

**COMMENTS ON PROPOSED REGULATIONS ON
CONTINUITY OF BUSINESS ENTERPRISE AND
CERTAIN RELATED ISSUES UNDER SECTION 368**

The following comments are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

These comments were prepared by individual members of the Committee on Corporate Tax of the Section of Taxation. Principal responsibility was exercised by David Wheat. Substantive contributions were made by John Barrie, Jasper Cummings, Mark Silverman, Robert Wellen, Rose Williams and Philip Wright. The Comments were reviewed by Robert Liles of the Section's Committee on Government Submissions and by Joseph M. Pari, Council Director for the Committee on Corporate Tax.

Although many of the members of the Section of Taxation who participated in preparing these Comments have clients who would be affected by the federal tax principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Overview. On March 1, 2004, the Treasury Department and the Internal Revenue Service (the “IRS”) proposed regulations relating to the effect of asset and stock transfers on the qualification of certain transactions as reorganizations under Section 368(a), including the continuity of business enterprise requirement and the definition of party to a reorganization. Prop. Treas. Reg. §§ 1.368-1(d)(4), -2(f), (k). These are our comments on the proposed regulations.

Background. To qualify as a reorganization under Section 368, a transaction must satisfy certain statutory and judicial requirements, including continuity of business enterprise (“COBE”). COBE requires that the issuing corporation either (i) continue the target corporation’s historic business or (ii) use a significant portion of the target corporation’s assets in a business. Treas. Reg. § 1.368-1(d)(2). The term issuing corporation generally means the acquiring corporation. In the case of a triangular reorganization, however, the issuing corporation includes the corporation in control of the acquiring corporation. In addition, the issuing corporation is treated as holding all of the businesses and assets of the members of the qualified group. For this purpose, the qualified group is one or more chains of corporations connected through stock ownership with the issuing corporation, but only if the issuing corporation owns directly stock meeting the requirements of Section 368(c) in at least one other corporation, and stock meeting the requirements of Section 368(c) in each of the corporations (except the issuing corporation) is owned directly by one of the other corporations.

Section 368(a)(2)(C) provides that a transaction otherwise qualifying as a reorganization under Section 368(a)(1)(A), (B), (C), or (G) will not be disqualified by reason of the fact that part or all of the acquired assets or stock are transferred to a corporation controlled by the acquiring corporation. For this purpose, control has the meaning contained in Section 368(c). Several rulings have concluded that the terms of Section 368(a)(2)(C) are permissive, rather than exclusive or restrictive. Rev. Rul. 2001-24, 2001-1 C.B. 1290; Rev. Rul. 2002-85, 2002-2 C.B. 986. Therefore, transfers of target stock or assets not described in Section 368(a)(2)(C) do not necessarily prevent the transaction from qualifying as a reorganization.

Under Treas. Reg. § 1.368-2(f), the term “party to a reorganization” includes a corporation resulting from a reorganization, and both corporations in a transaction qualifying as a reorganization where one corporation acquires stock or properties of another corporation. This regulation further provides that if a transaction otherwise qualifies as a reorganization, a corporation remains a party to the reorganization even though stock or assets acquired in the reorganization are transferred in a transaction described in Treas. Reg. § 1.368-2(k).

Under Treas. Reg. § 1.368-2(k), generally a transaction otherwise qualifying as a reorganization under Section 368(a)(1)(A), (B), (C), or (G) (where the requirements of Section 354(b)(1)(A) and (B) are met) will not be disqualified by reason of the fact that part or all of the assets or stock acquired in the transaction are transferred or successively transferred to one or more corporations controlled in each transfer by the transferor corporation. For this purpose, a corporation is a controlled corporation if the transferor corporation owns stock of such corporation constituting control within the meaning of Section 368(c).

The proposed regulations extend the principles described above in Treas. Reg. § 1.368-1(d), -2(f) and (k) to all types of reorganizations. The government reasoned that these transactions, in form, satisfy the statutory requirements of a reorganization and, in substance, constitute readjustments of continuing interests in the reorganized business in modified corporate form. Importantly, none of the transactions protected by the proposed regulations involve the transfer of the acquired stock or assets to a “stranger” which would be inconsistent with reorganization treatment. H.R. Rep. No. 83-1337, A134 (1954).

General. We commend the government for issuing these proposed regulations because we believe that they reflect sound corporate tax policy. In many cases, the proposed regulations adopt positions previously taken by the IRS in public and private rulings. Further, as noted in the preamble to the proposed regulations, the permitted asset and stock transfers are not made to a “stranger.” Rather, such transfers result in little or no change in the ultimate ownership of the acquired assets or stock. Thus, there is no policy justification for disqualifying a reorganization in such cases. Indeed, from a policy standpoint, it is desirable to prevent acquirers from unilaterally “busting” a reorganization through transactions resulting in little change in the parties’ circumstances. In the reorganization context, such transactions increase the likelihood that the target shareholders and the acquiring corporation might take inconsistent positions thereby creating whipsaw potential for the government.

Our principal suggestions are in two categories: (1) clarifications consistent with the intended scope of the regulations; and (2) expanding the scope of the regulations to cover additional issues and transactions (perhaps in separate projects).

Specific Suggestions. Specifically, we suggest the following:

1. **F Reorganizations.** Clarify, perhaps by example, that transfers of assets to members of a qualified group do not prevent a transaction from qualifying as a reorganization under Section 368(a)(1)(F).
2. **Divisive D Reorganizations.** Clarify, again perhaps by example, that transfers of assets to members of a qualified group do not prevent a transaction from qualifying as a divisive reorganization under Section 368(a)(1)(D).

3. **Active Trade or Business.** Clarify whether Prop. Treas. Reg. § 1.368-2(k) applies for purposes of the post-distribution active trade or business qualification under Section 355. We believe that it should. The purposes behind COBE and the active trade or business requirement are sufficiently similar that the same rules should apply in the context of post-transaction asset transfers.
4. **COBE and Diamond Transactions.** Our only suggestion for actual change affecting the proposed regulations is to reiterate our prior recommendation that the definition of “qualified group” in Treas. Reg. § 1.368-1(d) be modified so that it is determined by reference to Section 1504(a)(2) (perhaps limited to consolidated return situations), rather than Section 368(c).¹ As we have previously stated, a Section 1504(a)(2) standard minimizes the ability of the acquiring corporation to attempt to avoid reorganization treatment by transferring the acquired assets or stock to a subsidiary that does not meet the control requirements of Section 368(c). Adopting a Section 1504(a)(2) standard will more closely follow the economic substance of the transaction. Moreover, we believe that the Treasury and IRS have authority to prescribe reasonable interpretive rules relating to the application of COBE and the remote continuity requirement and are not limited by Section 368(a)(2)(C) in determining the permissible transfers that satisfy these requirements.
5. **Effective Date.** Given the sensible results reached by the proposed regulations, we urge prompt finalization of the regulations. We generally agree with a prospective effective date because certain aspects of the regulations could be viewed as changing current law, and, therefore, a retroactive effective date could upset legitimate tax planning. We note, however, that certain aspects of the proposal adopt positions previously stated in revenue rulings. We understand that the prospective effective date for the regulations does nothing to undermine the effect of those rulings.

We will be pleased to meet with you if that is appropriate.

¹ *Comments on the Continuity of Interest and Business Enterprise Proposed Regulations*, American Bar Association Section of Taxation, April 28, 1997.