REPORT #885

TAX SECTION

New York State Bar Association

Report on Postreorganization Continuity

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New York State Bar Association

October 15, 1996

Hon. Donald C. Lubick,
Acting Assistant Secretary
(Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Hon. Margaret M. Richardson,
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re: <u>Report on Postreorganization Continuity</u>

Dear Secretary Lubick and
Commissioner Richardson:

I am pleased to enclose our report on postreorganization continuity of interest. The report was prepared in response to a request for comments on this issue by the Internal Revenue Service and Treasury Department. The principal drafter of the report was Dana L. Trier, Co-Chair of our Corporations Committee.

This report addresses one of the more intractable and pervasive issues affecting Subchapter C practice. There is substantial uncertainty surrounding the treatment of postreorganization sales (and other dispositions), and the rules laid down by the existing authorities, to the extent they can be distilled, are often at significant variance with any sound Conceptual underpinnings for a postreorganization continuity doctrine.

Our report recommends that the Service and Treasury adopt a narrow view of the continuity of interest doctrine, focusing on whether the acquiring corporation issued the requisite amount of stock in the reorganization, rather than the postreorganization actions of the former target shareholders. We think such an approach would be well grounded in tax policy, as reflected by (among other things) a number of developments in the Subchapter C area. The narrow approach that we recommend also would be generally consistent with the decided cases in this area.

Our group was not able to reach a consensus as to the precise rule that might be adopted to implement the narrow approach to postreorganization continuity that we favor. Our differences arose respecting the case in which a large portion of acquiror equity is disposed of by target shareholders very promptly following the reorganization, with the acquiring company being involved in the disposition. There was support for three different approaches:

(i) Under the narrowest approach, the fact that the acquiring company actually issued its equity in the transaction would be accorded determinative significance. The dispositions of acquiror equity would therefore not impair reorganization status for non-disposing shareholders. This approach is supported by the policy irrelevance of shareholder sales as regards the treatment of non-disposing shareholders, as well as concerns for administrability and simplicity.

(ii) A second approach would not differ in broad concept from the policy direction or concerns for simplicity and administrability underlying that set forth in (i), but would, at least in an extreme case, accord greater significance to the potential substance of the transaction: as a result, the fact pattern referred to above might be construed as an acquiror sale of its equity for cash followed by a purchase of target equity with the cash proceeds. Obviously, the introduction of a substance over form analysis would in many cases undermine the very important objective that guidance in this area yield clear, predictable results.

(iii) A third approach, responsive to the policy merit of the narrowest approach, but concerned with the administrative issues presented by a substance-over-form overlay, would be more modest: a safe-harbor would be established based on the principles of IRC § 246(c). If the requisite percentage of former target shareholders held acquiror equity at the risk of the market for a period of, say, 30 to 45 days, the postreorganization continuity requirement would be considered satisfied. Existing standards that generally disregard sales by less than 5% shareholders of a public company would be continued. For transactions not satisfying the safe-harbor, present substantive rules would apply, although we also urge consideration of a rule that sales without acquiror involvement be disregarded.

Notwithstanding our lack of consensus as to the best approach to implementing a narrow concept of postreorganization continuity, we think any of these approaches would represent a substantial improvement in the state of the law in this area. We think that Treasury and the Service would be well-served to devote the resources to a project to adopt one of these approaches; and thereby greatly simplify and ease the administration of the tax law without jeopardizing any government interest.

We would be pleased to work with you and members of your staffs on such a project.

Very truly yours,

Richard L. Reinhold
Chair

[Enclosure]

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Corporations Committee

Reorganizations Committee

Report on Postreorganization Continuity of Interest[*]

The purpose of this Report is to propose a revision and clarification of the position of the Internal Revenue Service (the “Service”) on the continuity of interest doctrine as it applies to postreorganization transactions involving the stock of the acquiring corporation received by target shareholders in the reorganization. The principal issue addressed by the Report is the effect under the continuity of interest test of postreorganization sales or other dispositions of stock by target corporation shareholders.

In this Report, we propose that both the substantive and procedural positions of the Service with respect to this aspect of the continuity of interest test be restated. In our view, the primary function of the continuity of interest doctrine with respect to corporate acquisitions should be limited to supplementing the statutory definitions of reorganizations subject to tax-free treatment that do not have an explicit requirement relating to stock consideration. In particular, we believe that the principal role of the doctrine should be to impose a substantive

* This Report was prepared by a working group organized jointly by the Corporations Committee and Reorganizations Committee. The principal author of the Report was Dana L. Trier, Co-Chair of the Corporations Committee. Substantial contributions to the Report were made by Kimberly S. Blanchard, Robert A. Jacobs and Gil Marnin. Helpful comments were received from L. Howard Adams, Harold R. Handler, David P. Hariton, Stephen B. Land, Lisa A. Levy, Richard O. Loengard, Jr., Jay G. Milkes, Deborah L. Paul, Richard L. Reinhold, Jerome I. Rosenberg, Michael L. Schler, John Y. Taggart, David E. Watts and Ralph O. Winger.

requirement of the provision of stock consideration in statutory mergers subject to sections 368(a)(1)(A) and 368(a)(2)(D) of the Code[1] for which no explicit statutory stock consideration requirement is provided. Under this view, postreorganization sales would generally not implicate the continuity of interest doctrine. The Report discusses alternative approaches to continuity based on this narrow view of the function of the continuity test. For the reasons discussed further in this Report, we believe that any new proposed tests should be incorporated in regulations under section 368 of the Code.

While the focus of the Report is on the interpretation of the continuity of interest doctrine in the postreorganization context, the Report also addresses the broader role of the continuity of interest doctrine in the treatment of tax-free corporate transactions. The analysis presented in the Report ultimately calls into question the policy basis for any quantitative stock consideration requirement as a condition to the tax-free reorganization treatment of corporate acquisitions.[2] Moreover, one of the important themes of the Report is the advantage of application of the continuity of interest requirement consistently in the pre-reorganization and postreorganization contexts.

Several developments have converged to make a re-examination of postreorganization continuity of interest

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1 Citations to Code sections are to sections of the Internal Revenue Code of 1986 as amended unless otherwise indicated. Citations to Regulations are to the regulations promulgated thereunder.

2 See generally Wolfman, "Continuity of Interest and the American Law Institute Study," 57 Taxes 840 (1979); Hutton, "Musings on Continuity of Interest-Recent Developments," 56 Taxes 904 (1978); Jacobs, "Reorganizing the Reorganization Provisions," 35 Tax L. Rev. 415 (Spring 1980); Faber, "Continuity of Interest and Business Enterprise: Is It Time to Bury Some Sacred Cows?" 34 Tax Lawyer 239 (1981); and Miller, "The Devolution and Inevitable Extinction of the Continuity of Interest Doctrine," 3 Florida Tax Review No. 5,187 (1996)("Miller").

particularly appropriate at this time. First, legislative and regulatory developments in the last twenty-five years have made the policy vagaries of the continuity of interest doctrine obvious to any informed student of Subchapter C. It is now often possible to structure a corporate acquisition affording tax-free treatment to target shareholders receiving stock consideration from the acquiror with the same general legal and economic effect of an otherwise tax-free reorganization that fails to meet the continuity of interest requirement. Moreover, as discussed further below, the virtually complete separation of corporate and shareholder level tax consequences under current law with respect to corporate combination transactions also calls into question whether the doctrine has a significant continuing role with respect to corporate acquisitions.

Second, the sophisticated, modem financial market place clearly demonstrates the futility of a strictly administered continuity requirement as it relates to trading in the stock of the acquiror or target. In our experience, if the standards arguably applicable under the Service’s published authorities were, in fact, applied literally, many reorganizations reported as tax-free would likely be taxable.

Finally, the hotly debated decision of the Tax Court in the Seagram case[3] dealing with prereorganization continuity and the historic shareholder concept has focused attention on all aspects of the continuity of interest doctrine, including perhaps the practically most troubling aspect of the doctrine -- postreorganization continuity. We do not believe that the Seagram decision can easily be reconciled conceptually with the Service’s current published position on postreorganization continuity of interest.

[3] J.E. Seagram Corp. v. Commissioner, 104 T.C. 75(1995)(“Seagram”).

The Service's position on postreorganization continuity is represented by a combination of Internal Revenue Service substantive pronouncements and ruling guidelines.[4] The principal substantive pronouncement of the Service with respect to postreorganization sales or dispositions of stock, Revenue Ruling 66-23,[5] focuses on whether a target shareholder has acquired unrestricted ownership of acquiring corporation stock for the requisite length of time. In that case, a corporation, X, which owned 60 percent of the stock of a target corporation and received 18 percent of the stock of the acquiring corporation in a merger, was under an antitrust court order to dispose of the acquiring corporation stock within seven years. The Service held that the continuity of interest doctrine was not violated because the seven year period of ownership was sufficient to establish sufficient unrestricted rights of ownership in the acquiring corporation <u>and</u> ". . . since at the time of the reorganization X had no preconceived plan or arrangement for such sales."[6]

In Revenue Procedure 77-37,[7] the Service stated its administrative position that for ruling purposes it will take into account sales, redemptions and other dispositions of stock occurring both before and after the transaction "which are part of the plan of reorganization" in determining whether the continuity of interest test is met. Moreover, in connection with a ruling request, a representation must be given that there is no plan or intention by target shareholders who own five percent or more (or one percent or more, in the case of non-public corporations)

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[4] The general continuity of interest requirement applicable to tax-free reorganizations is contained in Regulation Section 1.368-1(b).

[5] 1966-1 C.B. 67.

[6] <u>Id</u>. at 68. <u>See</u> <u>also</u> Rev. Rul. 95-69, I.R.B. 1995-42 (nonliquidating partnership distribution of stock received in merger did not affect continuity of interest).

[7] 1977-2 C.B. 568.

and, to the best of the knowledge of management, no plan or intention of other shareholders, to sell or otherwise dispose of a number of shares of acquiring corporation stock received in the transaction that would reduce the ownership of such shareholders below fifty 0 percent of the value of the outstanding stock of the target corporation.[8]

Thus, while the Service has indicated in Revenue Procedure 77-37 that the ultimate question is whether related stock sales and dispositions are "part of the plan of reorganization," the Service appears to make the plans or intentions of shareholders themselves potentially substantively determinative as to this question. Revenue Ruling 66-23 required the former shareholder of the target to have both unrestricted rights of ownership and no plan or intention to sell the acquiring corporation stock for their stock to be counted for continuity purposes. Moreover, the representations required by the Service for a ruling would also appear to indicate that plans or intentions of the target shareholders receiving stock are substantively relevant to the determination of whether the continuity of interest test has been satisfied.[9]

The uncertain scope of the Service's substantive position on postreorganization continuity came back to haunt it in the leading case on postreorganization continuity, McDonald's Restaurants of Illinois. Inc. v. Commissioner ("McDonald's").[10] The

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8 Rev. Proc. 86-42, 1986-2 C.B. 722.

9 See also Ltr. Rul. 8802042 (Oct. 16, 1987)(unanticipated postreorganization sales of stock do not affect continuity).

10 688 F.2d 520 (7th Cir. 1982), rev'g, 76 T.C. 972(1981). See also Heintz v. Commissioner, 25 T.C. 132 (1955), N.A., 1958-2 C.B. 9. In Heintz, target shareholders had an oral agreement with the acquiror, wherein the target shareholders' stock received in the reorganization would be sold in a public offering to be effected within 30 days. The public offering did not occur, but the shareholders later sold the stock in a sale the acquiror helped to arrange pursuant to its promises. The court held the continuity of interest test was not satisfied.

McDonald's case involved the acquisition by McDonald's of a franchisee's restaurant corporations. The acquiror wanted to issue stock consideration in the transaction so as to assure pooling treatment for financial accounting purposes. The controlling shareholders of the target wanted to receive cash. A compromise was reached by an agreement providing that the target shareholder group could participate in McDonald's registration and underwriting planned for two to three months after the closing. The agreement further provided that the target selling group had a one time right to demand registration in the event that McDonald's did not undertake an offering within a year. The court assumed that the "group was not obligated to sell McDonald's stock but fully intended to do so."[11] After one delay in the planned postreorganization transaction, the shareholders sold their stock in a McDonald's offering.

The acquiror McDonald's reported the transaction as a taxable acquisition entitling it to a step-up in basis because, it claimed, the continuity of interest test was not satisfied. The Service disagreed, asserting a deficiency.

The Tax Court agreed with the government, holding that the continuity of interest test was satisfied because the taxpayers remained sufficiently at risk with respect to the acquiring corporation stock received in the transaction.[12] The Tax Court focused on the proper use of step transaction principles in application of the continuity of interest test: "... it is incumbent upon us to more fully examine the continuity principle so

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[11] McDonald's, 688 F.2d at 522. See also the Tax Court's decision, 76 T.C. at 989 ("In our view, the overwhelming weight of the evidence indicates that the Garb-Stern group intended to sell their McDonald's stock at the earliest possible moment.").

[12] 76 T.C. at 989.

that we may tailor the step transaction doctrine to its needs."[13] Finding that the law of continuity of interest required no postmerger holding period, the Tax Court determined that the most appropriate variant of the step transaction doctrine to apply was the mutual independence test. Applying that test, the Tax Court found that the continuity of interest test was met because the selling shareholders retained the ability to sell their stock: "They had unfettered discretion, within the constraints of the securities laws, to do with those shares as they wished."[14]

The Court of Appeals overruled the Tax Court's decision. The Court of Appeals also considered the traditional variations of the step transaction doctrine, but disagreed with the Tax Court's conclusions. Arguing that the Tax Court really applied the binding commitment test rather than the mutual independence test that it purported to apply and finding further that under any of the three step transaction tests the merger and subsequent sale should have been stepped together, the Court of Appeals held that the continuity of interest test was not satisfied in the transaction.

The precise scope of the Court of Appeals' holding in McDonald's is somewhat unclear. In reaching its decision, the Court of Appeals emphasized target shareholder intent, but indicated that no single factor was determinative:

> Admittedly, not every transaction would be as pellucid as this one, but here the history of the parties' relationships, the abortive attempt to buy some of the group's holdings, the final comprehensive deal, and the [selling shareholder] group's determination to sell even in the face of the falling price in the stock all are consistent and probative.[15]

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[13] Id. at 995.

[14] Id. at 999.

[15] 688 F.2d at 524.

Since McDonald's, however, the case seems to have been read for the proposition that the most significant question in applying the step transaction doctrine with respect to the continuity of interest test is shareholder intent to sell the stock received by them in the merger.[16]

Under the narrowest view of postreorganization continuity, neither the plans of target shareholders to sell their stock nor acquiring corporation involvement in those sales would be crucial determinants of whether the continuity of interest test is satisfied. As a result, the provision of registration rights of the type provided in McDonald's would not affect application of the test. Thus, as discussed further below, the narrow approach advocated in this Report is inconsistent with that applied by both the Tax Court and Court of Appeals in the McDonald's case.

The possible substantive tests of postreorganization continuity of interest considered in preparing this Report can perhaps usefully be divided into five distinct, conceptual categories. The first is a strict requirement of shareholder identity for some period of time after the transaction (the "strict identity test"). Thus, the requisite quantity of stock in the acquiring corporation would be required to be owned by target shareholders for some period of time, irrespective of whether any target shareholder had the plan or intention to sell the stock it received at the time the transaction was consummated. Although some language in the authorities might support a strict identity test, this approach to continuity of interest does not appear to have been actually adopted either administratively or judicially. Nonetheless, because this formulation represents the most

[16] See Penrod v. Commissioner, 88 T.C. 1415, 1437 (1987); Estate of Christian v. Commissioner, 57 T.C.M.(CCH)1231(1989). See generally, Russman, "Equity Swaps and Post-Transaction Continuity of Interest," 72 Tax Notes 113 (July 1, 1996).

restrictive form of the doctrine, it does provide a benchmark for a policy analysis of the continuity of interest requirement.

The second category would determine whether the test is met based on shareholder plans or intentions test to sell their stock (the “shareholder plan or intention” test). Thus, the stock of shareholders who plan or intend to sell their stock after the transaction and who actually do sell such stock after the merger would not count for continuity purposes. Language in both the administrative and judicial authorities is consistent with this view. As noted above, however, the Service applies this test for ruling purposes only with respect to larger shareholders.

The third would require, in addition to shareholder plan or intention to sell the stock, significant involvement in such postreorganization sales by the acquiring corporation (the “acquiror involvement” test). Although the opinion is far from clear on the point, this test may be viewed as that, in fact, adopted by the Court of Appeals in McDonald’s.

A fourth type would take into account postreorganization sales by former target shareholders if there were a binding commitment to sell at the time of the acquisition (the “binding commitment” test). This type of test is, in part, evidenced in Revenue Ruling 66-23 discussed above and is, of course, applicable under section 351.[17]

A fifth approach would focus on the narrow question whether the requisite stock was, in fact, issued in the reorganization transaction to shareholders of the target (the

[17] The Tax Court in McDonald’s viewed Heintz as, in effect, a binding commitment case (“The taxpayers in Heintz not only intended to sell their preferred stock, but they also committed themselves to sell.”). 76 T.C. at 1001.

“narrow” test). This test may be viewed as[18] consistent with one view of the Tax Court decision in Seagram, a prereorganization continuity case. We believe that this narrow view of continuity is the theoretically most appropriate one in the postreorganization context. The Report discusses several different approaches to modifying the current published guidance to reflect this narrow view of postreorganization continuity of interest.

Historically, general step transaction and substance over form principles have played a major role in applying the continuity of interest doctrine. As discussed above, both the Tax Court and Court of Appeals in McDonald’s purported to be applying step transaction principles, while coming to opposite conclusions.

Consistently with the Tax Court’s decision, we believe that application of step transaction and substance over form principles must be informed by a view of the proper role of the continuity of interest test itself. Thus, under the narrow continuity of interest test advocated in this Report, step transaction principles will have a more limited role than under current law. Even under this view of continuity, however, it is difficult to avoid completely such questions. Indeed, the different approaches to implementing a narrow view of postreorganization continuity discussed in this Report reflect, to a significant extent, different views of the role of step transaction principles and substance over form.

The remainder of this Report will be divided into three parts. In the first part, we outline the policy, legal, and other

[18] Some members of the Tax Section advocate applying a stock consideration requirement only where the statute explicitly states one. This approach, in effect, entails abolition of the continuity of interest requirement.

bases for adopting a narrow approach to postreorganization continuity. The second part describes certain specific aspects of our proposal in relation to other approaches and discusses issues that arise in implementation of a narrow postreorganization test. In the third part, we address certain administrative considerations of the Service and Treasury Department, including the implications of our proposed approach for the application of the continuity of interest doctrine to other types of transactions and the Service's authority for its position.

I. The Case For Revised Postreorganization Continuity of Interest Rules

In our view, there are four basic justifications for revising the Service's position on postreorganization continuity of interest. First, there is no substantial broad policy justification for strict application of a continuity of interest test to corporate acquisitions. Second, significant problems of and inconsistencies in administering the doctrine as currently articulated would be ameliorated by limiting the scope of the test. Third, the proposed modification of the guidance on postreorganization continuity is consistent with a rational application of the continuity of interest test to prereorganization transactions as reflected in the Seagram decision. Fourth, the limited role we propose for the continuity of interest doctrine with respect to these transactions is consistent with the current statutory scheme governing tax- free reorganizations.

A. Lack of Substantial Policy Justification for Continuity of Interest Doctrine

The lack of a substantial policy justification for a strict postreorganization continuity of interest standard is clear from an analysis of the current structure of the treatment of acquisitive transactions under Subchapter C. In assessing the broader policy role of continuity of interest in acquisitive reorganizations, it is perhaps useful to distinguish two aspects of a continuity of interest doctrine. The first is whether the identity of target shareholders as shareholders of the acquiring entity remains constant after the transaction,[19] a question as to which shareholder intent to sell or actual shareholder sales are relevant facts. The second is whether equity in the acquiring corporation is issued in the transaction so that at least a substantial portion of the aggregate assets of the combining entities remain in corporate solution.[20]

1. Lack of Policy Support for the Doctrine in Shareholder Treatment

A supportable policy rationale for the continuity of interest doctrine cannot be discerned in the treatment of the shareholders in tax-free reorganizations. One of the frequently criticized aspects of the tax-free reorganization provisions of Subchapter C is the dependence of one shareholder's treatment in an acquisitive transaction on what other shareholders receive in the transaction.[21] In whatever manner the doctrine is interpreted in the postreorganization context, it is clear that it is required that, in the transaction, other shareholders, together with the shareholder in question, receive the requisite aggregate amount of stock of the acquiring corporation for the test to be met.

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19 This view was explicitly rejected by Judge Nims in Seagram, 104 T.C. at 103.

20 This view appears to have been implicitly adopted by Judge Nims in Seagram. Id. As discussed in note 32 infra, this notion appears to underlie pooling of interests for financial accounting purposes.

21 See, e.g., Federal Income Tax Project - Subchapter C, Proposals on Corporate Acquisition and Dispositions, American Law Institute (1980) ("ALI Subchapter C Project") at 170.

Viewed in broad perspective, this aspect of the current structure of Subchapter C must be viewed as perverse -- or at least lacking in any substantial policy justification as it pertains to the treatment of a target corporation's shareholders.[22] The indirect relationship of any former target shareholder or group of former target shareholders to the assets of the target corporation after the transaction can become extremely attenuated, irrespective of application of the continuity of interest doctrine, simply as a result of the size of the acquiring corporation relative to that of the target corporation, a fact recognized by the Supreme Court in Minnesota Tea[23] long ago. Given this immutable reality, if any shareholder should get tax-free treatment in an acquisitive corporate transaction, it must be because of other factors: it cannot be justified based on the relationship of the target shareholders to the assets of the target after the transaction.[24]

Rather, the principal justification for tax-free rollover treatment would appear to be the forced investment decision imposed on at least some taxpayers in a corporate reorganization transaction. In a corporate merger, for example, a target shareholder who was not a motivating force in the transaction no longer has the choice of holding his old investment: through no fault of his own, he must either take stock in the acquiring corporation in which case he would have no cash to pay a tax -- or he must cash out completely -- a major economic decision and one

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22 Assessment of the policy merits of tax-free treatment of shareholders in corporate acquisitions is beyond the scope of this Report. See generally, Hellerstein, "Mergers, Taxes, and Realism," 71 Harv. L. Rev. 254 (1957) ("Hellerstein").

23 Minnesota Tea Co. v. Helvering, 302 U.S. 609(1938).

24 In this, regard, it is interesting that American Law Institute proposals prior to the enactment of the 1954 Code would have required that the target shareholders receive a minimum 20 percent minimum equity interest in the acquiring corporation. Hellerstein at 272-273.

that certainly entails paying the tax. In such a case, it is arguably a reasonable policy decision to defer the tax of the shareholder receiving acquiring corporation stock, at least until the shareholder sells the stock and has the cash to pay the tax.[25] Similar policies underlie the deferral of tax under section 1033 with respect to condemnation proceeds and the installment reporting of gain under section 453.

The crucial point is that this rationale can be present for a given shareholder irrespective of the precise quantum of stock consideration that other target shareholders receive in the transaction and irrespective of whether such other shareholders sell the consideration they receive in the transaction. Thus, it would seem most justifiable from a general tax policy perspective to determine whether a given target shareholder gets tax-free treatment in a corporate acquisition based simply on the nature of the transaction itself and of the interest in the acquiring corporation received by the particular shareholder.

The tax-free treatment of the individual shareholder has, in fact, been delinked in this manner from the consideration provided to other shareholders in at least one type of tax-free reorganization, the tax-free recapitalization under section 368(a)(1)(E). Under the Hickok case,[26] the continuity of interest doctrine does not apply to a recapitalization transaction. This

[25] There is very little legislative history revealing an explicit policy rationale for the tax- free reorganization provisions. At one point in the 1930's, a House Subcommittee proposed an elimination of the tax-free reorganization provisions. See Report of Subcommittee of House Committee on Ways and Means, 73d Cong. 2d Sess. (Dec. 4, 1933), reprinted in Seidman, Seidman's Legislative History of Federal Income Tax Laws, 1938-1861, p. 332 (1938) ("Seidman"). The Treasury Department, however, opposed the move, in part on the grounds that shareholder gains were "paper gains." See Report of Ways and Means Committee, 73d Cong., 2d Sess., H. Rept. 704, reprinted in Seidman at 338. See generally. Miller at 198-201.

[26] Hickok v. Commissioner, 32 T.C. 80 (1959), N.A., 1959-2 C.B. 8, N.A. withdrawn, 1977-2 C.B.3; see also Rev. Rul. 77-415, 1977-2 C.B. 311.

difference in treatment from acquisitive transactions can arguably be rationalized by the fact that, in a transaction that does not involve a change in corporate identity, the shareholder will <u>usually</u> have retained an equity interest in the same corporate assets, even though the fact that the same corporate identity is kept intact in a recapitalization does not actually prevent significant assets from moving into the corporation by purchase or leaving corporate solution by redemption as part of the same overall transaction. While we would question, for the reasons described above, whether this factor <u>should</u> make a difference, it does at least generally economically distinguish recapitalizations from corporate acquisitions.

As the law has developed, however, tax-free treatment can be achieved at the shareholder level without meeting the continuity of interest test in acquisitive corporate transactions with economic and substantive effects virtually identical to the acquisitive transactions to which the continuity of interest doctrine does apply. Even in corporate combination transactions, then, the tax fate of one shareholder can often be divorced from the question of the consideration received by the other shareholders.

The clearest example of this type of transaction is a section 351 transaction, a widely employed structure with respect to corporate mergers and acquisitions. After originally coming to the contrary conclusion,[27] the Service has made it clear that continuity of interest principles do not apply to section 351 transactions.[28] The nonapplication of the continuity of interest doctrine to the facts of the seminal National Starch transaction[29]

[27] Rev. Rul. 80-284, 1980-2 C.B. 117 and Rev. Rul. 80-285, 1980-2 C.B. 119.

[28] Rev. Rul. 84-71, 1984-1 C.B. 106(revoking Rev. Rul. 80-284 and 80-285).

[29] Ltr. Rul. 7839060(June 23, 1978).

was perhaps easy to justify. To the octogenarian target shareholder who received tax-free treatment in that case, the preferred stock interest received in a subsidiary of the acquiror was economically similar to that received in a recapitalization, to which, as noted above, the continuity of interest doctrine would not apply.[30] But section 351 applies to a broader set of acquisitive transactions that are in most economic and other respects identical to transactions of the type potentially subject to the tax-free reorganization rules requiring the continuity of interest test to be met.

Assume, for example, the following facts. A corporation, a large publicly held corporation, wants to acquire T corporation, a company one tenth its size. A corporation's lawyers set up H corporation, a holding company with two subsidiaries, Si and S2. After the requisite shareholder votes, S, is merged into T with T surviving and former shareholders of T getting, at their election, H stock or cash; and S_2 is merged into A with A surviving and with all former A shareholders (except dissenters) receiving H stock. Assume that T shareholders owning only 10 percent of the T stock elected to receive H stock, and that former shareholders of A owned more than 80 percent of H after the transaction. For federal income tax purposes, the transaction will be treated as a contribution by A's shareholders of A stock and by T shareholders of T stock to H in exchange for H stock in a tax-free transaction under section 351. Thus, the T shareholders receiving H stock will achieve tax-free treatment despite the fact that the former owners of only an insubstantial amount of T stock continue to have an interest,

30 In the National Starch transaction, a new corporation ("Newco") was organized under the acquiring corporation, with the target shareholder in question exchanging his target corporation stock for preferred stock of Newco in the transaction. Newco then purchased the target corporation stock through a subsidiary merger. Thus, after the transaction, through Newco, the former target shareholder had a claim against the assets of the target only, rather than against the combination of the assets of the acquiring corporation and target.

indirectly, in the T business, the interest that such shareholders do have is in an entity that combines the assets of the two corporations and such owners are not, in any way, in control of the resulting entity and need not be viewed as part of a control group for the transaction to be tax-free. In other words, the basic economic effect of the transaction is the same as a corporate merger in which target shareholders get less than the requisite continuity of interest in the acquiring corporation.

All corporate tax practitioners have learned to accept that simple differences in form can have substantially different tax results under Subchapter C. That no fundamental economic and legal differences exist between transactions subject to, the continuity of interest rule and those not subject to the rule suggests, however, that broad policy concerns relating to the tax treatment of shareholders in the target corporation are not at stake here.

2. The Policy Irrelevance of Postreorganization Continuity of Interest to Corporate Level Treatment

The effect of the consideration received by one shareholder on the tax treatment of other shareholders under the tax-free reorganization provisions could perhaps be understood if such a test were rationally applied to determine the corporate level treatment of a transaction and shareholder treatment were, for purposes of simplicity or statutory consistency, required to follow the corporate level treatment. The original conception of the continuity of interest doctrine seems, in fact, to have been motivated in part by a judicial attempt to distinguish tax-free reorganizations from corporate-level asset sales.[31] In this sense, the tax rules could be viewed as analogous to the pooling of interests rules of financial accounting, under which treatment of corporate level assets and earnings for accounting purposes is affected by what happens with respect to the outstanding stock of the amalgamating entities.[32]

For federal income tax purposes, however, the ability to achieve tax-free treatment at the corporate level can now be viewed as largely divorced from what happens with respect to the equity interests in the combining corporations. One of the hallmarks of Subchapter C after the legislation of 1980s is the virtually complete separation of the tax treatment of a given transaction of the corporate and shareholder levels. Under the current structure, it is perfectly possible for a transaction that has the effect of completely amalgamating the assets and liabilities of two corporations at the corporate level to be treated as tax-free at the corporate level (with a concomitant carryover of basis in assets), while at the same time one corporation's shareholders are completely cashed out and, to that extent, assets of the two entities have left corporate solution.

This result was possible in two somewhat limited respects prior to the tax legislation of the 1980s. First, one corporation could acquire all the stock of another corporation for cash, hold the target corporation as a wholly-owned subsidiary and file consolidated returns without triggering gain at the corporate level

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31 See Cortland Specialty Co. v. Commissioner, 60 F.2d 937, 939 (2d Cir. 1932) ("Reorganization, merger and consolidation are words indicating corporate readjustments of existing interests. They all differ fundamentally from a sale where a vendor corporation parts with its interest for cash and receives nothing more.")

32 APB Opinion No. 16. The apparent rationale for the financial accounting treatment is interesting in the context of our discussion: "No acquisition is recognized because the combination is accomplished without disbursing resources of the constituents." See "Summary," Id at 112.

of the target. Thus, the two corporations could achieve something very close to a de facto merger without triggering gain at the corporate level.

Second, through a downstream merger, two corporations could achieve actual legal amalgamation even though the shareholders of the resulting entity were wholly cashed out. In Revenue Ruling 70-223,[33] the Service held that such a transaction would be treated as a tax-free reorganization, implicitly adopting the view that the continuity of interest doctrine should be applied solely to the transferor's shareholders.[34] Thus, in a downstream merger, the continuity of interest doctrine was no barrier to tax-free treatment at the corporate level even though there was a complete legal amalgamation of the two corporations at the corporate level, the aggregate assets in corporate solution had been reduced by the total value of one of those corporations and none of the shareholders of one of the corporations remained a shareholder of the entity resulting from the merger.

These same results can be achieved in a more straightforward manner as a result of tax legislation enacted relating to sections 332 and 338. Under prior section 334(b)(2), as in effect prior to the enactment of section 338 in 1982, a cash purchase of all the stock of a target corporation followed by the liquidation of the target into the acquiring corporation (by merger or actual liquidation) was treated as a sale of assets at the corporate level followed by a liquidation by the target corporation. Prior to General Utilities repeal, the acquiring corporation recognized only recapture income under then section 337, but the acquiring corporation received a step-up in basis: in

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[33] 1970-1 C.B. 79.

[34] See generally Turnier, "Continuity of Interest -- Its Application to Shareholders of the Acquiring Corporation," 64 Calif. L. Rev. 902 (1976).

effect, the treatment applicable to a taxable merger was applied to this overall transaction.

After the check-the-box regime of section 338 was adopted, however, this transaction would be viewed as a taxable purchase of stock followed by a section 332 liquidation unless a section 338 election is made. Thus, as is made clear by Revenue Ruling 90-95,[35] a series of related steps, which under long-standing principles would generally have been viewed as in substance either a purchase of assets followed by a liquidation or as a merger,[36] is accorded tax-free treatment at the corporate level (as well as a carryover of attributes under section 381) even though no stock consideration is utilized. In effect, transactions with the same nontax substantive effects of either an A or C reorganization except for the use of cash consideration are given tax-free reorganization treatment at the corporate level unless the acquiring corporation makes a section 338 election, a step the acquiring corporation is generally unwilling to take unless the target is being purchased from another corporation. Thus, under today's law, the principal effect at the corporate level of satisfying the continuity of interest test is to prevent the acquiring corporation from electing taxable treatment at the corporate level: tax-free treatment at the corporate level will be applicable in any event.

Tax-free corporate level treatment has not yet become completely elective for transactions that do not qualify as tax-free reorganizations. The principles of Revenue Ruling 90-95 apply only to "qualified stock purchases," which, for example, cannot

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35 1990-2 C.B. 67.

36 See, e.g., Kimbell-Diamond Milling Co. v. Commissioner, 14 T.C. 74 (1950), aff'd, 187 F.2d 718 (5th Cir. 1951), cert, denied, 342 U.S. 827 (1951); King Enterprises, Inc. v. U.S., 418 F.2d 511 (Ct. Cl. 1969); and Rev. Rul. 67-274, 1967-2 C.B. 137.

always be accomplished in the acquisition of the stock of an already related corporation. More important, actual corporate sales of corporate assets followed by liquidation of the target cannot be afforded tax-free treatment at the corporate level by the mere election of the parties.

The relatively considerable amount of flexibility under current law, however, tends to indicate that broad policy concerns relating to corporate level treatment are not at stake. It thus also appears clear that no broad policy rationale relating to corporate level tax treatment supports a restrictive test relating to the consideration paid in the transaction.

B. Administrative Considerations

Given the absence of an important general policy rationale for any requirement relating to the aggregate stock consideration provided in a corporate acquisition, the case for a narrow role for the continuity of interest doctrine is, in our view, strengthened significantly by the virtual impossibility of administering a strict postreorganization continuity test in a manner that is consistent with coherent and equitable tax policy. In at least some transactions involving public companies, the actual ownership of stock by target shareholders will turn over virtually completely, both before and after a merger. This practical reality undermines the workability of any strict continuity test based on shareholder identity. Considerations such as this appear to have had a significant impact on the Tax Court's decision in Seagram involving postreorganization continuity:

> Respondent points out, correctly we believe, that the concept of continuity of interest advocated by petitioner would go far toward eliminating the possibility of a tax-free reorganization of any corporation whose stock is actively traded. Because it would be impossible to track the large volume of third

> party transactions in target's stock, all completed transactions would be suspect. Sales of target stock after the date of an announcement can be neither predicted nor controlled by publicly held companies.[37]

In apparent recognition of these considerations, the Service has, in its ruling procedures applicable to public corporations, required that representations as to actual plans or intentions of target shareholders be made only with respect to five percent shareholders, and that only knowledge representations be made with respect to other shareholders. This administrative position alone, however, does not give either an acquiring corporation or a target any control over the tax consequences to be anticipated from a corporate acquisition -- as evidenced in the Seagram case itself. Although this approach does perhaps assist the acquiring and target corporations in determining the actual facts with respect to a transaction after that transaction has occurred, it does not permit them to assure to the parties the anticipated tax consequences of the transaction.

Moreover, there appears to be no substantive policy basis for an approach under which the tax consequences of a reorganization depend on what relatively large shareholders do with either the target stock before the transaction or acquiring corporation stock after the transaction. A useful distinction can perhaps be made with section 382. As with the case of the ruling guidelines relating to tax-free reorganizations, the statute itself in section 382 incorporates the five percent shareholder concept, in part because of administrative considerations. But in the case of section 382, the substantive policy underlying the provision itself is directly implicated by sales of stock by or among larger shareholders. This activity may indicate substantial trading based on the net operating losses of the loss corporation that is particularly likely to result in later capital infusions permitting

[37] Seagram, 104 T.C. at 103.

enhanced loss utilization by the loss corporation in violation of tax neutrality.[38] Thus, administrative and substantive considerations operate in a relatively consistent manner under section 382. By contrast, as discussed above, shareholder level trading by larger stock owners does not appear to be related fundamentally to any articulable policy underlying the tax-free reorganization provisions.

More important, application of the continuity of interest doctrine in this manner has, in our view, three invidious effects. First, this approach exacerbates the problem of one shareholder's treatment being detrimentally affected by what other shareholders do. Thus, one of the perverse aspects of the current structure of the law potentially operates even more harshly if sales by other stockholders can affect another's treatment, irrespective of what was actually issued in the transaction by the corporate parties. In effect, the current administrative position of the Service puts small shareholders at the mercy of what one or a few larger shareholders do or intend to do with their stock.

Second, one likely result of such an approach is, as a practical matter, to make it significantly more difficult for closely held corporations to qualify for tax-free reorganization treatment than it is for publicly held corporations. The statute itself makes no such distinction, and we fail to see any substantial policy reason for such a distinction in this context. If tax-free treatment of the shareholders in corporate acquisitions is rooted in the involuntary forced investment decision potentially being imposed on target shareholders, that concern applies equally to any shareholder other than a controlling shareholder in a

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[38] See generally H. Rept. No. 99-426, 99th Cong., 1st Sess. (Dec. 7, 1985), p. 256. See also ALI Subchapter C Project at 232 ("Since the purpose of the limitation is principally to deal with the possibility of disguised contributions for less than an arm's length consideration, it should be permissible to ignore purchases by small shareholders.")

closely held corporation; if the acquiring corporation is also closely held, this consideration applies even more strongly because of the relative illiquidity of the stock consideration received. We understand that in some contexts -- for example spinoffs or other potential “bailout” transactions -- there might be a policy basis for rules that are, in effect, more strictly applied to closely held corporations. But we do not believe that there is a significant policy (as opposed to administrative) basis for such a distinction with respect to tax-free reorganizations.

Third, in our experience, as a practical matter, this approach to administration of the doctrine promotes lack of complete candor about shareholder intentions, or, at a minimum, purposive corporate ignorance of the predictable activity of the market place generally and the often demonstrable activity of arbitrageurs. This side effect is doubly undesirable in light of the fact that the continuity of interest doctrine has no clear broad policy rationale in the first instance.

C. Consistency With Rational Prereorganization Continuity Test

A narrow approach to postreorganization continuity would also have the virtue of greater conceptual consistency with what we regard as a rational approach to prereorganization continuity. In this respect, we believe that the Tax Court’s Seagram decision is a major step forward.

In Seagram, the Tax Court held that sales by public stockholders to a very large third-party buyer prior to a merger would not affect the continuity of interest analysis test so long as the third-party buyer was not acting in concert with the acquiror. Under the Tax Court’s analysis, the third party buyer would, in effect, step into the shoes of the former shareholders for continuity purposes.

The scope of the Seagram decision is not absolutely clear. For example, because the third-party buyer, Seagram, bought its stock in the target, Conoco, from the public, the case does not deal with the situation in which the selling shareholders are themselves large holders: it does not address, for example, the consequences of one large target shareholder (which could, for example, be in a control position with respect to the target) selling to a third-party buyer on the eve of the merger. Moreover, some would argue that the outcome should be different if it were clear from the beginning that Seagram was buying the target stock solely in order to participate in the merger with the acquiring company DuPont.

While these aspects of the Seagram case open the possibility of factually distinguishing other cases involving prereorganization sales, one reasonable reading of Seagram is that prereorganization sales by shareholders of the target corporation do not implicate the continuity of interest test unless those transactions can be viewed as, in effect, attributable to the corporate parties to the transaction. Thus, to the Tax Court, the most important assumed fact appears to have been the lack of a coordinated relationship between the acquiror, DuPont, and the third party prereorganization purchaser of target stock, Seagram:

> The parties stipulated that petitioner and DuPont, through their wholly owned subsidiaries, were acting independently of one another and pursuant to competing tender offers. Furthermore, there is, of course, nothing in the record to suggest any prearranged understanding between petitioner and DuPont that petitioner would tender the Conoco stock purchased for cash if petitioner by means of its own tender offer failed to achieve * control of Conoco. Consequently, it cannot be argued that petitioner, although not a party to the reorganization, was somehow acting in

connection with DuPont, which was a party to the reorganization. If such had been the case, the reorganization would fail because petitioner's cash purchases of stock would be attributed to DuPont, thereby destroying continuity.[39]

In respect of its emphasis on what the acquiring corporation issued in the transaction rather than on shareholder level trading, the Seagram decision is consistent with the narrow approach to continuity of interest advocated in this Report. Moreover, as noted above, in adopting this approach to prereorganization continuity, the Tax Court was responsive to the same administrative concerns leading us to advocate a narrow view of postreorganization continuity in this Report. Thus, while the reasoning of the Tax Court and its treatment of the previous authorities may be subject to criticism, we believe that the result of the decision represents a useful step forward in the formulation of a rational and workable continuity of interest doctrine. Now that Seagram has been settled, an important function of any new regulation on continuity of interest would be to confirm, for future transactions, the result reached by the Tax Court in Seagram and to address the questions of its interpretation discussed here.

The approach to prereorganization continuity exemplified by the Seagram decision is difficult to square with a postreorganization continuity test that views either target shareholder intentions to sell or actual postreorganization sales by target shareholders as potentially the sole determinants of whether the continuity of interest test is met. It seems to make little sense to have a rule under which one target shareholder

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39 104 T.C. 101. One case arguably can be read for the proposition that purchases by a shareholder of the acquiror should be taken into account even if the shareholder was acting on his own behalf. See The South Bay Corporation v. Commissioner, 345 F.2d 698 (2d Cir. 1965). Compare Rev. Rul. 68-562, 1968-2 C.B. 195 (cash purchase of T stock by individual shareholder of P in his individual capacity did not violate the solely rule under section 368(a)(1)(B) because shareholder was acting in his individual capacity). See also Rev. Rul. 85-139, 1985-2 C.B. 123 (cash purchase of T stock by subsidiary of P does violate solely requirement).

could freely sell to another target shareholder before a merger without affecting the continuity analysis, but the same shareholder could not intend to sell or sell its acquiring corporation stock immediately after the transaction to the same person without jeopardizing the tax-free treatment of the transaction. Thus, consistency with the position taken in Seagram as to prereorganization continuity represents one basis for the proposals discussed in this Report.

D. The Role of Continuity of Interest Doctrine Under the Statutory Scheme

We believe that the narrow view of the application of the continuity of interest test advocated in this Report is entirely consistent with the current statutory scheme relating to tax-free reorganizations. Under that scheme, one rational role for a continuity test is to provide by regulation a stock consideration requirement with respect to reorganizations under section 368(a)(1)(A) and section 368(a)(2)(D).

Although the current statute provides specific stock consideration requirements with respect to transactions coming within sections 368(a)(1)(B), 368(a)(1)(C) and 368(a)(2)(E), much of our discussion has called into question the policy basis for any quantitative stock consideration requirement. We believe, however, that it is reasonable, under the current statutory scheme, to require that some quantum of stock consideration be required to be paid in a state law merger as to which the current provisions do not provide an explicit stock consideration requirement to achieve tax-free reorganization treatment. Under principles articulated in Revenue Ruling 69-6,[40] an acquisitive merger transaction is

[40] 1969-1 C.B. 104.

conceptualized for tax purposes as, in substance, a sale of assets by the target corporation followed by a liquidation of the target corporation and the distribution of the proceeds to its shareholders. The statutory rules applicable to reorganizations under section 368(a)(1)(C) require that at least eighty percent of the consideration paid must be voting stock of the acquiring corporation for tax-free reorganization treatment to be applied to an asset sale followed by a liquidation. Given that explicit statutory requirement for “practical mergers,” it might be viewed as anomalous if there were no stock consideration requirement for a statutory merger, a transaction viewed for tax purposes as having the same economic effect. Thus, in our view, one reasonable remaining function of the continuity of interest doctrine is to eliminate that anomaly by providing a nonstatutory requirement that stock consideration be given in merger and consolidation transactions potentially subject to Code sections 368(a)(1)(A) and 368(a)(2)(D). While we believe that there are important general policy reasons to believe that no stock consideration requirement should be imposed by statute or otherwise, the principal lesson we draw from our analysis in this respect is that the role of the continuity of interest doctrine with respect to corporate acquisitions should be circumscribed as much as possible and should, at the most, be the limited one of rationalizing the current statutory scheme.

It is important to note that this limited function can be served without any requirement relating to the actual identity of shareholders immediately before or after the transaction. By contrast, the “control immediately after” requirement with respect to reorganizations under section 368(a)(1)(B) can be viewed as necessary to assure the requisite degree of combination of the acquiring and target corporation.

This same function need not be served in the context of a state law merger in which, by definition, the two entities have been amalgamated.

As ably demonstrated by Peter Faber in his recent article,[41] the narrow view of the role of the continuity of interest doctrine we advocate as a backstop to the statutory provisions without an explicit stock consideration requirement is consistent with its original judicial conception. The seminal case on continuity of interest is Cortland Specialty Co. v. Commissioner.[42] Cortland involved the purchase by one corporation of all the assets of another corporation solely for cash and short-term notes. The substantive definition of reorganization under section 203 of the Revenue Act of 1926 was, on its face, broad enough to encompass the transaction, as it defined a reorganization as a "merger" or "consolidation" including "the acquisition by one corporation of at least a majority of the total number of all other classes of stock of another corporation, or substantially all the properties of another corporation." Faced with a statute with no requirement of stock consideration, and, therefore, with no basis for distinguishing taxable corporate asset sales from tax-free corporate transactions, the court in Cortland imposed one.[43]

In the years since Cortland, Congress has specifically provided statutory stock consideration requirements with respect to transactions other than statutory mergers and consolidations.

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41 Faber, "Postreorganization Sales and Continuity of Interest," 68 Tax Notes 863 (Aug. 14, 1995).

42 60 F.2d 937(2d Cir. 1932), cert, denied, 288 U.S. 599 (1933).

43 One commentator has argued that application of the continuity of interest doctrine after 1934 to statutory mergers was not inevitable and criticizes Roebling v. Commissioner, 143 F.2d 810 (3d Cir. 1944) on that basis. However, this was perhaps not a surprising result because in the early years of the reorganization provisions before 1934 the state merger statutes themselves contemplated stock consideration. See Miller at 200, 205-207.

Given that fact and the historic backdrop against which Congress enacted the current provisions (which included judicial cases imposing a continuity requirement),[44] it would be inappropriate for no requirement to be imposed in the remaining cases in which no stock consideration requirement is imposed statutorily. In this respect, then, the continuity of interest doctrine is still a necessary adjunct to the statutory provisions and performs a role today analogous to that which it performed at the time of the Cortland case.

II. Implementation of a Narrow Test

The primary determinant of whether the continuity of interest test would be met under a narrow approach to postreorganization continuity is whether the acquiring corporation issued the requisite amount of stock in the merger transaction to stockholders of the target corporation. Under this view, the intent of former target shareholders to sell their stock in the acquiring corporations would not be determinative. In this Part of the Report, we will elaborate on several other aspects of a narrow approach to postreorganization continuity.

A. Registration Rights and the Relevance of Acquiror Involvement

Historically, one of the most sensitive facts with respect to postreorganization continuity has been the provision of registration rights to target shareholders by the acquiring

[44] See Cohen, Silverman, Jr., Surrey, Tarleau & Warren, "The Internal Revenue Code of 1954: Corporate Distributions, Organizations, and Reorganizations," 68 Harv. L. Rev. 393, 415(1955)("The requirements respecting 'continuity of interest'. . . presumably continue to apply even though the legislative history of the new Code does not expressly so indicate.").

corporation. Registration of the acquiring corporation stock held by large former target shareholders may be necessary for such shareholders to sell their stock freely even if the stock was registered in the merger.

A large variation in such rights is possible. One possibility is for the acquiring corporation to provide a shelf registration for the stock of large target shareholders. Such registration rights simply have the effect of putting these shareholders on more of a parity with shareholders who have fully tradable stock in the acquiror, and should clearly not affect the continuity analysis.

Other registration rights, like those involved in McDonald's, grant the shareholder in question the right to participate in an actual underwritten public offering undertaken by the acquiror, thus permitting potentially better execution than is possible with regular trading of acquiring corporation stock. These registration rights may be "piggyback", in which case the shareholders have no rights unless and until the acquiring corporation initiates the offering; or such rights may be "demand" registration rights, in which case the shareholders can require the corporation to undertake the offering. In some cases, the corporation is required to bear the costs of the underwriting. In many cases, the primary purpose of the provision of these rights will be to facilitate the eventual elimination of an unwelcome large shareholder of the acquiring corporation. In our view the provision of registration rights of this kind to former shareholders of a target corporation should, as a conceptual matter, generally not be viewed as affecting continuity of interest.

We have specifically considered -- and rejected -- a more expansive test of postreorganization continuity that would also focus in large part on corporate level conduct, including the provision of registration rights. This approach -- referred to above as the acquiror involvement test -- would emphasize whether the acquiring, corporation had a significant involvement in postreorganization sales that were contemplated by target shareholders at the time of the transaction. Under this conception of the doctrine, neither shareholder intent to sell, nor actual temporally related sales by former target shareholders, would, taken alone, be determinative in the application of the continuity of interest test. Under this approach, however, if, as in the McDonald's case, there were significant evidence of shareholder intent to sell having been considered in the negotiation of the transaction itself, coupled with substantial involvement of one or both of the corporate parties in facilitating such later sales, the continuity of interest test would be implicated. The provision of registration rights could be viewed as an important factor under this approach.

The acquiror involvement test of postreorganization continuity could be viewed as one based on a broad view of the "plan of reorganization" concept. It could also be viewed as at least reconcilable with the Tax Court's decision in Seagram with respect to prereorganization continuity of interest: the contest for control between Seagram and DuPont in that transaction -- at least in its initial stages -- precluded a finding that Seagram's purchases were pursuant to a "plan of reorganization" involving the acquiror, DuPont. Because mere shareholder trading or intent to sell, without involvement of the corporate parties, would not be determinative and because a plan of reorganization standard could possibly be formulated in a manner that rationalized existing case law, a regulation articulating such an approach could be viewed as a step forward in the administration of the continuity of interest test.

Nonetheless, we reject this more expansive approach for two reasons central to the motivations for the position advocated in this Report. First, for the reasons described above, we see no significant general policy argument for taking a broader approach to the continuity of interest doctrine than that which we are advocating. Second, under the more expansive, acquiror involvement approach to postreorganization continuity, the question of what is part of a plan of reorganization would inescapably give rise to difficult problems of administration. As noted above, the Court of Appeals itself in McDonald's was influenced by its weighing of a number of factors and pointed to the relative uniqueness of the interaction of those factors in that case. We acknowledge that, in rejecting this broad acquiror involvement approach, we propose an approach that is inconsistent with that applied by the Court of Appeals in McDonald's.

B. Identity of Shareholders and Binding Commitment To Sell

One of the implications of a narrow view of continuity is that the identity of persons receiving acquiring corporation stock in the transaction is generally not relevant to the continuity analysis so long as these persons are receiving that stock in respect of a stock interest in the target corporation. In this regard, we have specifically addressed the question whether the binding commitment of target shareholders to sell the acquiring corporation stock which they receive in the reorganization should generally be fatal for continuity purposes.

Assume, for example, that X, Y, and Z, who each own one-third of the stock of T, are entitled to receive A stock in a corporate merger between A and T. X, Y and Z agree, however, before the merger, to sell the A stock they receive to P, Q and R, respectively, immediately after the merger. In our view, it should not, as a conceptual matter, be determinative whether the recipients of the acquiring corporation stock in the merger are viewed as X, Y and Z or P, Q and R.

A number of the members of the Tax Section have articulated the contrary view -- that binding contracts to sell by target shareholders should be taken into account in applying the continuity of interest test. This position would be consistent with the standard applicable to section 351 transactions, which as noted above are now a common form of tax-free acquisition transaction. Moreover, even a binding commitment rule would involve a dramatic and beneficial narrowing of the current administrative position concerning postreorganization continuity.

A larger group of our Executive Committee was not in agreement with the binding commitment approach for three reasons. First, it seems somewhat anomalous for X, Y and Z in the example above to be able to sell their stock in the target corporation before the transaction without affecting continuity, but not to be able to agree, in binding agreements, to sell their new stock in the acquiring corporation immediately thereafter. Because under Seagram, and consistently with a narrow view of prereorganization continuity, prereorganization sale transactions would be permitted, it seems difficult to justify a binding commitment test for postreorganization continuity. Second, there would still be many of the same disadvantages associated with administration of continuity of interest doctrine currently if a binding commitment test were imposed. Actions beyond the control of either corporate party to the transaction would still affect the tax treatment of the entire transaction -- potentially to the disadvantage of small stockholders. Moreover, unless a five percent shareholder rule were adopted, it is questionable whether, in fact, it can be determined that binding contracts have not been entered into by stockholders of target with stock sufficient to defeat satisfaction of the continuity of interest test. Third, there is no policy or statutory rationale for such a requirement. By contrast, for example, application of the “control immediately after” requirement to reorganizations under section 368(a)(1)(B) serves, as noted above, the function of requiring the requisite amalgamation of the two entities. In rejecting a binding commitment test, we also may be viewed as rejecting the approach in fact applied by the Tax Court in McDonald’s, a judicial opinion generally viewed in a more favorable light by critics of the current state of the law on postreorganization continuity.

C. Relevance of Substance Over Form and Step Transaction Principles: Different Approaches to Implementation of a Narrow Test

While general principles of step transaction and substance over form would have a limited role under a narrow test of postreorganization continuity, some such questions may still arise in implementing such an approach. Consider, for example, the following extreme case that has been the focus of our discussions. Assume that corporation A wishes to acquire corporation T by merger. T has one shareholder, X, owning 10 percent of the T stock who wants A stock in the transaction and tax-free treatment; it is believed that the other shareholders want cash. A agrees to a merger with T, and pursuant to the merger documents agrees, at the election of target shareholders, simultaneously with the merger, to register the stock and pay for the costs of an immediate underwritten public offering of an amount of stock up to the ninety percent stock of A nominally received by the shareholders of T in the merger other than shareholder X so that target shareholders who desire cash can receive cash consideration immediately upon the closing of the merger transaction.[45]

A case such as this potentially brings a narrow approach test into conflict with the substance over form doctrine, and our group was not able to resolve the conflict in a manner satisfactory to all. Three different views of these issues were expressed.

One group believes that the simultaneous transactions involved in the above example should not violate postreorganization continuity even if the acquiring corporation arranged the target shareholders' sales to a third party and the target corporation's shareholders owned the acquiring corporation stock for only a very brief period of time during which they assumed little economic risk of ownership. This view was defended on the same basis that our narrow approach itself rests -- chiefly the policy irrelevance of other shareholders' sales and concerns of administrability and simplicity. A number of Executive Committee members thought that application of substance over form principles in even an extreme case would give rise to the same problems as those posed by the acquiror involvement approach to postreorganization continuity. This group believes, then, that satisfaction of postreorganization continuity should depend simply on whether the acquiring corporation actually issued stock in the transaction resulting in additional dilution of the acquiring corporation equity.

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45 <u>Cf</u>.Rev. Rul. 85-119, 1985-2 C.B. 60. Similar issues are potentially posed by an immediate sale of stock to a single third party arranged by the acquiring corporation.

Second, to some, an example like this one could be regarded as an extreme case in which a finding of postreorganization continuity is simply too much at odds with the substance of the transaction for even a narrow postreorganization continuity test to be met.[46] It should be emphasized that even those members who thought this case an appropriate one for denial of tax-free reorganization treatment under the current statutory scheme held the view that the test should be failed only in such an extreme case -- a case involving significant actual involvement by A in the stock sale by the target shareholders, as well as extremely brief legal ownership of the A stock by those persons. In effect, this group believes that, although stock is being issued by the acquiring corporation in the above example, it is not, in substance, being issued to shareholders of the target corporation.

A third group, in part in response to these types of concerns, supports a more modest approach to implementing a narrow postreorganization continuity of interest test that would rely on regulatory safe harbors based on section 246(c) principles. Under this approach, if a target shareholder bears the risk of ownership for some specified period of time after receiving stock in the reorganization transaction, perhaps 30 to 45 days, sales by such shareholder thereafter would not be taken into account

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[46] The result of application of substance over form principles by a court in deciding such a case under a narrow test that focused on the consideration issued to stockholders of target is not free from doubt. If it were established that the acquiring corporation would not have otherwise issued the stock in question and that the target shareholders actually legally owned the stock in question (albeit for a very brief period of time), it would be possible to find, under reasoning similar to that evidenced in Esmark v. Commissioner, 90 T.C. 171 (1988), aff'Ed, 886 F.2d 1318 (7th Cir. 1989), that A actually issued the stock in the merger. Moreover, a court might, like the Tax Court in McDonald's, view the freedom of shareholders to keep the acquiring corporation stock as determinative of the substance of the transaction. To eliminate the uncertainty of judicial treatment of this type of case under substance over form principles, some of those members of the Executive Committee who believe the test should not be met in this extreme case suggest that a regulation state specifically that, in substance, a postreorganization continuity is not present under these circumstances.

for continuity of interest purposes. For this purpose, whether a shareholder should be viewed as having a substantially reduced risk of ownership during any period would be determined utilizing the principles of section 246(c)(4). Thus, because the target shareholders in the above example do not bear the risk of ownership for the requisite period, the safe harbor would not be applicable. The principle reflected in the current ruling guidelines that one disregards, for continuity of interest purposes, sales of public securities by shareholders who own less than five percent would remain unchanged.

This type of rule would, in effect, be a safe harbor in that sales made after the at-risk period elapses would be disregarded regardless of the intent of the selling shareholder at the time of the reorganization. In addition, the involvement of the acquiror in arranging and facilitating the disposition of the shares after the at-risk period expires would not be relevant. Such a safe harbor would thus substitute an objective standard for the present subjective standard which has created significant difficulty.

Under this modest incremental approach to implementing a narrow post-reorganization continuity test, current law would continue to apply to cases outside the safe harbor. We, nevertheless, recommend that, even if this approach is adopted, the Treasury Department and the Service consider a regulation that states specifically that sales, both before and after the reorganization, in which there is no involvement of the acquiror would be disregarded for continuity of interest purposes. It would also be helpful if regulations were to specify that certain forms of acquiror involvement would be disregarded for continuity of interest purposes.

This third approach to implementation of a narrow test resembles the binding commitment approach which we have rejected as a general substantive test for postreorganization continuity. Thus, like the binding commitment approach, such a test might be seen to represent a discontinuity with the rule for prereorganization sales applied in Seagram, especially in cases in which the acquiror has no involvement in the sale and the purchaser cannot be said to be acting for the acquiror. The discontinuity, if it exists, however, can be explained by reference to the purpose underlying this approach, which is chiefly to ensure, with an administrably simple rule, that the acquisition consideration is issued in the merger transaction to persons who are receiving stock in such transaction as *bona fide* target shareholders; a pre-reorganization disposition like that in Seagram would create such bona fide target shareholders. Although the test may be viewed as over inclusive to the extent it affects cases in which there is no implication for actual issuance of the stock to target shareholders by the acquiring corporation because there is no troublesome corporate level activity, this over inclusiveness can perhaps be justified by the difficulty of describing simply and accurately such corporate level conduct.

D. Hedging Transactions

Hedging transactions entered into by target shareholders with respect to stock received in the reorganization also raise a number of questions concerning the application of a narrow postreorganization continuity of interest test. Thus, one basic question is whether under a narrow test an equity swap or costless collar transaction entered into by a former target shareholder with an investment bank with respect to the acquiring corporation stock immediately after receiving the stock (or in anticipation of receiving it) would have implications for the tax treatment of the reorganization transaction itself.[47]

The treatment of such transactions may differ under the three approaches to implementing a narrow test described above. Thus, the simple equity swap described above between a former target shareholder and an investment bank would, in principle, not raise continuity concerns under a narrow approach. Because shareholder identity is irrelevant under a narrow approach, it would generally not matter, as a conceptual matter, if the benefits and burdens of ownership of the stock were viewed for continuity purposes as shifted by the swap to a third party, the investment banking firm. Under the approach based on section 246(c), however, such a transaction would affect the ability to rely on the safe harbor provided under such approach if entered into before the end of the required 30 to 45 at-risk period.

Other cases are conceptually more difficult. Assume as another example that, contemporaneously with a reorganization, an acquiring corporation guaranteed for the benefit of target shareholders a five year equity swap with respect to target stock with a third-party swap dealer. Under the swap, the target shareholder would receive a Libor-based return on a notional principal amount equal to the current value of the acquiring corporation stock received by the shareholders and amounts reflecting any decreases in the acquiring corporation stock relative to the notional principal amount, and the shareholders would pay to the counterparty amounts equal to dividends on the stock plus increases in the value of the stock over the notional principal amount. Although such cases involving an acquiring

[47] We acknowledge that a significant tax policy issue is raised by such transactions in respect of whether such transactions should give rise to current recognition of income. In this Report, we are addressing such transactions only in the context of the continuity of interest test.

corporation guarantee are not common in our experience, it may be useful analytically to consider such cases.

Substantial arguments could be made that this stock should qualify under a narrow continuity of interest test. Although the target shareholders receiving the stock could be viewed as having no cognizable risk with respect to the stock for five years because the swap counterparty has assumed the economic risk for that period and the acquiring corporation has assumed the credit risk relating to the swap counterparty through its guarantee, the stock has in effect been issued by the acquiring corporation in the transaction to an outside party -- the swap counterparty, who has acquired the benefits and burdens of ownership of the stock for five years. Moreover, the target shareholder will, in effect, reacquire the benefits and burdens of the stock after that time. Thus, this transaction is not, for example, the same as a corporation issuing its own stock and then entering into an equity swap with the owners of that stock in which the issuer assumes all the risk of its own stock; the stock has, in substance, been issued to outside parties.

Nonetheless, this case could also be viewed as analogous to a case in which the acquiring corporation arranges the sale to a third party of the stock issued in the transaction contemporaneously with the consummation of the merger; indeed, it could be viewed as worse in one respect because, in addition to arranging the transaction with the third party, the acquiring corporation has assumed a credit risk with respect to that party. If this transaction is viewed in this manner, an argument can be made that the stock should not count for continuity purposes. One’s view of this type of transaction would presumably be affected by how one views immediate sales to third parties arranged by the acquiring corporation, and members of the second group described above, who are concerned with such sales, might view this transaction as troublesome. In any event, it is important that any new regulations deal with this type of transaction because of the current proliferation of hedging transactions in connection with tax-free corporate transactions.

Postreorganization transactions involving agreements by the acquiring corporation actually to purchase stock issued in the reorganization raise even more significant concerns because some transactions -- for example the exercise of a put option by the shareholder -- call into question the substantiality of the interest in the acquiring corporation issued in the transaction and whether this interest constitutes debt or equity for tax purposes. The rules that should be applicable for purposes of the general determination of whether the interest issued is a sufficiently permanent stock interest are beyond the scope of this Report.[48] We do not believe, however, that the purchase of acquiring corporation stock held by target shareholders pursuant to a general stock repurchase program of the acquiring corporation should implicate the continuity of interest doctrine.

III. Administrative Considerations

In formulating our proposals with respect to postreorganization continuity of interest, we have considered two types of additional administrative concerns to the Service: first, the relationship of such a continuity of interest standard to the role of the continuity of interest test applicable to corporate transactions other than mergers and acquisitions; and second, the potential exposure of the Service to whipsaw with respect

[48] See, e.g., Ward v. Commissioner, 29 B.T.A. 1251(1934), N.A. XIII-1 C.B. 31, aff'd sub nom Helvering v. Ward, 79 F.2d 381 (1935); Commissioner v. Fifth Avenue Bank of New York, 84 F.2d 787 (3d Cir. 1936); and U.S. v. Adkins-Phelps, Inc., 400 F.2d 737 (8th Cir. 1968).

to postreorganization continuity, given the existence of judicial decisions in apparent conflict with the narrow standard we have advocated.

A. Relationship of Proposed Test to Continuity of Interest Test Under Section 355

With respect to the relationship of the proposed approach to postreorganization of continuity to other areas, the most serious potential concern appears to be its implications for the continuity of interest test applicable under the section 355 Regulations with respect to corporate divisions.[49] Promulgated at the height of concern with "leaks" in General Utilities repeal with respect to corporate break-up transactions, the final section 355 Regulations issued in early 1989 strengthened the continuity of interest requirement considerably, clarifying that the concept applied with respect to interests in both the distributing and controlled corporation and confirming by regulation the positions taken in previous rulings.[50] While the guidance provided by the section 355 Regulations is relatively general, it is clear that the drafters intended, at least in part, to incorporate the standards applicable with respect to acquisitive reorganizations.[51]

These regulations could be viewed as adopting an approach inconsistent with the narrow approach advocated here. The section 355 Regulations emphasize the identity of the historic

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[49] See Regulation Section 1.355-2(c). The special status of F reorganizations makes it clear that continuity principles adopted in other areas should not necessarily influence application of such principles under application of the doctrine under section 368(a)(1)(F). See Rev. Rul. 96-29, 1996-24 I.R.B.

[50] See Preamble, T.D. 8238, 1989-1 C.B. 93, 94.

[51] The general rule, in its reference to "modified corporate form," reads very similarly. Moreover, the Regulations appear to indicate the quantum of continuity required is similar. See Regulation Section 1.355-2(c)(2), Ex. 2 and 4.

shareholders.[52] Moreover, the section 355 Regulations seem to take into account shareholder as opposed to corporate level plans.[53] Consequently, if a narrow approach to postreorganization continuity is adopted, it may be necessary to issue clarifying guidance with respect to continuity under section 355.

In this connection, we make the following observations. First, as with the application of the continuity of interest test to corporate acquisitions, the most important step is to clarify the central function of the doctrine under section 355. Under section 355, that function appears to be to determine whether an actual corporate division occurred rather than, in substance, a sale of corporate assets followed by a distribution of the proceeds. Because of the possible differences in function of the doctrine with respect to corporate acquisitions and divisions, adoption of the approach proposed in this Report should not be precluded because of concern as to scope of the doctrine under section 355.

Second, even though the function of the continuity of interest doctrine may differ under section 355 from that with respect to acquisitive reorganizations, the type of transaction that may be the focus of application of the continuity of interest test under the section 355 Regulations could be very similar to that discussed above. Thus, for example, if in an Esmark-like transaction, the distributing corporation arranged for the purchase of the distributed stock of the controlled corporation immediately after a corporate division, it would be very appropriate to apply the continuity of interest test to deny tax-free treatment,

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52 See Regulation Section 1.355-2(c)(2) Ex. 2.

53 See Id.

even if the application of Court Holding principles could not otherwise successfully be applied.[54]

Third, in extending section 355 continuity concepts beyond this type of extreme case, the Service faces some of the same administrability concerns discussed above. Thus, for example, if there is no distributing corporation involvement required for continuity to be implicated, application of a strict continuity requirement will be administratively difficult and could cause the corporate parties to lose control over the tax results of the corporate division to both such corporate parties and their shareholders.

Fourth, a safe harbor type approach such that discussed above which applies section 246(c) criteria in the postreorganization context may permit the Service and Treasury to cut the Gordian knot in this area. Significantly different policies in the section 368 and 355 area arguably justify confining safe-harbor relief to the former.

B. Whipsaw: Authority

We have also considered both the possibility of subjecting the Service to whipsaw with respect to the proposed narrow approach and the authority of the Service to adopt such a position. In part because of these considerations, we recommend that the Service and Treasury adopt this revised position through the promulgation of a regulation under section 368. In addition to stating general principles, this regulation should deal

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[54] See Rev. Rul. 96-30, 1996-24 I.R.B. In this regard, it should be noted that the "device" clause does not necessarily restrict the use of section 355 transactions used to accomplish what are, in effect, corporate sales. The device clause was designed to prevent bailouts of corporate earnings and would not apply, for example, in cases in which the corporate division is nonprata. Regulation Section 1.355-2(d)(5)(iv).

specifically with common fact situations, including those discussed above. Assuming the promulgation of a clear and comprehensive regulation, we do not believe concerns regarding either whipsaw or Service authority concerns should deter the Service from adopting (or courts from upholding) our proposed rules on postreorganization continuity of interest.

After the repeal of General Utilities, the class of situations in which whipsaw is a problem is significantly narrowed -- particularly compared to that existing at the time of the McDonald's case. The most common application of postreorganization continuity will be in statutory mergers in which there will be an incentive for both the target shareholders and the acquiring corporation to obtain tax-free treatment. True cases of whipsaw will likely be relatively limited and confined to rare cases like Seagram in which target shareholders have a large loss or cases in which the target corporation is a loss corporation.

More important, we would note that, given the vagueness of the current standard, whipsaw potential exists in considerable measure without the changes we propose. The promulgation of a clear and comprehensive regulation, then, would likely decrease whipsaw, if anything, assuming that the regulation is likely to be upheld in court.

In this regard, we believe the most significant concern is the potential inconsistency noted above between a narrow test and the decision in the McDonald's case. Although language in earlier decisions could be taken to imply a more expansive test that focuses on either the identity of the shareholders in the acquiring corporation or the intent of the former target shareholders, that language can reasonably be viewed as dicta. But, as noted above, a narrow approach of the type we are proposing clearly potentially conflicts with that applied in the McDonald's case.

This existing ease law, however, should not undermine the authority of a new Regulation. The existing case law on postreorganization continuity is relatively undeveloped. There is no Supreme Court decision directly in point, and the case law that does exist is confined to a couple of circuits. That case law -- particularly McDonald's itself -- was clearly heavily influenced by the Service's then current administrative position.[55]

Moreover, to a significant extent, the narrow position advocated in this Report is motivated by changes in applicable law. This change in the legal landscape provides a foundation for a reformulation of the continuity of interest test just as changes in the tax treatment of flow-through entities in part prompted proposing check-the-box regulations with respect to entity classification.

Thus, we believe that the regulatory power of the Service and Treasury Department to interpret the tax-free reorganization provisions should and would be found to be sufficient to adopt a narrow approach.

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[55] See 688 F.2d at 527-528.