New York State Bar Association

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NYSBA

July 9, 1998

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

The Honorable Charles O. Rossotti
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Secretary Lubick and Commissioner Rossotti:

I am pleased to enclose a report of the New York State Bar Association Tax Section proposing modifications to the Internal Revenue Service ruling guidelines under Revenue Procedures 77-37 and 86-42 in order to conform those guidelines to the recently finalized regulations concerning the continuity of interest and continuity of business enterprise requirements for corporate reorganizations.

Please let me know if we can be of any further assistance in addressing these issues.

Sincerely,

Steven C. Todrys

Enclosure

cc:

Internal Revenue Service
The Honorable Stuart L. Brown
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Department of the Treasury
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NEW YORK STATE BAR ASSOCIATION
TAX SECTION

Report on Conforming Rev. Proc. 77-37 and Rev. Proc. 86-42 to the New Continuity Regulations[1]

July 7, 1998

The final and temporary and proposed regulations concerning the "continuity of interest" ("COI") and "continuity of business enterprise" ("COBE") requirements, published on January 28, 1998, T.D. 8760, 63 Fed. Reg. 4174 (Jan. 28, 1998); T.D. 8761, 63 Fed. Reg. 4204 (Jan. 28, 1998), generally governing transactions occurring after January 28, 1998, clarify, and in important respects, simplify the determination of whether the COI and COBE requirements will be met with respect to a potential tax-free reorganization. In light of these regulations, the Internal Revenue Service (the "IRS") ruling guidelines, expressed in Rev. Proc. 77-37, 1977-2 C.B. 568, and Rev. Proc. 86-42, 1986-2 C.B. 722, require updating. This report proposes modifications to conform the guidelines to the new regulations. It also includes some comments and observations.

I. Background

A. COI

With respect to the COI requirement, Treas. Reg. Section 1.368-1(e) sets forth the requirement that, generally, to qualify as a "reorganization" under Section 368(a) of the Internal Revenue Code of 1986, as amended (the "Code"), a substantial part of the value of the "proprietary interest" of a target corporation must be preserved.[2] The regulations provide that a proprietary

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[1] The principal drafters of this report were Glen Kohl, Eric Solomon and Peter Bergman. Helpful comments and ideas were received from Peter Canellos, Robert Jacobs, Joseph Pari, Michael Schler, Jodi Schwartz, Lewis Steinberg and Steven Todrys.

[2] New Treas. Reg. Section 1.368-1(b) implies, as did its predecessor, that the COI requirement is not applicable to reorganizations under Section 368(a)(1)(D). See also preamble to the final regulations, T.D. 8760, 63 Fed. Reg. 4174 (Jan. 28, 1998). We

interest in the target corporation is preserved if it (i) is exchanged for a proprietary interest in the "issuing corporation," (ii) is exchanged by the acquiring corporation for a direct interest in the target corporation enterprise, or (iii) continues as a proprietary interest in the target corporation. As set forth in the regulations, and for purposes of this discussion, the term "issuing corporation" is defined as the acquiring corporation or, in the case of a triangular reorganization, as the corporation in control of the acquiring corporation. The regulations do not define the term "proprietary interest."

The regulations clearly establish that pre-reorganization sales of target stock or post-reorganization sales of issuing corporation stock are generally disregarded in determining whether a proprietary interest has been preserved. The only exceptions to this rule are transactions involving the target and issuing corporation and specified related persons, including transactions with persons who become related by virtue of the transaction or, in certain circumstances, in the reorganization.[3]

COI is not preserved to the extent the acquiring corporation uses consideration other than its stock. Further, a proprietary interest in a target corporation is not preserved if, in connection with a potential reorganization, stock issued by the issuing corporation in the transaction is redeemed. Similarly, as set forth in the temporary and proposed regulations, a proprietary interest is not preserved if, prior to and in connection with a potential reorganization, stock of the target corporation is redeemed.[4] With respect to redemptions by the issuing corporation, the regulations

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recommend clarification of this issue (one way or the other).

[3] For purposes of the COI regulations, each partner of a partnership is treated as owning or acquiring any stock owned or acquired, as the case may be, by the partnership in accordance with that partner's interest in the partnership. If a partner is treated as acquiring any stock pursuant to the preceding sentence, the partner is also treated as furnishing any consideration furnished by the partnership to acquire the stock.

[4] We note that prohibited redemptions by the target corporation in the temporary regulations are limited to those "prior to" a potential reorganization. Thus, consider, for example, that where an issuing corporation acquires 81% of the stock of a target corporation in a Section 368(a)(2)(E) reorganization, and the target corporation

provide an example where the redemption of a "small percentage" of stock of the issuing corporation as part of its ongoing stock repurchase program is not considered to affect the continuing proprietary interest of the target shareholders. Treas. Reg. Section 1.368-1(e)(6), Ex. 8.[5]

In addition, a proprietary interest is not preserved if, in connection with a potential reorganization, stock of the target corporation or stock of the issuing corporation issued in exchange for a proprietary interest in the target corporation is acquired by a person related to the issuing corporation for consideration other than stock of the issuing corporation. For this purpose, only another corporation can be related to the issuing corporation. Two corporations are related persons if either they are members of the same 1504 affiliated group (determined without regard to Section 1504(b)) or a "purchase of the stock of one corporation by another corporation would be treated as a

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subsequently redeems the remaining 19% of outstanding stock for cash, the redemption is not addressed by the temporary regulations. Nevertheless, either the redemption should prevent the 19% from counting as a continuing proprietary interest in the target corporation under Treas. Reg. Section 1.368-1(e)(1)(i), or the target corporation should be considered to be a related person with respect to the issuing corporation after the reorganization, such that the redemption by the target corporation will count against continuity under Treas. Reg. Section 1.368-1(e)(2)(i).

[5] A recommendation on the treatment of stock buybacks is beyond the scope of this report. We strongly urge additional guidance. A difficulty in addressing this issue is how to address the intractable problem that, in the context of publicly traded corporations, the buyers and sellers are anonymous. Without making a recommendation, we see at least four alternatives for the treatment of stock buybacks: (i) stock buybacks count against continuity unless the issuing corporation has knowledge the sellers are not former target shareholders; (ii) a pro rata portion of the stock issued in the reorganization is assumed to be sold by target shareholders to the issuing corporation for cash; (iii) stock buybacks do not count against continuity if the buyback is unrelated to the reorganization; if related, all or a pro rata portion of the redeemed stock will count against continuity; or (iv) stock buybacks do not count against continuity, except if the number received exceeds an arbitrary cap of from 25% to 50% of the shares outstanding prior to the reorganization, and except to the extent the issuing corporation has actual knowledge the sellers are former Target shareholders.

distribution in redemption of the stock of the first corporation under section 304(a)(2) (determined without regard to section 1.1502-80(b))." Treas. Reg. Section 1.368-1(e)(3)(i).[6]

The reference to Section 304 has the unfortunate consequence of bringing some of that section's unwanted baggage. For example, under the literal terms of Section 304(a)(1), a transaction described in both subsection (a)(1) and subsection (a)(2) is treated as being described solely in subsection (a)(2). When the constructive ownership rules are applied this means many transactions that, based on actual ownership, would be covered by Section 304(a)(1) (*e.g.*, transactions involving brother-sister subsidiaries of a common parent) literally become subject to Section 304(a)(2), notwithstanding that those transactions are not generally thought of as parent-subsidiary transactions.[7] Section 304(c)(3).

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[6] The reference to Section 304(a)(2) appears to mean that a proprietary interest is not treated as preserved to the extent that stock of the issuing corporation issued in exchange for a proprietary interest in the target corporation is purchased for cash after (but in connection with) the acquisition by a corporation that, after the purchase, either (a) is owned 50% by the issuing corporation or (b) owns at least 50% of the issuing corporation. We assume the latter result was intended. We note, however, that in the latter case, Section 304(a)(2) would not actually have applied to the purchase of stock of the issuing corporation, since the purchase is by a shareholder (rather than a subsidiary) of the issuing corporation. Moreover, as we discuss below, the use of the same Section 304(a)(2) test in the context of pre-transaction acquisitions of stock by persons related to the target corporation was apparently not intended to encompass purchases by persons becoming 50% shareholders (as opposed to purchased by 50% subsidiaries) of the target corporation.

[7] However, in Broadview Lumber Co. v. United States, 561 F.2d 698, 709 (7th Cir. 1977), the Court of Appeals concluded that Section 304(a)(2) should apply instead of Section 304(a)(1) only when the parent corporation had the necessary control of the subsidiary corporation without resort to constructively owned stock.

Similarly, the regulations under Section 304 seem to ignore the ordering rule of the statute. See Treas. Reg. Section 1.304-2(c), Exs. 1 and 3, which fail to mention the overlap. See generally Gross and Doloboff, 768 T.M.P., Stock Sales Subject to Section 304, A-5; Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders, ¶ 9.09[5] (6th ed. 1994).

There is an exception to the related person rule under Treas. Reg. Section 1.368-1(e)(2)(i) (and illustrated in Treas. Reg. Section 1.368-1(e)(6), Ex. 9) whereby a proprietary interest is preserved despite an acquisition by a person related to the issuing corporation if *those persons* who were the direct or indirect owners of the target corporation prior to the reorganization maintain a direct or indirect proprietary interest in the issuing corporation (the "Rev. Rul. 84-30 Exception"). This exception is apparently intended to ensure that intra-affiliated group mergers satisfy the continuity of interest requirement, reflecting a continuation of the guidance contained in Rev. Rul. 84-30, 1984-1 C.B. 114.[8] For this purpose, the determination of whether a person was a direct or indirect owner of the target corporation is made prior to the transactions undertaken in connection with the reorganization. This rule can also be read to confirm that back-to-back reorganizations will satisfy continuity of interest.

Presumably, the principle of a five year safe harbor for redemptions, as set forth in Rev. Rul. 78-142, 1978-1 C.B. 111, citing Rev. Rul. 66-23, 1966-1 C.B. 67,[9] is still valid under the COI

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[8] The reference to "those persons" in the Rev. Rul. 84-30 Exception presumably does not require that "those persons" who are maintaining continuity must directly own the stock of the issuing corporation. For example, assume that in Treas. Reg. Section 1.368-1(e)(6), Ex. 9, stock of the issuing corporation (P in the example), in lieu of being distributed to the common parent (X in the example), was instead subsequently sold to another subsidiary of X and sister of P (let's call it W for this purpose). In this example as modified, W is the related party acquiror of P stock whose purchase would preclude COI but for the fact that X is one of "those persons" who maintains sufficient continuity. This issue is in part unclear because in the actual Example 9, X is both the related party acquiror of P stock and the person maintaining continuity.

[9] In Rev. Rul. 66-23, 1966-1 C.B. 67, declared obsolete by T.D. 8760 (Jan. 28, 1998), Y corporation was merged into Z corporation in a statutory merger. Pursuant to a court imposed consent decree, a shareholder of Y corporation was ordered to divest its stock in the combined enterprise within seven years of the merger. In concluding that the continuity of interest regulations were nevertheless satisfied, the Service concluded that it would ordinarily treat five years of unrestricted rights of ownership as a sufficient period for the purpose of satisfying COI.

In Rev. Rul. 78-142, 1978-1 C.B. 111, preferred stock was issued to target

regulations even if such redemptions are arguably made in connection with a reorganization. In this regard, Rev. Rul. 66-23 was declared obsolete in the preamble to the final regulations because of its discussion indicating that sales pursuant to a plan or arrangement do not satisfy the COI requirement.[10] However, the rulings are still relevant for redemptions. Thus, the mandatory or optional redemption of issuing corporation stock pursuant to the terms of the stock, regardless of whether made in connection with a reorganization, more than five years after the date of a reorganization should still be disregarded.[11] The proposed amendments to the revenue procedure incorporate this rule.[12]

Related party acquisitions of target stock prior to the reorganization (*e.g.*, disguised redemptions) can also preclude COI under the temporary and proposed regulations. Specifically, a proprietary interest is not preserved if, prior to and in connection with a potential reorganization, stock of the target corporation is sold to a person related to the target corporation for consideration

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shareholders in a forward subsidiary merger. The preferred stock was subject to mandatory serial redemption requirements. Citing Rev. Rul. 66-23, the Service concluded that the mandatory redemption feature did not violate the COI requirement because the redemptions could not commence until after five years from the consummation of the reorganization.

10 The preamble to the COI regulations provides "Rev. Rul. 66-23 (1966-1 C.B. 67) is hereby obsoleted because it indicates that a plan or arrangement in connection with a potential reorganization for disposition of stock to unrelated persons does not satisfy the COI requirement." T.D. 8670, 63 Fed. Reg. 4174 (Jan. 28, 1998).

11 If the issuing corporation stock is preferred stock within the meaning of Section 351(g)(3)(A), a binding agreement to redeem the stock could cause the stock to be "nonqualified preferred stock" under Section 351(g). Until regulations addressing this issue are promulgated, nonqualified preferred stock apparently will count as stock for purposes of measuring continuity of interest. See H.R. Conf. Rep. No. 105-220, 105th Cong., 1st Sess. 544 (1997); Staff of the Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 1997, 210-213.

12 It is not clear that (and we make no recommendation as to whether) this safe harbor should apply to related party purchase provisions, particularly those that would be enforceable by a holder with creditor-like rights against the related party.

other than stock of the target or issuing corporation. For purposes of this provision, only the Section 304(a)(2) test (and not the Section 1504 affiliation test) for related persons applies. However, as drafted, the Section 304 cross-reference appears broader than intended and could cause the purchase of target corporation stock by a corporate shareholder to inappropriately count against continuity. Consider for example, a corporate shareholder ("Corporate Shareholder") who owns 30% of a target corporation and purchases another 25% "in connection with" a reorganization (following which the shareholder receives acquiring corporation stock in exchange for its target corporation stock). The Corporate Shareholder's purchase would count against continuity under the literal terms of the regulations. Specifically, notwithstanding that the preamble to the temporary regulations indicates that purchases are meant to count against continuity only if made by a lower tier corporation,[13] Treas. Reg. Section 1.368-1(e)(3)(i)(B) tests whether two corporations are related by analyzing hypothetical purchases by "one corporation" of the stock of "another corporation." Thus the related person test literally may be made both up and down a chain of corporations, so that a corporation can be related to a target corporation even though it is not a lower tier corporation. As a

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[13] The preamble to the temporary regulations provides:

> "The final regulations include as related persons any corporation that is a member of the affiliated group, within the meaning of section 1504, of which P is a member, and any corporation whose purchase of P stock would be treated as a redemption of that stock under section 304(a)(2). The section 1504 test was adopted because the IRS and Treasury Department were concerned that acquisitions of T stock or P stock by P affiliated corporations were no different in substance than acquisitions or redemptions by P. This concern does not generally extend to members of T's affiliated group that are not also considered related to T under section 304(a)(2) because such corporations are T shareholders participating in the potential reorganization along with the other shareholders of the target corporation. The temporary regulations treat two corporations as related persons if a purchase of the stock of one corporation by another corporation would be treated as a distribution in redemption of the stock of the first corporation under section 304(a)(2) (determined without regard to section 1.1502-80(b))."

result, the purchase by Corporate Shareholder in our example may improperly count against continuity.

Furthermore, under the temporary and proposed regulations, a proprietary interest is not preserved to the extent that, prior to and in connection with a potential reorganization, an extraordinary distribution is made with respect to stock of a target corporation. The determination of whether a distribution is an extraordinary distribution is determined on the basis of all the facts and circumstances, but the treatment of a distribution under Section 1059 is not taken into account.[14]

B. COBE

The regulations also revise Treas. Reg. Section 1.368-1(d), regarding the COBE requirement. The regulations retain the requirement that the issuing corporation either continue the target corporation's historic business or use a significant portion of the target corporation's historic business assets in a business. Of significance, the regulations explicitly expand the manner in which the COBE requirement may be satisfied by treating the issuing corporation as conducting the target corporation's business or using its assets in a business if these activities are conducted by a member of the issuing corporation's "qualified group" or by certain partnerships.[15] With respect to partnerships, the regulations provide that if the historic business is conducted in a partnership, and either (i) the members of the issuing corporation's qualified group, in the aggregate, own an interest in the partnership representing a "significant interest" in that partnership business, or (ii) one or more members of the qualified group have active and substantial management functions as a partner with

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[14] Presumably, the payment of periodic dividends by a target corporation consistent with its historical dividend practices is disregarded for this purpose, regardless of the timing of the announcement or payment of the dividends.

[15] Of course, while the COBE regulations may allow certain transfers, the technical requirements of the relevant reorganization provisions must still be satisfied. See Treas. Reg. Section 1.368-2(k)(3), Ex. 3.

respect to that partnership business, that fact "tends" to establish the requisite continuity, but is not alone sufficient.[16] For purposes of the COBE requirement, a qualified group is defined as one or more chains of corporations connected through stock ownership with the issuing corporation, but only if the issuing corporation owns directly stock meeting the requirements of Section 368(c) in at least one of the corporations, and stock meeting the requirements of Section 368(c) in each of the corporations is owned directly by one of the other corporations.

The consequences of the provision stating that continuity only "tends" to be established if a target business is conducted through a partnership is demonstrated in the examples to the regulations. In one example, the COBE requirement is satisfied where assets of a target business are transferred from a member of the acquiring corporation's qualified group to a partnership in which the member has active and substantial management functions and the members of the qualified group have a 20 percent interest in the partnership. Treas. Reg. Section 1.368-1(d)(5), Ex. 7. Another example concludes that the COBE requirement is not satisfied on facts that are similar except that the members of the qualified group have only a 1 percent interest in the partnership. Treas. Reg. Section 1.368-1(d)(5), Ex. 8.

In an example concerning the significant interest test, the COBE requirement is deemed satisfied where the members of the acquiring corporation's qualified group have a 33 1/3 percent interest in a partnership to which the target assets are transferred, and no member participates in the management of the partnership. Treas. Reg. Section 1.368-1(d)(5), Ex. 9. In an example involving tiered partnerships, the determination of whether the significant interest test is satisfied is based on the issuing corporation's proportionate interest in the target assets through the partnership tiers, *i.e.*,

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[16] We note that Treas. Reg. Section 1.368-1(d)(4)(i) provides a look-through rule which may apply to the significant interest test, under Treas. Reg. Section 1.368-1(d)(4)(iii)(B)(1), but that there is no provision addressing a look-through rule for purposes of having active and substantial management functions in a partnership.

acquiring's 50% interest in a partnership which in turn holds a 75% interest in the partnership to which the target assets were transferred, is treated as a 37 1/2% interest in the target assets. Treas. Reg. Section 1.368-1(d)(5), Ex. 12.

The preamble to the final regulations clarifies that satisfaction of the COBE requirements as set forth in the regulations will be deemed to constitute satisfaction of the remote continuity of interest doctrine arising out of Groman v. Commissioner, 302 U.S. 82 (1937), and Helvering v. Bashford, 302 U.S. 454 (1938).

The proposed COBE regulations were limited in their application to transactions enumerated in Section 368(a)(2)(C). The preamble to the final regulations states "The COBE provisions in the final regulations apply to all reorganizations for which COBE is relevant." T.D. 8761, 63 Fed. Reg. 4204 (Jan. 28, 1998). The Service thus left open the possibility in the final regulations, without expressing a view either way, that the COBE requirement may apply to reorganizations described in Sections 368(a)(1)(D) and (F) ("D" and "F" reorganizations, respectively).[17]

C. Section 368(a)(2)(C) Transfers

The new COBE regulations analyze the effect of drop-downs, assuming they would be allowed under the step transaction doctrine. Treas. Reg. Section 1.368-2(k), in conjunction with subsection (f),[18] confirms the accuracy of this assumption in certain situations, in effect providing

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[17] We note that in our report commenting on the proposed regulations, Notice of Proposed Rulemaking, 62 Fed. Reg. 361 (Jan. 3, 1997), we recommended the Service either clarify that the COBE and remote continuity doctrines do not apply to D and F reorganizations or, should the Service have a different view, extend the proposed regulations to cover non-divisive D and F reorganizations but not divisive D reorganizations. New York State Bar Association, Tax Section, "Report of the New York State Bar Association (Tax Section) on the Proposed Regulations Addressing the Remote Continuity and Continuity of Business Enterprise Doctrines" (July 24, 1997).

[18] Treas. Reg. Section 1.368-2(f) provides that, if a transaction otherwise qualifies as a reorganization, a corporation remains a party to the reorganization even though stock

that, with respect to the enumerated transactions, the step transaction doctrine will not apply to recharacterize an otherwise qualifying reorganization on account of a drop-down. See preamble to the final regulations, T.D. 8760, 63 Fed. Reg. 4174 (Jan. 28, 1998).

Specifically, Treas. Reg. Section 1.368-2(k) provides guidance regarding certain asset and stock transfers to one or more controlled corporations following specified reorganizations. With respect to a transaction otherwise qualifying under Sections 368(a)(1)(A), (B), (C), or (G) (where the requirements of Sections 354(b)(1)(A) and (B) are met), the regulations provide that the transaction will not be disqualified "by reason of the fact that part or all of the acquired assets or stock acquired in the transaction are transferred or successively transferred to one or more corporations controlled in each transfer by the transferor corporation." With respect to a transaction otherwise qualifying as a Section 368(a)(2)(E) reverse triangular merger, the regulations provide that the transaction will not be disqualified "by reason of the fact that part or all of the stock of the surviving corporation is transferred or successively transferred to one or more corporations controlled in each transfer by the transferor corporation, or because part or all of the assets of the surviving corporation or the merged corporation are transferred or successively transferred to one or more corporations controlled in each transfer by the transferor corporation."[19] The Section 368(c) control definition is used.

As noted in the preamble to the final regulations, Treas. Reg. Section 1.368-2(k) does not address transactions not described in Section 368(a)(2)(C), including D and F reorganizations.[20]

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or assets acquired in the transaction are transferred in a transaction described in Section 1.368-2(k). Treas. Reg. Section 1.368-2(f) also provides that a corporation will not cease to be a party to the reorganization if it transfers assets acquired in the transaction to a partnership in which it is a partner if the COBE requirement is satisfied.

19 Under a literal reading of the regulations, a forward triangular merger followed by a drop-down of stock of the controlled corporation is not permitted.

20 See supra n. 17.

The preambles to the final and temporary and proposed regulations state that Rev. Proc. 77-37 and Rev. Proc. 86-42 (the latter constituting an insert to the former) will be modified to the extent inconsistent with the regulations.

II. Suggested Modifications to Rev. Proc. 77-37 and Rev. Proc. 86-42

We suggest modifications to Rev. Proc. 77-37 and Rev. Proc. 86-42. The relevant provisions are marked to show suggested additions and deletions. (Additions are in bold italics; deletions are stricken.)

The suggested modifications to Rev. Proc. 86-42 regarding requested representations for ruling purposes are intended to be consistent with the style of Rev. Proc. 86-42. Thus, like Rev. Proc. 86-42, certain representations are written in absolute terms, even though certain exceptions or qualifications would not preclude a favorable ruling. Rev. Proc. 86-42 requires an "explanation" where a representation cannot be given as requested. For example, with respect to a reorganization under Section 368(a)(1)(A) of the Code, taxpayers are currently asked to represent that "Acquiring has no plan or intention to reacquire any of its stock issued in the transaction," even though it is clear that a redemption of up to 50 percent of the stock issued in the transaction would not cause a transaction to fail to meet the ruling guidelines, depending on all facts and circumstances, and should qualify for a favorable ruling. In other words, the representations are written to elicit the simplest answer if there is one, and all relevant facts in the alternative.

We suggest that Section 3.02 of Rev. Proc. 77-37 be modified as follows.

> The "continuity of interest" requirement of section 1.368-1(b) of the Income Tax Regulations is satisfied if ~~there is continuing interest through stock ownership in the acquiring or transferee corporation (or a corporation in "control" thereof within the meaning of section 368(c) of the Code) on the part of the former shareholders of the acquired or transferor corporation which is~~ ***a proprietary interest in the acquired or transferor corporation (the "target corporation")*** equal in value, as of the effective date of the reorganization, to at least 50 percent of the value of all of the formerly outstanding stock of the ~~acquired or transferor~~ ***target*** corporation as of the ~~same~~ ***effective*** date, ***is preserved in the***

transaction. Proprietary interest is preserved to the extent target corporation stock (i) is exchanged for issuing corporation stock (as defined in section 1.368-1(b) of the Income Tax Regulations), (ii) is exchanged by the acquiring corporation for a direct interest in the target corporation enterprise, or (iii) remains as outstanding stock of the target corporation. For purposes of clause (i) of the preceding sentence, it is not necessary that each exchanging shareholder of the ~~acquired or transferor~~ ***target*** corporation receive in the exchange ***a proportionate amount, or any***, stock of the ~~acquiring or transferee~~ ***issuing*** corporation ~~or a corporation in "control" thereof, which is equal in value to at least 50 percent of the value of his former stock interest in the acquired or transferor corporation, so long as one or more of the shareholders of the acquired or transferor corporation have a continuing interest through stock ownership in the acquiring or transferee corporation (or a corporation in "control" thereof) which is, in the aggregate, equal in value to at least 50 percent of the value of all of the formerly outstanding stock of the acquired or transferor corporation. Sales, redemptions, and other dispositions of stock occurring prior or subsequent to the exchange which are part of the plan of reorganization will be considered in determining whether there is a 50 percent continuing interest through stock ownership as of the effective date of the reorganization~~. ***A proprietary interest in the target corporation is not preserved to the extent that, in connection with the transaction, (i) target stock is acquired by the issuing corporation for consideration other than stock of the issuing corporation, (ii) stock of the issuing corporation furnished in exchange for stock of the target corporation is redeemed or (iii) stock of the issuing corporation furnished in exchange for stock of the target corporation or stock of the target corporation is acquired (other than in exchange for stock of the issuing corporation) by a person related to the issuing corporation (within the meaning of section 1.368-1(e)(3) of the Income Tax Regulations) except to the extent those persons who were the direct or indirect owners of the target corporation prior to the potential reorganization maintain a direct or indirect proprietary interest in the issuing corporation. Further, a proprietary interest in the target corporation is not preserved to the extent that, prior to and in connection with the transaction, an extraordinary distribution is made with respect to it, or if, prior to and in connection with the transaction (i) it is redeemed or (ii) persons related to the target corporation (within the meaning of section 1.368-1(e)(3)(i)(B) of the Income Tax Regulations) acquire it with consideration other than stock of the issuing or target corporation. Other sales and dispositions of stock will be disregarded.***

A clean version of Section 3.02 of Rev. Proc. 77-37, reflecting the suggested modifications, is as follows.

> The "continuity of interest" requirement of section 1.368-1(b) of the Income Tax Regulations is satisfied if a proprietary interest in the acquired or transferor corporation (the "target corporation") equal in value, as of the effective date of the reorganization, to at least 50 percent of the value of all of the formerly outstanding stock of the target corporation as of the effective date, is preserved in the transaction. Proprietary interest is preserved to the extent target corporation stock (i) is exchanged for issuing corporation stock (as defined in section 1.368-1(b) of the Income Tax Regulations), (ii) is exchanged by the acquiring corporation for a direct interest in the target corporation enterprise, or (iii) remains as outstanding stock of the target corporation. For purposes of clause (i) of the preceding

sentence, it is not necessary that each exchanging shareholder of the target corporation receive in the exchange a proportionate amount, or any, stock of the issuing corporation. A proprietary interest in the target corporation is not preserved to the extent that, in connection with the transaction, (i) target stock is acquired by the issuing corporation for consideration other than stock of the issuing corporation, (ii) stock of the issuing corporation furnished in exchange for stock of the target corporation is redeemed or (iii) stock of the issuing corporation furnished in exchange for stock of the target corporation or stock of the target corporation is acquired (other than in exchange for stock of the issuing corporation) by a person related to the issuing corporation (within the meaning of section 1.368-1(e)(3) of the Income Tax Regulations) except to the extent those persons who were the direct or indirect owners of the target corporation prior to the potential reorganization maintain a direct or indirect proprietary interest in the issuing corporation. Further, a proprietary interest in the target corporation is not preserved to the extent that, prior to and in connection with the transaction, an extraordinary distribution is made with respect to it, or if, prior to and in connection with the transaction (i) it is redeemed or (ii) persons related to the target corporation (within the meaning of section 1.368-1(e)(3)(i)(B) of the Income Tax Regulations) acquire it with consideration other than stock of the issuing or target corporation. Other sales and dispositions of stock will be disregarded.

We further suggest paragraphs 2 and 3 of Section 7.01 of Rev. Proc. 77-37, as amplified by Rev. Proc. 86-42, be deleted and new paragraphs 2 and 3 be inserted in lieu thereof, as follows. Paragraph 2 of Sections 7.02, 7.03, 7.04, and 7.05, and paragraph 6 of Sections 7.02 and 7.03, paragraph 5 of Section 7.04, and paragraph 4 of Section 7.05 of Rev. Proc. 77-37, as amplified by Rev. Proc. 86-42, should be similarly modified.[21] For purposes of Section 7.02 and 7.03 of Rev. Proc. 77-37, as amplified by Rev. Proc. 86-42, references to "Acquiring" should instead be references to "Parent," except that the second reference to "Acquiring" in clause 2(a)(i) should remain unchanged.

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[21] No suggested modifications are made with respect to Section 7.07, concerning F reorganizations. F reorganizations are unique in that they are generally considered apart from other transactions, even where the other transactions are undertaken pursuant to the same plan. See Rev. Rul. 96-29, 1996-1 C.B. 50.

Also, no suggested modifications are made with to Section 7.06 of Rev. Proc. 77-37, as amplified by Rev. Proc. 86-42, concerning acquisitive D reorganizations. We note that current paragraph 2 of Section 7.06 sets forth a representation regarding 50% continuity, although old Treas. Reg. Section 1.368-1(b) seemed to imply that the COI requirement did not apply to D reorganizations, as do the new regulations.

~~2. There is no plan or intention by the shareholders of target who own 1 percent or more of the target stock, and to the best of the knowledge of the management of target, there is no plan or intention on the part of the remaining shareholders of target to sell, exchange, or otherwise dispose of a number of shares of acquiring stock received in the transaction that would reduce the target shareholders' ownership of acquiring stock to a number of shares having a value, as of the date of the transaction, of less than 50 percent of the value of all of the formerly outstanding stock of target as of the same date. For purposes of this representation, shares of target stock exchanged for cash or other property, surrendered by dissenters, or exchanged for cash in lieu of fractional shares of acquiring stock will be treated as outstanding target stock on the date of the transaction. Moreover, shares of target stock and shares of acquiring stock held by target shareholders and otherwise sold, redeemed, or disposed of prior or subsequent to the transaction will be considered in making this representation. (Alternately, for publicly traded companies, submit the above representation substituting "5 percent" for "1 percent" where it appears.)~~

~~3. Acquiring has no plan or intention to reacquire any of its stock issued in the transaction.~~

2. The value of the Continuing Proprietary Interest (as defined below), as of the effective time of the transaction, will be at least 50 percent of the value, as of the effective time, of the Existing Proprietary Interest (as defined below) of Target. For purposes of this paragraph 2:

(a) The Continuing Proprietary Interest means all of the shares of outstanding Target stock as of the effective time of the transaction, other than shares of Target stock: (i) exchanged in the transaction for consideration other than Acquiring stock (including Target stock surrendered or exchanged for cash or other property by dissenters) but not including shares of Target stock surrendered by Acquiring in exchange for a direct interest in the Target corporation enterprise, (ii) acquired in connection with the transaction (other than in exchange for Acquiring stock) by Acquiring[22] or by a person related to Acquiring (within the meaning of section 1.368-1(e)(3) of the Income Tax Regulations),[23] (iii) exchanged in the transaction for Acquiring stock that, pursuant to a plan or intent existing at the effective time,[24] is either redeemed by Acquiring or acquired

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22 Following the form of the regulations, clause (i) addresses exchanges "in the transaction" and clause (ii) addresses exchanges "in connection with the transaction."

23 Note that the COI regulations may be satisfied even if there have been acquisitions within the definition of the second part of clause (ii) of the above sentence, if those acquisitions satisfy the Rev. Rul. 84-30 Exception, discussed supra p. 5. See also Treas. Reg. Section 1.368-1(e)(6), Ex. 9.

24 Although to strictly follow the regulation, the phrase "in connection with" would be used, we believe the plan or intent language would be more understandable to corporate officers who are asked to sign ruling requests or, for opinion purposes, are asked to sign officers' tax certificates (which are generally based on Rev. Proc. 86-42

(other than in exchange for Acquiring stock) by a person related to Acquiring (within the meaning of section 1.368-1(e)(3) of the Income Tax Regulations)[25] or (iv) acquired prior to the effective time and in connection with the transaction by persons related to Target (within the meaning of Section 1.368-1(e)(3)(i)(B) of the Income Tax Regulations), other than in exchange for Acquiring stock or Target stock. For purposes of this paragraph 2(a), [(i)] the optional or mandatory redemption of Acquiring stock by Acquiring pursuant to the terms of the stock will not be treated as undertaken in connection with the transaction if it occurs more than five years after the transaction [and (ii) additional stock buyback guidance[26]];

(b) The Existing Proprietary Interest means: (i) all of the shares of outstanding Target stock as of the effective time of the transaction (including shares acquired prior to the effective time and in connection with the transaction by persons related to Target), (ii) shares of Target stock redeemed prior to the effective time and in connection with the transaction, and (iii) the amount of any extraordinary distributions made by Target with respect to its stock prior to the effective time and in connection with the transaction.[27] For purposes of this paragraph 2(b), extraordinary distributions will not include periodic dividends that are consistent with Target's historic dividend practice;

(c) An acquisition of Acquiring or Target stock by a person acting as an intermediary for Acquiring, Target, or a person related to Acquiring or Target (within the meaning of section 1.368-1(e)(3) of the Income Tax Regulations) will be treated as made by Acquiring, Target or the related person, respectively;[28] and

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and Rev. Proc. 77-37).

25 Once again, the Rev. Rul. 84-30 Exception should be applicable with respect to clause (iii) of the above sentence in satisfying the COI regulations. We note that in Rev. Rul. 86-42, the continuity representations allow redemptions within the general 50% threshold, while separate representations preclude redemptions. We have continued this form.

26 See supra pp. 2-3.

27 The regulations do not specifically address whether (i) a new issuance of Target stock prior to the effective time and in connection with the transaction should be included in the "Existing Proprietary Interest" and (ii) any Acquiring stock received in exchange therefor should count as "Continuing Proprietary Interest." Our proposed language would effectively count such issuances to the good but this could easily be modified to exclude such issuances by treating the newly-issued shares as not outstanding as of the effective time for the purposes of suggested paragraphs 2(a) and 2(b).

28 See Treas. Reg. Section 1.368-1(e)(6), Ex. 5.

(d) Any reference to Acquiring or Target includes a reference to any successor or predecessor of such corporation to the extent provided in section 1.368-1(e)(5) of the Income Tax Regulations.

3. Acquiring has no plan or intention to reacquire any of its stock issued in the transaction[, subject to a possible exception for stock buybacks]. To the best of the knowledge of the management of Acquiring, no person related to Acquiring (within the meaning of section 1.368-1(e)(3) of the Income Tax Regulations) and no person acting as an intermediary for Acquiring or such a related person has a plan or intention to acquire any of the Acquiring stock issued in the transaction.

With respect to the COBE requirement, we suggest paragraph 6 of Section 7.01 of Rev. Proc. 77-37, as amplified by Rev. Proc. 86-42, be modified as follows. Paragraph 9 of Sections 7.02 and 7.03, paragraph 10 of Sections 7.04 and 7.07, and paragraph 8 of Sections 7.05 and 7.06 of Rev. Proc. 77-37, as amplified by Rev. Proc. 86-42, should be similarly modified.[29]

6. Following the transaction, Acquiring will continue the historic business of Target or use a significant portion of Target's historic business assets in a business. ***For purposes of this representation, Acquiring will be deemed to satisfy this requirement if (a) the members of Acquiring's qualified group (as defined in section 1.368-1(d)(4)(ii) of the Income Tax Regulations), in the aggregate, continue the historic business of Target or use a significant portion of Target's historic business assets in a business, or (b) the foregoing activities are undertaken by a partnership in which (i) the members of Acquiring's qualified group, in the aggregate, own at least a 33 1/3 percent [capital and/or profits] interest in the partnership, or (ii) one or more members[30] of the qualified group has active and substantial management functions as a partner with respect to the partnership business and the members of the qualified group, in the aggregate, own at least a 20 percent [capital and/or profits] interest in the partnership.***[31]

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29 For purposes of Sections 7.02 and 7.03 of Rev. Proc. 77-37, as amplified by Rev. Proc. 86-42, references to "Acquiring" should be to "Sub." For purposes of Sections 7.03 and 7.04, references to "Acquiring" should be to "Target." For purposes of Section 7.07, references to "Acquiring" should be to "Newco."

30 Although the language is ambiguous, presumably the members will be considered collectively for purposes of clause (ii).

31 The above language generally conforms to the examples in the regulations which refer only to the "interest" in the partnership. We suggest additional guidance on this issue. We note that where no member of the qualified group provides management functions it seems appropriate to require both a significant capital and profits interest, but where a member does provide active and substantial management functions arguably a significant profits interest or capital interest should be sufficient.

In addition, with respect to new Treas. Reg. Section 1.368-2(k)(1), we suggest paragraph 4 of Section 7.01 of Rev. Proc. 77-37, as amplified by Rev. Proc. 86-42, be modified as follows, such that the reference to Section 368(a)(2)(C) of the Code be replaced by a reference to Section 1.368-2(k)(1) of the Income Tax Regulations, and that the references to Section 368(a)(2)(C) in paragraph 7 of Section 7.02, paragraph 4 of Section 7.04, and paragraph 5 of Section 7.05 be similarly replaced.

> Acquiring has no plan or intention to sell or otherwise dispose of any of the assets of target acquired in the transaction, except for dispositions made in the ordinary course of business or transfers described in section ***1.368-2(k)(1) of the Income Tax Regulations*** ~~368(a)(2)(C) of the Internal Revenue Code~~.

With respect to new Treas. Reg. Section 1.368-2(k)(2), we suggest that paragraph 7 of Section 7.03 of Rev. Proc. 77-37, as amplified by Rev. Proc. 86-42, be modified as follows.

> Parent has no plan or intention to liquidate Target; to merge Target with or into another corporation; to sell or otherwise dispose of the stock of Target except for transfers ***of stock described in section 1.368-2(k)(2) of the Income Tax Regs.*** ~~of stock to corporations controlled by Parent~~; or to cause Target to sell or otherwise dispose of any of its assets or of any of the assets acquired from Sub, except for dispositions made in the ordinary course of business or transfers ***described in section 1.368-2(k)(2) of the Income Tax Regs.*** ~~of assets to a corporation controlled by Target.~~