

# Continuity of Interest — Its Application to Shareholders of the Acquiring Corporation

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*The continuity of interest doctrine is a keystone of tax-free reorganizations. Professor Turnier examines the history and policy behind the doctrine and points out that its use has been confined entirely to stockholders of the acquired corporation. The author demonstrates that such a mechanical application leaves open the possibility that form may overcome substance and allow an otherwise non-qualified reorganization to gain tax-free status. The Article concludes that the test should be applied to shareholders of both the acquiring and the acquired corporation.*

An exchange of property, including stock, for other assets normally gives rise to a taxable transaction causing gain or loss to be recognized.<sup>1</sup> Nevertheless, Congress has seen fit to provide for nonrecognition of gains or losses derived from certain types of exchanges.<sup>2</sup> These ameliorative provisions typically provide that the taxpayer carry over his old basis as the basis for the assets received in the exchange. Consequently, they might be viewed as providing for mere temporary nonrecognition of the gain or loss that otherwise would have been taken into account, the gain or loss eventually being accorded tax treatment when the new assets received in the exchange are disposed of in a taxable transaction. On the other hand, since subsequent values for the new assets might fluctuate prior to their being sold, and since the taxpayer can retain the new assets until he dies—at which point his transferees will acquire the value used for estate tax purposes as their basis in the assets<sup>3</sup>—these provisions may provide a means by which the gain of loss resulting from such an exchange is never recognized. At the very least, the Treasury temporarily forgoes the use of money it would otherwise have received, while the taxpayer retains the advantage of

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1. INT. REV. CODE OF 1954, §§ 1001-02.

2. See, e.g., *id.* §§ 351, 354, 1031-39.

3. *Id.* § 1014.

being able to time all subsequent sales so as to achieve the maximum tax benefit. Such nonrecognition provisions therefore represent significant drains on the Treasury and should be of particular concern to those interested in an equitable and efficient tax system.<sup>4</sup> Of those provisions of the Internal Revenue Code [the Code] that provide for nonrecognition of gain or loss, the tax-free reorganization provisions have attracted by far the greatest amount of attention from Congress, the Treasury, the bar and tax scholars.<sup>5</sup> Central to the entire tax-free reorganization area is the continuity of interest doctrine.

Continuity of interest is essentially a judicially created<sup>6</sup> doctrine requiring that a certain portion of the shareholders of the transferor (acquired) corporation or the transferor corporation itself maintain an equity position in the transferee (acquiring) corporation after the transfer is completed.<sup>7</sup> Congress has also established statutory continuity of interest tests requiring that, in exchange for their stock or assets, the transferors obtain stock in the acquiring corporation.<sup>8</sup> Failure to comply with these requirements results in the loss of nonrecognition treatment for the transferors.<sup>9</sup> The purpose of this Article is to explore the propriety of also applying both the judicial and the statutory continuity of interest tests to the shareholders of the acquiring corporation in the three principal types of tax-free corporate acquisitions: the statutory merger or consolidation;<sup>10</sup> the stock-for-stock exchange;<sup>11</sup> and the

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4. Curiously enough, the gamut of nonrecognition transactions has been either ignored or given only summary examination by the proponents of the tax expenditure budget. See S. SURREY, *PATHWAYS TO TAX REFORM* (1973). The federal budget for fiscal 1976 contained the first official estimate of revenue lost by the preferential treatment accorded certain types of transactions. Unfortunately, the official government tax expenditure budget seems virtually to have ignored the substantial revenue drain produced by the plethora of nonrecognition transactions present in the Code. The only nonrecognition transaction mentioned in the official tax expenditure budget for fiscal 1976 is the deferral of capital gain on home sales, which for fiscal 1976 is expected to produce a revenue loss of \$315,000,000. OFFICE OF MANAGEMENT AND BUDGET, *SPECIAL ANALYSES, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 1976*, at 109 (1975).

5. During the period 1968 through 1972, the code section index of the CCH FED. TAX ARTICLES contained over 100 separate entries for articles written on the subject of tax-free acquisition. See CCH 1968-1972 FED. TAX ARTICLES §§ 368.01-.88.

6. Subsequent to the initial judicial development of the continuity of interest doctrine, Congress imposed a statutory continuity of interest test with respect to two types of reorganizations. See text accompanying notes 105-14 *infra*. This Article deals with the propriety of applying both the judicial and statutory tests to the shareholders of the acquiring corporation.

7. See, e.g., B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 14.11 (3d ed. 1971) [hereinafter cited as B. BITTKER & J. EUSTICE]; D. KAHN, *BASIC CORPORATE TAXATION* 282-84 (2d ed. 1973).

8. INT. REV. CODE OF 1954, §§ 368(a)(1)(B)-(C), (a)(2)(D)-(E).

9. *Id.* §§ 354, 361(a).

10. *Id.* § 368(a)(1)(A).

11. *Id.* § 368(a)(1)(B).

asset-for-stock exchange.<sup>12</sup>

The following example illustrates the scope and import of the topic discussed: X corporation intends to acquire B corporation by merging B into X, or by acquiring all of the B stock or all of the B assets and issuing X stock to the former B shareholders in satisfaction of the rights of B shareholders—a transaction that will normally qualify for nonrecognition treatment.<sup>13</sup> If, rather than issuing B shareholders only X stock, X corporation issues a significant number of B shareholders something other than X stock—for example, cash or X debentures—the proposed acquisition will fail to qualify for tax-free treatment because the continuity of interest test has not been met.<sup>14</sup> Suppose, however, that the roles of the acquired and acquiring corporations are reversed by having B acquire X, either by merger or by an assets or stock acquisition—with the X shareholders receiving only B stock, and some or all of the B shareholders simultaneously being issued cash, B debentures or other property in exchange for their B stockholdings. If the continuity of interest test is applied only to the transferor corporation and its shareholders,<sup>15</sup> then, in this reversed arrangement, the continuity of interest test will still be met and the tax-free nature of the acquisition will be preserved.

As will be developed later in this Article,<sup>16</sup> a respectable case can be made for limiting the application of the continuity of interest test to the transferor corporation and its shareholders. Yet it will be apparent that limitation of the test to this group may often be tantamount to outright repeal of the test. Unless business<sup>17</sup> or other tax consider-

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12. *Id.* § 368(a)(1)(C).

13. *Id.* § 368(a)(1)(A)-(C).

14. See text accompanying notes 87-89 *infra*.

15. A reversal of roles would typically be used where a sufficient number of B corporation shareholders, although not concerned enough or in a position to block the reorganization, were willing to receive property other than stock in exchange for their shares, so that the statutory or judicial continuity of interest tests could not be met. If a reorganization were undertaken in such a case, using non-stock consideration, the non-recognition benefits would be lost to the remaining shareholders; and the combining corporations would also lose certain benefits accorded reorganizations. See text accompanying notes 33-39 *infra*. If the continuity of interest test were applied only to the transferors, reversal of roles would preserve for the combining corporations the benefits accorded to reorganizations and would preserve to the X shareholders and the remaining B shareholders the benefits of nonrecognition treatment accorded them under section 354 of the Code on their receipt of B stock. The B shareholders who were redeemed out would, of course, be subject to tax on the property received, with the treatment of any gain or loss determined under other provisions of the Code. See INT. REV. CODE OF 1954, § 302. The exchange by B, pursuant to the merger of its stock in exchange for X's assets, would be accorded nonrecognition treatment under section 1032; the basis of X's assets would be determined under section 362(b).

16. See text accompanying notes 115-16 *infra*.

17. Possession by X of a valuable grandfather privilege or a name with substantial commercial value would, for example, rule out adopting this procedure if a merger

ations<sup>18</sup> stand in the way, it is possible in most transactions (assuming that the continuity test is limited to transferor corporations and their shareholders) to reverse the roles of the acquired and acquiring corporations and preserve the essential tax-free nature of an acquisition that otherwise would have failed to satisfy the continuity of interest test.<sup>19</sup>

or an assets acquisition was necessary. Reversal of roles might also leave members of the board of directors of the nominal acquiring corporation either in control of or present on the board of the combined enterprise—a potentially undesirable result. Moreover, debt instruments occasionally call for acceleration of payment if the debtor is acquired by another corporation, but do not require such acceleration if the debtor itself acquires other corporations. Existence of such provisions would, of course, be determinative in the event it appeared otherwise desirable to reverse the roles of the acquired and acquiring corporations.

18. In a federal tax context, operation of the carryover provisions of sections 381-82 of the Code might preclude resort to such a device. See, e.g., B. BITTKER & J. EUSTICE, *supra* note 7, at ¶ 16.13; text accompanying notes 33-34 *infra*. In a state tax context, the absence of a reorganization exemption with respect to a real estate transfer tax might cause one to refrain from designating as the transferor in a merger or an assets acquisition the party that has significant real estate holdings. See, e.g., FLA. STAT. ANN. §§ 201.02-.021 (1971).

19. Analysis of the accounting implications of such a reversal of roles is beyond the scope of this Article. It should be noted, however, that by engaging in similar steps it might also be possible to qualify for pooling of interests treatment an acquisition that might otherwise be barred from using this method of accounting.

Traditionally, two different accounting methods have been used to reflect the effect of acquisitions—the purchase method and the pooling of interests method. Under the purchase method, the acquired stock or assets are reflected on the books of the acquiring corporation just as any other purchased asset might be reflected. Under the pooling of interests method, the assets, liabilities, earnings and net worth of the acquired corporation are combined or pooled with those of the acquiring corporation. One of the principal prerequisites to use of the pooling of interests method is that the acquiring corporation must issue “only common stock with rights identical to those of the majority of its outstanding common stock in exchange for substantially all of the voting common stock . . .” of another corporation. AICPA ACCOUNTING PRINCIPLES BOARD, Opinion No. 16, ¶ 47, at 298 (Aug. 1970). By reversing the roles of the acquired and acquiring corporations, it might be possible to qualify for the pooling of interests method an acquisition which, due to the planned issuance of consideration other than common stock, would have failed to qualify for such treatment under APB Opinion No. 16.

There are at least four distinct reasons why it is generally desirable to use the pooling of interest method, rather than the purchase method, to account for an acquisition. First, if the purchase method is employed and the fair market value of the stock and of the other consideration used to effect an acquisition exceeds the net fair market value of the tangible assets acquired, the excess is allocated to goodwill; in addition, under AICPA ACCOUNTING PRINCIPLES BOARD, Opinion No. 17 (Aug. 1970), that excess is amortized over a period not exceeding 40 years, during which period the earnings are consequently reduced. Second, under the purchase method the acquiring corporation continues in existence with its old retained as well as its current earnings, whereas under the pooling of interest method, the retained and current earnings of both companies are combined. Use of the latter method results in greater retained and current earnings for the acquiring company than would otherwise be the case. Third, under the pooling of interest method the income statements and balance sheets of the two corporations are combined for all periods, whereas under the purchase method these items are combined only for the period following the acquisition. Pooling of interest thus provides a corporation with the opportunity to acquire a favorable financial history. Finally, since under pooling of interest one does not write up assets to fair market value (as generally

This author has not discovered—in cases or in commentaries—discussion of the application of the continuity of interest test to the shareholders of both the acquired and acquiring corporations that are parties to a corporate reorganization.<sup>20</sup> In order to resolve this issue, therefore, it is necessary to examine the origins and purpose of both the reorganization provisions and the continuity of interest tests. This Article first explores the statutory requirements for and the consequences of classifying an acquisition as a reorganization and then examines the origins of, and the policies underlying, the reorganization provisions. Since these policies form the basis for the judicial development of the continuity of interest test, section II examines that test as it has been developed by the Supreme Court and articulated by the Treasury. Finally, the nature, origin and purposes of statutory continuity of interest tests for several types of reorganizations are examined prior to discussion of the suggested resolution of the issue posed by this Article.

## I

### STATUTORY TREATMENT OF REORGANIZATION

#### A. *Classification as a Reorganization*

The benefits accorded by the Internal Revenue Code to reorganizations are limited to several types of acquisitions, which are described by the Code with a fair degree of specificity. Three types<sup>21</sup> of acquisitions qualify as reorganizations: (1) a merger or consolidation occurring pursuant to state laws ("statutory merger or consolidation" or "A" type)<sup>22</sup>; (2) the acquisition by one corporation of the stock of another

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happens under the purchase method), the corporation retains on its books the often understated figures used by the acquired corporation. These understated figures result in an overstatement for financial reporting of earnings for the combined enterprise when: (1) depreciation and amortization are calculated on the basis of these low figures; and (2) understated assets are later sold by the combined entity for their fair market value. See L. BERNSTEIN, UNDERSTANDING CORPORATE REPORTS 145-66 (1974).

20. See generally B. BITTKER & J. EUSTICE, *supra* note 7; Z. CAVITCH, TAX PLANNING FOR CORPORATIONS AND SHAREHOLDERS §§ 9.04(3)(b), 10.04(5)(b) (1974); D. KAHN, *supra* note 7; 3 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 20.59 (1972); J. MCCORD, COURSE MATERIALS ON BUYING, SELLING AND MERGING BUSINESSES § 9.201 (1975); J. SCOTT, FEDERAL INCOME TAXATION OF CORPORATE REORGANIZATIONS AND DIVISIONS § 5.201 (1972); Beghe, *Consideration in Tax-Free Asset Acquisitions*, in N.Y.U. 26TH INST. ON FED. TAXATION 881 (H. Sellin ed. 1968) [hereinafter cited as Beghe]; Brookes, *The Continuity of Interest Test in Reorganizations—a Blessing or a Curse*, 34 CALIF. L. REV. 1 (1946); Griswold, "Securities" and "Continuity of Interest," 58 HARV. L. REV. 705 (1945).

21. Excluded from the scope of this Article are the nonacquisitive reorganizations involving certain corporate divisions, recapitalizations, and mere changes in form and identity. See INT. REV. CODE OF 1954, §§ 368(a)(1)(D)-(F).

22. INT. REV. CODE OF 1954, § 368(a)(1)(A). The result of an "A" reorganiza-

in exchange solely for voting stock of the acquiring corporation (or of a corporation which is in control of the acquiring corporation), provided that immediately after the acquisition the acquiring corporation is in control of the acquired corporation ("stock acquisition" or "B" type)<sup>23</sup>; and (3) the acquisition by one corporation of substantially all of the assets of another in exchange solely for stock of the acquiring corporation or of a corporation in control of the acquiring corporation ("asset acquisition" or "C" type).<sup>24</sup>

In addition to the garden-variety statutory merger, the Code also qualifies two "triangular" acquisitions, described in sections 368(a)(2)(D) and (a)(2)(E) of the Code, as "A" reorganizations. A statutory merger under section 368(a)(2)(D) is a corporate acquisition—carried out as a statutory merger—of substantially all of the assets of the acquired corporation in exchange for stock of a corporation in control of the "acquiring corporation", with both the controlled and the controlling corporations surviving the merger.<sup>25</sup> Although consideration other than stock of the controlling corporation may be used in the acquisition, use of stock of the "acquiring" controlled corporation is specifically forbidden.<sup>26</sup> A qualified reorganization under section 368(a)(2)(E) is an acquisition—carried out as a statutory merger of a controlled subsidiary of the acquiring corporation into the acquired corporation—pursuant to which the shareholders of the acquired corporation receive voting stock of the corporation in control of the merged

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tion is a single organization consisting of the assets of both corporations. In a statutory merger the acquired corporation ceases to exist and its assets and liabilities are transferred to the acquiring corporation, the surviving entity. The shareholders of the acquired corporation are issued stock of the acquiring corporation or other property in exchange for their stock in the now nonexistent acquired corporation. In a consolidation the combining corporations transfer their assets and liabilities to a new corporation, which issues its stock or other property to the shareholders of the combining corporations in exchange for their shareholdings in the new nonexistent combining corporations.

23. INT. REV. CODE OF 1954, § 368(a)(1)(B). Control for purposes of the reorganization provisions is described as ownership of stock possessing at least 80 percent of the total combined voting power of all classes of voting stock and at least 80 percent of the total number of shares of all other classes of stock. *Id.* § 368(c). After this reorganization, the acquired corporation is a controlled subsidiary of the acquiring corporation.

24. INT. REV. CODE OF 1954, § 368(a)(1)(C). Both corporations survive a C reorganization, with the acquired corporation becoming a holding company whose assets consist of stock issued by the acquiring company. These assets can, however, be distributed to the shareholders of the acquired corporation in a liquidation of that corporation. The tax-free nature of the transaction is retained in such a liquidation. *Id.* § 354(a).

25. For example, assume Company S, an 80 percent controlled subsidiary of Company P, merges with Company A. In such a merger the assets of Company A are transferred to Company S; the A stockholders receive stock in Company P; and Company A goes out of existence. Both Company S and Company P survive such a triangular reorganization.

26. INT. REV. CODE OF 1954, § 368(a)(2)(D)(ii).

subsidiary in exchange for enough stock in their acquired corporation to constitute control of such corporation.<sup>27</sup> After the merger has been completed, the acquired corporation must hold substantially all of its properties and those of the merged corporation.<sup>28</sup>

It should be noted that in the case of a garden-variety statutory merger or consolidation, or in the case of the triangular acquisition described in section 368(a)(2)(D) of the Code, the statutory definition of a reorganization does not forbid the use of consideration other than voting stock.<sup>29</sup> In contrast the statutory definitions of the remaining types of reorganizations—the stock acquisition, the asset acquisition, and the triangular “A” reorganization described in section 368(a)(2)(E)—do provide certain limitations on the consideration that may be used to effect a reorganization. In the case of a stock acquisition the Code forbids the use of consideration other than voting stock,<sup>30</sup> and in the case of the asset acquisition the Code provides for only limited use of consideration other than voting stock.<sup>31</sup> In the triangular “A” reorganization described in section 368(a)(2)(E), the shareholders of the acquired corporation transfer control of that corporation for voting stock of the corporation in control of the merged corporation. Thus, the Code also imposes a limited statutory restraint on the consideration that may be given to transferors in such acquisitions.

These statutory requirements governing stock and asset acquisitions and the triangular A reorganization described in section 368(a)(2)(E) in effect have imposed statutory continuity of interest tests that are not present with respect to statutory mergers, consolidations or the

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27. In other words, Company S, an 80 percent controlled subsidiary of Company P, merges with Company A. The A stockholders exchange their stock for stock in Company P; the assets of Company S are transferred to Company A; and Company S goes out of existence. Company A replaces Company S as the subsidiary of Company P.

28. INT. REV. CODE OF 1954, § 368(a)(2)(E)(i). For a thorough discussion of these two types of reorganizations, see Ferguson & Ginsburg, *Triangular Reorganizations*, 24 U. So. CAL. 1972 TAX INST. 1, subsequently edited and reissued under the same title at 28 TAX. L. REV. 159 (1973).

29. INT. REV. CODE OF 1954, § 368(a)(2)(D). See Ferguson & Ginsburg, *supra* note 28, 24 U. So. CAL. 1972 TAX INST. at 21-22, 28 TAX L. REV. at 173 [hereinafter cited as Ferguson & Ginsburg].

30. INT. REV. CODE OF 1954, § 368(a)(1)(B). For a thorough discussion of the “solely for voting stock” requirement of the “B” reorganization, see B. BITTKER & J. EUSTICE, *supra* note 7, at ¶ 14.13; Dailey, *The Voting Stock Requirement of B and C Reorganizations*, 26 TAX L. REV. 725 (1971) [hereinafter cited as Dailey].

31. The “solely for voting stock” requirement of § 368(a)(1)(C) of the Code is qualified by § 368(a)(2)(B), which provides that limited additional consideration (“boot”) may be given in a “C” reorganization if the acquiring corporation acquires solely for voting stock at least 80 percent of the fair market value of all the property of the acquired corporation with assumed liabilities being counted as cash only for such purposes. See B. BITTKER & J. EUSTICE, *supra* note 7, at ¶ 14.14; Beghe, *supra* note 20; Dailey, *supra* note 30.

triangular A reorganization described in section 368(a)(2)(D).<sup>32</sup> Hence, the same opportunity to attempt to avoid the application of the judicial continuity of interest test by reversing roles of the acquired and acquiring corporations exists with respect to the statutory tests.

### *B. Consequences of Classification as a Reorganization*

Classification as a reorganization affords substantial tax benefits to the shareholders who exchange their stock, to the corporation whose assets are acquired and to the acquiring corporation. If a transaction qualifies as a reorganization, as that term is defined in the Code,<sup>33</sup> a corporation that transfers its assets in exchange for stock of the acquiring company, shareholders who exchange their stock for stock of the acquiring company, and shareholders who are issued stock in a statutory merger or consolidation can qualify for nonrecognition of gain or loss.<sup>34</sup> If an acquisition fails to qualify as a reorganization, recognition of gain or loss is visited upon only those participants who entered into an exchange. For example, in the case of a merger that failed to qualify as a reorganization, only the shareholders of the merged corporation would lose the privilege of nonrecognition,<sup>35</sup> whereas in the case of a consolidation that failed to qualify the shareholders of both combining corporations would be deprived of the privilege of nonrecognition.<sup>36</sup> Qualification of an acquisition as a reorganization can have important tax consequences for the corporations that are parties to such transactions. The principal benefit available to the acquiring corporation (in all but the stock acquisition case) is the privilege of carrying over to the combined entity a number of the tax attributes of the acquired corporation.<sup>37</sup> Among the tax attributes of the acquired corporation pre-

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32. The disparity in the allowance of "boot" has been the subject of some criticism. The Subchapter C Advisory Group recommended, to no avail, that the "A" type reorganization be abolished and subsumed into the "C" type reorganization and that the continuity of interest test applied in "B" and "C" type reorganizations be limited to "a requirement that 50 percent of the consideration received in exchange for the stock or property transferred, measured by fair market value, consist of stock of the acquiring corporation." HOUSE COMM. ON WAYS AND MEANS, 84TH CONG., 1ST SESS., REPORT ON CORPORATE DISTRIBUTIONS AND ADJUSTMENTS 61-62 (Comm. Print 1957).

33. INT. REV. CODE OF 1954, § 368(a)(1).

34. *Id.* §§ 354, 361.

35. Shareholders of the acquiring or surviving corporation are not issued any property in addition to the stock in the acquiring corporation which they held before the merger. Since only the shareholders of the acquired corporation exchange their stock, in the event a merger does not qualify as a reorganization, it is only these shareholders who may be subject to taxation under INT. REV. CODE OF 1954, § 1002.

36. Since the shareholders of both corporations exchange their stock for new and different property, in the event a consolidation does not qualify as a reorganization, the shareholders of both combining corporations may be subject to taxation under INT. REV. CODE OF 1954, § 1002.

37. INT. REV. CODE OF 1954, §§ 381-82. Since the acquired corporation in a B



served for the acquiring company<sup>38</sup> are the basis of acquired assets, net operating losses, and earnings and profits.<sup>39</sup> These attributes, of course, are not preserved in the case of a mere purchase of assets; consequently, qualification of an acquisition as a reorganization is often as important for the acquiring corporation as it is for the transferor corporation or its shareholders.

## II

### ORIGINS OF, AND POLICY UNDERLYING, REORGANIZATION PROVISIONS

An examination of the origins of the reorganization provisions will give some indication of the reason Congress chose to afford this special tax treatment to certain transactions<sup>40</sup> and will provide some insight into the evolution and purposes of the continuity of interest test.

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reorganization continues to exist as a separate entity, the carryover provisions, of course, do not apply to such acquisitions unless the acquired corporation is liquidated in a transaction described in section 332.

38. In a reverse merger, where the large corporation agrees to act as the acquired corporation for purposes of quietly buying out some or all of the shareholders of the smaller corporation, carryover of tax attributes of the large corporation will occur if the requirements of INT. REV. CODE OF 1954, § 381 are satisfied. On the other hand, if the continuity of interest test were applied to both parties and the nonequity consideration is sufficiently large to cause a problem, such a reorganization would fail to qualify as a tax-free reorganization. Thus, unless a subsequent liquidation of the acquired corporation under § 381(a)(1) can be engineered, INT. REV. CODE OF 1954, § 381 would not apply, resulting in the survival of the tax attributes of only the acquiring corporation (in this case, the smaller one). Such a result probably would be unsatisfactory to the larger corporation, which presumably entered into this reversal transaction primarily for the benefit of the shareholders of the smaller company.

39. Section 381(c) of the Code contains a list of 24 of the most important tax attributes carried over from the transferor corporation to the transferee corporation pursuant to section 381(a). Treatment of tax attributes not mentioned in section 381(c) is the subject of a still unresolved controversy as to whether: (1) no carryover exists, since section 381 provides the exclusive treatment for carryovers; (2) carryover treatment is to be determined under the law developed prior to the passage of section 381 in 1954; or (3) such items are accorded treatment analogous to the treatment available under section 381. Rev. Rul. 72-452, 1972-2 CUM. BULL. 438 indicates that the Treasury may have adopted the second of the above positions and intends to apply the pre-existing case law to such items. See B. BITTKER & J. EUSTICE, *supra* note 7, at ¶ 16.14, and 1975 Supp. at ¶ 16.14.

40. For excellent discussions of the origins of the reorganization provisions, see R. MAGILL, *TAXABLE INCOME* 143-51 (rev. ed. 1945); R. PAUL, *STUDIES IN FEDERAL TAXATION* 19-53 (1940). Surprisingly little scholarly attention has been paid to the legislative purposes for enacting the reorganization provisions. See Cohen, *Conglomerate Mergers and Taxation*, 55 A.B.A.J. 40 (1969) [hereinafter cited as Cohen]; Hellerstein, *Mergers, Taxes, and Realism*, 71 HARV. L. REV. 254 (1957) [hereinafter cited as Hellerstein]; Sandberg, *The Income Tax Subsidy to "Reorganizations,"* 38 COLUM. L. REV. 98 (1938); Magill, *Notes on the Revenue Act of 1924—Income Tax Provisions*, 24 COLUM. L. REV. 836 (1924).

*A. Origins of the Provision*

The period 1918 to 1924 can be viewed as the formative period in the development of the reorganization provisions. In those years Congress refined the nonrecognition and the carryover basis concepts, developed the three basic categories of acquisitions accorded nonrecognition treatment, and provided some of the initial definitions of the principal terms employed in the reorganization provisions.

Prior to 1918 the Code contained no provisions granting nonrecognition treatment to reorganizations.<sup>41</sup> The first statutory nonrecognition provision is found in section 202(b) of the Revenue Act of 1918, which provided for nonrecognition of gain or loss with respect to stock or securities received "in connection with the reorganization, merger or consolidation of a corporation."<sup>42</sup> In 1921 Congress defined the hitherto undefined term "reorganization" as including the stock acquisition ("B" type reorganization) and the asset acquisition ("C" type reorganization), and extended nonrecognition treatment to recapitalizations ("E" type reorganization) and to mere changes in identity, form or place of incorporation ("F" type reorganization).<sup>43</sup> Shortly after passage of the 1921 Act it was discovered that Congress had failed to provide for a carryover basis in reorganizations and that transferors could obtain a stepped-up basis simply by entering into a tax-free reorganization.<sup>44</sup> The 1924 Revenue Act corrected this defect by providing for a carryover basis,<sup>45</sup> and also extended nonrecognition treatment both to corporate transferors and to transfers of all or a part of the assets of a corporation to a controlled corporation ("D" type reorganization).<sup>46</sup>

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41. Judicially created standards extending nonrecognition to very few internal corporate restructurings existed for nonacquisitive reorganizations. See R. MAGILL, *TAXABLE INCOME* 65-80 (1945); R. PAUL, *supra* note 40, at 8-18.

42. Ch. 18, § 202(b), 40 Stat. 1060. Section 202(b) of the Revenue Act of 1918 also contained a curious provision that limited nonrecognition to situations in which the par or face value of the securities received by the transferors did not exceed the par or face value of the securities surrendered. In the event a shareholder received securities with an aggregate par value in excess of the aggregate par value of the securities surrendered in a reorganization, the excess of this amount, to the extent it represented gain that would otherwise be unrecognized, was treated as taxable gain in the year of the exchange. This curious provision was repealed by Congress in the Revenue Act of 1921, ch. 136, § 202(c), 42 Stat. 230.

43. Revenue Act of 1921, ch. 136, § 202(c)(2), 42 Stat. 230.

44. This facet of the Revenue Act of 1921 inspired Randolph Paul to make the following comment: "These methods were like taking candy from children. Nowadays the Treasury may comfort itself with the thought that tax-avoiding taxpayers at least have to think." Paul, *The Background of the Revenue Act of 1937*, 5 U. CHI. L. REV. 41, 44 n.28 (1937).

45. Ch. 234, § 204(a), 43 Stat. 258-59.

46. *Id.* § 203(a), 43 Stat. 256.

### B. Underlying Policy

During the 6-year period from 1918 to 1924, in which the reorganization provisions assumed their basic skeletal form, Congress provided the only clear explanation of its reasons for enacting them.<sup>47</sup> A close examination of the legislative history shows two separate but interrelated reasons for according nonrecognition treatment to certain reorganizations: (1) the general unwillingness to tax business participation rearrangements in which the shareholders and bondholders continue as holders of proprietary intangible interests and receive neither cash nor marketable tangible property; and (2) the Congressional desire to avoid establishing a tax structure that would prevent businesses from reordering themselves to confront new economic challenges. These two diverse but interrelated goals will be explored separately.

#### 1. "Purely Paper Transactions"

The Senate Finance Committee stated that the nonrecognition provision was being added to the Code in 1918 "to negative the assertion of tax in the case of certain purely paper transactions."<sup>48</sup> In a lengthy explanation of the operation of the reorganization provisions of the 1921 Tax Act, Senators Watson and Smoot, both members of

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47. Scholars who have examined the legislative history of the reorganization provisions have at times reached different conclusions with respect to the original reasons for congressional enactment of the provisions. Professor Hellerstein, for example, finds that the legislative history "leaves no doubt" that the provisions were intended to cover mere changes in form and not substance, whereas an earlier scholar believed that "no one can satisfactorily explain why they were ever enacted or why, having been enacted, they have remained." Compare Hellerstein, *supra* note 40, at 258, with Sandberg, *supra* note 40, at 98.

48. S. REP. NO. 617, 65th Cong., 3d Sess., pt. 1, at 5 (1918). By focusing on this and other similar language, several critics of the reorganization provisions have misconstrued the essence of the congressional purpose in enacting these provisions and have attacked the present use of these Code sections to provide the benefits of nonrecognition to reorganizations involving substantial economic changes as inconsistent with such a purpose. See Cohen, *supra* note 40, at 43-44; Hellerstein, *supra* note 40, at 258-61, 266-72. The most glaring example of such an approach is provided by Professor Hellerstein who, by focusing only on such language and ignoring the lengthy congressional debates on the subject as well as the economic climate in which the reorganization provisions were enacted, reaches the conclusion that the reorganization provisions ought not be available to a merger involving two large manufacturers producing similar products since the change wrought for the shareholder constitutes a change of substance rather than a mere change of form. It is submitted that such a conclusion is at variance with the totality of the legislative history of the reorganization provisions, which were intended to be expansive and to facilitate a variety of business restructurings. Congress enacted reorganization provisions establishing a tax-free vehicle for corporate mergers, consolidations and acquisitions, and also separately provided for tax-free treatment of recapitalizations and mere changes in form. That the problem was approached in this manner should caution against concluding that the reorganization provisions were intended to be limited to mere changes in the form of the original investment. See text accompanying notes 50, 56-62 *infra*.

the Senate Finance Committee,<sup>49</sup> clarified the Congressional meaning of the phrase "purely paper transactions." Their remarks manifest the congressional intent during this period of economic distress to include within the scope of the reorganization provisions mergers involving vast nationwide economic empires with thousands of shareholders; the reorganization provisions were not directed at mere changes in the form of investments in corner grocery stores.<sup>50</sup> Senators Watson and Smoot clearly described such transactions as "paper affairs" and "paper transfer[s]."<sup>51</sup> From the remarks of both Senators it is clear that the phrase "paper transactions" describes a transfer in which the shareholder swaps an intangible investment in one corporation for an intangible investment in another, which then holds the object of his original investment as one of its constituent parts. Transposition of an investment into a totally new investment—as is done in the case of a sale—was, in Congress' estimation, sufficient to give rise to taxation, since such exchanges could hardly be deemed necessary to facilitate the restructuring and upbuilding of business in the period of wartime economic distress and postwar boom and depression during which the reorganization provisions were enacted.<sup>52</sup> Moreover, congressional concern about three factors—(1) the difference between parties to reorganizations and mere vendors; (2) ability to pay; and (3) difficulty in determining the amount to be recognized as gain in a merger—obviously contributed to Congress' decision to grant nonrecognition treatment to reorganizations.<sup>53</sup>

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49. 61 CONG. REC. 6563-65 (1921).

50. That the reorganization provisions were clearly intended to provide for major business restructurings is apparent from a number of remarks such as the reference to qualifying reorganizations involving "large country-wide corporations, in which there are thousands of stockholders." *Id.* at 6563-64 (remarks of Senator Watson, in which he refers to a merger involving 230,000 shareholders); *id.* at 6567 (remarks of Senator Reed, characterizing a reorganization such as the formation of U.S. Steel as potentially qualifying).

51. *Id.* at 6563, 6564.

52. The remarks of Senator Watson illustrate that a primary purpose in enacting the reorganization provisions was the importance of providing for business restructurings. He described a merger whereby a shareholder received \$1,000,000 of stock as [P]urely a paper affair. It is the exchange of stock of different corporations for business purposes; and at a time when so much reorganization is going on in the business world, it is thought by all those interested in the upbuilding of the industries of the country at this time that this is a very helpful provision.

*Id.* at 6563.

53. *Id.* at 6565 (remarks of Mr. King). Concern with such factors is in keeping with the establishment of nonrecognition treatment for like-kind exchanges in the Revenue Act of 1921 which, as originally enacted, allowed for the tax-free exchange of stock for stock. Ch. 136, § 202(c)(1), 42 Stat. 230. At the strong urging of the Treasury, Congress, within a little more than 1 year of the enactment of the "like-kind exchange" provisions, excluded stock and securities from the category of property which could qualify for like-kind exchange treatment. Act of Mar. 4, 1923, ch. 294, § 1, 42 Stat. 1560 (1923).

Against this background must be read subsequent statements, made by the Congress and Treasury in the course of passage of the 1924 Tax Act, that the nonrecognition provisions allow for "merely changes in form and not substance."<sup>54</sup> Moreover, because this terminology always appears as part of a general reference to section 203 of the Revenue Act of 1924, which gave nonrecognition treatment to a number of transactions in addition to reorganizations,<sup>55</sup> it is not at all clear that this should be regarded as the distillation of congressional wisdom in enacting the reorganization provisions. Lamentably, several commentators have focused only on this language and have ignored the totality of the legislative history.<sup>56</sup> That history as well as the addition of the "F" type reorganization to the Code in 1921 to provide for "a mere change in identity, form, or place of organization"<sup>57</sup> provide conclusive evidence that Congress envisioned that the three types of acquisitive reorganizations would have some larger role than providing for mere changes in form.

## 2. *Encouragement of Economic Restructuring*

Perhaps the principal reason for Congress' granting the benefits of nonrecognition to corporate reorganizations was a desire not to discourage, through the vehicle of the tax system, economic restructurings which otherwise would have occurred in the course of the orderly evolution of the nation's economy. The war years and the postwar boom and depression placed substantial burdens on the nation's businesses.<sup>58</sup>

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54. See H.R. REP. NO. 179, 68th Cong., 1st Sess. 16 (1924); S. REP. NO. 398, 68th Cong., 1st Sess. 17-18 (1924); Comments of A.W. Gregg, Special Assistant to the Secretary of the Treasury, as reprinted in SENATE FIN. COMM., 68TH CONG., 1ST SESS., STATEMENT OF THE CHANGES MADE IN THE REVENUE ACT OF 1921 BY H.R. 6715 AND THE REASONS THEREFOR 10 (Comm. Print 1924). Prior to the enactment of the Revenue Act of 1921, A.W. Gregg, acting in his official capacity, issued a statement in which he explained the impact of the Act on the then existing tax structure. This statement, which predated the two congressional reports on the subject, contained language similar to that found in those reports and undeniably is the source of that language. See N.Y. Times, Jan. 5, 1924, § 1, at 8, cols. 4-5.

55. For example, like-kind exchanges and involuntary conversions were afforded nonrecognition treatment. See Revenue Act of 1924, ch. 234, § 203, 43 Stat. 256.

56. See, e.g., Cohen, *supra* note 40; Dane, *The Case for Nonrecognition of Gain in Reorganization Exchanges*, 36 TAXES 244 (1958); Hellerstein, *supra* note 40; see note 47 *supra*.

57. Revenue Act of 1921, ch. 136, § 202(c)(2), 42 Stat. 230.

58. World War I produced a startling number of economic changes in the character of American business. In an effort to allow industry to meet production demands, all antitrust suits were halted during the war. Moreover, government contracting policies favored large semi-monopolistic corporations as reliable sources of war material. Many industries not vital to the war effort either shut down or reduced their operations during the war. The end of the war brought a flurry of economic activity followed by a short but severe economic contraction, which lasted from mid-1921 through 1922. The economic turnaround that began in the end of 1922 proceeded at a rapid pace; the ten-

The reorganization provisions were enacted in part to allow businesses to make the necessary changes to meet these and other business exigencies. As both the House Ways and Means Committee and the Senate Finance Committee noted in explaining the Revenue Act of 1924: "Congress has heretofore adopted the policy of exempting from tax the gain from exchanges made in connection with a reorganization in order that ordinary business transactions will not be prevented on account of the provisions of the tax law."<sup>59</sup> The numerous references indicating that the provisions would secure the means by which vast economic empires could be assembled, engage in acquisitions, or themselves be acquired<sup>60</sup> support the conclusion that Congress envisioned these provisions as a means toward achieving major economic restructurings.

Congressional awareness of the need of businesses to be free to merge with and acquire other businesses without burdensome tax consequences mandates adoption of a flexible, non-static approach to the reorganization provisions and requires that they be construed to allow businesses to meet the economic challenges of a changing economic world order. The suggestion that the benefits of nonrecognition should not be extended to mergers of vast economic empires<sup>61</sup> or to conglomerate acquisitions,<sup>62</sup> on the ground that such acquisitions constitute

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dency toward concentration of businesses, which had begun in the late 19th century and was refueled by the war, continued at an accelerated pace during the boom years of the 1920's. See T. COCHRAN & W. MILLER, *THE AGE OF ENTERPRISE* 300-03, 315-21 (1942); H. FAULKNER, *AMERICAN ECONOMIC HISTORY* 603-14 (7th ed. 1954).

59. H.R. REP. No. 179, 68th Cong., 1st Sess. 13 (1924) and S. REP. No. 398, 68th Cong., 1st Sess. 14-15 (1924) both contain the quoted language, which can also be found in SENATE FIN. COMM., 68TH CONG., 1ST SESS., *STATEMENT OF THE CHANGES MADE IN THE REVENUE ACT OF 1921 BY H.R. 6715 AND THE REASONS THEREFOR* 6 (Comm. Print 1924), and in N.Y. Times, Jan. 5, 1924, § 1, at 8, cols. 2-3 (statement of A.W. Gregg explaining the impact of the Revenue Bill of 1921—see note 54 *supra*).

60. See notes 49-53 *supra*.

61. See Hellerstein, *supra* note 40.

62. See Cohen, *supra* note 40, at 43. Former Commissioner of Internal Revenue, Sheldon Cohen, after dutifully recounting the dual nature of the congressional purpose in enacting the reorganization provisions, focused on the "mere change in form" language and postulated that conglomerate acquisitions may not come within the scope of the original reasons for enacting the reorganization provisions. Such a focus misreads the "mere change in form" language. See text accompanying notes 54-56 *supra*. In addition, such an attack on conglomerate mergers ignores, or at the very least is based upon a static view of, the second congressional purpose for enacting the reorganization provisions—allowing businesses to restructure to meet the economic exigencies they might confront. Some conglomerate mergers may have been motivated by nothing more than a desire to improve earnings by means of pooling of interest accounting, and many, viewed with the advantage of hindsight, perhaps never should have been consummated. Nonetheless, the conglomerate does occupy a vital place in the present economic setting. See, e.g., Berg, *What's Different About Conglomerate Management?*, 47 HARV. BUS. REV. 112 (1969); *Royal Little Looks at Conglomerates*, 91 DUNS REV. 25 (1968); Editorial, *The Case for Conglomerates*, FORTUNE, June 1967, at 163; Judelson, *The Conglomerate-Corporate Form of the Future*, 21 MICH. BUS. REV. No. 4 at 8 (1969); Leontiades, *Another Look at Conglomerates*, 25 FINANCIAL ANALYSTS J. No. 3 at 80 (1969).

something more than mere changes in form, is therefore inconsistent with the basic congressional purpose of allowing business to adjust to economic exigencies.

### III

#### THE CONTINUITY OF INTEREST DOCTRINE

##### A. *Judicial Development*

The lack of a congressional articulation of the distinction between simple sales and exchanges, which are taxable, and acquisitions, which qualify for nonrecognition treatment as reorganizations, encouraged a number of taxpayers to attempt to qualify as tax-free reorganizations. A variety of transactions in which the transferors received little or no equity interest in exchange for their stock or the assets of the acquired corporation.

In 1933, in *Pinellas Ice & Cold Storage Co. v. Commissioner*,<sup>63</sup> the Supreme Court first addressed the issue of the need, in a tax-free reorganization, for a portion of the shareholders of the transferor corporation to continue as equity holders in the combined entity. In 1926, Pinellas, a Florida corporation, transferred its assets to the Florida West Coast Ice Company in exchange for \$400,000 in cash and \$1,000,000 in short-term notes of Florida West Coast, all of which would fall due within 4 months. The Court was asked to decide whether Pinellas was taxable on any gain realized on the transaction. The Court faced two fundamental issues: first, whether the transaction was a reorganization within the meaning of section 203(h)(1);<sup>64</sup> and second, if the transaction was a reorganization, whether the notes qualified as securities within the meaning of sections 203(b)(3)<sup>65</sup> and 203(e).<sup>66</sup> Failure of the transaction to qualify as a reorganization under section 203(h)

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63. 287 U.S. 462 (1933).

64. The Revenue Act of 1921 defined a "reorganization" as "a merger or consolidation (including the acquisition by one corporation of . . . substantially all the properties of another corporation)." Ch. 136, § 202, 42 Stat. 230. This section was reenacted in the Revenue Act of 1924, ch. 234, § 203(h)(1)(A), 43 Stat. 257, and in the Revenue Act of 1926, ch. 27, § 203(h)(1), 44 Stat. 14 (predecessor of INT. REV. CODE OF 1954, § 368(a)(1)).

65. Section 203(b)(3) provided for nonrecognition of gain "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 a reorganization." Revenue Act of 1924, ch. 234, § 203, 43 Stat. 256, *reenacted in* Revenue Act of 1926, ch. 27, § 203(b)(3), 44 Stat. 12 (predecessor of INT. REV. CODE OF 1954, § 354(a)(1)).

66. Section 203(e) provided for the taxation of gain represented by any "boot" (i.e., property other than stock or securities of the transferee) received in a reorganization. Revenue Act of 1924, ch. 234, § 203(e), 43 Stat. 257, *reenacted in* Revenue Act of 1926, ch. 27, § 203(e), 44 Stat. 13 (predecessor of INT. REV. CODE OF 1954, § 356).

(1) would have resulted in all gain being fully recognized since section 203(b)(3), the basic nonrecognition section, would not have been applicable. Moreover, even if the transaction had qualified as a reorganization—if the notes did not qualify as “securities” under sections 203(b)(3) and 203(e)—their receipt would have been taxable as “boot” under section 203(e) along with the cash already so taxable.

In deciding the case in favor of the Commissioner, the Supreme Court addressed both the “securities” and the “reorganization” issues. On the securities issue the Court decided that the notes were not securities, but were cash equivalents and, like cash, should be rendered taxable as boot.<sup>67</sup> The Court then passed on the more fundamental issue,<sup>68</sup> whether the transaction qualified as a reorganization under the definition provided by section 203(h)(1). Justice McReynolds, speaking for the Court, noted:

[T]he 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 of ownership of its short-term purchase-money notes.<sup>69</sup>

In so holding, the Court cited with approval a Second Circuit decision, *Cortland Specialty Co. v. Commissioner*,<sup>70</sup> which had been handed down just 5 months previously on facts similar to those in *Pinellas*.

Judge Augustus Hand's<sup>71</sup> opinion in *Cortland* is perhaps the clear-

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67. The Court stated:

These notes . . . were not securities within the intendment of the act and were properly regarded as the equivalent of cash. It would require clear language to lead us to conclude that Congress intended to grant exemption to one who sells property and for the purchase price accepts well-secured, short term notes (all payable within four months), when another who makes a like sale and receives cash certainly would be taxed. . . . In substance the petitioner sold for the equivalent of cash; the gain must be recognized.

287 U.S. at 468-69.

68. Since the Court decided both the securities issue and the reorganization issue against the taxpayer, the disposition of one of the issues could be labeled as dictum or as an alternative holding. Dean Griswold chose to label the Court's disposition of the securities issue as dictum, perhaps because that suited the thesis of his article. See Griswold, *supra* note 20, at 708-09. Since the Court first disposed of the securities issue, thereby rendering the entire transaction taxable, it would appear that if one sought to place the label dictum on one of the pronouncements of the Court the term would be reserved for use with respect to the reorganization issue. The distinction between dictum and alternative holding in some cases is at best a tenuous one. See generally K. LLEWELLYN, *THE BRAMBLE BUSH* 43-45 (1951); Wambaugh, *How to Use Decisions and Statutes*, in A. VANDERBILT, *STUDYING LAW* 554-60 (1955). Perhaps the best explanation of the difference between dictum and an alternative holding when a court cites two independent grounds for reaching a decision is that something favoring one's client is an alternative holding, whereas something favoring one's opponent is dictum.

69. 287 U.S. at 470.

70. 60 F.2d 937 (2d Cir. 1932).

71. The panel assembled for *Cortland*, which consisted of Judges Augustus Hand,



est judicial articulation of the need for, and the justification of, the continuity of interest test. He observed that the reorganization provisions of the Code were not intended to encompass sales of stock or corporate assets, and asserted that in a reorganization (and not in the case of a sale) the "interests of the stockholders and creditors of any company which disappears [or which is acquired] remain and are retained again against the surviving or newly created company."<sup>72</sup> According to Judge Hand, the basic purpose of the reorganization provision

was to relieve those interested in corporations from profits taxes in cases where there was only a change in the corporate form in which business was conducted without an actual realization of any gain from an exchange of properties . . . In defining "reorganization," Section 203 of the Revenue Act gives the widest room for all kinds of changes in corporate structure, but does not abandon the primary requisite that there must be some continuity of interest on the part of the transferor corporation or its stockholders in order to secure exemption. Reorganization presupposes continuance of business under modified corporate forms.<sup>73</sup>

This distinction between a sale, in which there is no continuing participation by the transferors in the affairs of the new or acquiring entity, and other exchanges, in which there is some continuing participation by the transferor, gave rise to and became the touchstone of the continuity of interest test.

It should be noted that the *Pinellas* and *Cortland* decisions were essentially exclusionary in that they held that short-term bonds did not constitute a sufficient interest in the affairs of the acquiring corporation to warrant classification of a transaction as a reorganization. Although both *Pinellas* and *Cortland* did establish the existence of the continuity of interest test and indicated that qualification of an acquisition as a reorganization would require that the transferors obtain some interest in the affairs of the acquiring corporation more definite than short-term bonds, these decisions did little to indicate precisely what interests would satisfy the test. Two years after its decision in *Pinellas*, however, the Supreme Court, in a trilogy of cases,<sup>74</sup> delineated more pre-

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Learned Hand and Harrie B. Chase, was assembled subsequently through much of the 1930's and 1940's, and was perhaps one of the best panels ever assembled on the federal bench.

72. 60 F.2d at 939.

73. *Id.* at 940.

74. *John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935); *Helvering v. Minnesota Tea Co.*, 296 U.S. 378 (1935); *Helvering v. Watts*, 296 U.S. 387 (1935). A fourth case, decided on the same day, involved a government claim that an acquisition did not qualify as a reorganization. The claim was based in part on the contention that the continuity of interest requirement was not satisfied where the transferors received stock of the acquiring corporation—constituting more than 55 percent of the total value of all consideration given by the acquiring corporation—with cash and assumed liabilities

cisely the bounds of the continuity of interest test. The Court was asked to resolve whether preferred stock of the acquiring company or voting trust certificates representing its common stock would satisfy the test, and whether a considerable portion of the consideration received by the transferors could be in the form of cash as long as a meaningful portion of the consideration was in the form of an interest which, standing alone, would satisfy the continuity of interest test.

The principal case in the trilogy was *Helvering v. Minnesota Tea Co.*<sup>75</sup> It involved a situation in which substantially all the assets of one corporation were acquired by the Grand Union Corporation in exchange for voting trust certificates, representing approximately \$540,000 worth of Grand Union common stock, plus \$426,842 in cash. The Court held that the voting trust certificates met the requirement of *Pinellas*—that the transferor acquire an interest in the affairs of the acquiring company—and that those interests were substantial enough in value when compared to the total value of the property received to warrant classifying the transaction in question as a reorganization.<sup>76</sup> In *John A. Nelson Co. v. Helvering*,<sup>77</sup> the Court held that the continuity of interest test was satisfied where nonvoting redeemable preferred stock comprised approximately 38 percent of the total consideration received by the transferors and cash constituted the balance of the consid-

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comprising the balance of the transferred assets. The Supreme Court disposed of this case in favor of the taxpayer in a terse and imprecise decision that did not direct itself to the continuity of interest issue; nonetheless, since the Court's decision favored the taxpayer, it may be assumed that this issue was decided in his favor. The outcome of the Court's decision added nothing to the development of the law regarding the continuity of interest doctrine and is therefore never included in discussions on the subject. See Brief for Respondent at 10-11, *G & K Mfg. Co. v. Helvering*, 296 U.S. 389 (1935).

75. 296 U.S. 378 (1935).

76. The Court, further articulating its understanding of the continuity of interest doctrine, reiterated its prior statement in *Pinellas*—that the seller must acquire some definite interest in the purchaser—and then noted:

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. . . .

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.

*Id.* at 385-86. Subsequent to the consummation of the reorganizations in *John A. Nelson Co.*, *Minnesota Tea Co.*, and *Watts*, but prior to the Court's decision in these cases, Congress added the "solely for voting stock" requirements to the assets and stock acquisitions, with the result that none of these transactions would have qualified as reorganizations after 1934. See text accompanying notes 97-102 *infra*.

77. 296 U.S. 374 (1935).

eration.<sup>78</sup> The last case in the group was *Helvering v. Watts*,<sup>79</sup> in which the Court held that an acquisition by one corporation of the assets of another in exchange for stock and long-term bonds of the acquiring corporation constituted a reorganization and that the bonds constituted "securities" as that term is used in section 203(b)(2) of the Revenue Act of 1924.<sup>80</sup> The stock received by the transferors constituted approximately 45 percent of the total value of the consideration received, and the long-term bonds made up the balance.<sup>81</sup> The Court in *Watts* never indicated whether the long-term bonds standing alone would satisfy the continuity of interest requirement.

These cases thus established that some form of common or preferred equity holdings in the acquiring corporation would satisfy the

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78. The transferor corporation whose assets were acquired received \$2,000,000 in cash and 14,060 shares of \$100 par value redeemable preferred stock entitled to an annual dividend of \$7 per share. *John A. Nelson Co.*, 28 B.T.A. 529, 534-35 (1933). Most commentators, including this author, generally accord the preferred stock a value equal to its par value for purposes of demonstrating some minimally acceptable relative values for equity and nonequity consideration. See, e.g., B. BITTKER & J. EUSTICE, *supra* note 7, ¶ 14.11, at 14-18. This value assessment is probably justified. The government, in its arguments before the Court, assigned a fair market value to each share equal to its par value and the petitioner, in his reply brief, did not object to the value assigned; petitioner merely asserted that the relative values of the cash and stock were sufficient to satisfy the continuity of interest requirement. See Brief for Respondent at 15, Reply Brief for Petitioner at 5-6, *John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935).

The Treasury has indicated that it will issue favorable rulings in cases where the equity interest equals 50 percent of the total consideration. See text accompanying note 100 *infra*. In view of the Treasury's unwillingness to issue rulings where the equity received in an acquisition is less than 50 percent of the total consideration, attorneys are often called upon to issue letters of opinion with respect to such acquisitions and frequently rely on *Nelson* in so doing. Since it is impossible to determine the fair market value of the equity interest conveyed in that case, some caution appears to be called for in such a transaction. *But see Miller v. Comm'r*, 84 F.2d 415 (6th Cir. 1936), where a 25 percent equity interest was found to satisfy the continuity of interest requirement.

79. 296 U.S. 387 (1935).

80. Revenue Act of 1921, ch. 136, § 202(c)(2), 42 Stat. 231 *reenacted as* Revenue Act of 1924, ch. 234, § 203(b)(2), 43 Stat. 255, and Revenue Act of 1926, ch. 27, § 203(b)(3), 44 Stat. 12 (predecessor of INT. REV. CODE OF 1954, § 354). Since the bonds qualified as securities received pursuant to a reorganization, they (as well as the stock) qualified for nonrecognition treatment, a result that would not prevail today. See INT. REV. CODE OF 1954, §§ 354, 356.

81. *John J. Watts*, 28 B.T.A. 1056, 1061 (1933). The acquisition was a "B" reorganization and the acquiring corporation, as part of the acquisition, agreed to pay the debts of the acquired corporation. Such assumptions of debt constitute additional consideration only in "C" reorganizations because the shareholders of the acquired corporation in both the "A" and "B" reorganizations receive no benefit from payment of such debts. Assumption of debts of a shareholder transferor by the acquiring corporation is, of course, a wholly different matter. Payment of such debts bestows a direct monetary benefit on the shareholders sufficient to cause a "B" type reorganization to fail to meet the "solely for voting stock" requirement. See notes 30-31 *supra*; text accompanying notes 105-14 *infra*; INT. REV. CODE OF 1954, §§ 368(a)(1)(B), (a)(1)(C), (a)(2)(B); B. BITTKER & J. EUSTICE, *supra* note 7, ¶ 14.13, at 14-36 to -37; ¶ 14.14 at 14-46 to -48; *Dailey*, *supra* note 30, at 744-53.

continuity of interest requirement where those holdings accounted for slightly less than 50 percent of the consideration received by the transferors. The question whether only equity holdings would satisfy the test or whether interests such as long-term bonds would also be sufficient was left unresolved by the Court. The answer to those questions would not be long in coming.

The final major case<sup>82</sup> in the Supreme Court's development of the continuity of interest test was *LeTulle v. Scofield*,<sup>83</sup> in which the Court was asked to pass on an acquisition of all the assets of Gulf Coast Irrigation Company in exchange for \$50,000 in cash and \$750,000 in long-term bonds of Gulf Coast Water Company, the acquiring corporation. The Court rejected the decision below<sup>84</sup> and several other cases<sup>85</sup> that had held that receipt of long-term bonds, as contrasted with the short-term debt obligations involved in *Pinellas*, constituted a sufficient interest to satisfy the continuity of interest test.<sup>86</sup>

In summarizing, it should be observed that although the Court never said that only an equity interest in the acquiring corporation can satisfy the continuing and material interest required by the test, one

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82. Three years after the Court's decisions in the continuity of interest trilogy, the Court held that the assumption of liabilities of the transferor corporation in an assets (C type) acquisition constituted the payment of additional consideration to the transferor, but in that case the consideration was not relatively large enough to cause the reorganization to fail the continuity of interest test. *United States v. Hendler*, 303 U.S. 564 (1938). In 1939 Congress reacted against the Court's decision in *Hendler* and provided that for purposes of the "solely for voting stock" requirement of the "C" type reorganization, one should ignore the transferee corporation's assumption of the transferor corporation's liabilities. Int. Rev. Code of 1939, ch. 247 § 112(k), 53 Stat. 870 (now INT. REV. CODE OF 1954, § 357).

Although an assumption of liability will no longer, in and of itself, cause a reorganization to fail to qualify as a "C" reorganization, if the assumed liabilities are too large in relation to the size of the equity interest conveyed to the transferor, the acquisition might be deemed not to satisfy the continuity of interest requirement. Treas. Reg. § 1.368-2(d)(1), (1955) should be read in this context. It notes:

Though . . . an assumption does not prevent an exchange from being solely for voting stock for purposes of . . . section 368(a)(1)(C), it may in some cases, however, so alter the character of the transaction as to place the transaction outside the purposes and assumptions of the reorganization provisions.

83. 308 U.S. 415 (1940).

84. 103 F.2d 20 (5th Cir. 1939).

85. See cases cited in 308 U.S. 415, 420 n.7.

86. The Court stated:

We are of opinion that the term of the obligations is not material. 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. On the contrary, he becomes a creditor of the transferee; and we do not think that the fact . . . that the bonds were secured solely by the assets transferred and that, upon default, the bondholder would retake only the property sold, changes his status from that of a creditor to one having a proprietary stake, within the purview of the statute.

*Id.* at 420-21.

must conclude by negative implication that the continuity of interest test, as developed by the Supreme Court,<sup>87</sup> requires that, in any tax-free reorganization, a substantial portion of the property received by the transferors<sup>88</sup> in exchange for assets or stock must be in the form of an equity interest in the acquiring corporation. The precise portion of the total property received that must constitute an equity interest in the transferee has never been articulated, but it appears certain that receipt of an equity interest of slightly less than 50 percent of the total value of all property received by the transferors will satisfy the Court. Moreover, although long-term debt of the transferee will be treated as a security for purposes of the reorganization provisions, such an interest is insufficient to establish continuity of interest by the transferors. The continuing and material interest requirement of the test can be satisfied only by some form of common or preferred stockholdings.<sup>89</sup>

### B. The Treasury Viewpoint

The Treasury articulation of the judicial continuity of interest test is to be found in Treasury Regulation section 1.368-1(b) and Revenue Procedure 66-34.<sup>90</sup> The Treasury Regulations dealing with continuity

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87. Three other decisions of the Court handed down in the period dealt with the continuity of interest doctrine but are not relevant to the subject of this Article. See *Groman v. Commissioner*, 302 U.S. 82 (1937); *Helvering v. Bashford*, 302 U.S. 454 (1938); *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942). In *Alabama Asphaltic* the Supreme Court held that the transfer, at a trustee's sale, of all of the assets of a bankrupt corporation to a corporation controlled by the bankrupt's creditors in satisfaction of such debts satisfied the continuity of interest requirement since the creditors became proprietors of the debtor when they took steps to enforce their debts against the insolvent debtor. *Groman* and *Bashford* both dealt with the issue of remote continuity. They involved situations in which stock of the acquiring company's parent was used to consummate a transaction or in which the acquiring company, which used its own stock to acquire assets as part of the reorganization, transferred these assets to a subsidiary. Both transactions were held not to satisfy the continuity of interest requirement. Congress has since sought to permit such acquisitions by enacting INT. REV. CODE OF 1954, § 368(a)(2)(C). See *Ferguson & Ginsburg*, *supra* note 28, 24 U. SO. CAL. 1972 TAX INST. at 3-8, 28 TAX L. REV. at 160-65.

88. It should be observed that the present articulation of the continuity of interest test as being applicable to the transferor would theoretically result in the test's application to both of the corporate parties to a consolidation (a merger of two corporations into a new corporation).

89. The perennial issue of "debt versus equity" may make its appearance in several contexts in the continuity of interest area. First, payment of debts of the acquired corporation by the acquiring corporation can cause both "B" and "C" type reorganizations to fail to satisfy the continuity of interest requirement, if the debt is reclassified as stock. Second, the Treasury and the taxpayer might find themselves reversing their traditional roles—the taxpayers may argue that consideration received from the transferee, which appears to be debt, is a stock interest, and the Treasury may argue the opposite in an effort to increase the relative size of nonequity consideration and cause an acquisition to fail to meet the continuity of interest requirement.

90. Rev. Proc. 66-34, 1966-2 CUM. BULL. 1232, superseded by Rev. Proc. 74-26, 1974-2 CUM. BULL. 478, which incorporates verbatim the Treasury's standard for ruling on continuity of interest found in Rev. Proc. 66-34.

of interest are indicative of a somewhat confused state of affairs as to the Treasury's basic perception of the concept:

The purpose of the reorganization provisions of the Code is to except from the general rule [of recognition of gain or loss on sale or exchange] certain specifically described exchanges incident to such readjustments of corporate structures . . . which effect only a readjustment of continuing interest in property under modified corporate forms. Requisite to a reorganization . . . [is] a continuity of interest therein on the part of those persons who . . . were the owners of the enterprise prior to the reorganization. The Code recognizes as a reorganization the amalgamation (occurring in a specified way) of two corporate enterprises under a single corporate structure if there exists among the holders of the stock and securities of *either* of the old corporations the requisite continuity of interest in the new corporation, but there is not a reorganization if the holders of the stock and securities of the old corporation are merely the holders of short term notes in the new corporation.<sup>91</sup>

This Regulation deals with several matters warranting consideration.

First, the basic policy underlying the tax-free reorganization doctrine is that nonrecognition of gain or loss should be limited to mere readjustments in continuing property interests under modified corporate forms resulting from acquisitions, as contrasted with more drastic changes in substance such as: (1) an acquisition by one party of the entire interest of another party in a business for cash or other similar property; or (2) a combination of business enterprises where this result is produced.

Second, the Regulation indicates that the continuity of interest test will be satisfied in an "amalgamation," a term left undefined, if the holders of the "stock and securities" of "either" of the old corporations possess the requisite continuity of interest in the new corporation. Extension of the test beyond equity holders to security holders, presumably including holders of long-term debt under the Supreme Court's decision in *Watts*,<sup>92</sup> is puzzling. It is possible, though, that the term "security" was included to cover only those holders of debt in an insolvent corporation whose interests the Supreme Court had previously chosen to treat as debtor interests which, by virtue of the insolvency, had de facto evolved into equity interests.<sup>93</sup> More perplexing than inclusion of security holders in the class of persons who must meet the continuity of interest test is the indication that satisfaction of the continuity of interest test by the equity holders of "either" of the corporations party to an amalgamation will satisfy the continuity of interest re-

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91. Treas. Reg. § 1.368-1(b) (1956) (emphasis added).

92. See text accompanying notes 79-81 *supra*.

93. *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942).

quirement. If this interpretation is indeed correct, and if it is assumed that the undefined term "amalgamation"<sup>94</sup> was intended to encompass all statutorily defined reorganizations, then it may be concluded, either that it is unnecessary that the transferee corporation or its shareholders meet the continuity of interest test or that it is sufficient if the transferee corporation or its shareholders alone satisfy the continuity of interest test. Taken literally, the Regulations appear to constitute an outright repeal by executive fiat of the Supreme Court's decisions in the major continuity of interest cases.<sup>95</sup>

The third item of interest in the Regulations is the negative implication (produced by singling out short-term notes as not satisfying the continuity test) that long-term notes of the acquiring corporation may satisfy the test.<sup>96</sup> The failure of the Regulations to reflect completely and accurately the Supreme Court's holding in *LeTulle*<sup>97</sup>—that debt instruments of any term cannot be used to satisfy the continuity test—and the singling out of short-term notes as culprits, can be attributed to: (1) poor draftsmanship; (2) confusion of the continuity of interest test with the securities test; or (3) an improper understanding of the Supreme Court's holding in *Watts* that long-term debt obligations will be treated as securities under the provisions of the Code dealing with reorganization.<sup>98</sup>

The Treasury clarified its perception of the continuity of interest test in Revenue Procedure 66-34,<sup>99</sup> where it set forth the grounds

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94. The term "amalgamation" has no generally accepted meaning in the reorganization context. Nonetheless, since the judicial continuity of interest doctrine applies equally to all types of acquisitive reorganizations, it is probably reasonable to assume that Treas. Reg. § 1.368-1(b), which sets forth the Treasury's perception of the doctrine, was intended to apply to the three accepted types of tax-free acquisitions and that the term "amalgamation" and the parenthetical remark following it were intended to apply to otherwise qualifying "A," "B" and "C" type reorganizations.

95. It is, of course, unlikely that the Treasury intended to ignore the Court's decisions in *Pinellas*, *Minnesota Tea*, and *Le Tulle*. The articulation of the continuity of interest rule found in Treas. Reg. § 1.368-1(b) is more than likely the product of poor draftsmanship.

96. A similar negative implication with respect to long-term bonds is found in Treas. Reg. § 1.368-2(a) (1956), which also explains the continuity of interest rule in the following manner:

The application of the term "reorganization" is to be strictly limited to the specific transactions set forth in section 368(a). The term does not embrace the mere purchase by one corporation of the properties of another corporation, for it imports a continuity of interest on the part of the transferor or its shareholders in the properties transferred. If the properties are transferred for cash and deferred payment obligations of the transferee evidenced by short-term notes, the transaction is a sale and not an exchange in which gain or loss is not recognized.

97. See text accompanying notes 82-86 *supra*.

98. See text accompanying notes 79-81 *supra*.

99. 1966-2 CUM. BULL. 1232, superseded by Rev. Proc. 74-26, 1974-2 CUM. BULL.

under which it would issue a ruling that, among other things, the continuity of interest test had been satisfied:

The 'continuity of interest' requirement of section 1.368-1(b) of the Income Tax Regulations is satisfied if there is *a continuing interest* through stock ownership in the acquiring or transferee corporation . . . *on the part of the former shareholders of the acquired or transferor corporation* which is equal in value . . . to at least 50 percent of the value of all of the formerly outstanding stock of the acquired or transferor corporation . . . .<sup>100</sup>

As the above language indicates, although for ruling purposes the Treasury adopted a more stringent shareholding percentage requirement than did the Supreme Court in *Nelson*,<sup>101</sup> it has taken the position that for ruling purposes the continuity of interest test is applied only to the transferor or acquired corporation and its shareholders.<sup>102</sup> The Treasury also noted in Revenue Procedure 66-34 that the equity holding test was to be applied not to each shareholder individually, but to the transferor or acquired corporation shareholders as a group.<sup>103</sup> In

100. Rev. Proc. 66-34, § 3.02, 1966-2 CUM. BULL. 1232, 1233 (emphasis added).

101. See text accompanying notes 77-78 *supra*.

102. Rev. Proc. 66-34, § 3.02, 1966-2 CUM. BULL. 1232, 1233. A Revenue Procedure is nothing more than a device for informing the taxpayer of Treasury procedures that so affect the public that the information should be made a matter of general knowledge. Rev. Proc. 72-1, 1972-1 CUM. BULL. 693. Such devices purport neither to provide a definitive interpretation, as do the Regulations, nor to provide taxpayers with a precedent, as does a publicly issued Revenue Ruling. See, INT. REV. CODE OF 1954, § 7805; Rev. Proc. 72-1, *supra*; Rev. Proc. 69-1, 1969-1 CUM. BULL. 381; L. REDMAN & J. QUIGGLE, PROCEDURE BEFORE THE INTERNAL REVENUE SERVICE 39-45 (5th ed. 1974); Rogovin, *The Four R's: Regulations, Rulings, Reliance and Retroactivity—A View from Within*, 43 TAXES 756 (1965); Surrey, *The Scope and Effect of Treasury Regulations Under the Income, Estate and Gift Taxes*, 88 U. PA. L. REV. 556, 556-60 (1940). Consequently, it might be a mistake to place too much emphasis on any Revenue Procedure in an effort to construe a Code provision or Regulation. Nevertheless, the unclear nature of the Regulations compels resort to the Revenue Procedure as an interpretive tool. In addition, several factors justify assigning somewhat more weight to Rev. Proc. 66-34 than one might give to most other Revenue Procedures. First, Rev. Proc. 66-34 has recently been reissued, and the reissued version contains no changes in the part dealing with continuity of interest. Rev. Proc. 74-26, 1974-2, CUM. BULL. 478. Second, subsequent rulings appear to support the position of Rev. Proc. 66-34 on the main elements of the continuity of interest test. See Rev. Rul. 66-23, 1966-1 CUM. BULL. 67; Rev. Rul. 66-224, 1966-2 CUM. BULL. 114. Third, the tax bar has readily accepted Rev. Proc. 66-34 as a principal authority. See Beghe, *supra* note 20, at 881, 882 & n.4. Fourth, the Treasury has conceded that Rev. Proc. 66-34 is a conservative statement of the continuity test and does not purport to define its outer bounds. Rev. Proc. 66-34, § 2.03, 1966-2 CUM. BULL. 1232, 1233.

103. See also Rev. Rul. 66-224, 1966-2 CUM. BULL. 114, in which the Treasury indicated that the continuity of interest test would be met by an exchange in which 50 percent in value of the consideration received by the transferor shareholders consisted of stock of the acquiring corporation even if a number of the shareholders received no stock whatsoever.



deference to the step transaction doctrine,<sup>104</sup> the Treasury also asserted that sales, redemptions, and other dispositions of stock that occur either prior or subsequent to the reorganization and are part of the plan of reorganization will be considered in determining whether the equity holding requirements of the continuity of interest test have been met.

### C. *Origin and Purpose of Statutory Continuity of Interest*

The continuity of interest concept has also been subjected to scrutiny by Congress. Within 1 year after the Supreme Court established the judicial continuity of interest test in *Pinellas*, Congress addressed itself to the desirability of legislating a continuity of interest test as an essential element of the tax-free reorganization. In 1934, Congress provided that in both asset acquisitions ("C" type reorganization) and stock acquisitions ("B" type reorganization) the sole consideration the acquiring corporation may provide the transferors is the voting stock of the acquiring corporation.<sup>105</sup> Receipt of any other consideration by the transferors in such reorganizations would prevent the transaction from attaining tax-free status. This requirement was subsequently eased by amendments allowing the transferors to receive stock of the corporation in control of the acquiring corporation or to transfer acquired assets to a subsidiary<sup>106</sup> and by an amendment allowing a limited amount of nonequity consideration in asset acquisitions.<sup>107</sup>

The congressional reason for enacting these stringent statutory continuity of interest provisions was the same as that which motivated the Supreme Court—the need to prevent what are essentially sales from qualifying for nonrecognition treatment. In 1933 the House Committee on Ways and Means appointed a subcommittee to investigate what steps might be taken to prevent avoidance of federal income taxes. Among other things, the subcommittee endorsed the total repeal of the nonrecognition treatment accorded to reorganizations. The subcommittee recommended repeal of these provisions on two grounds: (1) they constituted "one of the most prevalent methods of tax avoidance"; and (2) their repeal would aid in the desirable process

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104. For a thorough discussion of the step transaction doctrine as it relates to reorganizations, see B. BITTKER & J. EUSTICE, *supra* note 7, at ¶ 14.51; Mintz & Plumb, *Step Transactions in Corporate Reorganizations*, N.Y.U. 12TH INST. ON FED. TAXATION 247 (1954).

105. Revenue Act of 1934, ch. 277, § 112(g), 48 Stat. 705 (predecessor of INT. REV. CODE OF 1954, § 368(a)(1)(B)-(C)); see notes 30-31 *supra*.

106. Act of Aug. 16, 1954, ch. 1, § 368(a)(2)(C), 68A Stat. 121, and Revenue Act of 1964, Pub. L. No. 88-272, § 218, 78 Stat. 57, both amending INT. REV. CODE OF 1954, §§ 368(a)(1)(B)-(C), (a)(2)(C).

107. Note 31 *supra*.

of simplifying the revenue laws.<sup>108</sup> The House Committee on Ways and Means refused to accept the suggestion of its subcommittee and instead decided in the case of acquisitions to limit the definition of the term "reorganization" to statutory mergers and consolidations. The Committee expressed some concern that in recent years taxpayers were attempting to qualify as reorganizations transactions which in fact were sales. Although the Committee noted that the courts, particularly the Supreme Court, had dealt with such transactions in a commendable fashion, it felt that by limiting the term "reorganization" to statutory mergers and consolidations Congress would be removing the danger completely.<sup>109</sup> The Committee never explained its willingness to distinguish between statutory mergers and consolidations and all other types of acquisitions.

Although accepted by the House, the suggestion of the House Committee was rejected by the Senate Finance Committee, who proposed that nonrecognition treatment be limited to: (1) statutory mergers and consolidations; 2) acquisitions by one corporation, in exchange solely for its voting stock, of at least 80 percent of the voting stock and 80 percent of the total number of all other classes of stock of the acquired corporation; and (3) acquisitions of substantially all of the assets of another corporation in exchange solely for voting stock of the acquiring corporation. While the Senate Finance Committee was in accord with the sentiments of the House Committee, it believed that the unavailability of the statutory merger and consolidation in a number of states, coupled with the substantial similarity between statutory mergers and stock and asset acquisitions of the type described, warranted extension of nonrecognition treatment to such acquisitions so long as no consideration other than voting stock of the acquiring corporation was used.<sup>110</sup> The Senate Finance Committee's version of the definition of an acquisitive reorganization was accepted by the conference committee and became part of the Revenue Act of 1934.

Left unaffected by these changes were those reorganizations cast in the form of a statutory merger or consolidation.<sup>111</sup> Congress' failure to impose on such acquisitions the solely for voting stock requirement can perhaps be attributed either to the desire that a single dissenter, exercising appraisal rights under state law, not possess the capacity to deprive any statutory merger or consolidation of tax-free treatment<sup>112</sup>

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108. PRELIMINARY REP. OF A SUBCOMM. ON THE COMM. ON WAYS AND MEANS, 73D CONG., 2D SESS., PREVENTION OF TAX AVOIDANCE 8-9 (Comm. Print 1933).

109. H.R. REP. NO. 704, 73d Cong., 2d Sess. 13-14 (1934).

110. S. REP. NO. 558, 73d Cong., 2d Sess. 17-18 (1934).

111. See INT. REV. CODE OF 1954, § 368(a)(1)(A).

112. It is also possible that Congress realized that, in the case of a merger or consolidation preceded by or contemporaneous with a redemption or other acquisition of

or to a mistaken assumption that under state law, with the exception of satisfying dissenters' appraisal rights, use of consideration other than voting stock was already forbidden in such acquisitions.<sup>113</sup>

As a consequence of congressional action, much of what the Supreme Court sought to accomplish with the continuity of interest doctrine appears to have been accomplished by the statutory requirements of sections 368(a)(1)(B) and (C) and 368(a)(2)(E)<sup>114</sup> of the Code. Nevertheless, whether or not the continuity of interest test applies to shareholders of the acquiring, as well as the acquired, corporation remains an issue in both the judicial and statutory formulations of the doctrine.

#### IV

##### A SUGGESTED RESOLUTION

In attempting to resolve the issue of the applicability of the continuity of interest test to the shareholders of the acquiring or transferee corporation, it will be convenient to treat separately the judicial continuity of interest test and the statutory tests. Since the judicial continuity of interest test predates the statutory tests and is central to the very concept of all reorganizations, it is appropriate first to explore the propriety of applying the judicial continuity of interest test to the shareholders of the transferee or acquiring corporation.<sup>115</sup>

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the shareholdings of acquired company shareholders, the acquiring corporation—whose assets were now commingled with those of the acquired corporation—would face an almost impossible burden in attempting to establish that it was not the source of the non-qualifying consideration.

113. Several states, including Ohio and California, had statutes at that time authorizing use of nonequity consideration. H. BALLANTINE, *CORPORATIONS*, § 291, at 686 (1946).

114. As has been observed, Congress has also imposed a limited statutory continuity of interest rule with respect to one type of statutory merger, the triangular "A" reorganization described in section 368(a)(2)(E) of the Code. See text accompanying notes 25-32 *supra*. In such reorganizations the shareholders of the acquired corporation must transfer control of that corporation to the merged corporation in exchange for stock of the corporation in control of the merged corporation. The reason for imposing this precisely limited statutory continuity of interest test was never articulated by Congress, although it is clear that Congress included section 368(a)(2)(E) in the Code as part of an effort to allow for limited liberalization of the "solely for voting stock" requirement with respect to acquisitions that were essentially "B" type reorganizations. H.R. REP. NO. 1778, 91st Cong., 2d Sess. (1971); S. REP. NO. 1533, 91st Cong., 2d Sess. (1971). Prior to the enactment of INT. REV. CODE OF 1954, § 368(a)(2)(E), acquisitions such as those described in that section were carried out as "B" type reorganizations with the requirement that the sole consideration given to the acquired company shareholders be voting stock of the corporation in control of the corporation merged into the acquired corporation. See Rev. Rul. 67-448, 1967-2 CUM. BULL. 144 (1967).

115. For purposes of this discussion, the term "transferee" or "acquiring corporation" with respect to all triangular reorganizations will be deemed to refer to the "de jure" acquiring corporation as well as to the corporation in control of such corporation.

*A. Judicial Continuity of Interest*

The first issue to be resolved is whether compelling reasons exist to justify confining the continuity of interest test to the transferor corporation and its shareholders. As much of the preceding material indicates, both the judiciary and the Treasury, either by design or by accident, have limited their articulation of the continuity of interest test to these parties. The most convincing argument for so confining the test seems to be based on the fact that in any purported reorganization it is the transferors who will suffer most if an acquisition is held not to be a tax-free reorganization. Since the principal adverse tax consequences of an acquisition not qualifying as a reorganization rests with the transferors, it might be plausible not to consider what other parties have done with their interests for the purpose of characterizing the exchange of the transferors.

At least three objections can be made to confining the continuity of interest test to the transferors. First, this position ignores the likelihood that classification of a transaction as a reorganization will have extremely important consequences for the acquiring corporation.<sup>116</sup> Second, if the transferors are party to a plan that has as one of its purposes or ostensible ends the obviation of the continuity of interest test in a given transaction, there is no reason to be reluctant to extend the continuity of interest test and thereby expose the transferors to tax, if there is a rational justification for so doing. Third, in most acquisitions in which a substantial portion of the shareholders of the acquiring corporation are cashed out by redemption or purchase of their stock, the shareholders of the acquired corporation obtain something quite different from what they would have acquired in a typical reorganization in which the shareholders of the acquiring corporation retained all of their stock. Redemption of the acquiring corporation shareholders will result in the shareholders of the acquired corporation obtaining a larger proportion of the control of the combined enterprise than otherwise would have been the case in a typical reorganization. The argument in favor of limiting the continuity of interest test to the transferors ignores this potential benefit to the transferors.

The absence of a compelling reason for confining the continuity of interest test to the transferors necessitates considering the propriety of extending the test to the shareholders of the acquiring corporation. In exploring this issue, consideration should first be given to whether the purchase or redemption of acquiring corporation stock was part of a plan of corporate restructuring that resulted in the acquisition and

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116. See, e.g., INT. REV. CODE OF 1954, § 381, and text accompanying notes 37-39 *supra*.

whether, as such, the transaction should be considered, under the step transaction doctrine, an integral part of the reorganization.<sup>117</sup> If the purchase or redemption cannot be deemed part of the reorganization, it of course should not affect the tax-free nature of the reorganization any more than similar sales of assets by the transferor corporation or stock by shareholders of the transferor should preclude the transferors from satisfying the continuity of interest test.<sup>118</sup>

If, after applying the step transaction doctrine to the redemption or purchase of transferee shareholdings, it appears appropriate to consider such transaction an integral part of the purported reorganization, two approaches may be taken in an effort to apply the judicial continuity of interest test to the acquiring company shareholders. If a reorganization involves a reversal of roles—an upside down merger—the substance over form doctrine<sup>119</sup> recommends ignoring the form of the acquisition; instead, the transaction should be treated as involving a purchase of the “de jure” acquiring corporation by the “de jure” acquired corporation, followed by an “F” reorganization or a series of “F” reorganizations or other tax-free transactions in which the “de jure” acquired and acquiring corporations switch their names, corporate charters and assets.<sup>120</sup> The second approach to the issue could be classified

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117. See, e.g., *Commissioner v. Gordon*, 391 U.S. 83 (1968); *King Enterprises Inc. v. United States*, 418 F.2d 511 (Ct. Cl. 1969); M.B. Kass, 60 T.C. 218 (1973) (sale of stock prior to merger that is part of acquisition is considered for continuity of interest); B. BITTKER & J. EUSTICE, *supra* note 7, at 1-19 to 1-20; Jacobs, *Supreme Court Further Restricts the Step Transaction Doctrine*, 29 J. TAX 2 (1968); Mintz & Plum, *supra* note 104.

118. See text accompanying note 104 *supra*.

119. Any finding that in substance the “de jure” acquiring corporation has actually been acquired by the “de jure” acquired corporation will be essentially one of fact. Although the crucial facts warranting such a finding will vary from case to case, the relative size of the corporations, the conduct of preliminary and final negotiations, as well as agreements with respect to voting control and composition of boards of directors will probably be determinative of most cases. For a general discussion of the substance over form doctrine, see Chirelstein, *Learned Hand's Contribution to the Law of Tax Avoidance*, 77 YALE L.J. 440 (1968).

120. The typical “C” reorganization (one in which the “de jure” acquired corporation was liquidated) could be accounted for as an acquisition by the “de jure” acquired corporation of the assets of the “de jure” acquiring corporation, followed by an “F” reorganization in which the “de facto” acquiring corporation acquires the name and corporate charter of the “de facto” acquired corporation. The typical “B” reorganization may be viewed as an acquisition of the stock of the “de facto” acquired corporation by the “de facto” acquiring corporation, followed by a drop down of the latter's assets (other than stock of the “de facto” acquired corporation) to the “de facto” acquired corporation which, in turn, contributes those assets to a newly formed subsidiary under INT. REV. CODE OF 1954, § 351. The shell holding company (the “de facto” acquiring corporation) is then merged into the “de facto” acquired corporation. This transaction is then followed by an “F” reorganization in which the newly formed subsidiary, which already possesses the assets of the “de facto” acquiring corporation, acquires the name and corporate charter of the “de facto” acquiring corporation. Similar sets of transac-

as the "reorganization definitional approach"; it involves an inquiry, as the courts have done under the judicial continuity of interest test, into whether the transaction in question should be classified as a reorganization. For purposes of discussion, it will be convenient first to explore the substance over form approach.

### 1. *The Substance Over Form Approach*

The substance over form doctrine permeates the entire body of tax law and in general can be described as authorizing the Treasury, where necessary to prevent tax avoidance, to use the substance and not the form of a transaction to determine the tax consequences of a given course of conduct.<sup>121</sup> This author was unable to discover any substance over form cases in which it was held that what purported to be an acquisition by the acquiring corporation of the acquired corporation was in fact an acquisition of the acquiring corporation by the acquired corporation.

Although the issue of the "upside down" acquisition has drawn little or no attention in the tax-free reorganization area, it has been carefully considered under state corporate law and under the federal consolidated tax return regulations. The resolution of the problems in these areas will hardly be dispositive of the issue in the continuity of interest context; nevertheless, the general approach and analysis employed should assist in analyzing the issue under consideration.

At common law, unanimous shareholder approval was required for any fundamental corporate change such as a merger. Business realities eventually forced an abandonment of the unanimity requirement which, in the case of mergers, was replaced by the remedy of appraisal rights. Almost all states now provide by statute that dissenters to corporate mergers are entitled to have their shares appraised and to receive the value of those shares in cash.<sup>122</sup> Appraisal statutes typically accord appraisal rights to dissenters whose corporations are acquired in a statutory merger and to dissenters whose corporations sell all or substantially all of their assets.<sup>123</sup> In the absence of a statute extending

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tions can also be worked out to explain the "A" reorganizations described in INT. REV. CODE OF 1954, §§ 368(a)(2)(D)-(E). See Chirelstein, *supra* note 119, at 440.

121. See note 148 *infra*; Chirelstein, *supra* note 119, at 448.

122. For an explanation of the development of appraisal rights, see Lattin, *Remedies of Dissenting Stockholders Under Appraisal Statutes*, 45 HARV. L. REV. 233 (1931); Levy, *Rights of Dissenting Shareholders to Appraisal and Payment*, 15 CORNELL L.Q. 420 (1930); Note, *The Right of Shareholders Dissenting From Corporate Combinations to Demand Cash Payment for Their Shares*, 72 HARV. L. REV. 1132 (1959).

123. See Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223, 262-65 (1962); Skoler, *Some Observations on the Scope of Appraisal Statutes*, 13 BUS. LAW. 240, 249-53 (1958).

appraisal rights to a sale of assets, some courts have nonetheless found that a sale of all or substantially all the assets of a corporation in fact produces the same problems for a minority shareholder of the vendor corporation as does a merger. Courts have labeled such asset acquisitions "de facto" mergers, thereby placing them within the scope of a statute that accords appraisal rights only in the case of a statutory merger.<sup>124</sup>

In some jurisdictions the "de facto" merger doctrine has been further extended to meet additional deficiencies of appraisal statutes.<sup>125</sup> Since most appraisal statutes afford protection in a merger or asset purchase only to dissenters of the acquired corporation or the corporation whose assets are acquired, when a liberal "de facto" merger doctrine is absent it is possible to vitiate appraisal statutes by causing the dissenters' corporation to become the acquiring corporation. In several jurisdictions the courts have extended the "de facto" merger doctrine to the shareholders of an acquiring corporation, where in their view the facts and circumstances of the individual case have warranted treating the acquiring corporation as the acquired corporation.<sup>126</sup> In jurisdictions where this approach has gained favor, the courts will examine factors such as the shifting of "de jure" and "de facto" control of the board of directors from the shareholders of the acquiring corporation to the shareholders of the acquired corporation, the relative value of the stock or assets of the acquiring corporation and the stock or assets of the acquired corporation, the use of an accounting technique (like "pooling of interest")<sup>127</sup> consistent with a merger, the intention to dissolve an acquired corporation, and the assumption by the acquiring corporation of the liabilities of a corporation whose assets are acquired. If, after considering all of the factors, it appears that the consequences of the

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124. See, e.g., *Marks v. Autocar Co.*, 153 F. Supp. 768 (E.D. Pa. 1954); *Rath v. Rath Packing Co.*, 257 Iowa 1277, 136 N.W.2d 410 (1965). *Contra*, *Argenbright v. Phoenix Fin. Co.*, 21 Del. Ch. 288, 187 A. 124 (Ch. 1936). The problem with restricting the appraisal right to mergers is graphically illustrated by the following example. Assume that corporations X and Y are incorporated in a jurisdiction that provides appraisal rights only in the case of mergers. If X merges into Y, the shareholders of X who dissent from the merger will be given cash for their shares. If Y instead chooses to acquire all the assets of X in exchange for Y stock and X thereupon liquidates distributing Y stock to its shareholders, strict limitation of the appraisal doctrine to legal mergers will deprive the dissenting X shareholders of their appraisal rights.

125. The "de facto" merger doctrine has recently been extended beyond the issue of appraisal rights. See, e.g., *Knapp v. North Am. Rockwell Corp.*, 506 F.2d 361 (3d Cir. 1974) (plaintiff in products liability case allowed recovery against purchaser of assets); *Williams v. Pennsylvania Co.*, 367 F. Supp. 1158 (E.D. Pa. 1973) (Securities Act of 1934, Rule 10b-5 action).

126. *Applestein v. United Board & Carton Corp.*, 60 N.J. Super. 333, 159 A.2d 146 (Ch.), *aff'd*, 33 N.J. 72, 161 A.2d 474 (1960); *Farris v. Glen Alden Corp.*, 393 Pa. 427, 143 A.2d 25 (1958).

127. See note 19 *supra*.

transaction and the purposes of appraisal rights demand that the transaction be treated as a merger under appraisal statutes, the shareholders of the acquiring corporation are then accorded appraisal rights by the court.

An example of application of the "de facto" merger doctrine to an acquiring corporation is provided by *Applestein v. United Board & Carton Corp.*<sup>128</sup> In that case, the sole shareholder of Interstate Container Corporation agreed to exchange all of his Interstate stock for 40 percent of the stock of United, the acquiring corporation. United's net assets were worth more than four times the value of Interstate's net assets. As part of the transaction, it was agreed that the old Interstate shareholder would become the president of United and that the board of directors of United would be expanded to allow control to pass to a group of individuals representing the interests of the old Interstate sole shareholder.<sup>129</sup> Certain United shareholders objected to this transaction and demanded appraisal rights. Counsel for Interstate and the old Interstate shareholder argued that the "de facto" merger doctrine ought to be limited to the dissenting shareholders of a corporation whose assets were being acquired and ought not be extended to protect the shareholders of an acquiring corporation. Rejecting this position and finding that the dissenting shareholders were entitled to exercise appraisal rights, the Chancery Division of the New Jersey Superior Court observed:

Whether a merger is *de jure* or *de facto*, the reason for protecting the dissenting shareholders will apply equally, whether they are shareholders of the *acquired* or *acquiring* corporation. The reason for statutory protection is that stockholders should not be forced against their will into something fundamentally different from that for which they bargained when they acquired their shares. If the argument of these defendants were sound, then by the simple device of labelling one of the corporations the *acquiring* corporation and the other the *acquired* corporation, the substantial rights of appraisal would be arbitrarily taken away.<sup>130</sup>

The "de facto" merger doctrine, however, has not always met with unchecked success whenever it has been applied to "upside down" acquisitions.<sup>131</sup> In addition, the fundamental principle upon which the

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128. 60 N.J. Super. 333, 159 A.2d 146 (Ch.), *aff'd*, 33 N.J. 72, 161 A.2d 474 (1960).

129. Other facts accorded weight by the court include use of pooling of interests accounting, a plan to dissolve the acquired corporation and the "de facto" control over the combined entity, which would be possessed by a group consisting of the former sole shareholder of Interstate and by persons closely identified with him. *Id.* at 348, 159 A.2d at 153-54.

130. *Id.* at 352, 159 A.2d at 156 (emphasis in original).

131. See, e.g., *Orzeck v. Englehart*, 41 Del. Ch. 223, 192 A.2d 36 (1963); *Hariton*



"de facto" doctrine is based—fairness to dissenting shareholders—is irrelevant to a tax inquiry. Nonetheless, the basic recognition of what is involved in an "upside down" merger, as well as the reluctance to exalt form over substance, should encourage serious consideration of a similar approach to the continuity of interest doctrine.

One tax context in which the problem of reversal of roles in a merger has been confronted<sup>132</sup> is the consolidated return regulations. Election to file a consolidated return bestows a number of benefits<sup>133</sup> and burdens<sup>134</sup> on the electing group. In order to prevent a group from filing a consolidated return in years in which it would be advantageous and discontinuing such filing in years in which it would be disadvantageous, the Treasury<sup>135</sup> has provided by regulation that a group electing to file a consolidated return must continue to do so<sup>136</sup> unless it can establish to the satisfaction of the Internal Revenue Service that good cause exists for it to grant permission to discontinue filing consolidated returns.<sup>137</sup> Of course, a group that has elected to file a consolidated return can also discontinue filing such a return if it ceases to exist

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v. Arco Electronics, Inc., 41 Del. Ch. 74, 188 A.2d 123 (1963), *aff'g* 40 Del. Ch. 326, 182 A.2d 22 (1962); Heilbrunn v. Sun Chem. Corp., 38 Del. Ch. 321, 150 A.2d 755 (Sup. Ct. 1959), *aff'g* 37 Del. Ch. 552, 146 A.2d 757 (Ch. 1958); Folk, *De Facto Mergers in Delaware*: Hariton v. Arco Electronics, Inc., 49 VA. L. REV. 1261 (1963).

132. Another tax context in which the issue of reverse acquisition has been confronted is INT. REV. CODE OF 1954, § 269, which gives the Treasury the power to disallow deductions, credits and allowances in the case of an acquisition of control of a corporation or control of property by a corporation made for the purpose of securing to the acquiring party a deduction, credit or allowance that it would not otherwise have enjoyed. After several faltering attempts it was held that this provision covered tax-motivated acquisitions of profitable businesses by loss corporations. See, e.g., F.C. Publication Liquidating Corp. v. Commissioner, 304 F.2d 779 (2d Cir. 1962) and the cases cited therein. The resolution of these cases depends on the broadly worded nature of section 269, which can be construed to encompass such acquisitions. Consequently, this area does not provide significant guidance in resolving the issue under consideration.

133. One of the principal benefits of a consolidated return is the privilege of offsetting losses by some members of the consolidated group against gains by other members of the group. Treas. Reg. §§ 1.1502-2 to -11 (1971-72). For a complete discussion of these complex provisions, see J. CRESTOL, K. HENNESSEY & A. RUA, *THE CONSOLIDATED TAX RETURN* (1973).

134. The intercompany transaction rules provide one of the most graphic examples of a burden that can be imposed by filing a consolidated return. Under these rules, an intragroup sale of depreciable section 1231 property is treated as resulting in ordinary gain or loss, recognition of which is spread out over the period of time during which the asset is being depreciated by the purchasing member of the group. Such treatment thus deprives the group of the ability to exploit the capital gains-ordinary income dichotomy and to time gains, losses and depreciation deductions for maximum advantage. See Treas. Reg. § 1.1502-13(d)(1) (1972).

135. Congress, in INT. REV. CODE OF 1954, § 1502, has given the Treasury extensive rulemaking authority with respect to the formulation of the consolidated return regulations. For an excellent discussion of the nature of such "legislative" regulations, see Rogovin, *The Four R's: Regulations, Rulings, Reliance and Retroactivity—A View from Within*, 43 TAXES 756, 758-63 (1965).

136. Treas. Reg. § 1.1502-75(a)(2) (1972).

137. *Id.* § 1.1502-75(c) (1972).

as a group. Such cessation could be accomplished in a variety of ways, such as liquidating or merging into a group that has not elected to file a consolidated return.<sup>138</sup> In order to prevent electing groups from being able to discontinue filing of a consolidated return at will by engineering a merger into a sham or insubstantial corporation that has not elected to file a consolidated return, as well as for a variety of other purposes,<sup>139</sup> the consolidated return regulations have introduced the concept of the reverse acquisition. Under the reverse acquisition procedures, whenever a group of corporations filing a consolidated return acquires or is acquired by a corporation or a group of corporations that have not elected to file a consolidated tax return, discontinuance of the consolidated filing is permitted to the new group only if the shareholders of the previously non-electing corporation or group of corporations own more than 50 percent of the value of the outstanding stock of the combined entity immediately after the acquisition.<sup>140</sup>

Since the consolidated return regulations are essentially "legislative" in character,<sup>141</sup> care should be taken not to view them as having any precedential value in other areas. Nonetheless, the reverse acquisition concept does suggest the need, in some areas of the tax law, to look beyond the formalities of which corporation was the acquirer and which was the acquired and to develop a set of rules consistent with the underlying policies and realities of a given situation.

Both the "de facto" merger doctrine and the reverse acquisition rules were developed to solve problems different from those the continuity of interest test attempts to solve. It therefore would be inappropriate to claim that either or both of these tests should be employed as the exclusive approach to making a substance over form determination with respect to what appears to be an upside down merger involving a question of continuity of interest. At least this much can be learned from the reverse acquisition and "de facto" merger doctrines, however—concentrating only on the party formally designated as the transferor or the acquired corporation and its shareholders reveals only a portion of the reality of any acquisition; in order to ascertain the true nature of any acquisition the transaction must be scrutinized in its entirety. The determination of whether an upside down merger exists

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138. *Id.* § 1.1502-75(d)(1) (1972).

139. The reverse acquisition rules serve a variety of other important purposes, such as the prevention of unwarranted use of the net operating loss of an acquiring corporation that is in fact being acquired and whose losses should not be available to the group. But discussion of the operation of the reverse acquisition rule in the election filing context, the context in which its function may most easily be explained, is sufficient to illustrate its operation and importance for the purposes of this Article.

140. Treas. Reg. § 1.1502-75(d)(3) (1972).

141. See note 135 *supra*.

and whether the continuity of interest test ought to be applied to the shareholders of the acquiring corporation necessarily involves a case-by-case determination based on the facts and circumstances of the acquisition being scrutinized. In order to retain some flexibility in approaching the issue, courts should eschew a mechanical approach—such as that employed by the reverse acquisition rules—and consider a variety of factors, much as is done in the “de facto” merger area.

## 2. *The Reorganization Definitional Approach*

It is also necessary to consider whether the nature and origin of, or the policy underlying, the reorganization provisions dictate that the category of reorganization exclude those acquisitions in which the shareholders of the acquiring corporation, as a step in the reorganization, dispose of a substantial portion of their equity holdings. Such an approach is at least necessary in situations where the substance and form of the transactions are in harmony.<sup>142</sup> Exploration of whether the continuity of interest test should be applied to the shareholders of the acquiring corporation should be based on an inquiry into the essential nature of any attempted reorganization. This approach will be referred to as the reorganization definitional approach.

A reorganization can be distinguished from a sale or redemption, or other type of nonqualifying acquisition, in terms of the relative proportionate proprietary interests remaining. Transactions other than reorganizations provide the remaining shareholders of the combined entity an opportunity to increase substantially their proportionate proprietary interest in the combined enterprise over what it would have been had two combining businesses been joined and had the stock of the combined enterprise been the only consideration issued to the former shareholders. The legislative history of the reorganization provisions indicates a strong interest in allowing businesses to combine on a tax-free basis to confront new economic challenges.<sup>143</sup> But nowhere does it indicate a congressional intention to extend the benefit of nonrecognition to acquisitions which are direct or indirect acquisitions of the proprietary interests of one group of shareholders by another group of

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142. For example, if A Corp. acquired all the assets of B Corp., and A possessed valuable grandfather rights that consequently survived the reorganization, it would be impossible to assert with any degree of confidence that what in fact had transpired was an acquisition of A's assets by B. Moreover, if, for example, the value of A's assets and the value of the stockholdings of A's shareholders were 10 times those of B and of B's shareholders, then even if A—subsequent to acquiring all of B's stock solely for A's stock—redeemed out 70 percent of A's old shareholders, it would be virtually impossible to label such a transaction as an acquisition of A by B, since the old A shareholders would possess at least 75 percent of the stock of the combined corporation after the reorganization and redemption had taken place.

143. See text accompanying notes 58-62 *supra*.

shareholders. Limitation of the continuity of interest principle to transferors would require classifying as a reorganization an acquisition in which almost all of the shareholders of the acquiring corporations were issued indebtedness of the combined enterprise in exchange for their equity interest, leaving substantially all of the proprietary control over the combined enterprise in the hands of the shareholders of the acquired corporation. Surely, such a transaction could not be considered a combination of business enterprises of the sort that Congress wished to classify as a reorganization and thereby accord the benefits of non-recognition. Consequently, the essential nature of a reorganization demands that the continuity of interest test be applied to the acquiring company shareholders.

It is apparent that if a reorganization fails the continuity of interest test under the substance over form approach, it will also fail the test under the reorganization definitional approach. In the event an acquisition fails to qualify as a reorganization, all parties who have transferred stock or assets in transactions not otherwise qualifying for tax-free treatment will be subject to tax on their exchanges. The choice of the "correct" approach is difficult. Use of the substance over form approach, incorporating the previously mentioned restructuring technique,<sup>144</sup> more clearly reflects the realities of the acquisition by simply reversing rules and imposing a tax not on the "de facto" purchasers (the "de jure" transferors), but on the parties who "de facto" were vendors of their shares or assets. Use of the reorganization definitional approach<sup>145</sup> retains the respective "de jure" roles but denies the existence of a tax-free event. It thus places the incidence of tax on the "de facto" purchasers (the "de jure" transferors) and does not place the incidence of tax from the nonqualifying reorganization on the "de facto" vendors. If an acquisition fails to qualify as a reorganization, the carryover of tax attributes provided by sections 381 and 382 of the Code is not available, and the acquiring corporation possesses only its own previously existing tax attributes plus any tax attributes normally accompanying a sale. In the case of "A" type and "C" type acquisitions, use of the substance over form test, incorporating the restructuring technique, also more closely reflects the realities by preserving for the combined entity the tax attributes of the "de facto" acquiring corporation rather than preserving the tax attributes of the "de jure" acquiring corporation (the "de facto" acquired) for the combined entity, as would be the case under the reorganization definitional approach.<sup>146</sup>

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144. See text accompanying notes 119-20 *supra*.

145. This result would also be produced if the substance over form technique were used without employing the restructuring technique.

146. See note 145 *supra*.

Nonetheless, since the substance over form doctrine has principally been used by the Treasury while the courts have generally compelled taxpayers to abide by the tax consequences of the form of their transactions<sup>147</sup> the Treasury would probably adopt the theory which, in each case, would produce the maximum tax dollar—and the taxpayer would pay that bill as the price of attempted tax avoidance.

### B. *Statutory Continuity of Interest*

As in the case of judicial continuity of interest, when dealing with a type of reorganization to which a statutory continuity of interest requirement applies, one must first determine whether some compelling reason exists for limiting the application of the continuity of interest test to its literal statutory formulation. The history of the development and construction of the Internal Revenue Code is interspersed with innumerable cases holding that literal compliance with statutory requirements will not safeguard tax avoidance schemes where the substance of a transaction is at variance with its form.<sup>148</sup> Neither the essential nature of the statutory continuity of interest rules, nor the legislative history of those provisions warrants allowing a taxpayer to exalt form over substance.<sup>149</sup> Consequently, as in the case of judicial continuity of interest, a transaction that in substance represents an acquisition by the "de jure" acquired corporation should be treated as a purchase by the "de jure" acquired corporation of the assets of the "de jure" acquiring corporation (or the stock of the "de jure" shareholders) followed by an "F" reorganization, a series of "F" reorganizations, or other tax-free transactions in which the "de jure" acquired and acquiring corporations switch names, corporate charters, and assets. The required continuity of interest test should then be applied to the shareholders of the "de jure" acquired corporation before the reorganization is accorded tax-free status. That some of the shareholders of the "de facto" acquired corporation receive some consideration other than voting stock in exchange for their stock will not automatically cause a reorganization to fail the statutory continuity of interest tests. Leaving aside the observation that in two of the reorganizations having a statutory continuity of interest requirement some limited amount of consideration other than voting stock is permitted,<sup>150</sup> one of the impor-

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147. See, e.g., *Higgins v. Smith*, 308 U.S. 473, 477-78 (1940). There are some indications that taxpayers on their own initiative might, on occasion, be able to escape the form of a transaction where so doing is of benefit to them. See, e.g., Proposed Treas. Reg. § 1.83-6(d), 36 Fed. Reg. 10793 (1971).

148. See, e.g., *Knetsch v. United States*, 364 U.S. 361 (1960); *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945); *Higgins v. Smith*, 308 U.S. 473 (1940); *Gregory v. Helvering*, 293 U.S. 465 (1935).

149. See text accompanying notes 105-14 *supra*.

150. INT. REV. CODE OF 1954, §§ 368(a)(2)(B), (E)(ii).

tant issues to be resolved is whether the additional consideration has been supplied directly or indirectly by the "de facto" acquiring corporation. It is well established that the acquired corporation, shareholders of the acquired corporation, or in fact any party other than the acquiring corporation may purchase stock of the acquired corporation prior or subsequent to a reorganization without interfering with the statutory continuity tests, so long as those parties hold such stock in an independent capacity.<sup>151</sup>

The principal problem with respect to the statutory continuity requirements in such substance over form acquisitions appears to lie in establishing that the source of the funds was not the "de facto" acquiring corporation. In most cases, discerning the source of consideration other than voting stock appears to be a simple matter, and it would generally be expected that it could be readily established that the "de facto" acquiring corporation was not the source of the non-qualifying consideration. Nevertheless, the cases of a reorganization followed by a redemption,<sup>152</sup> and a redemption prior or subsequent to a reorganization in which the "de facto" acquired corporation issued its debt,<sup>153</sup>

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151. See *Transport Prods. Corp. v. Commissioner*, 239 F.2d 859 (6th Cir. 1956); Rev. Rul. 73-102, 1973-1 CUM. BULL. 186; Rev. Rul. 73-16, 1973-1 CUM. BULL. 186; Rev. Rul. 72-354, 1972-2 CUM. BULL. 216; see generally Dailey, *supra* note 30, at 764-68 and the authorities cited therein.

152. In the case of a "C" reorganization followed by a redemption of shareholders of the "de facto" acquired corporation, it may prove to be virtually impossible to establish that the source of the property used to effect the redemption is in fact not the "de facto" acquiring corporation. Such a transaction will probably fail to qualify as a reorganization unless the amounts received in the redemption, plus all assumed liabilities, are small enough to satisfy the limited exception to the solely for voting stock requirement of the "C" reorganization provided by INT. REV. CODE OF 1954, § 368(a)(2)(B). In the case of a "B" reorganization followed by a redemption, if the "de facto" acquiring corporation provides the assets issued in exchange for the stock of the "de facto" acquired corporation, the reorganizations will of course fail to meet the solely for voting stock requirement of the "B" reorganization. For example, if cash is used by the "de facto" acquired corporation to effect the redemption subsequent to the receipt of a cash dividend from the "de facto" acquiring corporation, it would be virtually impossible to establish that the source of the boot was not the "de facto" acquiring corporation. A similar problem will also exist in the case of the triangular "A" reorganization described in section 368(a)(2)(E), although if the nonqualifying consideration meets the limited exception to voting stock consideration provided for such reorganizations, issuance of some nonqualifying consideration will not cause such a reorganization to fail to meet the prescribed voting stock requirement of that section of the Code.

153. When issued by the "de facto" acquired corporation in redemption of its stock, any debt which, after the series of "F" reorganizations and other tax-free transactions, remained outstanding as debt of the "de facto" acquiring corporation, would also provide an opportunity for the Treasury to establish that the nonqualifying consideration had been provided by the acquiring corporation and that the voting stock requirements of these reorganizations had not been met. This would be so since, after the restructuring steps outlined in note 120 *supra*, such debt would ultimately be the obligation of the "de facto" acquiring corporation, whose credit would be pledged to support the debt and whose assets would be used to make any payments in satisfaction of the debt. Regard-

would, on occasion, seem to provide two unsuspected opportunities for the Treasury to establish that the acquiring "de facto" corporation indeed was the source of the funds. In such a case, application of the statutory continuity test to the shareholders of the acquiring corporation would result in denial of the tax-free status to the reorganization.

Two additional problems might confront substance over form acquisitions in which the role of the acquired and acquiring corporations were reversed and, prior to the reorganization, the "de facto" acquired corporation disposed of a portion of its assets in a planned redemption integral to the reorganization. The first problem would be whether the requirement of the "C" reorganization and the triangular "A" reorganizations described in sections 368(a)(2)(D) and (E) of the Code—that substantially all of the assets of the transferor be acquired or held<sup>154</sup>—is jeopardized by the magnitude and character of the property used to effect the redemption. Resolution of this issue is beyond the scope of this Article, but it probably will depend on factors like the character of the assets retained, their relative value when compared with the total assets of the corporation prior to a redemption, and the nature of the redemption itself.<sup>155</sup> The second such problem would be whether a redemption involving more than 20 percent of the outstanding stock of the "de facto" acquired corporation prior to, or (assuming that statutory continuity is not thereby destroyed) subsequent to, the purported reorganization jeopardizes the requirement of the triangular "A" reorganization described in section 368(a)(2)(E)—that control of the acquired corporation be transferred in exchange for voting stock of the acquiring corporation. In addition, the redemption may violate the requirement of the "B" reorganization—that immediately after the exchange of stock for stock, the acquiring corporation have control (80 percent of voting power plus 80 percent of total number of all other stock regardless of class) of the acquired corporation. Nonetheless, since the acquiring corporation in both types of reorganizations will ultimately acquire control of the acquired corporation in exchange for its voting stock, it appears that the control requirements of sections 368(a)(1)(B) and (a)(2)(E) should be deemed to have been met.<sup>156</sup>

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less of whether the acquisitions were restructured as suggested in note 120 *supra*, since the assets of the "de facto" acquiring corporation would be available to satisfy the claims of the bondholders and in all likelihood would be so used, such redemptions would encounter substantial difficulties in satisfying the voting stock requirements of INT. REV. CODE OF 1954, §§ 368(a)(1)(B)-(C), (a)(2)(E).

154. INT. REV. CODE OF 1954, §§ 368(a)(1)(C), (a)(2)(D), (a)(2)(E)(i).

155. Ferguson & Ginsburg, *supra* note 28, 24 U. SO. CAL. 1972 TAX INST. at 28-30, 39-41, 28 TAX L. REV. at 177-80, 185-87.

156. In Rev. Rul. 68-285, 1968-1 CUM. BULL. 147 it was held that a redemption by the acquired corporation, prior to a reorganization, of 25 percent of its stock held

As in the case of judicial continuity of interest, the form and substance of a transaction may often correspond; resort must then be made to the reorganization definitional approach to determine if the sale or redemption of transferee stock was so great as to cause the transaction to be classified as not qualifying as a reorganization. Occasionally this might produce the strange result that a reorganization that meets the stringent statutory continuity of interest test imposed on transferors would nevertheless fail to qualify as a reorganization, because it has failed to satisfy the more liberal judicial continuity test as applied to the shareholders of the transferee.

### CONCLUSION

The continuity of interest doctrine serves a vital function with respect to corporate acquisitions by excluding from the category of reorganization those transactions that are essentially sales. As such, the doctrine supports the congressional intent in enacting the reorganization provisions, which was to grant significant tax benefits to corporate restructurings amounting to something other than mere sales. To date, the articulation of the doctrine has been limited to exploring the consideration received by the transferors. The need to exalt substance over form demands that the test be applied to the shareholders of the acquiring corporation where in fact the acquired and the acquiring corporations have reversed their "de jure" roles and the proverbial minnow has (in essence) swallowed the whale. Moreover, even if the substance and form of a transaction are in harmony, the essential nature of a reorganization as a device for pooling, as contrasted with a device for directly or indirectly purchasing business enterprises and thereby enlarging control over a combined enterprise, demands that the con-

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by dissenting shareholders, did not run afoul of the control requirements of INT. REV. CODE OF 1954, § 368(a)(1)(B), which prescribed that "immediately after the acquisition the acquiring corporation has control of [the acquired] corporation." The wording of INT. REV. CODE OF 1954, § 368(a)(2)(E)(ii) might appear to present somewhat more of the problem in that it requires that

[I]n the transaction, former shareholders of the [acquired] corporation exchanged, for an amount of voting stock of the [acquiring] corporation, an amount of stock in the [acquired] corporation which constitutes control of such corporation.

Nonetheless, since INT. REV. CODE OF 1954, § 368(a)(2)(E), was intended to provide a means whereby limited consideration may be paid in what is essentially a "B" reorganization, it might be reasonable to conclude that, despite the apparent wording of the statute, the control requirement of that section was not intended to be more extensive than was the control requirement of INT. REV. CODE OF 1954, § 368(a)(1)(B) and that, on the authority of Rev. Rul. 68-285, such a redemption would not run afoul of the control requirements of INT. REV. CODE OF 1954, § 368(a)(2)(E). See H.R. REP. NO. 1778, 91st Cong., 2d Sess. 2 (1971); S. REP. NO. 1533, 91st Cong., 2d Sess. 2 (1971); see also Ferguson & Ginsburg, *supra* note 28, 24 U. SO. CAL. 1972 TAX INST. at 36-37, 28 TAX L. REV. at 184.



tinuity of interest test be extended to include the shareholders of the acquiring corporation and separately applied against them as a group. Application of the test to the shareholders of the acquiring corporation may, in the case of a reorganization for which a statutory continuity of interest test exists, produce the curious result that a reorganization meeting the more stringent statutory continuity of interest test with respect to the transferors will be held to be a taxable transaction, since the more lenient judicial continuity of interest test will not have been satisfied with respect to the acquiring company shareholders.

The continuity of interest test, rooted as it is in the essential nature of a reorganization, is a fundamental doctrine in the reorganization area. It should be subject neither to manipulation by mere reversal of roles nor, by limitation to transferors, to a mechanical application not based on a total understanding of its importance and fundamental purpose. Indeed, it should be recalled that the continuity of interest test was created by the Court as a policy-oriented response to a wooden approach to the statutory definition of a reorganization. Limitation of this flexible test to transferors would be inconsistent with the judicial philosophy out of which the test arose. That philosophy demands adoption of a policy oriented approach to the continuity of interest test itself and extension of its application to include acquiring company shareholders.