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**The Pre-Reorganization
Continuity of Interest Regulations**

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I. INTRODUCTION

On August 30, 2000, the Department of the Treasury ("Treasury") and the Internal Revenue Service ("Service" or "IRS") issued final regulations under section 368 providing guidance on the application of the continuity of interest ("COI") requirement to pre-reorganization transactions.¹ These regulations supplement final, temporary, and proposed COI regulations issued in January 1998.² However, the final pre-reorganization COI regulations are substantially different from the temporary and proposed pre-reorganization COI regulations issued in 1998. This article discusses the COI requirement in general, reviews the 1998 temporary and proposed pre-reorganization COI regulations and the final pre-reorganization COI regulations, and analyzes when the final pre-reorganization regulations should apply to count pre-reorganization distributions and redemptions against the COI requirement.

In summary, the final pre-reorganization regulations apply the section 356 "boot" rule in determining whether a distribution or redemption prior to a reorganization counts against the COI requirement. Thus, one must determine when section 356 applies to distributions and redemptions prior to reorganizations.

This article concludes that the Service should apply a "source of funds" test in determining the application of the section 356 boot rule. Although this source of funds test does

¹T.D. 8898 (August 30, 2000). All Code section references are to the Internal Revenue Code of 1986, as amended, and the regulations thereunder, unless otherwise noted.

²T.D. 8760 (Jan. 23, 1998).

not always yield a clear answer, there is little need for the Service to adopt a more restrictive test for the following reasons:

- Cases under the COI requirement allow target shareholders to receive up to 60% cash in a reorganization without violating the COI requirement.
- Target shareholders may sell their target stock prior to the reorganization or sell their new acquiring corporation stock after the reorganization without violating the COI requirement.
- Other reorganization requirements such as the continuity of business enterprise requirement and the substantially all requirement provide additional limitations on the distribution of assets.

Thus, the issue of how the COI requirement applies to pre-reorganization transactions is often of little consequence.

II. THE CONTINUITY OF INTEREST REQUIREMENT

A. Overview

In order for a transaction to qualify as a tax-free reorganization under section 368, the transaction generally must satisfy the COI requirement.³ Under the COI requirement, the historic shareholders of the target corporation must have a continuing interest in the target assets and target business through the acquisition of the stock of the acquiring corporation. This requirement has its origins in cases dating back to Pinellas Ice & Cold Storage v. Commissioner,⁴ and Helvering v. Minnesota Tea Co.⁵ Treasury Regulations and an IRS revenue

³Treas. Reg. § 1.368-1(b). On February 25, 2005, Treasury amended the final section 368 regulations to provide that for transactions occurring on or after February 25, 2005, continuity of business enterprise and continuity of interest are not required for the transaction to qualify as a reorganization under section 368(a)(1)(E) or (F). See Treas. Reg. § 1.368-1(b), T.D. 9182, 70 Fed. Reg. 9219-9220 (Feb. 25, 2005).

⁴287 U.S. 462 (1933).

procedure provide the general safe harbor that the COI requirement will be satisfied as long as former target shareholders hold stock in the acquiring entity representing at least 50 percent of the value of the former target stock.⁶ However, cases generally allow target shareholders to hold stock in the acquiring entity representing approximately 40 percent of the value of the former target stock.⁷ In addition, an example in recently issued temporary regulations provides that the continuity of interest requirement is satisfied where target shareholders hold acquiring company stock worth approximately 40 percent of the value of the former target stock.⁸

B. 1998 Final Continuity of Interest Regulations

In January 1998, Treasury finalized COI regulations that included rules relating to the effect of post-reorganization transactions by target shareholders on the COI requirement.⁹ The final regulations state that the purpose of the COI requirement is to "prevent transactions that resemble sales from qualifying for nonrecognition of gain or loss available in corporate

⁵296 U.S. 378 (1935). See also Cortland Specialty Co. v. Commissioner, 60 F.2d 937 (2nd Cir. 1932).

⁶Treas. Reg. § 1.368-1(e)(7), Ex. 1; Rev. Proc. 77-37, 1977-2 C.B. 568.

⁷See, e.g., John A. Nelson Co. v. Helvering, 296 U.S. 374 (1934) (38 percent stock satisfies COI requirement); Helvering v. Minnesota Tea Co., 296 U.S. 378 (1935) (41 percent stock satisfies COI requirement); Miller v. Commissioner, 84 F.2d 415 (6th Cir. 1936) (25 percent stock satisfies COI requirement).

⁸Temp. Reg. § 1.368-1T(e)(2)(v), Ex. 1, 72 Fed. Reg. 12,974 (March 20, 2007). Under the regulations, whether a transaction satisfies the continuity of interest requirement is determined by reference to the value of the acquiror stock as of the end of the last business day before the first date there is a binding contract to effect the potential reorganization, provided the consideration is fixed in such contract. Temp. Reg. § 1.368-1T(e)(2). The new temporary regulations replaced final regulations published on September 16, 2005, which contained an example identical to that described above. See former Treas. Reg. § 1.368-1(e)(2)(v), Ex. 1.

⁹See Treas. Reg. § 1.368-1(e). For an in-depth analysis of the January 1998 regulations, see Silverman and Weinstein, The Continuity of Interest and Continuity of Business Enterprise Regulations, 25 J. Corp. Tax'n 219 (Autumn 1998), also contained in these volumes.

reorganizations."¹⁰ Thus, the regulations require that "a substantial part of the value of the proprietary interests in the target corporation be preserved in the reorganization."¹¹

In determining whether a proprietary interest in the target corporation is preserved, all the facts and circumstances are considered.¹² However, no proprietary interest in the target corporation is preserved if --

in connection with the potential reorganization, [the proprietary interest] is acquired by the issuing corporation for consideration other than stock of the issuing corporation, or stock of the issuing corporation furnished in exchange for a proprietary interest in the target corporation in the potential reorganization is redeemed.¹³

Thus, some post-reorganization transactions -- namely redemptions -- may cause a reorganization to fail the COI requirement. However, post-reorganization sales of stock will not destroy continuity, as long as such sales are not to the issuing corporation or a party related

¹⁰Treas. Reg. § 1.368-1(e)(1).

¹¹Id. Under the final regulations, a "proprietary interest" in the target corporation is preserved if the interest in the target corporation is (1) exchanged for a proprietary interest in the "issuing" corporation, (2) exchanged by the acquiring corporation for a direct interest in the target corporation enterprise, or (3) otherwise continued as a proprietary interest in the target corporation. Treas. Reg. § 1.368-1(e)(1).

The "issuing" corporation is the acquiring corporation, except that in determining whether a reorganization is a triangular reorganization under Treas. Reg. § 1.358-6(b)(2), the issuing corporation is the corporation in control of the acquiring corporation. Treas. Reg. § 1.368-1(b). Any reference to the issuing or target corporation "includes a reference to any successor or predecessor of such corporation, except that the target corporation is not treated as a predecessor of the issuing corporation and the issuing corporation is not treated as a successor of the target corporation." Treas. Reg. § 1.368-1(e)(6).

¹²Treas. Reg. § 1.368-1(e)(1). See PLR 200204002 (Oct. 4, 2001) (using facts and circumstances analysis in ruling that target shareholder's continuing interest in target corporation was minimal at best because indirect ownership was through preferred stock with voting control but little value); Chief Counsel Memorandum CC-2002-003 (Oct. 18, 2001) (same).

¹³Treas. Reg. § 1.368-1(e)(1)(i).

to the issuing corporation.¹⁴ Dispositions of stock of the target corporation by shareholders prior to a reorganization to persons unrelated to the target or issuing corporation are also disregarded for purposes of the COI requirement.¹⁵

C. 1998 Temporary and Proposed Pre-reorganization
Continuity of Interest Regulations

In addition to the final regulations, Treasury also issued temporary and proposed regulations addressing pre-reorganization continuity in January 1998.¹⁶ Although these regulations have essentially been rendered obsolete by the final pre-reorganization regulations (which are discussed infra), a discussion of these temporary and proposed regulations provides insight into the policy reasons behind the final pre-reorganization regulations and the application of such regulations.

Under the 1998 temporary and proposed regulations, a reorganization generally fails the COI requirement if, prior to and in connection with a reorganization, a proprietary interest in the target corporation is redeemed, or prior to and in connection with a reorganization there is an extraordinary distribution made with respect to such proprietary interest.¹⁷ Whether a distribution is extraordinary is a facts and circumstances determination.¹⁸

¹⁴Id. Two corporations are related if the corporations are members of the same affiliated group as defined in section 1504, or a purchase of the stock of one corporation by another corporation would be treated as a redemption under section 304(a)(2) (determined without regard to Treas. Reg. § 1.1502-80(b)). Treas. Reg. § 1.368-1(e)(4).

¹⁵Treas. Reg. § 1.368-1(e)(1). Thus, the final regulations codify the Tax Court's decision in J.E. Seagram Corp. v. Commissioner, 104 T.C. 75 (1995), where the Tax Court concluded that sales by public shareholders, prior to a reorganization, may be ignored when considering the COI requirement.

¹⁶See Temp. Reg. § 1.368-1T.

¹⁷Temp. Reg. § 1.368-1T(e)(1)(ii)(A). It is unclear what standards were intended to be used in determining whether a redemption or an extraordinary distribution was "in connection with a reorganization."

Commentators on the temporary and proposed regulations issued in December 1996 had suggested that the source of funds used by the target corporation to redeem its shareholders should be analyzed in order to determine whether a redemption should adversely affect the COI requirement.¹⁹ The commentators argued that if the acquiring corporation did not directly or indirectly furnish the funds used by the target corporation to redeem its shareholders, COI should not be affected.²⁰ However, the Service seemed to conclude that since, as a result of the reorganization, the target corporation and acquiring corporation are combined economically, they should be treated as one entity. Thus, cash coming from the target corporation should be treated the same as cash coming from the acquiring corporation. In addition, the Service argued that "a tracing approach would be extremely difficult to administer."²¹ Thus, tracing was not adopted in the temporary and proposed regulations, avoiding the "difficult process of identifying the source of payments."²²

The Service invited comments on "whether the regulations should provide more specific guidance" in the area of extraordinary distributions.²³ One area of particular concern to

The temporary and proposed regulations do not apply to a distribution of stock by the target corporation under section 355(a) (or so much of section 356 as relates to section 355), except to the extent that the shareholders of the target corporation receive boot to which section 356(a) applies, or the distribution is extraordinary in amount and is a distribution of boot to which section 356(b) applies. Temp. Reg. § 1.368-1T(e)(1)(ii)(B).

¹⁸Preamble to T.D. 8761 (Jan. 23, 1998).

¹⁹Id. See, e.g., Waterman Steamship Corp. v. Commissioner, 430 F.2d 1185 (5th Cir. 1970); Casner v. Commissioner, 450 F.2d 379 (5th Cir. 1971); TSN Liquidating Corp. v. United States, 624 F.2d 1328 (5th Cir. 1980); Litton Indus., Inc. v. Commissioner, 89 T.C. 1089 (1987).

²⁰Preamble to T.D. 8761 (Jan. 23, 1998).

²¹Id.

²²Id.

²³Id.

many taxpayers was whether S corporations should be treated the same as C corporations with respect to the extraordinary distribution rules. More specifically, commentators asked that the Service make clear the effect of the rules on S corporations that distribute their Accumulated Adjustments Account ("AAA Account") prior to a reorganization.²⁴ Under the temporary and proposed regulations, it appears that S corporations are treated the same as C corporations, and that the distribution of an S Corporation's AAA Account prior to a reorganization could be considered an extraordinary distribution.²⁵

In addition, commentators asked that the Service clarify exactly what the term "extraordinary" means. If the term is given its plain meaning, then any distribution that is not regularly made (i.e., almost any distribution in addition to the corporation's periodic dividends) can be an extraordinary distribution.²⁶ For example, suppose a corporation ordinarily issues a \$10 per share quarterly dividend to its shareholders in cash. If such corporation issues real estate with a fair market value of \$10 per share instead of its normal quarterly cash dividend, is that an extraordinary distribution? The total amount of the dividend is the same, but the type of the dividend is different.

D. Final Pre-reorganization Continuity of Interest Regulations

1. Overview

²⁴Id. See Preamble to T.D. 8898 (Aug. 30, 2000); Rev. Rul. 71-266, 1971-1 C.B. 262 (ruling that distribution of S corporation's AAA Account prior to reorganization under section 368(a)(1)(C) is not distribution under section 356).

²⁵IRS officials informally stated that the distribution of AAA Accounts could be considered an extraordinary distribution, but requested comments as to how the extraordinary distribution rule should apply to AAA Accounts.

²⁶Merriam-Webster's Collegiate Dictionary, 10th Ed., defines extraordinary as "going beyond what is usual, regular, or customary."

As discussed above, commentators argued that the temporary and proposed regulations were overly broad, and that redemptions and distributions should not be taken into account for COI purposes unless the acquiring corporation "directly or indirectly furnishes the consideration for the redemption or distribution."²⁷ In response to these comments, Treasury issued final regulations on August 30, 2000 (T.D. 8898), substantially modifying the temporary and proposed regulations. The final regulations "do not automatically take all pre-reorganization redemptions and extraordinary distributions in connection with [a] reorganization into account for COI purposes."²⁸

Under Treas. Reg. § 1.368-1(e)(1)(ii), the COI requirement will only be violated due to pre-reorganization redemptions of target stock or pre-reorganization distributions with respect to target stock if the amounts received by the target shareholder are treated as boot received from the acquiring corporation in the reorganization for purposes of section 356.²⁹

²⁷Preamble to T.D. 8898 (Aug. 30, 2000).

²⁸Id.

²⁹Treas. Reg. § 1.368-1(e)(1)(ii). Interestingly, the COI regulations now seem to provide two different standards, one for pre-reorganization transactions and one for post-reorganization transactions. A post-reorganization transaction generally counts against the COI requirement if it is "in connection with the potential reorganization," while a pre-reorganization transaction generally counts against the COI requirement only if the amounts received by the target shareholder would be treated as boot under section 356.

Query which rules apply where the distribution or redemption and the reorganization are simultaneous. Since the pre-reorganization regulations apply only to consideration received "prior to a potential reorganization," it seems that the post-reorganization regulations apply to simultaneous transactions.

Query also the continuing vitality, in light of the regulations, of the statement in Rev. Proc. 77-37, 1977-2 C.B. 568, that "[s]ales, redemptions, and other dispositions of stock occurring prior or subsequent to the exchange which are part of the plan of reorganization will be considered in determining" whether the transaction violates the COI requirement.

For purposes of determining whether section 356 applies, the final regulations provide that each target shareholder is deemed to have received some stock of the acquirer in exchange for such shareholder's target stock.³⁰ This provision is necessary because if a target shareholder receives only cash as a result of a complete redemption of such shareholder's target stock prior to a reorganization, the amount received is generally treated as a redemption under section 302, not as boot under section 356, regardless of whether the redemption and the reorganization are integrated transactions.³¹ Thus, without the deemed issuance of stock rule, the redemption would not count against the COI requirement under any circumstance because section 302, not section 356, would apply. With the deemed issuance of stock rule, however, since the target shareholder is treated as receiving cash and stock in exchange for his target stock, section 356 can apply.³² Thus, the redemption can count against the COI requirement.

2. Section 356

The cornerstone of the final pre-reorganization COI regulations is the application of section 356 to the amounts received by the target shareholders. Section 356 generally applies

³⁰Treas. Reg. § 1.368-1(e)(1)(ii).

³¹Rev. Rul. 74-515, 1974-2 C.B. 118.

³²See Rev. Rul. 74-515, 1974-2 C.B. 118. Treasury and IRS officials have stressed that the target shareholder is treated as receiving the stock of the acquirer solely for purposes of applying the COI requirement. Thus, since the target shareholder actually received no stock of the acquirer, section 302 applies for purposes of determining the tax treatment of the redemption to the target shareholder. However, even if the target shareholder were treated as receiving some stock of the acquirer in the transaction for purposes of determining the target shareholder's tax treatment upon the redemption, section 302 principles would likely apply anyway. See Commissioner v. Clark, 489 U.S. 726 (1989) (viewing reorganization with boot as stock for stock exchange followed by post-reorganization redemption); Rev. Rul. 93-61, 1993-2 C.B. 118 (same).

Treasury and IRS officials have stated that the fact that the target shareholder is deemed to have received stock of the acquirer should have no effect on the determination of whether the redemption is a separate transaction or part of the reorganization.

if "section 354 or 355 would apply to an exchange but for the fact that . . . the property received in the exchange consists not only of property permitted by section 354 or 355 to be received without the recognition of gain but also of other property or money."³³ Thus, section 356 requires (1) that section 354 or 355 apply,³⁴ and (2) that the boot be received "in the exchange."

a. Section 354

The first requirement under section 356 is that section 354 apply.³⁵ Section 354(a)(1) provides that "no gain or loss shall be recognized if stock or securities of a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization." Thus, section 354 can only apply if there is a qualifying reorganization under section 368, and there is an exchange of stock or securities of parties to the reorganization. As a result, section 356 will only apply if boot is received in a reorganization that qualifies under section 368, and there is also an exchange of stock or securities for stock or securities.³⁶

³³Section 356(a)(1); Treas. Reg. §1.356-1(a).

³⁴Because the COI regulations do not apply to section 355 transactions or section 368(a)(1)(D) reorganizations, for purposes of this article only section 354 is relevant. See Preamble to T.D. 8760 (Jan. 23, 1998).

³⁵As noted above, the COI regulations do not apply to section 355 transactions.

³⁶As noted below, reorganizations under section 368(a)(1)(B) require that an acquirer exchange solely its voting stock (or stock of its parent) for target stock. Thus, an acquirer may not transfer any boot in connection with a reorganization under section 368(a)(1)(B). As a result, section 356 cannot apply to pre-reorganization distributions and redemptions in the context of a "B" reorganization, as any nonqualifying property transferred by an acquirer would result in a failed B reorganization.

b. Received "In The Exchange"

The second requirement under section 356 is that the boot be received "in the exchange." When is an amount received in the exchange? Is a cash distribution received by a target shareholder one day prior to a reorganization treated as received in the exchange? What about a cash distribution received 30 days prior to a reorganization? 60 days?

If amounts received as a result of a pre-reorganization distribution or redemption are treated as being received in the exchange, section 356 should apply and the distribution should be counted against the COI requirement. However, if amounts received as a result of a pre-reorganization distribution or redemption are treated as not being received in the exchange, section 356 cannot apply and the distribution should not be counted against the COI requirement. So what standards should section 356 utilize in determining when amounts received prior to an exchange should be treated as being received "in the exchange?"

(i) The Step-Transaction Doctrine: In General³⁷

Neither section 356, nor the legislative history or regulations thereunder, provide guidance as to when amounts received prior to an exchange should be treated as received in the exchange. Thus, one could argue that under the plain language of the statute, amounts must actually be received in the reorganization in order to be treated as received in the exchange. If this argument prevails, no pre-reorganization distributions or redemptions will be treated as

³⁷Some of the authorities discussed in this article technically apply the "form vs. substance," "integrated transaction," or "sham transaction" doctrine, as opposed to the "step-transaction" doctrine. As all of these doctrines are essentially the same in the context of this article (all seeking to determine whether transactions should be combined), the term "step-transaction doctrine" in this article includes all of these doctrines.

received in the exchange, and thus no pre-reorganization distributions or redemptions will count against the COI requirement. Treasury and the IRS obviously did not intend this result.

The Preamble to the final regulations states that in considering whether section 356 applies, "taxpayers should consider all facts, circumstances, and relevant legal authorities."³⁸ Thus, taxpayers should analyze each transaction under relevant authorities, including authorities under the step-transaction doctrine. The step-transaction doctrine generally steps together two or more transactions if the particular facts and circumstances warrant.³⁹ If the step-transaction doctrine applies to step a pre-reorganization distribution or redemption together with the reorganization, amounts received by the target shareholders as a result of the distribution or

³⁸Preamble to T.D. 8898 (Aug. 30, 2000). IRS officials are presently considering whether to issue guidance under section 356.

³⁹In general, whether two transactions will be "stepped together" under the step-transaction doctrine will depend upon the facts and circumstances of the transaction. Courts have developed a number of approaches for dealing with step-transaction issues. Most prevalent are the binding commitment test, the mutual interdependence test, and the end result test. See McDonald's Restaurants of Illinois, Inc. v. Commissioner, 688 F.2d 520 (7th Cir. 1982). See also F.S.A. 199929013 (applying all three tests in determining whether the continuity of interest requirement under section 355 was satisfied); Novacare, Inc. v. United States, 52 Fed.Cl. 165 (Fed. Cl. 2002) (applying end result test and interdependence test in determining whether post-reorganization sales in a pre-1998 merger destroyed COI). Cf. True v. United States, 190 F.3d 1165 (10th Cir. 1999)(noting that a transaction needs to satisfy only one of the tests to apply the step-transaction doctrine).

Under the binding commitment test, a series of transactions will be stepped together only if at the time that the first step is commenced there is a binding legal commitment to undertake the subsequent step(s). See, e.g., Commissioner v. Gordon, 391 U.S. 83 (1968). Under the mutual interdependence test, a series of transactions will be stepped together if the steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series. See, e.g., King Enterprises, Inc. v. United States, 418 F.2d 511 (Ct. Cl. 1969). Under the end result test, a series of transactions will be stepped together whenever the evidence shows that the parties intent at the outset was to achieve the particular result, and that the separate steps were all entered into as means of achieving that result. See, e.g., Kuper v. Commissioner, 533, F.2d 152 (5th Cir. 1976).

redemption should be treated as received in the exchange, resulting in the application of section 356.

(ii) The Step-Transaction Doctrine and Source of Funds: Waterman Steamship

Very little authority discusses the step-transaction doctrine in the context of section 356.⁴⁰ However, numerous authorities under the step-transaction doctrine have analyzed whether a distribution prior to a stock sale should be treated as a separate transaction (treated as a distribution under section 301), or should be stepped together with the stock sale and treated as part of such sale (treated as part of the sales price). Such authorities provide guidance as to when a pre-reorganization distribution or redemption should be treated as a separate transaction or stepped together with the reorganization.

In Waterman Steamship Corp. v. Commissioner,⁴¹ a subsidiary ("S") declared a \$2.8 million dividend to its parent corporation ("T") shortly before S was acquired by a third party ("P") for approximately \$700,000 (T's basis in its S stock was \$700,000). Because S did not have the funds to pay the dividend, S issued a promissory note to T for the entire \$2.8 million. Shortly after the acquisition, P lent \$2.8 million to S, and S paid off the promissory note. Applying the step-transaction doctrine, the Fifth Circuit held that the \$2.8 million dividend was part of the purchase price by P, and that T realized capital gain on the sale in the amount of

⁴⁰See Rev. Rul. 56-184, 1956-1 C.B. 190 (referring to section 356 in ruling that a dividend followed by a B reorganization does not affect the qualification of such B reorganization, but noting that if the dividend were treated as cash received in connection with the reorganization, section 368(a)(1)(B) would not apply due to the failure of the solely for voting stock requirement).

⁴¹430 F.2d 1185 (5th Cir. 1970).

the dividend. Since the Court held that the dividend was part of the purchase price, one can deduce that if instead of a sale the parties participated in an asset reorganization,⁴² the \$2.8 million dividend to T would be treated as boot in the reorganization under section 356, and the dividend would count against the COI requirement.

The Fifth Circuit distinguished Waterman Steamship in TSN Liquidating Corp. v. United States.⁴³ In TSN Liquidating, S distributed assets (the stock of lower-tier subsidiaries) to T shortly before S was acquired by P for cash. Immediately after the purchase, P contributed cash to S. The Fifth Circuit held that the distribution was a dividend and not part of the sales price because P negotiated to acquire and pay for the S stock exclusive of the distributed assets. The Court noted that the key distinction between its holding in TSN and its holding in Waterman Steamship is that in TSN the distributed assets were not wanted by the acquirer and were retained by the selling shareholders, whereas in Waterman Steamship the acquirer negotiated a purchase price that included all the assets of the target and none of the assets were to be retained by the selling shareholders.⁴⁴ Since the Court held that the distribution in TSN was a dividend, one can deduce that if instead of a sale the parties participated in an asset reorganization,⁴⁵ the dividend to T would not be treated as boot in the reorganization under section 356, and the dividend would not count against the COI requirement.

⁴²As discussed below, section 356 does not apply in the context of a B reorganization.

⁴³624 F.2d 1328 (5th Cir. 1980).

⁴⁴Query whether the Court's analysis actually imposes a continuity of business enterprise requirement, rather than a continuity of interest requirement.

⁴⁵As discussed below, section 356 does not apply in the context of a B reorganization.

Numerous other authorities follow either the Waterman Steamship analysis in holding that a distribution and subsequent sale are treated as an integrated transaction,⁴⁶ or the TSN Liquidating analysis in holding that a distribution is a separate transaction.⁴⁷ The common thread that links these authorities seems to be the source of the funds paid to the target shareholders -- if the court determines that the acquirer is the source of the funds paid to the target shareholders, the court typically has stepped the transactions together. If not, the court typically has treated the transactions as separate.

(iii) The Step-Transaction Doctrine:
Authorities Under Section 368(a)(1)(B)

⁴⁶See, e.g., Basic, Inc. v. United States, 549 F.2d 740 (Ct. Cl. 1977) (holding that distribution of lower-tier subsidiary that is followed by acquisition of both distributing corporation and lower-tier subsidiary is part of purchase price and not a dividend); Casner v. Commissioner, 450 F.2d 379 (5th Cir. 1971) (holding that distribution of cash to individual shareholder that is followed by acquisition that was not binding at time of distribution is nonetheless part of purchase price and not a dividend). See also Zenz v. Quinlivan, 213 F.2d 914 (6th Cir. 1954) (holding that shareholder of target receives capital gain treatment on redemption of remaining shares of stock following stock sale because the combined effect of the stock sale and redemption was that her total interest in the corporation was extinguished); Rev. Rul. 84-114, 1984-2 C.B. 90 (following Zenz); Rev. Rul. 54-458, 1954-2 C.B. 167 (same); Rev. Rul. 55-745, 1955-2 C.B. 223 (same); Rev. Rul. 75-447, 1975-2 C.B. 113 (same).

⁴⁷See, e.g., Litton Industries, Inc. v. Commissioner, 89 T.C. 1086 (1987) (holding that distribution by target to parent over six months prior to acquisition of target is a dividend, despite the fact that distribution was in the form of promissory note and acquirer paid off note); Rev. Rul. 75-493, 1975-2 C.B. 109 (rejecting analysis in Casner in ruling that distribution of cash to individual shareholder that is followed by acquisition that was not binding at time of distribution is a dividend). See also Rev. Rul. 75-406, 1975-2 C.B. 125 (ruling that spin-off prior to reorganization does not violate COI requirement); Rev. Rul. 70-434, 1970-2 C.B. 83 (ruling that spin-off prior to attempted B reorganization does not affect the qualification of transaction as a B reorganization); Gilmore v. Commissioner, 25 T.C. 1321 (1956) (holding that distribution of unwanted assets by target that is followed by acquisition is a dividend); Coffey v. Commissioner, 14 T.C. 1410 (1950) (same); Rosenbloom Finance Corp. v. Commissioner, 24 B.T.A. 763 (1931) (same).

In addition to the Waterman Steamship distribution-followed-by-sale authorities, authorities analyzing distributions and redemptions prior to reorganizations under section 368(a)(1)(B) ("B" reorganizations) also focus on the source of funds used to pay the target shareholders. In Rev. Rul. 56-184⁴⁸ (dividend prior to attempted B reorganization) and Rev. Rul. 75-360⁴⁹ (redemption prior to attempted B reorganization), the Service ruled that if the acquiring corporation is the source of the funds transferred to the target shareholder, the funds are treated as being transferred in the reorganization.

Rev. Rul. 75-360 analyzed the transaction in McDonald v. Commissioner.⁵⁰ In McDonald, McDonald owned all the outstanding preferred stock of E&M Enterprises ("E&M") and most of E&M's common stock. As part of a plan of reorganization with Borden Company ("Borden"), E&M obtained a short-term loan and redeemed McDonald's E&M preferred stock. McDonald then exchanged all of his E&M common stock for Borden stock in a transaction intended to qualify as a B reorganization. Immediately thereafter, Borden transferred cash to E&M, which E&M used to pay off the short-term loan.

Under these facts, Rev. Rul. 75-360 concludes that because the redemption and reorganization constitute an integrated transaction, Borden's acquisition of E&M stock is not solely for voting stock, and thus is not a valid B reorganization. Where the acquirer is not treated as providing the funds used in a pre-B reorganization distribution or redemption, numerous rulings have concluded that the distribution or redemption will not affect the qualification of the B reorganization (i.e., the distribution or redemption is treated as a

⁴⁸1956-1 C.B. 190.

⁴⁹1975-2 C.B. 110.

⁵⁰52 T.C. 82 (1969).

transaction separate from the B reorganization).⁵¹ Thus, the B reorganization authorities -- like the sale authorities -- focus on the source of the funds paid to the target shareholders in determining whether the two transactions should be stepped together.

(iv) The Step-Transaction Doctrine:
Asset Reorganizations

Although numerous step-transaction authorities analyze distributions and redemptions prior to sales and B reorganizations, authorities do not analyze distributions or redemptions prior to asset reorganizations. It is unclear how the "source of funds" authorities such as Waterman Steamship and Rev. Rul. 75-360 apply to asset reorganizations, because asset reorganizations often involve the commingling of funds. As the following examples show, it can be very difficult to determine which party is the actual source of the funds transferred to T's shareholders in an asset reorganization:⁵²

Example 1: Assume P, a publicly traded corporation, wants to acquire T, a publicly traded corporation, but does not want to acquire one of T's businesses (which is worth 65% of the fair market value of T). Thus, T distributes the business to its shareholders, and

⁵¹See Rev. Rul. 70-172, 1970-1 C.B. 77 (distribution of property followed by B reorganization); Rev. Rul. 69-443, 1969-2 C.B. 54 (cash dividend followed by B reorganization); Rev. Rul. 68-435, 1968-2 C.B. 155 (cash dividend followed by B reorganization); Rev. Rul. 68-285, 1968-1 C.B. 147 (complete redemption of dissenting shareholders followed by B reorganization); Rev. Rul. 56-184, 1956-1 C.B. 190 (cash dividend followed by B reorganization).

Rev. Rul. 68-285 specifically notes that a complete redemption of dissenting shareholders followed by an attempted B reorganization will fail the section 368(a)(1)(B) solely for voting stock requirement if "the acquiring corporation pays the dissenting shareholders or reimburses the acquired corporation for its payment to the dissenting shareholders."

⁵²It may be impractical for the target and acquiring corporations to keep separate accounts and separate books after the merger, in order to make clear which party is the source of the funds transferred to the target shareholders.

immediately after the distribution, T merges into P in exchange for P stock in a transaction intended to qualify as a tax-free reorganization under section 368(a)(1)(A). Should the distribution of 65% of T's assets affect the COI requirement?⁵³ Since the distribution is of a business of T, T should be treated as the source of the funds transferred to the target shareholders, and thus the distribution should be treated as a separate transaction.⁵⁴

Example 2: Assume the distribution to T's shareholders in Example 1 is a cash distribution representing 65% of the value of T, as opposed to a distribution of one of T's businesses. Should the analysis be any different? Here, the source of the funds used to pay the target shareholders is more difficult to trace, as T's assets and P's assets are combined.

One can make the argument that since the assets came directly from T prior to the reorganization, and P never paid any amounts to the T shareholders, T should be treated as the source of the funds. What if P and T intended the consideration in the merger to consist of 65% cash and 35% P stock, but the parties structured the transaction as a distribution by T followed by an all-stock merger in order to avoid violating the COI requirement? The economic situation of the combined corporation will be exactly the same whether T distributes 65% cash to its shareholders prior to the merger, or P simply exchanges 65% cash and 35% P stock in the merger.⁵⁵ Some step-transaction cases hold that if a distribution and later transaction are part of

⁵³Note that no more than 66% of the assets of the target should ever be distributed to the target shareholders prior to a reorganization, because a distribution of more than 66% of the target assets would likely violate the continuity of business enterprise requirement. See Treas. Reg. § 1.368-1(d)(5), Ex.1.

⁵⁴See TSN Liquidating Corp. v. United States, 624 F.2d 1328 (5th Cir. 1980).

⁵⁵For example, assume T is worth \$100x prior to the transaction, and P is worth \$200x. If T first distributes \$65 to its shareholders and then receives only P stock in the merger, the combined entity will be worth \$235 (\$35 value of T following distribution + \$200 value of P). If P simply issues \$65 of cash and \$35 of P stock in the merger, the combined entity will still be worth \$235 (\$100 value of T + \$135 value of P following transfer of cash to T shareholders).

a pre-conceived plan to transfer consideration from the acquirer to the target shareholders, the distribution and the later transaction should be stepped together.⁵⁶ Nevertheless, in light of the other reorganization requirements such as the substantially all requirement, the continuity of business enterprise requirement, and the fact that under the COI regulations shareholders may sell their target stock prior to the reorganization or their acquiring stock after the reorganization, there is no need for the Service to take such a position.⁵⁷ Rather, simply looking to the payor should provide adequate protection.

Assume further that, because T distributed a large amount of cash to its shareholders prior to the merger, T's business needs operating funds after the merger, which it receives from one of P's businesses. Should P now be treated as the source of the funds transferred to T's shareholders in the pre-merger distribution? What if T received the operating funds from the P business six months after the merger? A year? Three years? How should the source of funds test apply in these scenarios?

Example 3: Assume that T distributes cash representing 10% of its assets to its shareholders. Immediately thereafter T merges into S, a newly formed wholly owned subsidiary of P, in exchange for 60% cash and 40% P stock in a transaction intended to qualify as a tax-free reorganization under sections 368(a)(1)(A) and 368(a)(2)(D).⁵⁸ In this example, because S only

⁵⁶See Basic, Inc. v. United States, 549 F.2d 740 (Ct. Cl. 1977); Casner v. Commissioner, 450 F.2d 379 (5th Cir. 1971); Steel Improvement and Forge Co. v. Commissioner, 314 F.2d 96 (6th Cir. 1963). But see Rev. Rul. 75-493, 1975-2 C.B. 109 (rejecting analysis in Casner).

⁵⁷See II.D.2.b.v., infra.

⁵⁸Note that T should not distribute more than 10% of its net assets and 30% of its gross assets because in order to qualify under section 368(a)(2)(D), T must transfer "substantially all" its assets in the merger. See Rev. Rul. 77-37, 1977-2 C.B. 568 (stating that for ruling purposes, substantially all means assets representing at least 90% of the fair market value of the target's net assets and at least 70% of the fair market value of the target's gross assets).

has nominal assets, there should be no commingling of funds issue. Thus, if a target wants to push out money prior to an asset reorganization in an amount that could violate the COI requirement, such target can attempt to avoid the "commingling of funds" issue by combining with an acquiring entity that has nominal assets.⁵⁹

Example 4: Assume the same facts as Example 3, except that instead of T's distribution of cash to its shareholders, T issues a note (with a fair market value equal to 10% of T's assets) to its shareholders. Again, since S only has nominal assets, it seems that T should be treated as the source of the funds and the note should not count against the COI requirement.

What if S instead of T issued the note, and such issuance was at the time of and in connection with the merger? Since the note is issued in connection with the merger, and not prior to the merger, the post-reorganization COI rules would appear to apply.⁶⁰ Thus, the note presumably would count against the COI requirement.⁶¹ Is this the correct result? Should there be a difference if S rather than T issues the note if T's assets are used to pay off the note?

Example 5: Assume the same facts as Example 3, except that shortly after the merger, the combined T/S corporation borrows money that it needs to operate its business from a

⁵⁹Assume T in this example is an S corporation, and the distribution of cash to T's shareholders prior to the reorganization is a distribution of T's AAA Account. In Rev. Rul. 71-266, 1971-1 C.B. 262, the Service ruled that a distribution of an S corporation's AAA Account prior to a reorganization under section 368(a)(1)(C) is not a distribution under section 356. Thus, one can argue that Rev. Rul. 71-266 provides authority that the distribution of an S corporation's AAA Account prior to a reorganization should not affect the COI requirement. However, Rev. Rul. 71-266 does not discuss the source of the funds distributed by the S corporation to its shareholders. As a result, the Service should clarify the application of the COI requirement to AAA Account distributions prior to reorganizations.

⁶⁰See Treas. Reg. § 1.368-1(e)(1)(i) (stating that the test for including post-reorganization consideration against the COI requirement is whether the consideration is issued "in connection with the potential reorganization").

⁶¹Id. See Rev. Rul. 71-364, 1971-2 C.B. 182, discussed in Example 6, below.

third party lender, and P guarantees the loan. Should the loan and guarantee be stepped together with the earlier transactions, resulting in P being treated as the source of the funds transferred to the T shareholders?⁶² What if P later pays off the loan? Should P be treated as the source of the funds?

Example 6: Assume T transfers 90% of its assets to P in exchange for P stock in a transaction intended to qualify as a tax-free reorganization under section 368(a)(1)(C). Immediately after the transfer, T liquidates, distributing the remaining 10% of its assets and its recently acquired P stock to its shareholders.⁶³

Under these facts in Rev. Rul. 71-364, the Service treated the receipt of T's assets by T's shareholders in the reorganization as boot under section 356 -- even though P provided no funds for the distribution. However, Rev. Rul. 71-364 is a post-reorganization ruling, not a pre-reorganization ruling, and thus is not specifically applicable to pre-reorganization distributions and redemptions. Nevertheless, if the rationale of Rev. Rul. 71-364 applies to a distribution to shareholders prior to a reorganization, the final pre-reorganization COI regulations could count distributions to T's shareholders against the COI requirement even if P provides no funds for the distribution.⁶⁴

⁶²See Plantation Patterns v. Commissioner, 462 F.2d 712 (5th Cir. 1972).

⁶³See Rev. Rul. 71-364, 1971-2 C.B. 182.

⁶⁴Under the specific facts of Rev. Rul. 71-364, the relevance of the COI requirement is minimal, because under section 368(a)(1)(C), T must transfer "substantially all" of its assets to P, and P may only use 20% boot in the transaction. See section 368(a)(2)(B). Thus, one of these statutory requirements will likely disqualify the transaction if the transaction even comes close to failing the COI requirement. However, other reorganizations do not have the strict requirements of section 368(a)(1)(C).

We believe Rev. Rul. 71-364 provides the wrong result. As noted above, there is ample authority that focuses on the source of the funds used to pay the target shareholders. Rev. Rul. 71-364 does not analyze the source of the funds at all. The Service should clarify that Rev. Rul. 71-364 does not apply to treat pre-reorganization distributions and redemptions as boot under section 356 for purposes of the COI requirement if the acquirer provides no funds for such distribution or redemption.

(v) The Step-Transaction Doctrine: Conclusion

Since the step-transaction authorities seem to turn on one overriding fact -- which party was the source of the funds paid to the target shareholders -- the source of the funds used to pay the target shareholders should be the test in determining whether a pre-reorganization distribution or redemption should be stepped together with the reorganization.

Based on the facts and circumstances of a particular case, if one determines that the funds received by the target shareholders came from the acquirer, the transactions should be stepped together and the distribution or redemption should count against the COI requirement. If one determines that the funds received by the target shareholders came from the target, the pre-reorganization distribution or redemption should be treated as a separate transaction and should not count against the COI requirement.

Applying the source of funds test to certain asset reorganizations could prove to be a difficult undertaking. Because the other reorganization requirements such as the continuity of business enterprise requirement and the substantially all requirement restrict many of the "games" the Service wishes to curtail in the context of asset reorganizations, there is little need

for the Service to adopt a more restrictive test.⁶⁵ Moreover, under the post-reorganization COI regulations, target shareholders may sell their target stock prior to the reorganization, or sell their new P stock after the reorganization, without affecting the COI requirement.⁶⁶ Thus, the issue of boot in a reorganization is often of little consequence.

3. Example in Final Regulations

Although the final pre-reorganization regulations do not provide direct guidance as to the standards that should be used in determining whether section 356 applies to a pre-reorganization distribution or redemption, they do provide an example that seems to focus on the source of the funds used to pay the target shareholders.⁶⁷ However, the example may provide more questions than answers.

In the example, T has two shareholders, A and B. P wants to acquire the stock of T, but A does not want to own P stock. Thus, T redeems A's shares for cash, and P then acquires all the remaining stock of T from B solely in exchange for P voting stock.⁶⁸ The example provides that "[n]o funds have been or will be provided by P" for the redemption.⁶⁹

⁶⁵The substantially all requirement applies to all reorganizations under sections 368(a)(1)(C), 368(a)(2)(D), and 368(a)(2)(E), while the continuity of business enterprise requirement generally applies to all asset reorganizations.

⁶⁶Treas. Reg. § 1.368-1(e)(1) (stating that sales of target stock to unrelated parties before a reorganization and sales of acquiring stock after a reorganization to unrelated parties are disregarded for purposes of determining whether the COI requirement is satisfied).

⁶⁷Treas. Reg. § 1.368-1(e)(7), Ex. 9.

⁶⁸Id.

⁶⁹Id.

The example in the final regulations concludes that since the cash received by A in the redemption is not treated as boot under section 356, the redemption does not affect the COI requirement.⁷⁰ On its face, this example simply seems to be following the "source of funds" analysis discussed above in stating that if no cash for the redemption is provided by the acquirer, section 356 will not apply and thus the redemption will not affect the COI requirement. A closer inspection, however, begs the question of how section 356 could possibly apply to the facts in the example even if P provided funds for the redemption.

Although not specifically referred to, the reorganization in the example is apparently intended to be a B reorganization. In order to qualify as a B reorganization, P must exchange solely P voting stock (or stock of its parent) for T stock. If P provides the funds for the redemption and the transactions are thus stepped together, P will not be treated as exchanging solely P voting stock for T stock, and thus the reorganization will not qualify as a valid B reorganization. Therefore, the question of whether section 356 applies will never be reached.⁷¹

⁷⁰Id. Query whether the percentage of T stock held by A is relevant to the COI analysis. Would it matter if A held 99% of the stock of T and T redeemed all of A's stock prior to the attempted B reorganization? Because the example does not state the percentage holdings of the two target shareholders, one can infer that such percentages are irrelevant. However, note that a complete redemption of a 99% shareholder would violate the continuity of business enterprise requirement. See Treas. Reg. § 1.368-1(d).

Although it is not entirely clear whether the statement in the example that "[t]he cash received by A in the pre-reorganization redemption is not treated as other property or money under section 356" is a statement of fact or a statement of law, IRS officials have indicated that this statement was intended to reflect the numerous authorities that have concluded that pre-reorganization redemptions followed by a reorganization under section 368(a)(1)(B) where no funds are provided by the acquirer for such redemption are treated as distributions under section 301. See Rev. Rul. 70-172, 1970-1 C.B. 77; Rev. Rul. 69-443, 1969-2 C.B. 54; Rev. Rul. 68-435, 1968-2 C.B. 155; Rev. Rul. 68-285, 1968-1 C.B. 147. See also Rev. Rul. 56-184, 1956-1 C.B. 190; Rev. Rul. 75-360, 1975-2 C.B. 110; McDonald v. Commissioner, 52 T.C. 82 (1969).

⁷¹See Rev. Rul. 75-360, 1975-2 C.B. 110. Rev. Rul. 75-360, which held that a redemption followed by an attempted B reorganization constituted an integrated transaction, makes no mention of section 356 -- the transaction failed the general requirements of a B

If P does not provide the funds for the redemption, the redemption will be treated as a separate transaction and again section 356 will not apply. Thus, it seems that section 356 cannot apply under any circumstance under the facts of the example in the final pre-reorganization COI regulations. As a result, the example provides little help for practitioners.⁷²

4. Effective Date

The final regulations generally only apply to transactions occurring after August 30, 2000, but taxpayers may request a private letter ruling permitting them to apply the final regulations to transactions entered into on or after January 28, 1998.⁷³ Thus, the 1998 temporary and proposed regulations, including the "extraordinary distribution" rule, should have little continuing applicability.

III. CONCLUSION

reorganization and thus section 356 was not relevant. While Rev. Rul. 56-184 (Rev. Rul. 75-360's dividend counterpart) does refer to section 356 in ruling that a dividend followed by a B reorganization does not affect the qualification of such B reorganization, that ruling correctly notes that if the dividend were treated as cash received in connection with the reorganization, section 368(a)(1)(B) would not apply due to the failure of the solely for voting stock requirement.

⁷²Having determined that the use of section 356 for purposes of the COI requirement is misplaced in the context of B reorganizations, the next question is what is the relevance of COI to B reorganizations (in the context of pre-reorganization transactions) at all? It seems that depending on the source of the funds used to pay target shareholders, an attempted B reorganization will either fail due to the "solely for voting stock" requirement, or succeed because the distribution or redemption is treated as a separate transaction. Is guidance on B reorganizations in the context of pre-reorganization distributions and redemptions even necessary? The Service should clarify the example in the regulations and the relevance of the COI requirement to B reorganizations in the context of pre-reorganization distributions and redemptions.

⁷³Treas. Reg. § 1.368-1(e)(8).

Treasury and the Service should be congratulated for issuing final pre-reorganization COI regulations that are more focused on the specific purpose of preventing tax-free treatment for transactions that resemble sales than were the 1998 temporary and proposed pre-reorganization COI regulations. However, the Service should issue guidance on the application of section 356 to pre-reorganization distributions and redemptions, focusing on the source of the funds provided to the target shareholders.