# THE M&A TAX REPORT

*The Monthly Review of Taxes, Trends & Techniques*

Volume 5, Number 4 November 1996



# Mergers and Continuity of Interest

by Robert Willens • Lehman Brothers, New York and Robert W. Wood • San Francisco

A statutory merger (or A reorganization) has generally been regarded as the easiest of all reorganization transactions to consummate, since it relies on state law (which is typically simple) for the actual combination of the entities. It is often favored by practitioners and businesspeople alike precisely because it is so simple to accomplish. At the same time, the continuity of interest requirement must be met, something that has nothing to do with the state merger law. After all, in order for a merger to qualify as a tax-free A

Continued on Page 5

**ALSO IN THIS ISSUE:**

## MERGERS & CONTINUITY Continued from Page 1

reorganization—so that the target's shareholders can receive acquiring corporation stock on a tax-free basis, and so the "movement" of target's assets to the acquiring corporation does not trigger gain—the merger must exhibit "continuity of interest."

Continuity of interest is one of the generic requirements of all reorganizations. Its fundamental doctrine is that the original owners of a corporation must have a continuing interest through stock ownership in a transferee or reorganized corporation after the dust settles. Despite this seemingly simple notion, the continuity of interest doctrine has generated volumes of authority. Originally designed to cut back on the types of reorganizations that are ostensibly permitted by the statute, the continuity of interest doctrine actually consists of a number of distinct considerations, depending on the type of

Continued on Page 6

## MERGERS & CONTINUITY Continued from Page 5

reorganization involved.

### How Much Is Enough?

A merger exhibits the requisite continuity where the shareholders receive (and retain) a continuing interest (through ownership of equity) in the business formerly conducted by the target. But continuity has a quantitative aspect, and it is this quantitative aspect that is at the heart of the continuity of interest doctrine, even though it is somewhat of a moving target. Just how much stock in the reorganized or transferee company must the former owners have in it after the dust settles?

The IRS considers 50% continuity to be sufficient. This percentage represents the proportion of equity consideration to aggregate consideration received for the transferred assets. It does not focus on the percentage of the buyer's outstanding stock owned by the target's shareholders. Actually, even the IRS at one time had recognized that 50% does not represent a lower limit on continuity, at one time even saying 45% continuity was enough. (See Rev. Rul. 61-156, 1961-2 C.B. 62.) But despite the current 50% IRS ruling threshold, many deals have proceeded with much less.

Indeed, it is well-settled by the case law that an appreciably smaller continuity percentage will suffice. Thus, in the well-known case, *John A. Nelson v. Helvering*, 296 U.S. 374 (1935), the Supreme Court found the requisite continuity of interest where the target's assets were conveyed for cash and preferred stock representing only 38% of the total. On the other hand, 15% and 16% continuity have each been held insufficient. See *Yoc Heating Corp.*, 61 T.C. 161 (1973) (15%); and *May B. Kass*, 60 T.C. 218 (1973), *aff'd*, 491 F.2d 749 (3d Cir. 1974).

Again, these percentages do not represent the relationship between the transferor's equity in the transferee and the total equity. Rather, they represent the proportion of equity consideration passing to the former shareholders of the acquired corporation in relationship to the aggregate consideration received for the transferred assets. Stated differently, it is continuity of interest *by value*, not by raw percentages, that is significant.

### Example:

Shareholders Art, Barbara, and Claude, who own INC equally, transfer all of the outstanding stock of INC to Conglomerate in exchange for one-half of one percent of the outstanding stock of Conglomerate in a B reorganization. Assuming they hold their shares for some time thereafter and do not dispose of them pursuant to the reorganization plan, the continuity of interest requirement is met. In fact, there is 100% continuity, even though, collectively, they only received one-half of one percent of Conglomerate's stock. If the transaction had been an A reorganization (permitting consideration other than voting stock), the continuity requirement would have been met even if Art received cash, with only Barbara and Claude acquiring stock in Conglomerate.

As the above example suggests, some shareholders may elect to receive cash. Indeed, a sizable percentage of the acquired corporation's shareholders may opt to receive cash, and this will not itself destroy continuity.

Moreover, while some percentage of shareholders in the acquired corporation may choose not to participate in the reorganization, and may prefer cash instead, there is some flexibility in making the determination of the percentage of shareholders in the acquired corporation that are deemed to participate. The courts have held that stock in the acquiring entity received by shareholders who also have the status of creditors may be counted in determining continuity of interest regardless of whether the shares received are attributable to their capacities as creditors or shareholders.

### Real Life Continuity

Berkshire Hathaways' acquisition of Flightsafety is being structured as a merger designed to qualify as an A reorganization. The merger features only 42% continuity. Obviously, based on *Nelson v. Helvering* (in which 38% continuity was held to be enough), this is sufficient to sail within the protected zone. Moreover, since 50% continuity is often looked to as a kind of IRS-blessed benchmark, the Berkshire

Continued on Page 7

**MERGERS & CONTINUITY** Continued from Page 6

Hathaway/Flightsafety deal is noteworthy. And, it is good precedent to cite to would-be acquirers who feel that only 50% continuity is sufficient. After all, the fact that Warren Buffet seems comfortable with 42% should be considered a pretty good irrefutable endorsement for this level of continuity. ■