February 1, 1998

IRS Final Regulations Codifying the Continuity of Interest and Continuity of Business Enterprise Requirements Add Flexibility to Corporate Reorganizations

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The Internal Revenue Code corporate reorganization provisions provide for norecognition treatment when a corporation transfers its property for stock or securities in another corporation that is a party to the reorganization, and also provide that the shareholders and creditors may exchange their stock or securities for new instruments without recognizing gain or loss. The types of transactions covered by the corporate reorganization provisions include mergers, consolidations, recapitalizations, acquisitions by one corporation of the stock or assets of another corporation, and changes in the form or place of organization. In addition to the statutory requirements, parties to a corporate reorganization are also subject to additional requirements which courts have added to prevent transactions that resemble sales from qualifying for nonrecognition as a corporate reorganization. These nonstatutory requirements include continuity of interest (COI) and continuity of business enterprise (COBE).

Background

As stated above, the purpose of the COI requirement is to prevent transactions that resemble sales from qualifying for nonrecognition of gain or loss available in corporate reorganizations. The Supreme Court, in a series of cases, held that only where the acquiring corporation (P) exchanges a substantial proprietary interest in P for a proprietary interest in the target corporation (T) held by T shareholders will tax-free status be accorded.[1] In *John A. Nelson Co. v. Helvering,*[2] however, the Court found the requisite continuity of interest where assets were transferred for consideration consisting of only 38 percent preferred stock and 62 percent cash. The IRS has stated in Rev. Proc. 77-37[3] that it will not issue a ruling letter where the shareholders of the acquired or transferor corporation do not receive stock ownership in the acquiring or transferee corporation equal to at least 50 percent of the value of the formerly outstanding stock of the acquired or transferor corporation.

In addition, where T shareholders dispose of their P stock shortly after the reorganization, some courts have utilized the step-transaction doctrine to hold that the sale of the P stock was part of the reorganization (i.e., the T shareholder intended to sell his P stock at the time of the potential reorganization) and therefore the requisite proprietary interest in P was not maintained.[4] A similar inquiry applied to sales of T stock prior to a potential reorganization (i.e., the T shareholders intended to cash out).[5] Therefore, parties to the reorganization could not be certain whether the COI requirement was met where there were sales of P stock by former T shareholders shortly after the potential reorganization or a disposition of T stock prior to the potential reorganization.

The COBE requirement focuses on whether the acquiring corporation continues a significant historic T business or uses a significant portion of T's historic business assets in a business. The policy behind this requirement is to ensure that reorganizations are limited to readjustments of continuing interests in property under modified corporate form.[6] The COBE requirement is not met if the acquired corporation sells its assets to a third party for cash and notes before it merges into the acquiring corporation, or if the acquiring corporation disposes of the acquired corporation's historic business assets immediately after the reorganization. Also, the COBE requirement is not met if the acquired corporation transfers assets obtained with the proceeds of a sale of its former operating assets.[7]

On December 31, 1996, the IRS issued proposed regulations relating to the COI requirement, and on January 3, 1997, published proposed regulations relating to the COBE requirement. Final regulations relating to the COI and COBE requirements were recently published in the Federal Register effective for transactions occurring after January 28, 1998, except for any transaction occurring pursuant to a written contract which is binding on January 28, 1998, and all times thereafter.[8] The IRS also issued temporary regulations with the same effective date to amplify the final regulations by specifying that the COI requirement will not be satisfied if certain transactions involving T's shareholders occur prior to, and in connection with the reorganization.[9]

COI Requirement under the Final and Temporary Regulations

As under the prior nonstatutory COI requirement, the final COI regulations require that a proprietary interest in the target corporation be preserved in the reorganization.[10] This requires that P's stock be exchanged either for T's stock, or T's assets, or where T stock is not acquired in connection with the reorganization, that the T stock otherwise continues as a proprietary interest in T.[11] Such an interest is not preserved where, in connection with the potential reorganization, it is acquired by P for other than its own stock, or where stock of P furnished in the exchange for a proprietary interest in T is redeemed. In addition, if a person related to P acquires, with consideration other than P stock, T stock or P stock furnished in exchange for a proprietary interest in T, the COI requirement is not met.[12] As under the judicial COI requirement, the final COI regulations provide that "all facts and circumstances must be considered in determining whether, in substance, a proprietary interest in the target corporation is preserved."[13]

The final COI regulations provide a major improvement over the nonstatutory COI requirement by shifting the focus away from the former T shareholders. The key consideration is whether P stock is used to acquire T's stock or assets, not whether the T shareholders intended to cash out of their T stock immediately before the reorganization or their P stock immediately after the reorganization, provided the sale is to parties unrelated to P. This approach is beneficial to the government in that it prevents the government from being "whipsawed" by P subsequently disavowing reorganization treatment to step up its basis in the T assets. This could occur by P arguing that the sales of P stock by former T shareholders violated the COI requirement.[14] In addition, this approach will prevent unilateral sales of P stock by the former majority T shareholder from adversely affecting the former minority T shareholders. The result is more certainty for the parties to the reorganization that the reorganization will be respected.

In addition, the temporary COI regulations provide that a proprietary interest in T is not preserved if, prior to, and in connection with a potential reorganization, T stock is redeemed, or an "extraordinary distribution" is made with respect to the T stock. An "extraordinary distribution" is not defined in the regulations except that the extraordinary dividend rules of Code Search7RH1059 do not apply for this purpose. Note that this provision can be a trap for certain S corporation shareholders planning a corporate reorganization. For example, if immediately prior to the planned reorganization, the S corporation's shareholders arrange for the corporation to distribute their after-tax earning left in the corporation, the IRS could assert that the distribution is an extraordinary distribution and thereby invalidate the reorganization.

The final COI regulations are applicable only to certain acquisitive reorganizations (i.e., statutory mergers, acquisitions by one corporation of the stock or assets of another corporation, and certain insolvency reorganizations). The COI requirement for divisive reorganizations under Code Search7RH355 is covered by the regulations under that section.[15] The IRS is studying the role of the COI requirement on transfers of assets to controlled corporations ("D" reorganizations), but it is unlikely that any guidance will be forthcoming on this issue in the near future.

COBE Requirement under the Final Regulations

The final COBE regulations continue the general requirement that P either continue a significant historic T business or use a significant portion of T's historic assets in a business. However, more significantly, the regulations also treat P as conducting a T business or owning T's business assets if these activities are conducted by a member of the "qualified group" or, in certain cases, by a partnership that has a member of the qualified group as a member. A "qualified group" is defined as one or more chains of corporations connected through stock ownership with P, but only if P owns directly, in at least one of the corporations, 80 percent of all classes of stock entitled to vote and at least 80 percent of the total number of shares in all other classes of stock.

Specifically, the regulations provide that P is treated as holding all the businesses and assets of all the members of the qualified group.[16] In addition, each member of a partnership will be treated as owning the T business assets used in the business in accordance with that partner's interest in the partnership. P will be treated as conducting a business of the partnership if members of the qualified group, in the aggregate, own an interest in the partnership representing a significant interest in that partnership business or one or more members of the qualified group have active and substantial management functions as a partner with respect to that partnership business. However, while the fact that P is treated as conducting T's historic business tends to establish COBE, it alone is not sufficient. The examples provide that a 20 percent interest in the partnership and active management is sufficient, while a 1 percent interest and active management is not.[17] It is not clear at what percentage the IRS will draw the line. However, while some uncertainty remains, the added flexibility of allowing members of a qualified group to drop-down assets to a partnership is a positive result.

The final COBE regulations are applicable to all reorganizations for which COBE is relevant. However, the COBE regulations do not address the other explicit statutory requirements of a reorganization. For example, drop-downs of acquired assets or stock is still limited by statute to only certain acquisitive reorganizations.[18]

Summary

The final COI and COBE regulations are generally favorable to taxpayers and add additional certainty and flexibility when engaging in corporate reorganizations. However, care must be exercised in planning any corporate reorganization to ensure that the requirements of the regulations are met.

[1] *LeTulle v. Scofield*, 308 U.S. 415 (1940); *Helvering v. Minnesota Tea Co.*, 296 U.S. 378 (1935); *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933).

[2] 296 US 374 (1935).

[3] 1977-2 CB 568.

[4] *McDonald's Restaurants of Illinois, Inc.*, 688 F.2d 520 (7th Cir. 1982); *Heintz v. Commissioner,* 25 T.C. 132 (1955), *non-acq.*, 1958-2 C.B. 9. But see Penrod v. Commissioner, 88 T.C. 1415 (1987); *Estate of Elizabeth Christian v. Commissioner*, 57 T.C.M. (CCH) 1231 (1989) where court held no intention to sell existed at the time of the reorganization.

[5] *J.E. Seagram Corp. v. Commissioner*, 104 T.C. 75 (1995); *King Enterprises, Inc. v. U.S.*, 418 F. 2d 511 (Ct. Cl. 1969); and *Yoc Heating Corp. v. Commissioner*, 61 T.C. 168 (1973).

[6] Treas. Reg. Search7RH1.368-1(d).

[7] Treas. Reg. Search7RH1.368-1(d)(5) examples 3-5, as effective prior to the final regulations adopted January 28, 1998.

[8] Treas. Reg. Search7RH1.368-1 and 2, as revised, January 28, 1998.

[9] Treas. Reg. Search7RH1.368-1T.

[10] Treas. Reg. Search7RH1.368-1(e).

[11] In the case of a triangular reorganization, the statute permits the use of the stock of the corporation in control of the acquiring corporation.

[12] Related person is defined in Treas. Reg. Search7RH1.368-1(e)(3) as any corporation a member of the affiliated group of which P is a member (80% test) or any corporation whose purchase of P stock would be treated as a redemption of that stock under Code Search7RH304(a)(2) (i.e., acquisitions by a subsidiary corporation or brother-sister acquisitions (50% test).

[13] Treas. Reg. Search7RH1.368-1(e).

[14] *McDonalds Restaurants of Illinois, Inc. v. Commissioner,* 688 F.2d 520 (7th Cir. 1982).

[15] Treas. Reg. Search7RH1.355-2(c).

[16] Treas. Reg. Search7RH1.368-1(d)(4)(i).

[17] Treas. Reg. Search7RH1.368-1(d)(5) Ex. 7-8.

[18] Code Search7RH368(a)(2)(C) and Treas. Reg. Search7RH1.368-2(k)(1).