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Continuity of Interest and Continuity of Business Enterprise Regulations

By

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I. INTRODUCTION

In January 1998, Treasury issued final continuity of interest and continuity of business enterprise regulations under section 368.[1] Although these regulations were proposed in similar form in December 1996, the final regulations are different from the proposed regulations in some important ways. At the same time that Treasury issued the final regulations, Treasury issued temporary and proposed regulations addressing pre-reorganization redemptions and extraordinary distributions.[2] These pre-reorganization regulations were finalized in modified form in August 2000.[3] Treasury has since issued proposed, temporary, and final regulations that address certain issues not dealt with in the earlier regulations and that modify certain aspects of the earlier regulations.[4] This article reviews the continuity of interest and continuity of business enterprise requirements, and explains and analyzes the final, temporary, and proposed regulations.

[1] T.D. 8760 (Jan. 23, 1998). All Code section references are to the Internal Revenue Code of 1986, as amended, and all references to "Treas. Reg. §" are to the regulations thereunder, unless otherwise noted.

In September 1998, Treasury issued amendments to the final regulations. T.D. 8783 (Sept. 23, 1998). The amendments to the final regulations are effective as of September 23, 1998.

[2] T.D. 8761 (Jan. 23, 1998); REG-120882-97 (Jan. 28, 1998).

[3] T.D. 8898 (Aug. 30, 2000).

[4] T.D. 9565 (Dec. 19, 2011); T.D. 9396 (May 9, 2008); T.D. 9316 (Mar. 20, 2007); REG-130863-04 (Aug. 16, 2004); 69 Fed. Reg. 48,4291 (Aug. 10, 2004).

II. CONTINUITY OF INTEREST

A. Overview

In general, for a transaction to qualify as a tax-free reorganization under section 368, the transaction generally must satisfy the continuity of interest ("COI") requirement.[5] 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[6] and Helvering v. Minnesota Tea Co.[7]

The Internal Revenue Service ("Service" or "IRS") considers the continuity of interest requirement satisfied if, following the transaction, historic shareholders of the target corporation hold stock of the acquiring corporation (as a result of prior ownership of target

[5] Treas. 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). Prior to the issuance of final, temporary, and proposed regulations in January 1998, this requirement was called the "Continuity of Shareholder Interest" or "COSI" requirement. For purposes of this article, "COI" is used to refer to this requirement, even if the referenced authority was issued when the test was referred to as "COSI."

[6] 287 U.S. 462 (1933).

[7] 296 U.S. 378 (1935). See also Cortland Specialty Co. v. Commissioner, 60 F.2d 937 (2d Cir. 1932).

stock) representing at least 40% of the value of the stock of the target corporation.[8] Cases have, however, approved reorganizations with lower percentages of stock consideration.[9]

B. Application of Step-Transaction Doctrine

1. Law Prior to Final Regulations

Under the law prior to the issuance of the final COI regulations in January 1998, the Service, and to a lesser extent the courts, applied the step-transaction doctrine to determine if the COI requirement was satisfied. Accordingly, transactions occurring before and after sales of stock generally were examined to determine their effect on COI.[10] However, dispositions not contemplated at the time of the reorganization transaction generally did not adversely affect the COI requirement.[11] The Service and the courts looked to the facts and circumstances of each transaction in determining whether to apply the step-transaction doctrine.

In McDonald's Restaurant of Illinois, Inc. v. Commissioner, the Seventh Circuit held that a merger failed the continuity of interest requirement where the shareholders of the

[8] See Treas. Reg. § 1.368-1(e)(2)(v), Ex. 1; Preamble to T.D. 9225 (September 16, 2005) (stating that the continuity of interest requirement is satisfied where 40-percent of the target corporation stock is exchanged for stock in the issuing corporation, regardless of whether the “signing date” rule applies). But see Rev. Proc. 77-37, 1977-2 C.B. 568 (stating that the continuing interest requirement is satisfied for advance ruling purposes where 50-percent of the target corporation stock is exchanged for stock in the issuing corporation).

[9] See e.g., John A. Nelson Co. v. Helvering, 296 U.S. 374 (1934) (38 percent stock); Miller v. Commissioner, 84 F.2d 415 (6th Cir. 1936) (25 percent stock).

[10] See, e.g., McDonald's Restaurant of Illinois v. Commissioner, 688 F.2d 520 (7th Cir. 1982); Superior Coach of Florida v. Commissioner, 80 T.C. 895 (1983); J.E. Seagram Corp. v. Commissioner, 104 T.C. 75 (1995). See also Rev. Proc. 77-37, 1977-2 C.B. 568 (stating 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 continuity of interest requirement is satisfied).

[11] Penrod v. Commissioner, 88 T.C. 1415 (1987).

target corporation sold their acquiring corporation stock soon after the transaction. The Court applied the step-transaction doctrine in determining that the merger and post-transaction sale were interdependent steps and that the target shareholders did not plan to continue as investors at the time of the merger.[12]

In J.E. Seagram Corp. v. Commissioner,[13] the Tax Court concluded that sales by public shareholders, prior to a reorganization, may be ignored when considering the COI requirement. In that case, Seagram purchased approximately 32% of Conoco's stock for cash pursuant to a tender offer. Subsequently, DuPont purchased approximately 46% of Conoco's stock pursuant to its own tender offer, and Conoco merged into DuPont. In the merger, Seagram exchanged its Conoco stock for DuPont stock. The Tax Court held that the continuity of interest requirement was satisfied, because DuPont acquired Conoco for 54% stock and 46% cash. The Tax Court concluded that Seagram "stepped into the shoes" of 32% of the Conoco shareholders. Accordingly, Seagram's recent purchase of stock did not destroy the COI requirement.[14]

2. Final Regulations

In December 1996, the Service issued proposed regulations relating to the effect of post-reorganization transactions by target shareholders on the COI requirement.[15] In January

[12] But see Novacare, Inc. v. United States, 52 Fed.Cl. 165 (Fed. Cl. 2002) (stating that "continuity of interest is not disrupted based solely on post-merger sales"); Penrod v. Commissioner, 88 T.C. 1415 (1987) (holding that a post-acquisition sale did not destroy COI because the target's shareholders did not decide to sell their stock until after the acquisition).

[13] 104 T.C. 75 (1995).

[14] Seagram attempted to argue that the transaction was taxable, as it had paid a premium for the Conoco stock, and wanted to deduct its loss upon its exchange of Conoco stock for DuPont stock.

[15] See Prior Prop. Reg. § 1.368-1(b) and (e), 61 Fed. Reg. 67,512.

1998, the Service finalized the proposed regulations, with some changes. In addition, the Service issued temporary and proposed regulations that cover pre-reorganization transactions.[16] 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 reorganizations."[17] Thus, the regulations require that "a substantial part of the value of the proprietary interests in the target corporation be preserved in the reorganization."[18]

In the preamble to the final regulations, the Service states that, although cases such as McDonald's focus on whether the target corporation's shareholders "intended on the date of the potential reorganization to sell their [acquiring corporation] stock and the degree, if any, to which [the acquiring corporation] facilitates the sale," the Service and the Treasury Department concluded that

> the law as reflected in these cases does not further the principles of reorganization treatment and is difficult for both taxpayers and the IRS to apply consistently.[19]

Thus, the Service decided to effectively reverse McDonald's, stating that the final regulations will "greatly enhance administrability in this area," and will "prevent 'whipsaw' of the government," such as where the target corporation's shareholders and the acquiring corporation take inconsistent positions as to the taxability of a transaction.[20]

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[16] Prior Temp. Reg. § 1.368-1T.

[17] Treas. Reg. § 1.368-1(e)(1).

[18] Id.

[19] Preamble to T.D. 8760 (Jan. 23, 1998).

[20] Note that the new COI regulations do not apply to section 368(a)(1)(D) reorganizations or section 355 transactions. Preamble to T.D. 8760 (Jan. 23, 1998).

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,[21] (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.[22] In determining whether a proprietary interest in the target corporation is preserved, all the facts and circumstances are considered.[23] 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.[24]

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[21] 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).

[22] Treas. Reg. § 1.368-1(e)(1). For purposes of the new regulations, 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).

[23] Id. 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).

[24] Treas. Reg. § 1.368-1(e)(1)(i). In addition, if in connection with the reorganization, stock of the target corporation, or stock of the issuing corporation furnished in exchange for a proprietary interest in the target corporation, is acquired by a person related to the issuing corporation for consideration other than stock of the issuing corporation, the transaction will also fail the COI requirement. Treas. Reg. § 1.368-1(e)(3). However, the transaction will not fail the COI requirement by reason of Treas. Reg. § 1.368-1(e)(3) if the direct or indirect owners of the target corporation prior to the reorganization maintain a direct or indirect proprietary interest in the issuing corporation. See Part II.C.Ex.5 for an example of the application of this regulation.

Thus, some post-reorganization transactions -- namely redemptions -- will cause a reorganization to fail the COI requirement.[25] 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 to the issuing corporation.[26] Thus, as noted above, the final regulations reverse McDonald's.

Under the final regulations, dispositions of stock of the target corporation prior to a reorganization to persons unrelated to the target or issuing corporation is disregarded for

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[25] Note that there is a safe harbor under Treas. Reg. § 1.368-2(k) providing that a transaction otherwise qualifying as a reorganization under section 368(a) will not be disqualified as a result of one or more subsequent transfers if certain requirements are met. The safe harbor has no application, however, to distributions of the stock of issuing, acquiring, or surviving corporation or to certain distributions received by former shareholders of the acquired or surviving corporation as consideration for proprietary interests in the acquired or surviving corporation. Treas. Reg. § 1.368-2(k)(1).

[26] Id. Two corporations are related under the regulations 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). Under section 1504, corporations are members of the same affiliated group if a common parent owns 80% of the vote and value of at least one other member of the group, and one or more of the other corporations in the affiliated group own 80% of the vote and value of each corporation in such group (except the common parent). Under section 304(a)(2), if X Corporation acquires Y stock from a shareholder of Y Corporation in return for property, and Y Corporation controls X Corporation, then such property is treated as a distribution in redemption of the stock of Y corporation. The regulations proposed in December 1996 had defined related with reference to sections 707(b)(1) and 267(b). See Prop. Reg. § 1.368-1(e)(1).

Corporations are related under the new regulations if a relationship exists immediately before or immediately after the acquisition. Treas. Reg. § 1.368-1(e)(4)(ii)(A). In addition, a corporation (other that the target corporation or a related person) will be treated as related to the issuing corporation if the relationship is created in connection with the reorganization. Treas. Reg. § 1.368-1(e)(4)(ii)(B). See Part II.C.Ex.7. Related persons do not include individuals or other non-corporate shareholders. See Preamble to T.D. 8760 (Jan. 23, 1998).

For purposes of the final regulations, each partner of a partnership will be treated as owning or acquiring any stock owned or acquired by the partnership in accordance with the partner's interest in the partnership (and, correspondingly, treated as furnishing its share of any consideration furnished by the partnership). Treas. Reg. § 1.368-1(e)(5).

purposes of the COI requirement.[27] Thus, the final regulations codify the Seagram analysis discussed above.

3. Temporary, Proposed, and Final Regulations: Pre-reorganization Continuity

a. 1998 Temporary and Proposed Regulations

In addition to the final regulations, the Service also issued temporary and proposed regulations addressing pre-reorganization continuity in January 1998.[28] Under the temporary and proposed regulations (applicable from January 28, 1998 until final regulations were issued on August 30, 2000), 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.[29]

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[27] Treas. Reg. § 1.368-1(e)(1).

[28] See Prior Temp. Reg. § 1.368-1T.

[29] Prior Temp. Reg. § 1.368-1T(e)(1)(ii)(A). It is unclear what standards will be used to determine whether a redemption or an extraordinary distribution is "in connection with a reorganization."

Under the temporary and proposed regulations, a reorganization also fails the COI requirement if, prior to and in connection with a reorganization, a person related to the target corporation acquires target stock, with consideration other than stock of either the target corporation or the issuing corporation. Prior Temp. Reg. § 1.368-1T(e)(2)(ii). Two corporations are "related" under the temporary regulations if a purchase of the stock of one corporation by another would be treated as a distribution in redemption of the stock of the first corporation under section 304(a)(2) (determined without regard to Treas. Reg. § 1.1502-80(b)). See Prior Temp. Reg. § 1.368-1(e)(4).

Finally, 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. Prior Temp. Reg. § 1.368-1T(e)(1)(ii)(B).

Commentators 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 continuity of interest.[30] 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.[31] However, the Service seemed to conclude that since the target corporation and acquiring corporation are combined economically, they should be treated as one entity. In addition, the Service argued that "a tracing approach would be extremely difficult to administer."[32] Thus, tracing was not adopted in the temporary and proposed regulations, avoiding the "difficult process of identifying the source of payments."[33]

In addition, under the proposed regulations, whether a distribution is extraordinary is a facts and circumstances determination.[34] Note, however, that the treatment of a distribution under section 1059 will not be taken into account.[35]

The Service invited comments on "whether the regulations should provide more specific guidance" in the area of extraordinary distributions.[36] One area of particular concern to

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[30] Preamble to T.D. 8761 (Jan. 23, 1998). 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).

[31] Preamble to T.D. 8761 (Jan. 23, 1998).

[32] Id.

[33] Preamble to T.D. 8761 (Jan. 23, 1998).

[34] Id.

[35] Id.

[36] Id.

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 affect of the rules on S corporations that distribute their Accumulated Adjustments Account ("AAA Account") prior to a reorganization. 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.[37]

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.[38] 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.

b. Final Pre-reorganization Continuity of Interest Regulations

Commentators on the temporary and proposed regulations had argued that the temporary and proposed regulations were overly broad, and that redemptions and distributions

[37] IRS 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.

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

should not be taken into account for COI purposes unless the acquiring corporation "directly or indirectly furnishes the consideration for the redemption or distribution.[39] In response to these comments, Treasury issued T.D. 8898 on August 30, 2000, finalizing the temporary and proposed regulations in substantially modified form. These final regulations "do not automatically take all pre-reorganization redemptions and extraordinary distributions in connection with [a] reorganization into account for COI purposes."[40]

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.[41]

Section 356 applies if sections 354 or 355 would apply to an exchange but for the fact non-qualifying property is received.[42] For purposes of determining whether section 356

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[39] Preamble to T.D. 8898 (Aug. 30, 2000). Commentators also argued that S corporations were adversely affected by the temporary and proposed regulations, particularly because such corporations typically distribute their AAA Accounts upon a merger into a C corporation. Id.

[40] Id.

[41] Treas. Reg. § 1.368-1(e)(1)(ii). Interestingly, the COI regulations now 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 if the amounts received by the target shareholder would be treated as boot under section 356.

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

[42] Section 356(a)(1). Section 354 can only apply if there is a qualifying reorganization under section 368. Section 354(a)(1).

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.[43] This provision is necessary because if a target shareholder receives only cash in the transaction, the amount received is generally treated as a redemption under section 302, not as boot under section 356.[44] Treasury and IRS officials have stressed that this "deemed stock" rule is solely for the purpose of determining whether section 356 applies, and no stock is treated as received by the target shareholder for any other purpose.

Because the final pre-reorganization regulations focus on whether section 356 applies, taxpayers must analyze each transaction under relevant authorities, including the step-transaction doctrine and authorities such as Waterman Steamship Corp. v. Commissioner.[45] These authorities generally analyze whether a redemption or distribution is a separate transaction (treated as a redemption under section 302 and/or a distribution under section 301), or part of a

[43] Treas. Reg. § 1.368-1(e)(1)(ii).

[44] See Rev. Rul. 74-515, 1974-2 C.B. 118.

[45] 430 F.2d 1185 (5th Cir. 1970). Because the final regulations rely on the amounts received being treated as boot under section 356, situations could arise whereby redemptions and distributions count against COI even if no funds are provided by the acquirer. For example, in Revenue Ruling 71-364, 1971-2 C.B. 182, Target transferred 90% of its assets to Acquirer in exchange for Acquirer stock in a transaction intended to qualify as a tax-free reorganization under section 368(a)(1)(C). Immediately after the transfer, Target liquidated, distributing the remaining 10% of its assets and its recently acquired Acquirer stock to Target's shareholders. The Service treated the receipt of the remaining 10% of Target's assets by its shareholders as boot under section 356. Thus, if the rationale of Rev. Rul. 71-364 applies to a distribution to shareholders prior to a reorganization, the final regulations would count the 10% of the assets received by Target's shareholder against the COI requirement -- even though Acquirer provided no funds for the distribution.

sale or reorganization (treated as part of the sales price or boot in the reorganization under section 356).[46]

The final pre-reorganization regulations provide one example explaining how the regulations work.[47] 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 T 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.[48] The example provides that "no funds have been or will be provided by P" for the redemption.[49]

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.[50] On its face, this example simply seems to be saying that if no cash for the

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[46] See 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); McDonald v. Commissioner, 52 T.C. 82 (1969); Rev. Rul. 75-360, 1975-2 C.B. 110; 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; Rev. Rul. 56-184, 1956-1 C.B. 190).

The Preamble to the final regulations states that in determining whether consideration is treated as boot under section 356, "taxpayers should consider all facts, circumstances, and relevant legal authorities." IRS officials are presently considering whether to issue guidance under section 356.

[47] Treas. Reg. § 1.368-1(e)(7), Ex. 9.

[48] Id.

[49] Id.

[50] Id. 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;

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 reorganization under section 368(a)(1)(B) (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, P is not be treated as exchanging solely P voting stock for T stock, and thus the reorganization does not qualify as a valid B reorganization. Therefore, the question of whether section 356 applies is never reached.[51] If P does not provide the funds for the redemption, the redemption is treated as a separate transaction and again section 356 does 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 Service should clarify the example and the relevance (if any) of the pre-reorganization regulations to intended B reorganizations.[52]

Rev. Rul. 68-435, 1968-2 C.B. 155; Rev. Rul. 68-285, 1968-1 C.B. 147; Rev. Rul. 56-184, 1956-1 C.B. 190). 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).

[51] See 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 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.

[52] Having 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

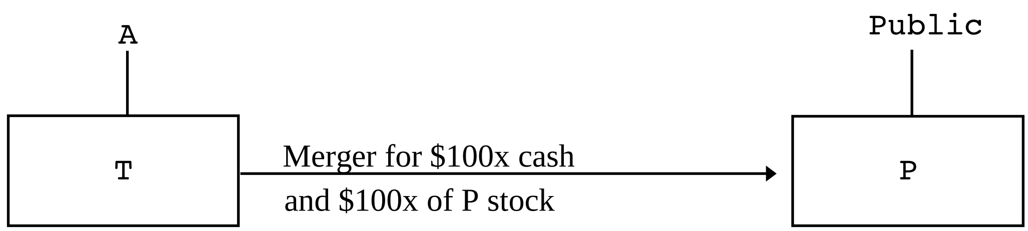
The final regulations generally only apply to transactions occurring after August 30, 2000, but taxpayers may request a private letter ruling permitting them to apply the final regulations to transactions entered into on or after January 28, 1998.[53] Thus, the temporary and proposed regulations, including the "extraordinary distribution" rule, should have little continuing applicability.

The following section provides a series of examples reflecting how the COI regulations operate.

C. <u>Examples Involving Continuity of Interest</u>

Note: In the following examples, T will be used to represent the target corporation and P will be used to represent the issuing corporation.

1. <u>Example 1 -- Quantitative Continuity</u>



<u>Facts</u>: T, a corporation wholly-owned by individual A, enters into an agreement to merge into P, a publicly traded corporation, in exchange for $100x and 100 shares of P stock at a time when P stock is trading at $1x per share.

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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 new regulations and the relevance of the COI requirement to B reorganizations in the context of pre-reorganization distributions and redemptions.

[53] Treas. Reg. § 1.368-1(e)(8).

In this example, continuity is satisfied. The Service considers the continuity of interest requirement satisfied if, following the transaction, historic shareholders of the target corporation hold stock of the acquiring corporation (as a result of prior ownership of target stock) representing at least 40% of the value of the stock of the target corporation.[54] Cases have, however, approved reorganizations with lower percentages of stock consideration.[55]

Assume that the facts are the same as Example 1, and that the $100x of P stock received by T in the merger represents 40% of the outstanding stock (vote and value) of P. Assume further that immediately following the merger, X, a corporation that owns 45% of the stock (vote and value) of P, purchases all of A's P stock received in the merger. Under the final regulations, X will be treated as a related person, because it is a member of P's affiliated group under section 1504 immediately <u>after</u> the transaction (i.e., X will own 85% of P's stock immediately after the transaction).[56] Thus, the transaction will fail the COI requirement. Note, however, that if X were an individual, the related person rules would not apply, and the transaction would pass the COI requirement under the regulations.[57]

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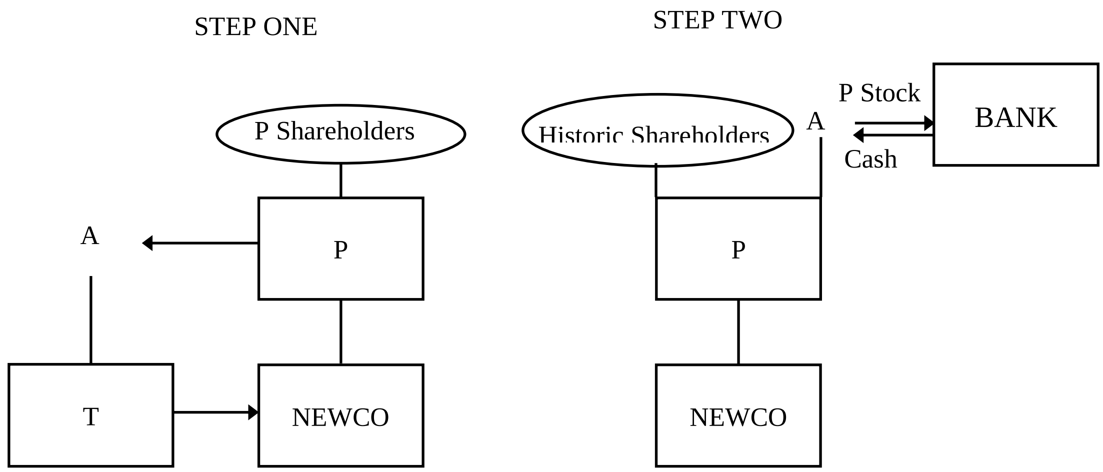
[54] <u>See</u> Treas. Reg. § 1.368-1(e)(2)(v), Ex. 1; Preamble to T.D. 9225 (September 16, 2005) (stating that the continuity of interest requirement is satisfied where 40-percent of the target corporation stock is exchanged for stock in the issuing corporation, regardless of whether the "signing date" rule applies).

[55] <u>See</u> <u>e.g.</u> <u>John A. Nelson Co. v. Helvering</u>, 296 U.S. 374 (1934) (38 percent stock); <u>Miller v. Commissioner</u>, 84 F.2d 415 (6th Cir. 1936) (25 percent stock).

[56] Treas. Reg. § 1.368-1(e)(4) (stating that corporations are treated as related if relationship exists immediately before or immediately after acquisition of stock involved). For a discussion of the requirements of section 1504, <u>see</u> note 26.

[57] <u>See</u> Preamble to T.D. 8760 (Jan. 23, 1998).

2. Example 2 -- Post-reorganization Continuity and the Final Regulations



Facts: A owns all of the stock of T Corporation. A and P agree that T will be merged into a newly formed subsidiary of P ("Newco") in a transaction intended to qualify as a reorganization under section 368(a)(2)(D). Pursuant to a binding agreement that is already in effect at the time of P's acquisition of T, A agrees to sell the P stock it receives in the transaction to Bank.

Is the continuity of interest requirement satisfied? Under prior law, a prearranged plan to dispose of stock received in the reorganization may have destroyed continuity of interest.[58] In this case, there is a binding commitment to dispose of all of the stock received in the transaction. Accordingly, continuity would not have been satisfied and the transaction would have been treated as an asset sale under prior law. Thus, A's unilateral action may have subjected T (and thus P) to corporate-level tax.

Prior to the adoption of the final regulations, many commentators argued that the continuity of interest requirement was intended to look only to the nature of the consideration

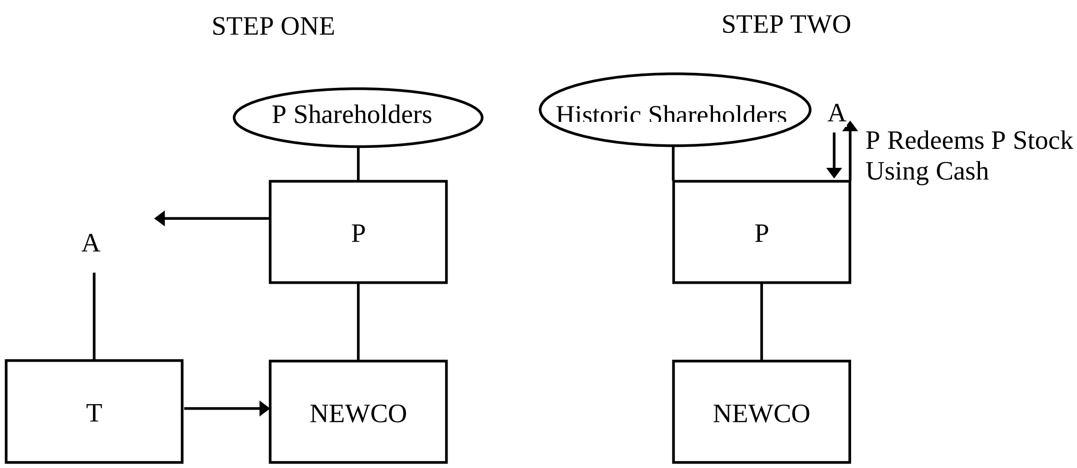
[58] See e.g., Rev. Rul. 66-23, 1966-1 C.B. 67; Rev. Proc. 77-37, 1977-2 C.B. 568; Rev. Proc. 86-42, 1986-2 C.B. 722; McDonald's Restaurants of Illinois v. Commissioner, 688 F.2d 520 (7th Cir. 1982); Penrod v. Commissioner, 88 T.C. 1415 (1987); Christian Est. v. Commissioner, 57 T.C.M. 1231 (1989).

issued by the acquiring corporation in the transaction. Where, as here, the acquiring corporation has not participated in (or even been aware of) the sale of its stock by the target shareholders, the sale should not destroy continuity.[59]

The final regulations essentially adopt this position. The regulations state that a mere disposition of stock of the issuing corporation received in a reorganization to persons not related to the issuing corporation is disregarded for purposes of COI.[60] Thus, under the final regulations, continuity would be satisfied in the above example.[61]

The regulations apply prospectively. Thus, they apply to transactions occurring after January 28, 1998 -- the date the final regulations were published in the Federal Register.[62]

3. Example 3 -- Post-reorganization Continuity (Sales to Issuing Corporation)



[59] See Rev. Rul. 66-23, 1966-1 C.B. 67.

[60] See Treas. Reg. § 1.368-1(e).

[61] See Treas. Reg. § 1.368-1(e)(7), Ex. 1.

[62] See Treas. Reg. § 1.368-1(e)(8). In addition, the regulations will not apply to "any transaction occurring pursuant to a written agreement which is binding" on January 28, 1998. Id.

Facts: Assume that the facts are the same as Example 2, except that A has an arrangement to sell the P stock back to P rather than to a third party bank.

The final regulations expressly provide that the COI requirement will not be satisfied if the stock of the issuing corporation is redeemed by the issuing corporation from the holders of the proprietary interest in connection with the reorganization.[63] Thus, the transaction will be treated as a sale of the T stock by A to P for cash.

Assume that the facts are the same as Example 2, except that P issues redeemable preferred stock (that is not nonqualified preferred stock under sections 351(g)) to A in the reorganization. The stock is redeemable three years after issuance. What if the preferred stock is sinking fund preferred which is redeemed pro-rata over a 20-year period? What if the shareholder has the right to put the stock to P after two years?[64] In all of these transactions, P may reacquire its stock. Thus, step-transaction principals must be applied to determine if each transaction satisfies the COI requirement.

Assume that the facts are the same as Example 2, except that A has an arrangement to sell the P stock to Newco. Under the final regulations, Newco is a **person** related to P, and thus the COI requirement is not satisfied.[65]

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[63] See Treas. Reg. § 1.368-1(e)(1) and (e)(6), Ex. 4; see also Treas. Reg. § 1.368-2(k)(1).

[64] IRS officials have informally stated that they will analyze whether puttable stock is equity in order to determine whether the COI requirement is satisfied, and, in doing so, will consider whether it is likely that the shareholder will put the stock, i.e., whether the put is deep in the money at the time of the transaction.

[65] See Treas. Regs. §§ 1.368-1(e)(4)(i) and 1.368-1(e)(7) Ex. 4(iii). There are situations where the related person rule is not so clear. For example, assume P and T execute a merger agreement and announce plans to merge on 01/01/99. On 01/15/99, X Corporation enters into negotiations with P to acquire all of P's stock for cash. On 03/01/99, P and T merge, and on 04/01/99, X acquires all of P's stock in a reverse subsidiary cash merger, with P's shareholders (which include T's historic shareholders) receiving cash in return for their P stock. Does the related person rule apply to destroy continuity? If the reverse cash merger is "in connection with" the T/P merger, it seems that X, which is a person related to P following the reverse cash

Assume that the facts are the same as Example 2, except A sells all of its P stock received in the merger to an unrelated party ("B"), and shortly thereafter P redeems the stock held by B for cash. Under the final regulations, if the purchase and redemption occur in connection with the reorganization, P has in substance exchanged solely cash for T stock in the merger, and the merger will fail the continuity of interest requirement.[66]

What if P does not redeem the stock held by B, but B pays for the stock purchased from A with proceeds from a bank loan guaranteed by P? Does it matter who the bank is looking to for repayment of the loan? Will the fact that B's interest rate is lower due to P's guarantee affect the outcome? Whether continuity of interest is satisfied in this situation will depend on a facts and circumstances analysis.

Assume that the facts are the same as Example 2, except A sells all of its P stock received in the merger to a partnership ("PRS") that is 85% owned by Newco. Under the final regulations, Newco is treated as having acquired 85% of what PRS acquired, and having furnished 85% of the consideration furnished by PRS.[67] Thus, since Newco is related to P under Treas. Reg. § 1.368-1(e)(4)(i), the COI requirement is not satisfied.[68]

Assume that the facts are the same as Example 2, except that, pursuant to an agreement with P to register the P stock, A obtains registration rights and sells its P stock on the

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merger, is acquiring the stock of P that P issued to T in the initial merger. Under a technical reading of the statute, this is a "related person acquisition," and the transaction fails the COI requirement. Note, however, that in order for the related person rule to apply, the reverse cash merger must be "in connection with" the P/T merger. IRS officials have informally stated that this transaction likely violates the COI requirement.

[66] Treas. Reg. § 1.368-1(e)(7), Ex. 5.

[67] Treas. Reg. § 1.368-1(e)(5).

[68] Treas. Reg. § 1.368-1(e)(7), Ex. 6.

open market shortly after the acquisition. Under the final regulations, continuity of interest will be satisfied.[69]

Assume that the facts are the same as Example 2, except that immediately after the merger, P repurchases a small percentage of its stock in the open market, as part of an ongoing stock repurchase program. Under the final regulations (prior to August 2000), if the repurchase program is not created or modified in connection with the reorganization, and the redemptions are a small percentage of the P stock, the COI requirement is satisfied.[70]

In Revenue Ruling 99-58, 1999-2 C.B. 701, the Service allowed a pre-existing stock repurchase program to be modified without violating the COI requirement. In Rev. Rul. 99-58, T merges into P with the former T shareholders receiving 50% P common stock and 50% cash. In an effort to prevent dilution resulting from the issuance of P stock in the merger, P's pre-existing stock repurchase program is modified to enable P to reacquire a number of its shares equal to the number issued in the merger. The repurchases are made on the open market, through a broker at the prevailing market price, and are not negotiated with T or T's shareholders. P does not know the identity of a seller of P stock, and former T shareholders who sell their P stock do not know the identity of the buyer. The Service ruled that in these circumstances, the repurchase of P stock on the open market is not "in connection with" the merger, and thus does not affect the satisfaction of the COI requirement. <u>See</u> <u>also</u> PLR 199935042 (holding that the post-merger repurchase by the acquiring company of its common

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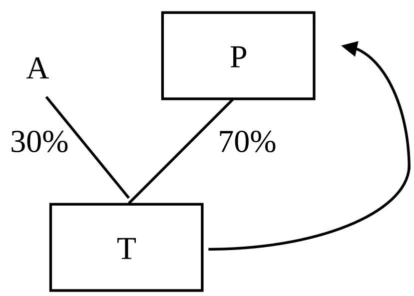
[69] Treas. Reg. § 1.368-1(e)(7), Ex. 3.

[70] Treas. Reg. § 1.368-1(e)(7), Ex. 8. It is unclear from Example 8 of Treas. Reg. § 1.368-1(e)(7) whether P may only repurchase a "small percentage," as opposed to a large percentage, of its common stock. Apparently, the Service did not consider that P might repurchase a "large" percentage of its stock in a repurchase program. In addition, if the term "small percentage" is important, it is unclear what percentage would be deemed to be "small."

stock pursuant to a revised repurchase plan does not affect the satisfaction of the COI requirement). In light of Rev. Rul. 99-58, in August 2000 the Service removed Treas. Reg. § 1.368-1(e)(7), Ex. 8, stating that the example "suggests a more restrictive approach to COI than was intended..."[71]

4. Example 4 -- Maintaining Direct or Indirect Interests in the Target Corporation



Facts. A owns 30% of the stock of T. P owns 70% of the stock of T. T merges into P, and A receives cash in the merger. P's 70% stock ownership was not acquired by P in connection with the acquisition of T's assets.

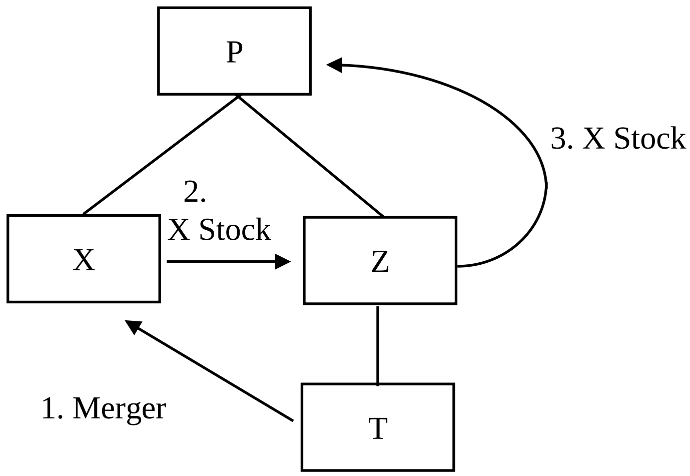
Under the final regulations, the COI requirement is satisfied if the acquiring corporation exchanges a proprietary interest in the target corporation for a direct interest in the target corporation enterprise.[72] Thus, in the example, the COI requirement is satisfied, because P's proprietary interest in T is exchanged by P for a direct interest in the assets of the target corporation enterprise.[73] If, prior to the merger, A had a 60% interest in T, and P had a 40% interest, the transaction would likely fail the COI requirement, and the entire transaction would be taxed.

[71] Preamble to T.D. 8898 (August 30, 2000).

[72] Treas. Reg. § 1.368-1(e)(1).

[73] Treas. Reg. § 1.368-1(e)(7), Ex. 7.

5. Example 5 -- Maintaining Direct or Indirect Interests in the Target Corporation

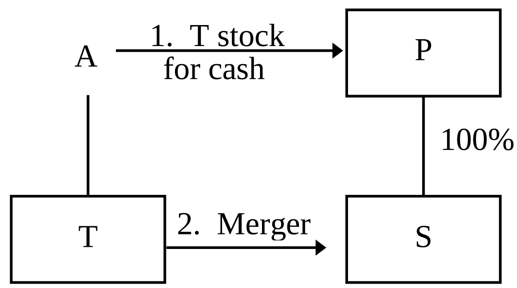


Facts. P owns all the stock of X Corporation and Z Corporation, and Z owns all the stock of T. T merges into X, Z receives X stock in the merger, and immediately thereafter Z distributes the X stock received in the merger to P.

Under the final regulations, P is related to X, and the COI requirement is satisfied, because P "was an indirect owner of T prior to the merger who maintains a direct or indirect proprietary interest in [X], preserving a substantial part of the value of the proprietary interest in T."[74]

[74] Treas. Reg. § 1.368-1(e)(7), Ex. 8.

6. Example 6 -- Yoc Heating



Facts. A owns all the stock of T. P owns all of the stock of S Corporation. P purchases A's T stock for cash. T then merges into S.

These facts are similar to the facts of Yoc Heating Corp. v. Commissioner,[75] where the Tax Court held that a similar transaction failed to qualify as a reorganization because, applying the step-transaction doctrine, historic shareholder continuity was not present. The Treasury regulations under section 338, however, conclude that, as to P, S and T, the COI requirement is satisfied when P makes a qualified stock purchase of T stock. See Treas. Reg. § 1.338-3(d) (T.D. 8940, I.R.B. 2001-15, 1016 (April 9, 2001)). However, the regulations do not extend to the minority shareholders of the target.[76] Thus, as to those shareholders, the transaction fails the COI requirement.

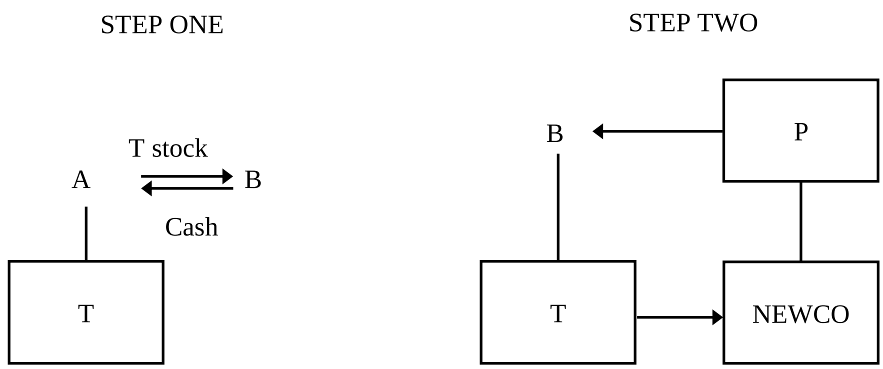
The final regulations, as amended by T.D. 8783, do not address whether the above transaction fails the COI requirement as to P, S, and T. Instead, the regulations provide that if P does not acquire the T stock in a qualified stock purchase, the transaction fails the COI

[75] 61 T.C. 168 (1973).

[76] Cf. Kass v. Commissioner, 60 T.C. 218 (1973), aff'd, 491 F.2d 749 (3d Cir. 1974).

requirement. However, if P does acquire the T stock in a qualified stock purchase, Treas. Reg. § 1.338-3(d) should apply, and the COI requirement should be satisfied as to P, S, and T.[77]

7. Example 7 -- Pre-reorganization Continuity



> Facts. A owns all of the stock of T Corporation. P wishes to acquire T in exchange for P stock. Pursuant to a binding agreement, A sells its T stock to B so that B rather than A participates in the reorganization. T is merged into a newly formed subsidiary of P (Newco) in a transaction intended to qualify as a reorganization under section 368(a)(2)(D) and B exchanges its recently purchased T stock for P stock.

Should B be treated as an historic shareholder of T (i.e., is there pre-reorganization continuity)? Under prior law, only consideration received by shareholders whose T stock is "old and cold" was counted in determining whether continuity was satisfied.[78] This prevented taxpayers from circumventing the post-reorganization continuity requirement by cashing out before, rather than after, the reorganization.

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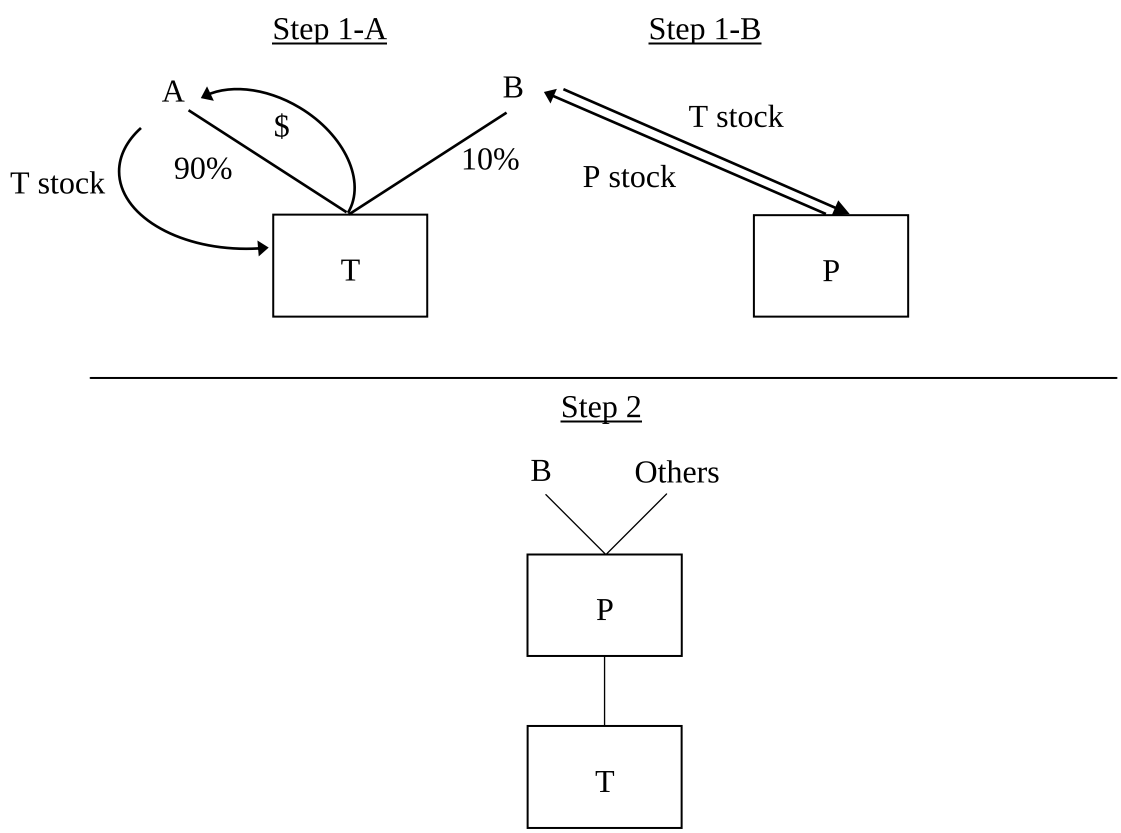
[77] Treas. Reg. § 1.368-1(e)(7), Ex. 4(ii). See Treas. Reg. § 1.338-2(d).

[78] See Superior Coach of Florida, Inc. v. Commissioner, 80 T.C. 895 (1983); Kass v. Commissioner, 60 T.C. 218 (1973).

In this case, the sale to B is pursuant to a binding agreement and presumably B would not be treated as an historic shareholder. Thus, the transaction, on its face, failed the continuity of interest test under prior law.

However, as noted above, the final regulations adopt the Seagram analysis, and state that mere sales of stock prior to a reorganization will not destroy continuity. Thus, this example satisfies the COI requirement under the final regulations.

8. Example 8 -- Pre-reorganization Continuity and Redemption Transactions



Facts. T redeems all of the T stock owned by A for $90x. No funds have been or will be provided by P for this purpose. P then acquires all the remaining T stock from B in exchange for P stock in a purported "B" reorganization.

Is continuity of interest satisfied? Should P be treated as having purchased the T stock from A for cash?[79] Under prior law, authorities looked to the source of the funds used to redeem A's shares.[80] However, the temporary and proposed regulations issued in January 1998 simply looked to whether there was a redemption prior to and in connection with a reorganization -- regardless of how T obtained the money to redeem A's shares.

Under those temporary and proposed regulations, the above transaction fails the COI requirement, because there is a redemption of target stock prior to and in connection with a potential reorganization.[81] Furthermore, if instead of a redemption by T, a related person of T purchased A's T stock prior to the reorganization, the transaction would likewise fail the COI requirement.[82]

However, under the final regulations issued in August 2000, this transaction does not violate the COI requirement unless the redemption is treated as boot under section 356.[83] An

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[79] See Waterman Steamship Corp. v. Commissioner, 430 F.2d 1185 (5th Cir. 1970). In Waterman Steamship, a subsidiary ("S") paid a $2.8 million dividend to its parent corporation ("P") shortly before the subsidiary was acquired by a third party ("A") for approximately $700,000 (P'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 P for the entire $2.8 million. Shortly after the acquisition, A lent $2.8 million to S, and S paid off the promissory note. Under these facts, the Fifth Circuit held that the $2.8 million dividend was part of the purchase price by A, and that P realized capital gain on the sale in the amount of the dividend.

[80] 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).

[81] Prior Temp. Reg. § 1.368-1T(e)(1)(ii)(A). See Prior Temp. Reg. § 1.368-1T(e)(6), Ex. 10(i). In addition, if A owns only 70% of the T stock (and B owns 30%), and A redeems all of its T stock, the preamble to the temporary regulations states that the transaction will also fail the COI requirement. Preamble to T.D. 8761 (Jan. 23, 1998).

[82] See Prior Temp. Reg. § 1.368-1T(e)(6), Ex. 10(ii).

[83] Treas. Reg. § 1.368-1(e)(1)(ii).

example in the regulations with similar facts to this example states that under these facts, "[t]he cash received by A in the prereorganization redemption is not treated as [boot] under section 356" and thus the transaction does not fail the COI requirement.[84] Thus, it appears from the example in the regulations that pre-reorganization redemptions made with funds not provided by the acquirer will not count against the COI requirement. However, as noted above, Rev. Rul. 71-364 provides that retained assets distributed following a reorganization are treated as boot under section 356 even if no funds are provided by the acquirer. Treasury should clarify that Rev. Rul. 71-364 will not apply to treat pre-reorganization distributions and redemptions as boot under section 356 for purposes of the COI requirement.

Assume the same facts as Example 8, except A owns 50% instead of 90% of T, and B owns the other 50% of T. Will A's redemption of all of its T stock for $50x destroy continuity under the temporary and proposed regulations? Since Treas. Reg. §1.368-1(e)(7), Ex.1 states that the COI requirement is satisfied if the target's shareholders receive 50% cash and 50% stock in the issuing corporation in the reorganization, this variation of the example should satisfy the COI requirement.[85]

Assume the same facts as Example 8, except that instead of redeeming A's target stock, T pays A and B an extraordinary distribution equal to 85% of T's assets. Under the temporary and proposed regulations, the COI requirement is not satisfied because T paid A and B an extraordinary distribution, and a substantial part of the value of the proprietary interest of T is not preserved.[86] In other words, A and B are treated as if they had received 85% cash and

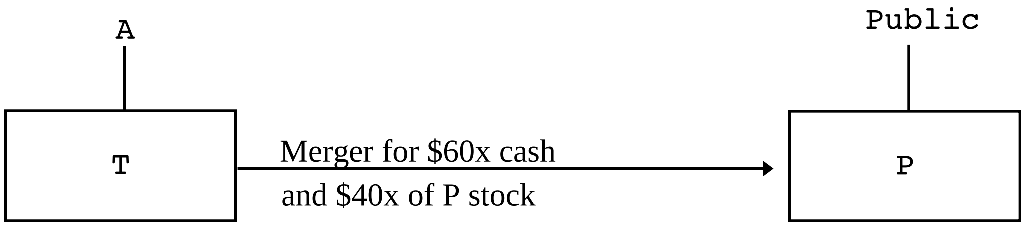
[84] Treas. Reg. § 1.368-1(e)(7), Ex. 9.

[85] See Part II.C.1., supra.

[86] See Temp. Reg. § 1.368-1T(e)(6), Ex. 11.

15% stock in exchange for their T stock. However, the transaction should satisfy the COI requirement under the final regulations issued in August 2000, as the "extraordinary distribution" rule was eliminated.[87]

9. Example 9 -- Changes In Share Price



Facts: On January 3 of Year 1, P and T sign a binding contract pursuant to which T will be merged with and into P on June 1 of Year 1. Pursuant to the contract, A will receive 40 P shares and $60 cash in exchange for all of the outstanding stock of T. At the end of the day on January 2 of Year 1, the P stock trades for $1 per share. On June 1 of Year 1, the P stock trades for $.25 per share.

Is continuity of interest satisfied? Under final regulations published on December 19, 2011 (which apply to transactions occurring pursuant to binding contracts entered into after December 19, 2011), the merger satisfies the continuity of interest requirement.[88]

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[87] T.D. 8898 (August 30, 2000).

[88] Treas. Reg. § 1.368-1(e)(2)(v), Ex. 1. The 2011 final regulations adopt temporary regulations published on March 20, 2007 with minor changes. The Service had failed to finalize the 2007 temporary regulations before they expired pursuant to section 7805(e)(2), but issued a notice on March 18, 2010, permitting taxpayers to rely on the identical proposed regulations issued on the same date as the temporary regulations. See Notice 2010-25, 2010-14 IRB 527. The 2007 temporary regulations had replaced final regulations published on September 16, 2005. The temporary regulations applied to transactions occurring pursuant to binding contracts entered into after March 20, 2007. See prior Temp. Reg. § 1.368-1T(e)(8)(ii). For transactions occurring pursuant to a binding contract executed after September 16, 2005, but on or before March 20, 2007, the parties were permitted to elect to apply the prior final regulations or the temporary regulations, provided that all relevant parties made the election. Id.

Under the final regulations, whether a transaction satisfies the continuity of interest requirement is determined by reference to the value of the acquirer stock as of the end of the last business day before the first date there is a binding contract to effect the potential reorganization (i.e., the signing date), but only if the contract provides for fixed consideration.[89] A "binding contract" is generally "an instrument enforceable under applicable law against the parties to the instrument."[90] The fact that insubstantial terms remain to be negotiated by the parties to the contract, or that customary conditions remain to be satisfied, generally will not prevent an instrument from being a binding contract.[91] In addition, the presence of a condition outside the control of the parties (e.g., regulatory approval) generally will not prevent an instrument from

[89] Treas. Reg. § 1.368-1(e)(2)(i). Proposed regulations provide for different methods of determining whether continuity of interest is satisified, even in the absence of fixed consideration. See REG-124627-11, 76 Fed. Reg. 78,591, 78,594 (Dec. 19, 2011). The proposed regulations generally provide that if, pursuant to a binding contract, an item of consideration varies as the value of issuing corporation stock declines between the stock's pre-signing date value and some lower value provided for in the contract (the "floor price") and the closing date value is less than the floor price, continuity of interest is determined as if the consideration that would have been delivered at the floor price were issued and valued based upon the floor price. Prop. Reg. § 1.368-1(e)(2)(iv)(A). The proposed regulations also provide that if, pursuant to a binding contract, an item of consideration varies as the value of issuing corporation stock increases between the stock's signing date value and some higher value provided for in the contract (the "ceiling price"), and the closing date value is greater than the ceiling price, continuity of interest is determined as if the consideration that would have been delivered at the ceiling price were issued and valued based upon the ceiling price. Prop. Reg. § 1.368-1(e)(2)(iv)(B). These proposed regulations also permit the use of an average value for issuing corporation stock in lieu of the value of issuing corporation stock on the closing date where the average price is based upon prices of issuing corporation stock occuring after the signing date and before the closing date and the binding contract uses such average price in determining the number of shares of each class of issuing corporation stock, the amount of money, and the other property to be exchange for the proprietary interests in the target corporation. Prop. Reg. § 1.368-1(e)(2)(iv)(C).

[90] Treas. Reg. § 1.368-1(e)(2)(ii)(A).

[91] Id.

being a "binding contract" under the final regulations.[92] If a term in a binding contract that relates to the amount or type of consideration received is modified, the contract as modified will generally be a binding contract, and the date of the modification will generally be treated as the first date there is a binding contract.[93]

Consideration will generally be treated as "fixed" under the final regulations if the contract states the number of shares of the issuing corporation, the amount of money, and the other property (identified either by value or by specific description), if any, to be exchanged for each or all of the proprietary interests in the target corporation, or to be exchanged for each proprietary interest in the target corporation.[94] A contract that provides a target corporation shareholder with an election to receive a number of shares of stock of the issuing corporation, money, or other property (or some combination thereof) in exchange for the shareholder's interest provides for fixed consideration if the determination of the number of shares of issuing corporation stock to be provided to the target corporation shareholder is determined using the

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[92] Id. The final regulations also provide that a tender offer that is subject to section 14(d) of the Securities and Exchange Act of 1934 and Regulation 14D and is not pursuant to a binding contract is nevertheless treated as a binding contract made on the date of its announcement, notwithstanding that it may be modified by the offeror or that it is not enforceable against the offerees. See Treas. Reg. § 1.368-1(e)(2)(ii)(C). If a modification (not pursuant to a binding contract) of such a tender offer is subject to the provisions of Regulation 14d-6(c) and relates to the amount or type of the consideration received in the tender offer, then the date of the modification shall be treated as the first date there is a binding contract. Id.

[93] Treas. Reg. § 1.368-1(e)(2)(ii)(B)(1). There is an exception to the general rule when a modification has the sole effect of increasing the shares or decreasing the amount of money or other property (or both) received by the target corporation's shareholders and, in the absence of the modification, the transaction would have resulted in the preservation of a substantial part of the value of the target corporation shareholders' proprietary interest in the target corporation. Treas. Reg. § 1.368-1(e)(2)(ii)(B)(2). A similar rule is included in the final regulations for transactions that fail the COI requirement in the absence of the modification. See Treas. Reg. § 1.368-1(e)(2)(ii)(B)(3).

[94] Treas. Reg. § 1.368-1(e)(2)(iii)(A).

value of the issuing corporation stock on the last business day before the first date there is a binding contract, even if the shareholder election precludes a determination, prior to the closing date, of the number of shares of each class of the issuing corporation, the amount of money, and the other property (or the combination thereof) to be exchanged for each proprietary interest in the target corporation..[95] If a binding contract provides for contingent consideration, the contract will be treated as providing for fixed consideration if the COI requirement would be satisfied in the absence of the contingency, but only if the contingency does not prevent the target's shareholders from being subject to "the economic benefits and burdens of ownership."[96] Placing part of the stock issued or money paid in escrow to secure customary target representations and warranties generally will not prevent the consideration from being treated as "fixed."[97]

Here, the determination is made as of the end of January 2 of Year 1, which is the signing date. Accordingly, for determining whether continuity of interest has been satisfied, the T stock is exchanged for $40 of P stock and $60 of cash. Thus, the transaction preserves a substantial part of the value of the proprietary interest in T (40%), and, therefore, satisfies the continuity of interest requirement.[98]

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[95] Treas. Reg. § 1.368-1(e)(2)(iii)(B).

[96] Treas. Reg. § 1.368-1(e)(2)(iii)(C).

[97] Treas. Reg. § 1.368-1(e)(2)(iii)(D).Similarly, the inclusion of an anti-dilution clause, the possibility of dissenters' rights, or the fact that money may be paid in lieu of issuing fractional shares will not necessarily prevent a contract from being treated as providing for fixed consideration. Treas. Reg. § 1.368-1(e)(2)(E) - (G).

[98] See Treas. Reg. § 1.368-1(e)(2)(v) Ex. 1.

III. CONTINUITY OF BUSINESS ENTERPRISE

A. Remote Asset Continuity: Groman-Bashford Doctrine

Prior to the enactment of the 1954 Code, the so-called "Groman-Bashford" doctrine, named after the cases of Groman v. Commissioner,[99] and Helvering v. Bashford,[100] would cause a reorganization to be disqualified on remote asset continuity grounds if the acquired assets or stock of a target were ultimately lodged in a subsidiary of an acquirer.

Congress enacted Section 368(a)(2)(C) as part of the 1954 Code in an attempt to limit the application of the Groman-Bashford doctrine. The Service has extended this statutory authority to include multiple drop-downs. Congress has since intervened repeatedly to limit the "remote continuity" doctrine by enacting statutory provisions that permit forward triangular mergers, reverse triangular mergers and triangular "B" and "C" reorganizations. The Service has now issued final continuity of business enterprise regulations that "do not separately articulate rules addressing remote continuity of interest," but effectively further limits the remote continuity doctrine.[101]

B. Continuity of Business Enterprise

1. Introduction

Continuity of business enterprise ("COBE") focuses on the business conducted by the corporate entity itself, rather than the consideration paid. The regulations provide that, in

[99] 302 U.S. 82 (1937).

[100] 302 U.S. 454 (1938).

[101] Preamble to T.D. 8760 (Jan. 23, 1998).

order to satisfy the continuity of business enterprise requirement, the issuing corporation[102] must either (i) continue a line of the target's historic business (the "historic business test"), or (ii) use a significant portion of the target's historic business assets[103] in any business (whether or not that business was historically conducted by the target) (the "historic asset test").[104] An example in the existing regulations (which were in existence prior to the regulations and which the regulations augment) states that the former requirement will be satisfied if one of three of the target's historic businesses is retained.[105] This example also seems to suggest that the historic asset test will be satisfied if one third of the target's historic assets are retained and used in the acquirer's business.[106] However, all the facts and circumstances will be considered in determining whether a transaction satisfies either the historic business test or the historic asset test.[107]

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[102] See note 21, supra, for the definition of "issuing corporation." Note that reorganizations described in sections 368(a)(1)(E) and 368(a)(1)(F) do not have to satisfy the COBE requirement to qualify as a tax-free reorganization.

[103] "Business assets" may include stock, securities, and intangible operating assets such as goodwill, patents, and trademarks, whether or not they have a tax basis. Treas. Reg. § 1.368-1(d)(3)(ii).

[104] Treas. Reg. § 1.368-1(d)(1). The fact that the issuing corporation is in the same line of business as the target corporation tends to establish the requisite continuity for the historic business test, but is not alone sufficient. Treas. Reg. § 1.368-1(d)(2)(i).

[105] Treas. Reg. § 1.368-1(d)(5), Ex. 1. Since the regulations do not specifically say that one third of the target's historic assets must be retained and used in the acquirer's business, a fraction less than one third may be permissible. However, these regulations, in conjunction with the new COBE regulations that relate to partnerships, seem to suggest that the Service would require the retention of one third of the target's assets in order to satisfy the COBE requirement.

[106] Courts have held that, even if the acquirer plans to sell the business to which the target assets are transferred in the near future, as long as the acquirer plans to use the assets in that business, the COBE requirement is satisfied. See Payne v. Commissioner, T.C. Memo 2003-90; Lewis v. Commissioner, 176 F.2d 646 (1st Cir. 1949).

[107] See Treas. Reg. §§ 1.368-1(d)(2)(iv) and 1.368-1(d)(3)(iii).

2. Final Regulations

In January 1997, the Service proposed regulations that addressed the questions of continuity of business enterprise that arise when target assets or target stock are transferred following a reorganization.[108] In January 1998, the Service finalized the COBE regulations, with modest changes.[109] The final regulations apply to transactions occurring after January 28, 1998.[110] The Service issued additional final regulations on October 24, 2007 that modify certain aspects of the final COBE regulations issued in 1998. These regulations are generally effective for transactions occurring on or after October 25, 2007.

a. Transfers to Corporations

The final COBE regulations implicitly permit transfers of target assets or target stock among members of a "qualified group" for purposes of satisfying the COBE requirement. The regulations provide that in determining whether the COBE requirement is satisfied, the issuing corporation is treated as holding all of the businesses and assets of all members of the

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[108] See Prop. Reg § 1.368-1(d) and (f).

[109] For example, the proposed COBE regulations did not apply to section 368(a)(1)(D) or (F) reorganizations. However, the new COBE regulations apply to all reorganizations for which COBE is relevant, regardless of the fact that section 368(a)(2)(C) does not apply to "D" or "F" reorganizations. Preamble to T.D. 8760 (Jan. 23, 1998). See also Rev. Rul. 2002-85, 2002-2 C.B. 986; note 111 and accompanying text.

It is unclear what affect the new COBE regulations have on Rev. Rul. 96-29, 1991-1 C.B. 50, and other F reorganization authorities that analyze transactions occurring immediately before or after F reorganizations for purposes of the COBE requirement.

[110] Treas. Reg. § 1.368-1(d)(1). However, the regulations do not apply to any transaction occurring pursuant to a written agreement which is binding on January 28, 1998, and at all times thereafter. Id.

qualified group.[111] The definition of qualified group was recently amended by final regulations issued by the Service on October 24, 2007.[112]

Prior to the 2007 amendment, the qualified group was defined as one or more chains of corporations connected through stock ownership with the issuing corporation, as long as the issuing corporation owns directly stock having the relationship specified in section 368(c) (i.e., ownership of at least 80% of the voting stock and 80% of each other class of stock) in at least one member of the group, and every member of the group (except the issuing corporation) is controlled (again, using the section 368(c) test) directly by another member of the group.[113] Thus, under the prior standard, in order to be a member of the qualified group, each corporation (except the issuing corporation) must be controlled directly by one, and only one other member of the qualified group.

The final regulations issued on October 24, 2007 expand the definition of a qualified group. Under the new standard, the qualified group is defined as one or more chains of corporations connected through stock ownership with the issuing corporation, but only if the issuing corporation owns directly stock meeting the requirements of section 368(c) in at least one other corporation, and stock meeting the requirements of section 368(c) in each of the corporations (except the issuing corporation) is owned directly (or indirectly through a partnership) by one or more of the other corporations. Accordingly, qualified group members aggregate their stock ownership of a corporation in determining whether they own the requisite

[111] Treas. Reg. § 1.368-1(d)(4).

[112] Treas. Reg. § 1.368-1(d)(4)(iv). The new final regulations do not apply to transactions occurring pursuant to a written agreement which is binding before October 25, 2007 and at all times thereafter.

[113] Prior Treas. Reg. § 1.368-1(d)(4)(ii).

section 368(c) control, provided that the issuing corporation owns directly stock constituting section 368(c) control in at least one other corporation.[114]

Commentators had suggested that the definition of control for purposes of determining the qualified group should be the definition set forth in section 1504.[115] However, the Service decided to keep the section 368(c) control test originally used in the proposed regulations "because the section 368 definition of control is a major structural component underlying the statutory framework of the reorganization provisions."[116]

b. Transfers to Partnerships

(i) Asset Transfers to Partnerships

The final regulations implicitly permit transfers of target assets to partnerships.[117] Under the regulations, a partnership is treated as an aggregate for COBE purposes, thereby reversing G.C.M. 35117 (Nov. 15, 1972).[118] However, there are a number of restrictions that apply in determining whether the COBE requirement is met. Under the regulations, partners are treated as owning the target corporation's business assets used in a partnership business in

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[114] Treas. Reg. § 1.368-1(d)(4)(ii). Commentators had suggested the definition of qualified group add an aggregation provision such as that contained in Treas. Reg. § 1.1502-34. See Preamble to T.D. 8760 (Jan. 23, 1998); ABA Members Want COBE Regs Clarified, 97 TNT 90-25 (May 5, 1997).

[115] See Preamble to T.D. 9361 (October 25, 2007).

The affiliation definition of section 1504 is satisfied if a common parent owns 80% of the vote and value of at least one other member of the group, and one or more of the other corporations in the affiliated group own 80% of the vote and value of each corporation in such group (except the common parent). Section 1504(a)(4) "vanilla preferred stock" is not included for purposes of the section 1504 definition.

[116] See Preamble to T.D. 9361 (October 25, 2007).

[117] Treas. Reg. § 1.368-1(d)(4)(iii).

[118] See infra Part III.C., Ex. 4.

accordance with such partner's interest in the partnership.[119] The issuing corporation is treated as conducting a business of the partnership if (1) members of the qualified group, in the aggregate, own a "significant interest" in the partnership business, or (2) one or more members of the qualified group have "active and substantial management functions" as a partner with respect to the partnership business.[120]

The "active management test" appears to be derived from Rev. Rul. 92-17 (satisfying the active business test of section 355 as a general partner of a partnership). From the examples in the final regulations, it appears that the active management test is satisfied only if the partner owns at least a 20% interest in the partnership.[121] In addition, it appears that the "significant interest test" is satisfied if the partner owns a 33 1/3% interest in the partnership.[122] Nothing in the final regulations suggests that a limited partnership interest cannot be significant.

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[119] Treas. Reg. § 1.368-1(d)(4)(iii). The "interest" in a partnership presumably must be determined using section 704(b) principles. If there are tiered partnerships, one must look through each partnership to determine the interest owned by the issuing corporation. For example, if P corporation owned 50% of X Partnership, which owned 75% of Y Partnership, P corporation is treated as owning 37.5% of Y Partnership (i.e., 50% x 75%). See Part III.C.Ex.6.

[120] Treas. Reg. § 1.368-1(d)(4)(iii)(B). If a significant historic business of the target corporation is conducted in a partnership, the fact that the issuing corporation is treated as conducting such business tends to establish the requisite continuity, but is not alone sufficient. Treas. Reg. § 1.368-1(d)(iii)(C).

[121] Treas. Reg. § 1.368-1(d)(5), Ex. 7.

[122] Treas. Reg. § 1.368-1(d)(5), Ex. 10. For purposes of calculating the significant interest test, the partnership interests of all members of the qualified group are aggregated. See Treas. Reg. § 1.368-1(d)(5), Ex. 11.

(ii) Stock Transfers to Partnerships

The final COBE regulations issued in 1998 did not permit the attribution of stock from partnerships.[123] Accordingly, under the prior standard, the qualified group would not be treated as holding stock owned by partnerships in which members of the qualified group were partners. Under final regulations issued on October 24, 2007, if members of the qualified group own an interest in a partnership that meets requirements equivalent to the control definition in section 368(c), any stock owned by such partnership is treated as owned by members of the qualified group.[124] It is unclear how the phrase "requirements equivalent to control" should be interpreted.

c. Safe Harbor

The final regulations issued in 1998 also provided a safe harbor for transfers to controlled corporations and transfers following reverse triangular mergers under section 368(a)(2)(E).[125] Under this safe harbor, a transaction that qualified as an A, B, C, or G reorganization is not recharacterized under the step transaction doctrine (or other applicable

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[123] See Treas. Reg. § 1.368-1(d)(4)(iii)A) (partners in a partnership treated as owning the T business assets used in a trade or business of the partnership); see also Prior Treas. Reg. § 1.368-2(k)(3), Ex. 3 (concluding that a post-reorganization stock transfer to a partnership causes a transaction to fail the control requirement in section 368(a)(1)(B), because P does not have control of T immediately after the acquisition of the T stock).

[124] See Treas. Reg. § 1.368-1(d)(4)(iii)(D).

[125] See Treas. Reg. §§ 1.368-2(f) and (k). The Service did not provide a safe harbor in the proposed regulations. The Service added the safe harbor to the final regulations in response to comments that suggested that the proposed COBE regulations were ambiguous and "could be interpreted to mean that a transfer of stock or assets to a qualified group member after an otherwise tax-free reorganization would be given independent significance and the step transaction doctrine would not apply." Preamble to T.D. 8760 (Jan. 23, 1998). The preamble to the final regulations clarifies that step transaction principles still apply, as the final regulations are only applicable to the COBE requirement and do "not address satisfaction of the explicit statutory requirements of a reorganization." Id. However, the Service provided the safe harbor in Treas. Reg. § 1.368-2(k) "to extend the application of section 368(a)(2)(C) to certain successive transfers." Id.

doctrines) and disqualified by reason of the fact that "part or all of the acquired assets or stock acquired in the transaction were transferred or successively transferred to one or more corporations controlled in each transfer by the transferor corporation."[126] Thus, a corporation may transfer assets through as many lower-tiered subsidiaries as it desires, as long as the transferor in each transfer owns at least 80% of the voting power and 80% of each other class of stock in each transferee.[127] Similarly, a reverse triangular merger under section 368(a)(2)(E) does not fail the COBE requirement by reason of the fact that --

> part or all of the stock of the surviving corporation is transferred or successively transferred to one or more corporations controlled in each transfer by the transferor corporation, or because part or all of the assets of the surviving corporation or the merged corporation are transferred or successively transferred to one or more corporations controlled in each transfer by the transferor corporation.[128]

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[126] Prior Treas. Reg. § 1.368-2(k)(1). Again, control is determined under section 368(c). Id. The Service stated in the preamble to the COBE regulations that it believes that "further study is needed" prior to extending § 1.368-2(k)(1) to section 368(a)(1)(D) reorganizations, section 368(a)(1)(F) reorganizations, or section 355 transactions. Preamble to T.D. 8760 (Jan. 23, 1998). In Rev. Rul. 2002-85, 2002-2 C.B. 986, the Service extended § 1.368-2(k) to section 368(a)(1)(D), ruling that an acquiring corporation's transfer of a target corporation's assets to a subsidiary following a section 368(a)(1)(D) reorganization does not violate the COBE requirement.

[127] See Rev. Rul. 2003-48 (applying § 1.368-2(k) in allowing transfer of acquired assets to a subsidiary following a reorganization that qualified under sections 368(a)(1)(A) and 368(a)(2)(E)). See also PLR 200124009 (allowing successive transfers of acquired assets to controlled corporations following a reorganization intended to qualify under sections 368(a)(2)(D) and 368(a)(1)(A)).

[128] Prior Treas. Reg. § 1.368-2(k)(2). Thus, the Service apparently will not apply step-transaction principles to view a section 368(a)(2)(E) reverse triangular merger and subsequent drop of Target stock to a controlled subsidiary of Parent as an invalid merger of Target into a second-tier subsidiary in exchange for grandparent stock. Likewise, step-transaction principles apparently will not be applied to drops of stock or assets to second-tier subsidiaries following a forward triangular merger under section 368(a)(2)(D), drops of stock after a triangular "B" reorganization, or drops of assets after a triangular "C" reorganization.

On March 2, 2004, the Service issued proposed regulations that would expand the scope of the safe harbor to all reorganizations under section 368(a).[129] The Service reissued the March 2, 2004 proposed regulations on August 16, 2004.[130] The Service then issued final regulations concerning the safe harbor on October 24, 2007, and reissued the final regulations on May 8, 2008 to clarify the application of the final regulations.[131] The reissued final regulations generally apply to transactions occurring on or after May 9, 2008.[132]

The reissued final regulations retain the scope of the safe harbor set forth in earlier proposed regulations to cover all reorganizations, but otherwise modify the prior proposed regulations. Under the reissued final regulations, a post-reorganization distribution of stock of the acquired corporation satisfies the safe harbor, as long as (i) less than all of the acquired stock is distributed and (ii) the distribution does not cause the acquired corporation to leave the qualified group.[133] Assets of the acquired, acquiring, or surviving corporation can generally be distributed under the reissued final regulations, provided that the distribution does not result in a liquidation of the distributing corporation (disregarding assets held prior to the

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[129] Prior Prop. Treas. Reg. § 1.368-2(k)(1). 69 Fed. Reg. 9771 (March 2, 2004).

[130] Prior Prop. Treas. Reg. § 1.368-2(k)(1). 69 Fed. Reg. 51209 (August 18, 2004).

[131] Prior Treas. Reg. § 1.368-2(k). 72 FR 60556 (Oct. 25, 2007); Treas. Reg. § 1.368-2(k). 73 Fed. Reg. 26322 (May 9, 2008).

[132] Treas. Reg. § 1.368-2(k)(3). The reissued final regulations do not apply to any transaction occurring pursuant to a written agreement which is binding before May 9, 2008, and at all times after that. The final regulations issued in 2007 generally apply to transactions occurring on or after October 25, 2007. The reissued final regulations are nearly identical in substance to the final regulations issued in 2007. See note 135.

[133] Treas. Reg. § 1.368-2(k)(1)(i).

reorganization).[134] For transfers other than distributions, the reissued final regulations provide that (all or part of) the assets or stock of the acquired, acquiring, or surviving corporation, as the case may be, can be transferred, provided that such corporation does not terminate its corporate existence in connection with the transfer.[135] For any transfer to satisfy the safe harbor, in addition to the general requirements described above, the COBE requirements must otherwise be satisfied.[136]

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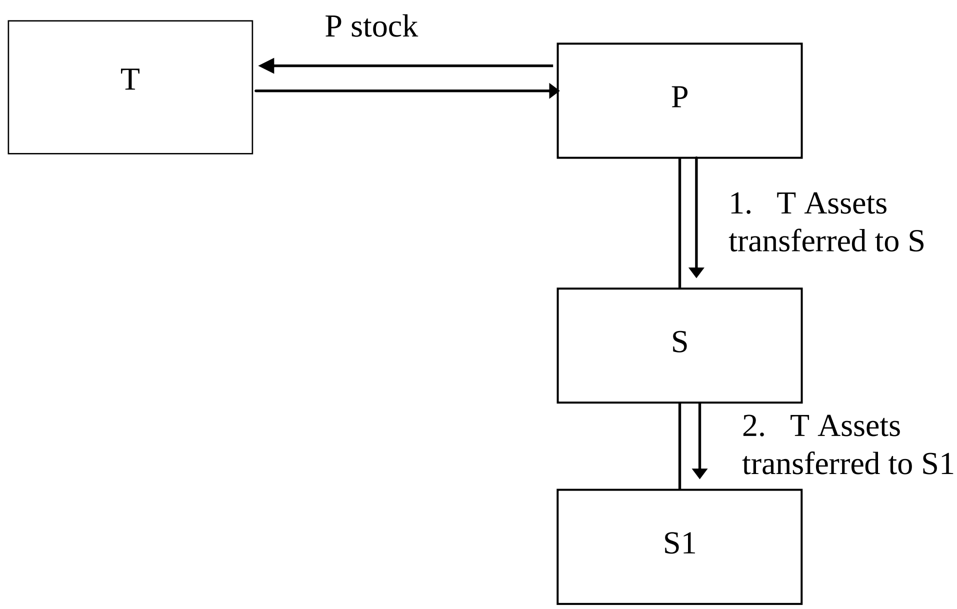
[134] Id. In general, the reissued proposed regulations required that "substantially all" of the assets not be transferred in connection with the reorganization. Prior Treas. Reg. § 1.368-2(k).

[135] Treas. Reg. § 1.368-2(k)(1)(ii). In the case of a stock transfer, the acquired, acquiring, or surviving corporation cannot leave the qualified group.

[136] Treas. Reg. § 1.368-2(k)(1)(i). The reissued final regulations are nearly identical in substance to the final regulations issued in 2007. The reissued final regulations, however, impose an additional requirement related to post-reorganization distributions to former shareholders of the acquired or surviving corporation, as well as to certain transfers made by such shareholders. This additional requirement was added to the reissued regulations in order to clarify the scope of the safe harbor. Under the reissued final regulations, the safe harbor does not apply to post-reorganization distributions to former shareholders of the acquired corporation (other than a former shareholder that is also the acquiring corporation) or the surviving corporation, as the case may be, to the extent that the transfer constitutes consideration in exchange for the proprietary interests in the acquired corporation or surviving corporation, as the case may be. In addition, the safe harbor does not apply to transfers by former shareholders of the acquired corporation (other than a former shareholder that is also the acquiring corporation) or the surviving corporation, as the case may be, of consideration initially received in the potential reorganization to the issuing corporation (or a related person).

C. Examples Involving Continuity of Business Enterprise

1. Example 1 -- Asset Transfers to Corporations



Facts. T merges into P and T shareholders exchange their T stock for P stock. P transfers the T assets to S, which immediately transfers them to S1.

Is the COBE requirement satisfied? A transfer of assets to a second-tier subsidiary should not prevent a transaction that otherwise qualifies as a reorganization from meeting the COBE requirement.[137] Indeed, even drop-downs to third-tier subsidiaries are permissible.[138] It is also permissible to transfer the assets to multiple subsidiaries.[139]

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[137] Section 368(a)(2)(C). See Rev. Rul. 64-73, 1964-1 C.B. 142. See also G.C.M. 30887. Note that the acquiring corporation must be in "control" of the subsidiary in order for the drop-down to be permissible. Section 368(a)(2)(C). Control is defined under section 368(c) as ownership of stock possessing at least 80 percent of the total combined voting power of all voting stock and at least 80 percent of the total number of shares of all other classes of stock. Section 368(c).

[138] See PLRs 9313024, 9151036, and 200124009.

[139] See Rev. Rul. 68-261, 1968-1 C.B. 147.

Under the final COBE regulations, as modified by final regulations issued in 2007, the issuing corporation is treated as holding all the businesses and assets of all the members of the "qualified group."[140] The "qualified group" is defined as one or more chains of corporations connected through stock ownership with P, provided that P owns stock meeting the control requirement of section 368(c) in at least one of these corporations, and stock meeting the requirements of section 368(c) in each of the other corporations (except the issuing corporation) is owned directly (or indirectly through a partnership) by one or more members of the other corporations.[141] P, S and S1 constitute a qualified group for this purpose. Accordingly, the COBE requirement is satisfied.[142]

Assume the same facts as Example 1, except S transfers some of the T assets to each of 10 wholly owned subsidiaries (S1 through S10). Assume further that no one subsidiary receives a significant portion of T's historic business assets, but each subsidiary uses T's assets in the operation of its business. Under the final regulations, this transaction satisfies the COBE requirement.[143] P is treated as conducting the businesses of S1 through S10, and as holding the historic T assets used in those businesses.[144] Thus, the COBE requirement is satisfied because,

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[140] See Treas. Reg. § 1.368-1(d)(4).

[141] See Treas. Reg. § 1.368-1(d)(4)(ii).

[142] Note that the COBE requirement would have been satisfied under the final COBE regulations issued in 1998. See Prior Treas. Reg. § 1.368-1(d)(4)(ii).

The safe harbor in Treas. Reg. § 1.368-2(k) also provides that the Service will not apply the step-transaction doctrine to treat T as transferring its assets directly to S1 in exchange for grandparent stock. The remaining vitality of Rev. Rul. 64-73, supra, which permits an acquirer in a section 368(a)(1)(C) reorganization to direct the target to transfer target assets to one of the acquirer's lower-tier subsidiaries, remains unclear in light of these regulations.

[143] Treas. Reg. § 1.368-1(d)(5), Ex. 6.

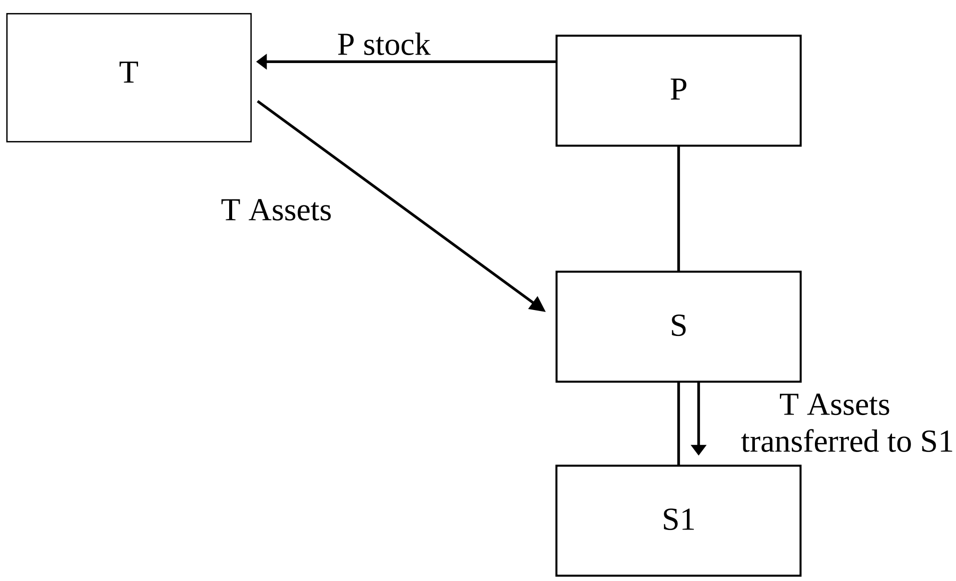
[144] Id.

"in the aggregate, the qualified group is using a significant portion of T's historic business assets in a business."[145]

Assume the same facts as Example 1, except that, instead of P acquiring T's assets, S acquires all of the outstanding stock of T in exchange solely for voting stock of P (in a triangular B reorganization), and S then transfers 10% of the stock of T to each of its wholly owned subsidiaries, s1 through s10. Under the definition of qualified group set forth in the final regulations issued in 2007, T would be treated as a member of the qualified group.[146]

Assume the same facts as Example 1, except that instead of transferring the T assets to S, P sells the T assets to S for cash. This transaction should satisfy the COBE requirement, because P is treated as holding all of S's assets under Treas. Reg. § 1.368-1(d)(4).

2. Example 2 -- Safe Harbor



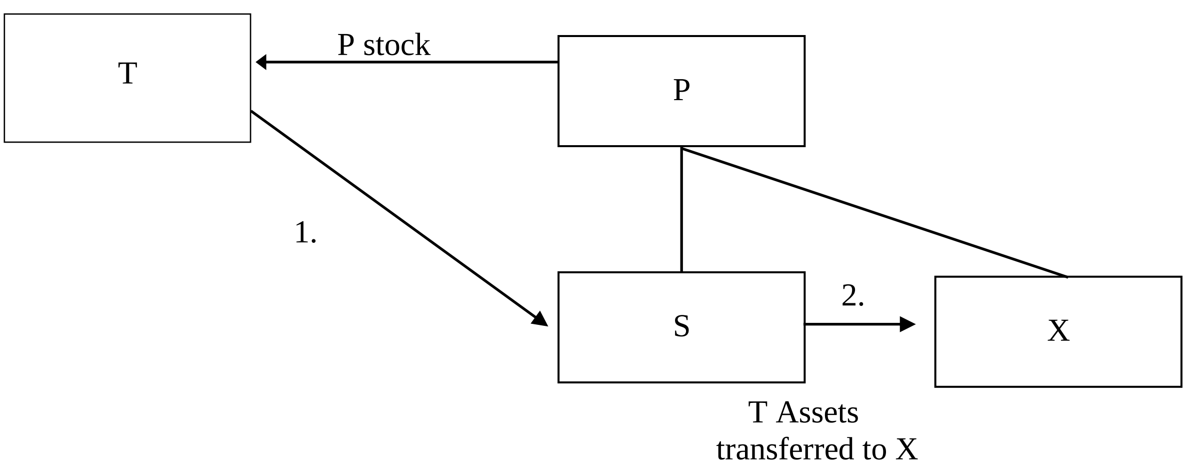
[145] Id.

[146] Treas. Reg. § 1.368-1(d)(5), Ex. 7. Note that T would not have been treated as a member of the qualified group under the final COBE regulations issued in 1998. See Prior Treas. Reg. § 1.368-1(d)(4)(ii).

Facts. Assume the same facts as Example 1, except that, pursuant to a plan of reorganization, T transfers its assets to S in exchange for P stock (in a triangular "C" reorganization). Shortly thereafter, S transfers the T assets to S1.

Treas. Reg. § 1.368-2(k) provides a safe harbor for transactions qualifying as reorganizations where there are successive transfers to corporations controlled by the transferor. Thus, under these facts, the COBE requirement is satisfied.[147] The same rule should apply, and the COBE requirement should be satisfied, if S had acquired all of the T stock (in a "B" reorganization) rather than the T assets, and then transferred the T stock to S1.[148]

3. Example 3 -- Cross-chain Transfers



Facts. P owns all the stock of S Corporation and X Corporation. T merges into S (with T's shareholders receiving P stock in exchange

[147] See Treas. Reg. § 1.368-2(k)(2), Ex. 1; PLR 200124009.

[148] Cf. Treas. Reg. § 1.368-2(k)(2), Ex. 7.

for their T shares) in a transaction intended to qualify as a reorganization under sections 368(a)(1)(A) and 368(a)(2)(D). Immediately thereafter, S transfers the T assets to X.

Under the final COBE regulations, the issuing corporation is treated as holding all the businesses and assets of all the members of the qualified group.[149] Thus, the COBE requirement is satisfied in this example, because P, S, and X are all members of the same qualified group, and P is treated as owning the assets held by X.

What if S had transferred the T assets directly to X's wholly owned subsidiary, Y? Although Treas. Reg. 1.368-1(d) would apply to treat the COBE requirement as satisfied because P, S, X, and Y are all members of the same qualified group, that regulation only applies for purposes of determining whether the COBE requirement is satisfied. The transaction must independently meet the requirements of section 368. The safe harbor of Treas. Reg. § 1.368-2(k) should be satisfied and, thus, the step transaction doctrine should not apply to treat the transaction as a transfer of assets to a second-tier subsidiary (Y) in exchange for "grandparent" (P) stock -- a violation of section 368 (which only allows the receipt of either the acquiring corporation or its parent's stock in a merger).[150] Assume the same facts as Example 3, except that after T transfers its assets (or the shareholders transfer the T stock) to S, P subsequently transfers its S stock to X. The safe harbor would also apply.[151] The safe harbor would also apply under the final regulations if S had acquired all of the T stock (instead of the T assets), and

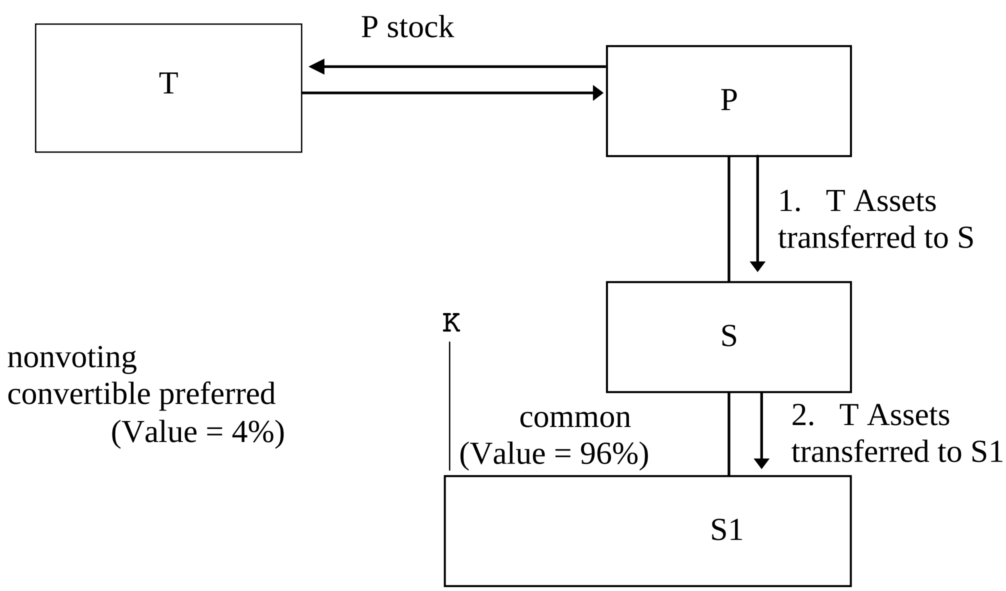
[149] Treas. Reg. § 1.368-1(d)(4)(i).

[150] See Treas. Reg. § 1.368-2(k)(1)(i); see also Rev. Rul. 2001-24, 2001-1 C.B. 1290; sections 368(a)(1)(A), 368(a)(1)(B), 368(a)(1)(C), 368(a)(2)(D), and 368(a)(2)(E).

[151] See Treas. Reg. § 1.368-2(k)(1)(i), (k)(2), ex. 7; see also Rev. Rul. 2001-24, 2001-1 C.B. 1290. Note that it appeared that the prior proposed regulations may not have applied the safe harbor because the proposed regulations applied to transfers of "part or all of the acquired assets or stock acquired in the transaction." Since S stock was not acquired in the transaction, the safe harbor did not seem to apply,

either (1) S had transferred the T stock to one of its wholly owned subsidiaries, or (2) P had transferred its S stock to X.[152]

4. Example 4 -- Continuity Of Business Enterprise



Facts. P owns all of the stock of S which owns all of the common stock of S1. Nonvoting convertible preferred stock of S1 is held by a third party but its value is only 4% of S1's total value. In a merger of T into P, the T shareholders exchange their T stock for P stock. Immediately following the merger, P transfers the T assets to S which transfers them to S1.

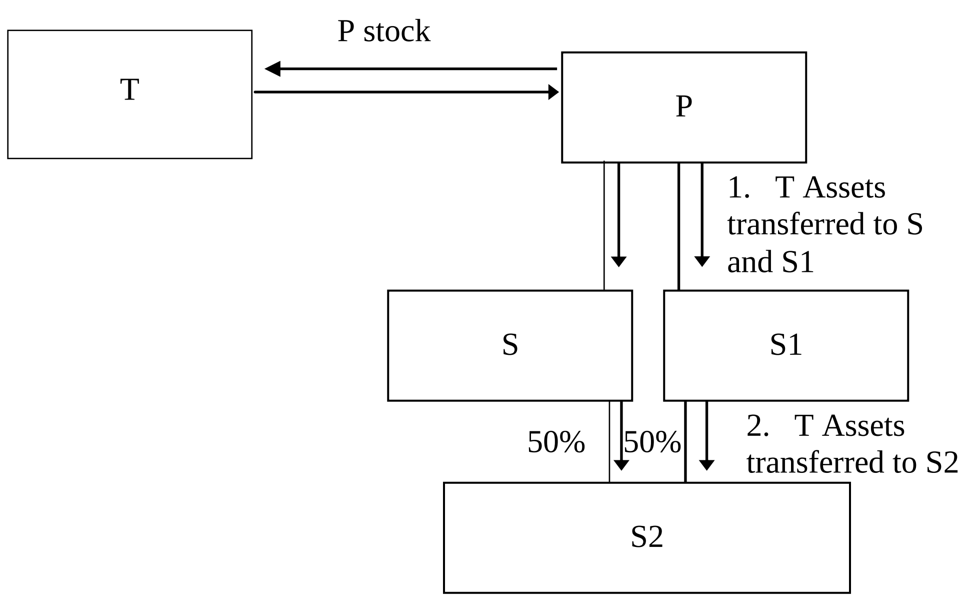
Under the law prior to the issuance of the final COBE regulations in 1998, this transaction fails the COBE requirement. Under section 368(a)(2)(C), transfers to subsidiaries must meet the control test under section 368(c). Under section 368(c), as interpreted by the Service in Rev. Rul. 59-259,[153] "control" means ownership of at least 80% of the vote and 80%

[152] See Treas. Reg. § 1.368-2(k)(1).

[153] 1959-2 C.B. 115.

of the total number of shares of <u>each</u> class of nonvoting stock. Since the entire class of convertible preferred stock is held by a nonmember, S1 is not "controlled" by S within the meaning of section 368(c).[154] Similarly, the final COBE regulations implicitly permit transfers among members of the issuing corporation's (P's) "qualified group" for purposes of satisfying the COBE requirement, and define the qualified group by reference to section 368(c).[155] Since S1 is not controlled by S within the meaning of section 368(c), the "qualified group" exception does not apply.

5. Example 5 -- Continuity Of Business Enterprise



Facts. P owns all of the stock of S and S1. S and S1 each own 50% of the stock of S2. In a merger of T into P, the T shareholders exchange their T stock for P stock. Immediately following the

[154] Interestingly, P, S, and S1 can file consolidated returns under sections 1501 and 1504. Under section 1504, affiliation is defined as 80% vote and value, excluding "vanilla preferred" stock.

[155] See Treas. Reg. § 1.368-1(d)(4).

merger, P transfers the T assets to S and S1 which transfer them to S2.

The final COBE regulations implicitly permit transfers among members of the issuing corporation's (P's) "qualified group" for purposes of satisfying the COBE requirement, and define the qualified group by reference to section 368(c).[156] Under the final regulations issued in 2007, this transaction satisfies the COBE requirement. Under these final regulations, group members aggregate their stock ownership of a corporation in determining whether they own the requisite section 368(c) control.

Under the law prior to the issuance of the final COBE regulations in 1998, this transaction would fail the COBE requirement. Under section 368(a)(2)(C), transfers to subsidiaries must meet the control test under section 368(c). Under section 368(c), as interpreted by the Service in Rev. Rul. 56-613,[157] there are no constructive ownership or aggregation rules for the control test. Therefore, S2 is not controlled by either S or S1. Similarly, the final COBE regulations issued in 1998 would not be satisfied because neither S nor S1 has control of S2. Therefore, the "qualified group" exception would not have applied.[158]

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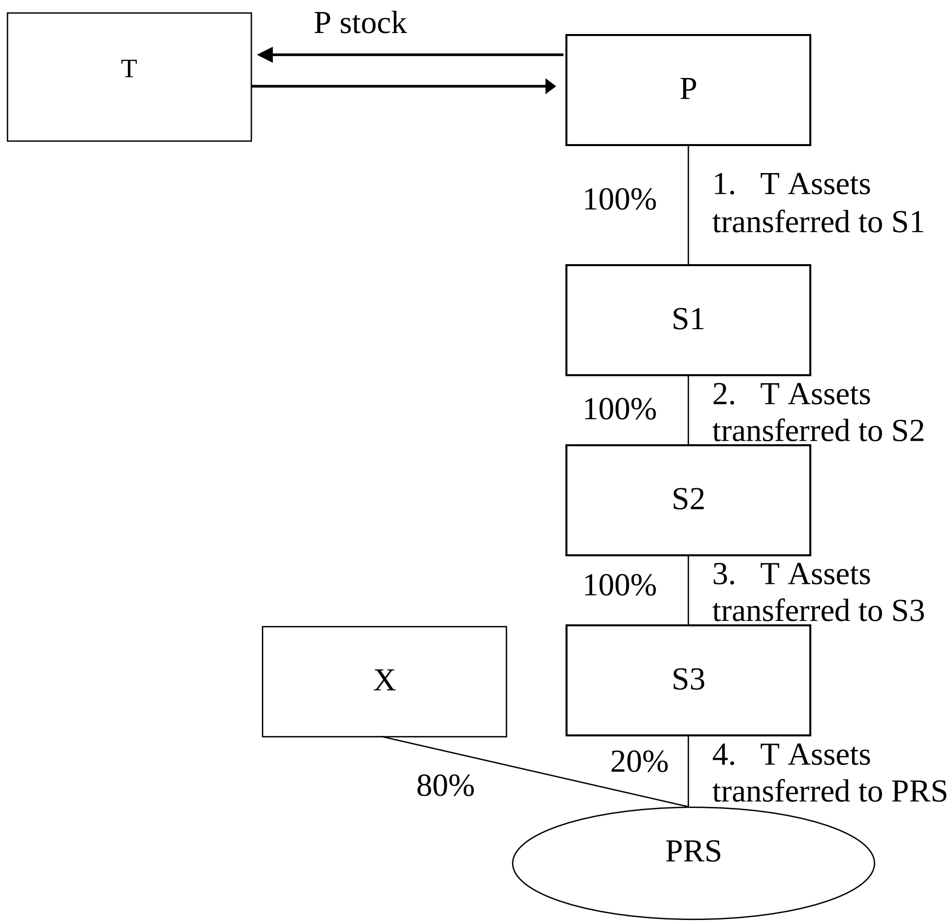
[156] See Treas. Reg. § 1.368-1(d)(4).

[157] 1956-2 C.B. 212.

[158] See Prior Treas. Reg. § 1.368-1(d)(4)(ii). As noted above, commentators had urged Treasury to amend the proposed regulations and adopt a section 1504 test in the final regulations instead of a section 368(c) test. See ABA Members Want COBE Regs Clarified, 97 TNT 90-25 (Jan. 23, 1998). Under section 1504(a)(1), the 80% control test is satisfied if one or more of the other corporations in the affiliated group own 80% of the vote and value of each corporation in such group. At the least, the Commentators suggested that a Treas. Reg. § 1.1502-34 standard (which aggregates stock ownership in consolidated groups) be adopted in cases where consolidated groups are involved. Id. However, Treasury decided to keep the section 368(c) test "because section 368 generally determines control by reference to section 368(c) . . . ." Preamble to T.D. 8760 (Jan. 23, 1998). The suggestion in favor of aggregation was adopted in the final regulations issued in 2007.

6. Example 6 -- Transfers to Partnerships



Facts: P owns all of the stock of S1, which owns all the stock of S2, which owns all the stock of S3. In a merger of T into P, the T shareholders exchange their T stock for P stock. Immediately following the merger, P transfers the T assets to S1, which transfers the T assets to S2, which transfers the assets to S3. S3 then transfers the assets to a partnership, PRS, in exchange for a 20% interest in PRS. X Corporation, an unrelated party, transfers cash to PRS in exchange for an 80% interest in PRS. S3, in its capacity as a partner, makes significant business decisions and regularly participates in the overall supervision, direction, and control of the PRS business.

Will the transfer of acquired assets to a partnership prevent the transaction from qualifying as a reorganization? Under prior law (at least in the view of the Service), the transfer of acquired assets to a partnership prevented the transaction from qualifying as a tax-free reorganization.[159] The final COBE regulations, however, permit certain asset transfers to partnerships.

In G.C.M. 35117, the Service argued that under the Groman/Bashford doctrine the interest acquired by the corporation was too "remote" to provide the requisite continuity. The Service expressly rejected the taxpayer's argument that the partnership should be viewed as an aggregate rather than an entity for this purpose, and that a partnership is not a qualifying entity under section 368(b). Thus, the transaction failed remote asset continuity and continuity of business enterprise.[160]

The final COBE regulations reject G.C.M. 35117 and allow asset transfers to partnerships.[161] Under these regulations, the issuing corporation will be treated as conducting a business of a partnership if the issuing corporation (or a member of the qualified group) has a 20% interest in such partnership, and the issuing corporation (or a member of the qualified group) performs active and substantial management functions as a partner.[162] Thus, under the

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[159] See G.C.M. 35117 (Nov. 15, 1972) (stating that drop-down to partnership following "A" reorganization is not permitted).

[160] But see G.C.M. 39150 (Mar. 1, 1984) (stating that drop-down of a portion of assets or stock to a partnership is permitted as long as COI and COBE are otherwise satisfied).

[161] Treas. Reg. § 1.368-1(d)(5), Exs. 8-13. See also Treas. Reg. § 1.368-2(f); Treas. Reg. § 1.368-2(k)(1).

[162] Treas. Reg. § 1.368-1(d)(5), Ex. 8. It is unclear how corporations are to calculate their partnership interests for purposes of the new regulations. Presumably, one looks to section 704(b), which includes an analysis of the partners' relative contributions to the partnership, the interests of the partners in economic profits and losses, the interests of the partners in cash flow and other non-liquidating distributions, and the rights of the partners to distributions of capital upon liquidation of the partnership. See Treas. Reg. § 1.704-1(b)(3).

above facts, the transaction satisfies the COBE requirement, as P is treated as conducting the business of PRS due to S3's performance of active and substantial management functions.[163]

However, note that if S3 performs active and substantial management functions, but only has a 1% interest in PRS, the transaction will fail the COBE requirement.[164] What if S3 has a percentage interest between 1% and 20% in PRS? By stating in the examples to the regulations that a 1% interest is insufficient and a 20% interest is sufficient, the Service seems to be leaving open the question of whether percentage interests between 1% and 20% will be sufficient. Thus, whether the COBE requirement is satisfied in those cases would most likely be a facts and circumstances determination.

In addition to the 20% active and substantial management function safe harbor, if the issuing corporation has a "significant interest" in the partnership (a 33 1/3% interest is treated as significant), the COBE requirement will also be satisfied, regardless of whether the issuing corporation performs active and substantial management functions.[165] It is unclear whether interests between 20% and 33 1/3% can qualify as a significant interest, although Example 11 of the regulations seems to assume that a 22 1/3% interest would not qualify as a significant interest.[166]

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[163] Id. As noted above, under the regulations, the issuing corporation is treated as conducting the business of the partnership if members of the qualified group (in the aggregate) own a significant interest in the partnership, or members of the qualified group have active and substantial management functions as a partner with respect to the partnership business. Treas. Reg. § 1.368-1(d)(4)(iii)(B).

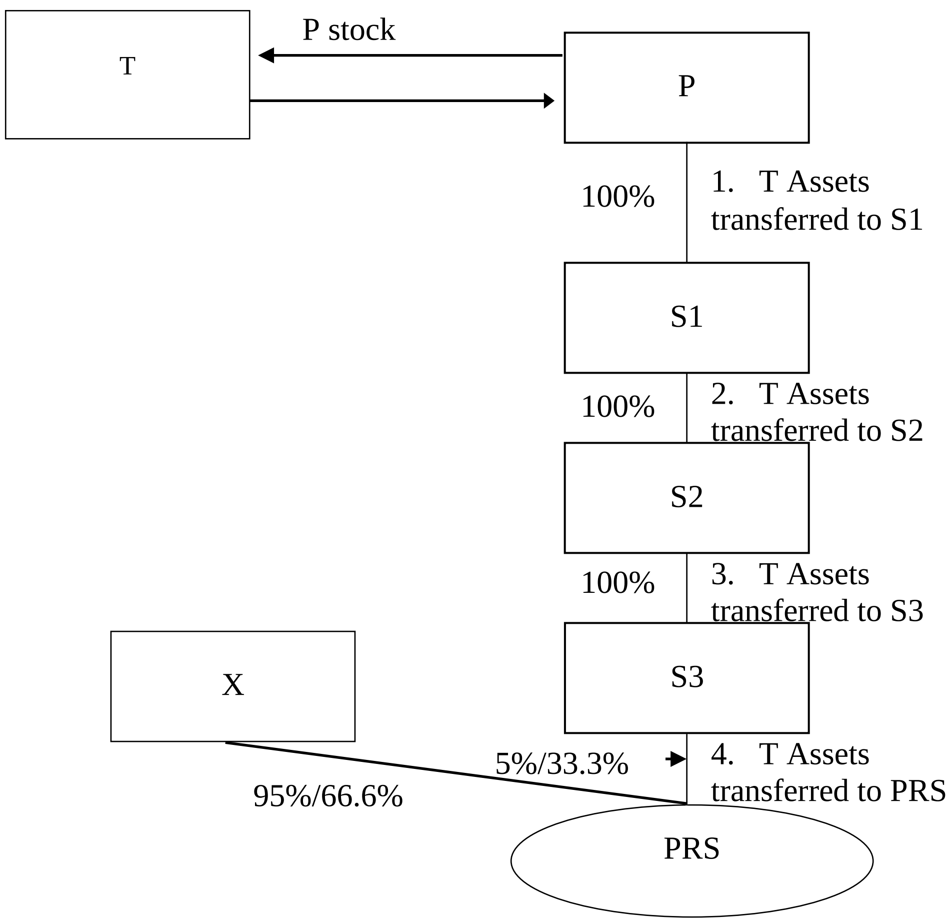
[164] Treas. Reg. § 1.368-1(d)(5), Ex. 9.

[165] Treas. Reg. § 1.368-1(d)(5), Ex. 10.

[166] Treas. Reg. § 1.368-1(d)(5), Ex. 12.

Assume that prior to and in connection with a merger with P, T transfers all its assets to a partnership, PRS, and receives a 50% interest in PRS (X, an unrelated party, contributes cash to PRS and holds the other 50% interest). Thus, following the merger, P holds a 50% interest in PRS. Presumably, the COBE requirement would be satisfied, as P would be treated as owning a significant interest in PRS. IRS officials have stated that the Service is considering how the COBE requirement applies to these facts.

7. <u>Example 7 -- Transfers to Partnerships</u>

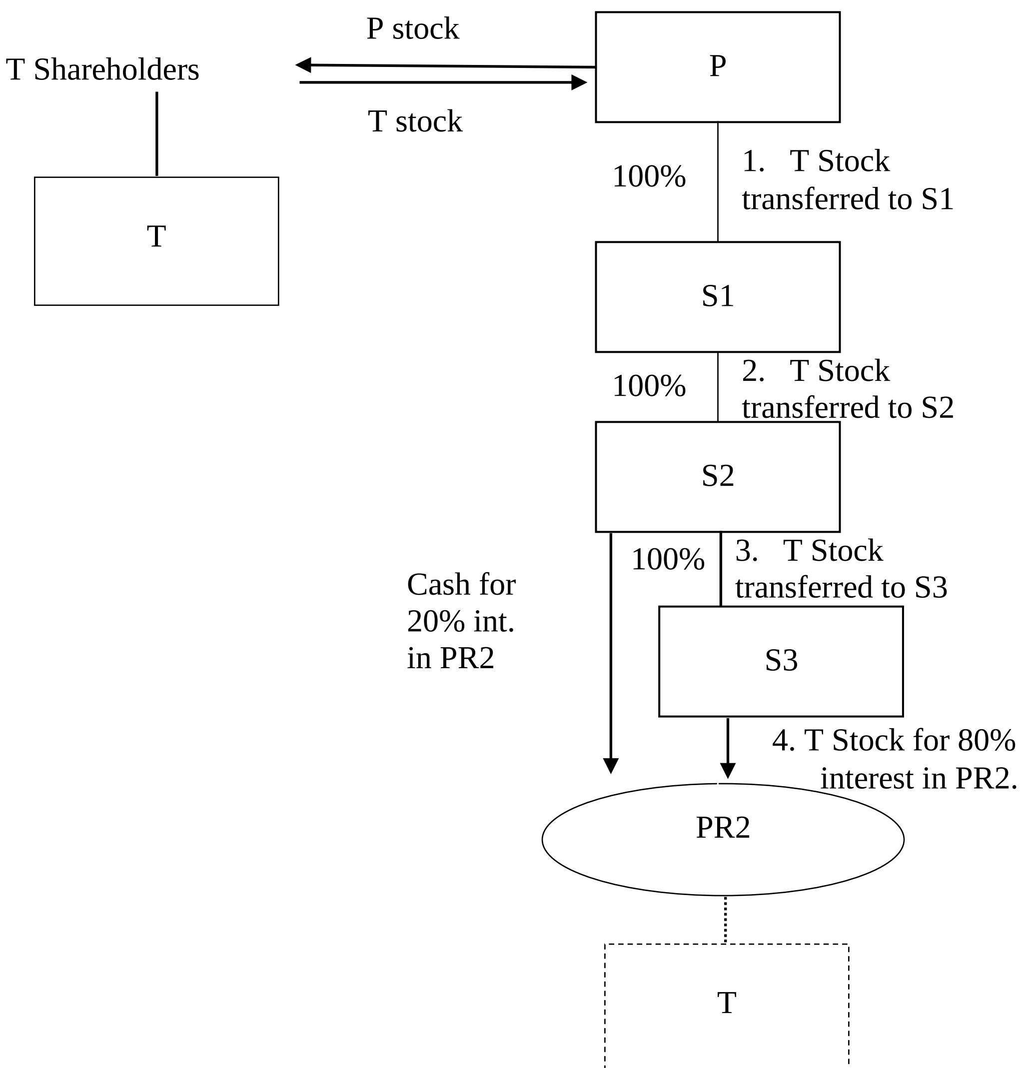


<u>Facts</u>. Assume the same facts as Example 6, except S3 owns a 5% interest in PRS and X owns a 95% interest in PRS prior to S3's transfer of T's assets to PRS. Assume further that S3 does not perform active and substantial management functions, and S3's

interest in PRS increases from 5% to 33 1/3% as a result of the transfer.

Under the final COBE regulations, S3 is treated as owning 33 1/3% of the T assets, and thus has a significant interest in PRS.[167] Therefore, the transaction satisfies to COBE requirement.

8. Example 8 -- Transfers of Stock to Partnerships



[167] Treas. Reg. § 1.368-1(d)(5), Ex. 11.

> Facts. Assume the same facts as Example 6, except (1) P acquires all of T's stock from T's shareholders, instead of its assets, solely in exchange for P stock, (2) the T stock is transferred down the chain to S1, S2, and then S3, and (3) S3 and S2 form a new partnership, PR2, to which S3 contributes the T stock in exchange for an 80% interest in PR2 and S2 contributes cash in exchange for a 20% interest in PR2.

Final regulations issued in 2007 permit the attribution of stock ownership from partnerships if members of the qualified group own interests in a partnership meeting the requirements of section 368(c).[168] Under these facts, members of the qualified group own all of the interests of the partnership. Accordingly, the COBE requirement would be satisfied.

The final COBE regulations issued in 1998 permitted the attribution of assets used in a business of the partnership, but did not permit the attribution of stock held by a partnership.[169] The final COBE regulations issued in 1998 contained an example that indicates the Service would allow the transfer of the T stock to S1, S2, and S3, but would not allow S3's transfer of the T stock to PR2. In Prior Treas. Reg. § 1.368-2(k)(3), Ex. 3, the Service concluded that the transaction fails the control requirement necessary in section 368(a)(1)(B), because P does not have control of T immediately after the acquisition of the T stock. The Service and Treasury indicated that they were reexamining their prior position in the Preamble to proposed regulations issued in 2004, and omitted the example setting forth that position in such proposed regulations.[170]

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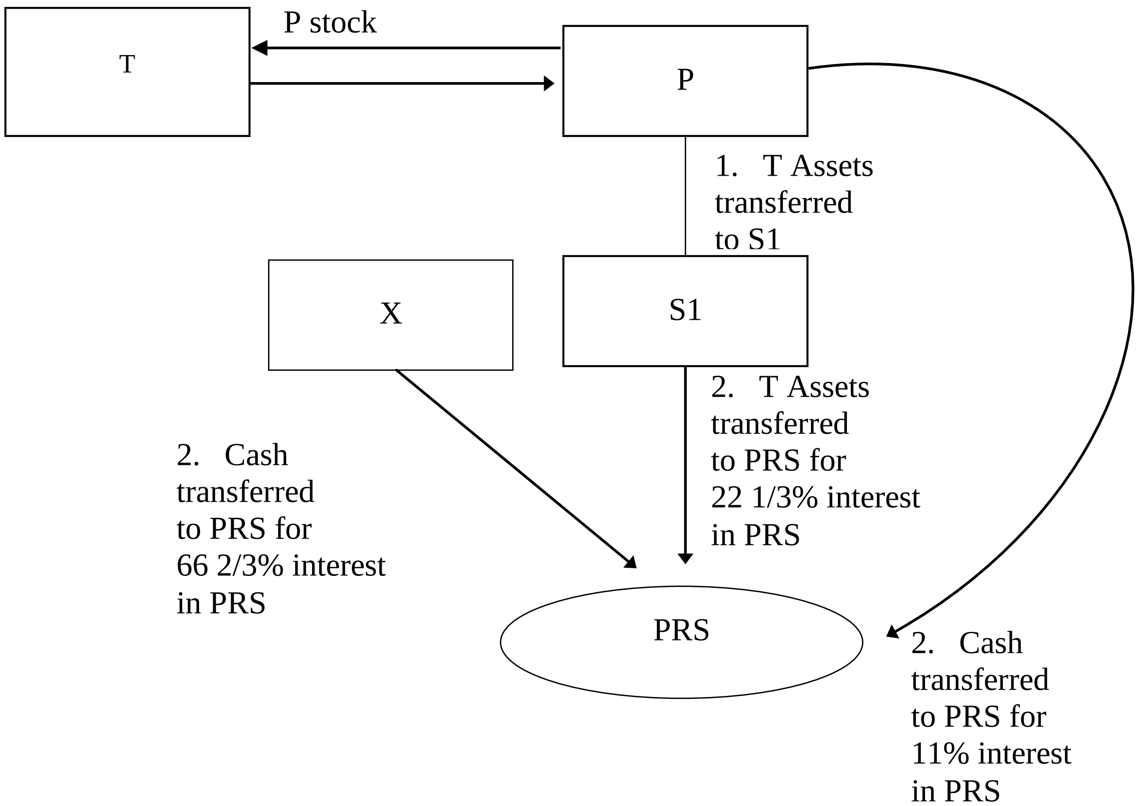
[168] See Treas. Reg. § 1.368-1(d)(4)(iii)(D).

[169] See Treas. Reg. § 1.368-1(d)(4)(iii)(A).

[170] See Preamble to Prop. Treas. Reg. § 1.368-2(k), 69 F.R. 51026 (Aug. 17. 2004).

9. Example 9 -- Aggregation of Partnership Interests

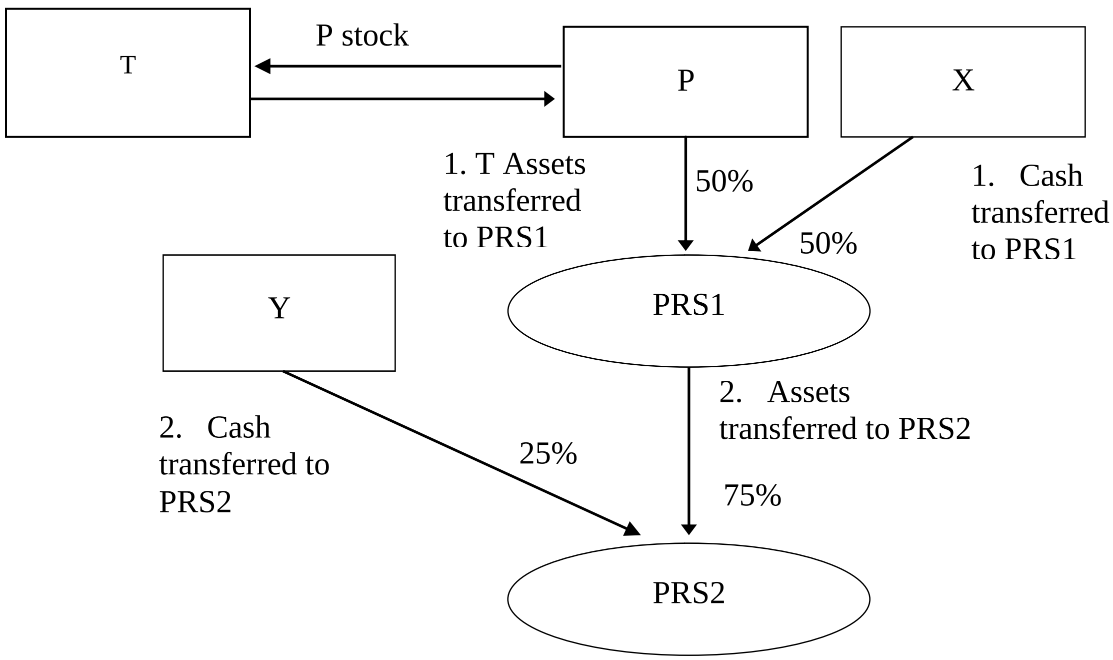


Facts: P owns all of the stock of S1. T merges into P. P transfers its T assets to S1, which transfers them to PRS in exchange for a 22 1/3% interest in PRS. PRS uses the historic T assets in its business. P and X each transfer cash to PRS in exchange for partnership interests. P receives an 11% interest in PRS, and X receives a 66 2/3% interest in PRS. No member of P's qualified group performs active and substantial management functions for PRS.

As noted in Example 6, if an issuing corporation has a 33 1/3% interest in a partnership, that interest will be a "significant interest," and the COBE requirement will be satisfied, regardless of whether the issuing corporation performs active and substantial management functions. Are P and S1 aggregated for purposes of the significant interest test?

The final regulations state that the interests of all members of the qualified group are aggregated for purposes of the significant interest test.[171] Thus, P's 11% interest in PRS is aggregated with S1's 22 1/3% interest in PRS, so that the qualified group holds a 33 1/3% interest in PRS.[172] Since P is treated as holding all the assets of all the members of the qualified group, the transaction satisfies the COBE requirement.[173]

10. Example 10 -- Tiered Partnerships



Facts: T merges into P solely in exchange for P stock. P transfers all of its T assets to a partnership, PRS1, in exchange for a 50% interest in PRS1. P does not perform active and substantial management functions as a partner in PRS1. X Corporation, an unrelated party, contributes cash in exchange for the remaining

[171] Treas. Reg. § 1.368-1(d)(5), Ex. 11.

[172] Id.

[173] Id.

50% interest in PRS1. PRS1 then transfers the T assets to a second partnership, PRS2, in exchange for a 75% interest in PRS2. PRS2 uses the historic T assets in its business. PRS1 does not perform active and substantial management functions as a partner of PRS2. Y Corporation, an unrelated party, contributes cash in exchange for the remaining 25% interest in PRS2.

When there are tiered partnerships, how is the significant interest test applied? Under the final regulations, P is treated as owning 50% of the assets of PRS1, and PRS1 is treated as owning 75% of the assets of PRS2.[174] Thus, P is treated as owning 37 1/2% (i.e., 50% x 75%) of PRS2. As noted in Example 6, if the issuing corporation has a 33 1/3% interest in a partnership, that interest will be a "significant interest," and the COBE requirement will be satisfied, regardless of whether the issuing corporation performs active and substantial management functions. Since P has a 37 1/2% interest in PRS2, the COBE requirement is satisfied.[175]

IV. **CONCLUSION**

Although there are questions as to the interpretation of certain provisions of the COI and COBE regulations, the final regulations, as modified by final regulations issued in 2007, provide taxpayers with much needed guidance. The Treasury Department and the Internal Revenue Service should be congratulated for promulgating these excellent regulations.

[174] Treas. Reg. § 1.368-1(d)(5), Ex. 12.

[175] Id.