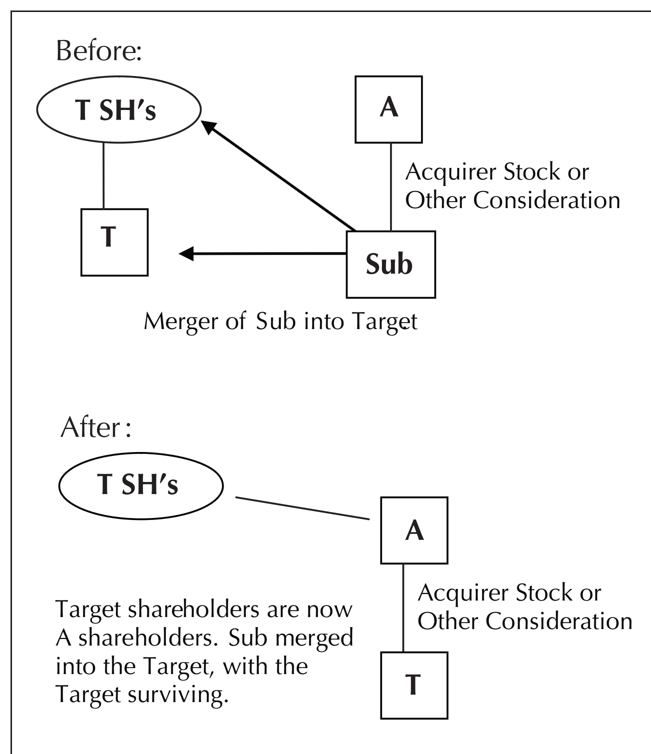
Diagram 4.



III. Tax Aspects of Mergers

This discussion is intended as an overview of the way tax-deferred reorganizations work and the difficulties presented under current rules. A complete and comprehensive review of all aspects of each acquisitive reorganization is beyond the scope of this article.

Generally, the sale or exchange of property is a realization event on which gain or loss is recognized. Under the general rule, a merger or consolidation is a realization event that would trigger gain recognition to the shareholder and possibly the target.[46] Absent an exception, even if target shareholders received stock of the acquirer in exchange for their target shares, this exchange would be a tax event treated as if target shareholders sold their shares for cash and then used the proceeds to buy acquiring company shares. An exception to the general rule is accomplished through Code Secs. 368, 361 and 354.

A merger, acquisition or consolidation will qualify for tax-deferred treatment only if the statutory[47] as well as judicial requirements are met. Complying with these requirements involves an examination of the form of consideration, assumption of liabilities, dissenting and minority shareholders, and consequences of toehold shares.[48] But the transaction structure must first make business sense by allowing the parties to achieve their goals and stay within their constraints. As discussed above, within the chosen reorganization definition, the transaction structure must not violate existing contracts, loan restrictions and covenants, or licenses that may not be assignable.

A. Code Sec. 361–Nonrecognition Rule for Corporations

Code Sec. 361 provides a nonrecognition rule for corporations that are parties to a reorganization as defined in Code Sec. 368.[49] Under the general rule in Code Sec. 361(a), no gain or loss is recognized by a corporation that is a "party to a reorganization"[50] and exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation that is a party to the reorganization.[51] Under Code Sec. 361(c), no gain or loss is recognized by the target corporation on the distribution to its shareholders of property in pursuance of the plan of reorganization so long as the target corporation is a party to the reorganization.[52] Code Sec. 1032 provides the nonrecognition rule for the acquiring corporation.[53]

B. Code Sec. 354–Nonrecognition Rule for Shareholders and Creditors

Code Sec. 354 provides the nonrecognition rule for shareholders pursuant to a Code Sec. 368 reorganization. A shareholder who transfers stock in a reorganization and receives stock or other consideration in exchange has realized a gain or loss after deducting their adjusted stock basis from the fair value of consideration received. Normally recognition rules in Code Secs. 61(a)(3) and 1001 would require recognition of this gain or loss.[54] Code Sec. 354[55] provides an exception to the recognition rules so that no gain or loss is recognized by target shareholders, if under a plan or reorganization, target shareholders exchange their target stock or securities solely for stock or securities of the acquiring corporation or parent of the acquirer.[56]

C. Code Sec. 368–Corporate Reorganizations

Code Sec. 368(a) spells out certain types of "reorganizations" that qualify for tax-deferred treatment, if the reorganization fits into one of the definitions in Code Sec. 368(a) nonrecognition treatment may apply.[57] The following discussion of the complexities of Code Sec. 368 will focus on "acquisitive reorganizations"[58] in Code Secs. 368(a)(1)(A)–(C)[59] and the triangular varia-

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tions of each of the basic acquisitive reorganizations.[60] A tax-deferred acquisitive reorganization involves a merger, acquisition or consolidation that qualifies under a tax regime that postpones tax until a later time. A Type A reorganization is a statutory merger. Type B is a stock-for-stock acquisition, this reorganization results in the target corporation becoming a subsidiary of the acquiring corporation. The Type C stock-for-assets acquisition involves a transfer of target assets[61] rather than transfer of target stock as in Type B.

Type B is the strictest reorganization definition, permitting cash to pay target shareholders only for fractional shares. Less strict is Type C, which permits up to 20-percent boot in the form of a combination of cash and or assumption of liabilities. The definition of the Type A is the least strict reorganization provision, permitting as much as 50 percent and perhaps more boot in a statutory merger or consolidation.[62] But the less strict rules in A can be deceiving because still lurking are the judicial tests which must be met and may be affected by the form of the transaction chosen.

1. Type A Reorganization

A Type A reorganization[63] requires compliance with state or federal corporate laws regarding merger or consolidation[64] and the transaction must comply with judicial tests detailed below. Statutory mergers or consolidations allow for more flexibility in the form of consideration exchanged between the parties to the transaction than is allowed in Type B or Type C. For continuity of interest, [65] Treasury regulations provide a safe harbor, the merger will qualify for a Type A if at least 50 percent of target shareholders become shareholders of the acquiring corporation.[66] The acquiring corporation must also acquire "control" of the target.[67] If an A reorganization is structured as a triangular merger, Code Sec. 368(a)(2)(E) requires 80 percent of all target shareholders tender their shares in exchange for acquiring corporation shares.

2. Type B Reorganization

A Type B reorganization is a stock-for-stock transaction in which the purchaser must acquire a controlling interest in target stock solely in exchange for all or part of the purchaser's voting stock.[68] The acquiring corporation must obtain control immediately after the transaction.[69] In a Type B reorganization, the purchasing company would become a parent of the target company by acquiring a controlling interest of stock in the target company and the target becomes a purchased subsidiary.

The Type B reorganization requires that the exchange be "solely for all or part" of the acquiring corporation voting stock or solely for all or part of the voting stock of the acquiring corporation's parent.[70] No boot is allowed by the "solely for voting stock" requirement, with only a minor exception for cash paid in lieu of fractional share interests.[71] The disallowance of boot acts as a continuity of proprietary interest requirement.[72]

Toehold shares held by the acquiring corporation before the plan of merger will not necessarily disqualify the transaction from being a Type B. The regulations allow toehold shares,[73] but only "solely for its voting stock." If the acquiring corporation paid cash for target shares in a previous transaction, the step transaction may result in the prior cash transaction being integrated with the stock-for-stock merger resulting in a violation of the voting stock requirement for Code Sec. 368(a)(1)(B).[74] Integration could be avoided with prior planning by unconditionally selling toehold shares to a third party *prior to* making the offer to acquire in a subsequent Type B.[75]

3. Type C Reorganization

A Type C reorganization is a stock-for-asset acquisition. A Type C involves "the acquisition by one corporation, in exchange for all or a part of its voting stock … of substantially all or part of the properties of another corporation."[76]

Type C requires that the purchaser corporation acquires "substantially all" of the properties of another corporation.[77] The acquiring corporation is restricted to exchanging only its own voting stock or the voting stock of the acquiring corporation's parent. In the C reorganization the acquirer may use limited amounts of "boot," cash or property other than voting stock as part of the exchange. Also, the purchasing company may assume liabilities and property subject to liabilities.[78] After the exchange the target must be liquidated.[79]

Toehold shares do not disqualify a transaction from being a Type C reorganization. But these toehold shares must be considered together with amounts paid to creditors and liabilities assumed because the combination might cause the transaction to fail the "solely for voting stock" requirement.[80]

4. Tax Consequences of a Tax-Deferred Reorganization, in General

Under Code Sec. 361(a), a transaction that meets the requirements of one of the reorganization definitions

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in Code Sec. 368 would not be taxable to the target or the acquirer. Target shareholders who receive only acquiring corporation stock will not have gain or loss on the exchange.[81] Code Sec. 354 operates as an exception to Code Sec. 331 under which target shareholders would ordinarily report gain or loss upon the complete liquidation of a corporation.[82] Target shareholders will have the same basis in their new acquiring corporation shares as in their exchanged target shares.[83] Those target shareholders who receive other property, or other property in addition to stock, will be taxed on the boot to the lesser of boot received or gain realized.[84]

No gain or loss is recognized by the acquiring corporation pursuant to Code Sec. 361.[85] The acquiring corporation will not recognize a gain on the exchange of its stock for target stock or target assets under Code Sec. 1032.[86] The acquiring corporation's basis in target assets will be the same as the target's basis.[87] The acquiring corporation would receive the target shareholder's basis in target stock[88] in a stock-for-stock exchange.

Even if target shareholders exchange target shares with the acquirer for acquirer shares, the transaction is viewed as if the target transferred assets and liabilities to the acquirer and then immediately transferred acquirer stock to its shareholders. Under Code Sec. 361(c), the target would not then be taxed on the distribution of acquirer stock or other property received from the acquirer to target shareholders.[89]

D. Judicially Imposed Tests

In addition to meeting the specific requirements of the Code to fit one of the definitions of reorganization in Code Sec. 368(a), judicially imposed tests must be satisfied. These judicial tests include continuity of interest, continuity of business enterprise, business purpose and the step-transaction doctrine.

1. Continuity of Interest (COI)

If shareholders remain invested in the new modified entity, the rationale is that the transaction should not trigger immediate recognition of gain or loss.[90] The COI requirement is built in to several of the Code Sec. 368(a)(1) reorganization definitions. For example, type and amount of consideration is specified in the statute for a Type B (solely for all or part) and Type C (solely for all or part of its voting stock, of substantially all of the properties). Judicially developed COI test continues to be relevant to Type A reorganizations.

To satisfy the previous threshold for the COI test, at least 50 percent of target shareholders had to become shareholders of the acquirer or the acquirer's parent.[91] Some cases allowed for less than 50-percent continued proprietary interest[92] and new Reg. §1.368-1(e)(2) provides a COI safe harbor where the COI is at least 40 percent.[93]

Under the regulations, COI in the target is maintained if target stock is exchanged for a substantial interest in acquirer stock. Substantial interest is achieved when at least 40 percent of target shareholders exchange their shares for acquirer shares.[94] Also, the regulations provide that COI is not satisfied at or below 25 percent leaving uncertainty between 25 percent and 40 percent.[95] In addition, the transaction will fail the test if the stock furnished by the acquiring corporation is redeemed.[96] In the case of shares redeemed, if the acquirer shortly after the transaction, redeems shares it recently issued, the acquirer has in substance exchanged cash for stock.[97]

A disposition of stock before a potential reorganization will not cause the subsequent transaction to fail the COI test so long as disposition is to persons not related to the target or to persons related to the issuing corporation.[98] Further, post-reorganization sales to related parties will cause the transaction to fail the COI requirement.

The COI test must not be confused with tests for "control" in Code Sec. 368(c). These are two different tests and both must be met. Control is what the acquirer must attain for Code Sec. 368. COI of target shareholders must be preserved for the judicial test.

2. Continuity of the Business Enterprise (CBE)

The CBE Test requires that the issuing corporation either continue the target's historic business or "use a significant portion of [the target corporation's] historic business assets in a business."[99] In general a corporation's "historic business" is the business it has conducted most recently.[100] If the target has more than one division or line of business, CBE requires only that the acquirer continue a significant line of business.[101]

3. Business Purpose

Reorganizations under Code Sec. 368(a) must be undertaken for reasons related to the continuance of the business of the corporation in order to give effect to "readjustment of continuing interests under modified corporate forms."[102] The transaction fails the business purpose test if it is "a mere device that puts on the form of a corporate reorganization as a

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disguise for concealing its real character, and the object and accomplishment of which is the consummation of a preconceived plan having no business or corporate purpose."[103]

4. Step-Transaction Doctrine

Under the step-transaction doctrine a series of transactions can be grouped together as if a single transaction to determine the appropriate tax consequences.[104] An example of the step transaction is illustrated in one of the examples given above where the COI tests fails if the acquiring corporation redeems stock it issued as part of a reorganization. In the first step, the acquirer issues its shares to the target shareholders in exchange for target stock. The second step involves the acquirer paying cash to buy back or redeem its stock issued in the transaction. The step transaction collapses these two steps which become in substance the acquiring corporation paying cash for target stock.

5. Substance over Form

The courts have given the IRS permission to recharacterize the form of transactions to reflect the economic reality or substance.[105] Normally the substance-over-form rule will prevent taxpayers from achieving a desired tax treatment by elevating the form of a transaction over its economic reality.[106] The area of tax-deferred corporate reorganizations is an exception to this common law anti-abuse rule. Current reorganization rules are one place in the code where form trumps substance. The form of the reorganization transaction dictates whether it will be taxable or tax-deferred.

Here I would argue that the tax code has not abandoned the substance of transactions for the sake of tax-deferred treatment. Rather, the substance of acquisitive corporate reorganizations, in all the various forms, is economically equivalent so long as continuity of investment is maintained. The end result in acquisitive reorganizations is the combination, amalgamation or merger of two or more corporations. But under the current reorganization regime, the transaction must be made to fit within complex tax rules with opposing requirements for different forms despite economically equivalent outcomes. So long as continuity of investment is maintained, the outcomes of acquisitive reorganizations are economically equivalent and elevating form over substance is a wasteful way of regulating tax-deferred treatment.

IV. Rationale of Tax-Deferred Reorganizations–"Substantially a Continuation of the Investment"

A. Continuity of Investment

The notions of "continuity of investment" or "substantially a continuation" influences nonrecognition rules. The rationale for nonrecognition treatment for a merger or acquisition is that "the new property is substantially a continuation of the old investment still unliquidated; and, in the case of reorganizations, that the new enterprise, the new corporate structure, and the new property are substantially continuations of the old still unliquidated."[107] Mere change in form is cited as justification for other nonrecognition rules such as Code Sec. 1031 like-kind exchanges.

B. Limitations of the Continuity Rationale–Lack of Precision

What does "continuity of investment" mean? One critic of the "continuity of investment" concept points out that the phrase is unclear.[108] This argument posits that if "continuity of investment" means the investment has not been cashed out, then the construction of "mere change in form" provisions such as Code Sec. 1031 like-kind exchange and Code Sec. 368 corporate reorganizations are too narrow and should apply whenever an exchange avoids receipt of cash. If "continuity of investment" means a "continuity of interest" an exchange of raw undeveloped land for an apartment building means a change in risks, income and performance. Likewise, in the context of corporate reorganizations, if "continuity of investment" means a "continuity of interest" an exchange of target stock for acquirer stock may indeed mean a change in attendant risks, income and performance. Here it would be argued that the interest is not continued. However, in the corporate reorganization context this argument would miss the reality that risks, income and performance can change every day. Sometimes changes in risks may warrant a corporate reorganization to keep up with a market or capitalize on an opportunity. Tax-deferred treatment of corporate reorganizations allows corporations to make changes to meet the business exigencies of the day without forcing a recognition event on shareholders.

A sale or exchange of an interest in a corporation will change the risks, potential return, potential in-

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come and nature of the asset held by the taxpayer. The change may matter to the taxpayer for business as well as personal reasons. Professors Bittker and Eustice suggest that a shortcoming of the continuity doctrine results because it will apply "without regard to the economic results of the transaction" and regardless of the size disparity between the target and the acquirer or the changes in attendant risks.[109] For example, a small merchant may exchange the stock of the closely held corporation for stock in a large diversified company; this exchange might be similar to a sale of the closely held stock followed by an investment in a large diversified company.[110] Professors Bittker and Eustice characterize this as an example of an exchange that "may drastically alter the shareholder's rights and risks."[111] Another commentator posits that this example suggests that tax-deferred reorganizations should be "denied to shareholders of small companies that combine with large, publicly traded companies."[112]

C. Defense of "Continuity of Investment" Rationale

Maybe a simple blunt instrument is preferable to an extremely complicated scalpel. Adding size requirements to corporate reorganizations whether *via* reference to Securities and Exchange rules or some other measure of size would add yet an additional layer of complexity. The example of the small merchant and the large public company points out that "continuity of investment" may allow some slippage for the sake of simplicity.

Control or continuity assures that the shareholder group has not given up too much of their collective interest in the target company. The same definition of control for Code Sec. 368 is also used for Code Sec. 351.[113] Under Code Sec. 351 control assures that the contributing shareholders as a unit have not transferred too much of their interests to other shareholders.[114] In the example of the small merchant and large public company, it would seem that the transaction could be structured utilizing Code Sec. 351, with the merchant contributing his stock to the new enterprise.

Reg. §1.1002-1(c) lists provisions of the tax code that are exceptions to the general recognition rule such as Code Secs. 351(a), 354, 361(a), 1031, 1035 and 1036. As noted above, Code Sec. 354 is the nonrecognition rule for shareholders and creditors, and Code Sec. 361 is the nonrecognition rule for corporations, in a reorganization pursuant to Code Sec. 368.

Other exceptions to the recognition rule listed in Reg. §1.1002-1(c) are effectively elective, through planning by the taxpayer. Under Code Sec. 351, parties forming a corporation and structure the incorporation or contribution to a corporation to either comply with this rule for tax-deferred treatment or purposely fail the test for taxable treatment.[115] Likewise, although like-kind exchanges are provided for under a nonelective provision, Code Sec. 1031 is effectively an elective provision, through planning on the part of the taxpayer.[116] These "mere change in form" provisions allow for planning and do not necessarily encourage abuse. What is advocated here is an elective regime for acquisitive reorganizations that allows Code Sec. 368 to function more similarly to Code Sec. 351 corporate formation or Code Sec. 1031 like-kind exchanges.

V. Analogy to Old Partnership/ Corporate Status System

The former system for tax classification of business entities has many of the characteristics of the present system for determining which acquisitive reorganizations will be treated as tax deferred transactions. Both systems have complex technical rules that involve significant compliance costs that add little or nothing to the value of the businesses. Because of the uncertainties under each system, taxpayers often request advance rulings to be assured of particular tax treatment. In some instances, the IRS will, as a matter of policy, refuse to provide an advance ruling.

Under former Reg. §301.7701, in general, both corporations and unincorporated entities that had a sufficient number of corporate characteristics as to resemble a corporation were treated as corporations for tax purposes.[117] Corporate characteristics considered by the IRS for purposes of entity classification included limited liability, continuity of life, centralized management and free transferability. For businesses, the choice was between taxation as an association (corporation) or as a partnership. This former "corporate resemblance test" required counting up corporate characteristics, without weight given for the importance of any particular characteristic, to determine whether the entity would be treated as a corporation.[118]

With the advent of the LLC[119] and subsequent acceptance by the IRS to tax an LLC as a partnership, entities were then available which had many corporate characteristics but yet were allowed partnership

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tax treatment.[120] Originally, the IRS would only rule that an LLC would be taxed as a partnership if the LLC had limited life (usually a term of 30 years) and restricted transferability of interests.[121] With limited liability, an LLC would already have one of the four corporate characteristics.[122] So statutes or operating agreements had to prevent an LLC from picking up two more corporate characteristics or the LLC would be taxed as a corporation.[123]

With the realization that existing entity classification standards had become meaningless and that taxpayers could achieve partnership status with any of a number of entities essentially equivalent to a corporation, the IRS proposed an elective regime for entity classification.[124] This proposed change to an entity classification based on taxpayer election brought up policy questions, such as should taxpayers be allowed to elect how their business would be taxed? The response to these policy concerns was that the entity classification system was already, in effect, elective. The entity classification system was, like the current corporate reorganization system, a transactional election.

The new procedure for entity classification allows businesses to elect tax treatment.[125] The "check-the-box" regulations allow an eligible entity with two or more members to elect classification as either an association taxable as a corporation or a partnership. An eligible entity is one that is not a business entity automatically classified as a corporation[126] because it is a corporation under state law.

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A. Entity Election Pointers for Reorganization Election

The new entity selection system bars state law corporations from making the election. What might seem as an arbitrary line is actually a reflection that the Treasury had no authority to allow state law corporations to elect partnership treatment.[127] This limitation keeps the entity selection system from being abused. A similar albeit arbitrary line must be drawn to keep an elective acquisitive reorganization regime within the overarching policy justification of "substantially a continuation of the investment."

Under the new Reg. §301.7701, once an election is made it generally cannot be changed for five years. When an election is changed, parties must beware of the tax implications. For purposes of election of tax treatment of an acquisitive reorganization, the election must be generally irrevocable. An elective reorganization regime should grant statutory authority to the IRS to revoke or change the election under extraordinary circumstances after application by the parties. As discussed below, the concern over tax abuse through trafficking in tax attributes will continue after five or more years. The parties to a reorganization, if elective treatment is granted, must make an election and then live with their decision, except in the event of extraordinary circumstances.

VI. Code Sec. 338 Election–Another Pattern for Change

Under Code Sec. 338 taxpayers can elect to step up the basis in target assets through a deemed sale and repurchase by the target of all assets to itself to get a fair market basis.[128] The elective provision in Code Sec. 338 traces its roots to the case of *Kimbell-Diamond Mining Co*.[129] In *Kimbell-Diamond,* the issue was the proper depreciable basis for a mill acquired by Kimbell-Diamond by purchasing the corporation that owned the mill and then liquidating the corporation. Kimbell-Diamond argued that it had liquidated the target which owned the asset the taxpayer then wanted to depreciate. The taxpayer's argument relied on a statutory provision that would give the distributee (Kimball-Diamond) the subsidiary's basis in the distributed property. In this case the target's basis was higher than the taxpayer's cost basis. The IRS argued successfully that the taxpayer intended a purchase and should have a cost basis in the underlying assets.[130] From this taxpayers began using the *intent* argument from *Kimbell-Diamond* as a way of arguing for a cost basis in an acquisition.[131]

The election under Code Sec. 338 has provisions that are relevant to applying an election to acquisitive reorganizations. Code Sec. 338 provides framework for qualifying a stock purchase to be treated as an asset acquisition. First, the election is allowed for stock purchases of control sufficient to meet 80-percent ownership test for consolidated reporting.[132] Second, the control or ownership required must be acquired in a transaction or series of transactions in a 12-month period.[133] Third, a timely election is required under Code Sec. 338.[134] Fourth, once the election is made the election is irrevocable, the parties must then live with the decision.[135]

VII. 1985 Proposed Reform: Carry-over Basis Election

In 1985 the Senate Finance Committee proposed replacing all Code Sec. 368[136] corporate reorganizations including acquisitive reorganizations, the

related triangular reorganization rules, recapitalizations, changes in identity and form, reorganizations in bankruptcy, and divisive reorganizations with a single elective reorganization system.[137] The proposal was to replace the current transactional election for acquisitive reorganizations with a single express election at the corporate level and tax-deferred treatment for shareholders as well as security holders of the corporation.[138] The proposal would have repealed the requirement of qualified consideration, continuity of interest, continuity of business enterprise and the business purpose requirement.[139]

The 1985 proposed reform for acquisitive reorganizations was prior to the repeal *General Utilities*.[140] Before the repeal of *General Utilities* it was possible to take corporate assets out of the corporate solution without significant tax consequences. The Tax Reform Act of 1986 did not adopt the proposed reform but repealed the *General Utilities* doctrine which put a great deal of pressure on the Code Sec. 368 rules.[141]

The 1985 Proposal noted that repeal of *General Utilities* was necessary because, *inter alia*, the ease of the proposed cost basis election together with *General Utilities* would have been abused. However, the proposal would have allowed tax-free treatment for divisive reorganizations and only disallowed cost basis elections. Tax-deferral for divisive reorganizations would still have provided an end-run to the *General Utilities* repeal.

In 1982, the Code Sec. 338 election was enacted, just a few years before the 1985 Proposal. The Proposal would have repealed Code Sec. 338 and incorporated a cost basis election for "qualified acquisitions." The "qualified acquisition" was similar to Code Sec. 338(d)(3) "qualified stock purchase" which requires purchase of stock representing "control" as defined in Code Sec. 1504(a)(2) within a 12-month period.

A. Qualified Acquisitions

This proposed express election would be allowed for "qualified acquisitions," transactions involving the merger or acquisition of two or more companies within a 12-month period. Aspects of "qualified acquisitions" included, that the type of consideration would be irrelevant, stock acquisitions had to be within 12 months and creeping stock acquisitions would have been allowed.[142] Asset acquisitions prohibited creeping acquisitions and required liquidation within 12 months.[143]

The definition of "qualified acquisition" and accompanying rules would have retained some minor inconsistencies of the Code Sec. 368 system. The proposed definition of "qualified acquisition" distinguished between stock and asset acquisitions with slightly different requirements for both. A "qualified stock acquisition" would consist of an acquisition of 80-percent "control" as defined in Code Sec. 1504 (80 percent of total voting power and total value of a corporation's stock), within 12 months.[144] A "qualified asset purchase" would consist of merger or acquisition transactions requiring purchase of at least 70 percent of the fair market value of gross assets and at least 90 percent of the fair market value of net assets held immediately before the acquisition.[145] The proposal seems unclear as to the consistent treatment of forward and reverse triangular mergers. Reverse triangular mergers were specifically treated as stock purchases, with no similar provision for forward triangular mergers.[146] The report gives no explanation why there should be any difference in treatment between the two and any disparate treatment would not make sense because the economic substance of both is equivalent. In addition, creeping stock acquisitions would have been permitted within the 12-month period, while creeping asset acquisitions would have been allowed.[147]

B. Shareholder Treatment–Dividend Equivalence

Shareholder treatment would be determined independently of corporate-level treatment under the proposal.[148] Even if a "qualified acquisition" is a cost basis acquisition, it could be completely or partially tax deferred at the shareholder level.[149] In addition, tax treatment at the shareholder and security holder level would be determined shareholder by shareholder and security holder by security holder with consequences to one not effecting consequences to another.[150] In a "qualified acquisition," a target shareholder or security holder who received stock or securities would receive nonrecognition treatment on their exchange."[151] If a shareholder received both qualified stock and other consideration (boot), the transaction would be tested for dividend equivalency.[152] If the transaction was equivalent to a dividend, the shareholder would be taxed as if they received a dividend, up to the lesser of the fair market value of nonqualifying consideration received or the shareholder's ratable share of undistributed earnings and profits, and would not be able to offset the dividend portion against basis. This dividend equivalence test would be an essential element in an elective regime.

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C. Consistency Requirement

The election for cost basis with a taxed transaction and carryover basis with a tax-deferred transaction is made on a corporation by corporation basis. Selective asset basis step-up would be prohibited.[153]

D. Lessons from the 1985 Proposal

The 1985 Proposal offered a simplified election regime which would have been a vastly superior alternative to the transactional election provided in Code Sec. 368. The time has come to reconsider the approach to acquisitive reorganizations. This Proposal was obviously long before the current check-the-box entity selection regime under Reg. §301.7701. The 1985 Proposal came just after the adoption of Code Sec. 338[154] and would have repealed but incorporated a similar cost basis election.[155]

A new elective reorganization regime should incorporate a dividend equivalence test, consistency requirement, and retain a continuity of interest requirement. Minor differences in requirements for stock and asset acquisitions may not matter since the 70/90 required for asset acquisitions and 80 percent for stock acquisitions would seem equivalent. Making the type of consideration irrelevant will add flexibility, yet for shareholders or security holders to receive tax-deferral shareholders must receive stock and security holders would have to receive securities. Similarly for continuity of interest purposes, target shareholders will necessarily have to receive a minimum threshold of the consideration in the form of an equity investment in the continuing enterprise.

As discussed above, the 1985 Proposal contemplated an elective regime for corporate reorganizations, not just acquisitive reorganizations. While tax-deferred treatment would have been made available to recapitalizations, changes in form or identify, and reorganizations in bankruptcy, the Proposal would not have allowed a cost-basis election for these non-acquisitive types of reorganizations.[156]

VIII. Proposed "Check-the-Box" Election for Acquisitive Reorganizations

With a "check-the-box" reorganization election, parties to reorganization of domestic corporations will have an express choice of tax or tax deferral. With a taxable transaction the price of the election is current tax with the benefit of a cost basis.[157] The tax-deferred transaction comes with the price of no step-up in basis.

This election must allow bifurcation of the transaction,[158] with part taxable and part tax-deferred. Bifurcation of the transaction should be allowed as to the shareholders, not as to the assets of the target corporation. A consistency requirement must be imposed on the parties to an elective reorganization who must not be allowed to select which assets will be acquired tax-deferred and which will receive a cost basis.[159] Allowing bifurcation will take into account the business reality of dissenting and minority shareholders, and allow the parties to the reorganization to make their election regardless of the dissenters or minority shareholders. Any potential concern over allowing tax deferral even with dissenters or minority shareholders would be addressed by a minimum continuity of interest test.[160]

The acquisitive reorganization tax election should allow for choice of consideration to be paid or exchanged. When cash or other nonqualified consideration is received by shareholders or security holders, this will mean a recognition event to the recipient. Still, tax-deferred treatment may be available to the shareholder who receives an installment note in exchange for his or her shares.[161]

An express election for reorganization treatment does not defeat the corporate tax system. A transactional election is already available under the current system. The express election would rationalize the system, impose a coherent set of rules and reduce compliance costs.[162] Under an election, tax is deferred, not forgiven. Of course, deferral continued for a long enough period is tantamount to forgiveness of the tax. An elective regime may enable further deferral that would not otherwise be possible. Even without an explicitly elective regime, taxpayers can defer tax through the existing transactional election of Code Sec. 368 or they simply hold onto investment. Why not allow them to also reorganize corporate investments which will hopefully result in more productive enterprises?

Each of the following requirements from Code Sec. 338 as well as lessons from the current entity classification rules in Reg. §301.7701 and the Senate Finance Committee Proposal are helpful in formulating an elective provision for acquisitive reorganizations:

1. **Control.** To qualify for the elective regime, an acquisition must achieve a certain percentage of control if structured as a stock acquisition, or a minimum percentage of the assets if structured as an asset acquisition. For purposes of defining "control," the new regime could either

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retain the Code Sec. 368(c) definition of at least 80 percent of voting and 80 percent of all other stock or adopt the Code Sec. 1504(a)(2) definition of at least 80 percent and vote or value.

2. **Minimum Period.** The reorganization election should contemplate transactions that involve initial purchases by the acquiring corporation before the merger agreement is approved. A minimum period draws a line to allow for certain purchases within that minimum period. Again this is arbitrary, but keeps the requirements from becoming needlessly complicated. In this case 12 or even 24 months would probably suffice, especially given the SEC requirement to report purchases of five percent or more in publicly traded companies.[163] If a creeping stock acquisition is allowed within the minimum period, then a creeping asset acquisition should also be allowed.
3. **Timely Election.** Parties to reorganizations must make the same kind of timely election as in the Code Sec. 338 election.
4. **Election Is Irrevocable.** Once the reorganization election is made, the election must be irrevocable. Parties must not be allowed to game the system by selecting the best treatment and then later changing to a more favorable treatment.
5. **"Substantial Continuation"—50-Percent Continuity.** An election for tax treatment of acquisitive reorganizations must include an arbitrary line drawn to ensure the policy rationale of "substantially a continuation of the investment" for deferral is respected while also achieving the efficiency of a check-the-box system. To ensure a "substantial continuation" the reorganization election should incorporate requirement similar to the safe harbor in Reg. §1.368-1(e)(2) and require a minimum of 40 to 50 percent of target shareholders, excluding dissenters, continue with the new enterprise. This will help bar sale transactions from masquerading as qualified reorganizations and also allow parties to reorganize utilizing the tax-deferred election while still dealing with dissenting shareholders. For purposes of reorganizations in bankruptcy, which developed largely in response to continuity of interest problems, a very small or no continuity requirement would be appropriate.
6. **Election Generally Irrevocable.** The reorganization election must be generally irrevocable with statutory authority granted to the IRS to revoke or change the election under extraordinary circumstances. Otherwise the parties to a reorganization must make an election and then live with their decision.
7. **Equivalent Treatment for Shareholders and Security Holders.** The same policy rationales which justify tax-deferral for shareholders apply for security holders as well. It would not make sense to reform Code Sec. 368 but retain disparate treatment for shareholders and security holders.
8. **Dividend Equivalence.** If the continuity of interest requirement will allow consideration other than stock of the acquirer, the transaction should be tested for dividend equivalency under Code Sec. 302(b) rules.[164] If the transaction was equivalent to a dividend, the shareholder would be taxed as if he or she received a dividend, up to the lesser of the fair market value of nonqualified consideration or the shareholder's share of earnings and profits,[165] and the shareholder would not be able to offset the consideration received against basis.
9. **Consistency Requirement.** The reorganization election will be made on a corporation by corporation basis. Selective asset basis step-up will be prohibited.[166] Bifurcation of the transaction should only be permitted on a shareholder level to deal with issues of dissenting and minority shareholders. That is the transaction may be taxable to some shareholders or security holders and tax-deferred to others. But bifurcation must not be allowed at the corporate level to cherry-pick which assets to transfer tax-deferred with a carryover basis and which assets to obtain a step up in basis.
10. **"Qualified Acquisitions."** The 1983 proposal spent a great deal of time worrying about the qualified acquisition definition. In so doing, the proposal may have retained too much complexity. For purposes of an elective reorganization regime, a "qualified acquisition" will be an acquisition which meets the control, minimum period, timely election, and substantial continuation requirements discussed above. Stock and asset acquisitions should have the same percentage requirements and minimum period; creeping acquisitions should be allowed; and the type of consideration should be similarly irrelevant for both within the confines of the continuity of interest requirement.

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IX. Abuse Issues

As detailed below, concerns for abuse of an elective acquisitive reorganization tax regime include lack of continuity of interest and trafficking in tax attributes. The first problem of continuity is addressed in the 50-percent continuity requirement. The larger abuse issue of trafficking in tax attributes must be addressed by retaining limitations embodied in Code Secs. 381 to 384 as detailed below. Also, the election must be generally irrevocable. This will also help prevent parties from switching their election in a way that might allow for abuse in the form of tax attribute trafficking.

A. Tax Attributes Rules–Code Secs. 381 to 384

Each corporation has its own distinctive tax characteristics such as net operating losses carryovers, earnings and profits, capital loss carryovers, method of accounting, inventories, method of computing depreciation and installment method, just to name a few. These and other tax characteristics are "tax attributes" which are listed in Code Sec. 381.[167]

The tax characteristics of a particular corporation might make acquisition by another corporation advantageous if for no other reason than to take advantage of these "tax attributes." The simplest example, and the one that raised the most concern with Congress, is the net operating loss.[168] Suppose a target has a large net operating loss for tax purposes but sufficient cash flow to cover operating expenses. This target would be particularly attractive to an acquirer with large amounts of taxable income that wishes to offset its taxable income against the target net operating losses. Congress viewed this and other tax motivated mergers or acquisitions as abuses of tax attribute carryovers. This abuse was described as "traffic[king] in loss corporations,"[169] Congress was concerned over what it saw as transactions that were motivated primarily by tax avoidance.[170] Tax code provisions were enacted to restrict traffic in tax attributes and these rules which started out in Code Sec. 269 have been added to and amended with the current rules in Code Secs. 381 to 384.[171]

An express election for acquisitive reorganizations will simplify and rationalize acquisitive reorganizations in much the same way that new Reg. §301.7701 "check-the-box" entity selection has simplified and rationalized the entity selection regime.

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Code provisions that govern the use of tax attributes are directly connected to Code provisions that govern changes in entity ownership because it is these changes in ownership through which tax attributes may change hands. In 1976, coordination between tax attribute restrictions and the rules for tax-deferred and taxable mergers, along with concerns over uncertainty and weaknesses in the tax attribute rules prompted Congress to recommend amending tax attribute restrictions.[172] Again in 1986 Congressional amendments sought limitations that would neutralize the tax attributes factor in mergers or acquisitions.[173]

B. Sale of Assets vs. Sale of Stock

In a simple sale of assets, the tax attributes stay with the selling corporation and are not transferred to the acquiring corporation. In an acquisition of the target through a stock sale, the tax attributes of the target may survive in the target which is then in the hands of the acquirer.

A taxable asset acquisition involves (1) a transfer of target assets to the parent or the subsidiary of the parent for any type of consideration and (2) the target distributes parent stock, money and or notes to shareholders.[174] Liabilities of the target corporation are not assumed by the acquiring corporation unless by specific agreement.[175]

In a sale of stock the target remains a distinct legal entity. When the target survives the reorganization, the tax characteristics survive because the target has survived. In a sale of stock, one corporation acquires all or part of the stock of another corporation directly from the shareholders of the target in exchange for its own stock.[176] For tax-deferred treatment involving the sale of stock, the proportion of acquiring corporation stock that must be exchanged with target shareholders depends on the particular acquisitive reorganization involved.[177]

C. Tax Attributes After the Acquisition

Under the general rule, tax attributes of a target corporation shall succeed to the acquirer after acquiring the assets or stock of the target in a tax-deferred reorganization.[178] Carryover rules do not

address limitations for Type B stock-for-stock mergers where the target becomes a subsidiary of the parent. In that situation, the tax characteristics of the target remain intact in the target as a subsidiary of the acquiring parent. Should the parent later decide to liquidate the acquired subsidiary, this liquidation under Code Sec. 332[179] would bring the carryover of tax characteristics within the limitations of Code Secs. 381 to 384.

One of the advantages of a tax-deferred reorganization is that the tax attributes of the target corporation survive.[180] The corollary is that tax attributes of the target in a taxable sale disappear.

D. Limitations

Code Sec. 381 provides for general carryover of tax attributes in acquisitive reorganizations subject to conditions and limitations[181] provided in Code Sec. 381 itself as well as in Code Secs. 381 to 384 and Code Sec. 269. Under Code Sec. 381, the acquiring corporation cannot carryback net operating losses (NOLs) or a net capital loss for a tax year ending after the date of distribution or transfer to a tax year of the target corporation.[182] Code Secs. 382 to 384 are a set of mechanical rules that apply to limit use of tax attributes following a change of ownership or reorganization.[183] Code Sec. 382 limits the extent to which the acquirer may offset its income with preacquisition NOLs of the target. Under Code Sec. 382, target NOLs are eliminated unless the continuity of business enterprise test is satisfied for two years following the change of ownership of the reorganization transaction. Offsetting built-in gains against NOLs is limited for five years from the transaction date by Code Secs. 382(h) and 384. Code Sec. 383 limits the use of unused general business credits[184] and minimum tax credit.[185]

In addition to the tax attribute carryover rules, the IRS may completely disallow any deduction or use of any tax attribute following an acquisition of control if "the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit or a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy."[186]

E. Changes to Code Secs. 381 to 384

Carryover limitations prevent trafficking in tax attributes by providing a confusing maze of limitations on how and when these characteristics can be used. Simplification of Code Sec. 368 acquisitive reorganizations would seem to go hand in hand with a simplification of carryover limitations. However, the underlying goals and policy of the carryover rules must be retained to prevent abuse by trafficking in tax attributes, as detailed above.

The focus of this article is on proposed changes to Code Sec. 368. As acquisitive reorganizations have grown in complexity, carryover rules in Code Secs. 381 to 384 have grown in kind. Clearly limitations on the use of tax attributes must be a part of a reorganization system. Full coverage of reforming Code Secs. 381 to 384 is beyond the scope of this article. These rules relate to not only acquisitive reorganizations, but all other types of reorganizations as well.[187] As a starting point, the following are some preliminary ideas on reforming carryover rules of Code Secs. 381 to 384.

1. Change the Current Rules to Reflect the Elective Reorganization

For now one approach to carryover rules would be to keep Code Secs. 381 to 384 in present form with only minor amendments for the sections that specifically address A, B or C reorganizations. The complexity of Code Secs. 381 to 384 is based on all the types of reorganizations, not just acquisitive reorganizations.

2. Quarantined Carryovers

Reform of carryover rules could take either the extreme of no limits, which would lead to abuse in the form of trafficking of tax attributes, or disallow carryovers altogether. A middle ground is not only more reasonable but also workable. The purpose of carryover rules is to prevent abuse. So these rules should be simplified to do just that while allowing tax attributes to survives.

Tax attributes should be entity specific. That is, tax attributes should belong to the entity that generates the net operating loss or net capital loss, just to name two. Whenever there is an acquisition, whether taxable or tax deferred, the tax attributes of the target entity could either disappear at the party's choice or be quarantined in the target for a minimum period of years, possibly five years. But the tax attributes continue to exist within the target division or subsidiary so long as quarantined. That would eliminate any incentive to use an acquisition merely to take advantage of tax attributes. These specific waiting periods would apply to taxable and tax-deferred acquisitive reorganizations. Bankruptcy reorganizations may depend on use of tax attributes in a shorter time frame.

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As part of a middle ground approach to carryover limitations, quarantined carryovers should be allowed at the election of the parties in a tax-deferred reorganization. For taxable acquisitions, tax attributes should either be allowed to disappear or carryover after the minimum quarantine period. For mergers where the target is absorbed or an acquisition where the acquiring company desires to consolidate returns under Code Sec. 1504 the rule should still be kept simple. In this case, the acquirer should either keep the target books separate and leave the tax attributes with the historic target division or relinquish the tax attributes of the target.

Much of the complexity in the carryover limitation rules of Code Secs. 381 to 384 lies in determining when the rules will apply. Code Sec. 382, for example, imposes limitations on NOL carryforwards when there is an "ownership change" in a loss corporation.[188] But Code Sec. 382(g) contains complex rules for determining when an "ownership change" has occurred.[189] Making the tax attributes specific to the entity and allowing carryover subject to a quarantine period would enable the rules to prevent abuse of carryovers without complex change of ownership mechanisms.

After the quarantine period, use tax attributes should be fully allowed by the combined entity.[190] If the combined entity is subsequently acquired in a new reorganization, the tax attributes of the combined entity will be quarantined from the new acquirer.

X. Conclusion

The current system of corporate acquisitive reorganizations under Code Sec. 368 is effectively a transactional election. With each new form of reorganization structure Congress has reacted by adding yet another rule in response instead of fashioning a policy-based rule that is rational and coherent.[191] Both the former entity selection system of "corporate resemblance" and the current acquisitive reorganization system involve significant compliance costs and add little or nothing to the value of businesses. An express election for acquisitive reorganizations will simplify and rationalize acquisitive reorganizations in much the same way that new Reg. §301.7701 "check-the-box" entity selection has simplified and rationalized the entity selection regime.

Endnotes

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1 Black's Law Dictionary 1298 (Henry Campbell Black Ed., 6th ed., West 1990).

2 Eleanor M. Fox & Byron E. Fox, 1 Corporate Acquisitions and Mergers, §1.01, at 1–2 (Release 83, Matthew Bender & Co. Inc. 2004). Defining various definitions of mergers, acquisitions and consolidations. A merger involves the combination of two or more corporations into a single corporation. An acquisition involves joining two or more corporations in ownership. A consolidation involves two or more corporations forming a new legal entity.

3 *See* Del. Gen. Corp. L. §251(a). (Although merger and consolidation are not specifically defined, the respective definitions of each are clear from the language in the statute.)

4 Target is used as shorthand for the corporation that is selling or being purchased.

5 *See* Code Secs. 61(a)(3) and 1001.

6 *See* Code Sec. 336.

7 *See* Code Secs. 368, 354 and 361.

8 *See* Douglas A. Kahn & Jeffrey S. Lehman, Corporate Income Taxation, §9.3, 835–37 (5th ed. West 2001) (tracing the history of the development and changes to reorganization rules). *See also E.S. Chapman*, CA-1, 80-1 ustc ¶9330, 618 F2d 856. In *Chapman*, the First Circuit discusses the legislative history of reorganizations and the eventual development of "continuity of interest" doctrine. The court traces the legislative history of Congress reacting in an attempt to address the latest perceived abuse in the world of reorganizations. One such Congressional response, in 1939, was a requirement that the acquiring corporation obtain at least 80 percent of the target. The 1954 Code retained much of the language in the 1939 Code, one of the things retained from the 1939 Code was the 80-percent requirement. Congress went on to add that this 80-percent requirement would not be required in a single step. But from this we can trace the current requirement in the Type B to the "continuity of interest" doctrine.

9 Code Sec. 368(a)(1)(A).

10 Fox & Fox, *supra* note 2, §4.02[1], at 4–16. (In a statutory merger or consolidation, the surviving or resulting corporation automatically assumes all liabilities of the disappearing corporation or corporations.")

11 Code Sec. 368(a)(1)(B).

12 Fox & Fox, *supra* note 2, §4.03[1], at 4–34. (In a Type B reorganization under Code Sec. 368(a)(1)(B), "the acquiring corporation becomes the parent of the acquired corporation and the acquired corporation becomes a subsidiary.") *See also* Kahn & Lehman, *supra* note 8, §9.3, 835–37. (The 1918 Code did not include the modern Type B stock-for-stock acquisition. In 1924 the Code added the letters that appear today, "A," "B" and so-on but in 1924 the Type B was a stock-for-asset acquisition. Congress added the stock-for-stock Type B in 1939. With each step of additions to reorganization rules, both Congress and the Judiciary were reacting to new business practices.) *See also Chapman, supra* note 8. (The legislative history of Code Sec. 368 recounted by the First Circuit shows that the current Type B was originally a stock-for-assets acquisition. The historical account in Chapman is particularly interesting because Chapman involved a Type B case in which the court was attempting to trace the origin, meaning and purpose of the 80 percent requirement. The First Circuit traced the 80-percent requirement to the continuity of interest test, which was a judicial reaction to perceived abuses.)

13 Code Sec. 368(a)(1)(C): "the acquisition by one corporation … of substantially all of the properties of another corporation … ."

14 Fox & Fox, *supra* note 2, §4.04[1], at 4–54. (In a Type C reorganization, the acquirer "*may* assume liabilities of the target or take its property subject to liabilities.")

15 Code Sec. 368(a)(2), 368(a)(1)(B), 368(a)(1)(C), 368(a)(2)(D) and 368(a)(2)(E).

16 Fox & Fox, *supra* note 2, §2.02 and 3.03[4].

[17] In a forward triangular reorganization the acquirer subsidiary survives. In a reverse triangular reorganization the acquirer subsidiary is merged into the target and the target survives.

[18] Code Sec. 368(a)(1)(A)–(C).

[19] Code Sec. 368(a)(2).

[20] Code Sec. 368(a)(1)(E), (F) and (G). A Code Sec. 368(a)(1)(E) "recapitalization" is not defined in the Code or regulations. In early *dicta* the Supreme Court described it as a "reshuffling of a capital structure, within the framework of an existing corporation" (*Southwest Consolidated Corp.*, SCt, 42-1 USTC ¶9248, 315 US 194, 204 (1942)) and encompasses transactions involving exchanges of one class of stock or securities in a corporation for another class issued by the same corporation. Reg. §1.368-2(e) provides examples that provide for stock for stock, common for preferred and preferred for common exchanges. A Code Sec. 368(a)(1)(F) "mere change in identify, form, or place" involves a mere change in the identify, form, or place of *one corporation*. A Code Sec. 368(a)(1)(G) reorganization in bankruptcy involves a "transfer by a corporation of all or part of its assets to another corporation in title 11 or similar case; but only if, in pursuance of the plan, stock or securities of the corporation to which the assts are transferred are distributed in a transaction which qualifies for section 354, 355, or 356." Any changes to the rules regarding reorganizations within bankruptcy or insolvency would also necessarily involve a consideration of related tax rules covering bankruptcy and insolvency. Recapitalizations, changes in form or identity, and reorganizations in bankruptcy do not present the same extent of complication as the acquisitive reorganizations and so are not illustrated in this article. However, it would be disjointed to provide an election regime for acquisitive reorganizations without similar treatment for the other forms. Fortunately, the elective regime will work for recapitalizations, changes in form or identify, and for reorganizations in bankruptcy.

[21] On a side note, the 1985 Proposal would have incorporated divisive reorganizations into the elective regime and would have accorded them tax-deferred treatment with a carryover basis. For divisive reorganizations, the Proposal would have banned the cost-basis election for divisive reorganizations by imposing related party rules. At the same time, that same proposal proposed the repeal of the *General Utilities* Doctrine. But yet with the repeal of *General Utilities,* an election for divisive reorganizations could be used as an end-run around that repeal.

[22] Boris I. Bittker & James S. Eustice, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, ¶14.01, at 14-6 (5th ed. Warren, Gorham & Lamont 1987).

[23] *Id.*

[24] Stephen A. Lind, Stephen Schwarz, Daniel J. Lathrope & Joshua D. Rosenberg, FUNDAMENTALS OF CORPORATE TAXATION, at 409 (5th ed. Foundation Press, 2002).

[25] *Id.*

[26] *See West Shore Fuel, Inc.,* DC-NY, 78-1 USTC ¶9311, 453 FSupp 956, *aff'd*, CA-2, 79-1 USTC ¶9357, 598 F2d 1236. (Underlying transaction was treated as a sale of merging company's assets to the acquiring corporation for its cash and notes, followed by a liquidation in which shareholders received cash and notes. In this merger deferral of tax would have been achieved through use of Code Sec. 453 installment provision. Because cash plus notes combined for 30 percent of the total purchase price, shareholders were not entitled to the benefits of Code Sec. 453 and had to report all of the gain in the year of the transaction.) *See also Home Sav. & Loan Assn.*, CA-9, 75-1 USTC ¶9423, 514 F2d 1199, *cert. denied*, 423 US 1015 (1975). (The court treated the merger as a sale of stock transaction because the consideration had more the characteristics of debt than equity, this failure made the transaction properly treated as a sale and liquidation rather than a merger that qualified as a tax-deferred reorganization. Because of the failure the taxpayer had to pay taxes as the transferee of the assets. In this case Home Savings was the acquirer, but was the one who had to pay the tax deficiency.) The 30-percent rule is no longer part of Code Sec. 453.

[27] For example, according to an RIA search on February 16, 2007, of private letter rulings from 1953 to present, parties to acquisitive reorganizations have secured 6,454 private letter rulings. Private letter rulings for Type A reorganizations totaled 4,850; Type B reorganizations totaled 1,013; and Type C reorganizations totaled 838. These three total 6,702, which double-counts 248 private letter rulings that overlapped among one or more of the three types of acquisitive reorganizations.

[28] Code Sec. 1012.

[29] Code Sec. 362(b).

[30] Code Secs. 61(a)(3) and 1001.

[31] Code Sec. 1032. (Nonrecognition upon issuing stock for property.)

[32] One commentator has advanced the notion that tax-deferred treatment of reorganizations is preferential tax treatment that ought to be done away with. *See* Yariv Brauner. *A good habit, or just an old one? Preferential tax treatment for reorganizations*, 2004 B.Y.U. REV. 1. (Mr. Brauner views the tax-deferred reorganization as a preferential tax treatment that ought to be abolished. I agree that the system should be changed but do not view tax-deferred reorganizations as any more of a preference than Code Secs. 351, 721 or 1031.)

[33] Reg. §301.7701.

[34] Code Sec. 338.

[35] The proposed elective regime was for all corporate reorganizations including acquisitive reorganizations, as well as divisive reorganizations, recapitalizations, changes in identify or form, and reorganizations in bankruptcy. *See* Staff of the Senate Fin. Comm., Report on the Reform and Simplification of the Income Taxation of Corporations, 98th Cong., 1st Sess. (Comm. Print 1983), S. REP. NO. 85. *See* also S.Prt. 99-47, 99th Cong., 1st Sess. 50-53 (1985). As the previously referenced sources may not be available, *see also* Bittker & Eustice, *supra* note 22, at ¶14.21. Note the sixth and seventh editions do not include a discussion of the 1985 Proposal. Bittker & Eustice fifth edition is cited to where possible for those who are unable to find the Senate Report.

[36] Under the check-the-box rules for entity classification, an entity that is not a corporation under state law is a partnership if it has two or more members or is disregarded as an entity separate from its owners if it has a single owner. *See* Reg. §301.7701-3(b). For an elective regime for acquisitive reorganization, setting the default as a taxable transaction seems sensible because that is the general rule. *See* Code Sec. 1001 (providing the general recognition rule).

[37] The 1985 Proposal contemplated a default of carryover basis and tax deferral for qualified reorganizations with an election for cost basis treatment. *See* S.Prt. 99-47, 99th Cong., 1st Sess. 50-53, 117–26 (1985).

[38] For an S election to be valid, under Code Sec. 1362(a)(2), all shareholders must consent to the election. In the world of mergers and acquisitions, dissenting shareholders are a fact of life. To require complete unanimity of all shareholders of all corporations that are parties to the transaction would almost completely do away with tax-deferred treatment of acquisitive reorganizations.

[39] Fox & Fox, *supra* note 2, §§1.04 and 1.07.

[40] One could debate whether a marriage is a merger, that is a union of two companies, or an acquisition in which one company acquires another and the target ceases to exist. But young couples need not worry about sharing "control" of their union within Code Sec. 368(c) for tax-deferred treatment under Code Sec. 351. However, divorce is a very taxable event, as Code Sec. 355 will not apply.

[41] For example, a new innovation may turn out to be the next asbestos.

[42] Fox & Fox, *supra* note 2, §2A.01, at 2A-1. (The concerns listed above are examples from a more comprehensive list contained in this named source.)

[43] *See* Boris I. Bittker & Lawrence Lokken, 4 FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS, ¶94.2.2, at 94-33–94-36 (3rd ed. Warren, Gorham & Lamont 2003). (This provision defines a reverse triangular merger, the same concept is applied here to a reverse merger.)

[44] *Id.*, at 94-31–94-33.

[45] *Id.*, at 94-33–94-36.

[46] *See* Code Secs. 61(a)(3) and 1001. *See also*

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Code Sec. 336. Note that some acquisitions may bypass the target corporation itself and only involve the acquiring corporation and target shareholders.

[47] *See* Code Sec. 368(a)(1)(A)-(C), (a)(2).

[48] "Toehold" is a term commonly used to refer to shares purchased by the acquiring company previous to the plan of merger or acquisition.

[49] *See* Code Sec. 368. Code Sec. 368(a) defines "reorganization" and Code Sec. 368(b) defines "party to a reorganization."

[50] As defined in Code Sec. 368(b).

[51] Code Sec. 361(a). Normally if a corporation distributes property (other than its own obligations) in a nonliquidating distribution, it must recognize gain in an amount equal to the excess of the fair market value of the property over adjusted basis, pursuant to Code Sec. 311.

[52] Code Sec. 361(c).

[53] Code Sec. 1032. ("No gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation.")

[54] Code Secs. 61(a)(3) and 1001.

[55] Code Sec. 354(a)(1). (Code Sec. 354 applies to shareholders of corporations that are "party to a reorganization" and "party to the reorganization." This term is defined in Code Sec. 368(b) and includes the corporation that results from the transaction, the acquiring corporation, the corporation that controls the acquiring corporation, and possibly the target corporation itself unless the transaction is a sale of stock.)

[56] Code Sec. 354(a)(1). "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."

[57] *See* Code Sec. 368(a). Note judicial requirements are also required.

[58] "Acquisitive Reorganization" is a term that shows up often in literature describing acquisitions covered by Code Sec. 368(a)(1)(A)–(C). "Acquisitive" seems fitting since that is what is contemplated by these sections. However, this term is not an invention of the author; it is unclear who is credited with this label.

[59] *Id.*

[60] Code Sec. 368(a)(2)(C), 368(a)(2)(D) and 368(a)(2)(E).

[61] Code Sec. 368(a)(1)(C) "the acquisition by one corporation … of substantially all of the properties of another corporation …"

[62] *See* Former Reg. §1.368-1(e)(6), Example 1 (as amended 02-24-2005). Example in case law allowed a transaction with only 38 percent equity to qualify for tax-deferred reorganization treatment. *John A. Nelson Corp. v. Helvering*, SCt, 36-1 USTC ¶9019, 296 US 374 (1935). (The Court found that consideration of 38 percent in nonvoting preferred stock and 62 percent in cash satisfied the continuity of interest requirement.)

[63] Code Sec. 368(a)(1)(A).

[64] Reg. §1.368-2(b)(1).

[65] The continuity of interest test is discussed below.

[66] *See* Rev. Proc. 77-37, 1977-2 CB 568, at §3.02; Rev. Proc. 86-42, 1986-2 CB 722. (Established a 50-percent safe harbor for the continuity of interest test.)

[67] Code Sec. 368(c). (Control includes 80 percent of the combined voting power of all classes of stock entitled to vote plus 80 percent of all other shares.)

[68] Code Sec. 368(a)(1)(B).

[69] Code Sec. 368(c). "[C]ontrol means 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."

[70] Code Sec. 368(a)(1)(B). (Receiving voting stock of the acquiring corporation's parent would make it possible for the acquirer to set up a subsidiary as the acquiring company with target shareholders receiving acquirer stock in exchange for target shareholders transferring target stock to the acquirer's subsidiary.)

[71] *See* Rev. Rul. 66-365, 1966-2 CB 116, 117.

[72] *Chapman, supra* note 8. In *Chapman*, the First Circuit discusses the legislative history of reorganizations and the eventual development of "continuity of interest" doctrine. The court traces the legislative history of Congress attempting to address the latest perceived abuse in the world of reorganizations. One such Congressional response, in 1939, was a requirement that the acquiring corporation obtain at least 80 percent of the target. The 1954 Code retained much of the language in the 1939 Code, one of the things retained from the 1939 Code was the 80-percent requirement. Congress went on to add that this 80 percent requirement would not be required in a single step. But from this we can trace the current requirement in the Type B to the "continuity of interest" doctrine.

[73] Reg. §1.368-2(c). (Regulation seems to say acquiring corp need not necessarily acquire an 80 percent controlling interest in one exchange and that toehold or old share won't prevent the acquiring corp from arranging a Type B reorganization.)

[74] *Chapman*, *supra* note 8. The taxpayer acquired target shares for cash in an earlier transaction that was part of a plan, and then argued that upon acquiring 80 percent control over the target solely in exchange for its own stock, that it satisfied Code Sec. 368(a)(1)(B). The First Circuit disagreed stating: "… the presence of non-stock consideration in a Type B reorganization, is inconsistent with treatment of the acquisition as a nontaxable reorganization."

[75] Rev. Rul. 72-354, 1972-2 CB 216. (The Treasury permitted Type B reorganization treatment in a case where the acquiring corporation sold shares previously acquired for cash in an unconditional sale with no agreement or arrangement to reacquire the stock and *subsequently* entered a Type B stock-for-stock exchange.)

[76] Code Sec. 368(a)(1)(C). Also note the rule allows the voting stock of either the acquiring corporation or parent of the acquiring corporation.

[77] One problem with the Type C reorganization is the "substantially all of the properties" requirement, Treasury regulations do not provide a percentage of assets rule. Instead, "substantially all" depends on facts and circumstances with importance given to the nature of the properties retained, the purpose of the retention, and the amount or proportion of properties retained. Rev. Rul. 57-518, 1957-2 CB 253 (emphasizing the nature of properties retained).

[78] Code Sec. 368 (a)(2)(B)(iii). Use of consideration other than voting stock for up to 20 percent of the acquisition will not disqualify the Type C reorganization. Code Sec. 368(a)(2) contains special rules relating to Code Sec. 368(a)(1). A relaxed "solely for voting stock requirement" is contained in Code Sec. 368(a)(2)(B) for Type C reorganizations. Under Code Sec. 368(a)(2)(B) additional consideration is allowed if (i) "one corporation acquires substantially all of the properties of another corporation," (ii) the Type C reorganization would otherwise qualify under Code Sec. 368(a)(1)(C) but for money or other property exchanged in addition to voting stock, and (iii) "the acquiring corporation acquires, solely for voting stock [in a Type C reorganization], 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 property of the other corporation." "[T]hen such acquisition shall be treated as qualifying under paragraph (1)(C). Solely for the purpose of determining whether clause (iii) of the preceding sentence applies, the amount of any liability assumed by the acquiring corporation shall be treated as money paid for the property." Also note under Code Sec. 368(a)(2)(B), at least 80 percent of all the property of the target corporation must be acquired in exchange solely for voting stock of the acquiring corporation. Care must be taken if the acquiring corporation assumes liability and pays consideration other than its own voting stock, liabilities assumed or liabilities to which property is subject shall be considered as money paid for the property. *See also* Rev. Rul. 73-102, 1973-1 CB 186. "[I]n determining whether the exchange is solely for stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability shall be disregarded."

[79] Code Sec. 368(a)(2)(G).

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[80] Code Sec. 368(a)(1)(C) and Reg. §1.368-2(d)(4)(i). In a Type C reorganization the "prior ownership of stock of the target corporation by an acquiring corporation will not by itself prevent the solely for voting stock requirement … from being satisfied." The amount paid to creditors, amount of liabilities assumed, together with the amount deemed to be distributed back to the acquirer *via* the acquisition of its own toehold shares, must not exceed 20 percent. With the old rule, there was a problem for prior ownership. *Bausch & Lomb Optical Co.*, CA-2, 59-1 USTC ¶9468, 267 F2d 75, *cert. denied*, 361 US 835 (1959. B&L acquired control in a two-step transaction, first they owned part of target. Problem was that as a target shareholder B&L surrendered target shares as part of the transaction. The commissioner position was that prior owned target shares were additional consideration paid by B&L in violation of the "solely for voting stock" requirement.

[81] Code Sec. 354.

[82] Code Sec. 331.

[83] Code Sec. 358.

[84] Code Sec. 356 and 354(a).

[85] Code Sec. 361.

[86] Code Sec. 1032.

[87] Code Sec. 362(b).

[88] *Id.*

[89] Code Sec. 361(c).

[90] Reg. §1.368-1(e) Continuity of Interest. "The purpose of the continuity of interest requirement is to prevent transactions that resemble sales from qualifying for nonrecognition of gain or loss available to corporate reorganizations. Continuity of interest requires that in substance a substantial part of the value of the proprietary interests in the target corporation be preserved in the reorganization. A proprietary interest in the target corporation is preserved if, in a potential reorganization, it is exchanged for a proprietary interest in the issuing corporation (defined in paragraph (b) of this section), it is exchanged by the acquiring corporation for a direct interest in the target corporation enterprise or it otherwise continues as a proprietary interest in the target corporation."

[91] *See* Former Reg. §1.368-1(e)(6), Example 1 (as amended Feb. 24, 2005; *superseded* Sept. 15, 2005 by T.D. 9225). (Under the previous regulations, the IRS would be satisfied with a Type A reorganization involving consideration from the acquiring corporation of 50 percent stock and 50 percent cash. In the example, "[t]he transaction satisfies the continuity of interest requirement because 50 percent of [the target shareholders'] stock was exchanged for [stock of the acquirer corporation,] preserving a substantial part of the value of the proprietary interest in [the acquired company].). *See also* Rev. Proc. 77-37, 1977-2 CB 568 (1977); Rev. Proc. 86-42, 1986-2 CB 722 (established a 50-percent safe harbor for the continuity of interest test).

[92] *See John A. Nelson Corp. v. Helvering*, SCt, 36-1 USTC ¶9019, 296 US 374 (1935). (A transaction in which only 38 percent of the consideration was equity qualified as a tax-deferred reorganization.)

[93] *See* Reg. §1.368-1(e)(2)(v). Note the examples provide a safe harbor where the COI is at least 40 percent. The examples further provide that there is no COI where continuity is 25 percent or less and leaves uncertainty between 25 percent and 40 percent.

[94] *See* Reg. §1-368-1(e)(2)(v), Example 1.

[95] Reg. §1.368-1(e)(2)(v). Example 3 provides that COI is not satisfied at 20 percent. Example 4 provides that COI is not satisfied at 25 percent.

[96] Reg. §1.368-1(e)(1)(i). "However, a proprietary interest in the target corporation is not preserved if, in connection with the potential reorganization, it is acquired by the issuing corporation for consideration other than stock of the issuing corporation, or stock of the issuing corporation furnished in exchange for a proprietary interest in the target corporation in the potential reorganization is redeemed."

[97] Reg. §1.368-1(e)(1).

[98] Reg. §1.368-1(e)(1)(i). Under the regulations, "[f]or purposes of the continuity of interest requirement, a mere disposition of stock of the target corporation prior to a potential reorganization to persons not related … to the target corporation or to persons not related to the issuing corporation is disregarded."

[99] Reg. §1.368-1(d)(1).

[100] Reg. §1.368-1(d)(2)(iii).

[101] Reg. §1.368-1(d)(2)(ii).

[102] Reg. §1.368-2(g).

[103] Reg. §1.368-1(c).

[104] Fox & Fox, *supra* note 2, §4.02, at 4–7 (Release 83, Matthew Bender & Co. Inc. 2004).

[105] *See, e.g., R.H. Schultz*, CA-9, 61-2 USTC ¶9648, 294 F2d 52. ("[I]n proper cases the Commissioner can go beyond the formal dealings of the parties to see if these forms reflect meaningful substance.") *C.E. Weller*, CA-3, 59-2 USTC ¶9667, 270 F2d 294, 296 (1959). (The court denied an interest expense deduction because "the entire transaction lack[ed] substance" and was therefore to be ignored for tax purposes.)

[106] Substance over form is a one-sided argument used by the IRS, but not taxpayers. It would seem that if the doctrine could be used evenly by taxpayers the taxpayer in a corporate reorganization would be able to use substance over form against nitpicky differences in the Treasury regulations.

[107] Reg. §1.1002-1(c). ("Exceptions to the general rule are made, for example by Sections 351(a), 354, 361(a), … 1031, 1035 and 1036. These sections describe certain specific exchanges of property in which at the time of the exchange particular differences exist between the property parted with and the property acquired, but such differences are more formal than substantial. Such differences shall not be deemed controlling, and that gain or loss shall not be recognized at the time of the exchange. The underlying assumption of these exceptions is that the new property is substantially a continuation of the old investment still unliquidated; and, in the case of reorganizations, that the new enterprise, the new corporate structure, and the new property are substantially continuations of the old still unliquidated.")

[108] Marjorie E. Kornhauser, *We Don't Need Another Hero*, 60 S. CAL. L. REV. 397, 410–11 (1987). (Discussing the continuity of interest rationale in the context of Code Sec. 1031.)

[109] Boris I. Bittker & James S. Eustice, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS. ¶12.21[9], at 12–45 (7th ed. 2000). Bittker and Eustice note that although the continuity doctrine was intended to prevent tax-deferral to transactions that are true sales, the doctrine "works more as a blunt instrument than a scalpel."

[110] *Id.*

[111] *Id.*

[112] Daniel M. Shapiro, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, 48 TAX L. REV. 1, at 57 (1993).

[113] Code Sec. 351(a) refers to the definition of "control" in Code Sec. 368(c).

[114] *Id.*, at 20.

[115] Code Sec. 351.

[116] Code Sec. 1031.

[117] Notice 95-14, 1995-1 CB 297. *See also* Former Reg. §301.7701-2 (amended 1993).

[118] Former Reg. §301.7701-2(a)(3) (as amended in 1993). ("[A]n unincorporated organization shall be classified as an association [taxed as a corporation] unless such organization has more corporate characteristics than noncorporate characteristics.")

[119] In 1977 Wyoming adopted the first LLC statute. (Wyo. Stat. Ann. §17-15-101.) At first the IRS position was to tax the new entity as a corporation. Proposed Reg. §301.7701-2(a)(2), withdrawn, 48 FR 14,389 (1983). That position was withdrawn and replaced by a ruling holding that the Wyoming LLC would be taxed as a partnership. Rev. Rul. 88-76, 1988-2 CB 360. The later ruling led other states to adopt their own LLC statutes. After this change, entities were available that had many corporate characteristics but yet were allowed partnership tax treatment. As the IRS referenced in Notice 95-14, with

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an LLC, businesses could achieve advantages and characteristics of a corporation without corporate tax treatment. With Notice 95-14 the IRS announced its willingness to consider permitting classification by taxpayer election.

120 Notice 95-14, 1995-1 CB 297.

121 *See* Louis F. Lobenhofer. *Limited Liability Entities in Ohio: A primer of the Limited Liability Company and Partnership with Limited Liability, Their Substantive and Tax Aspects*, 21 OHIO N.U.L. REV. 39 (discussing how the Ohio Limited Liability Company statute would have to avoid allowing continuity of life and free transferability for the statute to be "bullet proof").

122 As mentioned above, the four corporate characteristics the IRS considered were limited liability, continuity of life, centralized management and free transferability.

123 Wyo. Stat. 17-15-123(a) (1977). Originally the Wyoming LLC statute was drafted to ensure Wyoming LLCs would be classified as partnerships for tax purposes. The Wyoming statute provided the entity would have a limited rather than continuous life and interests would not be freely transferable.

124 Notice 95-14, 1995-1 CB 297.

125 Reg. §§301.7701-1, -2, -3.

126 Reg. §301.7701-2.

127 *See* Code Sec. 7805(a). (This grants the Treasury to interpret not to change the law.)

128 Code Sec. 338.

129 *Kimbell-Diamond Milling Co.*, 14 TC 74, Dec. 17,454 (1950), *aff'd per curiam*, CA-5, 51-1 USTC ¶9201, 187 F2d 718, *cert denied*, 342 US 827 (1951).

130 Kimbell-Diamond had first acquired the target then liquidated the target. The court viewed the transaction through the step-transaction doctrine to be in substance a purchase.

131 Prior to Code Sec. 338, there was a statutory codification of the *Kimball-Diamond* result that adopted a more objective analysis than the court's very subjective intent based analysis. *See* Boris I. Bittker & James S. Eustice, *supra* note 22, ¶11.45, at 11–53. ("[I]n 1954 Congress enacted §334(b)(2) to reduce the uncertainties from … Kimbell-Diamond …" "§334(b)(2) was repealed in 1982 and replaced by §338.")

132 Code Sec. 338(d)(3) and 1504(a)(2) (Code Sec. 1504(a)(2) provides the 80-percent voting and value test.)

133 Code Sec. 338(d)(3). However, note that control need not be acquired in a single step within a 12-month period.

134 Code Sec. 338(g)(1). (Not later than the 15th day of the ninth month, beginning after the month in which the acquisition date occurs.)

135 Code Sec. 338(g)(3).

136 Code Sec. 368(a)(1) and 368(a)(2).

137 *See* Report by the Staff of the Senate Finance Committee, the Subchapter C Revision Act of 1985 (not enacted) [S.Prt. 99-47, 99th Cong., 1st Sess. 50-53, 83–100, 106–40, and 211–55 (1985)]. If the actual text of the proposal is unavailable *see* Boris I. Bittker & James S. Eustice, *supra* note 22, ¶14.21. Please note that Bittker & Eustice stopped making mention of these proposed changes starting with the 6th edition.

138 *See* S.Prt. 99-47, 99th Cong., 1st Sess. 51 (1985). *See* also Boris I. Bittker & James S. Eustice, *supra* note 22, ¶14.21, at 14–107. (Professors Bittker and Eustice characterized the acquisitive reorganization regime as a transactional election which the proposal would replace with an "express election keyed to the parties decision.").

139 *See* S.Prt. 99-47, 99th Cong., 1st Sess. 50–53, 83–100, and 106–40 (1985). *See also* Bittker & Eustice at 14–107.

140 *See* S.Prt. 99-47, 99th Cong., 1st Sess. 58–68 (1985). The 1985 Proposal included the repeal of the *General Utilities* doctrine. The Proposal noted that this repeal would put pressure on corporations and shareholders involved in reorganizations. But this pressure was noted at the same time as the Committee advanced the notion of an elective regime.

141 *See* Bittker & Eustice at 14–113. (The "nonrecognition rules of Sections 336 and 337 were generally repealed, with no permanent exceptions at either the corporate or shareholder level.")

142 *See* S.Prt. 99-47, 99th Cong., 1st Sess. 50 (1985). *See also* Bittker & Eustice at 14–106 to 14–107.

143 *Id.*

144 *See* S.Prt. 99-47, 99th Cong., 1st Sess. 50 (1985) (*see* Proposed §364(b), at 112). *See also* Bittker & Eustice at 14–107. (Professors Bittker and Eustice speculated that only reverse triangular mergers would be treated as stock purchases.) In a forward triangular merger the target is merged into the acquiring parent's subsidiary. Here the proposal explicitly characterizes the transaction as a stock acquisition. In a reverse triangular, the subsidiary is merged into the target, the target controls all assets of the target and subsidiary before the merger, and the target survives. Both of these should be characterized the same, otherwise the system retains an asymmetrical outcome for transactions which are economically equivalent.

145 *See* S.Prt. 99-47, 99th Cong., 1st Sess. 50 (1985) (*see* Proposed §364(c), at 113). Note that this incorporates the 70/90 rule found in Rev. Proc. 77-37, 1977-2 CB 568. *See also* Bittker & Eustice at 14–108.

146 *See* S.Prt. 99-47, 99th Cong., 1st Sess. 50-53, 116, and 131 (1985) (*see* Proposed §364(f), at 116). *See also* Bittker & Eustice at 14–108.

147 *See* S.Prt. 99-47, 99th Cong., 1st Sess. 112–13, 223–24 (1985). *See also* Bittker & Eustice at 14–109.

148 *See* S.Prt. 99-47, 99th Cong., 1st Sess. 52, 83–94, 354–55 (1985).

149 *Id.*, at 52.

150 *Id.*, at 50, 83–88.

151 *See* S.Prt. 99-47, 99th Cong., 1st Sess. 83–84, 116 (1985) (*see* Proposed §§354 and 364, at 83 and 117). Note, the Proposal extended tax-deferral to security holders as well as shareholders. *See also* Bittker & Eustice at 14–112.

152 *See also* S.Prt. 99-47, 99th Cong., 1st Sess. 53, 97 (1985). ("The determination of dividend effect is made by treating the shareholder as having received only qualifying consideration in the exchange, and then as being redeemed of all or a portion of such qualifying consideration to the extent of the non-qualifying consideration received. For these purposes, earnings and profits of both the target and the acquiring corporations are generally taken into account." The dividend equivalency test would have relied on the tests under Code Sec. 302(b).) *See* Proposed §356(d), at 97 for the dividend equivalency test, proposed §356(d)(3)(B) incorporated the Code Sec. 302(b) tests. *See also* Bittker & Eustice at 14–113. "[D]ividend equivalency is tested by assuming a full issuance of stock followed by a hypothetical redemption of such stock for the boot by the acquiring corporation; if dividend equivalence results, it will be taxed in full as such, regardless of the shareholder's realized gain or loss on the exchange and measured by the combined earnings of the target and acquiring corporations."

153 *See* S.Prt. 99-47, 99th Cong., 1st Sess. 51, 119 (1985). *See also* Bittker & Eustice at 14–111.

154 Act Sec. 224(a) of the Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248).

155 *See* S.Prt. 99-47, 99th Cong., 1st Sess. 50-53, 117-126 (1985).

156 *See* S.Prt. 99-47, 99th Cong., 1st Sess. 50-53, 117-126 (1985). Also note that because the proposal did away with the continuity of interest requirement, those continuity of interest concerns for the "G" reorganization in bankruptcy were alleviated. Inclusion of "G" reorganizations in an elective regime would require either the elimination of continuity of interest entirely, which I do not propose, or an elimination or adjustment of that requirement as to reorganizations in bankruptcy.

157 Code Sec. 1012.

158 This is bifurcation of the transaction as to the shareholders, not the assets of the target corporation. Parties to an elective reorganization must not be allowed to select which assets will be acquired tax-deferred and which will receive a cost basis.

159 The 1985 Proposal included such a consistency requirement. *See* S.Prt. *See* S.Prt. 99-47, 99th Cong., 1st Sess. 51, 119 (1985).

160 *See* Reg. §1.368-1(e)(2)(v).

161 *See* Code Sec. 453.

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[162] For another perspective on corporate reorganizations, *see* Yariv Brauner. *A good habit, or just an old one? Preferential tax treatment for reorganizations*, 2004 B.Y.U. REV. 1. (Mr. Brauner views the tax-deferred reorganization as a preferential tax treatment that ought to be abolished.)

[163] 17 CFR §240.13d-1 (requiring any person who, after acquiring directly or indirectly ownership of five percent of any equity security that is registered under Section 12 of the Exchange Act, or any equity security of any insurance company which would have been required to be registered except for exemption).

[164] *See* S.Prt. 99-47, 99th Cong., 1st Sess. 52-53 (1985).

[165] *Id.*, at 52–53, 83–88 (1985).

[166] Bittker & Eustice at 14–111.

[167] Code Sec. 381(c).

[168] Bittker & Eustice, *supra* note 109, at ¶14.01[2].

[169] Bittker & Lokken, *supra* note 43, ¶95.5.1, at 95–63.

[170] *Id.*

[171] *Id.*

[172] *Id.*, at 95–64.

[173] *Id.*, at 95–68.

[174] Fox & Fox, *supra* note 2, §5C.01, p. 5C-2 – 5C-3 (Release 83, Matthew Bender & Co. Inc. 2004).
See also 51 U. MIAMI L. REV. 533, 562; and Boris I. Bittker & James S. Eustice, *supra* note 22, ¶95.1, at 95–2.

[175] *Id.*

[176] Fox & Fox, *supra* note 2, §5D.01, p. 5D-2 –5D-3 (Release 83, Matthew Bender & Co. Inc. 2004).

[177] Code Sec. 368(a)(1)(A)-(C).

[178] Code Sec. 381(a). Code Sec. 381 specifically lists the (A) and (C) acquisitive reorganizations in Code Sec. 368 among the instances when the carryover limitations apply.

[179] Code Sec. 332.

[180] Fox & Fox, *supra* note 2, §5.01[1], p. 5-1 (Release 83, Matthew Bender & Co. Inc. 2004).

[181] Code Sec. 381. Code Sec. 381 also considers other transactions that result in changes in ownership not considered here. Subsection (b) provides operating rules which govern applicable tax years and prohibits the acquiring corporation from offsetting or carrying back net operating losses or net capital losses back against tax years of the target.

[182] Code Sec. 381(b). Code Sec. 381(b) does allow the acquirer to carry back losses incurred after the transaction date, even if attributable to the target business, to the acquirer's prior years.

[183] Code Secs. 382–384.

[184] Code Sec. 39.

[185] Code Sec. 53.

[186] Code Sec. 269(a).

[187] *See* Code Sec. 368(a)(1)(D), (E), (F) and (G).

[188] Code Sec. 382.

[189] Code Sec. 382(g) (defining "ownership change").

[190] After the quarantine period there would be no limitation on the use of carryovers or NOLs such as the limitation in Code Sec. 382(b).

[191] *See* Kahn & Lehman, *supra* note 8, §9.3, 835–37 (5th ed. West 2001) (Tracing the history of the development and changes to reorganization rules). *See also Chapman*, *supra* note 8. In *Chapman*, the First Circuit discusses the legislative history of reorganizations and the eventual development of "continuity of interest" doctrine. The court traces the legislative history of Congress reacting in an attempt to address the latest perceived abuse in the world of reorganizations. One such Congressional response, in 1939, was a requirement that the acquiring corporation obtain at least 80 percent of the target. The 1954 Code retained much of the language in the 1939 Code, one of the things retained from the 1939 Code was the 80 percent requirement. Congress went on to add that this 80-percent requirement would not be required in a single step. But from this we can trace the current requirement in the Type B to the "continuity of interest" doctrine.

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