

THE M&A TAX REPORT

The Monthly Review of Taxes, Trends & Techniques

Volume 4, Number 4

November 1995



TAX INSTITUTE

Editor-in-Chief

Robert W. Wood
Robert W. Wood, P.C.
San Francisco

Advisory Board

Gilbert D. Bloom
KPMG Peat Marwick
Washington

Louis S. Freeman
Sonnenschein, Nath
& Rosenthal
Chicago

Elliot G. Freier
Irell & Manella
Los Angeles

Lawrence B. Gibbs
Miller & Chevalier
Washington

Steven K. Matthias
Deloitte & Touche
San Francisco

Matthew A. Rosen
Skadden, Arps, Slate,
Meagher & Flom
New York

Irving Salem
Latham & Watkins
New York

Joseph L. Schiffhauer
Federal Express Corp.
Memphis

Mark J. Silverman
Stephoe & Johnson
Washington

Robert Willens
Lehman Brothers
New York

Partnership Distribution of Stock Does Not Affect Continuity of Interest

by Robert W. Wood • San Francisco

The continuity of interest requirement applicable to reorganizations seems to get discussed relatively rarely these days. One of the lynchpins of reorganization status is that there must be continuity of business enterprise under modified corporate forms. Reg. §1.368-1(b). There must also be a continuity of interest on the part of those persons who, directly or indirectly, were the owners of the enterprise prior to the reorganization.

Thus, there are actually two continuity

Continued on Page 5

ALSO IN THIS ISSUE:

- Redemption Borrowing Expenses Slated to be Deductible 6
- Payments to Cancel Stock Options and SARs on Takeover are Deductible . . 8

CONTINUITY OF INTEREST Continued from Page 5

corporation treatment. Pursuant to binding written agreements between all of the parties, the merger occurred with the partnership (which held the Corp 1 stock), receiving 100 shares of Corp 2 stock in exchange. Immediately thereafter, the partnership made a nonliquidating distribution of the Corp 2 stock it received in the merger so that Corp 2 could qualify as an S corporation. Thus, the Corp 2 stock was distributed to the general partner and limited partner in accordance with their respective partnership interests. Pursuant to the plan, Corp 2 elected S treatment, with the Corp 2 shareholders consenting to the election.

No Problem

The ruling concludes that before the merger, the general and limited partners of the partnership indirectly owned the Corp 1 business enterprise. Likewise, after the merger (but before the partnership distributed the stock), the partners remained indirect owners of the Corp 1 business enterprise (this time through the Corp 2 stock). The distribution by the partnership of the Corp 2 stock in accordance with the partners' interest in the partnership, therefore, resulted in no change to their underlying ownership of the business enterprise operated by Corp 1. Consequently, the ruling concludes that the distribution did not affect whether the continuity of proprietary interest requirement of the regulations was satisfied.

How Much Continuity?

The question of just how much continuity is enough has been litigated and debated. For advance ruling purposes, of course, the IRS usually requires a high standard of continuity, generally 50%. Thus, shareholders of the acquired corporation need to have a continuing interest through stock ownership in the acquiring corporation that is equal in value on the date of the reorganization to at least 50% of the value of all the acquired corporation's outstanding stock as of the same date.

Not surprisingly, the case law has been far more liberal, with 25% or 30% continuity being held sufficient. On the other hand, in some rather notable cases, continuity at approximately the 15% level has been judged insufficient. See *Yoc Heating Corp.*, 61 T.C. 161 (1973). ■