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Continuity of Interest Rules May Be Liberalized —But Can Remain a Trap for the Unwary

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The Internal Revenue Service recently issued two sets of proposed regulations addressing aspects of the "continuity of interest" requirement in tax-free corporate reorganizations. While the proposed regulations would often make it easier for shareholders and corporations to qualify for tax-free treatment, there would remain many pitfalls that could lead to unfavorable tax treatment. Each set of regulations is proposed to be effective for transactions occurring after it is published as final regulations in the Federal Register; however, each set would not apply to transactions which occur pursuant to a written agreement which is binding on or before the date on which it becomes final.

Post-Reorganization Continuity of Interest

Background. The Internal Revenue Code has long permitted corporations to engage in "reorganizations" without their or their shareholders' being subject to income tax on the transaction. Such "reorganizations" generally include statutory mergers and certain other acquisitions of corporate stock and assets, provided a variety of statutory requirements are met. However, literal compliance with these requirements is not enough to ensure tax-free treatment of a transaction; there must also be a "continuity of proprietary interest" by the shareholders of the acquired corporation. Over 50 years ago, the Supreme Court held that a transfer of corporate assets in exchange solely for cash and securities -- a transaction that met the then-effective statutory definition of a "reorganization" -- could not qualify for tax-free treatment because there was no continuing proprietary interest by the shareholders of the transferor corporation in the continuing venture.[1] Such a transaction was simply a sale of the assets transferred, not a "reorganization." As the case law has developed, it is not necessary for the transferor corporation's shareholders to hold any particular interest in the acquiring corporation after the reorganization; however, a material part of the consideration received by those shareholders must consist of equity interests in the acquiring corporation in order to ensure that there is a continuity of proprietary interest.[2]

Even if the shareholders of the transferor corporation receive sufficient stock of the acquiring corporation as part of the consideration given in the reorganization, the case law has held that the continuity of interest requirement will not be satisfied if those shareholders, as "part of the overall transaction," dispose of "too much" of the stock that they received in the transaction. This rule led to significant uncertainties and litigation.[3]

Proposed Regulations. The proposed regulations published on December 20, 1996, would change the rules relating to the potential adverse impact of post-reorganization sales of stock on continuity of interest. Subsequent disposition by transferor corporation shareholders of stock of the acquiring corporation received in the reorganization would generally have no effect on the continuity of interest requirement. The examples in the proposed regulations demonstrate that the transferor corporation shareholders would be able immediately to sell their acquiring corporation stock to third parties, offer it for sale on the open market, or enter into a transaction to hedge the risk of loss on the shares, all without violating the continuity of interest requirement.

However, the rules are not quite as simple as they appear. The proposed regulations state that the Service will still look at all the facts and circumstances to ensure that the acquiring corporation has furnished the appropriate consideration (in substantial part, its own stock). Thus the transferor corporation's shareholders will <u>not</u> be able to sell their shares in the acquiring corporation to the acquiring corporation (for example, in a "redemption" transaction), or to a party related to the acquiring corporation, within a short period after the reorganization; in such a case, the acquiring corporation would, in effect, have furnished cash, rather than its own stock, to the transferor corpora-

tion's shareholders in the reorganization. Since the basic requirement that a material portion of the consideration consist of stock would not be changed by the proposed regulations, this failure to satisfy the continuity of interest requirement would lead to taxable consequences to the parties involved in the transaction.

Remote Continuity of Interest

Background. In addition to the requirement that the transferor corporation's shareholders receive acquiring corporation stock, the Supreme Court has also imposed the requirement that the acquiring corporation maintain ownership of the stock or assets of the transferor corporation that it receives in the reorganization.[4] This is referred to as the "remote continuity of interest doctrine." Although, in many types of reorganizations, the Internal Revenue Code specifically allows the acquiring corporation to drop the assets or stock of the transferor corporation to a first-tier controlled corporate subsidiary without violating the remote continuity of interest doctrine, there are no similar statutory dispensations for drop-downs through multiple tiers of corporations or to partnerships.

Proposed Regulations. The second set of proposed regulations, published on January 2, 1997, would further curtail the remote continuity of interest doctrine in acquisitive reorganizations by expanding the scope of allowable entities to which the acquiring corporation can drop the stock or assets of the transferor corporation. The acquiring corporation would be able to transfer the assets or stock of the transferor corporation to any other corporation in the acquiring corporation's "qualified group" without violating the remote continuity of interest doctrine. A qualified group consists of one or more chains of direct or indirect subsidiary corporations of the corporation whose stock is issued in the reorganization, connected to that corporation through stock ownership of at least 80% of the voting power and 80% of the total number of shares.

Certain significant limitations on the use of multiple tiers of corporations would continue, however. For example, even though the acquiring corporation could pass the assets or stock of the transferor corporation several layers down through a chain of ownership after the reorganization, the initial reorganization could still only involve no more than two corporate levels (i.e., the stock used to make the acquisition must be that of either the acquiring corporation or its direct parent).

Transfers to a partnership of assets (but not stock) of the transferor corporation, in exchange for a partnership interest, would also be permitted, apparently without regard to the size or nature of that partnership interest. However, transfers to a partnership, even if no longer impeded by the remote continuity of interest doctrine, may still violate the continuity of business enterprise requirement described below.

Continuity of Business Enterprise

Background. Current law requires that the acquiring corporation in a reorganization either continue the transferor corporation's historic business or use a significant portion of the assets of that historic business in another business, in order to render the reorganization tax-free.[5] Thus, since the acquiring corporation either has to either carry on the business or to use a significant portion of the assets of the transferor corporation, the stock or assets of the transferor corporation cannot be transferred to certain corporations controlled by the acquiring corporation, or to partnerships in which it is a partner, without violating this "continuity of business enterprise" requirement.

Proposed Regulations. The proposed regulations would ease the continuity of business enterprise requirement when the transferor corporation's stock or assets are transferred by the acquiring corporation either to another corporation in its "qualified group" or to a partnership in which it is a partner. (In permitting transfers of stock to a partnership, the continuity of business enterprise rules are more liberal than the remote continuity of interest rules.) As long as the other corporation in the qualified group continued the transferor corporation's business or used the assets of its historic business in some other business, the continuity of business enterprise requirement would be met. In fact, the examples in the proposed regulations demonstrate that the assets could even be spread among several corporations throughout the qualified group and still satisfy the continuity of business enterprise requirement, since the qualified group as a whole would be using a significant portion of the historic assets of the transferor corporation in a business.

With regard to transfers to partnerships, however, the proposed regulations are not as clear, but appear to be stricter in the case of asset transfers than the remote continuity of interest rules.[6] The requisite continuity of business enterprise could be established where the corporate partner had active and substantial management functions over the partnership's business or where the corporate partner's interest in the partnership was a "significant interest" in the partnership's business. While the facts and circumstances would have to be examined in each case to determine if a corporate partner was to be considered to be truly continuing the historic business of the transferor corporation or utilizing a substantial part of its assets in another business, examples in the proposed regulation show that active and substantial management would generally be found to exist where the corporate partner was involved in making significant business decisions of the partnership and regularly participated in the overall supervision, direction, and control of the employees of the partnership. The "significant interest" test would generally be satisfied if the corporate partner owned a 33-1/3% interest in the partnership.

Conclusion

The proposed regulations would liberalize rules that have governed tax-free treatment of reorganization for over 50 years and expand the possible use of the reorganization provisions by shareholders and corporations. However,

even if they are finalized in their present form, there will still be many uncertainties to trap the unwary if careful tax planning is not employed.

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[1] *LeTulle v. Scofield*, 308 U.S. 415 (1940).

[2] Thus, if 100% of the consideration received by the shareholders consists of acquiring corporation stock, the requisite continuity is present, even if that stock represents only a minuscule interest in the acquiring corporation. The "material part" inquiry addresses itself, rather, to what portion of the total consideration may take the form of cash, debt securities, etc. The IRS will issue a favorable ruling at the 50% level, *see* section 3.02 of Rev. Proc. 77-37, 1977-2 C.B. 568, but the case law is at least somewhat more liberal. Of course, even if the "continuity" requirement is satisfied, that part of the consideration received in the form of cash or other "boot" will still ordinarily be subject to tax.

[3] See, *e.g.*, *McDonald's Restaurants of Illinois, Inc. v. Commissioner*, 688 F.2d 520 (7th Cir. 1982).

[4] *See Helvering v. Bashford*, 302 U.S. 454 (1938); *Groman v. Commissioner*, 302 U.S. 82 (1937).

[5] Treas. Reg. section 1.368-1(b).

[6] Since the remote continuity of interest rules do not permit *any* transfers of stock to a partnership, even the restrictive continuity of business enterprise rules represent a liberalization in that area.

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