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New (Old) Issues In Reorganizations: Revenue Procedure 94-76, the "Anti-*Yoc Heating*" Regulations and the *Seagram* Case

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Downstream Mergers: Revenue Procedure 94-76

On December 13, 1994, the Service issued Revenue Procedure 94-76. That revenue procedure provides that the Service will not issue rulings on transactions where two corporations are combined and one of the corporations owns stock in the other, but the first corporation is not an "80 percent distributee" of the second corporation under Section 337(c). The revenue procedure cites the possibility that transactions of this type may circumvent the repeal of the *General Utilities* doctrine. It also noted that the Service was considering issuing regulations under Section 337(d) with respect to such transactions.

The notice applies to: (i) a "downstream" merger of a parent corporation into a non-controlled[1] subsidiary; (ii) an "upstream" merger of a non-controlled subsidiary into a parent corporation; and (iii) the acquisition by a third party of a parent and a non-controlled subsidiary in a transaction in which the parent and subsidiary are combined. Most of these transactions might have qualified as reorganizations prior to the issuance of this revenue procedure. See *Commissioner v. Gilmore's Estate*, 130 F.2d 791 (3rd Cir. 1942), *acq.* 1946-2 C.B. 2 and Rev. Rul. 85-197, 1985-2 C.B. 120 (situation i); Rev. Rul. 58-93, 1958-1 C.B. 188 (situation ii); *George v. Commissioner*, 26 T.C. 396 (1956), *acq.* 1956-2 C.B. 5 and Rev. Rul. 68-526, 1968-2 C.B. 156 (situation iii).

The Old Reorganization Issue

Historically, the Service had been hostile to downstream mergers of parent corporations into non-controlled subsidiaries, arguing that such transactions were in substance taxable liquidations of the parent. After losing a few cases (see, e.g., *Edwards Motor Transit v. Commissioner*, 23 T.C.M. 1968 (1964), *Commissioner v. Gilmore's Estate*, supra), the Service issued Revenue Ruling 85-197, supra, which had generally been perceived as the Service's surrender on this issue.

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The New Reorganization Issue

A downstream merger involving a non-controlled subsidiary allows a corporate asset (the parent's stock in the non-controlled subsidiary) to escape any corporate-level taxation, arguably circumventing the repeal of the *General Utilities* doctrine.

Scope and Related Issues

Revenue Procedure 94-76 only applies to transactions where the parent and the subsidiary are combined. It does not apply to transactions where the parent corporation acquires control of the non-controlled subsidiary via a "B" reorganization, or through a triangular reorganization such as an (a)(2)(E) or (a)(2)(D) (a "holding company transaction"). If the parent corporation is not an attractive candidate for a holding company, the subsidiary might acquire all of the stock of the parent via a "B" reorganization or a triangular reorganization, resulting in the parent becoming a wholly owned subsidiary of the non-controlled subsidiary (an "inversion transaction"). Though an inversion transaction may result in an unusual organizational chart, it achieves roughly the same result as a downstream merger. However, since the corporate level gain in the non-controlled subsidiary's stock does not vanish, it seems arguable that the Section 337(d) concern posed by the revenue procedure should not apply.[2]

In Notice 94-93, however, the Service announced that it was reviewing inversion transactions, citing the possibility that such transactions might permit the avoidance of income or gain in circumvention of the repeal of the *General Utilities* doctrine as one basis for such

[1] As a technical matter, the test is not "control" under Section 368(c) (80 percent of all voting stock, and 80 percent of the total number of shares of all other classes of stock), but the 80 percent vote and value test under Section 1504(a)(2) (80 percent of all voting stock and 80 percent by value of all stock (excluding "plain vanilla" preferred stock)). See Code §§ 337(c), 332(b), 1504(a)(2). This paper will generally refer to such relationship as "control" except where the context requires otherwise.

[2] See, however, Notice 89-37 and Prop. Treas. Reg. § 1.337(d)-3 (dealing with so-called May Company transactions). These proposed regulations would treat any stock acquired by a partnership in which one of the partners was the issuer of such stock as partially redeemed at the time of such acquisition, even though the stock remains outstanding.

review. Notwithstanding the foregoing, regulations issued pursuant to Notice 94-93 will not have retroactive effect unless the inversion transaction occurs after September 22, 1994 and the transaction is "disproportionate," e.g., it occurs on terms which do not reflect the relative values of the stock involved.[3] See Notice 94-93, supra. Thus, at the present time a "proportionate" inversion transaction should not be impacted by Notice 94-93.

Under prior law, where a subsidiary owned stock of its parent, the subsidiary could distribute the stock to the parent and, although such distribution might result in the creation of intercompany gain, such gain could be deferred indefinitely so long as the parent held the stock in treasury and did not reissue it. See GCM 39608. The new consolidated return regulations on intercompany transactions reverse this result, and trigger gain recognition whenever a corporation acquires its own stock from one of its subsidiaries, regardless of the form of such acquisition. See Treas. Reg. § 1.1502-13(f)(4). Thus, anyone considering an inversion transaction will have to be prepared to accept the awkward corporate organizational structure discussed above indefinitely.

Existing Commentary

Most of the commentary on Revenue Procedure 94-76 has focused on downstream mergers. One set of comments on Revenue Procedure 94-76 argued that all downstream mergers should trigger gain. See Report of the Tax Section of the New York State Bar Association on Notice 94-93 and Rev. Proc. 94-76, dated January 1, 1994 ("NYSBA Report"). However, the report argued that all upstream mergers should not be subject to gain recognition. While agreeing that there was no substantial difference between these two transactions, that report argues that since situations where abuse is likely will involve a substantial, possibly publicly-traded subsidiary, the upheaval involved in getting such a subsidiary to undertake an upstream merger should provide an effective check against such abuses. The NYSBA Report also suggested that any inversion transaction resulting in a non-controlled subsidiary acquiring control of the parent should trigger immediate gain recognition (on the theory that such gain will effectively escape taxation once the stock has been acquired by a member of a consolidated group).[4]

Other commentators have argued that the decision to trigger gain should be based, at least in part, on whether the companies being combined have significant operating assets. See Report of the Corporate Tax and Affiliated and Related Corporations Committees of the ABA Tax Section on Notice 94-93 and Rev. Proc. 94-76, dated July 27, 1995 ("ABA Report"). The ABA Report noted that a combination of two substantial operating companies, one of which has some cross-ownership in the other, would probably be for reasons other than a desire to avoid recognition of the imbedded gain in the non-controlled subsidiary's stock. However, the ABA Report also recognized that implementing such an approach would require some amount of arbitrary line drawing, and would result in a "facts and circumstances" approach to the problem which could result in increased costs of compliance as well as uncertainty of result.

Still other commentators have argued that the entire review by Treasury is misguided, and that mergers between parents and their non-controlled subsidiaries are not inconsistent with the repeal of the *General Utilities* doctrine. See Comments of KPMG Peat Marwick on Notice 94-93 and Revenue Procedure 94-76 ("KPMG Comments"); see also Comments of the Corporate Tax Committee of the Los Angeles County Bar Association Tax Section on Inversion Transactions and Downstream Mergers ("LACBA Comments"). The LACBA Comments argue that the repeal of the *General Utilities* doctrine relates fundamentally to ensuring that corporate earnings are

[3] The example given in the notice involved a transfer by shareholders of all of their stock in a holding company (which had assets, including its stock in a subsidiary, with a value of $400) to a subsidiary of the holding company (which had assets with a value of $100) in exchange for 90 percent of the stock of the subsidiary (a "disproportionate" inversion). On a stand alone basis, the contribution of assets worth $400 to a company with an existing value of $100 should only have merited an 80 percent interest in the resulting corporation (a "proportionate" inversion).

[4] In such situation the reason for applying Section 337(d) (that a corporate asset has been disposed of without triggering a corporate level tax) appears fairly weak. The asset still exists, but is in the consolidated group. The possibility continues to exist that the gain would be taxed, although admittedly the likelihood of such tax being triggered would be fairly remote. The NYSBA Report cites Notice 89-37 as further support for a position triggering immediate gain. Compare, however, Treas. Reg. § 1.1502-13(f)(iv), discussed above (distribution of parent company stock to parent triggers deferred intercompany gain with respect to such stock). Thus, there is no longer any ability to eliminate effectively and permanently the gain potential.

subject to a two-tier tax system, but that imposition of tax on downstream mergers would essentially result in a three-tier tax system. The ABA Report, in considering the issues associated with a downstream merger of a "pure" holding company, also notes that there is little consensus regarding the precise scope of *General Utilities* repeal, noting for example that a variety of provisions in the Code (such as Section 355) are contrary to the position that the repeal of the doctrine generally takes precedence over all other aspects of the Code.

Another issue raised in the comments deals with the probability or likelihood that regulations may be issued addressing how to deal with a parent corporation's gain inherent in the stock of a non-controlled subsidiary when control of that subsidiary is acquired. The policy issues raised by the Revenue Procedure and the Notice (escaping corporate tax on its subsidiary's stock) are also present in such situations. See ABA Report, Example IB. See also discussion of NYSBA Report, above, discussing whether gain should be triggered on a proportionate inversion transaction.

What Is Not Covered

At present, either a holding company transaction or a "proportionate" inversion transaction may be used to achieve a result contrary to Revenue Procedure 94-76. Even after regulations under Section 337(d) are issued, a corporation holding a sufficiently large block of a subsidiary's stock will still be able to achieve that result by engaging in a holding company transaction.

Circumventing General Utilities Repeal

There is admittedly some potential for abuse raised by downstream mergers. For example, consider a situation where a large corporate taxpayer spins-off or splits-off a company whose major asset is highly appreciated, publicly traded stock in another company.[5] The spun-off company then decides, a short but not unseemly time later, to merge into the publicly traded company at a slight discount to the market value of the stock it holds. The end result of this transaction is that the shareholders of the corporation, as well as the distributing corporation, have engaged in a tax-free distribution of the highly appreciated, publicly traded stock.[6]

A different example shows the other side of the argument. Consider a situation in which a taxpayer makes a venture investment in a start-up company that has promising technology. Assume that the venture's technology is successful, and becomes integrated into products made by the investing corporation. At that point, the investing corporation might consider a merger. The net result of such a merger is not in substance a "distribution" of stock, but instead a combination of the two companies.

Some of the commentary on Revenue Procedure 94-76 has argued that, regardless of whether there is an "effective" distribution of stock, the second example discussed above may also circumvent the repeal of the *General Utilities* doctrine because an appreciated asset (the stock) escapes corporate level tax. The precise basis for the position that such a transaction circumvents the repeal of the *General Utilities* doctrine is not well developed in the comments. While it is true that the stock will never be subject to tax on its built-in appreciation, this is due to the fact that the stock is canceled in the merger—it disappears. In this, it is not dissimilar to the effective disappearance that occurs where the subsidiary becomes consolidated with the parent. At that point, the stock also becomes effectively meaningless as an investment (see discussion in next paragraph). The only major distinction in this context is that in the direct merger, the organizational lines between the companies are completely erased, while in a consolidation context the stock continues in existence.

The disappearance of stock in the above situation should not, by itself, justify triggering gain. Certain provisions of the income tax laws (such as Section 332 and the consolidated return regulations) tend to support the theory that at some level of stock ownership, stock ceases to be an investment asset and instead represents only a different way to organize a company's operations. In furtherance of this, the Code and the regulations generally provide that once consolidation is achieved, the amount of basis a corporation has in a subsidiary's stock ceases to have much significance. See, e.g., Sections 332 and 337 (no gain or loss on liquidation), Treas. Reg. § 1.1502-20 (no loss on sale). Instead, the stock (and the division between two corporations that it represents) is

[5] Along with a relatively small five-year active trade or business, such as an art gallery or radio station.

[6] Although the Service could attack some of these transactions under the Section 355 "device" test, the ones which have been commented upon in the press have generally been able to get private letter rulings for their spin-offs or split-offs.

largely ignored except for certain bookkeeping purposes.[7] See, e.g., Treas. Reg. §§ 1.1502-32 and 1.1502-13. Under this view, when stock is canceled in a merger, it should be viewed as little more than the erasure of artificial divisions. And, as noted above, there seems to be no compelling reason for permitting corporations to obtain consolidation with non-controlled subsidiaries (at which time their stock tends to lose its investment value and become merely a means of organizing a business), while not allowing a direct merger of the subsidiary and the parent (at which time the divisions between the corporations are completely erased). The transactions have results which are, practically, identical.

It might be argued, however, that the provisions of Section 332 and 337 are specific in their scope, and that while such a change in the character of stock might be contemplated where control has been acquired, where such control does not exist there is no reason to treat stock owned by a corporation as anything other than an investment. Other provisions of the Code, however, tend to recognize that stock owned by a corporation may have a somewhat different status than stock owned by an individual, and that such status triggers at levels well below 80 percent. Thus, the dividends received deduction phases in, and the deemed paid foreign tax credit applies, at lower than 80 percent ownership levels

For the foregoing reasons, it seems that the appropriate analysis in determining whether a downstream merger circumvents the repeal of the *General Utilities* doctrine should focus on whether the stock at issue is being held as an investment by the corporation, or is instead a means of organizing operations. Where the stock is held by a parent primarily in its "investment" capacity, the practical effect of a downstream merger (where the other assets held by the parent are not significant) may be a distribution of such investment.[8] In such situations, a downstream merger could tend to circumvent the repeal of the *General Utilities* doctrine. However, where the intent underlying a particular transaction is not to distribute the subsidiary's stock, but to combine operations, then the fact that some amount of corporate cross-ownership disappears as a result of such combination should not be considered to circumvent the repeal of the *General Utilities* doctrine. This is consistent with the view that stock which is not being held by a corporation for investment represents merely a means of organizing a business (and the disappearance of such stock when such operations are combined should not be considered a "distribution" so much as the erasure of a boundary).

Unfortunately, intent is not a very workable standard. The most flexible (though probably least sure) method to resolve these issues seems to be the one outlined in the ABA Report. The approach discussed in that report would call for a facts and circumstances analysis, considering whether the parent and subsidiary are both operating companies, the amount and type of other assets held by the parent corporation, and such other factors as might tend to show that the companies involved are in substance combining their businesses rather than simply distributing stock of one entity to the shareholders of the other.[9]

Probable Scope of Regulations

Since the concern expressed in Revenue Procedure 94-76 relates only to the avoidance of a corporate level tax on the disappearing stock, the regulations which may be issued should probably be limited in scope to triggering a corporate level gain on such stock. Thus, if a downstream merger otherwise qualifies as a reorganization under applicable law, the transaction should still provide non-recognition treatment for the parent corporation's shareholders and for the parent corporation's assets other than its stock in the non-controlled subsidiary.

Consolidated Group Issues

Revenue Procedure 94-76 provides that it applies to transactions where two corporations are combined, one corporation has stock of the other, and the companies do

[7] It is worth noting that, in general, these rules tend to apply only in situations where the application of the more standard tax rules would produce a benefit, and that where no benefit is available (or application of such rules produces a harmful result), the traditional rules usually apply.

[8] The dividing line for deciding what is "insignificant" is somewhat blurry. If the parent corporation's assets other than the stock in the subsidiary are liquid assets, the fact that they are large in relation to the value of the stock should not be particularly telling.

[9] Although virtually identical issues are raised by a successful holding company transaction as by a downstream merger, the fact that the companies remain separate and the stock remains in existence (so that there is still a technical possibility that gain might be recognized in the future) makes the issuance of any regulations attacking such transactions under Section 337(d) problematic.

not have the relationship described in Section 1504(a)(2). The definition of an affiliated group is in Section 1504(a)(1), and that definition provides that a company may be a member of an affiliated group where one or more includible corporations own stock in another corporation of the type described in Section 1504(a)(2). Accordingly, the scope of this Revenue Procedure is such that it includes a merger between corporations that have always been in a consolidated group, but where one corporation is not owned at least 80 percent by the company into which it is merging (which might result accidentally due to a debt/ equity recharacterization). It is hard to imagine a situation where a combination under such circumstances might be considered abusive.[10]

Substance over Form Issues

There is an implication in the NYSBA Report that a "substance over form" argument might be appropriate to trigger gain after an effective holding company transaction (e.g., the parent acquires control of the non-controlled subsidiary) if the subsidiary is subsequently liquidated. While, if the two transactions are part of a single plan, the transaction might be recast as a "C" reorganization (and since such a reorganization might be a combination subject to Revenue Procedure 94-76, gain might be triggered). See Rev. Rul. 67-274, 1967-2 C.B. 141 (a "B" reorganization followed by a liquidation which occurs as part of a plan of reorganization is tested under the "C" reorganization rules). However, application of the step transaction doctrine where the two steps are not so indivisibly linked that they might be viewed from the start as a "C" reorganization, raises the possibility that any transaction to acquire control of another corporation might be used later as evidence of a bad intent to escape the strictures of Revenue Procedure 94-76.

This may also present a trap in situations where a purchaser makes a qualified stock purchase under Section 338 in several steps (and at varying prices), does not make a 338 election and liquidates the target. As discussed below, the regulations under Section 1.338-2(c) (the "Anti-*Yoc Heating*" regulations) would generally permit such a transaction. However, if the value of the target increased after the time of the initial purchase and prior to liquidation, it is possible that application of the step transaction doctrine in this situation might require recognition of gain on the stock acquired before full control was obtained.

Acquisitive Combination Issues

One transaction that does not appear to have been discussed very much involves the acquisition, by a third party, of both the parent corporation and its non-controlled subsidiary (scenario iii). The issues involved in that sort of acquisition seem somewhat different than in a more typical (scenario i) downstream merger. No policy should be violated by such third party's acquisition of control of either or both of the parent or the subsidiary in separate transactions. Nor is there any reason why an acquiring corporation should not be able to acquire control of both such corporations in a single transaction. However, as a practical matter there is little possibility a transaction of that sort can occur without a combination of the parent and the subsidiary.[11] Concerns over abuses, such as where the third party is formed by a facilitator to accomplish an otherwise prohibited downstream merger between a parent and its non-controlled subsidiary, could be covered adequately by an anti-abuse provision.

Continuity of Interest: The "Anti-*Yoc Heating*" Regulations and the *Seagram* Case

On October 26, 1995, the Service issued final Treasury Regulation Section 1.338-2(c)(3), dealing with continuity of interest after a qualified stock purchase. On January 24, 1995, the Tax Court issued a decision in *J.E. Seagram Corp. v. Commissioner*, 104 T.C. No. 4 (currently on appeal to the Second Circuit). Both the final regulations and the *Seagram* case consider the judicially created doctrine of

[10] Where the constituent corporations have not always been in the consolidated group, concerns may be raised because a first step transaction might acquire both the parent and the non-controlled subsidiary, and a second step (consolidated group) transaction might eliminate the intercompany stock ownership. As discussed below, there does not seem to be a strong reason not to prevent this type of transaction, but the issues involved are somewhat different than in a pure consolidated group context.

[11] For liability reasons, most corporations prefer that acquisitions occur as triangular reorganizations. However, triangular reorganizations must generally occur at the first tier level. If the amount of overlap between the two corporations being acquired is too great, the requirement that the parent corporation be in "control" of the target after the acquisition (in an (a)(2)(E) or (a)(2)(D)) may be violated unless a combining transaction occurs.

continuity of interest, and specifically the identity of "historic shareholders."

Treasury Regulation Section 1.338-2(c)(3) applies to situations where one corporation has made a qualified stock purchase ("QSP") of the stock of a target corporation, does not make a Section 338 election, and subsequently liquidates or merges the target into itself or an affiliated corporation. Relying on congressional intent not to permit corporations to treat a stock sale as an asset sale except where a qualified stock purchase has occurred and a Section 338 election has been made, these regulations provide that for purposes of determining continuity of interest, the purchaser shall be treated as an "historic shareholder" of the target. They also provide that the purchasing corporation shall be treated as a shareholder for purposes of determining whether the reorganization falls within the scope of Section 368(a)(1)(D). The regulations also provide that, as to any minority shareholders participating in the subsequent merger, the stock owned by the purchaser will generally not be treated as being owned by an historic shareholder.

In *Seagram*, the Tax Court considered a situation in which Seagram, Mobil and DuPont made competing tender offers for Conoco. Ultimately, DuPont's offer succeeded, but not before Seagram had acquired roughly 32 percent of the Conoco shares outstanding at the beginning of the contest. Upon realizing that DuPont would be successful, Seagram tendered the shares it had acquired to DuPont. If the shares of Conoco acquired by Seagram were not considered held by an historic shareholder, then the "historic" Conoco shareholders would have received no more than 22 percent stock in the transaction.[12] However, the Tax Court held that the stock of DuPont acquired by Seagram as part of the transaction should be treated as received by an historic shareholder of Conoco for purposes of determining continuity of interest, and accordingly found that there was roughly 54 percent continuity.

The Old Reorganization Issue

The Service had been successful in arguing that mergers occurring after a large cash tender offer for the stock of a target did not qualify as a reorganization since the "historic shareholders" of the target did not receive sufficient stock to satisfy continuity of interest. See *Yoc Heating v. Commissioner*, 61 T.C. 168 (1973), *Superior Coach of Florida v. Commissioner*, 80 T.C. 895 (1983) and *May B. Kass v. Commissioner*, 60 T.C. 218 (1973), *affirmed* 491 F.2d 749 (3rd Cir. 1973).

The New Reorganization Issue

In *Seagram*, the Tax Court held that the shareholders of a target prior to the time of the commencement of a series of tender offers were not necessarily the "historic shareholders" of the corporation for continuity of interest purposes. Thus, the court found reorganization treatment proper where the facts indicated that, at most, only 22 percent of the shareholders of Conoco prior to the commencement of the tender offers obtained DuPont stock. The Tax Court found that Seagram was an "historic shareholder," even though Seagram had purchased its stock in Conoco for cash only a few days prior to tendering to DuPont. In a similar vein, Treasury Regulation Section 1.338-2(c)(3) provides that a purchasing corporation that has made a qualified stock purchase of a target corporation's stock, but has not made a section 338 election, and then has merged or liquidated the target with a member of the purchaser's affiliated group, will be treated as an historic shareholder.

Discussion: Seagram

In *Seagram* the Tax Court made what appears to be a radical departure from the concept of "historic shareholder" used in *Yoc Heating*, *May B. Kass* and *Superior Coach*. The crux of the Tax Court's opinion appears to be that everyone who owns stock immediately prior to the effective time of the reorganization is an historic

[12] There were approximately 86 million shares of Conoco common stock outstanding at the start of the contest. Seagram acquired approximately 27.7 million shares of Conoco common stock. DuPont then exercised an option to acquire 15.9 million shares from Conoco (since these shares were issued by Conoco and not acquired from shareholders they were not considered by the Tax Court). DuPont also acquired 39.6 million shares for cash and 40.9 million shares for DuPont stock (including the 27.7 million shares tendered by Seagram).

shareholder, and only in those situations where a person acquires stock as part of an agreed-upon plan or arrangement with the purchaser will such person not be considered an "historic shareholder." Thus, since Seagram and DuPont were acting independently of each other in their competing tender offers, Seagram was considered an historic shareholder.[13]

The Tax Court had the most difficulty reconciling their decision with the line of cases dealing with post-acquisition continuity. See, e.g., *McDonald's Restaurants of Illinois v. Commissioner*, 688 F.2d 520 (7th Cir. 1982) (preexisting intent to dispose of shares received in merger, facilitated by registration of such shares by the purchasing corporation, caused transaction to fail continuity of interest); see also *Heintz v. Commissioner*, 25 T.C. 132 (1955) (similar holding). The court in *Seagram* agreed with the characterization of the *Heintz* case pressed by Seagram's counsel, e.g., that a post-acquisition sale of stock that was admittedly not pursuant to the plan of reorganization caused continuity to fail where the sale established an intent to divest the old shareholders of their proprietary interest in the continuing company. The court, however, disagreed that post-reorganization continuity and pre-reorganization continuity were identical concepts. Instead, the court held that in determining post-acquisition continuity "we must look not to the identity of the target's shareholders, but rather to what the shares represented when the reorganization was completed." See *Seagram*, supra. The Tax Court seems to be advocating the position that historic shareholders status is relevant only for pre-acquisition continuity purposes, while for post-acquisition continuity purposes, the relevant inquiry is whether the persons receiving stock in the transaction have a plan to dispose subsequently of an amount of such stock sufficient to destroy continuity. This is a distinction towards which many commentators have expressed some degree of skepticism.[14]

Some commentators have argued that a closer analysis of the *McDonald's of Illinois* decision leads to the conclusion that it is also based on the theory that only sales or dispositions that are part of a single "plan" of reorganization are considered for purposes of determining continuity, and that accordingly, continuity will be maintained even where such dispositions are anticipated but are not part of the "plan" of reorganization. See Willens and Phillips, "Do Equity Swaps Affect Satisfaction of Continuity of Interest?" Tax Notes at 101 (July 3, 1995). Although the words used by the Seventh Circuit to explain the holding in *McDonald's of Illinois* refer to the intended disposition of the stock as part of a "plan," as used in the opinion that term was broadly defined and appears to include almost any situation where there is an intent on the part of the shareholders receiving stock to dispose of it.[15] Thus, although the court in *McDonald's of Illinois*

[13] In an article dated March 7, 1995, Robert Willens of Lehman Brothers argued that the Tax Court had misconstrued certain prior precedent on this issue. Mr. Willens noted that in *Superior Coach* the court found that a purchase by a shareholder of the purchaser of all of the stock of the target for cash, followed by a merger between the purchaser and the target, was not a valid reorganization. The Court in *Seagram* distinguished that situation by noting that the parties had acted in concert, and that the purchase was "inextricably interwoven" with the merger, and accordingly the transaction failed because the shareholders were considered acting on behalf of the corporation. Mr. Willens noted, however, that in Rev. Rul. 68-562, 1968-2 C.B. 157, the Service had held that the prior purchase by the controlling shareholder of 50 percent of the stock of the target should not be considered attributed to the purchaser corporation, since in such situations the shareholder can be considered to act on its own behalf, rather than on behalf of the corporation.

[14] See, e.g., comments of Dana Trier and Professor Bernard Wolfman at May 1995 meeting of the ABA Tax Section, Corporate Tax Committee (reported on in a May 23, 1995 article in Tax Notes Today). Professor Wolfman argued that the way to reconcile these pre- and post-acquisition continuity positions was to find that *McDonald's of Illinois* was incorrectly decided, and instead provide that post-acquisition continuity should be measured by reference to the activity of the purchasing corporation only (and disregard sales to third parties, who have no relationship to the plan of reorganization). See also Peter Faber, "Postreorganization Sales and Continuity of Interest," Tax Notes 863 at 872 (August 14, 1995).

[15] Mr. Willens' position suggests that, so long as there is no overt assistance from the acquiring corporation, an enforceable agreement to sell the stock acquired in the reorganization will not affect continuity of interest. Thus, where a 100 percent owner of the target disposes of all of its stock, pursuant to a binding commitment to do so, by entering into one of the equity swaps discussed in Mr. Willens' article (assuming that an equity swap affects continuity), there would be no adverse affect. The language in the *Seagram* opinion, discussing post-acquisition continuity, would tend to indicate that no continuity exists in such a situation. The decision in the *McDonald's of Illinois* case might find that such a disposition was part of the "plan," even though it may never have been discussed with the purchasing corporation.

found that the acquiring corporation had assisted in the subsequent sale (e.g., by registering the stock), such activity did not appear to be critical to the court's holding that the subsequent sale was part of a single plan. The intent of the shareholders to sell appears to have been much more critical. See also *Penrod v. Commissioner*, 88 T.C. 1415 (1987) (focusing on shareholder's intent to sell as the touchstone for determining whether post-acquisition continuity exists).

In an August 14, 1995 article in Tax Notes, Peter Faber examined the doctrine of post-acquisition continuity, and argued, as he had done in a 1981 article, that the doctrine had little usefulness and should be largely abandoned. See Faber, "Postreorganization Sales and Continuity of Interest," Tax Notes at 863 (August 14, 1995) ("Postreorganization Continuity"). Mr. Faber noted that the cases from which the continuity of interest doctrine developed largely focused on the type of consideration received, and not on the length of time it was held.[16] He argued that *McDonald's of Illinois* largely missed the mark, focusing on the step transaction doctrine rather than analyzing continuity of interest, and noted that the court failed to adequately consider whether it was appropriate to treat the subsequent sales as part of the "plan" of reorganization. In discussing the *Seagram* case, Mr. Faber found the Tax Court's attempt to reconcile the post-reorganization continuity cases with the pre-reorganization cases unconvincing. See Postreorganization Continuity at 872.

The Willens and Faber articles both focus, to some extent, on defining a "plan" of reorganization. As noted in Mr. Willens' article, *McDonald's of Illinois* can be construed to hold that the sales at issue were part of the "plan" of reorganization. However, the development of the doctrine since that case has tended to focus largely on the intent of the shareholders.[17] See *Penrod*, supra. Mr.. Faber's article, on the other hand, tends to focus on the fact that once continuity-giving consideration has been received, third-party transactions affecting individual shareholdings should have little bearing on whether the underlying transaction was a valid reorganization.[18] This is basically in keeping with the Tax Court's premise for finding that Seagram was an historic shareholder. Because there was no understanding or agreement (and hence no "plan") between Seagram and DuPont, Seagram's acquisition of the shares of Conoco had no effect on continuity.

Although the Tax Court tried to distinguish post-reorganization continuity from the situations facing it in *Seagram*, most commentators seem to find the basis for the distinction rather weak.[19] The problem, as noted in the Willens article, is that many practitioners believe that the state of the law on post-reorganization continuity is based largely on the intent of the shareholders. See *Penrod*, supra; see also *Seagram*, supra ("[p]etitioner points out that these cases hold that a sale that was not pursuant to the plan of reorganization was fatal to continuity of interest where the sale 'establish[ed an] intent to divest'.").

[16] The one possible exception, *Nelson v. Helvering*, 296 U.S. 374 (1935) considered the issuance of preferred stock that was redeemable by the issuing corporation over a number of years following the transaction. The Supreme Court determined, however, that such stock was adequate to provide continuity of interest.

[17] In addition, the "assistance" in the *McDonald's of Illinois* case was relatively minor, consisting of piggyback registration rights and a demand registration right if the stock had not otherwise been registered in a few years. In practice, virtually every stock transaction will result in some form of registration rights, since the failure to obtain them places a significant drag on the value of the stock received.

[18] Two concerns are present here. First, as a policy matter it seems rather ludicrous that the unexpressed intent of a group of shareholders, as to which the parties negotiating the transaction may have no idea, could cause the transaction to fail to qualify as a reorganization. Second, as a practical matter most takeovers involving publicly held companies typically result in virtually all of the stock being acquired by arbitragers at some point in the few weeks prior to the transaction. Unless the holding in the *Seagram* case, or something reasonably similar, is upheld on appeal, then public company reorganizations may become quite difficult to opine upon.

[19] For example, under the *Seagram* case, it would appear to be perfectly okay for a shareholder to sell to a third party the day before the effective date of a merger (and such third party would be an historic shareholder), but it would be fatal for continuity purposes if that same shareholder entered into an agreement to sell the shares acquired in the merger to that same third party the day after the transaction.

Mr. Faber's article, however, argues that intent of shareholders is largely irrelevant, and that only in transactions where the acquiring corporation has some sort of arrangement to reacquire its shares from the former target shareholders should continuity be impacted. Arguably, only in that situation is the subsequent sale of the stock by the shareholders part of the "plan" of reorganization. This is because, as a practical matter, shareholders are often absent from the discussions and negotiations leading to an acquisition, and rarely play a major part in structuring a transaction. In such a situation, it seems odd to say that their acts and intentions (which are often unexpressed and even more often unsolicited) should somehow be integrated into the "plan" of reorganization.

However, in certain situations (such as the *McDonald's of Illinois* case), the shareholders of the target really were involved in structuring and negotiating the transaction, and the ultimate goal was not to provide such shareholders with an interest in the combined operations of the company, but instead to have them cash out. As noted in Mr. Faber's article in Tax Notes, the case law underlying the continuity of interest doctrine was concerned with whether the former shareholders of the target retained an equity interest in the continuing enterprise. Retaining such an interest was not the intended result of the parties involved in the *McDonald's of Illinois* transaction. There the parties really intended to receive cash, and they achieved this structure by arranging a "wired" sale of all of the stock they received. Although the sale of the stock received was to third parties, given the liquidity of the financial markets and the likelihood that McDonald's could float a secondary offering, there was little practical difference between giving stock which was going to be immediately resold and giving them cash.[20]

As noted above, the *Seagram* case is currently on appeal to the Second Circuit. As a practical matter, it seems unlikely that the taxpayers in Seagram will get the treatment they want since the effect of such a decision would be to make it very difficult for a public company transaction (where arbitragers tend to purchase most of the stock of the target immediately prior to the acquisition) to qualify as a reorganization. On the other hand, it is possible that the Second Circuit may continue to develop the line of cases dealing with post-continuity reorganization (which largely appears to be based solely on the "intent" of the former shareholders), and extrapolate that line of thinking to pre-continuity situations. Given the poor reception, however, for the *Seagram* court's attempt to distinguish between pre-acquisition and post-acquisition continuity, it seems unlikely that this aspect of the decision will go untouched on appeal.

Discussion: The Anti-Yoc Heating Regulations

The newly finalized regulations under Section 1.338-2(c)(3) deal with an issue analogous to the one discussed in *Seagram*, above. These regulations generally provide that a purchaser in a qualified stock purchase ("QSP") who has not made a Section 338 election is treated as an "historic shareholder" for purposes of subsequent reorganizations which occur within such purchaser's consolidated group. The regulations also provide that the purchaser is also treated as a "shareholder" of the target transferor in such situations (for purposes of determining whether "control" for purposes of Section 368(a)(1)(D) exists). The major surprise in these regulations, however, is that minority shareholders of the target are not entitled to treat the purchaser as an historic shareholder so that, in all likelihood, as to such minority shareholders the transaction will be taxable.

These regulations were issued under Section 338, not Section 368. The reason for the issuance of the regulations was the specific congressional intent that, following the enactment of Section 338, the only way to obtain a step-up in basis following a qualified stock purchase would be to make a Section 338 election (e.g., specifically reversing the *Kimbell-Diamond* doctrine).[21] See also Revenue Ruling 90-95, 1990-2 C.B. 67, holding that a qualified stock purchase, followed by a liquidation, should not be recast as an asset purchase (based on the legislative intent underlying Section 338).

The regulations reach this result by treating the purchasing corporation as an "historic shareholder."

[20] Admittedly, some amount of market risk was involved, as the shareholders in *McDonald's of Illinois* found out when they were unable to sell the stock immediately after the transaction due to a downturn in the market. However, other considerations (such as favorable accounting for the acquiring corporation) probably made accepting that risk fairly lucrative for the target shareholders.

[21] *Kimbell Diamond Milling v. Commissioner*, 10 T.C. 7 *(1948), affirmed* 187 F.2d 718 (5th Cir. 1951) *cert. denied* 342 U.S. 827 (1951).

Interestingly, this status only exists to the extent that the transaction is carried out within the affiliated group of the purchaser. See Treasury Regulation § 1.338-2(c)(3)(i). However, as discussed above, in any situation where the subsequent merger is with an entity outside of the affiliated group, a good argument should be available under the *Seagram* case that the purchaser should be treated as an "historic shareholder" in any event, regardless of the fact that it just engaged in a QSP.

The status of the purchaser as an historic shareholder, however, only applies to the extent that either the target or the purchaser is being considered. Thus, the target does not recognize gain, nor does the purchaser, on a subsequent reorganization. See, e.g., Treasury Regulation §§ 1.338-2(c)(3)(ii) and (iv), Examples (B), (C) and (D). Minority shareholders of the target, however, are not entitled to treat the purchaser as an historic shareholder. Thus, Treasury Regulation Section 1.338-2(c)(3)(i) provides,

> "Notwithstanding the rules of this paragraph (c)(3), section 354(a) (and so much of section 356 as relates to section 354) cannot apply to any person other than the purchasing corporation or another member of the same affiliated group as the purchasing corporation unless the transfer of target assets is pursuant to a reorganization as determined without regard to this paragraph (c)(3)."

The reason propounded by the Service for treating minority shareholders in this way was that, since the only reason for this special rule was the congressional intent not to allow taxpayers to achieve a result similar to *Kimbell Diamond* without making a Section 338 election, the only parties whose treatment should change as a result of these rules should be the target and the purchaser. As to other parties the old continuity of interest rules should continue to apply. It seems rather odd, however, to treat the target corporation as having engaged in a valid reorganization while treating some of its shareholders as not having done so.

However, the decisions in *Yoc Heating*, *May B. Kass* and *Superior Coach*, discussed above, do not mandate per se taxable treatment on a subsequent merger. As discussed above with respect to the *Seagram* case, these cases deal with situations where it can be shown that there was a single integrated "plan" including both the stock tender and the merger. See, e.g., *King Enterprises v. Commissioner*, 418 F.2d 511 (Ct.Cl. 1969). Thus, a subsequent decision to merge that was not part of the original plan can result in reorganization treatment. See *Penrod*, supra (transaction constituted a reorganization even though target shareholders sold their shares soon after transaction, where sale was not contemplated or intended at the time of the merger). In addition, the requirements for a QSP and a merger are somewhat different, and a purchase that may qualify as a QSP (but for the requirement that the stock at issue be acquired "by purchase") could also theoretically be small enough that on a subsequent merger continuity of interest would still be satisfied.[22]

Another point raised by the regulations is the treatment of the purchaser as a "shareholder" for purposes of determining whether Section 368(a)(1)(D) applies to the transaction. The major effect of such treatment is to cause gain recognition where liabilities exceed asset basis. However, as noted above, the requirement for a "D" reorganization is "control" as defined in Section 368(c), while the requirement for consolidation or a valid Section 338 QSP is the 80 percent vote and value test of Section 1504(a)(2). Accordingly, it should not be assumed that simply because a QSP has occurred any subsequent reorganization will be a "D" reorganization.

[22] For example, if the target had a large amount of plain-vanilla preferred stock under Section 1504(a)(4) (which is not considered for purposes of Section 1504(a)(2)), a QSP might be achieved where the target's other shareholders would still be able to achieve continuity of interest. Since the 338 rules only apply where the stock purchase would qualify as a QSP, but no Section 338 election is made, the unfortunate specter should not arise where the purchaser believes it has made a valid QSP of stock "by purchase," only to find that the stock has not been so acquired.