**Step Transaction Doctrine**

Code: IRC §§ 368(a)(2)(C) and 368(c)

Regs: Treas. Reg. §1.368-2(f) & (k)

B&E: ¶¶ 10.41-10.42; 12.61[3]

Revenue Rulings (we will go over these in class):

* Rev. Rul. 67-274
* Rev. Rul. 70-240
* Rev. Rul. 90-95
* Rev. Rul. 2001-46
* Rev. Rul. 2004-83
* Rev. Rul. 2008-25
* Rev. Rul. 2015-10

\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*\*

Final Regulations Continue Trend of Broadening the

Scope of Permissible Transfers of Assets and Stock After

Tax-Free Reorganizations

The Treasury Department and IRS today released for publication in the *Federal Register* final regulations (T.D. 9361) that generally adopt rules proposed in 2004 by further expanding the scope of permissible transfers of assets and stock following tax-free reorganizations.

***Background***

In March 2004, Treasury and the IRS issued proposed regulations (REG 165579-02) that were intended to amend Reg. section 1.368-2(k) and provide that a reorganization otherwise qualifying under section 368(a) would not be disqualified as a result of the transfer or successive transfers of part or all (1) the assets of any party to the reorganization, or (2) the stock of any party to the reorganization other than the issuing corporation. The proposed regulations were also intended to amend the continuity of business enterprise (CoBE) regulations under Reg. section 1.368-1(d) and the definition of a party to the reorganization under Reg. section 1.368-2(f). In August 2004, Treasury and the IRS withdrew the March 2004 proposed regulations, and the next day issued a new set of proposed regulations. The August 2004 proposed regulations expanded the application of the March 2004 proposed regulations to two additional situations.

The August 2004 proposed rules addressed whether a transaction that otherwise qualifies as a reorganization would continue to qualify when, under the plan of reorganization, either (1) assets or stock of the acquired corporation are distributed to a corporation or partnership following the reorganization (a “push up”), or (2) acquired assets or stock are transferred to a partnership in which the transferor owns an interest. No public hearing on the August 2004 proposed regulations was requested or held; however, written comments concerning the proposed regulations were received and are addressed in the final regulations.

***Final Regulations***

Concerning the CoBE rules, the final regulations expand the definition of a qualified group in two ways. First, they permit qualified group members to aggregate their direct stock ownership in a corporation in determining whether that corporation is a qualified group member (provided that the issuing corporation directly controls at least one qualified group member). The final regulations retain the section 368(c) control requirement for membership. Second, the final regulations provide that qualified group members are treated as owning the stock owned by a partnership if the partnership is a section 368(c) partnership. A section 368(c) partnership is one which qualified group members control under requirements equivalent to section 368(c) (presumably with the aggregation notion described above).

***Observation***

The notion of a section 368(c) partnership supports the position that a partnership is an entity separate from its partners for purposes of this rule. Said differently, only by this rule are the partners treated as owning the stock owned by a section 368(c) partnership.

The final regulations adopt a provision under the proposed regulations that permits a party to a reorganization to retain that status even though stock or assets acquired in the reorganization are transferred in a transaction described in Reg. section 1.368-2(k).

The final regulations also adopt rules under Reg. section 1.368-2(k). As a general rule, a purported reorganization is not disqualified or *recharacterized* as a result of one or more subsequent transfers of assets or stock if the CoBE requirement of Reg. section 1.368-1(d) is met, and the transfers are described in Reg. section 1.368-2(k)(1).

***Observation***

The final regulations state that a transaction will not be *disqualified* or *recharacterized*. The proposed regulations only stated that a transaction would not be *disqualified*. In this way, the final regulations elevate the chosen form of a transaction that is described in Reg. section 1.368-2(k), and shields the form from a substance-over-form and/or step-transaction challenge. The preamble and final regulations together confirm the shield effect of the adopted rule. The preamble states that the final rules do not implicate the fact pattern in Rev. Rul. 70-107, 1970-1 C.B. 78. In that ruling, a purported triangular C reorganization failed because part of the target corporation’s liabilities was assumed by the acquiring corporation’s parent corporation as part of the plan of reorganization. It is reasonable to infer that the ruling relied on step-transaction principles to include the parent corporation’s assumption as part of the reorganization, and as such, the ruling could conclude that the assumption was disqualifying boot.

As is relevant to this observation, the parent corporation in Rev. Rul. 70-107 did not receive any target assets distributed by the acquiring corporation. Reg. section 1.368-2(k)(2), *Example 2*, presents essentially the same facts as Rev. Rul. 70-107, with the additional fact that the parent corporation receives some target assets distributed by the acquiring corporation. Relying on the general rule of Reg. section 1.368-2(k)(1), it concludes that the reorganization qualifies as a triangular C reorganization. Implicitly, meeting the general rule’s requirements shields the reorganization transaction between the target and acquiring corporations from the planned distribution to and assumption by the parent corporation.

There are two kinds of transfers described in Reg. section 1.368-2(k)(1)—transfers that are distributions and other transfers. The description of distribution transfers embodies the notion of the push up of assets contained in the proposed regulations. Under the proposed regulations, an acquiring corporation could not distribute “substantially all” the assets of the target corporation to one or more shareholders pursuant to a plan. Those making comments complained that a “substantially all” standard was too uncertain. Treasury and the IRS responded by changing the rule to bar a distribution of a quantity of target assets that would result in a liquidation of the acquiring corporation for federal income tax purposes (disregarding acquiring’s pre-transaction assets).

***Observation***

The final regulation standard appears to rely on the notion of a de facto liquidation. The

standard for applying *de facto* liquidation may be as uncertain as the standard for “substantially all.”

The description of other transactions allows the acquiring corporation to transfer target or

acquiring corporation assets, or target or acquiring corporation stock (provided the transfer does not result in the corporation’s ceasing to be a member of the CoBE qualified group), or a combination of assets and stock, to a person other than to a shareholder of the acquiring corporation. This rule has a further condition: the acquiring corporation cannot terminate its corporate existence in connection with the transfer.

Lastly, the final regulations reverse the conclusion reached in Example 3 of former Reg. section 1.368-2(k), given that transfers of stock of a corporation to a controlled partnership adequately preserve the link between the former target shareholders and the target business assets. The final regulations permit both distributions of stock of the acquired corporation and other transfers of stock of the acquired, acquiring, or surviving corporation, provide the transfer of stock does not cause the transferred corporation to cease to be a member of the CoBE qualified group.

The final regulations are effective October 25, 2007 (which is the date that T.D. 9361 will be published in the *Federal Register*).