Corporate Reorganizations

Class 2: Basics of Corporate Reorganizations Jan. 25, 2018*

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Continuity of interest-

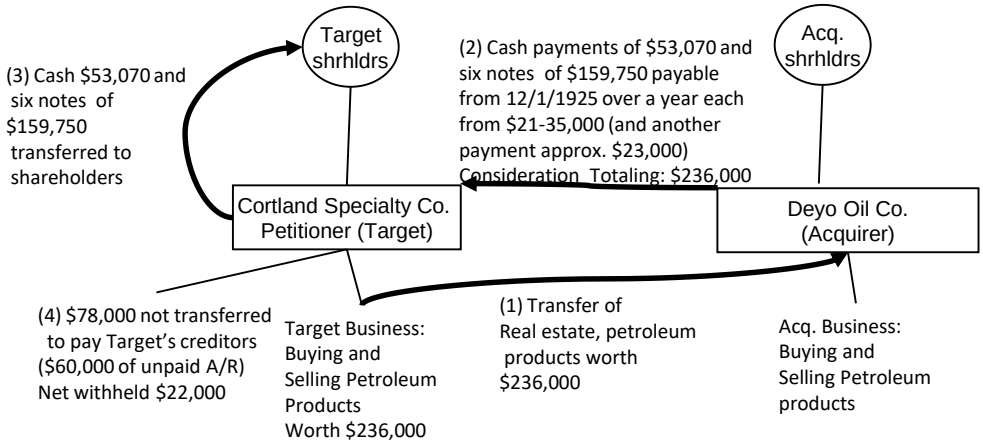
- Case law
- Rev. Rulings
- Rev. Proc. 86-42 and Rev. Proc. 77-37 standards
- Final regulations (1998) Treas. Reg. Section 1.368-1(e)
- Temporary regulations (3/20/2007) Treas. Reg. Section 1.368-1T(e)(2) TD 9565 (Measuring continuity) Final Regulations 2011

Cortland Specialty Co. v. Commissioner, 60 F.2d 937, 939 (2d Cir. 1932), cert. denied, 288 U.S. 599 (1933)

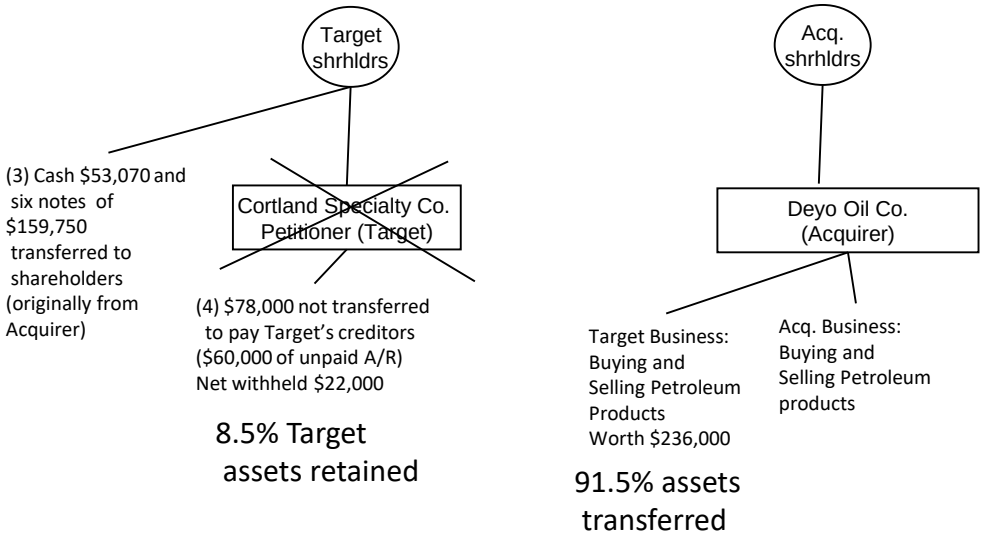
Continuity of Interest
Plan of Reorganization

Holding: A sale of the Target assets for notes and cash is not a reorganization

On October 1, 1925



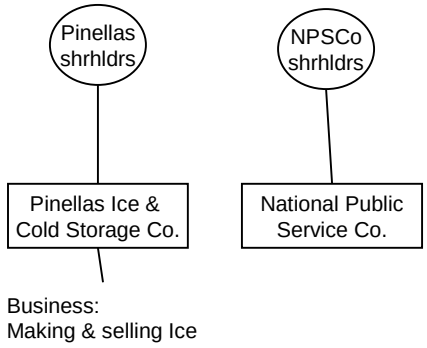
June 30, 1926 Target liquidates as part of the plan

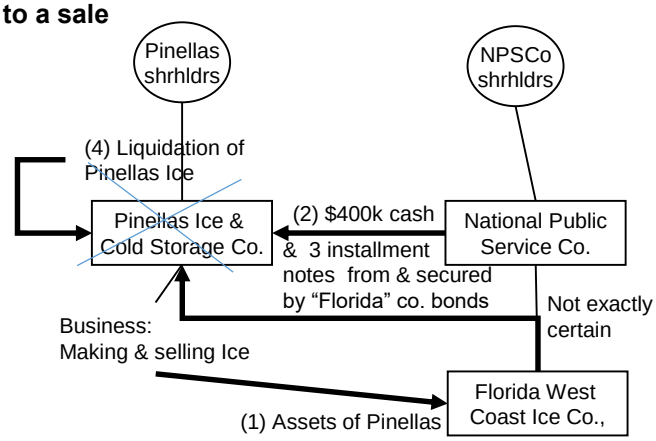


Pinellas Ice & Cold Storage Co. v. Com, 287 U.S. 462, 1933-1 C.B. 161 (1933)

Continuity of Interest Consideration Exchanged

Acquiring corporation's notes amount to a sale



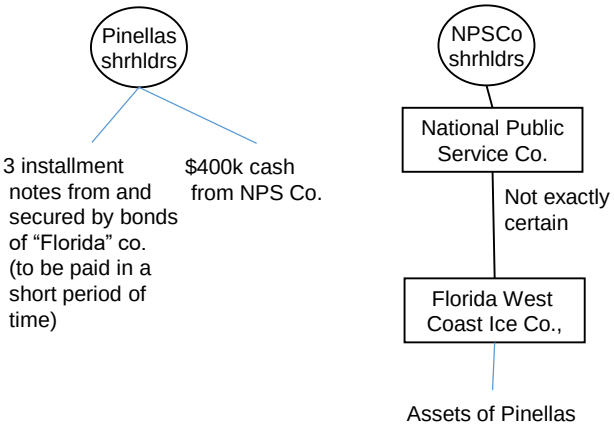


Facts: In October, 1926 Pinellas ("Vendor" or "Seller" per the contract) agreed to sell its physical plant, equipment and goodwill to National Public Service Co., ("Purchaser" per the contract). The amount of the purchase price was $1,400,000. The exchange occurred on December 6, 1926 and payments were to be made as follows:

$400,000 in cash immediately and the remainder in installments notes
$500,000 to be paid by 1-31-1927
$250,000 to be paid by 3-1-1927
$250,000 to be paid by 4-1-1927

The installment were evidenced by notes or bonds of the Florida West Coast Ice Company (Florida).

Result:



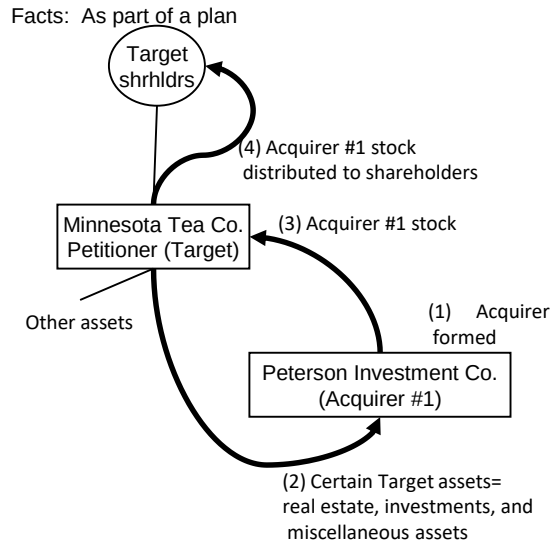
Held: The transaction in question amounted to a sale of property by Petitioner (Pinellas) for money and not an exchange for securities within the meaning of the statute. According to the Court, the contract stated that the "Vendor" agreed to "sell" and the "Purchaser" agreed to "Purchase" certain described property for a certain amount of money. All of this was paid for in cash and the balance paid for by notes secured by the balance of deposited mortgage bonds. These notes were not securities and are regarded as cash. The property of the target corporation was sold for cash, secured bonds, and notes payable within four months. These notes are mere evidence of an obligation to pay the purchase price. In substance, the Petitioner sold the equivalent of cash and gain must be recognized.

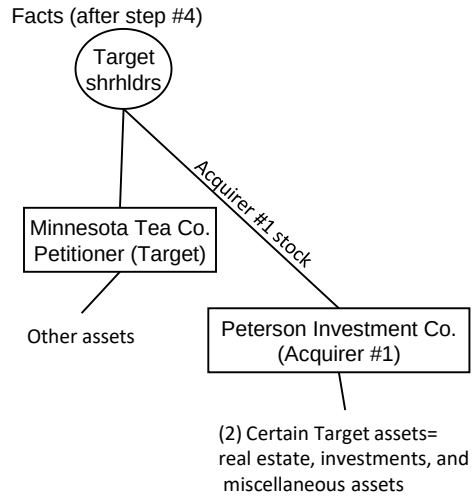
To be within the semblance of a merger or consolidation- the seller must acquire an interest in the affairs of the purchasing company more definite than that incident to ownership of its short term purchase money notes. See Cortland Specialty 60 F2d 937, 939, 940.

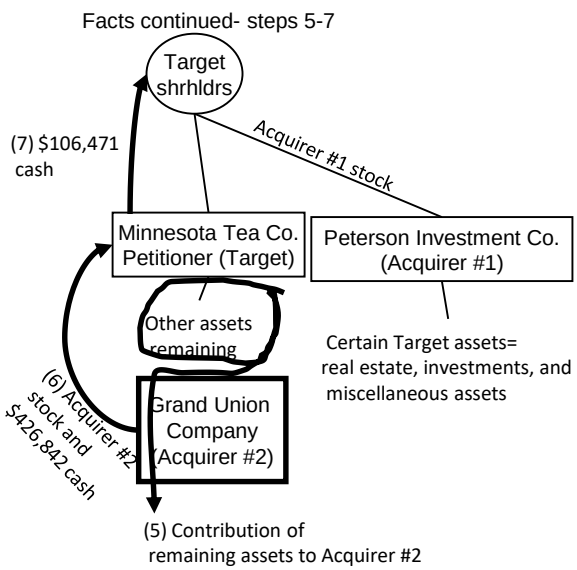
See also, section 203(a), (b)(1) and (2) exemption for a reorganization

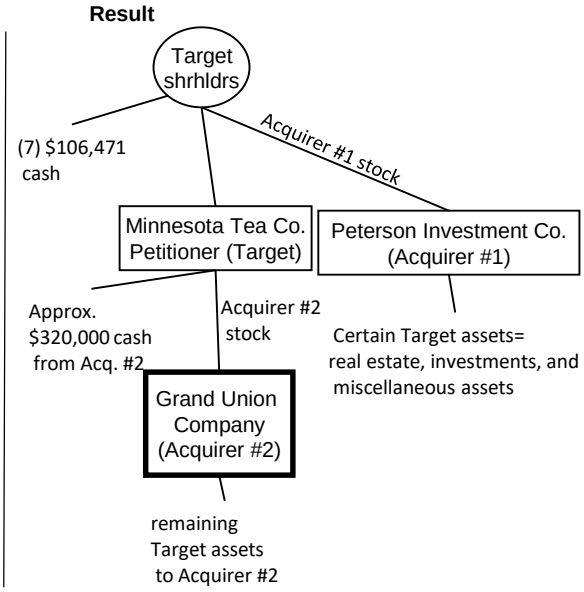
Helvering vs. Minnesota Tea Co., **Case 1, page 1 of 5** **Continuity of Interest**
296 US 378 (1935) **Amount of Consideration Exchanged**
Merger/consolidation

The transaction was held to be a reorganization









Facts: July 14, 1928, respondent caused Peterson Investment Company to be organized, and transferred to the latter real estate, investments, and miscellaneous assets in exchange for the transferee's entire capital stock. The shares thus obtained were immediately distributed among the three stockholders. August 23, 1928, it transferred all remaining assets to Grand Union Company in exchange for voting trust certificates, representing 18,000 shares of the transferee's common stock, and $426,842.52 cash. It retained the certificates; but immediately distributed the money among the stockholders, who agreed to pay $106,471.73 of its outstanding debts. Although of opinion that there had been reorganization, the Commissioner treated as taxable gain the amount of the assumed debts upon the view that this amount of the cash received by the company was really appropriated to the payment of its debts.

***** Note- under current law- Target would need to liquidate**

Respondent, a Minnesota corporation with three stockholders, assailed a deficiency assessment for 1928 income tax, and prevailed below. The Commissioner seeks reversal. He claims the transaction out of which the assessment arose was not a reorganization within section 112, par. (i)(1)(A), Revenue Act, 1928, c. 852, 45 Stat. 791, 816, (26 U.S.C.A. § 112 note). 'The term 'reorganization' means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation.' The Circuit Court of Appeals held otherwise, and remanded the cause for determination by the Board whether the whole of the cash received by the Minnesota Tea Company was in fact distributed as required by the act. We granted certiorari because of alleged conflicting opinions.

The petition also stated that, as the taxpayer made an earlier conveyance of certain assets, the later one, here in question, of what remained to the Grand Union Company did not result in acquisition by one corporation of substantially all property of another. This point was not raised prior to the petition for certiorari, and, in the circumstances, we do not consider it.

Statutory provisions presently helpful are in the margin. 1

Facts: July 14, 1928, respondent caused Peterson Investment Company to be organized, and transferred to the latter real estate, investments, and miscellaneous assets in exchange for the transferee's entire capital stock. The shares thus obtained were immediately distributed among the three stockholders. August 23, 1928, it transferred all remaining assets to Grand Union Company in exchange for voting trust certificates, representing 18,000 shares of the transferee's common stock, and $426,842.52 cash. It retained the certificates; but immediately distributed the money among the stockholders, who agreed to pay $106,471.73 of its outstanding debts. Although of opinion that there had been been reorganization, the Commissioner treated as taxable gain the amount of the assumed debts upon the view that this amount of the cash received by the company was really appropriated to the payment of its debts.

The matter went before the Board of Tax Appeals upon the question whether the Commissioner ruled rightly in respect of this taxable gain. Both parties proceeded upon the view that there had been reorganization. Of its own motion, the Board questioned and denied the existence of one. It then ruled that the corporation had realized taxable gain amounting to the difference between cost of the property transferred and the cash received, plus the value of the 18,000 shares; $712,195.90.

The Circuit Court of Appeals found there was reorganization within the statute, and reversed the Board. It concluded that the words, 'the acquisition by one corporation of * * * substantially all the properties of another corporation,' plainly include the transaction under consideration. Also, that clause (B), § 112(i)(1), first introduced by Revenue Act of 1924, and continued in later statutes, did not narrow the scope of clause (A). Further, that reorganization was not dependent upon dissolution by the conveying corporation. And, finally, that its conclusions find support in treasury regulations long in force.

These conclusions we think are correct.

The Commissioner maintains that the statute presents two definitions of reorganization by transfer of assets. One, clause (B), requires that the transferor obtain control of the transferee. The other, clause (A), is part of the definition of merger or consolidation, and must be narrowly interpreted so as to necessitate something nearly akin to technical merger or consolidation. These clauses have separate legislative histories, and were intended to be mutually exclusive. Consequently, he says, clause (A) must be restricted to prevent overlapping and negation of the condition in clause (B). Also, the transaction here involved substantially changed the relation of the taxpayer to its assets; a large amount of cash passed between the parties; there are many attributes of a sale; what was done did not sufficiently resemble merger or consolidation, as commonly understood.

With painstaking care, the opinion of the court below gives the history of clauses (A) and (B), § 112(i)(1). We need not repeat the story. Clause (A) first appeared in the Act of 1921; (B) was added by the 1924 act. We find nothing in the history or words employed which indicates an intention to modify the evident meaning of (A) by what appears in (B). Both can have effect, and if one does somewhat overlap the other the taxpayer should not be denied, for that reason, what one paragraph clearly grants him. Treasury regulations long enforced support the taxpayer's position, as the opinion below plainly points out.

Pinellas Ice & Cold Storage Co. v. Commissioner of Internal Revenue, 287 U.S. 462, 470, 53 S.Ct. 257, 260, 77 L.Ed. 428, considered the language of section 203(h)(1)(A), Act of 1926, which became section 112(i)(1)(A), Act of 1928, 26 U.S.C.A. § 112 note, and held that a sale for money or short-term notes was not within its intendment. We approved the conclusion of the Commissioner, Board of Tax Appeals, and Court of Appeals, that the transaction there involved was in reality a sale for the equivalent of money; not an exchange for securities. But we disapproved the following assumption and observations of the court: 'That in adopting paragraph (h) Congress intended to use the words 'merger' and 'consolidation' in their ordinary and accepted meanings. Giving the matter in parenthesis the most liberal construction, it is only when there is an acquisition of substantially all the property of another corporation in connection with a merger or consolidation that a reorganization takes place. Clause (B) of the paragraph removes any doubt as to the intention of Congress on this point.' And we said: 'The words within the parenthesis may not be disregarded. They expand the meaning of 'merger' or 'consolidation' so as to include some things which partake of the nature of a merger or consolidation but are beyond the ordinary and commonly accepted meaning of those words—so as to embrace circumstances difficult to delimit but which in strictness cannot be designated as either merger or consolidation. But the mere purchase for money of the assets of one company by another is beyond the evident purpose of the provision, and has no real semblance to a merger or consolidation. Certainly, we think that to be within the exemption the seller must acquire an interest in the affairs of the purchasing company more definite than that incident to ownership of its short-term purchase-money notes.' And we now add that this interest must be definite and material; it must represent a substantial part of the value of the thing transferred. This much is necessary in order that the result accomplished may genuinely partake of the nature of merger or consolidation.

Gregory v. Helvering, 293 U.S. 465, 55 S.Ct. 266, 79 L.Ed. 596, 97 A.L.R. 1355, revealed a sham; a mere device intended to obscure the character of the transaction. We, of course, disregarded the mask and dealt with realities. The present record discloses no such situation; nothing suggests other than a bona fide business move.

The transaction here was no sale, but partook of the nature of a reorganization, in that the seller acquired a definite and substantial interest in the purchaser.

True it is that the relationship of the taxpayer to the assets conveyed was substantially changed, but this is not inhibited by the statute. Also, a large part of the consideration was cash. This, we think, is permissible so long as the taxpayer received an interest in the affairs of the transferee which represented a material part of the value of the transferred assets.

Finally, it is said the transferor was not dissolved, and therefore the transaction does not adequately resemble consolidation. But dissolution is not prescribed, and we are unable to see that such action is essential to the end in view.

The challenged judgment is affirmed.

Revenue Act, 1918, c. 18, 40 Stat. 1060.

Sec. 202. (b) When property is exchanged for other property, the property received in exchange shall for the purpose of determining gain or loss be treated as the equivalent of cash to the amount of its fair market value, if any; but when in connection with the reorganization, merger, or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value, no gain or loss shall be deemed to occur from the exchange, and the new stock or securities received shall be treated as taking the place of the stock, securities, or property exchanged.

Revenue Act, 1921, c. 136, 42 Stat. 230.

Sec. 202. (c) For the purposes of this title, on an exchange of property, real, personal or mixed, for any other such property, no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value; but even if the property received in exchange has a readily realizable market value, no gain or loss shall be recognized—

(2) When in the reorganization of one or more corporations a person receives in place of any stock or securities owned by him, stock or securities in a corporation a party to or resulting from such reorganization. The word 'reorganization,' as used in this paragraph, includes a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or of substantially all the properties of another corporation), recapitalization, or mere change in identity, form, or place of organization of a corporation.

Revenue Act, 1924, c. 234, 43 Stat. 256.

Sec. 203. (a) Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 202, shall be recognized, except as hereinafter provided in this section.

(b) (2) No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

(3) No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

(4) No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange

such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange.

(e) If an exchange would be within the provisions of paragraph (3) of subdivision (b) if it were not for the fact that the property received in exchange consists not only of stock or securities permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then—

(1) If the corporation receiving such other property or money distributes it in pursuance of the plan of reorganization, no gain to the corporation shall be recognized from the exchange, but

(2) If the corporation receiving such other property or money does not distribute it in pursuance of the plan of reorganization, the gain, if any, to the corporation shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property so received, which is not so distributed.

(h) As used in this section and sections 201 and 204—

(1) The term 'reorganization' means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or (C) a recapitalization, or (D) a mere change in identity, form, or place of organization, however effected.

(2) The term 'a party to a reorganization' includes a corporation resulting from a reorganization and includes both corporations in the case of an acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation.

Revenue Act, 1926, c. 27, 44 Stat. 12 (26 U.S.C.A. § 112 note).

Section 203(a), (b)(2), (b)(3), (b)(4), (e), (e)(1), (e)(2), (h), (h)(1) and (h)(2) repeat the words of Section 203(a), (b)(2), (b)(3), (b)(4), (e), (e)(1), (e)(2), (h), (h)(1) and (h)(2) of the Act of 1924.

Revenue Act, 1928, c. 852, 45 Stat. 816 (26 U.S.C.A. § 112 note.)

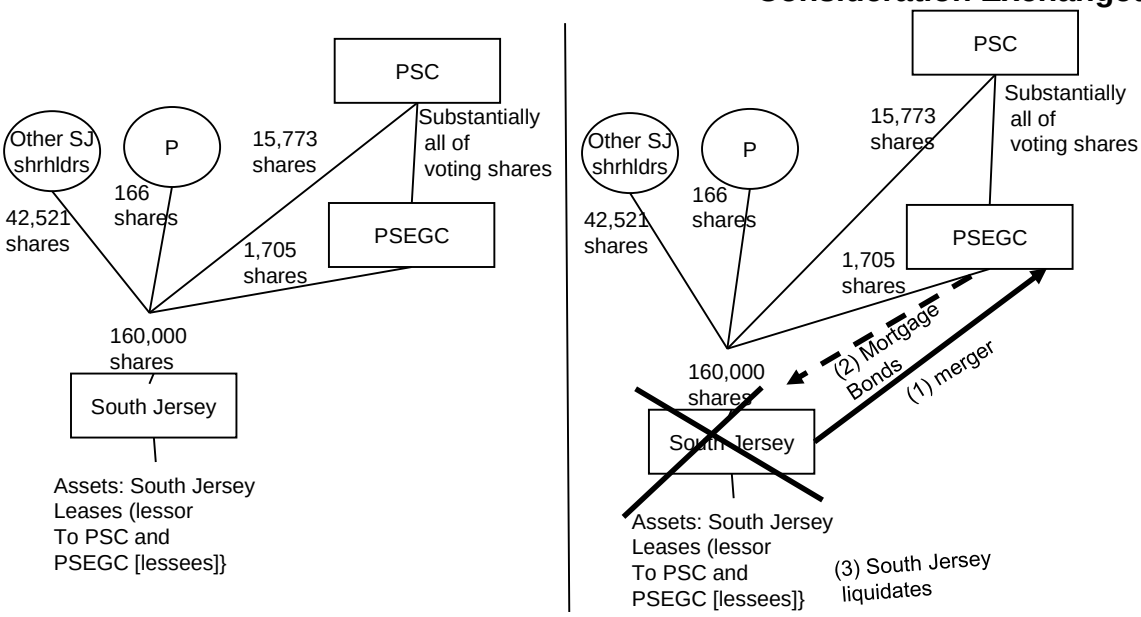
Section 112(a), (b)(3), (b)(4), (b)(5), (d), (d)(1), (d)(2), (i), (i)(1) and (i)(2) repeat the words of Section 203(a), (b)(2), (b)(3), (b)(4), (e), (e)(1), (e)(2), (h), (h)(1) and (h)(2) of the Act of 1924.

Revenue Act, 1932, c. 209, 47 Stat. 196 (26 U.S.C.A. § 112 and note.)

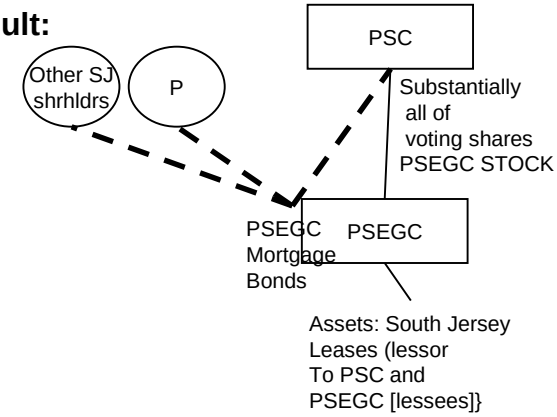
Section 112(a), (b)(3), (b)(4), (b)(5), (d), (d)(1), (d)(2), (i), (i)(1) and (i)(2) repeat the words of Section 203(a), (b)(2), (b)(3), (b)(4), (e), (e)(1), (e)(2), (h), (h)(1) and (h)(2) of the Act of 1924.

Roebling v. Comm.,
143 F.2d 810 (3rd Cir. 1944)

"A" Reorganizations
Continuity of Interest
Consideration Exchanged



Result:



Held: Not a good reorganization

Facts: South Jersey Gas, Electric and Traction Co., (South Jersey) had 160,000 shares of stock issued and outstanding and Petitioner held 166 of those shares. South Jersey merged, all under New Jersey law, into Public Service Electric & Gas Co. (PSEGC). PSEGC issued Mortgage bonds to South Jersey shareholders. The South Jersey corporation liquidated and its shareholders treated the transaction as a reorganization. The Commissioner had taken the position this was not a reorganization and the shareholders were liable on the recognized difference for the difference between the fmv of the PSEGC mortgage bonds and the basis the South Jersey shareholders had in the stock of South Jersey.

Tax Court and the Third Circuit held that: (1) regardless that the merger was completed under New Jersey law, New Jersey law alone is not sufficient by itself as to whether the transaction qualifies as a statutory merger under section 112(g)(1)(A) [now section 368(a)(1)(A)]; (2) even if the transaction meets the literal language of the statute, this does not necessarily mean that the transaction is a reorganization (citing numerous cases); and (3) The original shareholders in South Jersey had a proprietary interest in South Jersey. The shareholders of South Jersey exchanged their shares for Bonds in PSEGC and therefore there was no continuing stake in the merged (resulting) enterprise.

Paulsen v. Commissioner,
469 U.S. 131 (1985)

Continuity of Interest
Consideration Exchanged

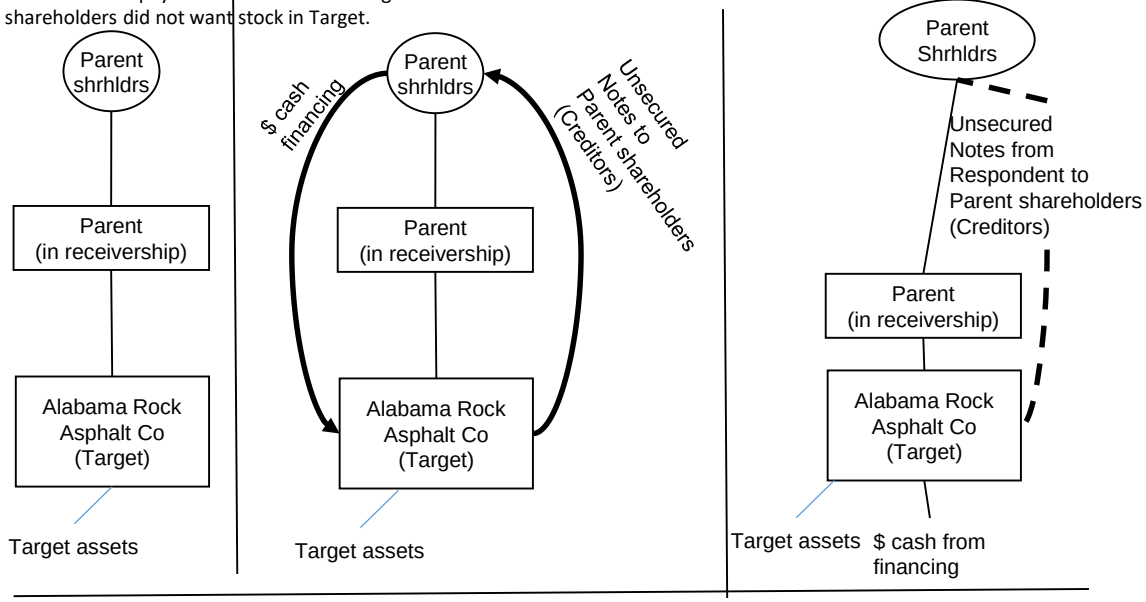
In Paulsen v. Commissioner, 469 U.S. 131 (1985), "a state-chartered stock savings and loan association merged into a federally-chartered non-stock mutual savings and loan association. The stockholders exchanged all of their stock in the state-chartered stock savings and loan association for passbook savings accounts and certificates of deposit in the federally-chartered non-stock mutual savings and loan association. The Supreme Court determined that the passbooks and certificates of deposit in the federally-chartered non-stock mutual savings and loan association had a predominantly cash-equivalent component and an insubstantial equity component. Because the passbooks and certificates of deposit essentially represented cash with an insubstantial equity component, the Court held that the transaction did not satisfy the continuity of interest requirement and, therefore, did not qualify as a tax-free reorganization." (See Rev. Rul. 2003-48, 2003-19 I.R.B. 863)

Helvering vs. Alabama Asphaltic Limestone Co., 315 U.S. 179 (1942)

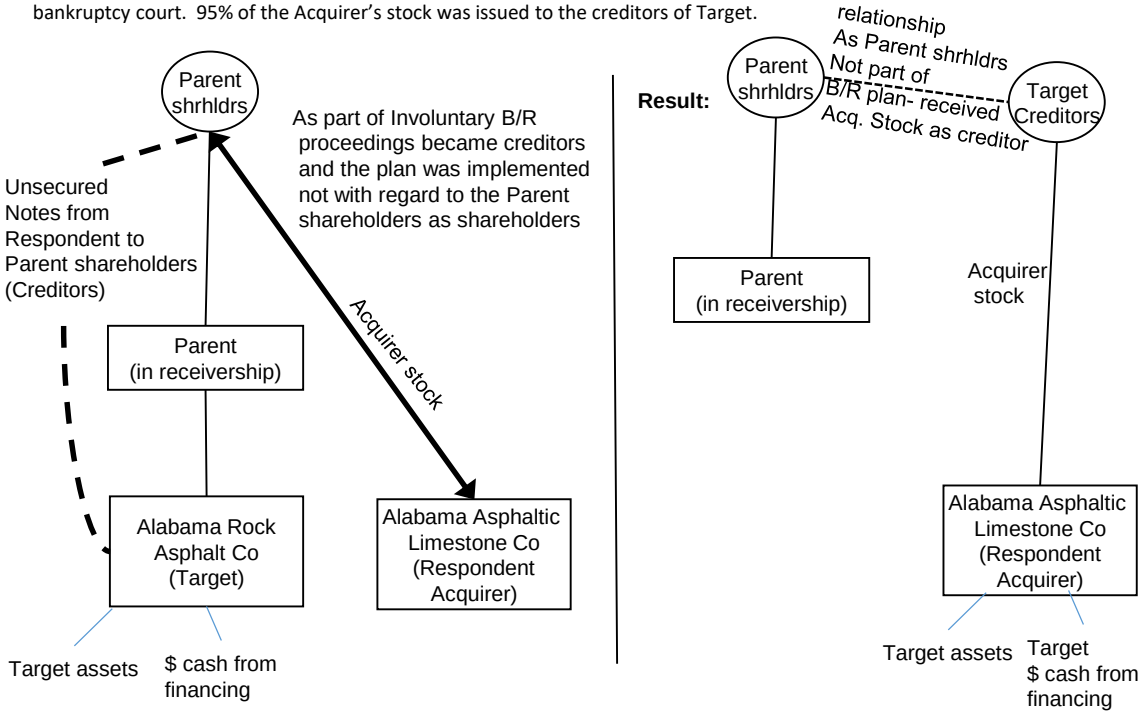
Page 1 of 3

Continuity of Interest
Consideration Exchanged
Section 368(a)(1)(G)
Bankruptcy / insolvency

Shareholder of Parent lent money to Target, a subsidiary of Parent (Parent was in receivership), in exchange for notes from Target. Eventually, Target was unable to make all of the payments on the notes. Target became insolvent and the Parent shareholders did not want stock in Target.



As part of a B/R plan structured by the Court, Respondent (Alabama Asphaltic Limestone Co./or "Acquirer") was formed and acquired all of the assets of Alabama Rock Asphalt, Inc., (Target) pursuant to a plan consummated with the aid of the bankruptcy court. 95% of the Acquirer's stock was issued to the creditors of Target.



Facts: Respondent (Alabama Asphaltic Limestone Co./or "Acquirer") acquired all of the assets of Alabama Rock Asphalt, Inc., (Target) pursuant to a plan consummated with the aid of the bankruptcy court.

Respondent in 1934 treated its assets as having the same basis which they had in the hands of the old corporation. The Commissioner determined the basis based on the price paid at the B/R sale.

Facts: The old corporation was a subsidiary of a corporation which was in receivership in 1929. Stockholders of the parent had financed the old corporation taking unsecured notes for their advances. Maturity of the notes was approaching and not all of the noteholders would agree to take stock for their claims. Accordingly a creditors' committee was formed late in 1929 and a plan of reorganization was proposed to which all the noteholders, except two, assented. The plan provided that a new corporation would be formed which would acquire all the assets of the old corporation. The stock of the new corporation, preferred and common, would be issued to the creditors in satisfaction of their claims. Pursuant to the plan involuntary bankruptcy proceedings were instituted in 1930. The appraised value of the bankrupt corporation's assets was about $155,000. Its obligations were about $838,000, the unsecured notes with accrued interest aggregating somewhat over $793,000. The bankruptcy trustee offered the assets for sale at public auction. They were bid in by the creditors' committee for $150,000. The price was paid by $15,000 in cash, by agreements of creditors to accept stock of a new corporation in full discharge of their claims, and by an offer of the committee to meet the various costs of administration, etc. Thereafter respondent was formed and acquired all the assets of the bankrupt corporation. It does not appear whether the acquisition was directly from the old corporation on assignment of the bid or from the committee. Pursuant to the plan respondent issued its stock to the creditors of the old corporation—over 95% to the noteholders and the balance to small creditors. Nonassenting creditors were paid in cash. Operations were not interrupted by the reorganization and were carried on subsequently by substantially the same persons as before.

From the Pinellas case, Pinellas Ice & Cold Storage Co. v. Commissioner of Internal Revenue, 287 U.S. 462, 53 S.Ct. 257, 77 L.Ed. 428 to the Le Tulle case, Le Tulle v, Scofield, 308 U.S. 415, it has been recognized that a transaction may not qualify as a 'reorganization' under the various revenue acts though the literal language of the statute is satisfied. See Paul, Studies in Federal Taxation (3d Series) p. 91 et seq. The Pinellas case introduced the continuity of interest theory to eliminate those transactions which had 'no real semblance to a merger or consolidation' (287 U.S. page 470, 53 S.Ct. page 260, 77 L.Ed. 428) and to avoid a construction which 'would make evasion of taxation very easy.' Id., 287 U.S. page 469, 53 S.Ct. page 260, 77 L.Ed. 428. In that case the transferor received in exchange for its property cash and short term notes. This Court said (Id., 287 U.S. page 470, 53 S.Ct. page 260, 77 L.Ed. 428), 'Certainly, we think that to be within the exemption the seller must acquire an interest in the affairs of the purchasing company more definite than that incident to ownership of its short-term purchase-money notes.' In the Le Tulle case, we held that the term of the obligation received by the seller was immaterial. 'Where the consideration is wholly in the transferee's bonds, or part cash and part such bonds, we think it cannot be said that the transferor retains any proprietary interest in the enterprise.' 308 U.S. pages 420, 421, 60 S.Ct. page 316, 84 L.Ed. 355. On the basis of the continuity of interest theory as explained in the Le Tulle case it is now earnestly contended that a substantial ownership interest in the transferee company must be retained by the holders of the ownership interest in the transferor. That view has been followed by some courts. Commissioner v. Palm Springs Holding Corp., supra; Helvering v. New President Corp., supra. Under that test there was 'no reorganization' in this case since the old stockholders were eliminated by the plan, no portion whatever of their proprietary interest being preserved for them in the new corporation. And it is clear that the fact that the creditors were for the most part stockholders of the parent company does not bridge the gap. The equity interest in the parent is one step removed from the equity interest in the subsidiary. In any event, the stockholders of the parent were not granted participation in the plan qua stockholders.

We conclude, however, that it is immaterial that the transfer shifted the ownership of the equity in the property from the stockholders to the creditors of the old corporation. Plainly the old continuity of interest was broken. Technically that did not occur in this proceeding until the judicial sale took place. For practical purposes, however, it took place not later than the time when the creditors took steps to enforce their demands against their insolvent debtor. In this case, that was the date of the institution of bankruptcy proceedings. From that time on they had effective command over the disposition of the property. The full priority rule of Northern Pacific R. Co. v. Boyd, 228 U.S. 482, 33 S.Ct. 554, 57 L.Ed. 931, applies to proceedings in bankruptcy as well as to equity receiverships. Case v. Los Angeles Lumber Products Co., 308 U.S. 106, 60 S.Ct. 1, 84 L.Ed. 110. It gives creditors, whether secured or unsecured, the right to exclude stockholders entirely from the reorganization plan when the debtor is insolvent. See In re 620 Church St. Bldg. Corp., 299 U.S. 24, 57 S.Ct. 88, 81 L.Ed. 16. When the equity owners are excluded and the old creditors become the stockholders of the new corporation, it conforms to realities to date their equity ownership from the time when they invoked the processes of the law to enforce their rights of full priority. At that time they stepped into the shoes of the old stockholders. The sale 'did nothing but recognize officially what had before been true in fact.' Helvering v. New Haven & S.L.R. Co., 2 Cir., 121 F.2d 985, 987.

That conclusion involves no conflict with the principle of the Le Tulle case. A bondholder interest in a solvent company plainly is not the equivalent of a proprietary interest, even though upon default the bondholders could retake the property transferred. The mere possibility of a proprietary interest is of course not its equivalent. But the determinative and controlling factors of the debtor's insolvency and an effective command by the creditors over the property were absent in the Le Tulle case.

Nor are there any other considerations which prevent this transaction from qualifying as a 'reorganization' within the meaning of the Act. The Pinellas case makes plain that 'merger' and 'consolidation' as used in the Act includes transactions which 'are beyond the ordinary and commonly accepted meaning of those words'. 287 U.S. page 470, 53 S.Ct. page 260, 77 L.Ed. 428. Insolvency reorganizations are within the family of financial readjustments embraced in those terms as used in this particular statute. Some contention, however, is made that this transaction did not meet the statutory standard because the properties acquired by the new corporation belonged at that time to the committee and not to the old corporation. That is true. Yet the separate steps were integrated parts of a single scheme. Transitory phases of an arrangement frequently are disregarded under these sections of the revenue acts where they add nothing of substance to the completed affair. Gregory v. Helvering, 293 U.S. 465, 55 S.Ct. 266, 79 L.Ed. 596, 97 A.L.R. 1355; Helvering v. Bashford, 302 U.S. 454, 58 S.Ct. 307, 82 L.Ed. 367. Here they were no more than intermediate procedural devices utilized to enable the new corporation to acquire all the assets of the old one pursuant to a single reorganization plan.

Affirmed

Voting Stock
F Reorganizations
B Reorganizations
C Reorganizations

In Helvering v. Southwest Consol. Corp.,
315 U.S. 194, 202 (1942), the Supreme Court noted that a recapitalization as a "reshuffling of a capital structure within the framework of an existing corporation." Quote from F reorganizations 2015
Technically this case was regarding the predecessor of a "C" reorganization (See Rev. Rul. 2003-48, 2003-19 I.R.B. 863 [citing Helvering v. Southwest Consol. Corp which defined a recapitalization as a "reshuffling of a capital structure within the framework of an existing corporation."])

Voting Stock
B Reorganizations
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<u>In Helvering v. Southwest Consol. Corp</u>., 315 U.S. 194, 202 (1942), the Supreme Court noted that a recapitalization as a "reshuffling of a capital structure within the framework of an existing corporation." Quote from F reorganizations 2015

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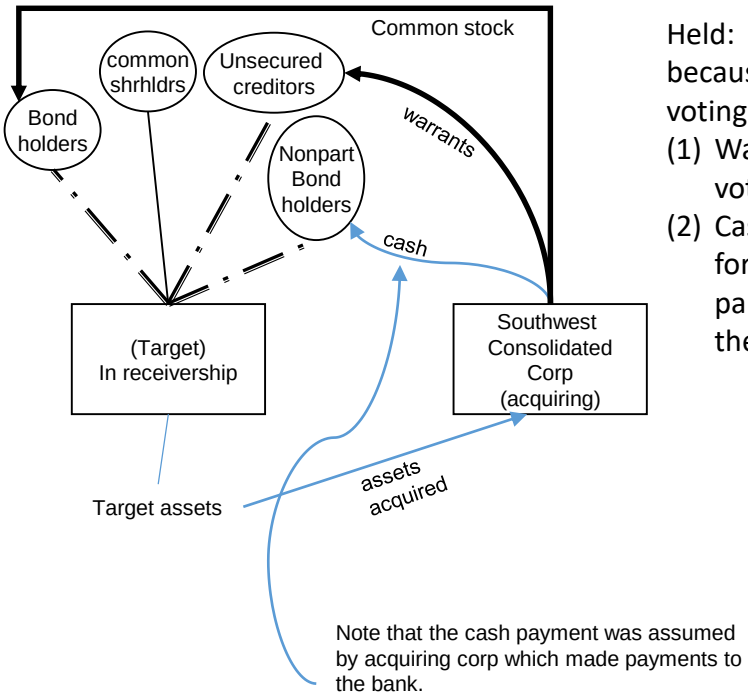
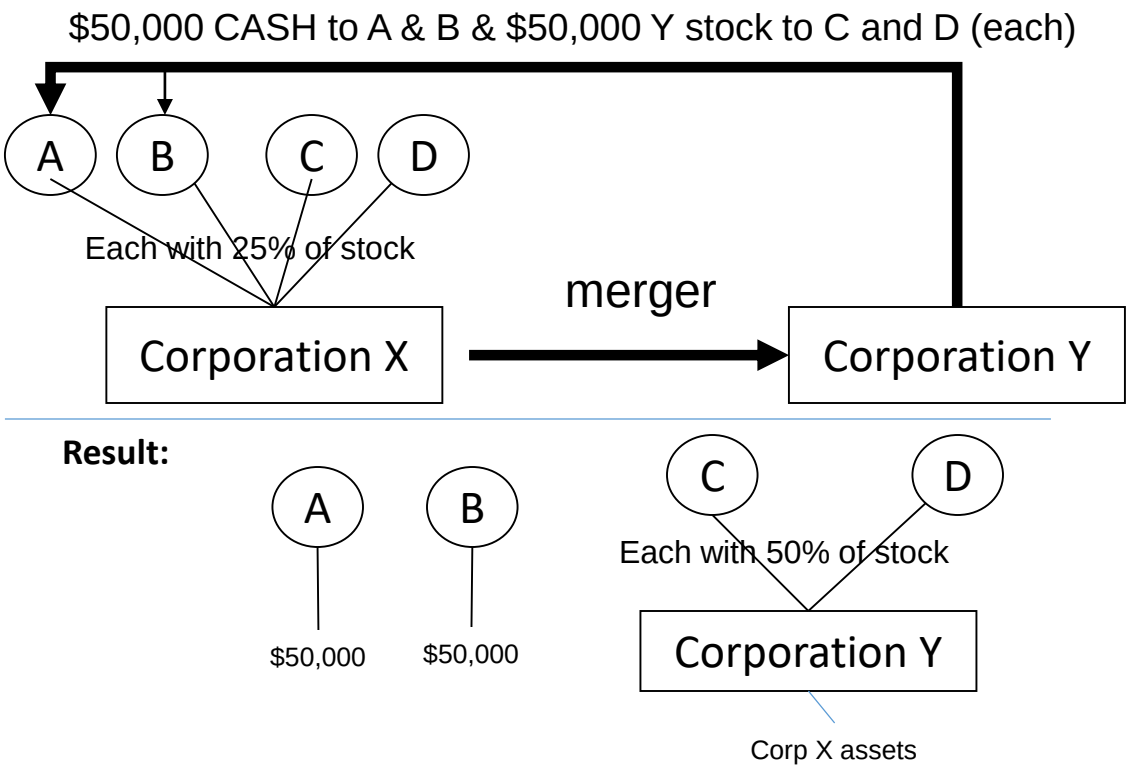


Held: Not a valid reorganization because (was not made solely for voting stock):

(1) Warrants as consideration are not voting stock;
(2) Cash paid by acquiring corp to pay for cash provided to non participating bondholders is part of the reorganization

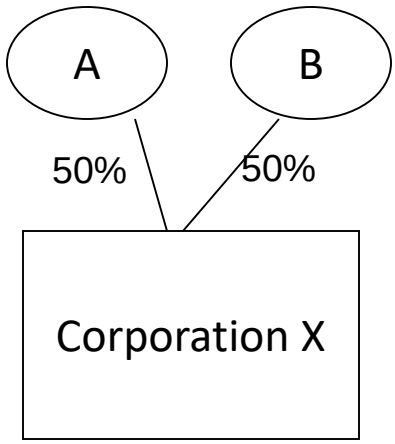
Rev. Rul. 66-224 COI in an Acquisitive Reorganization **COI**

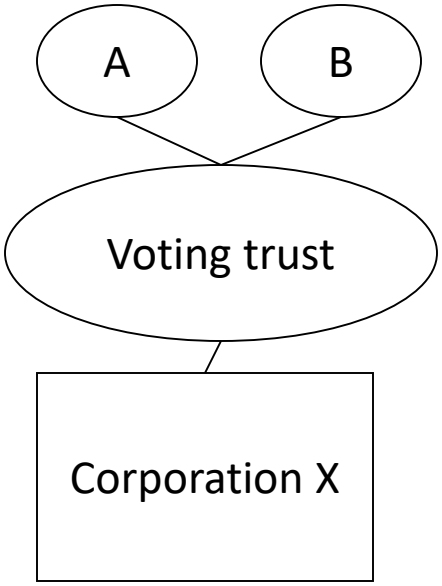


<u>Rev. Rul. 66-224 Continuity of Interest</u>

Corporation X was merged under state law into corporation Y. Corporation X had four stockholders (A, B, C, D), each of whom owned 25 percent of its stock. Corporation Y paid A and B each $50,000 in cash for their stock of corporation X, and C and D each received corporation Y stock with a value of $50,000 in exchange for their stock of corporation X. There are no other facts present that should be taken into account in determining whether the continuity of interest requirement of section 1.368-1(b) of the Income Tax Regulations has been satisfied, such as sales, redemptions or other dispositions of stock prior to or subsequent to the exchange which were part of the plan of reorganization.

Held, the continuity of interest requirement of section 1.368-1(b) of the regulations has been satisfied. It would also be satisfied if the facts were the same except corporation Y paid each stockholder $25,000 in cash and each stockholder received corporation Y stock with a value of $25,000.



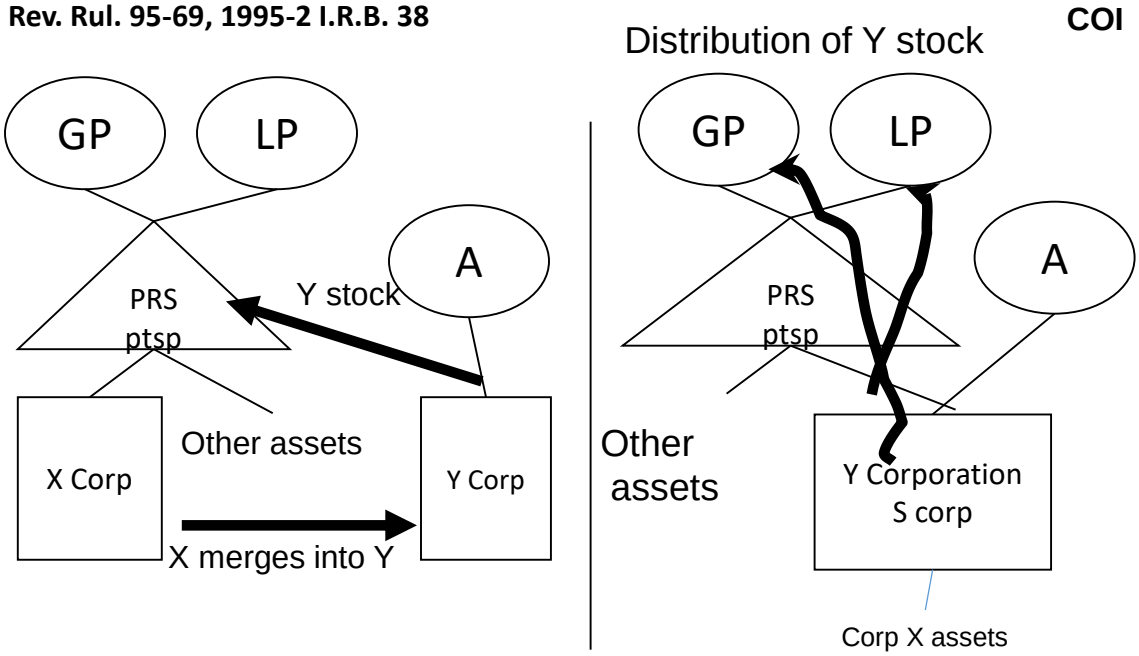


Revenue Ruling 75-95 continuity of interest

Corporation X had two stockholders, A, and B, each of whom owned 50 percent of its stock. A and B established a voting trust, appointed an unrelated voting trustee, and transferred all of their stock of X to the trust in exchange for an equal amount of voting trust certificates. The terms of the trust agreement state that the voting trustee has legal title to the stock and exclusive voting rights for the period of the trust. However, A and B will receive all dividends paid by X. Upon termination of the trust, the shares of X will be returned to A and B.

Held, for purposes of determining whether the continuity of interest requirement of section 1.368-1(b) of the Income Tax Regulations is met, in transactions under section 368(a)(1), A and B will be considered as the owners of the stock of X. See Rev. Rul. 71-262, 1971-1 C.B. 110, which holds that the holder of a voting trust certificate is the owner of the shares of stock held by a voting trust and is the redeemed shareholder for purposes of section 302. See also Helvering v. Minnesota Tea Co., 296 U.S. 378, 80 L. Ed. 284, 56 S. Ct. 269, 1936-1 C.B. 189 (1935), XV-1 C.B. 189 (1936), where voting trust certificates received by one corporation as consideration for the transfer by it of property to another corporation were held to represent a definite and substantial interest in the acquiring corporation for purposes of qualifying the transaction as a reorganization under the Revenue Act of 1928.

Rev. Rul. 95-69, 1995-2 I.R.B. 38 **COI**



Rev. Rul. 95-69 COI

FACTS PRS, a limited partnership, holds all of the 100 outstanding shares of stock of X corporation. GP and LP, the partners of PRS, are United States individuals. PRS holds other assets in addition to the stock of X.

All of the outstanding stock of Y corporation is held by A, a United States individual. For valid business reasons, X will merge into Y and, after the merger, Y will elect to be treated as an S corporation. X, Y, PRS, GP, and LP execute a binding written agreement and plan of reorganization pursuant to which they effect the following transaction:

(1) On December 30 of Year 1, X merges into Y pursuant to state law. In the merger, PRS receives 100 shares of Y stock in exchange for its 100 shares of X stock. GP and LP are not in control of Y within the meaning of §304(c) .

(2) Immediately thereafter, PRS makes a non-liquidating distribution of the Y stock received in the merger in order that Y can qualify as a small business corporation eligible to elect to be an S corporation. The Y stock is distributed to GP and LP in accordance with their interests in PRS.

(3) Y elects to be treated as an S corporation, and the Y shareholders consent to such election.

Analysis: Prior to the merger, GP and LP, through their interests in PRS, owned the X business enterprise indirectly within the meaning of §1.368-1(b). After the merger and before the distribution, GP and LP remained indirect owners of the X business enterprise through the Y stock held by PRS. PRS's distribution of the Y stock to GP and LP in accordance with their interest in PRS does not result in a change in GP's and LP's underlying ownership of the X business enterprise. Accordingly, the distribution does not affect whether the continuity of proprietary interest requirement of §1.368-1(b) is satisfied. Cf. Rev. Rul. 84-30, 1984-1 C.B. 114.

HOLDING: Satisfaction of the continuity of proprietary interest requirement of §1.368-1(b) is not affected by a partnership's distribution of stock received in a reorganization to its partners in accordance with their interests in the partnership.

Rev. Proc. 77-37, section 3.02

.02. The "continuity of interest" requirement of section 1.368-1(b) of the Income Tax Regulations is satisfied if there is continuing interest through stock ownership in the acquiring or transferee corporation (or a corporation in "control" thereof within the meaning of section 368(c) of the Code) on the part of the former shareholders of the acquired or transferor corporation which is equal in value, as of the effective date of the reorganization, to at least 50 percent of the value of all of the formerly outstanding stock of the acquired or transferor corporation as of the same date. It is not necessary that each shareholder of the acquired or transferor corporation receive in the exchange stock of the acquiring or transferee corporation, or a corporation in "control" thereof, which is equal in value to at least 50 percent of the value of his former stock interest in the acquired or transferor corporation, so long as one or more of the shareholders of the acquired or transferor corporation have a continuing interest through stock ownership in the acquiring or transferee corporation (or a corporation in "control" thereof) which is, in the aggregate, equal in value to at least 50 percent of the value of all of the formerly outstanding stock of the acquired or transferor corporation. Sales, redemptions, and other dispositions of stock occurring prior or subsequent to the exchange which are part of the plan of reorganization will be considered in determining whether there is a 50 percent continuing interest through stock ownership as of the effective date of the reorganization.

TD 8760, 63 FR 4174 (Jan. 28, 1998)

COI

Distinguish Reorganizations from Sales

Target shareholders and the Acquiring Corporation

Dispositions Before Merger

Dispositions after Merger

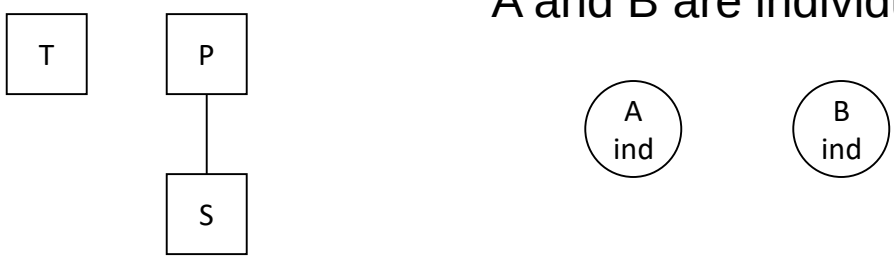
Redemptions and Related Parties

COI- Treas. Reg. Section 1.368-1(e)(8) Examples

COI

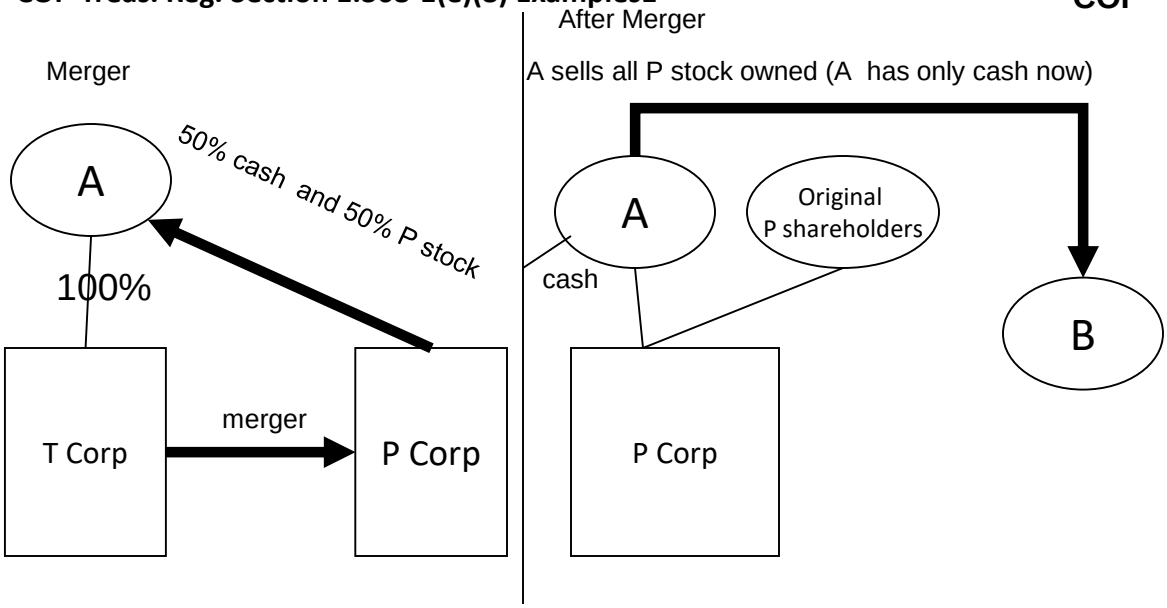
T, P and S are corporations

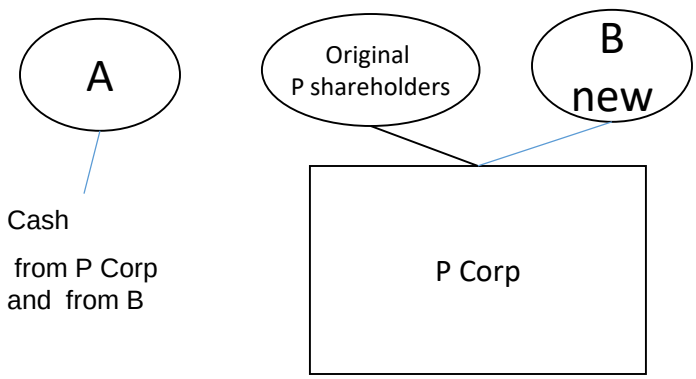
A and B are individuals



(7) Examples. For purposes of the examples in this paragraph (e)(7), P is the issuing corporation, T is the target corporation, S is a wholly owned subsidiary of P, all corporations have only one class of stock outstanding, A and B are individuals, PRS is a partnership, all reorganization requirements other than the continuity of interest requirement are satisfied, and the transaction is not otherwise subject to recharacterization. The following examples illustrate the application of this paragraph (e):

COI- Treas. Reg. Section 1.368-1(e)(8) Examples1 **COI**





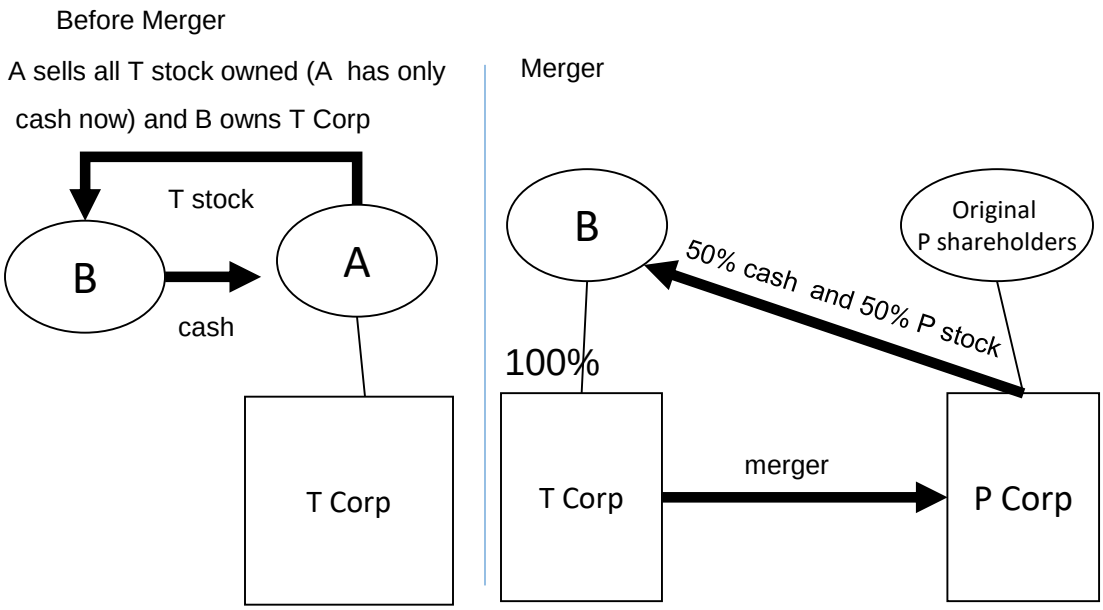
COI

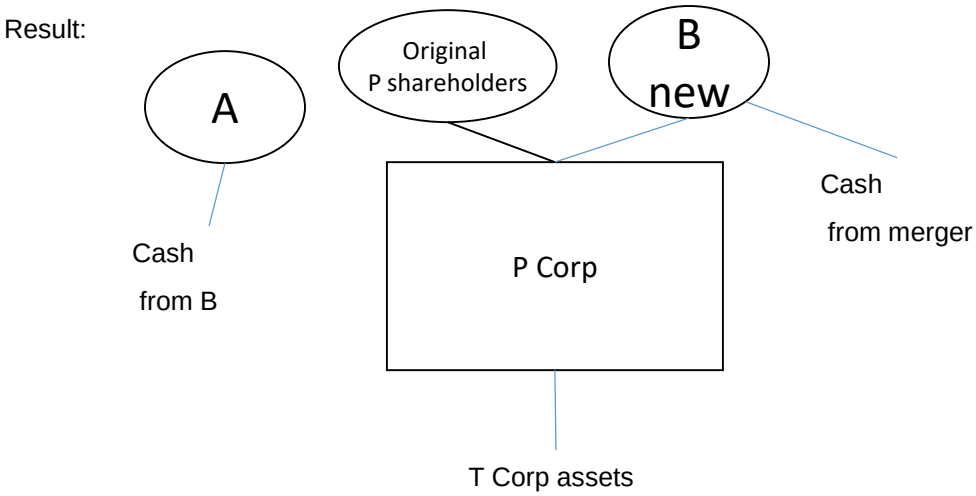
1.368-1(e)(8)

Example 1. Sale of stock to third party. (i) Sale of issuing corporation stock after merger. A owns all of the stock of T. T merges into P. In the merger, A receives P stock having a fair market value of $ 50x and cash of $ 50x. Immediately after the merger, and pursuant to a preexisting binding contract, A sells all of the P stock received by A in the merger to B. Assume that there are no facts and circumstances indicating that the cash used by B to purchase A's P stock was in substance exchanged by P for T stock. Under paragraphs (e)(1) and (3) of this section, the sale to B is disregarded because B is not a person related to P within the meaning of paragraph (e)(4) of this section. Thus, the transaction satisfies the continuity of interest requirement because 50 percent of A's T stock was exchanged for P stock, preserving a substantial part of the value of the proprietary interest in T.

COI- Treas. Reg. Section 1.368-1(e)(8) Examples

COI

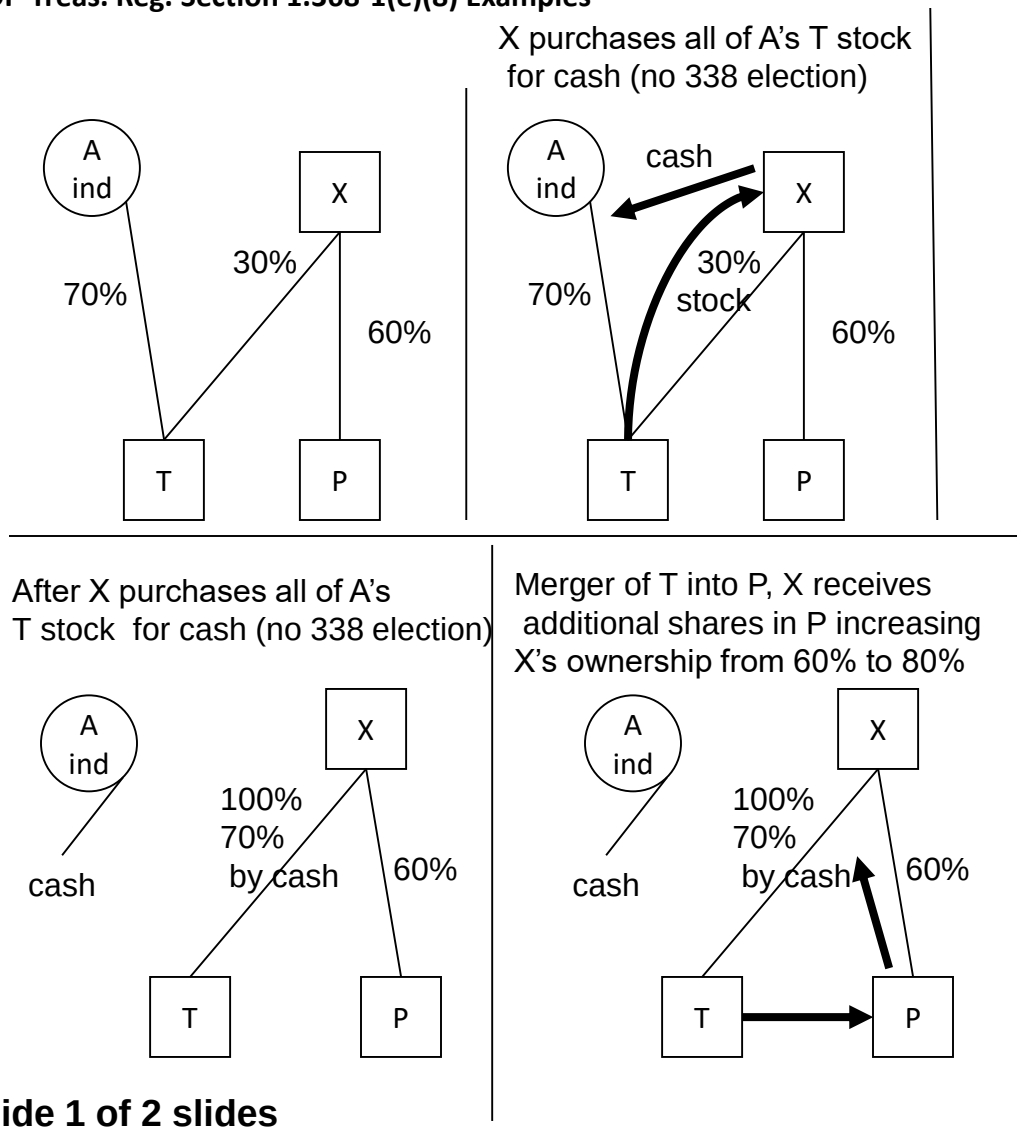




COI 1.368-1(e)(8) Example 1. (Continued)

(ii) Sale of target corporation stock before merger. The facts are the same as paragraph (i) of this Example 1, except that B buys A's T stock prior to the merger of T into P and then exchanges the T stock for P stock having a fair market value of $ 50x and cash of $ 50x. The sale by A is disregarded. The continuity of interest requirement is satisfied because B's T stock was exchanged for P stock, preserving a substantial part of the value of the proprietary interest in T.

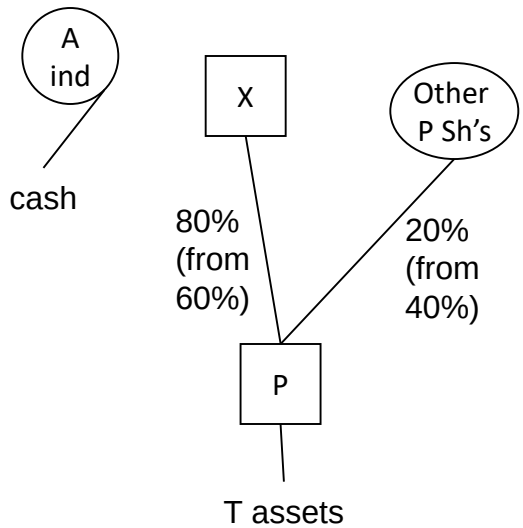
COI- Treas. Reg. Section 1.368-1(e)(8) Examples



Slide 1 of 2 slides

Example 2. Relationship created in connection with potential reorganization. Corporation X owns 60 percent of the stock of P and 30 percent of the stock of T. A owns the remaining 70 percent of the stock of T. X buys A s T stock for cash in a transaction which is not a qualified stock purchase within the meaning of section 338. T then merges into P. In the merger, X exchanges all of its T stock for additional stock of P. As a result of the issuance of the additional stock to X in the merger, X s ownership interest in P increases from 60 to 80 percent of the stock of P. X is not a person related to P under paragraph (e)(4)(i)(B) of this section, because a purchase of stock of P by X would not be treated as a distribution in redemption of the stock of P under section 304(a)(2). However, X is a person related to P under paragraphs (e)(4)(i)(A) and (ii)(B) of this section, because X becomes affiliated with P in the merger. The continuity of interest requirement is not satisfied, because X acquired a proprietary interest in T for consideration other than P stock, and a substantial part of the value of the proprietary interest in T is not preserved. See paragraph (e)(3) of this section.

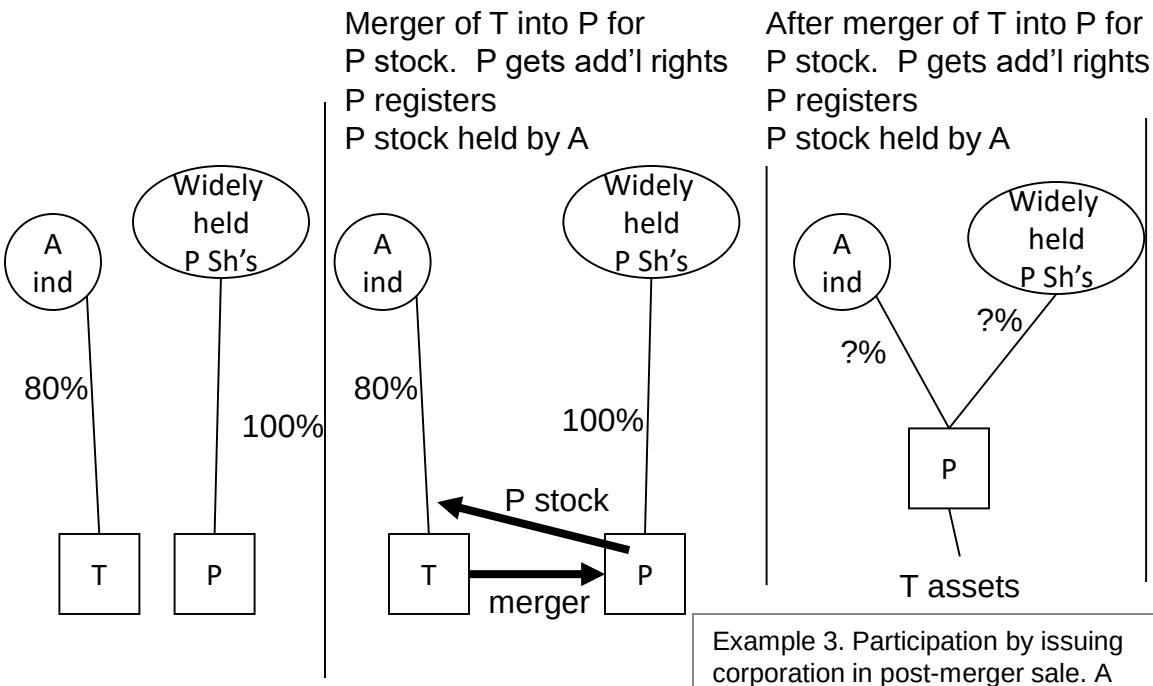
After Merger of T into P, where X receives additional shares in P increasing X's ownership from 60% to 80%

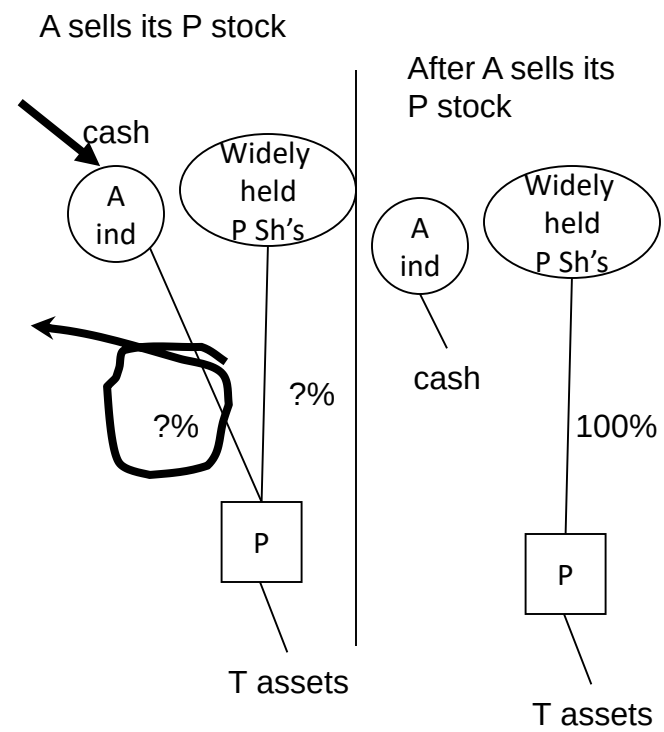


Slide 2 of 2 slides

Example 2. Relationship created in connection with potential reorganization. Corporation X owns 60 percent of the stock of P and 30 percent of the stock of T. A owns the remaining 70 percent of the stock of T. X buys A s T stock for cash in a transaction which is not a qualified stock purchase within the meaning of section 338. T then merges into P. In the merger, X exchanges all of its T stock for additional stock of P. As a result of the issuance of the additional stock to X in the merger, X s ownership interest in P increases from 60 to 80 percent of the stock of P. X is not a person related to P under paragraph (e)(4)(i)(B) of this section, because a purchase of stock of P by X would not be treated as a distribution in redemption of the stock of P under section 304(a)(2). However, X is a person related to P under paragraphs (e)(4)(i)(A) and (ii)(B) of this section, because X becomes affiliated with P in the merger. The continuity of interest requirement is not satisfied, because X acquired a proprietary interest in T for consideration other than P stock, and a substantial part of the value of the proprietary interest in T is not preserved. See paragraph (e)(3) of this section.

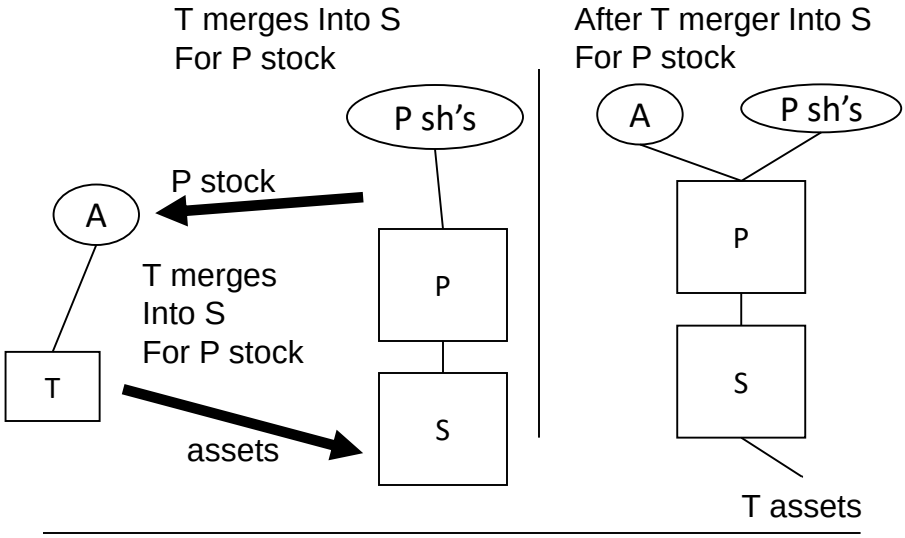
COI- Treas. Reg. Section 1.368-1(e)(8) Examples **COI**

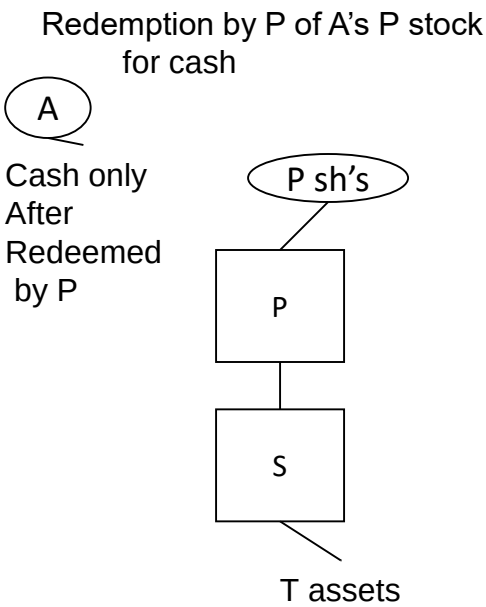




Example 3. Participation by issuing corporation in post-merger sale. A owns 80 percent of the T stock and none of the P stock, which is widely held. T merges into P. In the merger, A receives P stock. In addition, A obtains rights pursuant to an arrangement with P to have P register the P stock under the Securities Act of 1933, as amended. P registers A's stock, and A sells the stock shortly after the merger. No person who purchased the P stock from A is a person related to P within the meaning of paragraph (e)(4) of this section. Under paragraphs (e)(1) and (3) of this section, the sale of the P stock by A is disregarded because no person who purchased the P stock from A is a person related to P within the meaning of paragraph (e)(4) of this section. The transaction satisfies the continuity of interest requirement because A's T stock was exchanged for P stock, preserving a substantial part of the value of the proprietary interest in T.

COI- Treas. Reg. Section 1.368-1(e)(8) Examples **COI**





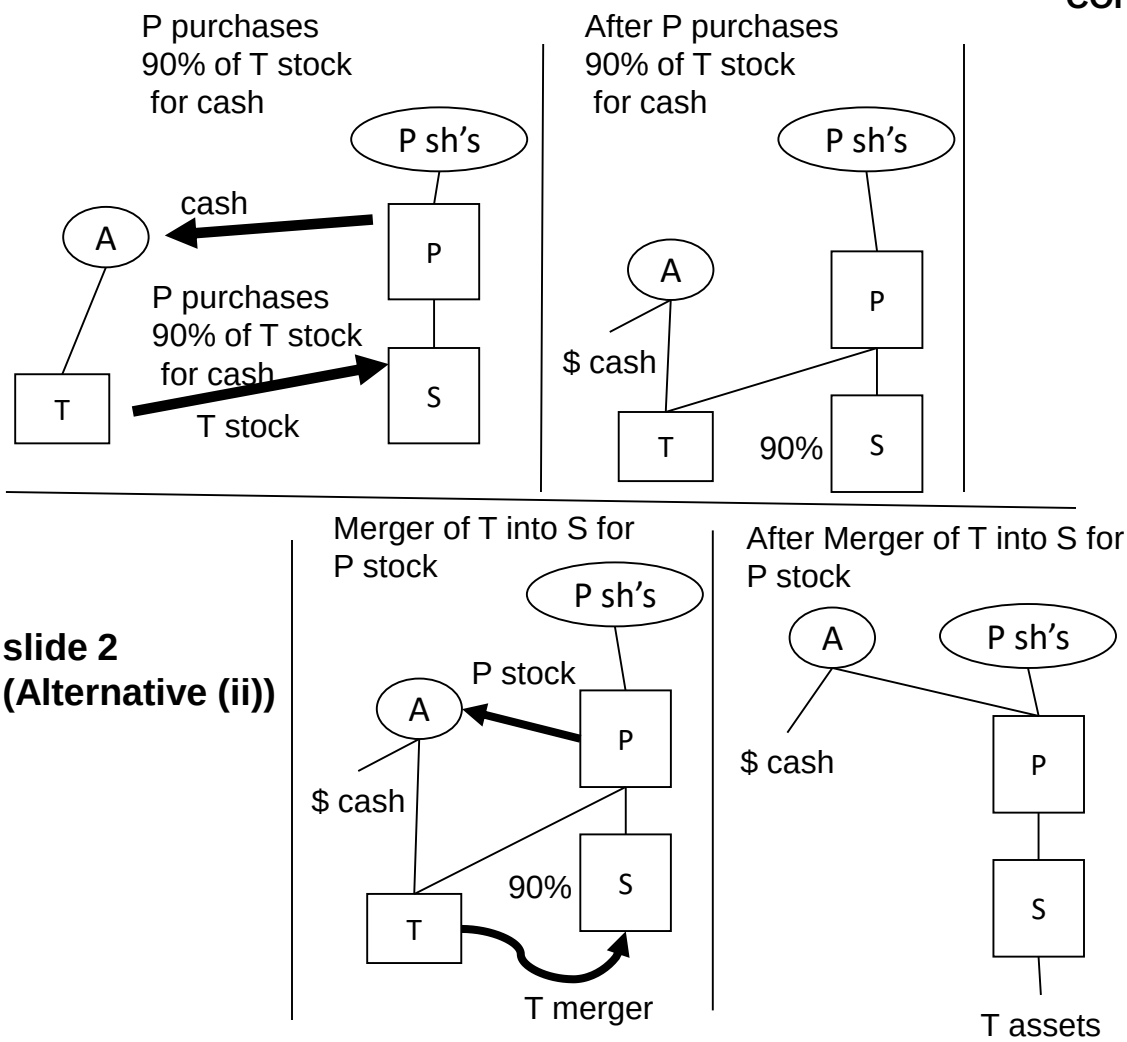
1.368-1(e)(8) COI

Example 4. Redemptions and purchases by issuing corporation or related persons. (i) Redemption by issuing corporation. A owns 100 percent of the stock of T and none of the stock of P. T merges into S. In the merger, A receives P stock. In connection with the merger, P redeems all of the P stock received by A in the merger for cash. The continuity of interest requirement is not satisfied, because, in connection with the merger, P redeemed the stock exchanged for a proprietary interest in T, and a substantial part of the value of the proprietary interest in T is not preserved. See paragraph (e)(1) of this section.

One of several diagrams - slide 1

COI- Treas. Reg. Section 1.368-1(e)(8) Examples

COI



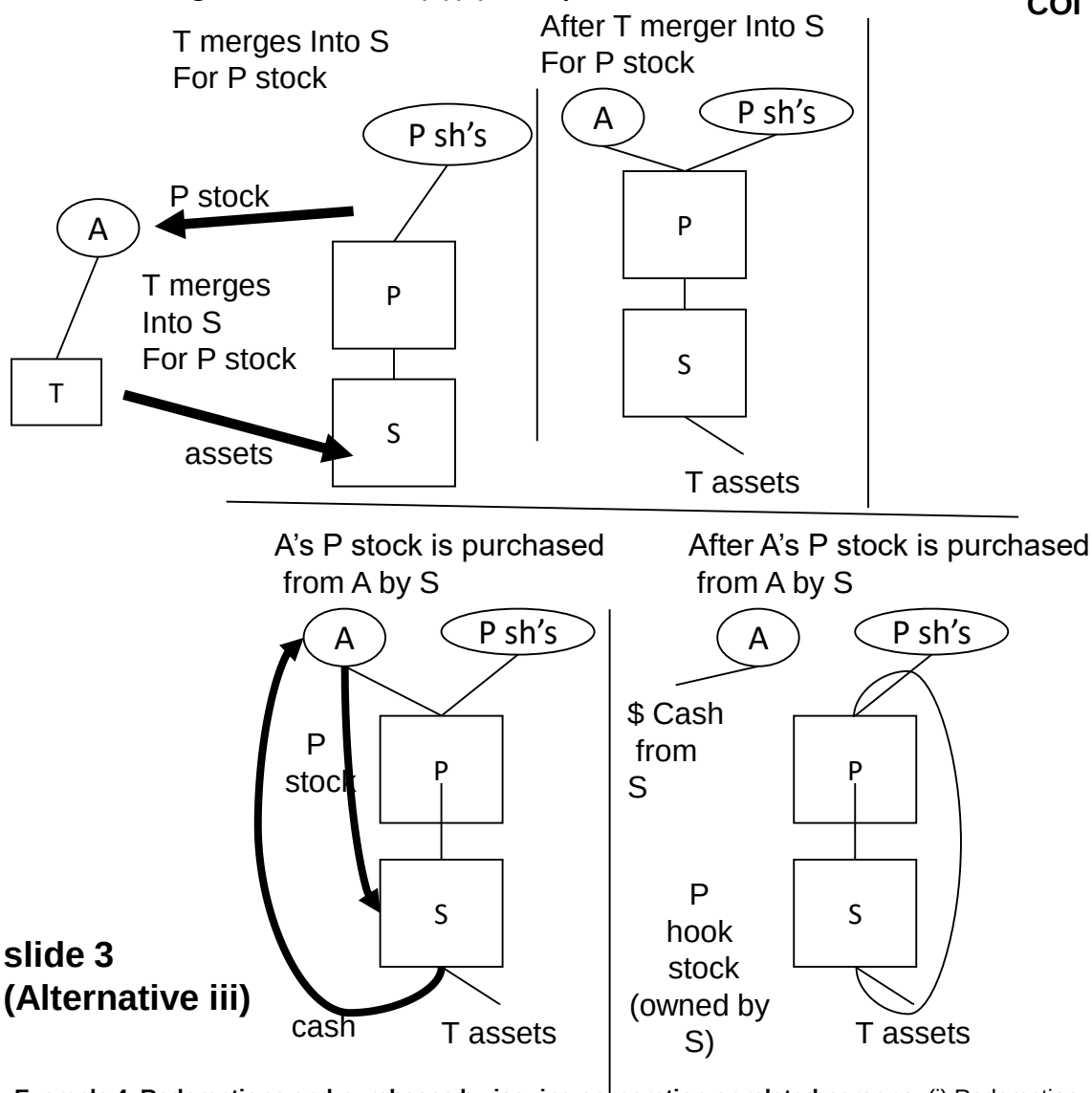
slide 2
(Alternative (ii))

Example 4. Redemptions and purchases by issuing corporation or related persons. (i) Redemption by issuing corporation. A owns 100 percent of the stock of T and none of the stock of P. T merges into S. In the merger, A receives P stock. In connection with the merger, P redeems all of the P stock received by A in the merger for cash. The continuity of interest requirement is not satisfied, because, in connection with the merger, P redeemed the stock exchanged for a proprietary interest in T, and a substantial part of the value of the proprietary interest in T is not preserved. See paragraph (e)(1) of this section.

(ii) Purchase of target corporation stock by issuing corporation. The facts are the same as paragraph (i) of this Example 4, except that, instead of P redeeming its stock, prior to and in connection with the merger of T into S, P purchases 90 percent of the T stock from A for cash. The continuity of interest requirement is not satisfied, because in connection with the merger, P acquired a proprietary interest in T for consideration other than P stock, and a substantial part of the value of the proprietary interest in T is not preserved. See paragraph (e)(1) of this section. However, see § 1.338-3(d) (which may change the result in this case by providing that, by virtue of section 338, continuity of interest is satisfied for certain parties after a qualified stock purchase).

COI- Treas. Reg. Section 1.368-1(e)(8) Examples

COI

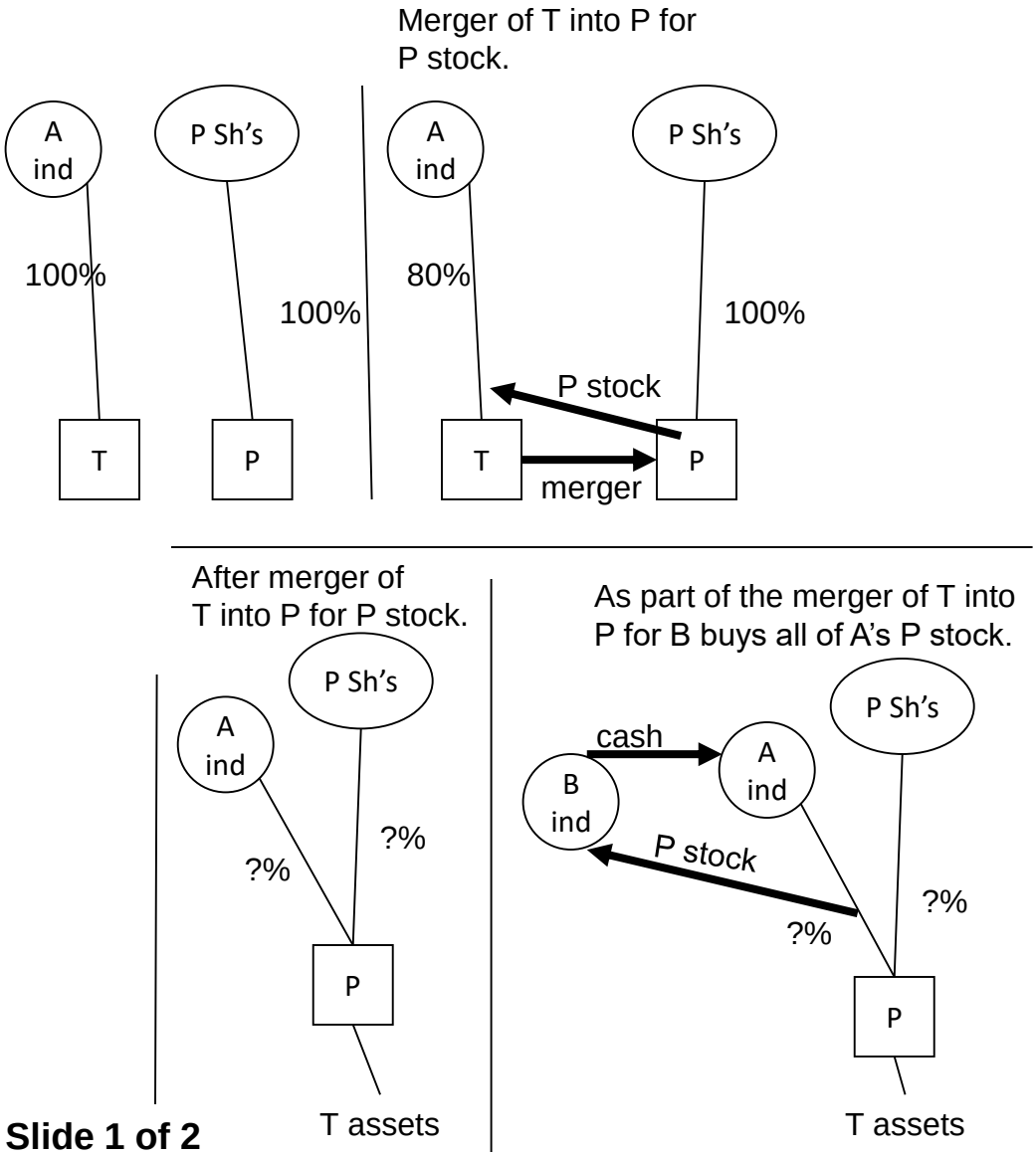


slide 3
(Alternative iii)

Example 4. Redemptions and purchases by issuing corporation or related persons. (i) Redemption by issuing corporation. A owns 100 percent of the stock of T and none of the stock of P. T merges into S. In the merger, A receives P stock. In connection with the merger, P redeems all of the P stock received by A in the merger for cash. The continuity of interest requirement is not satisfied, because, in connection with the merger, P redeemed the stock exchanged for a proprietary interest in T, and a substantial part of the value of the proprietary interest in T is not preserved. See paragraph (e)(1) of this section.

(iii) Purchase of issuing corporation stock by person related to issuing corporation. The facts are the same as paragraph (i) of this Example 4, except that, instead of P redeeming its stock, S buys all of the P stock received by A in the merger for cash. S is a person related to P under paragraphs (e)(4)(i)(A) and (B) of this section. The continuity of interest requirement is not satisfied, because S acquired P stock issued in the merger, and a substantial part of the value of the proprietary interest in T is not preserved. See paragraph (e)(3) of this section.

COI- Treas. Reg. Section 1.368-1(e)(8) Examples **COI**



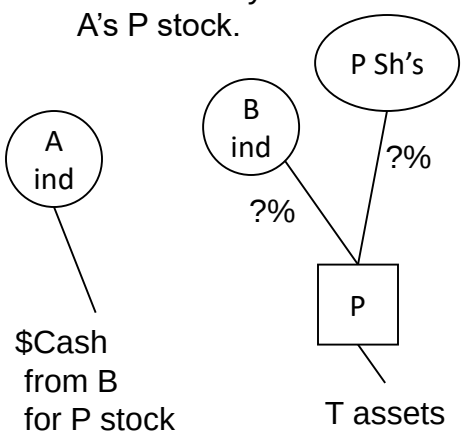
Slide 1 of 2

Example 5. Redemption in substance by issuing corporation. A owns 100 percent of the stock of T and none of the stock of P. T merges into P. In the merger, A receives P stock. In connection with the merger, B buys all of the P stock received by A in the merger for cash. Shortly thereafter, in connection with the merger, P redeems the stock held by B for cash. Based on all the facts and circumstances, P in substance has exchanged solely cash for T stock in the merger. The continuity of interest requirement is not satisfied, because in substance P redeemed the stock exchanged for a proprietary interest in T, and a substantial part of the value of the proprietary interest in T is not preserved. See paragraph (e)(1) of this section.

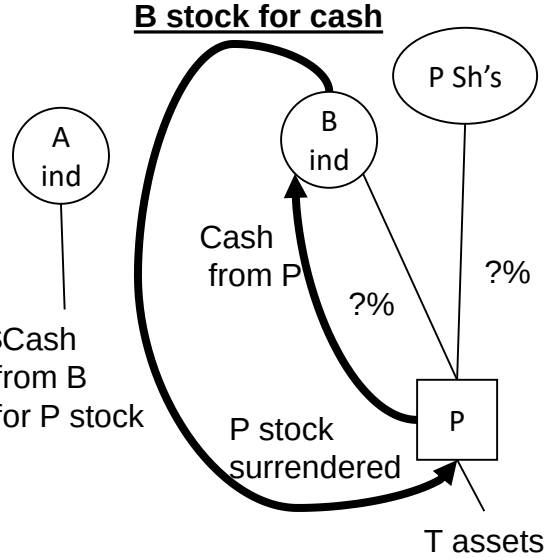
COI- Treas. Reg. Section 1.368-1(e)(8) Examples

COI

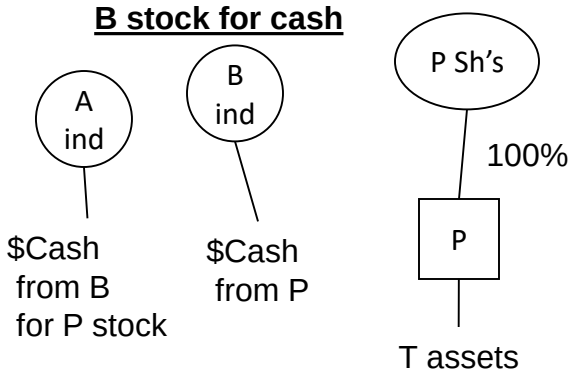
After part of merger where B buys all of A's P stock.



As part of T merger and after B's purchase of A's P stock, **P redeems B stock for cash**



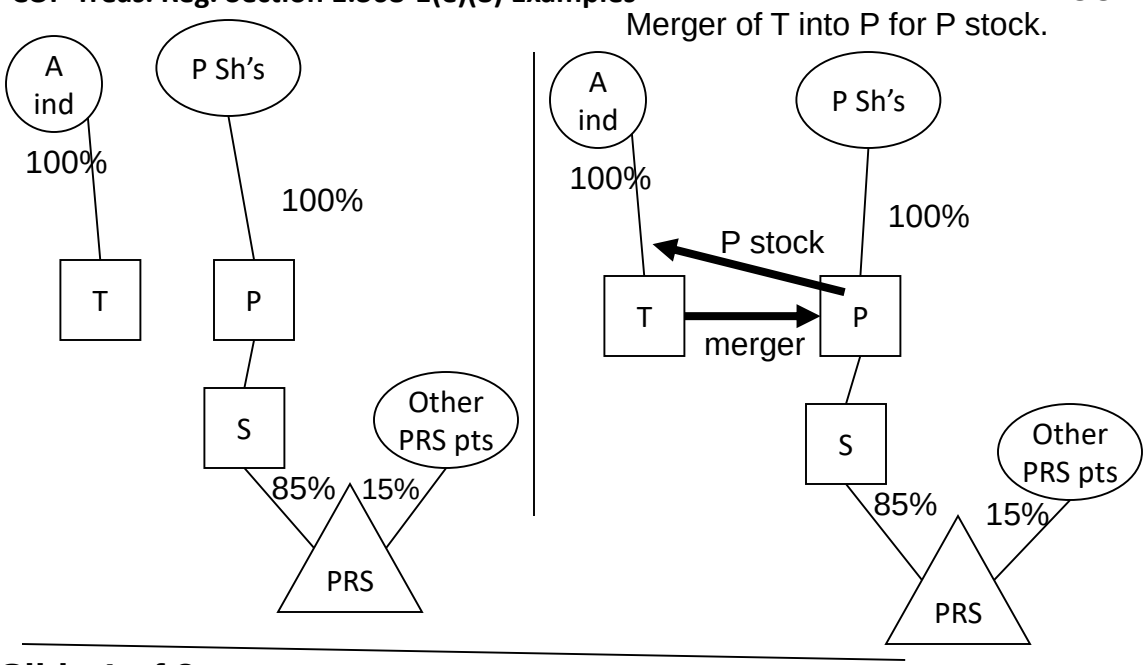
After (as part of T merger and after B's purchase of A's P stock) **P redeems B stock for cash**



Slide 2 of 2

Example 5. Redemption in substance by issuing corporation. A owns 100 percent of the stock of T and none of the stock of P. T merges into P. In the merger, A receives P stock. In connection with the merger, B buys all of the P stock received by A in the merger for cash. Shortly thereafter, in connection with the merger, P redeems the stock held by B for cash. Based on all the facts and circumstances, P in substance has exchanged solely cash for T stock in the merger. The continuity of interest requirement is not satisfied, because in substance P redeemed the stock exchanged for a proprietary interest in T, and a substantial part of the value of the proprietary interest in T is not preserved. See paragraph (e)(1) of this section.

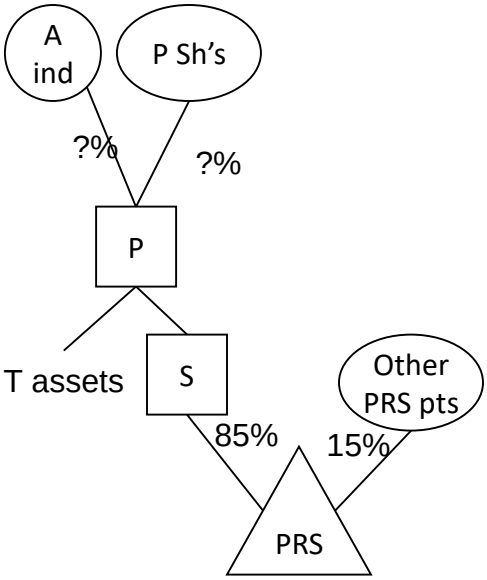
COI- Treas. Reg. Section 1.368-1(e)(8) Examples **COI**



Slide 1 of 2

Example 6. Purchase of issuing corporation stock through partnership. A owns 100 percent of the stock of T and none of the stock of P. S is an 85 percent partner in PRS. The other 15 percent of PRS is owned by unrelated persons. T merges into P. In the merger, A receives P stock. In connection with the merger, PRS purchases all of the P stock received by A in the merger for cash. Under paragraph (e)(5) of this section, S, as an 85 percent partner of PRS, is treated as having acquired 85 percent of the P stock exchanged for A's T stock in the merger, and as having furnished 85 percent of the cash paid by PRS to acquire the P stock. S is a person related to P under paragraphs (e)(4)(i)(A) and (B) of this section. The continuity of interest requirement is not satisfied, because S is treated as acquiring 85 percent of the P stock issued in the merger, and a substantial part of the value of the proprietary interest in T is not preserved. See paragraph (e)(3) of this section.

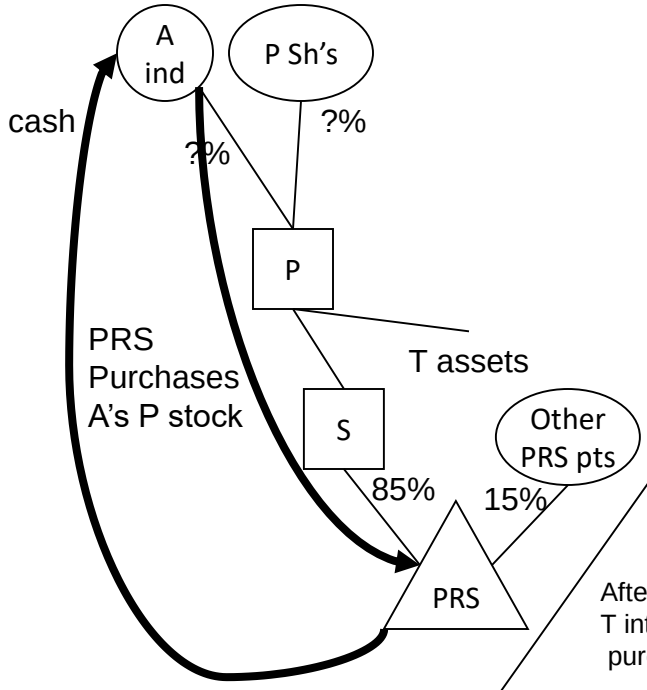
After merger of
T into P for P stock.



COI- Treas. Reg. Section 1.368-1(e)(8) Examples

COI

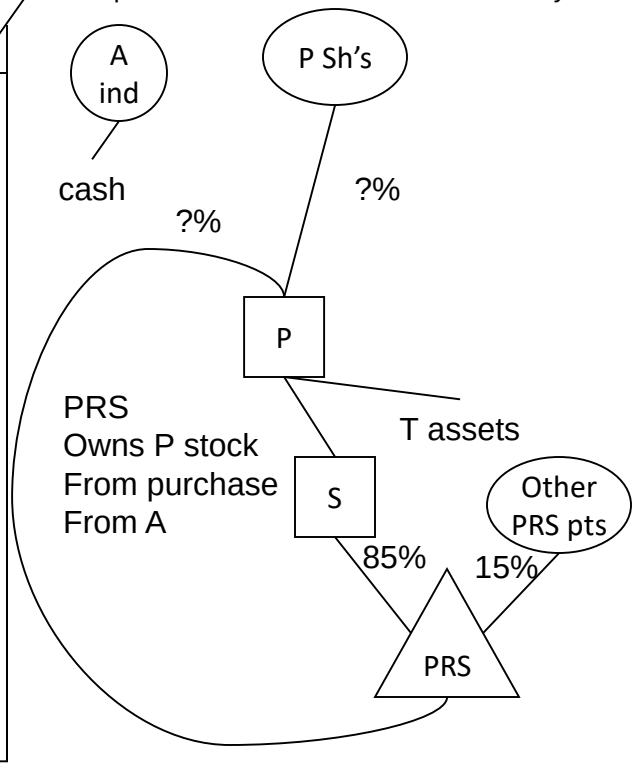
As part of and after the merger of T into P for P stock,
PRS purchases all the P stock received by A.

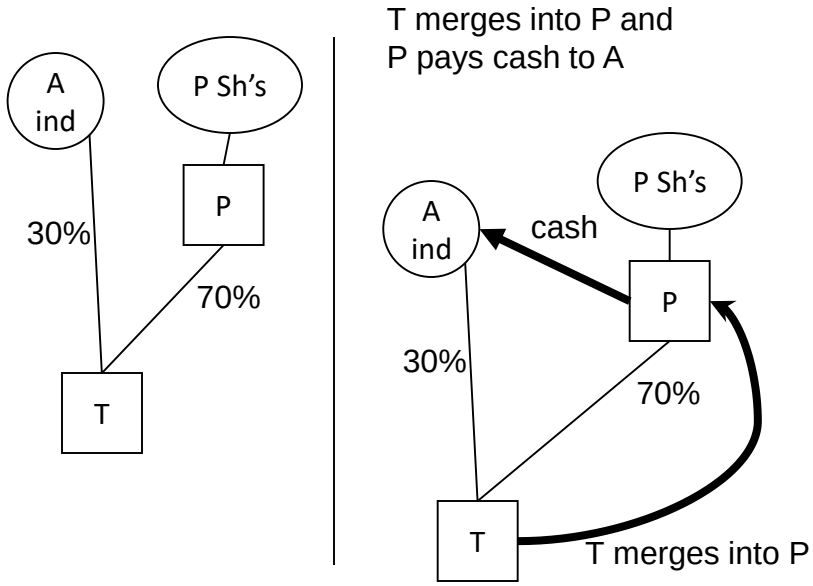


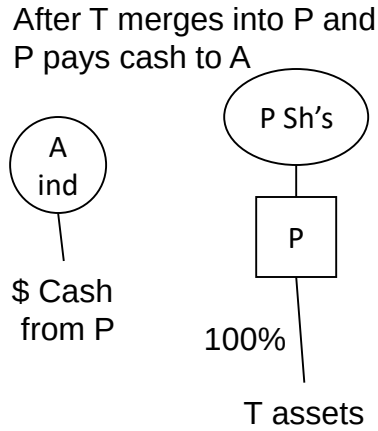
Slide 2 of 2

Example 6. Purchase of issuing corporation stock through partnership. A owns 100 percent of the stock of T and none of the stock of P. S is an 85 percent partner in PRS. The other 15 percent of PRS is owned by unrelated persons. T merges into P. In the merger, A receives P stock. In connection with the merger, PRS purchases all of the P stock received by A in the merger for cash. Under paragraph (e)(5) of this section, S, as an 85 percent partner of PRS, is treated as having acquired 85 percent of the P stock exchanged for A's T stock in the merger, and as having furnished 85 percent of the cash paid by PRS to acquire the P stock. S is a person related to P under paragraphs (e)(4)(i)(A) and (B) of this section. The continuity of interest requirement is not satisfied, because S is treated as acquiring 85 percent of the P stock issued in the merger, and a substantial part of the value of the proprietary interest in T is not preserved. See paragraph (e)(3) of this section.

After the merger of
T into P for P stock as well as the PRS
purchase of all the P stock received by A.



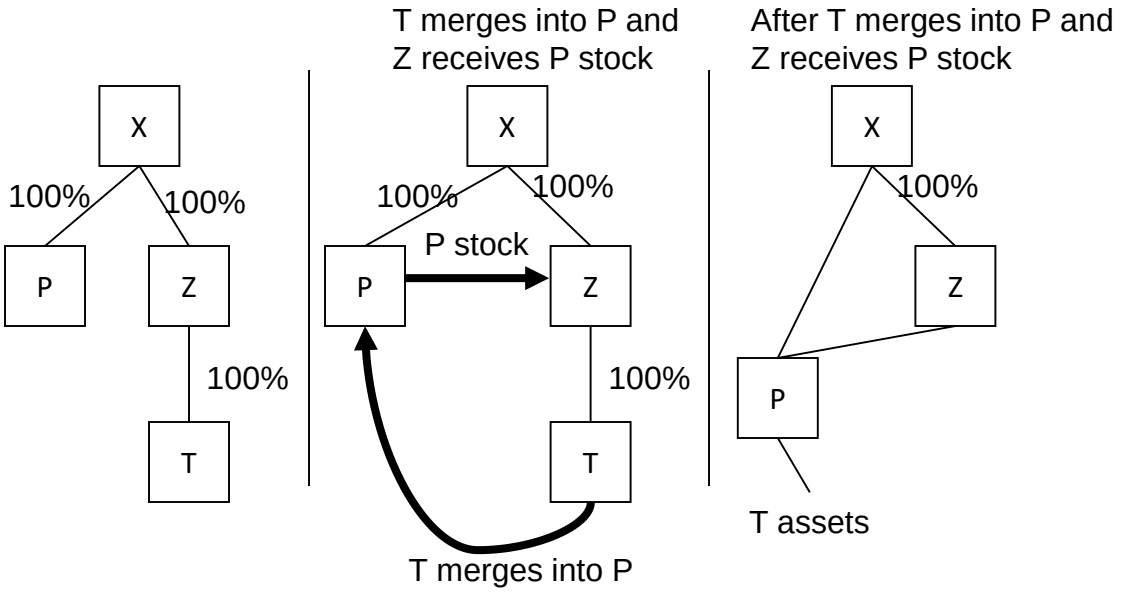


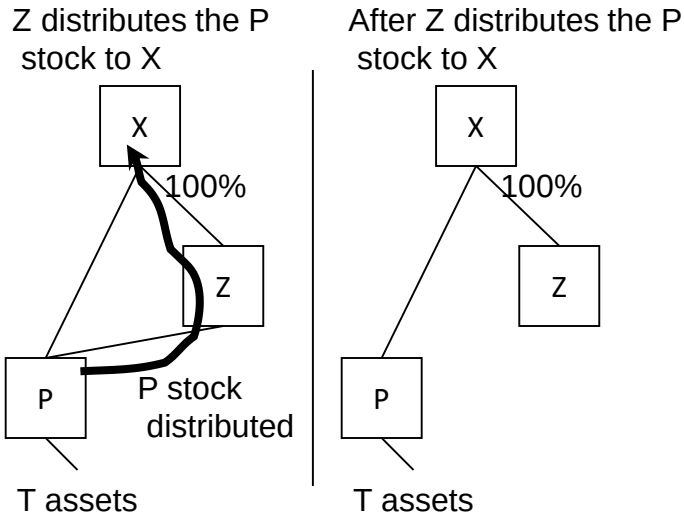


Example 7. Exchange by acquiring corporation for direct interest. A owns 30 percent of the stock of T. P owns 70 percent of the stock of T, which was not acquired by P in connection with the acquisition of T's assets. T merges into P. A receives cash in the merger. The continuity of interest requirement is satisfied, because P's 70 percent proprietary interest in T is exchanged by P for a direct interest in the assets of the target corporation enterprise.

NOTES: under the Code, in the upstream merger, the T assets are transferred to P (section 361(a)) in exchange for P stock and then distributed to the shareholder (P) upon liquidation of T (section 361(c))

COI- Treas. Reg. Section 1.368-1(e)(8) Examples **COI**

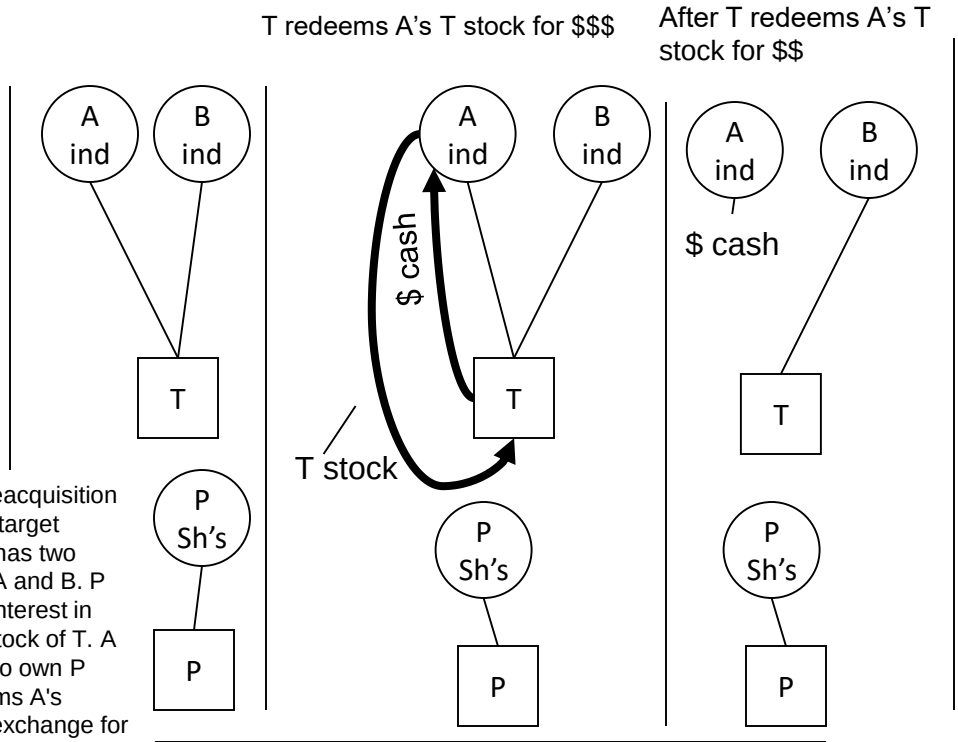




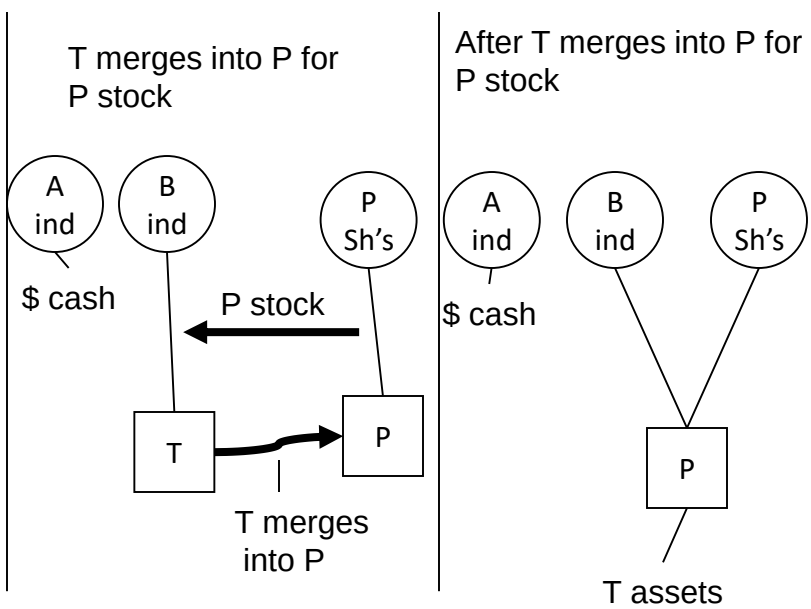
Example 8. Maintenance of direct or indirect interest in issuing corporation. X, a corporation, owns all of the stock of each of corporations P and Z. Z owns all of the stock of T. T merges into P. Z receives P stock in the merger. Immediately thereafter and in connection with the merger, Z distributes the P stock received in the merger to X. X is a person related to P under paragraph (e)(4)(i)(A) of this section. The continuity of interest requirement is satisfied, because X was an indirect owner of T prior to the merger who maintains a direct or indirect proprietary interest in P, preserving a substantial part of the value of the proprietary interest in T. See paragraph (e)(3) of this section.

COI- Treas. Reg. Section 1.368-1(e)(8) Examples

COI



Example 9. Preacquisition redemption by target corporation. T has two shareholders, A and B. P expresses an interest in acquiring the stock of T. A does not wish to own P stock. T redeems A's shares in T in exchange for cash. No funds have been or will be provided by P for this purpose. P subsequently acquires all the outstanding stock of T from B solely in exchange for voting stock of P. The cash received by A in the prereorganization redemption is not treated as other property or money under section 356, and would not be so treated even if A had received some stock of P in exchange for his T stock. The prereorganization redemption by T does not affect continuity of interest, because B's proprietary interest in T is unaffected, and the value of the proprietary interest in T is preserved. 2



COI- TD 9565, 76 FR 78540 (12-19-2011)

Closing Date Rule

Signing Date Rule

Modification after Binding contract date but before date of closing

Modification of consideration?

yes

no

No modification

Meet 1 of the 3 below?

(i) Issuance of additional acq. Shares, or

(ii) Effect of decreasing the amount of $ to target or Target shareholders, or

(iii) Decreasing the amount of cash and providing for additional issuance of acq. stock

yes

No- (still look through the "yes" to make certain it is correct)

Does modification of contract do 1 of 3 things below?

(i) Result in fewer shares of acq (solely), or

(ii) Effect of increasing the amount of $ to target or Target shareholders (solely), or

(iii) Increasing the amount of cash and providing for less shares of acq. stock

Modification
(see example 4)
Use modification date to determine COI

yes

no

Modification as of modification date

No modification
(see example 5)
Use binding commitment date to determine COI

COI- Treas. Reg. Section 1.368-1(e)(2)(v) Examples (Measuring Continuity) **COI**

<u>Contingent Adjustment?</u>

Is contingent adjustment based on Acquiring corporation's stock value?

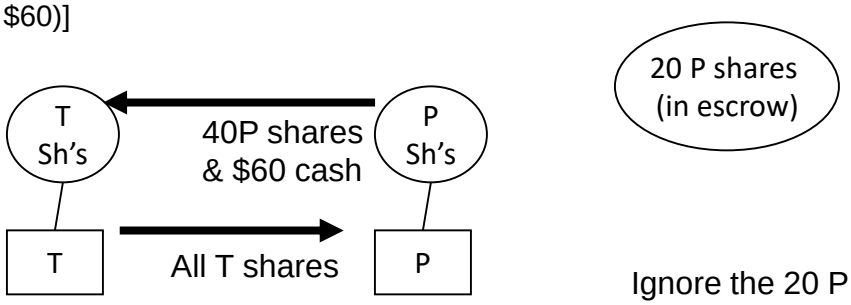
yes

The contract is not for fixed consideration (see example 10)

No (for example based on value of Target stock)

The Acquiring corporation's stock value is as of the binding contract date and other consideration is based on any actual receipt of cash (what $ cash is actually received) (See examples 11 & 12)

Jan. 3 -binding contract (40% P stock) =[40 * $1.00/ (numerator + $60)]
June 1 -anticipated merger date ends up as (14.28% P stock) = [40 * $.25/ (num. + $60)]



Ignore the 20 P shares in escrow

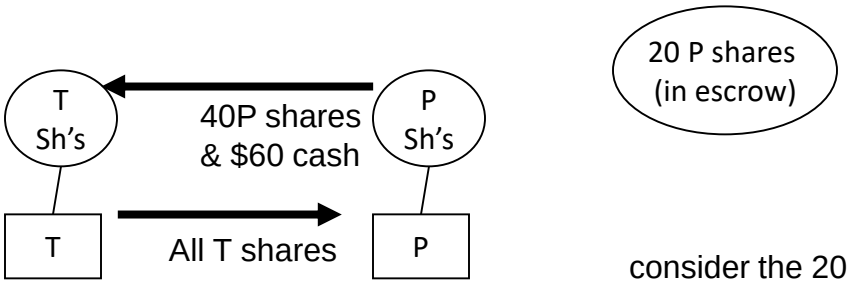
1.368-1(e)(2)(v) COI

Example 1. Application of signing date rule. On January 3 of Year 1, P and T sign a binding contract pursuant to which T will be merged with and into P on June 1 of Year 1. Pursuant to the contract, the T shareholders will receive 40 P shares and $ 60 of cash in exchange for all of the outstanding stock of T. Twenty of the P shares, however, will be placed in escrow to secure customary target representations and warranties. The P stock is listed on an established market. On January 2 of Year 1, the value of the P stock is $ 1 per share. On June 1 of Year 1, T merges with and into P pursuant to the terms of the contract. On that date, the value of the P stock is $ .25 per share. None of the stock placed in escrow is returned to P. Because the contract provides for the number of shares of P and the amount of money to be exchanged for all of the proprietary interests in T, under paragraph (e)(2) of this section, there is a binding contract providing for fixed consideration as of January 3 of Year 1. Therefore, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on January 2 of Year 1. Because, for continuity of interest purposes, the T stock is exchanged for $ 40 of P stock and $ 60 of cash, the transaction preserves a substantial part of the value of the proprietary interest in T. Therefore, the transaction satisfies the continuity of interest requirement.

Jan. 3 -binding contract (40% P stock) =[40 * $1.00/ (numerator + $60)]
June 1 -anticipated merger date ends up as (14.28% P stock) = [40 * $.25/ (num. + $60)]

Because there are 20 P shares escrowed

Jan. 3 -binding contract (25% P stock) =[20 * $1.00/ (numerator + $60)]
25% P stock does not meet COI

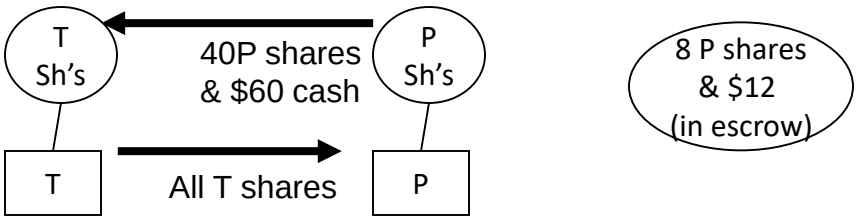


consider the 20 P shares in escrow

Example 2. Treatment of forfeited escrowed stock. (i) Escrowed stock. The facts are the same as in Example 1 except that T's breach of a representation results in the escrowed consideration being returned to P. Because the contract provides for the number of shares of P and the amount of money to be exchanged for all of the proprietary interests in T, under this paragraph (e)(2), there is a binding contract providing for fixed consideration as of January 3 of Year 1. Therefore, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on January 2 of Year 1. Pursuant to paragraph (e)(1)(i) of § 1.368-1, for continuity of interest purposes, the T stock is exchanged for $ 20 of P stock and $ 60 of cash, the transaction does not preserve a substantial part of the value of the proprietary interest in T. Therefore, the transaction does not satisfy the continuity of interest requirement.

Jan. 3 -binding contract (40% P stock) =[40 * $1.00/ (numerator + $60)]
June 1 -anticipated merger date ends up as (14.28% P stock) = [40 * $.25/ (num. + $60)]

8 P shares & $12 in cash escrowed
Answer-
Jan. 3 -binding contract (40% P stock) =[32 * $1.00/ (numerator + $48)]
40% P stock meets COI (32/80 = 40%)

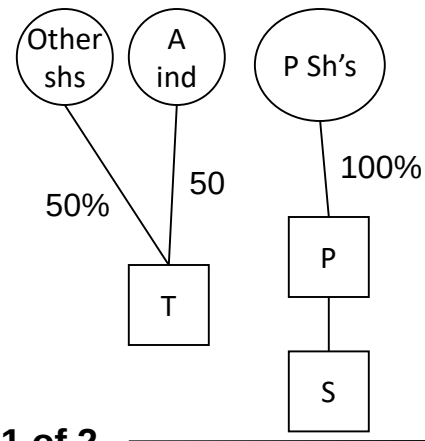


Consider the 8 P shares & $12 in escrow

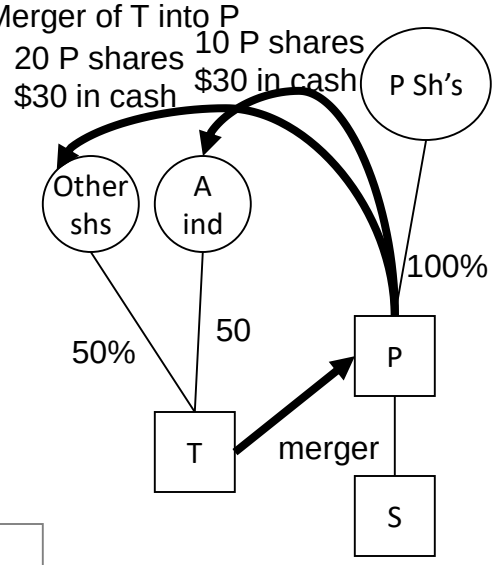
(ii) Escrowed stock and cash. The facts are the same as in paragraph (i) of this Example 2 except that the consideration placed in escrow consists solely of eight of the P shares and $ 12 of the cash. Because the contract provides for the number of shares of P and the amount of money to be exchanged for all of the proprietary interests in T, under this paragraph (e)(2), there is a binding contract providing for fixed consideration as of January 3 of Year 1. Therefore, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on January 2 of Year 1. Pursuant to paragraph (e)(1)(i) of § 1.368-1, for continuity of interest purposes, the T stock is exchanged for $ 32 of P stock and $ 48 of cash, and the transaction preserves a substantial part of the value of the proprietary interest in T. Therefore, the transaction satisfies the continuity of interest requirement.

COI- Treas. Reg. Section 1.368-1(e)(2)(v) Examples (Measuring Continuity)

COI



Merger of T into P

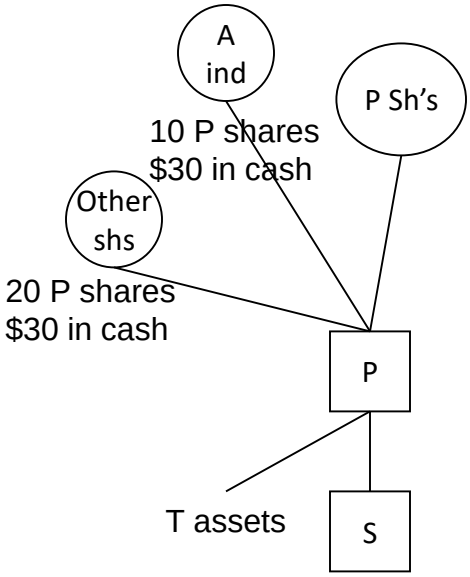


10 P shares in escrow

Slide 1 of 2

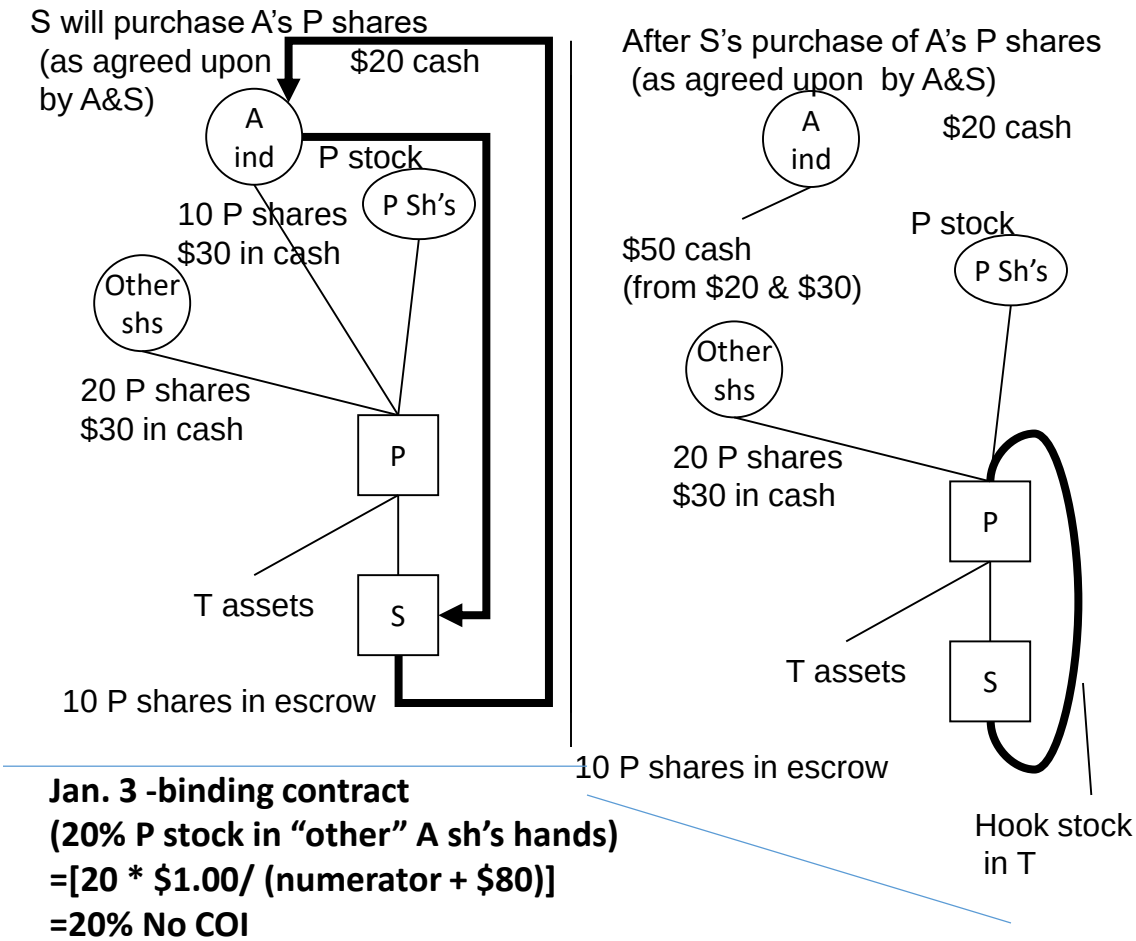
Example 3. Redemption of stock received pursuant to binding contract. The facts are the same as in Example 1 except that A owns 50 percent of the outstanding stock of T immediately prior to the merger and receives 10 P shares and $ 30 in the merger and an additional 10 P shares upon the release of the stock placed in escrow. In connection with the merger, A and S agree that, immediately after the merger, S will purchase any P shares that A acquires in the merger for $ 1 per share. Shortly after the merger, S purchases A's P shares for $ 20. Because the contract provides for the number of shares of P and the amount of money to be exchanged for all of the proprietary interests in T, under this paragraph (e)(2), there is a binding contract providing for fixed consideration as of January 3 of Year 1. Therefore, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on January 2 of Year 1. In addition, S is a person related to P under paragraph (e)(4)(i)(A) of § 1.368-1. Accordingly, A is treated as exchanging his T shares for $ 50 of cash. Because, for continuity of interest purposes, the T stock is exchanged for $ 20 of P stock and $ 80 of cash, the transaction does not preserve a substantial part of the value of the proprietary interest in T. Therefore, the transaction does not satisfy the continuity of interest requirement.

After merger of T into P



10 P shares in escrow

COI- Treas. Reg. Section 1.368-1(e)(2)(v) Examples (Measuring Continuity) COI



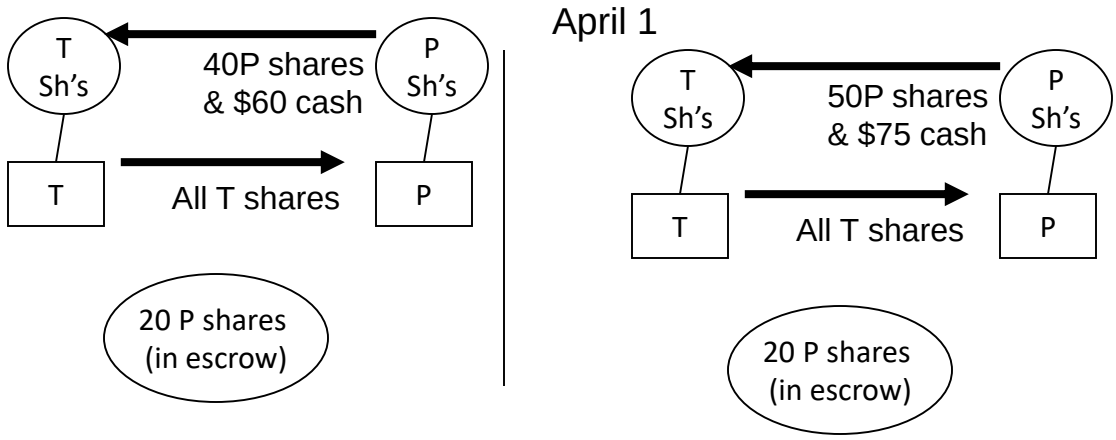
Jan. 3 -binding contract
(20% P stock in "other" A sh's hands)
=[20 * $1.00/ (numerator + $80)]
=20% No COI

Slide 2 of 2

Example 3. Redemption of stock received pursuant to binding contract. The facts are the same as in Example 1 except that A owns 50 percent of the outstanding stock of T immediately prior to the merger and receives 10 P shares and $ 30 in the merger and an additional 10 P shares upon the release of the stock placed in escrow. In connection with the merger, A and S agree that, immediately after the merger, S will purchase any P shares that A acquires in the merger for $ 1 per share. Shortly after the merger, S purchases A's P shares for $ 20. Because the contract provides for the number of shares of P and the amount of money to be exchanged for all of the proprietary interests in T, under this paragraph (e)(2), there is a binding contract providing for fixed consideration as of January 3 of Year 1. Therefore, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on January 2 of Year 1. In addition, S is a person related to P under paragraph (e)(4)(i)(A) of § 1.368-1. Accordingly, A is treated as exchanging his T shares for $ 50 of cash. Because, for continuity of interest purposes, the T stock is exchanged for $ 20 of P stock and $ 80 of cash, the transaction does not preserve a substantial part of the value of the proprietary interest in T. Therefore, the transaction does not satisfy the continuity of interest requirement.

COI- Treas. Reg. Section 1.368-1(e)(2)(v) Examples (Measuring Continuity) **COI**

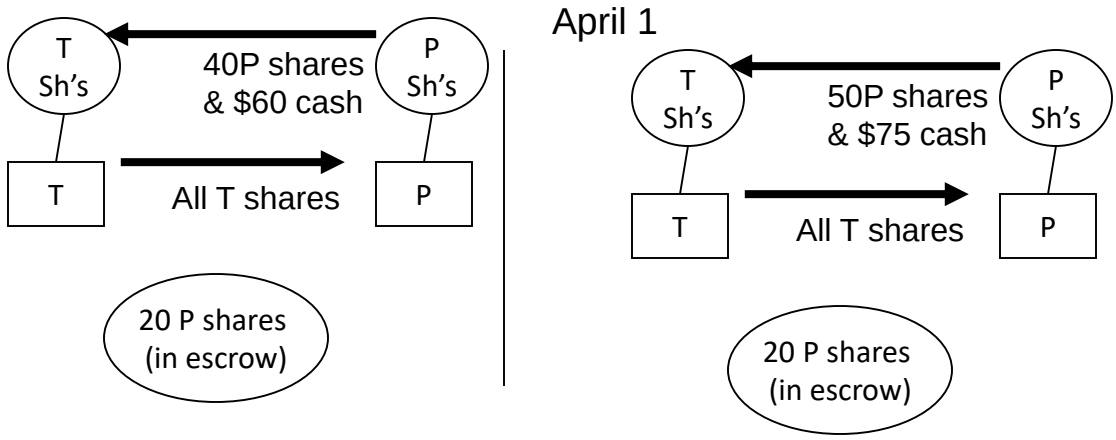
Jan. 3 -binding contract (40% P stock) =[40 * $1.00/ (numerator + $60)]
June 1 -anticipated merger date ends up as (14.28% P stock) = [40 * $.25/ (num. + $60)]
April 1- modify T shs get 10 more P shares and $15 more in cash
April 1 (25% P stock) =[50 * $.50/ (numerator + $75)] NO COI



Example 4. Modification of binding contract--continuity not preserved. The facts are the same as in Example 1 except that on April 1 of Year 1, the parties modify their contract. Pursuant to the modified contract, which is a binding contract, the T shareholders will receive 50 P shares (an additional 10 shares) and $ 75 of cash (an additional $ 15 of cash) in exchange for all of the outstanding T stock. On March 31 of Year 1, the value of the P stock is $ .50 per share. Under this paragraph (e)(2), although there was a binding contract providing for fixed consideration as of January 3 of Year 1, terms of that contract relating to the consideration to be provided to the target shareholders were modified on April 1 of Year 1. The execution of the transaction without modification would have resulted in the preservation of a substantial part of the value of the target corporation shareholders' proprietary interests in the target corporation if there had been no modification. However, because the modified contract provides for additional P stock and cash to be exchanged for all the proprietary interests in T, the exception in paragraph (e)(2)(ii)(B)(2) of this section does not apply to preserve the original signing date. Therefore, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on March 31 of Year 1. Because, for continuity of interest purposes, the T stock is exchanged for $ 25 of P stock and $ 75 of cash, the transaction does not preserve a substantial part of the value of the proprietary interest in T. Therefore, the transaction does not satisfy the continuity of interest requirement.

COI- Treas. Reg. Section 1.368-1(e)(2)(v) Examples (Measuring Continuity) COI

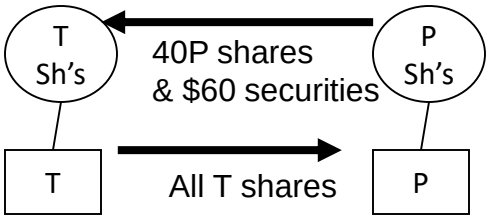
Jan. 3 -binding contract (40% P stock) =[40 * $1.00/ (numerator + $60)]
June 1 -anticipated merger date ends up as (14.28% P stock) = [40 * $.25/ (num. + $60)]
April 1- modify T shs get 20 more P shares and no more in cash
April 1 (28.57% P stock) =[60 * $.40/ (numerator + $60)] COI MET-use Jan. 3 Yr. 1 date because only add'l
P shares but no add'l cash so use original 1/3/yr. 1

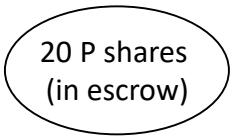


Example 5. Modification of binding contract disregarded--continuity preserved. The facts are the same as in Example 4 except that, pursuant to the modified contract, which is a binding contract, the T shareholders will receive 60 P shares (an additional 20 shares as compared to the original contract) and $ 60 of cash in exchange for all of the outstanding T stock. In addition, on March 31 of Year 1, the value of the P stock is $ .40 per share. Under this paragraph (e)(2), although there was a binding contract providing for fixed consideration as of January 3 of Year 1, terms of that contract relating to the consideration to be provided to the target shareholders were modified on April 1 of Year 1. Nonetheless, the modification has the sole effect of providing for the issuance of additional P shares to the T shareholders. In addition, the execution of the terms of the contract without regard to the modification would have resulted in the preservation of a substantial part of the value of the T shareholders' proprietary interest in T because, for continuity of interest purposes, the T stock would have been exchanged for $ 40 of P stock and $ 60 of cash. Pursuant to paragraph (e)(2)(ii)(B)(2) of this section, the modification is not treated as a modification for purposes of paragraph (e)(2)(ii)(B)(1) of this section. Accordingly, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on January 2 of Year 1. Because, for continuity of interest purposes, the T stock is exchanged for $ 60 of P stock and $ 60 of cash, the transaction preserves a substantial part of the value of the proprietary interest in T. Therefore the transaction satisfies the continuity of interest requirement.

COI- Treas. Reg. Section 1.368-1(e)(2)(v) Examples (Measuring Continuity) COI

Jan. 3 -binding contract (40% P stock) =[40 * $1.00/ (numerator + $60 securities)]
June 1 -anticipated merger date ends up as (14.28% P stock) = [40 * $.25/ (num. + $60 securities)]



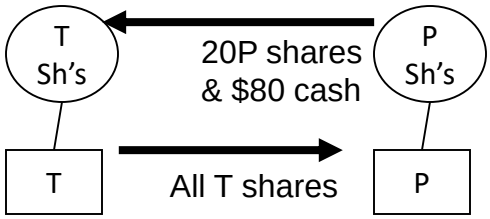


Ignore the 20 P shares in escrow

Example 6. New issuance. The facts are the same as in Example 1, except that, instead of cash, the T shareholders will receive a new class of P securities that will be publicly traded. In the aggregate, the securities will have a stated principal amount of $ 60 and bear interest at the average LIBOR (London Interbank Offered Rates) during the 10 days prior to the potential reorganization. If the T shareholders had been issued the P securities on January 2 of Year 1, the P securities would have had a value of $ 60 (determined by reference to the value of comparable publicly traded securities). Whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock and the P securities to be issued to the T shareholders on January 2 of Year 1. Under paragraph (e)(2)(iv) of this section, for purposes of valuing the new P securities, they will be treated as having been issued on January 2 of Year 1. Because, for continuity of interest purposes, the T stock is exchanged for $ 40 of P stock and $ 60 of other property, the transaction preserves a substantial part of the value of the proprietary interest in T. Therefore, the transaction satisfies the continuity of interest requirement.

COI- Treas. Reg. Section 1.368-1(e)(2)(v) Examples (Measuring Continuity)

Jan. 3 -binding contract (20% P stock) =[20 * $1.00/ (numerator + $80)]

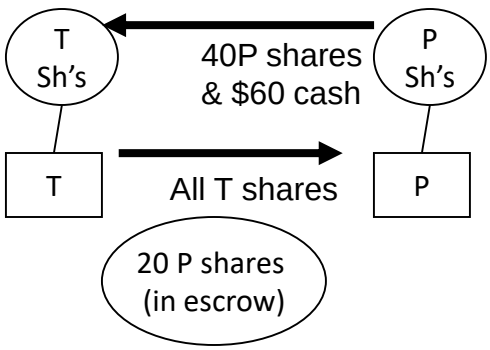


Example 7. Fixed consideration -- continuity not preserved. On January 3 of Year 1, P and T sign a binding contract pursuant to which T will be merged with and into P on June 1 of Year 1. Pursuant to the contract, 60 shares of the T stock will be exchanged for $ 80 of cash and 40 shares of the T stock will be exchanged for 20 shares of P stock. On January 2 of Year 1, the value of the P stock is $ 1 per share. On June 1 of Year 1, T merges with and into P pursuant to the terms of the contract. This contract provides for fixed consideration and therefore whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on January 2 of Year 1. However, applying the signing date rule, the P stock represents only 20 percent of the value of the total consideration to be received by the T shareholders. Accordingly, based on the economic realities of the exchange, the transaction does not preserve a substantial part of the value of the proprietary interest in T. **Therefore, the transaction does not satisfy the continuity of interest requirement.**

COI- Treas. Reg. Section 1.368-1(e)(2)(v) Examples (Measuring Continuity)

Jan. 3 -binding contract (40% P stock) =[40 * $1.00/ (numerator + $60)]
April 10- stock split

No anti dilution clause



April 10, Yr. 1, stock split of P And NO anti-dilution clause-

Can't use 1/3/Yr. 1 date

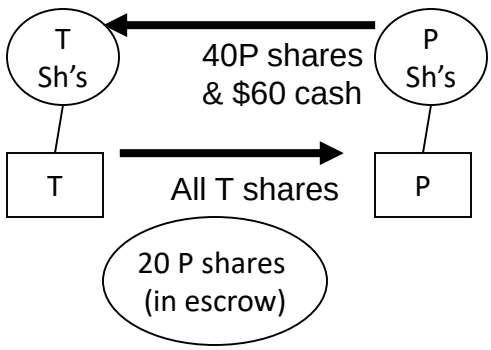
Example 8. Anti-dilution clause. (i) Absence of anti-dilution clause. On January 3 of Year 1, P and T sign a binding contract pursuant to which T will be merged with and into P on June 1 of Year 1. Pursuant to the contract, the T shareholders will receive 40 P shares and $ 60 of cash in exchange for all of the outstanding stock of T. **The contract does not contain a customary anti-dilution provision.** The P stock is listed on an established market. On January 2 of Year 1, the value of the P stock is $ 1 per share. On April 10 of Year 1, P issues its stock to effect a stock split; each shareholder of P receives an additional share of P for each P share that it holds. **On April 11 of Year 1, the value of the P stock is $ .50 per share. Because P altered its capital structure between January 3 and June 1 of Year 1 in a manner that materially alters the economic arrangement of the parties, under paragraph (e)(2)(iii)(E) of this section, the contract is not treated as a binding contract that provides for fixed consideration.** Accordingly, whether the transaction satisfies the continuity of interest requirement cannot be determined by reference to the value of the P stock on January 2 of Year 1.

COI- Treas. Reg. Section 1.368-1(e)(2)(v) Examples (Measuring Continuity)

Jan. 3 -binding contract (40% P stock) =[40 * $1.00/ (numerator + $60)]
April 10- stock split (40% P stock) =[80 * .50/ (numerator + $60)

* Although take Jan. 3, Yr. 1 date, need to adjust for stock split

Anti dilution clause



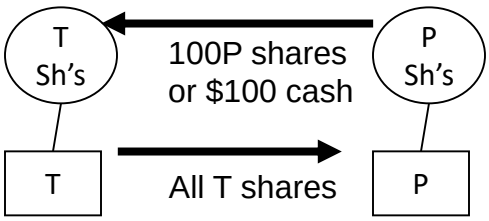
April 10, Yr. 1, stock split of P anti-dilution clause-

Example 8(ii)

(ii) Adjustment for anti-dilution clause. The facts are the same as in paragraph (i) of this Example 8 except that the contract contains a customary anti-dilution provision, and the T shareholders receive 80 P shares and $ 60 of cash in exchange for all of the outstanding stock of T. Under paragraph (e)(2)(iii)(E) of this section, the contract is treated as a binding contract that provides for fixed consideration as of January 3 of Year 1. Therefore, whether the transaction satisfies the continuity of interest requirement is generally determined by reference to the value of the P stock on January 2 of Year 1. However, under paragraph (e)(2)(iii)(E) of this section, the value of the P stock on January 2 of Year 1 must be adjusted to take the stock split into account. For continuity of interest purposes, the T stock is exchanged for $ 40 of P stock (($ 1/2) x 80) and $ 60 of cash. **Therefore, the transaction satisfies the continuity of interest requirement.**

COI- Treas. Reg. Section 1.368-1(e)(2)(v) Examples (Measuring Continuity)

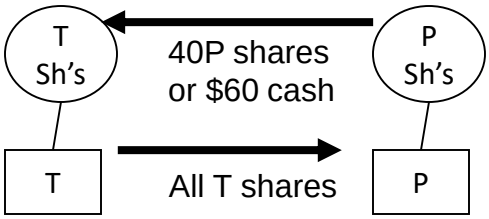
Jan. 3 -binding contract (100% P stock) =[100 * $1.00/ (numerator + $60)]
June 1 -anticipated merger date



Example 9. Shareholder election. On January 3 of Year 1, P and T sign a binding contract pursuant to which T will be merged with and into P on June 1 of Year 1. On January 2 of Year 1, the value of the P stock and the T stock is $ 1 per share. Pursuant to the contract, **at the shareholders' election, each share of T will be exchanged for cash of $ 1, or alternatively, P stock.** The contract provides that the determination of the number of shares of P stock to be exchanged for a share of T stock is made using the value of the P stock on the last business day before the first date there is a binding contract (i.e., $ 1 per share). Accordingly, the contract provides for fixed consideration, and the determination of whether the transaction satisfies the continuity of interest requirement is based on the number of shares of P stock the T shareholders receive in the exchange and by reference to the value of the P stock on January 2 of Year 1.

COI- Treas. Reg. Section 1.368-1(e)(2)(v) Examples (Measuring Continuity) COI

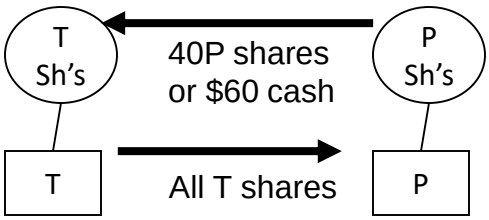
Jan. 3 -binding contract (40% P stock) =[40 * $1.00/ (numerator + $60)] (if P share value does not change)
June 1 -anticipated merger date
Additional $.16 of P stock and $.24 for every $.01 drop in value of P stock after 1/2/yr.1
-T shareholders receive 24 more P shares ((60 [each time P stock decreased by $.01] x $ .16)/$ .40 [share price 6/1/yr.1])
and $ 14.40 more cash (60 [each time P stock decreased by $.01] x $ .24) than they would absent an adjustment.
–total of 64 P shares and $74.70
- P shares are fixed on June 1 (25.60% P stock) =[64 * $.40/ (numerator + $74.40)] COI not met



Example 10. Contingent adjustment based on the value of the issuing corporation stock--continuity not preserved. On January 3 of Year 1, P and T sign a binding contract pursuant to which T will be merged with and into P on June 1 of Year 1. On January 2 of Year 1, the value of the P stock is $ 1 per share. Pursuant to the contract, if the value of the P stock does not decrease after January 2 of Year 1, the T shareholders will receive 40 P shares and $ 60 of cash in exchange for all of the outstanding stock of T. Furthermore, the contract provides that the T shareholders will receive $ .16 of additional P shares and $ .24 for every $ .01 decrease in the value of one share of P stock after January 2 of Year 1. On June 1 of Year 1, T merges with and into P pursuant to the terms of the contract. **On that date, the value of the P stock is $ .40 per share. Pursuant to the terms of the contract, the consideration is adjusted so that the T shareholders receive 24 more P shares ((60 x $ .16)/$ .40) and $ 14.40 more cash (60 x $ .24) than they would absent an adjustment. Accordingly, at closing the T shareholders receive 64 P shares and $ 74.40 of cash. Because the contract provides that additional P shares and cash will be delivered to the T shareholders if the value of the stock of P decreases after January 2 of Year 1, under paragraph (e)(2)(iii)(B)(2) of this section, the contract is not treated as providing for fixed consideration, and therefore whether the transaction satisfies the continuity of interest requirement cannot be determined by reference to the value of the P stock on January 2 of Year 1. For continuity of interest purposes, the T stock is exchanged for $ 25.60 of P stock (64 x $ .40) and $ 74.40 of cash and the transaction does not preserve a substantial part of the value of the proprietary interest in T. Therefore, the transaction does not satisfy the continuity of interest requirement.**

COI- Treas. Reg. Section 1.368-1(e)(2)(v) Examples (Measuring Continuity) COI

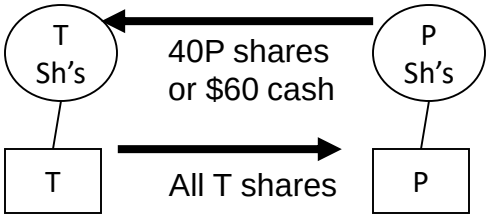
Jan. 3 -binding contract (40% P stock) =[40 * $1.00/ (numerator + $60)] (If T shares don't increase)
June 1 -anticipated merger date
Additional $1.00 cash for $.01 increase in value of T stock after 1/3/yr.1
40/140= 28.57% binding contract (28.57% P stock) =[40 * $1.00/ (numerator + $100)]



Example 11. Contingent adjustment to boot based on the value of the target corporation stock -- continuity not preserved. On January 3 of Year 1, P and T sign a binding contract pursuant to which T will be merged with and into P on June 1 of Year 1. On January 2 of Year 1, T has 100 shares outstanding, and each T share is worth $ 1. On January 2 of Year 1, each P share is worth $ 1. Pursuant to the contract, **if the value of the T stock does not increase after January 3 of Year 1,** the T shareholders will receive 40 P shares and $ 60 of cash in exchange for all of the outstanding stock of T. Furthermore, the contract provides that the T shareholders will receive **$ 1 of additional cash for every $ .01 increase in the value of one share of T stock** after January 3 of Year 1. On **June 1 of Year 1, the value of the T stock is $ 1.40 per share and the value of the P stock is $ .75 per share.** Pursuant to the terms of the contract, the consideration is adjusted so that the T shareholders receive $ 40 more cash (40 x $ 1) than they would absent an adjustment. Accordingly, at closing the T shareholders receive 40 P shares and $ 100 of cash. Because the contract provides the number of shares of P stock and the amount of money to be exchanged for all the proprietary interests in T, and the contingent adjustment to the cash consideration is not based on changes in the value of the P stock, P assets, or any surrogate thereof, after January 2 of Year 1, there is a binding contract providing for fixed consideration as of January 3 of Year 1. Therefore, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on January 2 of Year 1. For continuity of interest purposes, the T stock is exchanged for $ 40 of P stock (40 x $ 1) and $ 100 of cash. Therefore, the transaction does not satisfy the continuity of interest requirement.

COI- Treas. Reg. Section 1.368-1(e)(2)(v) Examples (Measuring Continuity) COI

Jan. 3 -binding contract (40% P stock) =[40 * $1.00/ (numerator + $60)] (if T share value does not decrease after 1/3/yr.1)
June 1 -anticipated merger date
If T shares decrease after 1/3/yr.1, for every $.01 T share decrease, decrease in $.40 P stock and $.60 cash
-T shareholders receive 12 less P shares ((30 [each time T stock decreased by $.01] x $ .40)/$1)
and $ 18.00 less cash (30 [each time T stock decreased by $.01] x $ .60) than they would absent an adjustment.
–total of 28 P shares and $42 received on closing date
-P shares are fixed on Jan 2, Yr.1 (40% P stock) =[28 * $1.00/ (numerator + $42)] ** this is what is used COI met
-If, notice, we were to use the value on June 1, Yr. 1, I think COI still would have been met? (this is not part of the example)
-P share prices are fixed on 6/1/Yr. 1 (33.33% P stock) =[28 * $.75/ (numerator + $42)] ** this is what is used & COI is met (33.33% P stock) =[21/21&42]



Compare with example 10, if the contingent adjustment
relates to the value of T stock (versus P stock)- use binding contract date

Example 12. Contingent adjustment to stock based on the value of the target corporation stock -- continuity preserved. On January 3 of Year 1, P and T sign a binding contract pursuant to which T will be merged with and into P on June 1 of Year 1. On that date T has 100 shares outstanding, and each T share is worth $ 1. On January 2 of Year 1, each P share is worth $ 1. Pursuant to the contract, if the value of the T stock does not decrease after January 3 of Year 1, the T shareholders will receive 40 P shares and $ 60 of cash in exchange for all of the outstanding stock of T. Furthermore, the contract provides that the T shareholders will receive $ .40 less P stock and $ .60 less cash for every $ .01 decrease in the value of one share of T stock after January 3 of Year 1. The contract also provides that the number of P shares by which the consideration will be reduced as a result of this adjustment will be determined based on the value of the P stock on January 2 of Year 1. On June 1 of Year 1, T merges with and into P pursuant to the terms of the contract. On that date, the value of the T stock is $ .70 per share and the value of the P stock is $ .75 per share. Pursuant to the terms of the contract, the consideration is adjusted so that the T shareholders receive 12 fewer P shares ((30 x $ .40)/$ 1) and $ 18 less cash (30 x $ .60) than they would absent an adjustment. Accordingly, at closing the T shareholders receive 28 P shares and $ 42 of cash. Because the contract provides for the number of shares of P stock and the amount of money to be exchanged for all of the proprietary interests in T, the contract does not provide for contingent adjustments to the consideration based on a change in value of the P stock, P assets, or any surrogate thereof, after January 2 of Year 1, and the adjustment to the number of P shares the T shareholders receive is determined based on the value of the P shares on January 2 of Year 1, there is a binding contract providing for fixed consideration as of January 3 of Year 1. Therefore, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on January 2 of Year 1. For continuity of interest purposes, the T stock is exchanged for $ 28 of P stock (28 x $ 1) and $ 42 of cash. Therefore, the transaction satisfies the continuity of interest requirement.

COBE

Case law

Regulations TD 8760 (1998)

Revenue Rulings

COBE was updated for TD 9361 Temp
Need to update for Final regs under TD 9396

Section 1.368-1(d) COBE Updated for TD 9361 (published in F.R. October 25, 2007). TD 9361 has an impact on COBE examples 7 to 14 as well as the 1.368-2(k) regs

Decision Tree for COBE

COBE requires either:

(1) issuing corporation continue the target's historic business (business continuity) or

(2) use a significant portion of target's business assets (asset continuity)

Either of the below suffices

Business continuity test OR Asset continuity test

Is there more than one significant line of business (**SLOB**) of the the target continued in the issuing corporation or a member of the **qualified group** of the issuing Corporation?

Note: qualified group membership of a corporate subsidiary is met using 368(c) control.

However, the definition is tweaked to allow ownership to be aggregated.

Thus, for example, if issuing corp P owns S-1 and S-2 and S-1 and S-2 own ½ of the 368(c) control of S-3. If the target assets are in S-3, the 368(c) ownership of S-3 can be attributed up to P as if P owns the business assets since S-3 is a member (in a chain) of the qualified group of P. Normally, 368(c) requires each sub to own 80% directly at each level (thus not meeting 80%). However, these rules are different from the normal application

If Yes- COBE is met so far-

If some of the assets/stock are contributed to a partnership go to the next page

Is a significant portion of T's historic business assets (**HBA**) used in the issuing corporation of one of its **corporate qualified group** members?

If Yes- COBE is met so far-

If some of the assets are contributed to a partnership go to the next page

Section 1.368-1(d) COBE Updated for TD 9361 (published in F.R. October 25, 2007). TD 9361 has an impact on COBE examples 7 to 14 as well as the 1.368-2(k) regs

Decision Tree for COBE (Contribution to partnership)

Contribution of Target stock or assets/(business) to a partnership?

Contribution of **target stock** to a partnership

368(c) control of partnership
by COBE QG member?
(rem: can aggregate stock)
=80% total voting all classes and
80% of each class of non voting stock

Yes

No
This is a
COBE problem

Examples 14, 15

Contribution of **target assets /(business)** to partnership

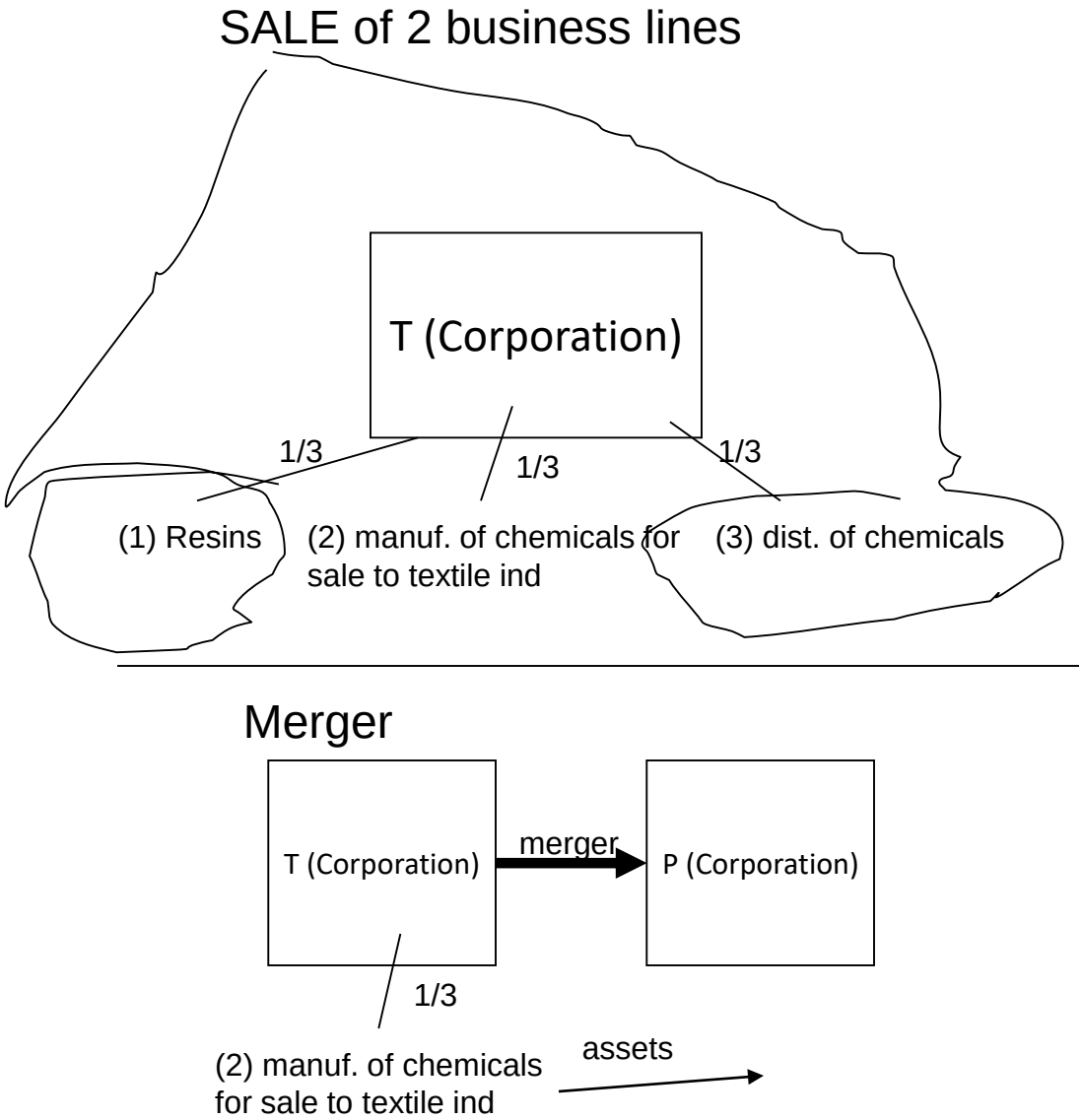
Either:
(1) Owns significant interest in ptsp (33.33%)
and no requirement of pasmf, or
(2) Pasmf and interest in partnership
(not 1%), must be larger % (not necessarily 33.33% as meet above …. not certain)? (reminder: can aggregate for these tests (1) and (2) above)

Yes

No
This is a
COBE
problem

Examples 8, 9, 10, 11, 12, 13

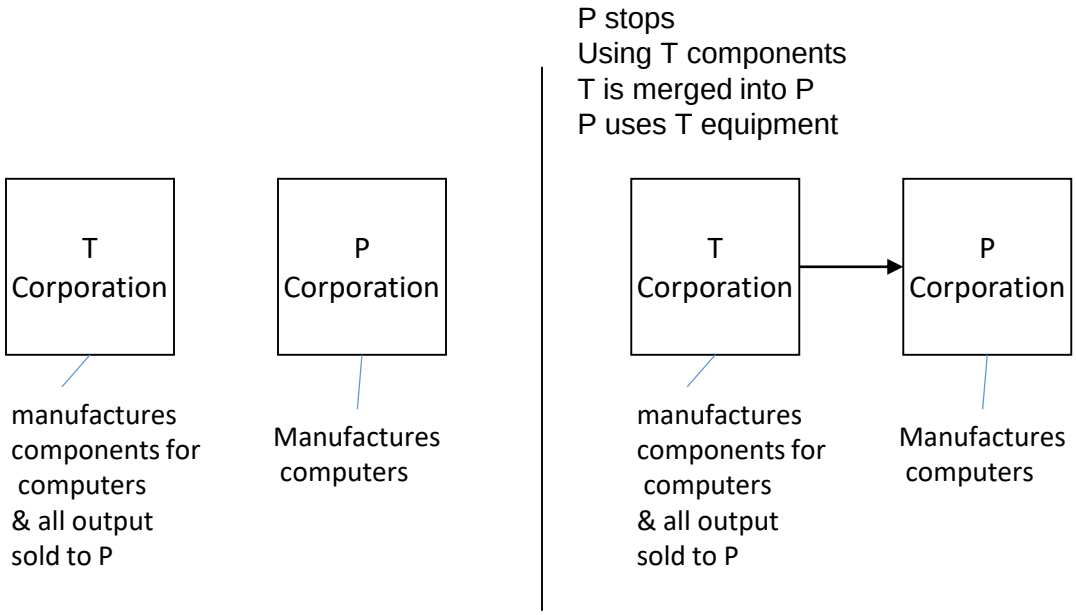
Section 1.368-1(d) COBE Updated for TD 9361 (published in F.R. October 25, 2007). TD 9361 has an impact on COBE examples 7 to 14 as well as the 1.368-2(k) regs



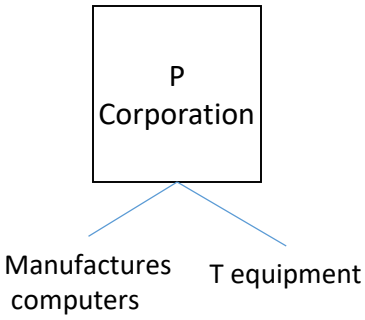
COBE 1.368-1(d)(5)

Example 1. T conducts three lines of business: manufacture of synthetic resins, manufacture of chemicals for the textile industry, and distribution of chemicals. The three lines of business are approximately equal in value. On July 1, 1981, T sells the synthetic resin and chemicals distribution businesses to a third party for cash and marketable securities. On December 31, 1981, T transfers all of its assets to P solely for P voting stock. P continues the chemical manufacturing business without interruption. The continuity of business enterprise requirement is met. Continuity of business enterprise requires only that P continue one of T's three significant lines of business.

Section 1.368-1(d) COBE Updated for TD 9361 (published in F.R. October 25, 2007). TD 9361 has an impact on COBE examples 7 to 14 as well as the 1.368-2(k) regs



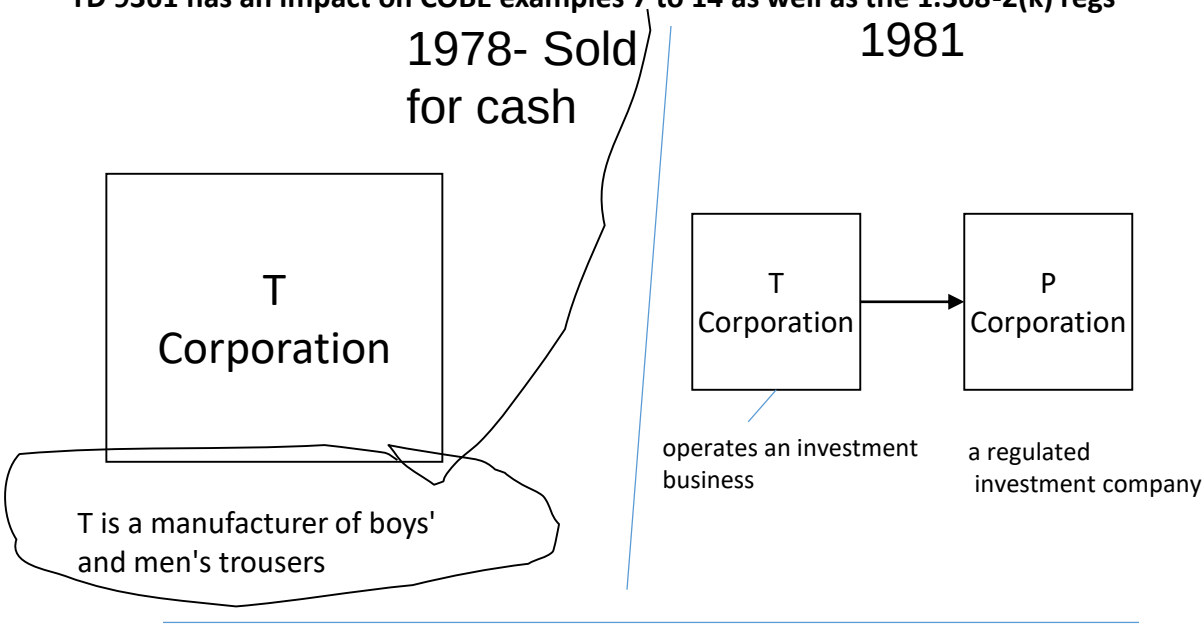
Result:



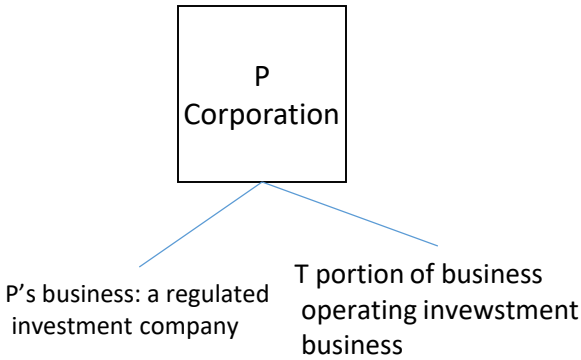
1.368-1(d)(5) COBE

Example 2. P manufactures computers and T manufactures components for computers. T sells all of its output to P. On January 1, 1981, P decides to buy imported components only. On March 1, 1981, T merges into P. P continues buying imported components but retains T's equipment as a backup source of supply. The use of the equipment as a backup source of supply constitutes use of a significant portion of T's historic business assets, thus establishing continuity of business enterprise. P is not required to continue T's business.

Section 1.368-1(d) COBE Updated for TD 9361 (published in F.R. October 25, 2007). TD 9361 has an impact on COBE examples 7 to 14 as well as the 1.368-2(k) regs



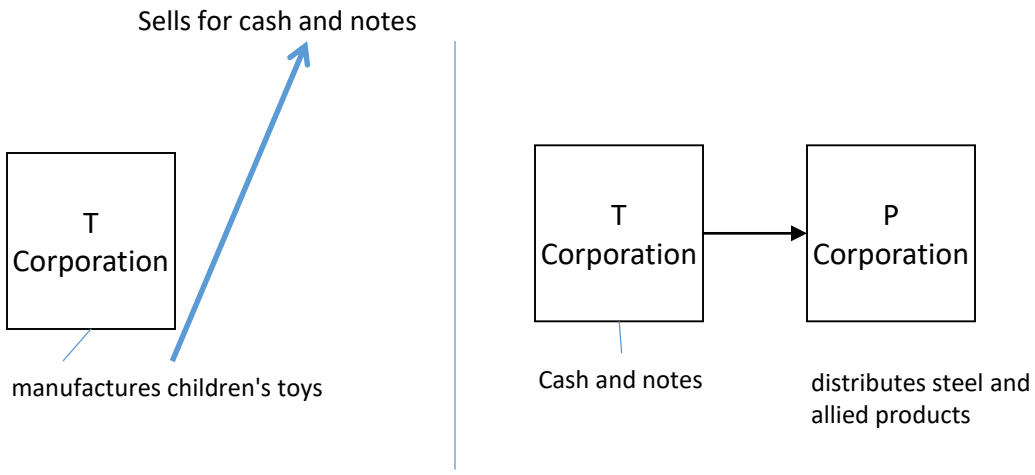
Result:



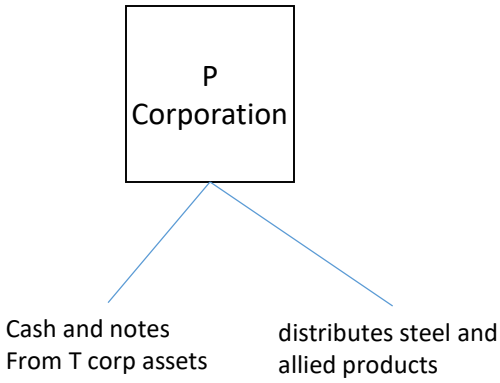
1.368-1(d)(5) COBE

Example 3. T is a manufacturer of boys' and men's trousers. On January 1, 1978, as part of a plan of reorganization, T sold all of its assets to a third party for cash and purchased a highly diversified portfolio of stocks and bonds. As part of the plan T operates an investment business until July 1, 1981. On that date, the plan of reorganization culminates in a transfer by T of all its assets to P, a regulated investment company, solely in exchange for P voting stock. The continuity of business enterprise requirement is not met. T's investment activity is not its historic business, and the stocks and bonds are not T's historic business assets.

Section 1.368-1(d) COBE Updated for TD 9361 (published in F.R. October 25, 2007). TD 9361 has an impact on COBE examples 7 to 14 as well as the 1.368-2(k) regs



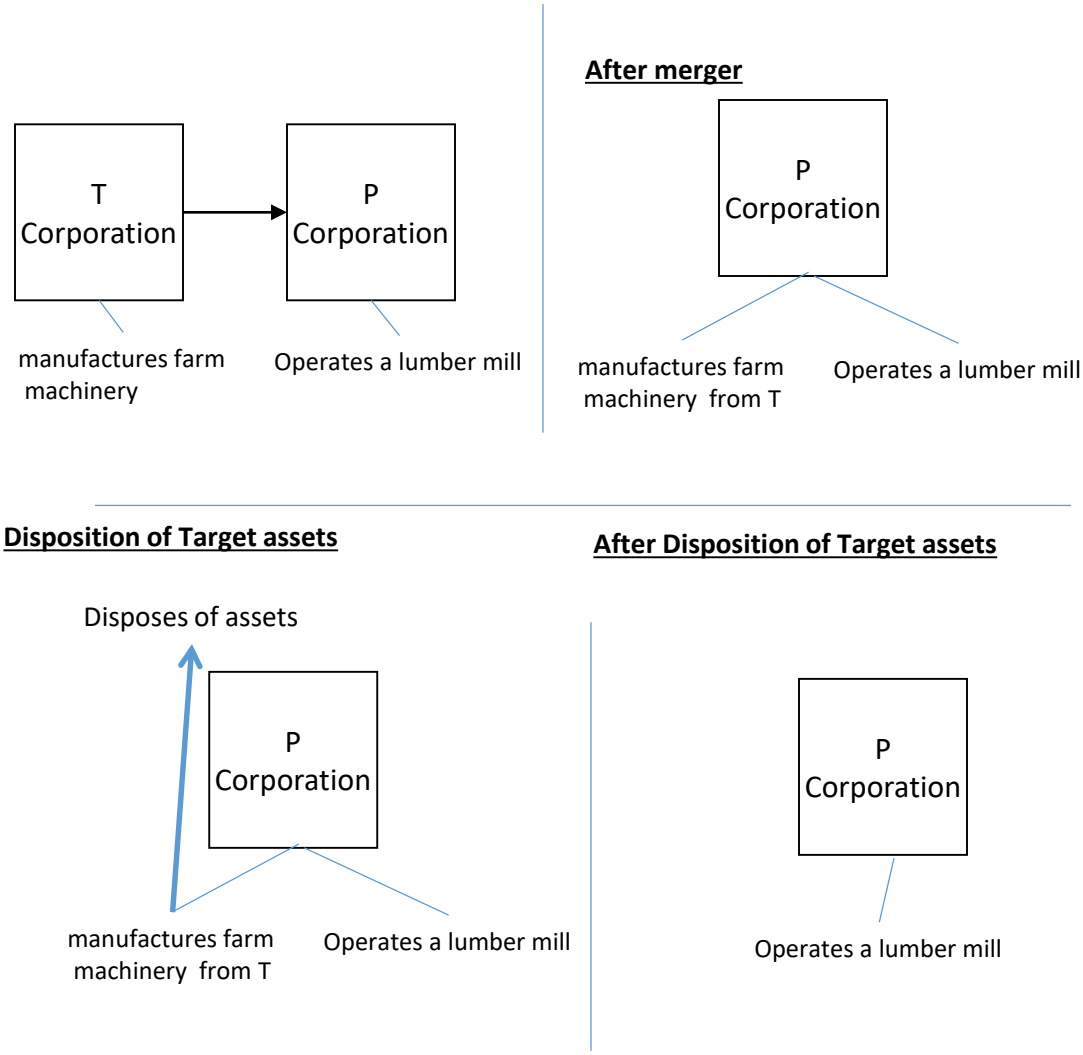
Result:



1.368-1(d)(5) COBE

Example 4. T manufactures children's toys and P distributes steel and allied products. On January 1, 1981, T sells all of its assets to a third party for $ 100,000 cash and $ 900,000 in notes. On March 1, 1981, T merges into P. Continuity of business enterprise is lacking. The use of the sales proceeds in P's business is not sufficient.

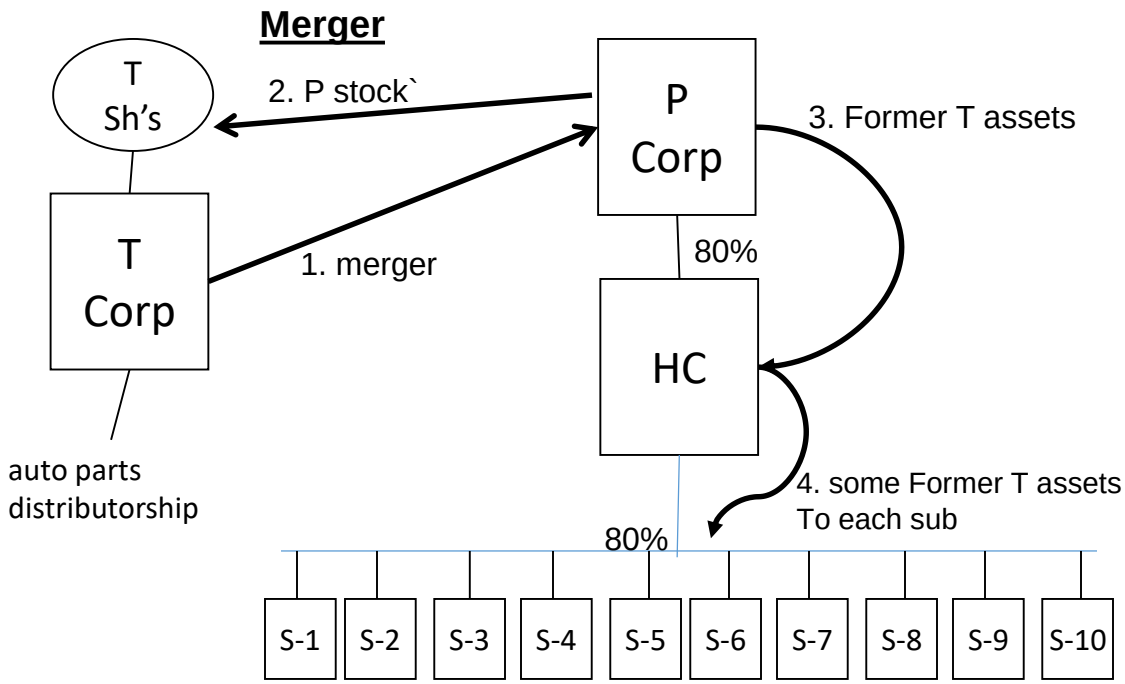
Section 1.368-1(d) COBE Updated for TD 9361 (published in F.R. October 25, 2007). TD 9361 has an impact on COBE examples 7 to 14 as well as the 1.368-2(k) regs



1.368-1(d)(5) COBE

Example 5. T manufactures farm machinery and P operates a lumber mill. T merges into P. P disposes of T's assets immediately after the merger as part of the plan of reorganization. P does not continue T's farm machinery manufacturing business. Continuity of business enterprise is lacking.

Section 1.368-1(d) COBE Updated for TD 9361 (published in F.R. October 25, 2007). TD 9361 has an impact on COBE examples 7 to 14 as well as the 1.368-2(k) regs



S-1 through S-10 each separately operate a full service gas station

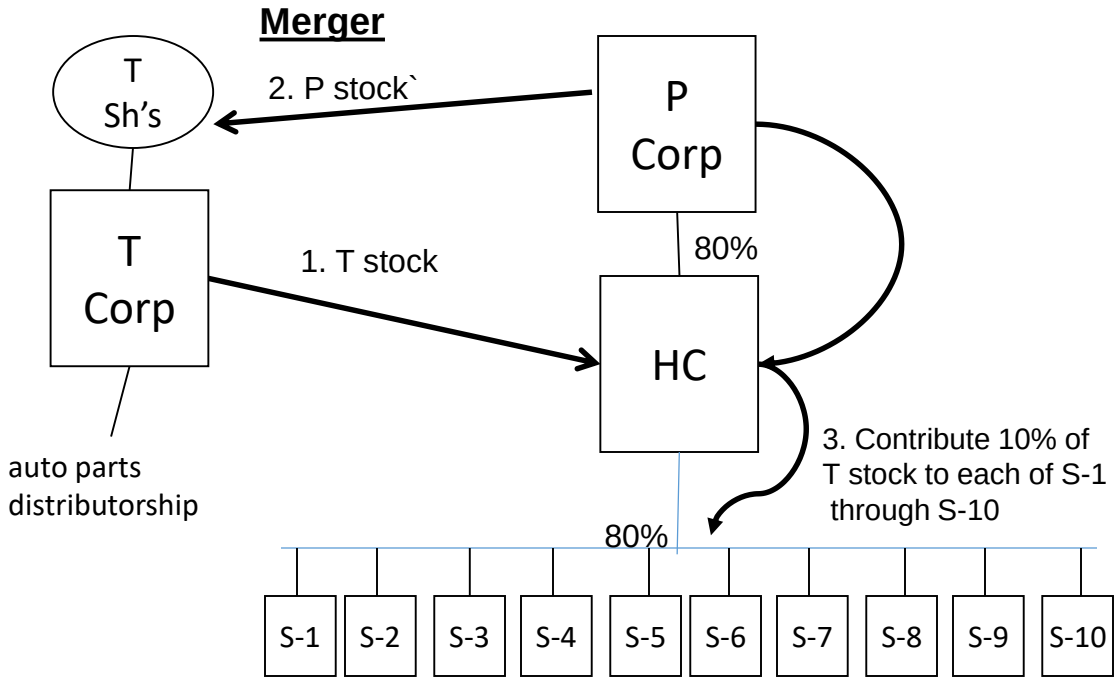
1.368-1(d)(5) COBE

Example 6. Use of a significant portion of T's historic business assets by the qualified group. (i) Facts. T operates an auto parts distributorship. P owns 80 percent of the stock of a holding company (HC). HC owns 80 percent of the stock of ten subsidiaries, S-1 through S-10. S-1 through S-10 each separately operate a full service gas station. Pursuant to a plan of reorganization, T merges into P and the T shareholders receive solely P stock. As part of the plan of reorganization, P transfers T's assets to HC, which in turn transfers some of the T assets to each of the ten subsidiaries. No one subsidiary receives a significant portion of T's historic business assets. Each of the subsidiaries will use the T assets in the operation of its full service gas station. No P subsidiary will be an auto parts distributor.

(ii) Continuity of business enterprise. Under paragraph (d)(4)(i) of this section, P is treated as conducting the ten gas station businesses of S-1 through S-10 and as holding the historic T assets used in those businesses. P is treated as holding all the assets and conducting the businesses of all of the members of the qualified group, which includes S-1 through S-10 (paragraphs (d)(4)(i) and (ii) of this section). No member of the qualified group continues T's historic distributorship business. However, subsidiaries S-1 through S-10 continue to use the historic T assets in a business. Even though no one corporation of the qualified group is using a significant portion of T's historic business assets in a business, the COBE requirement of paragraph (d)(1)

of this section is satisfied because, in the aggregate, the qualified group is using a significant portion of T's historic business assets in a business.

Section 1.368-1(d) COBE Updated for TD 9361 (published in F.R. October 25, 2007). TD 9361 has an impact on COBE examples 7 to 14 as well as the 1.368-2(k) regs



S-1 through S-10 each separately operate a full service gas station

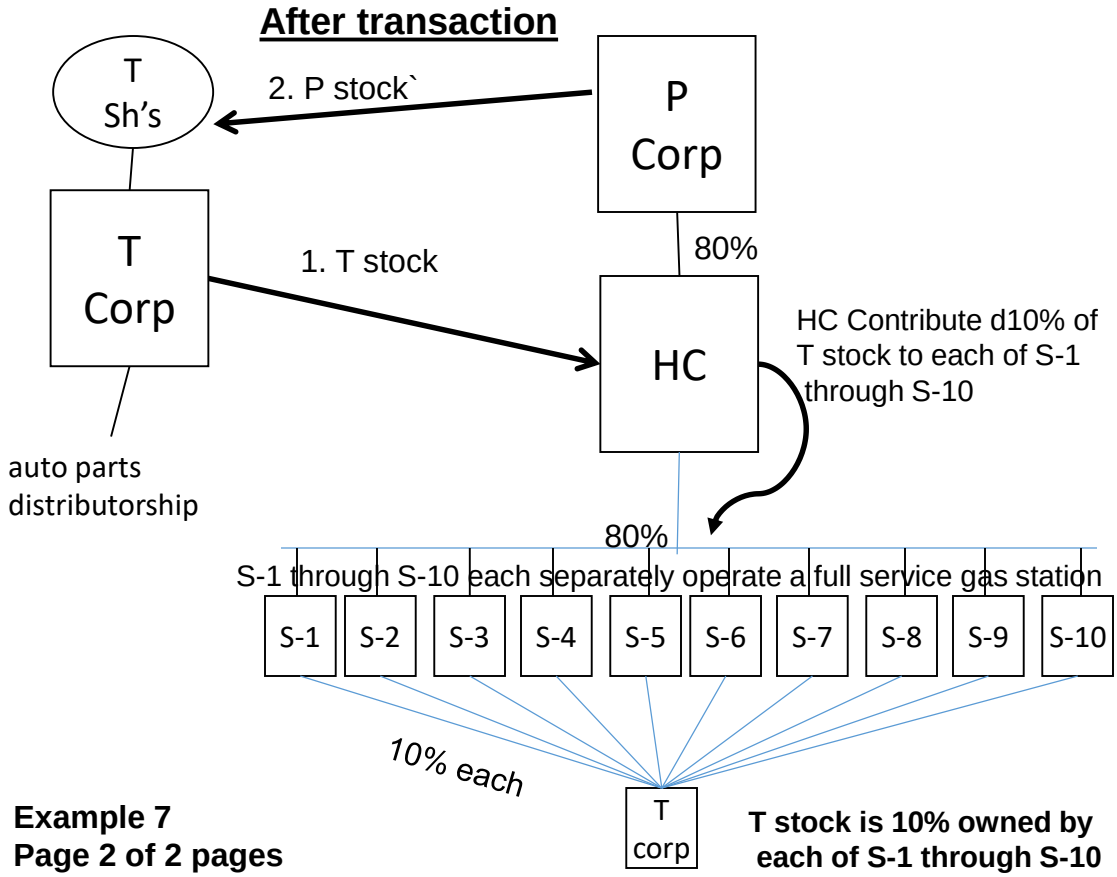
Example 7
Page 1 of 2 pages

1.368-1(d)(5) COBE

Example 7. Transfers of acquired stock to members of the qualified group--continuity of business enterprise satisfied. (i) Facts. The facts are the same as Example 6, except that, instead of P acquiring the assets of T, HC acquires all of the outstanding stock of T in exchange solely for stock of P. In addition, as part of the plan of reorganization, HC transfers 10 percent of the stock of T to each of subsidiaries S-1 through S-10. T will continue to operate an auto parts distributorship. Without regard to whether the transaction satisfies the COBE requirement, the transaction qualifies as a triangular B reorganization (as defined in § 1.358-6(b)(2)(iv)).

(ii) Continuity of business enterprise. Under paragraph (d)(4)(i) of this section, P is treated as holding the assets and conducting the business of T because T is a member of the qualified group (as defined in paragraph (d)(4)(ii) of this section). The COBE requirement of paragraph (d)(1) of this section is satisfied.

Section 1.368-1(d) COBE Updated for TD 9361 (published in F.R. October 25, 2007). TD 9361 has an impact on COBE examples 7 to 14 as well as the 1.368-2(k) regs



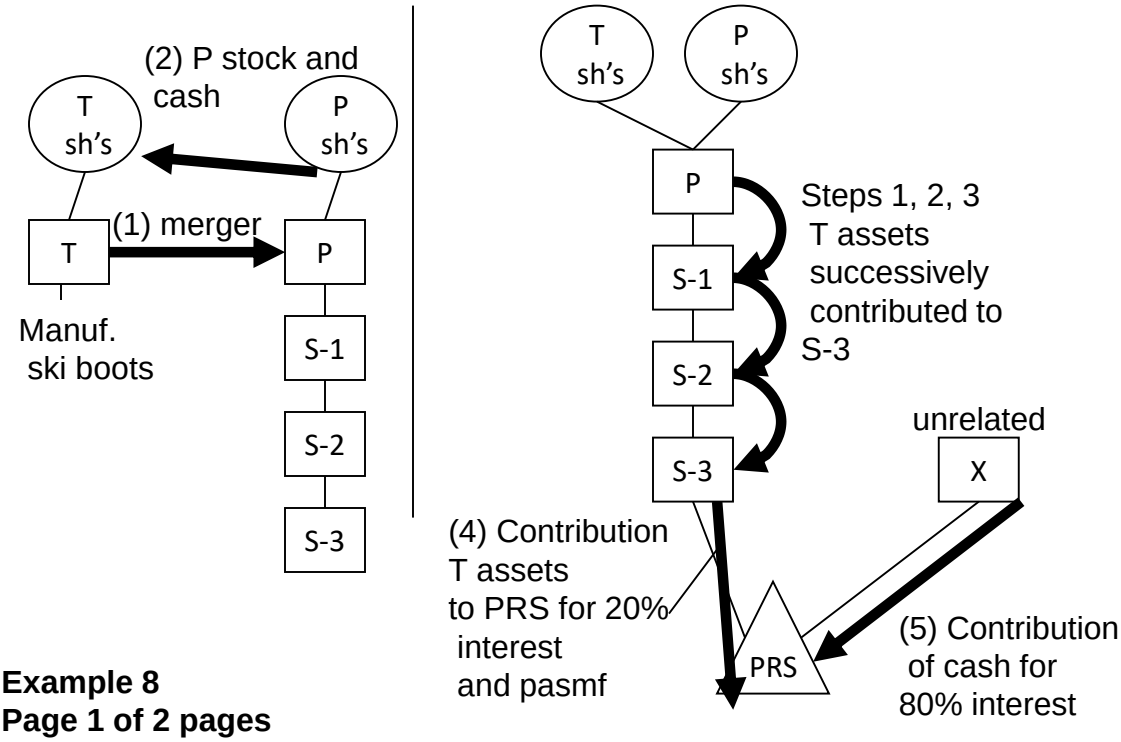
Example 7
Page 2 of 2 pages

1.368-1(d)(5) COBE

Example 7. Transfers of acquired stock to members of the qualified group--continuity of business enterprise satisfied. (i) Facts. The facts are the same as Example 6, except that, instead of P acquiring the assets of T, HC acquires all of the outstanding stock of T in exchange solely for stock of P. In addition, as part of the plan of reorganization, HC transfers 10 percent of the stock of T to each of subsidiaries S-1 through S-10. T will continue to operate an auto parts distributorship. Without regard to whether the transaction satisfies the COBE requirement, the transaction qualifies as a triangular B reorganization (as defined in § 1.358-6(b)(2)(iv)).

(ii) Continuity of business enterprise. Under paragraph (d)(4)(i) of this section, P is treated as holding the assets and conducting the business of T because T is a member of the qualified group (as defined in paragraph (d)(4)(ii) of this section). The COBE requirement of paragraph (d)(1) of this section is satisfied.

Section 1.368-1(d) COBE Updated for TD 9361 (published in F.R. October 25, 2007). TD 9361 has an impact on COBE examples 7 to 14 as well as the 1.368-2(k) regs



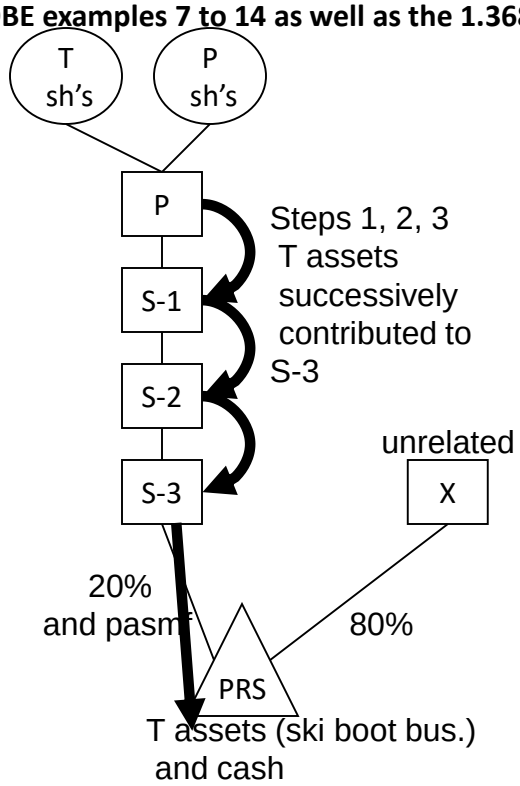
Example 8
Page 1 of 2 pages

Example 8. Continuation of the historic T business in a partnership satisfies continuity of business enterprise. (i) Facts. T manufactures ski boots. P owns all of the stock of S-1. S-1 owns all of the stock of S-2, and S-2 owns all of the stock of S-3. T merges into P and the T shareholders receive consideration consisting of P stock and cash. The T ski boot business is to be continued and expanded. In anticipation of this expansion, P transfers all of the T assets to S-1, S-1 transfers all of the T assets to S-2, and S-2 transfers all of the T assets to S-3. S-3 and X (an unrelated party) form a new partnership (PRS). As part of the plan of reorganization, S-3 transfers all the T assets to PRS, and S-3, in its capacity as a partner, performs active and substantial management functions for the PRS ski boot business, including making significant business decisions and regularly participating in the overall supervision, direction, and control of the employees of the ski boot business. S-3 receives a 20 percent interest in PRS. X transfers cash in exchange for an 80 percent interest in PRS.

(ii) Continuity of business enterprise. Under paragraph (d)(4)(iii)(B)(2) of this section, P is treated as conducting T's historic business because S-3 performs active and substantial management functions for the ski boot business in S-3's capacity as a partner. P is treated as holding all the assets and conducting the businesses of all of the members of the qualified group,

which includes S-3 (paragraphs (d)(4)(i) and (ii) of this section). The COBE requirement of paragraph (d)(1) of this section is satisfied.

Section 1.368-1(d) COBE Updated for TD 9361 (published in F.R. October 25, 2007). TD 9361 has an impact on COBE examples 7 to 14 as well as the 1.368-2(k) regs



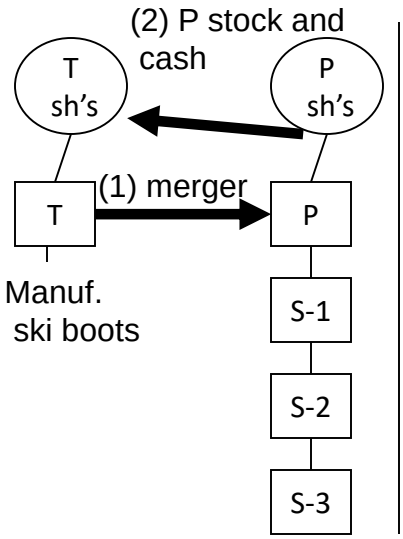
Example 8
Page 2 of 2 pages

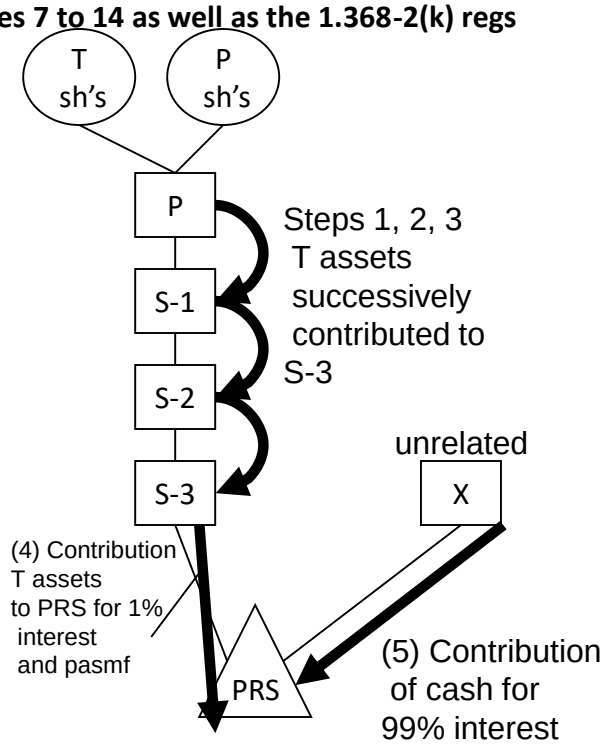
Example 8. Continuation of the historic T business in a partnership satisfies continuity of business enterprise. (i) Facts. T manufactures ski boots. P owns all of the stock of S-1. S-1 owns all of the stock of S-2, and S-2 owns all of the stock of S-3. T merges into P and the T shareholders receive consideration consisting of P stock and cash. The T ski boot business is to be continued and expanded. In anticipation of this expansion, P transfers all of the T assets to S-1, S-1 transfers all of the T assets to S-2, and S-2 transfers all of the T assets to S-3. S-3 and X (an unrelated party) form a new partnership (PRS). As part of the plan of reorganization, S-3 transfers all the T assets to PRS, and S-3, in its capacity as a partner, performs active and substantial management functions for the PRS ski boot business, including making significant business decisions and regularly participating in the overall supervision, direction, and control of the employees of the ski boot business. S-3 receives a 20 percent interest in PRS. X transfers cash in exchange for an 80 percent interest in PRS.

(ii) Continuity of business enterprise. Under paragraph (d)(4)(iii)(B)(2) of this section, P is treated as conducting T's historic business because S-3 performs active and substantial management functions for the ski boot business in S-3's capacity as a partner. P is treated as holding all the assets and conducting the businesses of all of the members of the qualified group,

which includes S-3 (paragraphs (d)(4)(i) and (ii) of this section). The COBE requirement of paragraph (d)(1) of this section is satisfied.

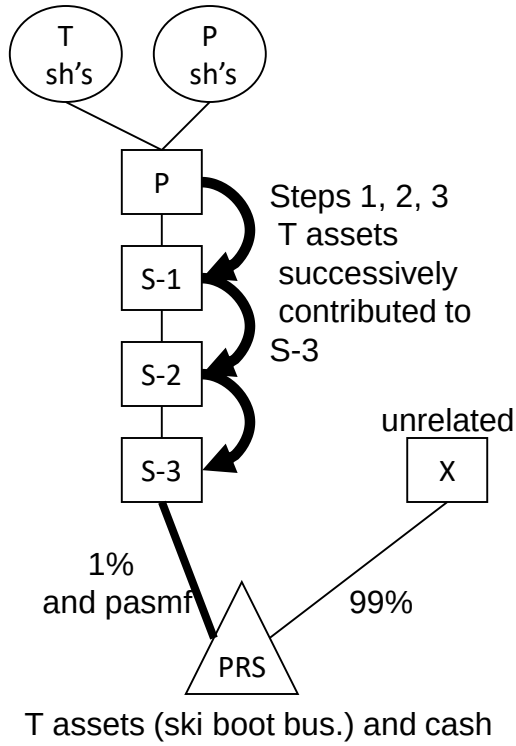
Section 1.368-1(d) COBE Updated for TD 9361 (published in F.R. October 25, 2007). TD 9361 has an impact on COBE examples 7 to 14 as well as the 1.368-2(k) regs



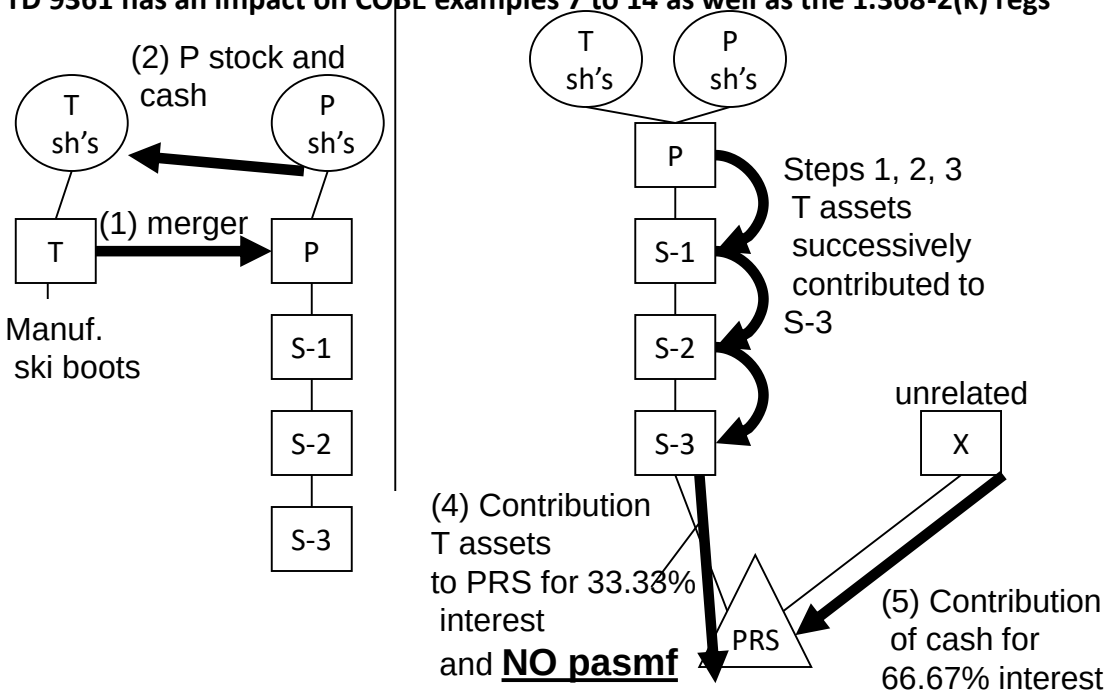


Example 9. Continuation of the historic T business in a partnership does not satisfy continuity of business enterprise. (i) Facts. The facts are the same as Example 8, except that S-3 transfers the historic T business to PRS in exchange for a 1 percent interest in PRS.

(ii) Continuity of business enterprise. Under paragraph (d)(4)(iii)(B)(2) of this section, P is treated as conducting T's historic business because S-3 performs active and substantial management functions for the ski boot business in S-3's capacity as a partner. The fact that a significant historic T business is conducted in PRS, and P is treated as conducting such T business under (d)(4)(iii)(B) tends to establish the requisite continuity, but is not alone sufficient (paragraph (d)(4)(iii)(C) of this section). The COBE requirement of paragraph (d)(1) of this section is not satisfied.

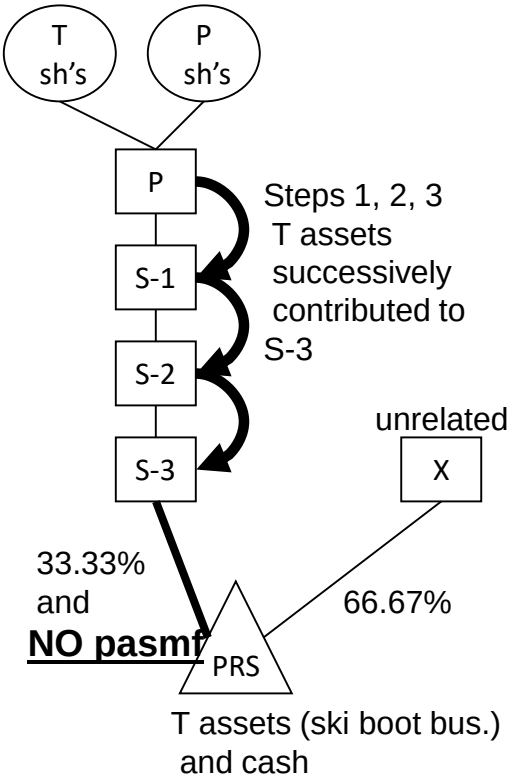


Section 1.368-1(d) COBE Updated for TD 9361 (published in F.R. October 25, 2007). TD 9361 has an impact on COBE examples 7 to 14 as well as the 1.368-2(k) regs

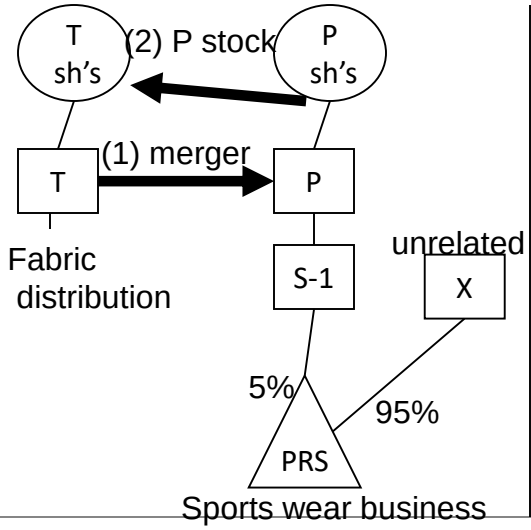


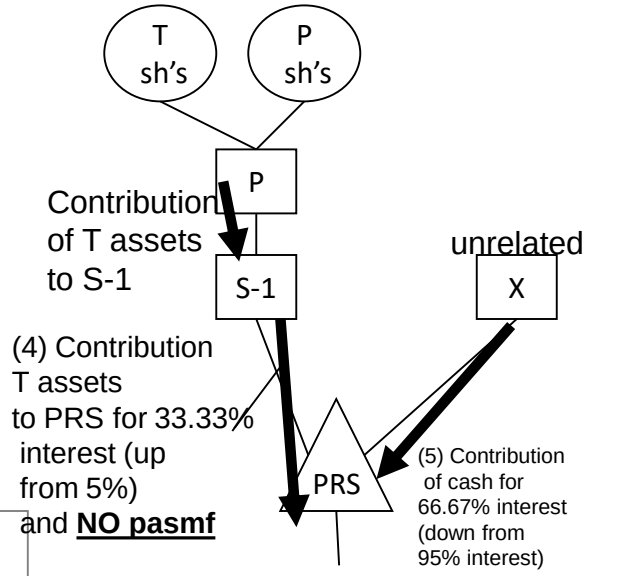
Example 10. Continuation of the T historic business in a partnership satisfies continuity of business enterprise. (i) Facts. The facts are the same as Example 8, except that S-3 transfers the historic T business to PRS in exchange for a 331/3 percent interest in PRS, and no member of P's qualified group performs active and substantial management functions for the ski boot business operated in PRS.

(ii) Continuity of business enterprise. Under paragraph (d)(4)(iii)(B)(1) of this section, P is treated as conducting T's historic business because S-3 owns an interest in the partnership representing a significant interest in that partnership business. P is treated as holding all the assets and conducting the businesses of all of the members of the qualified group, which includes S-3 (paragraphs (d)(4)(i) and (ii) of this section). The COBE requirement of paragraph (d)(1) of this section is satisfied.



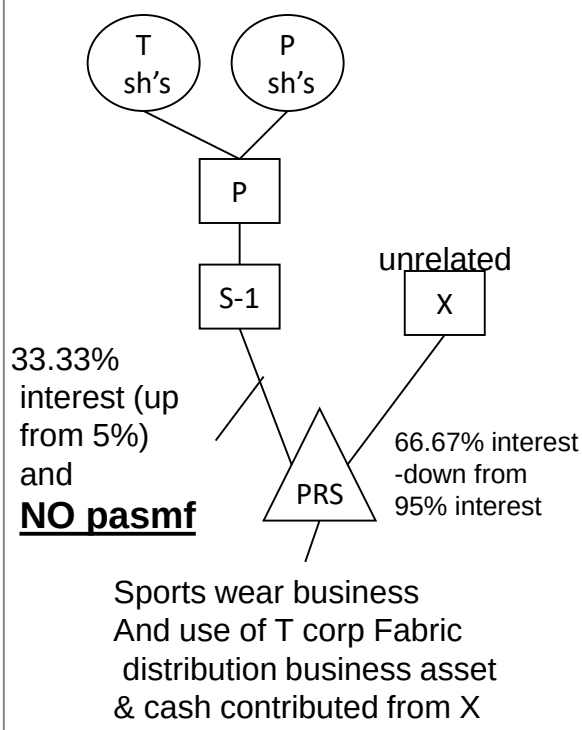
Section 1.368-1(d) COBE Updated for TD 9361 (published in F.R. October 25, 2007). TD 9361 has an impact on COBE examples 7 to 14 as well as the 1.368-2(k) regs





Example 11. Use of T's historic business assets in a partnership business. (i) Facts. T is a fabric distributor. P owns all of the stock of S-1. T merges into P and the T shareholders receive solely P stock. S-1 and X (an unrelated party) own interests in a partnership (PRS). As part of the plan of reorganization, P transfers all of the T assets to S-1, and S-1 transfers all the T assets to PRS, increasing S-1's percentage interest in PRS from 5 to 33 1/3 percent. After the transfer, X owns the remaining 66 2/3 percent interest in PRS. Almost all of the T assets consist of T's large inventory of fabric, which PRS uses to manufacture sportswear. All of the T assets are used in the sportswear business. No member of P's qualified group performs active and substantial management functions for the sportswear business operated in PRS.

(ii) Continuity of business enterprise. Under paragraph (d)(4)(iii)(A) of this section, S-1 is treated as owning 33 1/3 percent of the T assets used in the PRS sportswear manufacturing business. Under paragraph (d)(4)(iii)(B)(1) of this section, P is treated as conducting the sportswear manufacturing business because S-1 owns an interest in the partnership representing a significant interest in that partnership business. P is treated as holding all the assets and conducting the businesses of all of the members of the qualified group, which includes S-1 (paragraphs (d)(4)(i) and (ii) of this section). The COBE requirement of paragraph (d)(1) of this section is satisfied.



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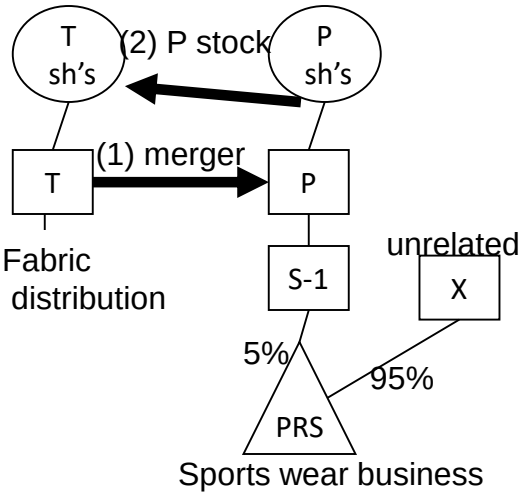
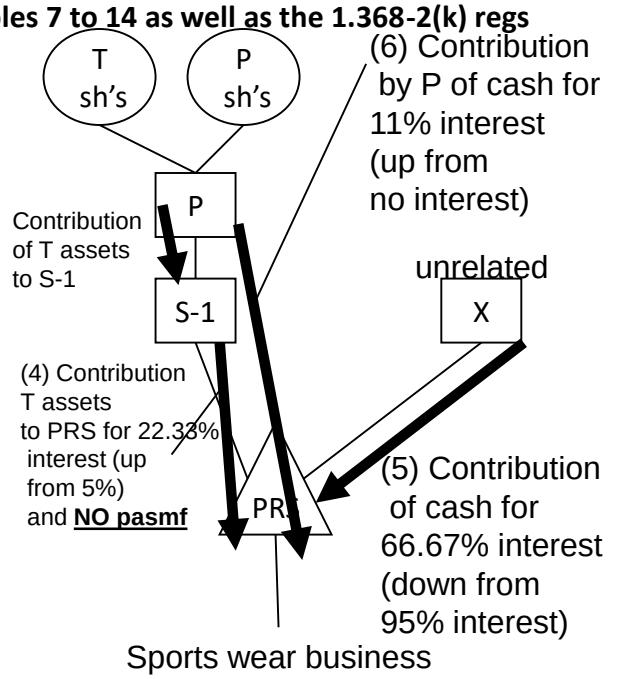
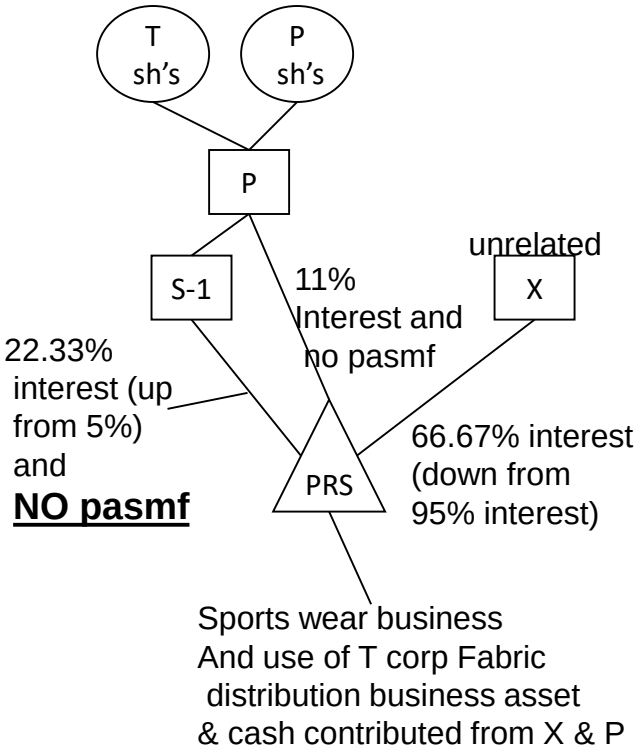


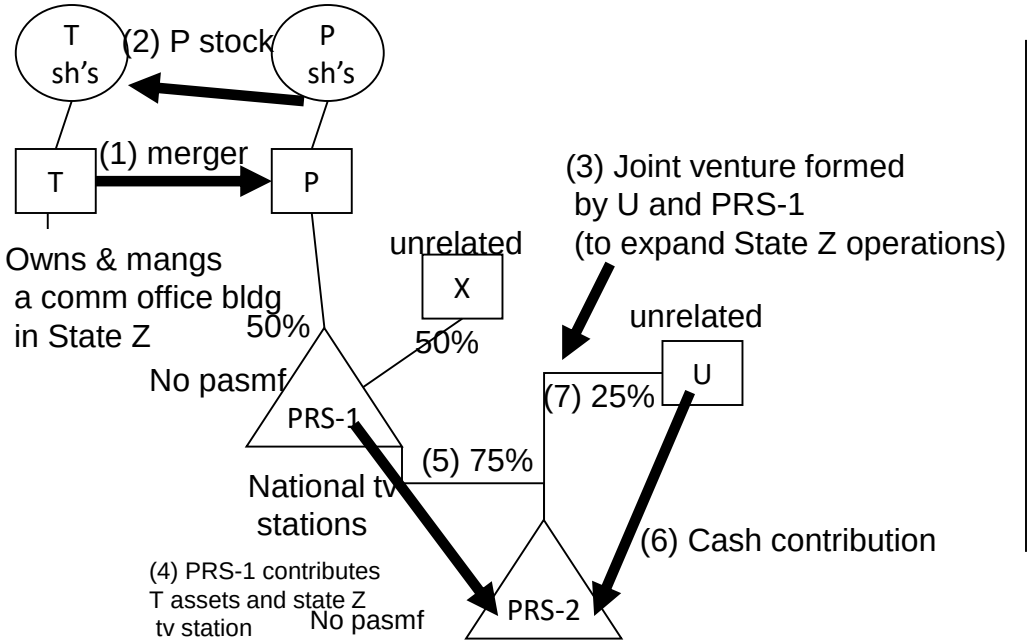


Example 12. Aggregation of partnership interests among members of the qualified group: use of T's historic business assets in a partnership business. (i) Facts. The facts are the same as Example 11, except that S-1 transfers all the T assets to PRS, and P and X each transfer cash to PRS in exchange for partnership interests. After the transfers, P owns 11 percent, S-1 owns 22 1/3 percent, and X owns 66 2/3 percent of PRS.

(ii) Continuity of business enterprise. Under paragraph (d)(4)(iii)(B)(1) of this section, P is treated as conducting the sportswear manufacturing business because members of the qualified group, in the aggregate, own an interest in the partnership representing a significant interest in that business. P is treated as owning 11 percent of the assets directly, and S-1 is treated as owning 22 1/3 percent of the assets, used in the PRS sportswear business (paragraph (d)(4)(iii)(A) of this section). P is treated as holding all the assets of all of the members of the qualified group, which includes S-1, and thus in the aggregate, P is treated as owning 33 1/3 of the T assets (paragraphs (d)(4)(i) and (ii) of this section). The COBE requirement of paragraph (d)(1) of this section is satisfied because P is treated as using a significant portion of T's historic business assets in its sportswear manufacturing business.

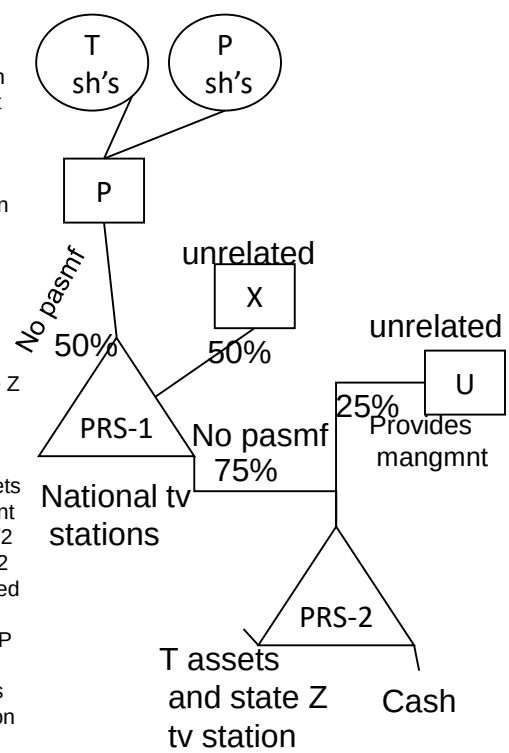


Section 1.368-1(d) COBE Updated for TD 9361 (published in F.R. October 25, 2007). TD 9361 has an impact on COBE examples 7 to 14 as well as the 1.368-2(k) regs

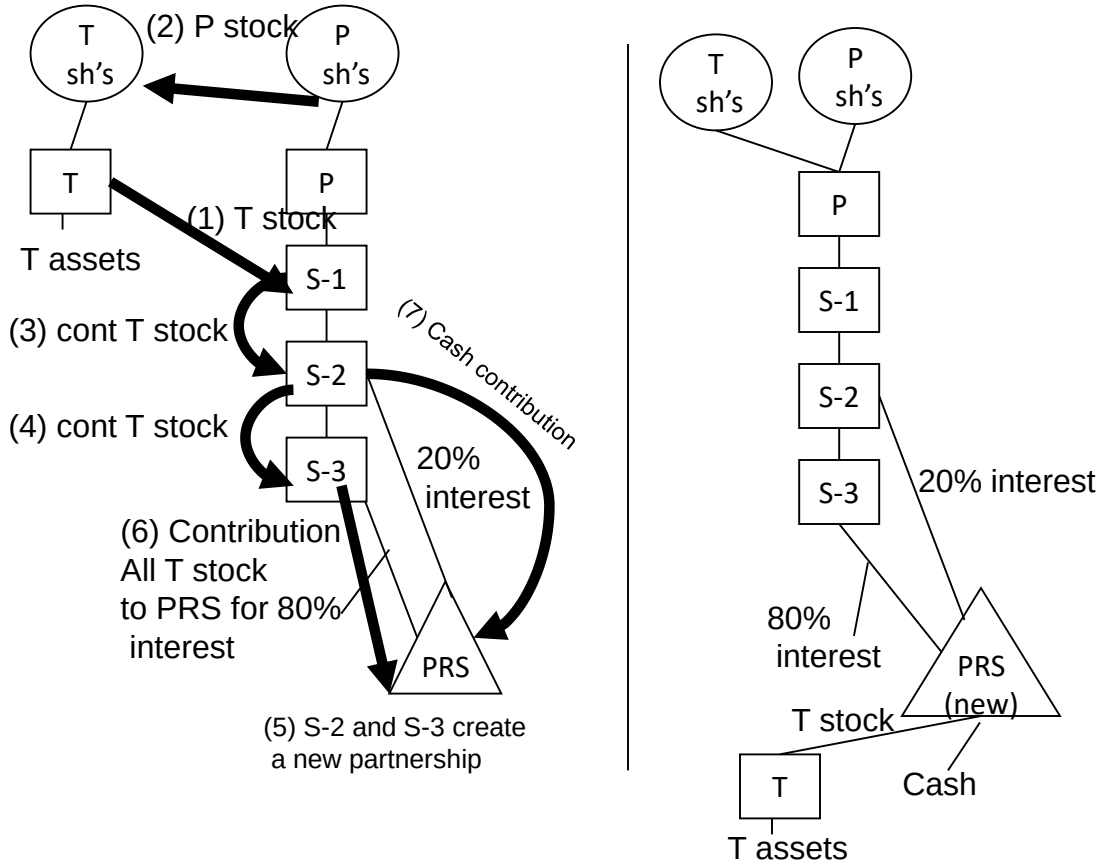


Example 13. Tiered partnerships: use of T's historic business assets in a partnership business. (i) Facts. T owns and manages a commercial office building in state Z. Pursuant to a plan of reorganization, T merges into P, solely in exchange for P stock, which is distributed to the T shareholders. P transfers all of the T assets to a partnership, PRS-1, which owns and operates television stations nationwide. After the transfer, P owns a 50 percent interest in PRS-1. P does not have active and substantial management functions as a partner with respect to the PRS-1 business. X, not a member of P's qualified group, owns the remaining 50 percent interest in PRS-1. PRS-1, in an effort to expand its state Z television operation, enters into a joint venture with U, an unrelated party. As part of the plan of reorganization, PRS-1 transfers all the T assets and its state Z television station to PRS-2, in exchange for a 75 percent partnership interest. U contributes cash to PRS-2 in exchange for a 25 percent partnership interest and oversees the management of the state Z television operation. PRS-1 does not actively and substantially manage PRS-2's business. PRS-2's state Z operations are moved into the acquired T office building. All of the assets that P acquired from T are used in PRS-2's business.

(ii) Continuity of business enterprise. Under paragraph (d)(4)(iii)(A) of this section, PRS-1 is treated as owning 75 percent of the T assets used in PRS-2's business. P, in turn, is treated as owning 50 percent of PRS-1's interest the T assets. Thus, P is treated as owning 37 1/2 percent (50 percent x 75 percent) of the T assets used in the PRS-2 business. Under paragraph (d)(4)(iii)(B)(1) of this section, P is treated as conducting PRS-2's business, the operation of the state Z television station, and under paragraph (d)(4)(iii)(A) of this section, P is treated as using 37 1/2 percent of the historic T business assets in that business. The COBE requirement of paragraph (d)(1) of this section is satisfied because P is treated as using a significant portion of T's historic business assets in its television business.



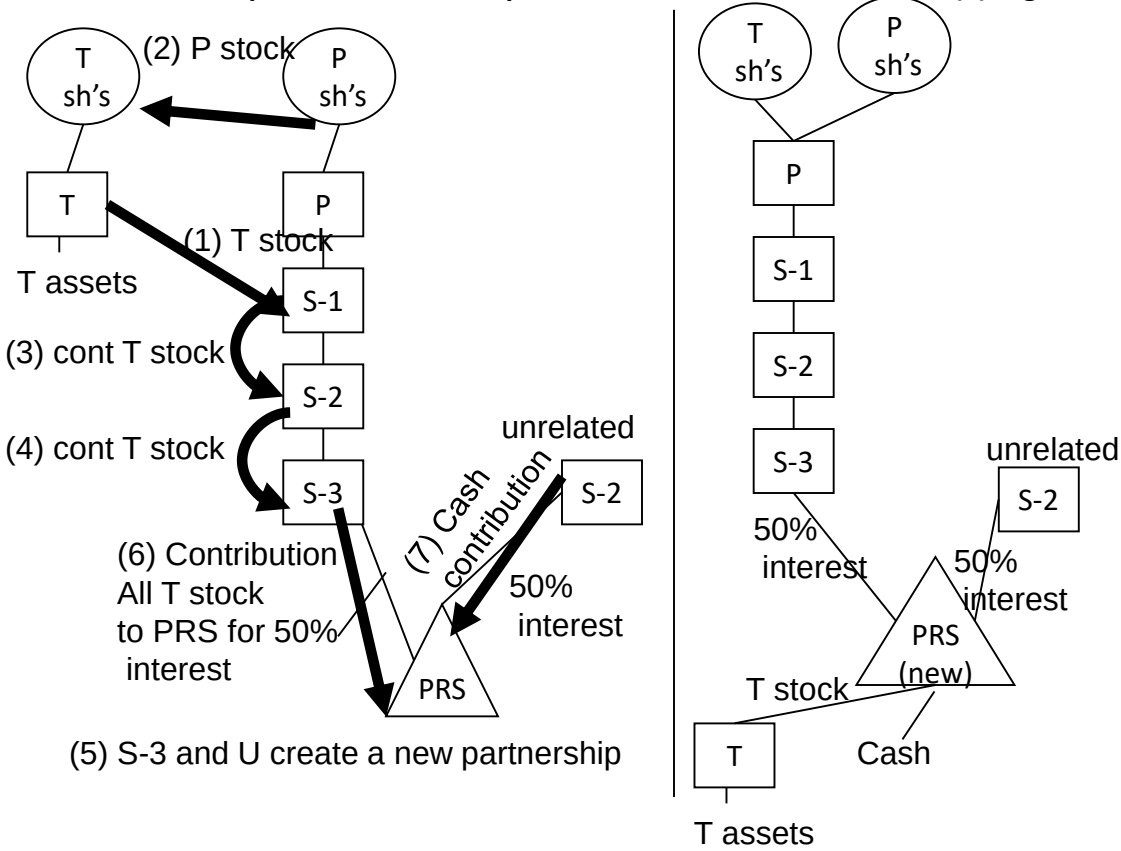
Section 1.368-1(d) COBE Updated for TD 9361 (published in F.R. October 25, 2007). TD 9361 has an impact on COBE examples 7 to 14 as well as the 1.368-2(k) regs



Example 14. Transfer of acquired stock to a partnership--continuity of business enterprise satisfied. (i) Facts. Pursuant to a plan of reorganization, the T shareholders transfer all of their T stock to a subsidiary of P, S-1, solely in exchange for P stock. In addition, as part of the plan of reorganization, S-1 transfers the T stock to its subsidiary, S-2, and S-2 transfers the T stock to its subsidiary, S-3. S-2 and S-3 form a new partnership, PRS. Immediately thereafter, S-3 transfers all of the T stock to PRS in exchange for an 80 percent interest in PRS, and S-2 transfers cash to PRS in exchange for a 20 percent interest in PRS.

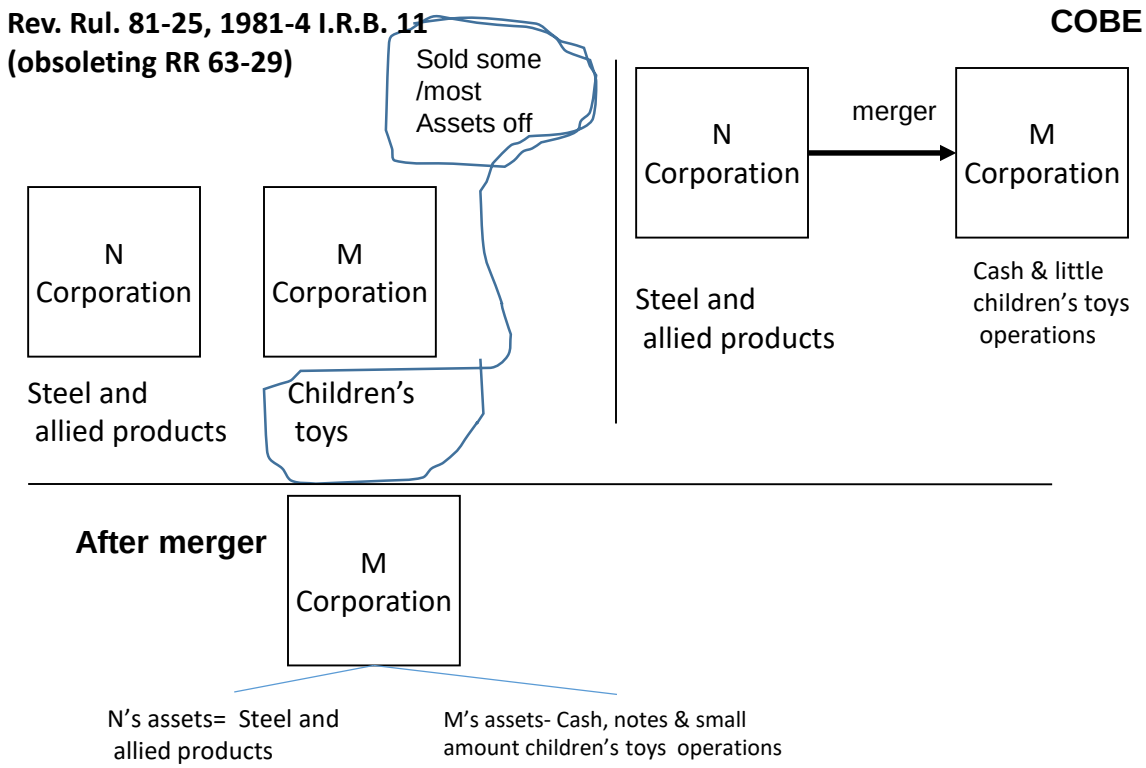
(ii) Continuity of business enterprise. Members of the qualified group, in the aggregate, own all of the interests in PRS. Because these interests in PRS meet requirements equivalent to section 368(c), under paragraph (d)(4)(iii)(D) of this section, the T stock owned by PRS is treated as owned by members of the qualified group. P is treated as holding all of the businesses and assets of T because T is a member of the qualified group (as defined in paragraph (d)(4)(ii) of this section). The COBE requirement of paragraph (d)(1) of this section is satisfied because P is treated as continuing T's business.

Section 1.368-1(d) COBE Updated for TD 9361 (published in F.R. October 25, 2007). TD 9361 has an impact on COBE examples 7 to 14 as well as the 1.368-2(k) regs



Example 15. Transfer of acquired stock to a partnership--continuity of business enterprise not satisfied. (i) Facts. The facts are the same as in Example 14, except that S-3 and U, an unrelated corporation, form a new partnership, PRS, and, immediately thereafter, S-3 transfers all of the T stock to PRS in exchange for a 50 percent interest in PRS, and U transfers cash to PRS in exchange for a 50 percent interest in PRS.

(ii) Continuity of business enterprise. Members of the qualified group, in the aggregate, own 50 percent of the interests in PRS. Because these interests in PRS do not meet requirements equivalent to section 368(c), the T stock owned by PRS is not treated as owned by members of the qualified group under paragraph (d)(4)(iii)(D) of this section. P is not treated as holding all of the businesses and assets of T because T has ceased to be a member of the qualified group (as defined in paragraph (d)(4)(ii) of this section). The COBE requirement of paragraph (d)(1) of this section is not satisfied because P is not treated as continuing T's business or using T's historic business assets in a business.



Facts from Rev. Rul. 63-29 (obsoleted by Rev. Rul. 81-25) COBE

M corporation and N corporation were respectively engaged in the manufacture of children's toys and in the distribution of steel and allied products. At some time in the past, M corporation sold a substantial part of its operating assets for cash and notes to a third party and more recently sold all but a small part of the remaining operating assets for cash, also to a third party. Thereafter, for valid business reasons, it acquired all of the property of N corporation solely in exchange for its voting stock. N corporation distributed the M stock received to its shareholders and then dissolved. M corporation used the assets resulting from the sale of its operating assets to expand the operations of the steel distributing business acquired from N corporation.

Holding Rev. Rul. 81-25 (as well as regulations)

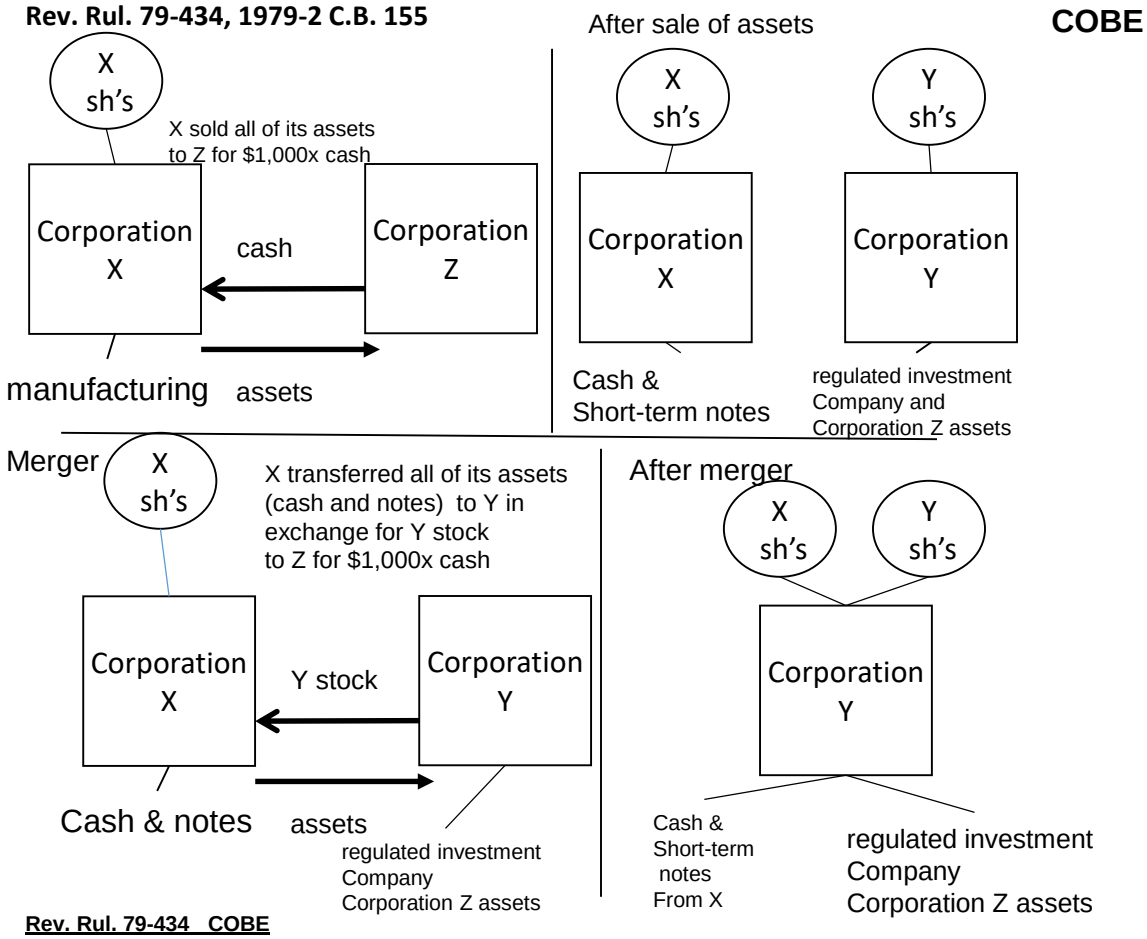
In a section 368(a)(1) reorganization the continuity of business enterprise requirement does not apply to the business or business assets of the transferee corporation prior to the reorganization.

Rationale: Section 1.368-1(b) of the Income Tax Regulations states that in order for a reorganization to qualify under section 368(a)(1) there must be continuity of the business enterprise under the modified corporate form.

Rev. Rul. 63-29, 1963-1 C.B. 77, holds that the continuity of business enterprise requirement of section 1.368-1(b) of the regulations was satisfied where a transferee corporation sold its assets and discontinued its business, then acquired the assets of another corporation in exchange for its voting stock, and used the sales proceeds realized from the sale of its assets to expand the business formerly conducted by the acquired corporation. The holding of Rev. Rul. 63-29, 1963-1 C.B. 77 is now reflected in the recent amendment to section 1.368-1(1.368-1(d)) of the regulations, which looks only to the transferor's historic business or historic business assets for determining if the continuity of business enterprise requirement is satisfied.

Rev. Rul. 79-434, 1979-2 C.B. 155

COBE



Rev. Rul. 79-434 COBE

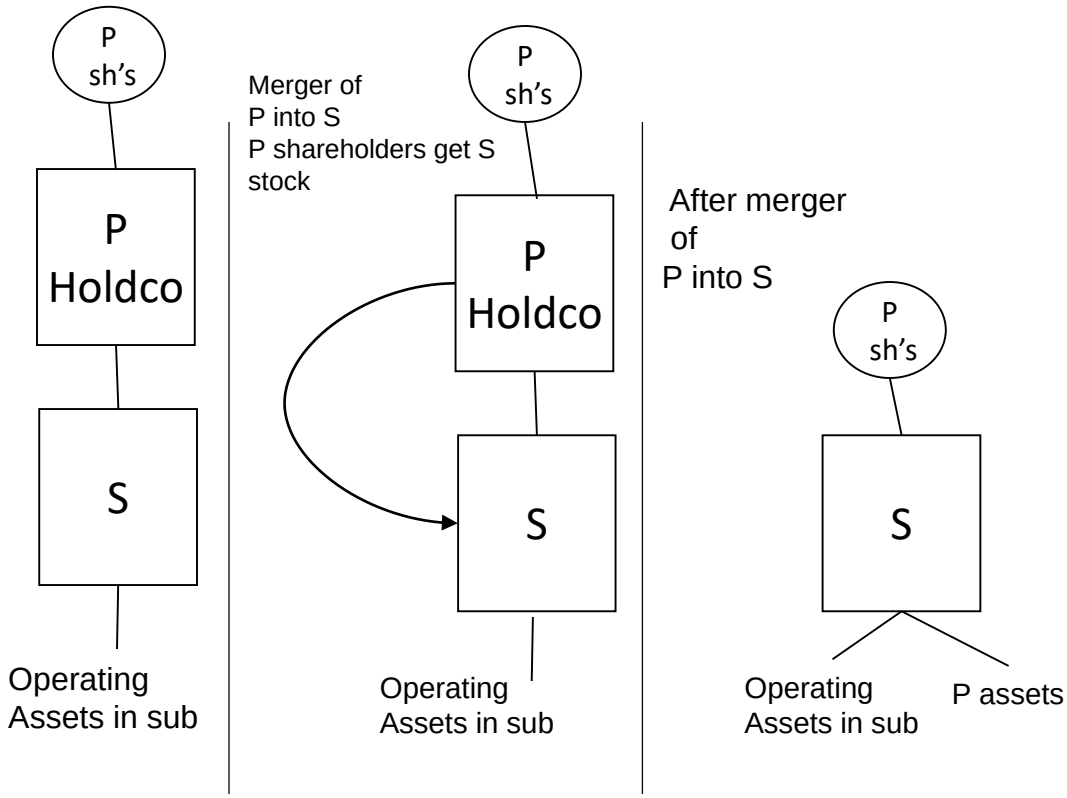
FACTS: Corporation X, a corporation engaged in manufacturing, sold all of its assets to unrelated corporation Z for $1,000x cash This sale was made in anticipation of X's acquisition by corporation Y, an open-end diversified investment company that qualifies as a regulated investment company as that term is defined in section 851 . Pursuant to an agreement between X and Y, X transferred all of its assets (cash and short-term Treasury notes that X had purchased with the proceeds from the sale of its assets) to Y in return for 1,000 shares of Y. As provided in the agreement, X dissolved after the transfer and distributed the stock of Y to its shareholders, individuals A and B, in exchange for their X stock.

LAW AND ANALYSIS A tax-free reorganization assumes that "the new enterprise, the new corporate structure, and the new property are substantially continuations of the old [ones] still unliquidated." Section 1.1002-1(c) of the Income Tax Regulations. To exclude transactions that are not within the intended scope of a reorganization, the specifications of a reorganization are precise. A reorganization must satisfy both the terms of the specifications and their underlying assumptions. Section 1.368-1(b). Thus, section 368 does not apply to a transaction that "upon its face is outside the plain intent of the statute." See, Gregory v. Helvering, 293 U.S. 465 at 470 (1935). For example, a transaction that in substance is a mere sale of assets is not a reorganization. See, section 1.368-1(b) and Cortland Specialty Co. v. Commissioner, 60 F.2d 937 (2d Cir.), cert. denied, 288 U.S. 599 (1932). Similarly, a transaction that in substance is a mere purchase by one corporation of stock in another corporation is not a reorganization.

HOLDING The transfer of cash or short-term Treasury notes for stock does not qualify as a reorganization under section 368(a)(1) because in substance it represents a purchase by X of the shares of Y prior to X's liquidation.

The fair market value of the Y stock distributed by X to its shareholders in complete liquidation will be treated as in full payment in exchange for their X stock under section 331 . Gain or loss is recognized to the shareholders of X under section 1001.

Rev. Rul. 85-197, 1985-2 C.B. 120 **COBE**



<u>Rev. Rul. 85-197 COBE</u>

Facts

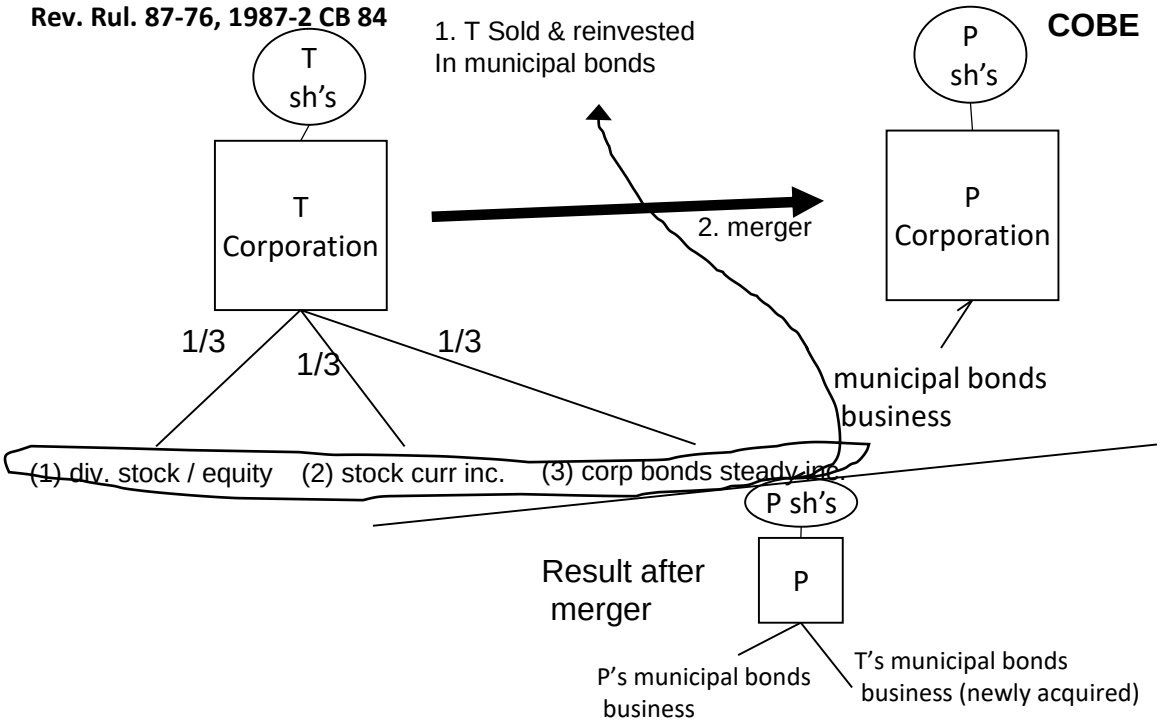
P is a holding company whose only asset consists of all the stock of an operating subsidiary, S. P merges into S and the P shareholders exchange their P stock for S stock.

For purposes of the continuity of business enterprise requirement, the historic business of P is the business of S, its operating subsidiary. Therefore, after the merger, S continues to conduct P's historic business.

HOLDING

The continuity of business enterprise requirement is satisfied when a holding company is merged into its wholly owned operating subsidiary.

Rev. Rul. 87-76, 1987-2 CB 84



FACTS: T is a corporation engaged in the investment business since 1975. From its inception, T's investment practice has been to maintain approximately one-third of the value of its investment portfolio in diversified corporate stock purchased primarily for equity growth, one-third in corporate stock purchased with a view to maximizing current income, and the remaining one-third in general corporate bonds purchased with a view to producing steady, predictable returns of income. T has no other significant assets. P is a diversified open-end management investment company whose investment policy since it was organized in 1978 has been to attract investors who wish to participate in a managed portfolio consisting exclusively of high grade municipal bonds, the income from which is exempt from federal income tax. In 1982, P acquired substantially all of T's assets in exchange solely for shares of P voting common stock in a transaction intended to qualify as a reorganization described in section 368(a)(1)(C) Pursuant to the plan of reorganization, T was required, prior to the reorganization, to sell its entire portfolio of corporate stock and bonds, and reinvest the proceeds therefrom in municipal bonds that were subject to P's approval.

For more than 3 years prior to the proposed transaction, both P and T have been "investment companies" as defined in section 368(a)(2)(F) and at no time following the transaction will P fail to meet the diversification requirements of section 368(a)(2)(F)(iii). Except as to the issue of whether the continuity of business enterprise requirement has been met, the transaction otherwise qualified as a reorganization described in section 368(a)(1)(C).

Rationale In the present situation, the transaction does not meet the asset continuity test since all of T's historic assets, the portfolio of corporate stocks and bonds, were, as part of the plan of reorganization, sold before the transaction was consummated, and the proceeds were reinvested in municipal bonds. Consequently, the issue is whether P will continue T's historic business.

Section 1.368-1(d)(3)(i) of the regulations provides that the fact that the acquiring corporation is in the same line of business as the acquired corporation tends to establish the requisite continuity, but is not alone sufficient. In Example (1) of section 1.368-1(d)(5), the manufacture of synthetic resins was considered a different line of business from the manufacture of chemicals for the textile industry. In the present situation, although P and T were both in the business [of making investments, T's historic business of investing in corporate stocks and bonds is not the same line of business as investing in municipal bonds. Moreover, as provided in section 1.368-1(d)(3)(iii), a corporation's historic business is not one the corporation enters into as part of a plan of reorganization. The business that P will continue after the reorganization is consummated is not the same as the historic business T was engaged in prior to the reorganization.

HOLDING The continuity of business enterprise requirement of section 1.368-1(d) of the regulations is not met upon the transfer to P of all of T's assets consisting of municipal bonds T purchased with the proceeds from the sale of its historic business assets. Accordingly, the transaction does not qualify as a reorganization under section 368(a)(1)(C).

Rev. Rul. 85-198, 1985-52 I.R.B. 7, (COBE) **COBE**

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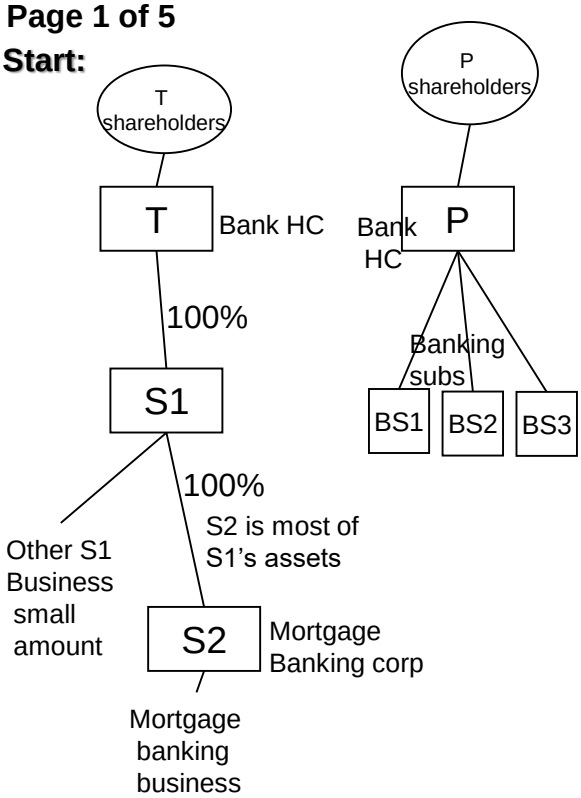
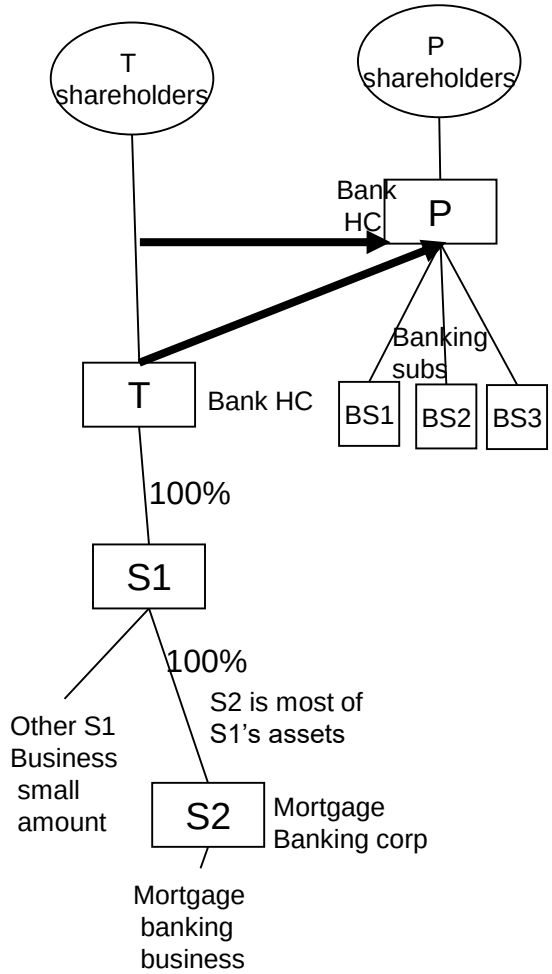


Wip ONSERT

P acquires T stock and then T merges into P



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Rev. Rul. 85-198, 1985-52 I.R.B. 7, (COBE) **COBE**

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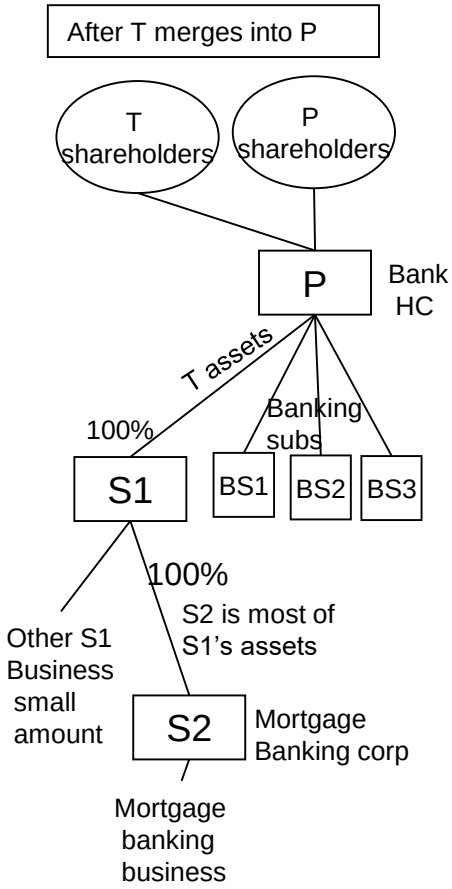

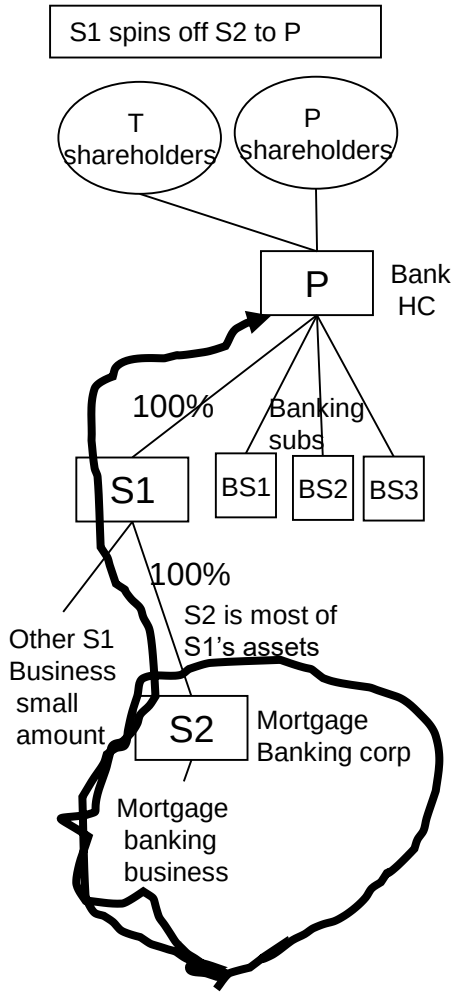

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Rev. Rul. 85-198, 1985-52 I.R.B. 7, (COBE) **COBE**

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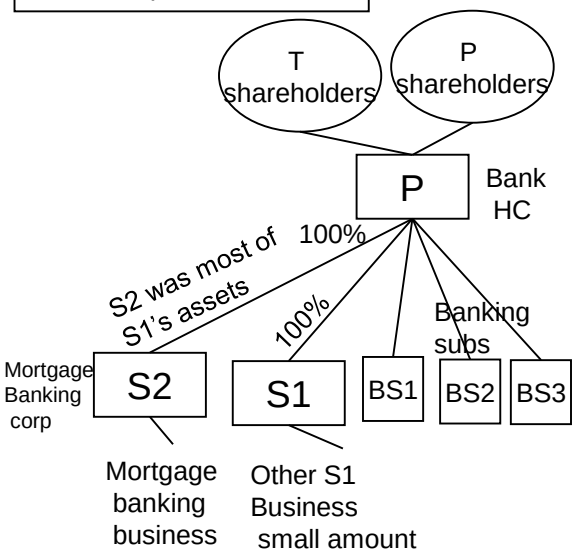
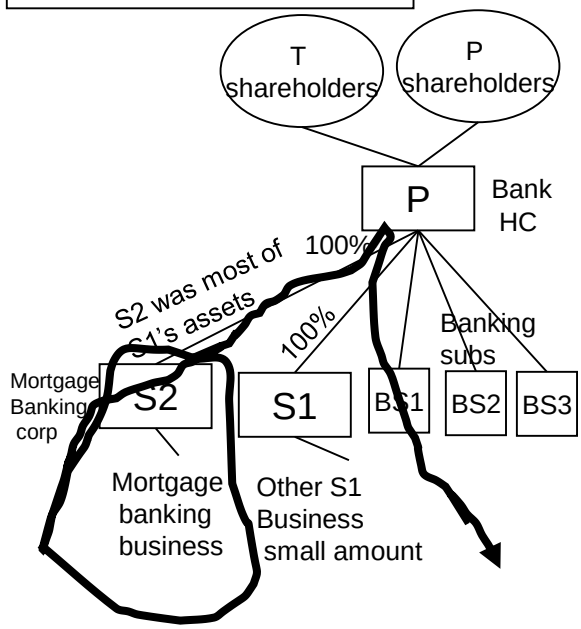
After S1 spins off S2 to P



S2 stock is transferred to one of P's banking subsidiaries



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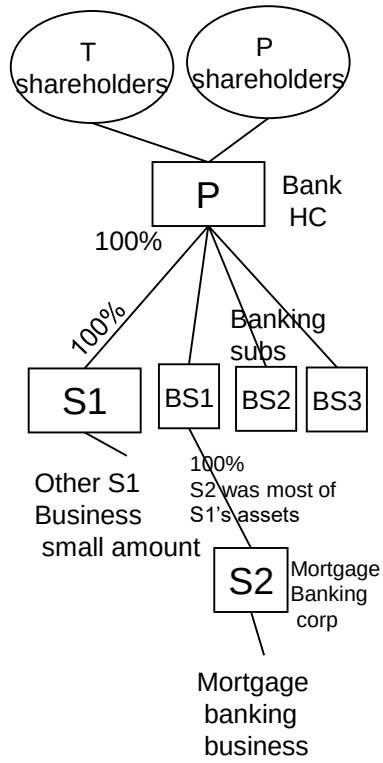
After S2 stock is transferred to one of P's banking subsidiaries



Rev. Rul. 85-198, 1985-52 I.R.B. 7, (COBE)

COBE

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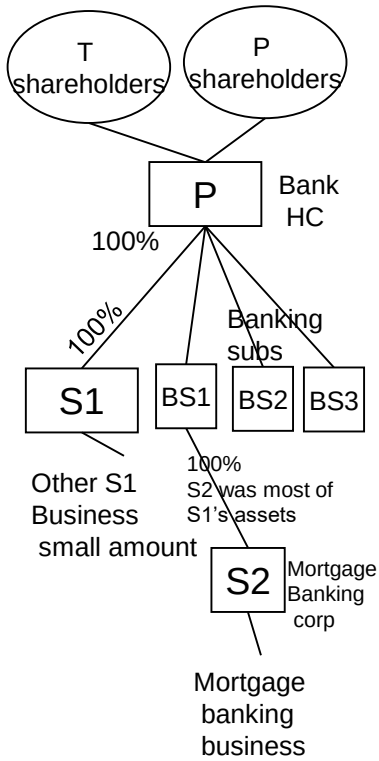
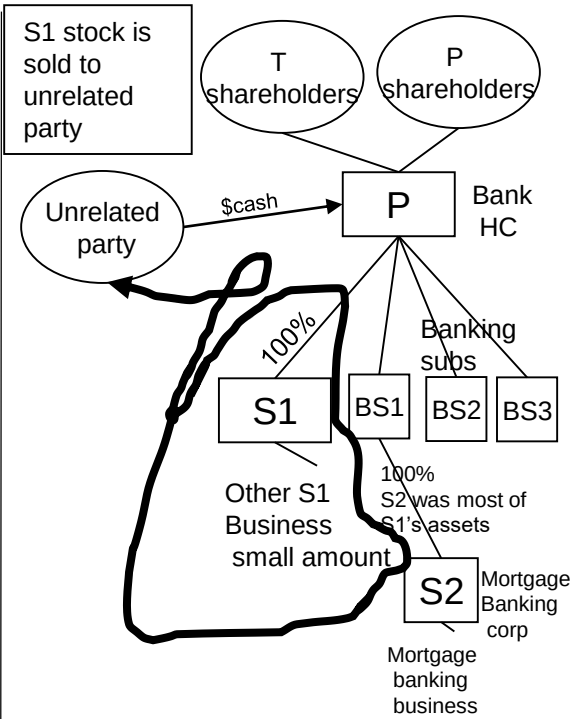
After S2 stock is transferred to one of P's banking subsidiaries



S1 stock is sold to unrelated party



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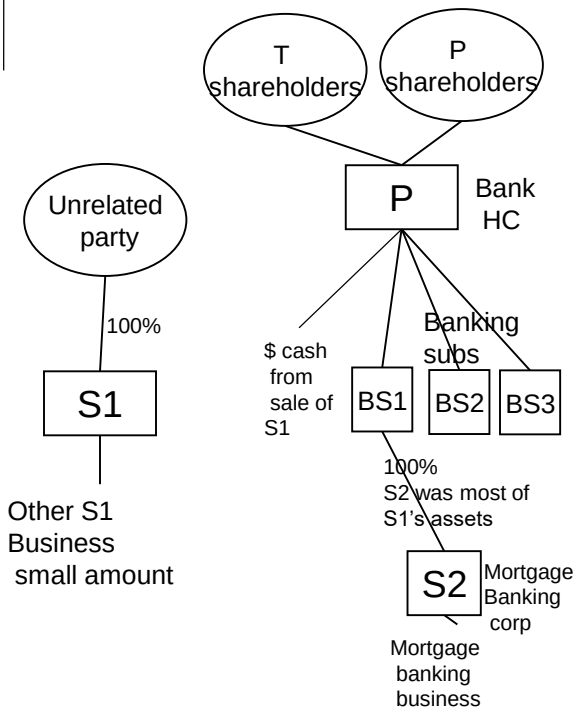

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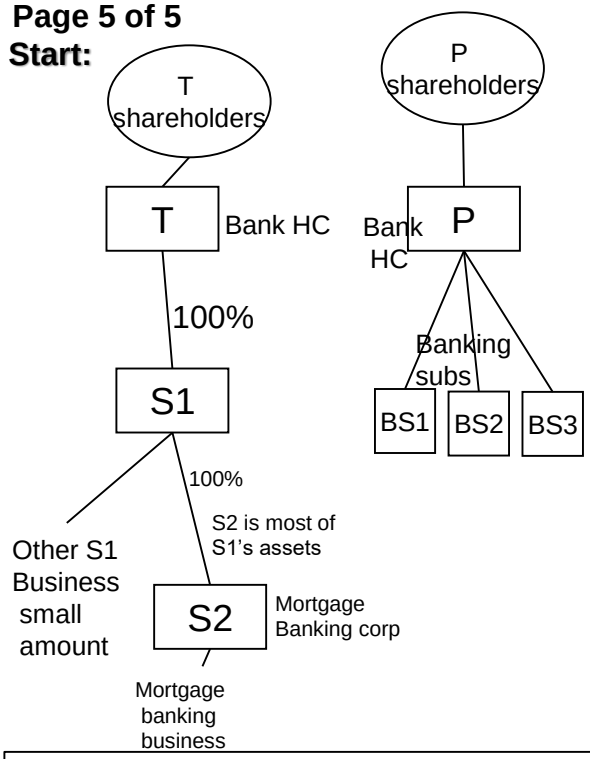

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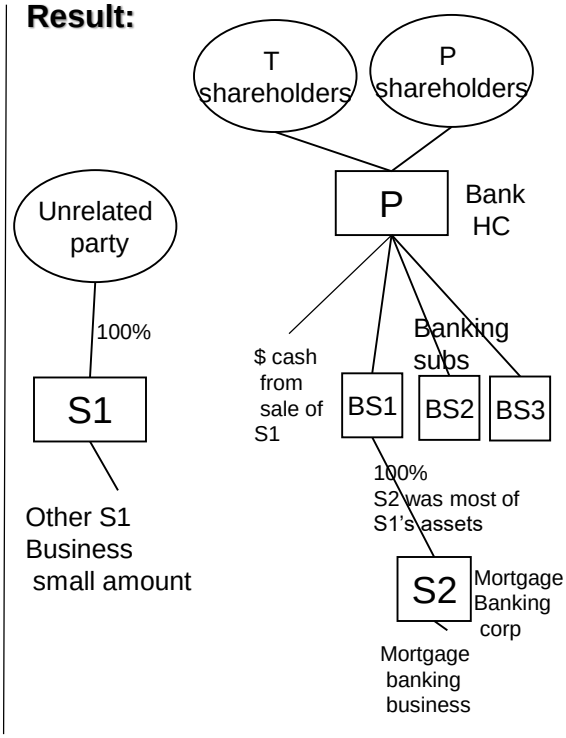


Rev. Rul. Law and Analysis: Treas. Reg. section 1.368-1(b) of the regulations states that requisite to a reorganization under the Internal Revenue Code is a continuity of the business enterprise under modified corporate form. Section 1.368-1(d)(2) of the regulations states that a continuity of business enterprise requires that the acquiring corporation either continue the historic business of the acquired corporation or use a significant portion of the acquired corporation's historic business assets in a business. The same section states that:

> "The application of this general rule to certain transactions, such as mergers of holding companies, will depend on all facts and circumstances. The policy underlying this general rule, which is to ensure that reorganizations are limited to readjustments of continuing interests in property under modified corporate form, provides the guidance necessary to make these facts and circumstances determinations."

Also, section 1.368-1(d)(3)(ii) states that if the acquired corporation has more than one line of business, the acquiring corporation need only continue a significant line of business.

In the instant case, the policy enunciated in section 1.368-1(d)(2) of the Regulations is satisfied. T indirectly operates two significant businesses through its wholly owned subsidiaries, S1 and S2. After the merger P will continue to operate, indirectly, one of the two significant businesses through S2, now P's second tier subsidiary. See section 1.368-1(d)(5), Ex. 1 of the Regulations.

Holding: The continuity of business enterprise requirement is satisfied.

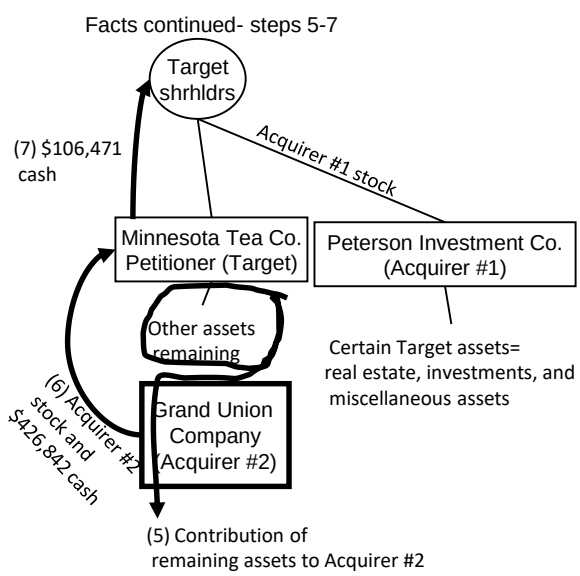
Step Transaction Doctrine

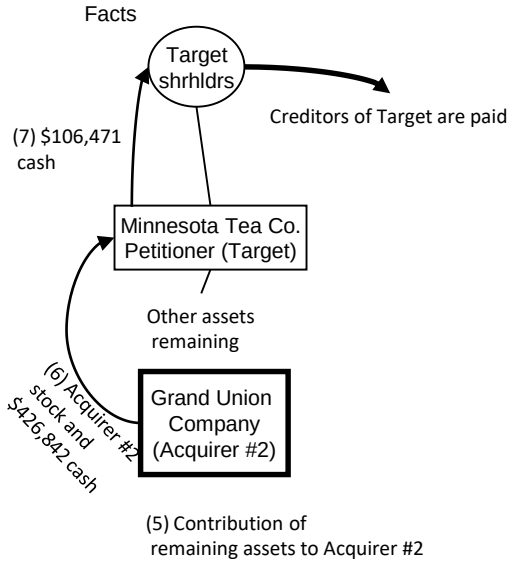
Minnesota Tea Co. vs. Helvering, 302 U.S. 609 (1938) **Case 2, page 1 of 1** **Step transaction doctrine**

This is the second of two U.S. Supreme Court cases, after the first case, which was held to be a reorganization in Helvering vs. Minnesota Tea Co., 296 US 378 (1935): under the continuity of interest principles, this case had at issue the $106,471 that was distributed to Petitioner's (Target's) shareholders.

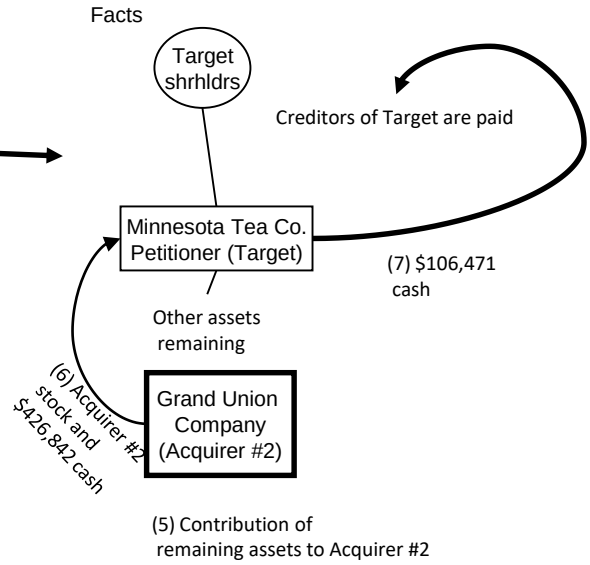
This amount was used to pay off Target's creditors.

If Target paid creditors, the cash received would be taxable, however, the taxpayer arranged it so that the amount was distributed to Target shareholders to pay creditors (which would be tax-free). The tax court applied the step transaction doctrine to treat the transaction as if Target paid Target creditors (and not distributed).





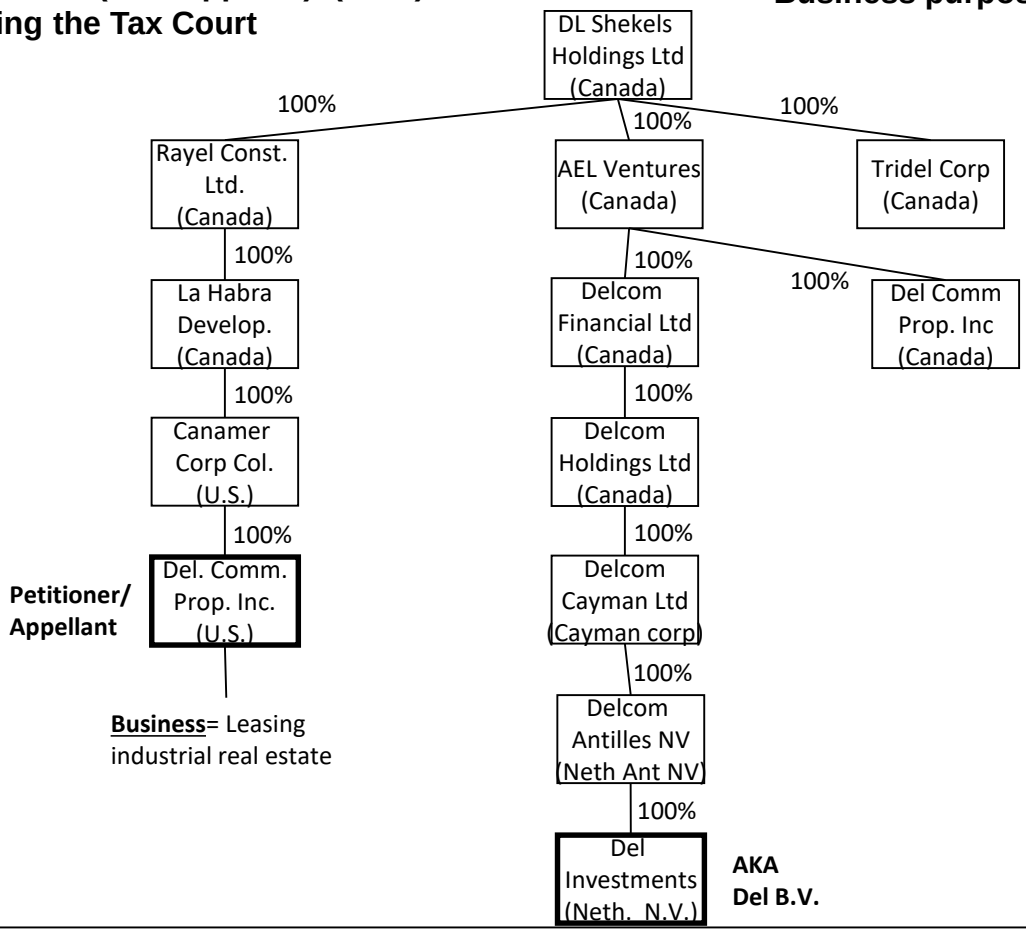
U.S. Supreme Court stepped the transaction as if Target directly paid its creditors (subject to gain)*



***The law has since been changed Re: creditor purging payments**

Del Commercial Properties vs. C.I.R., 251 F.2d 210 (D.C. Appeals), (2001) Affirming the Tax Court

Step transaction/ Business purpose



Court of Appeals affirming the Tax Court for the Commissioner

I. BACKGROUND

Del Commercial Properties, Inc. ("appellant") is an Illinois corporation whose principal place of business is in Ontario, Canada. It is a fourth-tier subsidiary of an affiliated group of corporations ("the Affiliated Group") whose common parent is DL Shekels Holdings Ltd. Delcom Financial, Ltd. is a second-tier subsidiary in the Affiliated Group. Delcom Financial is a Canadian corporation that owns 100% of the outstanding stock of Delcom Holdings, Ltd., another Canadian corporation. In turn, Delcom Holdings owns 100% of Delcom Cayman, Ltd. (a corporation organized in the Cayman Islands), which owns 100% of the outstanding stock of Delcom Antilles, N.V. (a corporation organized in the Netherlands Antilles). Delcom Antilles owns 100% of the outstanding stock of Del Investments Netherlands B.V. ("Del BV"), a corporation organized in the Netherlands.

From 1990 through 1993, appellant's principal business was leasing industrial real estate it owned in the United States. In 1990, when appellant needed funding to refinance and improve some of its American properties, one of DL Shekels's first-tier subsidiaries, Tridel Corporation, arranged the following financing scheme: On July 18, 1990, the Royal Bank of Canada loaned $18 million (in U.S. dollars) to Delcom Financial. That same day, Delcom Financial made two unsecured interest-bearing loans to Delcom Holdings. One of those loans (the one directly relevant to this case) was for $14 million. Delcom Holdings then contributed "about $14 million to Delcom Cayman for common shares of stock." Stipulation of Facts at 5, Del Commercial Props., Inc. v. Commissioner, T.C.M. 1999-41 (Oct. 22, 1998). On the same day, "Delcom Cayman contributed about $14 million to Delcom Antilles and received common shares of stock in that entity. Later on that same date, Delcom Antilles contributed about $14 million to Del BV and received common stock in that entity." Id. at 5-6.

Del Commercial Properties vs. C.I.R., 251 F.2d 210 (D.C. Appeals), (2001) Affirming the Tax Court

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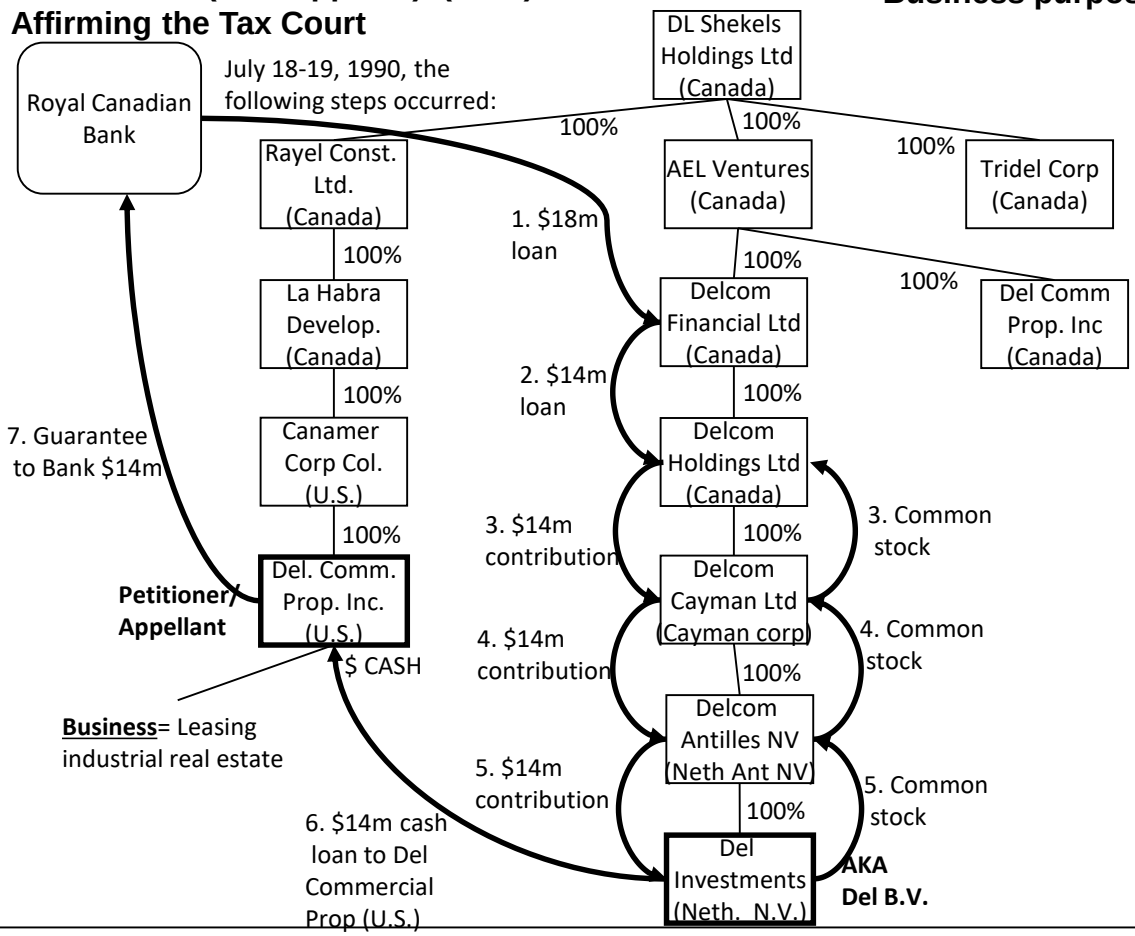

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The following day, July 19, appellant borrowed $14 million from Del BV. That same day, appellant "guaranteed repayment of a portion of amounts owed by Delcom Financial to Royal Bank" and authorized Royal Bank to place a mortgage on its real property in the U.S. Id. at 7. Appellant also agreed to provide Royal Bank with "annual financial statements, to insure its real property, to assign the insurance policies to Royal Bank, to defer paying dividends to shareholders, and to use the proceeds from any sales of real property to make payments on the $14 million Royal Bank loan." Brief for the Appellee at 6.

Del Commercial Properties vs. C.I.R., 251 F.2d 210 (D.C. Appeals), (2001)

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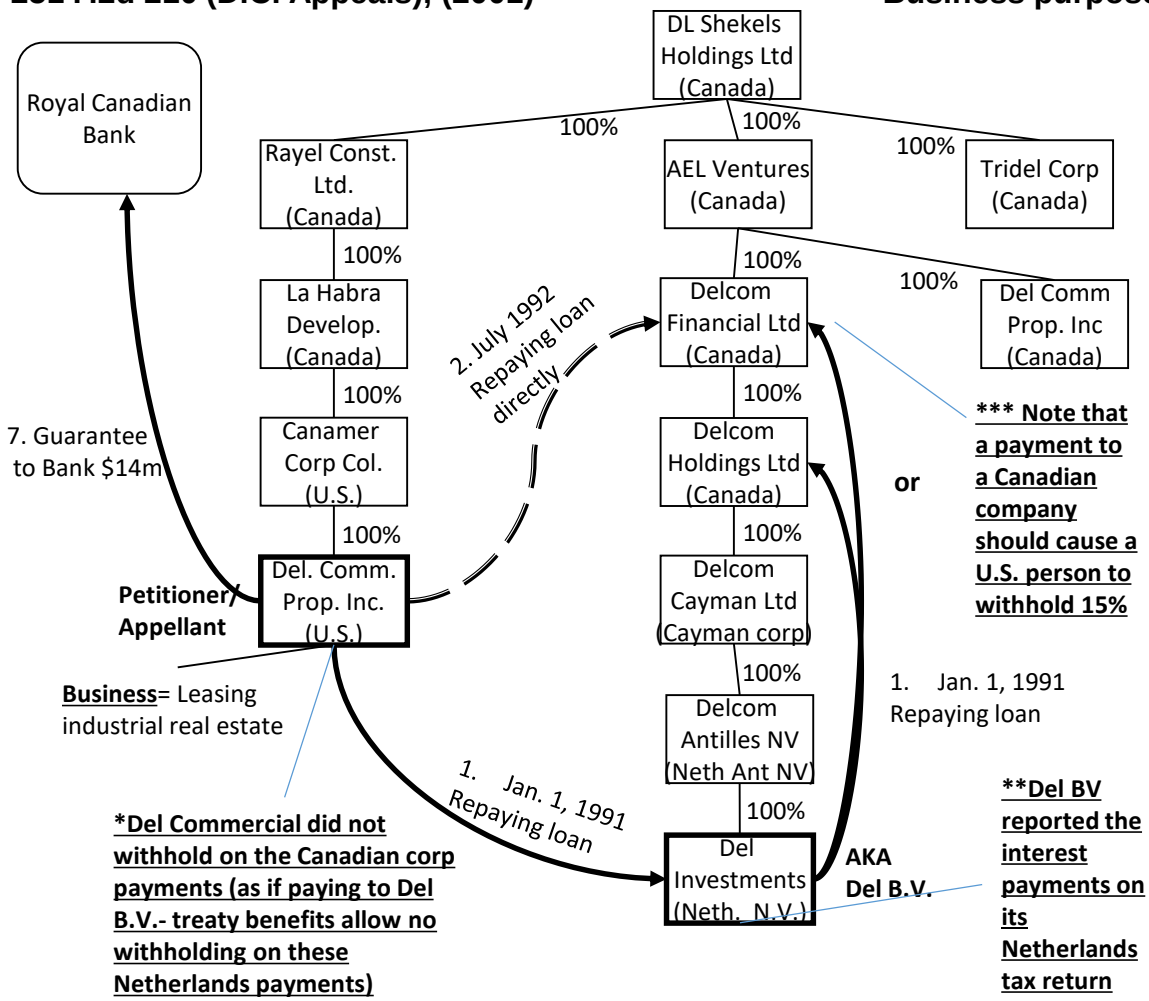
Step transaction/ Business purpose



On January 1, 1991, appellant began repaying Del BV. Del BV transferred these payments "either to Delcom Holdings or Delcom Financial. The funds were used to pay principal and interest owed on the $14 million Royal Bank loan." Del Commercial Props., T.C.M. 1999-411, slip op. at 7. Beginning in July 1992, however, appellant began making its loan payments directly to Delcom Financial, "and Delcom Financial then forwarded funds to Royal Bank in payment on the Royal Bank loan." Id. Throughout this time, Del BV reported the interest paid by appellant as income on its Netherlands tax returns. Meanwhile, appellant did not file United States withholding tax returns or deposit withholding taxes on any payments related to the loan.

On October 30, 1997, the Commissioner provided appellant with a Notice of Deficiency stating that it owed taxes and additions based on the interest payments made between 1990 and 1993. See 26 U.S.C. 881, 1442, 6651(a)(1), 6656. Appellant petitioned the Tax Court to determine the correct amount of taxes and additions, contending that under a treaty between the United States and the Netherlands, no tax is owed to the United States on interest payments made by an American corporation to a Dutch corporation. The Tax Court held that the series of loans and stock contributions that began with Delcom Financial and ended with appellant "reflect a step transaction created simply to bypass U.S. withholding tax." Del Commercial Props., T.C.M. 1999-411, slip op. at 11. Because the appellant had not "presented any credible argument" that its failure to file a tax return or deposit withholding taxes was "attributable to reasonable cause," the Tax Court concluded that appellant owed penalties in addition to the withholding taxes. Id. at 13. Accordingly, the Tax Court ordered appellant to pay $1,194,573 in taxes and additions.

Appellant challenges the Tax Court's decision on two grounds. First, it argues that the Tax Court erred in concluding that it was responsible for withholding United States taxes on the interest payments it made to Del BV. According to appellant, the financing scheme was not designed solely to avoid U.S. taxes. Rather, the scheme sought to allow the Affiliated Group to achieve substantial Canadian tax savings, a permissible business purpose under American tax law. Second, appellant contends that even if it should have withheld U.S. taxes on the interest payments, the Tax Court erred by imposing a penalty for appellant's failure to file withholding tax returns or to deposit the withholding tax. Specifically, appellant suggests that it should not be penalized because its decision not to withhold represented a reasonable difference of opinion with the Commissioner. We address each of these issues in turn.

A. Withholding of Interest Payments

- The Internal Revenue Code requires foreign corporations to pay "a tax of 30 percent of the amount received from sources within the United States by a foreign corporation as interest ... to the extent the amount so received is not effectively connected with the conduct of a trade or business within the United States." 26 U.S.C. 881(a). An American taxpayer who makes such interest payments is required to deduct and withhold the tax owed by the foreign corporation. See 26 U.S.C. 1441, 1442. If the American taxpayer fails to deduct and withhold the tax, he is personally liable for the tax due. See 26 U.S.C. 1461.
- Pursuant to the United States-Netherlands Tax Treaty, interest payments made by American taxpayers to Netherlands corporations are exempt from taxes in the United States. See Supplementary Convention on Taxes on Income and Other Taxes, Dec. 30, 1965, U.S.-Netherlands, Art. VI, 17 U.S.T. 896, 901. In contrast, under the United States Canada Tax Treaty, the tax on interest payments "shall not exceed 15 percent of the gross amount of the interest" if the recipient of the payments is "the beneficial owner of such interest." Convention on Taxes on Income and Capital, Sept. 26, 1980, U.S.-Can., Art. XI, T.I.A.S. No. 11087.
- Under the step-transaction doctrine, a particular step in a transaction is disregarded for tax purposes if the taxpayer could have achieved its objective more directly, but instead included the step for no other purpose than to avoid U.S. taxes. See Minn. Tea Co. v. Helvering, 302 U.S. 609, 613 (1938). In step-transaction cases, "the existence of formal business activity is a given but the inquiry turns on the existence of a nontax business motive." ASA Investerings, 201 F.3d at 512. As we explained last year, "the absence of a nontax business purpose is fatal." Id. Although taxpayers "are entitled to structure their transactions in such a way as to minimize tax," there must be a purpose for the "business activity ... other than tax avoidance" and that purpose cannot be a "facade." Id. at 513; see also N. Ind. Pub. Serv. Co. v. Commissioner ("NIPSCO"), 115 F.3d 506, 512 (7th Cir. 1997) (stating that the IRS cannot "disregard economic transactions ... which result in actual, non-tax-related changes in economic position").
- The Internal Revenue Service--and the courts--will ignore a step in a series of transactions if that step does " 'not appreciably affect [the taxpayer's] beneficial interest except to reduce his tax.' " ASA Investerings, 201 F.3d at 514 (quoting Knetsch v. United States, 364 U.S. 361, 366 (1960) (emphasis added) (quoting Gilbert v. Commissioner, 248 F.2d 399, 411 (2d Cir. 1957) (Hand, C.J., dissenting))). In two separate revenue rulings the IRS specifically has held that an American taxpayer cannot avoid U.S. taxes merely by relying on a treaty with a foreign country. See Rev. Rul. 84-153, 1984-2 C.B. 381; Rev. Rul. 84-152, 1984-2 C.B. 383. In other words, if the sole purpose of a transaction with a foreign corporation is to dodge U.S. taxes, the treaty cannot shield the taxpayer from the fatality of the step-transaction doctrine. For the taxpayer to enjoy the treaty's tax benefits, the transaction must have a sufficient business or economic purpose. We accord these rulings Skidmore deference--that is, they are " 'entitled to respect' " to the extent they "have the 'power to persuade,' " Christensen v.

Harris County, 529 U.S. 576, 587 (2000) (quoting Skidmore v. Swift & Co., 323 U.S. 134, 140 (1944))--and we find them persuasive given the plain meaning of 26 U.S.C. 881 and 1442, as informed by Gregory v. Helvering, 293 U.S. 465, 469 (1935).

From July 1992 through 1993, appellant made its loan payments directly to Delcom Financial. This fact is uncontested. Although Del BV may have recorded interest payments in its ledgers and reported them on its Dutch tax returns, there is no evidence that appellant paid anything to Del BV during this period. The U.S.-Netherlands Tax Treaty does not apply to direct transactions between a U.S. corporation and a Canadian corporation. Accordingly, appellant unquestionably should have withheld taxes on its payments to Delcom Financial beginning in July 1992. The Tax Court plainly did not err in coming to this conclusion.

Likewise, the Tax Court did not clearly err in concluding that the payments from appellant to Del BV were in substance payments made to Delcom Financial and that those payments only served to avoid U.S. taxes. The Tax Court's decision in Gaw v. Commissioner is instructive. T.C.M. 1995-531, Nos. 17906-92, 18268-92 (Nov. 9, 1995), aff'd, 111 F.3d 962 (D.C. Cir. 1997) (unpublished table disposition). Gaw dealt with a U.S. corporation's interest payments to a Dutch corporation that was a subsidiary of a Hong Kong corporation. The Tax Court held that the payments were subject to U.S. taxes because in substance they were directed to the Hong Kong corporation. The Tax Court explained that "[u]nder the substance over form doctrine, although the form of a transaction may literally comply with the provisions of the

- Internal Revenue] Code, that form will not be given effect where it has no business purpose and operates simply as a device to conceal the true character of that transaction." Id., slip op. at 96. The court reasoned that the taxpayer had not carried his burden of proving that the loans had been structured for any nontax business reason. See id. at 114. Consequently, the court treated the loan as if it had been made by the Hong Kong corporation and ruled that the loan was subject to the withholding tax. See id. at 141-43.
- Similarly, in this case, several facts demonstrate the nexus between the original Royal Bank loan and the loan from Del BV to appellant: (1) the interest rates and repayment schedules of the two loans closely correspond; (2) Royal Bank obtained a guaranty of repayment from appellant and a security interest in appellant's real property; and (3) beginning in the third quarter of 1992, appellant made payments on the loan directly to Delcom Financial at Royal Bank's request. Like the taxpayer in Gaw, appellant has failed to carry its burden of proving that Del BV was in substance the real lender for tax purposes. If appellant had received the loan from Royal Bank or Delcom Financial directly, the interest payments would have been taxable under the U.S. Canada Tax Treaty. Appellant has not shown that Del BV served any role with a "sufficient business or economic purpose to overcome the conduit nature of the transaction." Rev. Rul. 84-153, 1984-2 C.B. at 384.
- Appellant contends that the series of transactions between Delcom Financial, Delcom Holdings, Delcom Cayman, Delcom Antilles, Del BV, and appellant was not designed solely to avoid U.S. taxes. Instead, according to appellant, by structuring the transactions as it did, Delcom Financial achieved sizable Canadian tax savings. Appellant claims that Delcom Financial was able to take advantage of a Canadian tax code provision that allows corporations to deduct interest payments. In other words, Delcom Financial was able to deduct the value of the interest payments it made to Royal Bank as part of the original loan. This deduction was particularly valuable to Delcom Financial (and thus the Affiliated Group) because it received no additional income from which to offset the deduction. In addition, appellant asserts that under Canadian law and a treaty between Canada and the Netherlands, no corporations in the Affiliated Group were required to pay taxes "on amounts that were remitted by Del BV up the chain and ultimately received by [Delcom Financial] as dividends." Brief for Appellant at 7. Ultimately, appellant maintains that the Affiliated Group received substantial Canadian tax benefits relative to the U.S. taxes it avoided.
- In Tax Court proceedings, the petitioner maintains the burden of proof. See Tax Ct. R. 142(a). In this case, appellant absolutely failed to carry its burden; it did not offer any evidence that the Affiliated Group achieved Canadian tax savings. Indeed, appellant did not submit Delcom Financial's Canadian tax returns. Nor did appellant submit any of Delcom Financial's corporate records. Without this evidence, the Tax Court could not have found that Delcom Financial reported or deducted the interest payments and dividends, or otherwise received any Canadian tax benefits.

In addition, appellant did not ask the Tax Court (or this Court) to take judicial notice of the relevant provisions of the Canadian tax code or the Canada-Netherlands tax treaty through which the Affiliated Group claims to have achieved tax savings--it did not even cite the provisions on which it claims to have relied. Given the state of the record, we cannot possibly conclude that appellant carried its burden before the Tax Court or that the Tax Court clearly erred in finding that the transactions served any purpose other than avoiding U.S. taxes.

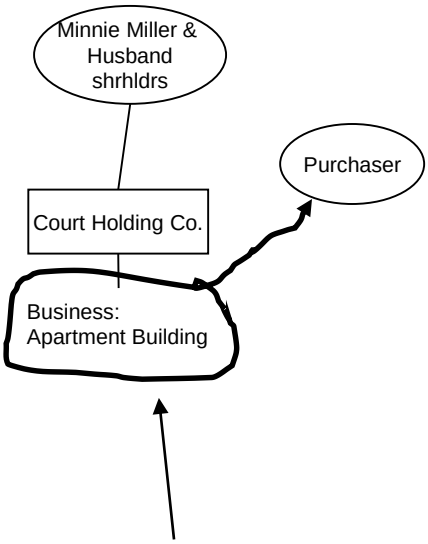
The only evidence presented to the Tax Court concerning the transactions' supposed Canadian tax benefits is the testimony of William Christie, vice president of corporate planning and taxation at Tridel Corporation (a corporation in the Affiliated Group that provided management and executive services to the related corporations). Christie testified that "I was told" that the "objectives" of the transaction were to secure financing for appellant and "to maximize [the Affiliated Group's] Canadian tax benefits." He also testified that his boss "said that he wanted to finance the [appellant's] operations and to do it in a very tax efficient manner for Canada."

Christie's testimony concerning the objectives of the transactions is hearsay. See Fed. R. Evid. 801, 802; see also 26 U.S.C. 7453 (providing that Tax Court proceedings shall be conducted "in accordance with the rules of evidence applicable in trials without a jury in the United States District Court of the District of Columbia"). As a result, the Tax Court could not--and apparently did not--rely upon it for the truth of the matter asserted.

- Likewise, the only evidence appellant offers to establish that the Affiliated Group actually achieved Canadian tax benefits from the transactions is conclusory testimony by Christie. This testimony is inadequate to carry appellant's burden of proof and certainly does not establish that the Tax Court clearly erred.
- Appellant contends that the IRS has held that foreign tax avoidance in general is a legitimate business purpose. See Rev. Rul. 89-101, 1989-2 C.B. 67. Revenue Ruling 89-101, on which appellant relies, focused on a transaction in which "a first-tier foreign subsidiary corporation distributes the stock of a second-tier foreign subsidiary corporation to the domestic parent corporation to reduce the amount of foreign withholding tax imposed on distributions by the second-tier corporation." Id. at 67. The IRS held that the transaction served a corporate business purpose within the meaning of Treasury Regulation 1.355-2(b) "because it will benefit the affiliated group of corporations by reducing substantially the amount of foreign withholding tax imposed on distributions from a member of the group." Id. at 68.
- The Commissioner does not concede that foreign tax avoidance is a legitimate business purpose, and we do not need to address that question here. While perhaps not directly applicable to this case, Treasury Regulation 1.355-2(b) is instructive. That regulation, which formed the basis for Revenue Ruling 89-101, provides that "reducing non Federal taxes is not a corporate business purpose" if (1) the property distribution reduces "both Federal and non Federal taxes because of similarities between Federal tax law and the tax law of the other jurisdiction" and (2) "the reduction of Federal taxes is greater than or substantially coextensive with the reduction of non Federal taxes." Treas. Reg. 1.355-2(b)(2). Based on this regulation and the revenue ruling on which appellant relies, even if foreign tax avoidance is a sufficient business purpose, appellant failed to establish that the Affiliated Group (or any of its members) achieved foreign tax savings greater than its U.S. tax savings--or that it achieved any foreign tax savings for that matter.

Comm. vs. Court Holding Co., 324 US 331 (1945) Step Transaction Doctrine

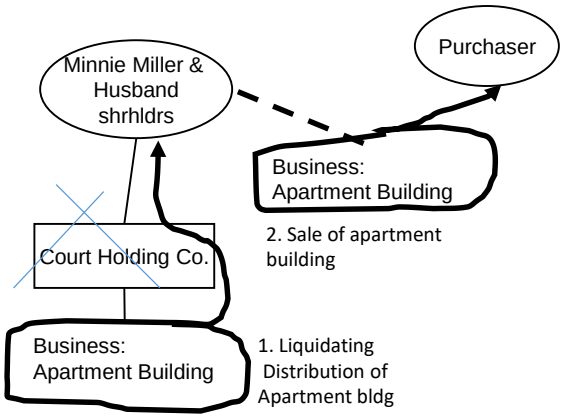
October 1, 1939 to February 1940
Negotiations by Corporation
to sell Apartment Building



U.S. Supreme Court held sale was by the Corporation citing Gregory v. Helvering and Minnesota Tea

What was done:

Property was distributed by Corporation to shareholders



Comm. vs. Court Holding Co., 324 US 331 (1945) Step Transaction Doctrine

Procedural: Tax Court held the transaction was taxable, the Circuit Court of Appeals reversed and this decision by the US Supreme Court reversed Court of Appeals. Statute in question=

§ 22 of the Internal Revenue Code 3 for the gain which accrued from the sale. The answer depends upon whether the findings of the Tax Court that the whole transaction showed a sale by the corporation rather than by the stockholders were final and binding upon the Circuit Court of Appeals.

1 143 F.2d 823.
2 2 T. C. 531.

Profits from the sale of property are taxable as income under § 22(a) of the Internal Revenue Code, 26 U. S. C. 22. The Treasury Regulations have long provided that gains accruing from the sales of a corporation's assets, in whole or in part, constitute income to it, but that a corporation realizes no taxable gain by a mere distribution of its assets in kind, in partial or in complete liquidation, however much they may have appreciated in value since acquisition. §§ 19.22(a)-19, 19.22(a)-21, Treasury Regulations 103.

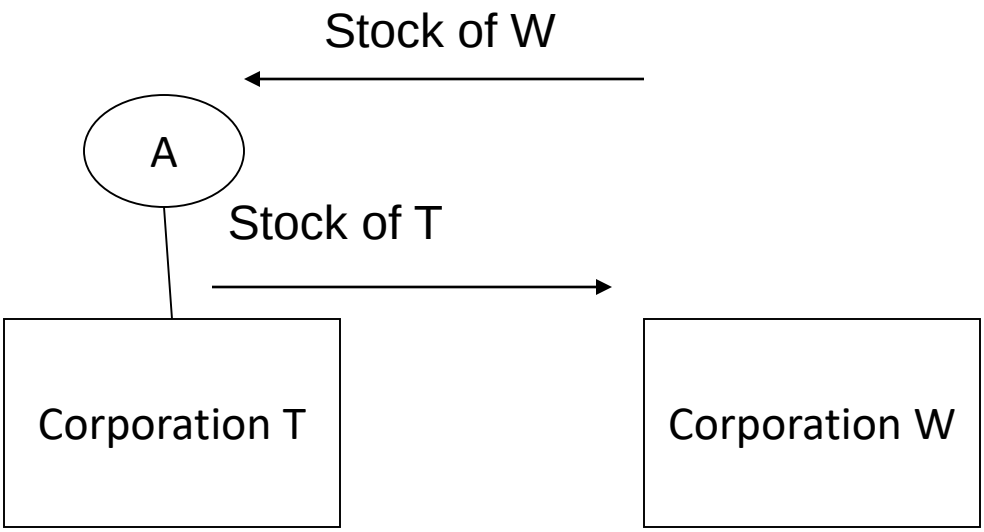
The respondent corporation was organized in 1934 solely to buy and hold the apartment building which was the only property ever owned by it. All of its outstanding stock was owned by Minnie Miller and her husband. Between October 1, 1939 and February, 1940, while the corporation still had legal title to the property, negotiations for its sale took place. These negotiations were between the corporation and the lessees of the property, together with a sister and brother-in-law. An oral agreement was reached as to the terms and conditions of sale, and on February 22, 1940, the parties met to reduce the agreement to writing. The purchaser was then advised by the corporation's attorney that the sale could not be consummated because it would result in the imposition of a large income tax on the corporation. The next day, the corporation declared a "liquidating dividend," which involved complete liquidation of its assets, and surrender of all outstanding stock. Mrs. Miller and her husband surrendered their stock, and the building was deeded to them. A sale contract was then drawn, naming the Millers individually as vendors, and the lessees' sister as vendee, which embodied substantially the same terms and conditions previously agreed upon. One thousand dollars, which a month and a half earlier had been paid to the corporation by the lessees, was applied in part payment of the purchase price. Three days later, the property was conveyed to the lessees' sister.

The Tax Court concluded from these facts that, despite the declaration of a "liquidating dividend" followed by the transfers of legal title, the corporation had not abandoned the sales negotiations; that these were mere formalities designed "to make the transaction appear to be other than what it was" in order to avoid tax liability. The Circuit Court of Appeals drawing different inferences from the record, held that the corporation had "called off" the sale, and treated the stockholders' sale as unrelated to the prior negotiations.

Comm. vs. Court Holding Co., 324 US 331 (1945) Step Transaction Doctrine

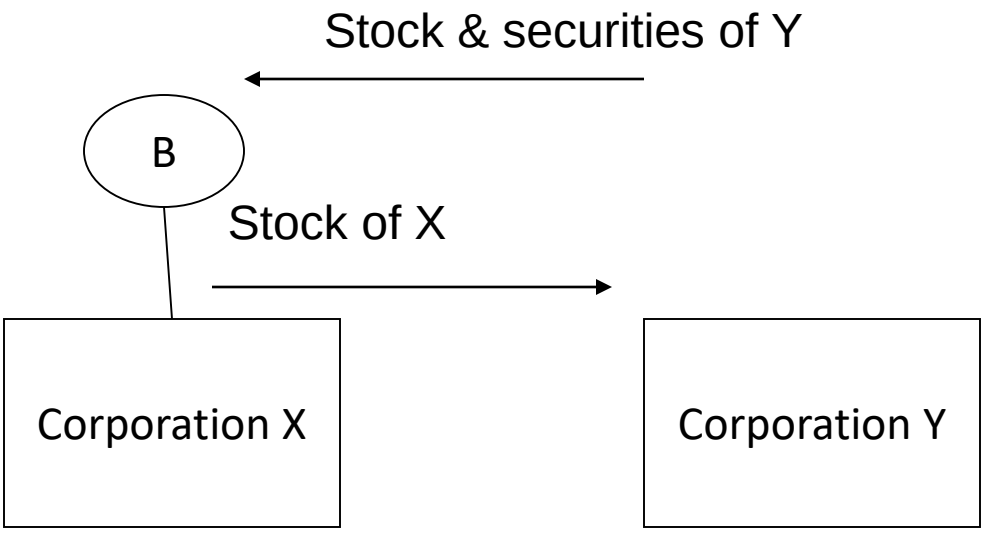
On the basis of these findings, the Tax Court was justified in attributing the gain from the sale to respondent corporation. The incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.

It is urged that respondent corporation never executed a written agreement, and that an oral agreement to sell land cannot be enforced in Florida because of the Statute of Frauds, Comp. Gen. Laws of Florida, 1927, vol. 3, § 5779. But the fact that respondent corporation itself never executed a written contract is unimportant, since the Tax Court found from the facts of the entire transaction that the executed sale was in substance the sale of the corporation. The decision of the Circuit Court of Appeals is reversed, and that of the Tax Court affirmed.



1.354-1(d)

Example 1. Pursuant to a reorganization under section 368(a) to which Corporations T and W are parties, A, a shareholder in Corporation T, surrenders all his common stock in Corporation T in exchange for common stock of Corporation W. No gain or loss is recognized to A.

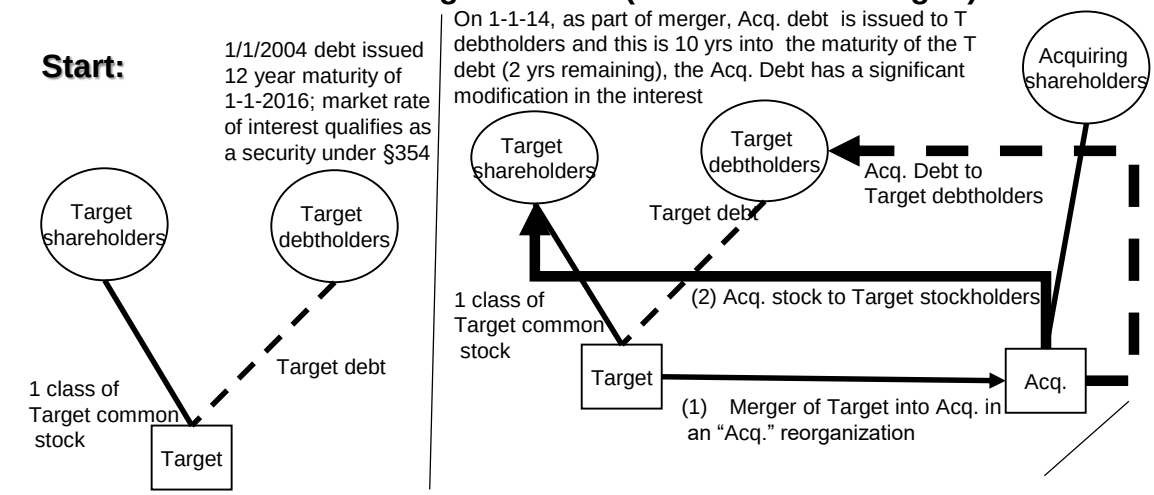


1.354-1(d)

Example 2. Pursuant to a reorganization under section 368(a) to which Corporations X and Y (which are not railroad corporations) are parties, B, a shareholder in Corporation X, surrenders all his stock in X for stock and securities in Y. Section 354 does not apply to this exchange. See, however, section 356.

Rev. Rul. 2004-78, 2004-2 C.B. 108, Receipt of Stock or Securities in Certain Reorganizations (Securities Exchanged)

§354



Issue: Under the circumstances described below, whether a debt instrument issued by the acquiring corporation in a reorganization in exchange for a security of the target corporation is a security within the meaning of § 354.

Facts: On 1-1- 2004, Target Corporation issues debt instruments with a stated maturity date of 1-1-16. On the issue date, the debt instruments provide for a market rate of interest and are securities within the meaning of § 354. Target Corporation has outstanding one class of common stock. On 1-1-14, pursuant to state law, Target Corporation merges into Acquiring Corporation in a transaction that qualifies as a reorganization under § 368(a)(1)(A). In the merger, the Target Corporation stockholders exchange their Target Corporation common stock for Acquiring Corporation common stock. Also in the merger, the Target Corporation security holders exchange their Target Corporation securities for Acquiring Corporation debt instruments with terms identical to those of the Target Corporation securities (including the maturity date), except that the interest rate is changed (for example, to reflect differences in creditworthiness between Target Corporation and Acquiring Corporation). The modification of the interest rate is a significant modification under Treas. Reg. §1.1001-3.

Law and Analysis: Section 354(a)(1) provides, in part, that no gain or loss shall be recognized if securities in a corporation that is a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for securities in such corporation or in another corporation that is a party to the reorganization.

Section 1.368-1(b) sets forth the general rule that, upon an exchange, gain or loss must be recognized if the new property differs materially in kind or extent from the old property. The regulation then explains that the purpose of the reorganization provisions is to except from the general rule certain exchanges incident to readjustments of corporate structures that are required by business exigencies and that effect only a readjustment of continuing interests in property under modified corporate forms. Congress has recognized that when a taxpayer receives stock or securities in exchange for stock or securities owned by the taxpayer incident to a readjustment of a corporate structure, the new stock or securities are treated as taking the place of the stock or securities exchanged therefor. See H.R. Rep. No. 704, at 13-14 (1933).

Neither § 354 nor the regulations under § 354 define the term "securities." Under case law, an instrument with a term of less than five years generally is not a security. See, e.g., Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462, 1933-1 C.B. 161 (1933) (holding that short-term notes payable within four months were not securities within the meaning of the reorganization provisions); Lloyd-Smith v. Commissioner, 116 F.2d 642 (2d Cir.), cert. denied, 313 U.S. 588 (1941) (holding that two-year notes were not securities); Neville Coke & Chemical Co., 148 F.2d 599 (3d Cir.), cert. denied, 326 U.S. 726 (1945) (holding that three, four, and five-year notes were not securities).

Under the foregoing authorities, an instrument with a term of two years generally would not qualify as a security. However, because the debt instruments of the Acquiring Corporation are issued in the reorganization in exchange for securities of the Target Corporation and bear the same terms (other than interest rate) as the securities of the Target Corporation, the debt instruments of the Acquiring Corporation represent a continuation of the security holder's investment in the Target Corporation in substantially the same form. Therefore, the debt instruments of the Acquiring Corporation exchanged for the securities of the Target Corporation are securities within the meaning of § 354.

Holding: Under the circumstances described above, a debt instrument issued by the acquiring corporation in a reorganization in exchange for a security of the target corporation is a security within the meaning of § 354.