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Comment

Corporate Reorganizations Get A New Look: Tightening the Reigns on the Runaway Continuity of Interest Doctrine

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* J.D., University of the Pacific, McGeorge School of Law, to be conferred 1998; B.A., University of Maryland, 1995. I wish to thank J. Hinkel for being my personal cheerleader and showing me that we really can have it all. Additionally, I want to thank A. Bodolay and N. King for encouraging me to embrace my dreams, and R. Mentch and C. Manolakas for making the abstruse world of taxation so damned interesting.

I. INTRODUCTION

Federal income taxation of corporate reorganizations is a complex subject, replete with intricate statutory provisions and influenced by numerous judicial doctrines. This Comment examines the rules and regulations that govern corporate reorganizations as defined in section 368 of the Internal Revenue Code, and the impact of Proposed Treasury R..gulations[1] and recent court decisions on those transactions. The purpose of this Comment is to provide a contemporaneous statement regarding the impact of new developments in the tax field[2] on long-standing assumptions underlying strategic corporate reorganization-structuring by tax practitioners.[3] To that end, an analysis of *J.E. Seagram v. Commissioner*[4] is provided.[5] The Tax Court opinion in *Seagram* combined with the Proposed Treasury Regulations profoundly impacts the continuity of interest doctrine, a significant judicial prerequisite to successful reorganization of corporate entities.

II. GENERAL PRINCIPLES

This Comment presumes an understanding of basic federal income tax principles. This Part elaborates on the basic principles underlying the tax consequences of acquisitive reorganizations.[6]

1. On December 23, 1996, the Internal Revenue Service (Service) published proposed regulations regarding the continuity of interest requirement for corporate reorganizations. Prop. Treas. Reg. §§ 1.368-1(a)-(e), 61 Fed. Reg. 67514 (1997). Additionally, on January 3, 1997, the Service proposed additional changes to the corporate reorganization provisions regarding the continuity of business enterprise requirement. Prop. Treas. Reg. §§ 1.368-1(d), 1.368-2(a), -(f), -(k), 62 Fed. Reg. 36101 (1997).
2. *See infra* notes 138-74 and accompanying text (discussing recently published Proposed Regulations).
3. *See infra* Part II.C (examining various judicial doctrines and decisional law that impacts business transactions and corporate tax practice).
4. 104 T.C. 75 (1995).
5. *See infra* Part III (analyzing the *Seagram* opinion).
6. Because the focus of this Comment is on the 1997 Proposed Regulations, the discussion is limited to the reorganizations to which the regulations apply.

A. Recognition & Nonrecognition Concepts

Under the American system of taxation, gain from dispositions of property is specifically included in gross income under section 61(a)(3).[7] Appreciation in the value of property is generally taxed when gain is realized, essentially when that property is sold or otherwise disposed of.[8] Initially, it would appear that any gain realized from "dealings in property" must be taken into consideration when taxable income is calculated for the corporate taxpayer.[9] Section 1001 requires that a taxpayer who sells or otherwise disposes of property recognize gain (or loss) to the extent that what is received by the taxpayer exceeds (or is less than) the taxpayer's adjusted basis in the property relinquished, unless another provision specifically provides otherwise.[10] Congress has enacted specific provisions for corporate reorganizations, mandating the nonrecognition of gain (or loss) to all parties to a reorganization[11] that exchange property while pursuing a plan of reorganization.[12]

To illustrate: If Corporation *T* is acquired by Corporation *P*, pursuant to a plan of reorganization, and former shareholders of *T* exchange all of their Corporation *T* stock for Corporation *P* stock, the capital investment has not been liquidated, but essentially continues unchanged except in form. This transaction, however, is a realization event, and any gain would be subject to inclusion under section 1001. Section 361, however, specifically provides that in the above situation, the gain or loss shall not be recognized. Notably, this mandatory section applies whenever its

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7. I.R.C. § 61(a)(3) (1997) (stating that "gross income" includes all income regardless of its source, including any gain derived from dealings in property). To determine the amount to be included, § 1001 explains that the amount realized (i.e. money plus fair market value of property other than money received) in excess of the adjusted basis (generally the cost of the property) is the gain from a disposition of property. *Id.* § 1001(a),(b); *see id.* § 1011(a) (defining "adjusted basis" by referencing § 1012's cost basis provision and § 1016's adjustments).

8. *See* Eisner v. Macomber, 252 U.S. 189, 201-03 (1920) (setting the standard for determining the taxability of a transaction). In *Macomber*, the Court held that it was unconstitutional to tax a shareholder on a pro rata dividend, contending that the dividend did not represent a severable interest in the corporation. *Id.* at 209-11. The Court held that the dividend was merely a representation of continued investment in a going concern, and not an indication of increased wealth. *Id.*

9. *See* I.R.C. § 61(a)(3) (1997) (including gain from "dealings in property" in the determination of tax liability).

10. *Id.* § 1001(c) (1997) (mandating recognition of gain or loss).

11. *See id.* §§ 354, 356 (1997) (containing the relevant provisions). The shareholders or debtholders of the acquired corporation, under § 354 and § 356 recognize no loss and only recognize gain to the extent property other than stock or securities is received in the exchange. *Id.*

12. The phrase "plan of reorganization" has not been statutorily defined. Although the regulations purport to ensure that nonrecognition status is confined to transactions that are actually related to § 368 reorganizations, the definition is vague, and to some, easily misconstrued. Notwithstanding the outdated Code provisions, for an excellent discussion of the concept see, Elliot Manning, *"In Pursuance of the Plan of Reorganization": The Scope of the Reorganization Provisions of the Internal Revenue Code*, 72 HARV. L. REV. 881 (1959).

criteria are met, its applicability is not dependant on taxpayer election. Absent this provision, an exchange of property for stock would constitute a taxable disposition of property at fair market value, and any gain would be included in the calculation of taxable income.[13] Therefore, a realizable event must occur before gain becomes taxable (or losses become deductible); mere appreciation or depreciation in value is disregarded until such an event has transpired. Once such an event occurs, a specific Code provision must allow a taxpayer to defer recognition of any realized gain.

Common with the principles underlying other nonrecognition sections, the Legislature has decided that the taxpayer's investment remains unliquidated, and that a mere change in the form of investment is not the proper time to tax any gain (or deduct any loss).[14] Before nonrecognition status is extended, however, the transaction must conform to the applicable reorganization provision. Unfortunately, even strict conformity is not sufficient. The Tax Court may subsequently examine the transaction to determine whether granting such status will effectuate Congressional intent, or whether the transaction is motivated by a desire to evade or avoid tax liability. Various judicial doctrines operate to ensure that nonrecognition treatment effectuates Congressional purpose.[15]

B. Definitions of Various Acquisitive Reorganizations

In the world of corporate finance, "reorganization" often refers to the reformation of a previously bankrupt entity into a viable corporation. For tax practitioners, however, the term is defined in Code section 368(a)(1) to include merger, consolidation, acquisition, and division of corporate entities.[16] A transaction must initially meet one of these statutory definitions to be treated as a reorganization for tax purposes.

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13. *See* I.R.C. § 61(a)(3) (1997) (noting gains from "dealings in property" as an example of items to be included in gross income).

14. *See generally* Edward T. Roehner & Shelia M. Roehner, *Realization: Administrative Convenience or Constitutional Requirement?*, 8 TAX L. REV. 173 (1953) (comparing the economic theories behind the "realization" requirement).

15. *See* discussion *infra* Part II.C (detailing the substance over form, step-transaction, and continuity doctrines).

16. I.R.C. §§ 368(a)(1)(A)-(G) (1997) (illustrating seven different types of corporate business transactions to which the term "reorganization" applies). These seven transactions can often be structured either as a § 368 reorganization where the parties receive tax-free or partially tax-free treatment. *See id.* §§ 354, § 356 (requiring recognition of any gain equal to the cash plus the fair market value of property other than acquirer stock or securities transferred). Because this Comment addresses newly proposed regulations impacting "A," "B," "C," and "G" reorganizations explicitly, these provisions are separately defined within the Comment. *See* discussion *infra* Part II.B.1-5 (specifying the requirements of these reorganization provisions).

1. 368(a)(1)(A)

Under section 368(a)(1), "A" reorganizations are statutory mergers or consolidations.[17] These are effected under federal or state law[18] when an acquiring corporation receives the assets of another corporation, the target, in exchange for assuming the liabilities of the target and exchanging former shareholders' target stock for stock in the acquiring corporation.[19] A "merger" under section 368(a)(1)(A) involves two or more corporations that combine with only one of the corporate entities surviving; the other corporation disappears by operation of law.[20] In contrast, in a consolidation, the corporations combine into an entirely new corporation.

If the target merges into a subsidiary of the parent, the subsidiary receives substantially all[21] of target's assets and the target shareholders receive sufficient parent stock, a "forward triangular merger" results.[22] A "reverse triangular merger" is an "A" reorganization in which a controlled subsidiary merges into the target corporation where the former target shareholders receive voting stock of the parent corporation, and the parent corporation acquires control of the target as a result of the transaction.[23] If a transaction qualifies as an "A" reorganization, the target corporation, the acquiring corporation, and the former target shareholders in receipt solely of acquiring corporation stock defer recognition of the resulting tax consequences.[24]

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17. I.R.C. § 368(a)(1)(A) (1997).

18. *See* Treas. Reg. § 1.368-2(b)(1) (1986) (dictating that to qualify as a reorganization, the transaction must satisfy federal, state, territory or District of Columbia corporate law). Every state has provisions for merging or consolidating corporations; the parties to a reorganization must strictly comply with the state statute to effectuate an "A" reorganization. *Id.*

19. I.R.C. § 368(a)(1)(A) (1997).

20. *See* Treas. Reg. § 1.368 (1986) (explicating the statutory requirements for these reorganizations).

21. The "substantially all" language was added to prevent a triangular merger from being used to effectuate a corporate division. *See* H.R. REP. No. 1902, 90th Cong., 2d Sess. 2-3 (1968), S. REP. No. 1653, 90th Cong., 2d Sess. 2 (1970). For a detailed discussion of the complexity inherent in the "substantially all" requirement, see Robert H. Wellen, *"More Problems Complicate the Application of 'Substantially All' to Acquisitions*, 79 J. TAX'N 366 (1993); *see also* Philip C. Cook & John L. Coalson, Jr., *The "Substantially All of the Properties" Requirement in Triangular Reorganizations—A Current Review*, 35 TAX LAW. 303 (1982).

22. A forward triangular merger can be effectuated under § 368(a)(1)(A) and § 368(a)(2)(D).

23. I.R.C. § 368(a)(2)(E) (1997). "Control" means ownership of at least 80% of the voting power of the voting stock and 80% of the total number of shares of all other classes of stock. *Id.* § 368(c) (1997).

24. The tax consequences to each party following a reorganization:

1. In exchange for its own stock, P recognizes no gain or loss on its receipt of T stock or assets. I.R.C. § 1032 (1997).

2. If T transfers its assets to P, T generally recognizes no gain or loss on the receipt of P stock exchanged; if property other than stock or securities is received, no gain or loss will be recognized if T distributes the other property to its shareholders or debtholders, in pursuit of a plan of reorganization. I.R.C. § 361(a), (b)(1)(A), (b)(3), (c)(3) (1997).

3. T's shareholders recognize no gain or loss if they exchange their T stock for P stock while pursuing a plan of an "A" reorganization. I.R.C. § 354. (1997) If T's shareholders receive P stock indirectly through T, such as in a "C" reorganization, the same rules apply. I.R.C. §§ 354(a)(1),

2. *368(a)(1)(B)*

"B," or "stock-for-stock," reorganizations enable one corporation to acquire another corporation as a subsidiary if the consideration transferred directly to target shareholders consists solely of voting stock[25] in the acquiring corporation, or its parent,[26] and the acquiring corporation has "control"[27] of the target corporation immediately following the transaction.[28] To qualify as a "B" reorganization, no property other than voting stock in the acquirer may be furnished as consideration for target stock received by the acquirer in the transaction.[29]

3. *368(a)(1)(C)*

Where the acquiring corporation acquires "substantially all"[30] of the target's assets and the consideration consists solely of voting stock in the acquirer, or voting

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368(a)(2)(G)(I) (1997).

4. T's shareholders are taxed to the extent they receive property other than P stock and P securities. A T shareholder in receipt of other property ("boot") is taxed on the fair market value of the property received or the gain realized in the transaction, whichever is less. I.R.C. § 356(a) (1997). "Boot" is not defined in the Internal Revenue Code. The term refers to cash or other "non-permitted" property that triggers recognition when received in an otherwise tax-free exchange.

See BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 13.10 (5th ed. 1987); *see also* I.R.C. § 356(a)(1)(B) (1997) (referencing permitted and nonpermitted property as it relates to nonrecognized transactions).

25. "Solely" is strictly interpreted. Thus, for example, if the consideration paid by the acquirer is 90% voting stock and 10% cash, the transaction fails to statutorily qualify as a "B" reorganization. The meaning of "voting stock," as used in REV. RUL. 72-72, 1972-1 C.B. 104, has been litigated in several cases. *See, e.g.*, Paulsen v. Commissioner, 469 U.S. 131 (1985) (holding that receipt of preferred stock with an exercisable right to receive additional cash qualified as voting stock, in satisfaction of the statute); Helvering v. Southwest Consolidated Corp., 315 U.S. 194 (1942) (finding that warrants issued in the transaction are not voting stock). For a complete analysis of the voting stock requirement see Richard D. Dailey, *The Voting Stock Requirement of B and C Reorganizations*, 26 TAX L. REV. 725 (1971).

26. I.R.C. § 368(a)(1)(B) (1997).

27. *See id.* § 368(c) (1997) (defining "control" as owning at least 80% of the combined voting power of stock entitled to vote and at least 80% of the total number of shares of every other class of stock).

28. *Id.* § 368(a)(1)(B) (1997). Because there cannot be any boot in a "B" reorganization, the requirement that at least 80% of an acquired corporation's stock must be acquired during the reorganization itself led practitioners to believe that if a corporation had previously acquired more than 20% of a target's stock, a "B" reorganization could not be effectuated. In 1954, however, the Code was amended, making it clear that a creeping acquisition of control can qualify as a valid "B" reorganization. *See* S. REP. No. 1622, 83d Cong., 2d Sess. 273 (1954) (changing the operative language of § 368(a)(1)(B)). Several notable articles deal more directly with this change in tax law. *See, e.g.*, Burton W. Kanter, *Cash in a "B" Reorganization: Effect of Cash Purchases on "Creeping" Reorganization*, 19 TAX L. REV. 441 (1964); Martin J. McMahon, Jr., *Defining the "Acquisition" in B Reorganizations Through the Step Transaction Doctrine*, 67 IOWA L. REV. 31 (1981).

29. I.R.C. § 368(a)(1)(B) (1997).

30. *Id.* § 368(a)(1)(C) (1997). For advance ruling purposes, the Internal Revenue Service (Service) has indicated that "substantially all of the assets" means assets representing at least 90% of the fair market value of the net assets (assets minus liabilities) and 70% of the fair market value of the gross assets held immediately before the transfer. *See* Rev. Proc. 77-37, 1977-2 C.B. 568-69.

stock and a limited amount of money[31] or other section 368(a)(2)(B) property, the transaction qualifies as a "C," "stock-for-assets" reorganization.[32] As an asset acquisition, it more closely resembles an "A" reorganization than a "B" reorganization, where solely stock is exchanged, and has been termed a practical "merger."[33] Additionally, an acquirer can assume the liabilities of the target in a "C" reorganization, or acquire the assets subject to the target's liabilities,[34] without violating the statutory scheme.[35]

4. 368(a)(1)(D)

Reorganizations effectuated under section 368(a)(1)(D) may utilize a wide range of consideration. Thus, property other than the stock of the acquirer may be given in exchange for the target's property. As defined in the Code, "D" reorganizations are transfers by a corporation of all or part of its assets to a corporation controlled[36] by the transferor or its shareholders, if the stock or securities of the controlled corporation are distributed by the transferor in a transaction that qualifies under section 354, section 355, or section 356.[37] Assuming the requirements of the Code are met, section 368(a)(1)(D) can be utilized by the transferor itself, its shareholders, or both to shift assets of the underlying corporation to a controlled corporation.[38]

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31. I.R.C. § 368(a)(1)(C) (1997).

32. *Id.* (allowing the acquirer to transfer money or other property to the target, as long as the acquirer receives solely voting stock representing at least 80% of the fair market value of all of the target assets). In most circumstances, however, it is nearly impossible to use nonvoting stock as the consideration for the exchange because the assumption of the target's liabilities represents more than 20% of the value of the assets, in violation of the 80% threshold. Since "substantially all" of the assets of the acquired corporation (target) must be obtained during reorganization under § 368(a)(1)(C), the degree to which assets can be stripped away by the eventual acquirer prior to reorganizing is limited. This is untrue of reorganizations consummated under § 368(a)(1)(A) or § 368(a)(1)(B). *Compare* I.R.C. § 368(a)(1)(C) (1997) (requiring that "substantially all" of the target's assets be acquired), *with* § 368(a)(1)(A) (1997), *and* § 368(a)(1)(B) (1997) (including no such requirement).

33. *See* American Potash & Chem. Corp. v. United States, 399 F.2d 194, 201 (Ct. Cl. 1968).

34. The target corporation must, however, liquidate. I.R.C. § 368(a)(2)(G) (1997).

35. *Id.* § 368(a)(1)(C). There are situations where an insolvent corporation is worth saving, particularly where there is a demand for the goods or services that the corporation produces. *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 377-79 (3d ed. 1986) (illustrating the value of some insolvent corporations).

36. Control is measured immediately after the transfer. *See* REV. RUL. 59-222, 1959-1 C.B. 80. Additionally, where creditors are also shareholders of the transferor, courts have found the requisite control to exist.

37. I.R.C. § 368(a)(1)(D) (1997). Reorganizations under "D," therefore, are not acquisitive reorganizations but rather shifts or divisions of ownership of the corporation's underlying assets.

38. *Id.*

5. 368(a)(1)(G)

In order to facilitate their rehabilitation as insolvent corporate debtors, defunct corporations may choose to utilize the tax-free corporate reorganization provisions in section 368(a)(1)(G).[39] Following a bankruptcy or similar event, a corporation may reorganize by transferring all or a part of its assets to another corporation if, pursuant to a plan of reorganization, stock or securities of the acquiring corporation are subsequently distributed in accordance with certain requirements.[40] The statutory requirements for a "G" reorganization, similar to a "D" reorganization, are stated in Code sections 355 and 354. The statutes require that the transferee corporation acquire all or substantially all of the insolvent corporation's assets,[41] all property received by the transferor, whether stock, securities, or other property, and all other transferor property must be distributed pursuant to a plan of reorganization.[42]

C. Relevant Judicial Doctrine

Several fundamental principles underlie judicial determination of tax cases. Although the legislature has extended nonrecognition status to transactions that readjust the corporate structure,[43] statutory qualification is only the initial hurdle that a transaction must clear. If a transaction is deemed not to be driven by economic considerations, the Internal Revenue Service, and later a court, may recharacterize the resulting corporate structure, with materially different tax consequences. The judicial doctrines of substance over form, step-transaction, business purpose, and continuity of business enterprise are particularly relevant in the corporate reorganization context.[44] These doctrines often lead to recharacterization

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39. *Id.* § 368 (a)(1)(G) (1997). For an excellent explication of the economic incentives shareholders of a nonviable business have to pursue reorganization, see Lynn M. LoPucki, *The Debtor in Full Control—Systems Failure Under Chapter 11 of the Bankruptcy Code?*, 57 AM. BANK. L.J. 247, 259 (1983) (observing that the owners have no incentive to cease operation, since their interest disappears after liquidation). *But see* William L. Cary, *Liquidation of Corporations in Bankruptcy Reorganization*, 60 HARV. L. REV. 173, 194 (1946) (positing that rehabilitation of the debtor does not always reflect the best option when a corporation's business operations are not economically sound).

40. I.R.C. § 368 (a)(1)(G) (1997); *see id.* (outlining the parameters of this type of reorganization). Where a corporation controls an acquiring corporation, the acquiring corporation can acquire a debtor corporation by effectuating a "triangular" "G" reorganization in exchange for the controlling corporation stock, instead of the acquiring corporation's stock. *Id.*

41. *Id.* §§ 354(b)(1)(A), 355 (1997).

42. *Id.* § 354(b)(2)(B) (1997). The legislative history reveals that "G" reorganizations must also meet the continuity requirements to qualify for nonrecognition treatment.

43. Treas. Reg. § 1.368-1(b) (1988) (detailing the purposes of excepting certain business transactions from the general requirement of recognizing gain or loss realized).

44. *See infra* Part II.C.1-3 (chronicling the development and imposition of these judicial doctrines within the corporate reorganization environment).

of transactions and must be taken into consideration when contemplating transfers of corporate property.

1. The Doctrine of Substance Over Form

Unquestionably, a transaction's form is of great importance. However, the form, or label, of a transaction is not the equivalent of its substance.[45] Two categories of this doctrine exist—legal substance over form and economic substance over form.[46] Using the legal substance over form doctrine, the court examines the legal rights and obligations of the parties, and determines whether or not the transaction should be recharacterized for tax purposes on the grounds that the legal "form" chosen does not correlate with the substantive results.[47] In the economic substance arena, the court's analysis is based on the premise that particular statutory provisions intentionally attach certain tax consequences to particular transactions.[48] When the economic consequences justify restructuring the transaction, different legal relationships than those actually created, together with different tax results, may be imposed by the court.[49]

2. The Step-Transaction Doctrine

The step-transaction doctrine effectively permits the court to "step together," or collapse, a series of separate transactions into a single transaction. Thus, while several steps may be taken by a corporate entity to effectuate a particular result, the court is not bound by the form those transactions take. Rather, if the court determines that a series of transactions are interrelated, the focus will be on the ultimate result, and not the intermediate steps, when determining the tax consequences of the exchange.[50]

45. *See* Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945) (stating that the label placed on a transaction is not determinative); *see also* Gregory v. Helvering, 293 U.S. 465 (1935) (recharacterizing shares distributed tax-free in a reorganization as a dividend). *But see* Esmark, Inc. v. Commissioner, 90 T.C. 171 (1988), *aff'd* 886 F.2d 1318 (7th Cir. 1989) (illustrating the recent reluctance to recharacterize an otherwise statutorily legitimate transaction and respecting the prearranged stock acquisition).

46. *See generally* Joseph Isenberg, *Musings on Form and Substance in Taxation*, 49 U. CHI. L. REV. 859 (1982) (expounding on this vague and amorphous doctrine).

47. *Id.* at 879-80.

48. *Id.*

49. *Id.*

50. "The principle of looking through form to substance . . . is the cornerstone of sound taxation . . . ." Weinert v. Commissioner, 294 F.2d 750, 755 (5th Cir. 1961). *See* Marvin A. Chirelstein & Benjamin B. Lopata, *Recent Developments in the Step-Transaction Doctrine*, 60 TAXES 970, 970-75 (1982) (explaining the step-transaction doctrine as it relates to the relationship between substance and form).

Three variations of the step-transaction doctrine overlay decisions in corporate reorganization cases.[51] In *McDonald's Restaurants v. Commissioner*,[52] the court explained the variations as follows:

> The step-transaction doctrine is a particular manifestation of the more general tax law principle that purely formal distinctions cannot obscure the substance of a transaction . . . . [U]nder the "end result test," . . . "purportedly separate transactions will be amalgamated with a single transaction when it appears that they [are] really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result."
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> . . .
>
> A second test is the "interdependence" test, which focuses on whether "the steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the [entire] series.
>
> . . .
>
> Finally the "binding commitment" test most restricts the application of the step-transaction doctrine .... The "binding commitment" test forbids use of the step-transaction doctrine unless ... "there [is] a binding commitment to take the later steps."[53]

No clear guidance exists regarding the applicability or appropriateness of these variations.[54] In the context of corporate reorganizations, the anticipation of the doctrine's role becomes particularly relevant. The recharacterization of a transaction as merely a step that is a part of an overall plan to take subsequent steps may cause the transaction to fail nonstatutory requirements[55] with radically different results.[56]

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51. *See, e.g.*, Security Indus. Ins. Co. v. United States, 702 F.2d 1234, 1244-45 (5th Cir. 1983) (discussing the "end result," the "interdependence," and the "binding commitment" tests, and concluding that taxpayers could manipulate the step transaction doctrine by avoiding a formal commitment to dispose of stock received); Redding v. Commissioner, 630 F.2d 1169, 1177 (7th Cir. 1980) (utilizing the interdependence test to determine whether each transaction would have been effectuated without a completion of every other transaction in the series).

52. 688 F.2d 520 (7th Cir. 1982).

53. *Id.* at 524-25 (citations omitted); *see* Penrod v. Commissioner, 88 T.C. 1415, 1430 (1987) (explaining the applicability of the interdependence test); *see also Security Indus. Ins. Co.*, 702 F.2d at 1244-45 (discussing the various tests). Simply stated, if the ultimate objective is to achieve goal *X*, and to achieve such goal, *Y* action must be taken, the interjection of several meaningless transactions between *Y* action and *X* result will be ignored, and the taxpayer will be treated as if only action *Y* was taken. *Id.*

54. *See* Ronald H. Jensen, *Of Form and Substance: Tax-Free Incorporations and Other Transactions Under Section 351*, 11 VA. TAX REV. 349, 359-67 (1991) (providing examples of cases incorporating different step-transaction tests).

55. *See infra* Part II.C.4 (discussing the continuity of interest doctrine).

56. Previously, if, pursuant to a plan of reorganization, parent exchanges its stock, and acquires target stock or target assets, and in accordance with their earlier intention, and the target shareholders sell the parent stock received in the tax-free transaction for cash, for purposes of determining tax treatment of all of the target shareholders, the parent, and the target as well, the shareholders are likely to be viewed as not receiving an equity interest

3. *The Business Purpose Doctrine* [57]

Some purpose, other than tax avoidance, is required to consummate a transaction, and the regulations under section 368 take this requirement very seriously. The regulations state that the provisions for corporate restructuring are concerned with readjustments required by "business exigencies."[58] A transaction infused with obvious tax-avoidance motivation may be disregarded by the Service as a sham transaction, or may be recharacterized for tax purposes to better reflect its substance. The leading case on this subject is *Gregory v. Helvering*,[59] which established that in order for a transaction to fall within a particular Code provision, the requirements of the statute itself must be met *and* the transaction must possess an independent business purpose.[60]

4. *The Doctrine of Continuity of Interest*

The continuity of interest doctrine first developed by the judiciary in an effort to distinguish taxable sales from nontaxable exchanges. In *Cortland Specialty Company v. Commissioner*[61] and *Pinellas Ice & Cold Storage Company v. Commissioner*,[62] the courts were interpreting a newly enacted reorganization provision that contained a parenthetical regarding the extension of reorganization treatment to "merger-like" transactions.[63] In these two cases, the taxpayers transferred sub-

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in the acquiring corporation. This may cause the transaction to fail the continuity requirement, disqualifying it from reorganization treatment, imposing immediate tax liability on all participating parties. The Proposed Regulations change this result to the exact opposite. If adopted, the Proposed Regulations would remove the barrier to the post-reorganization dispositions. However, if the transaction is a purported "B" reorganization, the "solely for voting stock" requirement would not be met if the shareholders are considered to have received cash in exchange for their stock in the target.

To illustrate: on January 1, 2000, parent purchases 21% of target's stock and furnishes cash as the consideration for the exchange. On January 1 of the following year, the remaining 79% of target's stock is exchanged solely for voting stock in parent. The corporations effectuate these transactions in a purported "B" reorganization. In the above example, if the court combines the two transactions, parent will be treated as receiving all of target's outstanding stock for voting stock as well as cash, failing the requirements of a "B" reorganization.

57. Underlying this judicially created doctrine is the requirement that corporate transactions be undertaken with the objective of engaging in "business," and not avoiding taxation. Helvering v. Gregory, 69 F.2d 809 (2d Cir. 1934). Also, the acquiring corporation, to achieve reorganization, and hence, tax-deferred status, must continue the target's historic business, or use a significant amount of the business assets of the target corporation after the reorganization has been effectuated. *See* Gregory v. Helvering, 293 U.S. 465, 469-70 (1935) (declaring that for tax purposes a transaction will not be given effect absent a purpose other than avoidance of tax).

58. *See* Treas. Regs. §§ 1.368-1(b), (c) (1980) (elaborating on the business purpose requirement as it applies to acquisitive reorganizations).

59. 293 U.S. 465 (1935).

60. *Id.* at 469.

61. 60 F.2d 937 (2d Cir. 1932); *see id.* (distinguishing corporate-level asset sales from corporate restructuring and finding that the reorganization provisions presupposed a continuing interest in the transferred property).

62. 287 U.S. 462, 469-70 (1933); *see id.* (affirming the principle that the consideration furnished to the target shareholders must represent an "interest in the affairs" of the acquirer).

63. I.R.C. §§ 202, 203 (1926).

stantially all of their assets to the acquiring corporation and received cash and some short-term notes as the consideration for the exchange. Under the applicable Code section, tax-free treatment was only available if, among other things, the consideration received by the transferor(s) consisted of stock of the acquiring corporation.[64] The courts concluded that because the consideration did not consist of stock, the transaction did not uphold the general purpose of merger and consolidations by continuing the taxpayer's interest unliquidated.[65] Because the consideration received did not resemble the consideration required to be furnished in mergers or consolidations under state law, the Courts held that the transaction was not a reorganization for tax purposes.[66] Thus, the continuity doctrine was established. The *Pinellas* Court noted that to hold otherwise would render similar transactions indistinguishable from typical sales, an unlikely endeavor of the Legislature.

Unfortunately, the doctrine of continuity of interest has evolved erratically from its rational inception;[67] the relevant inquiry of the court regarding whether or not continuity exists has shifted unpredictably over time.[68] Initially, judicial scrutiny of the nexus between the quantum of stock and non-stock consideration given by the transferee to target shareholders to effectuate the merger dominated.[69] In *Groman v. Commissioner*[70] and *Helvering v. Bashford,*[71] the court explained that

64. *See Pinellas*, 287 U.S. at 469-70 (analyzing the applicable Code provisions); *Cortland*, 60 F.2d at 939-40 (establishing the principle behind the continuity of interest doctrine).

65. *See Pinellas*, 287 U.S. at 469-72 (explaining the applicable Code provisions); *Cortland*, 60 F.2d at 939-40 (examining the transaction in light of the continuity "requirement").

66. *See Pinellas*, 287 U.S. at 470 (disqualifying the transaction from reorganization status); *Cortland*, 60 F.2d at 940 (same).

67. *See* I.R.C. § 203 (1926) (containing requirements for tax-free treatment for the target).

68. *See* cases cited *infra* pp. 269-77.

69. When excessive non-stock consideration was conveyed, inquiry into permissible combinations of stock and non-stock consideration received amounted to a quantitative analysis. For example, the United States Supreme Court held that the interest in the acquiring corporation received by the target shareholders must be "definite and material." *See, e.g.*, John A. Nelson Co. v. Helvering, 296 U.S. 374, 377 (1935) (holding that because the consideration received consisted of 38% preferred stock in the acquiring corporation, continuity was satisfied). *Cf.* Southwest Natural Gas Co. v. Commissioner, 189 F.2d 332, 334 (5th Cir. 1951) (finding insufficient interest where less than one percent of the consideration received by the historic shareholders represented stock in the acquiring corporation).

70. 302 U.S. 82 (1937).

71. 302 U.S. 454 (1938).

Congressional intent to treat a reorganization as a continuation of the shareholders' investment unliquidated required the imposition of a "remote continuity" test.[72] Compliance with the statutory corporate reorganization requirements alone, the Court explained, is insufficient to warrant nonrecognition of gain upon an acquisitive reorganization.[73] According to these decisions, the relationship between the target corporation's shareholders' interest in the acquired corporation, relative to the interest they receive in the acquiring corporation, must possess certain characteristics to satisfy continuity.[74] These foundational opinions stand for the proposition that, in order for the tax-deferral provisions to apply, the historic shareholders must ultimately retain an equity interest in the acquiring corporation sufficient to show a "continuity" between the shareholders' original investment in the target and their subsequent investment in the acquiring corporation.[75] The Code's corporate reorganization provisions have repeatedly been amended to combat the restrictive interpretation of the "remote" continuity requirements in *Groman* and *Bashford*.[76]

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72. One aspect of the continuity of interest doctrine focuses on the "remoteness" or distance between the former target shareholders and the assets of the target which were transferred to the acquiring corporation, hence the term "remote continuity test." *See Groman*, 302 U.S. at 87-90 (failing the transaction on insufficient equity interest grounds). In *Groman*, the target shareholders transferred their target stock to a newly-created subsidiary of the parent. *Id.* In exchange, the shareholders received cash and stock in both the parent and subsidiary corporation. After the transfer, the target was liquidated into the subsidiary. The Court held that to the extent the target transferors received stock of the parent corporation, continuity did not exist. *Id.* To clarify, the percentage of consideration representing stock in the parent was not taken into consideration to determine if the applicable percentage of stock in the subsidiary (here, the acquiring) corporation requirement was satisfied. The facts of the companion case, *Bashford*, differed only slightly. The initial transfer of target property was made by the target shareholders to the parent but was subsequently transferred, pursuant to a single plan of reorganization, to the parent's wholly-owned subsidiary. *Bashford*, 302 U.S. at 455-56. The court applied the holding in *Groman* and disqualified the transaction from receiving nonrecognition status. *Id.* at 456-58.

73. *See* LeTulle v. Scofield, 308 U.S. 415, 420 (1940) (holding that despite satisfying the literal language of the statute, the transaction was not, in fact, a reorganization); *see also Pinellas Ice & Cold Storage Co.*, 287 U.S. at 469-70 (articulating that the interest in the purchasing corporation acquired by the transferor must be more than a short-term interest to qualify as a tax-free reorganization under the Code).

74. *See supra* notes 70-73 and accompanying text (reviewing these cases).

75. *See supra* notes 61-73 and accompanying text (synthesizing the early continuity of interest cases).

76. In 1954, Congress enacted Internal Revenue Code § 368(a)(2)(c) and provided that a transfer to a subsidiary of target stock or assets acquired through an "A" reorganization does not eliminate the potential for reorganization treatment. S. REP. No. 1622, 83rd Cong., 2d Sess. 51-52 (1954). Several Revenue Rulings were reversed by statute in an attempt to clarify the validity of the *Groman* doctrine. *Compare* REV. RUL. 67-326 (1967-2 C.B. 143) (holding that a merger of target into the subsidiary in exchange for stock in the parent, or controlling, corporation violated the continuity doctrine), *with* I.R.C. § 368(a)(2)(D) (1968) (providing that the transaction in Revenue Ruling 67-326, a "forward triangular merger," qualifies as a reorganization). Congress amended I.R.C. § 368(a)(1)(B) in 1964 to allow a parent corporation to transfer target stock to the parent's subsidiary subsequent to reorganization without violating the doctrine. S. REP. No. 830, 88th Cong., 2d Sess. 82 (1964). These amendments went far to reduce the reach of *Groman* and *Bashford*, effectively overruling both decisions. Interestingly, the formalistic interpretation of the "asset remoteness" aspect of the continuity doctrine survived and remained viable, however, in circumstances not specifically altered by the amendments. For a detailed discussion of the persistence of the *Groman* doctrine, see James A. Nitsche, *"Asset Remoteness" Problems Persist in Affiliated Group Acquisitive Reorganizations*, 83 J. TAX'N 94 (1995).

The judicial creation of an "equity interest" requirement, in the form of the continuity of interest requirement, raised fundamental questions that have been the subject of widely disparate, even conflicting, resolution.[77] Specifically, what quantum of interest in the acquiring corporation would the historic shareholders be required to hold? What qualities would the interest be required to possess? How long will historic shareholders be required to hold the stock representing their "equity interest?" Finally, of what import are pre- and post-reorganization dispositions of the "equity" stock? The disparate resolution, and added complexity,[78] of continuity requirements on corporate reorganizations have long been criticized by tax practitioners.[79]

a. Judicial Focus—Quality and Quantity of Acquired Interest

As noted above, to satisfy the continuity test the historic shareholders must exchange their target stock for stock in the acquiring corporation sufficient to represent an equity interest in the acquirer.[80] Several cases decided in 1935 exemplified the Court's "quantum" focus.

In *Helvering v. Minnesota Tea Company*,[81] the Court added that the continuity of interest requirement mandates that the shareholder's equity interest represent a "substantial part" of the value of the target stock transferred.[82] In this case, all of the assets of a target corporation were exchanged for common stock certificates and cash; the Court held that despite the cash transferred, the stock certificates (more than 50% of the consideration transferred) represented a substantial interest in the purchasing corporation sufficient to satisfy the doctrine.[83]

77. *See* cases cited *supra* notes 69-73 and accompanying text; *see infra* notes 81-96 and accompanying text.

78. The additional restrictions placed on reorganizations eventually became part of the Code itself. In 1933, Congress passed a bill that specifically delineated six types of reorganizations. *See* I.R.C. § 368 (1934) (replacing the judicial doctrine of continuity with a statutory mandate of shareholder continuity of interest).

79. *See, e.g.*, Bernard Wolfman, *Comments on the Continuity of Interest Regulations*, 74 TAX NOTES 371, 371-72 (1997) (viewing the Proposed Regulations as a step toward eliminating a judicial doctrine that has distorted legal analysis of acquisitive transactions and resulted in expensive and uncertain litigation); *see also* Martin D. Ginsburg, *Taxing Corporate Acquisitions*, 38 TAX L. REV. 177 (1983) (asserting that revision of the definitional standards applied in reorganization cases will vastly improve this complex area of law that "makes [no] sense at all").

80. *See* Cortland Specialty Co. v. Commissioner, 60 F.2d 937, 939-40 (2d Cir. 1932 (underscoring the importance of Congressional intent regarding the reorganization provisions and how imposition of a continuity requirement furthers Legislative goals); Pinellas Ice & Cold Storage Company v. Commissioner, 287 U.S. 462, 468-70 (elucidating the original focus of the judicial continuity doctrine).

81. 296 U.S. 378 (1935).

82. *See id.* at 385 (stating that "this interest must be definite and material; it must represent a substantial part of the value of the thing transferred").

83. *Id.* at 386.

Fifty percent stock consideration, however, is not an absolute. The Court found continuity satisfied in *John A. Nelson Company v. Helvering*,[84] where 38% of the consideration consisted of stock, and 62% was furnished in cash.[85] This case represents the Service's position regarding the minimum quantum of stock consideration that must be furnished when the transaction involves a substantial amount of cash as well.

For advance ruling purposes, the Internal Revenue Service has stated that, when focused on the quality and quantity of the interest received, the continuity requirement is satisfied if the consideration, when considered in the aggregate, consists of 50% stock in the acquiring corporation.[86] To clarify, if one or more target shareholders[87] receive an aggregate stock interest in the acquirer equal to at least 50% of the value of all of the acquirer's outstanding stock, continuity is satisfied.[88]

The quantum approach was further refined in *LeTulle v. Scofield*,[89] the first case to imbue the judicial doctrine with the requirement that, beyond representing a "substantial," or "definite and material" interest, as explained in *Minnesota Tea*, the interest must be proprietary.[90] Based on the Court's holding, if the consideration furnished to the target shareholder does not consist of some quantum of stock in the acquiring corporation, the shareholders fail to obtain sufficient interest in the acquirer to classify the transaction as a reorganization.[91] This case represented a clear departure from merely interpreting vague language within the Code, and propelled an entirely new concept—the character of the interest acquired—into judicial inquiry.[92]

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84. 296 U.S. 374 (1935).

85. *Id.* at 376-77. Additionally, in *Southwest Natural Gas Co. v. Commissioner*, 189 F.2d 332 (5th Cir. 1951), the court refused to find the requisite interest where less than 1% of the consideration consisted of acquirer stock. *Id.* at 338.

86. REV. RUL. 66-224, 1966-2 C.B. 114.

87. Because it is often inevitable that some shareholders will not agree to accept stock as consideration, the Service has stated that it is not required that every target shareholder become a shareholder in the acquiring corporation to satisfy the rule. *See* Reilly Oil Co. v. Commissioner, 189 F.2d 382, 384 (5th Cir. 1951) (recognizing that not all shareholders will desire to participate in the newly formed entity).

88. The Proposed Regulations state that the continuity requirement will be applied with regard to stock of the corporation in control of the acquirer, or the merged corporation, depending upon the nature of the triangular reorganization. *See* Prop. Treas. Regs. § 1.368-1(e)(2); *see also* Rev. Proc. 77-37, 1977-2 C.B. 568, § 3 (utilizing the acquisition, by target shareholders, of 50% of the value of all outstanding acquirer stock in the aggregate approach to extend reorganization treatment).

89. 308 U.S. 415 (1940).

90. *See id.* at 420-21 (holding that 100 year bonds do not represent requisite interest because such bonds render the transferee a creditor, and not one with a "proprietary interest in the enterprise").

91. *Id.*

92. Indeed, even though the transaction in *LeTulle* satisfied the earlier "quantum" tests under *Cortland* and *Pinellas*, and could have been effected under the statutory requirement of several state law provisions, the Court held that the transaction failed to furnish the target shareholders acquiring corporation stock, and therefore could not qualify as a tax-free reorganization. Previously, courts had held that if securities were received, sufficient interest was retained. *See* Commissioner v. Tyng, 106 F.2d 55, 59 (2d Cir. 1939) (citing several circuit court holdings), *rev'd*, Helvering v. Buchsbaum, 308 U.S. 527 (1940).

b. Judicial Focus—Temporality and Post-Reorganization Dispositions

In *Southwest Natural Gas Company v. Commissioner*,[93] the court required the historic shareholders to retain the stock received following a tax-free transaction.[94] The court in *Southwest* failed to state any requisite period of time that would satisfy continuity, but noted the significance of target shareholders' pre-arranged plans or arrangements to dispose of the stock received.[95] Thus, to satisfy the continuity requirement under this inquiry, the shareholders must demonstrate that, at the time the reorganization was effectuated, they had no plans to dispose of the stock interest furnished as the consideration that qualified the transaction as a tax-free reorganization. In Revenue Ruling 66-23, the Internal Revenue Service stated that the historic shareholders, as a group, must maintain an unrestricted, indefinite ownership interest in the acquiring corporation.[96] Resolution of the inquiry regarding the temporality of the consideration received and post reorganization continuity is made through application of the step transaction doctrine.

A determination of target shareholders' intent to dispose of the stock leads the court to examine all of the relevant facts and circumstances surrounding the disposition.[97] For example, where the shareholders were granted an option to sell the stock received, and did so immediately following the purported reorganization, the court held the disposition failed the continuity requirement.[98] The disqualification precluded the transaction from qualifying as a reorganization.[99] In *Morgan Manufacturing Company v. Commissioner*,[100] the court held that the continuity of interest requirement was not met when shareholders agreed to give up their stock interest in the acquiring corporation in consideration for the acquiring corporation's repayment of certain shareholders' debts.[101]

93. 189 F.2d 332 (5th Cir. 1951).

94. *See id.* at 334. Indeed, the court specified that the facts of every case presented must be examined to determine whether or not a "substantial proprietary stake" in the new corporation was retained by the former target shareholders, as well as whether such interest represented a significant portion of the entire consideration exchanged in the transaction. *Id.*

95. *Id.* at 334-35.

96. REV. RUL. 66-23, 1966-1 C.B. 67; *see also* REV. RUL. 78-142, 1978-1 C.B. 112 (concluding that five years sufficed to indicate that the interest retained was, in fact, definite and substantial).

97. Muskegon Motor Specialty Co. v. Commissioner, 134 F.2d 904, 907 (6th Cir. 1943).

98. Banner Mach. Co. v. Routzahn, 107 F.2d 147, 149 (6th Cir. 1939), *cert. denied*, 309 U.S. 676 (1940).

99. *Id.*

100. 124 F.2d 602 (4th Cir. 1941).

101. *See id.* at 605 (disqualifying the transaction for failing to meet the continuity requirements).

McDonald's Restaurants of Illinois v. Commissioner[102] represents a recent case where the unsettled guidelines and focus of judicial inquiry resulted in the establishment of poor case law. This case involved McDonald's Restaurants' acquisition of several restaurant corporations owned by a franchisee-target. Initially, McDonald's, the parent-acquirer, offered their stock as consideration; the controlling target shareholders rejected the tender offer because they wanted cash, not stock.[103] Eventually, McDonald's was able to reach a compromise with the shareholders when the shareholders agreed to accept McDonald's stock with the understanding that they would be able to offer that stock for sale in a public offering planned three months after the reorganization.[104] McDonald's merged with the target, and six months later the target shareholders disposed of nearly all of their stock in the acquiring corporation.[105] McDonald's reported the transaction as a taxable sale. Interestingly, the Internal Revenue Service claimed that the transaction should receive tax-free status. The Service relied on several factors[106] in arriving at the conclusion that the shareholders retained their interest long enough to satisfy continuity.[107] Specifically, both prior to and contemporaneous with the reorganization, the taxpayer was not contractually bound to dispose of the stock representing a proprietary interest in the acquiring corporation.[108] The Tax Court held that because the shareholders remained at risk regarding the value of the acquiring corporation stock they received in the transaction, the continuity of interest requirement was satisfied and the transaction was a tax-free reorganization.[109] On appeal, the Tax Court's decision was overruled.[110] The Court of Appeals stated that under any version of the step transaction test, McDonald's failed to satisfy the continuity test because at the time the reorganization was entered into, the shareholders intended to dispose of the stock representing their unliquidated interest in the acquiring corporation; the transaction should therefore be treated as a taxable event.[111]

In contrast, in *Penrod v. Commissioner*,[112] the target shareholders sold all of the parent stock seven months after reorganization.[113] The Tax Court, however, found

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102. 688 F.2d 520 (7th Cir. 1982).

103. *Id.* at 522.

104. *Id.*

105. *Id.*

106. The relevant factors included: (1) At no time did the shareholders request cash; (2) a positive relationship existed between McDonald's and the franchisee, sufficient to find the franchisee had no reason to terminate professional dealings with McDonald's; and (3) there was written evidence that the target shareholder had no intention to dispose of the stock received in the transaction. *See id.* at 523-24.

107. *Id.*

108. McDonald's Restaurants v. Commissioner, 688 F.2d 520, 523-24 (7th Cir. 1982).

109. *See* McDonald's v. Commissioner, 76 T.C. 972 (1981) (reporting the Tax Court opinion, later reversed at 688 F.2d 520 (7th Cir. 1982)).

110. *McDonald's Restaurants*, 688 F.2d at 520.

111. *Id.* at 523.

112. 88 T.C. 1415 (1987).

113. *Id.* at 1419-21.

that continuity was satisfied in this case because at the time of reorganization, the shareholders intended to retain their stock; events after the reorganization gave rise to their desire to sell, and the eventual decision to sell was not to be included in the determination of continuity.[114]

These cases represent the increased uncertainty regarding the interpretation of corporate reorganizations. Under the principles set forth in these case holdings, the post-acquisition conduct of target shareholders have the potential to determine the tax consequences of corporate transactions for numerous entities. The results are added complexity for taxpayers and, in the case of a publicly-held corporation with large numbers of shareholders, unadministrability for the Internal Revenue Service.[115]

III. J. E. SEAGRAM—IMPETUS FOR CHANGE

In 1995, the Tax Court decided *J.E. Seagram v. Commissioner*,[116] a case which turned on whether or not pre-reorganization disposition of the equity stock received by the target shareholders disqualified the transaction from reorganization status. The inquiry also involved the step transaction doctrine and led the court to conclude that the transaction amounted to a single "plan of reorganization" and did not represent independent transactions.[117] Concluding that the steps taken by Seagram were all part of an overall plan to effectuate a single result, the court held that the transaction satisfied the continuity requirements, much to the chagrin of the taxpayer, who wanted a tax deduction for the loss sustained.[118] Conceptually, the Tax Court's opinion in *Seagram* is not harmonious with the Internal Revenue Service's published position regarding post-reorganization continuity of interest,[119] and does

114. *Id.* at 1434-39. In another case, Christian Estate v. Commissioner, T.C. Memo 1989-413 (1989), the Tax Court held that the continuity of interest test was satisfied even though the stock received in a merger was sold as part of a public offering four months after reorganization.

115. Ascertaining the intent of shareholders in a publicly-held corporation is not practical from an administrative perspective. Attempting to track the desires of even a few individuals is generally impossible. Individuals change their minds; they believe they will act in a particular way and later behave completely inconsistently with their original intentions. Relying on "intent" as a litmus test for determining the tax consequences of corporate reorganizations is imprecise.

116. 104 T.C. 75 (1995).

117. *Id.* at 100-01.

118. *Id.* at 104-05. In a reversal of typical roles, the Internal Revenue Service was arguing for tax-free treatment and the taxpayer wanted the transaction treated as taxable exchange (so he could deduct the loss sustained). Perhaps the oddity of the position the parties' had taken led the court to examine the transaction more closely.

119. *See* REV. RUL. 66-23, 1966-1 C.B. 67.6 (stating that "unrestricted rights of ownership for a period of time sufficient [to conclude] that such ownership is definite and substantial" will suffice, regardless of whether "the shareholder is required . . . to dispose of the stock before the end of such period," and stating that "five years of unrestricted rights of ownership" is sufficient to satisfy the continuity test); *see also* REV. RUL. 95-69, 1995-42 (finding that distribution of stock received in merger by non-liquidating partnership did not negatively impact continuity).

not provide a strong foundation for treating post- versus pre-reorganization dispositions differently for tax purposes.

A. *The Factual Background*

During the summer of 1981, after two competing tender offers of acquisition, a subsidiary of DuPont Holdings, Incorporated (DuPont) owned 46% of the outstanding stock in Conoco; J.E. Seagram owned 32%; and the general public held 22%.[120] Conceding that it would never successfully acquire the Conoco corporation, Seagram tendered its shares of Conoco to DuPont for DuPont stock worth significantly less than the Conoco holdings.[121] Conoco subsequently merged with DuPont.[122] Thereafter, Seagram exchanged its Conoco stock for DuPont's subsidiary stock and attempted to claim a loss on the shares originally obtained in an effort to acquire Conoco.[123]

The Internal Revenue Service disallowed the loss and issued a deficiency for the tax liability owed.[124] The Service argued that the entire transaction was a reorganization under section 368.[125] Oddly enough, the Service was arguing for classifying the transaction as tax-free, rather than taxable. Going even further, the Service asserted that a continuity test that "includes third party transactions in target stock" that are not attributable to the acquirer's plan of reorganization "does not further Congress' purpose and should be rejected."[126]

Seagram, the taxpayer, argued that acts taken during the tender offer competition between Seagram and Conoco were independent of one another and caused the transaction to fail the continuity test.[127] The taxpayer posited that the transaction amounted to a taxable exchange, and that the loss realized should be recognized for tax purposes.[128] It also cited a variety of cases[129] in which the Service held that the changes in stock ownership prior to reorganization were stepped together with the eventual acquisition, resulting in a recognized sale.

The court distinguished the cases Seagram offered as precedent in two ways. First, the court found that the cases were different because the consideration fur-

120. *Seagram*, 104 T.C. at 87-88.
121. *Id.* at 88.
122. *Id.* at 89.
123. *Id.* at 89-90.
124. *Id.* at 90-91.
125. *Id.* at 91-92.
126. *Seagram*, 104 T.c. at 94-95.
127. *Id.* at 93.
128. *Id.*
129. *See id.* at 101-02 (listing the cases relied on by *Seagram*). *See, e.g.*, Yoc Heating Corp. v. Commissioner, 61 T.C. 168, 177-78 (1973) (holding that a transaction involving an acquiring corporation's purchase of 85% of the target's stock for cash and the creation of a subsidiary to which the assets of the target were transferred in exchange for subsidiary stock was a taxable sale).

nished to the target shareholders in *Seagram* was cash, not stock or securities.[130] Second, as suggested by the Service, the court stated that the continuity requirement was meant to distinguish sales by the target shareholders to the acquiring corporation from continuing investment by the shareholders in a reorganized entity.[131]

The court agreed with the Service and held that the parties fail or pass the continuity test solely as a result of the consideration furnished in the exchange. A disposition of the target stock prior to the reorganization does not effect continuity provided that the consideration for the stock does not originate with the acquirer.[132]

B. Practical Implications

In redirecting the focus of continuity inquiry back to the *Cortland* and *Pinellas* approach, the court made it clear that the result in cases focusing on target shareholder conduct, while proper as an application of the step transaction doctrine, is no longer precedent when the issue is continuity of interest. To clarify, whether or not continuity exists sufficient to grant tax free status is to be determined *solely* by examining the characteristics of the consideration received by the target shareholders. Although the court established a workable guideline for determining whether or not continuity is satisfied—if the proper consideration is furnished, and the pre-reorganization disposition is not attributable to the acquirer, the transaction qualifies as a reorganization—their decision has had greater impact on the world of corporate reorganizations than simply redirecting the focus of a judicial doctrine.[133]

Holding that the pre-reorganization disposition of equity stock should not impact the determination of continuity, the court has called into question the policy rationale behind the relevancy of post-reorganization dispositions. If the focus of continuity should be on the nature of the consideration given to effectuate an acquisition, disposing of the equity stock after reorganization should not disqualify the transaction from receiving nonrecognition treatment if the transaction cannot otherwise be characterized as a sale.

It would be perplexing if judicial inquiry of post-reorganization continuity continues to focus on target shareholders' plans to dispose of the equity stock received, as in the "temporality" cases,[134] or the actual disposition of the equity stock, as in the "disposition" cases,[135] given the opinion in *Seagram*. It makes little sense to

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130. *Seagram*, 104 T.C. at 101.

131. *Id.* at 103.

132. *Id. But see id.* at 103-04 (holding that changes of stock ownership of the target prior to reorganization do not violate the continuity of shareholder interest test).

133. *See* Gilbert D. Bloom, *Taxpayers Have More Planning Flexibility in Reorganization After* Seagram—*If It Survives*, 82 J. TAX'N 334 (1995) (elaborating on the potential impact of the *Seagram* decision).

134. *See* cases cited *supra* pp. 276-78 (cogitating the "temporality" approach to dispositions of the equity stock).

135. *See* cases cited *supra* pp. 276-78 (analyzing cases that focus on disposition of the equity stock post-reorganization).

disqualify a transaction from receiving reorganization treatment because a shareholder intends to sell the acquiring corporation stock to another shareholder *the day after* the reorganization, but to allow him to sell his stock to the same individual *the day before* without negatively impacting the status of the transaction.

The potential for the illogical result noted above has recently been addressed through the proposal of new Treasury Regulations.[136] The remainder of this Comment will address the technical and practical impact the regulations have on corporate reorganizations under section 368 of the Code.

IV. THE PROPOSED REGULATIONS—SOME OBSERVATIONS REGARDING WHAT HAS BEEN AND WHAT WILL BE

The Internal Revenue Service has published Proposed Regulations regarding the relationship between the judicial doctrine of continuity of interest and post-reorganization dispositions by target shareholders of the acquirer stock received pursuant to a plan of reorganization.[137] These regulations provide that in certain reorganizations,[138] stock transferred to qualified group members[139] will not disqualify the transaction from tax-free reorganization treatment under Chapter C of the Internal Revenue Code.[140]

A. *The Regulatory Scheme*

As explained in the regulations, if an acquiring corporation furnishes consideration to the target shareholders which represents a sufficient proprietary interest in operations of the acquirer, certain post-reorganization dispositions by the former target shareholders of that equity interest will not be taken into consideration for subsequent determination of the requisite continuity.[141] Thus, the doctrine of continuity of interest will be refocused on the mix of consideration issued by the acquiring corporation rather than on what interest the target shareholders retain.

136. Prop. Treas. Regs. § 1.368-1(b), -1(d), -(f).

137. *Id.*

138. The Regulations, if adopted, will apply to transfers subsequent to successful "A," "B," "C," and "G" reorganizations. *See supra* Part II.B (defining these reorganizations).

139. *See* Prop. Treas. Regs. § 1.368-1(f)(1)(I) (incorporating § 1.368-1(d)(5)(iii) and defining "qualified group" as at least one chain of corporations connected through specified stock ownership requirements of I.R.C. § 368(c) (1997)).

140. *Id.* § 1.368-1(f)(1)(I).

141. *Id.* § 1.368-1(f)(1)(I)-(ii) (declaring that continuity is not violated where there is a transfer or successive transfer of target stock or assets among members of the qualified group). Numerous positive comments regarding the proposed revision have been noted. *See* 1997 Daily Tax Rep. (BNA) 2, at G6 (labeling the proposal a "significant step forward," a "sea change" in the corporate reorganization area) (quoting Mark Silverman with Steptoe & Johnson, Washington and Lawrence Garrett, Arthur Andersen LLP, Washington).

Practitioners have frequently suggested revision of the corporate reorganization provisions or a limitation of the scope of continuity requirements.[142] Allowing taxpayers to transfer assets or stock received following reorganization refocuses analysis of continuity on the consideration received in corporate combination transactions, shifting the inquiry away from the conduct of the historic shareholders and toward the acquiring corporation. The Internal Revenue Service explained that because the earlier reorganization provisions failed to specify the requisite consideration to be furnished by the acquirer, the courts, to effectuate Congressional intent and distinguish taxable from tax-deferred exchanges, found it necessary to imbue these business transactions with equity interest requirements.[143] The Service noted that the circumstances surrounding the creation of the continuity of interest doctrine did not involve post-reorganization transfers by the historic shareholders; the cases giving rise to the requirement involved a mixture of stock and excessive non-stock consideration. The Service emphasized that the proposed rules do not expand the scope of business transactions that would qualify as reorganizations and stated that all of the facts and circumstances surrounding corporation reorganizations are proper subjects of analysis.[144] However, the Regulations themselves do not specify the necessary amount of equity stock that is required as consideration. The failure to specify the requisite amount of consideration leaves that issue either under the controlling precedent of the "quantum" line of cases outlined previously, or subjects the issue to litigation for resolution.

B. The Sordid Past

As this Comment reveals, the legislative and judicial developments in the last decade, and the policy vagaries of the continuity of interest doctrine itself, allow for inconsistent, even illogical, results. The hotly debated decision in *Seagram* regarding pre-reorganization dispositions and the historic shareholder concept have focused attention on the validity of the continuity doctrine as a whole. From its inception, the continuity doctrine was intended to focus solely on the nature of the consideration furnished by the acquiring corporation, and not on what the target shareholders did with the consideration post-merger. As long as the sale of the acquiring corporation stock was to unrelated third parties, and not to a buyer, or a buyer's affiliate, the sale should not defeat continuity. Indeed, the Congressional

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142. *See generally* Peter L. Faber, *Continuity of Interest and Business Enterprise: Is It Time To Bury Some Sacred Cows?*, 34 TAX LAW. 239 (1981) (advocating for a corporate tax environment without these stringent judicial requirements); Robert A. Jacobs, *Reorganizing the Reorganization Provisions*, 35 TAX L. REV. 415 (1980) (generally urging reform of Subchapter C's reorganization provisions); Bernard Wolfman, *"Continuity of Interest" and the American Law Institute Study*, 57 TAXES 840 (1979) (quantifying the results of a study regarding corporate reorganizations).

143. *See generally* Prop. Treas. Regs. § 1.368 (expounding the underlying principles regarding the continuity requirements).

144. *Id.*

debates surrounding adoption of the reorganization provisions reveal that Congress was concerned with the nature of the property transferred by the acquired corporation.[145] The Legislature assumed that the consideration furnished would be stock in the acquiring corporation, and nonrecognition was extended to those individuals receiving qualified stock in exchange for stock. Because Congress did not specify the quantum or quality of the consideration required to be furnished, the courts were called upon to interpret the vague statutory language. Courts initially relied upon the "continuity test" to help distinguish sales, or taxable events, from non-sales, or reorganizations, in order to determine whether or not gain realized should be recognized for tax purposes.[146] Accordingly, the cases laying the foundation for the test were concerned with whether the nature of the consideration furnished was consistent with the concept of a "reorganization," a tax-free exchange,[147] and not with whether post-reorganization continuity existed.

Eventually, the courts began to examine dispositions of the continuity interest postmerger. The language in some of these decisions makes clear that the courts felt the continuity of interest test required some semblance of a continuing ownership interest in the acquiring corporation *after* the merger had been effectuated, and did not merely refer to the nature of the consideration furnished. Because this interpretation is inconsistent with the legislative history surrounding the adoption of the cooperate reorganization provisions themselves, its reliability is called into question.

C. The Importance of McDonald's *and* Seagram

In the *McDonald's* case, the Tax Court found for the Service and held that the transaction was a tax-free reorganization.[148] The court noted that the cases in which the continuity of interest doctrine developed were not "helpful" because examination of later dispositions, even if prearranged, should not destroy continuity.[149] In the court's view, once the target shareholders acquire a sufficient proprietary interest in the acquiring corporation, they should be free to dispose of their shares irrespective of whether the disposition takes place prior to or after the

145. *See* 61 CONG. REC. 6550, 6561-569 (1921). For a good discussion of this early legislative history, see Valentine Brookes, *The Continuity of Interest Test in Reorganizations—A Blessing or a Curse?*, 34 CAL. L. REV. 1 (1946).

146. *See supra* Part II.C.4 (cataloging the requirements of the continuity of interest doctrine).

147. In defining a "reorganization," section 203 of the Revenue Act of 1924, ch. 234, section 203(h), 43 Stat. 253 (1924), granted wide latitude for all types of changes in existing corporate structure. In *Cortland Specialty Co. v. Commissioner*, 60 F.2d 937, 940 (2d Cir. 1932), however, the court noted that the Legislature "[did] not abandon the primary requisite that some continuity of interest on the part of the transferor corporation or its stockholders exist in order to secure exemption. Reorganization presupposes continuance of business under modified corporate forms." *Id.*

148. *McDonald's*, 688 F.2d at 532-33.

149. *Id.*

merger.[150] Additionally, the court stated that "the Internal Revenue Service, the commentators, and at least one court all agree that a post merger disposition, even within a short interval, will not break continuity if the disposition is unrelated to the merger."[151] The court held that the fact that the target shareholders intended to sell their proprietary interest in the acquirer did not vitiate the discretionary nature of such sale.[152] Most importantly, the court's holding asserts that it is the province of the Legislature, and not the Judiciary, to infuse a holding period requirement into the corporate reorganization environment.[153] Unfortunately, the Tax Court's opinion was reversed by the Seventh Circuit.[154] Applying the step-transaction doctrine, and collapsing several distinct acts into one,[155] the Court of Appeals noted that the target shareholders had always intended to sell their acquiring corporation stock, and that the merger would not have occurred unless the wishes of the target shareholders to sell the acquirer's stock were accommodated.[156]

The Internal Revenue Service itself has offered little guidance on its views of post-transaction continuity. Revenue Procedure 77-37, which states the Service's general requirements for issuing advance rulings on reorganization validity, implies that sales occurring during or after a reorganization *that are not part of the overall plan of reorganization* will not be considered in determining continuity.[157] Different results might be reached if the target shareholders are contractually bound to sell their acquiring corporation stock prior to the merger, or if a pre-merger disposition is made, to the acquiring corporation itself.

Several cases involved pre-reorganization sales. All of these cases involved sales of the acquirer stock that were included in the overall plan of reorganization.[158]

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150. *See generally McDonald's*, 688 F.2d 520.

151. *McDonald's*, 76 T.C. at 996-97.

152. *Id.* at 997 n.45; *Id.* at 998-99. The Tax Court surmised that they would have reached a different result if there had been a definitive obligation at the time of reorganization to sell the acquirer stock. *Id.* at 999 n.52.

153. *See generally McDonald's*, 688 F.2d 520.

154. *Id.*

155. While the court reached it decision formally through application of the step-transaction doctrine, the court also considered various "additional considerations." *McDonald's*, 688 F.2d at 527-28. Notably, the court found the Commissioner's position regarding the corporation's tax liability objectionable since the Service had already reaped the benefits of collecting taxes from the shareholders on the sale of the stock. *Id.*

156. *Id.* at 523-25. The court cited several factors that evidenced the intent of the shareholders to sell: The overall relationship between the target shareholders and the acquirer, the rights to participate in a future public offering of stock, and the determination of the shareholders to sell regardless of the profit or loss on sale. *Id.*

157. Rev. Proc. 77-37, 1977-2 C.B. 568, § 3.02. If the Proposed Regulations are adopted this Revenue Procedure will be superseded.

158. *See, e.g.*, Kass v. Commissioner, 60 T.C. 218 (1973), in which a corporation bought 84% of the target's stock for cash and later absorbed the target in a statutory merger. Because of the absence of continuity of interest, the Tax Court held that the parent's (i.e. the acquiring corporation) stockholdings did not contribute to continuity because the holdings were acquired as part of the plan for eventual acquisition. In *Yoc Heating Corp. v. Commissioner*, 61 T.C. 168 (1973), a corporation bought over 85% of a target corporation's stock for cash and later caused the target to merge into one of the acquiring corporation's wholly owned subsidiaries. *Id.* at 168-69. The court held that the merger and acquisition were part of an overall plan to acquire the target and the previously acquired holdings could not be counted toward continuity. *Id.* at 171-78. In both of these cases, the cash purchase

All of the dispositions were made *to the acquiring corporation*, or its affiliates. In these cases, where the buyer reacquired its own stock, the requisite continuity did not exist. However, despite the failure of the transactions in these cases to satisfy the continuity test, the proposition that a sale *to a third party* will disqualify the transaction from tax-free status does not follow.

The court faced the "third party scenario" in *Seagram*. While the reasoning of the *Seagram* case[159] is incompatible with the Seventh Circuit's result in *McDonald's*,[160] the *Seagram* decision is more soundly based. Taking a functional approach to the determination of continuity, the court queried whether the disposition of the acquiring corporation stock received in the merger was part of the overall plan of acquisition. In that case, although the cash purchases of stock coincided with the acquisition, the court found that they were not part of the same transaction for purposes of applying the continuity of interest test.[161] The Service argued successfully in *Seagram* that only purchases made "pursuant to the acquiring corporation's plan of reorganization should count" when determining continuity.[162] The Service added that *any formulation* of the continuity test that includes disposition of the acquiring corporation's stock to third parties does not further Congressional intent and "should be rejected."[163] The slight variance regarding the time of sale should not be dispositive. Conditioning the result of tax litigation on whether or not a shareholder sells the equity stock the day before, or the day after, reorganization establishes an arbitrary and illogical basis for determining the tax consequences to significant business transactions, and leaves little room for effective tax planning.

Although the Internal Revenue Service has taken the position that post-reorganization sales of the acquiring corporation's stock by the acquired corporation's shareholders defeat continuity if they were contemplated at the time of the reorganization, the Service's position in *Seagram* seems to suggest that sales to unrelated third parties *do not* defeat continuity if the acquiring corporation does not facilitate them.[164] Adopting the Service's position—a test that depends on ascertaining human intent—will present huge administrative burdens regarding implementation. Target shareholders may not divulge their true intent prior to

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was part of an overall acquisition plan of the acquiring corporation, and combining the previous stock purchases with the eventual acquisition seems more justified than in situations involving unrelated third parties.

159. In *Seagram*, the court held that pre-reorganization disposition of the stock representing a proprietary interest in the acquiring corporation does not negatively impact the resolution of whether continuity existed at the time of reorganization. *Seagram*, 104 T.C. at 99.

160. The continuity requirements were not met in *McDonald's*. *See McDonald's*, 688 F.2d at 523-24 (recounting that the formulation of the intent to dispose of the acquiring corporation stock prior to reorganization precluded the transaction from qualifying as a tax-free reorganization).

161. *Seagram*, 104 T.C. at 102-03.

162. Brief for Internal Revenue Service at 97, J.E. Seagram, Corp. v. Commissioner, 104 T.C. 75 (1995).

163. *Id.*

164. *Seagram*, 104 T.C. at 93-101.

participating in a reorganization; still others may change their mind and refuse to dispose of stock they previously planned to sell.[165] Hinging some target shareholders' tax consequences of participating in a reorganization on the intentions of other target shareholders presents additional difficulties.

D. The Proper Test

Because the Proposed Regulations do not effectively add much clarity to this confusing area of the law, the substantive and procedural positions of the Service require extensive examination. The primary function of the continuity of interest doctrine should be limited to supplementing the statutory definitions of corporate acquisitions that *do not* state an explicit quantum of stock consideration requirement. Thus, the doctrine should be expressly limited to sections 368(a)(1)(A) and 368(a)(1)(D) of the Code because these sections do not expressly enumerate the type of consideration required. Hence, post-reorganization sales would generally not implicate the continuity of interest doctrine, thereby avoiding the risk of disqualifying the transaction from tax-free status.

In focusing exclusively on the consideration furnished, the Proposed Regulations constrict the necessity of the step transaction doctrine as it applies to continuity of interest, and provide the clarity necessary for target shareholders to accept equity stock in a reorganization knowing that they are free to dispose of their stock after the reorganization is concluded. Additionally, given the holding in *Seagram*, target shareholders are free to sell their target stock prior to the reorganization without impacting the status of the transaction for the other shareholders or corporate entities involved.[166]

1. Application of the Step Transaction Doctrine

The changes have been heralded as eliminating archaic legal strictures that hinder the "business world in which reorganizations get done."[167] In the future, courts can apply the continuity test by focusing exclusively on the consideration furnished by the acquiring corporation at the time of the reorganization. Only when a question arises regarding whether or not a cash purchase or sale prior to the reorganization destroys continuity should the court apply a modified step-transaction test to determine if the sale can be attributed to the buyer. The proper test for resolving this issue should clearly set a standard for determining whether, *at the time of reorganization*, the transfer qualifies as a tax-free exchange. By establishing a definitive position, the Internal Revenue Service can minimize the

165. *See McDonald's*, 76 T.C. at 998 n.43 (noting the inability of the court to discern a taxpayer's intent).
166. *See supra* Part III.B (opining the practical significance of the *Seagram* decision).
167. 1997 Daily Tax Rep. (BNA) 2, at d11 (quoting Barry Isaacs of Deloitte & Touche, L.L.P. California).

potential for inconsistent resolution of tax cases and further Congressional intent by extending tax-free status only if the transaction satisfies the underlying purposes of nonrecognition.

The "end-result" and "interdependence" versions of the step-transaction doctrine require the court to engage in the difficult, if not impossible, determination of the taxpayer's subjective intent.[168] Application of these versions has led to inconsistent results; the uncertainty surrounding resolution of reorganization cases renders a significant portion of corporate tax planning inefficacious.

The "binding commitment test,"[169] however, is devoid of these complications. Under this version of the step-transaction doctrine, the court objectively examines the circumstances surrounding the transaction to determine whether an obligation to sell the shares of acquirer stock received in the transaction existed *prior to the acquisition*. If the obligation existed, the transaction is a taxable exchange. If no such obligation existed, the transaction is a tax-free reorganization. When necessary to resort to application of a test to determine this issue, the "binding commitment" test provides taxpayers and tax planners the certainty they need to effectuate necessary changes in corporate structure. Additionally, the objective nature of the test poses no administrative burden. Ascertaining the true intent of the target shareholders is unnecessary.

2. *Examining the Characteristics of the Consideration Furnished*

Outside of reorganizations accomplished under sections 368(a)(1)(A) and 368(a)(1)(D), judicial inquiry should be limited to the nature of the consideration paid by an acquiring corporation in an acquisitive reorganization. The Proposed Regulations eliminate several of the courts' previous methods to determine continuity. If judges are to inquire about the consideration furnished, and not to whom it was furnished, or how long it was retained, the holdings in several cases utilizing such an approach are rendered meaningless. Additionally, redirecting judicial inquiry toward the consideration furnished will put an end to the uncertain and confusing interpretation of the Code's requirements regarding the non-recognition of reorganizations.

Despite these positive changes, the Proposed Regulations do not specify the quantum or quality of stock consideration required to effectuate a reorganization, although the Regulations note that it is this consideration that must be examined to

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168. *See supra* Part II.C.2 (describing the "end result" test as one that combines seemingly separate transactions into a single transaction when the transactions are intrinsically related).

169. *See supra* Part II.C.2 (stating the "interdependence" test as one where the court examines the various transactions to determine whether they would have been inefficacious without all of the other steps taken to achieve the final result).

determine whether continuity is met.[170] The position of the drafters of the Proposed Regulations regarding the consideration required for statutory mergers could, and should, have been specified. But, much like the drafters of the 1954 Code, they failed to address this concern. Continuity of interest was designed to effectuate Congressional intent to defer taxation of illiquid corporate shares. The proposal, if adopted, should be augmented with a quantitative requirement regarding the equity consideration furnished in reorganizations effected under sections 368(a)(1)(A) and 368(a)(1)(D). These reorganizations, as noted above, do not expressly contain quantum of stock requirements.[171] As such, neglecting to address these two provisions expressly fails to clarify two widely used and important reorganization schemes, and creates a fissure through which the judiciary may drive a new doctrinal wedge.

Despite the indication that the courts will not drop below the 38% quantum deemed acceptable in *Nelson v. Helvering*,[172] the Proposed Regulations should have been accompanied by a quantitative requirement in order to avoid future inconsistent and vague decisions like those that have led this area of the law into the abyss. For example, one practitioner advocates a requirement of 50% or 80% equity consideration, and suggests that such a requirement is an appropriate trade-off for allowing a target shareholder to do with the equity stock what he pleases post-reorganization.[173] The Proposed Regulations, if adopted, could expressly require that the consideration furnished by the acquiring corporation be no less than 30% equity stock to satisfy what would remain of the continuity of interest doctrine. If the consideration furnished is less than 30% equity stock, for purposes of a 368(a)(1)(A) or 368(a)(1)(D) reorganization, continuity is not present. Regardless of the amount, establishment of a definite standard is necessary.

VII. CONCLUSION

The Tax Court's opinion in *Seagram*, establishing that certain dispositions of target stock prior to reorganization do not effect continuity, and the Proposed Regulations, that allow the prior target shareholders to dispose of their equity stock to related parties, result in a reorganization environment in which the doctrine of con-

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170. *See generally* Prop. Treas. Regs. § 1.368-1(b), -1(d)(5), -1(f) (narrowing the focus of inquiry to the consideration furnished in the exchange).

171. *See* discussion *supra* Part II.B.1, 4.

172. *See supra* notes 85-86 and accompanying text (discussing the *Nelson* opinion).

173. *See* Lee A. Sheppard, *Why Repeal Continuity of Shareholder Interest?*, TAX NOTES, Feb. 3, 1997, at 550 (explaining that the Proposed Regulations impose few, if any, restrictions on either consideration or disposition of acquiring corporation stock). However, despite the fact that the Proposed Regulations are designed to minimize confusion and instill greater certainty in the planning of reorganizations, mandating an "80% rule" in the context of an "A" or "D" reorganization seems too harsh. The requirements in Revenue Procedure 77-37—that 50% of the consideration be equity stock in the acquiring corporation—for purposes of receiving a letter ruling appear more reasonable, but would require reconciliation with the decision in *Nelson*, where 38% was deemed sufficient.

tinuity of interest is largely non-existent. Because target stockholders can actively trade with third parties, those shareholders that wish to recognize gain or loss on their stock holdings are free to do so without determining the tax consequences of the transaction for the remaining shareholders that desire to continue their investment in the acquiring corporation. Additionally, the success of a corporate enterprise may depend in large part on proper structuring of assets and stock among its related business entities. By permitting acquiring corporations to relocate acquired assets or stock freely within their corporate group[174] without affecting continuity, the corporate officers' business acumen is respected. Efficient markets dictate that where the success of an acquisition depends on the acquiring corporation's ability to mobilize the benefits of acquiring another corporation, it should be permissible to do so without triggering immediate tax liability.

174. *See* Prop. Treas. Regs. § 1.368-1(f) (defining "controlled group" as a group consisting of one or more chains of corporations connected through stock ownership with the issuing corporation).

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