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COMPLIANCE WITH THE NEW CONTINUITY OF BUSINESS ENTERPRISE REGULATION

John J. O'Donnell*

In December, 1979, the U.S. Treasury issued a proposed regulation[1] setting forth continuity of business enterprise as an additional requirement for an income-tax-free acquisitive reorganization. This proposed regulation generated considerable comment and controversy within the tax bar.[2] Criticism arose on two grounds: first, that the requirement of continuity of business enterprise was invalid under existing statutes and case law; and second, that the regulation was unnecessarily vague and incomplete, making compliance with the requirement very difficult. One year later, the Treasury issued the regulation in final form[3] substantially unchanged from the proposed regulation, along with Treasury Decision (T.D.) 7745,[4] a seven-page rebuttal of the criticisms made by the tax bar. Thus the battle lines have been drawn, and the validity of requiring enterprise continuity in reorganizations is to be determined in the courts. For the many taxpayers choosing not to litigate such validity, the manner of compliance now becomes the more compelling question. Can the vague and incomplete regulation be complied with and, if so, can compliance be relatively painless?

Enterprise continuity requirements have existed in various forms throughout the field of corporate taxation for quite some time. The most prominent of these was adopted by the Supreme Court in 1957 in *Libson Shops, Inc. v. Koehler*.[5] In applying the carryover provisions of the 1939 code,[6] the Court refused to allow a corporation, formed by the merger of sixteen separate corporations, to carry over and deduct the pre-merger losses of three of the constituent corporations.[7] The Court denied the de-

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1. 44 Fed. Reg. 76,813 (1979).

2. *See, e.g.*, Aidinoff & Lopata, *The Continuity of Business Enterprise Requirement and Investment Company Reorganizations*, 58 TAXES 914 (1980); Bloom, *The Resurrection of a Dormant Doctrine: Continuity of Business Enterprise*, 7 J. CORP. TAX. 315 (1981); Faber, *Continuity of Interest and Business Enterprise: Is it Time to Bury Some Sacred Cows?*, 34 TAX LAW. 239 (1981); Libin, *Continuity of Business Enterprise: The New Regulations*, 39 N.Y.U. INST. ON FED. TAX. § 4.01 (1981).

3. Treas. Reg. § 1.368–1(d) (1980).

4. 1981–8 I.R.B. 9.

5. 353 U.S. 382 (1957).

6. Int. Rev. Code of 1939, §§ 23(s), 122, *as amended by* Rev. Act of 1939, ch. 247, §§ 211, 122, 53 Stat. 867–68.

7. 353 U.S. at 388–90.

duction of pre-merger losses against post-merger profits "not produced by substantially the same businesses which incurred the losses."[8]

In 1954, Congress expressly legislated the enterprise continuity concept into the current Internal Revenue Code in two important tax areas: tax-attribute carryovers and divisive reorganizations. The carryover of tax attributes where corporate ownership changes by a purchase transaction is now permitted only if the corporation continues to carry on a trade or business substantially the same as that conducted prior to the purchase.[9] In divisive corporate reorganizations, tax-free status depends upon each surviving corporation continuing to conduct a trade or business that the previously unified corporation had been conducting for the five-year period preceding the reorganization.[10]

Many questions unanswered by the new regulation have already been dealt with in these older forms of continuity of enterprise requirements. This article will discuss the major unanswered questions of the new regulation, examine how the older forms of continuity of enterprise have dealt with such issues, and consider the propriety of applying the older-form decisions to the new reorganization-enterprise continuity regulation. The result will be some guidance, although unfortunately no guaranteed methods, on how to avoid being forced to litigate the validity of the regulation itself.

I. FORMS OF TAX-FREE REORGANIZATIONS

Internal Revenue Code section 368 defines the transactions eligible for treatment as tax-free reorganizations. An "A" reorganization is the combination of two existing corporations either by merger or by consolidation under local state corporation law.[11] In a "B" reorganization, target corporation shareholders transfer their controlling stock interest to the acquiring corporation in exchange for some or all of the voting stock of the acquiring corporation.[12] In a "C" reorganization, the acquiring corporation obtains substantially all of the assets of the target corporation by transferring some or all of its voting stock to the target corporation or target corporation shareholders.[13] "A," "B," and "C" reorganizations all involve takeovers of target corporations and hence are often called acquisitive reorganizations.

8. *Id.* at 390.
9. I.R.C. § 382(a)(1)(C).
10. *Id.* § 355(b)(1).
11. *Id.* § 368(a)(1)(A).
12. *Id.* § 368(a)(1)(B).
13. *Id.* § 368(a)(1)(C).

In a "D" reorganization, a corporation transfers some or all of its assets to another corporation controlled by some or all of the shareholders of the transferor corporation.[14] If the transferor corporation transfers only some of its assets, then two corporations survive the transaction and a divisive "D" reorganization results. If the transferor corporation transfers all of its assets, then only one corporation survives, producing a non-divisive "D" reorganization.

Three types of reorganizations are neither acquisitive nor divisive because they involve only one corporation. An "E" reorganization is a recapitalization that involves reordering the rights of common and preferred shareholders and bondholders in a single corporation.[15] An "F" reorganization is a mere change in form of a single corporation involving little or no transfer of actual assets, such as a mere change in its state of incorporation.[16] A "G" reorganization is the reorganization of a single corporation in bankruptcy.[17]

II. CONSEQUENCES OF NONCOMPLIANCE WITH ENTERPRISE CONTINUITY

Failure to achieve the requisite enterprise continuity produces a reorganization taxable as an exchange of property,[18] usually with catastrophic results. Although the details of such taxation vary with the form of attempted reorganization, certain taxation patterns are relatively clear. Shareholders in the transferor corporation will be treated as making a taxable exchange of their stock for stock of the acquiring corporation. In reorganizations involving the actual transfer of assets, such as types "C" and "D" reorganizations,[19] and in mergers viewed as asset sales, the transferor corporation itself will be taxed on the exchange of its appreciated assets for shares of the acquiring corporation unless the transferor liquidates as part of the reorganization plan.[20] In stock-exchange reorganizations, such as type "B,"[21] and in mergers viewed as exchanges of

14. *Id.* § 368(a)(1)(D).
15. *Id.* § 368(a)(1)(E).
16. *Id.* § 368(a)(1)(F).
17. *Id.* § 368(a)(1)(G).
18. Treas. Reg. § 1.368–1(b) (1955).
19. *See* text accompanying notes 13 & 14 *supra.*
20. Such liquidation will qualify under I.R.C. § 337, which provides that under those circumstances the corporation is exempt from all but recapture-type taxes on sales and exchanges of assets.
21. *See* text accompanying note 12 *supra.*

stock, the transferor corporation itself engages in no taxable activity.[22] The acquiring corporation that receives property in exchange for its own stock also engages in no taxable activity.[23]

Not all taxpayers, however, will resist having their transactions taxed as exchanges rather than reorganizations. Taxpayers are often tempted to liquidate a corporation, retain the liquid assets received, and transfer the operating assets to another corporation. Taxing the retention of liquid assets as an exchange for stock surrendered in liquidation is an attractive method of distributing corporate earnings in a manner taxable at lower capital gain rates. The government has successfully attacked these liquidation-reincorporation schemes as types "D,"[24] "E,"[25] and "F"[26] reorganizations. Taxpayers might now be able to structure liquidation-reincorporations in a manner that fails to satisfy the new enterprise continuity regulation, thereby precluding classification as "D," "E," or "F" reorganizations. This result would deprive the government of its main weapons against such bail-out devices.

III. HISTORICAL BACKGROUND

The concept of reorganization-enterprise continuity has existed since the beginning of federal income taxation. Many early reorganization cases mentioned the phenomenon,[27] although whether these early cases actually established a definite enterprise continuity requirement is at the heart of the validity question.[28] In any event, the Treasury has consistently held that enterprise continuity, whatever it might be, is a prerequisite for a valid reorganization. The reorganization regulation[29] both before and since addition of the new continuity requirement for acquisitive reorganizations has stated that a requisite to a tax-free reorganization is continuity of the business enterprise under the modified corporate form;

22. Since the acquiring corporation will acquire at least 80% of the transferor, subsequent liquidation of the transferor will, under I.R.C. § 332, be free of all but recapture-type taxes.

23. I.R.C. § 1032. Of course, the potential tax problems for the acquiring corporation become murkier in subsidiary and triangular mergers where the acquirer uses stock of its parent rather than its own stock to make the acquisition. For an extensive treatment of all the variations in taxation of taxable reorganizations, see Rachofsky, *The Reorganization That Fails: Tax Consequences of an Involuntarily Taxable Reorganization*, 32 N.Y.U. INST. ON FED. TAX. 639 (1974).

24. *E.g.*, James Armour, Inc., 43 T.C. 295 (1964).

25. Rev. Rul. 61–156, 1961–2 C.B. 62.

26. *E.g.*, Davant v. Commissioner, 366 F.2d 874 (5th Cir. 1966).

27. *E.g.*, Cortland Specialty Co. v. Commissioner, 60 F.2d 937, 940 (2d Cir. 1932), *cert. denied*, 288 U.S. 599 (1933); Graham v. Commissioner, 37 B.T.A. 623, 628 (1938).

28. *Compare, e.g.*, Aidinoff & Lopata, *supra* note 2, at 921–25 *with* T.D. 7745, 1981–8 C.B. 9, at 10–13.

29. Treas. Reg. § 1.368–1(b) (1955).

and this or similar provisions have existed in the predecessors of that regulation.[30]

The IRS sought to put flesh on this regulation in Revenue Ruling 56–330.[31] There the IRS held that the required enterprise continuity was lacking where the successor corporation in an otherwise qualifying reorganization engaged in a new business enterprise entirely different from that conducted by its predecessors. It was unable to sustain this position in court.[32] The IRS officially changed its position in Revenue Ruling 63–29[33] in which it recognized that, although the regulation required the surviving corporation to engage in a business enterprise, the corporation need not continue the activities conducted by its predecessors. Revenue Ruling 63–29 specifically revoked Revenue Ruling 56–330 and for all practical purposes laid to rest the continuity of business enterprise question in reorganizations for many years.

The depth of dormancy of the enterprise continuity requirement was demonstrated by two private rulings issued in 1978.[34] Both rulings concerned an operating company that made a taxable sale of its assets for cash and then, pursuant to a plan of reorganization, transferred the proceeds to a regulated investment company in exchange for voting stock of the investment company, which it then distributed to its shareholders. In each ruling, the transaction in question was held to be a nontaxable reorganization rather than a taxable liquidation of the transferor corporation. Consequently, the shareholders achieved a diversification of their personal investment portfolios without a capital gain tax. The Service soon had second thoughts and suspended further rulings on these transactions.[35] Over a year later, in December of 1979, the IRS completely reversed its position taken in the private rulings and announced the birth of the new regulation requiring continuity of enterprise in tax-free acquisitive reorganizations. In Revenue Ruling 79–433,[36] the IRS expressly suspended both the application of Revenue Ruling 63–29 and the issuance of further letter rulings in this area, pending finalization of the new regulation. In Revenue Ruling 79–434[37] it found that an attempted reorganization under section 368(a)(1)(C)[38] with a regulated investment company

30. *E.g.*, Treas. Reg. 86, § 112(g)–1 (1935) (requiring continuity of the business enterprise under the modified corporate form).

31. 1956–2 C.B. 204.

32. Bentsen v. Phinney, 199 F. Supp. 363, 367 (S.D. Tex. 1961).

33. 1963–1 C.B. 77.

34. I.R.S. Letter Rul. 7829092, [1978] 73 I.R.S. Letter Rul. Reports (CCH), Apr. 24, 1978; I.R.S. Letter Rul. 7825045, [1978] 69 I.R.S. Letter Rul. Reports (CCH), Mar. 23, 1978.

35. Faber, *supra* note 2, at 279.

36. 1979–2 C.B. 155.

37. *Id.*

38. *See generally* note 13 and accompanying text *supra*.

did not qualify as a tax-free reorganization because the transaction was, in substance, a purchase by the transferor of stock in the investment company followed by the taxable liquidation of the transferor. As previously mentioned, a considerable amount of criticism soon followed the proposed regulation,[39] and it was not until a year later that the final regulation was promulgated.

IV. SUMMARY OF FINAL REGULATION

The new regulation is quite short, consisting of approximately one page of text and one page of examples.[40] The general rule is that continuity of business enterprise requires that the acquiring corporation (*P*) either: (i) continue the acquired corporation's (*T*'s) historic business; or (ii)

39. *See* note 2 and accompanying text *supra*.

40. The full text of the new Treasury regulation, minus the examples, is as follows:

(d) *Continuity of business enterprise*—(1) *Effective date*. (i) This paragraph (d) applies to acquisitions occurring after January 30, 1981.

(ii) For an asset acquisition, the date of acquisition is the date of transfer. To determine the date of transfer, see § 1.381(b)-1(b).

(iii) For a stock acquisition, the date of acquisition is the date on which the exchange of stock occurs. If all stock is not exchanged on the same date, the date of exchange is the date the exchange of all stock under the plan of reorganization is complete.

(2) *General rule*. Continuity of business enterprise requires that the acquiring corporation (*P*) either (i) continue the acquired corporation's (*T*'s) historic business or (ii) use a significant portion of *T*'s historic business assets in a business. The application of this general rule to certain transactions, such as mergers of holding companies, will depend on all facts and circumstances. The policy underlying this general rule, which is to ensure that reorganizations are limited to readjustments of continuing interests in property under modified corporate form, provides the guidance necessary to make these facts and circumstances determinations.

(3) *Business continuity*. (i) The continuity of business enterprise requirement is satisfied if *P* continues *T*'s historic business. The fact *P* is in the same line of business as *T* tends to establish the requisite continuity, but is not alone sufficient.

(ii) If *T* has more than one line of business, continuity of business enterprise requires only that *P* continue a significant line of business.

(iii) In general, a corporation's historic business is the business it has conducted most recently. However, a corporation's historic business is not one the corporation enters into as part of a plan of reorganization.

(iv) All facts and circumstances are considered in determining the time when the plan comes into existence and in determining whether a line of business is "significant."

(4) *Asset continuity*. (i) The continuity of business enterprise requirement is satisfied if *P* uses a significant portion of *T*'s historic business assets in a business.

(ii) A corporation's historic business assets are the assets used in its historic business. Business assets may include stock and securities and intangible operating assets such as good will, patents, and trademarks, whether or not they have a tax basis.

(iii) In general, the determination of the portion of a corporation's assets considered "significant" is based on the relative importance of the assets to operation of the business. However, all other facts and circumstances, such as the net fair market value of those assets, will be considered.

(5) *Examples*. The following examples illustrate this paragraph (d).

Treas. Reg. § 1.368-1(d) (1980).

use a significant portion of *T*'s historic business assets in a business.[41] Enterprise continuity is satisfied if *P* continues any one of *T*'s significant historic lines of business. *T*'s historic business is that business which it most recently conducted, although a business started as part of the overall reorganization plan will not qualify.[42]

Enterprise continuity can also be achieved if *P* uses a significant portion of *T*'s historic business assets in any business. A corporation's historic business assets are, not surprisingly, the assets used in its historic business. These may include stock and securities, intangible operating assets such as goodwill, or patents and trademarks, whether or not they have a tax basis.[43] Thus, *P* has a choice of method in achieving enterprise continuity: it can continue *T*'s historic business; or, alternatively, it can use a significant portion of *T*'s business assets in any business.

The regulation gives no further explicit rules for determining the many specific questions that could arise, but rather offers a general statement of policy.[44] The policy underlining the general rule is to insure that reorganizations are limited to readjustments of continuing interests in property under modified corporate form. The regulation states that this policy should provide the guidance necessary for application of the enterprise continuity requirement.[45]

In lieu of explicit rules, the regulation provides five examples as further guidance.[46] An examination of these examples indicates that each one raises more questions than it answers. A review of each example and its unanswered questions will demonstrate where guidance from the older forms of enterprise continuity can be helpful—and, sometimes, even enlightening.

V. LINES OF BUSINESS—EXAMPLE (1)

Example (1) of the new regulation reads as follows:

> *T* conducts three lines of business: manufacture of synthetic resins, manufacture of chemicals for the textile industry, and distribution of chemicals. The three lines of business are approximately equal in value. On July 1, 1981, *T* sells the synthetic resin and chemical distribution businesses to a third party for cash and marketable securities. On December 31,1981, *T*

41. Treas. Reg. § 1.368–1(d)(2) (1980). "*P*" and "*T*" are used here in the same sense as in the regulation itself. *See generally* note 40 *supra*.
42. Treas. Reg. § 1.368–1(d)(3) (1980).
43. *Id.* § 1.368–1(d)(4).
44. *Id.* § 1.368–1(d)(2).
45. *Id.*
46. *Id.* § 1.368–1(d)(5).

transfers all of its assets to *P* solely for *P* voting stock. *P* continues the chemical manufacturing business without interruption. The continuity of business enterprise requirement is met. Continuity of business enterprise requires only that *P* continue one of *T*'s three significant lines of business.[47]

The Treasury tells us that example (1) shows that continuity of business enterprise requires that *P* continue only one of the significant lines of *T*'s business.[48] Consider, however, the number of additional questions that this proposition raises. What is a significant line of business? How active must a significant line of business be? What are the facts and circumstances to be considered in making these determinations? Instinctively, the section 355 rules concerning spin-offs and divisive reorganizations[49] come to mind as an area of fruitful inquiry. We can also gain some guidance here from the regulations under section 382.[50]

A. Distinguishing Lines of Business

1. The "Two Business Rule" and Vertical Divisions

Consider first the overall trends in identifying separate businesses under section 355. Identifying separate businesses is necessary because of two statutory requirements: first, at least two separate businesses must exist after the spin-off or reorganization;[51] and second, each such business must have a previous five-year history of ownership and conduct by the transferor.[52] Initially, the Treasury concluded that the requirement of separate existing businesses after the transaction meant that two separate businesses must have existed before the transaction.[53] It was long thought that a vertical division of a single business—that is, a split up of one fully integrated business into smaller parts, each carrying on all stages or functions of the original business—was not valid under section 355.[54] Thus the main question in section 355 cases was the pre-existence of at least two separate businesses. The "two business rule" was laid to rest in the case of *Edmond P. Coady*,[55] in which the Tax Court allowed vertical divisions of a previously existing fully integrated single business.

47. *Id.* § 1.368–1(d)(5), example (1).
48. T.D. 7745, 1981–8 I.R.B. 9, at 9.
49. *See generally* text accompanying note 10 *supra*.
50. *See generally* text accompanying note 9 *supra*.
51. I.R.C. § 355(b)(1).
52. *Id.* § 355(b)(2)(B).
53. Treas. Reg. § 1.355–1(a) (1955).
54. *See id.*
55. 33 T.C. 771 (1960).

Now we have the question, does example (1) mean that reorganization-enterprise continuity can be satisfied by a vertical split of *T*'s business with the retention of only a portion thereof by *P*, or is there an implied two-business rule? While not specifically stated therein, it appears that the example (1) situation satisfies the new continuity of business enterprise requirement only if there are two pre-existing businesses.

The new regulation states that *P* need continue only one significant line of business when *T* has more than one line of business, with no particular concern for the lines of business conducted by the other distributees of *T*.[56] If *P* were to conduct less than all of *T*'s previous single integrated business, then *P* would, at least, run the risk of not conducting a line of business that is "significant." Further, attempting to satisfy enterprise continuity by vertical split offers too convenient a method of avoiding the significant-portion aspect of the alternative continuity of business assets requirement. *P* could dispose of most of the assets and business of *T* and, while operating only a nominal or insignificant portion of *T*'s business, claim to fully satisfy the business continuity requirement by operating one of the lines of business of *T* resulting from a vertical split of the single pre-transfer business of *T*.

Such activities are also contrary to the regulations defining enterprise continuity for purposes of the carryover of tax attributes under section 382. Those regulations provide that continuity of business enterprise is broken if *P* discontinues more than a minor portion of the business carried on prior to the transfer.[57] Thus, it appears that the old two-business rule would apply to the example (1) situation. Consequently, we should look for guidance under section 355 only from the old regulations and case law, and should not consider the new proposed regulation[58] and cases decided after the abandonment of the two-business rule.

2. *Geographical Location*

Geographical location historically has also been a significant factor in identifying separate lines of business under section 355 situations. The examples under the section 355 regulations illustrate how separate locations constitute separate lines of business in a number of situations.[59]

56. Treas. Reg. § 1.368–1(d)(3)(ii) (1980).
57. Treas. Reg. § 1.382(a)–1(h)(7) (1962).
58. 42 Fed. Reg. 3866 (1977) (proposed Treas. Reg. §§ 1.355–1 to –3).
59. Treas. Reg. § 1.355–1(d) (1955). Examples (8), (9), (13) and (14) all indicate that locations in separate states of the same activities constitute separate businesses. Example (15) finds separate businesses because the same manufacturing functions are performed in separate states, although all sales work is performed for all locations at an office located in only one state. Example (10) finds separate businesses in locations as close as a city and a related suburb, although the fact that each

Under these examples any common facilities, beyond a sales office, serving activities in more than one state would make highly suspect a finding of more than one line of business solely on account of geographical location. Thus, the only definite conclusion that we can draw for situations other than those falling directly within the fact patterns of the examples is that separate geographical location is a significant factor to be considered in determining whether separate lines of business exist, but it by no means is determinative.

3. *Functional Divisions*

Another significant but elusive factor to consider is a functional distinction between businesses based on the type of business activity conducted. The current section 355 Regulations provide that an activity will not be considered a separate business unless the activity includes every operation which forms a part or step in the process of earning income or profit, including the collection of income and the payment of expenses.[60] Under example (11) of those regulations, selling and manufacturing activities in the meat products business are really two steps of an integrated business.[61] Under example (12), a captive coal mine does not constitute a business separate from the manufacturing and selling of steel because the coal mine operation did not include the independent production of income.[62]

There is no indication whether this need for separate customers for section 355 purposes is also a requirement for enterprise continuity in reorganizations. Example (1) of the enterprise continuity regulations and the case that inspired it, *Lewis v. Commissioner,*[63] are both tantalizingly vague on this point. The stated separate lines of business include the manufacturing of chemicals for the textile industry and distribution of chemicals. It is not clear whether the distribution business included the distribution of chemicals manufactured for textile industries or whether the manufacturing business performed its own distribution functions. Consequently, while the function or type of activity of each business seems to be one of the most significant factors in determining whether or not separate lines of business exist, we have no clear rules or indications of just how such determinations should be made.

location has a separate manager directing operations and making purchases and that there is a lack of common warehouse facilities also influences the finding of separate businesses.

60. *Id.* § 1.355-1(c).

61. *Id.* § 1.355-1(d), example (11).

62. *Id.* § 1.355-1(d), example (12).

63. 176 F.2d 646 (1st Cir. 1949).

B. *Activity Required for Separate Lines of Business*

Section 355 requires that each separate business be an active business.[64] This raises the question whether this requirement exists by analogy for reorganization-enterprise continuity purposes. The regulation governing carryover of tax attributes is more lenient, providing that the holding of property for investment purposes shall not be considered a trade or business unless such activities historically constituted the primary activities of the corporation.[65] T.D. 7745 adopts this more lenient view for reorganization enterprise continuity requirements by stating that investment operations may constitute a historic business if the investment assets were not acquired as part of a plan of reorganization.[66] This lack of active business requirement means that all section 355 regulation examples dealing with real estate and making distinctions based on activity of management and number of tenants[67] should not limit the identification of separate lines of business for continuity of enterprise purposes. Disposing of all of *T*'s operating assets other than real estate, however, does run the risk of violating the alternative requirement of continuity of business assets, while still not clearly satisfying the continuity of historic business requirement. Thus, caution is certainly advisable here, although retaining operating real estate might some day provide a convenient means of formally satisfying continuity of business enterprise, or at least might offer some straws to clutch at in a desparate situation.

Thus example (1) of the continuity of business enterprise regulations appears to raise more questions than it answers. A review of the law under sections 355 and 382 indicates that geographical location and type of business activity are significant in determining the identity of separate lines of business. Active as opposed to passive investment is not a necessary characteristic of a separate line of business for reorganization-enterprise continuity. Most likely, vertically integrated segments of a previously unified business will not constitute separate lines of business for purposes of reorganization-enterprise continuity. Whether an activity need have its own separate customers in order to constitute a separate line of business is not at all clear.

64. I.R.C. § 355(b)(1).

65. Treas. Reg. § 1.382(a)–1(h)(4) (1962).

66. 1981–8 I.R.B. 9, at 12.

67. Treas. Reg. § 1.355–1(d), examples (3), (4), (6) and (7) (1955).

VI. ASSET CONTINUITY—EXAMPLE (2)

Example (2) of the new enterprise continuity regulation provides as follows:

> *P* manufactures computers and *T* manufactures components for computers. *T* sells all of its output to *P*. On January 1, 1981, *P* decides to buy imported components only. On March 1, 1981, *T* merges into *P*. *P* continues buying imported components but retains *T*'s equipment as a backup source of supply. The use of the equipment as a backup source of supply constitutes use of a significant portion of *T*'s historic business assets, thus establishing continuity of business enterprise. *P* is not required to continue *T*'s business.[68]

According to T.D. 7745, example (2) shows that enterprise continuity may exist even if *P*'s use of *T*'s assets differs from *T*'s use of those assets.[69] Once again, a number of additional questions arise. Which assets constitute a significant portion of *T*'s assets both as to quantity and quality? How active a "use" must *P* make of *T*'s assets?

A. *Quantity and Quality of Assets*

T.D. 7745 tells us that example (2) is based on the case of *Atlas Tool Co. v. Commissioner*.[70] There, *T* transferred its machinery and inventory constituting 19% of its total assets to *P*, and transferred cash resulting from accounts receivable collections and accumulated earnings constituting 81% of its total assets to its own shareholders. In concluding that the transaction constituted a nondivisive "D" reorganization,[71] the court applied the tests under section 354(b)(1)(A), which requires that the acquiring corporation acquire substantially all of the assets of the transferor corporation.[72] Consequently it was the operational quality of the assets transferred, rather than their quantity, that satisfied the "substantially all" requirement.

If the tests under section 354(b)(1)(A) determine which assets are sufficient to satisfy continuity of business enterprise requirements, then we have narrowed the scope of the question without, however, gaining too

68. Treas. Reg. § 1.368-1(d)(5), example (2) (1980).
69. 1981-8 I.R.B. 9, at 9.
70. 614 F.2d 860 (3d Cir.), *cert. denied*, 449 U.S. 836 (1980).
71. *See generally* note 14 and accompanying text *supra*.
72. 614 F.2d at 865.

much additional certainty. *Atlas Tool* allowed 19% of the assets to constitute "substantially all,"[73] and the cases cited therein contain similar disproportionate percentages.[74]

For advance ruling purposes, the Internal Revenue Service takes the opposite viewpoint, requiring that at least 90% of the fair market value of the net assets and 70% of the fair market value of the gross assets held by the corporation be transferred to *P* in order to satisfy this "substantially all" requirement, with no distinction made between operating and other assets.[75] Although the requirement sets forth a safe haven for advance ruling purposes rather than the IRS view of the law, it makes it difficult to transfer anything less than all of *T*'s assets to *P* in order to satisfy the "substantially all" requirements of a nondivisive "D" reorganization, and arguably also to satisfy the reorganization-enterprise continuity requirements where *P* has no intention of continuing any of *T*'s lines of business.

A recent Sixth Circuit case, *Laure v. Commissioner,*[76] suggests, however, that a different mode of analysis may be appropriate under the enterprise continuity regulation. In that case the acquiring corporation (*P*) was a manufacturer, while the transferor corporation (*T*) operated an air transport service that *P* used for deliveries. The common owner of both corporations merged *T* into *P* to save *T* from financial difficulties. As part of the overall plan, *P* sold all of *T*'s principal operating assets, other than *T*'s land and hangar, to *T*'s former chief pilot, who continued to operate the service and leased the land and hangar from *P*.

The Tax Court, in an opinion[77] decided prior to the promulgation of the enterprise continuity regulation,[78] concluded that the merger failed to satisfy enterprise continuity because *P* neither continued *T*'s business nor used any of *T*'s assets.[79] *P*'s mere holding of ownership in the land and hangar was deemed an insufficient continuous participation in *T*'s assets.[80] The Sixth Circuit reversed, holding the Tax Court's finding of lack of enterprise continuity clearly erroneous.[81] It stated that all that enterprise continuity requires is that *P* receive and continue to use some mini-

73. *Id.* at 865–66.

74. *See also* James Armour, Inc., 43 T.C. 295 (1965), where "substantially all" was held to consist of 51% of the corporation's assets because they constituted 100% of its operating assets.

75. Rev. Proc. 77–37, 1977–2 C.B. 568, at 569.

76. 653 F.2d 253 (6th Cir. 1981).

77. Laure v. Commissioner, 70 T.C. 1087 (1978).

78. The proposed regulations were issued over one year after the Tax Court's decision, on December 28, 1979. *See* note 1 *supra*.

79. 70 T.C. at 1104.

80. *Id.* at 1105.

81. 653 F.2d at 262.

mum amount of *T*'s assets.[82] Twenty-seven and one-fourth percent of *T*'s assets was found substantial enough to constitute this minimum amount, especially in light of the importance of such assets to *P*'s ability to obtain continued air transport service for its deliveries.[83]

Of particular interest in this case is the Sixth Circuit's observation that, although the effective date of the new enterprise continuity regulation precluded application to the case at bar, the regulation supported the court's decision.[84] It noted that the regulation determined a business asset's significance on the basis of the relative importance of the asset to the operation of the business. The court found that, because of the extreme importance of the land and hangar to *P*'s business, these assets were substantial under the new regulation.[85]

Determining significance of the quality and quantity of *T*'s assets based on their importance to *P*'s business is a somewhat disturbing approach remarkably different from the "substantially all" test of section 354(b)(1)(A).[86] Here, *P*'s needs or desires for the assets, rather than *T*'s prior use of them, would be the paramount consideration. Both the operational quality of *T*'s use and the percentage of *T*'s total assets would be of little or no importance. Determining significance based on *P*'s showing of the assets' importance to its own business would establish a subjective test that would generate more uncertainty rather than more clarity in this area. Moreover, requiring *P* to show compelling business importance for its asset acquisition requires little, if anything, more than establishing a business purpose for the transaction. Business purpose, however, is a separate reorganization prerequisite of long standing.[87] Consequently, carried to its logical extreme, the Sixth Circuit's approach reduces enterprise continuity from a separate reorganization prerequisite to a minor subdivision of the business purpose requirement.[88]

Thus, at least three alternative approaches exist for determining sufficiency of quality and quantity in asset continuity. The IRS's advance ruling approach[89] offers the advantage of mathematical certainty, but the disadvantage of stringent requirements for actual compliance. The Sixth Circuit's approach[90] offers great ease in compliance, but the issues created

82. *Id.* at 261.
83. *Id.* at 261 & n.7.
84. *Id.* at 262 n.9.
85. *Id.*
86. *See generally* note 72 and accompanying text *supra*.
87. *See, e.g.*, Gregory v. Helvering, 293 U.S. 465, 469–70 (1935). *See also* Treas. Reg. § 1.368-1(c) (1955).
88. Some commentators have argued for just such a reduction. *E.g.*, Faber, *supra* note 2.
89. *See generally* note 75 and accompanying text *supra*.
90. *See generally* note 84 and accompanying text *supra*.

by this approach make its validity suspect. The section 354(b)(1)(A) approach[91] offers the most safety, both because an established line of case law offers at least some predictability of application[92] and because acquisition of most, if not all, of *T*'s operating assets will most likely also provide a basis for satisfying the Sixth Circuit's approach as well.

B. Asset Uses

The regulation offers no indication of how much actual use of *T*'s assets *P* must make. Example (2) states that use of the equipment as a backup source is sufficient. Backup source use, however, can mean almost anything, from having the assets fully operational and on line, to mere asset storage. In *Atlas Tool, P* began to use the backup equipment itself within approximately two months of acquisition, and within a year of the transfer was using all of the backup equipment in active manufacturing activities in exactly the same manner that they had been used prior to the transfer. This is a far cry from mere storage of assets.

What if *P* uses the assets in a manner that seeks to approximate the economic effect of selling them, such as by borrowing heavily against the assets, or leasing them under long term lease arrangements? In *Pebble Springs Distilling Co. v. Commissioner,*[93] the transferor corporation sold or distributed its inventory and cash equivalents to third parties or stockholders, purportedly sold its whiskey-distilling business and plant to the acquiring corporation, and then liquidated. The acquiring corporation never operated the distillery and merely rented out the plant to a variety of tenants. The court found that the transactions constituted a nondivisive "D" reorganization, although the question of continuity of enterprise or use of assets was never raised. Although the Sixth Circuit cited this case in its *Laure* decision[94] as authority that the acquiring corporation need not receive all of the transferor's assets in a reorganization, the *Laure* decision does not support the implication of *Pebble Springs* that any asset use, however passive, is sufficient. For the *Laure* decision emphasized the operational business importance to the acquiring corporation of its leasing out of the assets it did acquire.[95] Consequently, while it appears that passive use or holding of the assets is not per se a violation of asset continuity, prudence dictates that the acquiring corporation ought to develop

91. *See generally* note 72 and accompanying text *supra*.

92. These cases are cited in Atlas Tool Co. v. Commissioner, 614 F.2d 860, 865 n.5 (3d Cir.), *cert. denied,* 449 U.S. 836 (1980).

93. 231 F.2d 288 (7th Cir.), *cert. denied,* 352 U.S. 836 (1956).

94. 653 F.2d at 261.

95. *Id.* at 262 n.9.

some operational business reason for such passive use or holding of the assets.

VII. HISTORIC BUSINESS—EXAMPLE (3)

Example (3) provides as follows:

> *T* is a manufacturer of boys' and men's trousers. On January 1, 1978, as part of a plan of reorganization, *T* sold all of its assets to a third party for cash and purchased a highly diversified portfolio of stocks and bonds. As part of the plan *T* operates an investment business until July 1, 1981. On that date, the plan of reorganization culminates in a transfer by *T* of all of its assets to *P*, a regulated investment company, solely in exchange for *P* voting stock. The continuity of business enterprise requirement is not met. *T*'s investment activity is not its historic business, and the stocks and bonds are not *T*'s historic business assets.[96]

A. Overall Plan Requirement

The version of this example in the original proposal did not explicitly identify *T*'s investment activities as part of the overall reorganization plan,[97] and for that reason was the most controversial of the proposed examples.[98] Criticism arose because a three and a half year wait between assets sale and reorganization[99] made the implication of one overall plan unrealistic, and implied that any assets ever acquired by *T* with proceeds from the sale of former operating assets could never qualify as the historic business or assets of *T*.[100] Other criticism viewed the example as implying that investing in stocks or securities could never constitute a historic business.[101]

The final regulations and T.D. 7745 attempt to resolve some of these issues by specifically identifying *T*'s investment business as part of the overall plan. The Treasury Decision points out that investment operations may constitute a historic business and that the existence of such a business as part of an overall plan of reorganization is to be determined under traditional step-transaction principles. A lapse of time between steps is one factor in determining whether the steps are part of the overall plan, although all other facts and circumstances would also be considered. Consequently, the possibility exists that the mutual-fund reorganizations

96. Treas. Reg. § 1.368-1(d)(5), example (3) (1980).
97. 44 Fed. Reg. 76,813, 76,815 (1979) (proposed Treas. Reg. § 1.368-1(d)(5), example (3)).
98. T.D. 7745, 1981-8 I.R.B. 9, at 14. *See also* sources cited in note 2 *supra*.
99. T.D. 7745, 1981-8 I.R.B. 9, at 14.
100. *Id.*
101. *Id.*

that precipitated issuance of enterprise continuity regulations[102] can in fact still take place. How the IRS will rule on such applications, and what must be done to show that previous assets dispositions were not part of the overall plan, remains to be seen.

A number of major questions still remain unanswered by example (3). How long must a business have been held by the transferor to become a historic business? What about reviving dormant businesses? What about temporary shutdowns either before or after the transfer?

B. Investing as an Historic Business

The regulations and cases concerning enterprise continuity under section 382 offer some guidance here. Section 382(a) limits the carryover of tax attributes of corporations whose ownership has changed in a purchase transaction to those corporations that continue to carry on a trade or business substantially the same as that conducted prior to the purchase.[103] As previously noted,[104] regulation section 1.382(a)-1(h)(4) requires that investment activities must have historically constituted the primary activities of the corporation in order to constitute a trade or business. This rule was illustrated in the case of *Exel Corp. v. United States*.[105] There the taxpayer had operated retail lumberyards for over fifty years prior to selling all of its assets for cash. The corporation invested the cash in short term government securities and later on in common stock. About a year and a half after converting all of its assets into securities, the ownership of the taxpayer corporation changed sufficiently to invoke application of section 382(a).[106] The court found that the new owners had failed to continue the historic business of the corporation because the historic business of the corporation was not investment activities. The court rejected classification of the investment activities as the historic business because the corporation had initially invested entirely in short term securities that were converted completely into cash approximately a year after the sale of the lumber assets, and because there was no mention in the minutes about converting the corporation to the business of investing.[107]

Thus we can conclude that, while investment activity of a corporation *can* become its historic business, a year and a half of such activity is certainly not long enough to attain that status. Apparently the Treasury

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102. *See* note 34 and accompanying text *supra*.
103. I.R.C. § 382(a)(1)(C).
104. *See* note 65 and accompanying text *supra*.
105. 451 F.2d 80 (8th Cir. 1971).
106. *Id.* at 83.
107. *Id.* at 85–86.

feels that even three and a half years might not be long enough, despite the fact that the acquisition of the investment business was not part of the overall plan of subsequent transfer by the corporation.[108] Just how long a business must be held in order to become a historic business remains to be seen, and it is not clear whether it takes longer to properly season an investment business than a more active business.

C. Revival of Pre-Reorganization Dormant Business

Could the new owners of Exel Corporation avoid tax problems by reviving some retail lumberyard operations? Does a suspension of the conduct of the business permanently eliminate such business from being considered a historic business of *T*? This question is dealt with by a regulation in the area of carryover of tax attributes.[109] The regulation states that revival of a dormant business after change of ownership will not constitute the requisite continuity of business enterprise if a corporation indefinitely ceased its business operations, although a revival of business operations only temporarily suspended will suffice. The regulation's examples indicate that suspension of operations on account of general adverse business conditions constitutes the prohibited indefinite cessation, whereas suspension of operations on account of a fire constitutes the permitted temporary suspension.[110]

Case law under section 382 has taken a more liberal approach, treating business stoppages as allowable temporary suspensions whenever it appears that the corporation always intended to reactivate the business, despite the reason for the stoppage. Thus, in *H.F. Ramsey Co. v. Commissioner*,[111] the corporation was required by its bonding company to wrap up operations and sell its equipment in order to regain financial stability. Since the corporation showed an intention to strengthen itself and no intention to cease operations, the corporation was found only temporarily inactive. Thus, a change of business ownership during this inactive period followed by a revival of the business activity satisfied the continuity of business enterprise requirement. So too, in *Clarksdale Rubber Co. v. Commissioner*,[112] the corporation voluntarily ceased operations and leased its assets to a sister corporation in order to regain financial stability. There were no asset sales and there was no intention to close the

108. *See* note 69 and accompanying text *supra*. The Treasury never changed the dates in example (3), nor expressed any view about the propriety of the time period. It merely stipulated that the investment activity was part of the overall plan in the final version of example (3).

109. Treas. Reg. § 1.382(a)-1(h)(6) (1962).

110. *Id.*

111. 43 T.C. 500 (1965).

112. 45 T.C. 234 (1965).

business. Revival of the business by the new owners satisfied the continuity of business requirement. The IRS has non-acquiesced in *H.F. Ramsey Co.*[113] Consequently, revitalization of a dormant historic business offers some opportunity, but no guarantee of success, in satisfying the reorganization-enterprise continuity regulations.

Cases involving carryovers under section 382, however, have limited applicability in reorganizations under section 368. For instance, in *United States v. Fenix & Scisson, Inc.*,[114] the court found that the corporation's adoption of a plan of liquidation and dissolution indicated an intent to close the business permanently, rather than engage in a temporary suspension, so that continuity of business enterprise was considered broken. Yet, in many reorganization plans, the parties contemplate the liquidation of at least one of the participating corporations, and such liquidation is not inconsistent with the concept of reorganization.[115] Thus, what might in section 382 cases be indicative of permanent business cessation of an ongoing corporation is not necessarily an indication of permanent cessation of the business of either party in a reorganization, even if the transferor liquidates as part of the transaction.

VIII. POST REORGANIZATION DISPOSALS—EXAMPLE (5)

Following logic rather than numerical order, consider next example (5), which provides as follows:

> *T* manufactures farm machinery and *P* operates a lumber mill. *T* merges into *P*. *P* disposes of *T*'s assets immediately after the merger as part of the plan of reorganization. *P* does not continue *T*'s farm machinery manufacturing business. Continuity of business enterprise is lacking.[116]

Example (5) tells us that the sale of the business assets by *P* after the reorganization has the same disqualifying effect as sale of the business assets by *T* prior to the reorganization. The proposed version was more controversial, because it condemned *P*'s asset sale without explicitly identifying it as part of the plan of reorganization.[117] T.D. 7745 states that the final regulations clarify that only dispositions by *P* pursuant to a plan are proscribed, so that *P* would not be prevented from other post-acquisition changes in business or assets.[118]

113. Cumulative List of Non-Acquiescences, 1965–2 C.B. 7.

114. 360 F.2d 260 (10th Cir. 1966).

115. B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 14–129 (1979).

116. Treas. Reg. § 1.368–1(d)(5), example (5) (1980).

117. 44 Fed. Reg. 76,813, 76,815 (1979) (proposed Treas. Reg. § 1.368–1(d)(5), example (5)).

118. 1981–8 I.R.B. 9, at 14.

Once again, unanswered questions arise. What kind of changes and disposals can *P* make in *T*'s business? How long must *P* hold *T*'s business or assets before *P* can safely dispose of them? Is different treatment justified if *P*'s disposal is in a tax-free transaction, such as another reorganization or a section 332 liquidation?

A. *Factors Constituting a Prohibited Change in Business*

1. *In General*

The regulations and cases dealing with the carryover of tax attributes under section 382 again prove quite informative here. That section uses a test based on facts and circumstances to determine whether the business after the transaction was substantially the same as before the transaction. Among the relevant factors to be taken into account are changes in the corporation's employees, plant, equipment, production, location, customers, or other items that are significant in determining whether there is or is not a continuity of the same business enterprise.[119] Discontinuance of more than a minor portion of business carried on prior to the transaction breaks the continuity of business enterprise. Factors to be considered in determining what constitutes only a minor portion of business include the amount of capital investment, gross income, size of payroll, and similar factors.[120] Unfortunately, the examples under the section 382 regulations are not too helpful when applied to reorganization-enterprise continuity analysis. The enterprise continuity requirement under section 382 is not satisfied by continuance of merely *any* line of business, but rather requires that the particular pre-transaction line of business that produced the losses be continued after the transaction.[121]

2. *Change in Location and Personnel*

Changes in geographic location are subject to close scrutiny under the section 382 regulations. Changes in the location of the major portion of a corporation's activities breaks its continuity of enterprise when the result is substantial alteration of the business of the corporation.[122] The examples under this regulation tell us much not only about changes in location but also about the relative importance of other facts. In the first example, continuity of business was broken when a manufacturing enterprise

119. Treas. Reg. § 1.382(a)-1(h)(5) (1962).
120. *Id.* § 1.382(a)-1(h)(7).
121. *Compare id.*, example (1) *with id.*, example (2).
122. *Id.* § 1.382(a)-1(h) (9).

moved to a new state, disposed of its old assets and a majority of its old employees,[123] but maintained its same products and the same group of customers. In the second example, continuity of business enterprise was maintained when a store moved from the downtown area to a suburban location, retaining most of its former employees, product lines, and customers, but disposing of most of its assets.[124] In the third example, continuity of business was broken where a liquor store moved from one town to another and changed half of its employees and most of its customers, although it retained most of its assets.[125] From these examples we can conclude that, at least in the section 382 area, employees are the most significant, and identity of assets is the least significant, factor in determining business change. Continuity of a business's product lines or customers seems to fall somewhere in between.

The section 382 regulations contain an unusual rule concerning corporations that primarily engage in the rendering of services. If the particular individuals rendering services prior to the sale transaction do not continue on after the transaction, then business continuity is broken.[126] Application of this rule to the reorganization area could cause considerable difficulty, for example where public corporations merge with local insurance agencies.

Case law has been more tolerant of employee changes than have been the regulations. In *Commissioner v. Goodwyn Crockery Co.*,[127] a hard goods dealer added a dry goods business, moved the business from Tennessee to Illinois, lost half of its customers, opened retail stores, and changed all but one employee. The court noted that additions to the business have no effect on the continuity requirement so long as the old business also continues. Changes of location were not viewed as constituting a change of business where the new location remained within the original territory of the business. The court did not reach the question of the validity of the section 382 regulations because the challenged move occurred before issuance of the regulations.[128]

Both the relocation cases and the regulations emphasize that the determination of whether there has been a change of business is a question to be decided by the particular facts and circumstances of a given case. Thus all that the cases really tell us is that the emphasis on identity of employ-

123. *Id.*, example (1).
124. *Id.*, example (2).
125. *Id.*, example (3).
126. *Id.* § 1.382(a)-1(h) (10).
127. 315 F.2d 110 (6th Cir. 1963).
128. For a similar liberal allowance of changes in location, see The Wallace Corp., 1964 T.C.M. (P-H) ¶ 64,010.

ees might be misplaced. We still lack definite guidelines within the reorganization area, although the authorities under section 382 do indicate which facts and circumstances are in general more significant.

B. Holding Period of Acquired Business

In order to maintain enterprise continuity under section 382, the acquiring entity must effectively meet a two-year holding period requirement. This requirement results from an intelligent reading of section 382(a)(1)(A), (B), and (C).[129] This relatively short holding period could explain some of the harsher prohibitions against business changes in the section 382 regulations,[130] particularly the rule concerning service corporations.[131] There does not appear to be any other authority on how long *P* must continue to hold the business or assets of *T*, other than the general considerations of step-transaction doctrines[132] and the prudence of letting previous transactions grow old and cold before further tampering with results. One hopes the IRS will provide some sort of safe-haven holding, as it has done with shareholder stock and securities in the continuity of interest area.[133]

C. Subsequent Tax-Free Transfers of Acquired Business

There also does not appear to be any authority dealing directly with the effect on enterprise continuity of a tax-free subsequent transfer by *P* of *T*'s historic business or assets. The situation, however, is closely analogous to subsequent tax-free transactions by surviving entities in spin-offs under section 355.[134] The leading case in that area is *Commissioner v. Morris Trust*.[135] There the distributor corporation spun-off an unwanted business and then merged with a third corporation as part of an overall plan, in which the third corporation was the surviving corporation of the merger. The court ruled that the continuation of an active trade or business by the distributor after the spin-off was satisfied despite the merger,

129. B. BITTKER & J. EUSTICE, *supra* note 115, at 16–58 n.138.

130. For example, that suspension of operations on account of general adverse business conditions constitutes a prohibited cessation. Treas. Reg. § 1.382(a)-1(h)(6), example (1).

131. Treas. Reg. § 1.382(a)-1(h)(10)(1962). *See* note 126 and accompanying text *supra*.

132. The term "step transaction" refers to situations where two or more transactions independent in form are deemed to be so dependent in substance that the tax consequences are measured not by each separate step, but rather by combining all steps into one overall transaction. *See* J. MERTENS, LAW OF FEDERAL INCOME TAXATION §§ 20.161–.166 (1972).

133. Rev. Proc. 77-37, 1977-2 C.B. 568.

134. Such transactions must meet the statutory enterprise continuity requirements. *See* notes 51 & 52 and accompanying text *supra*.

135. 367 F.2d 794 (4th Cir. 1966).

because all of the parties intended that the distributor's business be continued indefinitely, and the merger in no way caused a discontinuance of the distributor's business.[136] The stockholders of the distributor had maintained a continuing interest in the distributor's business through stock ownership in the surviving third corporation. The court noted that if the distributor had been the survivor of the merger, then the government could not have raised the argument that the merger constituted a failure of the distributor to continue its own active trade or business after the spin-off.[137] The court stated that it would not change the tax result on the basis of a technicality as insubstantial as which of the two corporations actually survived the merger.[138] The IRS has agreed to follow this case.[139]

The policy of the new regulations is to insure that reorganizations are limited to readjustments of continuing interests in property under modified corporation forms.[140] The *Morris Trust* case indicates that if the acquiring corporation disposes of an acquired historic business in a subsequent tax-free reorganization, even if done as part of the original plan of the combined transactions, then this policy is not violated. Consequently, it would appear that reorganization-enterprise continuity is not lost by the subsequent transfer of historic business or assets by the acquiror in another tax-free reorganization.

IX. PRE-REORGANIZATION DISPOSALS—EXAMPLE (4)

Finally, let us turn to example (4), which provides as follows:

> *T* manufactures children's toys and *P* distributes steel and allied products. On January 1, 1981, *T* sells all of its assets to a third party for $100,000 cash and $900,000 in notes. On March 1, 1981, *T* merges into *P*. Continuity of business enterprise is lacking. The use of the sales proceeds in *P*'s business is not sufficient.[141]

Example (4) is the most mysterious of the five examples in the regulation, and it is not entirely clear why the Treasury included it here. The example demonstrates that continuity of enterprise cannot be based upon *T*'s conversion of business assets to liquid assets prior to the reorganization, but we have already learned this lesson in example (3). Example (5) tells us that *P* cannot dispose of the assets immediately after the reorganization.

136. *Id.* at 799.
137. *Id.*
138. *Id.*
139. Rev. Rul. 68–603, 1968–2 C.B. 148.
140. Treas. Reg. § 1.368–1(b) (1955).
141. Treas. Reg. § 1.368–1(d) (5), example (4) (1980).

Thus, anyone even at least faintly familiar with the step-transaction doctrine[142] could readily have predicted the outcome of example (4).

The Treasury Department offers an explanation that further muddies the waters.[143] It states that example (4) is a variation on the facts of Revenue Ruling 63–29,[144] and the example reaches a result different from the revenue ruling.[145] It further states that the transaction is not a mere purchase by *T* of *P*'s stock, because *T* received third-party notes which are not cash equivalent. This does little to clarify the reason for the inclusion of this seemingly redundant example.

A. Identity of Survivor

A review of revenue rulings prior to and since the issuance of the final regulation, however, gives some understanding of what the Treasury Department is trying to say in example (4). As previously mentioned,[146] Revenue Ruling 79–434 found a similar transaction to constitute a purchase of stock followed by a liquidation. The only factual difference between Revenue Ruling 79–434 and example (4) is that in Revenue Ruling 79–434 the acquisition of stock was solely for cash and treasury notes, whereas in example (4) *T* acquires *P*'s stock in exchange for both cash and third-party notes. This is the distinction that the Treasury Department refers to in its comments about cash equivalence.[147] Apparently, the situation dealt with in Revenue Ruling 79–434 does not even rise to the dignity of analysis as a potential reorganization because it so obviously constitutes a sale. Thus, one might suspect that such a situation would always be taxed as a purchase and liquidation, rather than as a reorganization, regardless of how long the transferor corporation had held the cash and treasury notes, and regardless of whether or not investing in cash equivalents had become *T*'s historic business. In example (4), on the other hand, because of the existence of non-cash-equivalent third-party notes, the situation is distinguishable from a purchase and liquidation, on its face at least. Therefore, analysis as a potential reorganization is in order. Under this analysis we look for continuity of business enterprise and, since it is lacking, the regulation concludes that even without cash equivalents such a transaction fails to qualify as a tax-free reorganization.[148]

142. *See generally* note 132 *supra*.

143. T.D. 7745, 1981–8 I.R.B. 9, at 9.

144. 1963–1 C.B. 77.

145. T.D. 7745, 1981–8 I.R.B. 9, at 9.

146. *See* note 37 and accompanying text *supra*.

147. T.D. 7745, 1981–8 I.R.B. 9, at 9.

148. This analysis indicates that the IRS would never accept the merger of a personal holding company consisting entirely of cash equivalents into an investment company, and would be ex-

Further enlightenment comes from comparing Revenue Ruling 63–29 both to example (4) and to a subsequent IRS pronouncement in Revenue Ruling 81–25.[149] The only factual difference between Revenue Ruling 63–29[150] and example (4) is that in the Revenue Ruling the corporation that disposed of its business assets survived the merger (technically, a "C" reorganization), whereas in example (4) the corporation continuing its own business survived the merger. In Revenue Ruling 63–29 the IRS originally held the enterprise continuity requirement to be satisfied so long as the surviving corporation conducted any business. In example (4) this conclusion is narrowed because, although the surviving corporation continues to conduct its own business, it does not continue to conduct the business of the transferor. It thus seems that a distinction is being made based upon which corporation survives the merger, the insubstantial technicality that so offended the court[151] in the *Morris Trust* case.

The IRS has agreed.[152] It quite frankly states that the continuity of business enterprise requirement does not apply to the business or to the business assets of the transferee corporation prior to the reorganization.[153] Consequently, if the target corporation is the survivor of the reorganization, then the parties can make whatever changes they would like, both to the businesses and the assets of the target corporation, without violating the new continuity of business enterprise regulation. Thus, in an attempt to define more precisely the substance of a valid reorganization, the IRS has created another formal distinction in this area. Enlightened practitioners will avoid continuity of enterprise issues entirely whenever it is possible to structure the reorganization in a manner that confines the pre- or post-reorganization manipulation of assets or businesses to the surviving corporation. Enterprise continuity, then, becomes in many cases merely a trap for the unwary, rather than an all pervasive substantive requirement for a valid reorganization.

B. Lack of Overall Plan Requirement

One last observation about example (4) is in order. Both examples (3) and (5) were amended in the final form to specifically identify the disqualifying business and assets disposals as being part of the overall plan of

tremely reluctant to approve such a merger when the personal holding company held third-party notes unless they were extremely old and cold. Neither proposition has yet been tested in the courts.

149. 1981–4 I.R.B. 11.

150. 1963–1 C.B. 77.

151. *See* text accompanying note 138 *supra*.

152. Rev. Rul. 81–25, 1981–4 I.R.B. 11.

153. *Id.* at 11.

reorganization.[154] Example (4), in both its proposed and final form, does not make such a qualification. Consequently, while not explicitly stated anywhere, one cannot help but expect that the government may view such disposals by the target corporation close in time to the reorganization transaction as disqualifying the reorganization regardless of intention of the parties. This appears to be the position taken by the IRS in Revenue Ruling 79–434, that the economic substance of the transaction is so obvious that purchase and liquidation treatment is in order regardless of the format of the transaction and intention of the parties.[155] Apparently the government's view is the same, not only on account of cash equivalence, but also on account of proximity in time to the reorganization transaction. Since time—including planned delays—heals many wounds, again example (4) appears to present another trap for the unwary. Pre-reorganization planning should now insure that major asset and line-of-business disposals by the target corporation be allowed to grow old and cold prior to the reorganization if the acquiring corporation is to be the survivor; or alternatively the reorganization should be structured to leave the target corporation as the survivor.

X. OTHER QUESTIONS

A. *Effect of Compliance with Statutory Requirements*

Does compliance with the statutory requirements of section 368 for acquisitive reorganizations automatically insure compliance with the new enterprise continuity regulation? Surely this is not the case in "A" and "B" reorganizations.[156] Compliance wih state merger laws is no guarantee that any line of business will be continued or that substantially all of the assets of the transferor will be retained by the acquiror. The stock-for-voting-stock requirements of a "B" reorganization create little, if any, pre- or post-transaction limitations on manipulations of assets and business.[157] The "substantially all" property requirement of section 368(a)(1)(C) might force most "C"[158] reorganizations into a form of compliance analogous to example (2) of the new regulation. Not all

154. *Compare* 44 Fed. Reg. 76,813, 76,815 (1979) (proposed regulation) *with* Treas. Reg. § 1.368–1(d)(5) (1980).

155. *See* notes 37 & 38 and accompanying text *supra*.

156. A statutory merger of a subsidiary, for example, is taxed as a liquidation rather than an "A" reorganization. Treas. Reg. § 1.332–2(d) (1955); B. BITTKER & J. EUSTICE, *supra* note 115, at 14–140. *See generally* text accompanying notes 11 & 12 *supra*.

157. *See also* Rev. Rul. 81–92, 1981–12 I.R.B. 6.

158. *See generally* note 13 and accompanying text *supra*.

"D"[159] reorganizations will automatically qualify. As previously mentioned, a vertical split of an integrated business will satisfy the statutory requirements of sections 368 and 355 without necessarily constituting continuation of a historical line of business for enterprise-continuity purposes.[160] Thus, enterprise-continuity compliance is a new factor that reorganization planners must consider, independent of steps taken to comply with the statutory requirements of most acquisitive reorganizations.

B. *Applicability to All Types of Organizations*

It is obvious from the examples that the new regulation applies to asset-transfer reorganizations such as types "A," "C," and "D."[161] The Treasury Department points out that the final regulations have been amended to clarify that they do in fact also apply to "B" reorganizations.[162] But what about nonacquisitive reorganizations such as "E" and "F" reorganizations? Technically speaking, a corporation which changes its line of business and soon thereafter changes its state of incorporation would violate the continuity of business enterprise regulation. Yet there does not seem to be any policy reason for denying tax-free status to such a transfer. Prudence, however, would suggest obtaining a letter ruling on this point prior to the transaction.

The "substantially all" requirement of section 354(b) has been made expressly applicable to the new type "G" reorganization for corporations in bankruptcy proceedings.[163] It is difficult to see how this requirement can be satisfied when large amounts of corporate assets are used to satisfy creditor claims, rather than transferred to the surviving corporation. One hopes any liberalization of the requirements under section 354(b) will also apply to the enterprise continuity regulation.

C. *Minimizing Risks Through Warranties*

While some relatively predictable answers exist, we still are faced with the problem of how to avoid, or at least to minimize, the risks and uncertainties in this area. As previously mentioned, we can avoid the whole problem by having the business- or asset-disposing corporation, *T*, sur-

159. *See generally* note 14 and accompanying text *supra*.

160. *See* part V. *A.1. supra*.

161. Examples (2), (4), and (5) are mergers and hence "A" reorganizations. Examples (1) and (3) involve asset transfers and hence can be either "C" or "D" reorganizations, depending on the amount of voting stock received in the exchange.

162. T.D. 7745, 1981–8 I.R.B. 9, at 13.

163. I.R.C. § 354(b)(1).

vive the reorganization. This, however, is not always possible, for innumerable reasons beyond tax considerations.

Another way to minimize risks, or at least to divide them more equitably, is through warranties between the parties to the reorganization. The target corporation would most likely not be making any warranties regarding enterprise continuity because of the vagaries of present law, and because the facts that might control such determinations can usually be readily ascertained by the acquiring corporation. The target corporation, and most likely its shareholders, would be much more interested in receiving warranties from the acquiring corporation as to its future plans for the target corporation's business and assets. The acquiring corporation would most likely be extremely reluctant to offer an absolute indemnity for taxes arising on account of failure to meet enterprise continuity, and would also most likely be extremely reluctant to commit itself to an inflexible retention of assets and business for an indefinite or stated period of time.

The target corporation and its shareholders would most likely demand, and the acquiring corporation would most likely give, a representation that neither party contemplated the subsequent disposal of the business or the assets by the acquiring corporation as part of the overall plan of the transaction. Such warranty and representations, while not guaranteeing any safety, would at least offer some starting point in a defense against an allegation that the continuity of business enterprise regulations were not complied with.

XI. CONCLUSION

Some, but not all, older-form continuity of enterprise answers are appropriate in dealing with reorganization-enterprise continuity. In identifying lines of business for purposes of the regulation, it seems likely that the vertical division of a single integrated business will not produce a separate line of business, so guidance from the section 355 area is limited to the old regulations and the pre-*Coady* decisions. Geographical location is a factor, but not itself conclusive, in identifying a separate line of business. It is not clear whether the maintenance of pre-reorganization separate customers is a prerequisite for existence of a separate line of business.

Asset continuity appears to be governed by the law developed under section 354(b)(1)(A), thus offering more certainty in this area. Operational quality, rather than economic quantity, determines what constitutes a significant portion of assets. The measure is based on all assets of the

transferor rather than just on the assets of one line of business. The acquiror's use of the assets, however, can be quite passive.

The historicity of a line of business must be established prior to the formulation of the reorganization plan. While passive investment activity can theoretically constitute a historic line of business, three years of pre-reorganization conduct appears to be a minimum requirement. Post-reorganization revival of a dormant business line has received more sympathy from the courts than from the IRS, with the pre-reorganization motive for business cessation being the controlling factor on the effectiveness of post-reorganization revival.

Post-reorganization business changes contemplated by the reorganization plan appear theoretically possible, although vagaries abound. Continuity of employees and of a location within the same business area appear to be the most important considerations, with identity of product line and customers holding somewhat less importance. Identity of assets seems least important, except when no line of business is being continued.

Although some guidance is available from the older forms, the new reorganization-enterprise continuity regulation raises more questions than it answers. Despite this uncertainty, at least two areas of safety are available for prudent practitioners. Whenever possible, the parties can avoid the whole problem by having the target corporation survive the reorganization. Whenever this is not possible, the parties ought to exchange warranties that show a good-faith attempt to comply with the new regulation, and equitably divide any remaining tax risks.