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Post Bruno's Bankruptcy Planning:
An Analysis of Taxable Emergence Structures

Christopher Woll*

I. INTRODUCTION - TAXABLE EMERGENCE FROM BANKRUPTCY

The purpose of this article is to analyze both the benefits and risks of emergence from a bankruptcy filing under Chapter 11 of the U.S. Bankruptcy Code ("Chapter 11") in a taxable manner where the vast majority of the business assets are controlled, following emergence, by debtor's historic creditors. While tax-free reorganizations are often afforded beneficial treatment under the Internal Revenue Code,1 there are certain instances when a more advantageous post-emergence tax position is achieved by structuring the emergence transaction as a taxable asset sale by the bankrupt corporation to its creditors.

Historically, Chapter 11 bankruptcy reorganizations, in which the debtor's creditors obtained majority ownership of the bankrupt corporation's equity pursuant to the Plan of Reorganization, were structured as either single party tax-free recapitalizations under section 368(a)(1)(E) ("E recapitalizations") or two party tax-free reorganizations under section 368(a)(1)(G) ("G reorganizations"). However, a 1999 transaction in which Bruno's Inc. emerged from Chapter 11 in a taxable fashion shook the foundation of bankruptcy emergence tax planning.

To be beneficial, the bankrupt corporation will ideally have assets with an aggregate fair market value in excess of their aggregate tax

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KPMG LLP, the audit, tax and advisory firm (www.us.kpmg.com), is the U.S. member firm of KPMG International. KPMG International's member firms have nearly 100,000 professionals, including 6,800 partners, in 148 countries.

The information contained herein is general in nature and based on authorities that are subject to change. Applicability to specific situations is to be determined through consultation with your tax adviser.

1. Unless otherwise indicated, all references to "section" or "sections" contained in the text of this document are references to the Internal Revenue Code of 1986, as most recently amended (the "Code") or to the U.S. Treasury Department Regulations, as most recently adopted or amended (the "regulations").
basis and be at risk of losing almost all of its net operating losses ("NOLs") and other tax attributes through attribute reduction pursuant to sections 108 and 1017. Under this factual scenario, while the bankrupt corporation will emerge with no NOLs, capital loss carry-forwards or credits, taxable emergence will be beneficial because the debtor corporation’s successor will emerge with fair market value (i.e., stepped up) basis in the assets that were sold to the creditors. On a going-forward basis the debtor will receive higher depreciation and amortization deductions as well as recognize less gain (or more loss) on subsequent asset sale transactions. The cancellation of debt ("COD") income realized on emergence from Chapter 11 bankruptcy should not be taxable even if it is in excess of the total tax attributes subject to reduction.2

II. Qualification as a Taxable Transaction

A. Historic Structure - The Bruno’s Transaction

Bruno’s Inc. ("Bruno’s"), a southern regional supermarket chain, had about $1 billion in debt when it filed for bankruptcy protection pursuant to Chapter 11.3 The debt included approximately $462 million in secured bank debt, $421 million of junk debt and $135 million of other unsecured trade debt.4 The shareholders and the junk bond holders received no distribution pursuant to the Plan of Reorganization.5 The trade creditors received 30 cents on the dollar in cash.6 The secured creditors received equity valued at $275 million.7 The original Bruno’s Inc. entity (i.e., "Old Bruno’s") survived the reorganization with $20 million of retained real estate assets.8

An exchange of equity for debt would have left Bruno’s with roughly $700 million of COD income.9 Upon emergence, Bruno’s had approximately $180 million of NOL carryovers and the tax basis of its assets was roughly $550 million.10 Accordingly, attribute reduction pursuant to section 108 (assuming no section 108(b)(5) election was made) would have completely eliminated Bruno’s NOL carryovers

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4. Id.
5. Id.
6. Id.
7. Id.
8. See Sheppard, supra note 3, at 987.
9. Id. at 984.
10. Id.
and the tax basis in its assets following emergence would have been approximately $30 million.\textsuperscript{11}

Therefore, instead of swapping debt for equity, which would have been treated as an E recapitalization, Bruno's had the secured creditors buy its assets.\textsuperscript{12} Under the plan, Bruno's transferred its assets, subject to the bank debt, to an acquisition vehicle, New Bruno's, which issued shares to the creditors in exchange for their debt.\textsuperscript{13} New Bruno's thereby obtained a tax basis in its assets of approximately $310 million.\textsuperscript{14} The gain recognized on the sale of the assets was offset by Bruno’s NOL carryovers.\textsuperscript{15} Old Bruno's issued all of its equity to the same creditors in exchange for their remaining debt.\textsuperscript{16} Bruno's told the bankruptcy court that the proposed transaction was not a sale of the assets for purposes of corporate law.\textsuperscript{17} To-date, the IRS has never publicly opined on the Bruno's Structure.

B. Possible Alternative Structure

The benefits associated with the “Historical Bruno’s Structure” discussed above may be achieved through several alternative structures. One example of an alternative structure that tax practitioners have used in the past is the “Grandfather Structure.” A Plan of Reorganization implementing the Grandfather Structure would include some version of the following transaction. First, the creditors will form three new corporations: Holding, Parent, and Operating. Holding will wholly-own Parent, and Parent will wholly own Operating. Holding will contribute to Parent, in exchange for all of its issued and outstanding stock, Holding common stock. Then, Parent will contribute

\textsuperscript{11} \textit{Id.} The Bruno’s bankruptcy preceded the enactment of treasury regulation section 1.1502-28 which covers the application of section 108(a) and the reduction of tax attributes pursuant to section 108(b) in the consolidated return context. Treas. Reg. § 1.1502-28(a) (as amended in 2005).
\textsuperscript{12} \textit{See} Sheppard, \textit{supra} note 3, at 984.
\textsuperscript{13} \textit{Id.} at 985.
\textsuperscript{14} \textit{Id.}
\textsuperscript{15} \textit{Id.} at 984.
\textsuperscript{16} \textit{See} Sheppard, \textit{supra} note 3, at 985. Old Bruno’s executed a triple net lease with New Bruno’s for the retained real estate. \textit{Id.} at 989. A triple net lease is a lease in which the lessee pays rent to the lessor, as well as all taxes, insurance, and maintenance expenses that arise from the use of the property. \textit{See} BLACK’S \textsc{Law Dictionary} 907-09 (8th ed. 2004).
\textsuperscript{17} \textit{Id.} When a sale by a debtor in possession in a bankruptcy occurs, the Debtor owes several fiduciary duties (in addition to its obligation to comply with section 363 of the bankruptcy code) to its creditors including securing a reasonable price for the assets which were sold. \textit{See generally}, \textit{In re Schipper}, 933 F.2d 513 (7th Cir. 1991) (discussing a debtor's fiduciary duty to its unsecured creditors). Most likely, Bruno's was attempting to avoid the burdens of compliance with these requirements by its announcement that the transaction was not a sale for corporate law purposes.
the Holding common stock to Operating in exchange for all of its issued and outstanding stock. Finally, the debtor corporation ("Debtor") will merge into Operating with Operating surviving the merger. Certain tax practitioners have modified this structure to include a second middle tier company, Parent II. As discussed later in this document, it is possible that the addition of Parent II could make it more difficult for the Internal Revenue Service ("IRS" or "Service") to challenge the validity of the transaction.

In exchange for the satisfaction and cancellation of their claims, Debtor's creditors—as a group—will receive Holding common stock from Operating. Debtor's creditors may also receive additional types of consideration such as cash, notes, warrants, etc. In cases where the assets acquired include subsidiary stock, Operating and Debtor may elect under section 338(h)(10) to treat the acquisition of the subsidiary stock as an asset acquisition.18

C. Recent IRS Guidance

The IRS has accepted the lawfulness of a plan involving a taxable emergence from bankruptcy in at least one case. In IRS CCA 200350016,19 Corporation A's ("A") Chapter 11 plan of reorganization provided for the consolidation of certain of its subsidiaries and the transfer of the assets of a division ("Division Assets") to a new entity.20 All prepetition equity interests in A were extinguished, and A continued certain of its business operations as reorganized A.21 More specifically, various subsidiaries were merged into A.22 Then, A formed corporation B ("B") and subsequently sold special Division Assets to B.23 Next, A sold and transferred to the creditor representative an undivided percentage interest in the remaining Division Assets (subject to certain liabilities), in exchange for the cancellation of claims of creditor classes in an amount equal to the fair market value of such Division Assets.24 The creditor representative contributed the

18. I.R.C. § 338(h)(10) (2005). This presumes that the stock acquisition otherwise meets the requirements of section 338.
19. Pursuant to § 6110(k)(3), private letter rulings and similar documents (such as field service advices or technical advice memoranda) are not to be relied upon or otherwise cited as precedent. I.R.C. § 6110(k)(3). I refer to them only to demonstrate a position taken by the Internal Revenue Service.
21. Id. at *2.
22. Id.
23. Id.
24. Id.
interest in the Division Assets to B. Finally, A sold and transferred to B an undivided percentage interest in the remaining Division Assets. B assumed all of the division liabilities. B issued common shares and notes to certain creditors of A. A also issued common shares to certain of its creditors.

The IRS ruled that this series of transactions did not qualify as a reorganization because the requirement that the stock of the transferee corporation be distributed in a transaction that qualified under section 354, 355, or 356 was not satisfied. More specifically, all prepetition stock interests in A were cancelled and there were no prepetition holders of "securities" within the meaning of sections 354 and 355. As such, the creditors of A that received stock in B were neither stock holders nor securities holders of A prior to the reorganization. Accordingly, there was no exchange of securities as required by all three sections since none of the creditors that received stock were either stock holders or security holders.

D. Benefits of Taxable Emergence

As mentioned above, in order for a taxable emergence to be beneficial, there are two essential characteristics of the debtor that should exist. First, the bankrupt corporation should have assets with an aggregate fair market value in excess of their aggregate tax basis. Accordingly, the asset sales discussed in the Historic Bruno's and Grandfather Structures will result in the overall recognition of tax

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26. Id.
27. Id.
28. Id.
29. Id. at *3.
30. I.R.S. Chief Counsel Advisory, IRS CCA 200350016, available at 2003 WL 2293171, at *6 nn 1-4. (August 28, 2003). See also I.R.C. § 368(a)(1)(G) (2005). As discussed in detail infra, if the transaction cannot meet the requirements for a reorganization, the transaction will generally be taxable as the other reorganization provisions contain more restrictive requirements. Pursuant to § 368(a)(1)(G), the term reorganization includes a transfer by a corporation of all or part of its assets to another corporation in a title 11 or similar case; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction qualifying under section 354, 355, or 356. I.R.C. § 368(a)(1)(G) (2005).
32. Id.
33. Id. at *7. The IRS also determined that the series of transactions did not qualify for tax free treatment pursuant to § 351. Id.
34. There may be instances where a taxable emergence transaction will result in a "step down" in tax basis but the Debtor would still be in a better post-emergence tax position as a result of the taxable emergence.
gain, and the debtor corporation’s successor will receive a stepped-up basis in its assets. Pursuant to section 108(b)(4) the determination of attribute reduction is made after the determination of the federal income tax imposed on the debtors for the taxable year of the discharge.\textsuperscript{35} Thus, if debtors sell assets in the year of the discharge, section 108(b)(4) allows them to use their NOLs and capital loss carry-forwards to offset gains from the sale of their assets before requiring attribute reduction under section 108(b). Nevertheless, the asset sales should still be limited in such a manner to ensure that the debtor has sufficient NOLs and capital loss carryovers to prevent any tax liability from arising as a result of the transactions.\textsuperscript{36}

Second, the debtor should be at risk of losing the vast majority of its tax attributes as a result of the application of section 108(b). In general, a taxpayer’s gross income includes income arising from the cancellation of debt.\textsuperscript{37} However, gross income does not include COD income if the debt\textsuperscript{38} discharge occurs in a title 11 case (i.e., in a bankruptcy) or if the discharge occurs when the taxpayer is insolvent.\textsuperscript{39} In order for the discharge to be treated as occurring in a title 11 case, the taxpayer must be under the jurisdiction of a court in a case under title 11 of the United States Bankruptcy Code and the discharge must be granted by the court or pursuant to a plan approved by the court.\textsuperscript{40}

Where a debtor corporation transfers stock to a creditor in satisfaction of its debt, the corporation is deemed to have satisfied the debt with an amount of money equal to the fair market value of the stock.\textsuperscript{41} Therefore, the debtor corporation has COD income, which may or may not be excluded from gross income, to the extent that the adjusted issue price of the debt satisfied exceeds the value of stock issued to the creditor. Where a debtor corporation issues a debt instrument to a creditor in satisfaction of debt, the corporation is deemed to have satisfied the debt with an amount of money equal to the issue price of the new debt instrument.\textsuperscript{42}

\textsuperscript{36} It is important to note that, because only 90 percent of its alternative minimum taxable income can be offset by Alternative Minimum Tax (“AMT”) NOL carry forwards, the Debtor will still be subject to AMT (20 percent tax rate) unless its current year loss exceeds the gain recognized from the taxable emergence transaction. I.R.C. § 55 (b) and § 56 (d).
\textsuperscript{38} See I.R.C. § 108(d)(1) (2005). Debt of the taxpayer includes both debt for which the taxpayer is liable and debt subject to which the taxpayer holds property. Id.
\textsuperscript{39} I.R.C. § 108(a)(1)(A) & (B) (2005).
\textsuperscript{40} I.R.C. § 108(d)(2) (2005).
\textsuperscript{41} I.R.C. § 108(e)(8) (2005). This section is the repeal of the “stock-for-debt exception” to COD that existed in some form until 1993.
new debt instrument is less than the adjusted issue price\textsuperscript{43} of the old debt instrument, the debtor corporation has COD income to the extent of the shortfall.\textsuperscript{44}

In exchange for the benefit of exclusion of COD from gross income, the Code requires taxpayers to reduce their tax attributes by the amount of COD so excluded.\textsuperscript{45} As discussed above, the taxpayer's attributes are reduced after the determination of U.S. federal income tax for the taxable year of the discharge.\textsuperscript{46} The reduction of attributes under the general rule occurs in the following order:

(1) Net operating losses;\textsuperscript{47}
(2) General business credits;
(3) Minimum tax credits;
(4) Capital loss carryovers;
(5) Basis reduction;\textsuperscript{48}
(6) Passive activity loss and credit carryovers; and
(7) Foreign tax credit carryovers.\textsuperscript{49}

The amount of reduction is one dollar of attribute for each dollar of excluded COD, except in the case of credits which are reduced by 33 ? cents for each dollar of excluded COD.\textsuperscript{50} COD income realized on emergence from Chapter 11 bankruptcy will not be taxable even if it is in excess of the total tax attributes subject to reduction.\textsuperscript{51} Assuming for simplicity that a consolidated group of corporations is not involved and regulation section 1.1502-28 is not applicable, a debtor corporation with projected COD income equal to or in excess of its available tax attributes may be in a better post-emergence tax position if it emerges in a taxable transaction as it will have tax basis remaining

\textsuperscript{43} See Treas. Reg. § 1.1275-1(b)(1) (2002). The adjusted issue price of the old debt instrument is the issue price of the instrument increased by any original issue discount previously included in the gross income of the holder and decreased by the amount of any payment previously made on the debt instrument other than a payment of qualified stated interest. \textit{Id.}

\textsuperscript{44} Treas. Reg. § 1.61-12(c)(2)(ii) (1997).


\textsuperscript{47} See I.R.C. § 108(b)(4)(B) (2005). Reductions in losses (net operating and capital) are made first to the loss for the taxable year of the discharge and then in the carryovers to such taxable year in the order of the taxable years in which the losses arose. § 108(b)(4)(B). \textit{Id.}

\textsuperscript{48} Reduction of basis under § 108(b)(2)(E) shall not exceed the excess of the aggregate of the bases of the property held by the taxpayer immediately after the discharge over the aggregate liabilities of the taxpayer immediately after the discharge. I.R.C. § 1017(b)(2). This limit does not apply to the reduction in basis where a § 108(b)(5) election is made. \textit{Id.} The Code provides an alternative to the order of attribute reduction set forth above. Specifically, section 108(b)(5) provides that the taxpayer can elect to first reduce the basis of its depreciable property. I.R.C. § 108(b)(5) (2005).


\textsuperscript{50} I.R.C. § 108(b)(3)(A) and (B) (2005).

after the reorganization. Under both the taxable and non-taxable sce-
arios, the debtor would emerge with no tax attributes other than tax
basis in its assets. Moreover, on a going-forward basis, the debtor
emerging in a taxable transaction will receive higher depreciation and
amortization deductions as well as recognize less gain (or more loss)
on subsequent asset sale transactions.

E. Costs of Taxable Emergence

As demonstrated above, there are situations where taxable emer-
gence from bankruptcy can be quite beneficial; however, this is not
always the case. For instance, a taxable emergence transaction will
wipe out all of the debtor's pre-bankruptcy tax attributes including
NOLs, capital loss carry-forwards and credits. 52 Accordingly, if the
debtor can structure its plan of reorganization so that most of its tax
attributes will remain post-emergence, the debtor might be better
served by structuring the transaction so that the requirements for an E
or G reorganization are satisfied.

In addition to the exclusion of COD income from taxable income
pursuant to section 108(b), the Code contains several provisions that
offer taxpayers involved in Chapter 11 proceedings beneficial treat-
ment that is not afforded taxpayers choosing to emerge from bank-
ruptcy in taxable transactions. These provisions can have the effect of
ensuring that a large portion of the debtor's tax attributes survive the
reorganization. For instance, section 368(a)(1)(G) permits businesses
to reorganize tax-free and pass their tax attributes (including loss car-
ryovers) to the surviving or acquiring
53 In addition, there
are special section 382 provisions with respect to an ownership change
that occurs pursuant to a court-approved plan of reorganization for a
loss corporation that was a debtor in a title 11 or similar case immedi-
ately before the ownership change. 54

52. This assumes that the Debtor corporation either liquidates or has COD income in excess
of these attributes.
54. A corporation that has a § 382 ownership change faces an annual limitation on its ability
to use NOL carryforwards and certain other tax attributes arising on or before the ownership
change ("pre-change NOLs") to offset taxable income arising after the ownership change date.
I.R.C. § 382 (2005). A § 382 ownership change generally occurs when, over a three-year period,
the aggregate stock ownership percentage (by value) of "5-percent shareholders" has increased
by more than 50 percentage points over such shareholders' lowest percentages within that testing
period. Id. at § 382(g). In general, debtors reorganizing in bankruptcy proceedings experience
ownership changes as a majority, if not all, of the stock of the corporation surviving the Plan of
Reorganization is owned by the Company's former creditors (i.e., not the former equity
holders).
III. G Reorganization Recast

A. General

Despite the fact that the IRS did not object to the taxable emergence transaction in IRS CCA 200350016, the greatest risk to the successful implementation of this tax planning method is a recast as a tax-free G reorganization. Section 368(a)(1)(G) was enacted to facilitate the rehabilitation of corporate debtors in bankruptcy and eliminates certain reorganization requirements that previously impeded a debtor corporation’s ability to engage in a tax-free reorganization. Thus, unlike the prerequisites under sections 368(a)(1)(A), (C), or (D), respectively, a G reorganization does not have to be a statutory merger or consolidation, the debtor corporation does not have to receive solely voting stock in exchange for its assets, and neither the debtor corporation nor its former shareholders have to control the corporation that receives the debtor’s assets.

Thus, if the Grandfather Structure discussed above were to qualify as a reorganization described in section 368(a), it would most likely qualify as a reorganization described in section 368(a)(1)(G) due to the less restrictive requirements of that provision. Stated another way, for the taxable emergence transaction to work, it must be structured so that it does not qualify as a “G reorganization.” Section 368(a)(1)(G) provides that the term reorganization includes:

a transfer by a corporation of all or part of its assets to another corporation in a title 11 or similar case; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction qualifying under section 354, 355, or 356.56

Also, section 368(a)(2)(D) provides the following expansion for G reorganizations:

The acquisition by one corporation, in exchange for stock of a corporation (referred to in this paragraph as “controlling 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)(G) if:

no stock of the acquiring corporation is used in the transaction. . . .57

As such, the statutory test for qualification as a G reorganization can be broken down into four essential requirements: (1) the transaction

56. If a transaction qualifies as a G reorganization, as well as a tax-free transaction pursuant to §§ 332 or 351, then (except if § 357(c) applies) the transaction shall generally be treated as qualifying only as a G reorganization.
involves a Title 11 or similar case; (2) assets are transferred; (3) stock or securities of the transferee or corporation in control thereof are distributed; and (4) the distribution transaction qualifies under section 354, 355, or 356. G reorganizations, similar to most tax-free reorganizations pursuant to section 368, also must satisfy several judicially created elements such as (1) continuity of interest, (2) continuity of business enterprise, and (3) business purpose. 58

B. Statutory Requirements

1. Title 11 Case

Section 368(a)(3)(A) defines a title 11 or similar case as either a case under title 11 of the United States Code, or a receivership, foreclosure, or similar proceeding in a federal or state court. In application, both the Historic Bruno’s and Grandfather Structures will satisfy this statutory requirement because a Chapter 11 proceeding will exist in both cases.

2. Asset Transfer Pursuant to Title 11

A transfer of assets of the corporation is treated as made in a title 11 case if any party to the reorganization is under the jurisdiction of the bankruptcy court and the transfer is pursuant to a plan of reorganization approved by the court. 59 The term “party to a reorganization” includes a corporation resulting from a reorganization and both corporations in an acquisitive reorganization. 60 In certain reorganizations, including a reorganization pursuant to section 368(a)(1)(G), the term “party to a reorganization” includes the corporation controlling the corporation to which the assets or stock are transferred. 61 This requirement will be satisfied in both the Historic Bruno’s and the Grandfather Structures because in both cases the transfer of assets will occur pursuant to plans of reorganization approved by the court, and both the Debtor in the Grandfather Structure and Old Bruno’s in the Historic Bruno’s Structure are under the jurisdiction of the court.

61. Id. For purposes of §368, control is defined as ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation. I.R.C. § 368(c) (2005).
3. Stock or Securities of the Transferee Are Distributed

Section 368(a)(1)(G) indicates that stock or securities of the transferee corporation must be used in the acquisition transaction. Section 368(a)(2)(D) modifies this requirement by stating that the acquisition by one corporation—in exchange for stock of a corporation that is in control of the acquiring corporation—of substantially all of the properties of another corporation does not disqualify a transaction under section 368(a)(1)(G) if no stock of the acquiring corporation is used in the transaction. Thus, for a good G reorganization, either (but not both) stock of the acquiring corporation or a corporation in control of the acquiring corporation can be used in the asset acquisition transaction. A transaction in which assets of one corporation are exchanged for stock of a grandparent of the corporation acquiring the assets generally does not qualify as a reorganization under section 368(a)(1).\footnote{62}

To illustrate, in Revenue Ruling 74-565,\footnote{63} the Service concluded that the transaction at issue did not satisfy the statutory requirements for a merger described in sections 368(a)(1)(A) and 368(a)(2)(E) because stock of a corporation controlling the corporation that controlled the merged corporation (i.e., so called “grandparent” stock) was issued.\footnote{64} In the ruling, a grandparent corporation formed a parent corporation that in turn formed a subsidiary.\footnote{65} The subsidiary then merged into a target in exchange for grandparent corporation stock.\footnote{66} Having concluded that the transaction did not qualify as a merger, the Service also concluded that the subsidiary’s existence should be disregarded because it was transitory.\footnote{67} Having disregarded the subsidiary, the Service then concluded that the transaction qualified as a reorganization described in section 368(a)(1)(B) in which the target stock was acquired by the parent corporation solely in exchange for voting stock of a corporation in control of parent corporation.\footnote{68}

In application, the Grandfather Structure does not satisfy this stock distribution requirement as Holding’s stock, not the stock of the transferee (i.e., Operating) or a corporation in control of the transferee

65. Id.
66. Id.
67. Id.
68. Id.}
(i.e., Parent), will be used in the exchange with the creditors. As such, a transaction using the Grandfather Structure should literally fail to qualify as a G reorganization by virtue of this control requirement. The Historic Bruno’s Structure, however, will satisfy the requirement that stock of the acquiring corporation be distributed because stock of New Bruno’s will be distributed to the creditors.

4. 354, 355, 356 Requirement
Divisive Versus Acquisitive G Reorganization

The final section 368(a)(1)(G) requirement is that the stock or securities of the corporation to which the assets are transferred be “distributed in a transaction qualifying under section 354, 355, or 356.” Section 368(a)(1)(G) contains the distribution requirement to insure that either “substantially all of the assets of the financially troubled corporation, or the assets which consist of an active trade or business under the tests of section 355 are transferred to the acquiring corporation.”

a. Section 354

Section 354 applies if the transaction is an acquisitive G reorganization. As such, generally only the transferee will remain in existence following the reorganization because section 354 requires liquidation of the debtor/transferor. More specifically, section 354(a) provides that “no gain or loss is recognized if stock or securities in a corporation a party to a reorganization are, . . . exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.” But section 354(a) does not apply to an exchange in connection with a G reorganization unless (i) the corporation to which the assets are transferred acquires substantially all of the assets of the transferor and (ii) the stock, securities, and other properties received by the transferor are distributed in pursuance of the plan of reorganization.

69. The Grandfather Structure could not be recast as a B reorganization because Debtor will not remain in existence.
70. Section 356 only applies to a transaction that would qualify under either § 354 or § 355 absent the existence of “boot.” Because qualification under one of these sections is a prerequisite to its application, § 356 will not be separately analyzed.
72. See I.R.S. Chief Counsel Advisory, IRS CCA 200350016, available at 2003 WL 2293171 (August 28, 2003). The Service has acknowledged that the statute’s “language requires the transferor to liquidate” in order to satisfy § 354 in the context of a “G” reorganization. Id.
The legislative history of the G reorganization provision indicates that the "substantially all" test is to be interpreted in light of the underlying intent of the statute to facilitate the reorganization of companies in bankruptcy or similar cases for rehabilitative purposes.\textsuperscript{75} Accordingly, the facts and circumstances surrounding the reorganization need to be analyzed to assess this intent. The legislative history provides that the "substantially all" test for a G reorganization is not failed simply because, prior to the transfer to the acquiring corporation, payments to creditors and asset sales were made in order to leave the debtor with more manageable operating assets to continue in business.\textsuperscript{76}

Section 368(a)(2)(C) permits a transfer by an acquiring corporation to a controlled corporation of all or part of the stock or assets acquired in a transaction otherwise qualifying as a reorganization under section 368(a)(1)(G), if the requirements of section 354(b)(1) are met with respect to the acquisition of assets.\textsuperscript{77} In addition, in a transaction otherwise qualifying as a reorganization within the meaning of section 368(a)(1)(G), regulation section 1.368-2(k)\textsuperscript{78} permits successive transfers to one or more corporations controlled in each transfer by the transferor corporation.\textsuperscript{79} The term "control," as defined in section 368(c), means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent to the total number of shares of all other classes of stock of the corporation.\textsuperscript{80}

b. Section 355

Section 355 provides for non-recognition of gain or loss if the transaction is a divisive G reorganization.\textsuperscript{81} Generally, in a divisive G Reorganization, both the debtor and a newly created company will remain in existence. Section 355(a)(1) provides that if (1) a corporation distributes to a shareholder, with respect to its stock or distributes to a security holder, in exchange for its securities, solely stock or securities of a corporation which it controls immediately before the distribution; (2) the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corpora-

\textsuperscript{76} Id.
\textsuperscript{77} I.R.C. § 368 (a)(2)(C) (2005).
\textsuperscript{79} Id. at §.368-2(k).
\textsuperscript{80} I.R.C. § 368(c) (2005).
\textsuperscript{81} I.R.C. § 355 (2005). Similar to § 354,§355 may require a distribution to a shareholder or a security holder.
tion or the controlled corporation or both; (3) the active trade or business requirements of section 355(b) are satisfied; and (4) as part of the distribution, the distributing corporation distributes all of the stock in the controlled corporation held by it immediately before the distribution or an amount of stock in the controlled corporation constituting control within the meaning of section 368(c), then no gain or loss will be recognized to and no amount will be includible in the income of such shareholder on the receipt of such stock. In addition to the above listed factors, Section 355 also imposes several other requirements that need to be satisfied, including the existence of a corporate business purpose for the transaction.

However, for purposes of this article, the active trade or business requirement is the only section 355 requirement that will receive further analysis. As mentioned above, the active trade or business test is incorporated through section 368(a)(1)(G)'s reference to section 355. Section 355(b) states that:

Subsection (a) shall apply only if either-
(A) the distributing corporation and the controlled corporation (or, if stock of more than one controlled corporation is distributed, each of such corporations) is engaged immediately after the distribution in the active conduct of a trade or business, or
(B) immediately before the distribution, the distributing corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is engaged immediately after the distribution in the active conduct of a trade or business.

Therefore, both companies must operate an active trade or business within the meaning of section 355(b) in order for the reorganization to qualify under this provision.

c. Summary

In a 1992 Field Service Advice ("FSA"), the IRS analyzed two separate proposed Chapter 11 Plans of Reorganization. Parent was the sole shareholder of Debtor, a manufacturing corporation. Due to numerous lawsuits involving one of its products, Parent and Debtor filed for bankruptcy protection under Chapter 11 of the bankruptcy Code. Under both Plans, Parent proposed to merge into Debtor and

86. Id.
87. Id.
its liquid assets were to be distributed to creditors. The parties would form a new corporation ("Newco") in order to receive certain assets comprising a division of Debtor in exchange for senior notes, common stock, warrants, assumption of certain liabilities and the promise to fund an expense commitment. Newco would own and operate the business of Debtor's previous division on a going forward basis. Debtor would remain in existence for the purpose of liquidating certain claims. Two shares of Debtor stock would be held by "the Reorganized Securities Trust" with court-appointed Fund Administrators serving as trustees. Upon the sale of the Debtor stock or liquidation, the consideration would be distributed by the Fund Administrators to the Claimants. The primary difference between the two plans involved which creditors received Newco stock.

The IRS strongly hinted that both Plans involving the transfer of Debtor assets to Newco failed to qualify as G reorganizations because in each case Debtor would remain in existence and certain Claimants were to receive little or no stock in either the Debtor or the New Corporation. Regarding the Debtor's Plan, the transaction may have failed to meet the requirements of 354, 355, or 356. The transaction may have failed to meet the requirements of sections 354 and 356 because of the continued existence of the Debtor. The transaction may have failed to meet the requirements of section 355 because the Debtor, while still in existence, did not operate an active trade or business within the meaning of section 355(b) after the reorganization. Moreover, the requirement that a corporate business purpose exist for the transaction may not have been satisfied. As such, the Debtor's Plan failed to qualify as a tax-free G reorganization.

Regarding the requirement that there be an exchange of stock or securities for stock or securities, the courts and the Service have addressed whether a debt instrument such as a bond, mortgage or other similar instrument, qualifies as a security for purposes of sections 354,
A security has been defined by the courts as long-term indebtedness, a semi-permanent or permanent type of investment, a proprietary interest or indebtedness which represents a continuing interest in the enterprise. The line for determining whether a debt instrument is a security is drawn somewhere between long-term bonds and short-term notes. In general terms, short-term notes are not securities, whereas, long-term bonds are securities. The Tax Court in Camp Wolters stated that the test as to whether notes are securities is not a mechanical determination of the time period of the note. Although time is an important factor, the controlling consideration, according to the court, is an over-all evaluation of the nature of the debt, the degree of participation and continuing interest in business, the extent of proprietary interest compared with the similarity of the note to a cash payment and the purposes of the advances. As a general rule, a debt instrument with a term of less than five years is not likely to be treated as a security and a debt with a term of more than ten years is likely to be treated as a security. However, depending on the facts, a debt with a term between five and ten years may or may not be treated as a security.

The Historic Bruno's Structure did not involve an exchange as required by sections 354 and 355 because, although the banks received stock in New Bruno's, the bank debt, unlike the junk bonds, did not qualify as securities. Moreover, the Historic Bruno's Structure does not satisfy the section 354(b) requirement that the Debtor will be liq-

101. Compare Pinellas Ice & Cold Storage Co. v. Comm'r, 287 U.S. 462, 468-69 (1933) (finding that short term notes were evidence of obligation to pay and were not securities), with Comm'r v. Sisto Fin. Corp., 139 F.2d 253, 255 (2d Cir. 1943) (finding that short term secured notes were not securities, but noting that long term obligations were to be treated as securities), Camp Wolters Enter., Inc., 22 T.C. 737, 752 (1954) aff'd, 230 F.2d 555 (5th Cir. 1956) (finding that 89 nonnegotiable, unsecured installment notes due in installments in 5-9 years were securities); and Rev. Rul. 59-98, 1959-1 C.B. 76 (noting that where a corporation issues newly authorized common stock in exchange for all of its first mortgage (long-term) bonds, the bonds were considered securities).

102. Camp Wolters, 22 T.C. at 751 (citing Helvering v. Watts, 296 U.S. 387 (1935)).

103. Id.

104. Id.

105. See Pinellas, 287 U.S. at 468-69 (suggesting that bonds must be held for longer than the short-term bonds due within four months to qualify as securities); Sisto, 139 F.2d at 255 (secured notes payable in six months or less were not securities but short term obligations having the character of temporary evidence of debt).


107. Rev. Rul. 59-98, 1959-1 C.B. 76 (secured bonds with an average term of 6.5 years were a security).

108. Please note that the Bruno's Structure is fact intensive and many situations could satisfy this requirement.
uidated since Old Bruno’s will survive with $20 million of retained real estate assets. The Historic Bruno’s Structure also should not qualify as a divisive G reorganization because sufficiently active assets would need to remain behind in Old Bruno’s for section 355’s active trade or business requirement to be satisfied. The Historic Bruno’s Structure should not satisfy section 355 because Old Bruno’s only asset after implementation of the plan will be a triple net lease.\textsuperscript{109} Merely holding a triple net lease should not qualify as an active trade or business as required by section 355.

Regarding the Grandfather Structure, section 354 should not apply because the creditors will be receiving Holding stock. Because Holding, as a grandparent of Operating, will not be a “party to the reorganization,” the exchange should not meet the requirements of section 354 or 356 as the receipt of the Holding stock will constitute solely the receipt of “other property” by the creditors.\textsuperscript{110} The Grandfather Structure should not meet the requirements of section 355 because a divisive transaction will not occur as Debtor will be merged into Operating.

C. Judicially Created Requirements

As mentioned above, in addition to satisfying the statutory requirements of section 368(a)(1)(G), a transaction must also satisfy the judicial doctrines of continuity of interest, continuity of business enterprise and business purpose.

1. Continuity of Interest

The judicial doctrine of continuity of interest requires that the former shareholders of the merging corporation have a sufficient continuing interest in the acquiring corporation. For example, the Service determined that continuity of interest was not met in the merger of X, a state chartered savings and loan, into Y, a federally chartered non-stock savings and loan association, because shareholders of X received

\textsuperscript{109} Gada v. U.S., 460 F. Supp. 859, 867 (Sept 12, 1978) (finding that the corporation was not actively engaged in a trade or business where it had minimal income and had no indicia of corporate endeavors); Atlee v. Comm’r, 67 T.C. 395, 405 (Dec. 8, 1976) (finding that Hansen-Atlee retained virtually all of the operating assets of the corporation and transferred very little to Atlee Enterprises); and Treas. Reg. § 1.355-3(c), Ex.13 (as amended in 1989) (noting that a new subsidiary is not engaged in active trade or business when it merely rents space to its parent company).

\textsuperscript{110} If a transaction qualifies as a G reorganization by virtue of § 368(a)(2)(D), the term “party to a reorganization” includes the controlling corporation (i.e., Parent). However, the term does not include grand parents such as Holding.
Y passbooks which had a large cash worth and a much smaller ownership value.\textsuperscript{111}

The IRS requires that 40 percent of the value of the package of consideration received by shareholders as a group be comprised of stock in order to satisfy continuity of interest.\textsuperscript{112} The judicial standard is generally perceived as being lower than this amount.\textsuperscript{113}

Ordinarily, it is the shareholders who hold the proprietary interests in a corporation. However, courts have recognized that when corporations are in bankruptcy the creditors are the true owners of the business. In March 2005, the Treasury Department released proposed regulations determining when and to what extent the creditors of a corporation will be treated as proprietors of that corporation for purposes of determining whether continuity of interest is preserved in a reorganization.\textsuperscript{114} The regulations provide that in bankruptcy and insolvency cases, if any creditor receives a proprietary interest in the issuing corporation in exchange for its claim, every claim of that class of creditors and every claim of all equal classes of creditors (in addition to claims of shareholders) is a proprietary interest in the target corporation immediately prior to the reorganization.\textsuperscript{115}

Generally, under the proposed regulations, all creditors' claims are treated as a proprietary interest in the target corporation to the extent of the fair market value of the claim.\textsuperscript{116} However, the regulations treat the claims of the most senior class of creditors receiving a proprietary interest as representing in part a creditor claim and in part a proprietary interest in the corporation. More specifically, the value of a proprietary interest in the target corporation represented by a senior claim is determined by multiplying the fair market value of the creditor's claim by a fraction, the numerator of which is the fair market value of the proprietary interests in the issuing corporation that are

\textsuperscript{111} Revenue Ruling 69-6, 1969-1 C.B. 104.

\textsuperscript{112} Treas. Reg. § 1.368-1(e)(2)(v) (ex. 1) (as amended in 2005) (suggesting that a transaction where one stock is transferred in exchange for at least $40 of the new stock and $60 cash meets the continuity of interest requirement).

\textsuperscript{113} See generally, Nelson v. Helvering, 296 U.S. 374 (1935). Although it is possible that a less than 38 percent proprietary interest could be treated as satisfying the continuity of interest requirement, a proprietary interest of less than one percent will not. See e.g., Miller v. Comm'r, 84 F.2d 415, 418 (6th Cir. 1936) (stating that the Supreme Court has not defined what is mean by a "definite and material interest" but that a 25% interest in the shares transferred in a transaction is a substantial part of the value of the thing transferred); and Southwest Natural Gas Co. v. Comm'r, 189 F.2d 332 (5th Cir.), cert. denied, 342 U.S. 860 (1951) (finding insufficient continuity of interest).


\textsuperscript{115} Id. at § 1.368-1(e)(6)(i), 70 Fed. Reg. at 11907.

\textsuperscript{116} Id. at § 1.368-1(e)(6)(ii), 70 Fed. Reg. at 11907.
received in the aggregate in exchange for the senior claims, and the denominator of which is the sum of the amount of money and the fair market value of all other consideration (including the proprietary interests in the issuing corporation) received in the aggregate in exchange for such claims.\textsuperscript{117}

To illustrate, in FSA 1466050 (discussed in detail above), the transaction may have failed to qualify as a G reorganization, in part, because creditors received too much non-equity consideration in addition to Debtor stock.\textsuperscript{118} The IRS stated that the two shares of Debtor stock, held by the Fund Administrator, may have made the entire transaction fail to satisfy continuity of interest because it caused the entire class of similarly situated claimants to be pulled into the continuity of interest computation.\textsuperscript{119} These claimants tainted the entire transaction because they received, in addition to the shares, a large amount of non-equity consideration including the stock of an unspecified corporation and insurance proceeds.

In application, using enough non-equity consideration in either the Historic Bruno's or Grandfather Structures could cause the failure of the continuity of interest requirement. The Historic Bruno's Structure as originally constructed would satisfy continuity of interest under the proposed regulations because secured creditors were the most senior class of claimants to receive equity in New Bruno's and those claimants received 100 percent of the equity in New Bruno's. The Grandfather Structure presents a more difficult continuity of interest question even though no Operating stock will be distributed in the transaction.\textsuperscript{120} However, continuity of interest should also exist in the Grandfather Structure because continuity is generally deemed to be preserved if the original ultimate proprietary interest holders (i.e., secured creditors) continue to hold a direct or indirect interest in acquiring (i.e., Operating).\textsuperscript{121}

\begin{thebibliography}{99}

\bibitem{117} \textit{Id.} at § 1.368-1(e)(6)(ii)(B), 70 Fed. Reg. at 11910.


\bibitem{119} \textit{Id.}

\bibitem{120} See Treas. Reg. § 1.368-1(e)(1) (as amended in 2005). This section provides, in part, that proprietary interest in the target is not preserved if, in connection with the potential reorganization, it is acquired by the issuing corporation for consideration other than stock of issuing corporation. Treas. Reg. § 1.368-1(b) defines issuing corporation as the acquiring corporation (as that term is used in § 368(a)) except that, in determining whether a reorganization qualifies as a triangular reorganization, the issuing corporation means the corporation in control of the acquiring corporation. \textit{Id.}

\bibitem{121} See generally Rev. Rul 84-30, 1984-1 C.B. 114; Treas. Reg. § (e) (as amended 2005). The continuity of proprietary interest requirement of § 1.368-1(b) is satisfied when the stock of the acquiring corporation given in exchange for the acquired corporation is distributed through its 100 percent parent corporation. \textit{Id.}
\end{thebibliography}
2. Continuity of Business Enterprise

Generally, the continuity of business enterprise requirement mandates that the acquiring corporation continue the acquired corporation's business or use a significant portion of the acquired corporation's historic business assets in a business. In determining whether the continuity of business enterprise requirement is satisfied, the acquiring corporation is treated as holding all the businesses and assets of the members of the qualified group. A qualified group is one or more chains connected through stock ownership with the acquiring corporation, but only if the acquiring corporation directly owns stock meeting the requirements of section 368(c) in at least one other corporation, and stock meeting the requirements of section 368(c) in each of the corporations (except the acquiring corporation) is owned directly by one of the other corporations.

In FSA 1609136 (discussed in detail above), the IRS also discussed the possibility that the Plan of Reorganization may have lacked continuity of business enterprise as required by regulation section 1.368-1(d). The facts in the FSA indicated that most, if not all, of the historic business assets of the subsidiaries were sold and their respective businesses discontinued. However, one of Parent's businesses was to continue after the mergers. Thus, the IRS held that if the continuity of business enterprise requirement was applied to the group, the continuity of business enterprise might not be met as Parent was attempting to sell its remaining assets and liquidate completely.

In application, in the Historic Bruno's Structure, New Bruno's will continue the historic business of Old Bruno's. Similarly, in the Grandfather Structure, most, if not all, of the assets used in the Debtor's historic trade or business will be transferred to Operating and used in its trade or business. As such, continuity of business enterprise should be satisfied in both cases.

3. Business Purpose

The final requirement to qualify as a tax-free reorganization under section 368(a)(1) is that the reorganization have a business purpose. The business purpose cannot be for the avoidance of federal income

122. Treas. Reg. § 1.368-1(d) (as amended in 2005).
124. Id.
125. Id.
126. Id.
127. Treas. Reg. § 1.368-1(b) (as amended in 2005).
tax or the IRS may disallow the tax-free treatment of the reorganization. In application, a valid business purpose generally should exist in a bankruptcy reorganization as implementation of the Plan of Reorganization is necessary in order for the debtor to be "rehabilitated."\(^{128}\)

IV. POTENTIAL RISKS

A. Recast

While the IRS would likely challenge the Historic Bruno's Structure by arguing that the creditors' claims exchanged for New Bruno's stock qualify as securities, the IRS might seek to recast the steps of the Grandfather Structure in order to engineer them to qualify as a tax-free reorganization. A recast of the Grandfather Structure would likely involve one of two re-orderings by the IRS. First, the IRS could claim that Debtor's assets were transferred to Holding in a valid reorganization and that the assets were dropped in successive transfers to Parent and Operating pursuant to section 368(a)(2)(C). Second, the IRS could claim that Debtor merged into Parent in a triangular reorganization and that the assets were contributed into Operating pursuant to section 368(a)(2)(C).

In Technical Advice Memorandum 9841006,\(^{129}\) Corporation G ("G") acquired Corporation H's ("H") stock from Corporation C ("C"), which was in bankruptcy along with several other members of its consolidated group.\(^{130}\) G was formed by C and Corporation F ("F"), pursuant a Plan of Reorganization, with an exchange of their H stock for an equivalent amount of G stock.\(^{131}\) C and F were members of a consolidated group with Corporation B ("B") as their common parent.\(^{132}\) Immediately after the contribution, C and F distributed the G stock to creditors of the B consolidated group.\(^{133}\) Also as part of the plan, C, along with several other subsidiaries of B, were liquidated into B.\(^{134}\) C and G made a joint election under section 338(g) and (h)(10).\(^{135}\) The plan also provided for the eventual dissolution of B.\(^{136}\)

The IRS analyzed the plan to determine whether G's acquisition of the H stock from C and F qualified as either a taxable purchase or a

\(^{128}\) See Treas. Reg. §1.269-3(e) (1992). As discussed later in this document, this business purpose is not sufficient for purposes of § 269. Id.


\(^{130}\) Id.

\(^{131}\) Id.

\(^{132}\) Id.

\(^{133}\) Id.


\(^{135}\) Id.

\(^{136}\) Id.
First, the IRS ruled that the transaction qualified as a G reorganization. The IRS stated that the "substantially all" test must be interpreted in light of the intent of the G reorganization rules which is to facilitate the reorganization of companies in bankruptcy or similar cases. Therefore, despite the fact that C had retained an interest in Corporation E (E was C’s other major asset aside from its interest in H) at the time of liquidation, the test was met because the E stock was worthless in the hands of C. Also, despite the direct transfer of the G stock to X, the section 354 exchange requirement was met by virtue of the deemed distribution of the G stock in exchange for B’s C stock followed by the transfer of the G stock to its creditor, X. The continuity of interest requirement was not defeated by the transfer of the G stock to X, a major creditor of the B group, because the bankruptcy of B qualifies X as an equity holder for continuity purposes. Finally, even if the transaction did not qualify as a G reorganization, the court held that it would qualify as a C reorganization because "it cannot be said that less than 80 percent of the fair market value of the property of [Corp] C was acquired solely for voting stock [of G]."

In Revenue Ruling 64-73, 1964-1 C.B. 142, L owned all of the stock of M. M, in turn, owned all of the stock of N. L exchanged its stock for all of the assets of X, a third party corporation. A portion of the assets were transferred to L and a portion of the assets were transferred to N. Because neither the assets transferred to L or N, independently, qualified as substantially all of the assets of X as required by section 368(a)(1)(C), the IRS had to determine whether the transaction qualified as a tax-free reorganization. In holding that a valid C reorganization had occurred, the IRS stated that the fact that the plan of reorganization provides for some of the assets to be transferred directly from X to N, rather than through L and M, does not

137. Id.
138. Id.
140. Id.
141. Id.
142. Id.
143. Id.
146. Id.
147. Id.
148. Id.
149. Id.
detRACT FROM THE CONCLUSION THAT IN SUBSTANCE L IS TO ACQUIRE SUBSTANTIALLY ALL OF THE X ASSETS.\textsuperscript{150}

In Private Letter Ruling 9151036,\textsuperscript{151} Parent corporation ("Parent") wholly-owned a subsidiary ("Sub"), Sub wholly-owned a subsidiary ("Sub 2") and Sub 2 wholly-owned a subsidiary ("Sub 3").\textsuperscript{152} All four entities were corporations and joined in filing consolidated federal income tax returns.\textsuperscript{153} Target was the common parent of its own affiliated group of corporations. In the transaction that was the subject of the Ruling, Sub organized Interim for the sole purpose of merging into Target.\textsuperscript{154} Sub also organized NewSub for the sole purpose of holding the Target stock.\textsuperscript{155} The merger of Interim into Target was effected in accordance with applicable state law.\textsuperscript{156} All holders of Target common stock, other than holders who asserted dissenters' rights, had their shares of Target common stock converted automatically into the right to receive shares of Parent voting common stock.\textsuperscript{157} Sub transferred the stock of Target to NewSub as a capital contribution.\textsuperscript{158}

The parties then proposed that NewSub would merge into Sub 2 in accordance with applicable state law.\textsuperscript{159} They would then convert the outstanding NewSub stock into Sub 2 stock which Sub would continue to hold.\textsuperscript{160} Target would then merge into Sub 3 pursuant to state law.\textsuperscript{161} The parties then convert the outstanding Target stock, by operation of law, into Sub 3 common stock which would be owned by Sub 2. The IRS ruled that the steps detailed above should be disregarded. Instead, the IRS will consider the overall transaction as if Parent had acquired substantially all of the assets of Target in exchange solely for shares of Parent voting common stock and the assumption by Parent of the liabilities of Target and the Target assets were subsequently contributed down the ownership chain to Sub 3.\textsuperscript{162}

\begin{itemize}
\item \textsuperscript{150} Rev. Rul. 64-73, 1964-1 C.B. 142. \textit{See also} Rev. Rul. 70-224, 1970-1 C.B. 79 (noting that where some of the assets were transferred directly to the wholly owned subsidiary of a corporation controlled by the acquiring corporation the transaction was viewed as an acquisition of substantially all of the properties by the acquiring corporation).
\item \textsuperscript{151} I.R.S. Priv. Ltr. Rul. 9151036 (Dec. 20, 1991).
\item \textsuperscript{152} \textit{Id}.
\item \textsuperscript{153} \textit{Id}.
\item \textsuperscript{154} \textit{Id}.
\item \textsuperscript{155} \textit{Id}.
\item \textsuperscript{156} I.R.S. Priv. Ltr. Rul. 9151036 (Dec. 20, 1991).
\item \textsuperscript{157} \textit{Id}.
\item \textsuperscript{158} \textit{Id}.
\item \textsuperscript{159} \textit{Id}.
\item \textsuperscript{160} \textit{Id}.
\item \textsuperscript{161} I.R.S. Priv. Ltr. Rul. 9151036 (Dec. 20, 1991).
\item \textsuperscript{162} \textit{Id}.
\end{itemize}
and the assumption of liabilities of Target in exchange solely for shares of Parent voting common stock was a reorganization pursuant to section 368(a)(1)(C). Moreover, the reorganization was not disqualified by reason of the constructive transfers of Target assets by Parent and its subsidiaries.163

As discussed above, Revenue Ruling 74-565 is an example of the IRS characterizing a similar transaction involving grandparent stock as failing to qualify as a tax-free reorganization pursuant to either section 368(a)(1)(A) or (a)(2)(E). The IRS' finding that a reorganization pursuant to section 368(a)(1)(B) had occurred is not problematic in this case because in the Grandfather Structure the reorganized Debtor is eliminated so the transaction can not qualify as a B reorganization.

Similarly, unlike Technical Advice Memorandum 9841006 where the G stock was deemed exchanged for B's C stock, the Grandfather Structure involves grandparent stock (i.e., "other property" as described in section 356) which would not satisfy section 354 as required by section 368(a)(1)(G) because it is not stock of the acquirer (i.e., Operating).

However, Revenue Ruling 64-73 and Private Letter Ruling 9151036 do provide some basis for recasting the Grandfather Structure in one of the two manners described above based on the true substance of the transaction. Similar to both Rulings, the IRS would need to manufacture a series of steps that would be tax-free and in which Operating would ultimately end up owning the Debtor's assets.

In the case of the Grandfather Structure, the IRS could use Revenue Ruling 64-73 to recast the transaction in a tax-free manner. As such, the Debtor would be left with no stepped-up basis in its assets and little, if any, tax attributes following emergence from bankruptcy. However, as discussed in the Grandfather Structure description section of this document, the Grandfather Structure can be modified so that two middle tier entities are formed. In that Structure, Holding would own Parent I and Parent II, and Parent I and Parent II would own Operating. Using that structure, a potential recast using Revenue Ruling 64-73 would fail because the structure would fail the requirements of both section 368(a)(2)(C) and the continuity of business enterprise test.

First, as discussed in detail above, section 368(a)(2)(C) affords corporations the opportunity to transfer assets acquired in a tax-free reorganization as long as the transfers are to "controlled corporations."
However, if the control requirement is not met, the transaction will no longer meet the requirements for a tax-free reorganization.

Section 368(a)(2)(C) permits a transfer by an acquiring corporation to a controlled corporation of all or part of the stock or assets acquired in a transaction, otherwise qualifying as a reorganization under section 368(a)(1)(G), if the requirements of section 354(b)(1) are met with respect to the acquisition of assets.\(^{164}\) In addition, in a transaction otherwise qualifying as a reorganization within the meaning of section 368(a)(1)(G), regulation section 1.368-2(k) permits successive transfers to one or more corporations controlled in each transfer by the transferor corporation.\(^{165}\) The term "control," as defined in section 368(c), means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent to the total number of shares of all other classes of stock of the corporation.\(^{166}\) In application, assuming Parent I and Parent II each own 50 percent of Operating, no successive contribution or merger scenario will satisfy this 80 percent control requirement.

Second, with respect to continuity of business enterprise, regulation section 1.368-1(d)(4) indicates that the continuity of business enterprise requirement for a valid reorganization will not be satisfied if the assets or businesses acquired are transferred outside of the "qualified group."\(^{167}\) A qualified group is defined as one or more chains of corporations connected through stock ownership with the issuing corporation, but only if the issuing corporation directly owns stock meeting the requirements of section 368(c) in at least one other corporation, and stock meeting the requirements of section 368(c) in each of the corporations is owned directly by one of the other corporations.\(^{168}\) Again, assuming Parent I and Parent II each own 50 percent of Operating, no successive contribution or merger scenario will satisfy this 80 percent control requirement.

Finally, while the IRS will have a difficult time recasting either the Historic Bruno's or Grandfather Structure, the above analysis should illuminate the fact that there is a risk. Under federal income tax principles, the substance of a transaction entered into by a taxpayer generally prevails over the legal form in which the transaction is cast.\(^{169}\)

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\(^{166}\) I.R.C § 368(c) (2005).

\(^{167}\) Treas. Reg. § 1.368-1(d)(4) (as amended in 2005).

\(^{168}\) Id. at § 1.368-1(d)(4)(2).

\(^{169}\) See generally Helvering v. Lazarus & Co., 308 U.S. 252, 255 (1939) (stating that "in the field of taxation, administrators of the laws and the court are concerned with substance and
Thus, a reordering of steps to recast a transaction as having occurred in a manner inconsistent with its actual form generally occurs if the transaction lacks economic substance or the form of the transaction is inconsistent with its true substance. As such, a wise tax adviser would probably ensure that the various entities involved in any taxable emergence plan have sufficient economic substance. For example, in the Historic Bruno’s Structure, Old Bruno’s retained real estate assets which had the added benefit of preventing the application of section 354, while still not rising to the level of an active trade or business as required by section 355.

B. "All Boot" D Reorganization Analogy to G Reorganizations

Because the language in section 368(a)(1)(D) ("D Reorganization") requiring a section 354, 355 or 356 distribution is identical to the language in section 368(a)(1)(G), the Service could also challenge the Historic Bruno’s and Grandfather Structures citing the case law and guidance issued by the Service governing "all boot" D reorganizations. For example, in Revenue Ruling 70-240, B owned all of the stock of both X and Y corporations. X sold its operating assets to Y for their fair market value, i.e., $34X. Following this sale, X paid all of its debts and liquidated. The liquidating distribution to B was $29X. In ruling that a D reorganization had occurred, the IRS stated that "although no actual shares of the stock of Y were distributed to B as a result of the transaction, B is treated as having received Y stock since he already owned all of the Y stock." As such, the exchange requirement of section 354 was deemed satisfied.

Also, in James Armour, Inc. v. Commissioner, two individuals were the sole stockholders in Armour Excavating, Inc. and James Armour, Inc. James Armour, Inc. transferred certain of its assets to Armour Excavating, Inc. in exchange for cash and accounts receiva-
James Armour, Inc. then liquidated and distributed all of its assets to its shareholders. The shareholders contended that a D reorganization did not occur since the statutory requirement that stock or securities of the corporation to which the assets are transferred be distributed in a transaction which qualifies under section 354, 355 or 356 was not met. In its holding that the transaction was a D reorganization the court indicated that, since the shareholders already owned all of the stock of Armour Excavating, Inc., the issuance of further stock to it would be a "meaningless gesture."

In summary, the Service could rely on the holdings in Revenue Ruling 70-240 and Armour to argue that a section 354, 355 or 356 distribution is not necessary for a valid G reorganization if such an exchange would be a "meaningless gesture." However, because the creditors receiving stock in both the Historic Bruno’s and Grandfather Structures would not be stockholders prior to the effective date of the plan, the Service would need to argue that the creditors were equity holders prior to emergence in order for the "meaningless gesture" requirement to be satisfied. In Alabama Asphalthic, the Supreme Court held that the continuity of interest requirement was satisfied in a case in which creditors, having bid on the bankrupt debtor's assets, paid cash and agreed to accept stock in a new corporation in full discharge of their claims because for practical purposes the creditors became the equity owners of the property from the stockholders not later than the date of the institution of the bankruptcy proceedings. However, the Supreme Court in Southwest Consolidated determined that it was one thing to say creditors stepped into the shoes of stockholders for continuity of interest purposes, but "quite another to say that they were the 'stockholders' of the old company within the purview of clause C" (requiring that the transferor or its stockholders control the transferee corporation). As such, it appears unlikely that the IRS would be successful in arguing that the distribution of New Bruno’s and Operating stock or securities in the cases of the Historic Bruno’s and Grandfather Structures, respectively, would be "meaningless gestures." Moreover, to-date, the Service has not attempted to apply this analysis to a G reorganization.

178. Id.
179. Id.
180. Id. at 302.
182. Id. at 183.
184. Id. at 202.
C. Section 269

In addition to, or in lieu of, seeking to recast a transaction, the Service could make an argument that section 269 applies to the transaction and, if successful, could deny the parties the benefit of the intended tax consequences. Section 269 provides that if any person or persons acquire, or acquired on or after October 8, 1940, directly or indirectly, control of a corporation . . . and the principal purpose for which such acquisition was made is evasion or avoidance of federal income tax by securing the benefit of deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the secretary may disallow such deduction, credit, or other allowance.\footnote{185} Regulation section 1.269-2(a)(2) states that if the purpose to evade or avoid federal income tax exceeds in importance any other purpose, it is the principal purpose.\footnote{186}

For purposes of paragraphs (1) and (2), control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of all classes of stock of the corporation.\footnote{187} An acquisition of control occurs when one or more persons acquire beneficial ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation.\footnote{188} For purposes of section 269, creditors of an insolvent or bankrupt corporation (by themselves or in conjunction with other persons) acquire control of the corporation when they acquire beneficial ownership of the requisite amount of stock.\footnote{189} Although insolvency or bankruptcy may cause the interests of creditors to predominate as a practical matter, creditor interests do not constitute beneficial ownership of the corporation's stock.\footnote{190} Solely for purposes of section 269, creditors are treated as acquiring beneficial ownership of stock of a corporation no earlier than the time a bankruptcy court confirms a plan of reorganization.\footnote{191}

Regulation section 1.269-1(a) provides that the term "allowance" refers to anything in the internal revenue laws which has the affect of

189. Id. at § 1.269-5(b).
190. Id.
191. Id.}
diminishing tax liability.\textsuperscript{192} The term includes a deduction, a credit, an adjustment, an exemption, or an exclusion.\textsuperscript{193} Under section 269, an amount otherwise constituting a deduction, credit, or other allowance becomes unavailable as such under certain circumstances.\textsuperscript{194} Characteristic of such circumstances are those in which the effect of the deduction, credit or other allowance would be to distort the liability of a particular taxpayer when the essential nature of the transaction or situation is examined in the light of the basic purpose or plan which the deduction, credit or other allowance was designed by the Congress to effectuate.\textsuperscript{195}

In determining whether an acquisition pursuant to a plan of reorganization in a case under title 11 was made for the principal purpose of evasion or avoidance of federal income tax, the fact that a governmental unit did not seek a determination under 11 U.S.C. 1129(d) is not taken into account and any determination by a court under 11 U.S.C. 1129(d) that the principal purpose of the plan is not avoidance of taxes, is not controlling for purposes of section 269.\textsuperscript{196}

However, the courts and the Service have recognized that section 269 was not intended to condemn every acquisition which results in tax savings, especially if there are other Code provisions that indicate Congress' intent to provide a benefit to taxpayers who have met the statutory conditions.\textsuperscript{197} For example, in \textit{Supreme Investment},\textsuperscript{198} an acquiring corporation purchased all the shares of another corporation and then promptly liquidated the target corporation.\textsuperscript{199} The issue was whether section 269 prevailed over former section 334(b)(2) to prevent the acquiring corporation from obtaining a step-up in basis in one of the target's assets rather than a carryover basis.\textsuperscript{200} The court held that the "web of statutory provisions governing this particular transaction" prevented the Service from using section 269 to make an exception to the cost basis rule of former section 334(b)(2), and, therefore,

\begin{itemize}
\item \textsuperscript{192} Treas. Reg. § 1.269-1(a) (1962).
\item \textsuperscript{193} \textit{id.}
\item \textsuperscript{194} Treas. Reg. § 1.269-2(b) (1962).
\item \textsuperscript{195} \textit{id.}
\item \textsuperscript{196} Treas. Reg. § 1.269-3(e) (1992).
\item \textsuperscript{197} Supreme Inv. Corp. v. Comm'r. 468 F.2d 370, 378 (5th Cir. 1972), rev'g 320 F.Supp. 1328 (W.D. La. 1970); see also 1998 FSA LEXIS 408, at *8 (June 24, 1998) (noting that there are some transactions which are not considered to be tax avoidance because it was determined that Congress intended the tax benefit).
\item \textsuperscript{198} \textit{Supreme Inv. Corp.}, 468 F.2d at 373.
\item \textsuperscript{199} \textit{id.} at 373.
\item \textsuperscript{200} \textit{id.} at 375.
\end{itemize}
the taxpayer correctly took a stepped-up basis as allowed by specific provisions of the Code.

Also, in Revenue Ruling 76-363, an individual created corporation X to engage in the sale and distribution of certain products. This business operation was originally performed by corporation M, also wholly owned by A. The principal purpose for the organization of X was to secure the benefits of subchapter S. The Service ruled that although A's principal purpose in creating X was to secure the benefit of exemption from corporate tax, section 269 does not apply to disallow any deduction, credit, or other allowance resulting from an election to be taxed under subchapter S. Similarly, in Revenue Ruling 70-238, the Service ruled that the deliberate creation of a subsidiary for the express purpose of qualifying it for the tax benefits afforded to Western Hemisphere Trade Corporations under section 921 does not amount to tax avoidance under section 921. The Ruling further provides that Congress intended to make the special deduction provided by section 922 available to any domestic corporation provided only that it could satisfy the specific requirements of section 921.

In the Grandfather Structure, the creditors will acquire, directly, control of Holding and, indirectly, control of Operating, which will own all of the assets currently owned by Debtor. Similarly, in the Historic Bruno's Structure, the creditors will acquire direct control of New Bruno's. Whether section 269 can apply, with respect to both Structures, will depend on "the principal purpose" for the respective acquisitions. In both the Grandfather and Historic Bruno's Structures, the creditors are acquiring control of Operating and New Bruno's, respectively, for tax planning purposes. Nevertheless, the fact that the parties will consider the federal income tax consequences of a transaction, and structure the transaction in the least costly manner, is not enough to invoke section 269. Therefore, the critical inquiry is whether this tax planning purpose rises to level of evasion or avoidance of federal income tax rather than simply good tax advice. As discussed in Supreme Investment and Revenue Rulings 76-363 and

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201. Id. at 377.
203. Id.
204. Id.
205. Id.
206. Id.
208. Id.
209. Id.
70-238 above, Congress did not intend to use section 269 to override specific provisions in the Internal Revenue Code. Section 1012 and regulation section 1.1012-1(a) provide that, if a corporation acquires a target's assets in a taxable transaction, the acquiring corporation's basis in the assets equals the cost to acquire the assets.\(^2\) As such, it does not appear that structuring the purchase transactions in the Grandfather and Historic Bruno's Structures to achieve a cost basis in assets (without any built-in losses, NOLs or other tax attributes surviving the bankruptcy emergence) are the types of acquisitions of tax attributes at which section 269 is aimed.

**VII. CONCLUSION**

Despite the fact that certain tax professionals have been critical of this type of tax planning, the taxable emergence structure has been employed in several public bankruptcies.\(^2\) Moreover, the IRS National Office seems to have accepted the concept of a taxable emergence from Bankruptcy as nothing more than a variation on an idea that the IRS has already accepted.\(^2\)

Importantly, the notion that bankruptcies should be treated in a special manner aids in the argument against attacking taxable emergence structures as abusive transactions with the same voracity as other tax planning mechanisms. As a matter of public policy, the Code recognizes in several sections that bankruptcies are different and, accordingly, several specific provisions allow taxpayers to emerge from bankruptcy in the best possible position to succeed. For instance, section 368(a)(1)(G) and related provisions were enacted in 1980 and 1981 to facilitate the "rehabilitation" of financially troubled business by permitting the business to reorganize tax-free and pass its tax attributes (including loss carryovers) to the surviving or acquiring corporation.\(^2\)

Finally, it is important to keep in mind that the "G reorganization" and "E recapitalization" structures will often be preferable when the debtor is in a net unrealized built-in loss position or when its tax attributes, excluding tax basis, significantly exceed the potential for COD income pursuant to the plan of reorganization. The focus of the

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211. See Sheppard, supra note 3 (discussing the conversion of an existing asset into a tax shelter).
analysis should always be on retention of the largest amount of useable tax attributes following emergence from Chapter 11.