New Final Regulations on Reorgs

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Just days before Halloween, the IRS issued final regulations dealing with transfers of assets and stock following a reorganization. These final regulations also touch on the continuity of business enterprise rules, and even the definition of a "party to a reorganization." In short, in T.D. 9361, Tax Analysts No. 2007-23670, 2007 TNT 207-4, the IRS tackles some big topics.

Not So Ancient History

Not so many years ago, in August of 2004, the IRS proposed regulations dealing with asset and stock transfers after reorganizations. These proposed regulations, REG-130863-04 (69 FR 51209), also included amendments to the continuity of business enterprise regulations, and the definition of a "party to a reorganization." Actually, there were two sets of proposed regulations in 2004. The first iterations (REG-165579-02 (69 FR 9771)), published in March of 2004, were withdrawn. The idea of the 2007 final regulations is to conclude that regulatory debate.

Interestingly, the preamble begins with some pretty fundamental fundamentals, including the axiom that a reorganization is only a readjustment of continuing interests in property under modified corporate forms. Noting the *Groman* and *Bashford* cases from the 1930s, and the "remote" continuity of interest doctrine, the IRS moves from general platitudes about reorganizations to the idea that some level of remoteness is OK, adequately preserving the link between former target shareholders and target business assets.

Noting a few of the seminal pieces of legislation in sub-chapter C over the years, the preamble goes on to talk more about remote continuity. Yet, the IRS notes that it does not (in these current regulations) include separate rules addressing remote continuity. Why? Because the IRS and the Treasury believe these issues are adequately

addressed by the continuity of business enterprise rules in T.D. 8760 (63 FR 4174).

These final regulations continue the IRS's trend of broadening the rules regarding transfers of assets or stock following an otherwise tax-free reorganization, where the transaction adequately preserves the link between former target shareholders and target business assets. For that reason, the definition of "qualified groups" in Reg. §1.368-1(d)(4)(ii) and the rules regarding stock or asset transfers in Reg. §1.368-2(k) have been expanded.

Subsequent Transfers

The final regulations generally adopt the rules announced in the 2004 proposed regulations regarding subsequent transfers of either assets or stock. In general, a transaction that otherwise qualifies as a reorganization will not be disqualified or re-characterized as a result of one or more subsequent transfers (or even successive transfers) of assets or stock. What's most important, though, is that continuity of business enterprise must be satisfied, and the transfers must qualify as distributions or other transfers. [*See* Reg. §1.368-2(k)(1).]

Interestingly, the final regulations take a different approach on the "substantially all" standard. In the case of a distribution of stock over the acquired corporation, the distribution will not incur the wrath of disqualification or re-characterization as long as the distribution consists of less than all of the stock of the acquired corporation that was acquired in the transaction, and as long as it doesn't cause the acquired entity to cease being a member of the qualified group. Second, as to distributions of assets, what is important is that the distributions do not result in a liquidation of the distributing corporation for federal income tax purposes. For this purpose, assets held by the acquiring corporation are disregarded.

Continuity of Business Enterprise

There is much about continuity of business enterprise in these regulations. Continuity of business enterprise, after all, is one of those bellwether subjects meant to parse the line between those transactions meeting the spirit of the reorganization rules and those that don't. That's a heavy task.

The IRS and the Treasury have expanded the definition of a qualified group by allowing group members to aggregate their direct stock ownership of a corporation for purposes of determining whether they own the requisite control as specified in Code Sec. 368(c). This aggregation concept is similar to that found in Code Sec. 1504(a). Repeating the reorganization mantra, the preamble notes that aggregating stock ownership within the qualified group adequately preserves the link between the former target shareholders and the target business assets, while further facilitating the post- acquisition relocation of assets and stock as necessary within the group. What is required is that the issuing corporation must own directly stock meeting the control requirement in at least one other corporation. [*See* Reg. §1.368-1(d)(4)(ii).]

Partnerships

Given all the current interplay between corporate and partnership roles in acquistions today, it is interesting that partnership rules are noted. The IRS has concluded that transfers of corporate stock to a controlled partnership (one in which members of the qualified group own interests meeting requirements that are equivalent to Code Sec. 368(c) control) do adequately preserve the link between the former target shareholders and the target business assets. Thus, reversing the rule announced in former Reg. §1.368-2(k), Example 3, the IRS now allows this "equivalent" 368(c) control standard for transfers of stock to a partnership.

Moreover, the final regulations allow distributions of stock of the acquired corporation and other transfers of stock of the acquired, acquiring or surviving corporation. What is necessary is that the transfer of the stock must not cause the transferred corporation to cease to be a member of the continuity of business enterprise qualified group. To achieve that, the IRS has expanded the continuity of business enterprise regulations to provide that if members of the qualified group own interests in a partnership (again, that meet requirements equivalent to the control defined in Code Sec. 368(c)), any stock owned by such a partnership will be attributed to (and treated as owned by) members of that qualified group. This full stock attribution rule thus treats partnerships in a manner similar to members of the continuity of business enterprise qualified group.