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I. INTRODUCTION

Corporations comprising an affiliated group[1] may elect to file a consolidated tax return.[2] However, once such an election is made, the affili-

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1. Pursuant to I.R.C. § 1504(a) (P-H 1987), an affiliated group constitutes one or more includable corporations connected by stock ownership in which a common parent corporation owns stock possessing 80% of the voting power of all classes of stock entitled to vote and 80% of the value of all the stock of such corporation. Such stock ownership requirements are satisfied with respect to the remaining includable corporations by one or more of the other includable corporations. For this purpose, the definition of stock excludes nonvoting, nonconvertible preferred stock with redemption and liquidation rights not in excess of the paid in capital or par value represented by such stock. *See* I.R.C. § 1504(a)(4). An includable corporation is any corporation with certain designated exceptions, such as tax exempt organizations under § 501, foreign corporations, and most insurance companies and regulated investment companies. *See* I.R.C. § 1504(b).

2. I.R.C. § 1501 (P-H 1987) provides that an affiliated group may make the election to file on a consolidated basis simply by filing a consolidated return. All of the members of the group must consent to such a filing, but the act of filing a consolidated return is indicative of such consent. *See*

ated group may not discontinue such filing in subsequent years without the prior consent of the Commissioner of the Internal Revenue Service (IRS).[3] The continuous filing requirement is necessary to prevent the abuses that would occur if corporations within an affiliated group could choose whether to file separate returns or a consolidated return for a given year.[4] A complex set of regulations[5] specify under what circumstances the Commissioner will consider an affiliated group as continuing in existence so as to require continuous consolidated filing. Unfortunately, these rules were not crafted with divisive reorganizations in mind, and consequently, the regulations are often ineffective in dealing with these transactions, offering a taxpayer, in many instances, the opportunity to opt out of consolidation despite the contrary intention of the statute and the regulations. This Article will analyze the regulations' inconsistencies and deficiencies pertaining to divisive transactions and will suggest changes that would allow the regulatory pattern to achieve its intended purpose.

II. The Regulatory Pattern

A. *The General Rule*

An affiliated group exists so long as a common parent corporation remains in existence with at least one affiliated subsidiary.[6] An affiliated group exists even if a subsidiary was not previously part of the consolidated group, or other subsidiaries leave the group. An affiliated group terminates only if the common parent liquidates, the common parent liquidates its sole subsidiary or engages in a "down stream" merger with that subsidiary.

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id.

3. *See, e.g.*, Davis Bros. Restaurant, Inc. v. Commissioner, 60 T.C. 525 (1973). Such consent is not easily obtained. *See generally* Treas. Reg. § 1.1502-75(c) (as amended in 1973).

4. *See* Regal, Inc. v. Commissioner, 53 T.C. 261, 266 (1969), *aff'd per curiam*, 435 F.2d 1922 (2d Cir. 1970) (stating that "there is always a very real possibility that when there is a shifting back and forth between consolidated returns and separate returns there may be gaps or overlaps that would produce distortions in income").

5. Treas. Reg. § 1.1502-75(d) (as amended in 1973).

6. The general rule for continuing affiliation is found in Treasury Regulation § 1.1502-75(d)(1) (as amended in 1973) [hereinafter (d)(1)], which includes the following example. *P* forms *S* as a wholly owned subsidiary during 1965 and files a consolidated return with *S* for that calendar year. In 1966 *P* purchases all of the stock of *S-1* and thereafter sells the stock of *S*. The group, originally consisting of *P* and *S*, is considered to remain in existence and is now comprised of *P* and *S-1*, because *P* remains in existence with at least one affiliated subsidiary, *S-1*. It should be noted, however, that if the steps of the example were reversed and *S* were sold prior to the acquisition of *S-1*, although both occur in the same taxable year, the old group would terminate and *P* and *S-1* would be entitled again to elect to file either on a separate or consolidated basis.

B. Common Parent No Longer in Existence

An affiliated group continues even if the common parent ceases to exist, as long as the parent transfers substantially all of its assets to one or more members of the affiliated group and a member of the group continues to function as the common parent.[7] This is distinguishable from a "down stream" merger of the parent into its sole subsidiary. In a "down stream" merger the group terminates not because the parent no longer exists, but because a group of corporations joined by common stock ownership no longer exists. Under Treasury Regulation section 1.1502-75(d)(2)(ii), a similar transfer of assets to a subsidiary, even though coupled with a termination of the parent, does not terminate the group because another member of the continuing group assumes the role of common parent without conflicting with the requirements of regulation section (d)(1).[8] The obvious goal of this provision is to prevent an affiliated group from opting out of consolidation by merely having the common parent "formally" terminate without a substantive change in the group.[9]

C. Reverse Acquisitions

A reverse acquisition occurs when a corporation acquires either the stock or substantially all of the assets of the affiliated group's common parent[10] and, following the transaction, the shareholders of the common

7. *See supra* note 1.

8. If the parent were to continue to exist there would be at least a technical conflict with (d)(1) as indicated by the following example. *P* transfers substantially all, but not all, of its assets to an existing, wholly owned subsidiary, *S-1*, which, in turn, owns all of the stock of *S-2*, and continues to exist. Because *P* continues to own *S-1* and act as the common parent, the literal language of (d)(1) is satisfied. The continued existence of *P* prevents the requirements of (d)(2)(ii) from also being satisfied, although it is questionable whether *P* should remain the common parent in view of the transfer of substantially all of its assets to *S-1*. See *infra* notes 34-42 and accompanying text for a more detailed analysis of this issue.

9. The importance of substance over form that underlies (d)(1) has been taken a step further in Revenue Ruling 82-152, 1982-2 C.B. 205 [hereinafter Rev. Rul. 82-152], which extends (d)(2)(ii) to the merger of a second tier subsidiary into the common parent in which the common parent survives as a subsidiary of its former first tier subsidiary (*e.g.*, by virtue of the merger the parent has assumed the place in the corporate hierarchy of its former second tier subsidiary). Because tbe common parent in these circumstances continues to exist, the literal language of (d)(2)(ii) is not satisfied. If, however, the subsidiary had been the surviving corporation, the parent would have ceased to exist, which satisfies the literal requirements of (d)(2)(ii). The ruling considers the two alternatives to be substantively and functionally equivalent, despite the common parent's retention rather tban (as required by the language of the regulation) transfer of its assets to other members of the group, because the group continues the business of the common parent in either case with only a change in form—precisely what (d)(2)(ii) intended to embrace. For a more detailed analysis of this ruling as it applies to a divisive reorganization, see *infra* notes 34-42 and accompanying text.

10. A reverse acquisition could also occur if the affiliated group's parent corporation is the acquiring rather than the acquired corporation. It should also be noted that an acquisition need

parent own more than fifty percent in value of the acquiring corporation's stock.[11] Although the common parent has either ceased to exist[12] or exists as a subsidiary of the acquiring corporation, under the IRS regulations the affected group continues to exist with the acquiring corporation as the new common parent. The objective of these regulations is to prevent the form of the acquisition—in other words, which corporation in fact acts as the acquiring corporation—from determining the continued existence of the affiliated group. Rather, the continuing affiliated group is that group which made the principal contribution to the combined group.[13]

To illustrate, assume that *X* Corporation and *Y* Corporation are each common parents of unrelated affiliated groups, that the value of the *X* group is twice that of the *Y* group, and that on January 1, 1988, *X* merges into *Y* in exchange for *Y* stock. Based upon the relative values, the *X* shareholders would receive twice the number of shares of *Y* as were outstanding in the hands of the *Y* shareholders. Thus, the *X* shareholders would own two-thirds of the stock of the combined corporation after the merger, and the transaction would be characterized as a reverse acquisition in which the *X* affiliated group survives, the *Y* group terminates, with *Y* being treated as the common parent of the continuing group.

The reverse acquisition provisions are important not only in determining whether a new affiliated group continues for the purpose of filing a consolidated return,[14] but also in determining whether net operating losses and other carryovers are to have limited application.[15]

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not be a tax free reorganization in order to constitute a reverse acquisition for purposes of these rules. A reverse acquisition may occur in a taxable, partially taxable, or tax-exempt transaction.

11. Treas. Reg. § 1.1502-75(d)(3) (as amended in 1973) [hereinafter (d)(3)].

12. Although the regulations appear to contemplate termination of the common parent's existence, the language does not require termination. Therefore, (d)(3) is literally applicable to divisive transactions in which the common parent retains an insubstantial portion of its assets and continues to exist. For a discussion of the conflict between (d)(1) and (d)(3) as they apply to divisive transactions, see *infra* note 40. For a discussion of the conflict between (d)(2)(ii) and (d)(3) in similar circumstances, see *infra* notes 40-47 and accompanying text.

13. Principal contribution is defined as more than 50% of the value of the combined group's stock. *See infra* notes 28-31.

14. In the preceding example, whether a new election to file on a consolidated basis is available depends upon which of the two groups previously filed on a consolidated basis. Because the *X* group is considered to continue in existence, its method of filing would he continued. Thus, if *X* filed on a consolidated basis that method of filing would be continued by the combined group even though *Y* previously may have filed on a separate return basis. However, if *X* had previously filed on a separate return basis and *Y* on a consolidated basis, the continuing group, including *Y* and its subsidiaries, could elect to file either on a separate or consolidated basis.

15. The reverse acquisition rules serve other purposes as well, including the determination of taxable years of the constituent corporations, designation of the accounting period of the successor group, and the determination of the acquiring corporation for purposes of I.R.C. § 381 (P-H 1987). *See generally* J. CRESTOL, K. HENNESSEY & A. RUA, THE CONSOLIDATED TAX RETURN § 2.04(1)(a) (1980).

Losses generated by a member of an affiliated group in a separate return limitation year (hereinafter SRLY) ordinarily may be offset only against that member's contribution to consolidated taxable income for the year. A SRLY year is any year in which a member[16] files a separate return or joins in the filing of a consolidated return by another group.[17]

These rules create SRLYs for each of the taxable years of the acquiring corporation, and each of its subsidiaries in a reverse acquisition, whereas the taxable years of the acquired corporation and its subsidiaries do not have SRLYs. As applied to the previous example, each of the taxable years of the *Y* group ending prior to January 1, 1988, will be a SRLY year. As a result, the pre-acquisition losses of a member of the *Y* group may be carried over to offset consolidated income of the combined group in subsequent years only to the extent of that member's contribution to consolidated taxable income in the subsequent year.

III. Application of the Regulatory Pattern to Divisive Reorganizations

A. *The General Rule*

By focusing on the continued existence of the common parent with at least one includable subsidiary, the general rule relies primarily on the formality of corporate existence, rather than on substantive factors relating to the continuation of the group's business. Consequently, the general rule often permits a common parent to maintain or terminate its consolidated return filing status merely by restructuring the group in a divisive reorganization.[18]

16. *See* Treas. Reg. § 1.1502-1(f) (as amended in 1973). For this purpose, a member includes a predecessor of the member. Predecessor is defined as a transferor of assets to a member in a transaction to which I.R.C. § 381 applies.

17. The SRLY restrictions may not apply to a corporation during a year in which it was a member of the group for the entire taxable year provided the group did not elect multiple surtax exemptions under I.R.C. § 1562(a) for such year. A further exception to characterization as a SRLY is provided for the corporation that is the common parent of the affiliated group for the consolidated return year to which the the net operating loss or other tax attribute is to be carried. Treas. Reg. § 1.1502-1(f)(2)(i) (as amended in 1973).

18. I.R.C. § 355 (P-H 1987) allows the distribution of a controlled corporation's stock without tbe recognition of gain under limited circumstances which require, generally, that a distributing corporation distribute only the stock or securities of a controlled subsidiary for a valid business purpose and not as a device to distribute earnings. In addition, the distributing corporation and the controlled corporation both must be engaged in the conduct of an active business immediately after the distribution. Moreover, each such business must have been actively conducted throughout the five-year period immediately preceding the distribution, but must not have been acquired in a transaction in which gain or loss was recognized during that five-year period. A split-up, as distinguished from a spin-off, involves the creation of one or more subsidiary corporations by the distributing corporation transferring the assets of a five-year active business to each such subsidiary followed by the distribution of the stock of all of the subsidiaries then owned by the distribut-

A simple example illustrates the ease with which a taxpayer can manipulate the general rule to maintain or terminate its consolidated return filing status. Assume *X* Corporation files a consolidated return with its sole subsidiary *S-1*. *X* also operates two businesses of its own, a primary business comprising ninety percent of *X*'s total value (including the value of *S-1*, which is engaged in a related business), and a secondary business comprising the balance of *X*'s assets. *X* transfers all of the stock of *S-1* and its primary business to a new subsidiary, *S*, in exchange for all of the latter's stock, which *X* promptly distributes to its shareholders in a transaction qualifying as a divisive reorganization pursuant to I.R.C. section 355.[19] Under the general rule, the *X* affiliated group ceases to exist following the spin-off, because *X* is no longer affiliated with a subsidiary. Substantively, ninety percent of the assets and the primary business of *X*, plus the assets and business of *S-1*, continue to be owned by the shareholders of *X* in a corporate structure comparable to that which existed previously—except that *S* has replaced *X* as the operating parent. Nevertheless, the spin-off has created a new affiliated group, comprised of *S* and *S-1*, which may elect to file on either a consolidated return or separate return basis.

If this transaction is reversed and *X* transfers its secondary business to *S* and distributes the *S* stock received in the exchange to its shareholders in a qualifying spin-off, no opportunity for a new consolidated return election exists. *X*, the common parent, continues to exist with *S-1* as an affiliated subsidiary. Thus, under the general rule, the *X* affiliated group continues to exist and, therefore, retains its consolidated return filing status. This alternative restructuring places the shareholders of *X* in exactly the same position with respect to the assets of the group as the position produced by a spin-off of ninety percent of *X*'s assets as demonstrated in the previous example. In either instance, the aggregate business is conducted through a parent/subsidiary group and an unaffiliated corporation, the sole difference being that the primary business is conducted by the spun-off corporation in one instance and by the continuing common parent in the other. A formal restructuring provides the opportunity to cease filing on a consolidated return basis and undermines the intention of the regulations. The process becomes elective by the expedient of engaging in, or abstaining

ing corporation. Immediately prior to such distribution, the statute limits tbe distributing corporation solely to the ownership of stock or securities of the controlled corporation which ought to be distributed; it prohibits the distributing corporation from directly owning the assets of an active business.

19. This assumes that the five-year active business requirement (as to both *X*'s primary and secondary businesses), the business purpose, and other technical requirements of that section essential to such qualification are satisfied. *See* I.R.C. § 355 (P-H 1987).

from, a change in corporate form and the method chosen for effecting that change.

This ability to manipulate the rules is even more apparent if the general rule is applied to a split-up of, rather than a spin-off from, the common parent. Assume the previous example is changed as follows: *X* transfers the assets of its primary business to *S* in exchange for all of the stock of *S*, but transfers the stock of *S-1* to another newly formed subsidiary, *S-2*, together with the assets of its secondary business in exchange for all of the stock of *S-2*. Thereafter, *X* liquidates by distributing the stock of *S* and *S-2* to its shareholders in a qualifying split-up under I.R.C. section 355. Literal application of the general rule[20] results in termination of the *X* affiliated group, because *X*, the common parent, has ceased to exist by virtue of the split-up.[21] A new affiliated group consisting of *S-2*, the parent, and *S-1* is created and is entitled to elect to file either a consolidated return or separate return. The general rule permits a new election with respect to that portion of the assets of the old affiliate now owned by *S-2* and *S-1*, despite the lack of any substantive change in ownership.[22]

The underlying purpose of the regulations pertaining to divisive transactions is to preserve the consolidated return filing election. This goal would be better served if (d)(1) were amended to provide for the continuation of the affiliated group that is the functional successor of the former common parent. This position is taken in (d)(2)(ii),[23] under which an affiliated group continues to exist despite the common parent's termination if the members of that group succeed to substantially

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20. The general rule of (d)(1) rather than (d)(2)(ii) applies because the continuing affiliated group comprised of *S-2* and *S-1* has not succeeded to substantially all of the assets of the old group.

21. I.R.C. § 382(a) (P-H 1987) provides, generally, tbat the acquiring corporation in an acquisitive reorganization will be the successor to the tax attributes of tbe acquired corporation. This section is specifically made inapplicable to a divisive reorganization pursuant to I.R.C. § 368(a)(1)(D). Thus, it offers no help in determining which, if either, corporation in a split-off should be considered the successor of the deceased parent corporation for purposes of maintaining the tax attribute of consolidated return filing.

22. The example may be fiawed in that it provides only a single affiliated group, *S-2* and *S-1*, which could conceivably continue to file on a consolidated basis. But the decision of who should succeed to the *X* consolidated group filing status should not be made on that pragmatic basis because a slight alteration of the facts of the example would produce two competing affiliated groups to vie for the privilege of continued filing on a consolidated basis. To remove that practical distinction, it need only be assumed that *X* initially had two first-tier subsidiaries rather tban only *S-1*, and that the stock of this second subsidiary was contributed to *S* prior to the split-up.

23. The same position is also taken in (d)(3) in which a transfer of substantially all of the assets of the acquired corporation is necessary in order that the transfer constitute a reverse acquisition. When coupled with the requirement that the shareholders of the acquired corporation own more than 50% of the stock of the acquiring corporation, the substantially all requirement identifies the functionally surviving consolidated group.

all of the assets of the former common parent.

The purpose of (d)(2)(ii) is to prevent the distribution of a parent's assets among existing group members in a manner that retains the operating integrity of the common parent's business but terminates its corporate existence and the existence of the affiliated group.[24] A distribution of this type is prevented by requiring the common parent to transfer substantially all of its assets to other group members. In the reorganization area,[25] the substantially all concept serves a similar purpose by preventing the division of a single corporation into two or more corporations.[26] Thus, the concept of substantially all is antithetical to spin-off transactions and should not be used as the basis for determining which of the constituent corporations in a spin-off is the functional successor to the former parent corporation. A different mechanism[27] is necessary to cope with the particular problems in determining continuity of the affiliated group created by divisive reorganizations.[28] A test based upon the relative fair market values of the assets retained by the constituent corporations is suitable for this purpose. Such a test allows for the determination of the functional successor to the old

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24. The language of (d)(2)(ii) permits certain divisive transactions in that it requires the members of the group to succeed to substantially all, rather than all, of the former parent's assets. The nonsubstantial portion of the assets not so transferred may apparently be distributed to shareholders, sold to third parties, or disposed of by other means including certain divisive reorganizations. The provisions of (d)(2)(ii) would appear capable of embracing a split-up, because the parent ceases to exist as a necessary part of the reorganization, if the division of assets meets the requisite test of substantially all, and the technical requirements of § 355 are satisfied. The rule of (d)(2)(ii) will not, however, embrace a spin-off, regardless of the division of assets, because the common parent corporation continues to exist.

25. A transfer of substantially all the assets is required in a reorganization effected pursuant to I.R.C. § 368(a)(1)(C) (P-H 1987) (indicating that "substantially all of the properties" of the transferor corporation must be exchanged solely for voting stock of tbe transferee corporation) and a transaction qualifying under I.R.C. §§ 368(a)(1)(D) and 354(b)(1)(A) (P-H 1987) (stating that the transferee corporation must acquire "substantially all of tbe assets" of the transferor). *See infra* notes 30-31 for the definitional requirements of "substantially all."

26. *See* Rev. Rul. 57-465, 1957-2 C.B. 250.

27. Consistency is desired so that to the extent possible similar transactions may be treated similarly under the general rule of (d)(1) and under (d)(2)(ii) and (d)(3).

28. For example, if it is assumed in the split-up described above, see *supra* notes 20-22 and accompanying text, that *S-1* possesses approximately 40% in value of the combined assets of tbe group, the general rule fails to provide any guidance as to continuation of the group. Since the old parent has ceased to exist and the stock of *S* and *S-2* are of approximately equal value, the existing rules seemingly result in a termination of the old affiliated group without a successor. The transaction cannot satisfy the reverse acquisition requirements because *X* has not transferred substantially all of its assets to a single acquiring corporation, but in approximately equal amounts to both. *Cf.* Revenue Ruling 73-303, 1973-2 C.B. 315, which indicates that a corporate, nonaffiliated parent corporation's transfer of the stock of each of two wholly owned subsidiaries (each being a parent of its own consolidated group) to a holding company were treated separately for purposes of determining if either transfer constituted a reverse acquisition under (d)(3). Any modification of the general rule should provide for the continuation of the old group by the continuing affiliated group that succeeds to a majority in value of the former's business assets.

group. In addition, the test is consistent with the concepts underlying the regulations pertaining to reverse acquisitions without the anti-divisive bias inherent in the substantially all test.[29] Under the market value test a constituent corporation would be the functional successor to the old group if it controlled more than fifty percent in value of such group's assets.

Any test based on fair market value should employ the "business asset concept" utilized by the courts in applying the substantially all requirement. A test based solely on the relative fair market values of the constituent corporations or affiliated groups might be easily manipulated by a significant shift of investment assets between constituent corporations. This value may not accurately reflect which of the constituent corporations is the functional successor of the old common parent. Therefore, only the value of those assets necessary to the conduct of an operating business[30] of the old common parent[31] should be

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29. See, for example, I.R.C. § 368(a)(1)(D) (P-H 1987), which provides for both divisive transactions pursuant to § 355 and for acquisitive reorganizations under § 354(b). The latter section requires the transfer of substantially all of the assets of the transferor specifically to distinguish the acquisitive and divisive functions of the statute.

30. This includes assets directly or indirectly used in an ongoing business. The determination of fair market value should include the value of stock interests held by the common parent in affiliated operating companies. Although not directly applicable to this situation, Revenue Proceeding 77-37, 1977-2 C.B. 568, defines "substantially all" for reorganization purposes as at least 90% of the fair market value of the transferor corporation's net assets and 70% of its gross assets just prior to transfer. In so doing, however, it fails to distinguish between those assets that are held directly and tbose held througb operating subsidiaries. The difficulty exists in determining whether a stock interest in a subsidiary primarily represents an interest in the underlying operating business or is held primarily as an investment for purposes of appreciation. *See* Corn Prods. Refining Co. v. Commissioner, 350 U.S. 46 (1955) (futures contracts within the literal definition of a capital asset are nevertbeless excluded because they were beld solely for business rather than investment purposes); Booth Newspapers, Inc. v. United States, 303 F.2d 916 (Ct. Cl. 1962) (loss realized on sale of stock purchased to provide dependable source of newsprint is ordinary rather tban capital in nature). Rather tban require the inquiry into motive and intent mandated by *Corn Products*, it is suggested that for purposes of determining the functional successor to the old parent for consolidated return reporting purposes, a 50% controlling stock interest in a subsidiary be required in order that the asset values underlying the investment in stock be included in the determination of substantially all of the assets dedicated to the conduct of the business of the group.

31. Using the fair market value of only those assets devoted to the conduct of an active business is consistent with the substantially all test as that test has been defined for reorganization purposes. Reorganization treatment requires that a *single* transferee corporation obtain substantially all of the assets of the transferor. *See* I.R.C. § 354(b). This has been interpreted to mean a transfer of substantially all of the assets essential to the conduct of the business, whicb imposes a business continuity test rather than a test based on tbe percentage in value of the aggregate assets transferred. *See* American Mfg. Co. v. Commissioner, 55 T.C. 204 (1970) (a transfer of 20% of total assets represented "substantially all"); James Armour, Inc. v. Commissioner, 43 T.C. 295 (1964)(50% of assets transferred). Liquid assets have been included as operating assets only when essential to conducting the business. *See* Swanson v. United States, 479 F.2d 539 (9th Cir. 1973); Simon Trust v. Commissioner, 402 F.2d 272 (Ct. Cl. 1968).

In the context of determining a functional successor to the old common parent for consolidated return reporting purposes following a divisive reorganization, a concept that accounts for taken into account (*i.e.*, the "business asset concept").

B. *Intra-Group Asset Transfers*

If the common parent of an affiliated group terminates its existence as a result of a transaction involving the transfer of substantially all of the parent's assets to other members of the affiliated group, (d)(1) provides for termination of the group. To prevent a formal shift of assets between group members from creating an opportunity to elect whether to retain or discontinue filing on a consolidated basis, (d)(2)(ii) sets forth an exception to the general rule. Regulation (d)(2)(ii) mandates continuation of the group despite the termination of the common parent. Revenue Ruling 82-152[32] considerably expands the application of (d)(2)(ii) to include transactions in which the common parent continues to exist.

Revenue Ruling 82-152 involves the substitution of a first tier subsidiary corporation, *S-1*, for a common parent corporation, *P*, accomplished by: first, the merger of a second tier subsidiary, *S-2*, into *P* with *P* as the survivor; second, an exchange of *P* stock for *S-1* stock; and, third, the cancellation of *S-1*'s stock owned by *P*. Consequently, *P* continues to exist as the subsidiary of *S-1* following the merger. The Ruling states that (d)(2)(ii) applies because there is no significant difference between a transaction in which *S-2* is the survivor and the transaction at issue in which *P* survives. If *S-2* were the survivor, (d)(2)(ii) would apply because *P* ceases to exist. Structuring the transaction so that *P* survives is considered a variation of form but not of substance.[33] Thus, the old affiliated group is considered to remain in existence with *S-1* as the new common parent.

The Ruling states that the function of (d)(2)(ii) is

> to recognize the continuity of an affiliated group after a transaction that, even though formally restructuring the group, did not effect any substantial change in the composition of the group (judged by reference to the underlying assets of the group). It is implicit in the single economic entity theory underlying the consolidated returns regulations that the group ought to continue in existence after such a transaction.[34]

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continuation of the business of the distributing parent corporation by more than a single corporation must be employed. This is accomplished by use of a test based on the relative fair market values of the resulting, constituent companies.

32. Rev. Rul. 82-152, 1982-2 C.B. 205.

33. Literally, the merger of *P* into *S-2* with *P* as the survivor qualifies as a reverse acquisition pursuant to regulation (d)(3)(i)(A), because *S-1* acquires control of *P* and *P*, but for (d)(3)(i)(A), would have become a member of an affiliated group of which *S-1* was the common parent. The Ruling asserts, however, that (d)(3) is inapplicable to intra-group transactions. This assertion is hardly free from doubt. *See infra* note 44 and accompanying text.

34. Rev. Rul. 82-152, 1982-2 C.B. 205-06.

By ignoring the requirement that the common parent ceases to exist,[35] this interpretation creates a clear conflict between the provisions of (d)(2)(ii) and the general rule of (d)(1).

To illustrate (hereinafter the Example), assume *P* operates two businesses that comprise ninety percent and ten percent of its assets respectively, exclusive of the value of the stock of two first tier subsidiaries, *S-1* and *S-2*. A second tier subsidiary, *T*, is formed as a wholly owned subsidiary of *S-1*, specifically for the purpose of being merged with *P*. The merger is completed with *P* surviving as a subsidiary of *S-1*, as Revenue Ruling 82-152 permits. Immediately thereafter, and as part of the plan of reorganization, *P*'s primary business (ninety percent in value of *P*'s assets) is transferred to a newly formed subsidiary, *S-3*, in exchange for all of *S-3*'s stock. *P* immediately distributes the *S-3* shares to *S-1*. *S-1* then distributes the stock of *P* (received in the merger) to its shareholders, who are the old shareholders of *P*. The net effect of these transactions is to place the principal business of *P* in a subsidiary of *S-1*, as prescribed by Revenue Ruling 82-152, and at the same time spin-off the corporate entity that was *P*, stripped of all but ten percent of its original assets and the stock of its remaining subsidiary, *S-2*, to *P*'s original shareholders.

P continues to exist with an affiliated subsidiary, *S-2*, outside of the group of which *S-1* is the common parent, but substantially all of the assets of *P* belong to the *S-1* affiliated group. Which is the continuation of the old *P* group? The response appears to depend upon whether (d)(1) or (d)(2)(ii) controls the transaction. Literally each provision is applicable. Under Revenue Ruling 82-152, the transfer of substantially all of the assets of *P* to *T* by a merger qualifies under (d)(2)(ii). This results in *S-1* and *S-3* being considered as the continuation of the *P* group, but under (d)(1) the continued existence of *P* causes the *P* and *S-2* group to be considered the continuing group.

A rule based upon the formality of corporate existence, such as (d)(1), should not govern a situation such as this in which form is so easily manipulated. In the above Example the same restructuring of corporate form could be accomplished by transferring *P*'s secondary business to *S-2* and its primary business to *S-3* followed by a liquidation of *P*. In this case *P* would cease to exist and (d)(1) would not apply. Applying (d)(1) literally to the transaction described in the Example is incongruous and inconsistent with (d)(2)(ii) and the "single

35. Arguably, Revenue Ruling 82-152 does not conflict literally with (d)(1) because the old parent corporation, *P*, does not necessarily continue to exist with at least one affiliated subsidiary, but is itself a subsidiary of the new parent, *S-1*.

economic entity theory"[36] underlying the consolidated regulations. The "single economic entity" theory looks to the location of substantially all of the group's assets (and continuing shareholder interests) for determining the continuing group. The literal language of (d)(1) must give way to the underlying purpose of (d)(2)(ii) and the regulations as a whole.[37]

The incongruity of permitting the formalism of the general rule of (d)(1) to override the substance of (d)(2)(ii) is all the more apparent if a slightly different transaction is considered. Assume that instead of the spin-off described in the Example, *P* was split-off, so that the shareholder group originally holding ten percent of *P*'s stock receives all of the stock of *P* after the merger and transfer of assets to *S-3*. *P* now holds ten percent of the old group's assets. The other ninety percent of the shareholders would control one hundred percent of the group comprised of *S-1* and *S-3* and thus control ninety percent of the old group's assets. The *S-1* and *S-3* group represents the continuing business and shareholder interests. It would be anomalous to hold that the *S-1* and *S-3* group was not the continuing group. Yet this is precisely the result that follows from a literal reading of (d)(1). Therefore, if (d)(1) is not amended in the manner previously suggested concerning divisive transactions,[38] (d)(1) should apply only in those situations in which (d)(2)(ii) is inapplicable.[39]

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36. Rev. Rul. 82-152, 1982-2 C.B. 205-06. The Ruling takes the position that the continuance of the affiliated group is determined by reference to whether or not substantially all of the group's assets remain in the group and that the same result should apply regardless of whether the old common parent or the transferee subsidiary is the surviving corporation. Thus, continuation of the group is not based on the presence or absence of the old common parent as it would be pursuant to (d)(1). Once substantially all the assets are found to remain in the group, the relevance of the old common parent's existence—either completely out of existence, in existence as a subsidiary of the group, or in existence outside the group—is minimal. To hold otherwise would in effect substitute a requirement that all of the assets of the common parent be transferred rather than substantially all as required by tbe literal language of (d)(2)(ii).

37. *See* Bob Jones Univ. v. United States, 461 U.S. 574, 586 (1983). The Court stated:

> The general words used in the clause . . . taken by themselves, and literally construed, without regard to the object in view, would seem to sanction the claim of the plaintiff. But this mode of expounding a statute has never been adopted by any enlightened tribunal—because it is evident that in many cases it would defeat the object which the Legislature intended to accomplish. And it is well settled that, in interpreting a statute, the court will not look merely to a particular clause in which the general words may be used, *but will take in connection with it the whole statute . . . and the objects and policy of the law . . . .*

Id. at 586 (emphasis in original) (quoting Brown v. Duchesne, 60 U.S. (19 How.) 183, 194 (1857)).

38. If this suggested change is effected, the issue becomes moot as either the general rule of (d)(1) or the provisions of (d)(2)(ii) will cause the affiliated group of *S-1* and *S-3* to be considered the continuing group.

39. The applicability of (d)(2)(ii) should be ascertained by reference to Revenue Ruling 82-152, 1982-2 C.B. 205. *See* CSC-Laundry v. United States, 450 U.S. 1, 6 (1981) (stating that "it is a basic principle of statutory construction that a specific statute . . . controls over a general provision . . ., particularly when the two are interrelated and closely positioned").

C. *Reverse Acquisitions*

The Example also presents a conflict between the applicability of (d)(2)(ii) and the reverse acquisition provisions of (d)(3).[40] As previously stated, a reverse acquisition occurs when a corporation, referred to as the "first corporation," transfers substantially all of its assets to a second corporation, and following the exchange, the shareholders of the first corporation own more than fifty percent of the stock of the second corporation. The merger of *P* into *T* as described in the Example is a reverse acquisition[41] because the former shareholders of *P* control *S-1*, which, in turn, controls the corporate entity surviving the merger, *P*.[42]

The IRS has resolved this apparent conflict between (d)(2)(ii) and (d)(3) by taking the position that (d)(3) cannot apply to an intra-group restructuring. The language of (d)(3) allegedly requires that the first corporation, *S-1*,[43] cannot be a member of the group of which the second corporation, *P*, is the common parent.[44] It is difficult to reconcile

40. Situations also exist in which the reverse acquisition rules conflict with the general rule of (d)(1). Assume that Corporation *A* is the common parent of an affiliated group, and Corporation *B* is the unrelated common parent of a separate affiliated group. Corporation *A* transfers substantially all of its assets (including the stock of affiliated corporations) to *B* in exchange for 80% of the latter's stock, retaining one active affiliated subsidiary, then spins off *B* (and its group) to its shareholders. The result is tbat the *A* shareholders now hold the remnants of Corporation *A* and 80% of Corporation *B*'s stock, with *B* holding substantially all of the assets of Corporation *A* and its affiliates. This transaction satisfies all of the requirements of (d)(3)(i)(b), and accordingly the *B* group is deemed to cease to exist, while the *A* group (with Corporation *B* as the new common parent) is deemed to remain in existence. However, this result is directly contrary to a literal application of (d)(1), which holds that the *A* group continues to exist with Corporation *A* as the common parent because Corporation *A* remains in existence with at least one subsidiary. This conflict would be resolved if the general rule as applied to spin-off transactions were modified as suggested, since tbe spin-off in tbe situation described would result in the survival of the *A* group with *B* as the new common parent because the *B* group retains substantially all of the assets of the *A* group.

41. Proposed Treasury Regulation § 1.1502-(75)(d)(4), 49 Fed. Reg. 30, 535 (1984), provides that in a reverse triangular merger pursuant to I.R.C. § 368(a)(1)(A) and (2)(E) (P-H 1987), the common parent of the merged subsidiary corporation, *S-1* in the Example, is considered the first corporation, and the transferee corporation, *P* in the Example, is considered the second or acquiring corporation for purposes of the reverse acquisition rules.

42. The subsequent spin-off of the corporate entity *P* with only 10% of its former assets is of no significance in terms of the conflict between (d)(3) and (d)(2)(ii). That conflict results from the merger of *T* into *P* in the manner described. The subsequent spin-off is relevant in that it creates a further conflict between (d)(2)(ii), as interpreted in Revenue Ruling 82-152, and the general rule of (d)(1), since it places *P* outside the old group as the continuing parent of its own affiliated group.

43. *See supra* note 41.

44. The language of (d)(3), however, does not necessarily support this interpretation. Use of the word "any" with reference to the first corporation's affiliated group throughout (d)(3) makes clear that (d)(3) does not require that the first corporation be the parent of a separate affiliated group, hut only recognizes that it might be. *See* 1 F. PEEL, CONSOLIDATED TAX RETURNS § 23:03, at 14 (3d ed. 1984) (stating that "Reg. § 1.1502-75(d)(3) does not literally require that either the first corporation or the second corporation be a member of a group before the transaction").

To illustrate that the literal language of (d)(3) encompasses intra-group transactions, upon an this position with the permissible overlapping of (d)(2)(ii) and (d)(3) found elsewhere in the regulations.[45] Overlaps can occur only if (d)(3) applies to intra-group restructurings such as those contemplated by (d)(2)(ii). If this is not the case, then the overlapping provision, regulation (d)(3)(iv), is meaningless. Such an interpretation is contrary to the cardinal rule of statutory construction that interpretation should not render any portion of the statute meaningless, superfluous, void, or insignificant.[46]

A narrow interpretation of (d)(3) places the transaction described in the Example in a regulatory "no man's land": (d)(3) is inapplicable to the merger of *P* and *T* because it is an intra-group transaction, but (d)(2)(ii) is equally inapplicable because, as part of the plan, *P* has been spun-off from the group presumably mandating application of the general rule of (d)(1).[47]

This anomaly can be best resolved by a revocation of Revenue Ruling 82-152 and the IRS's return to its former position that (d)(3) is applicable to intra-group restructurings.[48] The current position, reflected in Revenue Ruling 82-152, stems from the anomalous results

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exchange of all of the outstanding shares of a parent corporation for shares of a newly formed suhsidiary corporation, the parent, but for (d)(3), would become a member of a new affiliated group of wbich the subsidiary corporation is the common parent as described in (d)(3)(i)(A). As a result, the language of (d)(3) provides for the continuation of the parent's former group (as the only group in existence) with the subsidiary as the continuing common parent. Moreover, the acquisition of stock in the manner described is not materially different from the merger transaction described in the Example or in Revenue Ruling 82-152. *See* Gen. Couns. Mem. 38,886 (Aug. 9, 1982) (making clear that for tax purposes the transaction described in Rev. Rul. 82-152 was not an asset transfer but rather a § 351 stock exchange); *see also* Gen. Couns. Mem. 39,372 (June 24, 1985) (recognizing that Rev. Rul. 82-152 makes (d)(2)(ii) applicable to stock exchanges).

45. Treasury Regulation § 1.1502-75(d)(3)(iv) (as amended in 1973) [hereinafter (d)(3)(iv)] sets forth a priority rule intended to resolve such an overlap by providing that (d)(3) will not apply in situations in which (d)(2)(ii) applies. *See also* Gen. Couns. Mem. 39,528 (July 14, 1986).

46. *See, e.g.*, Market Co. v. Hoffman, 101 U.S. 112, 115-16 (1879); Stonecipher v. Bray, 653 F.2d 398, 402 (9th Cir. 1981), *cert. denied*, 454 U.S. 1145 (1982); Union Cent. Life Ins. Co. v. Commissioner, 77 T.C. 845, 863 (1981), *modified*, 720 F.2d 420 (1983).

47. Despite Revenue Ruling 82-152, however, application of (d)(1) would recognize *P* and *S-2* as the continuing group, which emphasizes form at the expense of the single economic entity theory underlying the regulations that is more consonant with treating *S-1* and *S-3* as the continuing group based on their retention of substantially all of the assets of that group. This theory underlies both the intra-group transactions of (d)(2)(ii), which require a transfer of substantially all the assets of the old parent, and the reverse acquisition rules of (d)(3), which are based similarly on a transfer of substantially all of the assets of the second corporation or an 80% stock interest within the meaning of I.R.C. § 1504(a) (P-H 1987).

48. This revision also should be coupled with appropriate amendments to the SRLY year limitations as applied to intra-group reverse acquisitions. At least until 1980 the IRS took the position that (d)(3) applied to all inter-group transactions and all intra-group transactions other than (d)(2)(ii) downstream mergers (*e.g.*, when *P* merges into *T* with *T* as the survivor). *See, e.g.*, Priv. Ltr. Rul. 80-46-065 (Aug. 21, 1980) (ruling that an intra-group stock exchange of the type involved in Rev. Rul. 82-152 was a (d)(3) reverse acquisition).

provided by the regulations governing the determination of the SRLY limitations in intra-group reverse acquisition transactions.[49] It is far more logical to limit the application of the SRLY provision, (f)(3), to inter-group reverse acquisitions, than to indulge in the elaborate interpretive rewriting of (d)(2)(ii) found in Revenue Ruling 82-152.

A return to the prior position of the IRS, coupled with the proposed change in (f)(3), adheres to the literal language of the regulations and prevents the weighing of substance and form necessitated by Revenue Ruling 82-152. As applied to the Example, the merger of *T* into *P*, with *P* as the survivor, is governed by (d)(3). The transaction is a reverse acquisition and the old *P* group survives with *S-1* as the new common parent. The proposed change in the rules of (f)(3) prevents any of the constituent corporation's taxable years from being classified as SRLY years. The subsequent spin-off of *P* and *S-2* does not affect this result because, unlike the (d)(2)(ii) rules, there is nothing in the language of (d)(3) requiring the old common parent to terminate. Thus, the spin-off, although a part of the restructuring, should be treated for consolidated return reporting purposes as a divisible transaction,[50] which, pursuant to the general rule of (d)(1) as modified above,[51] would permit the new group of *P* and *S-2* either to file on a consolidated return basis or to file separately.

The application of (d)(2)(ii) to intra-group transactions will be limited to those transfers in which the surviving corporation is not the old

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49. Treasury Regulation § 1.1502-1(f)(3) (as amended in 1973) [hereinafter (f)(3)] provides that a (d)(3) transaction causes the prior taxable years of the first corporation, *S-1* in the Example, and its subsidiaries to be treated as SRLY years. This is viewed as anomalous for an intra-group transaction. *See* J. CRESTOL, K. HENNESSEY & A. RUA, *supra* note 15, § 2.04(c).

As applied to the facts of the Example, if the merger of *T* and *P* is considered a reverse acquisition under (d)(3), the existing provisions of (f)(3) would characterize all of the taxable years of *S-1* and its subsidiary, *S-3*, ending prior to the merger as SRLY years so that a net operating loss carryover from either corporation could be utilized only against their respective contributions to consolidated net income, whereas the net operating loss carry forwards of *P* and *S-2* would not be subjected to SRLY limitations. This is a clearly inappropriate result because these corporations were all members of the same affiliated group for the entire taxable year which satisfies one of the exceptions to SRLY classification.

50. *Cf.* Reef Corp. v. Commissioner, 368 F.2d 125 (5th Cir. 1966), *cert. denied*, 386 U.S. 1018 (1967) (a stock redemption occurring in connection with a reorganization functionally unrelated to the reorganization exchange and taxed pursuant to I.R.C. § 302 rather than as boot under I.R.C. § 356).

51. See *supra* notes 23-31 and accompanying text in which it is recommended that (d)(1) be changed to account for the functional successor of the old common parent in divisive reorganization transactions determined by which of the constituent corporations succeeds to the majority of the business assets of the old group. In the Example, the spin-off of *P* and *S-2* involves approximately 10% of the aggregate business assets of the group, and thus, *S-1* would continue as the parent of the group after the spin-off which follows the reverse acquisition. As a consequence, *P* is entitled to a new election as the parent of a new affiliated group which includes *S-2*.

common parent.[52] The need to expand the language of that regulation to embrace intra-group transactions excluded specifically from its coverage will be eliminated. This may provide an additional administrative benefit to the IRS. At present, a taxpayer can rely on the substance over form rationale of Revenue Ruling 82-152 or, in contrast, attempt to hold the IRS to the literal language of its regulations.[53] This provides the taxpayers with an unintended election and places the IRS at the risk of being whipsawed because IRS relies on substance over form in contradiction with the precise language of the regulations. The recommended changes will harmonize the regulatory language with the substantive result intended and thereby eliminate this unintended option.

IV. Conclusion

The regulatory pattern governing the continuation of a consolidated group is rife with contradiction and inconsistency when applied to intra-group divisive transactions. In order to bring the three substantive rules into harmony, it is recommended that the general rule of (d)(1) be modified to create a specific exception for divisive transactions. The general rule should not depend upon continuing corporate existence, but rather should depend upon a more substantive basis—that being, which one of the constituent corporations possesses the principal (more than fifty percent) business assets of the group. The regulations also should be modified to eliminate application of the SRLY rules to intra-group divisive restructurings in order to permit the reverse acquisition provisions of (d)(3) to apply without anomalous results. This modification will obviate the need to rely on the substance over form analysis in Revenue Ruling 82-152 that contravenes the specific language of the regulations, and will permit that ruling to be revoked. It also will allow (d)(2)(ii) and (d)(3) to be interpreted literally and consistently with (d)(3)(iv) in situations in which the two provisions overlap. Any remaining inconsistencies should be resolved in con-

52. This would encompass an acquisitive reorganization pursuant to I.R.C. § 368(a)(1)(C) or (D) (P-H 1987) or a reverse merger pursuant to I.R.C. § 368(a)(1)(A) and (2)(D) as well as any transfer of assets to other corporations in the affiliated group in a nonreorganization transaction. As previously indicated, in those situations in which the old common parent makes such a transfer and continues in existence there is a conflict between (d)(1) and (d)(2)(ii) that should be resolved, based on the recommended change in (d)(1), in favor of (d)(2)(ii). There would no longer be an additional conflict between (d)(2)(ii) and (d)(3) in these circumstances as (d)(3)(iv) would control and thereby mandate the application of (d)(2)(ii) as was apparently intended on promulgation of (d)(3)(iv).

53. *See* Woods Inv. Co. v. Commissioner, 85 T.C. 274 (1985) (consolidated return regulations must be applied literally).

formity with rules of statutory interpretation[54] by applying the more specific rule over the more general.

54. *See* Bulova Watch Co. v. United States, 365 U.S. 753, 761 (1961).