Are Tax-Free Mergers With 'Grandparent' Stock Now Possible?

By Michael L. Schultz

Michael L. Schultz is a partner in the Washington office of Bingham McCutchen LLP.

It is well accepted that stock of the parent of the acquiring corporation can be used in a tax-free merger, but not stock of a grandparent corporation. The issue is worth revisiting, however. The supposed prohibition on tax-free mergers with grandparent stock was rooted in the "remote continuity" doctrine. Regulations issued in 1998 to implement the continuity of business enterprise requirement rendered the remote continuity doctrine superfluous and effectively eliminated it. Although most would find the prospect surprising, it may now be possible to use grandparent stock in a tax-free merger. It would be useful for Treasury and the IRS to clarify the application of the continuity of interest test to mergers with grandparent stock and to bring them within the existing rules for triangular mergers to avoid a potential "zero basis" issue. Providing tax-free treatment to mergers with grandparent stock, however, need not require a statutory amendment.

Table of Contents

I. Background

A. The Supposed Prohibition

Subchapter C is full of seemingly odd incongruities that provide dramatically different tax consequences to transactions that are economically similar, if not identical. Most of these incongruities are historical relics. They represent the quintessential traps for the unwary. Fortunately, most of these traps are widely recognized and thus easily avoided, at least by the well-advised. They have also come to be accepted as part of the peculiar subchapter C landscape. "Why does one form of acquisition qualify for nonrecognition treatment while another, almost identical, transaction is fully taxable?" the uninitiated might ask. "That's just the way it is," a knowing practitioner would respond with a sigh, perhaps adding, "You know subchapter C."

Because these incongruities are accepted as facts of life in the corporate tax area, we don't question them. We recognize them to be indefensible but believe that eliminating them would require legislation. And Congress has more important things to do these days. As long as the traps are easily avoided, we put up with them.

But some of these incongruities may have been resolved while we weren't looking. Much of the law in subchapter C finds its source not in the statute, but in judicial doctrines and administrative pronouncements that reflect them. Evolution of these doctrines and administrative interpretations can significantly affect the enduring vitality of these accepted incongruities.

The triangular merger is an example of the phenomena described above. It is well accepted that, while a merger can qualify as a tax-free reorganization when the target corporation merges into a first-tier subsidiary of the corporation that issues stock to the target shareholders, a merger of the target into a second-tier (or lower) subsidiary does not qualify for tax-free treatment. In other words, parent stock can be used in a merger, but not *grand*parent stock. If an acquiring group wants the assets of the acquired corporation to reside in a second-tier subsidiary, that result can be accomplished, but not directly. The acquired corporation can merge directly into the parent, for example, and the acquired assets can then be contributed down two levels to the second-tier subsidiary. Or the acquired corporation can merge into a first-tier subsidiary of the parent, and the acquired assets can be dropped down one level to the second-tier subsidiary.

But try to merge the acquired corporation *directly* into the second-tier subsidiary and get tax-free treatment? Not allowed, most would say. Why not? Just one of those things. So the law allows corporations to do indirectly what they can't do directly? This seems like the antithesis of the step transaction doctrine, which often treats taxpayers as having done directly what they tried to do indirectly to avoid an adverse tax result. Why doesn't the step transaction doctrine treat the acquired corporation as having merged directly into the second-tier subsidiary? Because we all understand that there's nothing inherently wrong with mergers into second-tier subsidiaries. The end result is not objectionable. The inability to accomplish that result directly is simply one of the many anomalies of subchapter C.

Or is it? The question is worth revisiting. If we push further on the question of *why* a target corporation cannot merge directly into a second-tier subsidiary of the acquiring parent, we find that the answer is rooted in a judicial doctrine created over 70 years ago that died a slow death and was finally put to rest more than a decade ago.[1] The full implications of the demise of this doctrine, known as ''remote continuity,'' have yet to be drawn out. But one implication is that it may now be possible under current law for a target corporation to merge into a second-tier subsidiary of a parent corporation that issues stock in the merger, with all of the parties receiving nonrecognition treatment. In other words, although most would find the prospect surprising, it may now be possible to use grandparent stock in a tax-free merger. At most, a simple amendment to the regulations would be all that would be needed to allow it. Approving the use of grandparent stock in a merger need not require action by Congress.[2] Because the issue is grounded in a long and rather tortured history, understanding the issue inevitably requires at least a brief tour through that history.

B. The Remote Continuity Doctrine

The remote continuity doctrine is a corollary of the more general continuity of interest doctrine. Although continuity of interest has long been a fixture in the law, it arose, in Prof. Wolfman's words, ''almost accidentally.''[3] Under the early reorganization rules, any merger or consolidation, or any transaction in which an acquiring corporation acquired substantially all the assets of another, qualified definitionally as a reorganization, even if the shareholders of the acquired corporation received no stock in the acquiring corporation.[4] Thus, a transaction in which the consideration paid by the acquiring corporation consisted only of cash or short-term notes was literally a reorganization. But the qualification of the transaction as a reorganization had no practical consequence. Both the acquired corporation and its shareholders would recognize in full any gain realized in the exchange. Nonetheless, in addressing these transactions, the courts adopted a broader rationale than necessary to require recognition of gain. They held that the transactions did not qualify as reorganizations, even though they met the statutory definition, by adding a new extrastatutory requirement: An acquisition qualified as a reorganization only if, in the transaction, the shareholders of the acquired corporation maintained their investment in that corporation's business through a proprietary interest in the acquiring corporation.[5]

A few years after establishing the continuity of interest doctrine, the Supreme Court added the proviso that the shareholders of the acquired corporation not only had to maintain a proprietary interest in the acquired business, but the retained interest also had to be direct. Thus was born the remote continuity doctrine. It finds its origin in two Supreme Court cases. The first, *Groman v. Commissioner*,[6] involved a transaction in which the Glidden Co. formed an acquisition subsidiary to acquire the assets of Metals Refining Co. In the transaction, the Metals Refining shareholders received, in exchange for their Metals Refining stock, preferred stock of both Glidden and the acquisition subsidiary, and cash. The taxpayer, a former shareholder of Metals Refining, treated the acquisition as a reorganization and reported gain only to the extent of the cash he received. The operative nonrecognition rules for shareholder exchanges in a reorganization then (as now) provided that shareholders of the acquired corporation recognized gain only to the extent that they received property (boot) other than stock of a corporation a party to the reorganization.[7]

Although the commissioner conceded that the transaction qualified as a reorganization, he claimed that the Glidden stock as well as the cash should have been treated as taxable boot. The Supreme Court agreed, on the ground that Glidden was not a party to the reorganization. The statute then (again, as now[8]) defined the phrase ''party to the reorganization'' in a nonexclusive manner, stating that the phrase ''includes'' various parties. Thus, the statute did not answer the question before the Court.[9] Even though Glidden, as the parent of the acquisition subsidiary to which the Metals Refining assets were transferred, was not specifically listed by the statute as a party to the reorganization, Glidden might still have qualified because the statutory definition was nonexclusive. The Court concluded, however, that Glidden should not be treated as a party to the reorganization because the Glidden stock received by the Metals Refining shareholders did not represent a sufficiently direct interest in Metals Refining's business. The Glidden stock, the Court reasoned, did not represent ''a continued substantial interest'' in the transferred assets, but instead was an interest in the assets of Glidden, which owned the transferred assets only indirectly, through its ownership of the stock of the acquisition subsidiary.[10] In the second

[1] *See generally* Michael L. Schultz, ''The Evolution of the Continuity of Interest Test, *General Utilities* Repeal and the Taxation of Corporate Acquisitions,'' 80 *Taxes* 229, 242-246 (Mar. 2002).

[2] The New York State Bar Association (NYSBA) Tax Section recommended a few years ago that tax-free mergers with grandparent stock be allowed, but assumed that implementation of its recommendation would require legislation. NYSBA, ''Report on Selected Issues in Triangular Reorganizations'' (Sept. 22, 2008), *Doc 2008-20242, 2008 TNT 185-18* (NYSBA report).

[3] Bernard Wolfman, '''Continuity of Interest' and the American Law Institute Study,'' 57 *Taxes* 840 (Dec. 1970).

[4] *See, e.g.*, Revenue Act of 1926, P.L. No. 20, 44 Stat. 9, 14 (1926).

[5] *See, e.g.*, *Pinellas Ice & Storage Co. v. Commissioner*, 287 U.S. 462 (1933); *Cortland Specialty Co. v. Commissioner*, 60 F.2d 937 (2d Cir. 1932). *See generally* Michael L. Schultz, ''The Future of Acquisitive D Reorganizations,'' 84 *Taxes* 107, 125 (Mar. 2006).

[6] 302 U.S. 82 (1937).

[7] The rules appear in sections 354(a)(1) and 356(a)(1) of the current code.

[8] *See* section 368(b).

[9] In proceedings below, the Seventh Circuit held that the definition of ''party to the reorganization'' was exclusive, *Commissioner v. Groman*, 86 F.2d 670, 672 (7th Cir. 1936), *aff'd*, 302 U.S. 82 (1937), but the Supreme Court agreed with the taxpayer that it was not. *See Groman*, 302 U.S. at 86.

[10] *See Groman*, 302 U.S. at 89.

of the two cases that established the remote continuity doctrine, *Helvering v. Bashford*,[11] the Court extended the doctrine to a case involving a postacquisition drop-down of assets.

In response to *Groman* and *Bashford*, Congress included provisions in the 1954 code that limited the remote continuity doctrine but apparently did not eliminate it. Section 368(a)(1)(C) specifically allowed triangular stock-for-assets acquisitions in which a subsidiary acquired substantially all the assets of a target corporation in exchange for voting stock of the acquirer's parent. And section 368(a)(2)(C) allowed postacquisition drop-downs of acquired assets to a first-tier controlled subsidiary after a merger or stock-for-assets C reorganization. Although the House Ways and Means Committee report on the 1954 code described the relevant provisions as ''overruling'' *Groman* and *Bashford*, the Senate Finance Committee report expressed an intent merely to ''modify'' the rule of those cases.[12] Moreover, the Ways and Means Committee cautioned that ''a corporation may not acquire assets with the intention of transferring them to a stranger.''[13] Thus, the remote continuity doctrine apparently remained in effect after 1954 to the extent it was not specifically overruled. Certainly that is how the IRS, with one notable exception, interpreted the 1954 amendments.[14]

After each ruling in which the IRS applied the remote continuity doctrine, Congress promptly responded by liberalizing the rules. For example, the IRS held in Rev. Rul. 67-326[15] that the operative nonrecognition rules would not apply to a forward triangular merger of a target corporation into a subsidiary of the corporation that issued stock in the merger unless the transaction also qualified as a stock-for-assets triangular C reorganization. The following year, in response, Congress enacted section 368(a)(2)(D), which provides that the use of parent stock in an otherwise qualifying merger does not preclude treatment of the transaction as a reorganization under the merger rules of section 368(a)(1)(A).

Rev. Rul. 67-326 ultimately rested on the proposition that the remote continuity doctrine continued to apply after 1954 except to the extent specifically overruled. To the extent that the ruling articulates a rationale, it seems to be that the parent corporation in the forward triangular merger would not be a party to the reorganization unless the acquisition qualified as a triangular C reorganization. (When Congress approved triangular C reorganizations in 1954, it added the parent corporation in a triangular C reorganization to the list of corporations specifically included as parties to the reorganization.) The ruling states that section 368(b) does not include as a party to a reorganization ''a corporation which is in control of the acquiring corporation in a reorganization qualifying under section 368(a)(1)(A) of the Code.'' But this conclusion requires reading section 368(b) as exclusive, despite its use of the nonexclusive term ''includes.''

As noted above, although the *Groman* Court had held that parent stock issued in a triangular reorganization was taxable boot because the parent was not a party to the reorganization, it also agreed with the taxpayer (and disagreed with the lower appellate court) that the predecessor of section 368(b) was nonexclusive. When Congress enacted section 368(b) as part of the 1954 code, it gave no indication that it meant to change the definition of ''party to a reorganization'' to be exclusive. Thus, if Rev. Rul. 67-326 reached an appropriate result, it could only be on the grounds that the parent corporation stock issued in the merger did not provide a sufficient link to the assets of the acquired business because the parent owned those assets only indirectly. Obviously, the link between the parent stock and the acquired assets would be the same regardless of whether the transaction also qualified as a triangular C reorganization. The difference was that Congress had specifically approved triangular C reorganizations, and thus overruled *Groman* and *Bashford* in the case of those transactions, but not in the case of forward triangular mergers that did not also qualify as triangular C reorganizations.

As noted above, Congress responded to Rev. Rul. 67-326 by amending the code the following year to specifically allow forward triangular mergers to qualify as reorganizations under section 368(a)(1)(A). In explaining the amendments, the Finance Committee accepted that forward triangular mergers could not qualify as A reorganizations under previous law, apparently agreeing with the interpretation adopted in Rev. Rul. 67-326.[16] But the committee recognized that the result of a forward triangular merger could be achieved if the target corporation first merged into the parent and the parent then contributed the acquired assets to its subsidiary.[17] The Finance Committee agreed with the Ways and Means Committee ''that there is no reason why tax-free treatment should be denied in cases . . . where for any reason the parent cannot or, for business or legal reasons, does not want to acquire the assets (even temporarily) through a merger.''[18] Section 368(a)(2)(D) provides that the use of stock of the parent of the acquiring corporation in a merger will not prevent the transaction from qualifying as a reorganization under section 368(a)(1)(A) if a merger into the parent would have qualified and if no stock of the acquiring corporation is used in the transaction.

The developments through the late 1960s left the law in a confused state. It seemed that the remote continuity doctrine of *Groman* and *Bashford* retained some vitality,

---

[11]302 U.S. 454 (1938).

[12]*See* H.R. Rep. No. 83-1337 at 40 (1954); S. Rep. No. 83-1622, at 273 (1954).

[13]*See* H.R. Rep. No. 83-1337, *supra* note 12, at A134.

[14]*See* Rev. Rul. 67-326, 1967-2 C.B. 143 (operative nonrecognition rules for reorganizations did not apply to an acquisition of assets by merger in which target shareholders received stock of parent of acquiring corporation unless the acquisition also qualified as a triangular C reorganization); Rev. Rul. 63-234, 1963-2 C.B. 148 (denying reorganization treatment to triangular stock swap). *But see* Rev. Rul. 64-73, 1964-1 C.B. 142 (approving ''double drop'' of assets to second-tier controlled subsidiary after stock-for-assets C reorganization).

[15]Rev. Rul. 67-326, *supra* note 14.

[16]S. Rep. No. 90-1653 (1968), *reprinted in* 1968-2 C.B. 849, 850.

[17]*Id.*

[18]*Id.*

but its scope was unclear. The statutory amendments allowing triangular reorganizations and drop-downs apparently did not define the limits of what the law would allow, as demonstrated by Rev. Rul. 64-73,[19] which allowed a drop-down of acquired assets to a second-tier subsidiary after a stock-for-assets C reorganization. Congress's repeated actions to expand the list of specifically approved triangular reorganizations and drop-downs in response to the IRS's narrow construction of the previous rules suggested reservations about the remote continuity doctrine. Nonetheless, the caution expressed by the Ways and Means Committee in 1954 had to be heeded: Transactions in which acquired assets ended up in a "stranger" should be denied nonrecognition treatment. The question of how to distinguish between stranger and acquaintance remained open.

Regulations adopted in 1998 eliminated the remote continuity doctrine once and for all. The regulations began as separate proposals regarding the continuity of interest doctrine and its corollary, continuity of business enterprise (COBE).[20] Continuity of interest requires only that the former shareholders of an acquired corporation receive a sufficient amount of stock in the acquisition. COBE generally requires the acquiring corporation to continue the business of the acquired corporation, so that the stock received by the former shareholders of the acquired corporation provides a sufficient link to its business to justify nonrecognition treatment.[21] The continuity of interest regulations proposed in 1997 focused the test on the consideration provided by the acquiring corporation in the acquisition so that postacquisition dispositions by the former target shareholders of stock received in the acquisition were generally not taken into account. The proposed COBE regulations generally applied COBE in reference to the acquiring corporation's "qualified group" so that transfers of the acquired stock or assets within that group did not violate COBE. The regulations defined "qualified group" to include chains of subsidiaries connected by controlling stock ownership with the acquiring corporation. The 1997 COBE proposals included separate rules addressing remote continuity that generally reached the same result as the proposed COBE rules: Transfers of acquired stock or assets within the acquiring corporation's qualified group did not violate the remote continuity doctrine just as they did not violate COBE.

Because the COBE and remote continuity rules were coextensive, having both sets of rules was unnecessary. When Treasury and the IRS finalized the proposed regulations in 1998, they reached this obvious conclusion and eliminated the separate rules for remote continuity. The preamble to the 1998 amendments explains, "The IRS and Treasury Department believe the COBE requirements adequately address the issues raised in *Groman* and *Bashford* and their progeny. Thus, the final regulations do not separately articulate rules addressing remote continuity of interest."[22] Remote continuity had finally and fully expired. Any transaction that meets the COBE rules does not violate remote continuity. Remote continuity therefore no longer exists as a separate test for reorganization treatment; it has (appropriately) been subsumed within COBE.

As noted at the outset, the process of drawing out the implications of the elimination of the remote continuity doctrine has proceeded slowly. One of the first glimmers of the post-remote-continuity world came in 2001 with the issuance of Rev. Rul. 2001-24.[23] That ruling involved a postacquisition drop-down of the stock of an acquisition subsidiary after a forward triangular merger. The ruling concludes that the drop-down did not deny reorganization treatment to the merger, even though the drop-down was not specifically approved by section 368(a)(2)(C), because "section 368(a)(2)(C) is permissive rather than an exclusive or restrictive section."

Rev. Rul. 2001-24, with its interpretation of section 368(a)(2)(C) as permissive rather than restrictive, reflected the elimination of the remote continuity doctrine. By its terms, section 368(a)(2)(C) is indeed merely permissive. It says that specified drop-downs do not disqualify an otherwise qualifying reorganization. It does not say that a drop-down not within the approved list disqualifies the acquisition from reorganization treatment. Nonetheless, while the continuing vitality of the remote continuity doctrine remained in doubt, a postacquisition drop-down not on the approved list might have violated that doctrine and denied reorganization treatment to the acquisition. Now that remote continuity no longer exists as a separate test for reorganization treatment, the omission of a drop-down from the approved section 368(a)(2)(C) list does not mean that the drop-down disqualifies the acquisition from reorganization treatment.

The IRS reached a similar result in Rev. Rul. 2002-85,[24] which allowed a postacquisition drop-down after an acquisitive reorganization described in section 368(a)(1)(D). Again, the ruling involved a drop-down not on the specifically approved list. And again, relying on its previous interpretation of section 368(a)(2)(C) as "permissive and not exclusive or restrictive," the IRS concluded that the drop-down did not disqualify the acquisition as an acquisitive D reorganization.

II. Grandparent Stock Mergers Under Current Law

Even today, the full implications of the demise of the remote continuity doctrine have yet to be fully drawn out. One of those implications is that mergers involving grandparent stock may now be permissible. The remote

[19]Rev. Rul. 67-326, *supra* note 14.

[20]*See* Notice of Proposed Rulemaking and Notice of Public Hearing: Continuity of Interest, REG-252231-96, 1997-1 C.B. 800, *Doc 96-32725, 96 TNT 248-14*; and Notice of Proposed Rulemaking and Notice of Public Hearing: Continuity of Interest and Business Enterprise, REG-252233-96, 1997-1 C.B. 802, *Doc 97-364, 97 TNT 2-1*.

[21]*See* T.D. 7745, "Continuity of Business Enterprise Requirement for Corporate Reorganizations," 1981-1 C.B. 134, 135.

[22]T.D. 8760, "Continuity of Interest and Continuity of Business Enterprise," 1998-1 C.B. 803, 806, *Doc 98-4301, 98 TNT 28-26*.

[23]2001-1 C.B. 1290, *Doc 2001-12686, 2001 TNT 87-9*.

[24]2002-2 C.B. 986, *Doc 2002-27007, 2002 TNT 237-13*.

continuity doctrine was the only stumbling block preventing triangular mergers from qualifying for nonrecognition treatment. Now that remote continuity is dead, it may not matter that, when the scope of that doctrine remained unclear, Congress specifically approved only mergers into first-tier subsidiaries of the corporation that issues stock in the merger. The specific rules for forward triangular mergers provided in section 368(a)(2)(D) need no longer be viewed as defining the limits of the law (if indeed they ever did).

As part of the task of cleaning up after the remote continuity doctrine, it is worth considering whether mergers involving grandparent stock can now qualify for full nonrecognition treatment. The following simple example can serve as a framework for discussion:

> **Example.** Parent owns all the stock of Sub 1, which owns all the stock of Sub 2. Under applicable state law, Target, a previously unrelated corporation, merges into Sub 2. At the effective time of the merger, the assets and liabilities of Target become the assets and liabilities of Sub 2, Target's separate legal existence ceases, and the Target stock held by its shareholders is converted into Parent stock. After the merger, Sub 2 continues the conduct of Target's historic business.

A. The Statutory Requirements

Target's merger into Sub 2 would meet the statutory definition of a reorganization described in section 368(a)(1)(A). That section includes within the definition of ''reorganization'' ''a statutory merger or consolidation.'' There is nothing about triangular mergers that prevents them from being described in section 368(a)(1)(A). Indeed, the IRS acknowledged in Rev. Rul. 67-326 that the forward triangular merger addressed in that ruling was ''a statutory merger.'' The ruling did not conclude that the merger failed to qualify as an A reorganization. It held instead that the operative nonrecognition rules for reorganization exchanges would not apply unless the acquisition also qualified as a triangular C reorganization. Otherwise, in the IRS's view, the parent corporation that issued stock in the merger would not qualify as a party to the reorganization. The parties to the transaction would, of course, have viewed it as cold comfort that, even though the transaction was fully taxable, it still qualified as a reorganization. But the distinction, although of no practical consequence in 1967, is potentially significant in considering whether some fundamental aspect of triangular mergers prevents their qualification as statutory mergers under section 368(a)(1)(A) in the absence of specific rules approving them.

Although regulations adopted in 2006 purport to add additional conditions that must be met for a merger to qualify as a reorganization under section 368(a)(1)(A), Target's merger into Sub 2 would meet those additional conditions. Reg. section 1.368-2(b)(1)(ii) provides that a state law merger is described in section 368(a)(1)(A) only if, at the effective time of the merger, two events occur simultaneously. First, all the assets and liabilities of the merged corporation must become assets and liabilities of the surviving corporation. Second, the merged corporation must cease its separate legal existence. Both of these events occurred simultaneously under applicable state law in the case of Target's merger into Sub 2.

B. The Extrastatutory Requirements

1. Business purpose. For a transaction to qualify as a reorganization, it must meet not only the terms of the relevant statutory definition provided in section 368, but also three extrastatutory tests. In addition to satisfying the continuity of interest and COBE tests, the transaction must have a business purpose.[25] The location of the entity that survives the merger within the acquiring group should not affect the business purpose of the merger. Thus, whatever business purpose would have justified a merger of Target into Parent should apply with equal force to Target's merger into Sub 2. That leaves for consideration continuity of interest and COBE. Because the application of the latter test informs the application of the former, it makes sense to begin with COBE.

2. COBE. The COBE test, as implemented by reg. section 1.368-1(d)(1), requires that the ''issuing corporation'' must either ''continue the target corporation's (T's) historic business or use a significant portion of T's historic business assets in a business.'' For this purpose, ''the issuing corporation is treated as holding all of the businesses and assets of all members of the qualified group.''[26] As noted above, a qualified group includes a parent corporation and those subsidiaries connected by at least 80 percent stock ownership.[27] Finally, reg. section 1.368-1(b) defines the term ''issuing corporation'' to mean ''the acquiring corporation (as that term is used in section 368(a)),'' except that, in the case of triangular reorganizations described in reg. section 1.358-6(b)(2), the issuing corporation is the corporation in control of the acquiring corporation.

The merger of Target into Sub 2 should meet the COBE test. Under a literal application of the rules, it appears that Sub 2 would be the acquiring corporation. Although section 368(a)(1)(A) does not use the term ''acquiring corporation,'' those subparagraphs of paragraph 368(a)(1) that do use the term use it to refer to the corporation that acquires the stock or assets of the acquired corporation. (Because Parent does not directly own the stock of Sub 2, the merger of Target into Sub 2 is not a triangular reorganization under reg. section 1.358-6(b)(2).) Thus, Sub 2's conduct of Target's former business arguably meets the COBE requirement without regard to any larger qualified group. Even if Parent (or, for that matter, Sub 1) were treated as the issuing corporation for purposes of the COBE test, the test would still be met because Parent, Sub 1, and Sub 2 are members of the same qualified group.

3. Continuity of interest. Because Target's merger into Sub 2 meets the COBE test, it should meet the general continuity of interest test as well. The general continuity of interest test ensures that the former shareholders of the acquired corporation receive a sufficient quantum of stock in the reorganization. The COBE test ensures that

[25]Reg. section 1.368-2(g).

[26]Reg. section 1.368-1(d)(4)(i).

[27]Reg. section 1.368-1(d)(4)(ii).

the stock they receive provides a sufficient continuing link to the acquired corporation's business. The former shareholders of Target received no consideration in the merger other than stock. Thus, the relevant policy question is not whether the Target shareholders received enough stock, but whether the Parent stock they received represents a sufficient continuing link to Target's business. Because Sub 2 is an indirect, wholly owned subsidiary of Parent, the COBE rules answer this question affirmatively. Nothing remains to be policed by the general continuity of interest test.

When one turns to the technical terms of the continuity of interest regulations, however, the issue is not quite so simple. The merger of Target into Sub 2 ought to meet the continuity of interest test. Whether it does so as a technical matter requires some fine parsing of the governing regulations. That parsing, however, should be done mindful that, for the reasons explained above, the policies weigh in favor of granting nonrecognition treatment. Therefore, technical ambiguities should be resolved in favor of the taxpayers.

Reg. section 1.368-1(e)(1)(i) describes consideration that counts toward continuity of interest and consideration that counts against it. But the Parent stock issued to the former Target shareholders is not literally described in either category. Specifically, reg. section 1.368-1(e)(1)(i) provides:

> A proprietary interest in the target corporation is preserved if, in a potential reorganization, it is exchanged for a proprietary interest in the issuing corporation . . . it is exchanged by the acquiring corporation for a direct interest in the target corporation enterprise, or it otherwise continues as a proprietary interest in the target corporation. However, a proprietary interest in the target corporation is not preserved if, in connection with the potential reorganization, it is acquired by the issuing corporation for consideration other than stock of the issuing corporation. . . . All facts and circumstances must be considered in determining whether, in substance, a proprietary interest in the target corporation is preserved.

Because the former shareholders of Target exchanged their Target stock for Parent stock, the merger of Target into Sub 2 would meet the continuity of interest test if Parent was the "issuing corporation." As noted above, reg. section 1.368-1(b) defines "issuing corporation" to mean the "acquiring corporation" under section 368(a)(1). Although section 368(a)(1)(A) does not use the term "acquiring corporation," if the meaning of the term is determined by reference to its use in subparagraphs of section 368(a)(1) other than section 368(a)(1)(A), this means that Sub 2, as the acquirer of Target's assets, would be the acquiring corporation and thus the issuing corporation.

Even if Sub 2 is treated as the issuing corporation, the continuity of interest test might still be met, even though the former Target shareholders received Parent stock rather than Sub 2 stock in the merger. The Parent stock received by the former Target shareholders in consideration for their Target stock would concededly be "consideration other than stock of the issuing corporation." But it does not follow that the proprietary interest represented by the Target stock was not preserved in the merger.

The regulations, again, list three circumstances in which continuity is preserved and one in which it is not. Continuity is preserved if target corporation stock is exchanged for stock of the issuing corporation. Or if the acquiring corporation owned target corporation stock before the transaction that it exchanged for a direct interest in the target's assets (as in an upstream merger). Or if the proprietary interest represented by the target corporation stock "otherwise continues as a proprietary interest in the target corporation." A proprietary interest in the target corporation is not preserved if the acquiring corporation acquires "it" (that is, the proprietary interest) in exchange for consideration other than stock of the issuing corporation.

The merger of Target into Sub 2 does not present any of these four circumstances. It is neither specifically blessed nor specifically condemned by the regulations. The Target shareholders did not exchange their Target stock for stock of Sub 2, the presumed issuing corporation. Nor does the Target stock "otherwise continue" as a proprietary interest in Target, because Target does not exist after the transaction. However, even though the Target stock was exchanged "for consideration other than stock of the issuing corporation," the merger of Target into Sub 2 does not present the only identified nonqualifying circumstance. Again, the regulation states that a proprietary interest in a target corporation is not preserved if the issuing corporation acquires that proprietary interest for consideration other than its own stock. But Sub 2 did not acquire "a proprietary interest" in Target. It acquired "a direct interest in the target corporation enterprise." This might sound like nitpicking, but the regulations carefully distinguish between the two. A direct interest in the target corporation enterprise is not a proprietary interest in the target corporation.

Thus, the regulation, read literally, does not specify whether the proprietary interest represented by the Target stock is preserved after the merger of Target into Sub 2. The issue arguably turns on a consideration of "all facts and circumstances." Because the Target shareholders have preserved their investment in Target's business through their ownership of Parent stock — which, under the COBE rules, represents a sufficient link to Target's business to justify nonrecognition treatment — the continuity of interest test should be satisfied.

C. Section 368(a)(2)(D)

The merger of Target into Sub 2 should not be denied treatment as a reorganization described in section 368(a)(1)(A) on the ground that it does not qualify under the special rules for forward triangular mergers provided in section 368(a)(2)(D). By its terms, section 368(a)(2)(D) does not limit reorganization treatment. It simply grants reorganization treatment to transactions that might not otherwise qualify. In other words, section 368(a)(2)(D) "is permissive rather than an exclusive or restrictive section."[28] In particular, section 368(a)(2)(D) provides:

> The acquisition by one corporation, in exchange for stock of a corporation . . . which is in control of the acquiring corporation, of substantially all of the properties of another corporation shall not disqualify a transaction under paragraph (1)(A) . . . if —
>
> (i) no stock of the acquiring corporation is used in the transaction, and
>
> (ii) . . . such transaction would have qualified under paragraph (1)(A) had the merger been into the controlling corporation.

Because the merger of Target into Sub 2 is not an "acquisition by one corporation, in exchange for stock of a corporation . . . which is in control of the acquiring corporation, of substantially all of the properties of another corporation," section 368(a)(2)(D), by its terms, has no application to the merger. But section 368(a)(2)(D) might create a negative implication relevant to qualification of the merger of Target into Sub 2 as an A reorganization.[29] Unless the terms of section 368(a)(2)(D) are a nullity, they suggest that, but for that section, a merger of a target into a first-tier acquisition subsidiary of a parent corporation that issues stock in the merger might not qualify as an A reorganization.

Why is (or was) that the case, and does a merger into a second-tier acquisition subsidiary of the parent raise the same issue? The answer, of course, is that Congress enacted section 368(a)(2)(D) because, at that time, the scope of the remote continuity doctrine was unclear. The only reason a merger described in section 368(a)(2)(D) might not have qualified as an A reorganization in the absence of that section was that it might have violated the remote continuity doctrine — the same reason that a drop-down not described in section 368(a)(2)(C) might have been problematic. Now that the remote continuity doctrine has been eliminated — subsumed into COBE — section 368(a)(2)(D) does not create any negative implication that would prevent the merger of Target into Sub 2 from qualifying as an A reorganization. That Parent does not directly control Sub 2 is of no moment. Because Parent indirectly owns all of the stock of Sub 2, the Parent stock issued to the former Target shareholders provides a sufficient continuing link to Target's business to justify nonrecognition treatment.

D. Application of Operative Nonrecognition Rules

The analysis presented above establishes only that the merger of Target into Sub 2 can qualify as a reorganization. But the qualification of a transaction as a reorganization (as we saw in Rev. Rul. 67-326) does not dictate the tax consequences of the transaction to the parties involved. The actual tax consequences of the transaction are governed by a separate set of operative rules that apply to the exchanges made in accordance with the reorganization by the corporations involved and their shareholders.

The tax consequences to the Target shareholders of their exchange, in the merger, of Target stock for Parent stock depend on whether Parent is a party to the reorganization under section 368(b). Section 354(a)(1) provides the basic shareholder-level nonrecognition rule for reorganization exchanges. Under that rule, the shareholders of the acquired corporation recognize no gain or loss if, in pursuance of a plan of reorganization, they exchange their stock in the acquired corporation for stock "in another corporation a party to the reorganization."

Parent in our example is not among the corporations listed as parties to the reorganization under the nonexclusive definition provided by section 368(b). That section provides that "the term 'a party to a reorganization' includes" specified corporations. For example, "a corporation resulting from a reorganization" is a party to the reorganization. If the reorganization involves "the acquisition by one corporation of the stock or properties of another," both corporations are parties. In the case of a forward triangular merger described in section 368(a)(2)(D) or a reverse triangular merger described in section 368(a)(2)(E) (in which an acquisition subsidiary merges into the target corporation), the parent of the acquiring (or acquired) corporation is a party to the reorganization. But the merger of Target into Sub 2 does not qualify as a reorganization under the existing forward triangular merger rules because Sub 2 is not a first-tier subsidiary of Parent.

Because the definition of "party to the reorganization" provided in section 368(b) is not exclusive, however, Parent could be a party to the reorganization involving the merger of Target into Sub 2 even though Parent is not specifically listed in section 368(b). Parent is a party to the reorganization in the sense that it is involved in the transaction: It issued the stock received by the Target shareholders in the merger. Moreover, as explained above, the Parent stock issued to the Target shareholders provided them with a continuing interest in Target's business that should be sufficient to meet the continuity of interest and COBE requirements. Therefore, Parent should be treated as a party to the reorganization. The only reason for not treating Parent as a party to the reorganization would be if its stock did not provide the requisite link to Target's business. That is precisely what the *Groman* Court did, but under standards of continuity

---

[28] *Cf.* Rev. Rul. 2002-85 and Rev. Rul. 2001-24.

[29] NYSBA, in its report on triangular reorganizations, apparently took this view. *See* NYSBA report, *supra* note 2. The report viewed the definition of "control" provided in section 368(c), rather than the grandparent's qualification as a party to the reorganization, as the principal impediment to nonrecognition treatment for mergers with grandparent stock. Thus, the report implicitly viewed section 368(a)(2)(D) as delimiting the bounds of nonrecognition treatment for forward triangular mergers. Under that view, Parent's lack of "control" over Sub 2 would require denial of nonrecognition treatment. And Parent's failure to control Sub 2, despite owning indirectly all of the stock of Sub 2, results from the inability to use attribution rules in determining control. It is seemingly for that reason that NYSBA concluded that an amendment to the section 368(c) control definition was necessary to allow nonrecognition treatment for mergers with grandparent stock. The apparent premise on which these views are based — that section 368(a)(2)(D) is not merely permissive but defines the bounds of reorganization treatment for forward triangular mergers — is not explained in the report.

that no longer apply. Under modern sensibilities, stock of a parent corporation that controls a subsidiary that conducts the business of the acquired corporation provides an adequate link between the shareholders of the acquired corporation and the business of that corporation regardless of whether the parent corporation's control is direct or indirect. The issuer of stock in any transaction that meets the COBE test should qualify as a party to the reorganization. If Parent is treated as a party to the reorganization in which Target merges into Sub 2, the operative nonrecognition rules will apply not only to the shareholders' exchange of Target stock for Parent stock, but also to Target's constructive transfer of its assets for Parent stock and distribution of that stock to the Target shareholders.[30]

E. Potential 'Zero Basis' Issue

One last point remains to be considered: If Target is treated as having transferred its assets to Sub 2 in exchange for Parent stock,[31] how did Sub 2 get that Parent stock, and what are the consequences to Sub 2 of its exchange of Parent stock for Target's assets? If the Parent stock transferred by Sub 2 to the Target shareholders were treated as having been contributed by Parent through Sub 1 to Sub 2 by successive capital contributions, Sub 2 could be treated as having a zero basis in the Parent stock. Section 362(a) provides that, when a corporation acquires property as a capital contribution from a shareholder, the corporation takes that property with the shareholder's basis. Applying that rule to the contribution by Parent of its stock raises the question of what basis, if any, it had in its own stock. The logical answer is that, because Parent's unissued stock is not property in Parent's hands, that stock has no basis to Parent.

Although the absence of basis and a zero basis are not the same thing, until recently the IRS reasoned that a corporation has a zero basis in its own stock. Thus, Rev. Rul. 74-503[32] held that when a parent corporation transfers its stock to a subsidiary in a section 351 exchange, the subsidiary takes the stock with a zero basis.

Despite criticism of the ''zero basis'' ruling, it remained in effect for many years. Rather than withdrawing the ruling, the government adopted by regulations a series of work-arounds to avoid the zero basis problem. For example, in 1995 Treasury adopted regulations that treated triangular reorganizations, for specified purposes, as involving acquisitions by the parent corporation followed by transfers to the subsidiaries.[33] Under this ''over the top'' model, the parent stock received by the shareholders of the acquired corporation is treated as having been issued by the parent corporation itself. The rules thus avoid the issue of the basis of that stock in the hands of the subsidiary. (The parent corporation recognizes no gain on the issuance of its stock because of the rule, provided in section 1032(a), that a corporation recognizes no gain or loss on the receipt of money or property for its own stock.) In 2000 Treasury adopted rules governing a subsidiary's use of contributed parent stock in taxable acquisitions.[34] The regulations adopt a ''cash purchase model'' that treats the parent as having contributed cash to the subsidiary, which the subsidiary then used to acquire the parent stock used in the acquisition.[35] The subsidiary is thus treated as having a cost basis in the contributed stock equal to its fair market value,[36] and recognizes no gain (or loss) on its transfer of that stock to acquire other property. The deemed cash purchase rule of reg. section 1.1032-3(b)(1) does not apply, however, if the recipient of the parent stock takes that stock with a substituted basis.[37]

Finally, in 2006 the IRS revoked Rev. Rul. 74-503.[38] In announcing the revocation, the IRS noted that its zero basis position was ''under study.''

Pending further guidance, Sub 2 might be required to recognize gain on its deemed issuance of Parent stock to Target in exchange for Target's assets (unless it separately pays for the stock by, for example, issuing a note to Parent). The ''over the top'' rules for triangular mergers would not apply to the merger of Target into Sub 2, for the good reason that the merger would not have qualified for nonrecognition treatment in 1995 when those rules were issued. The deemed cash purchase rule of reg. section 1.1032-3(b)(1) would not apply, because Target would be treated as receiving the Parent stock with a substituted basis. Under section 358(a)(1) and (d), Target's basis in the Parent stock would equal the basis of the transferred assets, reduced by the amount of liabilities assumed by Sub 2. Sub 2 could argue that it should be treated as having acquired the Parent stock with a cost basis under section 1012. The general rule for a corporation's basis in property acquired by capital contribution provided in section 362(a) cannot be applied because, as noted above, Parent's own stock is not property in its hands. Thus, Parent can have no basis in its own stock. Because the rule that would otherwise determine Sub 2's basis cannot be applied, Sub 2's basis in the Parent stock deemed to have been contributed down the chain through Sub 1 should be determined under the default rule of section 1012.

Ultimately, if the government agrees that current law now allows tax-free mergers with grandparent stock, in addition to clarifying the application of the continuity of interest regulations to those transactions, the government should also bring them within the rules that apply the ''over the top model'' to determine basis questions in connection with triangular reorganizations.

[30]*See* section 361(a) and (c).

[31]*Cf.* Rev. Rul. 69-6, 1969-1 C.B. 104.

[32]1974-2 C.B. 117.

[33]*See* ''Controlling Corporation's Basis Adjustment in its Controlled Corporation's Stock Following a Triangular Reorganization,'' T.D. 8648, 1996-1 C.B. 37, *Doc 95-11327, 95 TNT 248-11*.

[34]''Guidance Under Section 1032 Relating to the Treatment of a Disposition by an Acquiring Entity of the Stock of a Corporation in a Taxable Transaction,'' T.D. 8883, 2000-1 C.B. 1151, *Doc 2000-13223, 2000 TNT 93-8*.

[35]*See* reg. section 1.1032-3(b)(1).

[36]*See* section 1012(a).

[37]Reg. section 1.1032-3(c)(3).

[38]Rev. Rul. 2006-2, 2006-1 C.B. 261, *Doc 2005-25550, 2005 TNT 244-7*.

III. Conclusion

Although the assertion would doubtless surprise many familiar with subchapter C, it may now be possible, under current law, for a merger of an acquired corporation into a second-tier subsidiary of the corporation that issues stock in the merger to qualify for nonrecognition treatment. The only real impediment to that treatment was a judicial doctrine dating from the 1930s that was significantly limited (at least) by the 1954 code, further limited by amendments to the code during the 1960s, and then finally eliminated with the adoption of the existing COBE regulations in 1998. The technical issue raised by the transaction is whether the issuer of the stock is a party to the reorganization. The statute, with its nonexclusive definition of the key term, does not answer that question. The now-defunct remote continuity doctrine provided the only ground for excluding the issuer from qualification as a ''party.'' Remote continuity is now subsumed within COBE. As long as the issuer of the stock is treated as continuing the business of the acquired corporation under the COBE rules, there is no longer any reason to deny it status as a party to the reorganization. This result is possible under current law.[39] No clear stumbling block remains.

The conclusion that a merger with grandparent stock can be given nonrecognition treatment under current law, however, does involve a careful parsing of the continuity of interest regulations and reliance on a subjective facts-and-circumstances analysis. Treasury and the IRS could provide greater clarity by amending the regulation to provide that any corporation treated under the COBE rules as conducting the business of the acquired corporation qualifies as an ''issuing corporation'' for purposes of the continuity of interest test. An amendment along those lines would more clearly define the respective roles of the continuity of interest test and its corollary, COBE. The continuity of interest test would ask whether the target shareholders received enough stock, leaving to the COBE test the question of whether that stock provides a sufficient continuing link to the acquired corporation's business to justify nonrecognition treatment. But a clarifying amendment to the regulations, while helpful, is arguably unnecessary. A merger of an acquired corporation into a second-tier subsidiary of the corporation that issues stock in the merger can qualify for nonrecognition treatment under existing law.

And that perhaps surprising conclusion shows the value of periodically questioning those apparently enduring anomalies in subchapter C. Because they often rest on judicial doctrines, changes in the interpretation and application of those doctrines can eliminate the anomalies. Given the interdependence of the rules and the interpretive doctrines, changing one piece in the puzzle can have significant and potentially unappreciated implications. So sometimes, when we face one of those nagging anomalies, it's worth asking why we must accept it. It may be just one of those subchapter C things. Or it may be that the anomaly was resolved when we weren't looking.

---

[39]*But see* NYSBA report, *supra* note 2.