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F Reorganizations and Double Dummies

LTR 201222014 ruled that persons contributing property to a new corporation in exchange for stock can form a control group with other persons contributing the stock of another corporation (target), and therefore enjoy Section 351 nonrecognition treatment. This might seem obvious to practitioners familiar with combined reorganization/351 contributions that were first treated favorably under Section 351 by LTR 9143025. The transaction often takes the form of a double dummy drop down, whereby a new holding company puts the contributed property in one subsidiary and holds the acquired target corporation as the other subsidiary.

Specifically, the ruling held that a reverse triangular merger that qualified as a reorganization under Section 368(a)(2)(E) could be treated as a contribution of stock by the target's shareholders and combined with other direct contributions to the holding company for purposes of obtaining 80 percent control of the holding company and Section 351 nonrecognition for the contributors of the other property. The ruling did not treat the merger as both a Section 351 and 368(a)(2)(E) nonrecognition event, but rather as a Section 351 event solely for purposes of satisfying the 80 percent control group test for the other contributors.

The deeming of a reorganization exchange to be part of another contributor's property exchange for Section 351 purposes was extended to a forward merger in LTR 200136023, in which mergersub merged into target and then target merged into holding company. It deemed the target's asset transfer in the second merger to be part of the other person's Section 351 exchange of property for stock of the holding company. That ruling was a precursor of Rev. Rul. 2001-46. However, if the transaction had been a forward subsidiary merger of target into mergersub of holding company, it would not have worked, because nothing on the side of the target was contributed to the parent for Section 351 purposes. *See* Rev. Rul. 84-44, 1984-1 CB 105.

The F Reorganization

There is, though, one scenario in which the recharacterization described above will not work to create a Section 351 exchange: when the part of the two-step transaction that is treated primarily as a reorganization is an F reorganization. In that case, the other person contributing property to the new corporation is simply contributing property to the corporation that reorganized, and unless the person obtains 80 percent control by itself, it will not qualify for a Section 351 exchange.

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Rev. Rul. 68-349, 1968-2 C. B. 143, illustrates the F reorganization case, but is not entirely clear about its grounds. It first states that there was no business purpose to create the new corporation, and that it was done to assist the property contributor in claiming Section 351 control. Then it says the new corporation was just a continuation of the old corporation. Finally, it says the old corporation engaged in an F reorganization.

All it needed to say was that the old corporation engaged in an F reorganization—that meant that the new corporation was a continuation of the old corporation. Moreover, even F reorganizations require a business purpose, so the prior statement about business purpose cannot have meant there was absolutely no business purpose and should be viewed as surplusage.

Business Purpose

Unfortunately, the confusion about business purpose was deepened by Rev. Rul. 76-123, 1976-1 C. B. 94, which approved a combination C reorganization and Section 351 exchange, where two shareholders contributed all the stock of two corporations to a new corporation and one of the old corporations liquidated. The liquidating corporation got the C reorganization treatment and the other corporation's shareholder got the Section 351 treatment. The distinction between this ruling and Rev. Rul. 68-349 was said to be that there was a business purpose for the liquidation; the shareholders wanted to maintain the separation of two corporations but reincorporate one in a different state (the one that reorganized).

That is a pretty thin business purpose. Indeed, it does not appear to be the proper analysis of Rev. Rul. 68-349. GCM 37897 (3/23/79) stated that Rev. Rul. 68-349 must have involved a de minimis contribution of property, because only if the property contribution had been de minimis could there have been an F reorganization under then-existing law. That GCM was revoked on other grounds by GCM 38537.

The currently proposed F reorganization regulations, Prop. Reg. 1.368-2(m) (2004), similarly would not allow more than a de minimis amount of newco stock to be issued in conjunction with an F reorganization.

If the other property contributor puts so much value into a new holding company that a direct asset reorganization into that holding company cannot be an F reorganization as to the target corporation, then it either will be no reorganization at all—in which case, Section 351 should apply—or it will be an A, C or D reorganization—in which case, LTR 200136023 stands for the proposition that it can be a combination 351/368 transaction.

Conclusion

A double dummy drop down, or even a single dummy, or no dummy, can qualify as a combined Section 351/368 transaction. Care must be taken, however, to avoid the F reorganization and the transaction in which property is not transferred to the same corporation from each side of the transaction.

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