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The Consolidated Group: Continuation and Termination Issues

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THE CONSOLIDATED GROUP: CONTINUATION AND TERMINATION ISSUES

I. INTRODUCTION¹

- A. The continued existence of an affiliated group that is filing consolidated returns (a consolidated group) is important in many respects. The tax consequences associated with the termination of a consolidated group include:
1. Gain or loss on intercompany transactions may be accelerated and taken into income. § 1.1502-13.²
 2. Excess loss accounts may be included in income. § 1.1502-19.
 3. Tax years of members of the terminated group will be separate return limitation years (SRLY). § 1.1502-1(f)(3). Thus, any unused investment tax credits, net operating losses, capital loss carryovers, or other tax attributes of such members will be subject to the SRLY limitations if the overlap rule of § 382 is inapplicable. § 1.1502-3(c), -21(c), -22(c) (see discussion of overlap rule in Section V.E., *infra*). Losses of the group's common parent generally will not be subject to the SRLY rules as a result of the "lonely parent" exception to such limitations. §§ 1.1502-1(f)(2)(i), -1(f)(3), and -75(d)(2)(ii) (second sentence). But see CCA 200441026 (June 25, 2004), discussed in section V.E.2.A below, and CCA 200901031 (June 15, 2006), which limit the applicability of the "lonely parent" exception to certain separate return years of the group's common parent.
 4. With certain exceptions, the requirement of continued filing of consolidated returns is ended. § 1.1502-75(a).

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1. The authors acknowledge and express their appreciation to Andrew J. Dubroff and John Broadbent, whose excellent paper entitled *The Continued Existence of a Group Following a Reverse Acquisition* was an invaluable reference in connection with the development of this outline. Other authorities that were consulted in the preparation of this outline include: Jack Crestol et al., *The Consolidated Tax Return* (5th ed.); Andrew J. Dubroff et al., *Federal Income Taxation of Corporations Filing Consolidated Returns* (2d ed. 1997); Fred W. Peel, Jr., *Consolidated Tax Returns* (3d ed. 1995). The authors also express their appreciation to those who provided assistance in earlier versions of this outline.
 2. Unless otherwise indicated, all references to "§" or "§§" are to the Internal Revenue Code of 1986, as amended, or the regulations issued by the U.S. Department of Treasury, as the case may be.

5. The taxable years of the subsidiaries are terminated if the group is terminated during a taxable year. This may accelerate return filing deadlines. § 1.1502-76.
 6. Life insurance members of a life-nonlife consolidated return may be prohibited from joining in a consolidated return with the nonlife members for five years.
 7. The sole surviving corporation from a series of intragroup mergers may elect to be taxed immediately as an S corporation upon the termination of the consolidated group.
 8. Certain elections previously made by the consolidated group that is terminated will be terminated. See e.g., Priv. Ltr. Rul. 200003012 (Oct. 20, 1999) (ruling that a target corporation's election under § 1.1502-13(l)(3), which applied § 1.1502-13 to stock elimination transactions to which prior law would otherwise apply, was terminated as a result of the target corporation group's termination on its acquisition by an unrelated consolidated group).
 9. If a consolidated group terminates, its members may be precluded for five years from joining in the filing of a consolidated return with another affiliated group with the same common parent (or a successor of such common parent). See section 1504(a)(3).
 10. In general, § 965 (relating to the temporary deduction for dividends received from controlled foreign corporations) applies to a consolidated group as though it is a single taxpayer. Special rules apply to members that join or depart from a group, including a departure caused by the termination of the group. To the extent that subsidiaries enter and leave consolidated groups, eligible dividends received by such subsidiaries may qualify for the § 965 dividends received deduction in multiple groups. See Notice 2005-38 (May 31, 2005) for detailed guidance on the application of § 965 in these situations.
- B. The rules in § 1.1502-75(d), which provide when a group continues or terminates, are essentially "group accounting rules." The requirements that a group continue despite a change in the common parent and that only one of multiple combining groups survives necessarily derive from the continued filing requirement, among other things. See Andrew J. Dubroff et al., *Federal Income Taxation of Corporations Filing Consolidated Returns* § 12.01, at 12-2 (2d ed. 1997).

- C. Due to a conflict in judicial precedents applying the consolidated return regulations, it is uncertain whether the rules governing the continuation of a group will be applied literally or consistent with their somewhat uncertain purposes. *Compare CSI Hydrostatic Testers, Inc. v. Commissioner*, 103 T.C. 398 (1994) (no published administrative authority supporting taxpayer position; literal application of the consolidated return regulations despite contrary policies), *aff'd*, 63 F.3d 136 (5th Cir. 1995), and *Woods Inv. Inc. v. Commissioner*, 85 T.C. 274 (1985) (application of the consolidated return regulations as written; policy decision at issue did not have a clear resolution as evidenced by Treasury/IRS inability to promulgate regulations) *with Wyman-Gordon Co. and Rome Indus., Inc. v. Commissioner*, 89 T.C. 207 (1987) (disregard for the literal language of the consolidated return regulations in light of the policies of the regulations). *See also Walt Disney Inc. v. Commissioner*, 97 T.C. 221 (1991) (deference to the IRS in interpreting consolidated return regulations), *rev'd*, 4 F.3d 735 (9th Cir. 1993); *Saloman Inc. v. United States*, 976 F. 2d 837 (2d Cir. 1992) (same); *Aeroquip –Vickers, Inc. v. Commissioner*, 347 F.3d 173 (6th Cir. 2003) (same). The bright line rules set forth in the regulation for determining when a group continues indicate that the IRS might interpret the rules in accord with their literal language. However, the apparent substance-over-form inquiry required by the regulation militates in favor of interpreting the rules in accord with their purposes. At least in the case of certain transactions analogous to the downstream exception under § 1.1502-75(d)(2)(ii) the IRS has chosen to interpret the regulation consistent with the “single economic entity theory” underlying the consolidated return regulations rather than in accordance with the regulations’ literal language. *See* Rev. Rul. 82-152, 1982-2 C.B. 205, 205-06. More recently, the IRS’ National Office found a reverse acquisition based on the purposes of § 1.1502-75(d)(3), notwithstanding that the literal requirements of the regulation seemingly were not satisfied. *See* Tech. Adv. Mem. 9806003 (Oct. 1, 1997) (finding a reverse acquisition even though, at the completion of the transaction, the former shareholder of the acquired corporation did not have any direct stock ownership interest in the acquiring corporation because it contributed the stock in the acquiring corporation to a wholly owned subsidiary).
- D. The 2002-2003 Priority Guidance Plan indicated that IRS and Treasury would be issuing published guidance regarding “continuation of a consolidated group in certain transactions,” no revisions to the group continuation and termination rules under § 1.1502-75 were

published, although such item was dropped from subsequent Priority Guidance Plans. The issue was reinstated in the 2019-2020 Priority Guidance Plan which provides that regulations under § 1.1502-75(d) regarding group continuation are again guidance priorities. *See* Treasury Department Office of Tax Policy and Internal Revenue Service, *2019-2020 Priority Guidance Plan* (Oct. 8, 2019).

II. SECTION 1.1502-75(d): WHEN A GROUP REMAINS IN EXISTENCE

- A. Section 1.1502-75(d) sets forth the rules that govern when a group remains in existence or terminates. Although the general rule provides that the common parent must continue as the common parent for the group to remain in existence, exceptions are provided.
- B. The rules employ a “substance-over-form” approach intended to prevent the termination of a group as the result of a restructuring of its members. In addition, in the case of a combination transaction, the rules use a similar approach to identify which of the combining groups continues. Because the regulation itself is mechanical in nature, the rules may be manipulated in many instances to produce different results for transactions that are economically similar (if not identical) and in certain cases to produce results presumably not contemplated by the drafters.
- C. The determination of whether a group continues or terminates is made based upon a corporate-level inquiry. Where a change in a group is merely a restructuring of its form, the continuation of that group is generally not affected. *See* § 1.1502-75(d)(2) and Rev. Rul. 82-152. In contrast, where two groups combine, the rules attempt to identify the larger of the two groups, determined by reference to the relative net equity capitalization of the two groups, as the surviving group. *See* § 1.1502-75(d)(3).
- D. The focus on changes at the corporate level, rather than the shareholder level, should make irrelevant issues relating to whether the transaction in question is taxable or whether there is continuity of shareholder interest.
- E. Regulations under § 1.1502-77, regarding the agent for the consolidated group, contain several provisions relating to the termination of the consolidated group under § 1.1502-75(d).

1. Under § 1.1502-77(a)(4)(i), the common parent for the consolidated return year remains the agent for the group with respect to that year until the common parent's existence terminates regardless of whether the group terminates or continues with a new common parent.
2. Pursuant to § 1.1502-77(a)(4)(iii), if the group continues in existence with a new common parent pursuant to § 1.1502-75(d) during the consolidated year, the common parent at the beginning of the year is the agent for the group through the date of the § 1.1502-75(d) transaction. The new common parent becomes the agent for the group beginning the day after the § 1.1502-75(d) transaction, at which time the new common parent becomes the agent for the group with respect to the entire consolidated return year (including the period prior to the § 1.1502-75(d) transaction) and the former common parent is no longer the agent for that year. *See* § 1.1502-77(f), *Exs. 5 and 6*.
3. Pursuant to § 1.1502-77(d)(1)(i), if a common parent's existence terminates, prior to such termination it may designate a substitute agent for the group. Such designation is subject to the Commissioner's approval and is not effective before the existence of the common parent terminates. *See* § 1.1502-77(d)(1)(ii). The common parent may designate, as a substitute agent for the group, any corporation that was a member of the group during any part of the consolidated return year and has not subsequently been disregarded as an entity separate from its owner or reclassified as a partnership for Federal tax purposes; however, a disregarded entity may be designated a substitute agent if no corporation remains eligible to serve as the substitute agent for the group's consolidated year. The common parent may also designate, as a substitute agent for the group, any successor of such corporation or of the common parent that is a domestic corporation and is not disregarded as an entity separate from its owner or classified as a partnership for Federal tax purposes, including a corporation that will become a successor at the time that the common parent's existence terminates; however, a disregarded entity may be designated as a substitute agent if no corporation remains eligible to serve as the substitute agent for the group's consolidated return year. *See* § 1.1502-77(d)(1)(i) (A)(1) and (2); 1.1502-77(f), *Ex. 4*.

4. If the common parent fails to designate a substitute agent for the group before its existence terminates and if the common parent has a single successor that is a domestic corporation, such successor becomes the substitute agent for the group upon termination of the common parent's existence. The term successor means an individual or entity (including a disregarded entity) that is primarily liable, pursuant to applicable law (including, for example, by operation of a state or Federal merger statute), for the tax liability of a member of the group. *See* § 1.1502-77(d)(2); LAFA 20071701F (Aug. 22, 2006).

III. SECTION 1.1502-75(d)(1): CONTINUED EXISTENCE OF COMMON PARENT

- A. Section 1.1502-75(d)(1) provides: "A group remains in existence for a tax year if the common parent remains as the common parent and at least one subsidiary that was affiliated with it at the end of the prior year remains affiliated with it at the beginning of the year, whether or not one or more corporations have ceased to be subsidiaries at any time after the group was formed."
 1. This rule was adopted in 1994 and is effective for consolidated return years beginning after December 31, 1994. T.D. 8560 (Aug. 12, 1994).
 2. Example 1.³ Mr. J owns all the stock of corporation P. On January 1 of Year 1, P acquires 100% of the stock of corporation S1, and P and S1 file a consolidated return for Year 1. On April 1 of Year 2, P acquires 100% of the stock of S2, and on July 31 of Year 2, P sells the stock of S1. The P group, which consisted of P and S1 in Year 1, remains in existence throughout Year 2 because P has remained as the common parent and S1 remained affiliated with the P group at the beginning of Year 2.
 - a. The P group includes P for all of Year 2, S1 from January 1 through July 31 of Year 2, and S2 from April 2 through December 31 of Year 2.

3. The discussion and examples in this outline assume that the taxpayers described use the calendar year as their annual accounting period.

- b. S1 must file a separate return for the period from August 1 through December 31 of Year 2, and S2 must file a separate return for the period from January 1 through April 1 of Year 2.
- B. The current rule, unlike former § 1.1502-75(d)(1) (the “Former -75(d)(1) Regulation”), prevents the group from terminating as the result of a gap in ownership of subsidiaries during a single taxable year. *See* § 1.1502-76(b)(4), Ex. (1). In order to ensure that a group will continue from year to year, the common parent need only retain ownership of one subsidiary from the last day of any given year through the first day of the succeeding year. The same subsidiary does not have to remain affiliated with the common parent throughout the entire succeeding year. In fact, as long as the consolidated group exists at the beginning of a year by virtue of § 1.1502-75(d)(1), the common parent can freely sell or liquidate existing subsidiaries and acquire or form new subsidiaries during that subsequent year without causing the termination of the group. Accordingly, under the current rule, a consolidated group remains in existence throughout the entire taxable year even if, for example, the common parent sells its only existing subsidiary during a taxable year and does not acquire or form any new subsidiaries during the remainder of that taxable year.
 1. Example 2. In Year 1, P is the common parent of a group of which P and S1 are the only members. On January 31 of Year 2, P sells the stock in S1 to an unrelated individual and S1 leaves the P group. On December 1 of Year 2, P acquires 100% of the stock of S2. The P group, which consisted of P and S1 in Year 1, will not terminate mid-year but will remain in existence throughout Year 2, despite the fact that P did not own any subsidiary from February 1 through November 30 of Year 2, because P has remained as the common parent and S1, which was affiliated with the P group at the end of Year 1, remained affiliated with the P group at the beginning of Year 2.
 - a. The P group includes P for all of Year 2, S1 from January 1 through January 31 of Year 2, and S2 from December 2 through 31 of Year 2. *See* § 1.1502-76(b)(5), Example 1(c).
 - b. S1 must file a separate return for the period from February 1 through December 31 of Year 2, and S2 must file a separate return year for the period from January 1 through December 1 of Year 2. *See id.*

2. Example 3. In Year 1, P is the common parent of a group of which P and S1 are the only members. P has an item of intercompany income resulting from a 1989 intercompany sale of property to B, a former member of the group. Prior to Year 1, P had reacquired such property upon the merger of B with and into P. On March 31 of Year 2, S1 ceases to be a member of the P group, and P does not acquire another subsidiary during year 2. The P group, which consisted of P and S1 in Year 1, will not terminate mid-year but will remain in existence through the end of Year 2, despite the fact that P did not own any subsidiary after March 31 of Year 2. This result follows from the fact that P has remained as the common parent and S1, which was affiliated with the P group at the end of Year 1, remained affiliated with the P group at the beginning of Year 2.
 - a. The P group includes P for all of Year 2 and S1 from January 1 through March 31 of Year 2. *See* § 1.1502-76 (b)(5), Example 1(b).
 - b. S1 must file a separate return for the period from April 1 through December 31 of Year 2. *See id.*
 - c. P's intercompany item is not taken into account on December 31 of Year 2 even though the P group terminates at that time. *See* the former § 1.1502-13(f)(2)(ii)(b); *compare* § 1.1502-13(j)(6). If P were to become a corporation described in § 1504(b) (e.g., an S corporation, a Real Estate Investment Trust, a Regulated Investment Company, or a Foreign Corporation), however, such intercompany item must be taken into account at such time if the intercompany transaction occurred in a tax year beginning after July 11, 1995. *Id.*
- C. In order for a mid-year absence of affiliation to be disregarded such that the group continues until the end of the year, at least one subsidiary that was affiliated with the common parent at the end of the immediately preceding year must have remained affiliated with the common parent at the beginning of the year in question. Thus, a group is treated differently in the common parent's first year of affiliation than in subsequent years.
 1. Example 4. In Year 1, P is the common parent of a group of which P and S1 are the only members. P sells S1 on February 1 of Year 2. On January 1 of Year 3, P buys 100% of the stock

of S2. The P group terminates at the close of Year 2 because no subsidiary that was owned at the end of Year 2 is owned at the beginning of Year 3.

2. Example 5. P owns no subsidiaries prior to February 1 of Year 2, at which time P buys 100% of the stock of S1. On March 31 of Year 2, P sells S1. On July 1 of Year 2, P buys 100% of the stock of S2. P retains its interest in S2 until Year 4. If P elects to file consolidated returns, under a literal application of the rule, the P group will terminate on March 31 of Year 2, because the gap in ownership of a subsidiary from April 1 until June 30 of Year 2 is not disregarded since P did not have a subsidiary affiliated with it at the beginning of Year 2 that was also affiliated with it at the end of Year 1.
 - a. The better result would be that there is a single group for the period from January 1 of Year 2 through the end of Year 2.
 - b. This example illustrates that, under a literal application of the rule, a gap problem will always exist in P's first year of affiliation because it will have had no subsidiary on December 31 of the prior year.
- D. The Former -75(d)(1) Regulation, which applies to consolidated return years beginning before January 1, 1995, provided that a group remained in existence only so long as the common parent remained the common parent and at least one subsidiary remained affiliated with it, regardless of whether the subsidiary was a member in a prior year or whether any corporations ceased to be subsidiaries at any time.
1. Under the Former -75(d)(1) Regulation, if the common parent disposed of the stock of its only subsidiary and then, after an interval, but during the same taxable year, acquired another subsidiary, the disposition of the first subsidiary would terminate the consolidated group but would not terminate P's taxable year. The acquisition of the second subsidiary would terminate P's taxable year if P elected to begin a new consolidated group with a new taxable year. *See* Rev. Rul. 57-294, 1957-2 C.B. 176. Under current § 1.1502-75(d)(1), this gap in ownership would not terminate the P consolidated group.
 2. Thus, under the Former -75(d)(1) Regulation, the P group in Example 2, *supra*, will terminate on January 31 of Year 2, when the common parent no longer has a subsidiary affiliated with it.

3. This change in result frustrates one planning technique that was frequently used to accelerate a corporation's election to be an S corporation. Under the Former -75(d)(1) Regulation, P's consolidated group including S1 would terminate on January 31 of Year 2 when P sold the stock of S1. P would begin a new group with S2 with the consolidated group's tax year beginning on December 2 of Year 2 (assuming P elected to file a consolidated return with S2). If it otherwise qualified, P would have been eligible to elect to be an S corporation beginning on December of Year 2 rather than January 1 of Year 3 (its otherwise earliest opportunity to be an S corporation after disposing of S1). *See* Priv. Ltr. Rul. 8915015 (Jan. 6, 1989).
- E. As § 1.1502-75(d)(1) illustrates, subject to the exceptions in §§ 1.1502-75(d)(2) and (d)(3), the continued existence of the common parent is crucial to the continuation of the group. The importance attached to the common parent results in the rules often respecting the form of a transaction, notwithstanding its substance. For example, the rules are not concerned with the location (or movement outside of the group) of the group's assets as long as there exists, under § 1504, a chain of includible corporations connected through stock ownership with the common parent. The rules therefore sometimes achieve results inconsistent with their purpose.
1. Example 6. P, a holding company, is the common parent of a group of which P, S1, S2, and S3 are the only members. P owns all of S1's stock and S1 owns all of S2's and S3's stock. P distributes its sole asset, the stock of S1, to its shareholders in a liquidation. The P group is terminated at the close of the day of its liquidation. Contrast the treatment of this liquidation with the treatment of the transaction illustrated in Example 12, *infra*, where P merges downstream with and into S1. Although the transactions differ slightly (*e.g.*, in the latter transaction, the tax attributes of P remain in the group), query whether these substantially identical transactions should be treated differently.
 2. Example 7. P, a holding company, is the common parent of a group of which P, S1, and S2 are the only members. P owns all of S1's and S2's stock. S2 holds operating assets that comprise substantially all of the P group's assets. P sells S2 to a third party. The P group continues with P and S1 as its only members, notwithstanding that substantially all of P group's historic operating assets have been transferred out of the group.

3. Example 8. The facts are the same as those in Example 7, *supra*, except that, instead of selling S2, P distributes the S2 stock to its shareholders, either as a § 301 distribution or a tax-free § 355 spin-off. The P group continues with P and S1 as its only members, notwithstanding that substantially all of P group's historic operating assets have been transferred out of the group.
 4. These examples illustrate the ease with which a taxpayer can manipulate § 1.1502-75(d)(1) to continue or cause the termination of a group. At least commenter has espoused the view that the goal of regulations to preserve the consolidated return filing election would be better served, at least with respect to divisive transactions, if § 1.1502-75(d)(1) were amended to provide for the continuation of the group that is the "functional successor" of the common parent. *See* Matthew B. Krasner, "Continuation of the Affiliated Group Subsequent to a Divisive Reorganization: A Patchwork of Inconsistent Rules with Uncertain Application," 41 Vand. L. Rev. 283, 289 (Mar. 1988). This position is taken in § 1.1502-75(d)(2)(ii), which requires that members of the group succeed to substantially all of the former common parent's assets in order for the group to continue, and § 1.1502-75(d)(3), which requires a transfer of substantially all of the assets of the acquired corporation and that shareholders of the acquired corporation own more than 50% of the stock of the acquiring corporation. *See id.* at 289-90.
- F. In addition to the continued existence of the common parent, § 1.1502-75(d)(1) requires, subject to the exceptions in § 1.1502-75(d)(2) and (d)(3), that the common parent continue as the common parent. An issue is presented for purposes of determining whether a common parent remains as the common parent of its consolidated group when it becomes a subsidiary of a new holding company (as described in Revenue Ruling 82-152 when analyzing the acquisition solely up to the time of the holding company formation) where such subsidiary thereafter is subsequently distributed as part of a plan to the shareholders of the newly formed holding company.
1. In Tech. Adv. Mem. 8946006 (July 31, 1989) Oldco organized Newco, which in turn organized S1, which in turn organized S2. S2 and Oldco merged with Oldco surviving, and the Oldco stock was converted to Newco stock. Therefore, after this step, Newco owned S1 and Oldco. Oldco then formed Holding,

transferred to Holding its assets other than those used in business A, and distributed the Holding stock to S1. S1 then distributed the stock of Holding and Oldco to Newco and then dissolved. At this point, Newco owned the stock of Holding and Oldco. Twenty-six days later, Newco distributed the Oldco stock to its shareholders. Notwithstanding that the form of the transaction was a spin-off *of* Oldco, the taxpayer had received a private letter ruling that characterized the transaction as a transfer of assets and subsidiary stock by Oldco to Newco followed by a spin-off *by* Oldco of the stock of Newco. *See* Priv. Ltr. Rul. 8637009 (May 28, 1986), *revoked in part by*, Priv. Ltr. Rul. 8737019 (Jun. 12, 1987), *and supplemented by*, Priv. Ltr. Rul. 8739023 (Jun. 29, 1987), *supplemented by*, Priv. Ltr. Rul. 8801048 (Oct. 13, 1987), *supplemented by*, Priv. Ltr. Rul. 8936033 (Jun. 12, 1989). In the Tech Adv. Mem., the IRS' National Office determined that it was unable to conclude the recast applied in the private letter ruling was in error. Because the transaction as recast did not involve two consolidated groups the technical advice memorandum rejected the taxpayer's argument that § 1.1502-75(d)(3) applied. The memorandum also concluded that § 1.1502-75(d)(ii), as expanded by Rev. Rul. 82-152, did not apply because of the separation of the common parent and assets from the original group. Because neither of the exceptions applied, the National Office concluded that § 1.1502-75(d)(1) applied such that the Oldco group continued with Oldco as its common parent and Newco was the common parent of a new group. In reaching this conclusion, the memorandum apparently disregarded Oldco's interim position as a subsidiary as a step in the series of interrelated transactions. *See also* Tech. Adv. Mem. 8946007 (July 31, 1989) (same).

2. The issue considered in Tech. Adv. Mem. 8946006 and 89476007 ultimately was resolved by the Tax Court when it determined that a common parent's interim position as a subsidiary in a group together with its distribution destroyed its status as the common parent of the historic group. In *Interlake Corp. v. Commissioner*, 112 T.C. 103 (1999), Acme Steel Co. ("Acme") was the common parent of a consolidated group that consisted of various subsidiaries, including Alabama Metalurgical Corp. ("AMC"). Acme organized Interlake Corporation ("Interlake") on February 26, 1986, in anticipation of a planned restructuring

whereby the group would be split. As a result of the restructuring, on May 29, 1986, Acme became a wholly owned subsidiary of Interlake. The Tax Court's opinion states, "As a result of the restructuring transaction, [Interlake] became the successor common parent of the continuing group." On June 23, 1986, as part of the same plan and 25 days after the inversion of Acme and Interlake, Interlake distributed the Acme stock pro rata to its shareholders, thereby severing Acme's ties to the group. Thereafter, both Interlake and Acme were common parents of consolidated groups. The Tax Court and both consolidated groups treated Interlake as the successor common parent of the pre-split Acme group. In light of the technical advice memoranda discussed in Section III.F.1., *supra*, it is possible that the Tax Court merely respected an agreement among or stipulation by the parties that Interlake became the common parent of the pre-split Acme group. If, consistent with the positions in the technical advice memoranda, *supra*, Acme's interim status as a subsidiary as a step in the restructuring and split-off plan were disregarded, the group's common parent, Acme, would have remained the common parent and at least one subsidiary, AMC, would have remained affiliated with it such that the Acme group would have continued. *See* § 1.1502-75(d)(1). Neither the technical advice memoranda nor the court specifies the purpose for the form chosen by the taxpayer in Interlake or indicates whether the transaction could have been accomplished by Acme's distribution of Interlake. If Acme had distributed the stock of Interlake, the historic Acme group undoubtedly would have continued. Taking into account, however, the importance of form in spin-off transactions (i.e., the different results that may follow depending on the direction of the distribution) as well as the procedural history of the issues presented in each of the private letter ruling, the technical advice memoranda and the Interlake decision, it would appear that the IRS' challenge to taxpayer's form may have been merely attributable to concerns related to whipsaw which would seem to have been resolved by a subsequently promulgated regulation. *See* § 1.1502-78(b)(1) (providing that, in all cases of a tentative carryback adjustment where a loss is deducted or a credit is allowed in computing the consolidated tax liability for a consolidated tax return year, any refund shall be made to and in the name of common parent corporation for the carryback year); 65 FR 57755 (Sep. 26, 2000)

(preamble to proposed regulations, made final in T.D. 9002 (June 28, 2002); adding “for the carryback year” after common parent corporation in § 1.1502-78(b)(1) to “clarify that any refund under § 1.1502-78(b) related to a tentative carryback adjustment must be paid to the corporation that was the common parent (or is the designated agent) for the carryback year”).

3. The position of the Tax Court that is implicit in the *Interlake* decision is at odds with the National Office’s position in Tech. Adv. Mem. 8946006 as the *Interlake* decision and the technical advice memorandum address the same transaction/taxpayer. For a number of reasons, we believe the form of the transaction in any number of fact patterns should be respected although prudence unquestionable suggests seeking an advance IRS ruling regarding proper resolution of this issue.
 - a. Notwithstanding the National Office’s position in Tech. Adv. Mem. 8946006, the National Office in Priv. Ltr. Rul. 201119002 (Oct. 14, 2010), *supplemented by* Priv. Ltr. Rul. 201120015 (Feb. 14, 2011), respected the form of a similar transaction and determined that a common parent’s interim position as a subsidiary in a group followed by its distribution by the new common parent as part of an integrated plan did not prevent the continuation of the group. In the ruling, publicly traded Oldco was the common parent of an affiliated group of corporations that included wholly owned corporate subsidiaries Sub 1, Sub 2, and Distributing 2. Distributing 2 owned all of the stock of Distributing 1. Through a chain of disregarded entities, Distributing 2 formed Merger Sub and Merger Sub merged with and into Oldco. Immediately thereafter, Oldco was a wholly owned subsidiary of Distributing 2. The stock of Oldco was subsequently transferred to Distributing 1 in a transaction that coupled with a distribution by Oldco qualified as a reorganization under § 368(a)(1)(F). Distributing 1 distributed the stock Sub 2 to Distributing 2 and thereafter, Distributing 2 distributed the stock of Distributing 1 (of which Oldco was a wholly owned subsidiary) to its shareholders, pro rata. The IRS respected the form and the timing of the steps of the transaction as a distribution of Distributing 1 (and its subsidiary, Oldco) and relied on Rev. Rul. 82-152 to conclude that the Oldco group remained

in existence with Distributing 2 as its new common parent. In connection with its conclusion that the Oldco group did not terminate, but rather continued, the IRS also ruled that Distributing 2's basis in the Oldco stock is adjusted to equal Oldco's net basis, as determined under § 1.1502-31(c). For purposes of determining Oldco's net asset basis, consider the application of § 1.1502-80(d) (§ 357(c) does not apply to intercompany transfers unless transferor or transferee leaves the group as part of the transaction) and the impact of Oldco leaving the consolidated group as part of the transaction. Query what level of assets distributed would cause the consolidated group's existence to terminate? *See* Priv. Ltr. Rul. 2001451013 (Sept. 8, 2004) (discussed *infra*).

4. The IRS distinguished the *Interlake* decision in Field Service Advice 199948005 (Aug. 27, 1999), which involved the question of who is the proper party to consent to extend the statute of limitations with respect to a consolidated group following a spin-off of a first-tier subsidiary's acquisition of the common parent. This Field Service Advice distinguished *Interlake* primarily based on the effective date of the predecessor to § 1.1502-77A(e), but noted several factual differences, including that in *Interlake* the common parent, rather than a first-tier subsidiary, was spun off from the original group. *See also* 2000 IRS NSAR 10066 (Oct. 5, 2000) (in determining who could execute Form 872 for consolidated group, distinguished *Interlake* because *Interlake* dealt with (i) years prior to effective date of predecessor to § 1.1502-77A(e) and (ii) *Interlake* dealt with a tentative refund adjustment governed by § 1.1502-78).
- G. In addition to the requirements that the common parent continue its existence and continue as the common parent, § 1.1502-75(d)(1) requires that at least one subsidiary that was affiliated with the common parent at the end of the prior year remains affiliated with it at the beginning of the year. Under § 1504(a)(1), a subsidiary is affiliated with a common parent only if stock meeting the requirements of § 1504(a)(2) is owned by (1) the common parent or (2) one or more of the includible corporations (including the common parent). Pursuant to § 1504(a)(2), the stock must possess at least 80% of the total voting power of the stock of the corporation, and the stock must have a value equal to at least 80% of the total value of the stock of the corporation (the value

requirement). Thus it is possible that a consolidated group may terminate as a result of a change in the relative values of different classes of stock of one or more subsidiaries.

1. For example, assume P owns 100% of the voting common stock of S, which has a value of \$80, and A (an unrelated individual) owns 100% of the non-voting preferred stock of S that is not described in § 1504(a)(4), which has a value of \$20. P has no other subsidiaries that are includible corporations. If the value of the preferred stock increases relative to the value of the common stock, the value requirement will no longer be satisfied and the P group may terminate.
2. Section 1504(a)(5)(D) directs the Secretary to prescribe regulations that disregard an inadvertent ceasing to meet the value requirement by reason of changes in relative values of different classes of stock (the inadvertence exception to the value requirement). In Notice 2004-37, 2004-1 C.B. 947, pending the promulgation of temporary or final regulations, the IRS announced that it will not challenge the position that the value requirement is satisfied if certain conditions are satisfied.

IV. SECTION 1.1502-75(D)(2): COMMON PARENT CEASES TO EXIST

- A. Section 1.1502-75(d)(2) provides two exceptions to the general rule that a group's continued existence requires the continuing existence of its common parent as the common parent. The exceptions apply when (1) there is a mere change in identity of the common parent or (2) the common parent transfers substantially all of its assets to one or more of its subsidiaries and there remains one or more chains of includible corporations meeting the affiliated requirements of § 1504.
- B. Mere change in identity. "[T]he common parent shall remain as the common parent irrespective of a mere change in identity, form, or place of organization of such common parent corporation." § 1.1502-75(d)(2)(i).
 1. This exception will apply where the common parent effects an "F" reorganization, which involves a "mere change in identity, form, or place of organization of one corporation." See § 368(a)(1)(F). In such case, the group will not terminate as a result of the "F" reorganization, and the taxable years of the common parent or the group will not close.

2. Example 9. P, a Tennessee corporation, is the common parent of a group that includes S1 and S2. P owns all of S1's stock, and S1 owns all of S2's stock. P reincorporates as a Delaware corporation in a transaction described in § 368(a)(1)(F). The P group will not terminate as a result of the change of P's state of incorporation. *See* Priv. Ltr. Rul. 8110042 (Dec. 10, 1980).
 3. Example 10. In a transaction which appears to be what is commonly referred to as a "sponsored" spin-off, P, the common parent of a group, formed Distributing and Distributing formed Merger Sub. Merger Sub merged into P with P surviving so that P became a wholly owned subsidiary of Distributing. After the merger, P converted into a limited liability company wholly owned by Distributing. The merger and the conversion into a disregarded entity were treated as a reorganization under § 368(a)(1)(F) so the P group will continue with Distributing as its common parent. *See* Priv. Ltr. Rul. 200708016 (Nov. 9, 2006). Absent the P conversion, the IRS appears to adopt the view that the P group terminates thus making the group continuation rules in this context elective. *Compare* Priv. Ltr. 200451013 (Dec. 17, 2004). We believe the former rule carries out the purposes of the group continuation rules and the latter ruling position should be reconsidered.
 4. This exception has been interpreted by the IRS as applying to situations beyond "F" reorganizations. For example, in Priv. Ltr. Rul. 8731052 (May 7, 1987), the IRS ruled that the merger of Acquired, an insolvent thrift institution, with and into Acquiring, a newly created stock savings bank, in a transaction described in § 368(a)(1)(G) should be accorded the same tax consequences as an "F" reorganization for the purposes of § 1.1502-75(d)(2)(i) and therefore Acquired's affiliated group continued. *See also* Priv. Ltr. Rul. 9008060 (Nov. 29, 1989). This conclusion, however, may be limited to situation where the "G" reorganization is the functional equivalent of an "F" reorganization.
- C. Transfer of assets to subsidiary. "The group shall be considered as remaining in existence notwithstanding that the common parent is no longer in existence if the members of the affiliated group succeed to and become the owners of substantially all of the assets of such former parent and there remains one or more chains of includible corporations connected through stock ownership with a common

parent corporation which is an includible corporation and which was a member of the group prior to the date such former parent ceases to exist.” § 1.1502-75(d)(2)(ii).

1. This exception (often referred to as the downstream exception) essentially has two requirements:
 - a. One or more members other than the former common parent must succeed to substantially all of the assets of the former common parent; and
 - b. There must remain a chain of includible corporations connected through a common parent that were members of the group before the former common parent ceased to exist.
2. The term “substantially all” is not defined for purposes of § 1.1502-75(d)(2)(ii).
 - a. We believe that the better view in applying the “substantially all” test takes into account both the common parent’s directly held operating assets and subsidiary stock. *See* Priv. Ltr. Rul. 200344002 (July 15, 2003); *see also* Andrew J. Dubroff et al., *Federal Income Taxation of Corporations Filing Consolidated Returns* § 12.03[2] at 12-8 n.24 (2d ed. 1997). In the transactions considered in Priv. Ltr. Rul. 200344002, “Parent will transfer substantially all of its assets (principally the stock of Sub and the subsidiaries of Sub) to New Parent in exchange for New Parent stock and debt instruments and the assumption of certain indebtedness of Parent...Parent will not transfer to New Parent certain assets.” The IRS ruled that the transfer and subsequent liquidation and termination of Parent will qualify as a transaction under § 1.1502-75(d)(2)(ii), and the Parent consolidated group will continue in existence with New Parent as the common parent.
 - b. It is unclear at what time the “substantially all” determination is made – at the time of the downstream transaction itself or at the time the overall plan begins (*e.g.*, in the case of a downstream transaction that is a step in a series of transactions). A field service advice applied a step-transaction analysis in determining what assets are taken into account for purposes of the “substantially all” determination. *See* FSA 200203007 (Sept. 28, 2001). This FSA indicated that the common parent’s disposition of

assets in transactions unrelated to the downstream transaction were not taken into account in applying the “substantially all” test. On the other hand, dispositions that are part of the same plan or in integrated transactions are considered in applying the “substantially all” test. Thus, FSA 200203007 concluded that, absent some link between the transactions, assets distributed to a shareholder several years prior to the downstream transaction are not considered common parent assets. *See also* Priv. Ltr. Rul. 200451013 (Sept. 8, 2004), in which Old Parent disposed of assets. In the ruling, publicly traded Old Parent owned all of the stock of New Parent and New Parent owned all of the stock of T. T merged into Old Parent in a reverse subsidiary merger in which Old Parent’s shareholders received New Parent stock and Old Parent became a wholly owned subsidiary of New Parent. Third party investors purchased greater than 50 percent of New Parent’s stock, and certain members of Old Parent Management owned the remaining stock. Old Parent distributed cash to New Parent, which was used to redeem the former public shareholders of New Parent and to pay New Parent’s transaction costs. As a result of this series of transactions, Old Parent lost a sufficient percentage of its net and gross assets so that New Parent could not be said to have acquired “substantially all” of the assets of Old Parent within the meaning of § 1.1502-75(d)(2)(ii). The IRS ruled that the Old Parent consolidated group terminated because the series of transactions did not meet the requirements of § 1.1502-75(d)(2)(ii), § 1.1502-75(d)(3), or Rev. Rul. 82-152. We believe the provisions would operate properly if and only if the “substantially all” determination were to be applied to test for the acquisition of substantially all of the Old Parent’s assets immediately before the downstream transfer by reference to those assets owned immediately thereafter, rather than woodenly applying step transaction without regard to the purpose of the provision to test whether substantially all of the Old Parent’s historical assets continue to be held by the New Parent following the completion of all of the related steps subsequent to the downstream transfer. Such an application of the rule,

similar to the concept for reorganizations under § 368(a)(1)(F), would comport with the principles articulated in *Falconwood*, discussed below, and prevent electivity with respect to group continuation. This aligns the analysis and outcome of § 1.1502-75(d)(2)(i) with § 1.1502-75(d)(2)(ii).

3. A “chain” of includible corporations may exist for purposes of § 1504(a), and thus § 1.1502-75(d)(2)(ii), if as few as two includible corporations – one common parent and one subsidiary – are linked by stock meeting the requirements of § 1504(a)(2). *See The Falconwood Corporation v. United States*, 60 Fed. Cl. 485 (2004), *rev’d* 422 F.3d 1339 (Fed. Cir. 2005).
4. The U.S. Court of Federal Claims interpreted the term “remains” to denote continuity in existence from one taxable year to the subsequent taxable year; that is, a continued existence. Under this view, the existence of subsidiaries for only an interim period of time between steps of multi-step transaction will not satisfy this requirement. *See Falconwood*, 60 Fed. Cl. At 490-91 (“With respect to the second condition of Treas. Reg. § 1.1502-75(d)(2)(ii), it is clear that the existence of subsidiaries for only three hours following the downstream merger does not satisfy the requirement of continuity ‘from one year to the subsequent year,’ or the ‘continued existence,’ set forth in *Union Electric [Company of Missouri v. United States]*, 305 F.2d 850, 854 (Ct. Cl. 1962)].”). This view, which critically failed to account for both the government’s obligation to prescribe clear rules so that taxpayers can plan their affairs and the very formalistic nature of the rules governing the “continuation of the group” was properly reversed by the Federal Circuit Court of Appeals. *See Falconwood*, 433 F.3d 1339.

The Federal Circuit adopted the ordinary meaning of the term “remains” and based its decision on the plain meaning of the regulation. The court stated:

Because the government chose not to define in section 1.1502-75(d)(2)(ii) more expressly the temporal span of “there remains,” we think it inappropriate to accord the terms anything more than their plain meaning. *See Gould v. Gould*, 245 U.S. 151, 153, 38 S.Ct. 53, 62 L.Ed. 211 (1917) (“In the interpretation of statutes levying taxes it is the established rule not to ... enlarge their operations so as to embrace matters not specifically pointed out. In case of doubt they are construed most strongly against the government, and in favor of the citizen.”); *Int’l Tel. & Tel. Corp. v.*

United States, 221 Ct. Cl. 442, 608 F.2d 462, 477 (1979) (“Consolidated return regulations are ‘legislative’ character and have the force and effect of law.”).

As to the application of the “step transaction” doctrine, the Federal Circuit restated its historical position “that various expressions of the step transaction doctrine may have *different meanings in different contexts*, and that there ‘may be not one rule, but several, depending on the substantive provision of the Code to which they are being applied.’” *Id* at 1350 (quoting *King Enters., Inc. v. United States*, 418 F.2d 511, 516 (Ct. Cl. 1969) (quotation marks omitted) (emphasis added)). The context in this case which compelled the rejection of the step transaction doctrine appears predicated on the formalistic nature of the rule in question which fails to provide for consistent results in economically equivalent cases, as described in footnote 7 of the Federal Circuit’s opinion:

Hypothetically, had [Taxpayer] merged upstream into [the common parent of the group] such that [the latter] was the surviving entity, [the historical common parent] would have remained as the parent corporation throughout the merger and until the [consolidated group] reached [the final step of the transaction]. Section 1.1502-76(b)(1) would then require [the historical common parent] to cover its operations through March 31, 1987, in the group’s final consolidated return. Interestingly, [by reversing the direction of the merger between Taxpayer and the historic common parent] an application of the step transaction doctrine to remove [the interim step] as asserted by the government in this case] from the reorganization process and thus collapse the reorganization into one primary step [rather than two] presumably would not have precluded [the historical common parent] from covering its operations for the full taxable year in the group’s final return.

Our holding thus avoids the peculiar result of the Court of Federal Claims’s judgment in this case that in one scenario, [the historic common parent’s] downstream merger in [Taxpayer] for an independent business purpose allows for the application of the step transaction doctrine to alter the associated tax consequences of the reorganization, whereas in another, [Taxpayer’s] upstream merger into TMCH would not. The substantive outcome is the same under both scenarios—the product of the [Taxpayer/historical common parent] merger and its taxable year survive termination of the group at the [final step of the transaction]....[A different result, such as the one resulting under the Court of Federal Claims’s judgment]...would turn on its head a doctrine that when used properly elevates the substance of a transaction over its form. *See*

Brown v. United States, 329 F.3d 664, 671 (9th Cir. 2003) (“substance should prevail over form” (quotation marks omitted)); *King*, 418 F.2d at 517 (stating that the doctrine assures that “tax consequences turn on the substance of a transaction rather than on its form”).

Id. at 1352. N. 7. In summary, the Federal Circuit agreed with the taxpayer that following the downstream merger there continues to be one or more includible corporations connected through stock ownership with a common parent corporation that was a member of the group prior to the date the former parent corporation ceased to exist, even if only for a few hours. Presumably, based upon the court’s analysis, it would have reached the same conclusion even if the period such ownership continued was an even shorter period of time as long as the chain of chain of subsidiaries did not cease to exist simultaneously with the downstream merger. We understand the position of the IRS would be to follow the decision of the Federal Circuit on any similar fact pattern presented in the future.

5. Example 11. P, a holding company, is the common parent of a group of which P, S1, and S2 are the only members. P owns all of S1’s stock, and S1 owns all of S2’s stock. On January 2, P merges downstream with and into S1. On January 4, as part of a single plan including P’s downstream merger into S1, S2 merges upstream with and into S1. Query whether the P group should continue in existence with S1 as its new common parent.
 - a. On similar facts under the Former -75(d)(1) Regulation, the Federal Circuit in *Falconwood* determined that the group did not terminate because there “remained” a chain of corporations affiliated with the subsidiary as the subsidiary did not cease to be a member of the group in a transaction occurring simultaneously with the downstream merger.
 - b. Unlike under the Former -75(d)(1) Regulation, a group remains in existence until the end of the year so long as the common parent remains as the common parent. As a result, the rules under the § 1.1502-75(d) may produce different results in economically identical transactions. For example, an upstream merger or liquidation of a common parent’s only subsidiary will not terminate the group until the end of the year. However, a downstream merger

of the common parent with and into its only subsidiary will terminate the group immediately because there is no continuing chain of includible corporations following the merger. Thus, in some situations a taxpayer has the ability to elect whether a group continues or terminates by choosing the form of the transaction. Should transactions that are economically similar produce such different results? Should the continued existence of the group depend on the direction of the merger? There does not appear to be any logical policy rationale that would dictate different results in such economically similar transactions. Assuming that is correct, query whether § 1.1502-75(d)(2)(ii) should be amended to more closely follow § 1.1502-75(d)(1).

- c. One lesson from the *Falconwood* case is, because the results under § 1.1502-75(d) are driven by the form of the transaction, it is important to structure transactions carefully to ensure the desired results are achieved.
6. The downstream exception states that if certain requirements are met, the group will continue “notwithstanding that the common parent is no longer in existence.” § 1.1502-75(d)(2)(ii). Based upon this language, it appears that the exception does not actually require that, but merely contemplates the possibility that, the common parent cease to exist. However, the IRS has taken the position that the downstream exception applies only where the common parent ceases to exist. *See* Rev. Rul. 82-152, 1982-2 C.B. 205, 205; Gen. Couns. Mem. 38,886 (Aug. 9, 1982); Priv. Ltr. Rul. 8702016 (Oct. 9, 1986). Interestingly, in one private letter ruling, the IRS ruled that the downstream exception applied where the common parent did not actually cease to exist but was deemed to have liquidated by virtue of the acquisition of its stock in a § 338(h)(10) transaction. *See* Priv. Ltr. Rul. 200407007 (Nov. 12, 2003).
7. It does not matter for purposes of § 1.1502-75(d)(2)(ii) whether the transfer of the common parent’s assets is accomplished in a taxable transaction or a tax-free reorganization.
8. The function of this provision is “to recognize the continuity of an affiliated group after a transaction that, even though formally restructuring the group, did not effect any substantial change in the composition of the group (judged by reference to the underlying assets of the group).” Rev. Rul. 82-152, 1982-2 C.B. 205,

205. Without the downstream exception, a group could circumvent the continued filing requirement of §1.1502-75(a)(2) by merely formally restructuring in a manner that did not effect any substantial change in the composition of the group's assets. *See* Priv. Ltr. Rul. 9437009 (June 10, 1994) (extending principles of § 1.1502-75(d)(2)(ii) to continue a group).

9. Example 12. P, a holding company, is the common parent of a group of which P, S1, S2, and S3 are the only members. P owns all of S1's stock, and S1 owns all of S2's and S2's stock. P merges downstream with and into S1 with S1 surviving and the former P shareholders receiving S1 stock. The P group will continue with S1 as its new common parent. *See* Priv. Ltr. Rul. 9738032 (June 25, 1997).
10. Example 13. P is the common parent of a group of which P, S1, and S2 are the only members. P owns all of S1's stock, and S1 owns all of S2's stock. P merges with and into S2 in a transaction described in § 368(a)(1)(A) and (a)(2)(D) so that the former shareholders become shareholders of S1. (This transaction is commonly used to create a holding company for an existing consolidated group.) Although the common parent P has ceased to exist as a result of the transaction, the group will not terminate because all of P's assets were acquired by S2, which was a member of the former P group, and S1, which was a member of the former P group, became the common parent of a chain of includible corporations which include a former member (*i.e.*, S2). *See* Priv. Ltr. Rul. 8048078 (Sept. 8, 1980). Note that even though this transaction could be described as a reverse acquisition, § 1.1502-75(d)(3)(iv) provides that, because § 1.1502-75(d)(2) applies, the reverse acquisition rules do not apply.
11. Example 14. P is the common parent of a group of which P, S1, and S2 are the only members. P owns all of S1's stock and S1 owns all of S2's stock. P operates businesses A and B. Businesses A and B are of equal value and together represent 90% of the value of P. P forms Controlled by contributing to it the B business. Controlled is distributed pro-rata to the shareholders of P pursuant to § 355 (*i.e.*, a D/355 with the B business). P, with only business A and the stock of S1 remaining, merges with and into S1 in a transaction described in § 368(a)(1)(D) so that the former P shareholders become shareholders of S1.

Although the common parent P has ceased to exist as a result of the transaction, does the group terminate because “substantially all” of P’s assets were not acquired by S1? Does the answer solely depend on whether the spin-off and the downstream merger were part of the same plan? Does the opportunity exist to end a consolidated group following a spin-off when the “substantially all” standard cannot be met under § 1.1502-75(d)(2)(ii)?

12. Example 15. P is the common parent of a group of which P and S are the only members, and P owns all of S’s stock. P merges downstream with and into S in a tax-free reorganization so that the former P shareholders become shareholders of S. Although the common parent P has ceased to exist by virtue of the acquisition of all of P’s assets by S, the exception under § 1.1502-75(d)(2)(ii) will not apply because there does not remain a chain of includible corporations. The group will terminate under § 1.1502-75(d)(1) and its tax year will end under § 1.1502-76(b)(1) at the time of the downstream merger because P goes out of existence and its taxable year terminates. *See* Priv. Ltr. Rul. 9852005 (Sept. 21, 1998) (ruling that the group terminates and its tax year ends on the date of the merger of the common parent with and into its only subsidiary); Priv. Ltr. Rul. 9833027 (May 20, 1998)(same); Priv. Ltr. Rul. 9707018 (Nov. 15, 1996) (same). If, instead of P merging downstream with and into S, S merges upstream with and into P, the P group will not terminate until year end and would continue thereafter if P acquired another subsidiary before year end. In either case, intercompany gains and losses are not triggered under § 1.1502-13(j)(6) and excess loss accounts are not included in income under § 1.1502-19(b)(2). If P becomes a corporation described in § 1504(b) (e.g., an S corporation, a Real Estate Investment Trust, a Regulated Investment Company, or a Foreign Corporation), however, such intercompany item must be taken into account at such time if the intercompany transaction occurred in a tax year beginning after July 11, 1995. *Id.*
13. The form of the transaction (*i.e.*, a liquidation or upstream merger vs. a downstream merger) will affect the timing of the group’s termination if the transaction occurs on a date other than the last day of P’s taxable year. In the case of an upstream

merger of a sole subsidiary with and into its parent (P) (assuming P does not acquire another subsidiary), the resulting termination of the group will not occur until the end of the P group's taxable year. However, in the case of a downstream merger of P into its sole subsidiary, as in Example 15, *supra*, the group will terminate immediately. This distinction may be important for at least a couple of reasons.

- a. First, it will affect the timing of P's eligibility to be taxed as an S corporation. An election to be treated as an S corporation for any taxable year generally is made at any time during the preceding taxable year or within the first 3 months and 15 days of the taxable year. § 1362(b). The election is valid for the entire taxable year for which it is made. § 1362(c). In the case of the downstream merger, because the group terminates immediately, P is eligible to elect to be taxed as an S corporation beginning on the day after the merger. In the case of the upstream merger, because the group does not terminate and P does not begin a new taxable year until the end of the P group's taxable year, P is not eligible to be taxed as an S corporation until the beginning of the *following* taxable year. *See* Priv. Ltr. Rul. 9852005 (Sept. 21, 1998); Priv. Ltr. Rul. 9833027 (May 20, 1998); Priv. Ltr. Rul. 9707018 (Nov. 15, 1996).
 - b. Second, it will affect the ability to offset losses sustained by the subsidiary after the transaction but before the end of the P group's taxable year against the P group's income.
14. In the case of a transaction to which the downstream exception applies, the following special rules apply:
- a. For purposes of determining the SRLY limitation on built-in losses, §1.1502-15(c)(3) provides, "If the common parent has become the common parent of an existing group within the previous five year period in a transaction described in section 1.1502-75(d)(2)(ii)..., the principles of section 1.1502-91(g)(6) and 1.1502-96(a)(2)(iii) shall apply." These provisions control the determination of whether the members of the group meet the five-year continuous affiliation requirement for inclusion in a subgroup.

- b. For purposes of § 1.1502-15(f) (built-in losses recognized by common parent of group) and § 1.1502-21(b) (offspring rule for carryovers and carrybacks of consolidated net operating losses), references to the common parent are to the common parent before the downstream merger. *See* § 1.1502-15(f)(1); § 1.1502-21(b)(2)(ii)(B).
- c. If the common parent became the common parent in the downstream merger within the previous five-year period, appropriate adjustments must be made in applying § 1.1502-91(g)(2)(ii)(A) so that corporations that have not been members of the group for five years are not included. *See* § 1.1502-91(g)(6).
- d. Similarly, appropriate adjustments must be made in applying § 1.1502-96(a)(2)(ii) and (3), and references to the common parent are to the common parent before the downstream merger. *See* § 1.1502-96(a)(2)(iii).
- e. For purposes of § 1.1502-35(c), which provides for the suspension of losses on certain stock dispositions, a surviving group is treated as a successor to a consolidated group (the terminating group) that ceases to exist as a result of the application of § 1.1502-75(d)(2)(ii).
 - (1) Losses of the common parent before the downstream merger generally will not be subject to the SRLY rules as a result of the “lonely parent” exception to such limitations. § 1.1502-1(f)(2)(i), -1(f)(3), and -75(d)(2)(ii) (second sentence). It is unclear whether a similar result applies to losses of the new common parent after the downstream merger to the extent such losses are carried back to the period prior to such merger. Notwithstanding the apparent lack of policy justification for a distinction between these two situations, the IRS has suggested the “lonely parent” rule is inapplicable in the latter situation. *See* CCA 200441026, footnote 8 (June 25, 2004) (discussed more fully in section V.E.2.A. below).
- f. Following a downstream merger constituting a group structure change, the basis of the members in the stock of the acquiring corporation is adjusted immediately after the group structure change under § 1.1502-31(b)(1).

- g. Following a downstream merger constituting a group structure change, the earnings and profits of the new common parent are adjusted under § 1.1502-33(f) to reflect the earnings and profits of the former common parent immediately before the downstream merger.

D. Revenue Ruling 82-152: Another Exception or Simply an Interpretation?

1. The pertinent facts in Rev. Rul. 82-152 are as follows: P is the common parent of a group of which P, S (a newly formed holding company), and T are the only members. P owns all of the stock of S, and S owns all of the stock of T. T is merged with and into P in a transaction described in § 368(a)(2)(E) such that the former P shareholders become shareholders of S and S owns all of the stock of P. This transaction is used frequently to create a holding company for the P group.
2. The ruling concludes that the downstream exception of § 1.1502-75(d)(2)(ii) does not apply because the common parent P does not cease to exist. As discussed in Section V.F., *infra*, the ruling also concludes that the reverse acquisition exception of § 1.1502-75(d)(3) does not apply. Nonetheless, the ruling holds that the P group continues because the downstream exception, consistent with the “single economic entity theory” that underlies consolidated return regulations, is aimed at formal restructurings that do not effect any substantial change in the composition of the group. Because the transaction was indistinguishable in substance from the transaction contemplated by the downstream exception, the IRS ruled that the P group did not terminate. *See* Priv. Ltr. Rul. 8702016 (Oct. 9, 1986) (holding that a consolidated group remains in existence because the transaction was “indistinguishable in substance” from the transaction described in § 1.1502-75(d)(2)(ii)).
3. Although it is unclear, it appears, based upon subsequent private letter rulings, that the IRS considers Rev. Rul. 82-152 an administratively created exception to the general rule rather than an interpretation of the regulation. Assuming, as the ruling asserts, that the result is at odds with the literal requirements of the regulation, taxpayers are left with the prospect of applying the regulation either in accordance with its literal terms or consistent with the policy of the consolidated return regulations and Rev. Rul. 82-152. Furthermore, to the extent that on determines that Rev. Rul. 82-152 constitutes and administratively

created exception, one is left to similarly expand the interpretation of a number of other consolidated return provisions that make reference to § 1.1502-75(d)(2) (see discussion in paragraph 6 below). Because of the significant conflicting case law regarding a literal vs. substantive interpretation of these regulations (*see* cases cited in Section 1.C., *supra*), judicial precedents offer little certainty. Consequently, taxpayers may be free to take whatever position they choose without fear of the substantial underpayment penalty as it currently exists. The situation places the IRS at risk of being whipsawed.

4. The IRS, however, has repeatedly informally indicated, that it is reconsidering Rev. Rul. 82-152 as part of its longstanding study of the group continuation rules. Nonetheless, the IRS has followed Rev. Rul. 82-152 in recent private letter rulings. *See e.g.*, Priv. Ltr. Rul. 201424010 (Mar. 10, 2014) (extending Rev. Rul. 82-152 beyond a section 368(a)(2)(E) reorganization); Priv. Ltr. Rul. 201416002 (Dec. 23, 2013) (same); Priv. Ltr. Rul. 201341018 (May 20, 2013) (applying Rev. Rul. 82-152); Priv. Ltr. Rul. 201140017 (June 29, 2011) (same); Priv. Ltr. Rul. 201120015 (Feb. 14, 2011) (extension of Rev. Rul. 82-152), *supplementing*, Priv. Ltr. Rul. 201119002 (Oct. 14, 2010); Priv. Ltr. Rul. 201015004 (Dec. 11, 2009) (same); Priv. Ltr. Rul. 200935002 (May 27, 2009) (same). However, we understand that Rev. Rul. 82-152 and the group continuation rules under § 1.1502-75(d) may in certain cases be an area the IRS declines to rule in the interest of sound tax administration in view of its pending open regulation project on group continuation included in the 2019-20 Priority Guidance Plan and its evolving views. *See Consolidated Group Next-Day Rule Falls Off IRS's Radar, Highlights and Documents* 8556 (October 22, 2019).
 - a. For example, in Priv. Ltr. Rul. 9745013 (Aug. 7, 1997), the IRS applied the principles of Rev. Rul. 82-152 to the following facts: Target was a mutual life insurance company and the parent of an affiliated group of corporations filing life-nonlife consolidated returns pursuant to an election under § 1504(c)(2). Target organized Mutual Holding, a corporation, and Mutual Holding organized Stock Holding, a corporation. Target converted into a stock insurance company, and thereafter Target issued stock to Stock Holding and became a wholly owned subsidiary of Stock

Holding. Citing § 1.1502-47(d)(12)(vi), § 1.1502-75(d)(2)(ii), and Rev. Rul. 82-152 for authority, the IRS ruled that the Target affiliated group remained in existence with Mutual Holding as the new common parent, and that the election to file a life-nonlife consolidated federal income tax return under § 1504(c)(2) remained in effect.

- b. In Priv. Ltr. Rul. 9712021 (Dec. 20, 1996), Distributing, the common parent of a consolidated group, was a publicly traded corporation with one class of common stock and two classes of preferred stock outstanding. The common stock represented 80% of the total voting power and at least 80% of the total value of the outstanding stock. Distributing formed Holding, and Holding acquired all of the Distributing common stock in exchange for Holding stock in a § 351 exchange. The IRS ruled, citing Rev. Rul. 82-152, that the Distributing group remained in existence with Holding as its common parent.
- c. Similarly, in Priv. Ltr. Rul. 9621030 (Feb. 23, 1996), Distributing was the common parent of a consolidated group. Distributing formed Holding, and Holding formed Transitory. Transitory merged with and into Distributing whereby Distributing became a subsidiary of Holding. The IRS ruled that Distributing's consolidated group remained in existence with Holding as its common parent.
- d. In Priv. Ltr. Rul. 200905001 (Oct. 22, 2008), the IRS cited Rev. Rul. 82-152 for its underlying principle to treat a consolidated group as remaining in existence following a distribution by foreign corporation, D, of all of the stock of its wholly owned US subsidiary corporation, C. the common parent of a consolidated group, to a newly formed US holding company ("Newco"). In the ruling, D, a publicly traded foreign corporation, formed Newco, which formed Merger Sub and Merger Sub merged into D, with D surviving. The holding company formation was ruled to constitute a 'B' reorganization. D subsequently distributed all of the C stock to Newco in a transaction qualifying under §355. The acquisition of C by Newco in the distribution would not appear to be governed by terms of Rev. Rul. 82-152 as the acquisition in question did not occur in the holding company formation itself. Citing the

revenue ruling with a citation signal ‘See’, the IRS ruled that the C group remained in existence with Newco as the common parent. The IRS also ruled that § 1.1502-31 applied notwithstanding that the C stock was not transferred basis property in the hands of Newco although we understand it has since acknowledged informally that this basis ruling was in error. Query whether this application of the underlying principle of Rev. Rul. 82-152 applies if (i) Newco was an existing corporation prior to the commencement of the plan to distribute C and had (x) owned all of the D stock throughout its existence, (y) acquired the D stock 25 months prior to the distribution or (z) owned more than 50% of the D stock throughout its existence acquiring all of the minority owned stock 6 months before the distribution, (ii) Newco was a holding company or held other significant assets, or (iii) Newco was the common parent of a consolidated group prior to the distribution although it had owned all of the D stock throughout its existence?. As Rev. Rul. 82-152 recognizes the transaction at issue in the ruling theoretically could have been accomplished through a different structure which would have qualified for “group continuation” treatment, is it necessary that such a theoretical alternative exist in all other cases – *i.e.*, in Priv. Ltr. Rul. 200905001, one theoretical alternative would have been to form Newco first as a holding company for C and thereafter Newco could acquire D.

5. The IRS also has carved out exceptions to the general rule for other transactions, based in large part on the reasoning of Rev. Rul. 82-152. General Counsel Memorandum 39,420 (Oct. 11, 1985), for example, involved the formation of a holding company. M was the common parent of an affiliated group filing consolidated returns. Holding was a corporation to be formed by nominees of M, with the intention of Holding becoming the parent of M. Pursuant to a plan of exchange, each share of M stock was exchanged for one share of Holding common stock. As a result, Holding owned all of the outstanding stock of M, and former shareholders of M owned all of the outstanding stock of Holding. The memorandum concluded, based on the reasoning of Rev. Rul. 81-152, that the transaction should not terminate the group. *See also* Priv. Ltr. Rul. 9526013 (Mar. 30, 1995).

- a. Note the use of nominees in these cases – the IRS seems to be of the view that if a nominee is involved the transaction should be treated as if the common parent formed the corporation directly.
- b. If Holding had not been formed by M or nominees of M, the treatment of the transaction might not have been controlled by the reasoning in Rev. Rul. 82-152, although the transaction then might have qualified as a reverse acquisition under § 1.1502-75(d)(3).
 - (1) For example, in Priv. Ltr. Rul. 20028011 (Mar. 11, 2000), the IRS ruled that the exchange of parent stock for holding company stock constituted a reverse acquisition under § 1.1502-75(d)(3), and qualified as a group structure change under § 1.1502-31 and § 1.1502-33. The shareholders of a parent corporation formed a holding company and contributed property in exchange for stock of the holding company. Then the shareholders exchanged their parent stock for stock of the holding company. After this exchange, the parent company distributed cash and stock of a subsidiary to the holding company. Without expressly addressing the issue, the IRS apparently distinguished this situation from that in Priv. Ltr. Rul. 9526013 based on the view that the shareholders were not acting on behalf of the parent corporation when they formed the holding company. Similarly, in Priv. Ltr. Rul. 200317019 (Jan. 22, 2003), Parent, the parent corporation of an affiliated group that files a consolidated return converted from a non-profit, non-stock public benefit corporation to a for-profit stock corporation. The converted corporation issued stock to Entity A and Entity B, as required by state law. Immediately thereafter, Entity A and Entity B transferred their Parent stock to Holdings, a newly formed, wholly owned subsidiary of New Parent, in exchange for New Parent stock. New Parent was organized for the purpose of undertaking this transaction, but the ruling was silent as to its organizer(s). Soon thereafter, upon the state's approval, New Parent sold stock in an initial public offering. The ruling held

that the transfer of Parent stock in exchange for New Parent stock by Entity A and Entity B was a reverse acquisition as defined under § 1.1502-75(d)(3). The ruling is interesting because if New Parent had been, or was deemed to have been, formed by Parent, then under Rev. Rul. 82-152, the transaction would not have been a reverse acquisition, but rather a transfer of assets to a subsidiary under § 1.1502-75(d)(2)(ii). Because the IRS failed to apply (or even mention) Rev. Rul. 82-152, it would appear that the IRS concluded that New Parent should not be treated as having been formed by Parent. This conclusion appears to be inconsistent with the IRS' previous position in similar situations that New Parent must have been formed by Parent or an agent of Parent in order for the restructuring to constitute a reverse acquisition.

- (2) A similar result was reached in Priv. Ltr. Rul. 200744006 (July 31, 2007). In the ruling, Former Parent is wholly owned by LLC 1, a limited liability company treated as a partnership for federal income tax purposes. The Former Parent stock constituted more than 50% of the fair market value of the assets of LLC 1. Prior to the transaction at issue, LLC 1 functioned as a holding partnership, and Former Parent was the common parent of an affiliated group of companies that filed a consolidated federal income tax return. On Date 1, the following series of transactions occurred: (1) LLC 1 formed Taxpayer, a corporation for federal income tax purposes; (2) Taxpayer formed LLC 2, a limited liability company wholly owned by Taxpayer; and (3) LLC 2 merged with and into LLC 1, with LLC 1 surviving such that LLC 1 became a wholly owned limited liability company of Taxpayer, and the holders of membership units in LLC 1 became shareholders of Taxpayer. Following the transaction, LLC 1 was treated as a disregarded entity such that Taxpayer was treated as owning all the Former Parent stock and the other assets owned by LLC 1. The Service

ruled that the transaction was a reverse acquisition pursuant to § 1.1502-75(d)(3) and the Former Parent group remained in existence.

- (3) Subsequently, Priv. Ltr. Rul. 200829007 (Apr. 15, 2008) modified the facts and representations of Priv. Ltr. Rul. 200744006. Priv. Ltr. Rule. 200829007 described additional transactions involving LLC 1 issuing additional membership units as part of the Date 1 transaction and Taxpayer issuing common and convertible preferred stock subsequent to the Date 1 transaction. Furthermore, the modified representations included that: (1) the holders of membership units in LLC 1 received at least 0% of the fair market value of the outstanding stock of Taxpayer at the time of the acquisitions; and (2) at the time of the acquisition, the fair market value of the stock of Former Parent was at least a% of the fair market value of all the assets of LLC 1. The Service ruled that the additional information and modified representations had no adverse effect on the reverse acquisition ruling. Query – Should the additional issuances of LLC membership units and Taxpayer stock be taken into account for purposes of §1.1502-75(d)(3)?
6. In this regard, it is noteworthy that the group structure change rules refer to P succeeding T as the common parent “under the principles” of § 1.1502-75(d)(2) or (3). *See* § 1.1502-31(a)(1); *see also* § 1.1502-33(f)(1)(i) (adjustment of earnings and profits after group structure change). The IRS has applied the group structure change rules in cases where the consolidated group of an acquired corporation continued under an application of Rev. Rul. 82-152. *See, e.g.*, Priv. Ltr. Rul. 9621030 (Feb. 23, 1996).
7. In Priv. Ltr. Rul. 199941023 (July 14, 1999), a mutual life insurance company underwent a bankruptcy reorganization in which it transferred “substantially all” of its assets and liabilities, except stock of a first tier subsidiary, to a second-tier subsidiary. As part of the transaction, the members of the mutual company then exchanged their “interests” in the common parent for stock of the first-tier subsidiary. The IRS held that this reorganization was considered a transfer of assets to a subsidiary within the meaning of § 1.1502-75(d)(2)(ii) so that the consummation of

the reorganization would not terminate the mutual company's consolidated group – the group continues with the first-tier subsidiary becoming the new common parent. Presumably, this conclusion is based on the theory that Rev. Rul. 82-152 is an expansion of § 1.1502-75(d)(2).

V. SECTION 1.1502-75(d)(3): REVERSE ACQUISITIONS

- A. Section 1.1502-75(d)(3) provides another exception to the general rule for a reverse acquisition.
 - 1. A reverse acquisition occurs if:
 - a. One corporation (“Acquiring”) or any member of the group of which Acquiring is the common parent acquires, in exchange for Acquiring stock, (i) stock of a second corporation (“Target”) such that Target becomes a member of Acquiring’s consolidated group or (ii) “substantially all” of the assets of Target; and
 - b. The shareholders of Target, as a result of owning stock of Target, own (immediately after the acquisition) more than 50% of the fair market value of the stock of Acquiring.
 - 2. The IRS interprets these rules to “deal [] with situations in which the acquiring and acquired corporations were not affiliated with each other prior to the transaction” and the inquiry is which of the two groups should remain in existence and which should terminate. Rev. Rul. 82-152, 1982-2 C.B. 205, 205; *see* Priv. Ltr. Rul. 200302022 (Sept.30, 2002) (ruling that a reverse acquisition occurs where Acquiring indirectly held less than 80% of Target prior to the restructuring); *see also Acme Steel Co. v. Commissioner*, 85 T.C.M. (CCH) 1208 (2003) (stating in dicta that § 1.1502-75(d)(3) “contemplates situations in which the acquiring and acquired corporations were not affiliated prior to the restructuring”).
 - a. This interpretation derives from the language of the regulation that describes Acquiring as the common parent of a consolidated group, suggesting that Acquiring cannot be an affiliated subsidiary of Target. *See* Priv. Ltr. Rul. 8702016 (Oct. 9, 1986).

- b. Query whether the court's reasoning in *Adobe Resources Corp. v. United States*, 967 F.2d 152 (5th Cir. 1992) (discussed in Section VI.I.2.b.(4), *infra*), is inconsistent with this view.
 - c. It might be sufficient that Acquiring and Target are not affiliated immediately before the acquisition, notwithstanding any prior affiliation. For example, consider the facts of Tech. Adv. Mem. 9649002 (June 7, 1996), where FP, a foreign corporation, owned FP2, another foreign corporation. FP2 owned P1, a domestic corporation that was the common parent of an affiliated group. P1 formed P2, a domestic corporation, and distributed the P2 stock to FP2. With respect to P2's acquisition of P1, both the examining agent and the taxpayer treated the transaction as a reverse acquisition. The IRS' National Office, however, declined to express an opinion regarding whether the transaction qualified as a reverse acquisition.
- 3. If a transaction constitutes a reverse acquisition, any group of which Acquiring was the common parent terminates on the date of the acquisition, and any group of which Target was the common parent remains in existence with Acquiring as its new (nominal) common parent. The consequences of having Acquiring as its new common parent include (among other things): (a) Form 1120 and most other forms are filed in Acquiring's name; (b) Acquiring generally makes the estimated income tax payments on behalf of the group; and (c) Acquiring's Employment Identification Number (EIN) is used on group filings..
 - 4. The substance-over-form determination made by the reverse acquisition rules (*i.e.*, providing that the larger corporation is treated as the acquiring corporation) is limited to the issues set out in the regulations. For example, the larger corporation is treated as the acquiring corporation for purposes of determining the taxable years of the group and determining taxable years for the purposes of § 381. The substance-over-form determination does not extend to other areas of the Code, such as computing the research credit under § 41. *See* Tech. Adv. Mem. 200330001 (May 2, 2003).

5. In the case of a reverse acquisition, the following special rules apply (*see* discussion at Section I.A., *supra*, regarding the possible tax ramifications of the termination of the Acquiring consolidated group):
- a. For purposes of determining the SRLY limitation on built-in losses, § 1.1502-15(c)(3) provides, “If the common parent has become the common parent of an existing group within the previous five year period in a transaction described in section . . . [1.1502-75(d)(3)], the principles of sections 1.1502-91(g)(6) and 1.1502-96(a)(2)(iii) shall apply.”
 - b. For purposes of § 1.1502-15(f) (built-in losses recognized by common parent of group) and § 1.1502-21(b) (offspring rule for carryovers and carrybacks of consolidated net operating losses), references to the common parent are to the common parent before the reverse acquisition. *See* § 1.1502-15(f)(1); § 1.1502-21(b)(2)(ii)(B).
 - c. If the common parent became the common parent in the reverse acquisition within the previous five year period, appropriate adjustments must be made in applying § 1.1502-91(g)(ii)(A) so that corporations that have not been members of the group for five years are not included. *See* § 1.1502-91(g)(6).
 - d. Similarly, appropriate adjustments must be made in applying § 1.1502-96(a)(2)(ii) and (3), and references to the common parent are to the common parent before the reverse acquisition. *See* § 1.1502-96(a)(2)(ii)(D).
 - e. For purposes of § 1.1502-35(c), which provides for the suspension of losses on certain stock dispositions, a surviving group is treated as a successor group of a consolidated group (the terminating group) that ceases to exist as a result of the application of § 1.1502-75(d)(3).
 - f. Losses of the continuing group’s former common parent generally will not be subject to the SRLY rules as a result of the “lonely parent” exception to such limitations. § § 1.1502-1(f)(2)(i) and -1(f)(3). *But See* CCA 200441026, in which the IRS concludes that the “lonely parent” exception applies only to loss carryovers from pre-reverse

acquisition separate return years to post-reverse acquisition consolidated return years (discussed more fully in section V.E.2.A below).

- g. Following a reverse acquisition constituting a group structure change, basis adjustments or redeterminations may be required under § 1.1502-31. In the case of a reverse acquisition accomplished through the acquisition of “substantially all” of Target’s assets, the basis of the members in the stock of Acquiring is adjusted immediately after the group structure change under § 1.1502-31(b)(1). In the case of a reverse acquisition accomplished through the acquisition of Target stock, the basis of the members in the Target stock immediately after the group structure change that is, or would otherwise be, transferred basis property is redetermined under § 1.1502-31(b)(2). Thus, § 1.1502-31(b)(2) will not adjust the stock basis if the basis of the members in the Target stock is a cost basis.
 - h. Following a reverse acquisition constituting a group structure change, the earnings and profits of the common parent are adjusted under § 1.1502-33(f) to reflect the earnings and profits of the common parent immediately before the reverse acquisition.
- 6. Example 16. Mr. J owns 100% of Target, the common parent of a group, and an unrelated individual owns 100% of Acquiring, which has 100 shares of stock outstanding and which is the common parent of another group. Target is merged with and into Acquiring, with Acquiring as the surviving corporation, and Mr. J receives 200 shares of Acquiring stock in the merger. Because Mr. J owns two-third of the stock of Acquiring as a result of his stock ownership in Target prior to the merger, transaction constitutes a reverse acquisition. Consequently, the Acquiring group terminates, and the Target group remains in existence with Acquiring as the new (nominal) common parent.
- B. In some sense, the reverse acquisition rules attempt to identify, based upon relative shareholder ownership after the transaction, the larger of the two combining groups as the acquiring corporation – even though in form the smaller corporation is the acquiring corporation. As a result, in the case of certain acquisitions (*e.g.*, involving the issuance of a combination of cash and stock), the reverse acquisition rules based only on the amount of stock issued will not accurately

measure the larger of the two groups. In situations involving all stock acquisitions, however, the determination of the surviving group depends, in the first instance, on the relative net equity capitalization of each group. If the intent was to determine the larger of the two corporations, query whether relative net equity capitalization should have been selected as the measurement standard.

1. Depending upon one's view of how to choose which of two or more groups should survive a combination transaction, the selection of relative net equity capitalization as the measurement standard may seem inappropriate in many cases. Other standards (*e.g.*, net change in value of the acquiring corporation, gross asset value, net sales, gross income, net income, length of time a group has existed, etc.) could have been chosen that would dictate different results in many cases. It appears, however, that the reverse acquisition rules attempt to continue the group that ultimately controls the combined entity and it is not clear that any of these other measurement standards could reach more sensible results in significantly more cases. Consequently, because relative net equity capitalization is the measurement standard that often directly indicates control (or ultimately ownership percentage), it appears to be a reasonable measurement standard for this purpose. Note that this measurement standard, however, can be manipulated, particularly through the introduction of non-stock consideration in the acquisition. Furthermore, this purpose may not be achieved if non-voting stock is used.
2. Given that the relative net equity capitalization forms the basis of the measurement standard, all stock is considered in determining which group is larger – a selection that increases administrative simplicity in determining which of two combining groups continues by providing a bright-line rule. Query whether recently enacted legislation that treats nonqualified preferred stock as defined in § 351(g) as boot in a reorganization should affect this determination. *See* §§ 345(a)(2)(C), 356(e). Section 351(g)(4) authorizes the Secretary to prescribe regulations to treat nonqualified preferred stock as not stock for purposes of other provisions of the Code, and the House bill provides that nonqualified preferred stock shall continue to be treated as stock until regulations are issued. *See* H.R. Conf. Rep. No. 105-220, at 544 (1997). In any event, it does not seem to be advisable

or particularly important that nonqualified preferred stock be carved out and treated differently than any other type of non-participating preferred stock for purposes of the reverse acquisition rules.

C. Approach for Revised Reverse Acquisition Rules.

1. The reverse acquisition rules ensure that when two consolidated groups combine, one consolidated group remains in existence. The consequence of the continuation of only one group rather than both groups (*i.e.*, the termination of one group) is not as important today as it once was because many regulations provide subgroup or whole group exceptions to prevent the negative consequences that may arise from the termination of the group. *See, e.g.*, § 1.1502-13(j)(5) (items from intercompany transactions generally will not be taken into account if the parties to the intercompany transaction become members of the acquiring group); § 1.1502-19(c)(3) (excess loss accounts generally will not be triggered if the members of the terminating group become members of the acquiring group); § 1.1502-21(c)(2) (SRLY limitation will be determined on a subgroup basis); and § 1.1502-35 (basis redetermination rule does not apply because of the termination of the group).
2. From the government's perspective, the importance that a specific group remains in existence following the combination of two different groups has been reduced. *See, e.g.*, §§ 382, 384. It is unclear as a policy matter whether there continues to be a need for substance-over-form rules regarding which group should remain in existence.
3. In situations where the common stock of the two combining groups (or if one of the corporations is a stand-alone corporation, the stock of the stand-alone corporation) is publicly traded and the groups are comparable in size, in the absence of any strong policy concerns to the contrary, we believe taxpayers *should* be able to elect which of the two combining groups will remain in existence. *Cf. Falconwood* (indicating that the direction of a transaction may determine whether the group remains in existence). The availability of an election for cases of comparability would be premised on the notion that the combination of comparable sized enterprises would not be driven in any respect by an intent to manipulate reverse acquisition rules, and in such cases, there probably is not a "right" answer as to

which group ought to survive because the selected threshold is somewhat arbitrary. Our view is also based on a belief that §§ 269, 382, and 384 generally are more than sufficient to prevent abusive attribute trafficking in fact patterns involving “comparability.” The availability of such an election, however, would require establishing a standard for determining when two groups are comparable in size. Rather than establishing a single point in time to determine comparability, which would result in a potential for manipulation that exists under the current regulation, we believe comparability would be fairly established with minimum manipulation by examining a time period (*e.g.*, the market capitalization of the two corporations is within 5% of each other throughout the six month period preceding the acquisition). We believe that an elective approach is warranted and well suited for situations where the parties are publicly traded so that the ability to manipulate stock ownership and therefore the proposed rule would generally be low.

4. In situations where the common stock of either (or both) of the two combining groups (or if one of the corporations is a stand-alone corporation, the stock of the stand-alone corporation) is not publicly traded, the valuation of multiple classes of stock is inherently more difficult. Notwithstanding this difficulty, we believe that there should exist the same degree of electivity to promote certainty given the various protections in place to protect the fisc (*e.g.*, §§ 269, 382, and 384). In this case, comparability perhaps could look to the reasonableness of some additional factors to ease the difficulty of valuation (*e.g.*, sales or net profits for the three years preceding the acquisition).
5. The current regulations do not provide special rules for determining which corporations are treated as the continuing group following a divisive transaction (*i.e.*, a distribution of a subsidiary under § 311 or § 355 by the company parent). Thus, under the current regulations a group remains in existence with the common parent continuing as the common parent, notwithstanding that majority of the group’s assets may have been distributed. Any revision of the existing rules should address divisive transaction and treat the corporations that reflect the majority of the group’s value as the continuing group. This proposed approach for divisive transactions would provide symmetry with the rule that treats the larger of two combining

groups as the continuing consolidated group. The “comparability” rule presumably should be available in this fact pattern as well.

D. Impact of Reverse Acquisition on Taxable Years.

1. If, in a reverse acquisition, Acquiring files a consolidated return for the first taxable year ending after the date of the acquisition, then Acquiring and each member of Acquiring’s group shall close its taxable year as of the date of the acquisition. Each such corporation shall, immediately after the acquisition, change to the taxable year of Target. § 1.1502-75(d)(3)(v)(a); *see* Priv. Ltr. Rul. 200744006 (July 31, 2007) (ruling that the consolidated return for the first taxable year after the reverse acquisition to be filed by the Acquiring will use as its taxable year the taxable year of Target); Priv. Ltr. Rul. 9751028 (Sept. 19, 1997) (ruling that Acquiring and its subsidiaries shall adopt the taxable year of Target).
 - a. Compliance with § 1.1502-75(d)(3)(v) will not be considered a prior change in annual accounting period for purposes of the 48-month period of time required between a prior accounting period change and a change effected under Rev. Procs. 2006-45, 2006-45 I.R.B. 851 (providing the exclusive procedures for certain corporations to obtain automatic approval to change their annual accounting periods under § 442) and 2006-46, 2006-45 I.R.B. 859 (providing the exclusive procedures for certain partnerships, S corporations, electing S corporations, and personal service corporations to obtain automatic approval to adopt, change, or retain their annual accounting periods under § 442).
2. If the reverse acquisition is a transaction described in § 381(a)(2), then for purposes of § 381, the following rules apply:
 - a. All taxable years ending on or before the date of acquisition, of Acquiring and each corporation that, immediately before the acquisition, was a member of Acquiring’s group shall be treated as taxable years of the transferor corporation. § 1.1502-75(d)(3)(v)(b)(1). *See e.g.*, Rev. Rul. 89-80, 1989-1 C.B. 273 (post-consolidation losses of entity formed in the consolidation of two unrelated common parent corporations could not be carried back to prior

years of the terminating group, losses of historical members of terminating group may, however, be carried back to prior years of terminating group).

- b. Target shall not close its taxable year merely because of the acquisition; all taxable years ending on or before the date of acquisition, of Target and each corporation that, immediately before the acquisition, was a member of Target's group shall be treated as taxable years of the acquiring corporation. § 1.1502-75(d)(3)(v)(b)(2).
- c. Presumably, no challenge could now be made that the Treasury exceeded the scope of its authority and legislated outside the authority delegated to it by Congress in providing for the reversal of § 381 in § 1.1502-75(d)(3). *See* § 1502 (the last sentence overrules the Federal Circuit's reasoning in *Rite Aid*).

E. Impact of Reverse Acquisitions on Loss Utilization.

- 1. Ordinarily, when a corporation or a consolidated group is acquired by a consolidated group, Target's (or the Target group's) tax year closes at the end of the day of the acquisition. § 1.1502-76(b). Target's tax years that end on or before the acquisition are generally treated as SRLYs. § 1.1502-1(f). Historically, the absorption of any losses that arose in SRLYs are subject to limitation. § 1.1502-21(c).
- 2. In a reverse acquisition, taxable years of the Target group that end on or before the acquisition are not treated as SRLYs (unless they were so treated immediately before the acquisition). § 1.1502-1(f)(3); *see also* Priv. Ltr. Rul. 200744006 (July 31, 2007). Taxable years of the Acquiring group that end on or before the date of the acquisition are treated as SRLYs. If a reverse acquisition occurs as a result of a merger in which Target goes out of existence, then the tax years of Acquiring ending prior to the merger are treated as SRLYs. § 1.1502-1(f)(3). Acquiring, nonetheless, remains eligible to be included in a SRLY subgroup. *See* FSA 200002003 (Oct. 4, 1999).
 - a. Losses of the continuing group's common parent generally will not be subject to the SRLY rules as a result of the "lonely parent" exception to such limitations. §§ 1.1502-1(f)(2)(i) and -1(f)(3). This exception, however, does not apply if the losses were previously subject to a SRLY

limitation in the continuing group. Furthermore, the IRS asserts that the “lonely parent” exception applies only to loss carryovers from pre-reverse acquisition separate return years to post-reverse acquisition consolidated return years. *See* CCA 200441026. In the CCA, P’s shareholders contributed cash and all of their P stock to X in exchange for all of X’s stock in a transaction purporting to qualify as a reverse acquisition in Year 1. As a result, the P group remained in existence with X becoming the new common parent. In Year 4, X converted into an S Corporation and six members of the group made QSub elections, causing the group of which X is the common parent to terminate. For Year 4, P filed a consolidated return on behalf of a new group that included P and its remaining subsidiary. T dissolved during Year 4, and P filed separate returns in each of Years 5, 6, and 7. P carried its NOLs from Years 5, 6, and 7 back to the Year 3 consolidated return of the Old P group. The IRS concluded that P’s NOLs from Years 5, 6, and 7 were subject to the SRLY rules, because P is not the “lonely parent” for years following the reverse acquisition. Rather, in the view of the IRS, X is the “lonely parent” for consolidated return years of the Old P group following the reverse acquisition, including Year 3. The IRS stated, “the taxpayer’s argument necessarily leads to the nonsensical conclusion that, for years after the break-up of the group, the separate return years of both the first corporation (Y) and the second corporation (X) qualify for the Lonely Parent exception to the SRLY rules.” Query whether the position espoused by the IRS creates two “lonely parents” for Year 3 (*i.e.*, P is the “lonely parent” with respect to NOL carrybacks, and X is the “lonely parent” with respect to NOL carryforwards).

3. If a stand-alone corporation becomes a member of a consolidated group within six months (the “SRLY Event”) of a transaction that gives rise to a §382 limitation (the “382 Event”) the transaction is subject to a special rule (the “Overlap Rule”). Where the Overlap Rule applies, the loss is subject to limitation only under § 382, and the SRLY limitation is expressly inapplicable. § 1.1502-21(g).

- a. Similar rules apply for business credits under § 1.1502-3, built-in losses under § 1.1502-15, capital losses under § 1.1502-22, and the alternative minimum tax under § 1.1502-55.
 - b. The Overlap Rule for NOLs, built-in losses, and capital losses was adopted in 1999 and is effective for consolidated return years with an unextended due date after June 25, 1999. T.D. 8823 (Jun. 25, 1999). The Overlap Rule for credits and the alternative minimum tax was adopted in 2000 and is effective for consolidated return years with an unextended due date after May 25, 2000. T.D. 8884 (May 24, 2000).
 - c. Example 17. Individual A owns all of the stock of P, a stand-alone corporation. Individual B owns all of the stock of X, the common parent of a consolidated group. Individual A is unrelated to Individual B. P has a \$200 net operating loss carryforward from 1999. On January 1, 2001, P acquired all of the X stock from Individual B in exchange for P stock. Immediately after P's acquisition of X, Individual B owned 65% of the outstanding P stock. Because the transaction was a reverse acquisition within the meaning of § 1.1502-75(d)(3), P's acquisition of X caused P to become a member of the X consolidated group. As a result, the acquisition caused a SRLY Event with respect to the 1999 net operating loss carryforward. The acquisition also caused a § 382 limitation to be imposed on P's 1999 net operating loss carryforward and therefore caused a 382 Event. Because the SRLY Event occurred within six months of the 382 Event, the Overlap Rule applies to P's net operating losses and eliminates the application of the SRLY rules to this net operating loss, thus precluding the application of any SRLY limitation on P's NOL.
4. If multiple corporations become members of a consolidated group, the Overlap Rule applies as to any given loss only where there is a co-extensive § 382 subgroup and SRLY subgroup with respect to that loss. The requirement of co-extensive subgroups with respect to each particular loss means that all members

(including predecessors) of the § 382 subgroup must also be members (including predecessors) of the SRLY subgroup, and vice-versa.

- a. The rationale for the co-extensive subgroup requirement is based on an assumption that “the simultaneous or proximate imposition of a § 382 limitation reasonably approximates a corresponding SRLY limitation.” Preamble to T.D. 8823, 1999-2 C.B. 34, 37. Where multiple corporations are acquired this assumption would break down if the two limitations (*i.e.*, the SRLY limitation and the § 382 limitation) are not based on the values and operations of the same corporations. If a corporation is included in one subgroup but not the other subgroup, then the two limitations would not approximate each other and therefore would violate the central assumption of the Overlap Rule. Query whether a difference in subgroups that does not produce a material difference is equally valid.
- b. A SRLY NOL subgroup under § 1.1502-21(c)(2) requires that (1) two or more corporations that were members of one affiliated group become members of another affiliated group together, *and* (2) at least one of the corporations has an NOL that was not SRLY to the former affiliated group (whether or not the group filed consolidated returns) but is a SRLY carryover to the current group, *or* was subject to the Overlap Rule in the former affiliated group (whether or not the group filed consolidated returns).
- c. A SRLY built-in loss subgroup under § 1.1502-15(c)(2) consists of at least two members of a group that have been continuously affiliated (or deemed affiliated) with one another (in one or more former groups) for the 60 consecutive months ending immediately before they became members of the group in which the loss is recognized.
- d. A § 382 NOL subgroup under § 1.1502-91(d)(1) requires that (1) two or more companies that were affiliated in a former group (whether or not that former group filed a consolidated return), (2) bear a § 1504 subgroup relationship to each other through a subgroup parent immediately after they join the current group (or are deemed to do so pursuant to a § 1.1502-91(d)(4) election), and (3) at least one of the companies has an NOL that was not SRLY to

the former group, or was folded into the former affiliated group under §1.1502-96. An attribute that has folded in under § 1.1502-96 is treated as an attribute of the acquiring group for purposes of future ownership changes. An attribute will fold-in at the earlier of a § 382 ownership change six months before, at the time of, or after joining the consolidated group or the expiration of five years in the group.

- e. A § 382 built-in loss subgroup under § 1.1502-91(d)(2) requires that (1) two or more companies that were continuously affiliated in one or more former groups (whether or not those groups filed consolidated returns) for the five-consecutive-year period immediately before they joined the current group, (2) bear a § 1504 subgroup relationship to each other through a subgroup parent immediately after they join the current group (or, are deemed to do so pursuant to a § 1.1502-91(d)(4) election), and (3) the companies have a subgroup net unrealized built-in loss when they join the current group.

- 5. Because the Overlap Rule eliminates the SRLY limitation with respect to losses, it has been heralded as the end of the SRLY regime. Although the role of the SRLY regime has been limited, it is by no means the end of SRLY as a result of the co-extensive subgroup requirement that, in practice, often is not satisfied. Moreover, in terms of planning, an acquirer will quite often not be in a position to know whether this rule can be satisfied, thus requiring SRLY planning as if the rule were to apply. In addition, the Overlap Rule is inapplicable to the carryback of net operating losses from one consolidated group to another group. As a result, it is essential to maintain an understanding of the SRLY regime and those cases in which the Overlap Rule will apply and those situations that will prevent its applicability. The majority of the situations where the Overlap Rule might be expected not to apply are likely caused by the difference in the definition of a SRLY subgroup and a § 382 subgroup or the carryback of losses.

- a. Example 18. Individual A owns all of the stock of P, the common parent of a consolidated group. Individual B owns all of the stock of X, the common parent of a consolidated group. X has a wholly owned subsidiary X1.

Individual A is unrelated to Individual B. Together X and X1 have a \$200 consolidated net operating loss carryforward from 1999. On January 1, 2001, P purchased all of the X stock from Individual B. P's acquisition of X caused X and X1 to become members of the P consolidated group. As a result, the acquisition caused a SRLY Event with respect to the 1999 consolidated net operating loss carryforward. With respect to the 1999 consolidated net operating loss carryforward, X and X1 comprise a SRLY subgroup in the P group. P's acquisition of X also caused a § 382 limitation with respect to the 1999 consolidated net operating loss carryforward. The imposition of a § 382 limitation on the 1999 consolidated net operating loss carryforward caused a 382 Event. The §382 limitation is based on the § 382 subgroup composed of X and X1. In this Example, all members of the § 382 subgroup (*i.e.*, X and X1) are members of the SRLY subgroup and vice versa. The SRLY Event occurred within six months of the 382 Event and the Overlap Rule is available because the § 382 subgroup and the SRLY subgroup are co-extensive. As a result the 1999 consolidated net operating loss carryforward is not subject to a SRLY limitation in the P consolidated group.

- b. Example 19. Individual A owns all of the stock of P, the common parent of a consolidated group. Individual B owns all of the stock of X, the common parent of a consolidated group. X has two wholly owned subsidiaries, X1 and X2. Individual A is unrelated to Individual B. Together X, X1, and X2 have a \$200 consolidated net operating loss carryforward from 1999, all of which is attributable to X1. On January 1, 2001, P purchased all of the X1 and X2 stock from X. P's acquisition of X1 and X2 caused them to become members of the P consolidated group. As a result, the acquisition caused a SRLY Event with respect to the 1999 consolidated net operating loss carryforward attributable to X1. With respect to the X1 loss carryforward X1 and X2 comprise a SRLY subgroup in the P group. P's acquisition of X1 also caused a § 382 limitation to be imposed on the X1 loss carryforward and therefore caused a 382 Event. Because X1 and X2 are not members of the same § 382 subgroup, the §382 limitation is based solely on X1 and not on a § 382 subgroup

composed of X1 and X2. The reason X1 and X2 do not comprise a § 382 subgroup is because they do not satisfy the § 1504 relationship requirement. As mentioned previously, the Overlap Rule will not apply unless the § 382 subgroup and the SRLY subgroup are co-extensive notwithstanding that the SRLY Event occurred within six months of the 382 Event. In this Example, there is a SRLY subgroup, but there is not a § 382 subgroup. As a result, the 1999 net operating loss carryforward is subject to a SRLY subgroup limitation in the P consolidated group and a separate company § 382 limitation.

- c. Limited relief to protect the application of the Overlap Rule in such circumstances is provided under §1.1502-91(d)(4) whereby a consolidated group may make an election to treat the § 1504 subgroup requirement as satisfied. One consequence of making this election is that all the members of the deemed §382 subgroup will be treated as a subgroup parent for the subgroup for purposes of testing future ownership changes.
 - (1) Example 20. Individual A owns all of the stock of P, the common parent of a consolidated group. Individual B owns all of the stock of X, the common parent of a consolidated group. X has two wholly owned subsidiaries, X1 and X2. Individual A is unrelated to Individual B. Together X, X1, and X2 have a \$200 consolidated net operating loss carryforward from 1999, all of which is attributable to X1. On January 1, 2001, P purchased all of the X1 and X2 stock from X and makes an election under §1.1502-91(d)(4).
 - (i) P's acquisition of X1 and X2 caused them to become members of the P consolidated group. As a result, the acquisition caused a SRLY Event with respect to the 1999 consolidated net operating loss carryforward attributable to X1. With respect to the X1 loss carryforward, X1 and X2 comprise a SRLY subgroup in the P group. P's acquisition of X1 also caused a § 382 limitation to be imposed on the X1 loss carryforward and therefore caused a 382 Event.

The § 382 limitation is based on a § 382 subgroup composed of X1 and X2 because the §1504 subgroup requirement is deemed to be satisfied by virtue of the election made under § 1.1502-91(d)(4).

- (ii) As mentioned previously, the Overlap Rule will not apply unless the § 382 subgroup and the SRLY subgroup are co-extensive, notwithstanding that the SRLY Event occurred within six months of the 382 Event. In this Example, all members of the § 382 subgroup also are members of the SRLY subgroup and vice versa. As a result, X1's loss carryforward is not subject to a SRLY limitation in the P consolidated group.
- (2) Although Example 20 illustrates that the § 1504 subgroup requirement can be deemed satisfied by making an election under § 1.1502-91(d)(4), it is important to note that not all § 1504 subgroup problems can be rectified. The inability to correct all the problems emanates from the effective date of § 1.1502-91(d)(4). According to § 1.1502-99(b) an election under § 1.1502-91(d)(4) can only be made for acquisitions occurring in a taxable year with an unextended due date after June 25, 1999. Thus, where corporations with net operating loss carryforwards were acquired without a loss subgroup parent in a taxable year with an unextended due date prior to June 26, 1999, there will be an inability to satisfy the co-extensive subgroup requirement of § 1.1502-21(g)(4).
- d. Example 21. Individual A owns all of the stock of P, the common parent of a consolidated group, and T, a stand-alone corporation. P has two wholly owned subsidiaries, P1 and P2. T has a \$200 net operating loss carryforward from 1996. On January 1, 1998, Individual A contributed all of the T stock to P. Individual B, an individual who is unrelated to Individual A, owns all of the stock of X, the common parent of a consolidated group. On January 1, 2004, X purchased all of the P stock from Individual A.

- (1) P's acquisition of T caused T to become a member of the P consolidated group. As a result, the acquisition caused a SRLY Event with respect to the 1996 net operating loss carryforward. P's acquisition of T, however, did not cause a § 382 limitation to be imposed on T's 1996 net operating loss carryforward. Because the SRLY Event did not occur within the six months of a 382 Event, the Overlap Rule does not apply to T's net operating losses and therefore T's 1996 net operating loss is subject to a SRLY limitation in the P group.
 - (2) X's acquisition of P caused the members of the P group, including T, to become members of the X consolidated group. As a result, the acquisition caused a SRLY Event with respect to T's 1996 net operating loss carryforward. A SRLY subgroup does not exist with respect to the 1996 net operating loss carryforward because T's 1996 loss arose in a SRLY to the P group and T did not join the P group in an Overlap transaction. With respect to T's 1996 net operating loss P, P1, P2, and T comprise a § 382 subgroup in the X group. There is a § 382 subgroup with respect to the 1996 net operating loss because T's 1996 loss folded into the P consolidated group (under § 1.1502-96) after T was a member of the P group for five years without an ownership change.
 - (3) As mentioned previously, the Overlap Rule will not apply unless the § 382 subgroup and the SRLY subgroup are co-extensive, notwithstanding that the SRLY Event occurred within six months of the 382 Event. In this Example, there is a § 382 subgroup, but there is not a SRLY subgroup. As a result, T's 1996 net operating loss carryforward is subject to a §382 subgroup limitation in the X consolidated group and a separate company SRLY limitation.
6. Example 22. Individual A owns all of the stock of P, the common parent of a consolidated group, and T, a stand-alone corporation. P has two wholly owned subsidiaries, P1 and P2 that have been a member of the P consolidated group for more than 60 months. On January 1, 2001, T merged into P1 solely in

exchange for P stock in a transaction qualifying under § 368(a). Individual B, an individual who is unrelated to Individual A, owns all of the stock of X, the common parent of a consolidated group. On January 1, 2003, P acquired all of the X stock from Individual B. Immediately after P's acquisition of X, Individual B owned more than 50% of the outstanding P stock. At the time of P's acquisition of X, P had a net unrealized built-in gain of \$10, P1 had a net unrealized built-in loss of \$30, and P2 had a net unrealized built-in loss of \$10. Assume that these amounts exceed the threshold requirements of § 382(h)(3)(B).

- a. P's acquisition of X was a reverse acquisition within the meaning of § 1.1502-75(d)(3). As a result, the P consolidated group terminated and the X consolidated group remained in existence. Unless the Overlap Rule applies, § 1.1502-15 will limit the absorption of the built-in loss items of the P consolidated group in the X consolidated group. The application of the Overlap Rule depends on the satisfaction of the co-extensive subgroup requirement.
- b. The SRLY built-in loss subgroup requires that members be continuously affiliated for 60 months. In the P consolidated group, P, P1, and P2 have continuously been affiliated for more than 60 months. Query whether T's merger into P1 prevents P1 from satisfying the 60 month continuous affiliation requirement. According to § 1.1502-15(e), references to a member includes a reference to predecessor or successor as defined in § 1.1502-1(f). Section 1.1502-1(f) provides that a corporation will be a successor to another corporation if, among other things, it acquires assets in a transaction described in § 381(a). Because a § 368(a) merger is a transaction described in § 381(a), P1 is a successor to T. As a result, P1 may not be treated as affiliated with P and P2 for the required 60 months. If P1 does not satisfy the requirement, P and P2 will constitute a built-in loss subgroup and P1 is subject to a separate company limitation. On the other hand, if P1's successor status does not prevent P1 from satisfying the 60 month affiliation requirement, then P, P1, and P2 will be treated as a built-in loss subgroup.

- c. A similar issue arises for determining the § 382 built-in loss subgroup. Section 1.1502-91(d)(2) requires, among other things, that only those corporations that have been continuously affiliated for five years can be included in a § 382 subgroup. According to § 1.1502-91(j) references to a member includes a reference to predecessor or successor as defined in § 1.1502-1(f). Thus, P1 may or may not be prevented from joining in the § 382 built-in loss subgroup.
- d. The determination of whether P1 is included in the SRLY built-in loss subgroup and the § 382 built-in loss subgroup should not matter if a consistent approach is taken for both rules. Either the respective subgroups will be P, P1, and P2 or there will be a subgroup of P and P2 and a separate company limitation on P1. As a result, the built-in loss is not subject to a limitation under § 1.1502-15, but rather only subject to a § 382 limitation.

F. Revenue Ruling 82-152 Revisited.

1. As discussed in Section IV.D., *supra*, Rev. Rul. 82-152 concludes that the reverse acquisition exception of § 1.1502-75(d)(3) does not apply to an acquisition where Acquiring and Target were affiliated with each other prior to the transaction. This conclusion is hardly free from doubt. *See* Matthew B. Krasner, “Continuation of the Affiliated Group Subsequent to a Divisive Reorganization: A Patchwork of Inconsistent Rules with Uncertain Application,” 41 Vand. L. Rev. 283, 296 n.44 (Mar. 1988).
2. General Counsel Memorandum 39,528 (July 14, 1986) reaffirms the position set forth in Rev. Rul. 82-152, wherein the IRS concluded that when a foreign parent corporation (FP) “merged” into its wholly owned domestic subsidiary (S1) that was the parent of a consolidated group, the reverse acquisition exception did not apply even though the shareholders of the acquired corporation, FP, owned all of the stock of the acquiring corporation, S1, after the transaction. As a result, the S1 group continued to exist under § 1.1502-75(d)(2), and therefore S1’s net operating losses were not subject to the SRLY limitations.
3. The language of the regulation contemplates that both Acquiring and Target be members of different affiliated groups prior to the acquisition. Although this is consistent with Rev. Rul. 82-152, wherein the IRS noted that the reverse acquisition

rules do not apply where Acquiring and Target were affiliated with each other prior to the transaction, the IRS also has ruled that a reverse acquisition can occur despite the fact either Acquiring or Target (or both) is not a member of an affiliated group (*i.e.*, a stand-alone corporation) prior to the acquisition. *See* Rev. Rul. 89-80, 1989-1 C.B. 273 (finding a reverse acquisition upon the consolidation of two unrelated common parent corporations into a newly formed corporation not a member of an affiliated group prior to the acquisition); Rev. Rul. 72-322, 1972-1 C.B. 287 (finding a reverse acquisition where the common parent of an affiliated group acquired a target that was not a member of an affiliated group prior to its acquisition); Priv. Ltr. Rul. 200102025 (Oct. 6, 2000) (granting relief to file a late consolidated return election where the acquisition of a stand-alone corporation in a reverse acquisition terminated the acquiring consolidated group). In order to avoid a group terminating in the case of a mere internal restructuring, the IRS presumably has not applied the reverse acquisition rules among affiliates, notwithstanding its willingness to resist a literal interpretation of those rules to apply them to stand-alone corporations.

4. The IRS' ruling position reflects a well-intentioned effort to get sensible results in this area, but the goal is better accomplished by amendment to the regulations. To reflect the IRS's current ruling position, the regulation would need redrafting to provide rules that Acquiring and Target not be affiliated with each other prior to the acquisition (and that they need not be part of a separate affiliated group) without reference to whether either Acquiring or Target is the common parent of an affiliated group.

VI. ILLUSTRATION OF CERTAIN REQUIREMENTS AND ASPECTS OF REVERSE ACQUISITION RULES

- A. Test is by Reference to Fair Market Value of Acquiring's Stock. The 50% threshold of § 1.1502-75(d)(3) is tested by reference to the fair market value of the Acquiring stock. For this purpose, all stock of Acquiring is considered, including plain vanilla nonvoting preferred stock described in § 1504(a)(4) and nonqualified preferred stock within the meaning of § 351(g).
 1. Example 23. Acquiring, which has \$100 worth of stock outstanding, is the common parent of one group. Target, which

was \$200 worth of stock outstanding, is the common parent of another group. Acquiring acquires the stock of Target from the Target shareholders in exchange for \$200 of Acquiring's newly issued § 1504(a)(4) preferred stock. The transaction constitutes a reverse acquisition because the former Target shareholders receive, in exchange for their Target stock, Acquiring stock which constitutes more than 50% of the fair market value of Acquiring's stock. As a result, the Acquiring group terminates, and the Target group continues with Acquiring as its new (nominal) common parent. *See* Priv. Ltr. Rul. 8233089 (May 20, 1982) (acquisition in exchange for noncumulative, nonconvertible voting preferred stock). While the shareholders of Target have relinquished their participation in the future growth of the corporation, the reverse acquisition rules determine which group continues by what is exclusively a corporate-level inquiry at the time of the transaction. That being so, query why the reverse acquisition rules do not consider all of the acquisition consideration (*i.e.*, stock, debt, cash, and other property). For example, should the result be the same if the Target shareholders, who might be indifferent as to whether they receive § 1504(a)(4) preferred stock or subordinated debt, accept subordinated debt merely for the purpose of avoiding a reverse acquisition? Because of the similarities between § 1504(a)(4) preferred stock and subordinated debt, where the mix of consideration is altered in such a manner for the purpose of manipulating the reverse acquisition rules, the analysis arguably should be (but is not currently) affected. However, the difference in treatment is justified based on the fact that § 1504(a)(4) preferred stock, although similar to subordinated debt, is treated as equity for federal income tax purposes.

2. In applying the 50% test of § 1.1502-75(d)(3), only Acquiring *stock* is taken into account; options, rights to acquire stock, and other equity flavored instruments (unless they constitute stock) are disregarded. *Cf.* § 1.1504-4 (treating options as exercised under certain circumstances for purposes of determining whether a corporation is a member of an affiliated group under § 1504).
3. Note that although the use of nonqualified preferred stock within the meaning of § 351(g) might cause a transaction that otherwise would be tax-free to be taxable, it would not disqualify a transaction as a reverse acquisition.

- B. In CCA 199944001 (Mar. 5, 1999), the IRS' National Office considered the effect of certain stock on the 50% threshold of § 1.1502-75(d)(3). Specifically, the Chief Counsel Advice examined (1) Acquiring stock owned by Acquiring's subsidiary and (2) unvested Acquiring stock granted to Acquiring's employees. The IRS' position in CCA 199944001 is that Acquiring stock owned by its subsidiary is not taken into account for purposes of § 1.1502-75(d)(3). The conclusion is based on the IRS' concern that a contrary decision would overstate the value of Acquiring's stock. With respect to the employee stock, the IRS' position is that the stock is not outstanding for purposes of § 1.1502-75(d)(3) until the stock has vested.
- C. The 50% Test is Applied at Time of Acquisition.
1. The relative holdings of the shareholders of Target and Acquiring, for purposes of applying the 50% test, are determined at the moment of the acquisition. As a result, subject to the related transaction rule in the last sentence of § 1.1502-75(d)(3)(i) (described below), the relative size of the groups can be adjusted prior to the acquisition by transfers of property to, or distributions from, one of the corporations to ensure which group will be deemed the surviving group.
 2. The related transaction rule provides that any acquisition or redemptions of the stock of Acquiring or Target pursuant to the plan or acquisition must be taken into account. § 1.1502-75(d)(3)(i) (last sentence).
 3. Example 24. Acquiring, which has \$100 worth of stock outstanding is the common parent of one group. Target, which has \$150 worth of stock outstanding, is the common parent of another group. The shareholders of Acquiring and Target are identical and desire to combine their two groups. Because Acquiring has substantial net operating losses, the shareholders prefer that the Acquiring group survive. Target recapitalizes \$60 of its stock into 20-year debt. Acquiring then acquires all of the Target stock or assets in exchange for \$90 of Acquiring stock. Subject to the related transaction rule of § 1.1502-75(d)(3)(i), the acquisition will not constitute a reverse acquisition because the Target shareholders do not own more than 50% of the Acquiring stock by reason of their ownership of Target stock. Thus, the Target group terminates and the Acquiring group continues. If the recapitalization constitutes a redemption of Target stock, query whether the related transaction rule would apply and what the

related transaction rule means when it provides that the redemption must be “taken into account.” Does this mean that the redemption is given effect or not?

4. Example 25. The facts are the same as those in Example 24, *supra*, except that Target acquires all of the stock or assets of Acquiring. The acquisition constitutes a reverse acquisition because the Acquiring shareholders own at least 50% of the Target stock by reason of their ownership of Acquiring stock. Thus, the Target group terminates and the Acquiring group continues. Again, it is the size of the groups, rather than the direction of the acquisition, that determines which group survives.

D. Only Acquiring Stock Acquired As a Result of Owning Target Stock Counts.

1. Target shareholders must own more than 50% of Acquiring’s stock “as a result of” owning Target stock.
2. This means that only Acquiring stock that is *acquired* as a result of a shareholder’s former interest in Target is taken into account in applying the 50% test, *i.e.*, the Target shareholders must acquire more than 50% of the Acquiring stock in exchange for Target stock in the transaction.
 - a. In Tech. Adv. Mem. 9806003 (Oct. 1, 1997), a reverse acquisition occurred notwithstanding that, in form, Acquiring stock was not acquired in exchange for Target stock. This ruling, however, is consistent with the general rule set forth above because the IRS properly acknowledged that the substance of the transaction was an exchange of stock for stock. In the ruling, Parent (the Target corporation) is a domestic corporation which was the common parent of an affiliated group. FY, a foreign corporation, held shares of Parent common stock and most of the shares of Parent class B stock. The public owned the remaining shares of Parent common stock. Management of Parent decided to take Parent “private” and to consolidate certain of its operations. Parent devised a plan involving a series of steps pursuant to which Parent would become a wholly owned subsidiary of a new holding company (Holdings, the Acquiring corporation), in which FY would own 50% of the vote and 60% of the value, and Investor III would own 50% of the vote and 40% of the value. Holdings was

incorporated, and FY and Investor III contributed funds to Holdings in exchange for different classes of Holdings stock such that FY and Investor III each owned 50% of the outstanding stock of Holdings. Holdings formed Acquisition 1 to acquire the Parent shares held by Parent's minority (public) shareholders. Holdings transferred the funds received from FY and Investor III to Acquisition 1. Acquisition 1 also entered into a bridge loan. Acquisition 1 made a tender offer to acquire all of the Parent common stock held by the public. Parent declared a cash dividend to be payable after the merger of Acquisition 1 with and into Parent (described below). Holdings acquired shares of Parent common stock and all shares of Parent class B stock held by FY for cash and a one-day note. No shares of Holdings stock were exchanged for the shares of Parent stock acquired in this step. FY contributed funds to Holdings in exchange for common and preferred stock, and Investor III contributed funds to Holdings in exchange for common stock. Afterwards, FY owned more than 50% of the value of Holdings. Holdings then contributed its newly-received shares of Parent stock to Acquisition 1. Acquisition 1 merged with and into Parent, with the result that Parent became a wholly owned subsidiary of Holdings. Parent paid the previously-declared dividend to Holdings, and Holdings paid off the note to FY with the dividend received from Parent. The taxpayer treated Holdings' acquisition of the Parent stock held by FY as a reverse acquisition under § 1.1502-75(d)(3) because the circular flow of cash from FY to Holdings and back to FY was transitory and thus should be ignored for federal income tax purposes, and the National Office agreed. If the circular cash flows were ignored, Holdings would be deemed to have issued more than 50% of its stock to FY to acquire FY's stock in Parent. The National Office rejected the examining agent's analysis that each step of the transaction should be treated separately with the result that Holdings did not acquire stock of Parent in exchange for its stock. The National Office instead analyzed the transaction in accordance with its substance. It found that Holdings'

acquisition of Parent constituted a reverse acquisition under § 1.1502-75(d)(3), and that the Parent group continued with Holdings as the new (nominal) parent of the group.

- b. Where a shareholder of Target also owns “old and cold” stock in Acquiring that was acquired in a transaction unrelated to Acquiring’s acquisition of Target’s stock or assets, the Acquiring stock owned prior to the transaction is not counted in the determination whether the Target shareholders own more than 50% of the stock of Acquiring. *See* Rev. Rul. 76-164, 1976-1 C.B. 270.
3. Revenue Ruling 76-164 rejects an interpretation of the “as a result of” language that would require only that the Target shareholders acquire some Acquiring stock in the transaction (*e.g.*, 5%) and that as a result of such acquisition, the Target shareholders own more than 50% of the Acquiring stock, including the stock owned prior to the transaction. The ruling appears to be correct because the rejected interpretation is inconsistent with a test designed to identify which of two groups has the greater net equity capitalization.
4. Example 26. Acquiring is the common parent of one group, and Target is the common parent of another, smaller group. Mr. J owns 15% of the Target stock and 10% of the Acquiring stock, which was acquired in a transaction prior to and unrelated to the acquisition of Target. Target merges with and into Acquiring, with Acquiring as the surviving corporation. In the merger, the former Target shareholders, including Mr. J, received 45% of the fair market value of the stock of Acquiring. Although the former shareholders of Target, including Mr. J, own more than 50% of Acquiring after the transaction, the transaction does not constitute a reverse acquisition under § 1.1502-75(d)(3) because the Acquiring stock acquired by Mr. J in an unrelated transaction prior to the merger is not counted toward the 50% threshold. If Mr. J acquired the Acquiring stock from Acquiring pursuant to the same plan of acquisition as Acquiring’s acquisition of Target (*e.g.*, through a capital infusion into Target immediately before the transaction), query whether the Acquiring stock should be taken into account in determining whether the 50% threshold is satisfied. *See* § 1.1502-75(d)(3)(i) (last sentence).

5. While stock that is not acquired as a result of owning Target stock (*e.g.*, an open market purchase for cash) is not counted for purposes of the 50% test, in the case of the acquisition of Target stock (as opposed to the assets of Target), such stock is taken into account in determining whether Target becomes affiliated with Acquiring as a result of the acquisition. *See* Rev. Rul. 72-30, 1972-1 C.B. 286 (finding a reverse acquisition where Acquiring acquired 78% of the Target stock in exchange for Acquiring stock and 4% of the Target stock for unspecified consideration).
- E. Divisive Transactions: Distributions, Sales, and Exchanges of Subsidiary Stock. The reverse acquisition exception applies only to acquisitive transactions, and there is no counterpart for divisive transactions such as the division of one group into two groups (*e.g.*, where 50% of the net equity of a group is liquidated or distributed).
1. In a technical advice memorandum, the IRS stated, “The reverse acquisition rules are not readily applicable to a situation where the assets of an existing parent are transferred to another corporation, but the former parent remains in existence as the parent of another affiliated group . . . The reverse acquisition rules are not intended to condone the division of a single consolidated group into two groups. Rather they designate the continuing group in a transaction that is acquisitive, rather than divisive, in nature.” Tech. Adv. Mem. 9351002 (Aug. 31, 1993).
 2. Thus, in spin-offs, split-offs, or split-ups under § 355, the relative sizes of the distributing corporation and the controlled corporation are irrelevant for purposes of determining which affiliated group will be the continuation of the original consolidated group. *See* Tech. Adv. Mem. 8946007 (July 31, 1989); Tech Adv. Mem. 8946006 (July 31, 1989). For a discussion of a recent decision that raises issues in certain split-off transactions, *see* Section III.F., *supra*. Note that the relative sizes of the corporations in a divisive transaction are relevant, however, to the apportionment of earnings and profits, allocation of basis, and the determination of § 382 limitations.
 3. Because the reverse acquisition exception applies only in transactions involving the combination of two or more groups and

there is not counterpart for divisive transactions, the same concerns received different treatment in combination transactions than in divisive transactions.

- a. Example 27. P, the common parent of the P group, owns two subsidiaries, S1, and S2. P has \$100 worth of stock outstanding, S1 has \$5 worth of stock outstanding, and S2 has \$90 worth of stock outstanding. S2 leaves the P group in a tax-free § 355 spin-off, and the P group continues notwithstanding the fact that 90% of the value of the P group (based on relative net equity capitalization) has left the P group.
- b. Example 28. HC, a domestic corporation, is formed by individual A to acquire all of the stock of F-T, a foreign corporation for cash. F-T owns all of the stock of other foreign corporations and all of the stock of S1, the common parent of a consolidated group. Several years later, F-T distributes all of its stock of S1 to HC in a tax-free spin-off. It appears that the S1 consolidated group terminates even though all of the assets of the consolidated group remain intact. Compare the result in this divisive reorganization to that in a downstream merger of F-T with and into S1. Query whether a substance-over-form approach could be taken based upon Rev. Rul. 82-152 and the IRS' treatment of the creation of a holding company (discussed in Section VII, *infra*).

F. Tax Status of Transaction.

1. A transactions' status as taxable or tax free does not affect its characterization as a reverse acquisition under § 1.1502-75(d)(3). For example, a transaction that would qualify as a 'B' reorganization but for the presence of disqualifying boot can constitute a reverse acquisition.
2. Example 29. Acquiring, which has \$100 worth of stock outstanding, is the common parent of one group. Target, which has \$200 worth of stock outstanding, is the common parent of another group. Acquiring acquires all of the stock of Target from the Target shareholders in exchange for \$200 of newly issued § 1504(a)(4) preferred stock. Because the preferred stock is nonvoting, the acquisition is not described § 368(a)(1)(B), and the exchange is taxable to the Target shareholders. Nevertheless,

the transaction constitutes a reverse acquisition whereby the Acquiring group terminates and the Target group continues with Acquiring as its new (nominal) common parent.

3. The fact that a transaction can be taxable or tax free makes the reverse acquisition rules more difficult to manipulate.
- G. Possible Methods of Controlling the Occurrence of a Reverse Acquisition.
1. Infusions, Distributions, and Redemptions.
 - a. The relative holdings of the shareholders of Target and Acquiring, for purposes of applying the 50% test, are determined at the moment of the acquisition. As previously discussed, an opportunity may exist to adjust the relative sizes of the groups by contributions of property to, or distributions of property from, one of the corporations to ensure which group will be deemed the surviving group. Additionally, subject to the related transaction rule of §1.1502-75(d)(3)(i) (last sentence), Acquiring or Target may be able to redeem its stock for the same purpose.
 - b. Example 30. Acquiring, which is the common parent of a group, has outstanding stock worth \$90, and Target, which is the common parent of another group, has outstanding stock worth \$100. Acquiring acquires Target for \$100 of stock and redeems \$20 worth of stock from the former Target shareholders following the acquisition. If form is respected, the transaction is a reverse acquisition. However, if Target required that \$20 of the consideration from Acquiring be cash, the acquisition and redemption would be mutually interdependent and the transaction thus would not be a reverse acquisition.
 2. Mix of Consideration.
 - a. Subject to the related transaction rule of § 1.1502-75(d)(3)(i) (last sentence), the mix of acquisition consideration can be used to control which group will continue.
 - b. Example 31. Acquiring, which is the common parent of a group, has outstanding stock worth \$90, and Target, which is the common parent of another group, has outstanding stock worth \$100. Compare the following (i) Acquiring acquires Target for \$80 stock and \$20 cash and (ii)

Acquiring acquires Target for \$100 stock and redeems \$20 worth of stock from the former Target shareholders following the acquisition. The former transaction is not a reverse acquisition because the Target shareholders do not own more than 50% of the Acquiring stock as a result of their ownership of Target stock. Should it make a difference if cash was included in the mix of consideration for the purpose of avoiding application of the reverse acquisition rules? The answer seems to be “no,” because the use of cash in the acquisition means that, in accordance with the purpose of the reverse acquisition rules, the Acquiring shareholders will be in control of the combined group. Moreover, the first transaction appears to go beyond the reach of the related transaction rule because the rule does not discuss “purpose” or “intent.” If form is respected, the latter transaction is a reverse acquisition. If Target agreed to be acquired only on the condition that 20% of the consideration from Acquiring be cash, such that the acquisition and redemption were mutually interdependent, query whether the form of the transaction might not be respected. Could the “shall be taken into account” language of the §1.1502-75(d)(3)(i) related transaction rule be overcome so that the tax motivated use of cash is not respected?

H. Step Transaction Issues.

1. The last sentence of § 1.1502-75(d)(3)(i) is a related transaction rule that employs step transaction principles to acquisitions and redemptions of stock made pursuant to the same plan as the acquisition in question. Moreover, Rev. Rul. 72-30, which was issued prior to finalization of the regulation containing the related transaction rule, applies the “mutual interdependence” variation of the step transaction doctrine to a series of stock acquisitions. These step transaction principles may have application in several areas.
2. Basic Application of Related Transaction Rule.
 - a. In determining whether Acquiring acquires the requisite amount of Target stock (in the case of a stock acquisition) and whether Target shareholders own more than 50% of the Acquiring stock, any acquisitions or redemptions of

the stock of Acquiring or Target pursuant to the plan of acquisition must be taken into account. § 1.1502-75(d)(3)(i) (last sentence).

- b. The related transaction rule was intended “to make clear that separate acquisitions of stock over a period of time are to be considered together to determine whether a reverse acquisition has occurred if the acquisitions are pursuant to a single plan of acquisition.” Tech. Info. Rel., 36 Fed. Reg. 16,661 (Aug. 25, 1971) (providing a technical explanation of an identical rule in the proposed regulations published August 25, 1971).
- c. Example 32. Acquiring is worth \$90 and Target is worth \$100. Mr. J is a Target shareholder owning 40% of the Target stock who does not want to participate in Acquiring’s proposed acquisition of Target for Acquiring stock. Accordingly, Mr. J is redeemed for cash or debt immediately before the acquisition of Target’s stock by Acquiring. Query how, if at all, the redemption should be taken into account. Absent the redemption, Target would have been the larger corporation. Should it make a difference that the stock acquisition presumably would not have occurred absent the redemption of all of Mr. J’s stock prior to the acquisition? Mr. J’s interest could have been cashed out by Acquiring’s acquisition of his stock for cash with the result that no reverse acquisition would have occurred. Should the result be different (*i.e.*, should there be a deemed reverse acquisition) if Mr. J is willing to accept Acquiring stock as consideration but Acquiring refuses so as to avoid triggering the reverse acquisition rules?
- d. In applying the last sentence of § 1.1502-75(d)(3)(i), what is the significance of the purpose of any related transaction? Compare the situation where there is a redemption prior to the acquisition to avoid a reverse acquisition with the situation where there is a redemption after the acquisition in order to have a reverse acquisition. What is the proper base line for determining whether there has been a reverse acquisition? Should redemptions that occur prior to the acquisition be disregarded solely on the basis of their purpose? Should redemptions that occur after the acquisition be disregarded if the redemption and acquisition

were not mutually interdependent? Consider Rev. Rul. 72-30, 1972-1 C.B. 286 (citing *ACF Brill Motors Co. v. Commissioner*, 189 F.2d 704 (3d Cir.), *cert denied*, 342 U.S. 886 (1951), and *American Bantam Car Co. v. Commissioner*, 11 T.C. 397 (1948), *aff'd*, 177 F.2d 513 (3d Cir. 1949), *cert. denied*, 339 U.S. 920 (1950)) (discussed *infra*), which was issued prior to finalization of the related transaction regulation, wherein the IRS suggested that mutual interdependence is the appropriate test.

- e. Note that the last sentence of § 1.1502-75(d)(3)(i) does not literally apply to distributions made pursuant to the plan of acquisition. Because this rule does not contain any general “anti-abuse” language (*i.e.*, principal purpose or intent language), it seems that a taxpayer properly could take the position that distributions by Acquiring or Target immediately prior to the acquisition may affect the application of the reverse acquisition rules. Additionally, subject to the application of some variant of the “meaningless gesture” doctrine to the issuance of stock, a capital contribution to Acquiring or Target by a pre-existing shareholder also would seem to fall outside the general usage of the word “acquisition.”

3. “Creeping” Reverse Acquisition.

- a. A “creeping” reverse acquisition is possible where Acquiring acquires more than 80% of the Target stock in a series of acquisitions if the acquisitions of Target stock were pursuant to the same plan of acquisition. *See* § 1.1502-75(d)(3)(i) (last sentence); *see also* Rev. Rul. 72-30, 1972-1 C.B. 286 (stepping together multiple acquisitions where the later acquisition would have served no useful purpose without the earlier acquisition). Similarly, a reverse acquisition is possible where, as part of a plan, Acquiring acquires less than 80% of the Target stock but the acquisition is followed by another transaction that has the effect of increasing Acquiring’s ownership to more than 80%. *See* Tech. Adv. Mem. 200136001 (Apr. 13, 2001) (concluding that a reverse acquisition occurred by reason of acquisitions occurring pursuant to a plan including a

contribution in exchange for Acquiring stock and a subsequent stock dividend that increased Acquiring's ownership in Target to more than 80%).

- b. Example 33. Acquiring is the common parent of one group, and Target is the common parent of another, larger group. On June 1 of Year 1, Acquiring acquired in exchange for Acquiring stock the assets of Partnership M. Partnership M's assets included a 35% stock interest in Target and a 90% ownership of Partnership L. Partnership L, in turn, owned a 40% stock interest in Target. On June 2 of Year 1, Acquiring liquidated Partnership L and thereby became the direct owner of 75% of the Target stock. Also on June 2 of Year 1, Acquiring acquired 10% of the Target stock from another unrelated shareholder. As a result of these acquisitions, Acquiring owned 85% of the Target stock, and the Target shareholders owned more than 50% of the Acquiring stock by reason of their ownership of Target stock. Assuming the two later acquisitions would have served no useful purpose without the initial acquisition, the series of transactions should be stepped together and treated as one transaction that constitutes a reverse acquisition under § 1.1502-75(d)(3). *See* Rev. Rul. 72-30, 1972-1 C.B. 286.

4. Combinations Involving More Than Two Corporations.

- a. A reverse acquisition can result from a combination involving more than two corporations. *See, e.g.,* Rev. Rul. 89-80, 1989-1 C.B. 273 (consolidation of two unrelated common parent corporations into a new corporation); Rev. Rul. 73-303, 1973-2 C.B. 315 (contribution by exempt corporation of two subsidiaries, both of which were common parents of separate groups, into a new corporation); *see also* Priv. Ltr. Rul. 7007310980A (July 31, 1970).
- b. Where the combination of more than two corporations involves more than two groups, there may exist an opportunity to control the occurrence of a reverse acquisition. Subject to the application of the related transaction rule of § 1.1502-75(d)(3)(i) (last sentence), as illustrated by Rev. Rul. 72-30, the combination of more than two

groups can be structured so that, depending on the relative sizes of the groups, any one of the groups would be treated as surviving.

- c. Example 34. Acquiring is the common parent of one group that is worth \$125. Acquiring has 125 shares of stock outstanding. Target-1 is the common parent of a second group that is worth \$175. Target-2 is the common parent of a third group that is worth \$200. The parties desire that Acquiring acquire both Target-1 and Target-2. Acquiring simultaneously acquires all of the Target-1 stock in exchange for 175 shares of Acquiring stock and all of the Target-2 stock for 200 shares of Acquiring stock. There is no reverse acquisition because neither the Target-1 shareholders nor the Target-2 shareholders own more than 50% of Acquiring as result of their ownership of Target-1 or Target-2 stock immediately after, or at any point following, each of the respective acquisitions. Thus, despite the fact that Acquiring is the smallest of the three combining groups, the Acquiring group continues and the Target-1 and Target-2 groups terminate. The result is the same even if Target-1 and Target-2 are owned by the same shareholders.
- d. Example 35. The facts are the same as in Example 34, *supra*, except that, so that Target-1 might be treated as the surviving group, Acquiring first acquires the stock of Target-1 in exchange for Acquiring stock. If form is respected, the transaction will constitute a reverse acquisition because the Target-1 shareholders will own more than 50% of the stock of Acquiring as a result of owning Target-1 stock, and the Target-1 group will continue with Acquiring as its new common parent. Thereafter, Acquiring will acquire the stock of Target-2 in exchange for Acquiring stock. If form is respected, the transaction will not constitute a reverse acquisition because the Target-2 shareholders will not own more than 50% of the stock of Acquiring, and the Target-1 group would continue with Acquiring as its common parent. *But see* § 1.1502-75(d)(3)(i) (last sentence); Rev. Rul. 72-30, 1972-1 C.B. 286.

- e. Example 36. The facts are the same as in Example 34, *supra*, except that the parties desire that Target-2 be treated as the surviving group. Target-1 and Target-2 will first be combined. Subsequently, in a separate transaction, Acquiring will acquire the resulting common parent in a transaction that will constitute a reverse acquisition, with the result that the Target-2 group will continue with Acquiring as its new common parent. *See id.*
- f. Example 37, FP, a foreign corporation, owns all of the stock of S1, the common parent of a consolidated group. Target is an unrelated domestic corporation. Target merges with and into S1 and the Target shareholders receive more than 50% of the stock of FP. The value of this stock represents more than 50% of the value of S1. If the form is respected, the transaction will not constitute a reverse acquisition because the Target shareholders do not receive S1 stock in the transaction. However, if FP acquired the stock of Target and thereafter contributed such stock to S1, the contribution of Target stock to S1 would be a reverse acquisition.
- g. The ability to structure transactions for the purpose of manipulating the reverse acquisition rules will depend upon whether two or more transactions may be stepped together. By regulation, in measuring the ownership of Target stock by Acquiring shareholders, any acquisitions or redemptions of the stock of Acquiring or Target pursuant to the plan of acquisition must be taken into account. § 1.1502-75(d)(3)(i) (last sentence).

I. Shareholder Level Issues.

1. Irrelevance of Identity of Shareholder Interest.

- a. The reverse acquisition rules are concerned with determining which of two combining groups predominates following the combination. This inquiry is largely concerned with the relative net equity of the two corporations and otherwise disregards stock ownership and shareholder makeup. Thus, there is no requirement under § 1.1502-75(d)(3) that the Target shareholders be “historic” shareholders of Target or that the Target shareholders retain

for any particular time following a reverse acquisition the stock of Acquiring owned by reason of their ownership of Target stock.

- (1) In Tech. Adv. Mem. 9806003 (Oct. 1, 1997), the National Office ruled that a transaction qualified as a reverse acquisition notwithstanding that the former shareholder of Target transferred the Acquiring stock to its wholly owned subsidiary following the reverse acquisition. The ruling stated that there is no requirement as to the period of time that the former shareholders of Target retain their shares of Acquiring following a reverse acquisition. The ruling noted that if a subsequent transfer could have the effect of disqualifying a transaction as a reverse acquisition, “the continuation or non-continuation of a consolidated group would be made optional to the taxpayer, clearly contrary to the intent of section § 1.1502-75(d)(3).” Nonetheless, the ruling appears to rely on the fact that the Acquiring stock was owned indirectly by the former shareholder of Target. *See* discussion in Section VI.J. *infra*. The drop down, which was part of a plan, following the stock-for-stock exchange, should satisfy any continuity of interest requirement. *Cf.* § 368(a)(2)(C). The ruling leaves open the possibility that a transfer immediately after an acquisition of Acquiring stock by the former shareholders of Target to a person other than a controlled subsidiary would disqualify the acquisition as a reverse acquisition.
- (2) In Priv. Ltr. Rul. 200603009 (Oct. 6, 2005), the IRS ruled that the contribution of Target stock by the historical Target shareholders to an S corporation immediately prior to the S corporation’s transfer of the Target stock to a new holding company qualified as a reverse acquisition under § 1.11502-75(d)(3) and the Target group remained in existence. The S corporation’s transitory ownership of more than 50% of the Target stock, which we infer from the language of the private letter ruling (and otherwise understand to be the case), did not prevent the

S corporation from being the relevant shareholder for purposes of determining whether the requirements of § 1.1502-75(d)(3) were satisfied. The facts of the private letter ruling involving the contribution of Target stock to the S corporation as part of the plan raise the question as to the meaning of the step transaction rule of § 1.1502-75(d)(3) (last sentence) (in this context, for purposes of determining whether the Target shareholder, the S corporation, owns more than 50% of Holdco, there shall be taken into account any acquisition of the stock of either corporation which is pursuant to the plan involving such acquisition).

- (3) In Priv. Ltr. Rul. 200709018 (Dec. 4, 2006) the IRS National Office ruled that a consolidated group remained in existence under § 1.1502-75(d)(3). The simplified facts are as follows. FP owned all of the stock of Target, the common parent of a consolidated group. As part of a restructuring, FP transferred all of the stock of Target to Acquiring, a newly formed domestic entity. FP subsequently transferred all of the Acquiring stock to its various creditors and dissolved. If FP's transfer of the Acquiring stock were to constitute an acquisition of Acquiring stock, it appears the IRS respected application of the related transaction rule so that the acquisition need not be "taken into account." *See also* Tech. Adv. Mem. 9806003 (§ 1.1502-7(d)(3) does not require any post-acquisition holding period).
- b. The absence of any relevance, as a general matter, of identity of shareholder interest under the reverse acquisition rules is sensible because the rules attempt to identify which corporation is the "acquiring" corporation on the basis of their relative sizes.
- c. Example 38. Acquiring is the common parent of one group, and Target is the common parent of another, larger group. Acquiring issues 90% of its stock to the Target shareholders in exchange for all of the Target stock. Pursuant to the same plan of acquisition, the former Target shareholders sell their Acquiring stock to unrelated purchasers. The transaction meets the regulatory requirements of a reverse

acquisition under § 1.1502-75(d)(3) even though there is no continuity on the part of the historic shareholders and regardless of whether the acquisition is taxable. Thus it constitutes a reverse acquisition notwithstanding the facts that the former Target shareholders do not retain an interest in Acquiring, the new common parent of the Target group, and that the ultimate owners of the 90% interest do not own their stock as a result of ownership of Target stock.

- d. Example 39. The facts are the same as Example 38, *supra*, except Acquiring issues § 1504(a)(4) preferred stock in exchange for the Target stock in a taxable acquisition. The result is the same as in Example 38, *supra*.
- e. There was a continuity requirement under the group structure change rules of former proposed regulation §§ 1.1502-31 and -33, however, that approach was rejected when the stock basis adjustment rules were finalized effective for tax years beginning on or after January 1, 1995.

2. Cross-Ownership Between Acquiring and Target.

- a. Target's Interest in Acquiring Before the Acquisition.
 - (1) Where Target has a substantial interest in Acquiring before the acquisition, it may be difficult to determine whether Target or Acquiring is the larger group. This determination is complicated because the value of Target derives, in part, from the stock it owns in Acquiring and such value should not be double counted in the reverse acquisition analysis.
 - (2) Example 40. F is a foreign corporation whose only asset is 100% of the stock of Acquiring, a U.S. corporation. Acquiring is the common parent of a consolidated group. F will merge downstream with and into Acquiring, whereby Acquiring will acquire all of F's assets (*i.e.*, its own stock), and F's shareholders will become the sole shareholders of Acquiring. The merger will not qualify under the downstream exception of § 1.1502-75(d)(2)(ii) because F is not a member of the group. The merger may constitute a reverse acquisition that causes the Acquiring group to terminate because the F shareholders own more than 50% of the stock of Acquiring as a result of

owning stock of F. It does not matter that F, the acquired corporation was not a member of an affiliated group prior to its acquisition. *See* Rev. Rul. 72-322, 1972-1 C.B. 287.

- (3) On facts similar to those of Example 40, *supra*, the IRS has held, based on substance-over-form principles, that there was no reverse acquisition where the purposes behind the reverse acquisition rules would not be furthered by characterizing a transaction as a reverse acquisition. *See* Priv. Ltr. Rul. 8619004 (Jan. 31, 1986); *see also* Gen. Couns. Mem. 39,528 (July 14, 1986). If the transaction described in Example 39 does not constitute a reverse acquisition, the P group will not terminate, and the effect will be the same as if F had liquidated.
- (4) Example 41. Target's only asset is the stock of Acquiring, which is the common parent of an affiliated group. Acquiring acquires all of the Target stock from the Target shareholders in exchange for more than 50% Acquiring's own stock. This transaction is an inversion transaction creating circular stock ownership between Acquiring and Target. Because Acquiring will have acquired all of the Target stock and the Target shareholders will own more than 50% of the Acquiring stock as a result of owning Target stock, the transaction is, as to the shareholders, similar in effect to a downstream merger. Nevertheless, the transaction appears to constitute a reverse acquisition that would cause the Acquiring group to terminate. In substance, however, this transaction is no different than a liquidation of Target into Acquiring, which would have no effect on Acquiring group.
- (5) In a transaction similar to the one described in Example 41, *supra*, the IRS found no reverse acquisition because the transaction "bears none of the hallmarks of a reverse acquisition,; despite the fact that, as the IRS acknowledged, the transaction fell within the literal language of the reverse acquisition exception. *See* Priv. Ltr. Rul. 8901011 (Sept. 27,

1988). In Priv. Ltr. Rul. 8901011, the common parent (P) of an existing affiliated group was more-than-50% owned by T. T, in turn, was almost entirely owned by a subsidiary of P. This ownership was indirect, the stock being held through partnership PRS. In a stock-for-stock exchange, P acquired all of the stock of T and later canceled the shares of P that were held by T. As a result of the stock-for-stock exchange, the shareholder of T (PRS) acquired more than 50% of the stock of P. Nevertheless, the shareholders of P did not change significantly, because most of the ownership of PRS was held indirectly by P. The IRS ruled that the literal satisfaction of § 1.1502-75(d)(3) did not transform the transaction into a reverse acquisition, because the substance of the transaction was that the P group remained intact and unaffected when measured from the perspective of the outside shareholders of P. As a result, the general rule applied so that the P group remained in existence.

- (6) In a ruling that may conflict with Priv. Ltr. Rul. 8901011, discussed in connection with Example 41, *supra*, the IRS held in a virtually identical transaction that a reverse acquisition occurred. *See* Priv. Ltr. Rul. 9122080 (Mar. 7, 1991). In Priv. Ltr. Rul. 9122080, Target owned nearly 50% of the Class A stock and all of the Class B stock of Acquiring. Acquiring's remaining shares of Class A stock were publicly traded, but Target was privately held. Both Target and Acquiring were common parents of affiliated groups. Target transferred all of its assets (other than its Acquiring stock) to Acquiring. Acquiring assumed all of Target's liabilities and issued to Target's shareholders shares of Acquiring stock having a value equal to the net value of Target's assets. The Acquiring stock previously held by Target was canceled. After the transaction, Target's shareholders held more than 50% of the stock of Acquiring. The IRS ruled without explanation that the transaction was a reverse acquisition in which the Target group survived. It is not clear, however,

whether the Target assets other than the Acquiring stock had a value greater than the value of Acquiring's value, a situation that would make the ruling consistent with Priv. Ltr. Rul. 8901011.

b. Acquiring's Interest in Target Before the Acquisition.

- (1) Likewise, where Acquiring has a substantial interest in Target before the acquisition, it may be difficult to determine whether Acquiring or Target is the larger group that should continue.
- (2) A special rule provides that, where Acquiring owns stock of Target, Acquiring will be treated as issuing new Acquiring stock to itself in exchange for its Target stock. § 1.1502-75(d)(3)(ii), (iii).
 - (i) The percentage of Acquiring stock that Acquiring will be treated as owning as a result of its ownership of Target stock is determined by multiplying the percentage of the fair market value of all Target stock that is owned by Acquiring before the acquisition by a fraction, the numerator of which is the fair market value of all Target stock before the acquisition and the denominator of which is the sum of the fair market value of all Acquiring stock before the acquisition and the fair market value of the Target stock not owned by Acquiring before the acquisition. § 1.1502-75(d)(3)(ii).
 - (ii) In order for the special rule to apply, Acquiring must have owned at least 25% of the fair market value of the Target stock for at least five years before the acquisition. § 1.1502-75(d)(3)(ii). The five-year rule eliminates the risk that ownership has been manipulated in order to garner the benefit of the special rule.
 - (iii) Moreover, the special rule applies only if Acquiring elects to have it apply. § 1.1502-75(d)(3)(iii).

- (3) Example 42. Acquiring's principal asset is 70% of the stock of Target, which it has owned for more than 5 years. All of Acquiring's other assets are fully encumbered with debt. Target is the common parent of a consolidated group. Acquiring acquires the remaining 30% of Target stock from the other Target shareholders in exchange for Acquiring stock. The former Target shareholders receive only 30% of the Acquiring stock by reason of their ownership of Target stock. Thus, absent an election, the acquisition does not constitute a reverse acquisition. If the election is made, Acquiring will be deemed to issue 70% of its stock to itself for its former Target stock, with the result that 100% of the Acquiring stock will be owned by Target shareholders as a result of owning stock of Target. Consequently, the acquisition will constitute a reverse acquisition, and the Target group will continue.
- (4) In *Adobe Resources Corp. v. United States*, 967 F.2d 152 (5th Cir. 1992), the Fifth Circuit, applying a substance-over-form analysis, extended the principles of the special rule to a situation where Acquiring owned 29% of the stock of Target before Acquiring and Target were combined. Section 1.1502-75(d)(3)(ii) was not available because Acquiring had not owned the stock of Target for 5 years. The court concluded that the taxpayer should be able to avail itself of the benefits of the reverse acquisition rules and held that the Target group continued. Contrary to its position in Rev. Rul. 82-152, the government argued that the form of the transaction controlled and that the Target group terminated even though it was larger when measured without taking into account Acquiring's interest in the Target stock.
- (5) In Priv. Ltr. Rul. 200302022 (Sept. 20, 2002), prior ownership of stock counted in determining that a restructuring was a reverse acquisition. In Priv. Ltr. Rul. 200302022, prior to the proposed restructuring, Holdco 1 owned 100% of Holdco 2 and Holdco 2 owned less than 80% of the stock of P, the common

parent of a consolidated group. The ruling implies that Holdco 1 and Holdco 2 file separate returns. The taxpayer proposed that Holdco 2 liquidate into Holdco 1 in a tax-free § 332 transaction. As a result, of this liquidation, Holdco 1 would own Holdco 2's P stock. P would then merge into Holdco 1. In this merger, the P shareholders other than Holdco 1 would receive Holdco 1 stock. The ruling indicates that Holdco 1 would make an election under § 1.1502-75(d)(3)(iii) to consider P stock held by Holdco 1 as effectively owned by Holdco 1's shareholders in determining whether the merger of P into Holdco 1 is a reverse acquisition under § 1.1502-75(d)(3). Absent this election, the merger would not have been a reverse acquisition because the shareholders of P (*i.e.*, Holdco 1 and the minority shareholders of P) did not own more than 50% of the stock of Holdco 1 after the transaction (Holdco 1 is not considered to own its own stock). If the merger were not a reverse acquisition, the P group would terminate.

- (i) In ruling that the proposed restructuring would be a reverse acquisition, the IRS did not expressly address the § 1.1502-75(d)(3)(ii) requirement that the corporation or members of its group continuously own stock for a period of at least five years to be eligible for the § 1.1502-75(d)(3)(iii) election. § 1.1502-1(a) provides that unless the context requires otherwise, the term "group" refers to a consolidated group rather than an affiliated group. As the transaction was proposed, it is implied that Holdco 1 will own P stock for only a brief period of time (most likely a few days at most) before P is merged into Holdco 1. Still the IRS ruled that the proposed transaction would be a reverse acquisition because Holdco 1's ownership of P would be attributed to its shareholders under § 1.1502-75(d)(3)(iii).
- (ii) From this ruling, it appears that the IRS was including the period the P stock was held by

Holdco 2 and suggests that the IRS was interpreting the term “group” in § 1.1502-75(d)(3)(ii) to mean the affiliated group rather than the consolidated group.

- c. There appears to be a spectrum in determining whether cross-ownership of Target stock by Acquiring is taken into account for purposes of the 50% test of the reverse acquisition rules.
 - (1) At one end of the spectrum is the case where Acquiring recently acquired the Target stock in a transaction that is mutually interdependent on the acquisition in question. In such case, the transaction likely will be viewed as a single transaction for purposes of applying the reverse acquisition rules. *See* § 1.1502-75(d)(3)(i) (last sentence).
 - (2) At the other end of the spectrum is the case where Acquiring has owned the Target stock for at least 5 years. In such case, if the taxpayer so elects, any Acquiring stock received with respect to the Target stock is treated as having been issued by Acquiring to itself in exchange for its Target stock. § 1.1502-75(d)(3)(ii), (iii).
 - (3) Facts similar to those in *Adobe Resources* would fall somewhere in the middle, and the Acquiring stock received with respect to the Target stock owned by Acquiring might be counted for purposes of the 50% test pursuant to the principles of § 1.1502-75(d)(3)(ii), (iii).
- 3. Stock Held by Nominees. Peculiar issues may arise where stock in either Acquiring or Target is held by a nominee of the other corporation. *See* Priv. Ltr. Rul. 8544021 (Aug. 7, 1985); Priv. Ltr. Rul. 8117082 (Jan. 28, 1981); Priv. Ltr. Rul. 8113066 (Dec. 31, 1980); Priv. Ltr. Rul. 8041102 (July 21, 1980); *see also* Priv. Ltr. Rul. 8104199 (Oct. 31, 1980). Thus, the real owners of stock must be known before the reverse acquisition analysis can be applied properly.

J. Drop Down of Assets.

1. In the case of a transaction involving Acquiring's acquisition of Target's assets, a subsequent transfer of all or part of the assets acquired from Target to a wholly owned subsidiary of Acquiring will not affect the transaction's characterization as a reverse acquisition under § 1.1502-75(d)(3). *See* Priv. Ltr. Rul. 8140029 (July 7, 1981). Technical Advice Memorandum 9806003 (Oct. 1, 1997), which involved the drop down of Acquiring stock by the former Target shareholders, is consistent with the treatment of the drop down of assets, although admittedly different issues are raised.
2. Example 43. The facts are the same as those in Example 16, *supra*, except that following Acquiring's acquisition of the assets of Target in the merger, Acquiring transfers part of the assets acquired from Target to Acquiring's wholly owned subsidiary S. The transaction constitutes a reverse acquisition even though some of Target's assets will be transferred to S.

K. Indirect Stock Ownership.

1. Viewing the substance rather than the form of the transaction, the IRS has found a reverse acquisition by comparing indirect ownership through a partnership before the transaction with direct ownership after the transaction. Priv. Ltr. Rul. 6808261350A (Aug. 26, 1968).
2. In Tech. Adv. Mem. 9806003 (Oct. 1, 1997), the IRs ruled that a transaction qualified as a reverse acquisition notwithstanding that the former shareholder of Target transferred the Acquiring stock to its wholly owned subsidiary following the reverse acquisition, apparently based on the fact that the Acquiring stock was owned indirectly by the former shareholder of Target.
3. Similarly, the IRS has also held that a transaction constitutes a reverse acquisition where the 50% test was satisfied through ownership of more than 50% of the value of Acquiring stock by the indirect owners of Target stock. Priv. Ltr. Rul. 8843013 (May 25, 1988).
4. Example 44. FP is a foreign corporation that owns Target, a U.S. subsidiary that is the common parent of a consolidated group. FP is "continued" as a U.S. corporation and then is merged into Acquiring, a new corporation. The former FP shareholders

receive all of Acquiring's stock in the merger. In order for the transaction to meet the literal requirements of the reverse acquisition rules, the Target shareholders must own more than 50% of the stock of Acquiring. That requirement is not "directly" satisfied because FP, the shareholder of Target, no longer exists. However, because the shareholders of FP indirectly own Acquiring before the transaction and they own over 50% of the stock of Acquiring after the transaction as a result of their indirect ownership of Acquiring, the transaction will constitute a reverse acquisition.

L. Prior Affiliation Between Acquiring and Target.

1. The reverse acquisition rules apply only where Acquiring and Target were not affiliated with each other prior to the transaction. Rev. Rul. 82-152, 1982-2 C.B. 205; Gen. Couns. Mem. 38,886 (Aug. 9, 1982).
 - a. The General Counsel Memorandum states that this conclusion is clear for two reasons.
 - (1) First, because § 1.1502-75(d)(3) describes the acquiring corporation as a common parent, it cannot be a wholly owned subsidiary.
 - (2) Second, § 1.1502-1(f)(3) provides that all taxable years of the first corporation ending on or before the date of a reverse acquisition shall be treated as separate return limitation years, which would be inappropriate where both corporations were members of the same group.
 - b. In order for a stock acquisition to constitute a reverse acquisition, Target must "become" a member of the Acquiring group as a result of the acquisition, which suggests that Target could not have previously been a member of the Acquiring group. Thus, the IRS' view seems correct, at least insofar as it applies to stock acquisitions – certainly asset acquisitions should be treated no differently.
2. Nonetheless, the IRS has found a reverse acquisition on the following facts: Corporation A, the common parent of a group, formed a wholly owned subsidiary B, which, in turn, formed its own wholly owned subsidiary C. C merged into A in an "A" reorganization, with A as the surviving corporation. Each share

of A stock will be converted into identical stock of B, and each share of C stock will be converted into A stock, with the result that C will no longer exist and A will be a subsidiary of B. *See* Priv. Ltr. Rul. 8051112 (Sept. 25, 1980); Priv. Ltr. Rul. 8029080 (Apr. 24 1980). The IRS did not address the fact that A, B, and C were members of the same affiliated group at the time of the acquisition. This conclusion is questionable in light of Rev. Rul. 82-152 and subsequent private letter rulings.

3. Outside of the holding company setting (discussed in Section VII., *infra*), the IRS has generally held that reshuffling within a corporate chain does not result in the termination of an affiliated group within that chain. For example, in Tech. Adv. Mem. 8619004 (Jan. 31, 1986), the ultimate parent corporation in a chain was a foreign holding corporation (FHC) that held a number of subsidiaries, including P, the common parent of an affiliated group. FHC merged with and into P in a transaction that technically resulted in a reverse acquisition because P acquired “substantially all” of the assets of FHC in exchange for stock of P, and the shareholders of FHC, as a result of owning FHC stock, received more than 50% of P stock. Nonetheless, the IRS recognized that the reverse acquisition rules had to be applied based on the substance of the transaction and not the form. Since P’s group remained unaffected by the transaction, in substance there was no reverse acquisition, and the IRS held that the group continued in existence with P as the continuing common parent.

M. Target May be a Subsidiary in Another Group.

1. Even if one group acquires only part of a larger group, not including its common parent, the transaction may constitute a reverse acquisition.
2. Example 45. Acquiring is the common parent of one group, and Target is the common parent of another, larger group. Target has a wholly owned first-tier subsidiary, Target-1, which has several lower-tier subsidiaries that also are members of the Target group. Acquiring issues 67% of its stock to Target in exchange for the Target-1 stock. The transaction may constitute a reverse acquisition under § 1.1502-75(d)(3). It appears that the Acquiring group terminates and a new group, including the Target-1 group, begins with Acquiring as the common parent. *Cf.* Rev. Rul. 89-80, 1989-1 C.B. 273 (Acquiring can be a

stand-alone corporation). The part of Target group that was not acquired continues as a separate group with Target as the common parent. If this interpretation is correct, the net operating losses of both Acquiring and Target-1's lower tier subsidiaries would be subject to the SRLY limitations. Target-1's net operating losses, however, should not be subject to a SRLY limitation under the "lonely parent" exception to such limitations. § 1.1502-1(f)(2)(i). One might question this outcome based on the unusual result (*i.e.*, double SRLY) and language in § 1.1502-75(d)(3) that seems to contemplate that the acquired corporation be the common parent of an existing group.

N. Acquiring Must be the Common Parent of a Consolidated Group.

1. If the acquiring corporation is not a common parent of a consolidated group, (or a stand-alone corporation), the transaction may not constitute a reverse acquisition.
2. Example 46. Acquiring is the common parent of one group and Acquiring-1 is one of its subsidiaries. Target is the common parent of another, larger group. Acquiring-1 issues 60% of its stock to the shareholders of Target in exchange for the Target stock. The transaction should be a reverse acquisition under § 1.1502-75(d)(3) because Acquiring-1, the corporation issuing stock, becomes the common parent of a group in the acquisition. It appears that the Target group does not terminate.

O. Unaffiliated Corporations.

1. It is not necessary that Target have been a member of an affiliated group prior to its acquisition in order for the acquisition to constitute a reverse acquisition under § 1.1502-75(d)(3). Rev. Rul. 72-322, 1972-1 C.B. 287; Priv. Ltr. Rul. 9706013 (Nov. 13, 1996) (ruling that Parent's acquisition of Life, a stock life insurance company, qualified as a reverse acquisition such that the Life "group" remained in existence); *see* Priv. Ltr. Rul. 9723041 (Mar. 11, 1997) (including taxpayer's representation that Parent's acquisition of a stand-alone corporation qualified as a reverse acquisition under § 1.1502-7d(d)).
2. Example 47. P is a holding company that owns 100% of the stock of Acquiring. Target is a corporation that is not a member of an affiliated group. S, a wholly owned subsidiary of Acquiring,

acquires the assets of Target solely in exchange for 90% of the Acquiring stock in a transaction described in § 368(a)(1)(C) (a “parenthetical C”). As a result, Acquiring is deconsolidated from P and becomes the common parent of the Acquiring group. *Cf.* Rev. Rul. 89-80, 1989-1 C.B. 273 (Acquiring can be a stand-alone corporation). The transaction constitutes a reverse acquisition under § 1.1502-75(d)(3), whereby Target is treated as having acquired the group comprising Acquiring and S.

3. Moreover, Rev. Rul. 72-322 states that § 1.1502-1(f)(3) contains an example of a reverse acquisition where neither corporation need have been a member of an affiliated group in order for the principles of reverse acquisitions to apply.
4. Considering Rev. Rul. 72-322 (finding a reverse acquisition where the acquired corporation was not a member of an affiliated group prior to its acquisition) together with Rev. Rul. 89-80 (finding a reverse acquisition notwithstanding the fact the acquiring corporation was newly formed and was not a member of an affiliated group prior to its acquisition of two unrelated common parents), it is reasonable to conclude that neither Acquiring nor Target need be a member of a group prior to the acquisition in question.

P. No Transfer of Acquiring Stock.

1. The 50% test literally requires that the Target shareholders’ ownership of Acquiring be by reason of their ownership of Target stock. Nonetheless, the reverse acquisition rules may be applied where stock of Acquiring is not actually issued in the acquisition or where Acquiring has no stock at all.
2. Constructive Transfer.
 - a. The IRS has ruled that the reverse acquisition rules apply notwithstanding the fact that Acquiring does not issue new stock where such issuance would be a “meaningless gesture” and there can be deemed a constructive transfer due to overlapping ownership. *See* Priv. Ltr. Rul. 7848063 (Aug. 31, 1978); *see also* Priv. Ltr. Rul. 9522009 (Feb. 23, 1995) (raising but not addressing the issue of constructive stock transfer).

- b. Example 48. Mr. J owns 100% of the stock of both Acquiring and Target. Acquiring, which has \$100 worth of stock outstanding, is the common parent of one group. Target, which has \$200 worth of stock outstanding, is the common parent of another group. Mr. J transfers all the Target stock to Acquiring in exchange for the increased capital of Acquiring; no new Acquiring stock is issued. The issuance of new Acquiring stock to Mr. J would have been a meaningless gesture because Mr. J already owned 100% of Acquiring. Accordingly, Mr. J will be deemed to have constructively received Acquiring stock, and the acquisition will constitute a reverse acquisition under § 1.1502-75(d)(3).
- 3. No Acquiring Stock At All.
 - a. Similarly, the IRS has ruled that the reverse acquisition rules apply despite the complete absence of Acquiring stock before the acquisition of Target by Acquiring. *See, e.g.*, Priv. Ltr. Rul. 9106049 (Nov. 16, 1990); *cf.* Priv. Ltr. Rul. 9616031 (Jan. 22, 1996) (ruling that the Acquiring group will remain in existence under § 1.1502-75(d)(1) in the merger of two mutual life insurance companies that will not qualify as a reverse acquisition because the owners of the Target proprietary interests will not own, as a result of owning their Target proprietary interests, more than 50% of the fair market value of all proprietary interests in Acquiring immediately after the merger).
 - b. Example 49. Target is a mutual corporation that is the common parent of a group. The principals of Target will form a holding company Acquiring in exchange for Acquiring common stock, Target's articles will be restated to authorize the exchange of the interests in Target held by its policyholders for Acquiring preferred stock, the Target policyholders will exchange their interests in Target for Acquiring preferred stock, and Target will be converted to a stock corporation that issues all of its stock to Acquiring. For tax purposes, Target will be treated as converting to a stock corporation and issuing stock to the policyholders, and the policyholders will be treated as exchanging their Target stock with Acquiring for Acquiring

stock. Consequently, the exchange of Target stock to Acquiring stock will constitute a reverse acquisition under § 1.1502-75(d)(3).

- c. A related issue is whether Target must actually a stock corporation that has shareholders. Query whether Target can be a mutual bank that does not have shareholders but only depositors.

Q. Separate Existence of Target After Acquisition.

1. If an acquisition constitutes a reverse acquisition, Acquiring becomes the nominal common parent of the Target group. If Target is later disposed of (whether by distribution or sale), this fiction is apparently not undone and Acquiring continues as the nominal common parent of the Target group even though Target has departed from the group.
2. Example 50. Acquiring is the common parent of one group, and Target is the common parent of another, larger group. Acquiring issues 67% of its stock to the Target shareholders in exchange for 100% of the Target stock. The transaction constitutes a reverse acquisition under § 1.1502-75(d)(3). Suppose, however, that Acquiring subsequently sells the Target stock. The surviving Target group apparently continues with Acquiring as the common parent once Target is no longer a member.

VII. **HOLDING COMPANIES**

The creation of a holding company by definition terminates an existing group under the general rule of § 1.1502-75(d)(1), because a new corporation is introduced as the parent of an existing group. The structure for creating a holding company can take any of a number of forms, some of which satisfy the exceptions to the general rule and others of which do not. Nevertheless, the substance of these transactions remains the same: the operating company represents virtually all of the value of the newly created group in spite of being a subsidiary rather than the parent corporation.

- A. Citing Rev. Rul. 82-152 (discussed in Sections IV.D. and V.F., *supra*), the IRS applies the downstream exception and the reverse acquisition exception regardless of the form used and uniformly holds that the operating company group survives the formation of a holding company structure.

- B. Generally, whether the holding company formation is considered a reverse acquisition depends on whether the existing group (or its agents or nominees) form the holding company. If the existing group (or its agents or nominees) form the holding company, the transaction is not a reverse acquisition under § 1.1502-75(d)(3), presumably because the prior affiliation between the existing group and the holding company. *See* Gen. Couns. Mem. 39,420 (Oct. 11, 1985). *But see* Priv. Ltr. Rul. 8051112 (Sept. 25, 1980); Priv. Ltr. Rul. 8029080 (Apr. 24, 1980). Instead, the IRS consistently, has held that the group continues to exist under § 1.1502-75(d)(2) and Rev. Rul. 82-152. *See, e.g.,* Priv. Ltr. Rul. 199926044 (Apr. 2, 1999); Priv. Ltr. Rul. 199916023 (Jan. 21, 1999); Priv. Ltr. Rul. 9745013 (Aug. 7, 1997); Priv. Ltr. Rul. 9712021 (Dec. 20, 1996); Priv. Ltr. Rul. 9415013 (Jan. 14, 1994); Priv. Ltr. Rul. 8702016 (Oct. 9, 1986). For example, in Priv. Ltr. Rul. 200028011 (March 11, 2000), the IRS ruled that the exchange of parent stock for holding company stock constituted a reverse acquisition under § 1.1502-75(d)(3), and qualified as a group structure change under §§ 1.1502-31 and 1.1502-33. The shareholders of a parent corporation formed a holding company and contributed property in exchange for stock of the holding company. Then the shareholders exchanged their parent stock for stock of the holding company. After this exchange, the parent company distributed cash and stock of a subsidiary to the holding company. *See also*, Priv. Ltr. Rul. 200420018 (Feb. 4, 2004) (IRS ruled that the exchange of parent stock for holding company stock constituted a reverse acquisition under § 1.1502-75(d)(3), and qualified as a group structure change under §§ 1.1502-31 and 1.1502-33).

NOTES