

AMERICAN BAR ASSOCIATION  
SECTION OF TAXATION

COMMENTS CONCERNING SUBCHAPTER C NO-NET-VALUE REGULATIONS  
PROPOSALS

These comments ("Comments") are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Jasper L. Cummings, Jr. of the Committee on Corporate Taxation. Substantive contributions were made by Philip B. Wright, Julie A. Divola, Timothy C. Sherck, Lee Zimet, and Stefan Gottshalk. The Comments were reviewed by Reginald Clark, Chair of the Committee; William M. Richardson, of the Section's Committee on Government Submissions, and Mark Yecies, Council Director for the Committee.

Although 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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Date: April 19, 2006

## EXECUTIVE SUMMARY

These comments address regulations proposed by REG-163314-03, 70 Fed. Reg. 11,903 (March 10, 2005). These Proposed Regulations address four aspects of Subchapter C of the Internal Revenue Code of 1986, as amended (“Code”)<sup>1</sup> that may be affected by the fact that a corporation is insolvent or that certain property transferred to a corporation is worthless when combined with certain liabilities:

- (1) Section 351 and worthless property or worthless stock;
- (2) Section 368 and a worthless target or acquiring corporation;
- (3) the liquidation of a subsidiary corporation that cannot make a distribution of net value with respect to each share of its stock; and
- (4) the conversion of a worthless target corporation into a valuable acquirer corporation in a Section 368 or bankruptcy reorganization.

The Section of Taxation of the American Bar Association (the “Tax Section”) commends the Internal Revenue Service (the “Service”) and the U.S. Department of the Treasury (the “Treasury”) for the extensive and well-considered Proposed Regulations addressing many difficult issues.

In areas (1) and (2), the Proposed Regulations would make fundamental changes in the law. In areas (3) and (4) the Proposed Regulations mostly amplify court-made rules. We question the fundamental changes, we question one court-made rule, and we make technical comments.

1. **Worthless Property.** We disagree with the proposal’s view that the receipt of valuable stock “in exchange” for worthless property cannot satisfy a statutory requirement that there must be a receipt of stock in exchange for property (i.e., Sections 351, 368(a)(1)(B), (C), (D), 361(a), 354 and 356). The Treasury and the Service base this result on the view that the stock cannot have been received in exchange for the property. This view implicitly assumes, however, that any debt assumption and any boot is deemed exchanged first for the property, i.e., “front loaded.” We believe that this conclusion is contrary to the implication of existing authorities. We also note that the basis for this result is not explained in the proposal. Absent a compelling reason, we recommend that those authorities be followed, and any stock received be viewed as in partial exchange for the gross value of the property.

2. **Net Property Valuation.** For purposes of determining the net value of property transferred or of a corporation’s property, we recommend that all liabilities be evaluated at market value. As a result, nonrecourse liability in excess of the current fair market value of the security would be ignored.

3. **Explanation of Treatment.** If the proposal’s approach of front loading of boot is to be used, we recommend that the regulations, as finalized, state that, when the absence of net property value precludes an exchange of the property for the stock, the transaction

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<sup>1</sup> All references to “section” are to Sections of the Code.

will be given effect in accordance with its true nature.<sup>2</sup> Specifically, we recommend that the regulations, as finalized, explain the treatment of valuable stock that is exchanged for either worthless property or for valuable property accompanied by boot equal to the property's value. For example, we assume that Section 305 could apply to stock received by a person that was already a shareholder. In addition, if the boot is to be treated otherwise than as the consideration in a Section 1001 recognition exchange, those possibilities should be explained.

4. **Worthless Stock.** We disagree with the proposal's view that the receipt of worthless stock for valuable property cannot satisfy a statutory requirement that there must be a receipt of stock in exchange for property. We base this conclusion on the fact that the Code has not heretofore refused to treat property or stock that is worthless as not constituting property or not stock. In this context as well, we recommend that, in lieu of the valuable stock requirement, the regulations, as finalized, state that the transaction will be given effect in accordance with its true nature with appropriate explanation.

5. **Type D Reorganizations.** We recommend that Rev. Rul. 70-240, 1970-1 CB 81, remain the law and the regulations, as finalized, should clarify that the statutory requirements for a Type D reorganization generally supplant any nonstatutory continuity of interest requirement.

6. **Section 332.** We recommend that the regulations reject the approach of *Spaulding Bakeries, Inc. v. CIR* and *H.K. Porter v. CIR* with the result that any distribution on stock held by a controlling corporate shareholder will be subject to Section 332, but any other stock held by such shareholder on which no distribution is received will be eligible for a Section 165 loss deduction.

7. **Type G Reorganizations.** We recommend that the surrender of net value requirement not apply to Type G reorganizations, or at least not to Type G reorganizations of subsidiaries of the bankrupt corporation.

## DISCUSSION

1. **Worthless Property.** The tax laws contain a presumption that is fundamental to all nonrecognition provisions, as well as taxable Section 1001 exchanges, i.e., when a corporation assumes a liability (or gives boot) in an exchange of its stock for property, the assumption, boot, and the stock are all parts of the consideration given for the property. In other words, such exchanges are not normally divided into a stock for property exchange and a separate liability assumption or boot issuance.<sup>3</sup>

The proposal, however, has gone beyond that presumption in cases where the total consideration given by the corporation (stock, boot and debt assumption) exceeds the gross value of the property, providing that, to the extent of the excess, none of the stock is exchanged for the property; that is, in order to defeat nonrecognition treatment the

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<sup>2</sup> See Treas. Reg. § 1.351-1(b)(1).

<sup>3</sup> See Treas. Regs. §§ 1.351-2(b), 1.357-1.

proposal not only separates the consideration, it implicitly assumes a front loading of the debt assumption (or other boot) in these exchanges.

We believe that front loading of boot or debt assumptions in such a manner is contrary to the spirit and implication of existing regulations. For example, Treas. Reg. § 1.301-1(l) states that a distribution is subject to Section 301 even though it takes place at the same time as another transaction, whether or not connected in a formal sense. Similarly, Treas. Reg. § 1.351-2(d) states that a Section 301 distribution can occur in conjunction with a Section 351 exchange. Section 358(a)(1)(B)(i) provides that dividends occurring in conjunction with a Section 351 exchange increase stock basis.

While, these authorities do not deal with disproportionate value cases, they do imply that, if there is any stock in the mix of consideration for property, then the stock is treated as exchanged for the property and the boot may be treated as not exchanged but as a related distribution. Consistent with this approach, in the no-net-value cases, one could view the stock as exchanged for the gross value of the property, with the assumption of liabilities (or boot) treated (in whole or in part) as a distribution. Indeed, commentators have stated that, in general, the receipt by a shareholder of more value than it contributed could be subject to such rules, resulting in the boot being taxed as a distribution and not under Section 351(b).<sup>4</sup>

Thus, in other contexts where the value of the stock and boot issued is greater than the property value received, the boot is back loaded. We believe that the proposal should take the authorities into account, and if they are not to be followed, indicate those policy reasons that justify a different result.

It is possible that the implicit front loading stems from the treatment of boot and debt assumption under Section 358, which determines the shareholder's basis in the stock received in a Section 351 exchange. In such exchanges the shareholder's exchanged basis is applied first to the fair market value of the boot received, with any remaining exchanged basis going to the stock received (augmented by gain recognized on the boot). While debt assumption is not "property" under Section 357(a), to "balance the books," Section 358(d) directs that it be treated as boot received, resulting in reduction of the exchanged basis and leaving the residual basis to be applied to the stock received. If the debt assumption exceeds the shareholder's exchanged basis, then under Section 357(c), the shareholder recognizes the excess as gain and no exchanged basis is left for the stock.

This treatment of basis by Section 358, however, does not prove that Congress intended that stock should be treated as not received in exchange for the property for purposes of Section 351. Just as the authorities cited above indicate the contrary as to boot in the form of cash and other property, Section 357(a) implies the same as to debt assumption, stating:

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<sup>4</sup> See Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders*, para. 3.16 (WG&L 7<sup>th</sup> ed.).

...if the taxpayer receives property which would be permitted to be received under section 351 or 361 without the recognition of gain if it were the sole consideration, and (2) as part of the consideration, another party to the exchange assumes a liability of the taxpayer, then such assumption shall not be treated as money or other property, and shall not prevent the exchange from being within the provisions of section 351 ....

It should also be noted that other areas of the tax law commonly disaggregate consideration in multiple asset exchanges and reflect a bias toward matching of qualifying property in potentially tax-free exchanges<sup>5</sup>. For example, in Section 1031 exchanges, the property given and received is disaggregated into their parts by type, and similar types are matched up for tax-free exchange purposes, reflecting a bias in favor of allocating the “qualifying” consideration in a potentially tax-free exchange.<sup>6</sup> Similarly, Treas. Reg. § 1.1031(b)-1(c) offsets liability assumptions by both parties to a Section 1031 exchange against each other, rather than apportioning the smaller assumption to the qualifying property. In addition, stock and boot received in a Section 351 exchange are allocated among the transferred properties for purposes of calculating gain recognition.<sup>7</sup>

Moreover, when the tax law directly addresses “off market” transactions, it generally seeks to discover what is actually going on, rather than render a nonrecognition rule inapplicable.<sup>8</sup> We believe that, in the prototypical case addressed by the Proposed Regulations, where a shareholder is receiving more from its corporation than it puts in, what is really going on is much more akin to a distribution than a sale.

In light of these authorities, it would be desirable for the Treasury and the Service to offer a rationale as to why backloading the stock received is appropriate in the no-net-value case. If this stacking can be justified by reference to some anti-abuse concern or otherwise, then we acknowledge that the stock clearly cannot be viewed as exchanged for the property and relevant Code requirements that stock be exchanged for property could not be satisfied.

In addition to the concerns expressed above, we have the more general concern that the Proposed Regulations would place taxpayers in difficult situations with respect to valuations of both property and liabilities. Valuation issues also are chronically difficult ones for the Service to deal with. They are not unique to these Proposed Regulations, but such issues are made the focal point of many transactions by these Proposed Regulations. We have not seen identified abusive transactions or other factors affecting tax administration that would justify expanding the situations in which such issues must be addressed.

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<sup>5</sup> See *Williams v. McGowan*, 152 F.2d 570 (2d Cir. 1945).

<sup>6</sup> See Treas. Reg. § 1.1031(1)-1, Rev. Rul 89-121, 1989-2 CB 203.

<sup>7</sup> Rev. Rul. 68-55, 1968-1 CB 140.

<sup>8</sup> See Treas. Reg. § 1.351-1(b)(1) (disproportionate exchange involving two shareholders recast as proportionate exchanges and gift).

Determining the amount of liabilities is similarly problematic, although for different reasons. The Preamble to the Proposed Regulations states that liabilities are to be broadly defined and not limited to liabilities as recognized for tax purposes.<sup>9</sup> We believe that such approach is reasonable, as discussed below, but adds to the difficulty of ascertaining net value. We are concerned that the regulations, if finalized as proposed, will inhibit exchanges in which no net value issues may arise and place too large a premium on valuation. Therefore, the ascertainment of the amount of liabilities, discussed below, will have to both be somewhat generic in approach and carefully crafted.

Finally, we note that heretofore the Treasury and the Service have not appeared to be concerned with absence of net value in non-arm's length cases, which will comprise the majority of potential underwater property cases. For example, Rev. Rul. 95-74, 1995-2 CB 36 involved the incorporation of property subject to potentially large contingent liabilities. The published ruling does not state whether or not the property had net value.<sup>10</sup>

2. **Net Property Valuation.** The proposal asked for comments on determining the amount of liabilities and suggests several alternatives. We believe that the approach should be dictated by the fact that, in the context of these Proposed Regulations, the meaning of liability is secondary to the meaning of net value. Once the Treasury and the Service decide that net value means real economic value, then gross value must be reduced by anything that economically reduces fair market value, without regard to tax concepts of liabilities, debt instruments, or issue price.

Unlike other situations (Sections 357 and 362, for example), in this context, the definition is not constrained by a statutory reference to "liability," which may implicate the concept of liabilities for Federal income tax purposes. Therefore, the approach of Section 358(h)(3) should be followed, which encompasses all obligations for payment, because that section also undertakes to establish real economic value.

As between issue price and actual value of liabilities, there seems to be no reason, other than convenience and administrability, not to use actual fair market value. As the Preamble noted, under Treas. Reg. § 1.752-7(b)(3)(ii), a liability is valued on the basis of what one would have to pay to get another to assume it in an arm's length transaction. We believe that this approach would be appropriate in the no-net-value regulations. But, unlike the Section 752 regulations, in the no-net-value regulations the arm's length standard is appropriate as to all, and not just certain obligations because in this context the aim is solely to determine the net value of properties. In contrast, in the Section 752 regulation, the arm's length standard is not used in all cases, because there it is necessary

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<sup>9</sup> Preamble, Explanation of Provisions, 1,B(iii).

<sup>10</sup> However, the revenue procedure for Section 351 rulings does require the taxpayer to represent that the property's gross value exceeded the liabilities assumed. Rev. Proc. 83-59, 1983-2 CB 575. That revenue procedure cross references Section 357(c) as to assumed liabilities. Rev. Rul. 95-74 ruled that the contingent liabilities were not liabilities that had to be taken into account for Section 357(c) purposes, and thus did not reduce the stock basis under Section 358(d). Therefore, it is not clear whether such a representation would have meant that net value was exchanged for the stock as an economic matter.

also to ascertain an amount of income or basis adjustment. Therefore, here, the issue price of a debt liability should be irrelevant.<sup>11</sup>

The Treasury and the Service have proposed to use the approach of Rev. Rul. 92-53, 1992-2 CB 48, which disregards the amount of a nonrecourse liability in excess of the value of the security for purposes of determining the extent of insolvency. While we understand that ruling to be based on considerations peculiar to Section 108, we believe that in general there is no reason to view other property transferred in an exchange as diminished in value by the excess amount of nonrecourse liability. Therefore, we recommend that the same approach apply here.

3. **Explanation of Treatment.** The proposal does not explain the treatment of a transfer of property not having net value. Example 4 of Prop. Treas. Reg. § 1.351-1(a) simply states that in the case of an exchange of property for stock where the property lacks net value due to an associated nonrecourse obligation, the stock is not exchanged for the property, and therefore Section 351 cannot apply.

If the proposal is to be adopted, we recommend that the results be explicitly set forth. For example, does the shareholder realize the amount of the nonrecourse liability and recognize gain or loss on the property under Treas. Reg. § 1.1001-2(a)(4) (subject to limitations on loss recognition including Section 267(a)(1))? Is receipt of stock by the shareholder subject to Section 305(a)? Do Sections 118 and 362 apply to the corporation? Arguably, a transaction that takes place solely because of the shareholder/corporation relationship, such as this one, should not be forced into a Section 1001(a) exchange.<sup>12</sup>

4. **Worthless Stock.** The proposal's disregard of worthless stock should be carefully distinguished from the rule discussed above, i.e., that an exchange in form of property for stock cannot in substance involve the receipt of stock for property if the property is worthless due to associated assumed liabilities. These are not opposite sides of one coin, but rather two very different proposed rules.

As noted, if one accepts the stock backloading assumption used in the worthless property case, that part of the proposal becomes a straightforward application of substance-over-form. Thus, if the property is worthless, the property transferor cannot really have received the stock for the property, so he or she must have received the stock for some other reason. As a consequence, Code rules that require the receipt of stock for property, including Sections 351, 361 and 354, cannot apply.

It is easy to conflate application of the substance-over-form doctrine with the very different proposition that worthless property is not property. If one accepts that proposition, the property end of the Section 351 exchange is missing. Just because,

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<sup>11</sup> However, as a simplifying convention, the use of issue price might be sanctioned, subject to adjustment.

<sup>12</sup> Cf., *CIR v. Fink*, 483 U.S. 89 (1987) (majority shareholder does not recognize loss on contributing some of his stock to the corporation).

however, no stock is issued for property, it does not logically follow that what is transferred, and what is received, are not property.

The proposal explains the parallel rule -- that the stock issued for valuable property must also be valuable -- only by saying (in connection with asset reorganizations): “the receipt of worthless stock in exchange for assets cannot be part of an exchange for stock.” That is, if the rule requires one to get stock for value, but the stock was worthless, one did not get stock and one did not satisfy the rule.

We do not believe that the rationale for this conclusion has been adequately explained. While, as noted, it may make sense to say that valuable stock received for worthless property cannot be part of an exchange for that property, it does not make sense to say that worthless stock received for valuable property cannot be part of an exchange for the property. Unlike the obverse case, there generally is no other justification for the receipt of the stock, however worthless it may be, except that it is for the property.

The Government’s reasoning may have been that when taxpayers appear to do something that is not economically rational, something else must be going on. In other words, why would one exchange valuable property for apparently worthless stock? There are at least two explanations: if (1) the stock is not really worthless, or (2) the transferor is obtaining some value other than the stock (including possibly the psychic value of making a gift). While the possibilities for that other value are endless, there are only two values that the Treasury should care about: (1) some indirect financial benefit to the property transferor (which could be a dividend, for example); and (2) a value derived from shifting value to some taxpayer other than the property transferor.

For example, if a father contributes property for worthless stock of a corporation whose debts were guaranteed by his shareholder son, the transaction should be recast as a gift to the son followed by the son’s contribution to the corporation.<sup>13</sup> But outside cases where recasting is needed, or where some other measurable benefit flows to the property transferor, the Government has no apparent reason not to respect the form of the transaction. For example, where Corp. X owns valuable Sub 1 and worthless Sub 2, Sub 1 merges into Sub 2, and Sub 2 is still insolvent, there has been no shifting of value between shareholders and the transaction should qualify as a Type A reorganization, rather than a deemed liquidation and reincorporation of the assets of Sub 1. In that case, property was transferred to a corporation for its stock and there is no reason to look behind the form.

The peril of requiring stock to have value in order to be respected as stock is that it is very difficult to know where it will lead. Anywhere the words “property” or “stock,” or the like, appear in the Code they can be interpreted not to include worthless property. For example, this idea was recently picked up in *Santa Monica Pictures v. CIR*,<sup>14</sup> The opinion there concluded, in the alternative, and with questionable citation, that worthless

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<sup>13</sup> See Treas. Reg. §§ 25.2511-1(h)(1); 1.351-1(b)(1); cf. Rev. Rul. 73-233, 1973-1 CB 179; Rev. Rul. 74-329, 1974-2 CB 269.

<sup>14</sup> T.C.M. para. 2005-104.

property is not property for purposes of Section 721. Therefore, the partnership that received the property (purportedly in exchange for a partnership interest) did not enjoy the carryover of its partner's high basis in the loss property and did not realize the built-in loss that was at issue in the case. We believe that the court would have been more justified in concluding that the party receiving the partnership interest received it as a fee or in some other capacity (and, therefore, the partnership did not get a carryover basis).

In addition to the general conceptual inappropriateness of the worthless stock rule, we object to it for two practical reasons. First, as mentioned above, it would create many confusing issues about the valuation of stock. Second, it disregards the possibility that stock can have value even if the company appears to be insolvent. In this regard, we believe that if stock in fact does have value, as evidenced by arm's length sales, offers, and other objective indicia relative to the stock itself, then, at minimum, the presence of an equivalent intangible value inside the corporation should be inferred.

5. **Type D Reorganizations.** The proposal excepts acquisitive Type D reorganizations involving two solvent corporations from the requirement that the boot be less than the value of the property transferred, so that there is "room" for stock consideration. This leaves in place Rev. Rul. 70-240, although the proposal states that the Treasury is reconsidering it.

Rev. Rul. 70-240 is the so-called "all cash D" reorganization ruling, wherein one commonly controlled corporation sells all of its operating assets to its sister corporation for cash equal to the fair market value of the assets. The sale is treated as a Type D reorganization because one corporation has conveyed substantially all of its properties to a second corporation controlled by the shareholder of the first, and then liquidated. The ruling addressed the requirement of Section 368(a)(1)(D) that stock of the acquirer be distributed and ruled that was unnecessary because the common shareholder already owned all of the stock of the acquirer. Although the ruling stated "B is treated as having received Y stock since he already owned all of the stock of Y, ...," the two cases it cited in support actually said that issuance of additional stock would have been a "meaningless gesture," and did not impute a stock issuance.

Of course the stock distribution requirement for a Type D reorganization could be met if one share of the acquiring corporation was issued or even owned by the target corporation and distributed in its liquidation. By retaining Rev. Rul. 70-240, the proposal properly avoids making the treatment elective according to whether a de minimis amount of stock is issued or distributed. In this regard, however, we believe that a word about continuity of interest is in order.

Treas. Reg. § 1.368-1(b) recognizes that Type D reorganizations are excepted from the usual acquisitive reorganization continuity requirement that target stock be *exchanged* for issuing corporation stock to a substantial degree (now thought to be at least 40 percent). Generally, the requirement cannot be satisfied by the fact that the target shareholders already own stock in the acquirer. Rather, they must get stock in the acquirer (or issuing corporation) as a result of the exchange for the target stock or assets.

This requirement is clearly not satisfied in an all cash D reorganization. Therefore, in order for Rev. Rul. 70-240 to have been the law for 35 years, the statutory definition in Section 368(a)(1)(D) must contain a continuity rule that supplants the normal requirement. In relevant part, Section 368(a)(1)(D) defines a reorganization transaction in which one or more shareholders of the target are in control of the acquiring corporation.<sup>15</sup> We believe that Rev. Rul. 70-240 and related rulings are correct because we believe that this statutory control requirement is intended to take the place of the nonstatutory continuity of interest requirement.<sup>16</sup>

**6. Section 332.** We recommend that the interpretation of Section 332 be returned to what it was before, the decisions in *Spaulding Bakeries, Inc v. CIR*<sup>17</sup> and *H.K. Porter v. CIR*.<sup>18</sup> Stock held by the controlling parent on which a liquidating distribution is received should be subject to Section 332 treatment, and the parent should be allowed to recognize a loss on any stock that does not receive a distribution.<sup>19</sup> This would approximate the result reached by the proposal's conclusion that a subsidiary liquidation that does not qualify under Section 332 can be a reorganization of the subsidiary coupled with the parent's loss on stock that receives no distribution. It would, however, reach those results in a more direct way, and by overruling cases which we consider to be flawed.

*Spaulding Bakeries* and *H. K. Porter* held that, in order for Section 332 to apply in any degree to a subsidiary liquidation, there must be some distribution on *each* class of subsidiary stock held by the parent. Treasury previously has interpreted these cases to mean there must be a distribution in exchange for each class held by the parent, other than Section 1504(a)(4) preferred stock.<sup>20</sup> Thus if a subsidiary makes a liquidating

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<sup>15</sup> Section 368(a)(2)(H) incorporates the Section 304(c) definition of control, so that where X owns Sub 1 and Sub 2, and Sub 1 owns Sub 3 and Sub 2 owns Sub 4, then Sub 2 is deemed to own Sub 3 (meaning that if Sub 4 sells its assets to Sub 3, then Sub 4's shareholder (Sub 2) is in control of the purchaser).

<sup>16</sup> We recognize that concern has been expressed by some commentators about the so called 99:1 hypothetical case, where the controlling shareholder of the target corporation holds a small interest in the acquirer. This and other issues in this area are addressed in Schultz, *The Future of Acquisitive D Reorganizations*, 84 *Taxes* 107 (March 2006); and Yecies, *The Future of Acquisitive D Reorganizations—A Reply to Michael Schultz*, 84 *Taxes* 137 (March 2006). See also Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders*, para. 12.26[2] (WG&L 7<sup>th</sup> ed).

<sup>17</sup> 252 F.2d 693 (2d Cir. 1958), *aff'g* 27 T.C. 684 (1957), non acq. 1957-2 CB 8.

<sup>18</sup> 87 T.C. 689 (1986).

<sup>19</sup> We do not address here the Government's authority to issue regulations that may appear to conflict with these opinions, although that issue must be addressed. (*Swallows Holdings, Ltd v. CIR.*, 126 T.C. No. 6 (2006)).

<sup>20</sup> *Treas. Reg. § 1.332-2(b)* evaluates only the distributions on the stock that the controlling parent owns. The absence of a distribution on stock held by minority shareholders is irrelevant to the application of Section 332 to the parent. But the absence of a distribution to the parent on Section 1504(a)(4) preferred stock is also irrelevant under Section 332. Prior to 1986 the statute excluded nonvoting, limited and preferred stock from the stock of which the parent corporation must own 80 percent. In 1986 the Code was changed to exclude Section 1504(a)(4) stock. The Tax Court opinion in *Spaulding Bakeries, Inc.*, 27 T.C. 684 (1957), states that the application of Section 332 does not depend on a distribution on a class that is ignored for purposes of determining the requisite parental control. Apparently this is why Prop. *Treas. Reg. § 1.332-2(e)* Example 2 goes out of its way to state that the preferred stock the parent held was not

distribution only on preferred stock held by the parent, without any distribution on the common Section 332(b)(2) or (3) is not satisfied because there was not a distribution in redemption of “all its stock.”<sup>21</sup>

The reasoning of those cases was dubious on their own terms.<sup>22</sup> Their principal virtue is to allow the parent to recognize losses on both the common stock and the preferred stock of a liquidating subsidiary.<sup>23</sup>

In 1958, *Spaulding Bakeries* decided only that Section 332 did not deny a worthless stock loss on the subsidiary’s common stock where the parent received a partial distribution only on the preferred.<sup>24</sup> In 1986 *H.K. Porter* further addressed the partial distribution on the preferred itself. The court concluded that that distribution as well was not subject to Section 332 nonrecognition because there was no distribution on the common.

We agree that a Code section governing redemptions of stock (i.e., Section 332) should not apply to deny a Section 165 worthless stock deduction, where there has been no redemption/exchange for the stock. But we fail to see why the Section 165 worthlessness of one class of stock should prevent the application of the Section 332 redemption/nonrecognition rule to preferred stock for which there was an exchange. Nevertheless, the proposal concludes that assuming the transaction does not otherwise qualify as a reorganization, Section 331 and not Section 332 applies to any stock exchange that actually occurs if there is other stock as to which the parent receives nothing in exchange.<sup>25</sup>

As a preliminary matter it is not at all clear that Section 331 can apply where Section 332 does not. Both sections apply to “complete liquidation”. And it is not obvious that one has the requirement that there be a distribution on each class of stock while the other does not.<sup>26</sup>

In addition, we note that in 1959, after the decision in *Spaulding Bakeries*, but before *H.K. Porter* was decided, Prof. Boris Bittker started the logical view that denying Section 332 treatment to the common because it was not redeemed does not prevent its application to the redemption of the preferred. He then stated that the parent would

Section 1504(a)(4) stock. Although this removed a possibly confusing fact from the example, the conclusion of the example would not be different if the preferred were “not stock.” In that case, the parent would have received no distribution on stock at all for Section 332 purposes. It should be noted, however, that a partial distribution with respect to Section 1504(a)(4) stock should still be eligible to qualify for reorganization treatment, as discussed below.

<sup>21</sup> Bittker & Eustice, op. cit., para. 10.21[2].

<sup>22</sup> See Cummings, Foreign Subsidiary Losses Appear Safer, 2004 TNT 207-25 (Oct. 26, 2004).

<sup>23</sup> *Id.*

<sup>24</sup> Actually, because the statute ignored the preferred for this purpose, the court could find that there was no distribution on any stock.

<sup>25</sup> In addition to the major changes discussed in the text, the proposal would amend Treas. Reg. § 1.332-2(a) to reflect the change in the control definition made by the Tax Reform Act of 1986. For commentary on the Section 332 regulation project generally, see Los Angeles County Bar Association Tax Section, Corporate Tax Committee, The Missed Regime Change, 2003 TNT 94-124 (May 15, 2003).

<sup>26</sup> Cf. Section 346(a)(1).

recognize a Section 165 loss on the common stock, and that “presumably” Section 332 nonrecognition treatment would apply to the partial distribution on the preferred stock.<sup>27</sup> In other words, Prof. Bittker gave *Spaulding* a minimal impact that did not turn off the application of Section 332 in general. Rather he simply recognized that where a shareholder did not receive any distribution with respect to certain shares, those shares were outside the rules of either Sections 331 or 332 governing liquidating “distributions,” with the result that the shareholder suffered a worthless stock Section 165 loss.

Bittker’s approach has multiple advantages: (1) it does not depend on different definitions of “complete liquidation” for Sections 331 and 332, (2) it utilizes the logical view that a shareholder who receives nothing for a share of stock when the corporation liquidates has a Section 165 event rather than a redemption, and (3) it respects the core concept that Section 332 was not intended to hold up the recognition of loss on the common stock that received no distribution.

The proposal contains the potential for reorganization treatment, which may be coupled with recognition of loss with respect to worthless common stock, stating that the subsidiary liquidation that results in the parent receiving no more than the preferred stock preference could be a Type C reorganization.<sup>28</sup> (Presumably, if the liquidation were by merger it could be a Type A reorganization). The proposed regulation thus fits with the anti-*Bausch & Lomb* regulation in that both deal with subsidiary liquidations that are not subject to Section 332. *Bausch & Lomb Optical v. CIR*,<sup>29</sup> ruled that the liquidation of a 79 percent owned subsidiary into the parent could not be a Type C reorganization because the parent received the subsidiary assets in exchange for the stock it held in the subsidiary rather than in exchange for the acquirer’s voting stock, as required by Section 368(a)(1)(C). In 2000, the Treasury adopted Treas. Reg. § 1.368-2(d)(4), which effectively treats “old and cold” subsidiary stock that the parent holds as being exchanged for hypothetical parent voting stock issued in exchange for the subsidiary’s assets, thus making it possible to qualify a subsidiary liquidation that is not subject to Section 332 as a Type C reorganization.<sup>30</sup>

For example, assume wholly owned subsidiary (S) worth \$100 merges into its parent (P), which owns common stock with a basis of \$1000 and preferred stock with a basis and liquidation preference of \$500. Because the parent does not receive a distribution on the common, Section 332 cannot apply. But, because the S is solvent, the merger can be a Type A reorganization in which P hypothetically exchanges P stock for the S assets and

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<sup>27</sup> Bittker, *Federal Income Taxation of Corporations and Shareholders*, p. 275 (Federal Tax Press, 1959 ed.).

<sup>28</sup> Prop. Treas. Reg § 1.332-2(e) Example 2.

<sup>29</sup> 267 F.2d 75 (2d Cir. 1959), cert. denied, 361 U.S. 835 (1959); *see generally*, Bittker & Eustice, para. 12.63[5].

<sup>30</sup> The preamble accompanying the 1999 proposal for the regulations indicated that, just as an upstream merger into a corporate shareholder that was not controlled by Section 332 could be a Type A reorganization (see Rev. Rul. 58-93, 1958-1 CB 188), a similar upstream liquidation without merger that was not subject to Section 332 could be a Type C reorganization, stating that “An exchange is deemed to occur for purposes of Section 354 even if, in form, one does not occur.” REG-115086-98, 64 F.R. 31770-31772, (June 14, 1999).

then exchanges the preferred S stock for the hypothetical P stock, in nonrecognition events on both sides. The proposal implies, that because P could not receive even hypothetical P stock for the common stock it holds in the S, P can recognize a worthless stock loss under Section 165(g) on the S common.

Thus, by recognizing the possibility for reorganization which may be the norm rather than the exception, the proposal has undone the all-or-nothing result of *H.K. Porter* that the proposal embraces, by giving the parent part recognition and part nonrecognition treatment on the subsidiary liquidation, as Prof. Bittker recommended (but in a different way). We recommend that the solution in this area is not to write the case law into the regulations but to return to the proper interpretation of the statute.

Finally, we note that the foregoing illustrates some confusion in the policy grounds for the proposal. Such confusion will make it particularly difficult to apply the substance over form and step transaction doctrines that the preamble to the proposal indicates are to be used in determining the application of Section 332.<sup>31</sup>

**7. Type G Reorganizations.** We recommend that the surrender of net value requirement should not apply to Type G reorganizations, or at least not to Type G reorganizations of bankrupt subsidiaries of the bankrupt parent.

By definition, the Type G reorganization was created for insolvent corporations. For that reason alone it is curious that the proposal does not automatically exempt such corporations from the transfer of net value requirement. It is true that the proposal accomplishes this indirectly in most cases through its rule that debt cancelled in the reorganization does not count in the transfer of value analysis. A bankrupt corporation generally will be able to meet the proposed tests by virtue of the fact that it will be rendered solvent in the reorganization through a combination of asset infusion and debt cancellation. Nevertheless, a more straightforward approach would be to simply waive the requirement in these cases, as done for Type E and F reorganizations.

More serious problems can arise with respect to intercompany reorganizations of subsidiaries below a bankrupt parent, particularly when the subsidiary is insolvent due to intercompany debt. Frequently the parent will have multiple subsidiaries, which owe debts to each other. Assume that one bankrupt subsidiary merges into another subsidiary and debt to another affiliate is cancelled in the transaction pursuant to the order of the bankruptcy court. In that case the cancelled debt is not assumed under the aforementioned rule of the Proposed Regulations and the merging corporation could be found to have surrendered net value as required by the Proposed Regulations. But if the transferee is the creditor, as will frequently be the case when the subsidiary liquidates into the parent, the debt must be treated under the proposal as assumed by the parent and the subsidiary will not have transferred net value if it was initially insolvent. Thus it will have engaged in a “taxable” Section 331 liquidation.

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<sup>31</sup> Explanation of Provisions, 1, B(vi).

It does not seem reasonable or necessary to apply the proposed requirement in such a subsidiary liquidation case. So long as the corporation is rendered solvent in the bankruptcy reorganization, or its successor is solvent, that should be enough. For this reason we would recommend that, at minimum, the net value requirement for Type G reorganizations be removed where the survivor is a solvent member of the affiliated group of which the reorganizing corporation was a member and the debt is cancelled pursuant to the plan of reorganization in bankruptcy.