SPECIAL REPORT
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Uncovering the Cracks in *Granite Trust* Transactions

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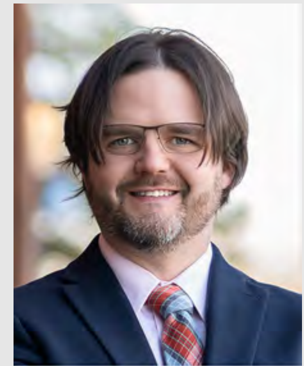
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In this report, the authors trace the evolution of problematic tax planning strategies that pair *Granite Trust* transactions with basis shifting under section 304, and they evaluate various legislative and administrative approaches to close this enforcement gap.

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I. Introduction

In 1956 the First Circuit decided *Granite Trust*,[1] ruling that transfers by an owner of 20.5 percent of a subsidiary's stock before the liquidation of the subsidiary would be respected, despite being solely motivated by the taxpayer's desire to recognize unrealized loss attached to the stock. The court determined that the preliquidation transfers to friendly parties were bona fide and allowed the recognition of the taxpayer's losses, even though the transactions had minimal economic substance.

In the years since, so-called *Granite Trust* transactions have become a widely used and

[1] *Granite Trust Co. v. United States*, 238 F.2d 670 (1st Cir. 1956), *vacating* 150 F. Supp. 276 (D. Mass. 1955).

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accepted staple of tax planning, permitting taxpayers to selectively recognize built-in losses. Modern *Granite Trust* transactions typically accomplish their objectives through sales to a related party controlled by the owner. As a result, this loss recognition can be accomplished with minimal, if any, disruption to the functional economics and activities of the relevant business.[2]

For many years, taxpayers paid a mild price for the convenience of *Granite Trust* transactions. Because more than 20 percent of stock must be divested by the taxpayer to recognize its loss on the liquidation, taxpayers generally had to defer more than 20 percent of that built-in loss when using related parties, effectively haircutting the recognized loss. However, taxpayer strategies have evolved (in part, thanks to certain IRS rulings issued in the 2010s), such that taxpayers now use potential basis shifting under section 304 to push for the immediate recognition of over 100 percent of the built-in losses in some circumstances. This new paradigm takes advantage of cross-border subsidiary relationships and U.S. international tax law to maximize a multinational group's ability to generate losses and therefore minimize tax.

In short, the *Granite Trust* decision and its subsequent interpretation have led to a regime that generally permits loss recognition by corporate groups at the election and convenience of the taxpayer. The losses at issue here are theoretically real and economic built-in losses; therefore, *Granite Trust* transactions generally present a timing issue, with current interpretation permitting what is effectively an acceleration of the loss.

While this status quo is long-standing, it remains at odds with the broader and more appropriate approach in the code, which generally attempts to require real economic shifts in a taxpayer's business or assets before allowing losses to be recognized. It is also at odds with the code's general disallowance of the recognition of losses when the relevant assets remain within an affiliated group.[3] There is no logical reason that a liquidation within a group should have a different result than other in-group transactions.

Transactions that allow related parties to recognize tax benefits without meaningful economic consequences deserve careful scrutiny and consideration by the IRS, Treasury, and Congress. Transactions between related parties that taxpayers argue entitle them to noneconomic tax benefits, such as those that could result through basis shifting under section 304, should be scrutinized even more heavily. Regulatory and legislative changes are appropriate to eliminate this elective (and sometimes noneconomic) recognition of losses, and the IRS should simultaneously pursue transactions that step over the line from currently lawful tax avoidance into abusive interpretation of the law.

This report begins with a history of *Granite Trust* transactions and some of the relevant IRS interpretations that have resulted in modern transaction structures maximizing a taxpayer's tax avoidance potential. Next, it examines an example transaction to describe modern tax planning strategies using related parties and section 304 to arguably accomplish loss recognition in excess of the planning available under a base *Granite Trust* transaction. This report then highlights various arguments available to IRS enforcement to cut down on transactions that do not comply with current law. Finally, we describe possible regulatory and legislative changes to address *Granite Trust* transactions.

II. *Granite Trust* Transactions

Granite Trust transactions were born out of tax planning opportunities presented by section 112(b)(6) of the Internal Revenue Code of 1939, the predecessor to current section 332. Former section 112(b)(6) largely resembled section 332, which requires nonrecognition treatment for complete liquidations when the receiving corporation owns

[2] This is already a significant expansion of the original *Granite Trust* decision, which respected sales and gifts to unrelated (but friendly) entities. However, because the underlying *Granite Trust* logic did not rest on relatedness, sales to related parties have become an accepted norm.

[3] *See, e.g.*, section 267(a)(1).

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80 percent or more of the stock on the date of the adoption of the plan of liquidation and through the liquidation itself.[4] Liquidations not subject to section 332 are governed by section 331, under which amounts distributed from the liquidating entity are treated as full payment in exchange for the stock of the shareholders, with the shareholders recognizing gain or loss on this exchange.

In *Granite Trust*, the Granite Trust Co. (GTC), the taxpayer bank, owned 100 percent of a subsidiary established in 1928 to acquire land and construct an office building that would be used by GTC to operate its bank. The subsidiary's stock was later written down at the behest of banking regulators to well below what GTC had paid, leading to significant built-in losses. Sometime before October 1943, GTC formulated a plan to purchase the subsidiary's assets and eventually liquidate it. In December 1943, to avoid nonrecognition under section 112(b)(6), GTC divested 20.5 percent of common shares of the subsidiary through a series of sales and gifts to unrelated (but "friendly") corporations, individuals, and nonprofit entities, and then recognized its built-in losses in the subsidiary upon liquidation.

On appeal, the IRS argued that the preliquidation transfers were invalid because they (1) used meaningless, intermediary steps to recognize a loss; and (2) in effect lacked substance because the sales and gifts were motivated "solely by tax considerations," without beneficial ownership ever passing. The First Circuit rejected those arguments.

As to the step transaction theory, the court emphasized the "rigid" conditions of section 112(b)(6) that must be met to trigger nonrecognition, rendering this theory, in the eyes of the court, essentially moot. The court also pointed to the later amendments to section 112(b)(6) in 1954 (restated under section 332), which, according to the Senate Finance Committee, left the remaining "elective features" of that section alone.[5] The court concluded that "Congress was primarily concerned with providing a means of facilitating the simplification of corporate structures," with the implication that loss planning should be accommodated.[6]

As to the lack of substance, the court held that the tax avoidance motive was not grounds for invalidating the transactions, holding instead that the sales and gifts were bona fide transactions.[7] Despite the fact that none of the buyers invested in an ongoing business for more than a few days and that they received their money back almost immediately when the target liquidated, the court viewed the brief ownership period of the buyers as exposing them to meaningful enterprise risks and the consequences of ownership.

Taxpayers have since pushed the use of *Granite Trust* to its limits (and in some cases, beyond). The transaction structure has now been established as a well-trodden and minimally disruptive method of recognizing built-in losses.[8] The IRS has also published nonprecedential

[4]The main difference between section 112(b)(6) and section 332 as enacted in 1954 was that Congress removed one of the conditions precedent to nonrecognition under section 112(b)(6)(A). Under the prior law, any stock sales between the adoption of a plan of liquidation and the receipt of property would have triggered recognition on the liquidation. Under current law, only sales that reduce the applicable ownership percentage below 80 percent trigger recognition.

[5]The amendments to section 112(b)(6) also codified the holding in an earlier case, *Commissioner v. Day & Zimmerman Inc.*, 151 F.2d 517 (3d Cir. 1945), in which a taxpayer avoided nonrecognition by selling shares of its subsidiary at auction to its treasurer to reduce its holdings below 80 percent. The Third Circuit held that the sale was bona fide because the price was fair, and there was no evidence that the treasurer had been directed to purchase the shares or that the taxpayer would retain any interest in the shares after the sale.

[6]*Granite Trust*, 238 F.2d at 675.

[7]The court cited *Sawtell v. Commissioner*, 82 F.2d 221, 222 (1st Cir. 1936); *Jones v. Grinnell*, 179 F.2d 873, 874 (10th Cir. 1950); and *Gregory v. Helvering*, 293 U.S. 465 (1935), for the proposition that planning to "minimize or avoid taxation" is not illicit. *Granite Trust*, 238 F.2d at 675.

[8]Successful challenges to transactions resembling *Granite Trust* are rare. One such example is *Associated Wholesale Grocers Inc. v. United States*, 927 F.2d 1517 (10th Cir. 1991). There, the taxpayer-parent sold shares in one of its subsidiaries to an unrelated entity but then repurchased the subsidiary's assets from the entity immediately after liquidation as part of a prearranged plan to recognize losses. As a result of the postliquidation repurchase, the Tenth Circuit found that the preliquidation transfer was merely transitory, and it denied recognition of the subsidiary's built-in losses. Considering the precedential value of *Granite Trust*, the Tenth Circuit concluded that "because *Granite Trust*'s decision in favor of the taxpayer hinged on a provision which is no longer present in the Code, *Granite Trust* is not dispositive in this case. However, to the extent that the *Granite Trust* court discussed provisions of section 112(b)(6) which are still contained in modern section 332, some of its reasoning is persuasive." *Id.* at 1523-1524.

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authority that facilitates *Granite Trust* transaction planning, including several private letter rulings[9] and field service advice,[10] which permitted loss recognition on *Granite Trust* transactions that occur solely among related entities.[11]

Granite Trust transactions that make use of related parties are also subject to a different set of rules. One key difference is the treatment of the preliquidation sale. When a third party is used, the sale is generally taxable and permits the selling shareholder to recognize its built-in loss in an amount equal to the percentage of stock sold. Final regulations issued in 2012 concluded that when a related party is used, the recognition of losses on that preliquidation sale is deferred and cannot be used by the taxpayer.[12] These final regulations codified the prior conclusion in chief counsel advice,[13] which determined that the preliquidation-sale stock loss is deferred and not deductible, applying aspects of the consolidated return regulations.[14] This treatment is effectively a haircut on the amount of loss that can be recognized in the transaction, limiting and deferring the realized loss by the percentage sold to a related party in the preliquidation sale.

While this related-party aspect of *Granite Trust* transactions is now long-standing, it creates additional issues. Viewed on an entity-by-entity level, there is no difference between a related party and the accommodation parties used in the original *Granite Trust*. But viewed at the group level, there are substantial differences. The group's profile of enterprise risk generally remains unchanged from before the transaction, and all the relevant assets of the business remain under the same common control. As a result, there is substantially less actual disruption to the business when using a related party to effect the transaction.

There is, however, no clear path under the applicable code sections to broadly disallow related-party transactions. Section 332 does not treat as relevant whether the transferor and transferee are related parties and is not informed by general constructive ownership rules. Moreover, the separateness of corporate entities despite common control is an even more long-standing principle of tax, and absent unusual circumstances, it will generally be respected.[15]

The key policy question, therefore, is whether the real economic built-in loss of the corporate group should be recognizable without a meaningful economic change to the corporate group's business, or whether recognition of the loss should be deferred until the relevant assets are disposed of outside the affiliated group in an economically significant arm's-length transaction.

III. *Granite Trust*/Section 304

In 1954, the same year Congress added section 332 to the code, Congress added section 304 to close tax loopholes deriving from stock sales between related corporations. Section 304 treats certain stock sales between brother-sister corporations and parent-subsidiary corporations as redemptions that are distributions treated as either dividends or payments in exchange for stock.

Taxpayers and their counsel have since realized that section 304 may present significant

[9] *See, e.g.*, LTR 201330004 (ruling that a preliquidation sale of stock would be subject to section 304 and taxable as a dividend under section 302(d) even though the selling corporation later liquidates as part of the same plan); LTR 201252008 (ruling that preliquidation sales of foreign corporations were subject to section 304 and permitting loss recognition on later liquidation of a foreign corporation resulting from a check-the-box election); LTR 201014002 (ruling that neither section 332 nor section 368(a)(1)(C) applied to the deemed liquidation, citing *Granite Trust* and permitting recognition of losses).

[10] FSA 200148004.

[11] FSA 200148004 also blesses another feature of modern *Granite Trust* tax planning: the use of a check-the-box election to force a deemed liquidation as part of a conversion of an eligible entity into a partnership. For nontax reasons, we would expect this will often be the preferred method of liquidating the applicable entity because it permits the entity's name to continue to be used for various purposes. While this alternative is not permitted for per se corporate entities, eligible entities such as limited liability companies with two or more owners are permitted under the check-the-box regulations to elect to be taxable as partnerships. *See* reg. section 301.7701-3 (2006). This election results in a deemed liquidation for tax purposes, followed immediately by a contribution of the entity's assets by the owners to a newly formed partnership. This treatment permits the recognition of losses under section 331 without an actual liquidation of the entity.

[12] T.D. 9583, 77 F.R. 22480 (Apr. 16, 2012).

[13] ILM 201025046.

[14] Some taxpayers at the time argued that these regulations were not permitted given the holding in *Granite Trust*, but Treasury concluded in the preamble to the final regulations that "the rules contained in the proposed regulations and these final regulations are consistent with applicable case law. These rules are intended to address the timing for taking into account a loss on a sale of property between members of a controlled group, and do not relate to whether a liquidation otherwise results in the recognition of a loss." Preamble to T.D. 9583, 77 F.R. at 22481.

[15] *See, e.g.*, *Moline Properties Inc. v. Commissioner*, 319 U.S. 436 (1943).

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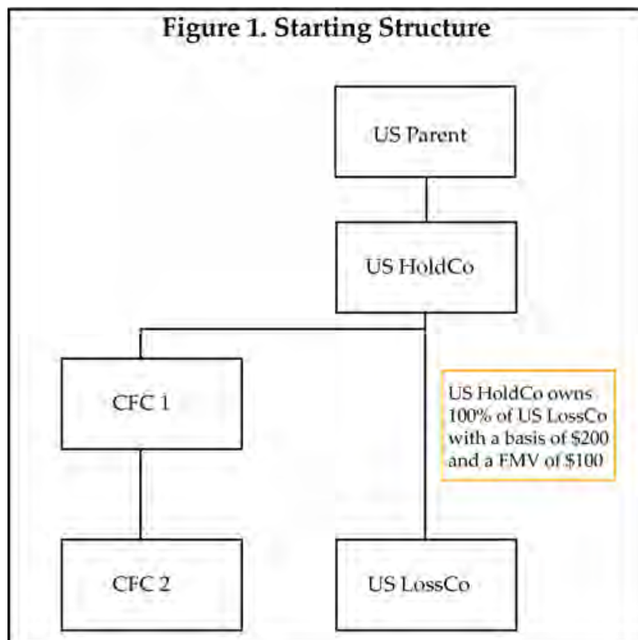
basis planning opportunities when paired with a *Granite Trust* transaction.

Consider the following fact pattern.

Example 1. US Parent undergoes a transaction generating a significant amount of capital gain. Likely before this transaction, US Parent begins discussions with its tax advisers to minimize the cash tax burden this gain will impose on its group. US Parent is advised to consider a *Granite Trust* transaction as a way to generate a taxable loss to offset the gain. US Parent identifies an indirect domestic subsidiary with a built-in loss (US LossCo), with a basis of $200 and a fair market value of $100. With the help of its advisers, US Parent begins to structure a transaction. It also identifies a wholly owned subsidiary controlled foreign corporation (CFC 1) and its subsidiary foreign corporation (CFC 2).

The group's relevant structure is represented in Figure 1.

Figure 1. Starting Structure



The taxpayer then undertakes the relevant steps to complete the *Granite Trust* transaction. First, US HoldCo sells 30 percent of US LossCo stock to CFC 2. Following the sale, US HoldCo authorizes the liquidation of US LossCo. These steps are shown in Figure 2.

If section 304 did not apply to the related-party sale between US HoldCo and CFC 2, the consequences would generally mirror those in the original *Granite Trust* case, though subject to the haircut described earlier in this report. It is also worth noting that section 304 can be planned around relatively trivially to avoid any dividend inclusion on the preliquidation sale. Generally, this is accomplished through the use of nonqualified preferred stock, which is not property within the meaning of section 304 — a result that has been blessed by the IRS.[16] The consequences of this related-party transaction avoiding section 304 are described in Figure 3.

However, unless section 304 is affirmatively structured around, because section 304 generally applies to a related-party stock sale between US HoldCo and CFC 2, the first step of the transaction will be recharacterized as a distribution in redemption of CFC 2 stock. This recharacterization is shown in Figure 4.

The tax treatment of the distribution in redemption from CFC 2 to US HoldCo depends, according to section 304, on the results of the tests under section 302, but they are measured against US HoldCo's post-transaction ownership of US LossCo.[17] Section 302 incorporates various tests to determine whether a redemption should be taxed as a dividend or as a sale, though generally the tests all look for a meaningful change in the ownership percentage after the redemption. When there is no meaningful change in ownership, the redemption is generally taxable as a dividend. Critically, the section 302 tests take into account constructive ownership. As a result, CFC 2's shares of US LossCo newly purchased from US HoldCo will be reattributed back to US HoldCo. Therefore, when tested immediately after the preliquidation sale, there is no shift in US HoldCo's deemed ownership of US LossCo. There are important counterarguments to this characterization and analysis, discussed in detail in Section IV, but under the taxpayer's interpretation, the deemed payment in redemption results in the presumptive payment of a dividend.

[16] *See, e.g.*, LTR 201419011; and Jasper L. Cummings, Jr., "Nonqualified Preferred Stock Is Nuts," *Tax Notes Federal*, Apr. 8, 2024, p. 321.

[17] Section 304(b)(1) applies section 302(b) for the determination of whether the deemed redemption is treated as a dividend or exchange, but "by reference to the stock of the issuing corporation." Section 304 generally uses the following terms to describe the three relevant entities involved in the structure; the "transferor" (US HoldCo), the "acquiring corporation" (CFC 2), and the "issuing corporation" (US LossCo).

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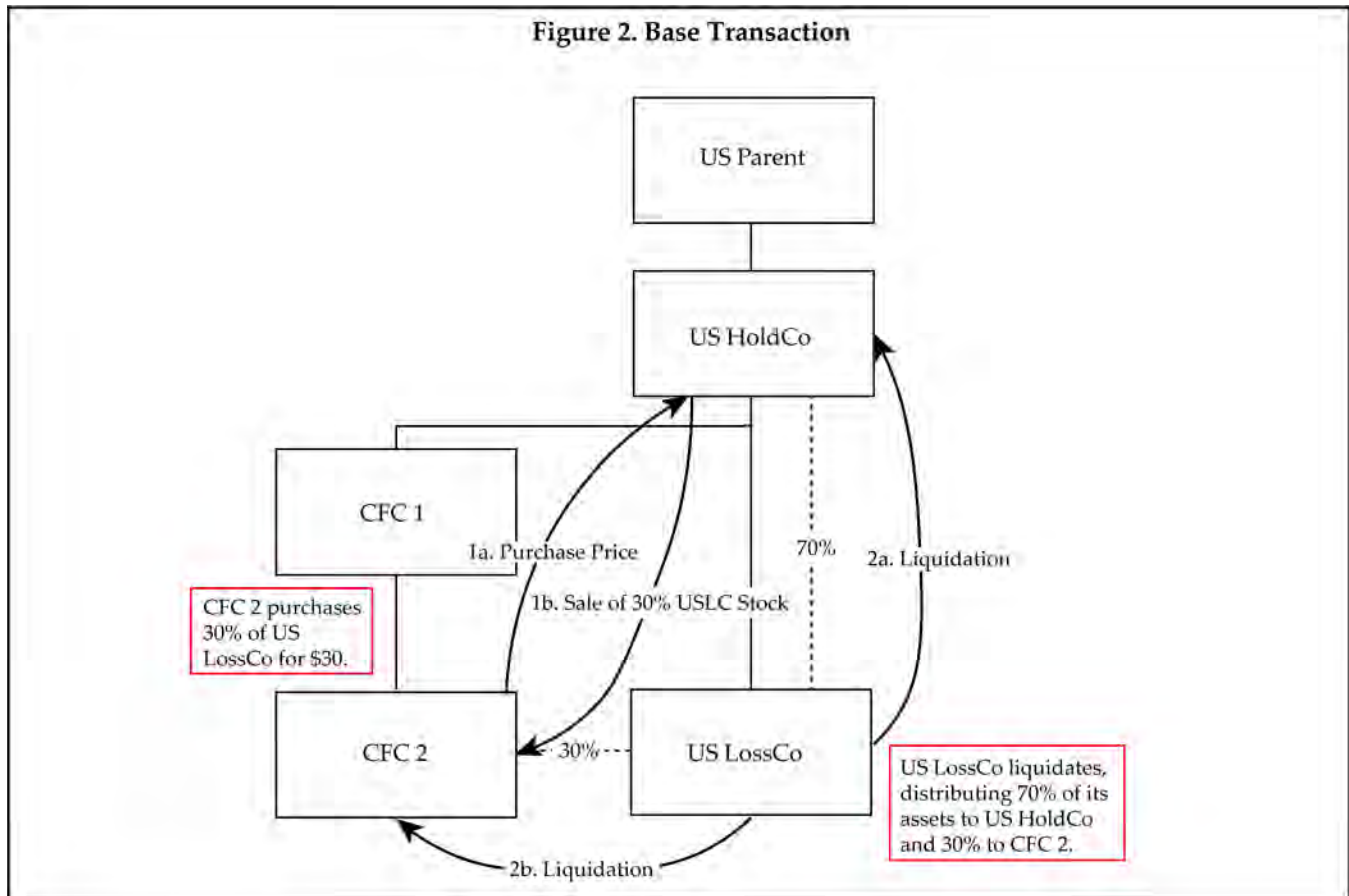

CFC 2 and US LossCo must have, on an aggregate basis, adequate earnings and profits to absorb the payment of the deemed dividend.[18] But having selected CFC 2 purposefully to ensure that this is the case, the taxpayer will take the position that the distribution in redemption to US HoldCo is taxable as a dividend.[19]

LTR 201330004 considered the question of a section 304 deemed redemption in the context of a broader *Granite Trust* transaction. The taxpayer disclosed the possibility of a liquidation following the related-party stock sale (representing that any affirmative plan to liquidate would not be adopted and that a liquidation would not occur for at least one day after the stock sale). Nonetheless, the letter ruling concluded that section 304(a)(1) applied to the stock sale and that the deemed distribution in redemption would be treated as a dividend under section 302(d).

The question then is how much loss US HoldCo (or US Parent's consolidated group) recognizes on the liquidation. That depends on US HoldCo's basis in its remaining US LossCo shares. Section 304 does not address this scenario. It only provides that in the event of a deemed dividend, the basis of the stock the transferor holds in the acquiring corporation is increased by the basis of the stock that the transferor surrendered in the acquisition.[20] However, under these facts, US HoldCo as transferor does not retain any shares in the acquiring corporation, CFC 2. This area of the law is uncertain, but the most recent guidance indicates that the basis may

[18] Section 304(b)(2)(B).

[19] Available foreign E&P might be scarcer in the wake of 2017's Tax Cuts and Jobs Act because the majority of foreign E&P may now be from so-called qualified business asset investments and used to offset tested losses under the global intangible low-taxed income regime. It remains unclear, however, whether there has been a meaningful reduction in the number of *Granite Trust* transactions being undertaken in the last several years.

[20] Reg. section 1.304-2(a). The regulation further provides that the acquirer treats the acquired shares as a contribution of capital, and it references section 362(a) for determining the basis of those shares. *See also* reg. section 1.302-2(c).

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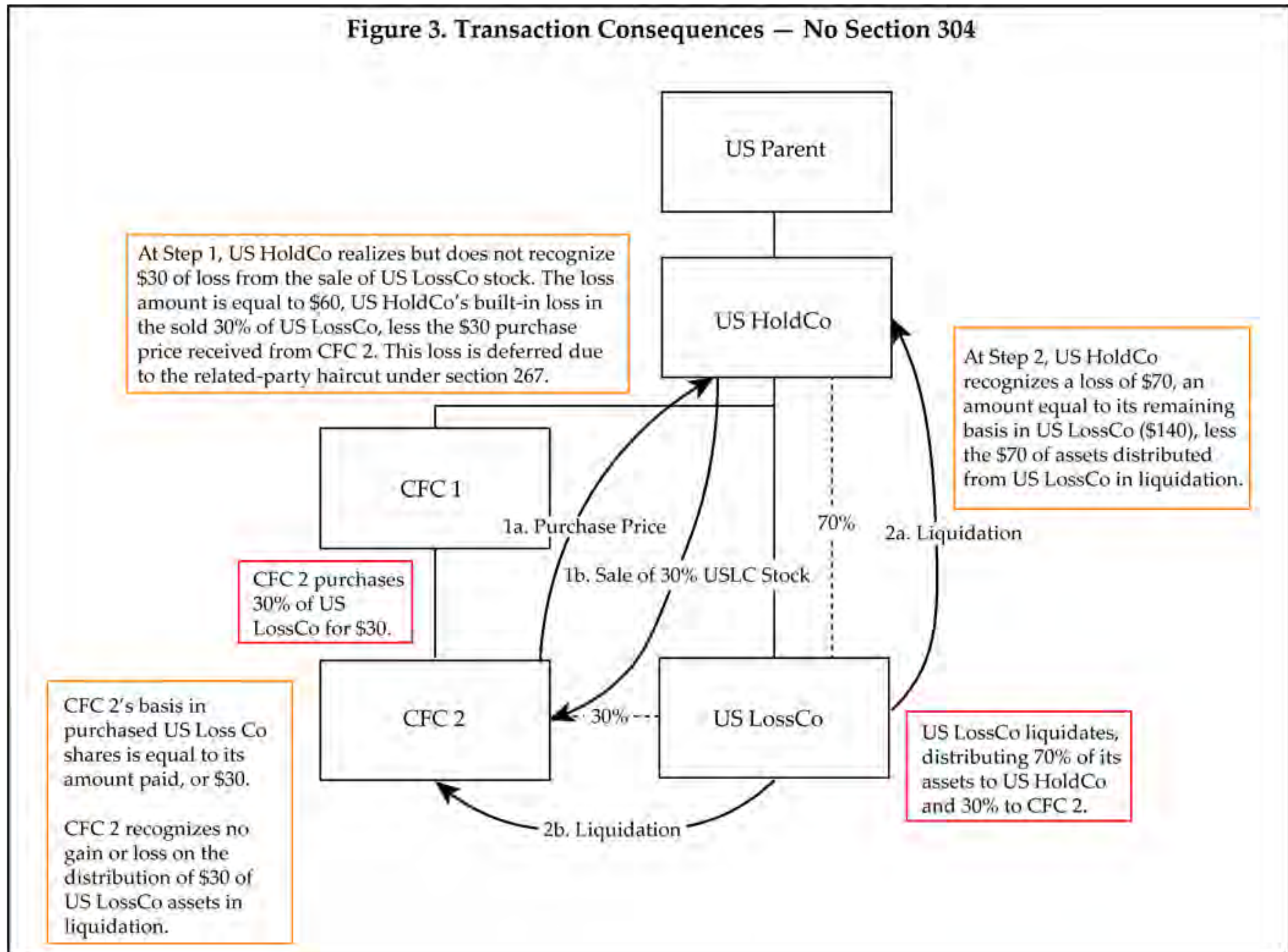

snap back to US HoldCo's retained shares in US LossCo. Rev. Rul. 71-563, 1971-2 C.B. 175, involved a transfer of stock from a father to a corporation owned by his son. Because the father did not own any shares in his son's corporation (other than through attribution from his son), the general basis rule, which would have applied the transferred basis to the father's nonredeemed shares in the son's corporation, could not apply. The ruling concluded that the father should add his transferred basis to his retained shares in the target corporation. The ruling simply concludes that the general rule cannot apply to the transaction and offers no specific rationale for this result.[21]

The facts in Rev. Rul. 71-563 are clearly distinguishable from the facts in the example *Granite Trust* transaction, but taxpayers may try to analogize the basis shift from this ruling to the *Granite Trust* transaction.[22] Under that interpretation, US HoldCo would arguably be permitted to add the transferred basis to its retained shares in US LossCo. When US LossCo liquidates, US HoldCo will receive 70 percent of US LossCo's assets (based on its then-percentage ownership of the underlying stock) and will determine its gain or loss on the liquidation by reference to its basis in US LossCo, which, under this interpretation, has been increased by US

[21] The rationale of this ruling and its potential impact on section 304 planning is helpfully described in Cummings, "Section 304 Games," Lexology, Oct. 23, 2013.

[22] Taxpayers may also point to reg. section 1.302-2(c), but the text and examples of this regulation do not directly address these circumstances.

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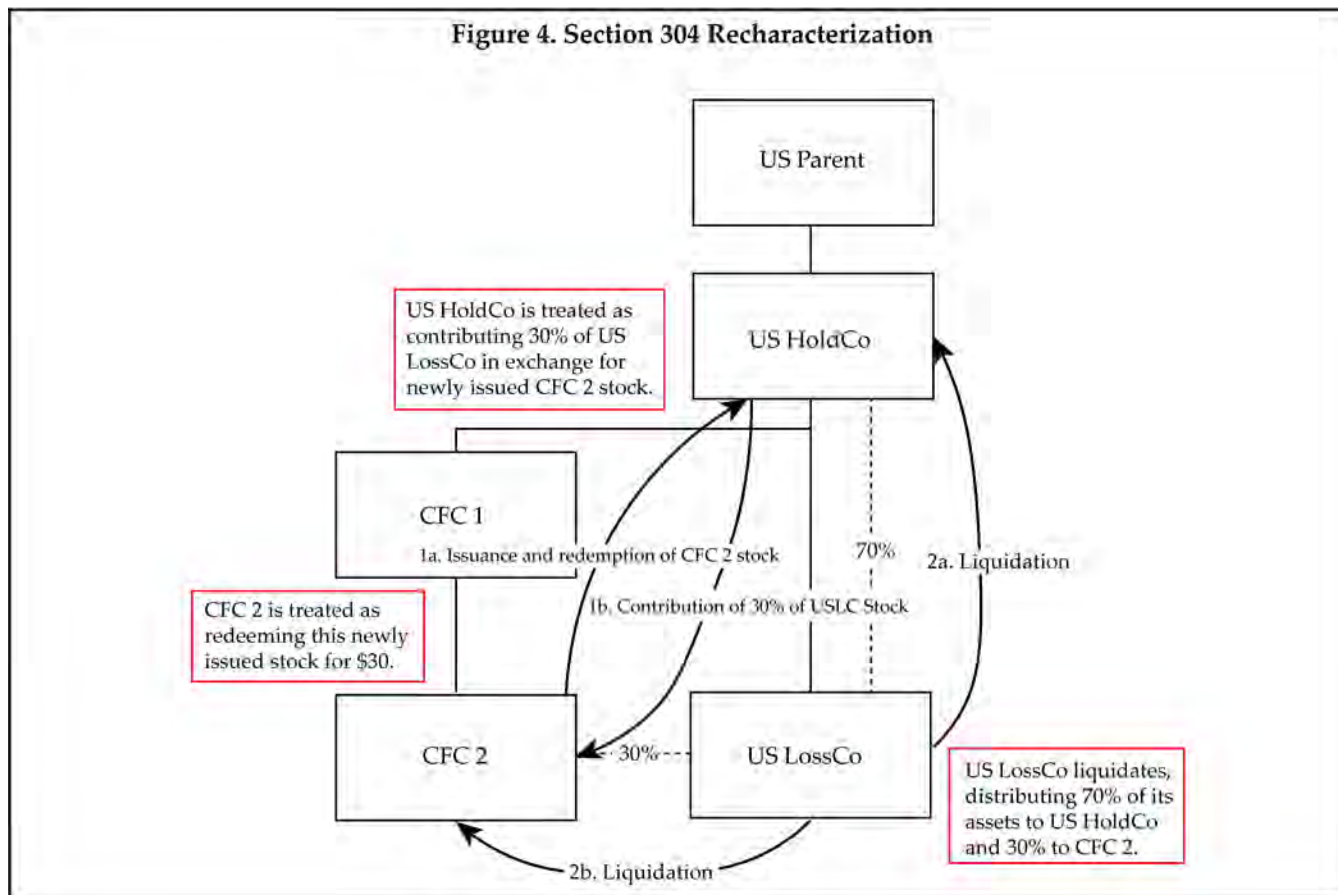

HoldCo's short-lived basis in the CFC 2 shares deemed issued under section 304.[23] As a result, based on US HoldCo's basis of $200 in US LossCo, US HoldCo will recognize a loss of $130. That is an improvement of $30 on the loss that would have been recognized if US HoldCo had simply sold all of US LossCo to a third party. These consequences are described in Figure 5.

This result is not entirely without justification — after all, US HoldCo has a current income inclusion equal to the deemed dividend received from CFC 2 on the preliquidation sale of US LossCo stock. In that sense, the group as a whole is paying for this additional loss. But that justification disregards the reality that US HoldCo can generally avoid tax on this dividend. About a decade ago, when this characterization was first raised, advisers assumed that otherwise unused foreign tax credits could be used to offset gain on the dividend inclusion.[24] Now, in light of the participation exemption introduced in the Tax Cuts and Jobs Act, US HoldCo may also be able to receive a 100 percent deduction on dividends received from a CFC.[25] And even if the taxpayer includes the dividend as income without deduction and therefore offsets a portion of the loss on liquidation, if the basis shifts the taxpayer will still be able to avoid the deferral haircut on the portion of its built-in loss sold in the preliquidation sale.

Provisions designed to police basis shifting under section 304 do not appear to be effective in shutting down these *Granite Trust* transactions. Section 1059 reduces basis in shares on which a so-called extraordinary dividend is paid when tax on that dividend is offset through a dividends received deduction, including under section

[23] One potential alternative would be to assign the orphaned basis to CFC 2's newly acquired shares in US LossCo because the attribution of those shares back to US HoldCo is what drives the characterization of the redemption as a dividend under section 302.

[24] *See, e.g.*, Amy S. Elliott, "*Granite Trust*-Type Ruling May Accelerate Losses if Basis Hops," *Tax Notes*, Oct. 28, 2013, p. 367.

[25] *See* section 245A.

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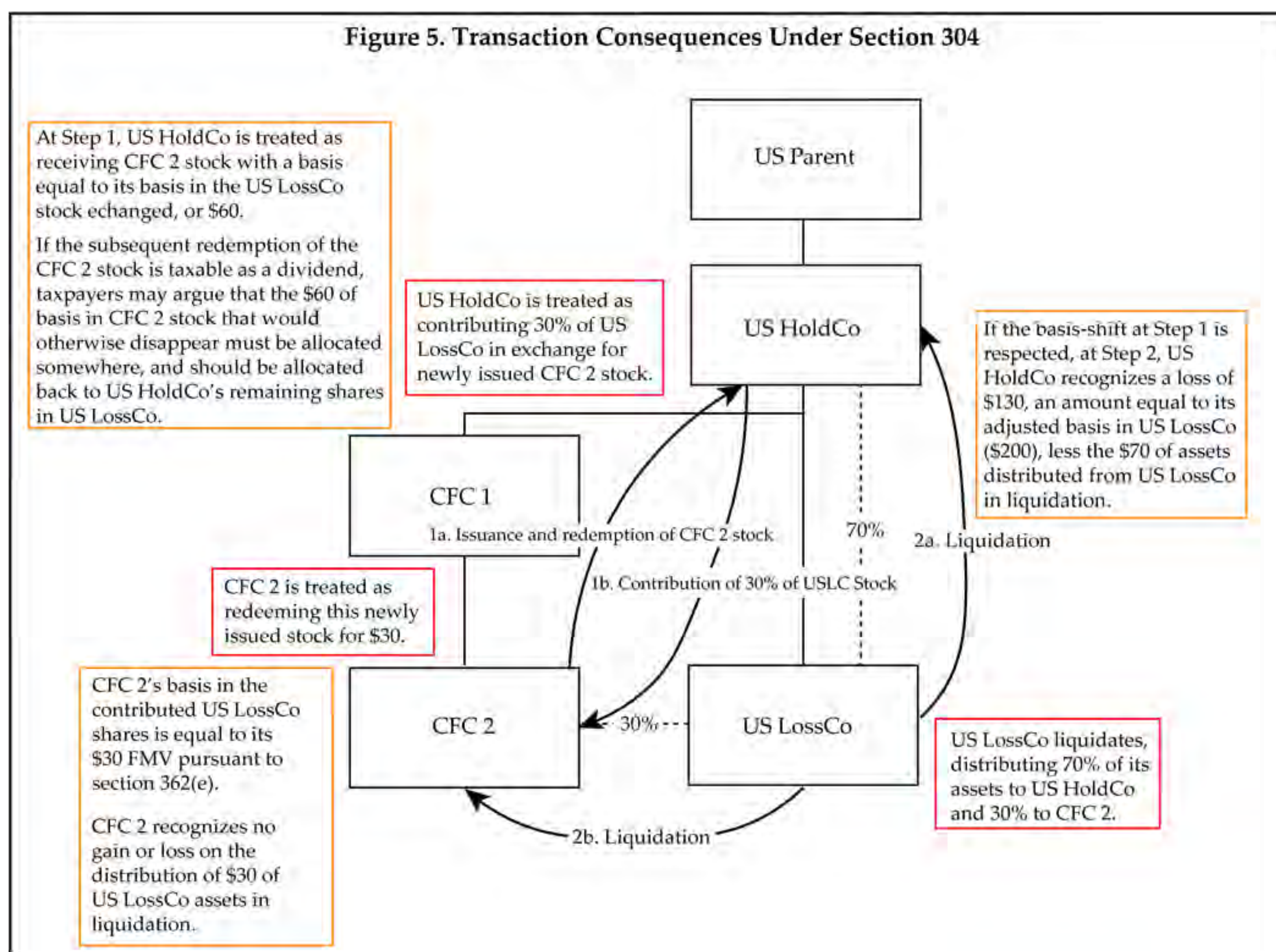

245A. Generally, deemed dividends under section 304 are per se extraordinary under section 1059(e) and therefore subject to a reduction in basis. However, reducing the dividend recipient's shares in the acquiring corporation's stock has no effect when, as is the case in *Granite Trust* transactions, the recipient holds no shares in the acquirer following the dividend. There is no clear authority in the current statutory or regulatory language to conclude that basis in a different stock — here the recipient's retained shares in the target — should be reduced in the event of that absence. There is similarly no ordering rule that would require a sort of retroactive reduction in basis for the redeemed shares, which would reduce the amount of basis reallocated to the recipient's shares in the target.

The potential benefits of a *Granite Trust* transaction using section 304 border on the absurd. However, there is no explicit authority disallowing this structure or positive case law or rulings discouraging taxpayers from attempting to recognize this noneconomic amount of loss. Further, limitations around information reporting and tax transparency, discussed in greater detail in Section V, worsen this problem, making information about the existence of these transactions difficult for the IRS to obtain and evaluate, though these information reporting issues are not limited to transactions using section 304.

Granite Trust transactions in any form permit taxpayers to accelerate their losses, providing a level of flexibility that is inconsistent with general principles of tax and with the treatment of affiliated groups generally. And while *Granite Trust* transactions have benefited from long-standing judicial precedent and historical acquiescence by the IRS and Treasury, there are several potential ways to address *Granite Trust*

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planning, including under current law. Some of these potential methods of addressing *Granite Trust* transactions may be more effective at targeting only those transactions paired with section 304, but all these options should be carefully considered and, when possible, advanced to close this loophole. The remainder of this report highlights these various options for current enforcement, additional regulation, and new legislation.

IV. Enforcement Options

While legislative or regulatory changes are likely required to fully eliminate *Granite Trust* transactional tax planning, the IRS has viable enforcement options meanwhile that are worth considering. Some variations of the transactions described above have systematic vulnerabilities under current statutes and regulations that empower the IRS to recharacterize these transactions to reduce, and in some cases eliminate, the reduction in tax. Arguments (non-exhaustively) include (1) recasting a transaction as a C reorganization, (2) recasting a transaction as a D reorganization, (3) recasting based on the existence of a firm and fixed plan, and (4) economic substance recasts.

A. C Reorganizations

The IRS may be able to recharacterize some *Granite Trust* transactions as C reorganizations. This argument has been well-discussed in several forums[26] and was the basis for the IRS's 2021 audit of a 2017 *Granite Trust* transaction undertaken by Bausch Health Cos. Inc. (the Bausch audit).[27]

Recharacterization of a transaction as a C reorganization disallows the recognition of losses under an applicable *Granite Trust* transaction because section 361(a) turns off gain or loss recognition on the distribution of assets to any recipient corporation that is a "party to a reorganization," including in a C reorganization.

C reorganizations require "the acquisition by one corporation, in exchange solely for all or part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of substantially all of the properties of another corporation."[28] In the Bausch audit, the company disclosed that it had transferred 31 percent of the liquidating corporation to the acquiring corporation. Based on this disclosure, the IRS's position was that under the facts and circumstances of the transaction, 69 percent of the liquidating corporation's assets constituted "substantially all" of the relevant assets, satisfying that definitional requirement of a C reorganization.[29]

The Bausch audit has now been settled favorably for the taxpayer, according to Davis Polk, which represented the company in the proceedings.[30] So it remains an open question how a reviewing court would view the merits of the IRS's position in this case. Bausch Health and its advisers appear to believe it would ultimately have triumphed. The company never took a reserve for this position and strongly pressed its argument in public documents, arguing that "the IRS's new position is flatly contradicted by long-standing case law"[31] and contradicted by the IRS's own policy of refusing to give taxpayers rulings that a transaction satisfies the "substantially all" test unless the target transfers at least 90 percent of its net assets and 70 percent of its gross assets to an acquiring corporation.[32]

But these arguments may undersell the constraint imposed on taxpayers by this standard.

As a matter of law, the determination of what constitutes substantially all is based on the facts

[26] *See, e.g.*, Robert Willens, "*Granite Trust* Technique Under Siege," *Tax Notes Federal*, Dec. 13, 2021, p. 1537; Joshua Lesser, "Liquidations and C Reorganizations Through the Prism of the IRS 2021 Audit of Bausch Health's 2017 *Granite Trust* Transaction," ABA Tax Times, May 6, 2022.

[27] Bausch Health, Quarterly Report (Form 10-Q), at 29 (Nov. 2, 2021).

[28] Section 368(a)(1)(C).

[29] Lesser, *supra* note 26.

[30] Davis Polk, "Healthcare Company Successful Resolution of $2 Billion *Granite Trust* Claim" (Feb. 23, 2023).

[31] Bausch Health, "Credit Suisse Healthcare Conference" (Nov. 10, 2021). Bausch cites two cases in support: *National Bank of Commerce of Norfolk v. United States*, 158 F. Supp. 887 (E.D. Va. 1958) (finding that a transfer of 81 percent of the target's assets to the acquirer did not constitute "substantially all" of the target's assets); and *Arctic Ice Machine Co. v. Commissioner*, 23 B.T.A. 1223 (1931) (finding that a transfer of all of the target's operating assets, constituting 68 percent of total assets, did not constitute "substantially all" of the target's assets).

[32] Bausch Health, *supra* note 31 (citing Rev. Proc. 77-37, 1977-2 C.B. 568, and LTR 201014002 (ruling that *Granite Trust* transaction did not qualify as reorganization)).

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and circumstances.[33] And courts have rejected tests based solely on percentages in favor of more holistic examinations involving the nature of the business and the transaction, though percentages have remained an important part of those analyses.[34] In the past, the IRS successfully attacked several liquidation and reincorporation transactions in which percentages well below 69 percent were transferred to the applicable corporation but were still held to constitute substantially all of the assets for C reorganization purposes.[35] Some liquidation and reincorporation cases also pointedly take into account a corporation's use of relevant property, rather than mere ownership of it. This is a factor that could be important in the *Granite Trust* context, given efforts by taxpayers to minimize any real economic disruption to the underlying business.[36]

These liquidation and reincorporation cases have meaningful differences from the facts of a *Granite Trust* transaction, and generally lower percentages were the result of courts disregarding the distribution of nonbusiness assets in determining whether substantially all was transferred to the relevant entity. Moreover, these cases generally did not involve distributions composed solely of subsidiary corporate stock, which is likely to be a common fact pattern in *Granite Trust* transactions but complicates the application of the liquidation and reincorporation cases' emphasis on operating assets.[37] Nonetheless, these cases leave open the possibility that courts will give a different meaning to "substantially all" in circumstances in which the IRS is asserting a C reorganization "offensively," as a way of disallowing an inappropriate loss. This difference in circumstance reasonably requires a different standard in evaluating *Granite Trust* transactions than the IRS requires in its ruling practice as a prerequisite for intentional C reorganizations, and a proper application of the test must account for the facts and circumstances of the transaction.[38]

In fact, the market appears to acknowledge the risk of this recast. There is no apparent reason for a company like Bausch Health to transfer anything more than just over 20 percent, other than to mitigate the risk of being found to have transferred "substantially all," especially because, as described above, the section 267 haircut means that additional transferred percentages often cost real dollars in deferred losses unavailable to offset cash taxes. This tax consequence gives taxpayers an incentive to push the limits of "substantially all" by transferring as little as possible in the preliquidation sale.

B. D Reorganizations

Alternatively, the IRS can recast certain transactions as D reorganizations. Though this enforcement option cannot recharacterize all or even most *Granite Trust* transactions, it could be an effective way to police an aggressive variant of

[33] *See*, *e.g.*, *Smith v. Commissioner*, 34 B.T.A. 702, 705 (1936) ("Whether the properties transferred constitute 'substantially all' is a matter to be determined from the facts and circumstances in each case rather than by the application of any particular percentage."). This standard was also explicitly adopted by the IRS in Rev. Rul. 57-518, 1957-2 C.B. 253, which adds, "Among the elements of importance that are to be considered in arriving at the conclusion are the nature of the properties retained by the transferor, the purpose of the retention, and the amount thereof."

[34] *See*, *e.g.*, *Britt v. Commissioner*, 114 F.2d 10 (4th Cir. 1940) (92 percent transferred, reorganization); *Arctic Ice Machine*, 67 F.2d at 983 (68 percent transferred, no reorganization); Robert Wellen, "More Problems Complicate the Application of 'Substantially All' to Acquisitions," Ivins Phillips Barker (Jan. 1, 1993).

[35] For liquidation/reincorporation cases very favorable to the IRS on this issue, see, *e.g.*, *Smothers v. United States*, 642 F.2d 894, 898 (5th Cir. 1981) (15 percent of assets transferred); *Atlas Tool Co. v. Commissioner*, 614 F.2d 860, 864 (3d Cir. 1980) (19 percent of assets transferred); *Vierick v. United States*, 3 Cl. Ct. 745, 753 (1983) (20 percent of assets transferred); *American Manufacturing Co. v. Commissioner*, 55 T.C. 204, 221-222 (1970) (less than 20 percent of assets transferred). *See also* Calvin H. Johnson, "A Full and Faithful Marriage: The Substantially-All-the-Properties Requirements in a Corporate Reorganization," 50 *Tax Law.* 319 (1997).

[36] *See Viereck*, 3 Cl. Ct. 745; and *De Groff v. Commissioner*, 54 T.C. 59 (1970).

[37] How much of a difference this should make remains an open question, however. As Wellen notes in his writing on the subject, "in line with general 'asset substitution' concepts, the separate existence of the target corporation and its subsidiaries should be disregarded. Assets and liabilities of subsidiaries generally should be treated as property of the target corporation itself, on a consolidated basis." Wellen, *supra* note 34, at 10. Also generally untested is the extent to which the transfer or retention of a controlling interest in the relevant subsidiary entities should factor into the substantially-all analysis, though this factor could be quite persuasive.

[38] The IRS did not argue that the *Granite Trust* transaction in the original case should have been recharacterized as a C reorganization. At the time, there was no authority that a so-called upstream C reorganization was possible, with some courts affirmatively disallowing them. *See Bausch & Lomb Optical Co.*, 267 F.2d 75 (2d Cir. 1959). This type of C reorganization became possible only after the IRS published regulations in 2000 that effectively abandoned this *Bausch & Lomb* doctrine, reversing the IRS's long-standing position. *See* preamble to T.D. 8885, 65 F.R. 31805, 31806 (May 22, 2000).

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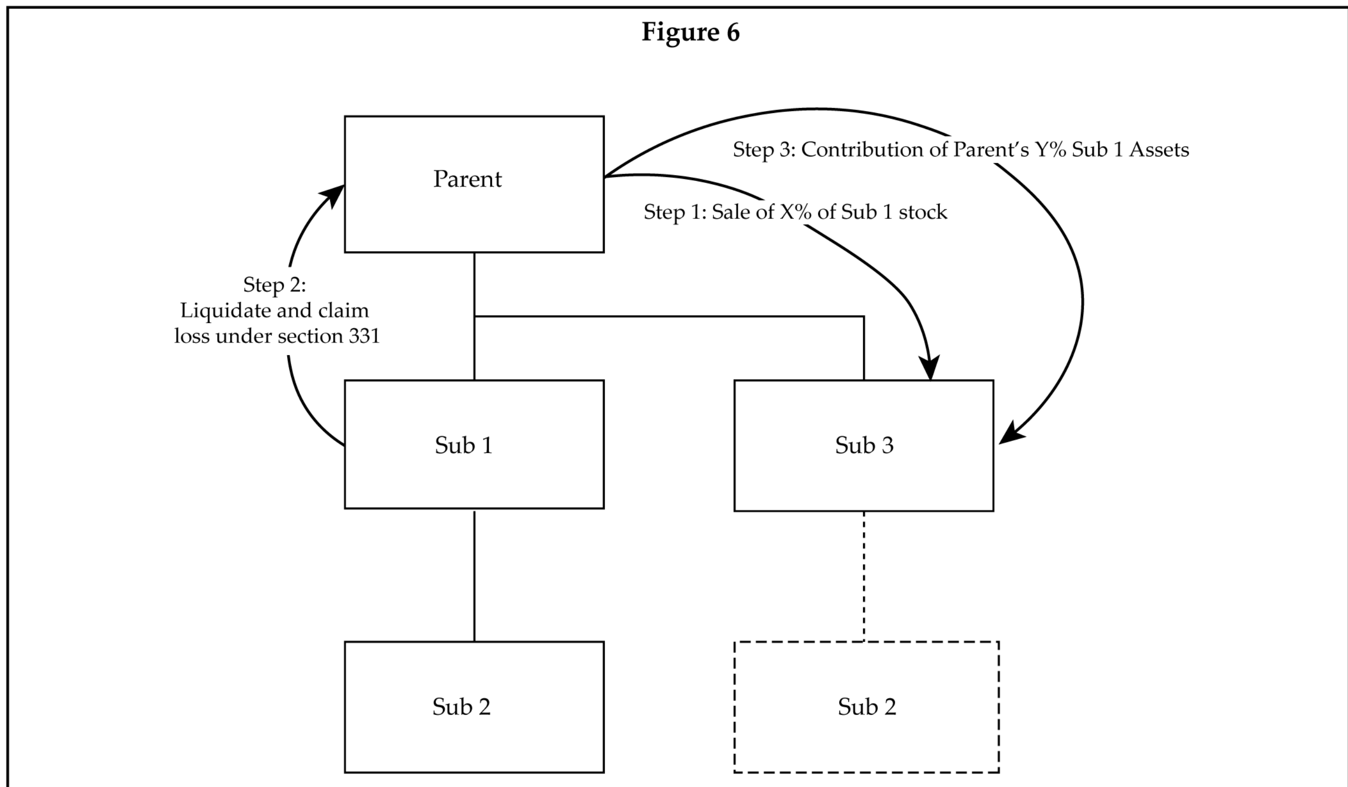
Figure 6



the transactions. Consider the fact pattern of Example 2.

Example 2. Parent wholly owns Sub 1. Parent sells X percent of Sub 1 to Sub 3, another wholly owned subsidiary of Parent, for FMV. After completion of the sale, Sub 1 liquidates, distributing X percent of its assets to Sub 3 and the remaining Y percent to Parent. Parent then contributes all its Y percent assets to Sub 3. This effectively recreates Sub 1 in the form of Sub 3, because Sub 3 will hold all the assets previously held by Sub 1 and can carry on the business of Sub 1 without interruption or change. (See Figure 6.)

This transaction may be recharacterized as a D reorganization. A D reorganization requires that assets be transferred from one corporation to another and that after the transfer of assets, one or more of the shareholders of the first corporation be in control of the second corporation.[39] This must be effected through a distribution of stock or securities of the second corporation under sections 354, 355, or 356.

This argument requires stepping together the distribution of assets to Parent and the later contribution to Sub 3, but after those steps are conflated, the transaction mirrors the transactions described in Example 1 of reg. section 1.368-2(l) and in Rev. Rul. 70-240, 1970-1 C.B. 81. For example, in the ruling, the sale of operating assets by one of two commonly owned corporations to the other, followed by a liquidation of the transferor, was held to result in a reorganization under section 368(a)(1)(D).[40] These authorities establish that D reorganizations may occur in a transaction in which there is no issuance of target stock, so long as the same person owns, directly or

[39] Section 368(a)(1)(D).

[40] This position was further confirmed in Rev. Rul. 75-383, 1975-2 C.B. 127, which states that "this principle is equally applicable where the assets of X are transferred to Y without consideration and where the common shareholder is a corporation rather than an individual." Rev. Rul. 70-240, 1970-1 C.B. 81.

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indirectly, all the stock of the transferor and transferee corporations in identical proportions.[41]

While this may not always be the case, transactions resembling the facts above appear ripe for application of the step transaction doctrine. The relevant steps will often occur according to a plan, and Parent's temporary ownership of a portion of the Sub 1 assets lacks meaningful substance because the ultimate business purpose of the transaction is to return the business entity to its original state in the acquirer.

Notably, although "substantially all" is also a requirement of an acquisitive D reorganization, that standard will clearly be met in the stepped-together transaction. Because Sub 3 will be treated as acquiring 100 percent of the assets of Sub 1 (after taking into account Parent's contribution of their portion) in the reorganization, it will clearly acquire "substantially all" of the relevant assets.[42]

As noted above, this enforcement option would not eliminate all or even most *Granite Trust* transactions because it requires taxpayers to take that extra step of contributing assets down to the acquirer. But it could be an effective method of policing an aggressive variant of the transactions.

C. Firm and Fixed Plans

In *Granite Trust*, the IRS argued that loss recognition was inappropriate because the taxpayer had effectively adopted a plan of liquidation before the consummation of the preliquidation sales. The court rejected this argument by reference to the statute, which permitted nonrecognition only if the tested owner's ownership percentage exceeded the 80 percent threshold when the plan of liquidation was adopted and did not change during the interim between adoption of the plan and the distribution of assets in liquidation.[43] For this reason, the timing of the adoption of the plan of liquidation was deemed irrelevant for purposes of the *Granite Trust* decision, but that is not the only angle of attack in which the timing of the taxpayer's plan is relevant.

In 1986 Merrill Lynch & Co. Inc., as the parent of a consolidated group, undertook a transaction in which, in anticipation of the sale of a subsidiary entity (the target), the target sold its 100 percent stake in a lower-tier subsidiary to a cross-chain affiliate before the third-party sale.[44] As described above, section 304 generally operates in these related-party transactions to require that the cross-chain stock sale be treated as a redemption of stock, which Merrill argued should be taxed as a dividend under section 302. Under the consolidated return regulations then in effect, the relevant result of this treatment was an indirect increase in the target shareholder's basis in the target stock, which resulted in the recognition of a loss when the target was sold.

The IRS successfully argued before both the Tax Court and the Second Circuit that the section 302 determination of the status of the distribution in redemption deemed to have occurred under section 304 must take into account, under the step transaction doctrine, the subsequent sale of the target to an unrelated third party. This holding resulted in Merrill failing to retain ownership of a sufficient amount of stock to result in dividend treatment. Instead, the IRS argued — and the courts upheld — that the redemption was in accordance with a transaction the result of which was the complete termination of Merrill's interest in the target's stock. As a result, the courts held that the redemption would be treated as a sale or

[41]These transactions also resemble many of the so-called liquidation-reincorporation cases, in which the government argued, often successfully, that a liquidation of a corporation followed by its reincorporation into a new entity through the transfer of all or part of the assets of the liquidating corporation should be stepped together to invalidate the tax planning and recharacterize the transaction as a reorganization. Liquidation-reincorporation transactions are no longer common following the repeal of the *General Utilities* doctrine, but the grounds for the recharacterization of these transactions remain strong.

[42]Even though "substantially all" is a facts-and-circumstances-based test, a deemed transfer of 100 percent of a target's assets to the acquirer should in all cases constitute a transfer of substantially all of the relevant assets.

[43]*Granite Trust*, 238 F.2d at 675 (discussing prior section 112(b)(6)). *See* section 332(b)(1) for the current rule, discussed *supra* note 4.

[44]*Merrill Lynch & Co. v. Commissioner*, 386 F.3d 464 (2d Cir. 2004), *aff'g in part* 120 T.C. 12 (2003). The specific transaction described was one of nine cross-chain sales undertaken by Merrill.

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exchange under section 302. This nullified the favorable tax result Merrill tried to achieve on the sale of the target.[45]

The courts' holdings rested on their interpretation of the "firm and fixed plan" test.[46] Neither party contested that the firm-and-fixed-plan test should be applied under these facts to determine the relevance of the later sale of the target, nor did either party argue that the test should be applied anytime other than at the time of the cross-chain sale of the lower-tiered subsidiary. The parties disagreed, however, on whether the firm and fixed plan test required a binding agreement to consummate the third-party sale at the time of the cross-chain sale, with Merrill stressing that the third-party buyer was not yet bound to complete the purchase of the target.

The reviewing courts ultimately agreed with the IRS that the firm and fixed plan test did not require a binding agreement. The courts relied in part on the previous *Bleily* decision, in which the court stated that "a plan need not be in writing, absolutely binding, or communicated to others to be fixed and firm although these factors all tend to indicate that such is the case."[47] Particularly persuasive to the reviewing courts as evidence of the existence of such a plan was the formal presentation to Merrill's board regarding the integrated transaction, which occurred only four days after the cross-chain sale. This presentation outlined both the consummated cross-chain sale and the proposed third-party sale (including by "unequivocally" identifying the third-party buyer as the purchaser of the target stock) and highlighted the "significant economic benefit, based on an opportunity in the tax law, in selling Merrill Lynch's proprietary lease business."[48]

This discussion mirrors the *Granite Trust* court's discussion (without ruling on it) of the IRS's argument regarding the timing of the adoption of the plan of liquidation. In *Granite Trust*, the IRS argued the following:

> To satisfy the first condition of nonrecognition prescribed in section 112(b)(6), it is not necessary to have a formal plan of liquidation, evidenced by a corporate resolution, but it is sufficient if there is a "definitive determination" to achieve dissolution. It is claimed by the Commissioner that such a definitive determination existed here by November 10, 1943, and, therefore, that the sale of stock to Howard D. Johnson Company which took place on December 6, 1943 (before the formal adoption of the plan of liquidation) occurred after the "adoption of the plan of liquidation" within the meaning of section 112(b)(6).[49]

In *Merrill Lynch*, having found a firm and fixed plan to complete the third-party sale, the courts concluded that when sections 304 and 302 test the post-transaction ownership of the redeemed shareholder, the test must consider the subsequent sale. Because the subsequent sale resulted in the shareholder no longer owning (directly or indirectly) any of the redeeming corporation's shares, the redemption was treated as a section 302(c) redemption in termination of the shareholder's stock and taxable as a sale rather than a dividend. In doing so, the reviewing courts disallowed the basis adjustments resulting from dividend treatment and upheld the IRS's adjustment.

Although the *Merrill Lynch* decision did not involve a *Granite Trust* transaction, it provides a blueprint for recasting the subset of *Granite Trust* transactions that plan into section 304. The specific evidence present in *Merrill Lynch*, such as

[45] The IRS made persuasive use of the famous decision in *Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954), to argue that "a partial redemption, which is one of a series of transactions intended to terminate completely a shareholder's ownership interest in a corporation, must be integrated with the related transactions for purposes of section 302(b)(3) and treated as a sale or exchange." *Zenz* has been relied on favorably by taxpayers for many years to allow favorable tax treatment on redemptions undertaken in connection with sales of stock.

[46] *Merrill Lynch*, 120 T.C. at 41 ("As a result of the decision in *Zenz*, other transactions must be taken into account in testing whether a redemption is a distribution under section 301 or a sale or exchange under section 302(a) where the redemption is part of a firm and fixed plan to terminate a shareholder's interest in a corporation. *Niedermeyer v. Comm'r*, 62 T.C. 280 (1974), aff'd 535 F.2d 500 (9th Cir. 1976) (articulating a *Zenz*-like standard).").

[47] *Bleily & Collishaw Inc. v. Commissioner*, 72 T.C. 751 (1979), *aff'd*, 647 F.2d 169 (9th Cir. 1981).

[48] This summary to Merrill's board also recommended a tax reserve based on the tax risks of the transaction, including the possible disallowance of the deemed dividend resulting from the cross-chain sale. *Merrill Lynch*, 120 T.C. at 23.

[49] *Granite Trust*, 238 F.2d at 674.

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board presentations that acknowledged the codependent steps of the transaction, may not always appear, but similar presentations or documents are likely regularly and habitually generated to explain the reasoning behind *Granite Trust* transactions (especially because there typically is no meaningful nontax business purpose motivating the transaction).

On its own, this recast does not undercut the fundamental ruling in the original *Granite Trust* case, which did not turn on any existence or nonexistence of a firm and fixed plan, but rather, on the validity, as a legal matter, of the initial partial sale.[50] But there is still significant merit in pursuing this argument. If the IRS is successful in establishing the existence of a firm and fixed plan in a *Granite Trust* transaction, the purported basis-shifting benefit of section 304 is foreclosed and the preliquidation sale will be taxed as a straightforward related-party exchange. This occurs because, as discussed in greater detail in Section III, *supra*, section 304(b)(1) requires applying the section 302(b) tests to determine whether a distribution in redemption will be treated as a dividend or exchange "by reference to the stock of the issuing corporation."

The deemed distribution under section 304 for the preliquidation stock purchase in a related-party *Granite Trust* transaction cannot be treated as a dividend under section 302 if the later liquidation is taken into account, because the group will retain no ownership in the relevant target shares postliquidation. Therefore, the group will be treated as reducing its collective interest in the target from 100 percent to 0 percent, mandating treatment as a sale or exchange under section 302(b)(3). Because the distribution cannot be taxed as a dividend, the purported basis shift cannot occur.

A taxpayer can still recognize built-in losses on its retained shares in the subsidiary upon liquidation, but it will be subject to the deferral haircut, meaningfully reducing the tax benefit of the transaction. This recharacterization therefore reduces incentives for taxpayers to undertake these transactions, and it diminishes the immediate cost to the fisc by reducing the magnitude of the loss that can be realized in a *Granite Trust* transaction.[51]

D. Economic Substance

The economic substance and related doctrines require that in many cases substance should triumph over form. Economic substance has its roots in Judge Learned Hand's opinion in *Gregory*,[52] which predated *Granite Trust*. In 2010 the doctrine was codified into law in section 7701(o), which states:

> In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if (A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.

Granite Trust transactions would appear to be susceptible to the application of section 7701(o), but these challenges have not historically been forthcoming. In part, this is because the circuit court's decision in *Granite Trust* explicitly rejected the government's application of the step transaction doctrine and the business purpose doctrine (the predecessor to the economic substance doctrine). The court refused to step together the preliquidation transfers with the subsequent liquidation, given its view of congressional acquiescence to the prior decision in *Day & Zimmerman* and legislative history indicating section 332 nonrecognition is intended to be elective.[53] The court acknowledged that the transaction lacked any nontax purpose (with the taxpayer openly conceding that the transaction was solely motivated by tax) but interpreted *Gregory* as allowing the taxpayer to minimize their

[50] *See supra* Section II.

[51] Tax planning using basis shifting under section 304 is by no means limited to *Granite Trust* transactions. Various planning techniques may use section 304 to achieve a favorable, and often improper, result for taxpayers. Therefore, aggressive IRS enforcement of firm and fixed plans to prevent these results under section 304 may result in additional revenue gain in *Granite Trust* transactions as well as in other transactions.

[52] *Helvering v. Gregory*, 69 F.2d 809 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1934).

[53] *Day & Zimmerman Inc.*, 151 F.2d 517, discussed *supra* note 5.

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taxes as long as the transaction was bona fide and not at odds with congressional intent.[54]

When the economic substance doctrine was codified, the IRS made several statements assuring taxpayers that it was not looking to challenge *Granite Trust* transactions on the basis of economic substance.[55] This history may make any enforcement position based on economic substance more challenging, particularly because the IRS has also since issued rulings blessing these transactions and has permitted loss recognition even when the transaction occurs solely among affiliates.

Still, the economic substance doctrine and related common-law doctrines may remain viable enforcement options for several reasons. The IRS is not bound by its previous statements, and its rulings on this subject are not precedential and cannot be relied on generally by taxpayers. These prior interpretations may generally even be affirmatively revoked by the IRS, which may independently have a valuable chilling effect on the market for *Granite Trust* transactions. Further, modern *Granite Trust* transactions have features such as the use of related parties and section 304 basis shifting, which were not present in litigated cases and are grounds to distinguish *Granite Trust*.[56]

The 2010 codification also makes clear that the economic substance test is now conjunctive, meaning a transaction can fail the test *either* because it lacks a substantial business purpose or fails to change the taxpayer's economic position. This was not the law when *Granite Trust* was decided, and courts have since observed that the First Circuit in particular has been historically hesitant to invalidate a transaction for lacking business purpose alone precodification.[57]

Under the conjunctive test, taxpayers may have difficulty articulating a substantial business purpose that would pass muster under section 7701(o)(1), given that *Granite Trust* transactions are generally exclusively or in all meaningful respects tax motivated. Indeed, the district court in *Granite Trust* invalidated the transaction on that basis alone before being overturned by the First Circuit.[58] Courts have also been willing to recast sham transactions among related parties solely for a lack of a legitimate business purpose and have done so even when taxpayers carefully follow the requirements of the relevant code sections and regulations.[59]

Economic substance arguments may present an uphill battle for the IRS in light of the agency's long-standing acquiescence to *Granite Trust*.[60] However, given the widespread lack of a legitimate business purpose underlying these transactions, continued efforts to make economic substance and related substance-over-form arguments appear to be justified and worthwhile of consideration.

V. Regulatory Solutions

Section 304 has been the subject of multiple regulatory efforts in the recent past. Treasury and the IRS have continually withdrawn these proposals, which would have addressed the

[54] This finding makes it difficult for the government to contest the first prong of section 7701(o)(1) when addressing modern *Granite Trust* transactions. As long as the sales are viewed as bona fide and the separateness of corporate entities is respected, *see Moline Properties*, 319 U.S. 436, the taxpayer's economic position will change: The taxpayer owns a smaller percentage of the liquidating subsidiary after the preliquidation sale, with a corresponding reduction in its rights to that entity's assets in liquidation.

[55] *See* Brandon L. Hayes, "Significant Recent Corporate Developments," *The Tax Adviser*, Jan. 1, 2011 (citing statements of the IRS).

[56] As is clear from *Associated Wholesale Grocers*, 927 F.2d 1517, courts can invalidate a *Granite Trust* transaction when taxpayers deviate from the original structure blessed by the First Circuit — meaning the presence of basis shifting, transitory sales, or related parties could tip the scale in favor of invalidating the transaction for lack of substance. *Associated Wholesale Grocers* even casts doubt on whether *Granite Trust* is controlling in the presence of those facts.

[57] *Santander Holdings USA Inc. v. United States*, 844 F.3d 15 (1st Cir. 2016). *See also Fabreeka Products Co. v. Commissioner*, 294 F.2d 876 (1st Cir. 1961) ("Unless Congress makes it abundantly clear, we do not think tax consequences should be dependent upon the discovery of a purpose, or a state of mind, whether it be elaborate or simple."); *Dewees v. Commissioner*, 870 F.2d 21 (1st Cir. 1989).

[58] *Granite Trust*, 150 F. Supp. 276 ("None of the steps taken by the taxpayer would have been taken except as parts of a general scheme to liquidate the Building Corporation in such manner as to achieve a tax reduction. This was simply an attempt to take a deduction in a manner without legal or moral justification — to circumvent section 112(b)(6) of the Internal Revenue Code.").

[59] *See, e.g.*, *H.J. Heinz Co. v. United States*, 76 Fed. Cl. 570 (2007) (shamming a subsidiary's purchase and subsequent sale of parent stock to the parent because the taxpayer only entered the transaction so that the sale would be treated as a dividend under 302 and basis would snap back to the subsidiary's retained shares under reg. section 1.302-2(c), which generated a significant capital loss when the retained shares were sold).

[60] A final decision in favor of the taxpayer in *Liberty Global Inc. v. United States*, No. 1:22-cv-02622 (D. Colo.) could also meaningfully restrict the government's ability to challenge certain transactions through economic substance, which could affect the viability of economic substance challenges to *Granite Trust* transactions.

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ambiguity around basis shifting in the section 304 analysis discussed above. While previous attempts to address basis-shifting issues broadly have been withdrawn, the 2024-2025 priority guidance plan indicates that the IRS and Treasury are continuing to work on these issues.[61]

Narrow regulations could address only *Granite Trust* transactions or only *Granite Trust* transactions using section 304 to purportedly shift basis. Regulations proposed in both 2002 and 2009 were broader than this narrow scope but would have eliminated the potential for basis shifting in a *Granite Trust* transaction using section 304.

Any new regulation purporting to address *Granite Trust* transactions should explicitly include rules eliminating the potential basis shift in a *Granite Trust* transaction using section 304. Broader regulations could also address the recovery of unused basis, take on basis shifting in the code more broadly, and clarify the IRS's understanding of when a *Granite Trust* transaction should be recast as a reorganization or when payment for the preliquidation sale in a *Granite Trust* transaction using section 304 should be treated under *Merrill Lynch* as a sale or exchange rather than as a dividend. Finally, regulations could set out new information reporting requirements that provide the IRS more information about the facts and circumstances leading up to reportable losses.

A. Narrow Fix for Basis Snap-Back

There are many regulatory options that could address or restrict *Granite Trust* transactions using section 304.

Overturning or revoking Rev. Rul. 71-563 or related previous rulings would begin to undermine the authority informally relied on by taxpayers to support their characterization of *Granite Trust* transactions.[62] As explained in Section III, *supra*, Rev. Rul. 71-563 is relied on for the premise that in a dividend-equivalent section 304 transaction in which the redeemed shareholder only constructively owns stock in the redeemed corporation after the transaction, section 304 results in the reduction and subsequent increase in the transferor's basis in its retained shares back to the same basis it held in all its shares before the transaction, maximizing its loss on the eventual liquidation.[63]

Yet this result does not follow directly from the text of the statute[64] and is, in fact, contrary to other authority. Moreover, the facts in a *Granite Trust* transaction subject to section 304 can be distinguished from the facts in Rev. Rul. 71-563, and Treasury and the IRS could clarify the appropriate result in that transaction through regulations or other guidance.

Alternatively, future regulations could target *Granite Trust* transactions using section 304 by adopting a loss deferral regime. To address circumstances in which basis would otherwise disappear, both the 2002 and 2009 proposed regulations incorporate such a deferral regime for

[61]Item 7 in the subsection titled, "Corporations and Their Shareholders," identifies a project on "Regulations regarding the allocation and recovery of basis in certain corporate transactions." 2024-2025 Priority Guidance Plan (Oct. 3, 2024).

[62]Some may argue that Treasury and the IRS's ability to pursue this approach is constrained by *Loper Bright Enterprises v. Raimondo*, 144 S. Ct. 2244 (2024). The direct ambit of *Loper Bright* is agency interpretations of ambiguous statutes, but some have taken the Supreme Court's reaction against *Brand X* and reaffirmation of *Skidmore* to suggest that the opinion more widely constrains changes in agency rules. However, nothing about the Court's approach in *Loper Bright* precludes overturning Rev. Rul. 71-563, 1971-2 C.B. 175. As explained in Section III, Rev. Rul. 71-563 was conclusory. Further, as explained below, it is inconsistent with the statutory text, purpose, and case law interpreting the code. *See also* Notice 2001-45, 2001-2 C.B. 129. Intervening changes to the statute may further clarify that the Rev. Rul. 71-563 approach is improper under current law. And all of the above grounds for overturning Rev. Rul. 71-563 are in addition to grants of discretion that exist in the code — both the general grant of authority under section 7805(a) and more specific grants that exist in code sections or subsections relevant to *Granite Trust* transactions that use section 304.

[63]As applied to overturning Rev. Rul. 71-563, Treasury and the IRS might be able to adopt this approach through subregulatory guidance. However, regulations may be preferable, especially because Rev. Rul. 71-563 invokes the section 304 regulations to reach its result, even if the result does not actually follow from the regulations.

[64]*See* Lawrence M. Axelrod, "Will Congress Fix Basis Shifting?" *Tax Notes Federal*, Oct. 4, 2021, p. 41 ("The rule that the basis of redeemed shares attaches to other shares, whether owned by the redeemed shareholder or a related party, is a creation of regulation, not statute."); preamble to REG-150313-01, 67 F.R. 64331, 64333 (2002) (proposed regulations on redemptions taxable as dividends), *withdrawn*, Announcement 2006-30, 2006-1 C.B. 879; preamble to REG-143686-07, 74 F.R. 3509, 3510 (2009) (proposed regulations on the allocation of consideration and allocation and recovery of basis in transactions involving corporate stock or securities), *withdrawn*, 84 F.R. 11686 (Mar. 28, 2019).

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the disappearing basis, with an inclusion date concept that triggers the recognition of the relevant loss.[65] This concept is an alternative to basis shifting and generally eliminates the purported rationale for, and potential benefits of, basis shifting in redemption transactions taxable as dividends under section 302.[66] The amount of loss deferred is equal to the basis of the redeemed stock. Generally, the inclusion date is the first date "on which the redeemed shareholder would satisfy the criteria of section 302(b)(1), (2) or (3) if the facts and circumstances that exist on such date had existed immediately after the redemption." In the context of a *Granite Trust* transaction using section 304, this regime could effectively limit the planned tax avoidance. Loss recognition would require waiting until the parent's ownership of the acquirer was significantly reduced or eliminated. And because no basis shift would occur, the haircut would be reinstated at the time of the liquidation.

In the context of *Granite Trust* transactions using section 304, regulations could alternatively determine that basis should unambiguously shift to the acquirer's recently purchased shares in the target.[67] Generally, section 362(e) limits the basis of built-in loss property in the hands of the transferee in section 351 contributions and generally limits the basis in the acquirer's shares of the target. The downside of this treatment would be that the relevant basis would effectively disappear. Taxpayers may object to this result, which disallows a legitimate loss, but it may be warranted under the circumstances. Section 304 is quite easy to plan around (and often is planned around to avoid this complexity and uncertainty). Also, section 332 disallows legitimate losses, so disallowing even legitimate losses on transactions structured solely to avoid section 332 is not inherently improper. Alternatively, Treasury and the IRS could theoretically conclude that the clarified rule should permit the transfer of the built-in loss to the acquirer, especially because the value of that loss in the hands of a non-U.S. acquirer will generally be meaningfully diminished or even nonexistent.

Each of these options should, however, account for the fact that any basis created or potentially shifted should ensure that taxpayers are not receiving an unjustifiable tax benefit. For example, any regulatory regime targeting *Granite Trust* transactions using section 304 should account for the fact that in many cases a dividend deemed paid under section 304 does not result in any cash tax to the parent, and therefore, tax benefits arising from any basis associated with the redeemed shares, even if deferred, may be a windfall to taxpayers.

B. Broader Regulatory Approaches

Broader regulatory approaches could also address the recovery of unused basis and take on basis shifting in the code more broadly. They could also potentially clarify the IRS's understanding of when a *Granite Trust* transaction using section 304 should be recast as a reorganization or when the deemed redemption should be treated as not equivalent to a dividend under *Merrill Lynch*.

1. Broader array of basis issues.

Both the 2002 and 2009 proposed regulations tried to address basis-shifting issues broadly, though these projects were ultimately withdrawn.[68] The 2009 proposed regulations, for example, would have created "a comprehensive approach to stock basis recovery and stock basis identification to produce consistent results among economically similar transactions, regardless of the transaction type or the specific Code provision that results in the application of section 301 or 302(a)."[69] Future regulations may benefit from a similar scope, though this ambition should not prevent Treasury and the IRS from acting swiftly to address *Granite Trust* transactions.[70]

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[65] REG-150313-01 (2002) and REG-143686-07 (2009).

[66] Both proposed rulemakings clarified further that this result applies to unused basis in section 304 transactions. Former prop. reg. section 1.304-2(a)(4) (2009); and former prop. reg. section 1.304-2(a)(3) (2002).

[67] This has a certain appeal because those shares were the relevant shares attributed back to the original owner and therefore prevented the redemption from being taxable as a sale.

[68] REG-150313-01, *withdrawn*, Announcement 2006-30; and REG-143686-07, *withdrawn*, 84 F.R. 11686.

[69] Preamble to REG-143686-07, 74 F.R. at 3510.

[70] Tax Law Center at NYU Law, "Recommendations for the 2022-2023 Priority Guidance Plan," at 3-4 (June 2, 2022); Tax Law Center at NYU Law, "The Teal Book: Options to Broaden the U.S. Tax Base," at 9 (May 2024). In addition to consistency, the theoretical advantage of a broader approach is that it might help address more of the transactions that taxpayers use in the alternative to achieve similar results.

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Treasury and the IRS determined in the 2009 proposed regulations that basis should be recovered share by share, consistent with *Johnson*.[71] In *Johnson*, the Fourth Circuit found that basis should be accorded share by share for corporate distributions under section 301. Section 301 in tandem with section 1012 determined this result. Section 1012, in turn, provides the code's general rule for basis of property: "The basis of property shall be the cost of such property," except as otherwise provided.[72] The Tax Law Center has previously recommended that Treasury and the IRS consider a stand-alone regulation confirming the view that a shareholder recovers its stock basis in a section 301 distribution using a share-by-share approach, consistent with *Johnson*.[73] This result is consistent with the code, including in the section 304 context when the redeemed shareholder only constructively owns shares in the acquiring corporation after the transaction.[74]

Although the 2009 proposed regulations adopting the *Johnson* approach were withdrawn, in doing so, Treasury and the IRS stated that they "continue to believe that *under current law*, the results of a section 301 distribution should derive from the consideration received by a shareholder in respect of each share of stock, notwithstanding designations otherwise" (emphasis added).[75]

Further, and as noted above, both the 2002 and 2009 proposed regulations were intended to modify reg. section 1.302-2 so that taxpayers would recognize loss from unused basis on the redemption date but not take it into account until a later inclusion date (or dates).[76] Treasury and the IRS explained that this approach is consistent with the general treatment of dividends.[77] And because this approach does ultimately allow the inclusion of loss stemming from the stock sale, it clarifies that that loss is deferred, not denied.[78]

2. Reorganizations, nonapplicability of section 301.

Treasury and the IRS could also clarify through regulations (or other guidance) when they believe *Granite Trust* transactions using section 304 should be treated as reorganizations or when the deemed redemption should be treated as not equivalent to a dividend. Consistent with the enforcement options discussed in Section IV, *supra*, current law supports recasting certain *Granite Trust* transactions as reorganizations. Further, *Merrill Lynch*, as extended to a situation involving a liquidation, supports treating certain transactions as not dividend-equivalent. Because these approaches are supported by the statute and case law, Treasury and the IRS could clarify they believe that, despite taxpayers' interpretation of certain letter rulings, these transactions are more appropriately nonrecognition transactions. While Treasury and the IRS have the authority to pursue enforcement strategies consistent with reorganization recasts and *Merrill Lynch* under rules already in effect, clarifying these strategies may be helpful for both voluntary compliance and taxpayer certainty.[79]

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[71] *Johnson v. United States*, 435 F.2d 1257 (4th Cir. 1971); preamble to REG-143686-07, 74 F.R. at 3511 (citing *Johnson*); *see also* former prop. reg. section 1.304-2(a)(4) (2009). The 2002 proposed regulations took a similar approach in the context they addressed, though they did not specifically invoke *Johnson*. *See* former prop. reg. sections 1.302-2 and 1.302-5 (2002); and former prop. reg. section 1.304-2(a)(3) (2002) (incorporating former prop. reg. section 1.302-5 by reference).

[72] Section 1012(a).

[73] Tax Law Center, "Recommendations for 2022-2023 Priority Guidance Plan," *supra* note 70, at 3-4.

[74] Upon withdrawing the 2002 proposed regulations in 2006, Treasury and the IRS asked for further comment on aspects of the regulatory approach pertinent to Rev. Rul. 71-563 and *Granite Trust* transactions using section 304. They specifically asked whether there should be a special approach to basis for "a redemption in which the redeemed shareholder only constructively owns stock in the redeemed corporation," as in Rev. Rul. 71-563, or for section 304(a)(1) transactions. Announcement 2006-30. Subsequently, the 2009 regulations adopted "a single model for section 301 distributions (dividend equivalent transactions) and a single model for sale or exchange transactions to which section 302(a) applies (non-dividend equivalent transactions), regardless of whether section 301 or section 302(a) applies directly or by reason of section 302(d), 304, or 356." Preamble to REG-143686-07, 74 F.R. at 3509 (citing *Johnson*, 435 F.2d 1257).

[75] Withdrawal of REG-143686-07, 84 F.R. at 11687.

[76] *See* former prop. reg. sections 1.302-2 and 1.302-5 (2009); and former prop. reg. sections 1.302-2 and 1.302-5 (2002).

[77] *See* preamble to REG-150313-01, 67 F.R. at 64334.

[78] This is consistent with the Tax Law Center's recommendations for the 2022-2023 priority guidance plan, *supra* note 70, at 3. However, Axelrod has suggested that the original regulatory project would have produced a denial rather than deferral of loss, consistent with the treatment that would apply under 332. Axelrod, *supra* note 64.

[79] However, there may be disadvantages to regulations on this front, especially ones that draw clear bright lines, because taxpayers may then be better able to adopt strategies that go as far as possible without downside risk. Some of the IRS's enforcement options — such as the determination of "substantially all" — rely on a facts-and-circumstances analysis under which no specific threshold is without risk for the taxpayer.

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3. Clarification of authority for regulations.

Regardless of the regulatory approach Treasury and the IRS adopt in the future, they should be clear about which authority they are specifically relying on to adopt the regulations that they propose. The 2002 and 2009 proposed regulations were promulgated under the general authority of section 7805(a), and Treasury and the IRS appropriately invoked *Johnson* in the 2009 regulations in support of the share-by-share approach to basis. Moreover, any regulations issued to this end would not be the first regulations promulgated under section 304 to address tax avoidance related to the application of that section.[80]

Treasury and the IRS can also consider explicitly noting additional sources of authority that support regulations that allow the IRS to prevent basis shifting or treat *Granite Trust* transactions using section 304 as nonrecognition events. Those sources of authority may include statutory changes to section 304 after Rev. Rul. 71-563,[81] statutory changes to related code sections after Rev. Rul. 71-563,[82] interactions with other code sections that Rev. Rul. 71-563 did not account for, specific regulatory authority under section 304,[83] and specific regulatory authority under other code sections that may be relevant to some *Granite Trust* transactions using section 304.[84]

Moreover, the economic substance doctrine, as codified, and other substance-over-form doctrines may support reading relevant code provisions as treating some *Granite Trust* transactions using section 304 as nonrecognition events, distinguishable from the specific facts of *Granite Trust* itself. The possibility of using economic substance as an enforcement strategy for *Granite Trust* transactions is discussed in greater detail in Section IV, *supra*. If these strategies are viable for some *Granite Trust* transactions using section 304, despite the government's loss in *Granite Trust*, they are viable because a proper reading of the code — including both the operative provisions and section 7701(o) — supports disallowing or deferring certain losses or treating certain events as nonrecognition events. Therefore, Treasury and the IRS would have authority to issue regulations consistent with that reading of the code.[85]

In theory, then, the broadest regulatory approach could try to overturn the result in *Granite Trust* itself or its subsequent application to related parties.[86] However, absent judicial abandonment of *Granite Trust*, a legislative solution to *Granite Trust* is a more practical approach to addressing the underlying transaction.

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[80] Reg. section 1.304-4 is designed "to prevent the avoidance of the application of section 304 to a controlled corporation." Reg. section 1.304-4(a). The proposed 2002 and 2009 regulations, by contrast, would have addressed tax strategies related to the use of section 304.

[81] Both the 2002 and 2009 proposed regulations would have conformed section 304 regulations to various statutory changes — most significantly, those made by the Taxpayer Relief Act of 1997, P.L. 105-34, section 1013. *See* preamble to REG-143686-07, 74 F.R. at 3509-3510; preamble to REG-150313-01, 67 F.R. at 64332-64333; the Tax Reform Act of 1986, P.L. 99-514, section 1875(b); the Deficit Reduction Act of 1984, P.L. 98-369, section 712(l); and the Tax Equity and Fiscal Responsibility Act of 1982, P.L. 97-248, section 226. *But see* Elliott, *supra* note 24 (reporting on doubt from one commentator that the Taxpayer Relief Act amendments affect the conclusion of Rev. Rul. 71-563). Further changes to section 304 were made by the Internal Revenue Service Restructuring and Reform Act of 1998, P.L. 105-206, section 6010(d) (adding new paragraph, "Avoidance of Multiple Inclusions"); Education Jobs and Medicaid Assistance Act, P.L. 111-226, section 215 (adding "Special Rule in Case of Foreign Acquiring Corporation").

[82] For example, section 362(e), enacted in 2004, provides a limitation on the transfer of built-in loss under section 362(a), to prevent abuse and duplication of losses in stock basis. Although not directly applicable to the transferor's basis in the stock sold, section 362(a) is one of the few sources of authority invoked by Rev. Rul. 71-563. *See* Section V.A for discussion of the possible application of section 362(e); *see also* the discussion of section 1059 in Section III.

[83] Although section 304 does not contain a broad specific grant of discretionary authority, section 304(b)(6) provides that "in the case of any acquisition to which subsection (a) applies in which the acquiring or the issuing corporation is a foreign corporation, the Secretary shall prescribe such regulations as are appropriate in order to eliminate a multiple inclusion of any item in income by reason of this subpart and to provide appropriate basis adjustments (including modifications to the application of sections 959 and 961)."

[84] *E.g.*, section 245A(g).

[85] Moreover, these doctrines may affect the proper reading of the scope of grants of discretion in the code that give the Treasury secretary authority to address avoidance.

[86] There are various uncertainties connected to the IRS's acquiescence to *Granite Trust*. These include: (1) what *Granite Trust* actually stood for; (2) whether the field service advice expanding it to related parties rests on sound authority; (3) the role of since-changed law; (4) the soundness of the *Granite Trust* court's finding for the taxpayer under the economic substance and step transaction doctrines; and (5) whether any *Granite Trust* transactions using section 304 may be susceptible to use of the *codified* economic substance doctrine.

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C. Improved Information Reporting

Under today's information reporting rules, it is probably difficult for the IRS to identify *Granite Trust* transactions using section 304 with its enforcement options under current law. This is a twofold problem. First, the IRS does not receive information reporting on certain steps of these transactions. Second, the IRS does not have the resources to comb through transactions that are reportable to identify which ones can be recast or treated as nonrecognition events. In addition to limiting enforcement, the lack of information reporting may undercut voluntary compliance by encouraging the most aggressive filers and advisers to continue to push the boundaries of existing law, given the lower likelihood of detection and challenge.

Transactions generating a significant loss are reportable.[87] For a *Granite Trust* transaction using section 304, this means that, under current law, the taxpayer must report the liquidation on which the taxpayer claims a loss. But enforcement options for *Granite Trust* transactions using section 304 depend on the facts and circumstances surrounding the liquidation — largely on the sales that preceded the liquidation. This means that the IRS may be unable to discern from reported information whether recognition of a loss is inappropriate or whether a loss is inappropriately inflated.

Requiring taxpayers to also disclose additional facts, including sales leading up to the recognition of a significant loss, could help with this problem.[88] To address the information gaps, however, it is important not just that taxpayers report those sales but also that they report them in such a way that the IRS can identify *Granite Trust* transactions using section 304, and identify whether the transactions fit within current-law enforcement options. The IRS's resources are especially limited when significant training and knowledge of the law may be required to identify on audit transactions that are likely to lead to the recovery of revenue. Further, the typical modern *Granite Trust* transaction using section 304 is part of a larger series of transactions, which makes it harder for the IRS to identify.[89] For all these reasons, it is important to structure any new reporting in a way that allows the IRS to make efficient use of it.[90]

VI. Legislative Solutions

It is likely that only a legislative fix could fully resolve the two problems at issue here: loss acceleration using *Granite Trust* and noneconomic basis shifting using section 304. Enforcement and regulatory solutions only address aspects of these problems. Accordingly, taxpayers can plan around them or, even when they cannot, may still get some benefit from *Granite Trust* and basis shifting even if the benefit is more limited. Moreover, there is reason to think that a legislative solution could receive bipartisan support: Regulations proposed under the administrations of both political parties have acknowledged and sought to address these issues.[91]

Various legislative options could resolve one or both of these problems, including solutions that could be narrowly tailored to address only the most abusive *Granite Trust* transactions. However, this report focuses on a couple of legislative solutions that have already been proposed. They have centered on section 267, the code provision that governs losses from transactions between related taxpayers.

[87] Reg. section 1.6011-4(b)(5)(A). For corporations, a transaction generating a loss of at least $10 million in a single year or $20 million in any combination of tax years is reportable. *Id.*

[88] *See* Notice 2001-45.

[89] *See, e.g.*, LTR 201330004.

[90] In Notice 2001-45, Treasury and the IRS addressed "basis shifting tax shelters" involving the redemption of stock of a party indifferent to or not subject to U.S. tax, and the shifting of the basis of that stock to a taxpayer under the section 318 and reg. section 1.302-2(c) attribution rules when the taxpayer also claims that the redemption of stock should be treated as a dividend under section 301. Treasury and the IRS took the position that the "proper adjustment" in reg. section 1.302-2(c), Example 2, was not applicable because it "is premised on the concept that an adjustment is appropriate where the redeemed spouse is required to include the full redemption proceeds as a dividend in gross income that is subject to U.S. tax and such spouse retains no stock to which the basis of the redeemed stock should attach." The IRS intended to disallow losses or increase taxable income or gains, when, instead, a transaction was the type of "basis shifting tax shelter" described in the notice. Notice 2001-45 also identified transactions of the type addressed in the notice, as well as substantially similar transactions, as listed transactions for the purposes of reg. sections 1.6011-4T(b)(2) and 301.6111-2T(b)(2), and it noted that those transactions might also be subject to other requirements under sections 6111 and 6112 and reg. sections 301.6111-2T, 301.6111-1T, and 301.6112-1T.

[91] *See* REG-150313-01, *withdrawn*, Announcement 2006-30; REG-143686-07, *withdrawn*, 84 F.R. 11686.

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As discussed above, in almost all modern *Granite Trust* transactions, stock of the subsidiary that will be liquidated is sold between two related parties controlled by an owner. The owner seeks to recognize losses while doing as little violence as possible to its corporate structure and the operation of the underlying business. This means that a legislative solution to the problem could come through an expansion of the code's existing provisions that govern denial or deferral of loss on transactions between related parties.[92]

Current section 267 denies losses from the "sale or exchange of property, directly or indirectly"[93] between "two corporations which are members of the same controlled group."[94] A controlled group for the purposes of section 267 is generally the same as under section 1563(a), except that section 267 uses a 50 percent vote-or-value threshold for parent-subsidiary controlled groups, whereas section 1563(a) uses an 80 percent threshold. Under current law, the section 267(a) loss denial does "not apply to any loss of the distributing corporation (or the distributee) in the case of a distribution in complete liquidation."[95] Further, section 267(f)(2) allows for deferral rather than denial of loss for sales or exchanges of property between members of the same controlled group.

Because current section 267 does not deny or defer losses "in the case of a distribution in complete liquidation," it is insufficient to respond to *Granite Trust* transactions. However, proposed modifications to section 267 would resolve this gap.

President Biden's administration has proposed modifying section 267 so that it covers "complete liquidations within a controlled group where the assets of the liquidating corporation remain in the controlled group after the liquidation."[96] Because this would make section 267(a) applicable to those liquidations, losses would be denied on the liquidating corporation's stock and property. Along similar lines as current section 267(f)(2), the proposal would allow for deferral rather than denial for some of these liquidations. The proposal would do so by giving the Treasury secretary authority to allow for deferral rather than denial "under the principles of section 267(f)."[97] The proposal would further give the secretary authority to address the use of controlled partnerships to avoid the denial-of-loss rules.

A similar approach in Build Back Better (H.R. 5376), which in 2021 passed the House but did not pass the Senate, would have addressed the problem of corporate basis shifting through a new subsection 267(h).[98] This provision would have deferred losses on the stock or securities of a liquidating corporation in a section 331 liquidation until the corporation receiving the property in the liquidation disposes of "substantially all property such other corporation received in such liquidation to one or more persons who are not related to such other corporation (within the meaning of subsection (b)(3) or section 707(b)(1))." New section 267(h)(2) would have authorized the secretary to issue regulations and guidance to carry out the purposes of subsection (h), including applying principles of the subsection to liquidating corporation stock or securities.

Both the Biden administration and Build Back Better proposals would address modern *Granite Trust* transactions by denying or deferring the loss. They differ principally in whether the default is the denial or deferral of the relevant loss and in the specificity of their provisions, because it is not clear whether Biden's green book proposal would also impose a "substantially all" test on the

[92] Because *Granite Trust* itself involved parties who were unrelated for tax purposes, this approach would not fully overturn *Granite Trust*. However, it would reject the extension of *Granite Trust* addressed in FSA 200148004 and would, for the reasons described above, be sufficient to address modern *Granite Trust* tax planning.

[93] Section 267(a)(1).

[94] Section 267(b)(3).

[95] Section 267(a)(1).

[96] Treasury, "General Explanations of the Administration's Fiscal Year 2025 Revenue Proposals," at 12, 239 (Mar. 11, 2024) (2025 green book); Treasury, "General Explanation of the Administration's Fiscal Year 2024 Revenue Proposals," 11, 211 (Mar. 9, 2023) (2024 green book).

[97] 2024 and 2025 green books, *supra* note 96.

[98] H.R. 5376, section 138142(b) (Sept. 27, 2021); *see also* Rose Jenkins, "Build Back Better and the Cycle of Tax Law Development," Tax Law Center at NYU Law (Mar. 24, 2022).

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disposition of the relevant assets outside the group.

These transactions appear to be a relatively well-known and commonly adopted tax planning tool, though the opacity of the transactions and limitations of current information reporting requirements (discussed *supra* Section V) may contribute to the current estimates of the revenue potential for these legislative solutions.[99] Individual transactions alone have the potential to be quite large in comparison with those estimates, taking as an example the $2.1 billion in additional income tax liability (not counting penalties and interest) that the IRS sought in the Bausch audit.

Legislators should also consider whether a more targeted solution is more appropriate. For example, the current proposals broadly cover related-party transactions. This approach removes the immediate tax benefit of undertaking a *Granite Trust* transaction and addresses the lion's share of modern *Granite Trust* transactions, all of which use related parties. It does not, however, comprehensively address the issues raised in this tax planning strategy. For example, while these proposals remove the immediate benefit of the purported basis shift using section 304, a deferral approach does not directly challenge or prevent that basis shift, leaving open the potential for that basis to be used in other ways or at a later time.[100] The legislative proposals also leave open the possibility of new transaction structures that replicate, as closely as possible, the old tax benefits and avoid the new rules. Such a transaction structure might involve a financial institution acting as an accommodation party to facilitate a non-related-party *Granite Trust* transaction.[101] This alternative would inevitably be less flexible and more costly to taxpayers than the current options, but it may be advisable to anticipate and eliminate the possibility of these transactions before they become a reality.

Although a legislative solution is the cleanest approach to resolving *Granite Trust* and corporate basis shifting, a legislative solution would complement, rather than substitute for, enforcement options under current law. Any legislative solution, like the options that have been proposed, would likely apply only to transactions after enactment.[102] As is clear from the Bausch audit, single transactions involving *Granite Trust* can involve billions of dollars of lost revenue. Therefore, lawmakers, Treasury, and the IRS should all consider appropriate actions to resolve the aspects of this problem that fall under their jurisdiction. ■

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[99] The president's 2025 budget scored this proposal at $547 million over the 10-year window. Office of Management and Budget, "Budget of the United States Government, Fiscal Year 2025" (2024). The Joint Committee on Taxation scored the Build Back Better proposal, including the provision above, at $1.78 billion over the 10-year window. JCT, "Estimated Budget Effects of the Revenue Provisions of Title XIII — Committee on Ways and Means, of H.R. 5376, the 'Build Back Better Act,'" JCX-46-21 (2021).

[100] Notably, however, both Build Back Better and the Biden administration's proposals appear to include language authorizing regulations to prevent the avoidance of a deferral through the use of controlled partnerships, which attempts to foreclose one of the more obvious methods of replicating the tax benefits of a *Granite Trust* transaction. *See* H.R. 5376, section 138142(b); 2025 green book, *supra* note 96, at 12.

[101] In this way, it would resemble the original fact pattern in *Granite Trust*.

[102] Applying legislative changes to tax laws retroactively is not technically barred and has been done in limited circumstances, but it would introduce new hurdles and political complexity. A more workable and likely approach would be to include language in any legislation confirming that the new laws are not intended to suggest that any implicated transactions were permissible under prior law.

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