REPORT #902

TAX SECTION

New York State Bar Association

Report on Proposed Regulations on Continuity of Shareholder Interest

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TAX SECTION

New York State Bar Association

May 19, 1997

Honorable Donald C. Lubick
Acting Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW, Room 3120
Washington, DC 20220

Hon. Margaret M. Richardson
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Dear Secretary Lubick and Commissioner Richardson:

I am pleased to enclose a Report prepared by the Committee on Reorganizations of the Tax Section of the New York State Bar Association, commenting on the Proposed Regulations regarding the continuity of shareholder interest ("COSI") requirement for corporate reorganizations. As stated in an earlier report of the Tax Section, dated October 15, 1996, the Tax Section supports the position that the COSI doctrine should focus on whether the acquiring corporation issued the requisite amount of stock in the transaction to shareholders of the target corporation, rather than on the post-transaction actions of the former target shareholders.

The enclosed Report supports the concept in the Proposed Regulations that all facts and circumstances must be considered in determining whether the acquiring corporation has furnished the required consideration. It recommends that the IRS and Treasury include an example in the final regulations that addresses a situation where the acquiring corporation furnishes equity consideration to the target shareholders, but the acquiring corporation has significant involvement in the immediate disposition of those shares by the target shareholders. In addition, the Report recommends that the IRS and Treasury open a separate regulations project to consider pre-reorganization COSI issues. Finally, the Report does not object in general to the proposed effective date, although it does recommend reconsideration of the rule on pre-effective date binding contracts, and encourages the IRS and Treasury to finalize the regulations as soon as possible.

Please let me know if we can be of further assistance in the finalization of the proposed regulations.

Very truly yours,

Richard O. Loengard, Jr.
Chair

CC: Kenneth J. Krupsky
Deputy Assistant Secretary
(Tax Policy)
United States Treasury

Jonathan Talisman
Tax Legislative Counsel
United States Treasury

Hon. Stuart L. Brown
Chief Counsel
Internal Revenue Service

Tax Report #902

New York State Bar Association

Tax Section

Report on Proposed Regulations on Continuity of Shareholder Interest

This report[1] of the Committee on Reorganizations of the Tax Section of the New York State Bar Association comments on proposed regulations (the “Proposed Regulations”) regarding the continuity of shareholder interest requirement for corporate reorganizations. The Proposed Regulations were issued on December 20, 1996.

In order for a transaction to qualify as a tax-free reorganization, it must satisfy both the statutory requirements of section 368[2] and certain non-statutory requirements, including continuity of shareholder interest (“COSI”). Section 1.368-1(e)(1) of the Proposed Regulations provides that COSI requires that the acquiring corporation furnish consideration representing a proprietary interest in the affairs of the acquiring corporation and that such consideration represents a substantial part of the value of the stock or properties transferred. In determining whether the acquiring corporation has furnished the requisite consideration, all facts and circumstances must be considered, including any plan or arrangement for the acquiring corporation or its successor corporation (or a person related to

[1] The principal drafter of this report was Eric Solomon. Members of the Committee who participated in the drafting of this report were Susan Goldbaum, Bertram Kessler, Annaliese Kambour, Aliza Levine, Jay Milkes, Dale Ponikvar, Gayle Sered, Lewis Steinberg and Linda Swartz. Helpful comments were received from Peter Blessing, Lawrence Garrett, Harold Handler, Robert Jacobs, Richard Loengard, Robert Rothman, Michael Schler, Robert Schwartz, Ann Thomas and Steven Todrys.

[2] Citations are to sections of the Internal Revenue Code of 1986, as amended.

the acquiring corporation or its successor corporation within the meaning of section 707(b)(1) or section 267(b) (without regard to section 267(e)) to redeem or acquire the consideration provided in the reorganization. If based on all the facts and circumstances the acquiring corporation has furnished insufficient equity consideration, the continuity of shareholder interest requirement is not satisfied. Section 1.368-1(e)(3) of the Proposed Regulations provides four examples illustrating the application of the proposed rules.

The regulations are proposed to apply to transactions occurring after the regulations are published as final regulations in the Federal Register, except that they would not apply to any transactions occurring pursuant to a written agreement which is (subject to customary conditions) binding on or before the regulations are published as final regulations.

SUMMARY OF COMMENTS

1. The Committee supports the general approach of the Proposed Regulations- the determining factor should be whether the acquiring corporation issued the requisite amount of stock in the transaction to shareholders of the target corporation. Dispositions of stock of the acquiring corporation by former target shareholders generally should not be taken into account.

2. The Proposed Regulations state that all facts and circumstances must be considered in determining whether the acquiring corporation has furnished the required consideration. The Committee supports this concept in the Proposed Regulations. The Committee recommends that the IRS and Treasury include an example in the final regulations that addresses the situation where the acquiring corporation furnishes equity consideration to

the target shareholders, but the acquiring corporation has significant involvement in the immediate disposition of those shares by the target shareholders.

3. The preamble indicates that the Proposed Regulations do not specifically address the effect on COSI of dispositions of target stock before a transaction potentially qualifying as a re-organization. The Committee recommends that the IRS and Treasury open a separate regulations project to consider this area.

4. The regulations are proposed to apply to transactions occurring after the regulations are finalized. In general, the Committee does not object to the proposed effective date. However, the Committee recommends that the IRS and Treasury reconsider the portion of the effective date provision which would make the old COSI rules applicable to transactions occurring after the effective date, pursuant to a binding written agreement entered into on or before that date. The report concludes by urging that the regulations be finalized as soon as possible.

DISCUSSION

1. General Approach

In its report submitted on October 15,1996 (the “1996 NYSBA Report”), the Tax Section recommended that the IRS and Treasury adopt a narrow view of the COSI doctrine that would focus on whether the acquiring corporation issued the requisite amount of stock in the transaction, rather than on the post-transaction actions of the former target shareholders. The report discussed at length how a narrow approach is well grounded in tax policy. Accordingly, the Tax Section supports the general approach of the Proposed Regulations.

Under the Proposed Regulations, cash paid to former target shareholders for their acquiring corporation stock by a person related to the acquiring corporation or its successor corporation within the meaning of section 707(b)(1) or 267(b) (without regard to section 267(e)) might be treated as provided by the acquiring corporation in the reorganization. The Committee supports this concept of focusing on the consideration provided by the acquiring corporation and its economic family, including related individuals. This concept is consistent with pre-reorganization COSI cases, such as Superior Coach of Florida, Inc. v. Commissioner, 80 T.C. 895 (1983), and Yoc Heating Corp. v. Commissioner, 61 T.C. 168 (1973), in which asset transfers failed the COSI requirement because parties related to the acquiring corporations purchased target stock before the asset transfers. Compare J.E. Seagram Corp. v. Commissioner, 104 T.C. 75 (1995) (Seagram acted independently in purchasing 32 percent of Conoco's stock, and therefore Seagram's purchases of Conoco stock did not cause the merger of Conoco into a DuPont subsidiary to fail the COSI requirement). The Committee recommends that the language of the regulations be clarified to make clear that the acquiring corporation need not be the source of the funds used by the related party to acquire the acquiring corporation stock from the target shareholders in order for the transaction to be characterized as a use of cash consideration by the acquiring corporation.[3]

[3] The Committee recognizes that in Rev. Rul. 68-562,1968-2 C.B. 157, the IRS took the position that a stock-for-stock acquisition qualified as a section 368(a)(1)(B) reorganization, even though two months before the stock-for-stock acquisition the majority shareholder of the acquiring corporation purchased half of the target's stock for cash. The Committee believes that for COSI purposes cash paid by related parties should be treated as provided by the acquiring corporation.

2. Scope of Application of Step Transaction and Substance Over Form Doctrines

A significant advantage of applying a narrow approach to COSI is that step transaction and substance over form principles would no longer have any relevance to a shareholder disposition of acquiring corporation stock where the acquiring corporation is not the purchaser and otherwise has no involvement in the disposition. However, as noted in the 1996 NYSBA Report, even under a narrow approach, questions regarding these doctrines would still arise.

The 1996 NYSBA Report posed a particular case to highlight the issue. Assume that corporation P wishes to acquire corporation T by merger. T has a 10 percent shareholder, X, who wants P stock in the transaction and tax-free treatment. It is believed that the other T shareholders want cash. P agrees to a merger with T, and pursuant to the merger documents agrees, at the election of the target shareholders, simultaneously with the merger, to register the P stock and pay for the costs of an immediate underwritten public offering of an amount of stock up to the percentage of P stock nominally received in the merger by the T shareholders other than X, so that T shareholders who desire cash can receive cash consideration immediately upon the closing of the merger transaction. This case involves significant actual involvement by P in the stock sale by the T shareholders, as well as extremely brief legal and economic ownership of the P stock by those persons.

The Proposed Regulations incorporate the step transaction and substance over form doctrines, stating that in determining whether the acquiring corporation has furnished the requisite consideration, all facts and circumstances must be considered.[4] Under current law, it is not clear whether a court would apply either of these doctrines in the case of the immediate public offering described above to conclude that COSI is lacking.[5] Accordingly, the treatment of that case (as well as various other situations) is unclear under the Proposed Regulations.

Furthermore, the examples in the Proposed Regulations do not provide clear guidance on the case of the immediate public offering. In Example 2, the majority target shareholder obtains registration rights with respect to acquiring corporation stock and sells such stock shortly after the merger in the open market. Example 2, in which the COSI requirement is satisfied, may be distinguished from the case of the immediate public offering because, in Example 2, the target shareholder sells the acquiring corporation stock "shortly after" the merger, which may be a longer period of ownership than in the case of the immediate public offering. Furthermore, in Example 2 the target shareholder sells the acquiring corporation stock in the open market, and not in the acquiring corporation's underwritten public offering.

In Example 1, immediately after the merger, and pursuant to a preexisting binding contract negotiated by the sole target

[4] The preamble states that "the proposed regulations emphasize that all facts and circumstances must be considered in determining whether the acquiring corporation has in substance furnished the required consideration." (Emphasis added.)

[5] As discussed in the 1996 NYSBA Report, if it were established that the acquiring corporation (P) would not have otherwise issued the stock in question and that the shareholders of die target corporation (T) actually legally owned the P stock in question (albeit for a very brief period of time), it would be possible to find, under reasoning similar to that in Esmark, Inc. v. Commissioner, 90 T.C. 171 (1988), aff'd, 886 F.2d 1318 (7th Cir. 1989), that P actually issued the stock in the merger. Moreover, a court might, like the Tax Court in McDonald's of Zion v. Commissioner, 76 T.C. 972 (1981), rev'd, 688 F.2d 520 (7th Cir. 1982), view the freedom of the T shareholders to keep the P stock as determinative of the substance of the transaction.

shareholder, the sole target shareholder sells all of the acquiring corporation stock received in the merger to a party unrelated to the acquiring corporation. In Example 3, the majority target shareholder, without the involvement of the acquiring corporation, arranges with an independent investment banker to hedge the risk of loss on the acquiring corporation stock received in the merger. Examples 1 and 3, in which the COSI requirement is satisfied, may be distinguishable from the case of the immediate public offering because, in Examples 1 and 3, the acquiring corporation has no involvement in the target shareholder's sale or hedge of the acquiring corporation stock.

In Example 4, pursuant to an agreement, shortly after the merger the acquiring corporation or its wholly owned subsidiary redeems for cash all of the acquiring corporation stock received by the majority target shareholder. Example 4, in which the COSI requirement is not satisfied, may be distinguishable from the case of the immediate public offering because, in Example 4, the redemption by the acquiring corporation (or the purchase by the acquiring corporation's subsidiary) has the effect that no more acquiring corporation stock is outstanding after the merger than before it.

The Committee supports the concept in the Proposed Regulations that all facts and circumstances must be considered in determining whether the acquiring corporation has furnished the required consideration. The Committee recommends, however, that the IRS and Treasury include an example in the final regulations that addresses the case posed in the 1996 NYSBA Report. The example would illustrate that COSI would exist if the acquiring corporation issues stock in the transaction to the target shareholders and such issuance results in additional acquiring corporation shares outstanding. COSI would exist even if the acquiring corporation helped to arrange the target shareholders' sales to third parties and the target shareholders owned the acquiring corporation stock for only a brief period of time. This approach would add some helpful certainty to the regulations by limiting step transaction and substance over form concerns to situations where the acquiring corporation subsequently redeems shares, as in Example 4 of the Proposed Regulations.[6] [7]

3. Pre-Reorganization COSI

The preamble states that the Proposed Regulations do not specifically address the effect on COSI of dispositions of target stock before a transaction potentially qualifying as a re-

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[6] Under this approach, COSI should exist even in a situation where the parties initially contemplated a new issuance of stock for cash and a cash merger, but subsequently decided to do a merger for stock followed by a shareholder sale of acquiring corporation stock. The Committee believes that adopting such a view in the COSI rules should not subvert the potential application of the principle of Commissioner v. Court Holding Co., 324 U.S. 331 (1945), in other situations.

[7] The 1996 NYSBA Report, submitted before the issuance of the Proposed Regulations, suggested an alternative approach. This alternative approach, concerned about the difficult issues that application of step transaction and substance over form doctrines would cause, would take a more modest approach than the Proposed Regulations. This alternative approach would retain current law, but would establish regulatory safe harbors. Under one safe harbor, sales without acquiror involvement would be disregarded. Under a second safe harbor, sales of acquiror stock by less than 5 percent shareholders of a publicly traded target would be disregarded. Under a third safe harbor, sales of acquiror stock by target shareholders after they have held the acquiror equity at the risk of the market (using the principles of section 246(c)) for a certain period of time (perhaps 30 or 45 days) would be disregarded. For transactions not satisfying a safe harbor, present law substantive rules would apply.

The Committee does not recommend that the IRS and Treasury now adopt this alternative approach. The Proposed Regulations represent a substantial improvement in the law, disregarding independent sales of acquiror stock by target shareholders. Furthermore, acquiror involvement is not present in most sales of acquiror stock by target shareholders. Consequently, the Committee does not recommend that the IRS and Treasury now reconsider the basic rule of the Proposed Regulations because of concerns about step transaction and substance over form issues raised by acquiror involvement in post-reorganization sales of acquiror stock.

organization. The words of the Proposed Regulations, however, appear to apply to pre-reorganization COSI as well as post-reorganization COSI.[8] Furthermore, in Example 1 of the Proposed Regulations, the COSI requirement is satisfied where before the merger, the sole target shareholder has negotiated and entered into a binding contract to sell the acquiror shares. If the COSI requirement is satisfied in Example 1, it should be satisfied if the sole target shareholder negotiated and completed a sale of his target shares before the merger.

In general, as a policy matter, there should be conceptual consistency between pre-reorganization and post-reorganization COSI. For example, independent shareholder sales before a merger should not affect COSI. A regulation to this effect would be consistent with the Tax Court’s holding in J.E. Seagram Corp. v. Commissioner, 104 T.C. 75 (1995), in which the COSI requirement was satisfied in the merger of Conoco into a DuPont subsidiary because Seagram acted independently of DuPont in purchasing 32 percent of Conoco’s stock before the merger.

In finalizing the COSI regulations, an important practical question is whether to deal with pre-reorganization COSI. The Committee recognizes that there are certain difficult issues arising from pre-reorganization transactions involving the target corporation’s stock. For example, suppose the acquiring corporation arranges to find someone who purchases all or a

[8] Section 1.368-1(e)(1) of the Proposed Regulations provides in relevant part: “Continuity of shareholder interest requires that the acquiring corporation furnish consideration representing a proprietary interest in the affairs of the acquiring corporation and that such consideration represents a substantial part of the value of the stock or properties transferred.” These words are not limited to post-reorganization COSI.

substantial portion of the target corporation's stock before the merger. As another example, suppose that the target corporation borrows in order to fund a redemption of a substantial portion of its stock, and the acquiring corporation assumes that debt in the merger. Under the principles of the Proposed Regulations, it would be necessary to examine all the facts and circumstances to determine whether in substance the acquiring corporation has furnished the cash as part of the merger. Thus, it is apparent there would be uncertainties about application of the step transaction and substance over form doctrines in pre-reorganization situations, too.

Furthermore, the IRS and Treasury would need to analyze the relationship of pre-reorganization COSI regulations to two-step acquisitions. Cash paid to target shareholders by the acquiring corporation or a person related to the acquiring corporation within the meaning of section 707(b)(1) or section 267(b) (without regard to section 267(e)) in a pre-reorganization stock purchase would presumably be treated as consideration furnished by the acquiring corporation that does not represent the required proprietary interest. For example, if A, an individual, purchases all the stock of T corporation for cash, and then T merges into P corporation, which is wholly owned by A, presumably for COSI purposes the cash would be treated as provided by P to the T shareholders, so that the COSI requirement would not be satisfied in the merger of T into P. See Superior Coach of Florida, Inc. v. Commissioner, 80 T.C. 895 (1983).

In addition, pre-reorganization COSI regulations would need to be coordinated with the specific rule about continuity of interest included in Reg. §1.338-2(c)(3), which deals with two-step acquisitions in which the first step is a qualified stock purchase. Reg. §1.338-2(c)(3) generally treats target stock acquired by a purchasing corporation in a qualified stock purchase as an interest that for COSI purposes can be continued in a reorganization. Thus, if the purchasing corporation makes a qualified stock purchase of a target corporation and subsequently merges the target into the purchasing corporation (or another member of the affiliated group of the purchasing corporation), the COSI requirement is treated as satisfied. However, the COSI requirement is not satisfied in the second step merger with respect to a minority shareholder of the target whose stock is not purchased by the purchasing corporation and who receives stock in the second step merger.

Pre-reorganization COSI regulations presumably would not change the results of Reg. §1.338-2(c)(3). That is, the COSI requirement would be satisfied for purposes of the transfer of assets from the target corporation to the purchasing corporation (or to another member of the purchasing corporation's affiliated group). However, with respect to a minority shareholder of the target corporation who receives stock in the second step merger, the cash received by the other target shareholders would be treated as provided by the corporation acquiring the target's assets in the merger, so that the COSI requirement would not be satisfied with respect to the minority shareholder, who consequently would not receive section 354 treatment.[9] [10]

In the Committee's view, the Proposed Regulations, if finalized, would represent a significant improvement in the law and, for this reason, the Committee recommends that the IRS and Treasury expeditiously proceed to resolve the remaining issues

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[9] In other words, presumably the result in the example in Reg. §1.338-2(c)(3) would not change. For purposes of T (the target corporation) and X (the transferee corporation in the merger), the COSI requirement would be satisfied, but for K (the minority shareholder of T) the COSI requirement would not be satisfied, so that K would not receive section 354 treatment.

[10] In the situation where the second step merger is into a newly formed shell subsidiary of the corporation that made the qualified stock purchase, the impact of Rev. Rul. 96-29, 1996-1 C.B. 50, on a minority shareholder of the target corporation (K) who receives stock of the newly formed corporation in the second step merger is unclear under current law. Rev. Rul. 96-29 deals with the impact of the step transaction doctrine on the qualification of a reincorporation as a section 368(a)(1)(F) reorganization where, as part of an overall transaction, there is a shift in ownership occurring in a step that precedes or follows the reincorporation. Arguably, Rev. Rul. 96-29 only applies to ease application of the step transaction doctrine for purposes of the identity of proprietary interest test in section 368(a)(1)(F) reorganizations, and has no effect on application of the step transaction doctrine for purposes of the COSI requirement in section 368(a)(1)(F) reorganizations. That is, the COSI requirement is not satisfied for K in this situation for purposes of section 368(a)(1)(F) (or any other reorganization provision), so that K would not receive section 354 treatment upon receipt of stock of the newly formed corporation in the second step merger. In preparing pre-reorganization COSI regulations, the issue about treatment of K in this situation should be considered.

Another issue for consideration is presented by King Enterprises, Inc. v. United States, 418 F.2d 511 (Ct. Cl. 1969). Suppose P (the acquiring corporation) acquires all the stock of T (the target corporation) for 50 percent P stock and 50 percent cash. Immediately thereafter, T merges into P. The question is whether, after the enactment of section 338, this transaction is a qualified stock purchase followed by a merger (as in Rev. Rul. 90-95, 1990-2 C.B. 67) or whether it is an overall merger without a qualified stock purchase. The same issue is presented by the facts of J.E. Seagram Corp. v. Commissioner, 104 T.C. 75 (1995). DuPont acquired over 90 percent of the Conoco stock for DuPont stock and cash prior to the merger of Conoco into a DuPont subsidiary. The issue is whether, after the enactment of section 338, this transaction would be a qualified stock purchase followed by a merger or whether it would be an overall merger without a qualified stock purchase.

about post-reorganization COSI and consider issues about pre-reorganization COSI in a separate regulations project.[11]

4. Effective Date

In general, the Committee does not object to the proposed effective date for the regulations. However, the Committee recommends that the IRS and Treasury reconsider the portion of the effective date provision which would make the old COSI rules applicable to transactions occurring after the effective date, pursuant to a binding written agreement entered into on or before that date. The Committee believes most, if not all, taxpayers will prefer to be governed by the new rules, and they will press practitioners and the IRS to tell them whether a change in the terms of an agreement will take the transaction outside this “grandfathering” provision and, if so, how significant the change must be.[12] Hence, the Committee would suggest either elimination of the binding agreement exception so that the new COSI rules will apply to all transactions closing after the effective date or alternatively giving the parties to the agreement who have the power to cancel it, the right to elect

[11] If the IRS and Treasury decide to consider issues about pre-reorganization COSI in a separate regulations project, they also need to consider whether to include limiting language in the general rule of the final regulations so that it applies explicitly and solely to post-reorganization COSI. The Committee notes that even if the final regulations contain a specific carve-out, nevertheless there would remain a clear implication about pre-reorganization COSI, particularly by reason of Example 1, in which the sole target shareholder has a preexisting binding contract to sell the acquiring corporation shares.

[12] For example, perhaps a change in the agreement eliminating restrictions on the ability of target shareholders to sell would be sufficient to make the new rules apply.

application of the new COSI rules. While the Committee considered recommending that the IRS and Treasury provide greater limited elective retroactivity, it decided rather to urge the IRS and Treasury to finalize the regulations as soon as possible.