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Proposed Regulations Issued on Continuity of Interest

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One of the perennial tax conference topics, for corporate practitioners anyway, is continuity of interest. Continuity of interest is sometimes even shortened to "continuity," thereby perhaps prompting confusion between continuity of interest and continuity of business enterprise. Even among tax practitioners, there can be a surprising amount of confusion over the age-old continuity of interest doctrine. Most corporate practitioners can remember at least one time when they had to work through the math to determine just how one achieves the bellwether 50% continuity.

Under an early formulation, continuity of interest requires that the original owners of a corporation have a continuing interest through stock ownership in a transferee or reorganized corporation after the dust settles. About this simple concept, volumes of authority have been generated. Originally designed to cut back on the types of reorganizations that were ostensibly permitted by the reorganization statutes, the continuity of interest doctrine actually consists of a number of distinct considerations, depending upon the type of reorganization involved.

New Regulations Proposed

Two installments of proposed regulations have just been released. The first installment provides the proposed new generic rule about continuity. Basically, continuity would exist if an acquiring corporation provides consideration that represents a proprietary interest in its affairs, and if that consideration is a substantial part of the value of the stock or properties transferred. What this really represents, then, is a new formulation (or restatement?) of the old continuity of interest law.

Indeed, in the preamble to these proposed regulations, the IRS goes through some of the hoary cases in the area, including *Helvering v. Minnesota Tea Co.*, 296 U.S. 378 (1935), *Pinnelas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933), and *Cortland Specialty Co. v. Commissioner*, 60 F.2d 937 (2d Cir. 1932), *cert. denied*, 288 U.S. 599 (1933). These are some of the big names in the continuity corner.

Continued on Page 2

ALSO IN THIS ISSUE:

CONTINUITY OF INTEREST Continued from Page 1

The attitude of the Service is that these seminal cases, and even their most recent progeny, did not involve situations in which shareholders of the target corporation disposed of stock consideration from the acquiring corporation after having received it. Over the years, one of the principal questions has been whether there really was continuity if the target shareholders, as contemplated at the time of the reorganization, subsequently disposed of the stock they received.

Thus, the new restatement of continuity law is that there will be continuity where the acquiring corporation provides consideration that represents a proprietary interest in its affairs, and where that consideration is a substantial part of the value of the stock or properties transferred. If this formulation seems less than clear (which I must confess it does to me), one must read on.

Pre-arranged Stock Dispositions

A number of distinct topics are addressed in these proposed regulations. For example, the proposed regulations cover stock dispositions of the acquiring corporation by a former target shareholder. According to the new proposals, such dispositions are generally not considered in determining whether the continuity requirement has been met. However, all facts and circumstances are to be considered in order to determine whether the acquiring corporation has provided adequate consideration.

Thus, suppose the acquiring corporation or a related party purchases the acquiring corporation's stock shortly after the reorganization. The facts and circumstances might indicate that the transaction should be recast to treat the acquiring corporation as furnishing cash in the reorganization, and therefore not satisfying the continuity of interest requirement. According to the preamble to the proposed regulations, this approach refocuses the continuity of interest requirement on what the Service claims is its initial purpose, of insuring that the acquiring corporation furnishes the proper type of consideration. According to the Service, this approach also promotes simplicity and administrability in applying the continuity of interest requirement.

The examples in the proposed regulations confirm that this "what consideration does the corporation provide" approach allows for a fair degree of selling activity without violating the continuity of interest requirement.

Example 1

A owns all of the stock of T. T merges into P. In the merger, A receives stock of P having a fair market value of \$50x and cash of \$50x. Immediately after the merger, and pursuant to a preexisting binding contract negotiated by A, A sells all of the stock of P received by A in the merger to B, a party not related to P. The transaction satisfies the continuity of shareholder interest requirement because A received stock of P representing a substantial part of the value of the total consideration transferred in the acquisition.

Example 2

A owns 80 percent of the stock of T and none of the stock of P, which is widely held. T merges into P. In the merger, A receives stock of P. In addition, A obtains registration rights pursuant to an agreement with P to register the P stock and sells such stock shortly after the acquisition in the open market. The transaction satisfies the continuity of shareholder interest requirement.

Continued on Page 3

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CONTINUITY OF INTEREST Continued from Page 2

Example 3

A owns 80 percent of the stock of T and none of the stock of P. T merges into P. In the merger, A receives stock of P. In addition, A arranges with an independent investment banker to hedge the risk of loss on the P stock received in the merger. Neither P nor a party related to P enters directly or indirectly into the hedging transaction. The transaction satisfies the continuity of shareholder interest requirement. (See Prop. Reg. §1.368-1(e)(3), Examples 1-3.)

Sales Before, and Other Topics

What about dispositions of target stock before a transaction? The proposed regulations do not cover this topic. Instead, they indicate that the Treasury Department and the IRS are studying this issue, as well as the role of continuity of interest in Section 355 transactions.

The proposed effective date to the first set of proposed regulations is prospective only, so will only apply after the proposed regulations have been finalized and published in the Federal Register. The second installment of proposed regulations deal with two other topics. They address the question whether transfers of target assets or stock to controlled corporations, or even partnerships, will prevent a transaction from satisfying the continuity of interest requirement. They also address whether such transfers may impact the continuity of business enterprise requirement.

Remote Continuity and "Qualified Groups"

The "remote continuity of interest doctrine" dates from several early cases, primarily *Groman v. Commissioner*, 302 U.S. 82 (1937), and *Helvering v. Bashford*, 302 U.S. 454 (1938). The remote continuity of interest doctrine basically holds that stock consideration received by a target corporation's shareholders does not provide the requisite continuity unless the target's assets or stock are ultimately held by the corporation that issued the stock. Significantly, the proposed regulations now would limit this remote continuity of interest doctrine by providing that assets can be transferred by nonmembers of a "qualified group."

Just what is a "qualified group"? A qualified group would consist of one or more chains of corporations that are connected through stock ownership with the issuing corporation. The stock ownership required is that the issuing corporation must directly own stock meeting the requirements of Section 368(c) in at least one other corporation, plus stock meeting the requirements of Section 368(c) in each of the corporations (except the issuing corporation) owned directly by one of the other corporations.

As proposed, the continuity of interest requirement would not be violated if there were transfers (or successive transfers) of target stock or target assets among members of such a qualified group.

Example

T manufactures playground equipment, including launch ramps and half pipes for skateboarding, in-line skating, and bicycling. The P affiliated group is engaged in architectural design and construction. A holding company (HC) owns 80 percent of the stock of each of P and S1. S1 in turn, owns 80 percent of the stock of S2, and S2 owns 80 percent of the stock of S3. T transfers all of its assets to P in exchange for HC voting stock, which T distributes to its shareholders. HC transfers all of the P stock to S1. S1 in turn transfers all of the P stock to S2, and S2 transfers the P stock to S3.

Continued on Page 4

CONTINUITY OF INTEREST Continued from Page 3

HC, P, S1, S2 and S3 are members of a qualified group. Thus, the successive transfers of the P stock to other members of the qualified group do not violate the continuity of interest requirement. Prop. Reg. §1.368-1(f)(2), Example.

Interestingly, the IRS is requesting comments on whether the qualified group can be defined other than by reference to Section 368(c). The IRS is also asking whether the rules should be extended to provisions other than the A, B, C, or G reorganization provisions, or to Section 355 divisive reorganizations.

Partnerships Analyzed, Too

The proposed regulations also discuss partnerships. The proposed regulations treat a partnership as an aggregate of its partners in analyzing whether a transaction meets the continuity of interest requirement. The proposed regulations provide that transactions in which a corporate partner transfers a target's assets to a partnership do not violate the continuity of interest requirement. However, the regulations do not provide for the transfer of stock to a partnership if Section 368 imposes a toll requirement. Furthermore, the transfer of a target's assets to a partnership may violate the continuity of business enterprise requirement (more about continuity of business enterprise below).

Continuity of Business Enterprise

Although it might have been best to address the *other* continuity requirement (continuity of business enterprise) in a separate release, the IRS has nonetheless issued proposed regulations dealing with the fraternal twin topics of continuity of business enterprise and continuity of interest. In the continuity of business enterprise section, the proposed regulations address only a couple of topics. The proposed regulations provide a framework for applying existing continuity of business enterprise concepts to situations where the assets of the target (or its stock) are transferred to certain controlled corporations, or assets are transferred to partnerships.

In the case of a transfer of all or part of the target assets or stock among members of a qualified group, the continuity of business enterprise requirement will not be violated where there are transfers or successive transfers of target stock or target assets among members of the qualified group. Thus, the qualified group concept discussed above in the context of remote continuity of interest has bearing here, too.

In the case of a transfer of the target's assets to a partnership, the continuity of business enterprise requirement will also not be violated by reason of the fact that part or all of the target's assets are transferred to a partnership. Like the continuity of interest rules, the continuity of business enterprise rules here adopt an aggregate approach in determining whether continuity of business enterprise exists when target assets are transferred to a partnership following the asset or stock acquisition of the target.

Thus, the proposed regulations provide that the corporate transferor partner will be treated as conducting a business of the partnership if the corporate transferor partner has active and substantial management functions as a partner with regard to that business, or if the corporate transferor partner's partnership interest in the partnership represents a "significant interest" in the partnership business. Furthermore, in determining whether the corporate transferor partner satisfies the asset continuity test, two rules will apply: (a) the corporate transferor partner will be treated as owning the assets of the partnership in accordance with the corporate transferor partner's interest in the partnership; and (b) the corporate transferor partnership will be treated as conducting a business of the partnership under the rules applicable to business continuity.

Example

T manufactures custom ski boots. T transfers all of its assets to P solely in exchange for P

Continued on Page 5

CONTINUITY OF INTEREST Continued from Page 4

> voting stock, which T then distributes to its shareholders. P plans to continue manufacturing ski boots and to expand this operation. As part of the expansion, P and R (an unrelated party) form a new partnership (PRS). As part of the plan of reorganization, P (PTR) transfers T's ski boot business to PRS in exchange for a 20 percent interest in PRS. PTR performs active and substantial management functions for PRS including the decision-making regarding significant business decisions of PRS and regular participation in the overall supervision, direction and control of the employees of PRS in operating the ski boot business. (Prop. Reg. §1.368-1(d)(6), Example 8.)

Interestingly, a caveat to this flow-through approach states that the fact that a corporate transferor partner meets the business continuity requirements of these new rules through active and substantial management of a partnership business tends to establish continuity of business enterprise. However, the fact that the corporate transferor partner conducts a partnership business is not sufficient by itself.

Like the first set of proposed regulations, this set is designed to be prospective in effect, only once final regulations are published. The written comment period expires April 3, 1997, and speaker requests/outlines are due by April 16, 1997. ■