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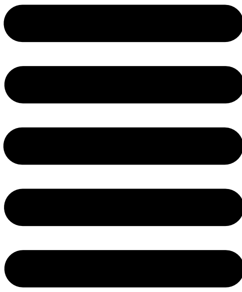

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Continuity and Remoteness

By Robert W. Wood • Wood & Porter • San Francisco

Continuity of interest, like business purpose, is one of those overlays to the technical reorganization rules. Yet, perhaps because the enigmatic "continuity" word is used in several different contexts, there is a surprising degree of confusion over what we mean by continuity of interest, continuity of business enterprise and even remote continuity.

Historic Continuity

The word "historic" is often used in the continuity context, too. Continuity of business enterprise requires that the acquiring company must either continue the historic business of the target, or must use a significant portion of the historic business assets of the target corporation in a business. [*See* Reg. §1.368-1(d)(1).] The emphasis in the last part of this phrase is on the word "a," meaning that the target's assets can be used in *any* business. As to the first part of the equation, the "historic" business here refers to the business that the target conducted most recently, unless that business was entered into as part of the plan of reorganization. [*See* Reg. §1.368-1(d)(2)(iii).]

In such a case, the historic business will be the business that the target conducted immediately before entering into a business as part of the plan of reorganization, and which it is conducting at the time the business combination occurs. Continuity of business enterprise is a requirement that the acquisitive corporation must satisfy, although the regulations refer to the company subject to this continuity of business enterprise rule as the "issuing" corporation.

Nevertheless, it is clear that an affiliate of the issuing corporation can be used to satisfy the continuity of business enterprise test. [*See* Rev. Rul. 81-247, 1981-2 CB 87.] Viewed another way, the continuity of business enterprise requirement will be met as long as either the issuing corporation itself meets it, or if it is met by any of the

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members of its qualified group (which requires 80 percent of voting power and 80 percent of number of shares). [*See* Reg. §1.368-1(d)(4).]

My Equity, Your Equity

At its root, of course, the continuity of business enterprise requirement is designed so that an acquiring corporation cannot receive the tax-free blessings of reorganization treatment, and at the same time fail to continue the target's historic business, or even use the target's assets in any other business. Yet, the continuity of business enterprise requirement can be satisfied when the target's historic business is continued by a lower-tier subsidiary of the issuing entity. If you will, some attenuation or remoteness is allowed.

The issuing corporation will be treated (for continuity of business enterprise purposes) as holding the businesses and assets of its lower-tier subsidiary. Of course, it is necessary for the subsidiary to be connected in the proscribed manner through the necessary level of stock ownership (80 percent) to the issuing corporation.

Partnerships Too

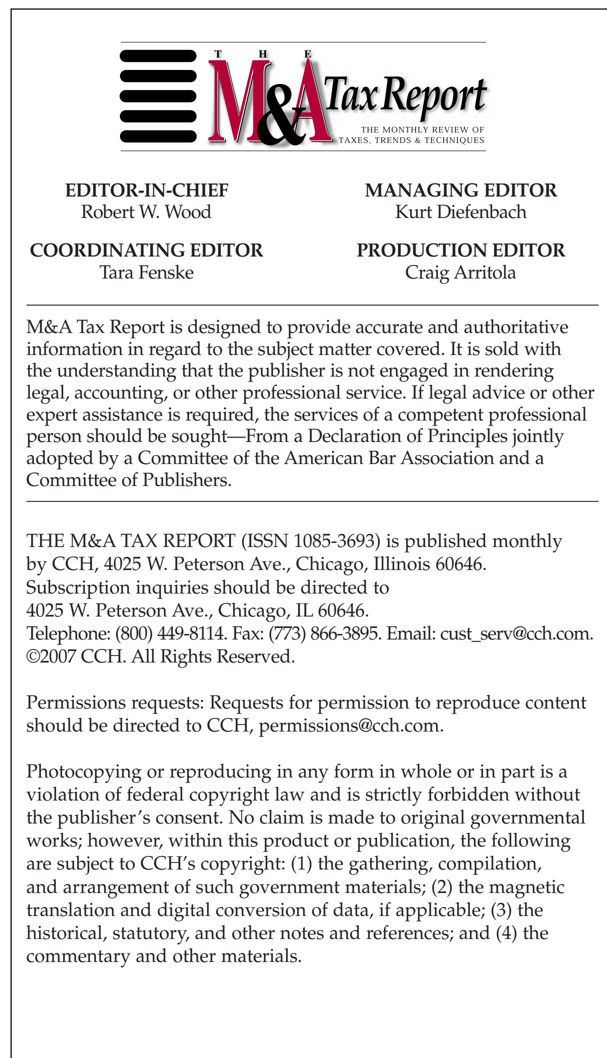
Partnerships can be used too, by allowing the issuing corporation to contribute the target's business assets into a more remote affiliate. Each partner of a partnership is treated as owning the target's business assets used in a business of the partnership in accordance with that partner's percentage interest in the partnership. The issuing corporation is treated as conducting the business of a partnership if members of the issuing corporation's qualified group own (in the aggregate) an interest in the partnership representing a significant interest in that partnership business.

Although there may be no bright line for what constitutes a "sufficient interest" in the partnership, it appears that a one-third capital and profits interest is enough. [*See* Rev. Rul. 92-17, 1992-1 CB 142.] Furthermore, even without such a one-third capital and profits interest, it may be enough if one or more members of the qualified group have active and substantial management functions as partners regarding that partnership business. [*See* Rev. Rul. 2002-49, 2002-2 CB 288, and Rev. Rul. 2007-28, IRB 2007-42, 42.] The partnership's business apparently is attributed to the partners performing those management functions, if the members of the qualified group (in the aggregate) possess at least 20 percent of the capital and profits interest in the partnership. [*See* Reg. §1.368-1(d)(5), Example 7.]

The long and the short of this is that the continuity of business enterprise requirement is generally not too burdensome to meet. Plainly, it needs to be considered, but if the business is a desirable acquisition target, it normally isn't too hard to jump through the requisite hoops to establish that the historic business is going to be continued, or at least that a significant portion of its historic business assets will be used in a (meaning *some*) business.

The Other Continuity

The continuity of business enterprise requirement actually pales in comparison to continuity of interest, which is often a harder test to meet. For continuity of interest to exist, a substantial part of the value of the proprietary interests in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the acquired corporation must be preserved in the reorganization. Proprietary interest equals ownership, which of course, is quite distinct from the historic business. A proprietary interest is preserved according to the requisite level when it is exchanged for a proprietary interest in the issuing corporation. [*See* Reg. §1.368-1(e)(1)(I).]

Conversely, a proprietary interest is not preserved when, in connection with a potential reorganization, it is acquired by the issuing corporation for consideration other than stock of the issuing corporation. This sounds simple. Yet, note that only the issuing corporation's stock will count toward satisfying continuity of interest, because only the issuing corporation's stock exposes the former owners of the target business to the risks of that business, permitting them to maintain the requisite continuity of interest in the business enterprise.

For the continuity of interest requirement to be met, generally not less than 40 percent of the value of the proprietary interest in the target must morph into proprietary interests in the acquiring company. [*See* Reg. §1.368-1(e)(2)(iv), Example 1.]

Measuring When?

One of the key issues affecting continuity of interest is timing. Just when do you make the determination whether the requisite 40 percent of consideration morphs from old equity into new equity? Generally, you measure only as of the effective time of the transaction. That means when it is consummated. That was the historic rule anyway. Thus, you took this measurement at closing.

Today, though, a more liberal rule can save the day. You need to value the stock for purposes of determining whether that stock represents the requisite proportion of the aggregate consideration to be transferred in the deal. You may be able to measure this as of the close of the last business day before the first date on which there is a binding contract to effect the reorganization.

In plain English, we're talking here about the day before the binding purchase agreement is signed, which may be a long time before closing. However, you get to use this favorable measurement date only if the contract provides for "fixed consideration." [*See* Reg. §1.368-1(e)(2)(I).]

Give Me the Remote

It is not enough to worry about the standards for:

(1) continuing the target's historic business, or at least continuing to use its historic assets in *some* business (along with the necessary determinations of what the business really is *etc.*); and

(2) continuity of interest, and the equity ownership shifting mechanism that continuity implies there's more.

There is also the "remoteness" problem. I have always found this one of the most confusing.

Put simply, even if stock of the issuing corporation represents the vast bulk of the consideration being offered to the target's shareholders (which sounds on the surface like continuity of interest would be satisfied in spades), you can fail continuity of interest if the *proximity* between the former target shareholders and the target's business enterprise is too great. Hmm. The remoteness issue goes back to the 1930s and *H.C. Groman*, SCt, 37-2 USTC ¶9533, 302 US 82, 58 SCt 108 (1937), and *R.I. Bashford*, SCt, 38-1 USTC ¶9019, 302 US 454, 58 SCt 307 (1938).

Today, the remoteness of continuity conundrum is most likely to appear in the partnership context. Thus, in GCM 39150 (Mar. 1, 1984) only a portion of the target's historic business assets (roughly a third of their value) were conveyed to a partnership. In a confusing discussion, the IRS suggested a connection between continuity of interest and continuity of business enterprise, and the notion of remoteness. But it is at least significant that the IRS did so here in an attempt to help the taxpayer.

If continuity of business enterprise is satisfied (because the issuing corporation and its affiliates retain the requisite percentage of the target's business assets), the fact that it transfers the remainder of the target's assets to a partnership will not cause the continuity of interest requirement not to be met. Of course, continuity of interest would not be satisfied if the acquired assets are conveyed to a partnership in which the issuing corporation is the sole general partner, and in which the issuing corporation possesses a capital interest amounting to 63.75 percent. That was the conclusion in GCM 35117 (Nov. 15, 1972).

Conclusion

The remote continuity of interest issue for corporations and subsidiaries has been

addressed in both the Code and regulations, allowing controlled corporate subsidiaries of the issuing corporation to wind up with the assets. Nevertheless, moving the target's business enterprise into a partnership remains much more dicey. That's not to say that putting historic assets in a partnership is always bad, of course. One should merely flag this issue as a potentially dangerous area that requires a bit more thought and care.

In this increasing age of partnership (and LLC) vehicles used in and after acquisitions, don't forget to work through this remote continuity of interest issue whenever a partnership is the ultimate repository for the historic business or its assets.