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Assessing the Value of the Proposed “No Net Value” Regulations

By

Mark J. Silverman
Steptoe & Johnson LLP
Washington, D.C.

Gregory N. Kidder
Steptoe & Johnson LLP
Washington, D.C.

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I. Overview

On March 10, 2005, the Internal Revenue Service (the “Service”) and the Treasury Department (“Treasury”) issued proposed regulations governing the treatment of nonrecognition transactions involving insolvent companies--perhaps the most significant guidance in the area in 25 years. The proposed regulations do two things: (1) establish a uniform “net value” requirement for nonrecognition treatment of section 351¹ contributions, section 332 liquidations, and section 368 reorganizations (the “no net value” regulations); and (2) clarify the circumstances in which creditors will be treated as holding proprietary interests in target corporations for purposes of satisfying the continuity of interest (“COI”) requirement for reorganizations under section 368 (the “creditor continuity” regulations).²

First, the proposed regulations establish that a transaction must involve an exchange (or distribution) of “net value” in order to qualify for nonrecognition treatment as a section 351 contribution, a section 332 liquidation, or a section 368 reorganization. For nonrecognition treatment under section 332, current law is clear that shareholders must receive at least some

¹ Unless otherwise indicated by context, all section references are to the Internal Revenue Code of 1986, as amended (the “Code”), or to the Treasury regulations thereunder.

² The creditor continuity regulations were finalized effective December 12, 2008. *See* T.D. 9434 (Dec. 11, 2008). The final regulations are substantially similar to the proposed regulations.

value in their capacity as shareholders. The proposed regulations codify existing authority and clarify that in order to qualify as a section 332 liquidation, the shareholder must receive some payment with respect to *each* class of stock in the liquidating subsidiary. Current law is less clear with respect to other nonrecognition transactions involving insolvent corporations. The proposed regulations extend the net value requirement applicable to section 332 liquidations to section 351 incorporations and section 368 reorganizations.

Second, with respect to reorganizations under section 368, the regulations clarify when a creditor may be treated as holding a proprietary interest for purposes of determining whether the COI requirement is satisfied. The regulations generally adopt the approach taken by the common law, but further relax the rules to enable creditors more easily to be treated as holding proprietary interests and transactions to more easily satisfy COI.

This article reviews the authority that currently governs nonrecognition transactions involving insolvent corporations and the new rules under the proposed regulations. In general, the proposed regulations clarify the requirements for certain transactions to qualify for nonrecognition treatment. Unfortunately, in doing so, the proposed regulations reject certain principles of *Norman Scott, Inc. v. Commissioner*³ and also deny a parent corporation the ability to convert its creditor position to equity in order to qualify as a liquidation under section 332. The regulations also leave many questions unanswered. The preamble specifically states that the Service and Treasury are still considering the best approach to valuing liabilities and are continuing to study whether the net value requirement should be applied to acquisitive D reorganizations. The preamble also leaves open questions as to how nonrecourse liabilities will be treated for purposes of the net value requirement and whether a similar net value requirement

³ 48 T.C. 598 (1967).

should be established with respect to contributions to a partnership (the proposed regulations only apply to contributions to a corporation).

One thing that is certain about the proposed regulations is that they continue the tendency of recent guidance to place an increased emphasis on valuations. The proposed regulations rely on comparisons of the fair market value of assets to outstanding liabilities and therefore necessarily depend on valuations of those assets and liabilities. In this way, the proposed regulations create further challenges for taxpayers.

II. The Proposed “No Net Value” Regulations

A. In General

The proposed regulations adopt a uniform “net value” requirement applicable to section 351 contributions, section 332 liquidations, and reorganizations under section 368.⁴ In general, the proposed regulations establish that property with a net value must be exchanged in these transactions (or distributed in the case of a section 332 liquidation). The preamble indicates that the Service and Treasury believe this uniform standard is appropriate because transfers of property in exchange for the assumption of liabilities or in satisfaction of liabilities are akin to taxable sales and should not be treated as nonrecognition transactions.⁵ The Service and Treasury also point to the language in the specific provisions providing for nonrecognition treatment, which all use the word “exchange,” in support of the net value requirement:⁶

⁴ The proposed regulations establish the “net value” requirement in addition to the other requirements for the respective nonrecognition transactions (e.g., COI for reorganizations under section 368).

⁵ Preamble to Proposed Regulations on Transactions Involving the Transfer of No Net Value (“Preamble to Proposed Regulations”), 70 Fed. Reg. 11,903, 11,904 (March 10, 2005).

⁶ *Id.*; see also *Meyer v. United States*, 121 F. Supp. 898 (Ct. Cl. 1954).

- Section 351(a) states “[n]o gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in *exchange* for stock in such corporation and immediately after the exchange such person or persons are in control of the corporation.”
- Section 354(a) states “[n]o gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of a plan of reorganization, *exchanged* solely for stock or securities in such corporation or in another corporation a party to the reorganization.”
- Section 361(a) states, “[n]o gain or loss shall be recognized to a corporation if such corporation is a party to a reorganization and *exchanges* property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.”

By focusing on whether or not equity value is exchanged in the transaction, the proposed regulations move the emphasis away from the formality of whether or not stock was actually issued in the transaction.⁷ Thus, the fact that stock is issued will not make a transaction tax-free if there is no equity value to support the issuance of such stock. The preamble to the proposed regulations indicates that the Service and Treasury believe that the proposed net value rule is preferable to a rule that looks to the issuance or failure to issue stock because, when the parties are related, the issuance or failure to issue stock might be meaningless.⁸

B. Liquidations

1. Current Law

In general, amounts received by a shareholder in complete liquidation of a corporation are treated as “full payment in exchange for the stock” and the shareholder recognizes gain or loss depending on the shareholder’s adjusted basis in the stock and the amount received upon liquidation.⁹ Section 332 is an exception to the general rule and provides that “[n]o gain or loss

⁷ See Prop. Treas. Reg. § 1.368-1(f)(5), Exs. 2, 3.

⁸ Preamble to Proposed Regulations, 70 Fed. Reg. at 11,905.

⁹ Section 331(a).

shall be recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation” if the corporate shareholder owns 80 percent of the subsidiary’s stock.¹⁰

Section 346 provides that a distribution shall be treated as a complete liquidation if “the distribution is one of a series of distributions in redemption of all of the stock of [a] corporation pursuant to a plan.”¹¹ This definition contemplates that for a liquidation to fall within either section 331 or section 332, the shareholder must receive a distribution with respect to its stock.

This requirement is made explicit by the partial payment rule contained in the regulations under section 332. Treasury Regulation section 1.332-2(b) states that section 332 applies “only to those cases in which the recipient corporation receives at least partial payment for the stock which it owns in the liquidating corporation.” As a result, it has long been held that the liquidation of an insolvent subsidiary does not qualify as a section 332 liquidation.¹² Although there is no regulatory “partial payment” rule for section 331, common law authority has concluded that the requirement that the shareholder receive partial payment for its stock applies to section 331 liquidations as well.¹³ Instead, the parent will be entitled to a bad debt deduction under section 166 and/or a worthless stock deduction under section 165 (a bad debt deduction to

¹⁰ Section 332(a).

¹¹ Section 346(a).

¹² See, e.g., *H.G. Hill Stores, Inc. v. Commissioner*, 44 B.T.A. 1182 (1941); Rev. Rul. 59-296, 1959-2 C.B. 87. The same rule applies where there is no actual distribution, but the effect of the transaction is a deemed liquidation. See Rev. Rul. 2003-125, 2003-52 I.R.B. 1243 (applying partial payment rule to deemed liquidation as a result of check-the-box election with respect to an insolvent subsidiary); see also P.L.R. 9610030 (Dec. 12, 1995); P.L.R. 9425024 (Mar. 25, 1994).

¹³ See *Braddock Land Co. v. Commissioner*, 75 T.C. 324 (1980); *Jordan v. Commissioner*, 11 T.C. 914 (1948).

the extent the outstanding debt exceeds the amount received in the distribution and a worthless stock deduction to the extent of the parent's basis in the subsidiary's stock).¹⁴

For a time there was some uncertainty among practitioners as to whether there was a gap between section 332 and section 165 such that a taxpayer could fall outside the scope of both provisions.¹⁵ This uncertainty was put to rest in Revenue Ruling 2003-125, which confirmed that if section 332 does not apply to the complete liquidation of a subsidiary because the subsidiary is insolvent, then the parent is entitled to a worthless stock loss under section 165. These rules present a planning opportunity because a taxpayer is able to check the box on an insolvent entity, continue the business carried on by that entity, and still recognize a worthless stock loss because section 332 does not apply. Because an insolvent subsidiary does not have assets sufficient to satisfy its liabilities, by definition the subsidiary cannot have assets with which to make partial payment with respect to its stock.¹⁶

In addition, case law has established that the parent must receive partial payment with respect to each class of the subsidiary's stock for a distribution to qualify as a section 332

¹⁴ See Treas. Reg. § 1.332-2(b) ("If section 332 is not applicable, see section 165(g) relative to allowance of losses in worthless securities"); see also *Continental Grain Co. v. Commissioner*, 56 T.C.M. (CCH) 900 (1988); *H.G. Hill Stores, Inc.*, 44 B.T.A. 1182; *Iron Fireman Mfg. Co. v. Commissioner*, 5 T.C. 452 (1945); *Glenmore Distilleries, Inc. v. Commissioner*, 47 B.T.A. 213 (1942); P.L.R. 8801028 (Oct. 9, 1987). The parent will be entitled to a bad debt or worthless stock deduction even if the parent continues to operate the subsidiary's business with the assets received in the distribution. See Rev. Rul. 2003-125, 2003-125 I.R.B. 52; Rev. Rul. 70-489, 1970-2 C.B. 53.

¹⁵ See F.S.A. 200226004 (Mar. 7, 2002) (concluding that a deemed liquidation under the check-the-box regulations was not an identifiable event for purposes of section 165(g) where the entity continued in operation as a partnership).

¹⁶ Presumably, the parent corporation would have to inject new capital to continue to operate the business of the liquidated subsidiary. Otherwise, a question would be raised as to how the subsidiary could have been insolvent prior to the liquidation.

liquidation. In *Spaulding Bakeries, Inc. v. Commissioner*,¹⁷ a corporate taxpayer held all of the outstanding common and preferred stock of a subsidiary. The taxpayer liquidated the subsidiary at a time when the fair market value of the subsidiary's assets was less than the liquidation preference of the preferred stock. The court held that the dissolution of the subsidiary was not a complete liquidation under section 112(b)(6) (the predecessor to section 332) because the taxpayer did not receive any consideration in exchange for its common stock.¹⁸ Thus, if a parent holds both preferred and common stock and the distribution received upon liquidation does not exceed the liquidation preference on the preferred stock, the distribution does not qualify as a section 332 liquidation because no payment is received on the common stock.

2. General Rule under Proposed Regulations

The proposed regulations retain the partial payment rule in the current Treasury regulations and codify the rule established in *Spaulding Bakeries* and *H.K. Porter* that payment must be received with respect to each class of stock to satisfy the partial payment rule.¹⁹ The proposed regulations, like the current regulations, cross reference the worthless security deduction under section 165(g) if the liquidation fails to qualify under section 332, but the proposed regulations codify the clarification in Rev. Rul. 2003-125 that closes the gap between liquidations and the worthless security deduction under section 165(g).²⁰

Example 1: Corporate Liquidation; Net Value Requirement Not Satisfied. P corporation owns all of the common and preferred stock of its subsidiary, S corporation. The fair market value of S's assets do not exceed the amount of the debt S owes to P. S

¹⁷ 252 F.2d 693 (2d Cir. 1958).

¹⁸ See also *H.K. Porter Co. v. Commissioner*, 87 T.C. 689 (1986).

¹⁹ See Prop. Treas. Reg. § 1.332-2(b).

²⁰ See Prop. Treas. Reg. § 1.332-2(e), Ex. 2.

distributes all its assets to P in complete liquidation and cancellation of the debt S owes to P.

Under the partial payment rule in the current and proposed Treasury regulations, the receipt by P of S's assets is not a distribution received by P within the meaning of section 332 because P did not receive partial payment for either the common or preferred stock it owns in S. Thus, P will be entitled to a worthless stock loss on its S stock.²¹

In addition, the proposed regulations go one step further than prior authority. *Spaulding Bakeries* and *H.K. Porter* only held that section 332 does not apply to a dissolution of a corporation if the dissolution does not result in a partial payment on each and every class of stock. Neither case addressed how to treat each class of stock after it was established that section 332 does not apply. The proposed regulations provide that if section 332 does not apply, then section 165(g) applies to allow a worthless securities loss for the stock for which no payment is received.²² With respect to a class of stock for which partial payment is received, the proposed regulations state the partial payment may qualify as a reorganization; if the partial payment is not a reorganization, the proposed regulations direct the taxpayer to section 331.²³

P cannot change this result by contributing the debt to S in order to make S solvent immediately prior to the liquidation. Under Revenue Ruling 68-602,²⁴ the contribution and the liquidation would be stepped together and the transaction would fail the partial payment requirement of section 332.²⁵ The proposed regulations continue this rule.²⁶ However, as discussed more fully below, the authors believe there is little reason to preclude the application of section 332 to such a transaction where P is the sole shareholder and creditor of S. Section 332 is generally viewed as an elective provision of the Code by virtue of the fact taxpayers have

²¹ See Treas. Reg. § 1.332-2(b); Prop. Treas. Reg. § 1.332-2(b).

generally been allowed to take steps to meet or fail the control requirement.²⁷ It is unclear why the partial payment rule should be applied differently to strictly limit the taxpayer's options.

Example 2: Corporation Liquidation; Net Value Requirement Only Satisfied With Respect to One Class of Stock. The facts are the same as the above example, except the fair market value of S's assets exceed the amount of the debt S owes to P, but does not exceed the liquidation preference on P's preferred stock.

Under the proposed regulations, the receipt by P of S's assets is not a distribution received by P within the meaning of section 332 because P did not receive any payment on its S common stock. To determine the tax consequences, the proposed regulations bifurcate the transaction and analyze each class of stock separately. P will be entitled to a worthless stock deduction for the common stock, because P did not receive any payment on the common stock in the liquidation. With respect to the preferred stock, the proposed regulations state that the distribution upon the dissolution of S will be treated either as a reorganization or a section 331 liquidation.

This bifurcation approach raises some issues. For example, if a partial payment with respect to only one class of stock qualifies as a reorganization, what becomes of the attributes of the liquidated corporation? In general, section 381 provides that a corporation that acquires the

²² See Prop. Treas. Reg. § 1.332-2(b), -2(e), Ex. 2.

²³ See *id.*

²⁴ 1968-2 C.B. 135.

²⁵ But see Treas. Reg. § 1.1502-13(g), treating intragroup debt as satisfied immediately before a liquidation without reference to how the debt was paid (and arguably thereby making the subsidiary solvent immediately before the liquidation).

²⁶ See Preamble to Proposed Regulations, 70 Fed. Reg. at 11,906.

²⁷ See *Granite Trust Co. v. United States*, 238 F.2d 670 (1st Cir. 1956); F.S.A. 200148004 (July 11, 2001).

assets of another corporation in a section 332 liquidation or in an A, C, acquisitive D, F, or G reorganization succeeds to the tax attributes of the other corporation.²⁸ However, section 382 limits the amount of income of a loss corporation that can be offset by net operating loss (“NOL”) carryovers or built-in losses following an “ownership change.” Specifically, section 382 limits the use of any NOL carryovers to offset future income if a loss corporation undergoes a 50-percent ownership change.²⁹ The amount of income that can be offset is limited to a percentage of the value of the loss corporation.³⁰ A 50-percent ownership change is deemed to occur if a 50-percent shareholder claims a worthless stock deduction with respect to a loss corporation’s stock and retains ownership of the stock at the end of the year in which the deduction is claimed.³¹ The effect of this rule is that the ownership change occurs at a time when the loss corporation has zero value. Therefore, the section 382 limitation will be zero and no future income may be offset by NOL carryovers.³² It is unclear how section 382 will apply if P is permitted a worthless stock deduction for one class of stock, but a distribution on the other class of stock is treated as a reorganization.

In addition, unless the subsidiary is liquidated by reason of an upstream merger, the reorganization is likely to be tested as a “C” reorganization. It is not entirely clear how the “substantially all” requirement will be applied in this context. Presumably, the assets transferred by S in satisfaction of its debt to P will count against substantially all. Accordingly, where the

²⁸ See section 381(a).

²⁹ See section 382(a), (d).

³⁰ See section 382(b).

³¹ See section 382(g)(4)(D).

³² See section 382(g)(4)(D).

subsidiary has more than an insignificant amount of debt outstanding, the partial payment is not likely to qualify as a reorganization.³³

Further, if partial payment with respect to only one class of stock does not qualify as a reorganization, it is unclear how section 331 applies. As discussed above, section 346(a) defines “complete liquidation” for purposes of both section 331 and section 332 as a redemption of “all of the stock of [a] corporation pursuant to a plan,” and the case law has extended the partial payment rule to section 331 liquidations.³⁴ Therefore, the reference to section 331 in the proposed regulations appears to be inconsistent with current law. If section 331 does not apply, presumably the partial payment would be a section 1001 exchange.

If taxpayers want to avoid the bifurcation rules, it may be possible to recapitalize the subsidiary so that only common stock is outstanding. However, such a recapitalization, to be respected, must not immediately precede the liquidation--if the recapitalization is merely transitory, the Service is likely to disregard it.³⁵

C. Section 351 Contributions

1. Current Law

Section 351(a) provides that no gain or loss will be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock of such corporation and, immediately after the exchange, such person or persons are in control of the corporation.” There

³³ In addition, although the assumption of liabilities does not violate the “solely for voting stock” requirement, the regulations under section 368 state that section 368(a)(1)(C) “does not prevent consideration of the effect of an assumption of liabilities on the general character of the transaction” and that an assumption may “so alter the character of the transaction as to place the transaction outside the purposes and assumptions of the reorganization provisions. *See* Treas. Reg. § 1.368-2(d)(1).

³⁴ *See supra* note 12.

³⁵ *See* Rev. Rul. 68-602, 1968-2 C.B. 135.

are two ways in which insolvency may implicate the requirements of section 351. First, the transfer of over-encumbered property may not constitute “property.” Second, if stock of an insolvent corporation is received, it may not satisfy the “solely in exchange for stock” requirement. In *Rosen v. Commissioner*,³⁶ the taxpayer transferred the assets and liabilities of a sole proprietorship to a newly formed corporation. At the time of the transfer, the liabilities exceeded the value of the assets, and the corporation was insolvent. The court held that the taxpayer realized gain under section 357(c) to the extent the liabilities assumed exceeded the adjusted basis of the assets transferred.³⁷ Implicit in the court’s holding in *Rosen* was the treatment of the transaction as a contribution that qualified under section 351, notwithstanding that the corporation was insolvent at the time of the transfer. Nonetheless, the court in *Rosen* did not analyze the section 351 issue. An earlier Court of Claims case, *Meyer v. United States*, held in dicta that the transfer of worthless property in exchange for stock did not meet the exchange requirement of the predecessor of section 351.³⁸ Thus, current law is unclear as to whether a contribution of over-encumbered property to an insolvent corporation qualifies for nonrecognition treatment as a section 351 transaction.

2. General Rule Under Proposed Regulations

The proposed regulations attempt to resolve the uncertainty by rejecting the implication in *Rosen* and adopting the position of *Meyer*. The proposed regulations require that the

³⁶ 62 T.C. 11 (1974).

³⁷ See also *Focht v. Commissioner*, 68 T.C. 223 (1977); G.C.M. 33,915 (Aug. 26, 1968). But see *DeFelice v. Commissioner*, 386 F.2d 704 (10th Cir. 1967) (rejecting the taxpayer’s argument that section 357(c) did not apply, because he was insolvent; the court found that the taxpayer failed to prove he was insolvent).

³⁸ 121 F. Supp. 898 (Ct. Cl. 1954).

transferor both surrender net value³⁹ and receive net value⁴⁰ for a contribution to qualify for nonrecognition under section 351. To satisfy the first part of the net value requirement (surrender net value), the fair market value of the assets transferred must exceed the amount of any liabilities of the transferor assumed or satisfied by the transferee in connection with the exchange. Thus, over-encumbered property would not be treated as property under the proposed regulations. To satisfy the second part (receive net value), the fair market value of the transferee must exceed the amount of its liabilities immediately after the transfer. In other words, the receipt of stock in an insolvent company is not sufficient to satisfy the “solely in exchange for stock” requirement of section 351. The application to these rules are illustrated in the following examples.

Example 3: Contribution; Net Value Requirement Not Satisfied (No Value Surrendered). P corporation transfers a building with a fair market value of \$100 and subject to a liability of \$150 to S corporation in exchange for S stock.

Under the proposed regulations, the transfer in the above example does not qualify as a section 351 exchange because P did not surrender net value in the exchange.⁴¹ Neither the proposed regulations nor the preamble addresses the tax consequences of this transaction after it is determined that section 351 does not apply. Depending on its adjusted basis in the building, it is possible that P should recognize gain on this exchange under *Commissioner v. Tufts*.⁴² It is also possible to analyze S’s assumption of liabilities in excess of the value of the assets as a distribution from S to P under section 301. If S has no earnings and profits (“E&P”), the

³⁹ Prop. Treas. Reg. § 1.351-1(a)(1)(iii)(A).

⁴⁰ Prop. Treas. Reg. § 1.351-1(a)(1)(iii)(B).

⁴¹ See Prop. Treas. Reg. § 1.351-1(a)(1)(iii)(A); -1(a)(2), Ex. 4.

⁴² 463 U.S. 1215 (1983).

distribution would be a return of basis to the extent of P's basis in the S stock and a capital gain to the extent of any excess.⁴³ Query whether the analysis is different depending on whether the debt is recourse or nonrecourse.

Note that the net value requirement can produce adverse results for a corporation that wishes to check the box for a disregarded entity that is insolvent. Checking the box (i.e., changing the classification of a wholly-owned limited liability company from a disregarded entity to a "C" corporation) is treated as a contribution of the assets and liabilities of the disregarded entity to a new corporation.⁴⁴ If the disregarded entity is insolvent, then no net value is transferred in the deemed exchange and the requirements of section 351 are not met. Therefore, like Example 3, the deemed transaction will be taxable as either a section 1001 exchange or a section 301 distribution.

What if, in addition to the building, P transfers unencumbered equipment worth \$75. Does the net value requirement apply on an aggregate basis, with the result that P transfers value of \$175 and liabilities of \$150, so that the net value requirement is satisfied? Or is the transfer bifurcated so that section 351 applies with respect to the equipment but not with respect to the building? Although the preamble to the proposed no net value regulations contains an example that adopts the former interpretation,⁴⁵ government representatives have suggested informally that the latter interpretation might be appropriate. Such a bifurcation approach, however, seems inconsistent with the statutory scheme of section 351 and the case law. For example, section 357(c), which requires gain recognition to the extent liabilities assumed exceed the basis of the

⁴³ See section 301(c)(2), (c)(3).

⁴⁴ See Treas. Reg. §301.7701-3(g)(1)(iv).

⁴⁵ 70 Fed. Reg. at 11,906.

assets transferred, is applied on an aggregate basis. Indeed, the purpose of section 351 was to facilitate the incorporation of ongoing businesses.⁴⁶ This purpose was reaffirmed by the enactment of section 357(c)(3) to avoid the harsh results of section 357(c) where ongoing businesses with deductible liabilities are incorporated.⁴⁷ This purpose would be undermined if section 351 were to apply on an asset-by-asset basis. In addition, there is authority applying section 351 to incorporations of ongoing businesses and treating the assets on an aggregate basis.⁴⁸

The preamble to the proposed no net value regulations states that Treasury and the Service are considering a rule similar to the one in Revenue Ruling 92-53⁴⁹ that would disregard the amount by which a nonrecourse liability exceeds the fair market value of the property securing the liability when determining the amount of liabilities assumed. If the liability in Example 3 were nonrecourse and such a rule applied, P would be treated as transferring an asset worth \$100 subject to a liability of \$100. Because the proposed no net value regulations require that the value of the property *exceed* the liabilities assumed, it would still not qualify as a section 351 exchange. Thus, the rule in Revenue Ruling 92-53 would only have an effect if multiple assets were transferred⁵⁰ and the net value requirement were applied on an aggregate basis.

⁴⁶ See S. Rep. No. 398, at 17-18 (1924); H.R. Rep. No. 350, at 9-10 (1921); *Portland Oil Co. v. Commissioner*, 109 F.2d 479, 488 (1st Cir. 1940); *G.D. Searle & Co. v. Commissioner*, 88 T.C. 252 (1987); Rev. Rul. 95-74, 1995-2 C.B. 36.

⁴⁷ Staff of the Joint Committee on Taxation, General Explanation of the Revenue Act of 1978, at 219 (Comm. Print 1979); S. Rep. No. 95-1263, at 185 (1978).

⁴⁸ See e.g., Rev. Rul. 85-164, 1985-2 C.B. 117, *Focht*, 68 T.C. 223.

⁴⁹ 1992-2 C.B. 48.

⁵⁰ Alternatively, it may be possible for the transferor to issue a note to the transferee corporation to avoid the transfer of underwater assets. As long as the note is bona fide, it should

Example 4: Contribution; Net Value Requirement Not Satisfied (No Value Received). P corporation transfers assets with a fair market value of \$200 and liabilities of \$150 to S corporation in exchange for S stock. Immediately after the exchange, S corporation has assets with a fair market value of \$300 and liabilities of \$350.

Under the proposed regulations, the above transfer is not a section 351 exchange because P corporation did not receive net value in the exchange (i.e., P received stock in an insolvent company). Again, neither the preamble nor the proposed regulations addresses the tax consequences of this transaction. Because P does not receive property with a net value, the transaction cannot be a section 301 distribution. The transaction is most likely best analyzed as a contribution to capital under section 118. P contributed net value and should receive an increase in its basis in S stock equal to the basis of the contributed property.⁵¹

If the transaction is not a contribution to capital, the only other possibility is to analyze the transaction as section 1001 exchange, which would lead to some anomalous results. If section 1001 applies, does P recognize a loss equal to its basis in the assets transferred because it received stock with no net value in return? If that is the case, what then is P's basis in the stock of S? Generally, P's basis should be equal to the cost of the stock. Does P recognize a loss on the exchange and then receive stock with a basis equal to zero? It is clear that the proposed regulations reject the concept that the stock received might have some option value in the event the assets of S appreciate in the future. Representatives of the government have suggested that this is because it is not really appropriate to recognize such option value in the context of related parties. Query whether it is more appropriate to trigger a loss upfront and recognize any future

be treated as an asset of the transferee corporation. See, e.g., *Peracchi v. Commissioner*, 143 F.3d 487 (9th Cir. 1998); *Lessinger v. Commissioner*, 872 F.2d 519 (2d Cir. 1989).

⁵¹ See Treas. Reg. § 1.118(a); *Commissioner v. Fink*, 483 U.S. 89 (1987).

appreciation in the future when the stock is sold (without option value) or to defer any gain or loss until the net appreciation is realized (without option value). It does not seem to be an appropriate time for recognition. Accordingly, as stated above, the transaction is probably best analyzed as a section 118 contribution of capital.

What if S were insolvent prior to the contribution, but immediately after P's contribution, S had assets with a fair market value of \$375 and liabilities of \$350? P's contribution thus made S solvent. Under the proposed regulations, the transaction should qualify as a tax-free section 351 exchange, because P transferred net value and S is solvent immediately after the exchange.⁵² Because the proposed regulations test the transferee's solvency immediately after the transfer, P may, in a tax-free manner, make S solvent.

3. Potential Extension to Cover Contributions to Partnerships

The preamble to the proposed regulations asks for comments on whether the net value requirement should be extended to contributions to a partnership in exchange for a partnership interest under section 721.⁵³ As an initial matter, it appears that contributions to a partnership should be distinguishable from contributions to a corporation. A partnership is a pass-through entity and there must be at least one general partner who remains personally liable for the debts of the partnership. Subchapter K contains an intricate set of rules that allocate partnership liabilities to the partners and deem distributions (which might give rise to partner-level gain) in the event excess liabilities are assumed by the partnership.⁵⁴ This stands in contrast to an assumption by a corporation of a shareholder's liability (or property subject to a liability),

⁵² See Prop. Treas. Reg. § 1.351-1(a)(1)(iii)(A), (B).

⁵³ Preamble to Proposed Regulations, 70 Fed. Reg. at 11,906.

⁵⁴ See sections 704 and 752.

because a corporation is a separate limited liability entity and none of the shareholders remain liable for the debts of the corporation. Moreover, the subchapter C rules do not allocate corporate liabilities to the shareholders. In the case of limited liability companies (“LLCs”) treated as partnerships, the owners do not remain personally liable. However, the same partnership rules allocating liabilities and deeming distributions apply. Thus, the fact that an LLC does not have an owner that remains personally liable should not cause LLCs to be treated differently from partnerships for purposes of assessing whether a net value rule should apply.

However, section 721, which applies to contributions to a partnership, uses the word “exchange” in a manner similar to section 351 and applies to “a contribution of property to the partnership in exchange for an interest in the partnership.”⁵⁵ If the no net value requirement is interpreted as a broader definition of the word exchange (i.e., the transfer of an asset without value or the receipt of an asset without value is not an “exchange”), then arguably the proposed regulations have a broader impact and should be applied to contributions to a partnership. The authors believe that the rules of subchapter K are sufficient to deal with net value concerns and, therefore, that any net value requirement should be limited to corporations.

D. Reorganizations

1. Current Law

Under section 361, no gain or loss is recognized by a corporation if such corporation is a party to a reorganization and exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.⁵⁶ The term “reorganization” is defined in section 368. Under current law, the controlling authority with

⁵⁵ Section 721(a).

⁵⁶ See section 361(a).

respect to whether property with a net value must be exchanged to effect a reorganization is *Norman Scott, Inc. v. Commissioner*.⁵⁷ In *Norman Scott, Inc.*, Norman Scott and his wife owned about 99 percent of the stock of Norman Scott, Inc., and owned 100 percent of the stock of River Oaks Motors, Inc. (“River Motors”), and Houston Continental Motors Ltd., Inc. (“Houston”). Both River Oaks and Houston were insolvent and Norman Scott and his wife were significant creditors of each one. Norman Scott, Inc. was solvent and an unsecured minority creditor of both River Motors and Houston. In addition, Norman Scott individually was personally liable on some of the debts of both River Motors and Houston. In the transaction at issue in the case, River Motors and Houston were merged into Norman Scott, Inc. The Service argued that because the transferor corporations were insolvent, any stock that the shareholders exchanged was worthless and thus they could not have obtained a proprietary interest in the transferee corporation and COI was not satisfied. However, the court disagreed and concluded that the COI requirement was satisfied, because the shareholders received a proprietary interest in the acquiring corporation *either* as a shareholder or as a creditor. The court also rejected the Service’s argument that the assets were transferred to the creditor in satisfaction of their debt, concluding that, unlike the partial payment rule applicable to liquidations, there is no specific requirement in section 368(a)(1)(A) that there must be a cancellation or redemption of stock to qualify for a statutory merger.

The Service acquiesced in the holding in *Norman Scott, Inc.*, but disagreed with its broad sweep.⁵⁸ In G.C.M 33859, the Service faulted the court for not determining the capacity in which the shareholder-creditor received the acquiring corporation’s stock. Citing *Helvering v.*

⁵⁷ 48 T.C. 598 (1967).

⁵⁸ See G.C.M 33859 (June 25, 1968).

*Alabama Asphaltic Limestone Co.*⁵⁹ (discussed further below), the Service argued that unless affirmative steps are taken by the creditors to assert their proprietary interest, the shareholders remain the equity holders of the corporation. Nonetheless, the Service believed that in light of the fact that Norman Scott and his wife owned 99 percent of the stock of the transferee corporations, the result reached by the court was reasonable. The Service reasoned that *Seiberling Rubber Co. v. Commissioner*,⁶⁰ and Rev. Rul. 54-610,⁶¹ which held that continuity was satisfied where former stockholders retained control, regardless of whether they retained control by virtue of their status as stockholders or creditors, support the conclusion that the Normans satisfied the COI requirement by their receipt of stock of Norman Scott, Inc. in their capacity as shareholders of the subsidiaries, and that their status as creditors did not affect that continuing proprietary interest.⁶²

The Service also disagreed with the holding that there was no specific requirement for an A reorganization to be in cancellation or redemption of stock, arguing that sections 354 and 361, the operative reorganization provisions, require that there be an exchange of property solely for stock or securities of the transferee corporation. The Service continued to maintain that a discharge of debt is insufficient to satisfy this standard.⁶³

⁵⁹ 315 U.S. 179 (1942).

⁶⁰ 189 F.2d 595 (6th Cir. 1948)

⁶¹ 1954-2 C.B. 152.

⁶² See G.C.M. 33859 (June 25, 1968)

⁶³ Nonetheless, the Service acknowledged that Rev. Rul. 59-296, 1959-2 C.B. 87, was distinguishable on other grounds, i.e., that it involved an upstream merger as opposed to a brother-sister merger. In the case of an upstream merger, the parent is obtaining a direct interest in the assets of the subsidiary, in effect removing the assets from corporate solution. See G.C.M. 33859; see also F.S.A. 002340. The Service concluded that a merger of a commonly controlled

As discussed below, the proposed regulations reverse the Service's acquiescence to the decision in *Norman Scott, Inc.* that a transaction may qualify as an A reorganization without an exchange of net value.

2. Rule under the Proposed Regulations

The proposed regulations effectively extend the partial payment requirement that has been applied in the context of section 332 liquidations to section 368 reorganizations. Further, under the proposed regulations, similar to section 351 contributions, there must be surrender of net value and a receipt of net value for a transaction to qualify as a reorganization.

The proposed regulations provide separate rules for asset reorganizations and stock reorganizations to take into account the fact that in a stock reorganization, the target continues to exist after the transaction. In addition, the proposed regulations apply a hybrid test to reverse subsidiary mergers under section 368(a)(2)(E) and do not apply to reorganizations under section 368(a)(1)(E) or section 368(a)(1)(F). The proposed regulations also do not apply to certain acquisitive D reorganizations under section 368(a)(1)(D), pending further study by the Service and Treasury.⁶⁴ The application of net value requirement in the proposed regulations to these different types of reorganizations are discussed below.

a. Asset Reorganizations

Under the proposed regulations, the surrender of net value requirement focuses on the assets and liabilities of the target corporation; the receipt of net value requirement focuses on the assets and liabilities of the issuing corporation (i.e., the corporation issuing stock in the

debtor into its creditor should constitute a reorganization, even though it extinguishes the debt, as long as there is a valid business purpose for merging the two.

⁶⁴ Preamble to Proposed Regulations, 70 Fed. Reg. at 11,905. *But see* Rev. Rul. 70-240, 1970 C.B. 81; Rev. Rul. 2004-83, 2004 I.R.B. 32.

reorganization). The surrender of net value requirement is satisfied if the fair market value of the property transferred by the target to the acquiring corporation exceeds the sum of (i) the amount of liabilities of the target corporation that are assumed by the acquiring corporation and (ii) the amount of any money and the fair market value of any property (other than stock permitted to be received under section 361(a) without the recognition of gain) received by the target corporation.⁶⁵ It is important to note that liabilities that are satisfied by the asset transfer are treated as assumed for purposes of the net value requirement. The receipt of net value requirement is satisfied if the fair market value of the assets of the issuing corporation exceeds the amount of its liabilities immediately after the exchange.⁶⁶

Example 5: Sideways Asset Reorganization; Parent Debt.

P owns all of the stock of both S and T. T has assets with a fair market value of \$100 and liabilities of \$160. All of T's liabilities are owed to P. The parties engage in the following transaction: (1) T transfers all of its assets to S in exchange for S stock with a fair market value of \$100; (2) T distributes the S stock to P in exchange for the T debt owed to P; and (3) T dissolves. P receives nothing in exchange for its T stock when T is dissolved.

This transaction satisfies the net value requirement because T surrenders net value and receives net value in the exchange with S. T surrenders net value because the fair market value of the property transferred by T to S (\$100) exceeds the amount of liabilities S assumed in the exchange (\$0). T receives net value because the fair market value of the assets of S exceeds the amount of its liabilities immediately after the exchange.⁶⁷ For a discussion of how this result would change in an upstream reorganization, see section II.E.

⁶⁵ Prop. Treas. Reg. § 1.368-1(f)(2)(i).

⁶⁶ Prop. Treas. Reg. § 1.368-1(f)(2)(ii).

⁶⁷ See Prop. Treas. Reg. § 1.368-1(f)(5), Exs. 1, 2.

What if the S stock were not transferred to P in exchange for its T debt, but rather S assumed T's debt in the transaction? This is similar to the facts of *Norman Scott, Inc.* Under the proposed regulations, however, the transaction would not qualify as a reorganization because T would not surrender net value (i.e., the value of the assets (\$100) would not exceed the liabilities assumed (\$160)).⁶⁸

Example 6: Sideways Asset Reorganization; Third Party Debt. In contrast, suppose that in the above example T's debt was to an unrelated third party, B, rather than P. In addition, T transfers all its assets to S in exchange for the assumption of T's liabilities. T then dissolves and P receives nothing exchange for its T stock.

Under the facts of this example, the transaction does not satisfy the net value requirement because T does not surrender net value. T does not surrender net value because the fair market value of the property transferred by T to S (\$100) does not exceed the amount of the liabilities of T assumed by S in the exchange (\$160).⁶⁹

Example 7: Sideways Asset Reorganization; Brother-Sister Debt. Alternatively, suppose that in the above example that T was indebted to S (rather than to P or an unrelated third party).

Under the facts of this example, the transaction does not satisfy the net value requirement. Because the proposed regulations treat a transfer in satisfaction of a debt as equivalent to the assumption of the debt, T did not surrender net value, because the fair market value of the assets transferred (\$100) does not exceed the amount of the liabilities assumed (\$160).⁷⁰ If the liabilities assumed are nonrecourse, the same question arises as was discussed in

⁶⁸ See Prop. Treas. Reg. § 1.368-1(f)(5), Ex. 3.

⁶⁹ Prop. Treas. Reg. § 1.368-1(f)(5), Ex. 3. Note that no equity of S is issued to either P, as the shareholder, or B, as the creditor. Thus, the COI requirement would not be satisfied.

⁷⁰ See Prop. Treas. Reg. § 1.368-1(f)(2)(ii); -(1)(f)(5), Ex. 5.

the context of section 351 contributions with respect to the amount of the liability for purposes of applying the net value requirement.

However, if the merger in the above example were done in the other direction such that S merged into T and the resulting entity were solvent, the net value requirement would be satisfied (because S's liabilities do not exceed its assets).⁷¹ Thus a parent can merge a solvent subsidiary into an insolvent subsidiary provided the transferee is solvent after the transaction, but cannot do the reverse. In this way, the net value requirement in the proposed regulations is very form-dependent.

b. Stock Reorganizations

The proposed regulations establish slightly different rules to judge net value in the case of stock reorganizations. The rules are modified to account for the fact that in a stock reorganization, the target continues to exist after the transaction. For stock reorganizations (in particular, "B" reorganizations), the surrender of net value requirement is satisfied if the fair market value of the assets of the target corporation exceeds the sum of (i) the amount of the liabilities of the target corporation immediately prior to the exchange and (ii) the value of any money or other property received by the shareholders of the target corporation in connection with the exchange.⁷² Assets of the target corporation that are not held immediately after the exchange and liabilities of the target corporation that are extinguished in the exchange (except if such debts are to the corporation into which the target is merged in a reverse subsidiary merger) are disregarded.⁷³ The receipt of net value requirement is satisfied if the fair market value of the

⁷¹ Prop. Treas. Reg. § 1.368-1(f)(5), Ex. 6.

⁷² Prop. Treas. Reg. § 1.368-1(f)(3)(i).

⁷³ *Id.*

assets of the issuing corporation exceeds the amount of its liabilities immediately after the exchange.⁷⁴

Example 8: Stock Reorganization. A and B own all of the stock of T. T has assets with a fair market value of \$50 and liabilities of \$90, all of which are owed to C and D, security holders of T. P acquires all of the stock and securities of T in exchange for P voting stock. In the transaction, A and B receive nothing in exchange for their stock of T. C and D exchange all of their securities of T for stock of P.

Under the facts of this example, the net value requirement is satisfied. There is a surrender of net value because the fair market value of the assets of T held immediately prior to the exchange that are held immediately after the exchange (\$50) exceeds the sum of the amount of liabilities of T immediately prior to the exchange (zero, disregarding the liabilities of \$90 extinguished in the exchange) and the fair market value of other property received in the exchange (other than stock received without the recognition of gain under section 354) (zero). There is a receipt of net value because the fair market value of the assets of P exceeds the amount of the liabilities of P immediately after the exchange. Because there is a surrender and receipt of net value, the net value requirement is satisfied.⁷⁵

What if A and B received P stock and C and D received P securities in the exchange? In that case, the transaction with respect to A and B should satisfy the “solely for voting stock” requirement of a “B” reorganization, notwithstanding that P also issued securities to security

⁷⁴ Prop. Treas. Reg. § 1.368-1(f)(3)(ii).

⁷⁵ See Prop. Treas. Reg. § 1.368-1(f)(5), Ex. 9. Note that this transaction is a exchange of debt for P voting stock. The facts in this example are similar to those in Rev. Rul. 59-222, 1959-1 C.B. 80, which held that the acquisition by one corporation, in exchange solely for its voting stock, of all of the newly issued stock of an insolvent corporation constitutes a “B” reorganization, where the creditors receiving stock in the reorganization were in reality the owners of the equity in the insolvent corporation and, in effect, surrendered their claims for the newly issued stock which was then exchanged for the acquiring corporation's stock.

holders in the transaction.⁷⁶ However, the net value requirement may change this result, depending on whether an exchange of T securities for P securities is treated similarly to an extinguishment of T securities. In the above example, the transaction satisfied the net value requirement because the \$90 of liabilities were extinguished in the exchange, and therefore disregarded for purposes of applying the net value requirement.⁷⁷ If the T securities are instead exchanged for P securities, and they are not disregarded under the rule, the transaction would fail the net value requirement, because the fair market value of the T assets held immediately after the exchange (\$50) is less than the liabilities of T immediately prior to the exchange (\$90). The authors believe this would be a strange result, particularly because the exchange of securities itself would be tax-free,⁷⁸ and therefore believe an exchange of T securities should similarly cause such securities to be disregarded so that the net value requirement is satisfied.

c. Reverse Subsidiary Mergers (section 368(a)(2)(E))

In an “A” reorganization under section 368(a)(2)(E), often referred to as a “reverse subsidiary merger,” a controlled corporation is merged into the target corporation. To qualify as a reorganization under section 368(a)(2)(E), (i) the controlled corporation must be merged into the target in a transaction that otherwise qualifies as a statutory merger under section 368(a)(1)(A); (2) the surviving target corporation must hold substantially all of its properties and substantially all of the properties of merged subsidiary after the transaction; and (3) former shareholders of the surviving target corporation must exchange, for an amount of voting stock of

⁷⁶ See Rev. Rul. 69-142, 1969-1 C.B. 107 (exchange of debentures of acquiring corporation for debentures of acquired corporation did not affect qualification of stock-for-stock exchange as reorganization).

⁷⁷ Prop. Treas. Reg. § 1.368-1(f)(3)(i).

⁷⁸ See section 354(a).

the controlling corporation, an amount of stock in the surviving corporation that constitutes control of such corporation.

To apply the net value requirement to a reverse subsidiary merger, the proposed regulations apply a net value test that is a hybrid of the test for asset and stock reorganizations. In a reverse subsidiary merger, the merger of the controlled corporation into the target corporation must satisfy the net value standard in the asset reorganization test, treating the controlled corporation as the target corporation. In addition, the acquisition of the target corporation must satisfy the net value standard in the stock reorganization test.

Note that if a transitory company that is never capitalized is used to effect a reverse subsidiary merger, the net value requirement for asset reorganizations would not be met because a newly formed corporation did not transfer value (its net value is zero, which does not satisfy the requirement in the proposed regulations). Thus, for example, if P forms S as a transitory shell with no capital, and S merges into T in a transaction in which the T shareholders receive P voting stock, S has not transferred assets with a net value in the exchange. At first glance, this would not seem to present a problem, because S has no built-in gain to recognize in the exchange. However, as a technical matter, the failure of the merger of S into T to satisfy the requirements of a “A” reorganization violates one of the statutory requirements for an (a)(2)(E) reorganization. This could not have been the intended result of the proposed regulations, and final regulations should clarify that the “A” reorganization requirement is satisfied in this context.

d. “E” and “F” Reorganizations

Final regulations issued by the Service and Treasury confirmed that neither continuity of business enterprise nor COI is required for “E” and “F” reorganizations.⁷⁹ In light of this guidance, the proposed regulations exclude “E” and “F” reorganizations from the scope of the net value requirement. The preamble states that the Service and Treasury concluded that the net value requirement is directed at the same purpose as the COI requirement (i.e., distinguishing sales from reorganizations), and therefore the net value requirement is not necessary for “E” and “F” reorganizations because such reorganizations involve only the slightest change in a corporation and do not resemble sales.⁸⁰

e. Acquisitive “D” Reorganizations

The proposed regulations exempt certain acquisitive “D” reorganizations from the scope of the net value requirement and thus preserve the result in Rev. Rul. 70-240.⁸¹ In Rev. Rul. 70-240, B owned all of the stock of X and Y. X sold its operating assets to Y for cash and then liquidated into B. The Service ruled that the transaction qualified as a “D” reorganization, notwithstanding that no stock of Y was distributed to B. Because B already owned all of the stock of Y, the Service concluded that X would be treated as receiving Y stock and cash in exchange for substantially all of its assets.⁸²

⁷⁹ Treas. Reg. § 1.368-1(b), applicable for transactions occurring on or after February 25, 2005.

⁸⁰ Preamble to Proposed Regulations, 70 Fed. Reg. at 11,905.

⁸¹ 1970-1 C.B. 81; *see also* Rev. Rul. 2004-83, 2004 I.R.B. 32.

⁸² *See also* Rev. Rul. 2004-83, 2004-32 I.R.B. 157 (concluding that a cross-chain sale of stock followed by a liquidation of the sold subsidiary qualified as a “D” reorganization).

The preamble acknowledged that the conclusion reached in Rev. Rul. 70-240, as well as the similar conclusion in *James Armour, Inc. v. Commissioner*,⁸³ are inconsistent with the principles of the net value requirement, because in both Rev. Rul. 70-240 and *Armour*, the transferor corporation does not transfer property with a fair market value in excess of the amount of money it receives in the exchange. Nonetheless, the preamble indicates that the Service and Treasury desired to preserve this result pending further study of acquisitive “D” reorganizations in general.⁸⁴ Thus, the proposed regulations provide that the net value requirement does not apply to transactions that would otherwise qualify as “D” reorganizations, as long as the fair market value of the property transferred from the transferor corporation to the transferee corporation exceeds the liabilities of the transferor immediately prior to the exchange, and the fair market value of the assets of the acquiring corporation equals or exceeds the amount of its liabilities immediately after the exchange.⁸⁵ In other words, the transferor (or target) corporation in the potential “D” reorganization must be solvent prior to the exchange, and the transferee corporation must be solvent after the exchange.

The authors believe the government should confirm that Rev. Rul. 70-240 is correct and that the net value requirement does not change this result. It is well established that if a parent corporation owns 100 percent of a subsidiary, it would be a meaningless gesture for the subsidiary to issue additional stock to the parent.⁸⁶ A requirement that stock actually be issued

⁸³ 43 T.C. 295 (1964).

⁸⁴ Preamble to Proposed Regulations, 70 Fed. Reg. at 11,905.

⁸⁵ Prop. Treas. Reg. § 1.368-1(f)(4).

⁸⁶ See, e.g., *Lessinger*, 872 F.2d 519; *Laure v. Commissioner*, 653 F.2d 253 (6th Cir. 1981); *Commissioner v. Morgan*, 288 F.2d 676 (3d Cir. 1961); *King v. United States*, 79 F.2d 453 (4th Cir. 1935); Rev. Rul. 64-155, 1964-1 C.B. 138.

under the facts of Rev. Rul. 70-240 to constitute a reorganization would render the “D” reorganization provision elective and cannot be the result intended by the net value requirement.

E. Sideways vs. Upstream Mergers

The proposed regulations create a distinction between sideways and upstream reorganizations. As discussed above, the upstream merger of an insolvent subsidiary into its creditor-parent does not qualify as an “A” reorganization, because the satisfaction of a liability is treated as the assumption of the liability for purposes of the net value requirement.⁸⁷ On the other hand, if the insolvent subsidiary merges sideways into a sister subsidiary, and the parent receives acquiring corporation stock in exchange for its subsidiary debt, the merger qualifies as a tax-free “A” reorganization.⁸⁸

The apparent reason for the distinction is that in the case of an upstream merger, the creditor-parent is receiving assets of the subsidiary in satisfaction of the liability--the proposed regulations state: “The purpose of the exchange of net value requirement is to prevent transactions that resemble sales (including transfers of assets in satisfaction of liabilities) from qualifying for nonrecognition of gain or loss available to corporate reorganizations.”⁸⁹ In the sideways merger context, the parent receives stock of another subsidiary in satisfaction of the liability. Thus, the difference is that assets have left corporate solution in the upstream merger context.

⁸⁷ See Prop. Treas. Reg. § 1.368-1(f)(2)(i); (f)(5), Ex. 5.

⁸⁸ See Prop. Treas. Reg. § 1.368-1(f)(5), Ex. 2.

⁸⁹ Prop. Treas. Reg. § 1.368-1(f)(1). The Service has previously distinguished the upstream reorganization from the sideways reorganization because (i) in the upstream context, the parent is effectively removing assets from corporation solution, and (ii) section 332 takes precedence where a section 332 liquidation and a reorganization overlap, as in the case of an upstream “A” reorganization. See G.C.M. 33,859 (June 25, 1968).

The proposed regulations also preserve the distinction between sideways and upstream reorganizations when the creditor-parent cancels the debt of the insolvent subsidiary immediately before the merger. In Revenue Ruling 68-602,⁹⁰ P cancelled indebtedness owed to it by its wholly owned subsidiary, S, and immediately thereafter S transferred all of its assets and liabilities to P in complete liquidation. The Service ruled that the debt cancellation was an integral part of the liquidation and had no independent significance other than to secure the tax benefits of S's net operating loss carryover. Therefore, the Service regarded the cancellation as transitory and disregarded it. On the other hand, in Revenue Ruling 78-330,⁹¹ the Service respected the debt cancellation. P owned all of the stock of S-1 and S-2. P wanted to merge S-1 into S-2 for valid business reasons. However, because of a debt owed by S-1 to P, S-1's liabilities exceeded the basis of its assets. As a result, section 357(c) would have applied to require S-1 to recognize gain to the extent of such excess. To avoid the application of section 357(c), P cancelled S-1's debt to it immediately before S-1 merged into S-2 so that S-1's asset basis would exceed its liabilities. The Service concluded that the cancellation had independent economic significance, because it resulted in a genuine alteration of a previous bona fide business relationship, and therefore, section 357(c) would not apply to the merger. G.C.M. 37,443 (Mar. 6, 1978) (which considered Rev. Rul. 78-330) added that the cancellation was not a sham undertaken to avoid taxes, but rather had the effect of making additional capital available for the combined operations of S-1 and S-2.

⁹⁰ 1968-2 C.B. 135; *see also* Preamble to Proposed Regulations, 70 Fed. Reg. at 11,906 (noting that the Service and Treasury intend that the substance-over-form and other nonstatutory doctrines be used to determine whether the net value requirement is satisfied, specifically citing Rev. Rul. 68-602).

⁹¹ 1978-2 C.B. 147; *see also* Prop. Treas. Reg. § 1.368-1(f)(5), Ex.7 (respecting a cancellation of debt immediately prior to a forward triangular merger).

The authors do not believe that a merger of an insolvent subsidiary into its creditor resembles a sale, even though the debt is extinguished in the merger, particularly where the acquiring corporation is a significant creditor of the target. As discussed below, the proposed creditor continuity regulations treat creditors of insolvent corporations as having a proprietary interest in that corporation for purposes of the COI requirement. Indeed, the preamble to the proposed regulations acknowledges that the purposes underlying the COI requirement and the net value requirement are the same.⁹² A different rule should not apply in the context of mergers into creditors. The creditor has simply converted its indirect interest in the subsidiary's assets into a direct interest. The COI regulations recognize that such a conversion does not resemble a sale: "[a] proprietary interest is preserved if, in a potential reorganization, . . . it is exchanged by the acquiring corporation for a direct interest in the target corporation enterprise."⁹³ The satisfaction of liabilities through merger into a creditor holding a proprietary interest thus stands in contrast to the transfer of property to a non-proprietary creditor in a transaction that does resemble a sale. The authors thus believe that a merger of an insolvent subsidiary into its creditor should qualify as a tax-free "A" reorganization. Such a rule would also obviate the need to try to make the subsidiary solvent in order to obtain tax-free treatment and would thus avoid the need to analyze pre-transaction debt cancellations to determine whether they are transitory (Rev. Rul. 68-602) or have independent economic significance (Rev. Rul. 78-330). Although perhaps a more difficult case, the authors believe the question should be considered whether similar principles should apply where the parent is the creditor and the debt remains outstanding (rather than being cancelled in the merger).

⁹² Preamble to Proposed Regulations, 70 Fed. Reg. 11,905.

⁹³ Treas. Reg. § 1.368-1(e)(1).

F. Valuation of Assets and Liabilities

As mentioned above, the proposed regulations create further challenges for taxpayers in that they must value their assets and liabilities in order to determine whether they satisfy the net value requirement.

1. Issues Regarding Valuation of Assets

On the asset side, valuation does not present too many difficulties, other than the expense of obtaining an appraisal. One issue that arises is whether intangibles, such as goodwill and going concern value, are taken into account for purposes of determining whether the net value requirement is met. The courts and the Service have concluded that such assets are taken into account in determining whether a liquidating subsidiary is insolvent for purposes of section 332.⁹⁴ Presumably such assets will similarly be taken into account for purposes of the net value requirement. Another issue that arises is whether contingent or inchoate claims of the taxpayer are taken into account in determining whether the net value requirement is satisfied. Such assets are currently taken into account in determining insolvency for bankruptcy purposes at their present or expected values.⁹⁵ Similar rules will presumably apply for purposes of the net value requirement. An additional issue that arises is whether assets that are exempt from creditors under state law are taken into account in determining whether the net value requirement is satisfied. Such assets are taken into account for purposes of determining whether a debtor is

⁹⁴ See, e.g., *Conestoga Transportation Co. v. Commissioner*, 17 T.C. 506 (1951); Rev. Rul. 2003-125, 2003-52 I.R.B. 1243.

⁹⁵ See, e.g., *In re Xonics Photochemical, Inc.*, 841 F.2d 198 (7th Cir. 1988).

insolvent under section 108⁹⁶ and presumably will be taken into account for purposes of the net value requirement.

2. Issues Regarding Valuation of Liabilities

a. Definition of Liabilities

The liability side presents many more challenges. First, one must identify what is a liability. The proposed regulations do not define the term “liability.” Nonetheless, the preamble to the proposed regulations states that the Service and Treasury intend that the term be interpreted broadly:

[F]or purposes of the proposed regulations, a liability should include any obligation of a taxpayer, whether the obligation is debt for federal income tax purposes or whether the obligation is taken into account for the purpose of any other Code section. Generally, an obligation is something that reduces the net worth of the obligor.⁹⁷

Similar definitions have recently been adopted elsewhere in the Code and regulations. For example, section 358(h) defines liability to include any fixed or contingent obligation to make payment, without regard to whether the obligation is otherwise taken into account for purposes of Code or regulations. In addition, recently finalized regulations that implement section 358(h) in subchapter K define liability to include any obligation that (i) creates or increases the basis of any of the obligor’s assets (including cash), (ii) gives rise to an immediate deduction to the obligor, or (iii) gives rise to an expense that is not deductible in computing the

⁹⁶ See *Carlson v. Commissioner*, 116 T.C. 87 (2001); T.A.M. 199935002 (May 3, 1999).

⁹⁷ Preamble to Proposed Regulations, 70 Fed. Reg. at 11,905.

obligor's taxable income and is not properly chargeable to capital.⁹⁸ These regulations provide a nonexclusive list of obligations: debt, environmental, tort, contract, and pension obligations, obligations under a short sale, and obligations under derivative financial instruments, such as options, forward contracts, futures contracts, and swaps.⁹⁹ The preamble to the proposed section 752 regulations notes that the Service and Treasury are considering adopting this definition of liability for purposes of subchapter C of the Code.¹⁰⁰

Other authorities have adopted more limited definitions of liability. For example, Treas. Reg. § 1.446-1(c)(1)(ii)(B) expressly defines a "liability" of an accrual method taxpayer as "any item allowable as a deduction, cost or expense for Federal income tax purposes." Treas. Reg. § 1.446-1(c)(1)(ii)(A) provides rules for when an item is allowable as a deduction:

[A] liability is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.

As a result, under section 446, an item is only a liability of an accrual method taxpayer if it satisfies the all events and economic performance tests.

Contingent liabilities and guarantees present particular difficulty. Such obligations would be treated as liabilities for purposes of section 358(h), but not for purposes of section 461.

⁹⁸ Treas. Reg. § 1.752-1(a)(4)(i); *see* Preamble to Proposed Regulations, 70 Fed. Reg. at 11,905 (citing to this rule in proposed form). This definition is consistent with prior authority under section 752. *See Salina Partnership LP v. Commissioner*, 80 T.C.M. (CCH) 686 (2000); Rev. Rul. 88-77, 1988-2 C.B. 128. *But see Helmer v. Commissioner*, 34 T.C.M. (CCH) 727 (1975).

⁹⁹ Treas. Reg. § 1.752-1(a)(4)(ii).

¹⁰⁰ Preamble to Prop. Treas. Reg. § 1.752-1, 68 Fed. Reg. 37,436 (2003).

Case law defining insolvency has similarly reached different conclusions. For purposes of determining whether a debtor is insolvent for purposes of section 108, it has been held that such contingent liabilities should be taken into account if the debtor can prove that, as of the calculation date, “it is more probable than not that he will be called upon to pay that obligation in the amount claimed.”¹⁰¹ This test is an all-or-nothing one. If it is more probable than not, then the entire amount is taken into account as a liability.¹⁰² On the other hand, for purposes of determining whether a debtor is insolvent for purposes of section 548 of the Bankruptcy Code, it has been held that contingent liabilities are counted, but are discounted by the probability of their occurrence.¹⁰³ Similarly, in valuing mortgage notes, courts have held that commercial realities, such as the solvency of the debtor, must be given due consideration in the valuation of such notes.¹⁰⁴

b. Valuation of Liabilities

A closely related issue to determining what is a liability is determining the amount of such liability. The preamble to the proposed regulations suggests a few different options for determining the amount of liabilities: (i) treating the amount of all liabilities as the value of such liabilities; (ii) treating the amount of liability represented by a debt instrument as its adjusted issue price under sections 1271 through 1275 of the Code and the amount of other liabilities as

¹⁰¹ *Merkel v. Commissioner*, 109 T.C. 463 (1997), *aff’d*, 192 F.3d 844 (9th Cir. 1999).

¹⁰² The dissenting opinion had argued that the liability should be discounted to take into account its probability of occurrence. *Merkel*, 192 F.3d 844 (O’Scannlain, J. dissenting).

¹⁰³ *See, e.g., In re Hall*, 304 F.3d 743 (7th Cir. 2002); *In re Oakes*, 7 F.3d 234 (6th Cir. 1993); *Covey v. Commercial Nat’l. Bank*, 960 F.2d 657 (7th Cir. 1992); *see also Commissioner v. Kellogg*, 119 F.2d 115 (9th Cir. 1941) (holding that a discount applied in valuing a liquidating dividend in the form of a cancellation of an obligation to pay).

¹⁰⁴ *See, e.g., Clayton v. Commissioner*, 42 T.C.M. (CCH) 670 (1981); *Bar L Ranch, Inc. v. United States*, 426 F.2d 995 (5th Cir. 1970); *Olster v. Commissioner*, 79 T.C. 456 (1982).

their value; and (iii) borrowing from the section 108 authorities, such as *Merkel*, to value contingent liabilities in full if it is more probable than not that the taxpayer will be called upon to pay that obligation in the amount claimed.¹⁰⁵ For purposes of (i) and (ii), the preamble to the proposed regulations suggests that one method of valuing liabilities is to determine the amount of cash that a willing buyer would pay to a willing assignee to assume the liability in an arm's-length transaction.¹⁰⁶

The authors believe that in the context of determining whether the net value requirement is satisfied in a nonrecognition exchange, the pure valuation approach, with the modified rule for valuing debt instruments at adjusted issue price, is appropriate. The pure valuation approach has been adopted to determine whether a corporation is solvent for purposes of the Bankruptcy Code.¹⁰⁷ Such approach was rejected by the court in *Merkel* only because of the specific language of section 108(d)(3), which defines insolvency as “the excess of liabilities over the fair market value of assets.” The court noted that unlike the definition of insolvency in the Bankruptcy Code, the phrase “fair market value” in section 108(d)(3) modifies “assets” but not “liabilities;” therefore, the court concluded that Congress did not intend for liabilities to be measured at fair market value.¹⁰⁸ We believe that the holding in *Merkel* was limited to section 108(d)(3) and was not intended to provide a general rule regarding the value of liabilities. The authors further believe that to the extent that the liability is represented by a debt instrument, its value should be determined as its adjusted issue price under sections 1271 through 1275 of the

¹⁰⁵ Preamble to Proposed Regulations, 70 Fed. Reg. at 11,905.

¹⁰⁶ *Id.*; see also Treas. Reg. § 1.752-7(b)(3)(ii); *Covey*, 960 F.2d at 660.

¹⁰⁷ See *supra* note 101.

¹⁰⁸ *Merkel*, 192 F.3d at 851.

Code. This approach is consistent with the regulations under section 1001, which provide that an amount realized that is attributable to a debt instrument is determined under Treas. Reg.

§ 1.1274-2(g).¹⁰⁹ Such approach also has the benefit of avoiding appraisals in the case of debt instruments.

c. Assumption of Liabilities

Finally, once liabilities are identified and valued, it must be determined whether or to what extent the liabilities are assumed by the transferee. The preamble to the proposed regulations provides that the Service and Treasury believe that the principles of section 357(d) should apply to determine whether a liability is assumed when more than one person might bear responsibility for the liability.¹¹⁰ Section 357(d) applies for purposes of sections 357, 358(d), 358(h), 362(d), 368(a)(1)(C), and 368(a)(2)(B).¹¹¹ In general, section 357(d) provides that a recourse liability is treated as having been assumed if, based on all of the facts and circumstances, the transferee has agreed to, and is expected to, satisfy the liability, whether or not the transferor has been relieved of such liability.¹¹² A nonrecourse liability is treated as having been assumed by the transferee of any asset subject to such liability, but is reduced by the lesser of (i) the amount of such liability that an owner of other assets not transferred to the transferee and also subject to such liability has agreed with the transferee to, and is expected to,

¹⁰⁹ Treas. Reg. § 1.1001-1(g)(2)(ii); *see also* Treas. Reg. § 20.2031-4 (providing for valuation of notes at the amount of unpaid principal plus interest accrued).

¹¹⁰ Preamble to Proposed Regulations, 70 Fed. Reg. at 11,906.

¹¹¹ Section 357(d)(1).

¹¹² Section 357(d)(1)(A).

satisfy, or (ii) the fair market value of such other assets.¹¹³ In an advance notice of proposed rulemaking, the Service announced that it is considering modifying the rules relating to the assumption of nonrecourse liabilities so that the transferee is not always treated as assuming the nonrecourse liabilities associated with the transferred assets.¹¹⁴ Because regulations have not yet been proposed, there remain some unresolved issues relating to the section 357(d) rules. Nonetheless, they apply for purposes of many of the nonrecognition rules of subchapter C, and it makes sense to apply them to the net value requirement as well.

The proposed regulations take into account not only liabilities assumed in the exchange, but also liabilities assumed “in connection with” the exchange.¹¹⁵ The preamble to the proposed regulations states that this rule is included so that the timing of the acquiring corporation’s assumption of the target corporation’s liabilities, whether before an exchange, in the exchange, or after the exchange, will have the same effect in determining whether there is a surrender of net value in the exchange.¹¹⁶ Similarly, the cancellation of liabilities in connection with the exchange, whether before, during, or after, may be respected.¹¹⁷

III. The Creditor Continuity Regulations

In addition to establishing the no net value rules, the proposed regulations clarify the circumstances in which creditors will be treated as holding proprietary interests in target corporations for purposes of satisfying the COI requirement for reorganizations under section

¹¹³ Section 357(d)(1)(B), (d)(2)(A)-(B).

¹¹⁴ Announcement 2003-37, 2003-24 I.R.B. 1025.

¹¹⁵ Prop. Treas. Reg. § 1.368-1(f)(2)(i).

¹¹⁶ Preamble to Proposed Regulations, 70 Fed. Reg. at 11,906.

¹¹⁷ Compare Rev. Rul. 78-330 with Rev. Rul. 68-602 (discussed above).

368. The portion of the proposed regulations addressing creditor continuity was finalized on December 12, 2008.¹¹⁸ The common law with respect to COI and the proposed and final creditor continuity regulations are discussed below.

A. Common Law

The purpose of the COI requirement for reorganizations is to distinguish between mere readjustments of corporate structures, which effect only a readjustment of continuing interest in the property in modified corporate form, and sales.¹¹⁹ The COI requirement originated as a judicial limitation on the definition of a “reorganization” and has been codified in the Treasury regulations under section 368.¹²⁰ In general, to satisfy COI, shareholders of a target corporation must maintain a certain amount of proprietary interests in the reorganized corporation. Thus, there are two aspects of the COI requirement--quality and quantity. As for the quality of the interest, former shareholders of the target corporation must generally receive stock of the acquiring corporation to maintain a proprietary interest--short-term debt will not establish continuity.¹²¹ As for the quantity of the interest, for advance ruling purposes, the Service generally requires that former shareholders of the target corporation receive stock of the acquiring corporation equal in value to at least 50 percent of the value of the formerly outstanding stock of the target corporation.¹²²

¹¹⁸ See T.D. 9434.

¹¹⁹ Treas. Reg. § 1.368-1(b).

¹²⁰ See Treas. Reg. § 1.368-1(e).

¹²¹ See *LeTulle v. Schofield*, 308 U.S. 415 (1940); *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933).

¹²² See Rev. Proc. 77-37, 1977-2 C.B. 568. However, caselaw has generally held that 40 percent is sufficient to satisfy continuity. See *John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935) (38 percent continuity sufficient). In addition, recent temporary regulations contain an

In reorganizations involving insolvent companies, the creditors of the insolvent companies often receive stock in the reorganized corporation rather than the historic shareholders. Absent a special rule, this would make the COI requirement difficult to satisfy and reorganizations of insolvent companies difficult to effect. However, the common law, as developed in cases discussed below, treated creditors as holding proprietary interests under certain circumstances for purposes of determining whether COI is satisfied.

In the landmark case of *Helvering v. Alabama Asphaltic Limestone Co.*,¹²³ the Supreme Court held that creditors of an insolvent corporation would be treated as equity holders for purposes of the COI requirement. The Court reasoned that the full priority rule operates in bankruptcy to give creditors the right to exclude shareholders from the reorganization plan of an insolvent debtor, so that the creditors step into the shoes of the shareholders. The Court held that the creditors stepped into the shoes of the shareholders (and therefore held proprietary interests) at the time the creditors instituted bankruptcy proceedings, because from that time on, the creditors had effective command over the disposition of the property.

In the companion case of *Palm Springs Holding Corporation v. Commissioner*,¹²⁴ the Supreme Court followed its holding in *Alabama Asphaltic Limestone Co.* in viewing creditors as equity holders when they instituted a foreclosure action to acquire effective command over the debtor's property. The Court noted that the particular legal process used to achieve effective

example that appears to bless 40 percent as a sufficient amount. *See* Temp. Treas. Reg. 1.368-1T(e)(v), Ex. 1.

¹²³ 315 U.S. 179 (1942).

¹²⁴ 315 U.S. 85 (1942).

command was not significant.¹²⁵ As a result of this case law, the Service adopted the position that a creditor must take some affirmative action to assert its claim against the target in order to be counted for COI purposes; once the creditor asserts its claim, the proprietary interest of the corporation no longer resides with the shareholders.¹²⁶

In addition to determining whether a creditor holds a proprietary interest, the common law had developed certain conventions for counting creditor continuity. In *Atlas Oil & Refining Corp. v. Commissioner*,¹²⁷ the Tax Court was faced with the question of who to treat as an equity holder where some creditors received stock and others did not. The reorganization plan provided for the formation of a new corporation. The new corporation would issue common stock to new investors in exchange for \$100,000 cash. First mortgage bondholders of the bankrupt corporation were to receive new bonds with less favorable terms; second mortgage bondholders were to participate in the plan as secured creditors to the extent of their security interest and were to receive preferred stock for any excess; the most junior class of creditors were to receive a cash distribution of 10 cents on the dollar; and the shareholders would receive nothing. The Service contended that the COI requirement was not satisfied because the equity holders of the debtor corporation included the first mortgage holders, who did not receive any qualifying consideration in the reorganization. The Tax Court nonetheless concluded that the COI requirement was satisfied, stating that:

[N]ot all creditors surviving the insolvency become ipso facto equity owners. The effect of the rule is merely that creditors who have a bona fide interest remaining who in fact receive stock in the

¹²⁵ See also *Western Massachusetts Theaters, Inc. v. Commissioner*, 236 F.2d 186 (1st Cir. 1956); *Maine Steel, Inc. v. United States*, 174 F. Supp. 702 (D. Me. 1959).

¹²⁶ See *Norman Scott, Inc.*, 48 T.C. at 598; G.C.M. 33859 (June 25, 1968).

¹²⁷ 36 T.C. 675 (1961), *acq.*, 1962-2 C.B. 3.

new corporation, by relation back, can be deemed to have been equity owners at the time of the transfer, so as to be capable of satisfying the continuity of interest requirement that stock go to former owners.¹²⁸

Thus, a special counting mechanism evolved as a result of *Atlas Oil*--the COI analysis begins with the most senior class of creditors that actually receive stock in the reorganization and ends with the last group of creditors or shareholders to receive any consideration in the reorganization. Thus, if general creditors receive preferred stock, subordinated creditors receive notes, and shareholders receive nothing, then general creditors and subordinated creditors are considered equity holders for purposes of determining whether the COI requirement is satisfied. These principles were adopted in the legislative history of the Bankruptcy Tax Act of 1980, which included the following discussion of the application of the COI rules to reorganizations under section 368(a)(1)(G):¹²⁹

It is expected that courts and the Treasury will apply to “G” reorganizations continuity-of-interest rules which take into account the modification by Public Law 95-598 of the “absolute priority” rule. As a result of that modification, shareholders or junior creditors, who might previously have been excluded, may now retain an interest in the reorganized corporation. For example, if an insolvent corporation’s assets are transferred to a second corporation in a bankruptcy case, the most senior class of creditor to receive stock, together with all equal and junior classes (including shareholders who receive any consideration for their stock), should generally be considered the proprietors of the insolvent corporation for “continuity” purposes.¹³⁰

¹²⁸ *Atlas Oil*, 36 T.C. at 688.

¹²⁹ A reorganization under section 368(a)(1)(G) is “a transfer by a corporation of all or part of its assets to another corporation in a title 11 or similar case; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356.”

¹³⁰ H.R. Rep. No. 96-833, at 31-32 (1980); S. Rep. No. 96-1035, at 36 (1980).

Example 9: Continuity of Interest Satisfied. T is in bankruptcy and has assets with a fair market value of \$150 and liabilities of \$200. T has two classes of creditors: senior creditors with claims of \$50, and junior creditors with claims of \$150. Pursuant to the plan of reorganization, T transfers its assets to A in exchange for A stock worth \$55 and \$95 cash. T distributes \$50 cash to the senior creditors. T distributes the remaining \$45 cash and \$55 stock to the junior creditors. T's shareholders receive nothing.

At first glance, the COI requirement does not appear to be satisfied, because only 36.6 percent (i.e., \$55 stock out of \$150 total consideration) of the total consideration consists of A stock. However, applying the special counting mechanisms, the most senior class of creditors to receive A stock is the junior creditors, and no one below them received any consideration in the reorganization. Therefore, under the common law, there is 55 percent continuity (i.e., \$55 stock out of \$100 consideration to junior creditors) so the COI requirement is satisfied.

Example 10: Continuity of Interest Satisfied. Now assume that T distributes \$40 cash and \$10 stock to the senior creditors; and the remaining \$55 cash and \$45 stock to the junior creditors. T's shareholders receive nothing.

Even applying the special counting mechanisms in this example, the COI requirement would likely not be satisfied because of the stock going to senior creditors. The most senior class of creditors to receive stock is the senior creditors and the most junior class to receive any consideration is the junior creditors. Thus, the senior and junior creditors both count toward the COI requirement. Thus, only \$55 out of the total \$150 consideration, or 36.6 percent, consisted of A stock.

B. Rule under Proposed Regulations

In general, the proposed regulations provide that that creditors will be treated as holding a proprietary interest in a target corporation for COI purposes under circumstances that satisfy the standard set forth by the Tax Court in *Atlas Oil* and reiterated by Congress in the legislative history of the Bankruptcy Tax Act of 1980. However, the proposed regulations go further than

the common law in several respects and generally make continuity easier to satisfy in transactions involving insolvent companies, both in terms of when creditors will be considered proprietors and in terms of counting continuity.

Unlike the common law, the proposed regulations do not require the creditors to take any affirmative steps to enforce their claims against the target. Instead, the fact that they agree to take stock in the acquirer in exchange for their claims is sufficient for a creditor to be treated as holding a proprietary interest if the target is in a title 11 or similar case or is insolvent.¹³¹ Further, the shareholders of the target do not forfeit their proprietary interest by reason of the creditors' holding a proprietary interest.¹³²

In addition to expanding the circumstances under which creditors may be considered to hold proprietary interests, the proposed regulations make COI easier to satisfy. The proposed regulations provide a specific methodology to quantify what portion of creditor interests may be considered proprietary interests for continuity purposes, which treats senior claims separately from junior claims. Senior claims¹³³ are treated as representing, in part, a creditor claim against the corporation, and, in part, a proprietary interest in the corporation. The portion that is treated as a proprietary interest is determined by calculating the average treatment of all senior claims (i.e., the ratio of stock received by all senior creditors to all consideration received by senior creditors) and multiplying that proportion by the fair market value of each senior creditor's

¹³¹ See Prop. Treas. Reg. § 1.368-1(e)(6)(i).

¹³² Prop. Treas. Reg. § 1.368-1(e)(6)(ii).

¹³³ Senior claims are defined to include claims of the most senior class of creditors receiving a proprietary interest in the acquiring corporation and any equal class of creditors. Prop. Treas. Reg. § 1.368-1(e)(6)(ii)(B).

claim.¹³⁴ In contrast to the treatment of senior claims, the proposed regulations treat the entire amount of a junior claim as representing a proprietary interest. The amount of the proprietary interest represented by a junior claim is the fair market value of the claim, which, as stated in the preamble, is generally determined by reference to the value of money and other consideration received in exchange for such claims.¹³⁵

The effect of the bifurcation of senior creditor claims is that the cash consideration going to senior creditors is treated as in payment for the creditor claim and is not treated as “bad” consideration received in exchange for the creditor’s proprietary interest. The preamble to the proposed regulations noted that this rule was intended to mitigate the adverse effect on COI of senior creditors’ seeking payment primarily in nonstock consideration while still taking some payment in stock of the acquiring corporation.¹³⁶ Government representatives have stated informally that the theory behind bifurcating the claims is that creditors look like creditors to the extent they assert their claim for cash repayment and like equity holders to the extent they do not.

Applying the proposed creditor continuity regulations to Examples 9 and 10, above, illustrate their mitigating effect. Recall in Example 9, of the total consideration of \$55 stock and \$95 cash, \$50 cash went to pay the \$50 senior creditor claims, and the remaining \$45 cash and \$55 stock went to junior creditors. Because T is insolvent immediately before the reorganization, the claims of the creditors are treated as proprietary interests under the proposed regulations. The proposed regulations bifurcate the claims of the most senior class of creditors that receive A stock, or the junior creditors in this example. The \$45 cash is treated as in

¹³⁴ Prop. Treas. Reg. § 1.368-1(e)(6)(ii)(B).

¹³⁵ Preamble to Proposed Regulations, 70 Fed. Reg. at 11,907.

¹³⁶ *Id.*

payment of the creditor claim and the remaining \$55 is in payment of the proprietary interest.

The value of the proprietary interest is \$82.50 (i.e., \$150 value of claim x (\$55 stock / \$100 total consideration)). Thus, because A acquired 66.7% ($\$55 / \82.50) of the value of the proprietary interest with stock, the COI requirement is satisfied. Note that the proposed regulations result in a higher level of continuity than current law.

Turning to Example 10, recall that \$40 cash and \$10 stock go to the senior creditors, and the remaining \$55 cash and \$45 stock go to the junior creditors. In contrast to Example 9, the senior creditors are the most senior class to receive stock, so their claim is bifurcated. The \$40 cash is treated as in payment for the creditor claim. The value of the senior creditors' proprietary interest is \$10 (i.e., \$50 value of claims x (\$10 stock / \$50 total consideration received by senior creditors)). The value of the junior creditors' claims is \$100, the total consideration received in exchange therefor. Because A is treated as acquiring \$55 of the total \$110 claims in exchange for stock, or 50 percent, the COI requirement is satisfied.¹³⁷ Accordingly, by treating the senior creditors' claims as part creditor claim, part proprietary interest, it permits a greater portion of the entire consideration paid to senior creditors to consist of cash without violating the COI requirement.

Because the proposed regulations bifurcate the claims of the most senior class of creditors to receive stock (and all equal classes), the issuance of a nominal amount of stock to a senior class of creditors can bust COI. For example, assume in Example 10 that a superior class of senior creditors has claims of \$5 and receives \$4 cash and \$1 stock--\$4 goes to the creditor claim and the proprietary interest is \$1. Now, all the stock and nonstock consideration going to the lower classes, including the senior and junior creditors, are counted toward COI. Because

¹³⁷ See Prop. Treas. Reg. § 1.368-1(e)(7), Ex. 10.

\$56 out of the total \$155 consideration, or 36.1%, consists of A stock, the COI requirement would not be satisfied.

In addition, the proposed regulations assume that each senior claim is satisfied with the same ratio of stock to nonstock consideration. To the extent senior creditors are treated differently, it can have an adverse effect on continuity. For example, assume in Example 10 that there were two senior creditors--one receives the \$40 cash and the other receives the \$10 stock. The value of the proprietary interests would be \$8 for the first creditor (i.e., \$40 claim x (\$10 stock / \$50 total consideration)). Thus, A acquired \$47 (\$2 senior and \$45 junior) out of the total claims of \$102 (\$2 senior and \$100 junior), or 46% for stock. In effect, \$8 of equity consideration is wasted.

C. The Final Regulations

On December 11, 2008, the Service and Treasury issued final regulations effective December 12, 2008.¹³⁸ The final regulations adopt the proposed regulations with only minor modifications and clarifications. The final regulations added a de minimis rule. Under this rule, where there is only one class (or one set of equal classes) of creditors receiving stock, there must be more than a de minimis amount of acquiring corporation stock that is exchanged for the creditors' proprietary interests before the stock will be counted for purposes of determining whether the COI requirement is satisfied. The amount of stock exchanged is evaluated relative to the total consideration received by the insolvent target corporation, its shareholders, and its creditors.¹³⁹

¹³⁸ See T.D. 9434.

¹³⁹ See Treas. Reg. § 1.368-1(e)(6)(ii)(A).

IV. Concluding Thoughts

The proposed regulations are a welcome clarification of the requirements for certain transactions to qualify for nonrecognition treatment. Although the regulations leave many questions unanswered, the government should be commended for its efforts to identify those questions and provide taxpayers with guidance on the current application of the law. In general, the net value requirement is a good rule to distinguish nonrecognition transactions from taxable sales. However, the authors believe that the net value requirement as set forth in the proposed regulations should be revised to allow a parent that is a creditor of a subsidiary to convert its creditor position to an equity interest in a nonrecognition transaction. The authors do not believe that a merger of an insolvent subsidiary into its creditor resembles a sale. As discussed above, the proposed creditor continuity regulations treat creditors of insolvent corporations as having a proprietary interest in that corporation for purposes of the COI requirement. A different rule should not apply in the context of mergers into creditors.