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Continuity of Business Enterprise/Continuity of Interest Regs

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For a transaction to qualify as a tax-free reorganization it must meet the relevant statutory requirements and also satisfy certain non-statutory precepts that are designed to disqualify transactions that too closely resemble sales. The principal non-statutory requirements are continuity of business enterprise and continuity of proprietary interest. The IRS recently issued final and temporary regulations with respect to these requirements, concluding a process—commenced in 1996—that, by any standard, liberalizes these venerable reorganization requirements.

The two sets of proposed regulations generated substantial controversy. (For *M&A Tax Report* coverage, see Bloom, "New Continuity Regulations Deserve Praise (and Scrutiny)," Vol. 5, No. 12 *M&A Tax Report* (July 1997), p. 1; and Part II of this article, Vol. 6, No. 1 *M&A Tax Report* (August 1997), p. 1. Both sets of proposed regulations received praise and certainly liberalized various aspects of these important nonstatutory requirements for reorganization treatment.

Apart from a few glitches (and on these glitches, readers should refer back to Gil Bloom's article in the July and August 1997 issues of the *M&A Tax Report*), the proposed continuity regulations in both their versions were generally considered quite helpful. Now that a short time later the regulations have been finalized, it is time to look at how liberal (at least compared to the old days) the continuity of business and continuity of proprietary interest regulations have really become.

Continuity of Business Enterprise

The venerable doctrine of continuity of business enterprise requires that the "issuing corporation" (the acquiring corporation or, in a triangular transaction, the corporation in control of the acquiring corporation) must either continue the target's historic business, or use these assets in a business. However,

Continued on Page 2

ALSO IN THIS ISSUE:

CONTINUITY REGS

Continued from Page 1

the issuing corporation is treated as holding all the businesses and assets of all the members of its "qualified group" (chains of corporations connected through 80% stock ownership with such issuing corporation). As a result, the continuity of business enterprise requirement can be satisfied even though the target's assets are lodged in one or more members of the qualified group, and not retained by the issuing entity itself.

Moreover, in a concession that adds substantial flexibility to this previously rigid requirement, the issuing corporation is treated as conducting a business of a partnership if:

- in the aggregate, the members of the qualified group own a significant interest in the business or
- one or more members of the qualified group have active and substantial management functions with respect to that business.

Partnerships and Attribution

The final regulations, through a system of attribution, aggregate the interest in a partnership business held by all of the members of a qualified group in determining whether the continuity of business enterprise requirement is satisfied. However, the regulations indicate that where the issuing corporation is, as described above, treated as conducting the business of a partnership, the continuity of business enterprise requirement may, nevertheless, not be met. How is that?

Well, the regulations find a lack of continuity of business enterprise in a situation in which the target's historic business is conveyed to a partnership in which an affiliate of the issuing corporation has the requisite active and substantial management functions, but has an interest in the business that amounts to only 1%. In effect, this is a *de minimis* rule. Conversely, the continuity of business enterprise requirement should always be satisfied in cases where the interest in the business is at least one-third, regardless of whether management functions are performed.

Continuity of Proprietary Interest

Continuity of Proprietary Interest requires that a substantial part of the value of the proprietary interests in the target be preserved in the transaction. A proprietary interest is preserved if it is exchanged for a proprietary interest in the issuing corporation, or otherwise continues as a proprietary interest in the target itself. Conversely, a proprietary interest is not preserved if, in connection with the transaction, it is either:

- acquired by the issuing corporation, or an affiliate thereof, with consideration other than stock of the issuing corporation; or
- redeemed (by the target) other than in a qualifying splitoff, or an extraordinary distribution is made with respect to it, or an affiliate of the target acquires it with consideration other than target stock or issuing corporation stock; or
- stock of the issuing corporation furnished in the transaction, is redeemed or acquired by an affiliate of the issuing corporation with consideration other than stock of that issuing corporation.

The regulations take the extraordinary step of eliminating the notions of pre- and post-reorganization continuity. Thus, a disposition of

Continued on Page 3

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CONTINUITY REGS

Continued from Page 2

target stock prior to the reorganization—to persons unrelated to the target or the issuing corporation—will be disregarded. In addition, a mere disposition of the stock of the issuing corporation—will be similarly disregarded. In this connection, the regulations take a decidedly narrow view of who a related person is. An individual shareholder of the target or issuing corporation is not a related person, and the term only encompasses corporate affiliates in which the issuing corporation has a 50% or greater interest.

Finally, the regulations remove the fear that drop-downs of target stock or assets to lower tier subsidiaries of the acquiring corporation could be viewed as direct acquisitions by those subsidiaries. A direct acquisition by a subsidiary would remove the transaction from reorganization status, so this, too, is a liberalizing change. Instead, unlimited drop-downs are permitted as long as in each drop-down transfer the transferor owns at least 80% of the stock of the recipient of the transferred stock or assets.

Temporary Regulations, Too

At the same time that the Service published the final regulations (T.D. 8760) on continuity of interest and continuity of business enterprise as discussed above, the Service also took the unusual step of issuing a set of temporary and proposed regulations. These temporary and proposed regulations (T.D. 8761; REG-1208820-97) deal with satisfying the continuity of interest requirement. They generally apply to transactions occurring after January 28, 1998. They do not, however, apply to any transaction that occurred under a written agreement that is binding on January 28, 1998.

The Service first notes that proposed regulations on continuity of interest were first published on December 23, 1996. Then, the final regulations were adopted (T.D. 8760), and are discussed above. These temporary and proposed rules (T.D. 8761), say the IRS, are to supplement those final regulations.

First, the temporary regs outline the circumstances under which a target corporation's redemption of its stock adversely effects satisfaction of the continuity of interest requirement. These temporary regs provide that redemptions by a target corporation that are connected to a potential reorganization will adversely effect satisfaction of the continuity of interest requirement. Moreover, the temporary regs provide that the continuity of interest requirement is adversely effected if:

- A target corporation issues promissory notes to redeem 70% of its stock;
- The issuing corporation assumes the target corporation's note in a merger; and
- The remaining shareholders of the target corporation receive solely stock in the issuing corporation.

Continued on Page 4

CONTINUITY REGS

Continued from Page 3

The temporary regulations provide that an extraordinary distribution of the target corporation's stock, followed by a sale of the remaining stock to the issuing corporation, has the same effect on the value of the proprietary interest in the target corporation as a *pro rata* redemption of the target corporation followed by a sale of the outstanding stock of the issuing corporation. In other words, it is the end result that matters here. To the extent that an extraordinary distribution is made with respect to the interest before and in connection with a potential reorganization, the temporary regulations add that continuity of interest is not preserved. Furthermore, a proprietary interest in the target corporation is not considered preserved if it is redeemed in connection with a potential reorganization.

These temporary regulations, coming on the heels of the final ones discussed above, do not provide guidance on a determination of whether a distribution will be treated as an extraordinary distribution. The IRS invites comments on whether guidance is needed in that area.

Related Parties Under the Temporary Rules

The temporary regulations also provide that a proprietary interest in a target corporation is not considered preserved if a person related to the target corporation uses consideration other than stock from the target or issuing corporation to acquire stock in the target corporation before and in connection with a potential reorganization. Under the final regulations, as noted above, related persons include corporations that are members of the affiliated group under Section 1504 (of which the issuing corporation is a member); and any corporation whose purchase of the issuing corporation's stock would be treated as a redemption of stock under Section 304(a)(2).

Similarly, the temporary regulations treat two corporations as related persons if the purchase of the stock of one corporation by another would be treated as a distribution in redemption of the first corporation's stock under Section 304(a)(2).

According to the preamble to the temporary regulations, these temporary rules are to apply solely for determining whether the continuity of interest requirement is satisfied. The IRS warns taxpayers not to draw inferences from the regulations about whether other reorganization requirements are satisfied, or about the characterization of any related transaction.

Last Word

A hearing on these temporary regulations is scheduled for May 26, 1998 at 10:00 a.m. in Room 2615 of the Internal Revenue building in Washington. Requests to testify and/or written comments are due earlier. Plus, now one may submit comments electronically at www.irs.ustreas.gov/prod/tax_regs/comments.html.■