# REEXAMINING TRIANGULAR B REORGANIZATION: REQUIREMENTS AND POTENTIAL TAX TRAPS OR A TIME TO REVISIT ITS FAVORABLE APPLICATION

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## I. INTRODUCTION

One of the most commonly executed changes in the structure of U.S. corporations is an exchange of one corporation's stock with stock of another corporation, a transaction that is often designed and implemented pursuant to Internal Revenue Code Section 368(a)(1)(B)[1] (often referred as a "B reorganization") and also a special variant of B reorganization which is known as "triangular B reorganization." It is known as "triangular" as it involves three corporations. Instead of using the acquiring corporation's stock in consideration of the target's stock, the acquiring corporation uses its parents' stock.[2]

While such an exchange does not fall within the general favorable tax deferral known as "like kind exchange" within the meaning of Code Section 1031, it nonetheless, assuming it meets all the conditions of Code section 368(a)(1)(B), qualifies for tax deferral treatment and possibly tax windfall.

The rationale for allowing such tax deferral furthers Justice Pitney's Supreme Court ruling that interprets "realization" for tax purposes narrowly.[3] Similarly, in 1918 and even more so in 1924, Congress enacted statutory provisions that qualified for favorable deferral. However, a century ago, the taxation of corporations and its shareholders was very different from today, primarily for two reasons. First, Congress imposed a more excessive tax burden at both corporate and shareholder levels. Second, the commercial setting was more domestic and there were less cross-border complex corporate structures available.

Previous literature on B reorganizations or triangular B reorganizations focused only on analyzing technical aspects in achieving favorable treatment. Whereas this paper not only focuses on several U.S. federal income tax aspects that arise upon execution of triangular B reorganizations, but also demonstrates that over the years the Service and the Courts understood the need to limit the favorable tax treatment in a wide variety of triangular B reorganizations. That this view has persisted suggests that the time has come for Congress to reexamine the application of triangular B reorganization in the cross-border context.

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1 B reorganization authorizes the acquiring corporation to receive the target's stock "in exchange solely for all or part of the voting stock of a corporation which is in control of the acquiring corporation."

2 DOUGLASS A. KAHN, JEFFREY H. KAHN, TERRENCE G. PERRIS & JEFFREY S. LEHMAN, CORPORATE INCOME TAXATION 505-508, (6th ed. 2009) ("The transaction is treated as if the parent's stock was first contributed to the acquiring corporation who then transferred it in exchange for the target's stock.").

3 *Eisner v. Macomber*, 252 U.S. 189, 211 (1920).

## II. QUALIFICATION AS A CODE SECTION 368(A)(1)(B) REORGANIZATION

Generally, a triangular B reorganization is an acquisition by S (a subsidiary of P) of T (the target corporation) stock in exchange for P (the parent corporation of S) stock in a transaction that qualifies as a reorganization under Code Section 368(a)(1)(B). However, a triangular B reorganization is often structured in a way that is not so simple, potentially leading one to overlook either of two crucial facts: that the transaction should qualify as a triangular B reorganization, or alternatively, trigger federal income tax liability due to certain federal income tax traps.

For example, consider the following transactions:

(1) SubCo1 issued a promissory note with an issue price of $500,000,000 ("Promissory Note 1") to a Switzerland limited liability company, CFC FinCo2, in exchange for $500,000,000 of cash;

(2) USCO transferred 100,000 of its own voting preferred interests, which were structured to avoid treatment as Code Section 351(g)[4] nonqualified preferred stock, and which constituted "voting stock" within the meaning of Code Section 368(a) because such interests have the right to elect up to 10% of the USCO board of directors (the "USCO Interests"), to SubCo1 in exchange for a $1 billion note ("Promissory Note 2"); and

(3) SubCo1 subsequently acquired all the shares of a BVI limited company, RnDSub, from a Delaware corporation, RnDCo, in exchange for the USCO Interests acquired in (ii) (the "Triangular B Reorganization").

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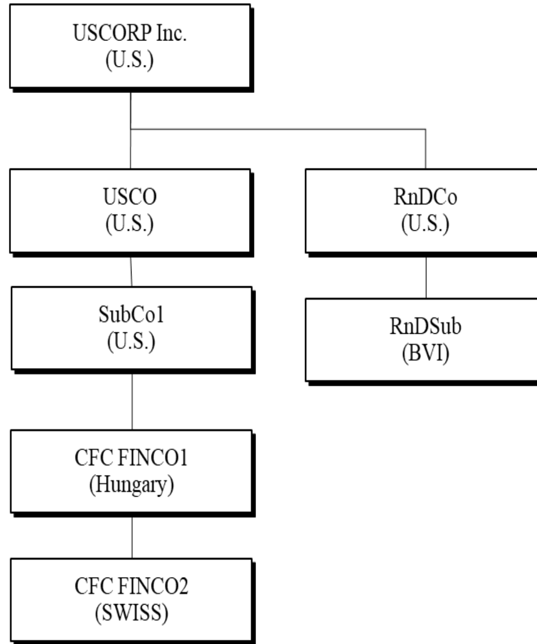
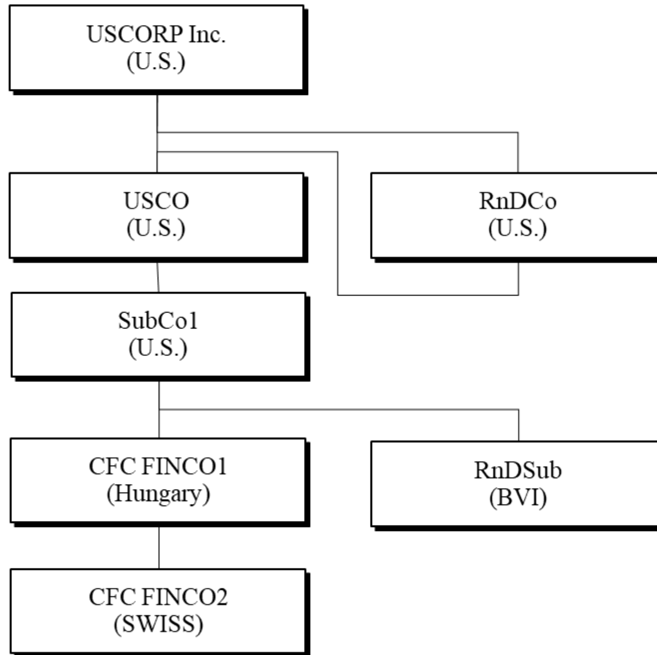
4 Except as otherwise indicated, all references to the "Code" are to the Internal Revenue Code of 1986, as amended, and all references to "26 C.F.R.." or the "Regulations" are to the Treasury Regulations interpreting the Code. All references to "Code Section" or "§" are to the sections of the Code or the Regulations, unless otherwise indicated. All references to "$" are to the U.S. dollar.




For U.S. federal income tax purposes, those steps in which USCO transferred the USCO Interests to SubCo1 solely in exchange for Promissory Note 2 coupled with those steps in which SubCo1 subsequently acquired all the outstanding shares of the Triangular B Target from the Triangular B Target Shareholder solely in exchange for the USCO Interests, should be treated as a tax-free triangular B reorganization. The requirements for being so treated are discussed in detail below.

### *A. Statutory and Judicial Requirements of a Code Section 368(a)(1)(B) Reorganization*

Code Section 368(a)(1)(B) provides that, for purposes of Code Section 301 through Code Section 368, the term "reorganization" includes "the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or part of the voting stock of a corporation which is in control of the acquiring corporation), of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition)."[5] Transactions in which the acquiring corporation uses the voting stock of a corporation as acquisition currency to control the acquiring corporation are generally referred to as "triangular B reorganizations."[6]

The following illustrates a triangular B reorganization:

> T has assets with a fair market value of $100 and no liabilities. The T shareholders have an aggregate basis in their T stock of $85 immediately before the reorganization. Pursuant to a plan, P forms S with $5 cash and S acquires all the T stock in exchange for $100 of P stock. The transaction is a reorganization to which Code Section 368(a)(1)(B) applies.[7]

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5 26 U.S.C. § 368(a)(1)(B); *see also* 26 C.F.R. § 1.368-2(c) ("In order to qualify as a 'reorganization' under section 368(a)(1)(B), the acquisition by the acquiring corporation of stock of another corporation must be in exchange solely for all or a part of the voting stock of the acquiring corporation (or, in the case of transactions occurring after December 31, 1963, solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), and the acquiring corporation must be in control of the other corporation immediately after the transaction.").

6 *See* 26 C.F.R § 1.358-6(b)(2)(iv) (defining a "triangular B reorganization" as an acquisition by a controlled subsidiary of stock of a target corporation in exchange for stock of the controlled subsidiary's parent corporation in a transaction that qualifies as a reorganization under 26 U.S.C. § 368(a)(1)(B)); General Explanation of the Tax Reform Act of 1986, JCS-33-76 (December 29, 1976); G.C.M. 37493 (April 10, 1978); PLR 200021046 (February 28, 2000); FSA 1609 (June 5, 1995).

7 26 C.F.R. § 1.358-6(c)(4), Ex. 3; *see also* PLR 9739047 (July 1, 1997) (Acquiring owned all the stock of Target, and Target owned the majority of the stock of Sub. Acquiring contributed to Target an amount of Acquiring voting stock equal in value to the minority interest in Sub, which Target then exchanged for such minority interest. The Service ruled that Target's acquisition of the Sub stock in exchange for Acquiring voting stock was a I.R.C. § 368(a)(1)(B) reorganization); PLR 8619023 (February 6, 1986) (similar). *Cf*. Rev. Rul. 74-564, 1974-2 C.B. 124 (recasting as a triangular B reorganization a reverse subsidiary merger in which the merging subsidiary used voting stock of its "grandparent" corporation as acquisition currency). Note that cross-chain triangular B reorganizations raise the potential application of 26 U.S.C. § 304(a)(1) given that a brother corporation acquires a sister corporation for stock that is "property" as defined by Code Section 317(a). However, both Congress and the Service have confirmed that reorganization status trumps the application of Section 304. *See*, *e.g.*, H.R. Rep, No. 432, at 1625 (1984) (stating that where the reorganization provisions apply, including those governing the treatment of exchanges

In addition to the statutory requirements for a Code Section 368(a)(1)(B) reorganization, the Regulations contain certain requirements that must be satisfied. Specifically, 26 C.F.R. §1.368-1(b) and 1.368-2(g) provide that the following additional requirements must be satisfied for a transaction to qualify as a tax-free reorganization under Code Section 368: continuity of business enterprise, continuity of shareholder interest, and business purpose, as discussed below. A further requirement for a valid triangular B reorganization status is that the transaction occurs pursuant to a "plan of reorganization."[8] Further, "nonqualified preferred stock" as defined in Code Section 351(g)(2) cannot be received by the shareholder of the target corporation.[9]

Finally, proposed Regulations would add a net value requirement to the other non-statutory requirements of an exchange for it to satisfy Code Section 368.[10] Although the proposed Regulations are not effective until finalized,[11] they are widely accepted as a statement of the Service's current position and reflect a

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by shareholders pursuant to a plan of reorganization, the rules of Section 304(a) providing treatment as a stock redemption would not apply); Rev. Rul. 2004-83, 2004-2 C.B. 157, Situation 2 (citing J. Comment. On Tax'n, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 192 (Comment. Print 1984), in stating that "[t]here is no policy that requires §304 to be applied when §368(a)(1)(D) would otherwise apply," and citing H.R. Rep. No. 432, at 1625 (1984), in stating that "the legislative history to the Deficit Reduction Act of 1984 . . . indicates that §304 was not intended to override reorganization treatment.").

8 *See* 26 C.F.R. § 1.368-2(g). *Cf.* 26 C.F.R. § 1.368-1(c) (stating that the provisions of the Code referred to therein (i.e., 26 U.S.C. § 354(a)(1), 356, 357, 361(a) and (b), 367, and 368(a)(1)) are inapplicable unless there is a "plan of reorganization," although the provisions that appear to be the focal point of the Regulation are Code Sections 354 and 361). However, this requirement may be limited to reorganizations described in Code Section 368(a)(1)(D), which expressly incorporates the rules of Code Section 354, including that the transaction occur pursuant to a plan of reorganization. *Compare Viereck v. U.S.*, 3 Ct. Cl. 745 (1983) (citing *Mitchell*, *infra*, and I.R.C. § 1.368-1(c) in stating that a requirement for reorganization status under Code Section 368(a)(1)(D) is that the transaction be in pursuance of a plan of reorganization), *Mitchell v. U.S.*, 451 F.2d 1395 (Ct. Cl. 1971), and TAM 8402001 (Aug. 16, 1983) (considering the "plan of reorganization" a prerequisite to reorganization status in the context of a reorganization under Code Section 368(a)(1)(D)), *with* 1997 FSA Lexis 613 (November 7, 1997) (citing Code Sections 354 and 361 (not 26 C.F.R. § 1.368-1(c)) in stating that, to qualify as a tax-free reorganization under Code Section 368(a)(1), the transaction "must have been pursuant to a plan of reorganization"), FSA 2120 (July 12, 1997) (same), 1996 FSA Lexis 539 (Dec. 3, 1996) (same), FSA 200233016 (May 9, 2002) (indicating that the "provisions" referenced in 26 C.F.R. § 1.368-1(c) are the "nonrecognition provisions governing reorganizations," *e.g.*, Code Sections 354 and 361, but not Code Section 368). *Cf.* TAM 9708001 (October 14, 1996) (considering, in analyzing whether a transaction qualified as a reorganization under Code Section 368(a)(1)(A), whether there was a "plan of reorganization," although the Service never expressly stated that this is a prerequisite to reorganization status). As a practical matter, however, the point often is moot given that Code Section 354 expressly requires such a plan, and the application of Code Section 354 generally is of governing importance in reorganization qualification.

9 *See* 26 U.S.C. § 351(g)(2); 26 U.S.C. § 354(a)(2)(C).

10 26 C.F.R. § 1.368-1(f).

11 26 C.F.R. § 1.368-1(f)(6).

view to which many tax practitioners subscribe. Accordingly, the net value requirement is also discussed herein.

Based on the above, the requirements necessary for a transaction to be treated as a triangular B reorganization are as follows:

(1) The consideration provided by the acquiring corporation must be composed "solely" of stock (the "Solely Requirement");
(2) The corporation the stock of which is used as consideration must "control" the acquiring corporation (the "Control of Acquirer Requirement");
(3) The stock consideration provided must be "voting stock" (the "Voting Stock Requirement");
(4) The acquiring corporation must "control" the target corporation "immediately after" the acquisition (the "Control of Target Immediately After Requirement");
(5) There must be a non-tax business purpose for the acquisition (the "Business Purpose Requirement");
(6) The reorganization must be pursuant to a "plan" (the "Plan of Reorganization Requirement");
(7) There must be a continuation of the target corporation's business or use of a significant portion of its assets in a business (the "Continuity of Business Enterprise Requirement" or the "COBE Requirement");
(8) There must be a continued interest maintained by the former shareholders of the target corporation in the corporation of which the stock was used as consideration by the acquiring corporation (the "Continuity of Shareholder Interest Requirement" or the "COI Requirement"); and
(9) There must be an exchange of net value (the "Net Value Requirement").

Each of these requirements is discussed separately in more detail below. For the reasons discussed below, the Triangular B Reorganization should meet each of these requirements.

1. The Solely Requirement

As discussed above, the consideration provided by the acquiring corporation must be composed "solely" of stock. While there is no express definition of "solely" for the purposes of Code Section 368(a)(1)(B), both the courts and the Service have interpreted "solely", as used in various subsections of Code Section 368(a)(1), literally. In other words, even if a controlling amount of the target corporation's stock is acquired for voting stock and the balance is acquired for other consideration, no consideration of any kind other than voting stock of the acquiring corporation (or the voting stock of a corporation controlling the acquiring corporation) may be used to acquire target stock as part of the overall plan of reorganization.

For instance, in *Helvering v. Southwest Consolidated Corp.*,[12] corporation P, which was insolvent, transferred its properties to a new corporation the common stock of which mostly went to P's bondholders, although a small portion, together with a part of the warrants of the new corporation, went to P's participating unsecured creditors. The balance of the warrants went to P's preferred and common stockholders. The Supreme Court ruled that this transaction was not a valid reorganization because the warrants were not "voting stock" and the fact that "consideration other than, or in addition to, voting stock" was used, the "solely" requirement of current Code Section 368(a)(1)(C) was violated. The Supreme Court stated that the term solely "leaves no leeway."[13]

The Service reached a similar conclusion in Rev. Rul. 75-123.[14] There, corporation X acquired 80% of corporation Y's outstanding stock in exchange for X voting stock. X purchased the remaining 20% of the outstanding Y stock for cash in a related acquisition. The Service noted that the cash was additional consideration for the Y stock and ruled that the "solely for voting stock" requirement of Code Section 368(a)(1)(B) was not satisfied even though an amount of stock constituting control was acquired solely for X voting stock.[15]

Aside from the more obvious problems, such as dilution of ownership, created through using consideration other than voting stock as the acquisition currency for the target stock, the acquiring corporation must also be sure to avoid the provision of ancillary benefits to the target shareholders. Such benefits may include paying expenses not solely and directly related to the reorganization, such as their personal tax planning or costs in evaluating other offers, using consideration other than voting stock.[16]

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12 *See, e.g.*, 315 U.S. 194, 195 (1942), *reh'g denied,* 315 U.S. 829 (1942), *reh'g denied,* 316 U.S. 710 (1942).

13 *Id* at 198.

14 1975-1 C.B. 115.

15 *See also* Rev. Rul. 85-139, 1985-2 C.B. 123 (stating that the Solely Requirement applies to the entire transaction in which stock of a corporation is acquired, not just to the acquisition of a block of stock constituting control, and thus that, first quoting Rev. Rul. 75-123, 1975-1 C.B. 115; then quoting *Chapman v. Comm'r*, 618 F.2d 856 (1st Cir. 1980); then quoting *Heverly v. Comm'r*, 621 F.2d 1227 (3rd Cir. 1980); and then quoting *Comm'r v. Turnbow*, 286 F.2d 669 (9th Cir. 1960), the acquisition by a corporation of 80% of the stock of a corporation in exchange for its voting stock and the remaining 20% in exchange for cash violates the Solely Requirement); IRS Gen. Couns. Mem. 35,736 (Mar. 20, 1974) (similar). *Cf. Mills v. Comm'r*, 39 T.C. 393, 401 (1962), *rev'd* 331 F.2d 321 (5th Cir. 1964) (providing that there is no de minimis exception for "solely," and stating that "[w]e note that where a taxpayer has a loss which he wishes to recognize, adding a minimal amount of other consideration to what would otherwise be a (B) reorganization will compel such recognition. We believe this is the result intended by Congress.").

16 *See*, *e.g.*, Rev. Rul. 73-54, 1973-1 C.B. 187 (ruling that the acquirer's payment of the target corporation's expenses, such as legal and accounting fees, appraisal fees, and other administrative costs, that were solely and directly related to the reorganization did not represent additional consideration paid and, thus, did not disqualify the transaction from qualifying as a Code Section 368(a)(1)(C) reorganization); Rev. Rul. 76-365, 1976-2 C.B. 110 (finding that accountant and consultant fees paid by the target corporation to evaluate the acquiring corporation's acquisition offer were solely and directly related to the reorganization and, thus, did not violate the solely for voting stock requirement of Code Section 368(a)(1)(C)); Rev. Rul. 75-450, 1975-2 C.B. 328

In the instant case, SubCo1 acquired the stock of the Triangular B Target for no consideration (including no consideration through indirect benefits, such as the payment of the Triangular B Target's expenses) other than the USCO Interests, and USCO was a corporation controlling SubCo1. Therefore, the Triangular B Reorganization should have satisfied the Solely Requirement.

2. Control of Acquirer Requirement

Code Section 368(a)(1)(B) requires that a corporation whose stock is used as consideration must "control" the acquiring corporation. For purposes of Code Section 301 through Code Section 384 (apart from Code Section 304), "control" is defined in Code Section 368(c) as the ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of each other class of stock of the corporation.[17]

As described before, SubCo1 was and continued to be treated as a corporation for U.S. federal income tax purposes both before and after the Triangular B Reorganization. Immediately prior to the Triangular B Reorganization, USCO held, for U.S. federal income tax purposes, 100% of the outstanding SubCo1 interests.[18] Further, USCO continued to wholly-own SubCo1 for U.S. federal income tax purposes after the Restructuring. Because USCO directly owned, for U.S. federal income tax purposes, 100% of the outstanding SubCo1 interests immediately before and after the RnDSub Stock Acquisition, the Control of Acquirer Requirement should have been satisfied in the Triangular B Reorganization.

3. Voting Stock Requirement

The Voting Stock Requirement mandates that the stock consideration provided must be "voting stock." The term "stock" is not defined for purposes of Code Section 354; however, "nonqualified preferred stock", as defined in Code

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(concluding that the payment of a finder's fee owed by a target corporation in connection with a Code Section 368(a)(1)(C) reorganization by the target's shareholders or by the acquiring corporation would not have disqualified the transaction from tax-free reorganization status).

17 *See* Rev. Rul. 59-259, 1959-2 C.B. 115. Note that in determining whether the control requirement is satisfied, only that stock directly held for U.S. federal income tax purposes is considered; constructive ownership principles do not apply. *See*, *e.g*., Rev. Rul. 56-613, 1956-2 C.B. 212 (finding that direct ownership is required for satisfaction of Code Section 368(c)); *Brams v. Comm'r*, 734 F.2d 290, 293 (6th Cir. 1984) (indicating that the stock attribution rules of Code Section 318 do not apply to Code Section 351 or Code Section 368(c)); I.R.S. Gen. Couns. Mem. 35,927 (Jul. 30, 1974) (vacated on other grounds by I.R.S. Gen. Couns. Mem. 39,100) (Dec. 21, 1983) ("Furthermore, it is clear that the control requirements of Code § 351(a) are not satisfied by way of some filial relationship. . . . Attenuated indirect ownership, albeit 100%, is simply inadequate.") (citations omitted).

18 *See, e.g.*, PLR200439003 (Sept. 24, 2004) (accepting a representation, and thus, acknowledging, that control can be acquired in connection with the reorganization and need not exist before the reorganization).

Section 351(g)(2), is not treated as "stock" for this purpose.[19] Code Section 351(g)(2) defines nonqualified preferred stock as preferred stock with respect to which:

The holder has the right to require the issuer or a related person to redeem or purchase the stock;

The issuer or a related person is required to redeem or purchase the stock;

The issuer or a related person merely has a right to redeem or purchase the stock but, as of the issue date, it is more likely than not that the right would be exercised; or

The dividend rate on the stock varies in whole or in part with reference to interest rates, commodity prices, or other similar indices.

The Code defines preferred stock as stock that is limited and preferred as to dividends and does not participate in corporate growth to any significant extent.[20] This definition excludes any preferred stock with a redemption right that may not be exercised within 20 years of the issue date of the stock.[21] Thus, an unqualified redemption right after 20 years from the issue date of the stock does not cause the stock to be "nonqualified preferred stock" within the meaning of Code Section 351(g)(2).

If no stock issued or deemed issued in a Restructuring Transaction was stock that is limited and preferred as to dividends or that does not participate in corporate growth beyond a limited dividend or liquidation preference. Rather, the stock issued (or deemed issued for U.S. federal income tax purposes) in each Restructuring Transaction in which shares (or an equity interest) were issued or deemed issued for U.S. federal income tax purposes entitled its holder to fully participate, without limitation, in any future growth in the issuer's earnings and asset values. At any time after the 20-year anniversary of the issue date of any USCO Interests, the holder of such interests may require the redemption of all or a portion of such interests by USCO. There is no such right within the initial 20-year period. Because the USCO Interests entitle its holder to fully participate, without limitation in any future growth in USCO's earnings and assets values and the redemption right cannot be exercised within the 20-year period after the issue date of the USCO Interests, such interests should not be "nonqualified preferred stock" within the meaning of Code Section 351(g)(2).

Neither Congress, nor the court, nor the Service has established bright-line, definitive standards governing the determination of whether stock is "voting stock" for purposes of Code Section 368(a)(1)(B). However, the courts and the Service have consistently held that the power to elect a corporation's directors is the most significant factor in determining whether stock may vote for purposes of determining affiliation under Code Section 1504(a). For example, in Rev. Rul. 69-126,[22] the common parent of an affiliated group of corporations owned 100% of the common stock and 50% of the preferred stock of a subsidiary. Pursuant to

19 26 U.S.C. § 354(a)(2)(C).

20 26 U.S.C. § 351(g)(3)(A)

21 26 U.S.C. § 351(g)(2)(B).

22 Rev. Rul. 69-126, 1969-1 C.B. 218.

the subsidiary's certificate of incorporation and bylaws, the preferred stock possessed the right to elect three directors, while the common stock possessed the right to elect five directors and had all other voting powers. Citing case law, the Service held that "since the preferred stock in the instant case participates in the election of directors, it is voting stock for the purposes of section 1504(a) of the Code."[23]

USCO, a Delaware limited liability company, had two classes of interests outstanding. The USCO Interests have the right to elect up to 10% of the USCO board of directors. As a result of the RnDSub USCO Stock Acquisition, SubCo1 acquired interests in its parent company, USCO. The corporate laws of certain states, such as Delaware, prohibit a subsidiary from exercising voting rights with respect to parent corporate stock owned by the subsidiary. We have not reviewed the limited liability company laws of Delaware to determine whether they contain a similar prohibition such that SubCo1 would not have the right to exercise any voting rights with respect to the USCO Interests that SubCo1 owned. Nevertheless, because the right to vote was inherent in the USCO Interests, such interests should have been treated as voting shares for Code Section 368(a)(1)(B) purposes, regardless of whether the particular shareholder owning such shares had the legal right under state law to exercise its voting privileges.[24] Because the

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23 In I.R.S Tech. Adv. Mem. 9714002, P owned 74% of the S voting stock and, thus, practically speaking, could elect 100% of the board of directors. P argued that it satisfied the "voting" test of Code Section 1504(a)(2)(A). In determining whether the requirements of Code Section 1504(a)(2)(A) were satisfied, the Service cited *Erie Lighting Co. v. Comm'r, 93 F.2d 883(1st cir. 1937)*, *Anderson-Clayton Securities Corp. v. Comm'r*, 35 B.T.A. 795 (1937), and Rev. Rul. 69-126, 1969-1 C.B. 218, as noting that participation in the management of a subsidiary through the election of the board of directors generally is the criterion used by the courts and the Service in determining voting power under Code Section 1504(a). I.R.S Tech. Adv. Mem. 9714002 (Dec. 6, 1996). *See also* I.R.S. Gen. Couns. Mem. 38422 (June 25, 1980) (providing that, to be included in a determination of whether the voting power requirement of Code Section 1504(a)(2) is met, the stock must participate in the election of directors (citing *Erie Lighting Co.*, 93 F.2d at 886, Rev. Rul. 69-126, *supra*, *Schlafly v. U.S.*, 4 F.2d 195, 200 (8th Cir. 1925), and Rev. Rul. 71-83, 1971-1 C.B. 268)). Several courts have refused to treat stock as possessing voting power where the power to vote for directors was contingent upon the occurrence of certain events, such as the non-payment of accrued dividends. *See*, *e.g.*, *Erie Lighting Co. v. Comm'r*, 93 F.2d 883, 886 (1st Cir. 1937); *Rudolph Wurlitzer Co. v. Comm'r,* 29 B.T.A. 443, 445 (1933), *aff'd,* 81 F.2d 971 (6th Cir. 1936), *cert. denied*, 298 U.S. 676 (1936).

24 As discussed above, Delaware General Corporate Law ("DGCL") generally prohibits a subsidiary from voting shares it owns in its corporate parent. We understand that, to comply with DGCL, the bylaws of many parent corporations explicitly restrict a subsidiary from exercising its voting rights with respect to the parent shares it holds. However, if and when such parent shares are transferred, the new holder of such parent shares will be entitled to regular voting privileges without any further action by the new holder of such shares or the parent corporation. Laws similar to that of DGCL have been addressed by the Service in various rulings. In Rev. Rul. 73-28, corporation X owned all of the shares of corporation Y, which owned all of the shares of corporation Z. Rev. Rul. 73-28, 1973-1 C.B. 187. Corporation X acquired all of the corporation Z shares from corporation Y in exchange for corporation X's own stock, after which corporation Y owned stock in its parent, corporation X. The Service held that the corporation X stock received by corporation Y constituted "voting stock" within the meaning of Code Section 368(a)(1)(B) "regardless of whether, by virtue of state law, it may be voted in the hands of Y." *Id.* Further, in

USCO Interests were not nonqualified preferred stock within the meaning of Code Section 351(g)(2) and possessed the right to elect directors of USCO, the USCO Interests used as consideration in the RnDSub Stock Acquisition should have satisfied the Voting Stock Requirement.

### 4. Control of Target Immediately After Requirement

As discussed above, to qualify for a tax-free reorganization under Code Section 368(a)(1)(B), the acquiring corporation must "control" the target corporation "immediately after" the acquisition. The definition of "control" is set forth above. The definition of a Code Section 368(a)(1)(B) Reorganization requires not only that the acquiring corporation obtain control of the target corporation in the acquisition, but also that such control exist "immediately after" such acquisition. Read literally, the "immediately after" caveat to the "control" requirement generally would be meaningless in that it would always be satisfied. However, neither the courts nor the Service view this limitation to the control determination so narrowly. Thus, "control" will not be satisfied if, at the time of the transaction, the acquiring corporation is under a binding commitment, or arguably has a plan or intent, to dispose of an amount of target corporation stock

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I.R.S Gen. Couns. Mem. 34979, the Service noted that "the inquiry [of whether a particular share qualifies as voting stock] is focused entirely upon the question of the effect of the particular arrangement upon the character of the stock issued rather than upon the capacity of the shareholder who received the shares in question." I.R.S. Gen. Couns. Mem. 34979 (Aug. 8, 1972); *see also Erie Lighting Co. v. Comm'r*, 93 F.2d 883, 885 (1st Cir. 1937), *rev'g* 35 B.T.A. 906 (1937); *Vermont Hydro-Electric Corp. v. Comm'r*, 29 B.T.A. 1006, 1010 (1934), *acq.* XII-1 C.B. 16 (1934). In addition, I.R.S. Gen. Couns. Mem. 34979 provides that "the apparent purpose of the 'solely' for 'voting stock' requirement contained in the (B) definition was to codify the continuity of interest requirement so as to ensure that none of the shareholders of an acquired corporation in effect 'sold' his shares for nonstock consideration pursuant to a reorganization transaction. *See* H. Rept. No. 704, 73d Cong., 2d Sess. 13, 14 (1934); S. Rept. No. 558, 73d Cong., 2d Sess. 16, 17 (1934). Consequently, the statutory requirement focuses attention upon the nature of the interest received by the shareholders of the acquired corporation rather than upon their ability to exercise the voting privilege with which the shares of stock received by them are invested. *For this reason, the phrase employed by Congress in adopting the original statutory forerunner of the present (B) definition utilizes language that is specifically descriptive of the stock interest itself*." *Id.* (emphasis added); *see also* I.R.S Gen. Couns. Mem. 34958 (Jul 21, 1972) (discussing the meaning of the Voting Stock Requirement). As noted above, we have not reviewed the Delaware limited liability company laws since this is out of scope for the purpose of this paper. However, even if Delaware has a law similar to that of the DGCL with respect to limited liability companies prohibiting SubCo1 from exercising voting rights with respect to the USCO Interests owned by it, such interests should still have been treated as voting stock for Code Section 368(a)(1)(B) purposes. This is because, under the authorities discussed above, whether the right to vote is inherent in the USCO Interests is the focus, not whether SubCo1 is able to exercise that right. As the right to vote is inherent in the USCO Interests, such interests should be treated as "voting" shares for purposes of Code Section 368(a)(1)(B), regardless of whether the particular interest holder owning such interests has the legal right under state law to exercise its voting privileges.

that reduces the acquiring corporation's stock ownership to below the 80% requirement of Code Section 368(c).[25]

SubCo1 acquired 100% of the outstanding stock of RnDSub in the RnDSub Stock Acquisition. Because SubCo1 acquired more than 80% of the total combined voting power of all classes of stock entitled to vote and more than 80% of the total number of shares of each other class of stock, SubCo1 controlled RnDSub immediately after the Triangular B Reorganization. Therefore, the Control Immediately After Requirement should have been met in the Triangular B Reorganization.

5. Business Purpose Requirement

A transaction must also satisfy the Business Purpose Requirement to qualify as a Code Section 368(a)(1)(B) Reorganization. Under 26 C.F.R. § 1.368-2(g), to qualify for reorganization status, a transaction "must be undertaken for reasons germane to the continuance of the business of a corporation [that is] a party to the reorganization." Therefore, a transaction will qualify as a reorganization only if it is undertaken for a valid business purpose, to wit, one unrelated to federal income tax. Once a business purpose is established, the mere presence of tax planning should not cause a reorganization to fail the Business Purpose Requirement so long as such tax planning has economic substance, and each step has independent, permanent legal and economic effect. Note that while it is unclear whether the business purpose may be manifested at the shareholder level, as opposed to the corporate level, several courts have accepted a shareholder business purpose in finding valid reorganizations.[26]

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25 *See* Rev. Rul. 79-194, 1979-1 C.B. 145 (providing that where a transferor in a putative Code Section 351 exchange sells some of the shares of stock received pursuant to a binding agreement entered into prior to the exchange, the Code Section 351(a) control requirement (set forth in Code Section 368(c)) is determined after the sales of the stock)). *See also Intermountain Lumber Co. & Subsidiaries v. Comm'r*, 65 T.C. 1025, 1033 (1976) (holding that, where more than 20% of a single class of voting common stock was sold to third parties who were not in substance co-transferors in a Code Section 351 exchange, the control requirement was not met), *Hazeltine Corp. v. Comm'r*, 89 F.2d 513, 518 (3d Cir. 1937); *Manhattan Bldg. Co. v. Comm'r*, 27 T.C. 1032, 1042 (1957); Rev. Rul. 70-140, 1970-1 C.B. 73 (ruling that incorporation followed by planned exchange of stock for stock of public company broke Code Section 368(c) control); Rev. Rul. 70-522, 1970-2 C.B. 81 (ruling that a reciprocal agreement to exchange 49% of stock of newly organized subsidiaries broke Code Section 368(c) control for both transferors); Rev. Rul. 79-70, 1979-1 C.B. 144 (providing that the Code Section 368(c) control requirement of Code Section 351 is not met where a transferor loses control of a corporation pursuant to a binding agreement to sell stock of the corporation entered into prior to or at the same time as the Code Section 351 transaction). *Cf.* PLR 9845012 (Aug. 6, 1998) (noting that the "Binding Commitment Doctrine," as established in *Hazeltine*, *supra*, and other authorities has been applied for purposes of Code Section 351 and for other tax purposes, and thus it is appropriate to apply this doctrine for Code Section 1239 purposes and, referencing as an example, a situation in which the Binding Commitment Doctrine had been so applied in *Berry Petroleum Co. v. Comm'r*, 104 T.C. 584, 651 (1995) (here, the court applied said doctrine to the Code Section 382(l)(4) "immediately after" standard)).

26 *Survaunt v. Comm'r*, 162 F.2d 753, 758 (8th Cir. 1947); *Lewis v. Comm'r*, 176 F.2d 646, 650 (1st Cir. 1949) (rejecting an argument that a valid shareholder purpose cannot satisfy the business

USCCORP could have undertaken the Restructuring as a whole for a number of business reasons. These business reasons include allowing USCORP to simplify its existing legal entity structure with a view towards moving substantially all of USCORP's foreign assets and operations underneath a single foreign holding company. Toward that end, the USCORP Group's newly acquired companies were integrated into USCORP's foreign operating structure. With respect to the Triangular B Reorganization, the principal business purpose was a desire on the part of USCORP to integrate RnDSub into USCORP's foreign operating structure under SubCo1. Further, the Restructuring will facilitate the future tax-efficient movement of cash between foreign entities, including those in different lines of business. The Restructuring resulted in the single foreign holding company having an enhanced ability to borrow in the future, thereby facilitating its ability to effectuate the integration transactions described herein and to obtain future cash from foreign affiliates. Therefore, the Triangular B Reorganization should have satisfied the Business Purpose Requirement.

6. Plan of Reorganization

To qualify as a Code Section 368(a)(1)(B) Reorganization, the Triangular B Reorganization must have been effectuated pursuant to a plan of reorganization.[27] The Regulations provide that a plan of reorganization must be adopted by each of the corporations that are parties to the reorganization.[28] Furthermore, 26 C.F.R. §1.368-2(g) defines the term "plan of reorganization" as follows:

> The term "plan of reorganization" has reference to a consummated transaction specifically defined as a reorganization under Section 368(a). The term is not to be construed as broadening the definition of "reorganization" as set forth in Section 368(a), but it is to be taken as limiting the nonrecognition of gain or loss to such exchanges or distributions as are directly a part of the transaction specifically described as a reorganization in Section 368(a).

Each transaction in the Restructuring occurred pursuant to a step plan in which the rights of the parties were clearly defined. Based on the foregoing, the Triangular B Reorganization, as part of the overall Restructuring, should have satisfied the Plan Requirement.

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purpose requirement and stating that it was "unrealistic and impractical" to distinguish between corporate and shareholder purposes, especially in a closely-held setting); *Estate of Parshelsky v. Comm'r*, 303 F.2d 14, 19 (2d Cir. 1962) (concluding that, in a closely held corporate setting, the shareholders and corporation are virtually indistinguishable and thus a non-tax shareholder purpose may be sufficient).

27 26 C.F.R. §1.368-1(c) (2011) ("A plan of reorganization must contemplate the bona fide execution of one of the transactions specifically described in Section 368(a). . .").

28 26 C.F.R. §1.368-3(a) (2011).

### 7. Continuity of Business Enterprise Requirement

26 C.F.R. § 1.368-1(b) provides that requisite to a reorganization under Code Section 368, including one under Code Section 368(a)(1)(B),[29] is a continuity of the business enterprise under modified corporate form as described in 26 C.F.R. § 1.368-1(d). 26 C.F.R. § 1.368-1(d)(1) provides that the acquiring corporation must either (i) continue the target corporation's historic business or (ii), use a significant portion of the target corporation's historic business assets in a business. It also should be noted that, in certain types of reorganizations (such as triangular B reorganizations), it is the corporation in control of the acquiring corporation and whose stock is exchanged in the reorganization, rather than the acquiring corporation itself, that must continue the acquired corporation's historic business or use a significant portion of the acquired corporation's historic business assets in a business.[30] In addition, as a general matter, the step transaction doctrine applies in determining the scope of a supposed reorganization and the fulfillment of the COBE Requirement.[31]

In determining whether the issuing corporation satisfies either of the above two tests, it is treated as holding all the businesses and assets of all the members of its qualified group.[32] The term "qualified group" means one or more chains of corporations connected through stock ownership with the issuing corporation, but only if (a) the issuing corporation directly owns stock meeting the requirements of Code Section 368(c) in at least one other corporation, and (b), stock meeting the requirements of Code Section 368(c) in each corporation (except the issuing corporation) is owned directly by one of the other corporations.[33] As discussed above, Code Section 368(c) provides that the term "control" means the ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote, and at least 80% of the total number of shares of all other classes of stock of the corporation.

In the present case, the COBE Requirement should have been satisfied if USCO, the issuing corporation, either (1) continued a significant historic business

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29 Rev. Rul. 81-92, 1981-1 C.B. 133 (ruling that treatment as a Code Section 368(a)(1)(B) reorganization was precluded where the target corporation subsequently sold off all of its historic assets for cash and reinvested the proceeds in a new business). Following the promulgation of 26 C.F.R. §1.368-1(d)(4), this revenue ruling presumably was subsumed therein.

30 26 C.F.R. §1.368-1(d)(1) (2011) (imposing the COBE Requirement on the "issuing corporation"); 26 C.F.R. §1.368-1(b) (2011) (defining "issuing corporation" as the "acquiring corporation" (as that term is used in Code Section 368(a)), except that, in determining whether a reorganization qualifies as a triangular reorganization (as defined in 26 C.F.R. §1.358-6(b)(2)), the issuing corporation means the corporation in control of the acquiring corporation").

31 *See* 26 C.F.R. § 1.368-1(d)(5), Ex. (5) (2011). In this example, T manufactures farm machinery and P operates a lumber mill. T merges into P. P disposes of T's assets immediately after the merger as part of the plan of reorganization. The example concludes that P does not continue T's farm machinery business and, therefore, the COBE Requirement is not satisfied. Accordingly, sales of the historic T business after the putative reorganization that are part of the plan of reorganization violate the COBE Requirement.

32 26 C.F.R. § 1.368-1(d)(4)(i).

33 *Id.* § 1.368-1(d)(4)(ii).

of the Triangular B Target or (2), used a significant portion of the Triangular B Target's historic business assets in a business. For purposes of the COBE Requirement, USCO should have been treated as owning all the business assets and conducting the businesses owned and operated by members of its "qualified group" as defined in 26 C.F.R. § 1.368-1(d)(4)(ii). USCO's qualified group, as relevant to the instant analysis, included SubCo1 and the Triangular B Target. Therefore, because (i) USCO had no plan or intention to dispose of any SubCo1 stock and (ii), SubCo1 had no plan or intention to dispose of any of the Triangular B Target's historic business assets, except in the ordinary course of business, the COBE Requirement should have been satisfied.

8. Continuity of Interest Requirement

The purpose of the COI Requirement is to prevent transactions that resemble sales from qualifying for nonrecognition of gain or loss available to reorganizations.[34] As interpreted by the courts, the COI Requirement generally focuses on the character of the consideration received in the acquisition by the former shareholders of the target corporation. If a sufficient portion of such consideration consists of instruments that carry the requisite degree of continuity of proprietary interest, the COI Requirement is satisfied. Thus, the COI Requirement generally requires that the shareholders of the target corporation receive equity[35] in the acquiring corporation that represents a significant percentage of the value of the target corporation.[36] In addition, it should be noted that the COI Requirement, in certain reorganizations (such as triangular B reorganizations), may be satisfied where the target shareholders receive a meaningful equity interest in a corporation that is in control of the acquiring corporation.[37]

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34 *See* 26 C.F.R. § 1.368-1(e)(1)(i).

35 Equity consideration is the only consideration taken into account for purposes of determining whether the COI Requirement is satisfied. While non-voting equity is taken into account, other types of interests that may become equity are not considered for purposes of testing the COI Requirement. *See* Rev. Rul. 69-91, 1969-1 C.B. 106 (deciding that a convertible debenture was not included in testing whether COI Requirement is met); 26 C.F.R. § 1.354-1(e) (2016) (providing that options and warrants considered to be securities for purposes of Code Section 354); Helvering v. Sw. Consolidated Corp., 315 U.S. 194, 200-01 (1942) (refusing to treat warrants as stock for purposes of determining whether a transaction qualified as a reorganization).

36 *See, e.g.*, Pinellas Ice & Cold Storage Co. v. Comm'r, 287 U.S. 462 (1933); Helvering v. Mn. Tea Co., 296 U.S. 378 (1935); John A. Nelson v. Helvering, 296 U.S. 374 (1935); LeTulle v. Scofield, 308 U.S. 415 (1940); Sw. Natural Gas Co. v. Comm'r, 189 F.2d 332 (5th Cir. 1951), *cert. denied* 342 U.S. 860 (1951).

37 26 C.F.R. §§ 1.368-1(e)(1)(i) (providing that a proprietary interest in the target corporation is preserved if it is exchanged for a proprietary interest in the "issuing corporation"), 1(b) (defining "issuing corporation as the acquiring corporation (as that term is used in Code Section 368(a)), except that, in determining whether a reorganization qualifies as a triangular reorganization (as defined in 26 C.F.R. § 1.358-6(b)(2)), the issuing corporation means the corporation in control of the acquiring corporation").

The courts have never established a bright-line test for determining the percentage of the value of the target corporation that must be exchanged for equity in the acquiring corporation to satisfy the COI Requirement. Instead, the courts have examined all the facts and circumstances surrounding the transaction to determine whether the COI Requirement was satisfied, including the attributes of the equity interest received.[38] However, the Service's private letter ruling guidelines provide that the COI Requirement is satisfied if there is a continuing interest through stock ownership in the acquiring corporation on the part of the former shareholders of the target corporation that is equal in value to at least 50% of the value of all the formerly outstanding stock of the target corporation.[39] For this purpose, sales, redemptions, and other dispositions of stock occurring prior or subsequent to the exchange that are part of the reorganization plan will be considered in determining whether there is a 50% continuing interest through stock ownership as of the effective date of the reorganization.[40]

Based on the foregoing, because (i) the Triangular B Target Shareholder received solely voting interests in USCO, a corporation for U.S. federal income tax purposes in control of the acquiring corporation, SubCo1, and whose interests were exchanged for the Triangular B Target's stock, in the RnDSub Stock Acquisition; (ii) there were no redemptions or purchases of such USCO Interests by USCO or a related party in connection with the plan of reorganization; and (iii), the Triangular B Target did not make a redemption or extraordinary distribution with respect to its stock prior to and in connection with the plan of reorganization, the COI Requirement should have been satisfied in the Triangular B Reorganization.

9. Net Value Requirement

Proposed Regulations published in 2005 would modify 26 C.F.R. § 1.368-1(b)(1) to add the requirement for certain reorganizations under Section 368 that there be an exchange of net value.[41] Similar to the COI Requirement, the purpose of the Net Value Requirement is to prevent transactions that resemble sales from receiving nonrecognition treatment.[42]

Under the proposed Regulations, to qualify as a Code Section 368(a)(1)(B) reorganization, there would need to be both the surrender of net value and the receipt of net value. Specifically, the proposed Regulations provide that there would be a surrender of net value if the fair market value of the target

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38 *See*, *e.g.*, John A. Nelson Co. v. Helvering, 296 U.S. 374, 376-77 (1935) (holding that the COI Requirement was met with 38% continuity but failing to establishing a bright-line rule).

39 *See* Rev. Proc. 77-37, 1977-2 C.B. 568, at § 3.02.

40 *See id.*

41 Transactions Involving the Transfer of No Net Value, 70 Fed. Reg. 11903 (proposed Mar. 10, 2005) (to be codified at 26 C.F.R. pt. 1). Note that the Net Value Requirement would not apply to reorganizations under Code Section 368(a)(1)(E) or (F) and certain reorganizations under Code Section 368(a)(1)(D).

42 *See* Creditor Continuity of Interest, 73 Fed. Reg. pmbl. 75566, (Dec. 12, 2008) (to be codified at 26 C.F.R. pt.1).

corporation's assets exceeds the sum of the value of the target corporation's liabilities immediately before the transaction, plus the amount of money and value of other property that the target's shareholders received in the transaction (other than stock permitted to be received under Code Section 354 without the recognition of gain and nonqualified preferred stock within the meaning of Code Section 351(g)).[43] In addition, for there to be a receipt of net value, the fair market value of the assets of the issuing corporation must exceed the amount of its liabilities immediately.[44]

For the Net Value Requirement to be met, as discussed above, there must be both the surrender of net value and the receipt of net value. Based on the Representations, the fair market value of Triangular B Target's assets exceeded the value of such Triangular B Target's liabilities immediately before the transaction. Further, as discussed below, the Triangular B Target Shareholder did not receive any money or other property (other than the USCO Interests permitted to be received under Code Section 354 without the recognition of gain). Thus, there should have been a "surrender" of net value of the assets in the Triangular B Reorganization. The first prong of the "Net Value" Requirement should have been satisfied. Furthermore, if after the Restructuring, the fair market value of the assets in USCO, the issuing corporation, exceeded the amount of its liabilities, then the second prong of the Net Value Requirement also should have been satisfied in the Triangular B Reorganization.

#### 10. Conclusion

In sum, for the reasons discussed above, all the requirements for a triangular B reorganization should have been satisfied in the Triangular B Reorganization.

## III. Consequences of a Code Section 368(a)(1)(B) Reorganization

Generally, a transaction described in the reorganization provisions of the Code is eligible for tax-free treatment. The specific rules providing treatment for the various parties are discussed below.

### *A. Treatment of the Target Shareholder*

#### 1. Non-recognition of Gain or Loss

In general, no gain or loss is recognized if stock or securities in a corporation that is considered to be a party to a reorganization, in pursuance of the plan of reorganization, are exchanged solely for stock or securities in such

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43 Transactions Involving the Transfer of No Net Value, 70 Fed. Reg. 11903 (proposed Mar. 10, 2005) (to be codified at 26 C.F.R. pt. 1).

44 *Id.*

corporation or in another corporation a party to the reorganization.[45] As discussed above, the term "stock" is not defined for purposes of Code Section 354; however, "nonqualified preferred stock" as defined in Code Section 351(g)(2) is not treated as "stock" for this purpose.[46]

The term "party to a reorganization" includes a corporation resulting from a reorganization and both corporations, in the case of a reorganization resulting from the acquisition by one corporation of the stock or property of another.[47] Generally, in the case of a Code Section 368(a)(1)(B) reorganization, both the acquiring corporation and the target corporation, but not the shareholder of target (whether or not a corporation), are "a party to a reorganization."[48] Also, in the case of a reorganization qualifying under Code Section 368(a)(1)(B) or Code Section 368(a)(1)(C), if the stock exchanged for the stock or properties is stock of a corporation that is in control of the acquiring corporation, the term "a party to a reorganization" includes the corporation controlling the acquiring corporation.[49]

A "plan of reorganization" refers to a consummated transaction specifically defined as a reorganization under Code Section 368(a).[50] A plan of reorganization must contemplate the bona fide execution of one of the transactions specifically described as a reorganization in Code Section 368(a) and the bona fide consummation of each of the requisite acts under which nonrecognition of gain is claimed.[51]

2. Basis and Holding Period

The basis to the target shareholders of the property permitted to be received under Code Section 354 nonrecognition is the same as that exchanged.[52]

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45 26 U.S.C. § 354(a)(1). As is the case under Code Section 368(a)(1)(B), the term "solely" must be applied literally; thus, the receipt of any consideration other than stock or securities precludes the application of Code Section 354(a)(1). 26 C.F.R. § 1.354-1(c) (stating that Code Section 354 is not applicable to such exchanges if there is received property other than stock or securities). Also, under Code Section 354(a)(2)(B), the receipt of stock or securities in consideration other than for stock or securities in a party to the reorganization (*e.g.*, securities received with respect to accrued but unpaid interest) is not eligible for tax-free treatment under Code Section 354(a)(1).

46 26 U.S.C. § 354(a)(2)(C).

47 26 U.S.C. § 368(b)(2).

48 26 C.F.R. § 1.368-2(f) (2023). For example, both Corporation O and Corporation P, but not Corporation S, are parties to the reorganization if Corporation O acquires stock of Corporation P from Corporation S in exchange solely for a part of the voting stock of Corporation O, if (i) the stock of Corporation P does not constitute substantially all of the assets of Corporation S; (ii) Corporation S is not in control of Corporation O immediately after the acquisition; and (iii) Corporation O is in control of Corporation P immediately after the acquisition. *Id.*

49 *Id*.

50 26 C.F.R. § 1.368-2(g).

51 26 C.F.R. § 1.368-1(c); *see also* 26 C.F.R. § 1.368-2(g) (providing that the transaction, or series of transactions, included in a plan of reorganization must not only come within the specific language of Code Section 368(a), but the readjustments involved in the exchanges or distributions effected in the consummation thereof must be undertaken for reasons germane to the continuance of the business of a corporation a part to the reorganization).

52 26 U.S.C. § 358(a)(1).

Moreover, the holding period of the stock or securities received by shareholders in a reorganization includes the holding period of the stock or securities surrendered in exchange therefor, provided that such original stock or securities were held as capital assets or as Code Section 1231 property.[53]

### 3. Application to the Triangular B Target Shareholder

We will assume that no stock issued or deemed issued in a Restructuring Transaction was stock that is limited and preferred as to dividends or that it does not participate in corporate growth beyond a limited dividend or liquidation preference. Rather, the stock issued (or deemed issued for U.S. federal income tax purposes) in each Restructuring Transaction in which shares (or an equity interest) were issued or deemed issued for U.S. federal income tax purposes entitles its holder to fully participate, without limitation, in any future growth in the issuer's earnings and asset values. At any time after the 20-year anniversary of the issue date of any USCO Interests, the holder of such interests may require the redemption of all or a portion of such interests by USCO. There is no such right within the initial 20-year period. Because the USCO Interests entitle its holder to fully participate, without limitation in any future growth in USCO's earnings and assets values and the redemption right cannot be exercised within the 20-year period after the issue date of the USCO Interests, such interests should not have been "nonqualified preferred stock" within the meaning of Code Section 351(g)(2), and the Triangular B Target Shareholder should have been treated as receiving stock for purposes of Code Section 354.

With regards to the Triangular B Reorganization, the Triangular B Target, SubCo1, and USCO —the corporation controlling SubCo1 and whose interests were exchanged for the Triangular B Target's stock—were parties to a reorganization. Moreover, because USCORP formulated, analyzed, approved, and adopted a single, integrated plan to execute the foregoing steps, it has executed a plan of reorganization. Accordingly, the Triangular B Target Shareholder should have recognized no gain or loss on the exchange, pursuant to the plan of reorganization, of its stock in the Triangular B Target, a party to the reorganization, for interests in USCO another party to the reorganization.

The Triangular B Target Shareholder's basis in the USCO Interests received should have been the same as its basis in the Triangular B Target's stock exchanged, immediately before the RnDSub Stock Acquisition. The Triangular B Target Shareholder's holding period of the USCO Interests should have included the period during which it held the stock of the Triangular B Target.

## *B. Treatment of the Target Corporation*

Code Section 361(a) provides that no gain or loss is recognized by a corporation that is a party to a reorganization if it exchanges property, in

53 26 U.S.C. § 1223(1).

pursuance of a plan of reorganization, solely for stock or securities in another corporation that is a party to the reorganization. Also, no gain or loss is generally recognized to a corporation that is a party to a reorganization on the distribution to its shareholders of property in pursuance of the plan of reorganization.[54]

In the case of a Code Section 368(a)(1)(B) reorganization, Code Section 361 is inapplicable. This result is obtained because the target is not within the scope of Code Section 361 as it is neither exchanging nor distributing any property in the transaction.[55]

The existence of the target corporation's tax attributes is generally unaffected by the occurrence of a Code Section 368(a)(1)(B) reorganization.[56] Thus, such tax attributes simply continue through the transaction.[57]

Concerning the Triangular B Target, no gain or loss should have been realized in the Triangular B Reorganization, and thus, Code Section 361 should have had no effect. Moreover, the Triangular B Target should have preserved all its U.S. federal tax attributes.

### *B. Treatment of the Acquiring Corporation*

#### 1. Nonrecognition of Gain or Loss

Generally, no gain or loss is recognized by a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation.[58] For this purpose, in certain reorganizations (such as a triangular B reorganization, as described in 26 C.F.R. § 1.358-6(b)), stock of the controlling corporation given to the target shareholders pursuant to the plan of reorganization is treated as a disposition by the controlling corporation of shares of its own stock for the target's stock.[59] In other words, neither the acquiring corporation nor the controlling corporation recognizes gain or loss on the exchange of controlling

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54 26 U.S.C. § 361(c)(1).

55 Moreover, Code Section 361 is inapplicable to the target shareholder since, under 26 C.F.R. § 1.368-2(f), it is not "a party to a reorganization," and the acquiring corporation also is not within the scope of Code Section 361 since its tax treatment is expressly governed by Code Section 1032.

56 *Cf.* 26 U.S.C. § 381(a) (providing tax attribute successor rules in the case of liquidations under Code Section 332 and certain types of reorganizations (not including those described in Code Section 368(a)(1)(B))).

57 While the existence of attributes generally is unaffected by a Code Section 368(a)(1)(B) reorganization, the ability to use such attributes may be changed. *See*, *e.g.*, 26 U.S.C. § 269, 382, 383, and 384.

58 26 U.S.C. § 1032(a); *see also* 26 C.F.R. § 1.1032-1(a).

59 26 C.F.R. § 1.1032-2(b); *see also* 26 C.F.R. § 1.1032-2(d), Example 1 (T has assets with an aggregate basis of $60 and a fair market value of $100 and no liabilities. Pursuant to a plan, P forms S by transferring $100 of P stock to S and T merges into S. In the merger, the T shareholders receive, in exchange for their T stock, the P stock that P transferred to S. The transaction is a reorganization to which Code Sections 368(a)(1)(A) and (a)(2)(D) apply. Under 26 C.F.R. § 1.1032-2(b), the P stock provided by P pursuant to the plan of reorganization is treated for purposes of 26 C.F.R. § 1.1032-1(a) as disposed of by P for the T assets acquired by S in the merger. Consequently, neither P nor S has taxable gain or deductible loss on the exchange.).

corporation stock for the target corporation stock when the stock is "*provided by*" the controlling corporation.[60] As discussed above, a "triangular Section 368(a)(1)(B) reorganization" is an acquisition of a target corporation by a controlled subsidiary in exchange for stock of the parent corporation in control of such subsidiary via a transaction that qualifies as a reorganization under Code Section 368(a)(1)(B).[61]

However, where the stock of the controlling corporation is not "*provided by*" such corporation, the acquiring corporation must recognize gain or loss to the extent the value of stock received in the triangular B reorganization exceeds the acquiring corporation's tax basis in the controlling corporation stock.[62] When the acquiring corporation purchases the controlling corporation's stock from someone other than the controlling corporation, the gain/loss analysis is generally straightforward. However, when the acquiring corporation acquires the controlling corporation's shares from the controlling corporation, and such an acquisition could be viewed as a Code Section 351 exchange, the analysis is less clear.[63]

In Rev. Rul. 68-629,[64] the Service concluded that a transferor has a zero basis in its own debt obligation and, hence, does not reduce its gain recognition under Code Section 357(c) by the principal amount of the obligation in cases in which the liabilities assumed by the transferee corporation exceed the aggregate adjusted basis of the other property transferred in the exchange. In *Lessinger v. Commissioner*,[65] however, the Second Circuit held that: (i) because a transferor obligation is not an asset in the transferor's hands, there is no transfer of zero basis property to the transferee corporation; (ii) because the transferor obligation is property in the hands of the transferee corporation and is received in exchange for property equal in value to the issue price of the obligation, it is proper to view the transferee corporation as having full basis in the transferor obligation; and (iii) the measure of gain under Code Section 357(c) is the excess of assumed liabilities over the basis of the transferred property in the hands of the transferee corporation, resulting in no Code Section 357(c) gain due to the full basis held by

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60 *Id*.

61 26 C.F.R. § 1.358-6(b)(2)(iv).

62 26 C.F.R. § 1.1032-2(c); *see also* 26 C.F.R. § 1.1032-2(d), Example 2 (T has assets with an aggregate basis of $60 and a fair market value of $100 and no liabilities. S is an operating company with substantial assets that has been in existence for several years. S also owns P stock with a $20 adjusted basis and $30 fair market value. S acquired the P stock in an unrelated transaction several years before the reorganization. Pursuant to a plan, P transfers additional P stock worth $70 to S and T merges into S. In the merger, the T shareholders receive $100 of P stock ($70 of P stock provided by P to S as part of the plan and $30 of P stock held by S previously). The transaction is a reorganization to which Code Sections 368(a)(1)(A) and (a)(2)(D) apply. Under 26 C.F.R. § 1.1032-2(c), S must recognize $10 of gain on the P stock not provided by P pursuant to the plan of reorganization.)

63 *See, e.g., Alderman v. Comm'r*, 55 T.C. 662, 665-66 (1971); *Lessinger v. Comm'r*, 85 T.C. 824, 834-36 (1985); *Peracchi v. Comm'r*, 143 F.3d 487, 489 (1998), *rev'g* 71 T.C.M. (CCH) 2830 (1996); Rev. Rul. 68-629, 1968-2 C.B. 154.

64 Rev. Rul. 68-629; 1968-2 C.B. 154.

65 872 F.2d 519, 524-25 (2d Cir. 1989), *rev'g* 85 T.C. 824 (1985).

the transferee corporation in the transferor obligation. The circularity of the third holding in *Lessinger* is that the basis of property in the hands of the transferee corporation is determined under Code Section 362(a) to be the basis in the hands of the transferor plus gain recognized by the transferor. In a case where there are no assumed liabilities under Code Section 357(c), as here, the better view is the first two holdings of the Second Circuit in *Lessinger*.

2. Basis and Holding Period

Where property is acquired in connection with a reorganization, such corporation's basis in the acquired property is same as it would be in hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer.[66] The holding period of the property so acquired shall include the period during which the target shareholder held such property.[67]

3. Application to SubCo1

SubCo1 should not have recognized any gain on the transfer of the USCO Interests to the Triangular B Target Shareholder in the Triangular B Reorganization. SubCo1 should not have recognized any gain because either: (1) the USCO Interests are treated as "*provided by*" USCO and hence 26 C.F.R. § 1.1032-2(b) applies to protect SubCo1from gain recognition; (2) SubCo1acquired the USCO Interests from USCO in a transaction that could not qualify as a Section 351 exchange due to SubCo1's preexisting obligation to transfer such shares to the Triangular B Target Shareholder, hence SubCo1 had a fair market value basis in the USCO Interests at the time of the transfer; and/or (3) even if Code Section 351 could be applied to SubCo1's acquisition of the USCO Interests, the concepts of *Lessinger* should have applied to give SubCo1 a fair market value basis in the USCO Interests.

Regarding item (2) above, SubCo1 entered into a binding commitment prior to acquiring the USCO Interests to dispose of such interests as part of the Triangular B Reorganization. Because that disposition was made to a person (the Triangular B Target Shareholder) that is not a co-transferor of property to USCO, there was a compelling argument that Rev. Rul. 79-194[68] does not apply to treat SubCo1 as a transferor of property to USCO in exchange for the USCO Interests for purposes of Code Section 351. Since SubCo1 was not a transferor of property to USCO in exchange for the USCO Interests for purposes of Code Section 351,

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66 26 U.S.C. § 362(b) (also noting that this rule does not apply if the property acquired consists of stock or securities in a corporation and/or a party to the reorganization, unless acquired by the exchange of stock or securities of the transferee (or of a corporation which is in control of the transferee) as consideration in whole or in part for the transfer); *see also* 26 C.F.R. § 1.358-4(a) (indicating that, with respect to a plan of reorganization adopted after October 22, 1968, Code Section 362, rather than Code Section 358, applies to determine the basis of property acquired in the reorganization).

67 26 U.S.C. § 1223(2).

68 Rev. Rul. 79-194,1979-1 C.B. 145.

SubCo1 should not have taken a carryover basis in the USCO Interests received in exchange for Promissory Note 2. Therefore, SubCo1 had a tax basis in the USCO Interests received in exchange for Promissory Note 2 equal to such interests' fair market value.

With respect to item (3) above, the proper view is that SubCo1 should have had a fair market basis in the USCO Interests upon receipt. This view is correct because, inter alia, (i) a transferor obligation (such as Promissory Note 2) is not an asset in the transferor's hands (here, SubCo1) and, therefore, there is no transfer of zero basis property to the transferee corporation (USCO), and (ii) the transferor obligation is property in the hands of the transferee corporation and is received in exchange for property equal in value to the issue price of the obligation. Thus, SubCo1 should have been treated as receiving the USCO Interests in exchange for the value of Promissory Note 2.

SubCo1's basis in the stock of the Triangular B Target should be the same as that in the hands of the Triangular B Target Shareholder immediately before the RnDSub Stock Acquisition. Further, because the Triangular B Target Shareholder should have, as explained above, recognized no gain on the exchange, there should have been no increase to SubCo1's basis in its stock of the Triangular B Target. Therefore, SubCo1's holding period for the stock of the Triangular B Target should have included the period during which the Triangular B Target Shareholder held such stock.

### C. *Treatment of Issuing Corporation*

#### 1. Nonrecognition of Gain or Loss

As stated above, generally, no gain or loss is recognized by a corporation on the receipt of money or other property in exchange for stock, including treasury stock, of such corporation.[69] Also, as stated above, in the case of a triangular B reorganization, stock of the controlling corporation provided by the controlling corporation to the target shareholders pursuant to the plan of reorganization is treated as a disposition by the controlling corporation of shares of its own stock for the target's stock.[70]

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69 26 U.S.C. § 1032(a); *see also* 26 C.F.R. § 1.1032-1(a).

70 26 C.F.R. § 1.1032-2(b); *see also* 26 C.F.R. § 1.1032-2(d), Example 1 (T has assets with an aggregate basis of $60 and a fair market value of $100 and no liabilities. Pursuant to a plan, P forms S by transferring $100 of P stock to S and T merges into S. In the merger, the T shareholders receive, in exchange for their T stock, the P stock that P transferred to S. The transaction is a reorganization to which Code Sections 368(a)(1)(A) and (a)(2)(D) apply. Under 26 C.F.R. § 1.1032-2(b), the P stock provided by P pursuant to the plan of reorganization is treated for purposes of 26 C.F.R. § 1.1032-1(a) as disposed of by P for the T assets acquired by S in the merger. Consequently, neither P nor S has taxable gain or deductible loss on the exchange.).

2. Basis and Holding Period

26 C.F.R. § 1.358-6 provides rules for computing the basis of a controlling corporation (“P”) in the stock of a controlled subsidiary (“S”) as the result of certain reorganizations involving the stock of P as described in 26 C.F.R. § 1.358-6(b).[71] In general, P’s basis in the stock of S, as a result of a triangular reorganization, is adjusted.[72] Specifically, in a triangular B reorganization, P’s basis in its S stock is adjusted as if (i) P acquired the target (“T”) stock acquired by S in the reorganization directly from the T shareholders in a “carryover basis” transaction in which P’s basis in the T stock was determined under Code Section 362(b) and (ii) P transferred the T stock to S in a “carryover basis” transaction in which P’s basis in its S stock was determined under Section 358.[73] Generally, this will yield a result of P’s basis in the S stock being increased by the aggregate basis of T shareholders in their target stock (the “Triangular B upward basis adjustment”).[74]

However, where the P stock used by S in the triangular B reorganization is not “*provided by*” P, the amount of P’s upward basis adjustment is decreased by the fair market value of any consideration that is exchanged in the reorganization that is not “*provided by*” P as part of the plan of reorganization (the “Triangular B downward basis adjustment”).[75] To avoid a Triangular B downward basis adjustment to P’s historic basis, 26 C.F.R. § 1.358-6(d)(2) provides a special rule that precludes any adjustment to P’s historic basis if the Triangular B downward basis adjustment would otherwise exceed the Triangular B upward basis adjustment.[76]

Where S acquires the P shares used in the triangular B reorganization in exchange for property, it is not clear whether such shares are “*provided by*” P

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71 26 C.F.R. § 1.358-6(a).

72 26 C.F.R. § 1.358-6(c).

73 26 C.F.R. § 1.358-6(c)(3). This result is not affected by 26 C.F.R. § 1.1502-30. 26. C.F.R. § 1.1502-30(b)(1).

74 For example, assume T has assets with a fair market value of $100 and no liabilities. The T shareholders have an aggregate basis in their T stock of $85 immediately before the reorganization. Pursuant to a plan, P forms S with $5 cash and S acquires all of the T stock in exchange for $100 of P stock. The transaction is a reorganization to which Code Section 368(a)(1)(B) applies. Under 26 C.F.R. § 1.358-6(c)(3), P adjusts its $5 basis in its S stock by treating P as if it acquired the T stock acquired by S in the reorganization directly from the T shareholders in exchange for the P stock in a transaction in which P’s basis in the T stock was determined under Section 362(b). Under Code Section 362(b), P would have an aggregate basis of $85 in the T stock received by S in the reorganization. P is then treated as if it transferred the T stock to S in a transaction in which P’s basis in the S stock was determined under Section 358. Under Code Section 358, P’s basis in its S stock would be increased by the $85 basis in the T stock deemed transferred. Consequently, P has a $90 basis in its S stock as a result of the reorganization. 26 C.F.R. § 1.358-6(c)(4), Example 3.

75 26 C.F.R. § 1.358-6(d)(1).

76 Controlling Corporation’s Basis Adjustment in Its Controlled Corporation’s Stock Following a Triangular Reorganization, 59 Fed. Reg. 66280 (proposed Dec. 23, 1994) (to be codified at 26 C.F.R. pt. 1).

within the meaning of 26 C.F.R. § 1.358-6(d)(1). A plain reading of the phrase "*provided by*" suggests that regardless of whether S has paid for the shares, such P shares were in fact "*provided by*" P, just as a service provider "*provides*" services to third parties for compensation. However, treating such shares as having been "*provided by*" P could be viewed as inconsistent with the policy provided by the preamble to the Regulations (the "Preamble").[77]

The Preamble provides that the adoption of the approach suggested by the Regulations "evidences Congressional intent that the basis results in a triangular reorganization should conform to the basis results in its counterpart parent/drop reorganization. Achieving comparability between a triangular reorganization and its counterpart parent/drop reorganization furthers sound tax policy by treating economically comparable reorganizations similarly." Thus, it appears that the Regulations provide for basis adjustments to S's stock basis to equate economically equivalent transactions, such as where P directly acquires T shares and contributes such shares to S. However, where the impact of the basis adjustments would create a different economic result — such as where S purchases the P shares used in the triangular B reorganization, essentially allowing P to "double up" on basis (P obtains basis in both the note and the shares of the acquiring subsidiary) — the policy behind the Regulations may require that P maintain its historical basis in S without any Triangular B upward basis adjustment.

By contrast, if S's "purchase" of P shares is treated as a distribution for U.S. tax purposes, as it is in 26 C.F.R. § 1.367(b)-10, obtaining basis in both the note and other property on one hand, and the S shares on the other , may be appropriate and not counter to the policy underlying 26 C.F.R. § 1.358-6. Further, the constructive distribution and recontribution created by 26 C.F.R. § 1.367(b)-10(b), as discussed below, provides additional arguments that the P shares used in the triangular reorganization are provided by P – primarily because the Regulations state that the deemed distribution is a separate and distinct transaction.

As discussed above, when the acquiring corporation acquires the controlling corporation's shares from the controlling corporation in exchange for an acquiring corporation obligation, and such acquisition could qualify as a Code Section 351 exchange, the analysis as to the controlling corporation's basis in the obligation is less clear.[78] In a case where there are no assumed liabilities under Code Section 357(c), as here, the better view is the first two holdings of the Second Circuit in *Lessinger* that: (i) because a transferor obligation is not an asset in the transferor's hands, there is no transfer of zero basis property to the transferee corporation; and (ii) because the transferor obligation is property in the hands of the transferee corporation and is received in exchange for property equal

77 *Id.*

78 *See Alderman v. Comm'r*, 55 T.C. 662, 665 (1971); *Lessinger v. Comm'r*, 872 F.2d 519, 524-25 (2d Cir. 1989), *rev'g* 85 T.C. 824 (1985); *Peracchi v. Comm'r*, 143 F.3d 487, 489 (9th Cir. 1998), *rev'g* 71 T.C.M. (CCH) 2830 (1996); Rev. Rul. 68-629, 1968-2 C.B. 154.

in value to the issue price of the obligation, it is proper to view the transferee corporation as having a fair market value basis in the transferor obligation.

3. Application to USCO

Under the authorities discussed above, USCO (the corporation controlling SubCo1 and whose interests were used to acquire the stock of the Triangular B Target) should have recognized no gain or loss on the exchange of its interests by SubCo1 for the stock of the Triangular B Target.[79]

The determination of USCO's basis in its SubCo1 stock is not clear and, as discussed above, depends on whether the USCO Interests are treated as being "*provided by*" USCO. SubCo1 purchased the USCO Interests used in the RnDSub Stock Acquisition from USCO in exchange for Promissory Note 2. Accordingly, there is a risk that the USCO Interests purchased would not have been treated as being "*provided by*" USCO. We address the consequences of each alternative below.

If the USCO Interests were treated as having been "*provided by*" USCO, consistent with 26 C.F.R. § 1.358-6(c), USCO should have made a Triangular B upward basis adjustment with respect to its SubCo1 shares as if USCO had acquired the stock of the Triangular B Target directly from the Triangular B Target Shareholder in a Code Section 362(b) transaction. This would give USCO a basis in the stock of the Triangular B Target equal to that in the hands of the Triangular B Target Shareholder immediately before the acquisition of the Triangular B Target. Then, USCO should have transferred the stock of the Triangular B Target to SubCo1 in a transaction to which Code Section 358 applied, increasing USCO's basis in its SubCo1 stock by the stock basis in the Triangular B Target determined under Code Section 362(b) in the previous step. USCO's deemed contribution of the stock of the Triangular B Target to SubCo1 should have been treated for basis purposes as a tax-free Code Section 351 exchange because SubCo1 has nonvoting stock, which makes treatment as a Code Section 368(a)(1)(B) reorganization inapplicable. Therefore, if the shares were treated as being "*provided by*" USCO, USCO should have increased its basis in its SubCo1 shares by a pro rata allocation of the aggregate basis in shares of the Triangular B Target transferred.

As with the Code Section 351 Exchanges, the analysis and rationale of *Fink*[80] and Rev. Rul. 82-112[81] should have been extended to USCO's basis in the SubCo1 shares following the Triangular B Reorganization. Because no stock was issued by SubCo1 in the Triangular B Reorganization, the Triangular B Reorganization was similar to the surrender of shares in *Fink* and Rev. Rul. 82-112. Therefore, similar basis consequences should have resulted. Code Section 367(c)(2) was distinguishable from the Triangular B Reorganization because the provisions of Code Section 367(a) were applied with respect to the Triangular B Reorganization,

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79 *See* 26 U.S.C. § 1032(a); 26 C.F.R. § 1.1032-1(a), -2(b).

80 483 U.S. 89 (1987).

81 Rev. Rul. 82-112, 1982-1 C.B. 59.

as discussed below. Further, the Service ruled that the basis attributable to deemed issued shares in a Code Section 367(c)(2) transaction would be added to the shareholder's existing shares of the transferee corporation or allocated among previously issued shares so that the per share basis would be the same. For these reasons, USCO's basis in its stock of SubCo1 should have been increased by a pro rata allocation of the aggregate basis in shares of the Triangular B Target transferred if the USCO Interests were treated as being "*provided by*" USCO.

On the other hand, if the USCO Interests were treated as not being "*provided by*" USCO, USCO should not have made any adjustment to its historic basis in the SubCo1 shares. Assuming that at the time of the Triangular B Reorganization, the fair market value of each Triangular B Target exceeded the Triangular B Target Shareholder's basis in its Triangular B Target shares. Accordingly, if USCO had been required to make a Triangular B downward basis adjustment with respect to its SubCo1 shares, such an adjustment would have exceeded its Triangular B upward basis adjustment. Therefore, because the Triangular B downward basis adjustment exceeded the Triangular B upward basis adjustment, no adjustment should have been required under 26 C.F.R. § 1.358-6(d)(2) and USCO should have maintained its historic basis in its SubCo1 shares.

USCO should have a fair market value basis in Promissory Note 2 because either: (1) SubCo1 acquired the USCO Interests from USCO in a transaction that could not qualify as a Code Section 351 exchange due to SubCo1's preexisting obligation to transfer such shares to the Triangular B Target Shareholder, hence USCO had a fair market value basis in Promissory Note 2 at the time of the transfer; or (2) even if Code Section 351 could be applied to SubCo1's acquisition of the USCO Interests, the concepts of *Lessinger* should have applied to give USCO a fair market value basis in Promissory Note 2.

Regarding item (1) above, SubCo1 entered into a binding commitment prior to acquiring USCO Interests to dispose of such interests as part of the Triangular B Reorganization. Because that disposition was made to a person (the Triangular B Target Shareholder) that is not a co-transferor of property to USCO. There is a compelling argument that Rev. Rul. 79-194[82] does not apply to treat SubCo1 as a transferor of property to USCO in exchange for the USCO Interests for purposes of Code Section 351. Because SubCo1 was not a transferor of property to USCO in exchange for the USCO Interests for purposes of Code Section 351, USCO should not have taken a carryover basis in Promissory Note 2. Therefore, USCO had a tax basis in Promissory Note 2 equal to such note's fair market value.

With respect to item (2) above, the proper view is that USCO should have had a fair market basis in Promissory Note 2 upon receipt because, inter alia, (i) a transferor obligation (such as Promissory Note 2) is not an asset in the transferor's hands (here, SubCo1). Therefore, there is no transfer of zero basis property to the transferee corporation (USCO). Also, (ii) the transferor obligation is property in the hands of the transferee corporation and is received in exchange

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82 Rev. Rul. 79-194, 1979-1 C.B. 145.

for property equal in value to the issue price of the obligation. Thus, USCO should have been treated as receiving Promissory Note 2 in exchange for the value of the USCO Interests.

## IV. SUMMARY

This paper focused on the most commonly executed tax-free reorganizations. Most scholars and tax practitioners intuitively view such deferral as justified. About a century ago, the corporate income tax environment was very burdensome and the effective tax rates were relatively high, but a lot has changed over the years, so the legislation of such favorable tax provisions is not as necessary now.

Over the years, for instance, corporate income tax rates were reduced significantly, distribution of corporate earning is hardly taxed twice, and the overall corporate tax payments at both the corporate level and at the shareholder level have been significantly decreased. Further, while the corporate structures were predominantly domestic a century ago, we now live in an era of globalization that enables taxpayers to form complex cross-border corporate structures at an affordable price and within reach of even medium size businesses. These changes possibly explain why over the years, the Service and the Courts limited the favorable U.S. federal income tax treatment in a wide variety of triangular B reorganizations. Therefore, we call Congress to reexamine the justification for such favorable tax treatment enacted a century ago when the economic reality and corporate income tax rules were vastly different and cross-border corporate structures were very limited. That is why the time has come to reexamine these provisions in the domestic context, and even more so in the cross-border context as such income tax deferral may possibly end up being fully - or almost fully - exempt from U.S. federal income taxes altogether.