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TO "NET VALUE" OR NOT TO "NET VALUE"? THAT IS THE QUESTION: A DISCUSSION OF THE PROPOSED NET VALUE REGULATIONS—THEIR PURPOSE, UTILITY, AND FUTURE

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In decisions dating back to the 1940s, courts have held that certain transactions in which property exchanged does not have net positive value do not rise to the level of tax-free exchanges. On the other hand, in decisions going back almost as far, courts have blessed the character of other transactions as tax-free, despite the absence of net value in these exchanges. Over the last few decades, these apparently inconsistent rulings have led to controversial questions:

- *When one or more parties to a reorganization is insolvent, does the reorganization fail to qualify as a tax-free transaction, despite meeting all mechanical requirements for such treatment under § 368?*
- *Does contribution of under-water property to a corporation by a shareholder qualify as a tax-free transaction under § 351?*

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- *Does contribution of property to an insolvent corporation by a shareholder qualify as a tax-free transaction under § 351?*
- *Does the liquidation of an insolvent subsidiary qualify as a tax-free transaction under § 332?*

The question as to whether a transaction in any of the above situations is nontaxable arises from the fact that the underlying property in the exchange is burdened by liabilities that exceed its fair market value. Nonrecognition transactions are premised on "exchanges" that leave the taxpayer in substantially the same position as before the exchange. Courts have addressed whether a transaction in which something of net positive value is not given or received qualifies as an "exchange."

In 2005, through proposed regulations, the Department of the Treasury and the Internal Revenue Service (IRS) took the position that transactions that do not involve exchanges of property with net positive value are not "exchanges" and thus do not qualify under nonrecognition provisions. Twelve years later, the proposed regulations were suddenly withdrawn.

This article explores court decisions on the application of corporate nonrecognition transactions involving insolvent entities and IRS rulings based on those decisions. More significantly, the article explores the proposed regulations on net value, their potential impact on various types of transactions, and the potential consequences of their withdrawal.

INTRODUCTION

Over the last several decades, numerous technical issues have arisen with respect to "net value" considerations in nonrecognition transactions. The question of "net value" stems from decisions wherein courts have ruled that a transaction does not rise to the level of a nontaxable exchange unless something of net positive value is given up and received. As such, the question arises as to whether a transaction—in which assets and liabilities are both transferred, and the value of the liabilities exceeds the value of the assets—can ever be viewed as a nontaxable "exchange." This question has primarily arisen in the context of Subchapter C of the Internal Revenue Code (the Code).[1]

[1] Title 26 of the U.S. Code, Subtitle A, Chapter 1, Subchapter C (§§ 301-385), "Corporate Distributions and Adjustments," addressing transactions between corporations and their shareholders.

In 2005, the Department of the Treasury issued proposed regulations attempting to address these issues (Proposed Net Value Regulations).[2] Twelve years later, the proposed regulations were withdrawn on July 13, 2017.[3] The issuance and subsequent withdrawal of the regulations leave unanswered questions. Part I provides an overview of the tax-free provisions in Subchapter C, including reorganizations, transfers of property to controlled corporations, and subsidiary liquidations, and presents the "exchange" requirement for nonrecognition transactions. Part II discusses the effect of the Proposed Net Value Regulations on these transactions. In Part III, the withdrawal of the Proposed Net Value Regulations is discussed, as well as questions that remain unanswered. The article concludes by acknowledging the current lack of guidance and the uncertainty created by the withdrawal of the Proposed Net Value Regulations for taxpayers and practitioners.

I. RECOGNITION OF GAIN OR LOSS ON EXCHANGES: HISTORY AND BACKGROUND

Since the inception of the income tax in the United States, there has been a genuine effort to determine a marker for realization and recognition events. Resolution of this complex issue involves determining the point at which a taxpayer should recognize the appreciation in value of property as taxable income. In 1920, the U.S. Supreme Court in *Eisner v. Macomber* defined "income" for income tax purposes as including "the gain derived from capital, from labor, or from both combined."[4] However, with respect to gain derived from capital, the Court was quick to clarify that it is "not a gain accruing to capital; not a growth or increment of value in the investment; but a gain, a profit, something of exchangeable value, proceeding from the property, severed from the capital . . . , received or drawn by the recipient (emphasis omitted)."[5] From an early age, it was established that increases and decreases in the value of property by themselves do not give rise to the recognition of gain or loss. Instead, there must be an event that separates (i.e., "severs") the gain or loss from the property that the

[2] REG-163314-03, 70 Fed. Reg. 11,903 (Mar. 10, 2005).
[3] 82 Fed. Reg. 32,281-01 (July 13, 2017).
[4] Eisner v. Macomber, 252 U.S. 189, 207 (1920).
[5] *Id.*

taxpayer owns and causes the taxpayer to enjoy or suffer that gain or loss in economic terms that are tethered to such an event.[6]

Consistent with this principle, the Code requires the recognition of gain or loss only when there is a "sale or other disposition of property,"[7] which, by implication, encompasses any transaction through which a taxpayer "disposes" of its interest in property in any form.[8] Exchanging one property for another satisfies that requirement and triggers recognition of gain or loss.[9] However, despite the general requirement that realized gains or losses are "recognized" in the absence of a statutory provision to the contrary,[10] in the spirit of *Macomber*, the Treasury regulations under § 1001 refrain from imposing recognition of gain or loss in an exchange unless the property received differs "materially either in kind or in extent" from the property given up in the exchange.[11] Throughout its evolution, the corpus of tax law stays true to this theme.

The notion that gain or loss should not be recognized in an exchange where the taxpayer does not acquire property that is in substance different from that given up is seen throughout the income tax provisions in the Code. The following provisions are the most notable examples of this principle:

- A corporate shareholder recognizes no gain or loss on distributions in complete liquidation of a corporation, if it owns the requisite percentage of the liquidating corporation's shares (§ 332).

[6] *See, e.g.*, Treas. Reg. § 1.165-1 ("To be allowable as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events . . . .").

[7] I.R.C. §§ 1001(a), 1001(c); Treas. Reg. §1.1002-1(a).

[8] Black's Law Dictionary's definition of the term "disposition" with respect to property is "The act of transferring property to another's care or possession…; the relinquishing of property." BLACK'S LAW DICTIONARY (10th ed. 2004) The terms "sale or other disposition" are applied broadly to include dispositions by a taxpayer without a voluntary action on his part. *See* Helvering v. Hammel, 311 U.S. 504, 511 (1941). The IRS also relies on this definition, considering a transaction as a "disposition" only when the taxpayer has relinquished its ownership of the property. *See*, *e.g.*, Rev. Rul. 76-339, 1976-2 CB 488.

[9] Treas. Reg. § 1.1002-1(a).

[10] I.R.C. § 1001(c).

[11] Treas. Reg. § 1.1001-1(a).

- No gain or loss is recognized by transferors on the transfer of property to a corporation if the transferors have the requisite degree of control over the corporation immediately after the transfer (§ 351).
- Exchange of equity or assets of a corporation for equity or assets of another corporation in a corporate reorganization is tax-free if all requirements are met (§ 368).
- No gain or loss is recognized on transfer of property to a partnership in exchange for an interest in the partnership by either the partnership or the contributing partner (§ 721).
- No gain or loss is recognized on the exchange of real property held for productive use in a trade or business or for investment real property of "like kind" held either for productive use in a trade or business or for investment (§ 1031).

The article's focus is on the corporate nonrecognition provisions. The common rationale of these provisions is that although the shareholder receives property that, in form, may be different from what it gives up, the shareholder, in substance, retains a continuing interest in the underlying property transferred and thus has not received anything different from what it has given up. For example, where corporation *A* merges with and into corporation *B*, with corporation *B* the surviving corporation under a state merger statute,[12] the corporation *A* stock held by its shareholders converts into stock of corporation *B* of equivalent value.[13] Since corporation *B* now owns everything that corporation *A* owned immediately prior to the reorganization, the corporation *A* shareholders continue their ownership interests in corporation *A*'s assets by reason of the reorganization. Therefore, corporation *A* shareholders do not recognize gain or loss in the exchange. Similarly, if corporation *X*, the stock of which is wholly owned by corporation *Y*, liquidates, it simply transfers all its property to corporation *Y*. After the liquidation, corporation *Y* directly owns everything it previously owned indirectly through its ownership of

[12] Such a merger generally qualifies as a reorganization under § 368(a)(1)(A), commonly referred to as a "type A reorganization."

[13] Each of the examples set forth in this paragraph is premised upon the absence of any cash or other nonqualifying property distributed in the transaction, commonly referred to as "boot."

corporation *X* stock. In light of corporation *Y*'s continuing interest in the assets formerly held by corporation *X*, corporation *Y* does not recognize gain or loss on the distribution and cancellation of its shares in corporation *X*. Finally, if individual *Q* transfers his grocery store to a newly created corporation *M* in exchange for 100 percent of the stock of corporation *M*, *Q* simply continues his ownership of the grocery store via his ownership of stock in corporation *M*. *Q*'s indirect continuing interest in the assets transferred to corporation *M* means that *Q* does not recognize gain or loss in the exchange.

Regulation § 1.368-1(b) describes the purpose of the corporate nonrecognition provisions:

> Under the general rule, upon the exchange of property, gain or loss must be accounted for if the new property differs in a material particular, either in kind or in extent, from the old property. The purpose of the reorganization provisions of the Code is to except from the general rule certain specifically described exchanges incident to such readjustments of corporate structures made in one of the particular ways specified in the Code, as are required by business exigencies and which effect only a readjustment of continuing interest in property under modified corporate forms.

Although the regulation specifically addresses tax-free reorganizations, it conveys the rationale common to all corporate nonrecognition transactions. In the same vein as tax-free reorganizations, a transfer of property to a corporation that the shareholder controls, or a transfer of property by a corporation to its corporate owner in complete liquidation, also reflects a readjustment in corporate structure, in which the ultimate owner of the property transferred remains substantially the same.

In order for a transaction to fit within the nonrecognition provisions of §§ 332, 351, or 368, there must be an "exchange." If a transaction in which a taxpayer relinquishes its ownership of property is not an exchange, it is nevertheless a "disposition." As such, the transaction results in realization of gain or loss, which must be recognized under the general rules discussed above.[14]

[14] *See supra* note 8 discussing the broad application of the terms "sale or other disposition" by courts and the IRS.

The word "exchange" appears in the definition of certain specific types of reorganizations in § 368(a)(1). For other types of reorganizations, although the word is not stated as a specific requirement, the description of the transaction is predicated on the exchange of equity for equity or equity for assets. Furthermore, § 354, which makes such reorganizations tax-free, requires an "exchange" of "stock or securities of a corporation a party to a reorganization … solely for stock or securities in such corporation or in another corporation a party to the reorganization." Likewise, § 351 requires a transfer of property "to a corporation by one or more persons solely in exchange for stock in such corporation" (emphasis added). Finally, Regulation § 1.332-2(a) states: "Section 332 applies only to those cases in which the recipient corporation receives at least partial payment for the stock which it owns in the liquidating corporation." Even though the word "exchange" is absent in the requirements of § 332, an "exchange" of property for the stock of the liquidating corporation is nevertheless required.

In the case of a complete liquidation of a corporate subsidiary under § 332, there is strong authoritative support for the "exchange" requirement. The Regulations under § 332 state that the section applies only if the shareholder receives a liquidating distribution in the capacity of a shareholder, not a creditor.[15] Where a shareholder receives property in the liquidation, but also assumes liabilities of the liquidating corporation and the assumed liabilities exceed the fair market value of the property distributed, the shareholder is in effect not receiving property with a net value for its stock that is cancelled in the liquidation. Thus, the shareholder has not "exchanged" its stock, and as a result, § 332 does not apply to such a distribution. The shareholder has in substance lost its status as an equity holder, since the capital stock of the liquidating corporation has no value. Instead, upon the liquidation of the corporation, the distributee-shareholder assumes the liquidating corporation's debts and/or takes property subject to debt. Such an arrangement steps outside the bounds of a tax-free liquidation, where the corporate shareholder is required to receive "property" from its subsidiary in respect of the cancellation of its stock in the subsidiary.[16]

Courts have consistently supported this premise. For example, in the earliest case addressing this issue, *H.G. Hills*

[15] *See* Treas. Reg. § 1.332-2(b), reflecting the judicial history, discussed *infra* text accompanying notes 17-19.
[16] Treas. Reg. § 1.332-2(a).

Stores, Inc. v. Commissioner,[17] a subsidiary liquidated and distributed its assets and liabilities to its parent in cancellation of its indebtedness to its parent. The court interpreted the phrase "in complete cancellation or redemption of all its stock" that appeared in the predecessor to Regulation § 1.332-2(a) as a requirement that a distribution be made to the parent in its capacity as a shareholder. Because the parent corporation received payment in its capacity as a creditor and not in its capacity as a shareholder, the court held that § 112(b)(6) (the predecessor to § 332) did not apply. Other cases followed the same logic in the liquidations area.[18]

The Treasury regulations under § 332 (§ 332 Treasury Regulations) support these court decisions, providing that tax-free treatment applies "only to those cases in which the recipient corporation receives at least partial payment for the stock which it owns in the liquidating corporation."[19] The IRS interprets this to mean that liquidation of an insolvent subsidiary is not a tax-free event under § 332.[20] Rather, consistent with the regulations and IRS rulings, such a liquidation gives rise to a worthless stock deduction under § 165(g)(3).[21]

IRS rulings extend the same logic to tax-free reorganizations. For example, in Revenue Ruling 59-296,[22] the IRS held that the merger of an insolvent subsidiary into its fully solvent parent qualified neither as a tax-free liquidation under § 332 nor a tax-free reorganization under § 368. The Ruling in effect puts liquidations and reorganizations on the same footing with the requirement of an exchange of net value. While the position of Revenue Ruling 59-296 is transparent and consistent with case law related to liquidations, reaching the same verdict on reorganizations is harder to justify. In particular, the Ruling cites two court cases in its analysis: *H.G. Hill Stores, Inc., v. Commissioner*[23] and *Roebling v. Commissioner*.[24] *H.G. Hill* pertains to a liquidation, and *Roebling* addresses a reorganization. In *Roebling*, the court refused to accept the underlying transaction

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[17] 44 B.T.A. 1182 (1941).

[18] *See, e.g.,* H.K. Porter Co. v. Comm'r, 87 T.C. 689 (1986), and Spaulding Bakeries, Inc. v. Comm'r, 27 T.C. 684 (1957), *aff'd*, 252 F.2d 293 (2d Cir. 1958).

[19] Treas. Reg. § 1.332-2(b).

[20] *See* Rev. Rul. 2003-125, 2003-2 C.B. 1243, and Rev. Rul. 70-489, 1970-2 C.B. 53.

[21] *Id.*

[22] 1959-2 C.B. 87.

[23] 44 B.T.A. 1182 (1941).

[24] 143 F.2d 810 (3rd Cir. 1944).

as a tax-free reorganization even though it met the formalities of a state merger statute, because the shareholders of the target corporation received debt from the acquirer in exchange for the target's equity and thus became creditors of the acquirer. The disqualification as a tax-free reorganization had nothing to do with the insolvency of either of the two corporations or the absence of net value in the exchange. The court held that "continuity of interest," a common law requirement of reorganizations in general, was not met.[25]

The position of the IRS in Revenue Ruling 59-296 with respect to reorganizations is not supported by the case law cited therein. The ruling cites decisions related to tax-free liquidations, and generalizes their logic to reorganizations, without a reasonable basis. In *Norman Scott, Inc. v. Commissioner*, [26] the Tax Court held that the cross-chain merger of an insolvent target qualifies as a type A reorganization. The IRS acquiesced in the results of this decision, but not in the court's analysis and reasoning.[27] After its acquiescence, the IRS held or acknowledged on at least three separate occasions that a merger otherwise qualifying as a tax-free merger under § 368 is not disqualified because one of the corporations is insolvent.[28]

As evident in the contradiction between the IRS's position with judicial authority and the inconsistency between the IRS's own rulings with respect to a requirement of solvency for parties to a reorganization, there was a significant need for additional guidance in this area. The Treasury and the IRS attempted to fill this vacuum through issuance of the Proposed Net Value Regulations.

II. THE PROPOSED NET VALUE REGULATIONS

On March 10, 2005, the Treasury and the IRS published a Notice of Proposed Rulemaking (2005 NPRM), presenting the Proposed Net Value Regulations that provide definitive guidance in this controversial area.[29] In applying the nonrecognition provisions for corporations, the IRS took the position in the

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[25] The Ruling was amplified by Revenue Ruling 70-489, 1970-2 CB 53, although the issue addressed in the latter was a liquidation issue (i.e., worthless stock loss under§ 165(g)(3), rather than a tax-free liquidation under § 332).
[26] 48 T.C. 598 (1967).
[27] *Id.*, *action on dec.*, 1967 WL 16360 (Dec. 7, 1967).
[28] *See* Chief Couns. Adv. 201315020 (Apr. 12, 2013); Field Serv. Adv. 20008012 (Nov. 8, 1999); Gen. Couns. Memo. 33,859 (June 25, 1968).
[29] REG-163314-03, 70 Fed. Reg. 11,903 (Mar. 10, 2005).

Proposed Net Value Regulations that an “exchange” is required, for a nonrecognition transaction to be recognized as such. In other words, a transaction in which all parties do not transfer and receive something of value is not an “exchange.” The nonrecognition provisions, which are predicated on an “exchange” in their wording and spirit, do not apply to such a transaction. Therefore, a transaction that may otherwise be tax-free under the nonrecognition provisions, but for the fact that the property received from one or more of the parties has no value, does not qualify for nonrecognition. Sometimes this view is to the detriment of the taxpayer and sometimes to its benefit, but regardless, the IRS has stood firm on its position. However, the IRS’s position in the Proposed Net Value Regulations has not always been supported by judicial authority and there is no clear statutory authority to settle the issue.

The Proposed Net Value Regulations memorialize the IRS’s position on the “net value” requirement in each of the nonrecognition areas for corporations. The IRS’s position had previously been pronounced in various revenue rulings, but in a scattered and incomprehensive manner. The 2005 NPRM explains:

> The IRS and the Treasury Department have decided to resolve the uncertainties by generally adopting a net value requirement for each of the described nonrecognition rules in subchapter C. The net value requirement generally requires that there be an exchange of property for stock, or in the case of section 332, a distribution of property in cancellation or redemption of stock. The IRS and the Treasury Department believe that the net value requirement is the appropriate unifying standard because it is more consistent with the statutory framework of subchapter C, case law, and published guidance than any other approach considered. In addition, the IRS and the Treasury Department believe that the net value requirement is the appropriate standard because transactions that fail the requirement, that is, transfers of property in exchange for the assumption of liabilities or in satisfaction of liabilities, resemble sales and should not receive nonrecognition treatment.[30]

[30] 70 Fed. Reg. at 11,904.

Consistent with the stated objectives reflected in the passage quoted above, the 2005 NPRM proposed changes to the Treasury regulations that would expressly impose the net value requirement on nonrecognition provisions for corporations. Whereas the net value requirement was previously implied, or imposed without sufficient force and clarity, the Proposed Net Value Regulations reinforce and clarify the requirement.

The discussion of the net value requirement in connection with all three tax-free provisions under Subchapter C—§§ 332, 351 and 368—is consistent with the stated objective in the NPRM to require an "exchange" in a transaction in order to apply the related nonrecognition provisions. The requirement of transfer and receipt of property with net positive value stems directly from the view propounded therein, equating an "exchange" with transfer of value, and requiring the presence of an "exchange" in a potential nonrecognition transaction.

The following detailed discussion of the Proposed Net Value Regulations is divided into two subparts: (A) subsidiary liquidations and (B) reorganizations and transfers to controlled corporations. Reorganizations and transfers to controlled corporations are considered together due to the similar issues they both present.

A. *Subsidiary Liquidations*

The requirement of an exchange of net value in a tax-free subsidiary liquidation under § 332 is consistent with both court rulings and Treasury regulations.[31] The Proposed Net Value Regulations help clarify the § 332 Treasury Regulations, which is best demonstrated by a comparison of the existing regulations to the Proposed Net Value Regulations. Regulation § 1.332-2(b) states: "Section 332 applies only to those cases in which the recipient corporation receives at least partial payment for the stock which it owns in the liquidating corporation. If section 332 is not applicable, see section 165(g) relative to allowance of losses on worthless securities." This regulation implies that if a subsidiary is insolvent, its liquidation is not subject to § 332 because the parent corporation receives no "payment" in respect of its stock in the liquidation. Rather, the parent corporation assumes liabilities (or takes title to assets subject to liabilities) that exceed the value of

[31] *See supra* notes 17-19 and accompanying text.

assets distributed in the liquidation. The regulation further implies that, under such circumstances, the parent corporation may claim a stock worthlessness loss under § 165(g) instead of tax-free liquidation treatment, which would otherwise preclude recognition of any loss. The IRS states this position more explicitly in Revenue Ruling 2003-125,[32] concluding that liquidation of an insolvent subsidiary is not a tax-free transaction under § 332. Instead, the liquidation was held to give rise to a worthless stock deduction for the stock of liquidated subsidiary.

The same conclusion could be reached from a straight reading of the § 332 Treasury Regulations, which state: "Section 332 applies only to those cases in which the recipient corporation receives at least partial payment for the stock which it owns in the liquidating corporation. If section 332 is not applicable, see section 165(g) relative to allowance of losses on worthless securities."[33] However, leaning on this statement alone would not leave an objective reader in a comfortable place to say that liquidation of an insolvent subsidiary gives rise to a worthless stock deduction. The fact that a subsidiary is insolvent does not necessarily mean that the shareholder does not receive a "payment" in liquidation. A sole shareholder may in fact receive all assets of a liquidating corporation subject to all of the corporation's liabilities. The shareholder may not be richer after the liquidation but has received some assets in the process.[34] Revenue Ruling 2003-125 made the leap by stating that, in the liquidation of the subsidiary of the insolvent subsidiary, the corporate shareholder in fact received no net payment, and hence § 332 did not apply. Because of the lack of sufficient clarity in the § 332 Treasury Regulations, Revenue Ruling 2003-125 is relied upon more extensively than those regulations to determine the tax consequences of the liquidation of an insolvent subsidiary.

The Proposed Net Value Regulations would have ended this ambiguity in the current § 332 Treasury Regulations. The regulations quoted would have been changed by the Proposed Net Value Regulations to read:

> Section 332 applies only when the recipient corporation receives at least partial payment for

[32] 2003-2 C.B. 1243.

[33] Treas. Reg. § 1.332-2(b).

[34] In the case of a "check-the-box" liquidation, as was the case in Revenue Ruling 2003-125, there is a *deemed* receipt of assets, subject to assumption of liabilities rather than actual receipt and assumption.

> each class of stock that it owns in the liquidating corporation. If section 332 does not apply, see section 165(g) regarding the allowance of losses for worthless securities for a class of stock for which no payment is received. Further, if section 332 does not apply and the recipient corporation receives partial payment for at least one class of stock that it owns in the liquidating corporation, see section 368(a)(1) regarding potential qualification of the distribution as a reorganization. If section 332 does not apply and the distribution does not qualify as a reorganization, see section 331 for those classes of stock for which partial payment is received.[35]

The added language provides clarity and does more than just make the § 332 Treasury Regulations more understandable. Although the § 332 Treasury Regulations support the principle that the liquidation of an insolvent subsidiary cannot be tax-free, the regulations do not state this premise clearly enough. In addition, the ambiguities in the § 332 Treasury Regulations leave some related questions unanswered. Specifically, under the § 332 Treasury Regulations:

- The liquidation of an insolvent corporation is not subject to § 332 for any class of stock on which the distributee corporation does not receive at least a partial distribution. Since the subsidiary is insolvent, if and when it satisfies the claims of the creditors, it will not have the means to make a distribution on the recipient corporation's stock. However, it is not clear how this would play out where different classes of stock are outstanding, and some shareholders receive "at least a partial distribution" in respect of their shares and others do not.
- Virtually all subsidiary liquidations could potentially qualify as tax-free reorganizations under § 368(a)(1)(A), § 368(a)(1)(C), or § 3681(a)(1)(D),[36] but the regulations preclude the

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[35] Prop. Treas. Reg. § 1.332-2(b) (prior to withdrawal in 2017).

[36] In the case of a liquidation where I.R.C. § 332 is inapplicable (1) if the liquidation is effected by a statutory merger of the corporation into its parent corporation (i.e., an upstream merger), it could potentially qualify as a type A

application of § 368 in a transaction subject to § 332 (i.e., § 332 trumps § 368).

- If § 332 is not applicable because of the insolvency of the liquidating corporation, it appears that qualification as a tax-free reorganization would again be possible, making the transaction tax-free (i.e., disallowing a loss recognition, despite the language in Regulation § 1.332-2(b) attempting to turn off tax-free treatment to such a transaction).

The Proposed Net Value Regulations would help resolve areas of nagging uncertainty by clarifying that the liquidation of an insolvent corporation in which the parent corporation does not receive property with a net value:

- Is not governed by § 332.
- Does not qualify as a reorganization under § 368.
- Gives rise to a worthless stock loss under § 165(g)(3) for the parent corporation.
- Is governed by a taxable liquidation for minority shareholders[37] under § 331.

Most significantly, the adoption of the Proposed Net Value Regulations would have avoided confusion about the applicability of the reorganization provisions to such a transaction by foreclosing the possibility of a tax-free reorganization in the case of a liquidation of an insolvent entity.[38]

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reorganization and (2) if the liquidation was accomplished by transferring the assets of the liquidating corporation and cancelling its stock, the liquidation could potentially qualify as a type C reorganization or possibly an acquisitive type D reorganization.

[37] In the context of a liquidation subject to § 332, where nonrecognition of gain or loss applies to the corporate shareholder with requisite stock ownership in the subsidiary, any other shareholder is referred to as a "minority shareholder" by the regulations. *See, e.g.*, Treas. Reg. § 1.332-5, outlining the tax consequences to a minority shareholder.

[38] For a substantive discussion of the consequences of the liquidation of an insolvent subsidiary in light of the *Spaulding Bakeries* and *H.K. Porter* decisions and the Proposed Net Value Regulations' embrace of the *Porter* holding, *see* Jasper L. Cummings, Jr., *New Prop. Regs. Change Rules for Transactions Where Property or Stock Lacks Net Value,* 103 J. TAX'N 14, 21-22 (July 2005).

B. *Tax-free Reorganizations and Transfers to Controlled Corporations*

The addition of the net value requirement in the Proposed Net Value Regulations to transactions governed by §§ 351 and 368 constitutes a significant extension of existing regulatory requirements. While many of the concepts in the proposed regulations regarding § 332 already exist in the current regulations and would only be clarified or amplified by the proposed regulations, for potential §§ 351 and 368 transactions the addition of a "net value" requirement is a completely new concept. Under the Proposed Net Value Regulations, a potential § 351 transaction does not qualify as tax-free if the fair market value of the assets transferred to the corporation, in the aggregate, does not exceed the liabilities assumed by the corporation, together with cash and other boot received in the transaction by the shareholder.[39] Accordingly, if a transfer to a corporation meets all other requirements of § 351 but the liabilities transferred to the corporation exceed the fair market value of the transferred assets, the transaction would fail to qualify under § 351 and thus would be a taxable transaction.[40]

Likewise, the Proposed Net Value Regulations require "an exchange of net value" for most types of reorganizations for the parties to such reorganizations to enjoy (or endure, where such treatment is to the taxpayer's detriment) tax-free status.[41] While this language seems to imply that giving and receiving property with net positive values in the exchange is required for tax-free treatment, two points must be kept in mind. First, not all types of reorganizations expressly require an "exchange." For example, a transaction qualifying under § 368(a)(1)(A) (a type A reorganization) simply requires a "statutory merger or consolidation" in which the shares of the target corporation are, by statutory fiat, converted into shares of the acquiring corporation.[42] Second, the Proposed Net Value Regulations take into account any

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[39] Prop. Treas. Reg. § 1.351-1(a)(1)(iii) (prior to withdrawal in 2017).

[40] *Id.*

[41] *See* in general Prop. Treas. Reg. § 1.368-1(f) (prior to withdrawal in 2017). The Proposed Net Value Regulations exempt types E and F reorganizations and, in some circumstances, acquisitive D reorganizations, from the net value requirement. *See* Prop. Treas. Reg. §§ 1.368-1(b)(1) and 1.368-1(f)(4) (prior to withdrawal in 2017).

[42] Note that while §§ 354 and 361 adopt the terminology of "exchange" to confer tax-free status to reorganization transactions, in the context of a type A merger these statutes contemplate the existence of a deemed exchange as opposed to a conversion of target shares into the shares of the acquiring corporation.

boot consideration received by target shareholders in the reorganization for purposes of determining the net value received by such shareholders.

Regarding stock reorganizations,[43] § 1.368-1(f)(3) of the Proposed Net Value Regulations imposes two requirements:

(1) Surrender of net value: The fair market value of the assets of the target corporation must exceed the sum of the amount of the liabilities of the target corporation immediately prior to the exchange and the amount of any money and the fair market value of any other property (other than stock permitted to be received without the recognition of gain) received by the shareholders of the target corporation in connection with the exchange.

(2) Receipt of net value: The fair market value of the assets of the issuing corporation must exceed the amount of its liabilities immediately after the exchange.

For asset reorganizations,[44] § 1.368-1(f)(2) of the Proposed Net Value Regulations imposes two slightly different requirements:

(1) Surrender of net value: The fair market value of the property transferred by the target corporation to the acquiring corporation must exceed the sum of the amount of liabilities of the target corporation that are assumed by the acquiring corporation in connection with the exchange and the amount of any money and the fair market value of any other property (other than stock permitted to be received without the recognition of gain) received by the target corporation in connection with the exchange.

(2) Receipt of net value: The fair market value of the assets of the issuing corporation exceeds the amount of its liabilities immediately after the exchange.

The theoretical concepts the Proposed Net Value Regulations contain are defensible. It appears that the shareholders

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[43] *I.E..*, stock-for-stock exchanges under § 368(a)(1)(B) and reverse triangular mergers under § 368(a)(2)(E).

[44] *I.E.*, reorganizations that involve a transfer of assets of the target corporation to the acquiring corporation, as described in §§ 368(a)(1)(A), 368(a)(1)(C), 368(a)(1)(D), and 368(a)(1)(G).

of neither the target corporation nor the acquiring corporation would be happy with, or consent to, an exchange in which the other corporation is insolvent. The acquiring corporation's shareholders would be unhappy if their shares were diluted, and in exchange, their corporation absorbed or acquired another corporation burdened with more liabilities than the value of its assets. Likewise, the shareholders of a target corporation would be equally unhappy if they exchanged their stock for the stock of an acquiring corporation that is insolvent before the exchange. Therefore, such a transaction would not take place unless there are suspicious motivations. In that sense, the proposed provisions would serve as anti-abuse safety valves, just as the protection common law requirements of tax-free reorganizations provide.[45]

Theories do not always measure up to the realities of the business world. Uncommon transactions occasionally occur because of unusual motivating factors. Business synergies and economies of scale, among other economic factors, occasionally persuade two corporations, one or both of which are insolvent, to combine their businesses. Applying the provisions of the Proposed Net Value Regulations to such transactions would disqualify the transactions as tax-free exchanges. Consider, for example, the following scenarios:

> <u>Scenario 1</u>: *A* and *B* are unrelated corporations. *A* is insolvent but hopes to recover in the future. *B* is solvent. *A* has advantageous vendor and customer supply contracts, leases, licenses, and other intangible assets that are at risk of cancellation by virtue of *A*'s insolvency. *B*, because of business circumstances, values such assets enough to justify a merger. *A* merges with and into *B*, with *B* surviving, through a statutory merger under § 368(a)(1)(A).
>
> <u>Scenario 2</u>: *A* and *B* are unrelated corporations. *A* and *B* are both insolvent. *A* merges with and into *B*, with *B* surviving, through a statutory merger under § 368(a)(1)(A), in which the post-merger shareholders contemplate that the combined entities will create enough synergy to eventually create a successful, solvent corporation.

Would such transactions be disqualified as tax-free reorganizations under the "net value" requirement? It appears so.

[45] These common law requirements, such as continuity of interest, continuity of business enterprise, and business purpose are incorporated in the Treasury regulations. *See* Treas. Reg. § 1.368-1.

In the first scenario, the "surrender of net value" requirement is violated. Specifically, § 1.368-1(f)(2)(i) of the Proposed Net Value Regulations provides that, with respect to asset transactions, the test is met when the fair market value of the property transferred by the target corporation to the acquiring corporation exceeds the sum of the amount of liabilities of the target corporation that are assumed by the acquiring corporation and the amount of any money and the fair market value of any other property received by the target corporation connected to the exchange. Since the target (*A*) is insolvent, and no boot is exchanged, the transaction fails this test for qualifying as a tax-free reorganization. The parties could have overcome this problem by effectuating a merger of *B* into *A* instead, with *A* surviving. Since *B* is solvent (and no boot is exchanged), the "surrender of net value" test is met. However, if the net fair market value of *B*'s assets is not sufficient to overcome *A*'s insolvency, the "receipt of net value" test would not be met. In other words, if the sum of the fair market values of *A* and *B*'s assets did not exceed the sum of their liabilities, the emerging entity would be insolvent. Under § 1.368-1(f)(2)(ii) of the Proposed Net Value Regulations, the test is met when the fair market value of the assets of the issuing corporation exceeds the amount of its liabilities immediately after the exchange. In such a case, the merger still fails as a tax-free reorganization because it also fails the "receipt of net value" test.

In the second scenario, not only is the "surrender of net value" requirement not met because of the insolvency of the target, it appears the "receipt of net value" requirement is also not met. Clearly the merger of two insolvent entities results in a combined insolvent entity immediately after the merger. The value of the synergies that the parties to the transaction may hope to create through the merger may or may not transpire after a period of combined operations. Therefore, it is not likely that the value of this synergy is meant to be included in the combined value of the assets under the Proposed Net Value Regulations, even assuming such value could be measured.[46]

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[46] In both instances it could be argued that the synergy created by the combination of the two entities is an unrecognized intangible asset, whose value would overcome the insolvency of either or both corporations. The Proposed Net Value Regulations do not provide a definition of "fair market value" for the purpose of applying their test. It seems that in the absence of this definition, the regular "willing buyer/willing seller" definition applies at the moment of measurement prescribed by the Proposed Net Value Regulations. Where the test is applied *immediately* after the transaction, no value can be measured for this synergy at that moment because no such synergy has yet been created. Where

Neither of the above transactions are inherently abusive or even tax motivated. Because of this, the purpose of the Proposed Net Value Regulations (which would disqualify them) cannot prevent abuse. Rather, the rationale for this seemingly draconian treatment has more to do with the basic philosophy of the Proposed Net Value Regulations: to qualify as a tax-free "exchange," a transaction must first *be* an "exchange." The Proposed Net Value Regulations do not consider a transaction in which both parties do not exchange something with a net positive value as an exchange.

Concerns about transactions like the ones in the scenarios described above were not raised by the practitioner community, because, admittedly, transactions like those are rare. But when they do occur, the application of the Proposed Net Value Regulations could have had a devastating effect on the shareholders participating in such transactions. In practice, one would not have to search far to find transactions that would have been affected by the Proposed Net Value Regulations. Transfers of assets are very common among subsidiaries within a common chain of ownership. In many instances, such transfers are deliberately structured as tax-free reorganizations, and very often, intercompany transfers are subject to tax-free reorganization rules *de facto*, without any action on the part of the taxpayer.[47] Following the same analysis as in the two scenarios, tax-free treatment is jeopardized if one or more of the entities involved in the transfers is insolvent. Unraveling the tax-free status of the transaction would not only trigger gain or loss within the group but would also affect the basis of the transferred assets.

Another class of transaction involves the transfer of assets to a controlled corporation, which is generally nontaxable to the shareholders under § 351 so long as the transferor shareholders own, immediately following the exchange, a requisite share of the stock of the corporation (at least 80 percent of the voting power and 80 percent of the nonvoting shares).[48] A common transaction

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the "surrender of net value" test is applied immediately before the transaction, clearly no synergy exists at that point. Therefore, it appears that the analysis of these two hypotheticals stands as articulated herein based on the plain language of the Proposed Net Value Regulations.

[47] For example, a transfer of substantially all assets of one subsidiary to another, whether structured as an uncompensated transfer, a sale of those assets or a sale of the subsidiary's stock followed by its liquidation is treated generally as a D reorganization by operation of the § 368 Treasury regulations.

[48] In a situation where a shareholder already owns 100 percent of the shares of a corporation, a transfer of property does not have to be followed by an actual issuance of stock. Rev. Rul. 64-155, 1964-1 C.B. 138; Rollins v. Comm'r, T.C. Memo 1993-643 (citing Lessinger v. Comm'r, 85 T.C. 824 (1985)), *aff'd* on this

is for the owner of an unincorporated business to create a new corporation (NewCo) and transfer all assets and liabilities of the business to NewCo in exchange for 100 percent of its stock. Such an exchange is generally a nontaxable transaction under § 351. However, the Proposed Net Value Regulations would require the transfer of net value to qualify the exchange as a tax-free transaction under § 351. Specifically, the fair market value of the assets transferred to NewCo would have to exceed the amount of liabilities transferred to NewCo.[49] This requirement would disqualify the transfer of an insolvent business to a corporation as a nontaxable transfer, resulting in a taxable gain or loss to the proprietor of that business.[50]

The net value requirements in the Proposed Net Value Regulations caused some dilemmas with respect to the types of transactions discussed in Part II.B, which some might argue were an unnecessary burden on taxpayers. However, because the Proposed Net Value Regulations also resolved some questions,[51] and because they provided needed clarity in the case of tax-free liquidations, one may have expected the proposed regulations eventually to become finalized, albeit in a more sensible form. Strangely, this did not happen. Over a decade after their proposal, the IRS withdrew the Proposed Net Value Regulations without a substantial explanation and without a promise to replace any of the guidance contained in them in the future.

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point, 872 F.2d 519 (2nd Cir. 1989); Atlas Tool Co. v. Comm'r, 70 T.C. 86 (1978), *aff'd*, 614 F.2d 860 (3rd Cir. 1980).

[49] Prop. Treas. Reg. § 1.351-1(a)(iii) (prior to withdrawal in 2017).

[50] The transaction described in this paragraph possibly implicates § 357(c). Under § 357(c), if the liabilities transferred to the corporation in either a § 351 transaction or a divisive type D reorganization exceed the aggregate adjusted basis of the transferred assets, the transferor generally recognizes gain in an amount equal to such excess. In a transfer of assets with no net value, as described in this context, often the liabilities exceed aggregate basis (as well as aggregate fair market value) of such assets, implicating § 357(c). Therefore, a gain may be recognized under § 357(c), regardless of the Proposed Net Value Regulations. However, the two conditions may not always coexist (basis may exceed the liabilities, while fair market value does not). If the two conditions do exist together, a gain under the Proposed Net Value Regulations may, in some circumstances, be larger than the gain under § 357(c) if the value received by the transferor exceeds its basis in the assets by more than the liabilities exceed such basis. As such, the Proposed Net Value Regulations can be viewed as casting a wider net than § 357 for implicating tax consequences to an otherwise tax-free transaction. For a substantive discussion of the interaction of that provision with the Proposed Net Value Regulations discussed in this article, *see* Cummings, *supra* note 38, at 17-22.

[51] *See, e.g.*, *supra* text accompanying note 36 (discussion of overlap between tax-free liquidations and tax-free reorganizations).

III. LIFE WITHOUT THE PROPOSED NET VALUE REGULATIONS

On July 13, 2017, the IRS announced the withdrawal of the Proposed Net Value Regulations (Withdrawal Notice).[52] More than 12 years after the release of the Proposed Net Value Regulations, their withdrawal may have come as a shock, and perhaps as a relief, to practitioners who mostly wondered when, not if, these proposed regulations would be finalized.

This article addresses unintended consequences that may have arisen from the application of the Proposed Net Value Regulations, as well as some significant perplexities that the proposed regulations would have undoubtedly created. In fact, such consequences may be the reason for the decision by the Treasury and the IRS to withdraw these proposed regulations instead of finalizing them. The withdrawal of the Proposed Net Value Regulations may resolve the confusion and prevent unintended consequences. However, it is not that simple.

Releasing the Proposed Net Value Regulations and then withdrawing them many years later does not have the same effect as never releasing them at all. The Withdrawal Notice imparts very little about the rationale for the withdrawal, stating only that

> The Treasury Department and the IRS are of the view that current law is sufficient to ensure that the reorganization provisions and section 351 are used to accomplish readjustments of continuing interests in property held in modified corporate form. With respect to section 332, the holdings of *H.K. Porter Co. v. Commissioner*, 87 T.C. 689 (1986), *Spaulding Bakeries Inc. v. Commissioner*, 27 T.C. 684 (1957), *aff'd*, 252 F.2d 293 (2d Cir., 1958), *H.G. Hill Stores, Inc. v. Commissioner*, 44 B.T.A. 1182 (1941), Rev. Rul. 2003-125, 2003-2 C.B. 1243, Rev. Rul. 68-602, 1968-2 C.B. 135, Rev. Rul. 68-359, 1968-2 C.B. 161, and Rev. Rul. 59-296,

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[52] 82 Fed. Reg. 32,281-01 (July 13, 2017). The notice is more accurately referred to as a "Notice of Partial Withdrawal" of the Proposed Net Value Regulations. In particular, a portion of the Proposed Net Value Regulations relating to matters other than the receipt of net value, such as creditor continuity of interest and certain other portions related to § 351 transfers and reorganizations were previously adopted as final regulations. Accordingly, the notice withdraws the remaining portions relating to net value matters.

1959-2 C.B. 87, continue to reflect the position of the Treasury Department and the IRS.[53]

The refusal by the IRS and the Treasury to state that they no longer hold the position they once did can by itself be a source of great trouble. For some, the government's silence speaks volumes. Saying that the existing authority is "sufficient" to ensure the law is properly administered does not mean that the Treasury no longer holds the position it once took in the Proposed Net Value Regulations. In the preamble to the proposed regulations, the IRS and the Treasury assert that the proposed regulations were supported by the existing authority. Does the withdrawal mean that in the Treasury's view the positions in the proposed regulations are sufficiently supported by the existing authority, so that no regulations are needed to enforce them? Does that mean that we must still hang on to the notion that an "exchange" entailing the transfer and/or receipt of net value is necessary for a tax-free transaction to keep its tax-free status?

To others, the withdrawal may say quite the opposite. The issuance and withdrawal of the Proposed Net Value Regulations could mean that the IRS and the Treasury once considered the requirement "net value" in a tax-free exchange to be necessary but have since concluded that no such necessity exists. For this group, the withdrawal of the proposed regulations closes the door to the "net value" discussion. Of course, the ambiguities resulting from the withdrawal of the proposed regulations could create new tax planning options, i.e., one could favor either side of the argument depending on which produces the greatest tax benefit.

Setting aside the somewhat philosophical discussion about the withdrawal itself: Where does the absence of guidance contained in the Proposed Net Value Regulations leave us? The Withdrawal Notice cites *Spaulding Bakeries*, *H.K. Porter*, *H.G. Hill*, and Revenue Rulings 59-296 and 2003-125 as the "current law" that ensures the propriety of nontaxable exchanges. All authorities cited in the Withdrawal Notice, however, address corporate subsidiary liquidations, save for Revenue Ruling 59-296, the weight of authority of which is questionable at best. If we are left to rely on these sources for assessing the application of § 332 to a liquidation, does that mean we abandon the requirement for a distribution on "every class of stock," as was articulated in the

[53] 82 Fed. Reg. 32,281-01 (July 13, 2017).

proposed regulations? None of the sources cited in the Withdrawal Notice expressly require such a class-by-class distribution.

Assuming that the requirement for an exchange of net value is not a necessary element for incorporations and reorganizations, dilemmas relating to the incorporation of insolvent businesses or the reorganization of most insolvent entities may be resolved in most cases by (1) applying the statutory requirements of §§ 351, 354, 361, and 368, and the established judicial and regulatory requirements and (2) ignoring the solvency or insolvency of the unincorporated business or the target and/or acquiring corporation. In the case of the upstream merger of an insolvent corporate subsidiary into its parent corporation, however, such a merger continues to be riddled with controversy, namely:

(1) Where the insolvent subsidiary has multiple classes of stock, could the upstream merger qualify as a tax-free liquidation where a distribution is made in respect of only the most senior class of stock?

(2) In the case of an upstream merger where the insolvency of the liquidating subsidiary is attributable to indebtedness owing to third party creditors, would such merger nonetheless qualify as a type A reorganization?[54]

(3) In the case of an upstream merger where the insolvency of the liquidating subsidiary is attributable to indebtedness owing to the parent corporation, rather than to a third-party creditor, could such merger still nonetheless qualify as a type A reorganization or, perhaps, simply a payment in satisfaction of the indebtedness extinguished in the merger?

Notwithstanding the IRS's best efforts to prevent tax-free status on the liquidation of an insolvent subsidiary, and considering the withdrawal of the Proposed Net Value Regulations, the door remains open, for both the IRS and taxpayers, to argue for tax-free status in such a case and all the resulting consequences.

[54] *See supra* text accompanying note 36.

CONCLUSION

Despite a substantial amount of judicial authority regarding potentially tax-free transactions involving insolvent entities, there is not always a clear answer as to whether such transactions should be given tax-free treatment. In some cases, the weight of authority tends to disqualify a transaction as tax-free and in other cases it does not. More importantly, for certain types of transactions it is completely unclear whether the tax-free character of a transaction involving one or more insolvent entities should be challenged or respected.

Where there is conflicting authority, Treasury regulations can provide clarity and end the controversy. In this case, the existing regulations have clearly fallen short of this task and leave a gap in each of the three corporate nonrecognition areas discussed in this article—subsidiary liquidations, transfers to controlled corporations, and reorganizations. The Proposed Net Value Regulations attempted to fill this gap, but appeared to overstep their bounds in providing guidance that contradicted the established judicial authority. As such, their subsequent withdrawal corrected a wrong.

The withdrawal of the proposed regulations, however, leaves us in a deeper void than before their issuance. The implication of the withdrawal, without sufficient explanation, is that the Treasury and the IRS have reversed their position on *everything* stated in the Proposed Net Value Regulations, including the portions of the judicial authority that were consistent with the Proposed Net Value Regulations. Although the judicial authority itself should be a valid source for taxpayers to rely upon, this uncertainty as to whether the IRS will accept or seek to combat those judicial sources is bound to be a source of anxiety for taxpayers and practitioners. In the few areas where the judicial authority is unclear, or where sources of judicial authority are at odds with each other or with the regulations, taxpayers are left completely on their own.