Norman Conquest? Insolvency Reorganizations and Net Value

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On March 10, 2005, the IRS issued proposed regulations that will require the exchange or distribution of net value in order to maintain nonrecognition in certain corporate reorganizations. [*See* REG-163314-03, 70 FR 11903-01.] While these proposed regulations are not yet in effect (they will be effective once final regulations are issued), there is no reason to suspect the IRS will modify its proposal.

These proposed regulations would reverse the long-standing holding in *Norman Scott, Inc.* [48 TC 598, Dec. 28,551 (1967)]. In *Norman Scott* the Tax Court determined that transactions involving an insolvent target corporation qualified as a reorganization under Code Sec. 368(a)(1)(A). In its announcement, the IRS stated that Rev. Rul. 59-296 [1959-2 CB 87] stands in direct conflict with the holding in *Norman Scott*.

Rev. Rul. 59-296 held that principles relevant to liquidations under Code Sec. 332 also apply to reorganizations under Code Sec. 368. Code Sec. 332 states that a distribution will be considered in a complete liquidation only if the corporation receiving the property was the owner of stock meeting the requirements of Code Sec. 1504(a)(2). This requisite ownership must exist as of the date of the adoption of the plan of liquidation, and at all times thereafter, until the receipt of the property.

Rev. Rul. 59-296 merely held that when a creditor-parent receives less than what the debtor-subsidiary owed to the parent upon full liquidation, the transfer of assets will be considered in satisfaction of the indebtedness, rather than as a distribution pursuant to a reorganization.

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In *Norman Scott*, the Tax Court held that the taxpayer's situation in Rev. Rul. 59-296 was distinguishable from the *Norman Scott* facts. The Tax Court held that nothing in the applicable statutes or regulations suggested a requirement that stock or assets received by a corporation in a merger must be received in the role of stockholder rather than that of creditor. The IRS had argued that it made a difference, and that there could be no reorganization where money or assets changed hands merely between debtor and creditor, regardless of the creditor/debtor relationship.

But the Tax Court didn't buy the IRS's argument. The court concluded that since such statutory language was present in Rev. Rul. 59-296 (which considered Code Sec. 332), the court was bound to follow that language. However, *Norman Scott* did not have to be considered under Code Sec. 332. Indeed, seeing a way out, the Tax Court looked to the form of the transaction and determined that it was a reorganization under state law. Consequently, it concluded that the taxpayer had really just done an A reorganization. Of course, an A reorganization has no requirement (explicit or implicit) about complete or partial payment being reciprocal in the deal.

Subtle Fix

In the proposed regulations, the IRS tries explicitly to confront the rather substantial difference in the language between Code Sec. 332 and Code Sec. 368. In an end-run that perhaps gives new verve to the oxymoronic moniker "legislative regulations," the IRS simply inserts a new net value requirement for A reorganizations. It seems the IRS just had it in for the *Norman Scott* case. In fact, the net value requirement under the proposed regulations does not extend to E and F reorganizations. According to one Treasury attorney, after all, it just wasn't necessary. [See 75 BNA DAILY TAX REPORT, Apr. 20, 2005, at G.]

The IRS also stated that it believes that the net value requirement is the appropriate unifying standard because it is more consistent with the statutory framework of subchapter C, with case law and with published guidance than any other approach the IRS considered. The IRS said it believes that the net value requirement is appropriate because transactions that fail the requirement resemble sales and should not receive nonrecognition treatment. After all, posits the IRS, a reorganization is a mere transfer of property in exchange for the assumption or satisfaction of liabilities.

In the proposed regulations, the IRS modifies Reg. §1.368-1(b)(1) to add the requirement that there must be an exchange of net value. In addition, in Proposed Reg. §1.368-1(f), the IRS sets forth rules for determining whether there is an exchange of net value. The rules are simple, requiring both a surrender and a receipt of net value.

In a potential asset reorganization (one in which the target corporation would not recognize gain or loss under Code Sec. 361), the target will be considered to surrender net value if the fair market value of the property transferred by it to the acquiring corporation exceeds the sum of the liabilities of the target corporation that are assumed by the acquiring corporation. In its announcement, the IRS says it believes the proposed rule better identifies whether a target corporation transfers property in exchange for stock. A rule that looks merely at the issuance (or failure to issue) stock is vacuous, since stock may simply not be issued. Indeed, when the parties are related, the issuance or failure to issue stock might be meaningless.

In a stock reorganization (a B or A reorganization by reason of Code Sec. 368(a)(2)(E)), the rules are modified to reflect the fact that the target remains in existence. An A reorganization, by way of Code Sec. 368(a)(2)(E), must satisfy the asset reorganization test for the merger of the controlled corporation into the target, and the stock reorganization test for the acquisition of the target.

Double Standard?

Despite all the lofty talk about unifying standards, the proposed regulations provide that the net value requirement does not apply to E and F reorganizations. However, the IRS thinks it has those transactions covered in another way. The IRS and the Treasury recently issued final regulations [T.D. 9182, IRB 2005-11, 713 (Feb. 25, 2005)] stating that continuity of business enterprise and continuity of interest are not required for a transaction to qualify as a reorganization under Code Sec. 368(a)(1)(E) or (F).

According to the IRS, the purpose underlying the net value requirement is the same as that underlying continuity of interest. Thus, the IRS and the Treasury concluded that applying the net value requirement for E and F transactions is not necessary. The proposed regulations also provide that the net value requirement does not apply to a limited class of transactions that qualify as D reorganizations.

That class of transactions is exemplified by *James Armour, Inc.* [43 TC 295, Dec. 27,071 (1964)] and Rev. Rul. 70-240 [1970-1 CB 81]. In *Armour*, the Tax Court held that distributions to shareholders are taxed as a dividend to the extent of the earnings and profits of the liquidating company. The reorganization provisions are sometimes used as an end-run in an attempt to prevent corporate earnings and profits from being taxed. In its recent proposed regulations, the IRS does acknowledge that the conclusions of these described authorities are inconsistent with the principles of the net value requirement. Nevertheless, the IRS preserved those holdings.

The proposed regulations do not give any specific guidance (other than with regard to the application of the net value requirement) about when a transaction will qualify as a D reorganization. Furthermore, Proposed Reg. §1.368-2(d)(1) removes the statement that the assumption of liabilities may alter the character of a transaction to place the transaction outside the purposes and assumptions of the reorganization provisions. The IRS stated that it believes the statement is unnecessary, because the proposed regulations provide more specific guidance about when an assumption of liabilities will prevent a transaction from qualifying as a C reorganization.

Some of the other provisions in the proposed regulations outline the circumstances under which transactions involving insolvent corporations would qualify for tax-free treatment. The proposed regulations generally provide that the nonrecognition rules of subchapter C don't apply unless there has been an exchange of property for stock or, in the case of a liquidation, a distribution of property in cancellation or redemption of stock (the net value requirement).

What's a "Liability"?

The IRS believes that transfers of property in exchange for the assumption or satisfaction of liabilities resemble sales and should not receive nonrecognition treatment. Yet sadly, the proposed regulations do not define "liabilities." The IRS does note that it intends to interpret the term broadly (which hardly is a surprise). In its announcement, the IRS stated that it is currently considering various approaches for determining the parameters regarding liabilities.

The proposed regulations provide further guidance on the circumstances in which (and the extent to which) an insolvent corporation's creditors will be treated as its proprietors for purposes of determining whether the continuity-of-interest requirement has been satisfied in a potential reorganization. Senior claims will be treated as partially representing a creditor claim, and partially representing a proprietary interest in the target. The entire amount of a junior claim will simply represent a proprietary interest in the target immediately before the potential reorganization.

The IRS also addressed whether Code Sec. 332 is satisfied when a subsidiary's liquidating distribution to its parent is in cancellation or redemption of fewer than all of the parent's shares. Under the proposed regulations, Code Sec. 332 will apply only if the recipient corporation receives at least partial payment for each class of stock that it owns in the liquidating corporation.

More to Come?

At the end of the day, the IRS has concocted (albeit in proposed form) some radical new rules surrounding tax-free reorganizations of insolvent companies. Of course, you are unlikely to care unless your own ox is being gored. Indeed, the IRS is simply now intending to impose a net value rule across the board (aside from two exceptions), regardless of court decisions. While the *Norman Scott* decision may be fading to black and white, it will probably be cited for years to come.