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The Devolution and Inevitable Extinction of the Continuity of Interest Doctrine

David S. Miller

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The Devolution and Inevitable Extinction of the Continuity of Interest Doctrine

*David S. Miller**

I. INTRODUCTION 189

II. THE PURE PAST BUT SORDID HISTORY OF THE CONTINUITY OF INTEREST DOCTRINE 191
A. *The Birth of the Reorganization Provisions* 192
B. *The Original Continuity of Interest Doctrine* 195
C. *The Statutory Continuity of Interest Doctrine* 198
D. *The Deadwood Decisions: Post-1934 Cases Interpreting Pre-1934 Law* 201
E. *Resurrection: The Emergence of a New Judicial Continuity of Interest Doctrine* 205

III. THE NEW JUDICIAL CONTINUITY OF INTEREST DOCTRINE IN FULL BLOOM 207
A. *Expansion of the Continuity Doctrine Beyond the Original Parenthetical* 208
1. *D Reorganizations* 209
2. *Section 355* 210
3. *F Reorganizations* 212
B. *Remote Continuity* 214
C. *Post-Reorganization Target Shareholder Conduct* . . . 218
D. *Double Duty—The Application of the Continuity of Interest Doctrine to Integrated Asset Purchases* 222
E. *The Specter of Historic Shareholder Continuity* 226

IV. THE DECLINE OF THE CONTINUITY OF INTEREST DOCTRINE 230
A. *Limitations on Remote Continuity* 230

* Associate, Cadwalader, Wickersham & Taft, New York, New York; B.A., 1986, University of Pennsylvania; J.D., 1989, Columbia University; LL.M. (Taxation), 1994, New York University School of Law. The author thanks David W. Feeney for his comments on a previous draft of this article.

B. *The All But Elimination of Continuity From Section 338 Integrated Transactions* 231
C. *Continuity Without Stock* 239

V. THE END OF CONTINUITY AS WE KNOW IT 241
A. *The Consequences of Continuity* 241
1. *Abuse Potential* 241
2. *Unadministrability* 243
3. *Economic Inefficiency* 243
4. *Unfairness* 244
5. *Uncertainty* 244
6. *Inconsistent and Anomalous Treatment* 245
7. *Inconsistency With the Tax Policies of Nonrecognition* 246
B. *Constructing a Valid Policy for a Strong Form of Continuity* 248
C. *Alternative Conceptions of Continuity* 250
1. *The Corporate Lawyers' Approach of Ginsburg & Levin* 250
2. *Continuity as an Anti-Abuse Rule* 251
3. *Bifurcation* 252
4. *Restricted Scope* 252
5. *Objective Continuity Test Determined Exclusively at the Corporate Level* 254

VI. CONCLUSION 257

I. INTRODUCTION

The continuity of interest doctrine, in its present form, is the extra-statutory requirement that the historic shareholders of a target company must retain a quantum of equity interest in the acquiror in order for an acquisition to qualify as a reorganization entitled to tax-free treatment. If sufficient stock of the acquiror is not retained by the target's shareholders for a long enough period, the transaction is not a tax-free reorganization, and the target corporation and target shareholders (including those that did retain the acquiror's stock) are subject to tax on their gains. On the other hand, because the doctrine is not an anti-abuse rule, if the continuity of interest requirement is not met, the target and its shareholders are entitled to recognize any loss on the transaction.

This summary of the doctrine and its consequences is, of course, greatly simplified. Every aspect of the continuity of interest doctrine carries with it a formidable array of complex issues. For example, for how long must the target's shareholders have held their stock to be considered "historic" shareholders? What types of interests in the target qualify as equity for purposes of the test? What type and quantum of continuing interest in the acquiror is required, and for how long and in what form must it be retained?[1] Some of these questions have recently attracted significant attention as a result of a Tax Court case, *J.E. Seagram Corp. v. Commissioner*,[2] newly issued regulations under section 338,[3] and an announcement that the Internal Revenue Service is considering a comprehensive reassessment of the doctrine.[4]

This article does not attempt to answer these metaphysical questions or purport to assert what the law should be (although a few suggestions are made along the way).[5] Instead, the article makes a simple prediction: The

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1. This list should not be regarded as exclusive. A fair measure of the number and extent of the issues raised by the continuity of interest doctrine is § 610 of Martin D. Ginsburg & Jack S. Levin, Mergers, Acquisitions and Buyouts (1995), a comprehensive study, which devotes 75 pages (divided into 15 separate sub-sections) and over 80 examples to the topic.

2. 104 T.C. 75 (1995). The case was appealed to the Second Circuit Court of Appeals, but was settled before that court made its decision.

3. 60 Fed. Reg. 54942 (1995).

4. Juliann Avakian Martin, IRS Considers Guidance on Postreorganization Sales and Continuity of Interest, 96 TNT 55-9 (Mar. 19, 1996) (LEXIS, FEDTAX library, TNT file); 'Seagram' Could Lead to Re-Evaluation of Continuity of Interest, Solomon Says, Daily Tax Report (BNA) (Nov. 6, 1995) (LEXIS, FEDTAX library, BNADTR file).

5. One could fill a small public library with articles and treatise chapters devoted to either or both of these objectives. A small sampling: Boris I. Bittker & James S. Eustice, Federal Income Taxation of Corporations and Shareholders (6th ed. 1994); Peter L. Faber, Postreorganization Sales and Continuity of Interest, 68 Tax Notes 863 (Aug. 14, 1995); Peter L. Faber, Continuity of Interest and Business Enterprise: Is It Time to Bury Some Sacred

continuity of interest doctrine in its present form will not survive for long. Crystal balls aside, this forecast is not as radical as it might first appear. The continuity doctrine, which was developed by courts before the enactment of the statutory "solely for voting stock" requirement of C reorganizations, was intended to prevent corporations from receiving tax-free treatment on sales of substantially all of their assets for cash and short-term notes of the acquiror. In 1934, Congress codified this expression of the doctrine for B and C reorganizations in the solely for voting stock requirement, and with that statutory change, the judicial rule should have died. Instead, subsequent courts, failing to recognize the original purpose of the judicial doctrine or the significance of the statutory amendment, began to apply it to statutory mergers. And the Service, flush with victory and blind to the evils of the double-edged doctrine it was forging, implied in the representations required for favorable private letter rulings that the continuity of interest doctrine requires the former shareholders of a target to maintain a relationship with each other as shareholders in the combined entity after the acquiror's tax-free acquisition of target.

Today, the doctrine is wielded to break otherwise valid tax-free reorganizations with equal vigor by the Service (which asserts it against taxpayers to cause gain recognition) and taxpayers (who, by failing to meet the continuity requirement, can claim a loss). Not surprisingly, this double duty has not left the doctrine unscathed. Most recently, the Tax Court in *Seagram* took pains to limit further expansion of the doctrine when it was asserted by a target shareholder seeking to claim a loss. On the other hand, the doctrine has acquired new meaning as the mechanism to cause taxable gain only for the historic minority shareholders who receive and retain acquiror's stock in a merger following a qualified stock purchase under section 338.

This article advances what should be an unremarkable proposition—a doctrine whose policy basis evaporated over 60 years ago and exists without any express or implicit basis in the statutes, which is as often invoked by taxpayers to recognize loss as by the Service to impose tax on gain, which in its present form is the source of significant instability and uncertainty, and which leads to results that are as inequitable and counterintuitive as they are economically inefficient—cannot survive for long. In the course of developing this argument, the article explores how this wayward doctrine went astray and how its course might be corrected.

Cows? 34 Tax Law. 239 (1981); William T. Hutton, Musings on Continuity of Interest—Recent Developments, 56 Taxes 904 (1979); Jere D. McGaffey & Kenneth C. Hunt, Continuity of Shareholder Interest in Acquisitive Corporate Reorganizations, 59 Taxes 659 (1981); Robert A. Rizzi, Continuity of Interest and Reorganizations: Toward a Unified Theory, 17 J. Corp Tax'n 362 (1991); Bernard Wolfman, Continuity of Interest and the American Law Institute Study, 57 Taxes 840 (1979).

The article is divided into five Parts. Part II presents the history of the doctrine, from its sensible judicial origins to its legislative codification in 1934, and explains the subsequent judicial decisions that freed the doctrine from its statutory mooring and permitted it to drift, untethered, into a new, modern form. Part III explores the fullest expression of the doctrine, which today is perhaps most brashly reflected in the "anti-*Yoc Heating*" regulations promulgated under section 338. Part IV identifies the doctrine's vulnerability. In the face of significant contrary policies, the doctrine is subject to legislative, judicial, and regulatory constriction, and Part IV describes some of the limitations that tenderly rein continuity's strongest form. Finally, Part V examines some of the unfortunate aspects of the doctrine that remain today—abuse potential, unadministerability, inefficiency, unfairness, and inconsistency—and pauses to reexamine the doctrine in its best light and glean from its strongest form a defensible policy rationale. Part V asserts that any justification for the doctrine's strong form is inconsistent with our modern tax system and argues that the doctrine's strength will continue its ebb to a modified form that is more consistent with its original purpose. Part V presents some alternative conceptions of the doctrine that might replace its current form.

II. THE PURE PAST BUT SORDID HISTORY OF THE CONTINUITY OF INTEREST DOCTRINE

The modern continuity of interest doctrine is really the result of a big mistake. This Part makes the point by tracing the doctrine's development through four stages. First, following the birth of the reorganization provisions, the doctrine was sensibly developed by the Second Circuit in *Cortland Specialty Co. v. Commissioner*,[6] and the Supreme Court in *Pinellas Ice & Cold Storage Co. v. Commissioner*,[7] to interpret a parenthetical clause in the fledgling definition of reorganization and exclude from that definition asset sales for cash and short-term notes. In the second stage, Congress intervened in 1934 to replace the judicial continuity doctrine established in *Cortland* and *Pinellas* with its own more restrictive statutory rule—the "solely for voting stock" requirement—which disallowed tax-free treatment for certain acquisitions that would have passed the *Cortland-Pinellas* test. In the third stage of the doctrine's adolescence, courts continued to apply the old judicial doctrine of *Cortland* and *Pinellas* to pre-1934 tax years. These cases were consistent with the teachings of *Cortland* and *Pinellas* that an asset sale should qualify as a tax-free reorganization only if the consideration is consistent with that of a state-law merger.

6. 60 F.2d 937 (2d Cir. 1932), cert. denied, 288 U.S. 599 (1933).
7. 287 U.S. 462 (1933).

In its fourth and final stage of development, the judicial continuity doctrine was reborn in *Roebling v. Commissioner*,[8] which ignored the 1934 legislation and revived the doctrine, applying it even to statutory mergers (which were the model for tax-free reorganization treatment in the first place). Once resurrected, the new judicial doctrine flourished, germinating from a test that distinguished merger-like tax-free reorganizations from taxable asset sales to an incipient basis for denying tax-free treatment as a result of the pre- and post-acquisition conduct of the acquiror, the target, and even the target's former shareholders.

A. *The Birth of the Reorganization Provisions*

The Revenue Act of 1918 contained the first reorganization provision, providing that no taxable gain or loss occurs when, "in connection with the reorganization, merger, or consolidation of a corporation," a person receives "in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value."[9] Mergers and consolidations were terms of art under state law, requiring compliance with restrictive conditions (or the grant of legislative approval) and giving rise to specific consequences. Among the requirements were that the acquiror and target carry on the same or similar businesses, the shareholders of the target acquire an equity (or other permanent) interest in the acquiror, and, after the merger, the target dissolve.[10] The most significant consequence of a state law merger was the acquiror's liability for the target's legal obligations.[11] The term "reorganization," on the other hand, was not generally defined under state law and was not generally applied to transactions with multiple corporations. In regulations, Treasury defined "reorganization" broadly, but maintained the state law

8. 143 F.2d 810 (3d Cir. 1944), cert. denied, 323 U.S. 773 (1944).

9. Revenue Act of 1918, § 202(b), 40 Stat. 1057, 1060. One serious deficiency of the 1918 Act was that the target was subject to tax even as a result of a reorganization. This failing was remedied in 1924. See Revenue Act of 1924, §§ 203(b)(3), (e), (f), (g), 43 Stat. 253, 256-57.

10. See, e.g, Del. Laws c. 241 (1833); Pa. Laws No. 1 (1837); N.J. Acts c. 90 (1853); Mass. Laws c. 74 § 1 (1827); Mass. Laws c. 50 § 1 (1840). See generally Comment, Statutory Merger and Consolidation of Corporations, 45 Yale L.J. 105, 106 & n.4, 109 & nn.16-18 (1935) (citing cases).

11. See, e.g., State v. Jefferson Lake Sulphur Co., 36 N.J. 577, 178 A.2d 329 (1962), cert. denied, 370 U.S. 158 (1962); Camben Safe-Deposit & Trust Co. v. Burlington Carpet Co., 33 A. 479, 480 (N.J. Ch. 1895); La Porta v. Enten Corp., 125 A.D. 2d 367, 509 N.Y.S. 2d 91 (2d Dep't 1986); Greene v. Woodland Ave. & West Side St. R.R., 62 Ohio St. 67, 79, 56 N.E. 642, 646-47 (1900); see also Eldon Bisbee, Consolidation and Merger, 6 N.Y.U. L. Rev. 404, 414 (1929); Comment, Statutory Merger and Consolidation of Corporations, 45 Yale L.J. 105, 122 n.90 (1935) (citing statutes and cases prior to 1918).

merger and consolidation requirement that the target be dissolved and, in the case of an upstream merger, required that both companies be affiliated.[12]

In 1921, Congress significantly broadened the definition of reorganization by including a B-type stock acquisition with a majority threshold (as opposed to the 80% requirement under current law) and a C-type asset acquisition. Section 202(c)(2) of the 1921 Act provided:

> The word "reorganization," as used in this paragraph, includes [A] a merger or consolidation (including *the acquisition by one corporation* [B] of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or [C] *of substantially all the properties of another corporation*), [E] recapitalization, or [F] mere change in identity, form, or place of organization of a corporation.[13]

The decision to include a stock acquisition as a reorganization was the subject of heated debate in the Senate,[14] but the addition of the parenthetical clause "to include" an asset acquisition does not appear to have been

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12.
> In general, where two (or more) corporations unite their properties, by either (a) the dissolution of corporation B and the sale of its assets to corporation A, or (b) the sale of its property by B to A and the dissolution of B, or (c) the sale of the stock of B to A and the dissolution of B . . . The term "reorganization," as used in section 202 of the statute, includes cases of corporate readjustment where stockholders exchange their stock for the stock of a holding corporation, provided the holding corporation and the original corporation, in which it holds stock, are so closely related that the two corporations . . . are thus required to file consolidated returns.

Regs. 45, art. 1567 (1921).

13. Revenue Act of 1921, § 202(c)(2), 42 Stat. 227, 230 (1921) (emphasis added). The predecessor paragraphs to modern § 368(a)(1) are bracketed and the key C reorganization phrase is italicized.

The relevant language was reenacted without substantive change in 1924, 1926, 1928, and 1932. See Revenue Act of 1924, § 203(h)(1), 43 Stat. 253, 257; Revenue Act of 1926, § 203(h)(1), 44 Stat. 9, 14; Revenue Act of 1928, § 112(i), 45 Stat. 791, 818; Revenue Act of 1932, § 112(i), 47 Stat. 169, 198. As described below in note 18, D reorganizations were added in 1924.

14. One senator argued that the exchange of a majority interest in a target corporation for stock in a corporate conglomerate was the equivalent of a sale and should be taxed as such. 61 Cong. Rec. 6560, 6566 (1921). The majority nevertheless voted for a broad definition of a tax-free stock acquisition for two reasons. First, in a "country-wide" corporation, it was often impossible to coordinate an exchange offer with more than a majority of the shareholders. See id. at 6564 (Senator Watson). Second, in the absence of the provision, a shareholder with a depreciated majority interest could contribute his interest to a newly-formed holding company in exchange for stock and claim a loss. See id. (Senator Smoot). This was probably not an unusual transaction in 1921 during the economic downturn that followed the end of World War I.

discussed at all. Nevertheless, contemporaneous sources indicate that asset acquisitions were included because some states had not yet passed statutes authorizing mergers and consolidations and other states prohibited mergers and consolidations with out-of-state corporations.

> Therefore, in drafting the Revenue Act of 1921 and subsequent acts, Congress sought to provide for the situation presented where an attempt was made to effectuate a practical merger or consolidation without compliance with the technical requirements of state laws, or where there is no state law, covering the readjustment which has taken place.[15]

However, in expanding the definition of reorganization to cover the merger-like acquisition of substantially all the assets of a target corporation, Congress neglected to include the requirement of state merger laws at that time: the consideration had to include acquiror stock.[16] (Incidentally, it took

15. Mark Eisner, Taxation Affecting Corporate Reorganizations, in Some Legal Phases of Corporate Financing Reorganization and Regulation 403, 419 (1931). These reasons were still present in 1934, when the House of Representatives proposed a repeal of the B and C reorganizations, and the Senate convinced the House to retain them (in restricted form) for the same reasons. See Part II.C.

16. See, e.g., Outwater v. Public Service Corp., 103 N.J. Eq. 461, 143 A. 729 (1928), aff'd, 104 N.J. Eq. 490, 146 A. 916 (1929) (putative merger whereby shareholders of target would receive preferred stock of acquiror that was redeemable at option of acquiror after three years was invalid under state law; target shareholders must obtain equity or other permanent or perpetual interest in target). In *Outwater*, the court held:

> Continued membership, until dissolution, is an inherent property right in corporate existence. A merger is but fusion of corporate assets and franchises and an allocation of stock in the merged company, and works a conversion not a destruction of that right. In the ordinary case of merging going concerns and the conversion of share for share upon parity of value, all rights, including voting rights, are reserved to the stockholders.

Id. at 465; see also Moore v. Splitdorf Elec. Co., 114 N.J. Eq. 358, 168 A. 741 (1933). See generally William L. Clark & William L. Marshall, A Treatise On the Law of Private Corporations § 359 at 1089 (1903) ("[t]he statute or the agreement, or both, generally provide that the consolidated corporation shall issue shares of its stock to the stockholders of the consolidating corporations . . ."); Walter Chadwick Noyes, A Treatise on The Law of Intercorporate Relations § 64 at 105 (1902) (same); Ernest L. Folk, III, et al., Folk on the Delaware General Corporation Law 14 n.13 (2d ed. 1990) (Delaware did not permit cash consideration until at least 1941); Homer Hendricks, Developments in The Taxation of Reorganizations, 34 Colum L. Rev. 1198, 1220 (1934) ("[i]n the usual form of strict merger or consolidation, the corporation which acquires the properties of another issues some stock or securities of its own. In this way the interests of the owners of the merging or consolidating corporations are continued in the enterprise, but the former owners may or may not control the resulting organization"). See also Pinellas Ice & Cold Storage Co. v. Commissioner, 57 F.2d 188, 190

Congress until 1968, when it enacted section 368(a)(2)(D), to require explicitly that for certain statutory mergers, the consideration must include stock to qualify as a reorganization.)

B. *The Original Continuity of Interest Doctrine*

The continuity doctrine developed as a sensible judicial interpretation of a poorly-drafted statute that expanded the definition of tax-free reorganization to include merger-like asset transfers without specifying the requisite consideration. The cases to first invoke the doctrine involved corporate taxpayers that transferred substantially all of their assets in exchange for cash and short-term notes of the acquirors in transactions that failed to qualify as statutory mergers or consolidations. Invariably, the taxpayer claimed that the asset sale was a reorganization as defined in the statute, and not a taxable sale.[17]

Under the 1926 Act (the earliest Revenue Act to be interpreted on this issue), tax-free treatment was available to a target only to the extent that (1) the transaction was pursuant to a plan of "reorganization" (i.e., "a merger or consolidation (including the acquisition by one corporation of . . . substantially all of the properties of another corporation)"),[18] and (2) the consider-

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(5th Cir. 1932), aff'd, 287 U.S. 462 (1933) ("As applied to corporations, the terms 'merger' and 'consolidation' have well known legal meanings . . . . In either event, the resulting corporation acquires all the property, rights and franchises of the dissolved corporations, and their *stockholders become its stockholders*" (emphasis added)) .

Congress also declined to address whether the target must liquidate after the transaction, as would generally be the case in a statutory merger or consolidation under 1921 law, and was in fact required under existing regulations. See supra note 12. In Helvering v. Minnesota Tea Co., 296 U.S. 378 (1935), the Supreme Court held that dissolution of the target was not required by the statute. See also Watts v. Commissioner, 75 F.2d 981 (2d Cir. 1935), aff'd, Helvering v. Watts, 296 U.S. 387 (1935). In 1984, however, the liquidation requirement for a C-type asset acquisition was reimposed by Congress. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 63(a), 98 Stat. 494, 583 (adding IRC § 368(a)(2)(G)).

17. See, e.g., Pinellas Ice & Cold Storage Co. v. Commissioner, 21 B.T.A. 425 (1930), aff'd, 57 F.2d 188 (5th Cir. 1932), aff'd, 287 U.S. 462 (1933); Cortland Specialty Co. v. Commissioner, 60 F.2d 937 (2d Cir. 1932); Sarther Grocery Co. v. Commissioner, 63 F.2d 68 (7th Cir. 1933); Prairie Oil & Gas Co. v. Motter, 66 F.2d 309 (10th Cir. 1933); Worchester Salt Co. v. Commissioner, 75 F.2d 251 (2d Cir. 1935); Le Tulle v. Scofield, 308 U.S. 415 (1940).

18. Section 203(h) of the 1926 Act provided:

> [t]he term "reorganization" means (A) a merger or consolidation (including *the acquisition by one corporation of* [B] at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation or [C] *substantially all the properties of another corporation*), or [D] a transfer by a corporation of all or part of its assets to another corporation if immediately after the transfer the

ation for the transaction consisted of "stock or securities" of the acquiror (or another corporate party to the transaction).[19] In each of the transactions, the taxpayer undoubtedly satisfied the literal definition of reorganization. Moreover, since the term "securities" was undefined by Congress for purposes of the reorganization provisions (as it has remained to this day), but had been defined broadly in other contexts,[20] the taxpayers had good reason to feel optimistic.

Nevertheless, in *Pinellas Ice Co.* and *Cortland Specialty Co.*, the first two cases to consider the issue, the Supreme Court and Second Circuit concluded that both conditions were failed. In each case, the consideration consisted of cash and notes (which, in *Cortland*, matured serially, with the longest having a 14-month term, were unsecured, and were "doubtless readily marketable," and in *Pinellas* had a 4-month term and were well-secured).[21] Each court concluded that although Congress failed to define "security," it could not have intended the word to include instruments, such as the notes, that were effectively cash equivalents. Although this rationale was sufficient to dispose of the cases, the courts also concluded that the transactions failed to qualify as "reorganizations."

Acknowledging that the literal language of the reorganization definition included all asset transfers, regardless of the consideration, the courts concluded that the parenthetical language of the phrase, "merger or

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> transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or [E] a recapitalization, or [F] a mere change in identity, form, or place of organization, however, effected.

(Emphasis added). The bracketed letters correspond to the analogous provisions of modern law. Clause [D] (which was (B) in the statute) was added in 1924 to enlarge the scope of the definition of reorganization. See Revenue Act of 1924, § 203(h), 43 Stat. 253, 257; House Comm. on Ways and Means, 68th Cong., 1st Sess., reprinted in J.S. Seidman, Seidman's Legislative History of Federal Income Tax Laws 697 (1953).

19. Section 203(b)(3) of the 1924 Act provided for nonrecognition "if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization." Section 203(e) of the 1924 Act subjected the target to tax on any gain to the extent the consideration consisted of money or property other than stock or securities (boot).

20. See Schedule A of Title XI of the 1918 Act, Revenue Act of 1918, 40 Stat. 1057, 1135 (imposing stamp tax on "all instruments, however termed, issued by any corporation with interest coupons or in registered form, known generally as corporate securities"). Section 23(k)(3) of the 1938 Act used substantially the same definition to distinguish debt instruments that give rise to capital losses from bad debts, which permit ordinary deductions. Revenue Act of 1938, 52 Stat. 447, 462.

Thus, it was unclear whether short-term debt instruments could be securities or whether the holder's interest had to be secured. See Neville Coke & Chemical Co. v. Commissioner, 148 F.2d 599, 601-02 (3d Cir. 1945), cert. denied, 326 U.S. 726 (1945) (discussion of confusion over whether time or some other factor is crucial).

21. *Cortland*, 60 F.2d at 940; *Pinellas*, 287 U.S. at 464.

consolidation (including the acquisition by one corporation of . . . substantially all of the properties of another corporation)," must be read in the context of the words "merger or consolidation" that precede it.[22] Since "the general purpose of [all state merger and consolidation statutes] has been to continue the interests of those owning enterprises, which have been merged or consolidated, in another corporate form,"[23] the courts held that an asset transfer is a reorganization only if the target corporation receives consideration of a type that is consistent with statutory mergers and consolidations (i.e., stock or securities);[24] otherwise, the transfer is indistinguishable from a mere sale.[25] It is this second rationale for denying reorganization treatment that became known as the continuity of interest doctrine.

The *Pinellas* and *Cortland* courts nicely wove the "stock or securities" requirement of the statute into the continuity-based distinction between a merger-like reorganization and a taxable asset sale. Thus, the *Cortland* court suggested that reorganization treatment might have been available had the consideration received by the target been "'securities,' though not stock, [that] created such obligations as to give creditors or others some assured participation in the properties of the transferee corporation,"[26] and the Supreme Court in *Pinellas* noted that *Cortland*'s interpretation "harmonizes with the underlying purposes of the provisions in respect of exemptions and gives some effect to all the words employed."[27] This interdependency between the reorganization definition and the stock or securities

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22. See also Le Tulle v. Scofield, 308 U.S. 415, 420 (1940) ("the section is not to be read literally, as denominating the transfer of all the assets of one company for what amounts to a cash consideration given by the other a reorganization").

23. *Cortland*, 60 F.2d at 939.

24. See id. at 939-40; *Pinellas*, 287 U.S. at 469-70 (citing *Cortland*, 60 F.2d at 937, 939, 940).

25. Had the taxpayers in *Pinellas*, *Cortland*, and the other early continuity cases consulted a sufficiently wily tax advisor before embarking on their respective transactions, their problems could have been ameliorated by first liquidating the target by distributing its assets to its shareholders and then having the shareholders sell the assets. Under regulations dating back to the 1918 Act, in kind liquidating distributions were tax-free to the dissolving company. See Regs. 69, art. 548 (1926); Regs. 45, art. 547 (1918); Hellebush v. Commissioner, 24 B.T.A. 660, 667 (1931), aff'd, 65 F.2d 902 (6th Cir. 1933). The shareholders would have been taxed on the liquidating distribution, but this would not have been a significant acceleration of the income they recognized upon the maturity of the short-term debt obligations. See Koppers Coal Co. v. Commissioner, 6 T.C. 1209 (1946). Section 337 of the 1954 Code effectively overruled *Cortland* and *Pinellas* by permitting a tax-free sale of assets prior to a liquidation. It was not until *General Utilities* was repealed in 1986 that *Cortland* and *Pinellas* were restored as good substantive law.

26. *Cortland*, 60 F.2d at 940.

27. *Pinellas*, 287 U.S. at 470.

requirement was later (and still remains in part) reflected in the regulations[28] and was maintained by case law through 1939, when the Second Circuit held in *Commissioner v. Tyng*[29] that because 20- and 40-year convertible bonds were clearly "securities," the transaction necessarily satisfied the continuity of interest requirement for tax-free treatment under the 1928 Act.[30]

The *Cortland* and *Pinellas* courts, having decided that the transactions at issue failed to qualify as reorganizations because the consideration failed to include any stock or securities of the acquiror, left open the question of whether any specific quantity of acquiror's stock or securities must be received by the target. Contemporaneous commentators assumed that "[t]he issuance of *any* substantial amount of stock or securities should be sufficient to bring the transaction within the parenthetical language."[31]

C. *The Statutory Continuity of Interest Doctrine*

In 1933, following the *Cortland* and *Pinellas* decisions and facing the prospect that the existing definition of reorganization might nevertheless permit corporate taxpayers to claim tax-free treatment on a sale of assets for short-term debt instruments, a subcommittee of the House Ways and Means Committee recommended a wholesale repeal of the tax-free reorganization provisions until "a more desirable method of treatment could be built up."[32] The Treasury opposed the repeal on the grounds that tax-free treatment was

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28. See, e.g., Regs. 101, § 112(g)-1 (1934) ("[a]ccordingly, under the Act, a short-term purchase money note is not a security of a party to a reorganization, . . . and a sale is nevertheless to be treated as a sale, even though the mechanics of a reorganization have been set up"); Regs. § 1.368-2(a) ("[i]f 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").

29. 106 F.2d 55 (2d Cir. 1939), rev'd, Helvering v. Tyng, 308 U.S. 527 (1940). See infra text accompanying notes 54 to 58, which discusses how the divorce of the stock or securities requirement from the judicial continuity of interest doctrine under pre-1934 law was a prelude to the judicial resurrection of the doctrine under post-1934 law.

30. *Tyng*, 106 F.2d at 59 ("[f]ive different Circuit Courts of Appeal, besides our own, and the Court of Claims as well, have decided that the receipt of 'securities' results in the retention of a continuity of interest necessary for a reorganization").

Ultimately, the Supreme Court held that the target or its shareholders must receive some equity in the acquiror. See Le Tulle v. Scofield, 308 U.S. 415 (1940), discussed infra Parts III.B and IV.A.

31. Hendricks, supra note 16, at 1220 (emphasis added); see also *Cortland*, 60 F.2d at 940 ("even if the transfer to Deyo was an exchange in pursuance of a 'plan of reorganization,' the property received by Cortland had to include *some* 'stock or securities' " (emphasis added)).

32. See Subcomm. of House Comm. on Ways and Means, 73rd Cong., 2d Sess. 8-9, 37-42 (1934), reprinted in J.S. Seidman, Seidman's Legislative History of Federal Income Tax Laws 332 (1953); see also H.R. Rep. No. 704, 73rd Cong., 2d Sess. 13 (1934), reprinted in 1939-1 C.B. 554, 563.

appropriate for legitimate reorganizations in which only "paper gains" were realized and, because the economic tide was turning, several reorganizations in progress at the time would give rise to the recognition of losses if they were taxable.[33] The full Ways and Means Committee was persuaded by the Treasury's arguments and proposed to retain the basic concept of tax-free reorganizations but to deny tax-free treatment for asset acquisitions of the type that were the subject of *Cortland* and *Pinellas*. Under the Ways and Means proposal, the definition of reorganization would have been confined to "(1) statutory mergers and consolidations; (2) transfers to a controlled corporation, 'control' being defined as an 80-percent ownership; and (3) changes in the capital structure or form of an organization."[34] These amendments were approved by the full House.

The Senate Finance Committee applauded the policies behind the House's proposal but, with respect to asset acquisitions, made the following observation:

> Not all of the States have adopted statutes providing for mergers and consolidations; and, moreover, a corporation of one State can not ordinarily merge with a corporation of another State. The committee believes that it is desirable to permit reorganizations in such cases, with restrictions designed to prevent tax avoidance.[35]

The Finance Committee proposed an expansion to the House's definition by permitting C-type asset acquisitions but requiring that the consideration consist "solely" of acquiror's "voting stock." The Committee also restricted tax-free "mergers and consolidations" to those specifically provided for under state "statutory" law (as opposed to those pursuant to private legislation, as had also been common). Congress passed the bill, as modified by the Senate Finance Committee:

> The term "reorganization" means [A] a statutory merger or consolidation, or [B] the acquisition by one corporation in exchange solely for all or a part of its voting stock: of at least 80 percentum of the voting stock and at least 80 percen-

33. 78 Cong. Rec. 2512 (1934).

34. H.R. Rep. No. 704, supra note 32, reprinted in 1939-1 C.B. 564.

35. Id. at 598. See George S. Hills, Definition-"Reorganization" Under the Revenue Act of 1934, 12 Tax Magazine 411, 411 (1934) ("a cursory examination of the business corporation laws of the forty-eight states discloses that fifteen states have no statutory provision for 'merger' or 'consolidation,' sixteen states have statutory provisions limited to domestic corporations, and seventeen states have statutory provisions covering domestic corporations and foreign corporations").

> tum of the total number of shares of all other classes of stock of another corporation; or [C] of substantially all the properties of another corporation, or [D] a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its shareholders or both are in control of the corporation to which the assets are transferred, or [E] a recapitalization, or [F] a mere change in identity, form, or place of organization, however effected.[36]

With these changes, Congress replaced the judicial continuity of interest doctrine with a more explicit—and restrictive—statutory version.[37] These amendments met the House's original concerns by preempting any attempt of taxpayers to obtain tax-free treatment for a *Pinellas*-type transaction and met the Treasury's and the Senate's objective of permitting tax-free asset acquisitions that were "sufficiently similar to mergers and consolidations as to be entitled to similar treatment."[38] Additionally, voting stock consideration was not made a condition of tax-free treatment for statutory mergers or consolidations, even though in 1934, under the laws of various states, there was no requirement that a plan of merger or consolidation provide for solely voting stock consideration and, in fact, some "modern" state statutes permitted mergers without *any* equity consideration.[39] Thus,

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36. Revenue Act of 1934, § 112(g)(1), 48 Stat. 683, 705. The letters in brackets are redesignated to correspond to current law.

37. See Helvering v. Southwest Corp., 315 U.S. 194, 198 (1942) ("[t]he continuity of interest test is made much stricter [by the 1934 Act]"); Comment, Corporate Reorganization to Avoid Payment of Income Tax, 45 Yale L.J. 134, 140-41 (1935); Hugh Satterlee, The Income Tax Definition of Reorganization, 12 Tax Magazine 639 (1934); Hills, supra note 35, at 412; Hendricks, supra note 16, at 1202 ("[t]he intent of Congress is thus made plain . . . [F]or future transactions, the views of the Board of Tax Appeals . . . regarding the interpretation to be given to Section 112(i)(1)(A) of the 1932 and prior acts are made inapplicable"); Erwin N. Griswold, Securities and Continuity of Interest, 58 Harv. L. Rev. 705, 711 (1945) (since "the definition of reorganization in the statute has now been changed so as to include only a 'statutory merger or consolidation,' or an exchange of property 'solely for voting stock,'" the definition of securities is "no longer of any particular importance" in determining whether a "reorganization" has taken place).

38. H.R. Rep. No. 704, supra note 32, reprinted in 1939-1 C.B. 598.

39. See, e.g., Ark. Dig. Stat. § 170112 (Crawford & Moses, Supp. 1931) ("[t]he agreement may provide for the distribution of cash, notes or bonds in whole or in part, in lieu of stock to the stockholders of the constituent corporations or any of them"); see also Cal. Civ. Code § 361 (Deering 1931); Fla. Comp. Gen. Laws Ann. § 6562 (Skillman 1927); Nev. Comp. Laws § 1638 (Hillyer 1930); Ohio Gen. Code § 8623-67 (Page, Supp. 1935); Tenn. Code Ann. § 3750 (Williams 1934); Ill. Rev. Stat. c. 32 § 62 (Cahill & Moore 1935) (permitting distribution of "shares or other securities or obligations of the new corporation"). See generally Henry Winthrop Ballantine, Ballantine on Corporations § 291 at 686 (1946); Comment, Corporate Reorganization To Avoid Payment of Income Tax, 45 Yale L.J. 134, 141 & n.48 (1935).

Congress confirmed that for statutory mergers and consolidations, the state requirements, such as a formal plan of merger, shareholder vote, and dissenters' rights, and the consequences—such as liability for the target's legal obligations—were sufficient to distinguish those transactions from sales, and that any requirements as to the nature of the consideration would be defined by state law.[40]

D. *Deadwood Decisions: Post-1934 Cases Interpreting Pre-1934 Law*

Following the 1934 Act and until at least 1940, the judicial continuity of interest doctrine continued to be applied as cases involving tax years before 1934 advanced through the courts. These cases were entirely faithful to three principles deriving from the *Cortland* and *Pinellas* decisions. First, although the literal language of the parenthetical describing B and C reorganizations would permit tax-free treatment to a target upon a "sale" of substantially all of its assets—regardless of the consideration—the parenthetical should be read to require consideration that is consistent with a statutory merger or consolidation.[41]

Second, the cases were consistent with the view that the continuity of interest required for transactions described in the parenthetical describing B and C reorganizations was *not* required for other reorganization transactions. For example, in *Schoo v. Commissioner*,[42] the court held that the exchange of preferred stock for 25-year bonds in a recapitalization was a reorganization, even though the shareholder's continuity of interest was broken by the transaction. The court made clear that the continuity of interest requirement was relevant only in determining whether a C-type asset transfer was sufficiently similar to a merger to deserve like treatment.[43]

Courts have long recognized that the receipt of voting stock is not necessary in a statutory merger. See, e.g., John A. Nelson Co. v. Helvering, 296 U.S. 374 (1935).

40. See Satterlee, supra note 37, at 688 ("the history and structure of the reorganization provisions prior to the Revenue Act of 1934 indicate that any requirement of a continuity of interest was consciously and advisedly omitted from the definition of reorganization in clause A").

41. Helvering v. Minnesota Tea Co., 296 U.S. 378, 385 (1935) (target or its shareholders must acquire a "definite" and "material" interest in acquiror "in order that the result accomplished may genuinely partake of the nature of merger or consolidation"); Coleman v. Commissioner, 81 F.2d 455, 457 (10th Cir. 1936) ("[d]id the transaction smack enough of a 'merger or consolidation' that it can fairly be said to fall within the parenthetical phrase?"); Worcester Salt Co. v. Commissioner, 75 F.2d 251, 252 (2d Cir. 1935) ("the transaction must at least 'partake of the nature of a merger or consolidation'"); see John A. Nelson Co. v. Helvering, 296 U.S. 374 (1935) (nonvoting preferred stock is adequate consideration for a tax-free C-type asset acquisition).

42. 47 B.T.A. 459 (1942).

43. Id. at 461; see also Commissioner v. Neustadt's Trust, 131 F.2d 528 (2d Cir. 1942) (1936 Act); Crofoot v. Commissioner, 4 T.C. Memo (CCH) 97, T.C. Memo (P-H)

Finally, courts continued to emphasize that the parenthetical clause was intended to expand the definition of reorganization and should be construed liberally, so long as it did not allow tax-free treatment for disguised asset sales. For example, in *John A. Nelson Co. v. Helvering*,[44] the Court held that the target need not receive voting securities; in *Nelson* and in *Helvering v. Minnesota Tea Co.*,[45] the Court held that even though a statutory merger or consolidation would generally require the target to dissolve, no such requirement was imposed by the parenthetical;[46] and in *Helvering v. Alabama Asphaltic Limestone Co.*,[47] the Court held that the sale by a bankrupt corporation of all its assets to a committee of its creditors for cash and stock of a newly-organized corporation owned by the creditors, which the bankrupt corporation, in turn, distributed to its creditors in satisfaction of its debts, constituted a tax-free reorganization. In *Alabama Asphaltic*, the Court disabused the view, "followed by some courts," that "a substantial ownership interest in the transferee company must be retained by the holders of the ownership interest in the transferor."[48] Stressing once again that reorganizations include "transactions which are beyond the ordinary and commonly accepted meanings of [merger and consolidation]," the Court held that the insolvent target's distribution of the acquiror stock to its bondholders was sufficiently similar to the analogous distribution by a solvent target to its shareholders to warrant tax-free treatment for the target on the transfer of its assets.

Nevertheless, three deadwood Supreme Court decisions, while consistent with the narrow purposes of the judicial doctrine as applied under the pre-1934 statute, were subsequently—and unfortunately—interpreted as dramatically expanding the continuity of interest requirement and sparking resurrection of the judicial doctrine under post-1934 law.

¶ 45,036 (1945); Annis Furs, Inc. v. Commissioner, 2 T.C. 1096 (1943) (1934 Act); Kirby v. Commissioner, 35 B.T.A. 578 (1937) (1926 Act and 1928 Act), modified on other grounds, 102 F.2d 115 (1939). As discussed below, the judicial continuity doctrine was not applied to D reorganizations under post-1934 law. See infra notes 73-74 and accompanying text.

44. 296 U.S. 374 (1935). See also United States v. Adkins-Phelps, Inc., 400 F.2d 737 (8th Cir. 1968) (continuity satisfied notwithstanding acquiror's right of first refusal to purchase its shares from target shareholder at par); Schweitzer & Conrad, Inc. v. Commissioner, 41 B.T.A. 533 (1940) (nonconvertible preferred stock with no right to vote, redeemable at any time and mandatorily redeemable after six months if a certain level of earnings was achieved; held, sufficient).

45. 296 U.S. 378, 385 (1935).

46. However, in 1984 Congress legislatively imposed a liquidation requirement on targets in C reorganizations. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 63(a), 98 Stat. 494, 583 (adding IRC § 368(a)(2)(G)).

47. 315 U.S. 179 (1942).

48. Id. at 183.

Groman v. Commissioner[49] and *Helvering v. Bashford*[50] each involved a B-type acquisition of a target's stock by a newly-formed subsidiary of a parent corporation. In each case, the acquisition was immediately followed by the target's liquidation into the subsidiary. The consideration for the transfer was cash, parent stock, *and* stock of the subsidiary. It was clear in each case that the transaction qualified as a reorganization, and the sole issue was whether the parent's stock was stock of a "party to the reorganization" so that the target shareholders would not have to recognize on receipt of it.

In *Groman*, the Court approached the question quite logically by starting with section 112(i)(2) of the 1928 Act, which defined "party to a reorganization" as "including" a corporation resulting from a reorganization and "both" corporations in a stock acquisition. After concluding that subsidiary and target were parties to the reorganization, the Court held that the parent was not encompassed by the statutory definition or any other ordinary meaning of the term "a party to the reorganization."

The *Groman* Court next considered whether the subsidiary could be ignored or otherwise regarded as the parent's alter ego. To answer this question, the Court delved into the purposes of the reorganization provisions, stating that the statute permitted tax-free treatment to target shareholders only if their interest "continues to be definitely represented in a substantial measure in a new or different [corporation, and] then to the extent, but only to the extent, of that *continuity of interest* . . . ."[51] In light of this requirement of a close relationship between target shareholders and acquirors, the Court held that the statute did not permit the actual acquiror (the subsidiary) to be ignored or the acquiror's parent otherwise to be deemed the "other" party to the reorganization. This conclusion was also reached in *Bashford*, where the target shareholders dealt exclusively with parent, which contributed the target stock to its subsidiary in exchange for subsidiary stock that it transferred to the target shareholders. (In *Groman*, the subsidiary had received parent stock and the subsidiary dealt exclusively with the target shareholders.)

Groman and *Bashford* are stinted and formalistic interpretations of the "party to a reorganization" definition, but they adhere to the statutory language and have nothing to do with the extra-statutory continuity of interest doctrine. In context, it is clear that by referring to "continuity of interest," the Court was *not* referring to the continuity of interest doctrine used to distinguish merger-like transactions from taxable sales and whose failure disqualifies the entire reorganization. Instead, the Court was explaining the

49. 302 U.S. 82 (1937).

50. 302 U.S. 454 (1938).

51. *Groman*, 302 U.S. at 89 (emphasis added).

statutory mechanism that permits tax-free treatment to target shareholders only to the extent they receive stock or securities—representing a "continuity" of their former proprietary interest—of the true acquiror, and not in some other corporation. Nevertheless, the Court's reference to "continuity of interest" has caused *Groman* and *Bashford* to be misunderstood as being more than cases interpreting the term "a party to a reorganization" and as announcing, instead, an expansion of the judicial continuity of interest doctrine whose failure (at least under pre-1934 law) disqualified an otherwise valid reorganization.[52] This view inexplicably persists today despite their double legislative repeal: first in 1934 when Congress undercut the decisions by requiring that the consideration in B-type stock acquisitions consist solely of acquiror voting stock (and not parent stock as well), thereby legislatively foreclosing *Groman* and *Bashford* transactions, and, again, when Congress expressly *permitted* triangular reorganizations in piecemeal legislation enacted over the 17 years from 1954 to 1971.[53]

The third deadwood decision that eventually helped resurrect judicial continuity was *Le Tulle v. Scofield*.[54] In *Le Tulle*, the Supreme Court interpreted pre-1934 law to require that, in a tax-free C-type asset acquisition, the consideration must consist of equity of the acquiror. The acquiror in the case obtained the target's assets solely for acquiror bonds payable serially over 11 years. Although the Court did not specifically hold that the bonds were "securities," that much seemed clear. Nevertheless, the Court held that the transaction failed to qualify as a reorganization.

Le Tulle was faithful to the Court's consistent view that the 1921 Act parenthetical was intended to expand the definition of reorganization to include, among other transactions, asset acquisitions that sufficiently resembled state mergers and consolidations. However, by requiring the consideration in a tax-free C-type asset acquisition to include at least some acquiror equity, *Le Tulle* effectively limited tax-free asset acquisitions to transactions that could have qualified as statutory mergers *in 1921*, when the tax-free reorganization provision was first enacted and state merger and consolidation laws generally required at least some acquiror stock consideration.[55] However, state merger law evolved considerably after the 1921 Act, and by 1931, when the *Le Tulle* transaction took place, many states permitted the acquiror's consideration to consist of non-equity securities, and some states

52. See, e.g., G.C.M. 35117 (Nov. 15, 1972) ("[t]he concept of remote continuity originated" in *Groman* and *Bashford*); G.C.M. 39150 (Mar. 1, 1984). General Counsel Memoranda 35117 and 39150 are discussed infra Part III.B.

53. The legislative repeal of *Groman* and *Bashford* is discussed infra Part IV.A.

54. 308 U.S. 415 (1940).

55. See supra note 16 and accompanying text.

even permitted all-cash consideration.[56] Thus, the *Le Tulle* transaction could have been consummated as a statutory merger under the laws of these states.

Since the purpose of the parenthetical clause was to permit transactions that did not qualify as statutory mergers to be treated as tax-free reorganizations, it is odd that the Supreme Court would *deny* reorganization status to a transaction that could have been completed as a statutory merger. In addition, by requiring that the target receive acquiror stock, the Court severed continuity's moorings in the statutory "stock or securities" requirement that Judge Hand had been so careful to preserve in *Cortland* and *Tyng*[57] and which had been extolled in *Pinellas*.[58] Thus, for the first time, the Supreme Court implied that the continuity of interest doctrine might be regarded as a requirement wholly independent of the statutory language. Even a transaction that satisfied every literal requirement of the 1921 Act and satisfied the *Cortland* and *Pinellas* test because the acquiror received substantially all of the assets of the target in exchange for acquiror's "stock or securities" might nevertheless fail to qualify as a tax-free reorganization unless target received stock of the acquiror.

E. *Resurrection: The Emergence of a New Judicial Continuity of Interest Doctrine*

Roebling v. Commissioner[59] is the first case to hold that the judicial continuity of interest doctrine survived the 1934 Act. No less significantly, the court held for the first time that, despite the clear statutory language to the contrary, a *statutory merger* failed to qualify as a reorganization.[60] In

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56. See supra note 39 and accompanying text. Oddly, the Treasury had recognized that legal advance in a 1927 published ruling, which treated a three-corporation consolidation as a reorganization, even as to a corporation whose shareholders were entirely cashed out. I.T. 2364, VI-1 C.B. 13. See infra note 61 for a discussion on this ruling.

57. Prior to *Le Tulle*, circuit court decisions were unanimous that if the target received securities of the acquiror, a sufficient continuity of interest would necessarily be retained. See Commissioner v. Tyng, 106 F.2d 55, 59 (2d Cir. 1939) (citing cases), rev'd, Helvering v. Tyng, 308 U.S. 527 (1940).

58. See *Pinellas*, 287 U.S. at 470 (*Cortland* "harmonizes with the underlying purpose of the provisions in respect of the exemptions *and gives some effect to all the words employed*" (emphasis added)).

59. 143 F.2d 810 (3d Cir. 1944), cert. denied, 323 U.S. 773 (1944).

60. In Morgan Mfg. Co. v. Commissioner, 124 F.2d 602 (4th Cir. 1941), two corporations agreed that if the acquiror paid the liabilities of the target to its shareholders, the target would merge into the acquiror under state law, and the target's shares would be canceled. The court held that even though the merger qualified as such under local law, it was not a tax-free reorganization. However, the decision was not based on continuity of interest, but on the authority of Gregory v. Helvering, 293 U.S. 465 (1935), the court finding that the substance of the transaction was a sale of the target's assets for the amount of liabilities owed to its

Roebling, the South Jersey Gas, Electric and Traction Co. (South Jersey) was merged under New Jersey law into the Public Service Electric and Gas Company (PSE&G), with PSE&G surviving and the former shareholders of South Jersey receiving 100-year bonds of PSE&G in exchange for their South Jersey stock. The court held that the judicial continuity of interest doctrine survived passage of the 1934 Act and, on the authority of *Le Tulle v. Scofield*, also held that continuity was relevant in a statutory merger.

Each of these conclusions was clearly wrong. Under the 1918 Act and every subsequent Revenue Act, the paragon for reorganization treatment was the statutory merger. In 1921, Congress *expanded* the definition of reorganization to additionally include similar transactions that failed to qualify as mergers under state law. From *Cortland* and *Pinellas*, courts had identified acquiror stock consideration as the salient characteristic of those transactions. However, until *Roebling*, it was clear that a statutory merger or consolidation was a tax-free reorganization, even if the consideration was cash.[61] In *Roebling*, the court turned seven Revenue Acts and twelve years of case law on their collective heads, and held that the very model of a tax-free reorganization—a statutory merger in which the target's shareholders received securities of acquiror—failed to qualify as a reorganization.[62]

The *Roebling* court compounded its error by ignoring the Revenue Act of 1934, by which Congress had entirely replaced the judicial continuity of interest doctrine with a solely for voting stock requirement that was applicable *only* to B and C reorganizations. The 1934 Act further affirmed that statutory mergers and consolidations were exempt from any continuity requirement by setting those transactions apart from asset and stock acquisitions in a separate clause that contained no voting stock requirement.

The court's decision also finds no support in *Le Tulle*, which construed the C reorganization definition to require that the target's shareholders receive acquiror stock, despite the subsequent liberalization of state merger law that permitted a statutory merger solely for debt (or even cash) consideration. *Le Tulle* did not disqualify a statutory merger from

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shareholders. The court also indicated that the terms of the merger agreement, which required the target shareholders to receive stock in the surviving corporation, were not in fact met.

61. See I.T. 2364, VI-1 C.B. 13, declared obsolete in Rev. Rul. 69-44, 1969-1 C.B. 312, which involved a consolidation of three corporations, *M*, *N*, and *O*, into a new corporation *P*. The ruling holds that the transaction is a reorganization with respect to each corporation, even though *O* received only cash, which it distributed to its shareholders. Since the consideration received and distributed by *O* was not stock or securities, *O* and its shareholders recognized gain or loss.

62. See Satterlee, supra note 37, at 688 ("the history and structure of the reorganization provisions prior to the Revenue Act of 1934 indicate that any requirement of a continuity of interest was consciously and advisedly omitted from the definition of reorganization in clause A").

reorganization treatment. Moreover, even if *Le Tulle* was correct under pre-1934 law, when Congress revisited the definition of reorganization in 1934, placing "statutory mergers or consolidations" in a separate clause, many contemporary state merger statutes permitted target shareholders to receive only nonequity securities of the acquiror.[63]

Finally, in citing for support the regulations, which provided in a general "purpose" clause (as they do to this day) that continuity of interest is "requisite to a reorganization,"[64] the court ignored several aspects of the regulations. First, the regulations were in fact satisfied in *Roebling* because they reflected (and to some extent still reflect) Judge Hand's pre-*Le Tulle* opinion in *Commissioner v. Tyng* that while short-term notes indicate a sale, a debt security of the acquiror is sufficient to establish continuity.[65] These regulations made clear that compliance with the specific requirements of clauses (A) through (E) of section 112(g)(1) would satisfy continuity because the transactions described in those clauses are, by definition, sufficiently distinguishable from a mere sale.[66] Thus, under the regulations, a statutory merger in which the target shareholders received only acquiror nonequity securities qualified as a reorganization.

III. The New Judicial Continuity of Interest Doctrine in Full Bloom

If *Le Tulle* supplied the breeze that loosened the continuity of interest doctrine from its statutory roots in the "stock or securities" requirement, and *Groman* and *Bashford* the gust that floated the doctrine into fertile soil, *Roebling* is the thunderstorm that allowed the new judicial doctrine to sprout. This Part summarily describes the doctrine in its fullest bloom, a Technicolor

63. See supra note 39 and accompanying text.

64. Regs. 86, § 112(g)-1 (1934).

65. Regs. 101, § 112(g)-1 (1938) ("Purpose") ("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. . . . Accordingly, under the Act, a short-term purchase money note is not a security of a party to a reorganization . . ., and a sale is nevertheless to be treated as a sale, even though the mechanics of a reorganization have been set up").

66. The regulations stated:

> The application of the term "reorganization" is to be strictly limited to the specific transaction set forth in section 112(g)(1). 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 stockholders 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.

Regs. 101, § 112(g)-2 (1938) (emphasis added).

spectacle that retains its color in the recent "anti-*Yoc Heating*" regulations issued under section 338.

The discussion is divided into five topics. First, this Part describes the application of the doctrine to D and F reorganizations and even section 355 divisive transactions. The use of continuity to disqualify a transaction from these provisions is surprising because the early continuity cases stress that it was applicable only to the stock and asset acquisitions described in the original parenthetical clause. Second, this Part examines the remote continuity doctrine, which unexpectedly developed from *Groman* and *Bashford*, cases that had nothing to do with the continuity of interest doctrine and in which the Court found that the transactions at issue were reorganizations. Third, this Part discusses the controversial expansion of continuity to disqualify otherwise valid reorganizations based on post-reorganization conduct of the target's shareholders. Fourth, this Part examines the use of the continuity doctrine as an alternative basis for finding that an acquiror that purchases stock of a target and then merges the target into a subsidiary as part of single integrated transaction is entitled to a stepped-up basis in the target's assets. Finally, this Part discusses the possible expansion of continuity to disqualify otherwise valid reorganizations based on target shareholders' preacquisition conduct.

A. *Expansion of the Continuity Doctrine Beyond the Original Parenthetical*

The original purpose of the continuity of interest doctrine, to distinguish a merger-like stock or asset acquisition from a cash purchase of the target's assets, had no application to the other types of reorganizations, as early case law recognized.[67] Nevertheless, the doctrine is now said to be an extra-statutory requirement of D[68] and F reorganizations (where a virtually 100% continuity requirement is imposed),[69] and even section 355 divisive transactions.[70] The application of continuity to D reorganizations, while perhaps justifiable on policy grounds in a few situations,[71] is not supported by the statute or the original case law. In contrast, the application

67. See, e.g., Hickok v. Commissioner, 32 T.C. 80 (1959) (holding continuity inapplicable to E reorganizations (recapitalizations)); Microdot, Inc. v. United States, 728 F.2d 593 (2d Cir. 1984); Golden Nugget, Inc. v. Commissioner, 83 T.C. 28 (1984). The Service now acknowledges that the continuity of interest doctrine does not apply to E reorganizations. See Rev. Rul. 77-479, 1977-2 C.B. 119; Rev. Rul. 77-415, 1977-2 C.B. 311.

68. See Bittker & Eustice, supra note 5, ¶ 12.26 at 12-92 to 12-93.

69. See Rev. Rul. 79-289, 1979-2 C.B. 145; Rev. Rul. 79-250, 1979-2 C.B. 156; Rev. Rul. 78-441, 1978-2 C.B. 152; Rev. Rul. 75-561, 1975-2 C.B. 129.

70. See Regs. § 1.355-2(c)(1), (2).

71. This topic is discussed below in Part V.C.4.

of continuity to F reorganizations and corporate divisions should be understood as an example of evolutionary convergence: the appearance of a concept analogous to the historic continuity requirement of *Pinellas* and *Cortland*, but unrelated as a matter of pedigree.

1. *D Reorganizations.*—D reorganizations have their genesis in section 203(h)(1)(B) of the 1924 Act, which included as a reorganization "a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred."[72] The original continuity cases were inapplicable because *Cortland* and *Pinellas* interpreted the parenthetical clause describing B and C reorganizations and D reorganizations were not included in that clause or intended as surrogates for statutory mergers. The "control" requirement of modern section 368(a)(1)(D) provided the closest analogy, and at times it was referred to by the courts as the continuity requirement of D reorganizations. The courts made clear, however, that the statutory definition of control, while similar to the continuity concept of *Cortland* and *Pinellas*, superseded it.

This point is made in *Weicker v. Howbert*,[73] where assets of a distributing corporation were transferred to its newly-organized subsidiary and the subsidiary was split-off, with a shareholder of the distributing company exchanging all but one of her shares for a 73% stake in the split-off subsidiary and another exchanging some of his shares for the remainder of the former subsidiary's stock. The court ruled that the transaction did not qualify as a D reorganization under the 1928 Act because, after the split-off, the distributing company's shareholders did not together control the former subsidiary (the single share retained by one of the shareholders being ignored): "In order to [be a D reorganization], there must be a continuity of interest on the part of the transferor corporation or its stockholders in the transferee corporation amounting to a control by the former of the latter."[74]

In 1954, Congress relaxed the control requirement of D reorganizations by permitting it to be met if former shareholders of the distributing corporation were in control of the controlled corporation after the transaction.[75] The current regulations insist that the judicial continuity test is a

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72. Revenue Act of 1924, 203(h)(1)(B), 43 Stat. 253.

73. 103 F.2d 105 (10th Cir. 1939).

74. Id. at 109. See also Williamson v. Commissioner, 27 T.C. 647, 660 (1957) ("The transaction, therefore, fails to qualify as a corporate [D] reorganization because it fails to comply with the provisions of the statute intended to result in a continuity of interest by the transferor corporation or its stockholders, or both, in the transferee corporation").

75. IRC § 368(a)(1)(D) (1954). See S. Rep. No. 1622, 83d Cong., 2d Sess. 273-74 (1954), reprinted in 1954 U.S.C.C.A.N. 4785, 4912.

condition of all reorganizations but also appear to acknowledge that, for D reorganizations, the statutory control test has replaced it.[76]

Nevertheless, issues continue to exist as to whether a transaction that otherwise qualifies as a D reorganization is disqualified if the acquiror's consideration consists of some of its stock but not a sufficient amount to satisfy traditional continuity thresholds,[77] and whether the remote continuity doctrine (discussed below in Part III.B) disqualifies a D reorganization if the target's assets are dropped into a subsidiary before or after the acquisition.[78]

2. *Section 355.*[79]—The current regulations under section 355 provide that judicial continuity is a requirement of tax-free divisive transactions, independent from the statutory control and business purpose tests.[80] This requirement is especially surprising since section 355 sprouted from D reorganizations, which historically were not required to meet judicial continuity, and since the provision permitting tax-free divisive transactions was in 1954 plucked from its place as an addendum to the reorganization provisions and placed in section 355. Section 355 lists several requirements for tax-free treatment but conspicuously omits to include a continuity requirement.

Nonrecognition for corporate divisions was first granted by the 1924 Act,[81] which permitted a tax-free distribution, "in pursuance of a plan of reorganization," of the stock or securities of a corporate party to a reorganization to a shareholder of that (or another) corporate party. This provision disappeared and reappeared in the statute, and finally was revamped in 1954 and moved to its present location in section 355. The 1924 Act also introduced the D reorganization, and it was understood that divisions could be D reorganizations.[82]

Section 355 of the 1954 Code set out the conditions for tax-free treatment under that provision and eliminated the requirement that a tax-free division be a reorganization. This change severed all ties with the continuity of interest doctrine. Nevertheless, while it does not appear that any court

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76. Regs. § 1.368-1(b) provides: "Requisite to a reorganization under the Code are . . . (*except as provided in section 368(a)(1)(D)*) a continuity of interest. . . ." (emphasis added).

77. See Bittker & Eustice, supra note 5, ¶ 12.26[2] at 12-92 to 12-93.

78. See Ginsburg & Levin, supra note 1, § 702.2 at 662-65.

79. For a discussion of the continuity requirement under the § 355 regulations, see Benjamin G. Wells, Continuity of Interest Under the New Section 355 Regulations, 16 J. Corp. Tax'n 203 (1989).

80. Regs. § 1.355-2(c).

81. Revenue Act of 1924, 203(c), 43 Stat. 253.

82. See generally Charles S. Whitman, III, Draining the Serbonian Bog: A New Approach to Corporate Separations Under the 1954 Code, 81 Harv. L. Rev. 1194, 1199-1200 n.25 (1968) (providing an excellent review of the history of § 355).

flunked an otherwise valid section 355 transaction for lack of continuity, the Seventh Circuit in *Redding v. Commissioner*[83] suggested (without any apparent authority) that an otherwise valid section 355 distribution might be rendered taxable by a prearranged sale by the shareholders of more than 50% of the stock received in the controlled company.[84]

Subsequent to the 1986 amendments to section 355 that helped effectuate a repeal of the *General Utilities* doctrine, but prior to the issuance of final regulations under section 355, government officials recognized the difficulty of importing a continuity doctrine into section 355 and struggled to find a statutory basis for such a requirement.[85] The regulations by fiat require continuity as a separate element of a section 355 transaction, in addition to the statutory "business purpose" and "device" tests, despite the absence of any statutory basis.[86]

Quite apart from this separate continuity requirement, a transaction or series of transactions in which the shareholders of a distributing company are able to cash-out their newly received stock tends to indicate a device for the distribution of earnings and profits or the lack of a valid business purpose, either of which is sufficient grounds for denying tax-free treatment. In light of Congress' broad grant of regulatory authority, the section 355 continuity requirement should be viewed as an element of those statutory tests.[87]

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83. 630 F.2d 1169 (7th Cir. 1980).

84. Id. at 1180 n. 22. See also Pamela B. Gann, Taxation of Stock Rights and Other Options: Another Look at the Persistence of *Palmer v. Commissioner*, 1979 Duke L. J. 911, 975 (1979) (discussing possible applicability of continuity test to § 355 transactions, and cited by the *Redding* court).

The reference to 50% was an apparent allusion to Rev. Proc. 77-37, 1977-2 C.B. 568, modified by Rev. Proc. 86-42, 1986-2 C.B. 722, discussed infra Part III.E.

85. See Prop. Regs. § 1.355-2(b) (1977) (stating that continuity is an aspect of business purpose); Lee A. Sheppard, Section 355 and Continuity of Interest, 39 Tax Notes 911, 912 (May 23, 1988) (quoting then-Tax Legislative Counsel Dana Trier: "Continuity of interest is an aspect of device, but that's not the whole point . . . Continuity of interest comes from the business purpose clause, not the device clause, which has its own continuity of interest aspect").

86. Regs. § 1.355-2(c)(1) ("This continuity of interest requirement is independent of the other requirements under section 355").

87. A recent legislative proposal would in effect add a statutory continuity requirement to § 355. In March 1996, the Clinton Administration announced a proposal that would subject the distributing company to tax on the appreciated value of the controlled company unless the "historic" shareholders of the distributing company (generally, those shareholders that owned stock continuously for the two years preceding the distribution) maintain a 50% interest in the vote and value of each of the distributing and controlled companies for a continuous two-year period immediately after the distribution. See Department of the Treasury, General Explanations of the Administration's Revenue Proposals (Mar. 1996); Joint Committee on Taxation, Description of Revenue Provisions Contained in the President's Fiscal Year 1997 Budget Proposal (released on Mar. 19, 1996) (JCS-2-96) (Mar. 27, 1996).

3. *F Reorganizations.*—The use of continuity to bust putative F reorganizations had nothing to do with preventing tax-free treatment for in-substance asset sales, as did *Cortland* and *Pinellas*, but instead was the courts' attempt to corral a rampant section 368(a)(1)(F), which was unloosed by the Service as a weapon against liquidation-reincorporation transactions but before long had turned on its master.[88]

In 1961, after Congress failed to pass legislation curbing tax-free liquidation-reincorporations, the Service asserted the F reorganization as a means to attack transactions in which an operating company was liquidated and reincorporated with shareholders receiving cash and/or notes but maintaining the same proportionate equity interests in the new corporation.[89] If the form of the transaction was respected, the shareholders could claim capital gain or loss on the liquidation. If the transaction was recast as a reorganization, no loss would be recognized, and the liquidation proceeds were taxable as boot (typically, as a dividend).

Although an F reorganization must be "a mere change in identity, form or place of organization,"[90] the Service's argument that it should also encompass multiple operating company transactions was wildly successful. In *Davant v. Commissioner*,[91] a group of shareholders with parallel ownership of two operating companies caused one to purchase the assets of the other and then liquidated the transferor. The Service argued in the Tax Court that the transaction was not only a D but also an F reorganization. The Service later realized the evils that would result from such a holding and attempted to bag its own errant theory by abandoning the F reorganization argument when it went before the Fifth Circuit. However, the effort was in vain. All on its own, the court held that the transaction was both a D *and* an F reorganization.[92]

Almost immediately, taxpayers claimed the spoils of the Service's pyrrhic victory in *Davant*. An F reorganization is the only acquisitive transaction that permits the acquiror to carryback a net operating loss from a year after the acquisition to offset income of the target in a preacquisition year.[93] Thus, if after an F reorganization, the acquiror operates at a loss in a post-

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88. The rise of the F reorganization is recounted in Patricia Ann Metzer, An Effective Use of Plain English—The Evolution and Impact of Section 368(a)(1)(F), 32 Tax Law. 703 (1979) and Richard Crawford Pugh, The F Reorganization: Reveille for a Sleeping Giant? 24 Tax L. Rev. 437 (1969).

89. See Rev. Rul. 61-156, 1961-2 C.B. 62.

90. IRC § 368(a)(1)(F).

91. 366 F.2d 874 (5th Cir. 1966), cert. denied, 386 U.S. 1022 (1967).

92. *Davant*'s litigation history is recounted in Rev. Rul. 69-185, 1969-1 C.B. 108.

93. IRC § 381(b) (flush language), (b)(3). Also enjoying this benefit is a single corporation undergoing an E-type recapitalization. See IRC § 381(a)(2). Also, the taxable year does not terminate as a result of an E or F reorganization.

acquisition year, it may use the losses to offset the target's preacquisition income and obtain a refund. If the reorganization is not an F, any tax benefit from the net operating loss might be delayed or lost altogether.

Now sensitive to the revenue loss that the unleashed F reorganization could wreak on the fisc, the Service attempted first to claim the desirable aspects of F reorganizations only for itself, arguing that they should continue to be liquidation-reincorporation busters but denying the loss carryback benefits to taxpayers engaging in multiple operating company acquisitions. These arguments failed to convince the courts.[94]

Ultimately, the Service conceded universal application of the desirable aspects of F reorganizations, but proposed a narrow interpretation of the definition of an F reorganization. Under Revenue Ruling 75-561,[95] the Service required for F reorganizations of multiple operating companies that (1) both corporations be engaged in the same or an integrated business, (2) the businesses remain unchanged after the acquisition and, most relevant to this discussion, (3) there must be a "complete identity of shareholders and their proprietary interests in the transferor corporations and acquiring corporations." With that ruling, a "super continuity" requirement for F reorganizations was born. The courts accepted these strictures (with a *de minimis* exception),[96] and they appear to remain the law notwithstanding Congress' ultimate (but, alas, probably incomplete) solution to the F reorganization mess: to limit the application of section 368(a)(1)(F) to a single corporation.[97]

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94. See, e.g., Rev. Rul. 69-185, 1969-1 C.B. 108 (describing the Service's litigation position and listing the courts that rejected it).

95. 1975-2 C.B. 129.

96. See, e.g., Romy Hammes, Inc. v. Commissioner, 68 T.C. 900 (1977); Berger Machine Products, Inc. v. Commissioner, 68 T.C. 358 (1977); Rev. Rul. 78-441, 1978-2 C.B. 152 (permitting an F reorganization with a less than 1% ownership shift).

97. See Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 225(a), 96 Stat. 324, 490.

With this change, one might hope that F reorganizations, like E recapitalizations, might entirely escape a continuity requirement. See Rev. Rul. 77-415, 1977-2 C.B. 311 (no continuity requirement for recapitalizations, which involve only one corporation). The Service seems to be moving slowly towards that conclusion. See Rev. Rul. 96-29, 1996-24 I.R.B. 5 (stating that the step transaction doctrine is not applied to disqualify an F reorganization that is part of a series of transactions that ultimately results in a change in shareholder ownership).

However, at least two factors suggest that the Service is unlikely to entirely relinquish its F reorganization continuity requirement. Notwithstanding the unambiguous statutory language, the legislative history indicates that Congress intended to prohibit only F reorganizations involving multiple *operating* companies, leaving the door ajar for multi-corporate F reorganizations. H.R. Rep. No. 760, 97th Cong., 2d Sess. 541 (1982), reprinted in 1982 U.S.C.C.A.N. 781, 1315 (stating that the new limitation "does not preclude the use of more than one entity to consummate the transaction provided only one operating company is involved"). Moreover, treating all mergers into shell companies as F reorganizations might

Although this F reorganization continuity requirement is lumped together with the requirement of A, B, and C reorganizations, it does not share their common ancestry in *Cortland* and *Pinellas*; instead, it should be regarded as an interpretation of the statutory language that limits F reorganizations to the "mere change in identity, form, or place of organization,"[98] which arguably does not occur when such a change is part of a bigger plan to change stock ownership. Nevertheless, it is worth noting that some of the most famous of the continuity cases involve F-reorganizations, and their holdings have been adopted as generally applicable continuity lore.[99]

B. *Remote Continuity*

As discussed above in Part II.E, the Supreme Court held in *Groman* and *Bashford* that, where the consideration consists of stock or securities of two corporations, one of the corporations may be not be a "party to the reorganization," with the result that its consideration is boot. Within a few

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have broader consequences. For example, the forward subsidiary merger of a target company into a newly-formed subsidiary of a corporate parent would be an F reorganization and a sale of stock if the merger failed to qualify under § 368(a)(2)(D) (or as an A, B, or C reorganization), rather than (1) a taxable sale of the target's assets, (2) a contribution by parent of target's assets to the newly-formed subsidiary, and (3) a liquidating distribution by the target of the consideration. Cf. Revenue Ruling 69-6, 1969-1 C.B. 104 (a merger not qualifying as a reorganization is treated as the sale of target's assets and a liquidating distribution of the consideration received). Treatment as an F reorganization and a sale of stock would subject the transaction to only a shareholder level of tax, exempting the target from corporate tax.

The Tax Section of the New York State Bar Association has recommended (as part of the *Yoc Heating* report discussed infra Part IV.B) that the continuity requirement for F reorganizations be abrogated for the second step of a two-part transaction in which a parent company makes a qualified stock purchase of target and then merges the target into the parent's newly-formed subsidiary. (It would probably exceed the Service's good graces to allow target minority shareholders to receive parent stock in the merger.)

This recommendation is the sensible result for an innocuous transaction that is consistent with the original purpose of the F reorganization. It recognizes that, after the 1982 amendment, the strict continuity requirement of F reorganizations is no longer necessary to prevent taxpayers from capitalizing on the ability of the acquiror in an F reorganization to carry post-acquisition net operating losses to preacquisition years, and it also highlights that the historical continuity requirement of *Cortland* and *Pinellas* has no application to F reorganizations, which are governed by rules specific to the purpose behind § 368(a)(1)(F).

98. IRC § 368(a)(1)(F).

99. See, e.g., Yoc Heating Corp. v. Commissioner, 61 T.C. 168 (1973). The *Yoc Heating* court was careful to cite only F reorganization cases as authority for its continuity holding, thus retaining (if only theoretically) the distinction between F reorganizations' special continuity requirement and the more generally applicable judicial continuity of interest doctrine. See id. at 178 (citing Helvering v. Southwest Corp., 315 U.S. 194 (1942) and Berghash v. Commissioner, 43 T.C. 743 (1965), aff'd, 361 F.2d 257 (2d Cir. 1966)).

years, those decisions were expanded beyond situations where the target received consideration from two corporations.

For example, in *Anheuser-Busch, Inc. v. Helvering*,[100] the target's shareholder received only acquiror stock, but the acquiror subsequently transferred the target's assets to a subsidiary. The court held that the parent stock was "other property" received in a reorganization. This holding was not a necessary consequence of *Groman* and *Bashford*. The *Anheuser-Busch* court could certainly have concluded that where the consideration consists of stock or securities of one corporation, that party is the true acquiror, and any subsequent transfer is independent of the reorganization. Nevertheless, *Anheuser-Busch* is not inconsistent with a reading of *Bashford* that determines the true acquiror by following target's assets and therefore denies "party" status to the parent of an ultimate operating company.

And, *Anheuser-Busch* remained true to the basic issue in *Groman* and *Bashford*: Was the putative acquiror a party to the reorganization, or should its stock or securities be treated as "other property" (boot)? The transaction in *Anheuser-Busch* was recharacterized as a tax-free reorganization of target into subsidiary in which target's shareholder received "other property." This holding confirms that the parent's stock supplied the requisite continuity, even though it was not stock of a party to the reorganization. Had the transaction failed continuity, it would not have been a reorganization, and the parent stock received by target's shareholder would have been sales proceeds and not "other property."

The Service no longer treats *Groman* and *Bashford* as "party" cases that cause certain consideration to be treated as "other property," but instead as the foundations of a "remote continuity" doctrine that entirely disqualifies a reorganization (including a statutory merger) if the target's assets are separated from the acquiror's consideration by an intervening impermissible entity.[101] Presumably, the theory behind this view is that continuity requires that a quantum of the consideration must consist of stock of the true acquiror, and if all of the consideration received by target shareholders is stock of a nonparty, none of the consideration counts for continuity purposes. However, this interpretation is entirely inconsistent with the *Groman*, *Bashford*, and *Anheuser-Busch* decisions, which all acknowledge that the acquisitions

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100. 115 F.2d 662 (8th Cir. 1940).

101. See, e.g., G.C.M. 35117 (Nov. 15, 1972) ("the transaction will not qualify as a tax-free reorganization under Code § 368(a)(1)(A) . . . unless S is a 'party to the reorganization' . . . "); G.C.M. 35486 (Sept. 20, 1973) ("The term 'continuity of interest' has come to be employed by the courts, the service, and the commentators as a reference to the various litmus-like qualifications imposed on tax-free reorganizations."); G.C.M. 39150 (Mar. 1, 1984). See also Ginsburg & Levin, supra note 1, §§ 610.11.1, 610.11.2, at 630-37.

considered in those cases qualified as reorganizations.[102] This interpretation is also inconsistent with the original purpose of the continuity of interest doctrine to distinguish merger-like asset acquisitions from sales, based on the nature of the consideration. *Anheuser-Busch*, in particular, could certainly have been accomplished as a state law merger solely for acquiror stock, followed by the drop down, without invoking the concern in *Pinellas* and *Cortland* that the target (or even its shareholders) get cashed out. And, while early merger statutes did not permit third-party consideration, there is no suggestion that the form in *Bashford* would not have been respected as a valid state law merger. In any event, some liberal merger statutes that were in place by 1934 expressly permitted stock or securities of a subsidiary or parent of the acquiror to serve as consideration.

Moreover, there is nothing inconsistent with the parent's stock providing sufficient equity interest to satisfy the continuity doctrine, but at the same time not being stock of a party to the reorganization.[103] *Cortland* and *Pinellas* were concerned with the treatment of a target that received cash equivalents in a putative reorganization; *Le Tulle* further required that the target receive consideration assuring some continued participation in target's former business. The *Anheuser-Busch* transaction satisfied that test. Although the target's shareholder received equity in a holding company, the economic effect was no different than had an operating acquiror obtained target's assets directly.

The distinction between *Groman* and *Bashford* as "party" cases or as establishing a remote continuity doctrine is subtle but important. Consider the alternative consequences to the target in a transaction in which the target merges into a second-tier subsidiary of the acquiror, and the target shareholders' consideration consists 10% of the second-tier subsidiary's stock and 90% of grandparent stock.[104] If *Groman* and *Bashford* are about continuity of interest, a finding of "discontinuity" would cause a transaction that otherwise qualifies as a reorganization to be a taxable sale. The second-tier

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102. See, e.g., *Anheuser-Busch*, 115 F.2d at 666 ("the Board concluded . . . 'the subsidiary and not the parent was a party to the reorganization.' We agree with the Board's conclusion").

103. An analogous issue is likely to arise if the Clinton Administration's current proposal to treat certain preferred stock as boot becomes law. Under *Nelson*, preferred stock is good consideration for continuity purposes, but under the Administration's proposal, it would be boot. For the reasons discussed in the text, there is nothing inconsistent with this result.

104. Cf. G.C.M. 39150 (Mar. 1, 1984) (dropping less than all of target's assets into a partnership owned 99% by acquiror may defeat reorganization status, depending on facts and circumstances).

It is important that target shareholders receive some stock or securities of a party to the reorganization in order to fit within the statutory requirements of § 361(a) and (b).

subsidiary would not accede to target's tax attributes or its asset bases; the target would recognize gain or loss equal to the difference between the value of its assets and their bases; and the acquiror's consideration (second-tier subsidiary and grandparent stock) would be received by the target's shareholders in liquidation of the target. If, on the other hand, *Groman* and *Bashford* are "other property" cases, the transaction would be a reorganization, and the second-tier subsidiary would take the target's attributes (including its net operating losses) and asset bases (increased by any gain recognized by the target); if the target distributes all of the consideration to its shareholders, it would recognize no gain or loss, and its shareholders would recognize gain (but not loss) only to the extent of the "other property" (grandparent stock).[105]

The Service's dogmatic adherence to remote continuity is perhaps best revealed in its approach to partnership drop-downs. The Service treats a drop-down of the target's assets to a 99%-owned partnership as an action that breaks the continuity of a contemporaneous merger, notwithstanding the legislative repeal of *Groman* and *Bashford* discussed below in Part IV.A.[106] Dropping fewer than all of the target's assets into a 99%-owned general partnership makes or breaks continuity, based on a "facts and circumstances" test.[107] This position renders the reorganization provisions of the Code almost entirely elective for intra-group transactions (subject perhaps to the partnership anti-abuse regulations),[108] a conclusion confirmed by the Service's enforcement of the remote continuity doctrine even for reorganizations among wholly-owned entities of a single corporate parent.[109] Moreover, it appears that the Service continues to insist that grandparent stock may not be used as consideration in a statutory merger, but that

105. See IRC § 361(b) (no gain or loss to target on the exchange); § 361(c) (target recognizes gain with respect to appreciated property that is distributed); § 354(a) (target shareholders do not recognize gain or loss with respect to acquiror stock); § 356(a), (c) (target shareholders recognize gain, but not loss, with respect to parent stock); § 362(b) (basis to acquiror).

106. See G.C.M. 39150 (Mar. 1, 1984); G.C.M. 35117 (Nov. 15, 1972). See generally Alfred D. Youngwood & Deborah B. Weiss, Partners and Partnerships-Aggregate vs. Entity Outside of Subchapter K, 48 Tax Law., 39, 57-60 (1994).

A Service official recently stated that G.C.M. 39150 and 35177 are under reconsideration. See Juliann Avakian Martin, IRS Considers Guidance on Post Reorganization Sales and Continuity of Interest, 96 TNT 55-9 (Mar. 19, 1996) (LEXIS, FEDTAX library, TNT file) (quoting Nelson F. Crouch, Chief of Branch 1: "The GCMs are out there . . . and we don't like them anymore").

107. G.C.M. 39150 (Mar. 1, 1984).

108. Regs. § 1.702-1.

109. See G.C.M. 39150 (Mar. 1, 1984) (discussing continuity in the context of a partnership whose partners are the corporate subsidiaries of a single parent).

sections 368(a)(2)(C) and 368(a)(2)(D) can be used concurrently to achieve tax-free treatment.[110]

In addition, the Service regards pre-transaction drop-downs by a target as analytically indistinguishable from the post-transaction drop-down at issue in *Anheuser-Busch.* Arguably, pre-transaction drop-downs are a step removed from *Anheuser-Busch,* and two steps away from *Bashford,* because there is no doubt that the acquiror is the true acquiror and not a broker for its subsidiary, as the Court found in *Bashford.* However, if one accepts the *Anheuser-Busch* expansion of *Groman-Bashford,* treating parent stock as other property in a post-reorganization drop-down of the target's assets to a subsidiary, there is some merit to the Service's conclusion that the same result should obtain in a pre-transaction drop-down. As a conceptual matter, however, in keeping with *Groman* and *Bashford,* the issue should be whether the target or target's partnership is the true "party to the reorganization," and not whether the transaction lacks continuity.[111] The original continuity of interest doctrine, as expressed in *Pinellas* and *Cortland,* is singularly concerned with the nature of the consideration and not with its spacial relationship to target's assets.

C. *Post-Reorganization Target Shareholder Conduct*

Perhaps the most significant expansion of the continuity of interest doctrine is its use to disqualify a reorganization based on target *shareholders'* intent and subsequent conduct. *Heintz v. Commissioner*[112] was apparently the earliest decision to take this uneasy step, and the principle was firmly

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110. See, e.g., Rev. Rul. 74-564, 1974-2 C.B. 124 (use of grandparent stock does not qualify under § 368(a)(2)(E); transaction nevertheless qualifies as a B reorganization); Rev. Rul. 74-565, 1974-2 C.B. 125 (same). See generally James A. Nitsche, Asset Remoteness Problems Persist in Affiliated Group Acquisitive Reorganizations, 83 J. Tax'n 94 (1995); Robert A. Rizzi, Continuity of Interest and Reorganizations: Toward a Unified Theory, 17 J. Corp. Tax'n 362, 366-68 (1991). Thus, apparently, a direct merger of the target into a second-tier subsidiary for grandparent stock may be taxable, but a merger of the target into a first-tier subsidiary for parent stock, followed by a drop-down of target assets into a second-tier subsidiary, is generally tax-free. See, e.g., Rev. Rul. 64-73, 1964-1 C.B. 142. Cf. Rev. Rul. 83-34, 1983-1 C.B. 79 (successive § 351 drop-downs are permissible); Rev. Rul. 77-449, 1977-2 C.B. 110 (same).

111. In Commissioner v. First Nat'l Bank, 104 F.2d 865 (3d Cir. 1939), the target transferred 86% of its assets to a newly-formed acquiror in exchange for acquiror stock and, pursuant to a plan, transferred that acquiror stock to the shareholders of acquiror's parent corporation for parent stock. The court held that the target had engaged in a reorganization but, under *Groman* and *Bashford,* the parent was not a party to that reorganization and was subject to tax. See Ballwood Co. v. Commissioner, 84 F.2d 733 (3d Cir. 1936) (predating *Groman* and *Bashford*); Electrical Sec. Corp. v. Commissioner, 92 F.2d 593 (2d Cir. 1937) (predating *Groman* and *Bashford*).

112. 25 T.C. 132 (1955).

planted in *McDonald's Restaurants of Illinois v. Commissioner.*[113]

Heintz and *McDonald's* involved similar facts: Target shareholders, desiring cash for their shares, accepted acquiror stock on the condition that the acquiror assist them in selling the stock to unrelated investors shortly thereafter.[114] The taxpayers in each case drew the continuity sword and argued that the side agreement severed continuity and caused the transaction to be a taxable sale.[115] In each case, the taxpayers prevailed.[116]

These "shareholder conduct" cases are expansions—rather than necessary consequences—of the original continuity cases, for several reasons. First, the analysis in the original decisions was directed solely at the corporate level, and examined only the nature of the consideration given by the acquiror in order to determine whether the transaction was more like a merger or a sale. In *Heintz* and *McDonald's*, the inquiry was focused at the shareholder level, and continuity was found lacking even though the target and its shareholders indisputably received acquiror stock in form and in substance. Target shareholders were under no compulsion to sell the acquiror's stock, they bore the risk of market fluctuations in the price of the stock, and there was no assertion that the stock should not be treated as equity for federal income tax purposes as a result of the side agreement between target shareholders and the acquiror.[117] Thus, the acquiror's stock quite clearly conferred, first in the

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113. 688 F.2d 520 (7th Cir. 1982), rev'g McDonald's of Zion v. Commissioner, 76 T.C. 972 (1981).

114. In *Heintz*, the transactions were structured as a stock exchange followed immediately by a liquidation of the subsidiary; in *McDonald's*, the target merged into the acquiror under a state statute.

115. In *Heintz*, target shareholders argued for sale treatment to recognize capital gains rather than ordinary "boot" income. In *McDonald's*, the acquiror sought sale treatment to achieve a stepped-up basis in the target's assets.

116. In contrast, in United States v. Adkins-Phelps, Inc., 400 F.2d 737 (8th Cir. 1968), the acquiror prevailed in asserting that a statutory merger was a reorganization, notwithstanding the agreement of the target's sole shareholder not to sell acquiror stock without offering it first to the acquiror at par value and the subsequent sale of acquiror stock back to acquiror at par. To similar effect are Commissioner v. Fifth Ave. Bank of New York, 84 F.2d 787 (3d Cir. 1936) (an option exercised by 99% of target shareholders to sell their acquiror stock for cash to acquiror's subsidiary did not defeat continuity); Daisy M. Ward v. Commissioner, 29 B.T.A. 1251 (1934), nonacq. 1934-1 C.B. 31, aff'd sub nom Helvering v. Ward, 79 F.2d 381 (8th Cir. 1935) (where target shareholders had, and exercised, an option to resell their acquiror stock back to acquiror, reorganization respected as separate from sale).

117. Compare Farr v. Commissioner, 24 T.C. 350 (1955), where the court found continuity to be met in a split-off under § 112(g)(1)(D) (1939), even though its purpose was to permit sale of distributing company stock to a third party (which was accomplished). The court stressed that "petitioner remained free to retain her entire interest in [the distributing company], [the buyer] was under no obligation to purchase any interest, and the petitioner alone had the risks and the benefits of [the distributing company's] continuing operations." *Farr*, 24 T.C. at 367.

target and then in its shareholders, a "proprietary stake" in the acquiror that was "definite and material,"[118] and certainly exceeded the equity risk that is sufficient to establish continuity under established case law.[119]

Second, in contrast to the historical continuity cases, the cash ultimately received by target shareholders in *Heintz* and *McDonald's* came not from the acquiror, but from unrelated secondary purchasers of target shareholders' acquiror stock. Unless these public shareholders are treated as the true acquirors of the target's assets, which is difficult to understand given the interposition of the acquiror, these shareholder conduct cases are clearly distinguishable from the asset sales in *Pinellas* and *Cortland*. In addition, since target shareholders bore the risk of market fluctuations in the value of the acquiror stock, the transaction was economically dissimilar from a direct sale of target stock for a cash equivalent.[120]

The fact that the historic roles of the litigants were reversed (taxpayers were asserting the absence of continuity) should have alerted the courts to the possibility that something was essentially different about these cases. Suddenly, the parties to a transaction that satisfied the statutory elements of a reorganization could, through side agreements, escape the package of beneficial and adverse tax consequences accompanying that characterization. Continuity was now the taxpayer's weapon.

Finally, the shareholder conduct cases introduced a cloak of uncertainty to the reorganizations area by hinging momentous tax consequences not simply on the nature of acquiror's consideration provided to target, but on the post-acquisition conduct of a critical mass of unrelated target shareholders. The result is uncertainty for taxpayers and unadministrability for the Service. The courts should have immediately recognized the unworkable nature of the test they were creating.

These shareholder conduct cases are better explained as a corollary of the step transaction doctrine that permits interdependent events to be

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118. Helvering v. Minnesota Tea Co., 296 U.S. 378 (1935).

119. See, e.g., John A. Nelson Co. v. Helvering, 296 U.S. 374 (1935) (preferred stock redeemable at stated intervals was sufficient to establish continuity); United States v. Adkins-Phelps, Inc., 400 F.2d 737 (8th Cir. 1968) (where acquiror had right of first refusal to purchase its shares at par from target shareholder, continuity satisfied); Schweitzer & Conrad, Inc. v. Commissioner, 41 B.T.A. 533 (1940) (nonconvertible nonvoting preferred stock, redeemable at any time and mandatorily redeemable after six months if earnings exceeded specific threshold, was sufficient equity stake for continuity purposes). See also Rev. Rul. 68-22, 1968-1 C.B. 142 (preferred stock, redeemable at 10% per year after one year, is sufficient equity consideration if acquiror has no present intention to redeem).

120. See McDonald's of Zion v. Commissioner, 76 T.C. 972, 997 n.43 (1981) (the market price of McDonald's stock on receipt was $66-3/8 per share; the stock was sold for $71-3/8); Heintz v. Commissioner, 25 T.C. 132, 139 (1955) (acquiror stock was worth $50 when received but was sold for $30).

integrated and, in certain circumstances, permits taxpayers to disavow their form if the tax treatment of the entire transaction is consistently reported.[121] In any event, it is important that these cases involved a concerted plan between the target shareholders and the acquiror.

Revenue Procedure 77-37,[122] which lists the representations necessary to obtain a private letter ruling, in effect offers a continuity safe harbor on the issue of extracurricular intent and conduct if the target's 1% (or for publicly-traded targets 5%) shareholders represent to the acquiror their plan and intention to retain acquiror stock representing at least 50% of the value of the target's outstanding stock immediately before the transaction. (The target's management must also represent that it knows of no plan or intention on the part of the remaining target shareholders to dispose of acquiror stock in excess of the 50% threshold.) Revenue Ruling 66-23[123] concludes that a five-year holding period of unrestricted rights of ownership should "ordinarily" suffice.

However, taxpayers that drift (intentionally or inadvertently) from these quantitative and temporal havens risk dangerously dark and murky waters. Commentators assert that the Service could bust an otherwise valid reorganization for *all of the parties* if a sufficiently large shareholder engages in a short-sale-against-the-box with respect to acquiror stock,[124] even though

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121. See generally Penrod v. Commissioner, 88 T.C. 1415, 1428 (1987) ("The resolution of this issue turns on the application of the so-called step transaction doctrine," explaining *Heintz* and *McDonald's* on that ground and finding continuity to be present despite sale of acquiror's stock with acquiror's assistance); Estate of Christian v. Commissioner, 57 T.C. Memo (CCH) 1231, 1239, T.C. Memo (P-H) ¶ 89,413 at 89-2014 (1989) (same). See also Ericsson Screw Machine Products Co. v. Commissioner, 14 T.C. 757 (1950). Severe restrictions on taxpayers' ability to invoke the step transaction doctrine are noted in Pittsburgh Realty Inv. Trust v. Commissioner, 67 T.C. 260, 274-78 (1976). See also Estate of Durkin v. Commissioner, 99 T.C. 561 (1992). See generally Ginsburg & Levin, supra note 1, § 608 at 536-56.

122. 1977-2 C.B. 568, as modified by Rev. Proc. 86-42, 1986-2 C.B. 722.

123. 1966-1 C.B. 67; see also Rev. Rul. 78-142, 1978-1 C.B. 111.

124. See Ginsburg & Levin, supra note 1, § 610.6.3 at 599-600. This issue has sparked the passion of tax practitioners on both sides. See Robert Willens & Andrea J. Phillips, Do Equity Swaps Affect Satisfaction of Continuity of Interest? 95 TNT 132-28 (LEXIS, FEDTAX library, TNT file) (answer: "no" for short-sales-against-the-box and equity swaps); Jared M. Rusman, Equity Swaps and Post-Transaction Continuity of Interest, 96 TNT 128-110 (LEXIS, FEDTAX library, TNT file) ("serious risk" that an equity swap or short-against-the-box could break continuity); Robert Willens & Andrea J. Phillips, Continued Interest in the Continuity of Interest Debate, 96 TNT 137-88 (LEXIS, FEDTAX library, TNT file) ("vigorously contest[ing] several of Mr. Rusman's assertions" and "eagerly await[ing] Mr. Rusman's response, should he choose to submit one"). Mr. Rusman has of yet not answered the challenge.

such a shareholder could truthfully make the representation required by Revenue Procedure 77-37.[125]

D. Double Duty—Application of the Continuity of Interest Doctrine to Integrated Asset Purchases

Continuity was expanded to a fourth category of cases involving integrated transactions in which an acquiror purchased stock but took additional steps in order to treat the transaction as an asset sale. Although the continuity doctrine provided a convenient basis to permit the stock sale to be treated as an asset sale, its invocation in these cases led to a great deal of confusion.

In a line of cases beginning before *Pinellas*, courts unanimously held that where a taxpayer expresses an unambiguous intention to purchase the assets of an incorporated company but for various business reasons is able to accomplish the asset purchase only by purchasing the company's stock and dissolving the corporation, the acquiror would be permitted (and, in fact, required) to treat the stock purchase and subsequent dissolution as a single integrated transaction for which the acquiror obtains a cost—rather than a carryover—basis in the target's assets.[126] The cases applied this "integrated transaction doctrine" whether the target was dissolved (1) by upstream merger with[127] or liquidation into[128] the acquiror, (2) pursuant to a merger of the

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125. In a short-sale-against-the-box, the shareholder retains the acquiror stock but borrows other acquiror stock and sells it into the market. Since the shareholder does not dispose of the acquiror stock received in the acquisition, the representation is not breached.

126. See, e.g., Security Indus. Ins. Co. v. United States, 702 F.2d 1234 (5th Cir. 1983); American Potash & Chem. Corp. v. United States, 399 F.2d 194 (Ct. Cl. 1968); United States v. M.O.J. Corp., 274 F.2d 713 (5th Cir. 1960); Cannonburg Skiing Corp. v. Commissioner, 51 T.C. Memo (CCH) 844, T.C. Memo (P-H) ¶ 86,150 (1986), aff'd sub nom. Russell v. Commissioner, 832 F.2d 349 (6th Cir. 1987); Estate of McWhorter v. Commissioner, 69 T.C. 650 (1978), aff'd without written opinion, 590 F.2d 340 (8th Cir. 1978); Yoc Heating Corp. v. Commissioner, 61 T.C. 168 (1973); Long Island Water Corp. v. Commissioner, 36 T.C. 377 (1961); Southwell Combing Co. v. Commissioner, 30 T.C. 487 (1958); American Wire Fabrics Corp. v. Commissioner, 16 T.C. 607 (1951); Kimbell-Diamond Milling Co. v. Commissioner, 14 T.C. 74 (1950), aff'd per curiam, 187 F.2d 718 (5th Cir.), cert. denied, 342 U.S. 827 (1951); Schumacher Wall Board Corp. v. Commissioner, 33 B.T.A. 1211 (1936); Warner Co. v. Commissioner, 26 B.T.A. 1225 (1932).

127. Cannonburg Skiing Corp. v. Commissioner, 51 T.C. Memo (CCH) 844, T.C. Memo (P-H) ¶ 86,150 (1986), aff'd sub nom. Russell v. Commissioner, 832 F.2d 349 (6th Cir. 1987); Estate of McWhorter v. Commissioner, 69 T.C. 650 (1978), aff'd without written opinion, 590 F.2d 340 (8th Cir. 1978). See also Kass v. Commissioner, 60 T.C. 218 (1973).

128. See, e.g., Security Indus. Ins. Co. v. United States, 702 F.2d 1234 (5th Cir. 1983); United States v. M.O.J. Corp., 274 F.2d 713 (5th Cir. 1960); Commissioner v. Ashland Oil & Ref. Co.. 99 F.2d 588 (6th Cir. 1938); Southwell Combing Co. v. Commissioner, 30 T.C. 487 (1958); Koppers Coal Co. v. Commissioner, 6 T.C. 1209 (1946); Warner Co. v. Commissioner, 26 B.T.A. 1225 (1932).

target into the acquiror's subsidiary,[129] or (3) following an asset transfer by the target to the acquiror's subsidiary.[130] As discussed below, these decisions were partially codified, first in 1954 and then in 1982 under current section 338.

Despite the uniform holdings of these cases, their legal bases varied depending upon the method that the taxpayer used to dissolve the target. Prior to 1936, the courts could respect each independent step of the transaction because the target's liquidation was a taxable event to its shareholders and therefore gave the acquiror a stepped-up basis in the target's assets.[131] After the enactment of section 112(b)(6) of the Revenue Act of 1936, which provided for tax-free liquidations with substituted basis, the liquidation of the target into a corporate acquiror following a stock purchase did not provide the acquiror with a stepped-up basis under the statute. Instead, courts permitted stepped-up bases by applying the common law principle of substance over form to disregard the transitory ownership of target stock and treat the stock purchase and liquidation as a single asset purchase by the acquiror under an integrated transaction doctrine.[132]

If the acquiring company purchased target stock and the acquiror then either merged the target into (or caused it to transfer its assets to) a new or existing subsidiary, the continuity of interest doctrine was added to and combined with the integrated transaction doctrine as an additional pillar of support against the Service's assertion that the merger was a tax-free reorganization giving rise to a carryover basis.[133] Since continuity was originally designed to deny corporate targets reorganization treatment on sales of their assets for cash or short-term notes, it was serving double duty as a

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129. Superior Coach of Florida, Inc. v. Commissioner, 80 T.C. 895 (1983); Long Island Water Corp. v. Commissioner, 36 T.C. 377 (1961). In *Superior Coach*, the acquirors were individual majority shareholders of an existing corporation who purchased target stock and caused the target to merge into their existing corporation, with former target shareholders receiving stock of their corporation. In *Long Island Water*, target shares were purchased by a parent company and contributed to a newly-formed subsidiary, and the target was then merged upstream into the subsidiary.

130. Yoc Heating Corp. v. Commissioner, 61 T.C. 168 (1973) (involving an asset transfer); American Wire Fabrics Corp. v. Commissioner, 16 T.C. 607 (1951); Schumacher Wall Board Corp. v. Commissioner, 33 B.T.A. 1211 (1936).

131. See, e.g., Commissioner v. Ashland Oil & Ref. Co., 99 F.2d 588, 591 (6th Cir. 1938); Koppers Coal Co. v. Commissioner, 6 T.C. 1209, 1221 (1946).

132. See *Koppers Coal Co.*, 6 T.C. 1209 (1946). In Kimbell-Diamond Milling v. Commissioner, 14 T.C. 74 (1950), aff'd per curiam, 187 F.2d 718 (5th Cir.), cert. denied, 342 U.S. 827 (1951), where the target's assets had a higher basis than the price paid for target stock, it was the Service, not the taxpayer, that argued for integrated transaction treatment.

133. Prairie Oil & Gas Co. v. Motter, 66 F.2d 309, 311 (10th Cir. 1933); Yoc Heating Corp. v. Commissioner, 61 T.C. 168, 171 (1973); Carter Publications, Inc. v. Commissioner, 28 B.T.A. 160, 164 (1933).

basis for permitting taxpayers to treat an integrated stock purchase and merger as an asset purchase. This doctrinal expansion produced no distortions when the sole issue was whether the acquiror obtained a cost basis in the transferred assets. However, the continuity of interest doctrine was far too blunt an instrument to provide the correct answer when it was applied to the target in these cases.

Under the law after 1936 and before 1954, if a purchase of target stock and the target's subsequent merger into the acquiror was treated under the integrated transaction doctrine as a liquidation of the target and the sale of its assets by target shareholders to the acquiror, the target was not affected by the recharacterization. Under the statutes then in effect, a corporation generally recognized no gain or loss on distributing its assets in liquidation, and the *Cumberland* case[134] permitted this rule to apply if the shareholders had first unsuccessfully attempted to sell their stock to the acquiror and then liquidated target and sold its assets.[135] The *Cumberland* holding certainly appears to have applied to a stock sale by target shareholders, followed by a merger of the target into the acquiror or acquiror's subsidiary, if the transactions were recharacterized under the integrated transaction doctrine as a liquidation of the target followed by an asset sale by target shareholders. However, since a failure of continuity historically resulted in the target being treated as *selling* its assets to the acquiror, the logical extension of applying the continuity of interest doctrine to these cases appears to be a corporate-level tax on the target—a result entirely ignored by the courts that applied the doctrine to taxable years between 1936 and 1954.[136] This suggests either that the continuity doctrine cited as a rationale for these cases was no longer the doctrine of *Cortland* and *Pinellas*, or else that courts were applying an integrated transaction doctrine, and not continuity.

This distinction remains important under current law.

> *Example.* Target is a wholly-owned subsidiary of a corporate Seller, and the two corporations file a consolidated return. Acquiror

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134. United States v. Cumberland Pub. Serv. Co., 338 U.S. 451 (1950).

135. See generally Bittker & Eustice, supra note 5, ¶ 10.05[5] at 10-31 to 10-34 and ¶ 10.41, at 10-84 to 10-89. Section 337 extended nonrecognition treatment to targets that sold their assets in the 12-month period prior to liquidation.

136. See Commissioner v. Ashland Oil & R. Co., 99 F.2d 588, 593 (6th Cir. 1938) (Hamilton, J., dissenting on grounds that target should be subject to tax on deemed asset sale). Cf. Carter Publications Inc. v. Commissioner, 28 B.T.A. 160 (1933) (taxing the target on deemed asset sale under continuity of interest theory, as applied to tax year before 1936).

Between 1954 and 1987, this result was codified in § 334(b)(2), which gave the acquiror a stepped-up basis in target's assets without subjecting the target to tax on any appreciation in the value of its assets. See infra note 156 and accompanying text.

purchases 79% of Target's stock[137] from Seller for cash and, as part of an integrated transaction, merges Target upstream into Acquiror, with Seller receiving Acquiror stock for the remaining 21% of Target's stocks.

If the integrated transaction doctrine is applied, Target is treated as first having liquidated tax-free into Seller,[138] and Seller is treated as selling Target's assets to Acquiror. Seller recognizes gain or loss equal to the difference between the value of the consideration received and Target's basis in its assets, and Acquiror holds Target's assets with a cost basis. Continuity has no place in this analysis because the merger is disregarded and the liquidation is deemed to occur prior to the asset transfer.

On the other hand, if the continuity of interest doctrine is applied, Target recognizes gain on either of two theories. First, the stock purchase by Acquiror could be respected, but if so, the upstream merger of Target into Acquiror fails continuity because Acquiror is not Target's historic shareholder.[139] Under this analysis, Seller has gain or loss equal to the difference between the value of the consideration received and its basis in the Target *stock*, and, after being deconsolidated from Seller, Target is treated as making a taxable sale of its assets to Acquiror in the upstream merger.[140] Alternatively, the stock purchase by Acquiror could be ignored, and Target could be viewed as merging directly into Acquiror, with Seller receiving Acquiror stock and cash.[141] The 21% equity consideration received by Seller is insufficient to satisfy traditional tests of continuity. Acquiror obtains a stepped-up basis under either theory, but, under the second, Target's gain or loss occurs while it is still a member of Seller's consolidated group.[142]

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137. This percentage is important because it bypasses the statutory result imposed by § 338 that is discussed infra Part IV.B.

138. IRC § 332. Seller acquires Target's assets with a carryover basis. See IRC § 334.

139. This was the apparent rationale of *Kass* and *Superior Coach*. See Superior Coach of Florida v. Commissioner, 80 T.C. 895, 906-07 (1983); Kass v. Commissioner, 60 T.C. 218, 222-23 (1973).

140. Whether Target's gain or loss is properly includible in Seller's or Acquiror's consolidated return is another matter. See Regs. § 1.1502-76(b)(1)(ii)(B)(4) (providing an exception to next-day rule for prearranged transactions) and (b)(2)(ii)(C) (providing an exception to ratable allocation rule for items that result in substantial distortion).

141. King Enterprises, Inc. v. United States, 418 F.2d 511 (Ct. Cl. 1969) (applying this analysis to treat as an A reorganization the upstream merger of target into acquiror following acquiror's purchase of target stock for consideration consisting 51% of acquiror stock).

142. Other uncertainties exist. If the first continuity analysis described in the text were applied literally, it would deny reorganization treatment on the second step merger even if the stock purchase was entirely for acquiror stock.

Under either theory, the transaction is taxable to a minority shareholder of Target. Regardless of whether the transaction is viewed as a liquidation followed by an asset sale, or as a stock sale followed by a busted reorganization (a taxable asset sale) and then a liquidation of Target, the minority shareholder is subject to tax. It was more or less the second theory that the Tax Court used in *Kass v. Commissioner*[143] as its basis for taxing one of Target's minority shareholders on her receipt of acquiror stock.[144]

Thus, although courts in these integrated transaction cases often appended the continuity doctrine as an alternate basis to find that an otherwise valid reorganization could be combined with an antecedent stock purchase and treated as a single asset purchase, the expansion of the continuity doctrine to reach this result only muddled the law. Moreover, these aspects of the integrated transaction doctrine (and its interaction with continuity) have been further complicated by the enactment of section 338, the repeal of *General Utilities*, and certain recently promulgated regulations which would significantly limit—but not eliminate—the application of continuity to many integrated transactions. These developments are discussed below in Part IV.B.

E. *The Specter of Historic Shareholder Continuity*

Lurking behind the integrated transaction cases is the possibility, suggested by the Service and commentators, that those cases may not be limited to an acquiror's concerted effort to purchase a target's assets. Instead, the cases might establish the continuity of interest doctrine as requiring a continuous thread of ownership linking the target's shareholders before the

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From time to time, courts have suggested that the first analysis is proper. See Russell v. Commissioner, 832 F.2d 349 (6th Cir. 1987); Kass v. Commissioner, 60 T.C. 218 (1973), aff'd without published opinion, 491 F.2d 749 (3d Cir. 1974). However, when push has come to shove, and the issue is squarely presented, the second analysis has been adopted (albeit not expressly). See King Enterprises v. United States, 418 F.2d 511 (Ct. Cl. 1969).

143. 60 T.C. 218 (1973), aff'd without opinion, 491 F.2d 749 (3d Cir. 1974). See also Russell v. Commissioner, 832 F.2d 349 (6th Cir. 1987).

144. In *Kass*, the acquiror first purchased more than 80% of the target's stock for cash and then merged the target upstream into the acquiror, with minority shareholders who had retained their target stock (including the taxpayer) receiving acquiror stock in exchange for their former target stock. The court held that because the acquiror had purchased the target's stock as part of a plan to absorb the target by merger, the acquiror could not be treated as one of the target's historic shareholders for continuity purposes. Accordingly, the merger failed to qualify as a reorganization, and the target's minority shareholders recognized gain or loss on their exchange of target stock for acquiror stock. The *Kass* transaction arose after the enactment of § 334(b)(2) of the 1954 Code, but it appears that the court's conclusions are applicable to transactions before 1954. The status of *Kass* after the enactment of § 338 is discussed below in Part IV.B.

acquisition to the combined corporation's shareholders afterwards. Under this view, if a sufficient number of target shareholders sell their stock in the dawn before an acquisition, the continuity fiber could snap. The nightmarish consequences of such a rule, if applied rigorously to a publicly held target, would be that even unsuspecting target shareholders could blow a reorganization (for all parties) by selling too many of their shares during the prelude to a proposed acquisition, regardless of whether the other parties to the transaction assisted or were even aware of the sales.

These fears are fanned by Revenue Procedure 77-37,[145] which states the conditions for private letter rulings confirming the tax-free status of acquisitions. It requires a representation that the target's 1% shareholders (5% shareholders for public targets) intend to retain acquiror stock representing at least 50% of the value of the target's outstanding stock immediately before the transaction and a representation that the target's management has no contrary knowledge with respect to the rest of the shares. Target stock sold, redeemed, or otherwise disposed of "prior to" the transaction is taken into account in applying the 50% test. Thus, Revenue Procedure 77-37 suggests that the Service might view continuity as threatened even in the absence of directed efforts by the acquiror to purchase target's stock for cash.

Anxiety is heightened by an example in regulations under section 355 that finds continuity to be lacking where, pursuant to a plan, a 50% shareholder of a distributing company sells its stock and the company then splits-off its subsidiary to the other 50% "historic" shareholder.[146] The example concludes that continuity is lacking because the distributing corporation's historic shareholders retain none of its stock (one selling out before the split-off and the other exchanging distributing corporation stock for stock of the controlled subsidiary). The example appears to confirm that preacquisition conduct of the target's shareholders is relevant to continuity analysis.

Indeed, it does not take a particularly vivid imagination to portend from these authorities a grand scheme of continuity reflecting a triple expansion of the post-acquisition shareholder conduct cases. First, *Heintz* and *McDonald's* would apply regardless of whether other parties to the transaction actively assist the target shareholders' sales; second, *Heintz* and *McDonald's* would apply to the sale of target stock prior to the acquisition; and third, these cases could be asserted by the Service, not just by taxpayers. Under this alternative reality, the essence of continuity would be the relationship of historic shareholders to each other, and a substantial shift in that relationship would affect all parties.

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145. 1977-2 C.B. 568.

146. Regs. § 1.355-2(c)(2) ex. 3.

Some of these doomsday apprehensions were at least temporarily consoled by the Tax Court's recent opinion in *J.E. Seagram Corp. v. Commissioner.*[147] In *Seagram*, Conoco, a public company, was the subject of two competing tender offers by Seagram and a DuPont subsidiary. Seagram, which succeeded in acquiring only 32% of the target in its tender offer, conceded defeat to the DuPont subsidiary, which had acquired 46% of Conoco's stock. Seagram, along with other target shareholders owning in the aggregate some 16% of the target, tendered its shares for DuPont stock that was worth substantially less than the price paid by Seagram in its tender offer. Subsequently, Conoco was merged into the victorious DuPont subsidiary, with shareholders holding the remaining 6% of Conoco's stock being squeezed out for DuPont stock.

It was not the Service that sought to realize practitioners' worst fears by taxing the target and its former shareholders. Instead, it was Seagram, the defeated bidder, that shot a newly whittled continuity arrow with hopes of killing the reorganization. Seagram had paid dearly for the target stock acquired for cash in its own tender offer and sought to recognize loss on its exchange for DuPont stock. It argued that its recent cash purchase, although unassisted by the target (and vehemently opposed by the ultimate acquiror), nevertheless disqualified it as a historic shareholder. And, since the DuPont subsidiary purchased 46% of Conoco's stock for cash, that left a mere 22% (100% less DuPont's 46% acquired for cash and Seagram's 32%) of Conoco's historic shareholders who could be said to have received DuPont stock. This amount, Seagram claimed, was insufficient to establish continuity.

The court dismissed this argument and validated the reorganization in an opinion that faced practitioners' fears directly. It acknowledged that Seagram's position could cast a long shadow on acquisitions of public companies by conditioning reorganization status on the independent actions of numerous target shareholders. More importantly, the court returned the continuity of interest doctrine a step closer to its historical roots. Continuity depends, the court held, solely on the nature and amount of the acquiror's consideration. Since DuPont's subsidiary obtained a majority of Conoco's stock for stock of DuPont, continuity was maintained.

This holding at once captures the essence of *Cortland* and *Pinellas*, which distinguished taxable sales of target assets from tax-free reorganizations based on the nature and amount of the acquirors' consideration, and rebukes the suggestion that the shareholder conduct cases of *Heintz* and *McDonald's* and the integrated transaction decisions are relevant as continuity

147. 104 T.C. 75 (1995). The case is discussed in Ginsburg & Levin, supra note 1, § 610.10 at 627-30; Jasper L. Cummins, Jr., Seagram Files Brief With Second Circuit, 69 Tax Notes 223 (Oct. 9, 1995).

of interest precedents. Instead, these decisions should be viewed as extensions of the step-transaction doctrine, which permits several steps of a single transaction to be treated as one if all of the parties cooperated to achieve a particular result. Equally important, the *Seagram* decision offers taxpayers and the Service alike stability and administrability. Under the decision, the characterization of a transaction as a reorganization or a taxable sale may be determined definitively at the moment of the acquisition, based on the objective nature of acquiror's consideration.

The *Seagram* opinion has been criticized, largely on two grounds.[148] First, commentators have dismissed as "misplaced" the court's concern about the ability of public targets to engage in tax-free reorganizations without tracking large volumes of pre-acquisition trading in target stock. Under their view, Revenue Procedure 77-37 which, for purposes of the representations necessary to obtain a favorable ruling, treats less-than-5% shareholders as historic, should have allayed the Court's fears.

This view raises two preliminary questions. First, should the representations required to obtain a private letter ruling preclude the Service from proceeding against taxpayers that fail to obtain a ruling? Second, is the 50% threshold of Revenue Procedure 77-37—which quite clearly is higher than the case law establishes[149]—a hindrance to tax-free acquisitions of public targets? Even conceding affirmative answers to these questions, the view of these critics simply illuminate another reason why the *Seagram* court's decision represents sound tax policy.

If Seagram's arguments were accepted, a target shareholder realizing a loss on its exchange could argue that, notwithstanding the safe harbor, continuity was failed under traditional standards. For example, these arguments, if accepted, would open the door to an argument that continuity is broken if (1) 50% of the target's stock is held by less-than-5% shareholders, (2) the balance is held by a taxpayer who purchased for cash immediately before the acquisition, and (3) the taxpayer is able to demonstrate that 60% of the target stock held by less-than-5% shareholders was sold for cash in contemplation of the transaction. Moreover, the Seagram position would encourage inconsistent tax positions and whipsaw of the government.

Alternatively, these commentators would accept the *Seagram* result, but only if Seagram had the intent of acquiring the target but no intent of exchanging its stock for DuPont stock. This test, however, would rest the status of reorganizations on the subjective intent of significant target shareholders—hardly a basis for stable, predictable, and consistent results.

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148. See Ginsburg & Levin, supra note 1, § 610.10 at 628-29.

149. See infra notes 194-196 and accompanying text.

IV. THE DECLINE OF THE CONTINUITY OF INTEREST DOCTRINE

Despite the historic and continued vigor of the continuity of interest doctrine, its tangled branches have undergone significant pruning by Congress, the Service, and the courts. This Part examines a variety of limitations that have restrained continuity from breaking otherwise valid reorganizations.

The discussion is divided into three subheadings. First, this Part describes the legislative limitations on the remote continuity doctrine. Second, this Part considers the partial codification of the integrated transaction doctrine in section 338 and the anti-*Yoc Heating* regulations, which all but eliminate continuity as a requirement for a reorganization following a qualified stock purchase. Finally, this Part traces the abolition of continuity as a doctrine of disqualification for mutual savings bank and mutual savings and loan association reorganizations.

A. *Limitations on Remote Continuity*

As discussed above in Part III.B, one of the earlier expansions of the continuity of interest doctrine was the development of a remote continuity aspect that could defeat otherwise valid reorganizations depending on the spacial relationship between the target's assets and the acquiror's consideration.

Starting in 1954, Congress began the piecemeal repeal of the remote continuity doctrine by adding to section 368(a)(1)(C) an anti-*Groman* parenthetical clause—"(or in exchange solely for all or part of the voting stock of a corporation which is in control of the acquiring corporation)"—and by enacting an anti-*Bashford* provision, section 368(a)(2)(C). The parenthetical in section 368(a)(1)(C) permits the use of parent stock in C reorganizations, while section 368(a)(2)(C) permits the target's assets to be dropped down to a subsidiary following an A or C reorganization. In 1964, an anti-*Groman* parenthetical was added to section 368(a)(1)(B), permitting parent stock to be used as consideration in a B reorganization. Finally, Congress added section 368(a)(2)(D) in 1968 and section 368(a)(2)(E) in 1971, thereby permitting triangular forward and reverse mergers to qualify as A reorganizations. Accompanying each amendment was an expansion of the definition of a party to a reorganization.[150]

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150. See IRC § 368(b). For a discussion of issues that remained after these statutory changes, see M. Carr Ferguson & Martin D. Ginsburg, Triangular Reorganizations, 28 Tax. L. Rev. 159 (1973).

Several years after these statutory changes were completed, the Service largely abandoned its view that consideration remoteness (which it had asserted even within a wholly-owned group) could break continuity.[151] Today, although there are lingering remoteness issues,[152] remote continuity remains a significant impediment only with respect to partnership drop-downs, the use of grandparent (rather than parent) voting stock,[153] and the use of consideration from two different parties.[154] And, based on the public statements of Service officials, remote continuity may soon undergo further limitations.[155]

B. *The Virtual Elimination of Continuity From Section 338 Integrated Transactions*

As discussed above in Part III.D, the continuity of interest doctrine became a convenient reason for treating the integrated stock purchase and merger of the target into the acquiror's subsidiary as an asset purchase, permitting the subsidiary a cost basis in target's assets. In 1954, Congress

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151. See Rev. Rul. 84-30, 1984-1 C.B. 114; G.C.M. 39100 (May 13, 1983). In 1981, the Service ruled that consideration remoteness resulted when the target's parent distributed acquiror stock to its own shareholders after the transaction, thereby separating the consideration (held above by the parent's shareholders) from the target's assets (held below in acquiror). G.C.M. 38660 (Mar. 19, 1981).

In Rev. Rul. 95-69, 1995-42 I.R.B. 4 (Oct. 16), the Service held that a partnership/shareholder's distribution of acquiror stock to its partners on a pro rata basis does not defeat continuity.

152. For example, is the conclusion in Rev. Rul. 84-30, supra note 151, limited to transactions among a wholly-owned group? For a discussion of this issue, see Ginsburg & Levin, supra note 1, § 610.11.1 at 631-32.

153. See James A. Nitsche, "Asset Remoteness" Problems Persist in Affiliated Group Acquisitive Reorganizations, 83 J. Tax'n 94, 97 (1995).

154. The anti-*Groman* parentheticals permit solely voting stock consideration from either the acquiror "*or*" its parent, and not acquiror "*and/or*" its parent. See IRC § 368(a)(1)(B) (parenthetical), (C) (parenthetical). However, the regulations state:

> As used in section 368, as well as in other provisions of the Internal Revenue Code, if the context so requires, the conjunction 'or' denotes both the conjunctive and the disjunctive, and the singular includes the plural. For example, the provisions of the statute are complied with if 'stock and securities' are received in exchange as well as if 'stock or securities' are received.

Regs. § 1.368-2(h).

Section 368(a)(2)(D) is clear that only parent—and not subsidiary—stock may be used. See IRC § 368(a)(2)(D)(i). Section 368(a)(2)(E) is ambiguous on this point.

155. See Juliann Avakian Martin, IRS Considers Guidance of Postreorganization Sales and Continuity of Interest, 96 TNT 55-9 (Mar. 19, 1996) (quoting Nelson F. Crouch, Chief of Branch 1, remarking on General Counsel Memoranda 39150 and 35117, which conclude that continuity may be broken on a post-reorganization drop-down to a partnership: "The GCMs are out there . . . and we don't like them anymore").

confirmed acquirors' ability to achieve a cost basis in certain integrated stock purchases by enacting section 334(b)(2), and it reaffirmed this treatment in 1982, when it substituted the present section 338 for section 334(b)(2). However, by eliminating the need to rely on a judicial doctrine to achieve the desired result, Congress further complicated continuity analysis. This confusion continues, but, under recently issued regulations, the continuity of interest doctrine is significantly limited for integrated qualified stock purchase and merger transactions.

Section 334(b)(2) was enacted as part of the 1954 Code to replace the subjective integrated transaction doctrine with an objective test, which permitted the acquiror a cost basis in the target's assets if it made a "qualified stock purchase" of at least 80% by value of the target's stock (excluding certain preferred stock) and liquidated the target in a transaction meeting various requirements.[156] The treatment of nonqualifying stock purchases followed by liquidations and of qualified stock purchases followed by statutory mergers and other asset transfers that failed to qualify as liquidations was left to common law.

In 1982, Congress replaced section 334(b)(2) with section 338, which permits acquirors to elect to treat a qualified stock purchase as an asset purchase, but treats the target as selling its assets for fair market value to a new target that does not succeed to the original target's corporate tax attributes. Under pre-1987 law, this deemed asset sale was tax-free to the target (except to the extent of certain recapture income).[157] In an oft-quoted passage, the Conference Report accompanying section 338 states that the provision was "intended to replace any nonstatutory treatment of a stock purchase as an asset purchase under the *Kimbell-Diamond* doctrine."[158]

In Revenue Ruling 90-95,[159] the Service relied on this language in interpreting section 338 as preempting and reversing the *Kimbell-Diamond* doctrine with respect to a qualified stock purchase followed by the target's liquidation where a section 338 election is not made.[160] In other words, a

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156. Sections 334(b)(2) and 337 left a doctrinal anomaly that rendered the statutory result inconsistent with the continuity of interest theory underlying prior case law: The acquiror was permitted a cost basis in the target's assets, which is consistent with an asset purchase, but the target was not taxed, and the stock seller's gain or loss on the sale was measured by reference to stock basis (which together are more consistent with a stock sale than a deemed liquidation followed by an asset sale).

157. See IRC § 337 (1954).

158. H.R. Conf. Rep. No. 760, 97th Cong., 2d Sess. 536 (1982), reprinted in 1982-2 C.B. 600, 632.

159. 1990-2 C.B. 67.

160. As discussed supra Part III.D, the *Kimbell-Diamond* doctrine would treat an integrated stock purchase and liquidation as a deemed asset purchase in which purchaser acquires the assets with a cost basis.

nonelecting acquiror purchasing 80% or more of target's stock for cash and liquidating target as part of an integrated transaction (the facts of *Kimbell Diamond*) is not treated as purchaser of the target's assets; instead, each step is "awarded independent significance," and the acquiror absorbs the target with a carryover basis in its assets.[161]

In October 1995, following the recommendations of the New York State Bar Association,[162] the Service promulgated regulations that significantly limit the application of the continuity doctrine, extending the result of Revenue Ruling 90-95 beyond the second-step liquidation transaction that was the subject of *Kimbell Diamond* to include a qualified stock purchase for which a section 338 election is not made, followed by a reorganization.[163] The regulations interpret section 338 to require, in effect, that a non-electing acquiror be treated as a historic shareholder of the target, but only with respect to the acquiror, its subsidiary, and the target. Thus, under the regulations, the qualified stock purchase of target stock by the acquiror, followed by a merger of the target into the acquiror's wholly-owned subsidiary, is a tax-free reorganization for target and subsidiary, and the subsidiary takes the target's assets with a carryover basis.

The regulations effectively reverse *Yoc Heating Corp. v. Commissioner*,[164] where an acquiror purchased 85% of a target's stock for cash and notes and, as part of an integrated transaction, caused the target to transfer its assets to acquiror's newly formed subsidiary. In the latter step, the target's minority shareholders received cash in exchange for their target stock, the acquiror received additional shares of its subsidiary, and the target liquidated. The Service argued that the second-step was a D or F reorganization and that the acquiror's subsidiary therefore received the target's assets with a carryover basis (which was less than the sum of the acquiror's purchase price and the cash paid by subsidiary for the minority shareholders' target shares). The taxpayer disputed this assertion and claimed the benefit of section 334(b)(2), the *Kimbell-Diamond* doctrine, or the integrated transaction doctrine to obtain a stepped-up cost basis in the acquired target assets.

The Tax Court, in allowing a cost basis, held that while section 334(b)(2) and the broader *Kimbell-Diamond* doctrine applied only to liquidations, the asset transfer by the target to acquiror's subsidiary also was

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161. IRC § 334(b).

162. New York State Bar Ass'n Tax Section, Report on Reorganizations of Target Corporations Following a Qualified Stock Purchase Under Section 338, 94 TNT 205-11 (Oct. 19, 1994) (LEXIS, FEDTAX library, TNT file).

163. Regs. § 1.338-2(c)(3), 60 Fed. Reg. 54942 (Oct. 27, 1995). The regulations were proposed in February, 1995. See 60 Fed. Reg. 9309 (Feb. 17, 1995).

164. 61 T.C. 168 (1973). Accordingly, the regulations are commonly known as the anti-*Yoc Heating* regulations, and are referred to as such from time to time in this article.

not a reorganization because it failed the continuity of interest test. The court held further that the integrated transaction doctrine provided authority for a stepped-up basis equal to the cash paid by the acquiror for target stock plus the cash paid by subsidiary to the target's minority shareholders.[165]

However, while the regulations reverse *Yoc Heating* and deem continuity to be satisfied with respect to acquiror and target, they retain the continuity of interest doctrine—and deem it to be failed—with respect to the target's minority shareholders, even if they receive acquiror or subsidiary stock in the transaction, unless the combined transactions otherwise satisfy the continuity requirement. Accordingly, minority shareholders of target in a section 338 integrated stock purchase and merger generally recognize gain or loss. This result preserves the result of *Kass v. Commissioner.*[166]

The Preamble to the Regulations explains the Service's view that Congress intended a section 338 election to be the exclusive means for acquiring a cost basis in a target's assets following a qualified stock purchase and that a merger of the target into a wholly-owned subsidiary therefore should not result in a cost basis unless the election is made. Deeming continuity to be met for target, acquiror, and subsidiary is "the simplest and most effective means" of achieving that result.[167] The Preamble asserts that retaining a continuity requirement for minority shareholders is appropriate because "the legislative history does not indicate any intention to provide reorganization treatment for all purposes to exchanges of stock incident to asset transfers after [qualified stock purchases]." The legislative history of section 338 does not "indicate any intent to eliminate the continuity of interest requirement generally . . . ."[168]

Neither the policy behind section 338 nor its legislative history compels the approach of the anti-*Yoc Heating* regulations. After the repeal of *General Utilities*, an acquiror cannot make a qualified stock purchase, decline to make a section 338 election, merge the target into the acquiror's wholly-owned subsidiary and simply claim a cost basis in target's stock, as could the taxpayer in *Yoc Heating*. Instead, if the second-step merger is integrated with the stock purchase or fails to satisfy continuity, the target recognizes gain or loss on the transfer of its assets in the merger,[169] which is exactly what

165. As discussed above in note 99, the *Yoc Heating* court applied the continuity test for F reorganizations, which arguably is different in purpose, history, and application from the more generally applicable continuity of interest doctrine that originated in *Cortland* and *Pinellas*.

166. *Kass* is described in supra note 144.

167. 60 Fed. Reg. 54942, 54943 (Oct. 27, 1995).

168. 60 Fed. Reg. 9309, 9310 (Feb. 17, 1995).

169. This result occurs whether the target is viewed as liquidating and its shareholders as making the sale, or the merger is viewed as a taxable asset sale.

happens with a section 338 election. The legislative history to section 338 that was relied upon in the Preamble as the basis for overruling *Yoc Heating* states only that Congress intended to replace common law "under the *Kimbell-Diamond* doctrine." As described above, the Tax Court in *Yoc Heating* (which was decided nine years before section 338 was enacted) took pains to hold that the *Kimbell-Diamond* doctrine applied only to a second-step liquidation, and *not* to a second-step reorganization.[170] Thus, if Congress intended to overrule *Yoc Heating*, it would not have done so by mentioning *only Kimbell-Diamond*. Moreover, if by citing only *Kimbell-Diamond* and not *Yoc Heating*, Congress intended to replace common law treatment for liquidations only, it would have no occasion for addressing the continuity of interest requirement. Thus, Congress' silence is not necessarily a basis for selectively taxing the target's minority shareholders on a merger following a qualified stock purchase.

Although the Preamble to the regulations offers no further insights to the statutory basis or other reasons for the new rules, the New York State Bar Association report (the Bar Report) that precipitated them offers several reasons for the treatment of both the corporate parties and the target's minority shareholders.

First, the Bar Report notes that, in the most straightforward case, in which the acquiror after a 100% qualified stock purchase merges the target into acquiror's wholly-owned subsidiary, tax-free treatment and a carryover basis could have been achieved by having acquiror's subsidiary make the stock purchase with funds contributed by the acquiror and then causing the target to liquidate into the subsidiary. Alternatively, where the target's minority shareholders receive subsidiary stock in a merger following the qualified stock purchase, the same result could be achieved by the acquiror and the target's minority shareholders contributing target stock to the subsidiary for subsidiary stock in a tax-free section 351 exchange and causing target to liquidate.[171] Since the result of a qualified stock purchase and merger can be accomplished tax-free by alternative means, the Bar Report argues that the direct transaction should also be tax-free. Stated another way, no valid policy is served by imposing a corporate-level tax on a target corporation that is merged into a nonelecting acquiror's subsidiary following

170. See supra text accompanying note 165.

It was necessary for Congress to make clear that a § 338 election was the exclusive means to obtain a cost basis in an integrated qualified stock purchase and liquidation transaction. In American Potash & Chem. Corp. v. United States, 399 F.2d 194 (Cl. Ct. 1968), the court held that § 334(b)(2) did not preempt the *Kimbell-Diamond* doctrine and that a taxpayer failing to satisfy § 334(b)(2) could still obtain a cost basis under *Kimbell-Diamond*.

171. Other paths to this happy result are traversed in Ginsburg & Levin, supra note 1, § 610.9 at 616-22.

a qualified stock purchase. Since the only bar to this treatment is the continuity of interest requirement, the most direct path to achieve this result (short of reexamining the entire continuity doctrine) is to deem continuity to be satisfied selectively.

However, this leaves the nagging question of why the continuity of interest requirement was not entirely eliminated for section 338 integrated transactions and why the regulations continue to apply it to cause the target's minority shareholders to recognize gain or loss on the exchange of target for subsidiary stock. The Bar Report offers several reasons for this result.

First, if the economically similar result were accomplished without a qualified stock purchase but simply by merging target into subsidiary with the consideration consisting of more than 80% cash, the continuity of interest doctrine would deny tax-free treatment to minority shareholders receiving subsidiary stock. Accordingly, the target's minority shareholders should not be entitled to tax-free treatment solely as a result of the acquiror's qualified stock purchase.

The argument that like transactions should be taxed similarly has great appeal. Absent a wholesale rejection of the continuity of interest doctrine (which would allow tax-free treatment to minority shareholders in either situation), if under any similar transaction, minority shareholders would be subject to tax, the regulations might be justified in maintaining the status quo. However, if the acquiror purchases target stock in a qualified stock purchase and together with target minority shareholders contributes target stock to the acquiror's subsidiary for subsidiary stock in a section 351 transaction, both acquiror and target minority shareholders would receive the subsidiary stock tax-free. The subsidiary could then liquidate the target tax-free into subsidiary and receive the target's assets with a carryover basis. Thus, the rationale for not taxing the corporate parties in a *Yoc Heating* transaction—that a nontaxable result can be achieved in an alternative structure—might also justify the conclusion that the continuity of interest doctrine should not be a bar to tax-free treatment for the minority shareholders.[172]

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172. Section 351 treatment is not available if target minority shareholders receive acquiror stock. There is no evident reason for taxing target minority shareholders if they receive acquiror stock, while not taxing them if they receive subsidiary stock, especially after the statutory repeal of *Groman* and *Bashford*. See supra Part IV.A and infra Part V.A.6.

However, parent stock consideration may be possible in a tax-free transaction. If the target is recapitalized before the merger by making its common stock mandatorily exchangeable for parent stock, this E-type recapitalization would apparently be respected, even though it is a component of a larger transaction. See Rev. Rul. 76-223, 1976-1 C.B. 103 (two step transaction in which preferred stock of target was converted into 19% of voting common stock and acquiror acquired remaining 81% of voting common stock for voting stock of acquiror qualified as a recapitalization followed by a B reorganization); Priv. Let. Rul. 9207028 (Nov.

Second, the Bar Report argues that it is appropriate to tax minority shareholders because existing law (e.g., *Kass*) denies tax-free treatment to the target's minority shareholders and, absent a compelling reason, regulations under section 338 should not change this result.[173] Although *Kass* held that minority shareholders in a section 334(b)(2) liquidation/merger were subject to tax, *Kass* (and for that matter *Yoc Heating*) was decided prior to the enactment of section 338. The legislative history of section 338 indicates that Congress intended to "replace any nonstatutory treatment of a stock purchase as an asset purchase." The only reason the *Yoc Heating* court treated the stock purchase as an asset purchase was the continuity of interest doctrine. If Congress really had the reversal of *Yoc Heating* in mind when it enacted section 338, it is far more likely that its stated intent to "replace *any* nonstatutory treatment" meant that the entire continuity doctrine should be abandoned in the context of a qualified stock purchase followed by a merger, rather than that it be retained only with respect to minority shareholders. This result is also more consistent with the statutory framework. Section 368(a)(1) defines a reorganization for all parties to a transaction, and if a reorganization is found, the balance of Part III of Subchapter C determines the consequences of the transaction for each party. The regulations reject that framework and impose another, in which "reorganization" is defined party by party. Perhaps the Service has the regulatory authority to promulgate such a rule, but even if Congress intended section 338 to reverse *Yoc Heating*, it likely did not intend to adopt the regulations' mechanism, rather than simply deeming the nonstatutory continuity requirement to be satisfied for all parties.

Finally, the Bar Report argues that minority shareholders should be taxed because the nature of their investment has changed. This argument simply begs the ultimate question of whether the continuity of interest doctrine is an appropriate basis to deny minority shareholders tax-free

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19, 1991) (recapitalization as part of an integrated merger respected as separate transaction), discussed infra text accompanying note 185. Of course, exchangeable stock presents issues that are beyond the scope of this article. See generally Kenneth H. Heitner & Jonathan M. Kushner, To Bifurcate or Not to Bifurcate: The Answer Becomes Less Clear, 46 Tax Law. 43 (1992).

In addition to its *Yoc Heating* recommendations, the Bar Report proposed that the continuity of interest requirement be jettisoned (even for minority shareholders) for the merger of a target into a newly-formed subsidiary in a transaction that would otherwise qualify as an F reorganization. See supra note 97. This proposal has not of yet been accepted or rejected by the Service. It is not clear as a policy matter why a merger into an existing subsidiary should be taxable to minority shareholders for failure of continuity, but the identical merger into a newly-organized subsidiary should be tax-free.

173. The Preamble also suggests that the Service saw some merit to this argument. See 60 Fed. Reg. 54942, 54943 (Oct. 27, 1995) ("extension of reorganization treatment to the minority shareholders in this case would inappropriately alter general reorganization principles, and would not be grounded in the policies of section 338").

treatment since all reorganizations change the nature of all target shareholders' investments.

The continuity of interest doctrine was originally developed to distinguish merger-like reorganizations from asset sales on the basis of the consideration received by the target. As described above in Part III.D, applying the continuity doctrine to integrated transactions is wholly inconsistent with its original purpose because its invocation has no effect on the target. Nevertheless, the doctrine did serve as a convenient basis to permit a purchaser of target stock to obtain a stepped-up basis for the assets after the target is merged into the acquiror's subsidiary. And, application of the continuity doctrine to integrated stock purchase and merger transactions did allow for consistent treatment of the acquiror's subsidiary (which, under *Madison Square Garden*,[174] received target's assets with a full step-up to fair market value) and target's minority shareholders (who, under *Kass*, recognized gain or loss on the transaction). With the enactment of section 338, failing continuity is no longer necessary to permit the subsidiary to achieve a cost basis; instead, that treatment is elected under section 338.[175] Thus, section 338 and its legislative history can be seen as a legislative rejection of the application of continuity to integrated qualified stock purchase and merger transactions.

Ironically, the Bar Report's suggestion to the Service that it tax only the minority shareholders in a merger following a qualified stock purchase may imperil the original purpose of the Report—to facilitate these transactions. Under the laws of many states, parents of subsidiaries with minority shareholders have a fiduciary duty to treat the minority shareholders fairly with respect to transactions with the parent (and, presumably, with the parent's other subsidiaries).[176] According to one court, this duty is breached when the parent receives something "to the exclusion of, and detriment to, the minority stockholders of the subsidiary."[177] It is an open question as to whether, without some additional compensation, this standard is satisfied by a merger that allows a parent to combine the business of two subsidiaries but subjects to tax *only* the minority shareholders that receive stock of the surviving corporation.

174. Madison Square Garden Corp. v. Commissioner, 500 F.2d 611 (2d Cir. 1974).

175. One must consider whether continuity is necessary where a § 338 or § 338(h)(10) election is made.

176. See generally David A. Drexler, et al., Delaware Corporation Law and Practice §§ 15.11, 15.59 (1996).

177. Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) ("Self dealing occurs when the parent, by virtue of its domination of the subsidiary, causes the subsidiary to act in such a way that the parent receives something from the subsidiary to the exclusion of, and detriment to, the minority stockholders of the subsidiary").

C. *Continuity Without Stock*

Despite the Service's success in *Le Tulle*, where the Court severed the stock or securities requirement from the definition of reorganization, holding that some acquiror stock was required to be received by the target in order for an acquisition to be a reorganization, the Service has not hesitated to distance itself from that requirement where contrary policies predominate.

In *Paulsen v. Commissioner*,[178] the Supreme Court, at the Service's urging, held that the statutory merger of a state stock savings and loan into a federal mutual was not a reorganization for lack of continuity. In the merger, the target's shareholders exchanged their stock for passbook savings accounts in the mutual. The Service argued that the transaction failed the continuity requirement because the passbook accounts were not equity in the mutual. The Court ruled for the Service, but based its opinion on the narrower ground that the passbook accounts were "cash equivalents,"[179] which were not an adequate interest in the acquiror to satisfy the continuity test. *Paulsen* is consistent with the teachings of *Cortland* and *Pinellas* that an asset transfer entirely for cash or cash equivalents is more like a sale than a tax-free transaction. Although the *Paulsen* Court was without statutory basis in applying the continuity doctrine to a statutory merger,[180] there is at least some historical support and strong policy reasons for requiring at least *some* acquiror equity consideration in even a statutory merger.

As discussed above, in 1934, when Congress introduced the statutory continuity requirement of solely voting stock consideration for B and C reorganizations, implicitly reaffirming that no continuity is required for a statutory merger, most states' laws required that the consideration in a statutory merger include stock or securities of the acquiror. Although A reorganizations continue to be defined by reference to state laws (presumably *current* laws), which reflect relaxed merger requirements since 1934, it was not unreasonable for the *Paulsen* court to, in effect, interpret the phrase "statutory merger or consolidation" by reference to the law in 1934, when Congress last considered the issue.

Moreover, a contrary holding, allowing a merger or consolidation with only cash consideration, would entirely eliminate the distinction between tax-free transactions and taxable sales. The *Paulsen* Court, in holding that the acquiror's consideration in a reorganization may not consist entirely of "cash equivalents," therefore adopted a pragmatic approach that was consistent with *Cortland* and *Pinellas* and as loyal to the statutory language as countervailing

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178. 469 U.S. 131 (1985).

179. Id. at 140. The position upheld in *Paulsen* was first asserted by the Service in 1969. See Rev. Rul. 69-6, 1969-1 C.B. 104.

180. See supra Part II.C.

policy views would permit. It is notable that the Court in *Paulsen* did not prohibit a statutory merger solely for securities of the acquiror.

The Service soon found that the requirement it succeeded in imposing in *Paulsen*—that the target or its shareholders must receive *equity* in the acquiror—would imperil tax-free treatment for other transactions involving mutual savings banks and mutual savings and loans. First, in a conversion of one of these institutions into a stock corporation, depositors in the mutual typically receive a "liquidation account" that preserves only their rights to the assets of the mutual on its liquidation (and only then to a limited extent). Depositors are also usually issued subscription rights for stock, but these rights normally require a cash payment by the holder on exercise. Under traditional debt/equity analysis, an instrument, such as the liquidation account, that provides a fixed return and does not provide for any meaningful upside potential or downside risk in the issuer, or voting rights, is not ordinarily treated as stock.[181] Thus, since neither the target nor its shareholders receive acquiror stock for target assets, the transaction apparently fails the Service's exposition of the continuity doctrine. Nevertheless, in two published rulings, the Service held that in the merger of one mutual into another, the liquidation accounts are a sufficient equity interest for continuity of interest purposes.[182] In Revenue Ruling 80-105,[183] the Service further held, on the basis of the earlier rulings, that the conversion of a mutual into a stock institution is an F reorganization.

Next, the Service was faced with whether such a converted entity could be acquired in a triangular reorganization. In a triangular merger of a former mutual into a subsidiary of a stock corporation, only actual shareholders in the target receive parent stock; the former passbook holders retain their liquidation accounts in the acquiring subsidiary. Thus, the lingering *Groman-Bashford* problem was presented in spades: If passbook holders *and* stockholders in the former mutual hold equity and the passbook holders receive an interest in subsidiary, while the stockholders receive an interest in the parent, is the parent or the subsidiary the "party to the reorganization?" Or, to take the Service's view of *Groman* and *Bashford*, the transaction flunks remote

181. See generally William T. Plumb, Jr., The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal, 26 Tax L. Rev. 369 (1971).

182. See Rev. Rul. 69-646, 1969-2 C.B. 54; Rev. Rul. 69-3, 1969-1 C.B. 103.

In dictum, the *Paulsen* court rationalized these rulings by comparing what target shareholders received with what they gave up; since passbook holders held only a nominal equity interest, they need receive nothing more. This reasoning is tangled in the branches of continuity dogma. The continuity question is whether, *at the corporate level*, the consideration tendered by the acquiror renders the transaction more sale-like or more merger-like. Only if the consideration received by the target is sufficiently merger-like is the consideration received by target's equity holders tested for "stock or security" status under § 354.

183. 1980-1 C.B. 78.

continuity. However, in a triumph of policy over doctrine, the Service, in a series of private rulings, adopted the inconsistent position that, although the liquidation accounts sufficed as a continuing interest in mutual-mutual mergers and mutual to stock conversions, they are not considered stock of the acquiror that could blow a triangular reorganization.[184]

The final hoop involved the consequences of an integrated transaction in which a mutual savings bank converts into a stock savings bank (with passbook holders in the mutual receiving liquidation accounts in the stock institution) and the new stock bank merges into a newly-formed subsidiary of an acquiror with former passbook holders receiving cash for their liquidation accounts.[185] If liquidation accounts are treated as equity in the former mutual for purposes of qualifying the first step of the transaction as an F reorganization, the immediate cash-out of that equity interest in the second step of the transaction defeats the first-step F reorganization. This time, to reconcile the irreconcilable, the Service held that the first-step conversion is not an F reorganization, as Revenue Ruling 80-105 held, but is instead an E-type recapitalization, which has no continuity requirement.[186]

V. THE END OF CONTINUITY AS WE KNOW IT

Parts I through IV of this article show how the continuity doctrine escaped its rationale and was applied indiscriminately without regard to its historical purpose, and how only significant contrary policies have forced Congress, the Service, and the courts to reexamine its outer boundaries. This Part begins by examining some of the consequences of the current continuity of interest doctrine from a tax policy perspective. It concludes that the consequences of the doctrine reflect such poor tax policy that revision is inevitable, and considers some alternative conceptions of continuity that could form the basis of a new doctrine of more limited scope.

A. *The Consequences of Continuity*

1. *Abuse Potential.*—Continuity has always been a doctrine of universal application. Historically, it has been invoked by taxpayers seeking

184. See, e.g., Priv. Let. Rul. 8942058 (July 25, 1989); Priv. Let. Rul. 8739053 (June 30, 1987).

185. See Priv. Let. Rul. 9207028 (Nov. 19, 1991). For a more detailed history and analysis of mutual conversions and acquisitions, see Robert J. Jones, et al., IRS Clarifies Conversions of Financial Institutions from Mutual to Stock Form, 6 J. Bank Tax'n 9 (1992); Gregory J. Soukup, The Continuity-of-Proprietary-Interest Doctrine and Thrift Institution Mergers, 12 J. Corp. Tax'n 141 (1985).

186. This ruling suggests that a recapitalization that is the first step of an integrated transaction is respected as such, and not collapsed into the other steps.

to recognize losses or avoid other undesirable consequences of reorganization status, with the same frequency and zeal as it has been invoked by the Service.[187] When the Service applies the doctrine expansively to force recognition of gain, it invites taxpayers to assert the doctrine to recognize loss. For example, the Service apparently maintains that remote continuity may be lost by an acquiror's transfer of a target's assets to a partnership largely owned by the acquiror (or even wholly-owned by an acquiror group).[188] When asserted by taxpayers, this position effectively permits taxpayers to elect out of reorganization treatment by engaging in an economically insignificant transaction. Additionally, in a private acquisition that hugs the boundaries of continuity thresholds, different parties may take inconsistent positions as to the existence of continuity, with, for example, target shareholders realizing gain on their receipt of acquiror stock reporting a tax-free reorganization and those with losses claiming that continuity was lacking.

In this respect, the *Seagram* case is interesting not only as a substantive decision, but as a roadmap of tax-planning potential for target shareholders wishing to deduct losses with respect to their exchanged target shares. In *Seagram*, escape from the reorganization provisions appears to have been an afterthought for a large target shareholder but, had the decision gone the other way, *Seagram*'s progeny would almost certainly have involved clever prearranged transactions in public deals.

A private letter ruling issued on the basis of the representations required by Revenue Procedure 77-37 may also open the door to inconsistent treatment. So long as less-than-5% noninsider shareholders of a public target own at least 50% of the target's stock, and at least 50% of the consideration in the acquisition consists of acquiror stock, continuity is deemed met, regardless of whether all of the target's shares immediately before—or the acquiror's equity consideration immediately after—changes hands. Current continuity law suggests that, notwithstanding a private ruling recognizing reorganization status, the target or target shareholders with information about pre- or post-acquisition sales could report the transaction as taxable, without affecting the other parties' treatment.[189] This abuse potential of continuity

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187. Reorganization status may give rise to adverse tax consequences that could be avoided by qualifying the transaction under some other nonrecognition provision and simultaneously breaking continuity. For example, preferred stock issued in a B reorganization may be § 306 stock, but preferred stock issued in a § 351 transaction is not § 306 stock. All other things being equal, taxpayers might choose to flunk continuity to avoid § 306. See Rev. Rul. 79-274, 1979-2 C.B. 131 (for purposes of § 306, § 368(a)(1)(B) and not § 351, governs if a transaction qualifies under both).

188. See supra note 101 and accompanying text.

189. Likewise, for reorganizations clearly busted under the continuity doctrine, but which might arguably qualify for tax-free treatment under § 351, the continuity doctrine suggests additional potential for inconsistent treatment.

is compounded if the representation protocol of Revenue Procedure 77-37 is a safe harbor for taxpayers, even in the absence of a private letter ruling, as some suggest.[190]

The anti-*Yoc Heating* regulations, by requiring inconsistent treatment of the corporate parties, on the one hand, and the target's shareholders, on the other, sanction what might be regarded as a similar abuse. For example, assume that a target's basis in its assets and the target shareholders' aggregate basis in their stock each exceed the value of target. If the shareholders sell 80% of the stock for cash to an unrelated parent company, and the parent company merges the target into its wholly-owned subsidiary without making a section 338 election, the target shareholders recognize loss on all of their target stock, including the 20% exchanged for stock of the parent, while the parent retains the benefit of the target's high asset basis.

While complexity, uncertainty, and inconsistency might be regarded as inevitable taxpayer tools in any sophisticated tax system, a test that depends upon subjective elements and ill-defined rules, as does the current continuity doctrine, is an invitation to abuse.

2. *Administrability*.—The *Seagram* case, viewed from the government's perspective, also reveals the unadministerability of a doctrine that depends on the intent and conduct of the acquiror and unrelated target shareholders, that does not require disclosure or consistent treatment, and that is vaguely-defined by uncertain criteria. If Seagram had ultimately succeeded in its litigation (Seagram lost in the Tax Court and the case was settled before a decision on appeals), the Service would have faced tremendous whipsaw potential from Conoco's public shareholders who are not likely to amend their returns to report gain. And, Seagram's failure in the Tax Court certainly does not prevent the Conoco shareholders that realized losses on receipt of DuPont stock from making similar claims on their open tax returns (especially now that the case will not win appellate level imprimatur). The Code could be amended to provide for disclosure and universal characterization of reorganization transactions, as it does in other contexts,[191] or to provide for unified audit procedures,[192] but the system is unequipped for the continuity doctrine in all of its present glory.

3. *Economic Efficiency*.—The current continuity rule creates basic economic inefficiencies. First, because under Revenue Procedure 77-37 only 5% or greater shareholders of a public target can adversely affect continuity,

190. Ginsburg & Levin, supra note 1, § 610.10 at 629.

191. See, e.g., IRC § 385(c) (issuer's characterization of instrument as equity or debt is binding on holders unless contrary position is disclosed).

192. See, e.g., IRC §§ 6221-6233 (unified audit procedures for partnerships).

the doctrine places a premium on their actions. This premium may be magnified if some 5% shareholders are unable (or unwilling) to indicate their intent with respect to the acquiror stock they will receive. (For example, mutual funds routinely decline to represent that they have no plan or intention to sell acquiror stock.)[193] This artificial premium generated by the tax law is inefficient because one historic 5% shareholder, by declining to give the necessary representation or threatening to dispose of acquiror shares immediately after receipt, can potentially stall an acquisition that would increase value for all target shareholders.

Second, the continuity representation of Revenue Procedure 77-37, by deeming all less-than-5% shareholders of a public target to be historic holders of target stock and long-term holders of acquiror stock, regardless of actual conduct, permits these shareholders to cash out. By also requiring that no more than 50% of acquiror's aggregate consideration consist of nonequity, Revenue Procedure 77-37 requires that target shareholders who cash out must use their own brokers to sell acquiror stock. The practical effect of this requirement is simply an added cost for these target shareholders: their broker's commission.

Finally, by virtue of the favorable representation for public targets—all less-than-5% (as opposed to 1%) noninsider target shareholders are counted as good for continuity purposes—the tax law encourages acquisitions of public as opposed to private targets because it is generally easier to be assured of tax-free treatment.

None of these inefficiencies is justified by any countervailing policy reason, and each of them could be reduced or eliminated by a lower continuity threshold.

4. *Fairness.*—Fairness concerns are always raised when an acquiror's post-reorganization use of target assets or the actions of a majority of the target shareholders has the potential to affect minority target shareholders. These concerns are also raised under the anti-*Yoc Heating* regulations, which tax only minority shareholders on a qualified stock purchase-merger transaction. As mentioned earlier, these fairness issues present interesting questions under state law.

5. *Uncertainty.*—It is unclear what percentage of the acquiror's consideration must consist of stock in order to satisfy the continuity of interest test. Revenue Procedure 77-37 provides that a favorable private letter ruling will be issued only if the historic target shareholders, as a group, exchange at least 50% by value of the total outstanding target stock for

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193. See Ginsburg & Levin, supra note 1, § 610.10 at 630.

acquiror stock. In *John A. Nelson Co. v. Helvering*,[194] the Supreme Court found that continuity was satisfied when 38% of the target shareholders' consideration consisted of stock. The Sixth Circuit has found continuity to be satisfied when only 25% of target shareholders' consideration consisted of acquiror stock.[195] On the other hand, the Tax Court found 16% to be inadequate in *Kass v. Commissioner*.[196] These ranges of acceptability create uncertainty, which tends to interfere with transactions at the fringes and otherwise to contribute to the heartburn of tax lawyers.

6. *Inconsistent and Anomalous Treatment*.—The existence of a continuity requirement for some nonrecognition transactions but not others results in anomalous treatment when economically similar transactions are characterized differently. For example, the Service apparently maintains that the use of grandparent stock as consideration for a merger violates the remote continuity doctrine, but a direct acquisition followed by a double drop-down of the target's assets to a second-tier subsidiary is tax-free.[197] Second, because the continuity test is concerned only with consideration received by the *target's* shareholders, a "cash out merger" of target into acquiror fails continuity, but the transaction can be made tax-free by reversing the parties.[198] Third, it is sometimes possible to use other nonrecognition provisions without a continuity requirement—such as section 351—to reach the same results as a reorganization.[199] Finally, nonconvertible, nonvoting preferred stock that is redeemable at any time and mandatorily redeemable if earnings exceed a specific threshold is considered a sufficient equity stake for continuity purposes,[200] but a reorganization is flunked on continuity grounds if the acquiror agrees to assist the target shareholders in selling acquiror stock, even if the shareholders bear real equity risk for six months.[201] These opportunities all perpetuate anomaly and elevate form over substance.

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194. 296 U.S. 374 (1935).

195. Miller v. Commissioner, 84 F.2d 415 (6th Cir. 1936).

196. 60 T.C. 218 (1973), aff'd without opinion, 491 F.2d 749 (3d Cir. 1974).

197. See supra note 110.

198. See Bittker & Eustice, supra note 5, ¶ 12.21[9] at 12-39; Ginsburg & Levin, supra note 1, §§ 610.12-610.13 at 637-40.

199. See, e.g., Rev. Rul. 84-71, 1984-1 C.B. 106 (failed reverse triangular merger treated as a § 351 transaction). See generally Ginsburg & Levin, supra note 1, § 610.14 at 640. See also Ginsburg & Levin, supra, § 610.15 at 640-41 (use of recapitalization to bypass continuity).

200. See Schweitzer & Conrad, Inc. v. Commissioner, 41 B.T.A. 533 (1940).

201. See McDonald's Restaurants of Illinois v. Commissioner, 688 F.2d 520 (7th Cir. 1982) (merger occurred on April 1, 1973; stock was sold on October 3, 1973).

7. *Tax Policy of Nonrecognition.*—A full discussion of the continuity doctrine requires at least some mention of the basic policies behind tax-free acquisitions and a consideration of whether the modern expression of the continuity doctrine is consistent with those policies. Two categories of policies are frequently cited as supporting tax-free treatment for reorganizations.[202]

From the target shareholders' perspective, a "paper transaction," in which the shareholders' investment acquires new legal form but is economically unchanged, is viewed as not being an appropriate event to trigger recognition of gain or loss.[203] Also, even if the target shareholders' investment changes dramatically (as often occurs when an operating target merges into an operating acquiror), the illiquidity or possibly difficult valuation of the newly-received shares (especially in a private deal), and the notion that a passive exchange should not be a taxable event, possibly requiring a sale of the investment to pay taxes, all argue against current taxation.[204]

At the corporate level, the policies are somewhat different. In addition to policies against the conversion of dividends into liquidation proceeds (e.g., in a liquidation-reincorporation transaction) or the artificial generation of losses (for example, by having an operating company with high basis assets sell those assets to a shell owned entirely by its former shareholders), the reorganization provisions act as a subsidy for—or, at least, do not discourage—certain corporate transactions meeting specific statutory descriptions.[205] These policies are tempered by a generalized tax policy against expanding nonrecognition to situations that are not intended to benefit from such favorable treatment. This countervailing policy is difficult to apply at the corporate level where the statutory policies supporting tax-free treatment are based largely on form and are at times indeterminate. However, it has been clear for over 60 years that cash asset sales are not deserving of nonrecognition treatment. The continuity of interest doctrine has served as one

202. See generally Staff of Joint Comm. on Taxation, 99th Cong., 1st Sess., Federal Income Tax Aspects of Mergers and Acquisitions, reprinted in DTR (BNA) No. 62 (April 1, 1985); Bittker & Eustice, supra note 5, ¶ 12.01[1] at 12-7 to 12-9; Sheldon S. Cohen, Conglomerate Mergers and Taxation, 55 A.B.A. J. 40 (1969); John Dane, Jr., The Case for Nonrecognition of Gain in Reorganization Exchanges, 36 Taxes 244 (1958); Jerome R. Hellerstein, Mergers, Taxes, and Realism, 71 Harv. L. Rev. 254 (1957); Milton Sandberg, The Income Tax Subsidy in Reorganization, 38 Colum. L. Rev. 98 (1938); Stanley S. Surrey, Income Tax Problems of Corporations and Shareholders: American Law Institute Tax Project—American Bar Association Committee Study on Legislative Revision, 14 Tax L. Rev. 1 (1958); William J. Turnier, Continuity of Interest—Its Application to Shareholders of the Acquiring Corporation, 64 Cal. L. Rev. 902, 910-16 (1976).

203. S. Rep. No. 617, 65th Cong., 3d Sess. 5 (1918).

204. See Hellerstein, supra note 202, at 262, 266.

205. See id. at 276-77; Sandberg, supra note 202, at 98.

mechanism to distinguish corporate transactions that advance corporate nonrecognition policies from those, such as asset sales for cash, that do not.

However, the use of continuity to disqualify a reorganization on the basis that it does not advance corporate-level policies sometimes clashes with the policies that support nonrecognition treatment at the shareholder level. Application of continuity in these cases to disqualify a reorganization elevates the corporate policies over the shareholder policies.

For example, if only 10% of the acquiror's consideration for target assets consists of acquiror equity—an insufficient amount to satisfy the modern continuity test—the corporate-level policies are advanced by denying the transaction tax-free treatment because it more resembles a sale than a merger and therefore is beyond the intended scope of the corporate-level subsidy. However, because continuity has not historically developed as a doctrine that taxes only the party for which tax-free treatment is inappropriate, applying the doctrine to the entire transaction, and taxing target shareholders who receive illiquid acquiror stock, conflicts with one of the important shareholder-level policies.

Moreover, while the continuity of interest doctrine is helpful in identifying transactions that at the corporate level are not deserving of nonrecognition treatment, it is not needed to distinguish those transactions in which tax-free treatment is inappropriate at the shareholder level. Sections 354 and 356 ensure that target shareholders receiving cash and other nonsecurity boot are subject to tax on any gain realized on the transaction, notwithstanding reorganization status.

This conflict between corporate-level policies against tax-free treatment and those favoring nonrecognition treatment at the shareholder level is inevitable without a statutory mechanism at the corporate level that taxes the target's realized gain in respect of assets transferred for nonqualifying consideration. The continuity doctrine could be understood to reflect the view that it is worse to allow a corporate target to escape taxation on an asset sale than it is to tax a target shareholder deserving of tax-free treatment. But there is no evidence that Congress ever made that choice. And the conflicting policies suggest that continuity should bust an otherwise qualifying reorganization only where the reasons for taxing the target are clear.

On the other hand, it is clearly inappropriate to use continuity to bust a putative reorganization that does not look like an asset sale at the corporate level if doing so would result in taxing target shareholders deserving of nonrecognition treatment. The *Seagram* case and the anti-*Yoc Heating* regulations demonstrate this point best.

At the corporate level in *Seagram*, the transaction had all of the hallmarks of a reorganization. The DuPont group's consideration for Conoco's assets consisted over 50% of stock, which traditional notions of continuity regard as sufficient to distinguish the acquisition from a taxable

sale, and no other corporate-level considerations were identified that are inconsistent with tax-free treatment. At the shareholder level, the DuPont stock, while neither illiquid nor difficult to value, was received under circumstances that are entirely consistent with the tax-free treatment of shareholders under the reorganization provisions. Application of the continuity doctrine to disqualify the reorganization therefore would not advance either corporate- or shareholder-level policies. To the contrary, the doctrine, if applicable, would permit Seagram to recognize a loss in a transaction that, from its perspective, is indistinguishable from any other tax-free transaction and—owing to the blunt nature of the continuity doctrine—could result in the taxation of Conoco and other Conoco shareholders that received DuPont stock.

Application of the continuity of interest doctrine to tax minority shareholders under the anti-*Yoc Heating* regulations is even more contrary to congressional policies. The regulations express a policy decision, supported by the legislative history to section 338, that the relevant corporate-level policies support *nonrecognition* treatment. Yet, regardless of the shareholder level policies that could be advanced by nonrecognition treatment (especially if acquiror's stock is illiquid and difficult to value), the regulations apply the dull edge of continuity to tax the minority shareholders on purely doctrinal grounds.

B. *Constructing a Valid Policy for a Strong Form of Continuity*

It is certainly possible to conceive of a policy rationale for a strong form of the continuity doctrine that would deny reorganization status to a corporation undergoing significant equity shifts. Historically, our classical tax system has tended to impose a corporate level of tax on those entities whose interests are freely transferable.[206] Today, by virtue of the ease of qualifying an entity as a partnership (including the recently proposed check-the-box regulations),[207] the corporate-level toll charge effectively applies *only* to operating entities whose interests are treated as liquid (publicly traded) under section 7704. To the extent that the reorganization provisions (by deferring corporate tax that would otherwise be imposed) represent an exception to the corporate-level toll charge for liquidity, it may be appropriate to condition this exception upon the equity holders foregoing their liquidity for some period. The continuity doctrine is such a condition.

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206. See Regs. § 301.7701-2(e) (distinguishing partnerships from corporations based on, among other things, whether their interests are freely transferred).

207. See Prop. Regs. §§ 301.7701-1 to -3.

A related policy, expressed for partnerships in section 708, measures liquidity by actual transfers and subjects to tax even equity holders that remain invested if the ownership of the entity shifts significantly over a short period of time. Continuity could be considered a similar rule, subjecting shareholders to tax if their brethren abuse the transferability privileges enjoyed by the group as a whole.[208]

However, if the continuity doctrine is a system for exacting a lock-up of corporate ownership interests in exchange for deferral of corporate-level tax, one would expect that a target corporation and its shareholders should not be able, by failing continuity, to recognize loss.[209] Moreover, if the continuity doctrine is a mechanism for moderating the toll charge when equity holders restrict transfers of their interests, its application is hopelessly imprecise. The doctrine is an absolute test: Full nonrecognition is permitted for targets experiencing significant shifts in ownership, so long as the shifts are not greater than the continuity threshold. On the other hand, the target and its shareholders are fully taxed on their gains if the threshold is exceeded by even one selling shareholder.

Moreover, analogies to section 708 are, on close scrutiny, inapposite. The continuity doctrine does not depend on the relative percentage interests of the former target group in the new combined enterprise; in contrast to section 708, a corporate minnow is permitted to swallow a whale tax-free without severing continuity.[210] The section 708 comparison breaks down entirely in the context of a publicly traded corporation, where the relationship among shareholders regularly shifts without consequence. Placing significance on this relationship for nontrading shareholders only proximate to an acquisition is inappropriate. Finally, this rationale for continuity does not embrace the remote continuity doctrine, which can break continuity even if

208. See Stanley S. Surrey & William C. Warren, Federal Income Taxation 1120 (1953) ("The congressional policy is that while such readjustments may produce changes in the conduct of a business enterprise, these changes do not involve a change in the nature or character of the relation of the owners of the enterprise to that enterprise sufficient to warrant taxation of gain [or] allowance of loss").

209. Partners in an operating partnership (i.e., with assets other than cash or marketable securities) that experiences a § 708 event are not permitted to claim a loss. See IRC § 731(a)(2).

210. When partnerships merge, the partnership whose members own more than 50% of the capital and profits interests in the surviving entity is deemed to continue; the other partnership terminates (possibly subjecting its members to tax). IRC § 708(b)(2)(A). Thus, the merger of a tiny partnership into a huge partnership is taxable for members of the tiny partnership; in contrast, a merger of a tiny target corporation into a huge acquiror can be entirely tax-free. Moreover, recently proposed regulations under § 708(b)(1)(B) would altogether eliminate tax for partners whose partnership experiences a § 708 event. See Prop. Regs. § 1.708-1(b)(1)(iv).

the target's shareholders retain their acquiror stock and is without parallel in subchapter K.

C. *Alternative Conceptions of Continuity*

The preceding discussion suggests that while the continuity doctrine is useful in some limited form to distinguish a taxable sale from a tax-free reorganization, the current doctrine has little statutory, historic, or tax policy basis. Although conceivable policy rationales for the strong form do exist, they have never been articulated by Congress or the Service, and at best are a crude mechanism to advance those policies. The balance of this Part suggests alternative and limited conceptions of continuity that could be the basis for a coherent doctrine.

1. *The Corporate Lawyers' Approach of Ginsburg & Levin.*—Professor Martin D. Ginsburg and Jack S. Levin, in their seminal treatise on the taxation of corporate transactions, advocate a restricted but still strong form of the continuity doctrine. They argue that the requirement that the target shareholders as a group maintain a substantial equity participation in the acquiror's enterprise following an acquisition is good tax policy.[211] In general, they would abandon the remote continuity doctrine and measure continuity based on beneficial interests in the target, whether directly or indirectly held.[212] They would codify Revenue Procedure 77-37 as a bright line test binding the Service and taxpayers alike. However, they support the anti-*Yoc Heating* regulations' treatment of the minority shareholders in an integrated qualified stock purchase and merger.[213] They would permit taxpayers to assert the failure of continuity on equal terms with the Service, and they argue that the taxpayer should have prevailed in the *Seagram* case.[214]

In many respects, the Ginsburg and Levin position represents practitioners' tempered continuity wish list. By rejecting remote continuity, they disclaim one aspect of the doctrine that most often interferes with legitimate business structures. By arguing for codification of Revenue Procedure 77-37, they express the tax lawyer's preference for clear rules that do not impede most transactions, as well as the savvy realization that wars are won battle by battle. Their failure to criticize the taxation of minority shareholders under the anti-*Yoc Heating* regulations may reflect the nature of their client base: typically, acquirors and targets who benefit from the rule, rather than minority shareholders who are harmed. And, their unequivocal

211. Ginsburg & Levin, supra note 1, § 610 at 566.
212. Id. §§ 610.11.1-610.11.3 at 630-37.
213. Id. § 610.19 at 612.
214. Id. § 610 at 626-30.

support for a doctrine that permits taxpayers to elect in and out of reorganization treatment by invoking continuity (even if that treatment is inconsistent with the treatment accorded to other parties to the transaction) reflects their desire to retain maximum flexibility for their corporate clients who might alternatively wish to defer gain or recognize loss.

Although Ginsburg & Levin's suggestions would introduce modest improvements in current law, they do not appear to be supported by any comprehensive policy or basis. Also, they would perpetuate many of the detrimental consequences of the continuity doctrine described above in Part V.A.

2. *Continuity as an Anti-Abuse Rule.*—Recent administrative practice suggests that if the continuity doctrine were first introduced today, it would be phrased as an anti-abuse rule whose failure would permit the Service to bust an otherwise qualifying reorganization, but would not be available to the target or its shareholders as a basis for deducting a loss on a transaction that otherwise meets the statutory reorganization definition.[215]

Transforming the continuity doctrine into an anti-abuse rule would be consistent with *Cortland* and *Pinellas*, which fashioned the doctrine to prevent taxpayers from obtaining reorganization treatment for transactions that are, in substance, taxable sales. It would, however, run contrary to *Heintz* and *McDonald's*, which suggest that continuity is equally available to taxpayers. It would also be inconsistent with the integrated transaction cases, to the extent that they rely on the continuity doctrine. (However, these cases may be discounted as of limited precedential value to the extent they have been overturned by section 338 and the anti-*Yoc Heating* regulations.)

Making continuity an anti-abuse rule would obviously eliminate the whipsaw potential for the Service under the present doctrine, and it would also improve administrability and curb anomalous treatments of economically similar transactions. Whether a regulatory anti-abuse rule would eliminate uncertainty, increase economic efficiency and fairness, and advance the tax policies of the reorganization provisions would depend upon the details of the regulations issued to effectuate the change (including any safe harbors they might provide). For instance, if failure of continuity continues to affect target shareholders receiving acquiror stock, the transformation would not advance the policies behind nonrecognition treatment at the shareholder level.

It appears that continuity as an anti-abuse rule has some appeal to the Clinton Administration. In March 1996, it introduced a proposal to tax the distributing company in a section 355 transaction if a requisite amount of continuity (as defined in the proposal) does not exist for two years before and

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215. See, e.g., Regs. § 1.701-2; Temp. Regs. § 1.1275-2(g).

two years after the transaction. No loss would be allowed for a distribution that failed this test.[216]

Although reasonable minds could differ on the issue, the Treasury probably has power to remove the continuity weapon from taxpayers' hands. While continuity originated as a judicial interpretation of the definition of reorganization, it appears today to be entirely an administrative creature. In the most recent Supreme Court case to consider the doctrine, *Paulsen v. Commissioner*,[217] the Court appeared most moved by the doctrine's specific mention in the reorganization regulations and the Service's consistent administrative practice in asserting it.[218] In litigation, the Service has argued unsuccessfully that the continuity doctrine should be treated as an anti-abuse rule (especially in the F reorganization context discussed above in Part III.A.3), but the Treasury has never promulgated this view in regulations. Although anti-abuse continuity regulations would be controversial, the power to issue them should exist.

3. *Bifurcation.*—A third conception of continuity, which is without any grounding in current practice, would be to limit the effects of a continuity failure to the corporate level. Under this approach, an otherwise valid reorganization that lacked continuity (e.g., a statutory merger in which only 20% of the consideration was acquiror stock) would be a taxable event for the target, but would be tax-free for target shareholders receiving acquiror stock or securities. The transaction could be treated as a wholly taxable event for the target, or the target's gain or loss could be more precisely measured by reference to the nonqualifying consideration.

This approach would go far towards advancing the tax policies behind nonrecognition treatment for target shareholders that do not cash out their investments and, at the same time, advance the policies that deny deferral for targets that engage in what amounts to a taxable sale. However, while it would generally ameliorate the condition of target shareholders subject to tax on the receipt of illiquid acquiror stock, it would not spare them from the indirect effects of the corporate tax paid by the target on its recognized gains. Moreover, a bifurcation approach would not necessarily eliminate uncertainty, inefficiencies, unfairness, or the inconsistent treatment of economically similar transactions.

4. *Restricted Scope.*—As discussed above, because reorganizations under sections 368(a)(1)(B), (C), and (E) must meet statutory continuity

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216. The proposal is described in somewhat more detail in note 87.

217. 469 U.S. 131 (1985).

218. See *Paulsen*, 469 U.S. at 136 ("known as the 'continuity-of-interest' doctrine, this requirement has been codified in Regs. §§ 1.368-1(b), 1.368-2(a)"), 142 (discussing Revenue Rulings).

requirements (e.g., a solely for voting stock requirement), the extra-statutory judicial continuity doctrine could be eliminated as a requirement for these types of transactions. Continuity could remain for acquisitive A and D reorganizations, to distinguish them from taxable sales, but the threshold requirement for continuity could be restated as a fixed percentage of the acquiror's consideration.

Removing B and C reorganizations from continuity's application is consistent with the 1934 Act, which replaced the judicial continuity doctrine for these transactions with the solely for voting stock test that applies only at the corporate level. Thus, a stock or assets acquisition satisfying the solely for voting stock requirement would qualify as a B or C reorganization, regardless of what the target's shareholders did with their stock (or stock of the acquiror) before or after the acquisition.

Subsidiary mergers under section 368(a)(2)(E), which requires that the former shareholders of the surviving corporation receive sufficient stock in the surviving corporation to constitute control, could also be exempted from the continuity doctrine. As with A and C reorganizations, the statutory requirement could be read to supplant the extra-statutory continuity test.

Section 368(a)(2)(D) subsidiary mergers present a more difficult question. Section 368(a)(2)(D) codifies *Le Tulle* by requiring that stock of the parent be included in the consideration. A reasonable inference from the statutory language, which does not specify a threshold, is that any meaningful amount should suffice. However, the original version of section 368(a)(2)(D) would have required that the consideration for a forward subsidiary merger consist "solely" of parent stock. An equally reasonable interpretation (and one endorsed by the commentators) is that Congress relied on the continuity of interest doctrine to ensure that a *Pinellas-Cortland* transaction could not be consummated through a subsidiary merger.

As this article suggests, there is historical support for not applying any continuity test to statutory mergers and consolidations. However, although significant differences remain between statutory mergers and asset transfers that do not qualify as mergers under state law,[219] state merger requirements have been liberalized significantly in the 62 years since the 1934 Act. Thus, the purpose of the original continuity doctrine—to distinguish in a meaningful way between asset sales and mergers (in the 1934 sense of the word)—would not necessarily be served by relying on state law definitions. By the same token, although the judicial continuity doctrine has not been generally applied to D reorganizations, to the extent that a target could engage in an effective asset sale for cash, but literally qualify the

219. For example, the acquiror assumes liability for the target's obligations in a statutory merger, but not in an asset transfer.

transaction as a D reorganization, tax-policy supports at least some continuity doctrine for D reorganizations.[220]

However, as to A and D reorganizations (and possibly section 368(a)(2)(D) subsidiary mergers), the promulgation of regulations setting a fixed continuity threshold would be a significant improvement, importantly advancing administrability and reducing uncertainty. The Treasury should have the authority to promulgate such a rule, and should not be constrained by judicial thresholds fashioned in the absence of regulatory guidance. Moreover, if this absolute threshold was lower than the 50% representation required by Revenue Procedure 77-37, but high enough to ensure that some real portion of the acquiror's consideration consists of stock, continuity could be returned to a test for distinguishing a taxable sale from a merger-like reorganization, but not one that acts as an obstacle to nonabusive tax-free combinations. This change would not be a panacea. If the test was still applied at the shareholder level so that solely stock consideration would not assure tax-free status, it would not fully eliminate uncertainty or inadministrability. Also, if lack of continuity continues to affect shareholder taxation, as well as the taxation of the corporations, this change would not eliminate the unfairness of minority shareholders being taxed on the receipt of acquiror stock in a busted reorganization or the potential for future *Seagram*-type litigation.

5. *Objective Continuity Test Determined Exclusively at the Corporate Level.*—Finally, the Tax Court's view in *Seagram* could be codified, returning continuity to an objective test depending only on the nature and amount of the acquiror's consideration, without regard for the pre- or post-acquisition conduct of target shareholders or the use of the target's assets. Under this view, cases like *Superior Coach* and *Kass* would be understood as resting entirely upon the integrated transaction doctrine (and not continuity), and the shareholder conduct cases would be understood as resting solely upon the taxpayer's limited ability to invoke the step transaction doctrine where all relevant parties agree to take consistent tax positions. It is this evolved but limited form of continuity that, while far from perfect, shows the most promise for the doctrine's long-term survival.

This alternative, if adopted, would create a historical anomaly: Continuity could deny reorganization treatment to statutory mergers and consolidations (the model for nonrecognition treatment), but would generally not apply to other types of reorganizations. However, the application of continuity to statutory mergers and consolidations is supported by the relevant policies. Although the Code is devoid of additional qualification requirements

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220. See Bittker & Eustice, supra note 5, ¶ 12.26[2] at 12-92 to 12-93.

for a statutory merger or consolidation, it would exalt form over substance to permit local law definitions to dictate federal income tax consequences, especially in the flexible world of state corporate statutes. As the recent experience with limited liability company legislation so aptly demonstrates, states are not beyond passing legislation solely to facilitate desired federal income tax results. At this late date, Congress' lack of foresight in drafting section 368(a)(1)(A) to hinge on state law definitions can be excused. Presumably, if *Roebling* had gone the other way, and a statutory merger with solely cash consideration had been held to be a reorganization, Congress would have intervened with a stock consideration requirement for statutory mergers. Accordingly, continuity should continue to apply to statutory mergers and consolidations.

So evolved—or devolved to its embryonic form—continuity would serve the purpose for which it was designed: exposing the naked corporate asset sale that is draped in the robes of a reorganization. It would not, however, endanger those tax-free acquisitions, such as the *Seagram* transaction, that bear all the characteristics of a reorganization at the corporate level.

Continuity's breath should extend no further. There is no need to deny reorganization treatment at the corporate level solely as a result of a shift in the target shareholders remaining invested in the wake of the acquisition. From the corporate perspective, the transaction is unaffected by the identity of the combined entity's shareholders. To ensure that sections 354 and 356 are sufficient to prevent the betrayal of shareholder-level policies, it may be appropriate to tighten the definition of "stock or securities," whose receipt gauges the extent of the target shareholders' tax-free treatment. For example, it is consistent with these shareholder-level policies to require that a target shareholder actually bear equity risk with respect to acquiror stock for some period of time in order to receive the stock tax-free.[221] Accordingly, rules could be promulgated to deny the deferral of gain on a shareholder-by-shareholder basis if market risk in the acquiror is hedged with an equity swap, short sale, or other device.[222] However, it frustrates the Congressional policies favoring shareholder nonrecognition treatment to subject target

221. The Clinton Administration has taken a small step toward this requirement by proposing that certain preferred stock be characterized as boot. As discussed in note 103, enactment of this proposal should not affect preferred stock's privileged status as good consideration for continuity purposes. Thus, a statutory merger solely for such preferred stock would be tax-free at the corporate level, but taxable at the shareholder level.

222. The Clinton Administration has already taken a large step in this direction with its "short-against-the-box" proposal, which would tax any appreciation in stock that is subject to a "constructive sale." See Revenue Reconciliation Bill of 1996, § 9512 (submitted to Congress on March 19, 1996).

shareholders remaining fully invested in the combined entity's equity to taxation at the whim and fancy of their fellow shareholders. Thus, the Tax Court's decision in *Seagram* is the correct result and should be codified.

The wisdom of *Seagram* should extend to the shareholder conduct and integrated transaction cases. The results of those cases are defensible on the narrower grounds of step transaction—rather than the continuity of interest doctrine—and their holdings should be so limited.

The same rationale should apply with even greater force to a section 338 transaction. As the legislative history to that section indicates, Congress intended that the subsequent conduct of the target's majority shareholder would not subject the target to corporate-level tax. In confirming the exemption of the corporate parties to a qualified stock purchase and merger from the modern continuity doctrine, Congress surely did not intend to *frustrate* the policies supporting minority shareholder nonrecognition by subjecting them to taxation on the involuntary receipt of possibly illiquid acquiror stock. Thus, the anti-*Yoc Heating* regulations should permit tax-free treatment to minority shareholders that receive acquiror stock in the second-step merger.

The concept of remote continuity should be put to bed once and for all. To hinder the acquiror's use of target assets following an otherwise valid reorganization only frustrates legitimate business planning. Congress' piecemeal anti-*Groman* and anti-*Bashford* legislation should be interpreted as a cautious correction of a complex statute, rather than a policy statement that transactions not specifically addressed are prohibited. Moreover, continued adherence to a doctrine as formalistic as the remote continuity doctrine only invites abuse.

Continuity's sustained utility depends not only upon a restricted mandate but also upon a clear assignment. Accordingly, its equity requirement should be set as an absolute threshold that is objectively determinable at the time of the acquisition.[223] An absolute threshold would cure uncertainty, improve administrability, and eliminate inconsistent treatment, although it would not be perfect. Even if it is imposed at the lower thresholds established by the courts (e.g., between the 16% that was insufficient in *Kass* and the 25% that was sufficient in *Miller*), it would perpetuate the inevitable conflict with the policies that favor nonrecognition for target shareholders who receive acquiror stock in a reorganization busted for lack of continuity (and are taxed, in addition to indirectly bearing the target-level tax on recognized gains). Nevertheless, in the absence of a statutory mechanism to

223. This proposal has some commonality with the Clinton Administration's proposal to tax the distributing corporation on a § 355 transaction if a four-year (two before, two after)/50% continuity threshold is not met. The proposal is described in general terms in note 87.

tax only the target corporation on such an asset transfer, a low absolute threshold would minimize the conflict.

Although any regulatory solution to the continuity mess would be controversial, these limitations would bring continuity closest to its historical source and in line with the relevant tax policies. These improvements are within the Treasury's power.

VI. CONCLUSION

Continuity is an endangered doctrine. Having wandered from its natural role of distinguishing at the corporate level between taxable asset sales and tax-free reorganizations, the modern continuity doctrine is now vulnerable to predators. Congress attacked the doctrine by significantly limiting remote continuity, and the Service thinned the doctrine further with the anti-*Yoc Heating* regulations and its rulings ignoring continuity concerns in mutual savings and loan association mergers. Most recently, the *Seagram* court preyed on the wearied and over-extended doctrine, and the Service has indicated that it may join the chase. Continuity must adapt or face extinction.

Continuity should devolve to its original form and again serve the important but modest function of disqualifying reorganizations that resemble taxable asset sales. The Service should confirm the demise of remote continuity and the inapplicability of continuity to the shareholder conduct and integrated transaction cases, and it should modify the anti-*Yoc Heating* regulations to allow tax-free treatment to minority shareholders. Finally, continuity should be expressed by an absolute equity threshold, determinable at the time of the acquisition and binding on taxpayers and the Service alike.