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IRS Issues Final Regulations on F Reorganizations

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In September 2015, the Treasury Department and the IRS issued final regulations (T.D. 9739) that provide guidance with respect to the qualification of a transaction as a reorganization under Section 368(a)(1)(F) (an "F" reorganizations). The final regulations generally retain the four requirements set forth in the proposed regulations on F reorganizations from 2004, and contain two additional requirements that are intended to address overlap scenarios where all or a portion of a transaction could potentially qualify as an F reorganization and also satisfy the requirements of another non-recognition provision. Further, the final regulations reaffirm that the qualification of a transaction as an F reorganization generally should be tested in isolation to other transactions. In addition, final regulations under Section 367(a) regarding outbound F reorganizations were issued, which generally adopt 1990 temporary regulations (T.D. 8280) including their effective dates.

Background

Section 368(a) allows for several types of reorganizations, the purpose of which is to provide non-recognition of gain or loss for transactions that are required by business reasons and effect only a readjustment of continuing interests in property under modified corporate form. Section 368(a)(1)(F) defines an F reorganization as a "mere change in identity, form or place of organization of one corporation, however effected." A typical F reorganization involves a corporation changing its domicile from one State to another State, whether effected by way of a merger or a conversion.

Expansion of 368(a)(1)(F) Requirements

The Treasury Department and the IRS had issued proposed regulations in 2004. The 2004 proposed regulations set forth four requirements for a transaction to qualify as an F reorganization. After the issuance of the proposed regulations, questions arose as to what changes may occur before, during or after a mere change in identity, form or place of organization that are compatible with the requirements for an F reorganization.

The final regulations generally adopt these four requirements with certain clarifying changes

and add two additional requirements relating to transactions where F reorganization treatment may overlap with other non-recognition treatment. The premise of the final regulations (as was the case for the 2004 proposed regulations) is that if one corporation (Transferor Corporation) changes its corporate shell by transferring its assets to another corporation (Resulting Corporation) while satisfying the identified requirements, tax-free treatment under Section 368(a)(1)(F) would be granted even if the potential F reorganization is part of a larger transaction and, correspondingly, the qualification of a transaction as an F reorganization would not affect the treatment of other transactions.

Under the final regulations, a transaction that involves an actual or deemed transfer of property by a Transferor Corporation to a Resulting Corporation qualifies as an F reorganization if the following six requirements are met:

- Immediately after the potential F reorganization, all the stock of the Resulting Corporation must have been distributed (or deemed distributed) in exchange for stock of the Transferor Corporation. This requirement is not violated if a *de minimis* amount of stock is issued by the Resulting Corporation with respect to its organization or maintaining its legal existence.
- The same person or persons must own all of the stock of the Transferor Corporation, determined immediately before the potential F reorganization, and all of the stock of the Resulting Corporation, determined immediately after the potential F reorganization, in identical proportions. This requirement is not violated if (i) shareholders exchange stock of the Transferor Corporation for stock of the Resulting Corporation with different terms but equivalent value, or (ii) shareholders receive distributions from the Transferor Corporation or the Resulting Corporation whether or not in exchange for stock of one of the corporations. Thus, a Transferor Corporation may recapitalize, redeem its stock or make distributions while still qualifying as an F reorganization.
- The Resulting Corporation may not hold any property or have any tax attributes immediately before the potential F reorganization. This requirement is not violated if the Resulting Corporation holds (i) a *de minimis* amount of assets with respect to its organization or maintaining its legal existence (and any tax attributes related thereto), or (ii) proceeds of a borrowing undertaken in connection with the potential F reorganization. This requirement relates to the long-standing view that an F reorganization should only involve one corporation.
- The Transferor Corporation must completely liquidate, for US federal income tax purposes, in the potential F reorganization. This requirement is not violated if the Transferor Corporation is not required to legally dissolve under applicable law and may retain a *de minimis* amount of assets for the sole purpose of preserving its legal existence. This requirement also relates to the long-standing view that an F reorganization should only involve one corporation.
- Immediately after the potential F reorganization, no corporation other than the Resulting Corporation may hold property that was held by the Transferor Corporation immediately before the potential F reorganization, if such other corporation would, as a result, succeed to and take into account tax attributes of the Transferor Corporation that are described in Section 381(c). This requirement is intended to prevent multiple claimants with respect to the tax attributes of the Transferor Corporation and reflects the view that an F reorganization does not include transactions that divide the property or tax attributes of the Transferor Corporation. For example, if a Transferor Corporation merges upstream into its Parent Corporation and a portion of the Transferor Corporation's assets are contributed to a potential Resulting Corporation, the transfer to the Resulting Corporation would not qualify as an F reorganization.
- Immediately after the potential F reorganization, the Resulting Corporation may not hold property acquired from a corporation other than the Transferor Corporation if the Resulting Corporation would, as a result, succeed to and take

into account tax attributes of such corporation that are described in Section 381(c). This requirement also relates to the long-standing view that an F reorganization should only involve one corporation and thus a F reorganization cannot consist of the simultaneous acquisition of more than one corporation.

Further, with respect to overlap scenarios, (i) if a potential F reorganization, or a step thereof, qualifies as another reorganization or part of another reorganization under Section 368(a), and the corporation in control of the Resulting Corporation is a party to the other reorganization, the potential F reorganization will not qualify as an F reorganization, and (ii) if a transaction could qualify as an F reorganization but also could qualify as another asset reorganization under Section 368(a), such transaction will only qualify as an F reorganization. For example, if a Parent Corporation contributes the stock of an existing subsidiary to a new subsidiary, and the existing subsidiary merges into the new subsidiary, the transfer will only qualify as an F reorganization.

Multi-Step Transactions and F Reorganizations

Under the final regulations, a potential F reorganization consisting of a series of related transactions that together constitute a mere change may qualify as an F reorganization whether or not certain steps in the series of the transaction, viewed in isolation, may be treated differently for US federal income tax purposes. This rule reflects that an F reorganization may involve an indirect transfer of assets by the Transferor Corporation to the Resulting Corporation, such as a liquidation of the Transferor Corporation followed immediately by a transfer of all of the Transferor Corporation's assets to a Resulting Corporation.

Additionally, the final regulations provide that a transaction or series of related transactions be tested against the six requirements at the point when the Transferor Corporation begins transferring (or is deemed to begin transferring) its assets to the Resulting Corporation, and ends when the Transferor Corporation has distributed (or deemed distributed) the consideration it receives from Resulting Corporation to its shareholders and liquidates for federal income tax purposes. In determining whether the six requirements are satisfied, deemed asset transfers include transfers treated as occurring pursuant to entity classification elections. For example, a deemed asset transfer would include a so-called "drop-and-check" transaction pursuant to which the stock of the Transferor Corporation is contributed to a Resulting Corporation in exchange for all of the Resulting Corporation stock, followed by a liquidation of the Transferor Corporation (including a deemed liquidation pursuant to a conversion to a limited liability company).

The final regulations, consistent with the 2004 proposed regulations, treat distributions by a Transferor Corporation during a potential F reorganization as a separate transaction occurring at the same time as the potential F reorganization.

Finally, consistent with the 2004 proposed regulations and the notion of an F reorganization being in a "bubble," events motivated by business reasons that either precede or occur subsequent to a potential F reorganization generally will not be integrated under the step transaction doctrine to prevent the transaction from qualifying as an F reorganization. The final regulations, however, note that the step transaction doctrine may still apply to related transactions that precede or follow the F reorganization.

Temporary Regulations on Outbound F Reorganizations Adopted without Substantive Changes

The final regulations under Section 367(a) retain the rules of 1990 temporary regulations for outbound F reorganizations. In this regard, regardless of the treatment as a corporate continuance under domestic or foreign law, in an outbound F reorganization: (i) the domestic Transferor Corporation is treated as transferring its assets to the acquiring foreign corporation in exchange for stock of such acquiring corporation under Section 361, (ii) the domestic Transferor Corporation is treated as distributing such acquiring corporation stock to its shareholders, and (iii) the shareholders of

the domestic Transferor Corporation are treated as exchanging their Transferor Corporation stock for acquiring corporation stock pursuant to Section 354. In addition, the taxable year of the domestic Transferor Corporation is treated as closing on the date of the outbound F reorganization, and the taxable year of the foreign acquiring corporation is treated as ending on the date that the domestic Transferor Corporation's taxable year would have ended, but for the outbound "F" reorganization.

The final regulations provide additional clarity to the 2004 proposed regulations and continue to provide considerable flexibility with respect to F reorganizations.

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