

CONFRONTING CONTINUITY: A TRADITION OF FICTION IN CORPORATE REORGANIZATIONS

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The “continuity of interest” doctrine has determined the tax treatment of corporate mergers for over seventy years. Under this doctrine, a corporate merger may qualify for tax-deferred treatment if an acquiror corporation pays shareholders of the target corporation consideration that consists of at least a minimum amount of the acquiror corporation’s stock. The continuity of interest doctrine has been criticized as unclear, inefficient, and unfair. Much of this criticism, however, is obsolete and largely unpersuasive. This Article offers a different justification for repealing the doctrine: The end that the continuity of interest doctrine is intended to achieve—an aggregate group of former target corporation shareholders maintaining a “continuity of interest” in the acquiror corporation following a merger—is fiction. Because the doctrine serves a fictional premise, it does not distinguish effectively between special mergers deserving of tax-deferred treatment and ordinary sales that should be taxed currently. The second half of this Article presents a new proposal for replacing the continuity of interest doctrine. Without any regard to the nature of the consideration paid, the proposal delivers tax-deferred treatment where the acquiror corporation continues the historic business of the target corporation for at least two years following the merger and where a target shareholder’s

position within the enterprise does not change significantly as a result of its exchange of target corporation stock for stock in this acquiror corporation. While the continuity of interest doctrine serves a fictitious premise, the proposal presented in this Article restores some sense of truth to the policy of reserving special tax treatment for mergers that represent mere changes in form.

I. INTRODUCTION

If Tevye from the Broadway classic *Fiddler on the Roof*¹ were a tax lawyer instead of a milkman, he might stare quizzically at the reorganization provisions of the Internal Revenue Code (the “Code”) and describe them as overflowing with peculiar traditions. Here, he might say, we have traditions for everything—how to assume liabilities, how to pay consideration, and even how to merge!² Because of these traditions, the tax law governing corporate mergers has kept its balance for many, many years. One may ask, how did these traditions get started? Understandably, Tevye might answer, “I’ll tell you—I don’t know.”³

Of all these strange traditions, there is none as puzzling, or as important, as the celebrated “continuity of interest”

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¹ JERRY BOCK, *FIDDLER ON THE ROOF* (1964).

² See, e.g., I.R.C. §§ 354, 357, 361, 368 (2005).

³ BOCK, *supra* note 1. Mercifully, refrains of “If I were a tax lawyer . . .” have been omitted from this Article.

doctrine.⁴ The tax law contains a significant exception from the general requirement that taxpayers must recognize gains and losses upon an exchange of property for something “materially different” in the case of mergers that qualify as “reorganizations.” These are special mergers that Congress has described as “mere changes in form” and “purely paper transactions” that do not merit current taxation.⁵ The courts developed the continuity of interest doctrine as a way to distinguish these special mergers from ordinary sales.⁶ Under the doctrine, the shareholders of the target corporation (a “Target”) in a merger must receive a definite, material, and substantial proprietary interest in the acquiror corporation (an “Acquiror”) in exchange for their Target stock in order for the merger to qualify as a reorganization.⁷ The doctrine has been refined to require that Target shareholders, in the aggregate, must receive merger

⁴ The continuity of interest doctrine first emerged in 1932 in the Second Circuit decision, *Cortland Specialty Co. v. Commissioner*, 60 F.2d 937 (2d Cir. 1932). For excellent works providing general background on the continuity of interest doctrine, see BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 12.21 (7th ed. 2004); MARTIN D. GINSBURG & JACK S. LEVIN, *MERGERS, ACQUISITIONS AND BUYOUTS* ¶ 610 (2004 ed.) (providing dozens of helpful examples that apply the continuity of interest doctrine); Jere D. McGaffey & Kenneth C. Hunt, *Continuity of Shareholder Interest in Acquisitive Corporate Reorganizations*, 59 TAXES 659 (1981); Michael L. Schulz, *The Evolution of the Continuity of Interest Test, General Utilities Repeal and the Taxation of Corporate Acquisitions*, 626 PLI/TAX 1165 (2004); Bernard Wolfman, *Continuity of Interest and the American Law Institute Study*, 57 TAXES 840 (1979).

⁵ S. REP. NO. 65-617, pt. 1, at 5 (1918); H.R. REP. NO. 68-179, at 16 (1924).

⁶ See *infra* Part II for a discussion of these decisions. See also Treas. Reg. § 1.368-1(e) (as amended in 2005).

⁷ Treas. Reg. § 1.368-1(e) (as amended in 2005); *Helvering v. Minn. Tea Co.*, 296 U.S. 378, 386 (1935) (transaction qualified as reorganization because Target shareholders acquired a “definite” and “substantial” interest in the Acquiror).

consideration that consists of at least forty percent Acquiror stock.⁸

As the continuity of interest doctrine plays a pivotal role in determining whether a corporate merger is tax-deferred or taxable, it has been extolled as “the keystone of tax-free reorganizations,”⁹ “the bedrock upon which reorganization theory rests,”¹⁰ and “the glue that holds the reorganization provisions together.”¹¹

Despite this acclaim, the doctrine has also been subject to an abundance of criticism over the years. It has been described as “an arbitrary, complex, if not Byzantine” doctrine,¹² a doctrine reeking of “illogic,”¹³ and even a “sacred cow.”¹⁴ Taxpayers have complained that the continuity of interest doctrine is unclear, inefficient, and unfair.¹⁵ Critics claim that, under the doctrine, any one of a number of missteps before or after a merger could jeopardize its intended tax treatment.

⁸ Treas. Reg. § 1.368-1(e)(2)(v), ex. 1 (as amended in 2006) (aggregate merger consideration consisting of \$40 worth of Acquiror stock and \$60 cash satisfied continuity of interest requirement).

⁹ William J. Turnier, *Continuity of Interest—Its Application to Shareholders of the Acquiring Corporation*, 64 CAL. L. REV. 902, 902 (1976).

¹⁰ William T. Hutton, *Musings on Continuity of Interest—Recent Developments*, 56 TAXES 904, 904 (1979).

¹¹ Daniel Q. Posin, *Taxing Corporate Reorganizations: Purging Penelope’s Web*, 133 U. PA. L. REV. 1335, 1371 (1985).

¹² Wolfman, *supra* note 4, at 840.

¹³ Posin, *supra* note 11, at 1373.

¹⁴ Peter L. Faber, *Continuity of Interest and Business Enterprise: Is It Time to Bury Some Sacred Cows?*, 34 TAX LAW 239, 239 (1981).

¹⁵ The amount of commentary that fits into this category is too great to list even in a weighty footnote. For a representative sampling, see BITTKER & EUSTICE, *supra* note 4, ¶ 12.21; Peter L. Faber, *Postreorganization Sales and Continuity of Interest*, 68 TAX NOTES 863 (1995); Hutton, *supra* note 10; McGaffey & Hunt, *supra* note 4; David S. Miller, *The Devotion and Inevitable Extinction of the Continuity of Interest Doctrine*, 3 FLA. TAX REV. 187 (1996); Posin, *supra* note 11; Robert A. Rizzi, *Continuity of Interest and Reorganizations: Toward a Unified Theory*, 17 J. CORP. TAX’N 362 (1991); Turnier, *supra* note 9; Wolfman, *supra* note 4.

Over the last ten years, the federal government, through the U.S. Department of the Treasury (the “Treasury”) and the Internal Revenue Service (the “IRS”), has steadily chipped away at the continuity of interest doctrine in an attempt to alleviate taxpayer concerns. These administrative agencies have repealed rules regarding, among other items, the amount of time that Target shareholders must retain Acquiror stock and whether an Acquiror must pay merger consideration to “historic” shareholders of the Target.¹⁶ Indeed, in September 2005, the Treasury addressed the fact that the value of Acquiror stock may fluctuate between the day on which a merger agreement is signed and the day on which the merger actually occurs, by issuing regulations that dramatically alter the manner in which continuity of interest is measured.¹⁷

Although taxpayers have greeted these administrative efforts with near-universal applause,¹⁸ this approach fails to address fundamental questions. The discussion of the proper role of the continuity of interest doctrine has reached a critical fork in the road. The Treasury appears to have chosen to continue refurbishing this antiquated judicial concept into a set of rules with which taxpayers can learn to live. The better route, however, is to confront the purpose that the continuity of interest doctrine currently serves and to question the role of the doctrine in delivering a special exception from the realization rule.

This Article argues that the continuity of interest doctrine fails to distinguish between mergers that represent mere changes in form and those that should be considered ordinary sales. More specifically, this Article asserts that the continuity of interest doctrine does not achieve its intended purpose—to identify mergers where an aggregate group of former Target shareholders maintain a “continuity of interest” in the Acquiror following the merger. Today, corporate mergers may satisfy the continuity of interest

¹⁶ Treas. Reg. § 1.368-1(e) (as amended in 2005).

¹⁷ *Id.* § 1.368-1(e)(2).

¹⁸ *See, e.g.*, GINSBURG & LEVIN, *supra* note 4, ch. 6.

requirement in form, but in substance, Target shareholders may receive or retain little meaningful proprietary interest in the Acquiror. The typical criticism of the doctrine has ignored this fundamental defect.¹⁹ By highlighting the fictional premise on which the continuity of interest doctrine rests, this Article offers a different justification for repealing the doctrine.

The second half of this Article offers a new alternative proposal (the “Proposal”) for replacing the continuity of interest doctrine. In the past, alternatives to the continuity of interest doctrine, including the most prominent alternative offered by the American Law Institute in 1980,²⁰ have emphasized rejecting the continuity of interest doctrine in favor of an explicitly elective regime. Those alternatives have aimed to increase administrative convenience and simplicity, but at the cost of devising rules that fail to serve any other policy objective.

In contrast, the Proposal offered in this Article serves as an effective alternative to the continuity of interest doctrine in identifying special mergers that could be considered “mere changes in form” and where Target shareholders experience “purely paper transactions.”²¹

This Article argues that whether a merger should be considered a mere change in form is highly dependent upon whether an Acquiror continues a Target’s historic business following a merger in a real and meaningful way. Under the Proposal, at the corporate level, a merger will qualify for tax-favored treatment as a “qualifying merger” if a Target merges into an Acquiror (transferring substantially all of its assets to the Acquiror) and the Acquiror continues the historic business of the Target for at least two years following the merger. The Acquiror may conduct the historic business of the Target directly or may utilize substantially

¹⁹ Part III *infra* describes the typical criticism of the continuity of interest doctrine (and the shortcomings of this criticism) in detail.

²⁰ A.L.I., FEDERAL INCOME TAX PROJECT: SUBCHAPTER C (1980).

²¹ S. REP. NO. 65-617, pt. 1, at 5 (1918); H.R. REP. NO. 68-179, at 16 (1924).

all of the assets of the Target in a business of the Acquiror that is of “like kind” to the Target’s historic business. There is no requirement under the Proposal that the Acquiror pay Target shareholders any specified amount of Acquiror stock, cash, or any other type of property.

The Article also contends that, at the shareholder level, changes in a Target shareholder’s particular circumstances after a merger should be considered in determining whether the shareholder has experienced a “purely paper transaction.” The Proposal provides that Target shareholders will not be taxed upon the receipt of stock of an Acquiror into which the Target has merged in a qualifying merger. There are two exceptions to this shareholder non-recognition rule. First, to the extent that a Target shareholder exchanges any voting stock for non-voting stock, or vice versa, the exchange will be taxable. Second, if a former Target shareholder experiences a disproportionate reduction in his percentage interest (measured by either vote or value) as a result of the merger, then the Target shareholder’s exchange of any Target stock for Acquiror stock will be taxable. There is no requirement under the Proposal, however, that Target shareholders receive any specified amount of Acquiror stock in order for the shareholder non-recognition rule to apply. Target shareholders will be taxed, as under current law, on the receipt of any cash or other non-stock property to the extent of their realized gain.

The remainder of this Article is presented in five parts. Part II offers a brief overview of the origin and rationale of the reorganization provisions. Part III describes the typical criticism of the continuity of interest doctrine, and why it fails to offer compelling justification for repealing the doctrine. Part IV offers a different argument for repealing the doctrine by asserting that the doctrine fails to serve its intended purpose. Part V offers a new alternative to the continuity of interest doctrine by presenting the Proposal described briefly above. Part VI is the conclusion.

II. OVERVIEW AND RATIONALE OF THE REORGANIZATION TRADITIONS

After the management teams of two corporations have agreed to combine their businesses, their first task is to choose a transaction structure for their combination.²² The parties must decide whether the Acquiror should obtain the stock or the assets of the Target. They must analyze, from a number of perspectives, whether a merger of the Target into the Acquiror, or into a subsidiary of the Acquiror, makes more sense. One of the most important economic decisions that they must make is whether the combination should be structured as a currently taxable transaction or a tax-deferred reorganization.

In tax language, an acquisitive reorganization is a transaction in which an Acquiror obtains control over the stock or assets of a Target and the shareholders of the Target receive stock of the Acquiror (or of an affiliate of the Acquiror) in exchange for their Target stock.²³ A transaction that qualifies as a reorganization under the tax law can result in especially favorable tax benefits to Target shareholders and to the Target itself.²⁴

²² For excellent discussions of the first steps that parties generally take to effect a corporate merger or acquisition, see generally MARTIN LIPTON & ERICA H. STEINBERGER, TAKEOVERS AND FREEZEOUTS (2002 ed.); Stephen M. Bainbridge, *Exclusive Merger Agreements and Lock-ups in Negotiated Corporate Acquisitions*, 75 MINN. L. REV. 239 (1990); Dennis J. Block, *Defensive Measures in Anticipation of and in Response to Unsolicited Takeover Proposals*, 51 U. MIAMI L. REV. 623 (1997).

²³ The reorganization provisions of the Code are contained in I.R.C. § 368(a) (2005). The term “reorganization” has a different meaning in tax language than it does in other contexts. To non-tax specialists, a “reorganization” may refer solely to a bankruptcy restructuring. However, in tax language, a reorganization is a much broader concept, referring to mergers, consolidations, recapitalizations, divisions, asset or stock acquisitions, and other corporate transactions.

²⁴ Assuming, of course, that the parties do not desire to recognize taxable losses currently. In a reorganization, a Target is not entitled to recognize a loss currently if it exchanges property under a plan of reorganization for stock, securities, or property of another corporation that is a party to the reorganization. I.R.C. § 361(a) (2005). Target

At the shareholder level, a Target shareholder does not recognize gain or loss currently in a reorganization if it receives solely Acquiror stock in exchange for its Target stock.²⁵ Rather, the gain or loss realized is deferred until the Target shareholder disposes of the Acquiror stock received in the reorganization. If the Target shareholder also receives cash or other property (referred to as “boot”) from the Acquiror, then the shareholder is required to recognize taxable gain at the time of the transaction, but only to the extent of the fair market value of the boot received.²⁶

At the corporate level, the Target does not recognize gain or loss on the transfer of its assets to the Acquiror or on the receipt of Acquiror stock or other property that it immediately distributes to its own shareholders.²⁷

If a forward merger fails to qualify as a reorganization, current taxation results at *both* the shareholder and corporate levels.²⁸

A. Overview of the Reorganization Traditions

With certain exceptions, acquisitive reorganizations are subject to three overarching traditions, which are discussed separately below: the continuity of interest, the continuity of business enterprise, and the business purpose doctrines.

shareholders also will not be allowed to recognize a loss currently if they exchange Target stock or securities for Acquiror stock or securities pursuant to a plan of reorganization. I.R.C. § 354(a) (2005).

²⁵ I.R.C. § 354(a) (2005).

²⁶ *Id.* § 356(a).

²⁷ *Id.* §§ 354(a)(1), 361(a).

²⁸ A “forward” merger refers to a merger of a Target into the Acquiror or a subsidiary of the Acquiror, with the Acquiror, or the subsidiary of the Acquiror, surviving the merger. The double incidence of taxation results from the classical model of the U.S. corporate tax system. In this model, corporations and their shareholders are treated as separate persons (unless an election to disregard the separate existence of the corporation is available and exercised). Consequently, in a failed corporate reorganization, both the Target and its shareholders are subject to current taxation.

1. The Continuity of Interest Doctrine

The continuity of interest doctrine is the key determinant of a merger's qualification as a reorganization. The doctrine provides that Target shareholders must receive a definite, material, and substantial proprietary interest in the Acquiror in exchange for their Target shares in order for a merger to qualify as a reorganization.²⁹ In determining whether an Acquiror delivers this type of interest to the Target shareholders, the continuity of interest doctrine considers the *aggregate* amount of Acquiror stock that the Target shareholders receive in a reorganization.³⁰ Only Acquiror stock is respected as a sufficient continuing proprietary interest in the Acquiror.³¹

Under the continuity of interest doctrine, as currently applied by the Treasury and the IRS, an Acquiror in a merger that qualifies as a reorganization must pay Target shareholders aggregate merger consideration consisting of at least 40 percent Acquiror stock.³² For example, if an Acquiror delivers merger consideration to Target shareholders consisting, in the aggregate, of \$60 cash and forty Acquiror shares that are worth \$1 each, this merger consideration satisfies the continuity of interest doctrine because it consists of forty percent Acquiror stock.

The continuity of interest doctrine is a purely judicial creation.³³ The decisions that formed the doctrine can be distilled into four distinct categories. First, the courts held that in a merger qualifying as a reorganization, an Acquiror

²⁹ Treas. Reg. § 1.368-1(e) (as amended in 2005).

³⁰ Rev. Proc. 77-37, 1977-2 C.B. 568.

³¹ See, e.g., *LeTulle v. Scofield*, 308 U.S. 415 (1940); *Pinellas Ice & Cold Storage Co. v. Comm'r*, 287 U.S. 462 (1933).

³² Treas. Reg. § 1.368-1(e)(2)(v), ex. 1 (as amended in 2005).

³³ See *Helvering v. Minn. Tea Co.*, 296 U.S. 378 (1935); *John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935); *Pinellas Ice & Cold Storage Co. v. Comm'r*, 287 U.S. 462 (1933); *Cortland Specialty Co. v. Comm'r*, 60 F.2d 937 (2d Cir. 1932), *cert. denied*, 288 U.S. 599 (1933). See Erwin N. Griswold, *Securities and Continuity of Interest*, 58 HARV. L. REV. 705 (1945) for a thorough discussion of the early judicial decisions leading to the continuity of interest doctrine.

must pay Target shareholders Acquiror stock in order to provide these shareholders with a “definite” continuing interest in the affairs of the Acquiror (the “What” decisions).³⁴ Second, the courts dramatically expanded the doctrine by defining how much of the aggregate merger consideration must consist of Acquiror stock (courts blessed amounts ranging from 38.5 percent to 56 percent) (the “How Much” decisions).³⁵ Third, the courts held that the Acquiror stock must be delivered not to just any Target shareholders, but to *historic* Target shareholders (the “Who” decisions).³⁶ Fourth, the courts established that post-reorganization sales of Acquiror stock by former Target shareholders could violate

³⁴ In *Pinellas*, the Supreme Court articulated the continuity of interest doctrine by providing that Target shareholders must acquire a “definite” interest in the affairs of the Acquiror. As a result of *Pinellas* and several other “What” decisions, the continuity of interest doctrine held that only Acquiror stock would represent such a definite interest in the Acquiror. See also *Cortland Specialty Co. v. Comm’r*, 60 F.2d 937 (2d Cir. 1932), *cert. denied*, 288 U.S. 599 (1933) (“[T]he primary requisite [of a reorganization] is that there must be some continuity of interest on the part of the transferor corporation or its stock holders.”).

³⁵ The Supreme Court significantly broadened the continuity of interest requirement in *Helvering v. Minnesota Tea Co.*, 296 U.S. 378 (1935), by establishing that Acquiror stock must represent a “substantial” and “material” part of the aggregate consideration paid by an Acquiror to a Target or its shareholders. On the same day that it decided *Minnesota Tea*, the Supreme Court also held in *John A. Nelson v. Helvering*, 296 U.S. 374 (1935), that Acquiror non-voting preferred stock (which comprised 38.5 percent of the aggregate consideration delivered to Target shareholders) represented a “definite and substantial interest in the affairs of the [Acquiror] corporation,” and thus, satisfied the continuity of interest requirement.

³⁶ See, e.g., *Yoc Heating Corp. v. Commissioner*, 61 T.C. 168 (1973), in which the Tax Court held that a transaction did not qualify as a reorganization if a sufficient quantum of Acquiror stock was not paid to “historic” shareholders of the Target, and *J.E. Seagram Corp. v. Commissioner*, 104 T.C. 75 (1995), where the Tax Court held that only Target stock that was purchased by the Acquiror *itself* prior to a reorganization (as was the case in *Yoc Heating Corp.*) counted against the historic continuity of interest requirement.

the continuity of interest requirement (the “How Long” decisions).³⁷

In recent years, the Treasury and the IRS have issued a significant amount of taxpayer-friendly guidance in response to taxpayer concerns that the continuity of interest doctrine was wreaking havoc in modern business transactions.

For example, in 1998, the U.S. Treasury instituted a monumental change in the application of the continuity of interest doctrine when it issued rules providing that Target shareholders’ sales of Target stock prior to a reorganization and sales of Acquiror stock after a reorganization, in each case to parties unrelated to the Acquiror, are disregarded for continuity of interest purposes.³⁸ These rules obviated the “Who” decisions and the “How Long” decisions.

In addition, as recently as September 2005, the Treasury clarified the minimum threshold contemplated by the “How Much” decisions by establishing a clear forty percent guideline for taxpayers to use in determining whether the Acquiror stock to be paid to Target shareholders in a merger would represent a “substantial” amount of the total merger consideration.³⁹ In those regulations, the Treasury also acknowledged that the value of Acquiror stock may fluctuate between the day on which a merger agreement is signed and the day on which the merger is closed by permitting taxpayers to use signing date values of Acquiror stock in

³⁷ The courts addressed this question in two judicial decisions that involved similar facts, *Heintz v. Commissioner*, 25 T.C. 132 (1955), and *McDonald’s Restaurants of Illinois v. Commissioner*, 688 F.2d 520 (7th Cir. 1982). In *Heintz*, Target shareholders (who wanted cash for their Target shares) received Acquiror stock on the condition that the Acquiror help those shareholders dispose of the stock after the merger. In *McDonald’s*, the Target shareholders sold Acquiror stock received in a merger immediately after the merger and pursuant to a prearranged plan. In each of these cases, the Target shareholders sold their Acquiror stock for cash to third parties unrelated to the Acquiror. The court in each case held that the post-reorganization sales violated the continuity of interest requirement.

³⁸ Treas. Reg. § 1.368-1(e) (as amended in 2005).

³⁹ See *id.* § 1.368-1(e)(2).

certain instances to perform the continuity of interest calculation.⁴⁰

2. The Continuity of Business Enterprise Doctrine

An acquisitive reorganization must also satisfy the continuity of business enterprise requirement.⁴¹ An Acquiror must continue the Target's historic business following a reorganization, or it must use a significant portion of the Target's business assets in its own business.⁴² In contrast to the continuity of interest requirement, however, the continuity of business enterprise requirement under current law has not been viewed as particularly onerous to taxpayers.⁴³

3. The Business Purpose Doctrine

Last, each reorganization must be motivated by a legitimate business purpose.⁴⁴ In the acquisitive (as opposed to the divisive) reorganization context, the business purpose requirement is also easy to satisfy.⁴⁵ The mere fact that a Target would agree to combine with an unrelated Acquiror

⁴⁰ *Id.*

⁴¹ Treas. Reg. § 1.368-1(d)(1) (as amended in 2006) ("Continuity of business enterprise (COBE) requires that the issuing corporation (P) . . . either continue the target corporation's (T's) historic business or use a significant portion of T's historic business assets in a business.").

⁴² *Id.*

⁴³ CHERYL D. BLOCK, CORPORATE TAXATION 347 (2d ed. 2002).

⁴⁴ *Gregory v. Helvering*, 293 U.S. 465 (1935) (stating that the transaction "was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else . . ."); see Arthur M. Michaelson, "Business Purpose" and Tax-Free Reorganization, 61 YALE L.J. 14 (1952) (providing an overview of the business purpose doctrine in the context of acquisitive reorganizations); Harvey M. Spear, 'Corporate Business Purpose' in Reorganization, 3 TAX L. REV. 225 (1947).

⁴⁵ See Louis S. Freeman, *General Overview and Strategies in Representing Sellers*, 618 PLI/Tax 7 (2004) (observing that "the business purpose requirement as applied to acquisitive reorganizations is substantially less stringent than the requirement as applied to spinoffs").

implies that the Target's management believes that the combination will yield valuable synergies, that the Acquiror will provide new strategic direction to the business of the former Target or that the Target is simply in need of capital to run its business.⁴⁶

B. Specific Forms of Acquisitive Reorganizations

An acquisitive reorganization must also meet the specific statutory requirements of one of the reorganization provisions of the Code. Several of these forms of reorganization contain more stringent requirements than the general traditions described above. Specifically, the judicial continuity of interest doctrine is only relevant in the case of statutory mergers and forward triangular mergers.⁴⁷ Consequently, those two reorganization forms are the focus of this Article.⁴⁸

1. Statutory Merger

A statutory merger of the Target directly into the Acquiror, in which Target shareholders receive stock of the Acquiror, qualifies as a reorganization.⁴⁹ In this transaction, the Acquiror is the surviving corporate entity after the

⁴⁶ If, on the other hand, the transaction appears to be motivated in significant part by a desire to avoid federal income taxes, then a careful analysis of all the purposes motivating the reorganization is necessary. As Judge Hand famously wrote in *Helvering v. Gregory*, 69 F.2d 809, 811 (2d Cir. 1934), "the meaning of a sentence may be more than that of the separate words, as a melody is more than the notes."

⁴⁷ The other acquisitive forms of reorganization contain specific statutory provisions that dictate the contents of the consideration to be paid by the Acquiror. See I.R.C. §§ 368(a)(1)(B), (C) and (a)(2)(E) (2005).

⁴⁸ This article, thus, does not address statutory requirements regarding the amounts of Acquiror stock that must be paid to Target shareholders in other types of reorganizations, such as reorganizations under I.R.C. §§ 368(a)(1)(B), (C) or (a)(2)(E) (2005).

⁴⁹ I.R.C. § 368(a)(1)(A) (2005).

merger.⁵⁰ There are no restrictions here as to the type of consideration paid to the Target shareholders as long as the judicial continuity of interest requirement described above is satisfied.⁵¹ The statutory merger generally has been viewed as the least restrictive of the specific reorganization forms.⁵²

2. Forward Triangular Merger

In a forward triangular merger, the Target merges into a corporate subsidiary of the Acquiror (rather than into the Acquiror itself), and the Target shareholders receive stock of the Acquiror.⁵³ The surviving corporate entity in this merger is the corporate subsidiary of the Acquiror. This transaction will qualify as a reorganization if the corporate subsidiary of the Acquiror acquires “substantially all” of the Target’s assets,⁵⁴ Target shareholders do not receive any stock of the corporate subsidiary of the Acquiror,⁵⁵ and, again, the judicial continuity of interest doctrine described above is satisfied.

⁵⁰ See Treas. Reg. § 1.368-2(b)(1)(ii) (as amended in 2006) for specific requirements of a statutory merger or consolidation under I.R.C. § 368(a)(1)(A) (2005).

⁵¹ Other specific forms of acquisitive reorganizations, by contrast, require that only voting stock may be paid to Target shareholders. See I.R.C. § 368(a)(1)(B) (2005).

⁵² See BITTKER & EUSTICE, *supra* note 4, ¶ 12.22 (citing statutory mergers under I.R.C. § 368(a)(1)(A) (2005) as “the oldest of, and the prototype for, the various reorganization forms”); Thomas P. Fitzgerald et al., *Corporate Mergers, Acquisitions and Reorganizations*, 626 PLI/TAX 707 (2004).

⁵³ I.R.C. § 368(a)(2)(D) (2005). The key advantage to this transaction structure, as opposed to a statutory merger, is that the Target’s liabilities become those of the corporate subsidiary of the Acquiror rather than of the Acquiror itself.

⁵⁴ The IRS views at least 90 percent of the Target’s net assets and 70 percent of the Target’s gross assets as substantial. Rev. Proc. 86-42, 1986-2 C.B. 722 amplifying Rev. Proc. 77-37, 1977-2 C.B. 568.

⁵⁵ I.R.C. § 368(a)(2)(D)(i) (2005).

C. Rationale of the Reorganization Traditions

The primary explanation for Congress's enactment of the reorganization provisions is that Congress believed that certain mergers constituted "purely paper transactions" and "mere changes in form"⁵⁶ that should not be subject to current taxation.⁵⁷ The reorganization provisions thus represent Congress's express desire to exempt certain types of mergers and other transactions from the realization rule of our tax system.⁵⁸ According to the drafters of the reorganization provisions, it would not be appropriate to tax Target shareholders on their stock-for-stock exchanges in these types of transactions because they did not cash out their original investment, and thus, they did not experience a realization event.⁵⁹ In the eyes of the drafters, a

⁵⁶ In 1918, the Senate Finance Committee commented that the nonrecognition principle under the reorganization provisions was intended to "negative the assertion of tax in the case of certain purely paper transactions." S. REP. NO. 65-617, pt. 1, at 5 (1918). *See also* H.R. REP. NO. 68-179 (1924); S. REP. NO. 68-398, at 17-18 (1924) (commenting that the reorganization provisions are "mere changes in form and not in substance, and consequently should not be considered as affecting a realization of income at the time of the exchange").

⁵⁷ The development of the modern reorganization provisions of the Code can be traced to the period immediately following World War I and stretching until 1934. Congress enacted the first reorganization provisions in the Revenue Act of 1918, which provided that no taxable gain or loss would occur with respect to stock or securities received by a Target shareholder "in connection with the reorganization, merger or consolidation of a corporation." Revenue Act of 1918, ch. 18, § 202(b), 40 Stat. 1057, 1060 (1919). *See* Steven A. Bank, *Mergers, Taxes and Historical Realism*, 75 TUL. L. REV. 1 (2000), for a thorough discussion of the history of the reorganization provisions.

⁵⁸ For a positive description of the realization rule, see Deborah H. Schenk, *A Positive Account of the Realization Rule*, 57 TAX L. REV. 355 (2004).

⁵⁹ *See* H.R. REP. NO. 68-179, pt. 1, at 16 (1924); S. REP. NO. 68-398, pt. 1, at 17-18 (1924) (commenting that reorganizations represent mere "changes in form not substance"). The tax law requires that a "material" modification to a taxpayer's investment must occur in order for gain realized to give rise to income. *See* *Cottage Sav. Ass'n v. Comm'r*, 499 U.S. 554 (1991) (exchange of property triggers realization event when

realization event could only occur when the former Target shareholders disposed of their Acquiror stock received in a reorganization in exchange for “materially” different property, such as cash.⁶⁰

Commentators have argued that the reorganization provisions serve a number of other policy objectives, such as subsidizing corporate combinations⁶¹ and relieving taxpayers of liquidity⁶² and valuation⁶³ hardships that could result from the taxation of stock-for-stock exchanges that occur pursuant to certain mergers. This Article makes no attempt to probe the normative justifications for the reorganization provisions. Rather, this Article considers whether the continuity of interest doctrine effectively identifies mergers that could be characterized as “mere changes in form” and

exchanged properties are “materially different”); Treas. Reg. § 1.1001-1(a) (1996).

⁶⁰ See A.W. Gregg, *Treasury Expert Explains Tax Bill*, N.Y. TIMES, Jan. 5, 1924, at 1. Gregg, a Treasury official in the 1920s, noted that Congress did not intend the reorganization provisions to apply to ordinary sales.

⁶¹ Senator Watson, one of the original drafters of the reorganization provisions, stated that “at a time when so much reorganization is going on in the business world, it is thought by all those interested in the upbuilding of the industries of the country at this time that this is a very helpful provision.” 61 CONG. REC. 6563 (1921). See Jerome R. Hellerstein, *Mergers, Taxes, and Realism*, 71 HARV. L. REV. 254, 276 (1957) (describing efficiency as one of the principal rationales of the reorganization provisions). The author criticized this rationale, however, by commenting that “Congress has not seriously considered the wisdom of granting non-recognition to reorganization exchanges.” *Id.* at 276 n.22.

⁶² See ROBERT S. HOLZMAN, CORPORATE REORGANIZATIONS: THEIR FEDERAL TAX STATUS 68 (1948) (“If an exchange is deemed taxable and yet the taxpayer has received nothing that is more than a paper profit, where is he going to get the money to pay the tax?”).

⁶³ See Bank, *supra* note 57 (“Adams rationalized the existence of the reorganization provision on the ground that ‘it is difficult to make appraisals. In the average reorganization, or in many reorganizations, there is no definite, fixed market price for the securities.’”) (quoting *An Act to Reduce and Equalize Taxation, to Amend and Simplify the Revenue Act of 1918, and for Other Purposes: Hearing on H.R. 8245 Before the S. Comm. on Fin.*, 67th Cong. 29 (1921) (statement of Prof. T.S. Adams)).

“purely paper transactions,” the types of mergers upon which Congress intended to bestow special tax treatment.

III. TYPICAL CRITICISM OF THE CONTINUITY OF INTEREST DOCTRINE

Taking shots at the continuity of interest doctrine is a tradition among tax scholars and practitioners that is almost as old as the doctrine itself. Not surprisingly, the criticism has tended to fall into some familiar categories. Three of the most common charges levied against the doctrine are that it contains unclear requirements, provokes transactional inefficiency, and results in unfair outcomes.⁶⁴ Despite the repeated articulation of these claims, they are not compelling justifications for repealing the doctrine. None of them addresses the more fundamental question of whether the continuity of interest doctrine is an appropriate means of distinguishing between a merger that is a mere change in form and one that is an ordinary sale. This Part briefly describes the typical criticisms and their shortcomings.

A. Lack of Clarity

A common criticism of the continuity of interest doctrine is that its requirements are unclear. The doctrine requires that an Acquiror must pay a “substantial” amount of Acquiror stock to Target shareholders in order for a merger to qualify as a reorganization.⁶⁵ But *how much* Acquiror stock is enough? Acquiror stock thresholds ranging from 56 percent⁶⁶ to 50 percent⁶⁷ to 38.5 percent⁶⁸ of aggregate merger consideration have all been cited with approval by the courts and the IRS as providing a sufficient continuing interest to

⁶⁴ See, e.g., Faber, *supra* note 14; Hutton, *supra* note 10; Miller, *supra* note 15; Posin, *supra* note 11; Wolfman, *supra* note 4.

⁶⁵ Helvering v. Minn. Tea Co., 296 U.S. 378 (holding that Acquiror stock must consist of “a substantial part of the value of the thing transferred”).

⁶⁶ *Id.*

⁶⁷ Rev. Proc. 77-37, 1977-2 C.B. 568.

⁶⁸ John A. Nelson Co. v. Helvering, 296 U.S. 374 (1935).

Target shareholders. Because the required minimum threshold is not definite, so the argument goes, parties to a merger lack certainty that their merger consideration consists of the proper amount of Acquiror stock.⁶⁹ Without clear rules, the parties risk stumbling into a fully taxable transaction. This lack of certainty has been criticized as tending “to interfere with transactions at the fringes and otherwise to contribute to the heartburn of tax lawyers.”⁷⁰

Although the lack of clarity argument is frequently offered, it does not support the outright repeal of the doctrine. If proponents of this argument find ambiguity regarding the minimum required percentage of Acquiror stock troubling, then they should argue in favor of more definitive guidelines. Judges, not Congress, created the continuity of interest doctrine, and so it is understandable that the minimum required amount of Acquiror stock has varied from case to case. Indeed, over the past few years, the Treasury and the IRS have made a serious effort to set a clear minimum threshold amount. In September 2005, the Treasury issued final regulations that state that merger consideration consisting of forty percent Acquiror stock will satisfy the continuity of interest requirement.⁷¹ The new bright line requirement thus puts an end to the inquiry regarding how much Acquiror stock is enough. The more important question is whether the payment of *any* Acquiror stock to Target shareholders is an indication that a Target has undergone a mere change in form.

B. Transactional Inefficiency

A related criticism of the doctrine is that it results in an unreasonable amount of transactional inefficiency. Proponents of this criticism typically argue that lawyers for parties entering into merger agreements devote too much time to negotiating the means by which the continuity of

⁶⁹ See BITTKER & EUSTICE, *supra* note 4; GINSBURG & LEVIN, *supra* note 4, ¶ 610.

⁷⁰ Miller, *supra* note 15.

⁷¹ Treas. Reg. § 1.368-1(e)(2)(v), ex. 1 (as amended in 2005).

interest requirement will be satisfied instead of more important business issues.⁷²

For example, in most public company mergers, the merger agreement conditions the closing of the merger on the receipt by each of the Acquiror and the Target of a written opinion of counsel that the transaction will qualify as a reorganization.⁷³ If the lawyers for each party to the merger have different views on the proper amount of Acquiror stock that must be paid to Target shareholders to satisfy the continuity of interest requirement, then the parties could find themselves at a standstill.⁷⁴

Also, in the past, transactional inefficiency resulted because continuity of interest was tested using the value of Acquiror stock on the day on which a merger actually occurred, rather than on the day on which the merger agreement was signed.⁷⁵ Parties would expend valuable time negotiating extremely complex “tax treatment preservation”

⁷² See Jasper L. Cummings, Jr., *Reorganization Tax Opinions*, 452 PLI/TAX 897 (1999) (“Does it matter how close to ‘the edge’ (be it 40 percent or 50 percent) of continuity you are? Yes, as difficult questions can be avoided if the relevant line could not be crossed under any circumstances.”).

⁷³ See Edward D. Herlihy et al., *Financial Institutions Mergers and Acquisitions 2001: Adapting to the Challenges of a Changing Landscape*, 1299 PLI/CORP 11 (2002) (“[I]n part-stock/part-cash transactions intended to qualify as tax-free reorganizations, customary closing conditions that each party receive a tax opinion from its respective counsel may . . . give each party a right to walk away from the deal if the buyer’s stock price declines significantly enough to threaten meeting the ‘continuity of interest’ requirement . . . (i.e., that stock represent at least 40 to 45 percent of merger consideration value at closing)”).

⁷⁴ See *id.*

⁷⁵ See N.Y. State Bar Ass’n Tax Section, *Report on Continuity of Interest and Pre-Closing Stock Value Fluctuation*, 102 TAX NOTES 596 (2004), for a thorough description of this problem. See also LIPTON & STEINBERGER, *supra* note 22, §10.02; Deborah L. Paul, *IRS to Ease Continuity Requirements for Part-Cash/Part-Stock Deals*, 8 No. 5 M & A LAW. 11, 11 (2004) (stating that the “current practice of measuring continuity of proprietary interest at closing is awkward”); Adam Sohn, *A-Signing Continuity of Interest* (2004) (unpublished article, on file with author).

provisions designed to ensure that the continuity of interest requirement would be satisfied even if the value of the Acquiror's stock dropped between the signing and closing dates.⁷⁶

The argument that the continuity of interest doctrine results in transactional inefficiency is largely obsolete. First, the Treasury's new bright line forty percent Acquiror stock threshold should reduce transactional inefficiency. Differences of opinion between counsel over the appropriate amount of Acquiror stock that must be paid to Target shareholders should disappear. Second, in September 2005, the Treasury issued final regulations that address the fluctuation issue.⁷⁷ These regulations appear to alleviate the fluctuation concern and the need for complicated tax treatment preservation provisions in most merger agreements.

Further, even if the continuity of interest doctrine resulted in transactional inefficiency, that consequence alone should not merit the doctrine's repeal. Taxpayers in reorganizations receive a very special benefit—neither the Target nor the Target shareholders are subject to the realization rule that would require them to pay current tax. In light of this benefit, it is understandable that they are forced to satisfy a requirement intended to distinguish a special merger from an ordinary sale, even if their effort results in incidental transactional inefficiency.

C. Unfair Outcomes

Vocal opponents of the continuity of interest doctrine have long argued for its repeal as a result of the unfair

⁷⁶ See Paul, *supra* note 75, at 11 (“Many merger agreements contain a provision that increases the amount of stock consideration and decreases the amount of cash consideration if an adjustment is required in order to satisfy the continuity requirement and obtain the tax opinion. In some cases, those price adjustments are heavily negotiated. In all cases, as a business matter, the parties would just as well do without such price adjustments.”).

⁷⁷ Treas. Reg. § 1.368-1(e)(2) (as amended in 2005).

outcomes that they contend it produces, particularly with respect to minority Target shareholders.⁷⁸ The continuity of interest doctrine may cause a minority Target shareholder that exchanges her Target stock solely for Acquiror stock to suffer current taxation in the event that too many of her fellow Target shareholders receive cash in exchange for their Target shares.

The Tax Court considered these facts in *Kass v. Commissioner*.⁷⁹ In that case, the Tax Court held that Mrs. Kass, a minority shareholder who elected to receive solely Acquiror stock in a merger, engaged in a taxable exchange because the consideration paid in the aggregate to Target shareholders failed to satisfy the continuity of interest requirement.⁸⁰

Critics argue that it is inequitable to tax minority shareholders, like Mrs. Kass, who desire to continue their proprietary interest following a merger simply because of the actions of their fellow shareholders.⁸¹ They contend that the continuity of interest doctrine requires minority shareholders to obtain sophisticated tax advice in order to understand the tax consequences of exchanging shares or receiving cash.⁸² Consequently, the continuity of interest doctrine has the potential to penalize minority shareholders.

The treatment of minority shareholders, however, is not a sufficient justification for repeal of the continuity of interest doctrine. The purpose of the continuity of interest doctrine is to classify a merger as a mere change in form because a significant number of former Target shareholders continue to own an interest in the Acquiror after the merger. If we assume that the premise of the doctrine is valid (although this premise is questioned below), then Mrs. Kass *should* have suffered current taxation because her merger did not result in continued ownership by a significant number of

⁷⁸ See, e.g., Wolfman, *supra* note 4; Posin, *supra* note 11.

⁷⁹ 60 T.C. 218 (1973).

⁸⁰ *Id.*

⁸¹ See Wolfman, *supra* note 4.

⁸² See *id.*

former Target shareholders, and consequently, was not a mere change in form of the Target. Whether the Target underwent a mere change in form, rather than Mrs. Kass's position as a minority or majority shareholder, should determine whether her stock-for-stock exchange is taxable.

It is also inappropriate to repeal the continuity of interest doctrine for the purpose of equalizing treatment between majority and minority shareholders. Minority shareholders assume the risk of a variety of adverse consequences (both tax- and non-tax-related) by virtue of holding their shares in the minority.⁸³ For example, a corporation's decision to merge with another entity or to amend its charter are decisions that may directly impact minority shareholders' interests, but are beyond the control of these shareholders as a result of their minority position. The imposition of adverse tax consequences on minority shareholders due to the actions of other shareholders is no different. The corporate law, not the tax law, should bear the responsibility for protecting the rights of minority shareholders.

IV. CONTINUITY OF INTEREST: A TRADITION OF FICTION

The typical criticism of the continuity of interest doctrine is unpersuasive, in large part, because it fails to ask deeper questions about the doctrine. The basic premise of the continuity of interest doctrine is that continued ownership by a significant proportion of former Target shareholders in an Acquirer following a merger is the key indicator that a Target has undergone merely a change in form.⁸⁴ Effectively, the doctrine judges whether a thing has changed by looking to its owners rather than to the thing itself. This premise is questionable.

The shareholders of a corporation have a myriad of unique characteristics and intentions. In many corporations,

⁸³ See generally, Douglas K. Moll, *Shareholder Oppression in Close Corporations: The Unanswered Question of Perspective*, 53 VAND. L. REV. 749 (2000).

⁸⁴ BITTKER & EUSTICE, *supra* note 4, ¶ 12.21.

there is no indication that shareholders think, speak, or act with any degree of coordination. Yet, the continuity of interest doctrine implies that a Target's identity is inextricably linked to its historic shareholder base. Moreover, if a certain proportion of those shareholders fail to continue to hold an ownership interest in the repackaged Target following a merger, then the doctrine considers the Target to have undergone something more than a mere change in form.

But even if we accept this premise—that continued historic shareholder ownership is critical to the mere-change-in-form inquiry—there is an even more basic question to be addressed. Does the continuity of interest doctrine work?

This Part argues that the continuity of interest doctrine should be repealed because it fails to serve its intended purpose. In many mergers that qualify as reorganizations, the concept of a minimum quantum of proprietary interests in the Target continuing as proprietary interests in the Acquiror is fiction. Because the doctrine does not identify effectively those mergers where Target shareholders actually continue their proprietary interests following a merger, it certainly cannot distinguish between a merger that is a mere change in form and one that is an ordinary sale.

A. Something Completely Different

One might think that when Target shareholders “continue” their proprietary interests following a merger that is a mere change in form, they hold stock in an Acquiror that conducts either the business of the former Target or at least a similar business.⁸⁵ Why then, one might ask, would Target

⁸⁵ Such an assumption would seem particularly plausible given the requirements of other non-recognition provisions of the Code. For example, I.R.C. § 1031 (2005) offers non-recognition treatment to taxpayers when property held for productive use in a trade or business or for investment is exchanged solely for property of a like kind to be held either for productive use in a trade or business or for investment. However, the property to be exchanged must be of “like kind” in nature

shareholders be deemed to have continued an interest in the Target by holding stock in the Acquiror?⁸⁶

Despite this intuition, current law does not contain a meaningful requirement that Target shareholders own stock, following a merger, in an Acquiror that conducts the business of the Target or even a business similar to the Target's, in order to satisfy the continuity of interest doctrine.⁸⁷ In fact, Target shareholders may exchange their stock in a Target that conducts one business for stock in an Acquiror that conducts, in the immortal words of Monty Python, "something completely different."⁸⁸

The tax law contains rules requiring an Acquiror in a reorganization to "continue" the business enterprise of a Target following a merger that qualifies as a reorganization. These rules, however, have frequently been criticized as "rather loose and reasonably easy to satisfy."⁸⁹ The key part of a corporation's identity, its business activities, can be unrecognizably transformed as a result of a merger that qualifies as a reorganization without breaching these rules.

In these types of mergers, it is difficult to argue that Target shareholders, no matter how many receive stock in the Acquiror, continue their proprietary interests—at least, in the same way as before the merger—at all. Consider the following relatively simple hypothetical.

For the past forty years, Farmer Brown has operated a local dairy business in Delaware through his wholly owned

and character. Treas. Reg. § 1.1031(a)-1(b) (as amended in 2002). As the following discussion illustrates, the continuity of interest doctrine and the reorganization provisions contain no such "like kind" requirement.

⁸⁶ Indeed, the plain English definition of the word "continuity" is "uninterrupted duration or continuation especially without essential change." MERRIAM-WEBSTER'S COLLEGIATE DICTIONARY (11th ed. 2005).

⁸⁷ The relevant regulations require that an Acquiror "continue" the business of the Target. Treas. Reg. § 1.368-1(d)(i) (as amended in 2005). There is no requirement (bright line or implied) that the Acquiror continue the business of the Target for a set amount of time.

⁸⁸ My sincere apologies to Monty Python for subjecting it to the world of corporate tax. See MONTY PYTHON, AND NOW FOR SOMETHING COMPLETELY DIFFERENT (1971).

⁸⁹ BLOCK, *supra* note 43.

corporation, Small Cheesecorp. The heart of his business activity has been delivering cheese products to the local residents and businesses of his county. One day, Farmer Brown receives an unsolicited takeover offer from Acme Purse Company, a large producer of women's leather products. Acme Purse Company is very interested in acquiring Farmer Brown's valuable cattle supply and using it, not for cheese, but for leather purse production. The acquisition will be structured as a reorganization in which Acme Purse Company will pay Farmer Brown merger consideration consisting entirely of Acme Purse Company stock in exchange for his Small Cheesecorp stock, and Small Cheesecorp will be merged into Acme Purse Company.⁹⁰ Farmer Brown accepts Acme Purse Company's offer and the transaction closes. Because Farmer Brown exchanges his Small Cheesecorp stock for merger consideration consisting solely of Acme Purse Company stock, the continuity of interest requirement is easily satisfied.⁹¹

Even though Farmer Brown owns stock in a very different corporation following the merger than he did before the merger, Farmer Brown is deemed to have "continued" his proprietary interest. Before the merger, Small Cheesecorp was the embodiment of Farmer Brown's personal business skills and interests—cheese production. After the merger of Small Cheesecorp into Acme Purse Company, Farmer Brown's proprietary interest relates to a business in which he has little knowledge or interest—women's leather purse production. The continuity of business enterprise rules under current law enable the merger to qualify as a reorganization as long as Acme Purse Company uses substantially all of Small Cheesecorp's assets in "a" business.⁹² Because the rules do not require Acme Purse Company's business to be similar to Small Cheesecorp's business, the corporate identity of Small Cheesecorp

⁹⁰ The Acme Purse Company/Small Cheesecorp merger is intended to qualify as a reorganization under I.R.C. § 368(a)(1)(A) (2005).

⁹¹ Treas. Reg. § 1.368-1(e) (as amended in 2005).

⁹² *Id.* § 1.368-1(d)(i).

disappears in the merger. Farmer Brown, nonetheless, is treated as “continuing” his proprietary interest as though nothing more than a mere change in form has occurred. This characterization is fiction.

The continuity of interest and continuity of business enterprise rules under current law are linked. Commentators have criticized the lax nature of the continuity of business enterprise requirement, but they do not identify the link between those rules and the continuity of interest requirement.⁹³ One of the reasons that the continuity of interest requirement serves a fictional premise is that there is no clear rule that the Acquiror must preserve the corporate identity of the Target (its historic business) following a merger in a real and meaningful way. Without such a requirement, Target shareholders like Farmer Brown are depicted as continuing their proprietary interests irrespective of the material change that those interests may have undergone.

B. Disproportionate Changes in Proportionate Interest

The continuity of interest doctrine does not require a Target shareholder to continue to own a proportionate interest in the Acquiror after a merger that is similar to the proportionate interest that it owned in the Target prior to the merger.⁹⁴ Just as the size of an Acquiror relative to that of a Target is irrelevant for continuity of interest purposes,⁹⁵ so too is the comparison of the Target shareholder’s proportionate interest in the Target with the proportionate

⁹³ See BLOCK, *supra* note 43.

⁹⁴ The relevant Treasury regulations state that “[a] proprietary interest in the target corporation is preserved if, in a potential reorganization, it is exchanged for a proprietary interest in the issuing corporation . . . , it is exchanged by the acquiring corporation for a direct interest in the target corporation enterprise, or it otherwise continues as a proprietary interest in the target corporation.” Treas. Reg. § 1.368-1(e) (as amended in 2005).

⁹⁵ Whether measured in terms of the Acquiror’s market capitalization, net asset value, or revenue, in the world of continuity of interest, size does not matter.

interest that the Target shareholder will hold in the Acquiror.⁹⁶ Consequently, a Target shareholder holding stock representing a large proportionate interest (whether in terms of voting power or value) in the Target can exchange his Target stock for Acquiror stock that represents a relatively insignificant proportionate interest in the Acquiror without violating the continuity of interest requirement.

To appreciate this surprising allowance, consider the following variation on the previous example: There are 1,000 shares of Small Cheesecorp stock outstanding, and Farmer Brown owns all 1,000 shares. Farmer Brown thus owns one hundred percent of the stock of Small Cheesecorp. Big Cheesecorp, the largest producer and distributor of cheese in the Eastern United States, offers to acquire Small Cheesecorp. The transaction will be structured as a reorganization in which Big Cheesecorp will pay Farmer Brown 1,000 shares of Big Cheesecorp stock (worth \$100,000 in the aggregate) in exchange for Farmer Brown's stock in Small Cheesecorp, and Small Cheesecorp will be merged into Big Cheesecorp.⁹⁷ There are approximately 100,000,000 shares of Big Cheesecorp stock outstanding and traded on the New York Stock Exchange. Farmer Brown accepts Big Cheesecorp's proposal. Again, because Farmer Brown exchanges his Small Cheesecorp stock for merger consideration consisting solely of Big Cheesecorp stock, the continuity of interest requirement is satisfied.⁹⁸

In this transaction, Farmer Brown's proportionate interest has changed dramatically. Whereas Farmer Brown owned 100 percent of Small Cheesecorp before the merger, Farmer Brown now owns a mere .001 percent of Big Cheesecorp after the merger.⁹⁹ Table 1 below illustrates the

⁹⁶ See also Posin, *supra* note 11 (observing that there is no requirement regarding relative size in the continuity of interest regulations).

⁹⁷ The Big Cheesecorp/Small Cheesecorp merger is intended to qualify as a reorganization under I.R.C. § 368(a)(1)(A) (2005).

⁹⁸ Treas. Reg. § 1.368-1(e) (as amended in 2005).

⁹⁹ As a result of the merger, Farmer Brown's proportionate interest has plummeted 99.999 percent.

change in Farmer Brown's proportionate interest following the merger:

Table 1. Farmer Brown's Relative Proportionate Interests in Small Cheesecorp and Big Cheesecorp

	Small Cheesecorp (Before Merger)	Big Cheesecorp (After Merger)
Shares Owned by Farmer Brown	1,000	1,000
Total Shares Outstanding	1,000	100,000,000
Farmer Brown's Proportionate Interest	100%	.001%

Prior to the merger, Farmer Brown was completely in control of the corporate actions of Small Cheesecorp. He decided who would run his cheesemaking equipment and maybe even how long his cheese would hang or at what temperature it would be prepared. However, *after* the merger, Farmer Brown is just another minority shareholder, owning an interest representing one thousandth of a percent of Big Cheesecorp. He cannot direct the corporate actions of the company; instead his role is relegated to attending shareholder meetings and occasionally voting for directors of the company in annual shareholder elections. His voting power, though, represents only 1,000 out of 100,000,000 votes.¹⁰⁰

Once again, Farmer Brown has exchanged his proprietary interest in Small Cheesecorp for stock in something completely different. As a result of the merger, Farmer Brown has experienced a very significant change in his role as a shareholder, as he has been transformed from a sole shareholder who controlled nearly all corporate decisions to one who has an almost infinitesimal role in corporate

¹⁰⁰ It is likely that, given Farmer Brown's relatively minuscule influence over the corporate affairs of Big Cheesecorp, Farmer Brown may not even participate in routine shareholder meetings. See Arthur D. Spratlin, Jr., *Modern Remedies for Oppression in the Closely Held Corporation*, 60 MISS. L.J. 405, 405 (1990) (discussing rights of minority shareholders in a publicly held corporation).

decisionmaking. Yet, the continuity of interest doctrine holds that Farmer Brown has continued his interest, experiencing a mere “readjustment” of his investment.

Other commentators have noted that the treatment of a merger of a small private company into a large public company as a reorganization represents a weakness in the continuity of interest doctrine. However, their analysis tends to focus on the “marketable” nature of the stock in a publicly traded Acquiror that Target shareholders receive.¹⁰¹ Because the Acquiror stock received in these mergers is marketable, Target shareholders can quickly dispose of it for cash.¹⁰² Commentators contend that the liquid nature of such Acquiror stock is contrary to the concept of continuity of interest.

This Part has offered a different argument by emphasizing the change in proportionate interest experienced by the Target shareholder, rather than the marketable nature of the Acquiror stock received. That a public market exists in which a former Target shareholder can easily dispose of his newly received Acquiror stock following a merger does not necessarily mean that the Target shareholder is not able to continue his proprietary interest. After all, a large privately held Target could just as easily merge into a large publicly held Acquiror, with the Target shareholders receiving marketable Acquiror stock in the merger. The more compelling indication that continuity of interest may not exist following this type of merger is that a former Target shareholder’s basic role within the enterprise and stake in its value (represented by proportionate interest) may have changed significantly as a result of the merger.¹⁰³

¹⁰¹ For example, Professors Bittker and Eustice observe that “the merger of an independent corner grocery store into a national food chain” is a reorganization, even though “the local merchant who has exchanged his stock for the marketable stock of the surviving corporation may feel, quite rightly, that he has sold out.” BITTKER & EUSTICE, *supra* note 4, ¶ 12.01. See also A.L.I., *supra* note 20, at 162.

¹⁰² See A.L.I., *supra* note 20, at 162.

¹⁰³ A likely rebuttal to the arguments presented above is that they place too much weight on the change in the *nature* of Farmer Brown’s

C. The Escrow Rules

In certain circumstances, Target shareholders may receive little or even no Acquiror stock in a transaction that technically satisfies the continuity of interest requirement. A merger agreement may contemplate merger consideration that consists of at least some Acquiror stock, but it may also require that a portion of that consideration be placed in an escrow account to secure a Target's customary pre-closing covenants or representations and warranties.¹⁰⁴ A Target may make certain representations and warranties regarding its business to an Acquiror through a provision in the merger agreement.¹⁰⁵ The merger agreement could provide that, after the merger, the Acquiror will be entitled to be indemnified by the former shareholders of the Target for damages resulting from any breaches of these representations. Under rules that the Treasury has recently enacted, Acquiror stock placed in escrow still counts toward satisfying the continuity of interest requirement, even though Target shareholders may never receive it.¹⁰⁶

Many members of the tax community have praised the new escrow rules as helpful to taxpayers engaging in real-world transactions where such escrow mechanisms are

proprietary interest. What if Farmer Brown did not exchange his Small Cheesecorp stock for Big Cheesecorp stock, but instead took Small Cheesecorp public through an initial public offering? Because Farmer Brown's retained interest in Small Cheesecorp would likely become more diluted and liquid, would we argue that Farmer Brown has experienced a realization event as a result of a change to the nature of his investment? The key difference between that hypothetical and a merger qualifying as a reorganization is that in the merger, Farmer Brown *actually* exchanges his Small Cheesecorp stock for something completely different—Big Cheesecorp stock.

¹⁰⁴ For a thorough explanation of such escrow agreements, see Elliott V. Stein, *Negotiating the Purchase Agreement for a Closely Held Business*, SK065 A.L.I.-A.B.A. 441 (2005).

¹⁰⁵ Representations in a merger agreement may address tax, corporate, environmental, litigation, and other potential areas of liability exposure for an Acquiror.

¹⁰⁶ Treas. Reg. § 1.368-1(e)(2)(iii)(D) (as amended in 2005). See GINSBURG & LEVIN, *supra* note 4, ¶ 610.2.

commonplace.¹⁰⁷ Few, however, have commented on the escrow rules' contribution to the illusory nature of continuity of interest. If the merger consideration that is earmarked for an escrow account in a part-cash, part-stock merger is some or all of the Acquiror stock, then Target shareholders may not receive this stock at all. Rather, that escrowed stock may remain in the escrow account indefinitely (or at least for a very long period of time).¹⁰⁸

For example, returning to Big CheeseCorp's merger with Small CheeseCorp, assume that instead of paying Farmer Brown merger consideration consisting entirely of Big CheeseCorp stock, the parties agree that Big CheeseCorp will pay Farmer Brown 400 shares of Big CheeseCorp stock (worth \$40,000 in the aggregate) and \$60,000 cash. The aggregate merger consideration on its face satisfies the continuity of interest requirement because forty percent of it is Acquiror stock. The parties agree that an escrow account will be created and that a portion of the merger consideration will be placed in this escrow account. If Big CheeseCorp suffers damages after the merger because some of Farmer Brown's representations in the merger agreement are breached, then Big CheeseCorp will be indemnified solely with funds from the escrow account.¹⁰⁹ The merger agreement also provides that Farmer Brown will not be entitled to vote any of the Big CheeseCorp stock held in the escrow account. Nor will any of this stock accumulate dividends. The parties agree that Big CheeseCorp will be entitled to maximum indemnification of \$30,000 from the

¹⁰⁷ The new regulation is particularly helpful in that it does not contain many of the requirements that the IRS previously imposed when issuing private letter rulings where stock of an Acquiror in a reorganization was deposited into an escrow account. *See* Rev. Proc. 84-42, 1984-1 C.B. 521.

¹⁰⁸ Treas. Reg. § 1.368-1(e)(2)(iii)(D) (as amended in 2005).

¹⁰⁹ This mechanism may be especially attractive to Farmer Brown if he knows of any significant potential liability that may result from a breach of his representations because it caps the total amount of Farmer Brown's possible indemnification at the value of the Acquiror stock deposited into the escrow account.

escrow account, so 300 shares of the Big Cheesecorp stock (worth \$30,000) to which Farmer Brown is entitled will be deposited into the escrow account. After the 300 shares of Big Cheesecorp stock are deposited into the escrow account, the merger consideration that Farmer Brown *actually* receives consists of approximately 86 percent cash and 14 percent Big Cheesecorp stock.¹¹⁰ Table 2 below illustrates the proportions of aggregate merger consideration consisting of Big Cheesecorp stock that Farmer Brown would receive depending on whether or not an escrow account is used.

Table 2. Proportions of Merger Consideration Consisting of Big Cheesecorp Stock Where an Escrow Account Is Used Versus No Escrow Account

	Assuming Escrow Account	Assuming No Escrow Account
Value of Cash Received	\$60,000	\$60,000
Value of Big Cheesecorp Stock Received	\$10,000 (100 shares @ \$100 per share)	\$40,000 (400 shares @ \$100 per share)
Proportion of Aggregate Merger Consideration Consisting of Big Cheesecorp Stock	14%	40%

Under the Treasury's recently enacted regulations, the merger in this example would satisfy the continuity of interest requirement and receive tax-favored reorganization treatment. Even though the aggregate merger consideration that Farmer Brown actually receives consists of only 14 percent Big Cheesecorp stock (rather than at least 40 percent Big Cheesecorp stock), Farmer Brown is still deemed to have "continued" his proprietary interest because he received a "substantial" interest in Big Cheesecorp.

The regulations provide that if the Big Cheesecorp stock held in escrow is eventually forfeited and returned to Big

¹¹⁰ \$10,000 worth of Big Cheesecorp stock divided by \$70,000 of aggregate merger consideration equals approximately 14 percent Big Cheesecorp stock.

Cheesecorp, then the escrowed stock counts against the merger's satisfaction of the continuity of interest requirement.¹¹¹ However, the regulations do not require that Farmer Brown be entitled to vote the Big Cheesecorp stock held in escrow or that the Big Cheesecorp stock held in escrow accrue dividends paid by Big Cheesecorp on its stock.¹¹² Indeed, the regulations do not require that the Big Cheesecorp stock held in escrow be released to Farmer Brown at all.¹¹³

The escrowed stock example is another illustration of the continuity of interest fiction. On paper, the merger agreement provides that Farmer Brown will own 400 shares of Big Cheesecorp stock after the merger. In reality, Farmer Brown does not exercise any of the typical rights of ownership over the shares held in escrow. The merger consideration that Farmer Brown actually receives following the merger consists of a very small proportion (14 percent) of Acquiror stock. The regulations pretend that Farmer Brown owns the 300 escrowed Big Cheesecorp shares for purposes of testing continuity of interest even though he does not possess

¹¹¹ Treas. Reg. § 1.368-1(e)(2)(v), ex. 2 (as amended in 2005).

¹¹² *Id.* Prior to the issuance of these regulations, whether escrowed stock counted towards satisfying the continuity of interest requirement was a major concern of practitioners. See N.Y. State Bar Ass'n Tax Sec., *Treatment of Variable Stock Consideration in Tax-Free Corporate Reorganizations* (Feb. 4, 2004), available in 102 TAX NOTES 864 (2004) (escrowed stock should be treated as owned by Target shareholders). As the 2004 New York State Bar Association Report indicates, "The primary indicia of stock ownership are (1) formalities of title (although these are given limited weight), (2) right to dividends, (3) ability to exercise voting power, (4) power to dispose of the stock, (5) opportunity for gain and (6) risk of loss . . ." *Id.*

¹¹³ The Big Cheesecorp stock could remain in the escrow account until the statute of limitations applicable to the reorganization has expired. After this point, the Big Cheesecorp stock in the escrow account could be released to Big Cheesecorp without enabling the IRS to apply the portion of the Treasury regulations that would cause this stock to count against the continuity of interest requirement. See Treas. Reg. § 1.368-1(e)(2)(iii)(D) (as amended in 2005).

any of the “primary indicia of stock ownership”¹¹⁴ over these shares.

D. “Mere Dispositions” and Post-Reorganization Continuity

If the concept of continuity of interest is that Target shareholders “preserve” or “continue” their proprietary interests following a merger by holding stock in the Acquiror, then post-reorganization sales of this Acquiror stock could rightfully be viewed as severing continuity.¹¹⁵ However, due to the burdens imposed on taxpayers, the Treasury effectively abolished the post-reorganization continuity of interest requirement in 1998.¹¹⁶

The 1998 Treasury regulations have been widely praised by tax commentators as making the continuity of interest requirement workable in modern business transactions. Taxpayers are now able to execute mergers without worrying that sales by Target shareholders of Acquiror stock after a merger could violate the continuity of interest requirement. This view, however, is shortsighted. While the new rules are a powerful display of administrative relief, certain aspects of

¹¹⁴ N.Y. State Bar Ass’n Tax Section, *Treatment of Variable Stock Consideration in Tax-Free Corporate Reorganizations* (Feb. 4, 2004), available in 102 TAX NOTES 864 (2004).

¹¹⁵ Indeed, in the “How Long” decisions, the courts held that sales of Acquiror stock by Target shareholders after a merger could cause the transaction to fail the continuity of interest requirement. *See, e.g.*, *Heintz v. Comm’r*, 25 T.C. 132 (1955) (holding that continuity of interest was severed where Target shareholders received Acquiror stock on the condition that they receive assistance from the Acquiror in selling that stock after the merger); *see also McDonald’s Rest. v. Comm’r*, 688 F.2d 520 (7th Cir. 1982) (the sale of Acquiror corporation stock immediately following a merger and pursuant to a pre-merger plan caused the merger to fail the continuity of interest requirement even though the target shareholders were not under a binding obligation to sell).

¹¹⁶ *See* Treas. Reg. § 1.368-1(e) (as amended in 2005). In its preamble to these regulations, the government stated that the regulations will “greatly enhance administrability in this area.” T.D. 8760, 1998-1 C.B. 803.

the rules contribute significantly to the fiction underlying the continuity of interest doctrine.

The 1998 Treasury regulations provide that post-reorganization sales of Acquiror stock by Target shareholders are disregarded for continuity of interest purposes as “mere dispositions” as long as the Target shareholders do not sell the stock to the Acquiror or to a party “related” to the Acquiror.¹¹⁷ Thus, immediately after a merger is consummated, Target shareholders may sell much of the Acquiror stock they received in the merger to a third party for cash and still receive tax-deferred treatment on the Acquiror stock they retain.¹¹⁸ This rule tests continuity of interest by taking a snapshot at the moment a merger closes.

But, even this snapshot image of continuity of interest is illusory. As discussed above, Target shareholders can dispose of the Acquiror stock that they receive immediately following the merger without violating continuity. The 1998 Treasury regulations disregard these sales even if they occur pursuant to a *pre-existing*, binding written contract.¹¹⁹ A Target shareholder can arrange to dispose of Acquiror stock that it will receive in a merger—even before owning it—without impinging upon continuity of interest.

Returning to our example, assume that Farmer Brown agreed to exchange his Small Cheesecorp stock for merger consideration consisting of \$60,000 cash and 400 shares of Big Cheesecorp stock (worth \$40,000 in the aggregate). Farmer Brown could sign a binding written contract, before the merger even closes, to transfer to a third party 300 of the shares that he will receive in the merger for \$30,000 cash.

¹¹⁷ See Treas. Reg. § 1.368-1(e) (as amended in 2005).

¹¹⁸ In fact, the 1998 Treasury regulations enable a Target shareholder to dispose of *all* of the Acquiror stock it receives *immediately* after a reorganization without infringing upon the continuity of interest requirement. See Treas. Reg. § 1.368-1(e) (as amended in 2005).

¹¹⁹ *Id.* § 1.368-1(e)(7), ex. 1 (as amended in 2006) (merger in which Target shareholder receives cash and Acquiror stock and, immediately after the merger, disposes of all of the Acquiror stock it received to a third party pursuant to a “preexisting binding contract” does not violate the continuity of interest requirement).

Immediately after the merger closes, therefore, Farmer Brown would hold a total of \$90,000 cash and one hundred shares of Big Cheesecorp stock (worth \$10,000 in the aggregate), meaning that a mere 10 percent of the aggregate consideration he receives would consist of Big Cheesecorp stock.

Table 3 below illustrates the proportion of the aggregate merger consideration delivered to Farmer Brown that consists of Big Cheesecorp stock assuming that Farmer Brown enters into a pre-existing binding contract to sell to a third party and, alternatively, assuming that he does not enter into such a contract.

Table 3. Proportion of Merger Consideration Consisting of Big Cheesecorp Stock Where Farmer Brown Enters into a Pre-Existing Binding Contract to Sell Versus Situation Where No Pre-Existing Binding Contract to Sell Exists

	Assuming Pre-Existing Binding Contract to Sell	Assuming No Pre-Existing Binding Contract to Sell
Value of Cash Received from Big Cheesecorp	\$60,000	\$60,000
Value of Cash Received from Third Party	\$30,000	\$0
Value of Stock Received from Big Cheesecorp	\$10,000 (100 shares @ \$100 per share)	\$40,000 (400 shares @ \$100 per share)
Proportion of Aggregate Merger Consideration Consisting of Big Cheesecorp Stock that Farmer Brown Receives	10%	40%

Does the end result here indicate that Farmer Brown received \$90,000 in cash and \$10,000 worth of Big Cheesecorp stock in the merger? Although Farmer Brown sold most of his Big Cheesecorp stock *before he even owned it*, according to the continuity of interest doctrine (as modified

by the 1998 Treasury regulations), the answer is “no.”¹²⁰ Farmer Brown benefited from tax-deferred treatment of the one hundred shares of Big Cheesecorp stock that he did retain because he “continued” his proprietary interest following the merger.¹²¹

Another aspect of the 1998 Treasury regulations that contributes to the continuity of interest fiction involves the requirement that the Target shareholders may not sell the Acquiror stock received in a reorganization to parties “related” to the Acquiror.¹²² This rule makes intuitive sense. If the Acquiror’s wholly owned subsidiary or sole shareholder could acquire for cash the Acquiror stock received by former Target shareholders in the merger, then, effectively, the Acquiror could deliver cash, and not stock, to those shareholders.¹²³

A major inconsistency in these rules, however, is that only a corporation can technically qualify as a “related person.”¹²⁴ If an individual, rather than a corporation, owns 100 percent of an Acquiror, this individual shareholder is not considered to be a person “related” to the Acquiror.¹²⁵ Consequently, in a statutory merger, an Acquiror that is

¹²⁰ *See id.*

¹²¹ If the continuity of interest doctrine viewed Farmer Brown as receiving \$90,000 in cash and \$10,000 worth of Big Cheesecorp stock, then Farmer Brown would realize a taxable gain equal to the difference between the full \$100,000 of merger consideration and his adjusted basis in his Small Cheesecorp stock. Treas. Reg. § 1.1001-1(a) (1996).

¹²² Treas. Reg. § 1.368-1(e)(7), ex. 1 (as amended in 2005).

¹²³ An Acquiror’s wholly owned corporate subsidiary qualifies as a “related person” to the Acquiror. *Id.* § 1.368-1(e)(4). It is logically consistent that this rule would also apply to shareholders in control of the Acquiror.

¹²⁴ *Id.* § 1.368-1(e)(4)(i). Generally, a person is related to the Acquiror under these regulations if either (A) the two corporations are members of the same affiliated group, as defined in I.R.C. § 1504 (2005) (without regard to I.R.C. § 1504(b)) (2005) or (B) (2005) the purchase of stock by one corporation would be treated as a distribution in redemption of stock of the first corporation under § 304(a)(2) (without regard to Treas. Reg. § 1.1502-80(b) (2005)).

¹²⁵ *Id.*

wholly-owned by an individual shareholder can agree to deliver aggregate merger consideration consisting of \$60,000 cash and 400 Acquiror shares (worth \$40,000 in the aggregate) to Target shareholders in exchange for their Target stock; prior to the consummation of the merger, the individual sole shareholder of the Acquiror can also make an agreement with the Target shareholders to repurchase 300 of the Acquiror shares for \$30,000 cash immediately after the merger closes. Even though the Target shareholders in such a transaction only receive merger consideration consisting of 10 percent Acquiror stock, because the Target shareholders agree to sell a portion of their Acquiror stock to a person that is “unrelated” to the Acquiror (the individual sole shareholder), the continuity of interest requirement is satisfied.¹²⁶

Despite the rule restricting an Acquiror’s post-reorganization repurchase of its stock for cash from Target shareholders, there are also certain instances in which an Acquiror can repurchase for cash the very Acquiror shares that it delivered to Target shareholders in a reorganization without adversely implicating continuity of interest. In Revenue Ruling 99-58,¹²⁷ the IRS ruled that an Acquiror’s post-reorganization stock repurchases did not infringe upon continuity of interest where the Acquiror repurchased these shares to “prevent dilution resulting from the issuance of [Acquiror] shares in the merger” pursuant to a pre-existing stock repurchase program.¹²⁸

This ruling, however, enables Acquirors to establish a vehicle by which to provide cash directly to Target shareholders in exchange for their interests in the

¹²⁶ *Id.* § 1.368-1(e)(7), ex. 1.

¹²⁷ Rev. Rul. 99-58, 1999-2 C.B. 701.

¹²⁸ *Id.* Several commentators have noted the significance of Rev. Rul. 99-58 in that it directly contradicts Treas. Reg. § 1.368-1(e) (as amended in 2005). See, e.g., Joseph Calianno, *The Impact of Stock Repurchase Programs on Corporate Reorganizations*, 2 BUS. ENTITIES 12, 16 (2000) (“[This Ruling] deviates from the example in the Regulations in that there is a direct modification of the issuing corporation’s stock repurchase program caused by the reorganization”).

Acquiror.¹²⁹ Indeed, in the ruling the Acquiror “modified” its stock repurchase program to enable it to acquire “a number of its shares equal to the number issued in the acquisition of [Target].”¹³⁰ An Acquiror may publicly announce its plans to institute a stock repurchase program after the merger is consummated.¹³¹ Even with such a program in place, satisfaction of the continuity of interest requirement is not threatened, and participating shareholders will not be taxed on the Acquiror stock that they do not sell back to the Acquiror.

The 1998 regulations and Revenue Ruling 99-58 have been lauded as positive developments.¹³² But, because they enable parties to satisfy the continuity of interest doctrine even when Target shareholders ultimately retain little Acquiror stock, they highlight how the doctrine, as applied today, fails to achieve its intended purpose.

E. Fictional Equity

The continuity of interest doctrine requires that shareholders of a Target receive a substantial, material, and definite interest in the Acquiror.¹³³ The doctrine, however, merely requires that Target shareholders in a reorganization receive an instrument from the Acquiror bearing the label

¹²⁹ Taxpayers have also observed that Rev. Rul. 99-58 does not set any parameters regarding the amount of Acquiror stock that may be repurchased without compromising continuity. *See, e.g.*, Mark J. Silverman, *Current Developments in Tax-Free Corporate Reorganizations*, SK028 A.L.I.-A.B.A. 2751, 2813 (2004) (“[i]t is unclear to what extent the size of the repurchase matters. Query whether . . . [Acquiror] may, for example, repurchase 90 percent of its stock in a stock repurchase program”).

¹³⁰ *Id.* at 2812.

¹³¹ There are a number of ways in which an Acquiror can inform the Target shareholders of the share repurchase program, including through public press releases or proxy statements.

¹³² *See, e.g.*, Calianno, *supra* note 128, at 14.

¹³³ *See* Treas. Reg. § 1.368-1(e) (as amended in 2005); *Helvering v. Minn. Tea Co.*, 296 U.S. 378, 386 (1935); *Pinellas Ice & Cold Storage Co. v. Comm’r*, 287 U.S. 462, 471 (1933).

“equity,” no matter how tenuous the equity characteristics of this instrument.¹³⁴

Almost any type of Acquiror stock—even preferred stock—will serve as valid consideration for continuity of interest purposes.¹³⁵ Preferred stock—as opposed to common stock—holders generally receive a fixed dividend from an Acquiror and do not participate in the potential economic growth of the Acquiror.¹³⁶

The courts and the IRS have ruled that Target shareholders may qualify as holding a sufficient continuing interest in the Acquiror where they receive merger consideration consisting of cash and non-voting preferred stock of the Acquiror that is redeemable for cash by the Acquiror at any time.¹³⁷ Thus, if Farmer Brown exchanged his Small Cheesecorp common stock for mandatorily redeemable, non-voting preferred stock in Big Cheesecorp, he would be deemed to have received a definite, material, and substantial proprietary interest that would satisfy continuity. In reality, the interest that Farmer Brown receives in Big Cheesecorp is significantly less equity-like than the common stock he held in Small Cheesecorp.

The tax law even treats so-called “non-qualified preferred stock” as a sufficient equity interest in the Acquiror when it

¹³⁴ See Rev. Rul. 78-142, 1978-1 C.B. 111. See also *Schweitzer & Conrad, Inc. v. Comm’r*, 41 B.T.A. 533, 542 (1940).

¹³⁵ See *John A. Nelson Co. v. Helvering*, 296 U.S. 374, 378 (1935) (Target shareholders’ receipt of merger consideration, 38.5 percent of which consisted of non-voting preferred Acquiror stock, satisfied the continuity of interest requirement.).

¹³⁶ 19 WILLIAM MEADE FLETCHER ET AL., *FLETCHER ENCYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* § 2:56 (perm. ed., rev. vol. 2004).

¹³⁷ *Schweitzer & Conrad, Inc.*, 41 B.T.A. at 550 (continuity of interest was satisfied where one corporation acquired all of the assets of another in exchange for preferred stock and cash, even though the preferred stock could be redeemed at any time on 30 days notice at par plus accumulated and unpaid dividends, and where the parties took steps within two months of the merger to redeem a substantial portion of this stock); Rev. Rul. 78-142, 1978-1 C.B. 111 (mandatorily redeemable preferred stock provides sufficient continuity of interest).

comes to testing continuity of interest.¹³⁸ Congress has considered this type of stock to be so similar to debt that when Target shareholders receive it in a merger, they are taxed on it.¹³⁹ Yet despite this designation, the tax law respects non-qualified preferred stock as stock in determining whether Target shareholders have continued their interest in the Acquiror.¹⁴⁰

The contrast between the continuity of interest doctrine's treatment of "fictional" equity (i.e., non-voting, mandatorily redeemable preferred stock) of the Acquiror and its treatment of long-term debt of the Acquiror is striking. The courts have held that 100-year bonds of an Acquiror do not provide sufficient continuity.¹⁴¹ Receipt of these types of debt interests probably compels former Target shareholders to maintain an even more significant continuing interest in the assets of the former Target than if the former Target shareholders had received stock. But because 100-year bonds do not bear the required "stock" label, they are not considered to provide former Target shareholders with a sufficient continuing interest in the Acquiror.¹⁴²

The obsessive focus of the continuity of interest doctrine on "equity" as the only viable form of proprietary interest in

¹³⁸ See TREASURY BLUE BOOK 213 (1997) (nonqualified preferred stock will be respected for continuity of interest purposes "unless and until Treasury regulations are issued requiring a different result"). See also GINSBURG & LEVIN, *supra* note 4, ¶ 610.1.1, n.26 ("Treasury's extensive regulatory authority under [this Section] presumably could be exercised to declare all [nonqualified preferred stock] bad consideration ('not stock') in testing [continuity of interest], but nothing suggests that Treasury is likely to do anything of the sort.").

¹³⁹ I.R.C. § 356(e) (2005); Treas. Reg. § 1.356-6(a) (as amended in 2000) (nonqualified preferred stock treated as boot at shareholder level).

¹⁴⁰ See TREASURY BLUE BOOK, *supra* note 138, at 213.

¹⁴¹ *Roebing v. Comm'r*, 143 F.2d 810, 813-14 (3d Cir. 1944) (Target shareholder's exchange of stock in Target for Acquiror's 100-year bonds with a fixed 8 percent return pursuant to a merger did not satisfy continuity of interest requirement, even though Target shareholder's economic position did not change significantly.).

¹⁴² *Id.* See also *Le Tulle v. Scofield*, 308 U.S. 415, 421-22 (1940) (long-term debt does not create holders of "proprietary interest").

the Acquiror adds to the fiction. In many cases, the Acquiror stock that Target shareholders receive in a reorganization does not contain concrete equity-like characteristics. In almost every other aspect of the tax law, whether an instrument represents equity or not is a difficult and important question.¹⁴³ The continuity of interest doctrine, on the other hand, does not adopt such a nuanced approach.

F. A Meaningless Tradition

This Part has demonstrated that the continuity of interest doctrine fails to achieve its intended purpose. Although the doctrine attempts to ensure that a substantial number of former Target shareholders continue to own an interest in the Acquiror following a reorganization, this objective is often unfulfilled. At the most basic level, it is very difficult to argue that, in many reorganizations, Target shareholders receive or retain interests in the Acquiror that could be described as a substantive “continuation” of their interests in the Target.

The continuity of interest fiction is the product of misguided judicial intervention coupled with administrative relief. Soon after the birth of Congress’s reorganization provisions, judges, not Congress, decided that continued Target shareholder ownership following a merger was a characteristic trait of a merger that was a mere change in

¹⁴³ For example, if a corporation issues an instrument that is respected as debt, then payments by the corporation with respect to that instrument may be deductible interest payments instead of non-deductible dividend payments. For fine works addressing the debt/equity question in other contexts, see Adam O. Emmerich, *Hybrid Instruments and the Debt-Equity Distinction in Corporate Taxation*, 52 U. CHI. L. REV. 118 (1985); Louis S. Freeman & Richard M. Lipton, *Tax Consequences of Business and Investment-Driven Uses of Derivatives*, 72 TAXES 947 (1994); David P. Hariton, *Distinguishing Between Equity and Debt in the New Financial Environment*, 49 TAX L. REV. 499 (1994); William Plumb, *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369 (1971); Anthony P. Polito, *Useful Fictions: Debt and Equity Classification in Corporate Tax Law*, 30 ARIZ. ST. L.J. 761 (1998).

form.¹⁴⁴ Without acknowledging the questionable nature of this premise, the Treasury, the IRS, and the courts created so many requirements to comply with this judicial ideal that the doctrine became onerous and impractical. Over the past ten years, the Treasury and the IRS have, in effect, conceded that the doctrine is not viable by significantly liberalizing its requirements.¹⁴⁵ This relief has contributed to the fiction and has led to the doctrine's persistence today as a meaningless tradition that the tax law continues to observe with "religious-like obeisance."¹⁴⁶

The continuity of interest doctrine fails to distinguish between a special merger deserving of reorganization status and one that is an ordinary sale. The continued ownership by former Target shareholders following a merger that qualifies as a reorganization looks very similar to that by former Target shareholders following a taxable merger. Because the doctrine does not adequately serve as a means for determining what types of mergers ought to receive Congress's special tax treatment, a new approach is needed.

V. THE END OF CONTINUITY: A NEW APPROACH

The continuity of interest doctrine is fundamentally and practically flawed. Instead of refining the continuity of interest rules further, we should consider an alternative way to determine whether a merger will enjoy tax-favored treatment.

Any replacement for the continuity of interest doctrine should consider the significance of the reorganization provisions of the Code in the context of the realization rule. A fundamental principle underlying our tax system is that

¹⁴⁴ See *supra* Part II for further discussion of the judicial development of the doctrine.

¹⁴⁵ Indeed, when the Treasury issued the 1998 regulations, it stated explicitly that the purpose of these regulations was to quell taxpayer uncertainty regarding satisfaction of the minimum Acquiror stock threshold. T.D. 8760, 1998-1 C.B. 803. See also Rev. Rul. 99-58, 1999-52 I.R.B. 701; Treas. Reg. § 1.368-1(e)(2) (as amended in 2005).

¹⁴⁶ Wolfman, *supra* note 4.

without a realization event, no income arises that can be the subject of current taxation.¹⁴⁷ With very few exceptions, the taxpayer experiences a realization event only when he exchanges his investment for something “materially different” (or when the taxpayer is deemed to have done so).¹⁴⁸

Mergers that qualify as reorganizations under current law are an exception to the realization rule. This exception is remarkable, especially in light of the sheer dollar value of tax revenue at stake in many mergers and that in a reorganization, corporate- and shareholder-level taxes are not imposed. Congress’s oft-stated rationale for the exception is that certain mergers represent mere readjustments—“purely paper transactions” and “mere changes in form”¹⁴⁹—rather than ordinary sales transactions.

An effective set of rules should deliver tax-favored treatment to mergers that appear to be mere changes in corporate form and where shareholders experience purely paper transactions. Thus, the key task is identifying the distinguishing characteristics of these special mergers. This Article’s Proposal asserts that the corporate- and shareholder-level characteristics described below should be present in a merger in order for a Target and its shareholders to enjoy an exemption from the realization rule.

First, the Proposal emphasizes that the fundamental corporate-level trait of a merger that is a mere change in form is that the Acquiror continues the historic business of the Target in a real and meaningful way. Unlike current law or past proposed alternatives, the Proposal offers strict rules mandating that the Acquiror conduct the Target’s historic business for at least a set amount of time after a merger. Further, the Proposal places other restrictions on the

¹⁴⁷ Treas. Reg. § 1.1001-1(a) (1996). For a description and discussion of the realization rule, see Schenk, *supra* note 58.

¹⁴⁸ See *Cottage Sav. Ass’n v. Comm’r*, 499 U.S. 554 (1991) (exchange of property triggers realization event when exchanged properties are “materially different”).

¹⁴⁹ H.R. REP. NO. 68-179, at 16 (1924); S. REP. NO. 68-398, at 17-18 (1924); S. REP. NO. 65-617, pt. 1, at 5 (1918).

Acquiror's post-merger conduct of a Target's historic business and specific uses of a Target's historic business assets. Whether a merger should be treated as an ordinary sale or as a special transaction, therefore, should depend on the extent to which the Acquiror continues the historic business of the Target following a merger.

Second, the Proposal contains a set of shareholder-level requirements intended to exempt Target shareholders from the realization rule where they engage in a purely paper transaction by exchanging Target stock for Acquiror stock. In a major departure from both current law and past proposed alternatives, the Proposal considers whether a Target shareholder's voting rights and percentage interest in the enterprise have changed dramatically as a result of a merger.

The Proposal represents a new alternative to the continuity of interest doctrine. Where the continuity of interest doctrine serves a fictitious premise, the Proposal restores some sense of truth to the mere-change-in-form and purely-paper-transaction depictions.

Before continuing further, one caveat is necessary. Neither the Proposal nor the rest of this Article address the broader normative question of whether we *should* continue Congress's special tax treatment of certain mergers. Rather, the Proposal is intended to present a more effective and rational approach to *how* we administer this special treatment.

A. Past Proposed Alternatives

Attempts to replace the continuity of interest doctrine are not a new phenomenon. Before examining the specific terms of the Proposal, it is helpful to review the alternatives that have been offered in the past.

The most well-known proposal to replace the continuity of interest doctrine was presented by the American Law Institute ("A.L.I.") in its multi-year study, *Federal Income*

Tax Project, Subchapter C,¹⁵⁰ which was completed in 1980 (the "A.L.I. Report"). The A.L.I. Report was so influential that the Senate Finance Committee eventually adopted significant elements of its proposal in 1985 (although the proposed legislation was not enacted).¹⁵¹

The A.L.I. Report proposed a bifurcation of the tax treatment of corporate mergers:

At the corporate level, the tax treatment of a merger of a Target into an Acquiror would be expressly elective by the taxpayer.¹⁵² If an Acquiror in a statutory merger desired taxable treatment, it would simply make an election to treat the merger as a taxable sale of assets by the Target to the Acquiror by filing a form with the IRS. The Acquiror would then assume a cost basis in the Target's assets.¹⁵³ If, on the other hand, an Acquiror desired tax-deferred, carryover basis treatment, it would make no election following the merger.¹⁵⁴

Shareholder-level consequences in a merger, under the A.L.I. Report's proposal, would be completely independent of the corporate-level election. If a Target shareholder received *any* amount of Acquiror stock in exchange for its Target stock, the shareholder would recognize no gain on that stock.¹⁵⁵

¹⁵⁰ See generally A.L.I., *supra* note 20.

¹⁵¹ See STAFF OF S. COMM. ON FINANCE, 99TH CONG., FINAL REPORT ON THE SUBCHAPTER C REVISION ACT OF 1985 (Comm. Print 1985).

¹⁵² See A.L.I., *supra* note 20, at 145 (Proposal C4).

¹⁵³ See *id.* ("[A]ny acquisition of assets by statutory merger or consolidation, if the surviving corporation shall so elect, shall be treated as if the acquired corporation had transferred its assets and distributed the proceeds in liquidation to its shareholders, and the acquired corporation or surviving corporation shall then be liable for all its income taxes including those resulting from the imputed asset transfer; and the acquired corporation's assets shall then have a fresh cost basis in the hands of the acquired corporation or the surviving corporation, as the case may be.").

¹⁵⁴ See *id.* at 73 (carryover basis default treatment for statutory mergers).

¹⁵⁵ See *id.* at 167 (Proposal D1) ("No gain or loss shall be recognized by any noncorporate shareholder if stock of an acquired corporation is, in pursuance of a plan of acquisition, exchanged solely for stock of one or more acquiring corporations.").

Even twenty-five years after its publication, the A.L.I. Report's proposed alternative to the continuity of interest doctrine has not been subject to serious challenge.¹⁵⁶ In describing the merits of the Proposal below, this Part will contrast the Proposal's ability to distinguish between ordinary sales and special mergers with that of the A.L.I. Report. This Part contends that the A.L.I. Report does not achieve this objective, but instead opts to achieve a regime of simplicity.

B. A New Approach

The Proposal presented in this Article diverges from both current law and the alternative offered by the A.L.I. Report. Its primary objective is to administer tax-favored treatment to mergers where the Target's historic business is preserved and a Target shareholder's role within the enterprise does not change significantly as a result of the merger. In contrast to the continuity of interest doctrine, the Proposal serves these policy goals.¹⁵⁷

1. The Proposal

The Proposal advances two sets of rules that address the corporate- and shareholder-level tax treatment of a merger. These rules are presented separately below:

Qualifying Merger. The first part of the Proposal is that where (a) a Target merges into an Acquiror in a statutory merger,¹⁵⁸ transferring substantially all of its assets to the Acquiror, and (b) for the two-year period

¹⁵⁶ See, e.g., Wolfman, *supra* note 4 (“But for general theme and scheme you have it all—by my lights, elegant and sensible as well as simple and short.”); but see George Yin, *A Carryover Basis Asset Acquisition Regime: A Few Words of Caution*, 37 TAX NOTES 415 (1987).

¹⁵⁷ The A.L.I. Report also ignores these principles in an effort to serve administrative convenience.

¹⁵⁸ For purposes of determining what constitutes a “statutory merger,” this proposal would retain the definition under the current reorganization provisions. See Treas. Reg. § 1.368-2(b)(1)(ii) (as amended in 2005).

immediately following the merger, the Acquiror (i) continues the historic business of the Target directly or (ii) uses a substantial portion of the assets of the Target in a business of the Acquiror that is of “like kind” to the Target’s historic business, the merger will be treated as a “qualifying merger.”¹⁵⁹ The Target will not recognize taxable gain or loss on its transfer of assets in a qualifying merger.¹⁶⁰ The Acquiror will hold any assets it receives from the Target as a result of a qualifying merger with the Target’s basis (i.e., a “carryover basis”) in the assets.¹⁶¹

Shareholder Non-Recognition. The second part of the Proposal is that, as a default rule, a Target shareholder will not recognize gain or loss on the exchange of *any* Target stock for stock of an Acquiror that is a party to a qualifying merger with the Target.

However, there are two exceptions to this default rule. First, to the extent that a Target shareholder exchanges any voting stock for non-voting stock, or vice versa, the exchange will be taxable.¹⁶² Second, if, immediately after the merger,

¹⁵⁹ This provision is intended to replace the concept of a reorganization under I.R.C. §§ 368(a)(1)(A) and (a)(2)(D) (2005) in the case of forward mergers of the Target into the Acquiror or its subsidiary.

¹⁶⁰ Accordingly, if a merger fails the qualifying merger requirements, the transaction will be treated as a taxable sale of assets by the Target to the Acquiror.

¹⁶¹ The term “carryover basis” generally means that the Acquiror will hold the former Target’s assets with a basis equal to the basis of the assets in the hands of the former Target, increased by any gain recognized by the Target on the transfer. The relevant provisions of the Code dealing with carryover basis treatment in a reorganization under current law can be found in I.R.C. § 362 (2005).

¹⁶² The Proposal would not, however, repeal or otherwise implicate the treatment of “non-qualified preferred stock” under current law. Under I.R.C. § 351(g) (2005), stock that resembles debt and is reasonably likely to be redeemed is treated as boot. This rule applies under current law irrespective of whether a Target shareholder exchanges voting or non-voting Target stock for Acquiror stock that is non-qualified preferred stock. Congress enacted this rule to preserve the debt-equity distinction. Because that policy objective differs from that of the Proposal, the non-qualified preferred stock rules should continue to be applied.

the former Target shareholder's percentage interest in the Acquiror (measured by either vote or value) is less than 20 percent of the former Target shareholder's percentage interest in the Target (measured by either vote or value) immediately prior to the merger, then the Target shareholder's exchange of any Target stock for Acquiror stock will be taxable.¹⁶³ In either case, if, in addition to the Acquiror stock received in the merger, a Target shareholder receives any cash or any property other than stock, then the shareholder will recognize gain solely with respect to the cash or other property received to the extent of the shareholder's realized gain.¹⁶⁴ A Target shareholder's basis in Acquiror stock received pursuant to a qualifying merger will be the same as the shareholder's basis in the Target stock he relinquished (decreased by the fair market value of any non-stock property received and increased by any gain that the Target shareholder recognizes).¹⁶⁵

2. Explanation of Corporate-Level Requirements

The "qualifying merger" requirements of the Proposal are intended to ensure that special tax treatment is applied to mergers where the Target could be described as undergoing a mere change in corporate form.

¹⁶³ The Proposal does not simply look to decreases in the *amount* of stock that a particular Target shareholder holds after a merger. Rather, the Proposal considers decreases in the Target shareholder's *percentage interest* in the Acquiror from the Target shareholder's percentage interest in the Target.

¹⁶⁴ The Proposal would also generally retain the reorganization provisions' treatment of boot received by Target shareholders under current law. See I.R.C. § 356(a)(1) (2005) ("If (A) section 354 or 355 would apply to an exchange but for the fact that (B) the property received in the exchange consists not only of property permitted by section 354 or 355 to be received without the recognition of gain but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.").

¹⁶⁵ The Proposal thus adopts the "substituted basis" rules that exist under current law. See I.R.C. § 358(a)(1) (2005).

a. Identifying Mere Changes in Form

The Proposal grants tax-favored treatment to mergers where the historic business of the Target survives the merger, even though the Target, as a corporate entity, does not. Unlike current law, the Proposal disregards the type and composition of merger consideration that an Acquiror delivers to Target shareholders.¹⁶⁶ A merger receives tax-favored treatment under the Proposal if substantially all of the Target's assets are transferred to the Acquiror in the merger¹⁶⁷, and the Acquiror continues the Target's historic business for at least two years following the merger.¹⁶⁸ During this two-year period, the Acquiror may fulfill the Proposal's historic business requirement by operating the Target's historic business directly or, alternatively, by using substantially all of the Target's assets in a business of the

¹⁶⁶ The continuity of interest requirement causes a merger to be wholly taxable if merger consideration that consists of less than the required aggregate amount of Acquiror stock is paid to Target shareholders. Treas. Reg. § 1.368-1(e) (as amended in 2005).

¹⁶⁷ The Proposal's requirement that a Target transfer "substantially all" of its assets to an Acquiror is intended to prevent taxpayers from achieving tax-deferral with respect to inherently divisive transactions. Without such a requirement, a Target could dispose of a large amount of its assets to a third party and then merge into an Acquiror in a "qualifying merger," which would not result in current taxation under the Proposal. The "substantially all" requirement prevents this result.

¹⁶⁸ The two-year period used in the Proposal is intended to represent a substantial amount of time. The choice of this amount of time is purely arbitrary. Other sections of the Code, however, also utilize a two-year period to monitor post-transaction activity. *See, e.g.*, I.R.C. § 355(e) (2005). It is possible that the required time frame could be longer or shorter than two years, but, in the world of tax law, two years is almost an eternity. Under the "step-transaction doctrine," courts, the IRS, and taxpayers may integrate the steps of a transaction to achieve a tax result that would not be possible if each step was analyzed independently. A common factor underlying many cases where the step-transaction doctrine was invoked involved transactions where a series of steps occurred in close proximity to each other. *See, e.g.*, *Murrin v. Comm'r*, 24 T.C. 502, 508 (1955) ("All of the transactions occurred in one day and the first would not have happened without a view to the last, for each of the several steps was in pursuance of a previously agreed upon plan.").

Acquiror that is of “like kind” to the Target’s historic business.

Why does the Proposal so heavily emphasize continuation of the Target’s historic business in administering tax-favored treatment? The reason is that the identity of the Target is inextricably linked to the business that it conducts.¹⁶⁹

For example, consider McDonald’s Corporation. This corporate entity is known around the globe as an operator of “fast-food” restaurants, and it prominently displays the “golden arches” that are synonymous with its business as its corporate logo.¹⁷⁰ Consumers associate McDonald’s Corporation with “Happy Meals” and other products of its fast-food business.¹⁷¹ The investing public purchases McDonald’s Corporation stock based on the earnings forecast of its fast-food business (and the restaurant industry at large).¹⁷² Moreover, lenders decide to make loans to McDonald’s Corporation only after reviewing the performance of McDonald’s Corporation’s business activity.¹⁷³ When deciding whether to interact with McDonald’s Corporation, these consumers, investors, and lenders all consider the *business* of McDonald’s Corporation before

¹⁶⁹ The question of whether a corporation should be treated as a separate person with a separate personality is age-old. *See, e.g.,* Arthur W. Machen, Jr., *Corporate Personality*, 24 HARV. L. REV. 253 (1911) (describing the corporate entity as a being separate from its owners as a result of its unique characteristics); Gregory A. Mark, *The Personification of the Business Corporation in American Law*, 54 U. CHI. L. REV. 1441 (1987). One of the fundamental distinguishing characteristics of a corporation’s identity is its primary business activity.

¹⁷⁰ Not surprisingly, the logo does not contain a single image of the corporation’s largest shareholder. *See* McDonald’s, <http://www.mcdonalds.com> (last visited Dec. 4, 2005). Dodge & Cox, Inc., McDonald’s Corporation’s largest shareholder as of December 21, 2005 (holding 5.54 percent according to a Thomson Financial Security Report), does not appear in any readily accessible McDonald’s Corporation promotional material.

¹⁷¹ *See* McDonald’s Corporation, Annual Report (Form 10-K) (Mar. 4, 2005).

¹⁷² *See id.*

¹⁷³ *See id.*

considering its *shareholders*. The unique business activity of a corporation is its central defining characteristic.

After a merger of a Target into an Acquiror, the Target can be described as continuing to exist, in substance, if the Acquiror continues the Target's historic business in a real and meaningful way. The Proposal rejects the excessive focus of current law on continued ownership by a Target's shareholders after a merger for purposes of determining whether the Target has changed. For the many reasons discussed in Part IV, in practice, continued ownership often does not exist or is illusory at best. The Proposal refocuses the rules squarely on the question of whether a Target's historic business, not its historic shareholder base, continues. While current law contains rules regarding an Acquiror's continuation of the historic business of the Target in a reorganization,¹⁷⁴ those rules are extremely flexible and easy to satisfy.¹⁷⁵

The two-year requirement of the Proposal is an effective means for distinguishing between mergers that are mere changes in form and those that are ordinary sales. In an ordinary sale, a financial investor may acquire the assets of a Target via merger and shortly thereafter, sell the assets to third-party buyers for cash. Private equity funds, for example, frequently acquire assets through mergers using a corporate subsidiary and then quickly "flip" the assets by selling off the pieces for cash.¹⁷⁶ On the other hand, an Acquiror that truly desires to conduct the Target's historic business may acquire the Target via merger and then continue the Target's historic business for a number of years. The Proposal distinguishes between these two types of transactions by mandating that an Acquiror conduct the

¹⁷⁴ Treas. Reg. § 1.368-1(d)(1) (as amended in 2006) ("Continuity of business enterprise (COBE) requires that the issuing corporation (P) . . . either continue the target corporation's (T's) historic business or use a significant portion of T's historic business assets in a business.").

¹⁷⁵ See *id.*; see also BLOCK, *supra* note 43, at 347.

¹⁷⁶ See Paul S. Bird, *Private Equity M&A: Current Topics*, 1339 PLI/CORP 11 (2002) (describing various exit strategies that private equity funds often utilize).

historic business of the Target for at least two years following the merger in order to receive tax-favored treatment. Current law, by comparison, does not contain any explicit rule regarding the amount of time that an Acquiror must continue a Target's historic business.¹⁷⁷

The Proposal's rule that an Acquiror may satisfy the historic business test during this two-year period by *directly* conducting the Target's business adds credibility to the mere-change-in-form construct. When an Acquiror continues the Target's historic business directly, the business, with all its unique attributes, survives the merger.¹⁷⁸ In this case, the corporate entity encapsulating the Target's historic business is the only real corporate-level alteration in such a merger. Consequently, a mere change in the Target's form can be said to have occurred.

The Proposal's alternative rule, that an Acquiror may use substantially all of the *assets* of the Target in a business that is of "like kind" to the Target's historic business, is essential to the mere change-in-form construct.¹⁷⁹ Returning to an example from Part IV, under current law, a merger of Small Cheesecorp (which produces cheese as its primary business) into Acme Purse Company (which produces women's leather products as its primary business) qualifies for tax-favored treatment even when Acme Purse Company uses the cattle assets of Small Cheesecorp to expand its leather product business. In this type of merger, where the Acquiror utilizes the Target's assets in a business that is completely different than that of the Target, it is difficult to argue that a mere change in the Target's corporate form is all that has

¹⁷⁷ Treas. Reg. § 1.368-1(d)(1) (as amended in 2005).

¹⁷⁸ Regulatory guidance would be needed to address mergers where a Target corporation conducts more than one line of business. Such guidance could provide that an Acquiror should only be required to conduct the most significant line of business of the Target following a merger.

¹⁷⁹ The concept of a "like kind exchange" that is exempted from the realization requirement already exists in other provisions of the Code that provide instructive guidance for the Proposal. See I.R.C. § 1031 (2005).

occurred.¹⁸⁰ The “like kind” business requirement of the Proposal avoids this fiction. Although exactly what types of businesses would qualify as “like kind” is not intuitively apparent, businesses that are part of the same industry and produce similar products generally should be considered “like kind.”¹⁸¹ Regulatory guidance would be necessary to explain in more concrete terms what types of businesses would qualify as “like kind.”¹⁸²

b. Contrasts with the A.L.I. Report

The A.L.I. Report differs significantly from the Proposal in considering the extent to which a Target’s historic business continues following a merger. The A.L.I. Report presents a detailed critique of the continuity of interest doctrine and argues for its repeal.¹⁸³ However, without similarly detailed explanation or analysis, the A.L.I. Report rejects the concept of the continuity of business enterprise requirement as well.¹⁸⁴ Under the alternative offered in the A.L.I. Report, the Acquiror may use the Target’s business assets for *any* purpose. The A.L.I. Report’s alternative would even allow the Acquiror to cease the Target’s historic business altogether after the merger and sell off a portion of

¹⁸⁰ An Acquiror is only required under current law to use a significant portion of a Target’s historic business assets in “a” business. Treas. Reg. § 1.368-1(d)(i) (as amended in 2005). This lack of specificity means that the Acquiror can use the Target’s business assets in any type of business it chooses, as long as the business is “a” business of the Acquiror.

¹⁸¹ The rules of I.R.C. § 1031 (2005), of course, would serve as a critical foundation for determining what types of businesses would qualify as “like kind.” Regulations underlying § 1031 provide that an exchange of a copyright on a novel for a copyright on a song does not constitute a like kind exchange. Treas. Reg. § 1.1031(a)-2(c)(3), exs. 1 and 2 (as amended in 2002). Likewise, a cheese production business and a leather purse production business should not be considered like kind.

¹⁸² See, e.g., Treas. Reg. § 1.1031(a)-1, 2 (as amended in 2002).

¹⁸³ See A.L.I., *supra* note 20, at 165.

¹⁸⁴ The A.L.I. Report comments that “while it would be possible to impose a continuity-of-business-enterprise requirement without a continuity of interest requirement, many of the reasons for dispensing with the latter would also seem to apply to the former.” *Id.* at 162.

the Target's business assets for cash.¹⁸⁵ Thus, the A.L.I. Report implicitly suggests that the benefit of tax deferral should be bestowed upon mergers that represent complete transformations of the Target.

The A.L.I. Report's express election mechanism also fails to consider any special characteristics of a merger before conferring tax-favored treatment upon the merger.¹⁸⁶ Under the A.L.I. Report, the tax treatment of a merger does not hinge on the Acquiror's continuation of the Target's historic business (as it does under the Proposal) or on any other special factors. Rather, the tax treatment is merely the result of an Acquiror's decision to file an IRS form classifying the merger as tax-deferred or taxable.¹⁸⁷

The A.L.I. Report's election mechanism also could cut against the government disproportionately and lead to unintended abuse. The government has learned from recent experience that taxpayer elections may be detrimental to its interests and, at the same time, unfairly advantageous to the taxpayer. For example, the use of "check-the-box elections" by foreign business entities has forced the government to spend the last several years combating taxpayer abuse.¹⁸⁸

¹⁸⁵ See *id.* at 73.

¹⁸⁶ See *id.*

¹⁸⁷ See *id.* at 41 ("The solution to the trouble is to make tax classification explicitly elective and as independent as possible of corporate procedural considerations.").

¹⁸⁸ The "check-the-box elections" allow taxpayers to elect the legal status of an entity for tax purposes. Commentators have observed that the use of the check-the-box election regulations in the international context has resulted in taxpayer-favorable consequences that the Treasury did not intend. See Jeffrey L. Rubinger, *Tax Court Upholds 'Check and Sell' Strategy to Avoid Subpart F Income: Has Pandora's Box Been Opened*, THE M&A TAX REPORT, VOL. 13:2 (2004) ("Since the final check-the-box Regulations were issued in December of 1996, taxpayers have been devising strategies to exploit them in ways that the drafters probably never intended."). Most recently, taxpayers have successfully utilized the check-the-box regulations to avoid inclusions of "Subpart F income." See *Dover Corporation*, 122 T.C. No. 19 (2005) (check-the-box election of a lower-tier subsidiary filed just before the sale of its stock by its parent, a controlled foreign corporation, characterized as a disposition of assets used

Similarly, the taxpayer election for safe harbor leasing, which was introduced in the 1980s, led to such significant taxpayer abuse that Congress eventually repealed the provision.¹⁸⁹

This is not to say that all tax elections are unjustified or harmful; on the contrary, where tax elections serve an important policy objective or create needed clarity they can be beneficial. However, in the case of tax-favored treatment for corporate mergers, an election mechanism does not serve any important policy other than to provide simplicity, and, to be blunt, an opportunity for corporate taxpayers to decide whether to pay current tax or not.

3. Explanation of Shareholder-Level Requirements

The shareholder non-recognition rules of the Proposal are intended to deliver tax-favored treatment to stock-for-stock exchanges that could be characterized as “purely paper transactions.”

a. Exempting Purely Paper Transactions

Under the Proposal, the aggregate amount of Acquiror stock delivered to Target shareholders, either as a group or individually, is completely irrelevant. As long as a Target shareholder receives stock in an Acquiror that has participated in a qualifying merger with the Target, the Target shareholder does not recognize gain or loss on that stock-for-stock exchange unless one of the exceptions in the Proposal is triggered.¹⁹⁰ In determining whether to confer this special non-recognition treatment, the Proposal does not take into account the relative proportions of stock and cash

in the controlled foreign corporation's trade or business and thus, not Subpart F income).

¹⁸⁹ See Alvin C. Warren and Alan J. Auerbach, *Transferability of Tax Incentives and the Fiction of Safe Harbor Leasing*, 95 HARV. L. REV. 1752 (1982).

¹⁹⁰ The treatment, of course, is subject to classification of the Acquiror stock as “non-qualified preferred stock” under I.R.C. § 351(g) (2005).

that the Target shareholders receive. Instead, the Proposal asks whether an individual Target shareholder's role within the enterprise has changed significantly following a merger.

The Proposal's treatment of a Target shareholder's exchange of voting stock for non-voting stock (or vice versa) as taxable is vital to the objective of reserving shareholder non-recognition for purely paper transactions. The shareholder's right to vote generally means that the shareholder may, at the very least, participate in the election of the directors of a corporation.¹⁹¹ Those directors, in turn, are empowered to make fundamental decisions affecting the strategic direction of the enterprise.¹⁹² Although non-voting stock may allow its holder to participate in the economic growth of the corporation through dividend distributions, it does not entitle the holder to have any say over corporate decisionmaking (except as otherwise required by law).¹⁹³ Because voting stock carries with it the ability to have a voice in the governance of a corporation, it generally trades at a premium to non-voting stock.¹⁹⁴ Current law ignores the

¹⁹¹ See Rev. Rul. 69-126; 1969-1 C.B. 218 (preferred stock that entitles holders to vote for three out of eight directors is considered voting stock for federal income tax purposes); see also *Erie Lighting Co. v. Comm'r*, 93 F.2d 883 (1st Cir. 1937) (defining voting stock for purposes of the Revenue Act of 1926 by negative implication).

¹⁹² Some have argued that the powers bestowed upon a board of directors are so great that the board of directors is the key force influencing the strategic direction of a corporation. Professor Stephen M. Bainbridge has articulated a theory of "director primacy" which comments that "to the limited extent to which the corporation is properly understood as a real entity, it is the board of directors that personifies the corporate entity." Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2003).

¹⁹³ See, e.g., Lucian Arye Bebchuk, *The Case Against Board Veto in Corporate Takeovers*, 69 U. CHI. L. REV. 973 (2002) (describing the importance of shareholder voting and proposing that shareholders be required to approve takeover transactions).

¹⁹⁴ See Paul J. Much & Timothy J. Fagan, *The Value of Voting Rights*, in FINANCIAL VALUATION: BUSINESSES AND BUSINESS INTERESTS (1996) (finding 1.15 percent to 2.83 percent premium for voting stock over non-voting stock); Ronald C. Lease, John J. McConnell & Wayne H. Mikkelson, *The Market Value of Control in Publicly Traded Corporations*, 11 J. FIN.

importance of a Target shareholder's loss or gain of voting rights as a result of a merger that qualifies as a reorganization.¹⁹⁵ This aspect of the tax law contributes directly to the continuity of interest fiction described in Part IV.

The Proposal seeks to cure this fiction by treating such a dissimilar exchange as something more than a purely paper transaction. If a Target shareholder gives up stock that entitled him to vote in exchange for stock that carries no such voting right (or vice versa), that Target shareholder should not be treated for tax purposes as though no substantive change has occurred.¹⁹⁶ This aspect of the Proposal considers not only the question of whether a Target shareholder has exchanged stock for stock, but more specifically, whether that shareholder has received stock that bears significantly different rights than that which he relinquished.

Similarly, the disproportionate ownership reduction test under the Proposal underscores the need to consider changes in a Target shareholder's relative position as a shareholder following a merger. Under the Proposal, a greater-than-eighty-percent decrease (by vote or value) in a shareholder's

ECON. 439 (1983) (finding 5.44 percent premium for voting stock over non-voting stock).

¹⁹⁵ Neither I.R.C. § 368(a)(1)(A) (2005) (forward mergers of Target into Acquiror) nor I.R.C. § 368(a)(2)(D) (2005) (forward mergers of Target into Acquiror's subsidiary) require the stock that Target shareholders receive pursuant to the reorganization to consist of Acquiror voting stock. Consequently, a Target shareholder may exchange Target voting stock for Acquiror non-voting stock, and vice versa, in a merger that satisfies either of these provisions.

¹⁹⁶ The rules regarding changes to the terms of debt instruments look to whether the debt instrument has undergone a "significant modification," in which case the holder is treated as exchanging the old instrument for a new one in a taxable exchange. Treas. Reg. § 1.1001-3(c)(1) (1996). Here, a Target shareholder *actually* exchanges old stock for new stock and the new stock bears significantly different rights and privileges in comparison to the old stock. The same principles that apply in the deemed debt exchange context should apply in an actual stock exchange context as well.

percentage interest following a merger leads to current taxation of the shareholder's stock-for-stock exchange. (The Proposal refers to percentage interest in terms of both "vote" and "value" because it considers such a significant downward change in a shareholder's voting power or share of the value of the enterprise to merit relaxation of the default shareholder non-recognition rule.¹⁹⁷)

This rule effectively addresses mergers of corporations with few shareholders into corporations with many shareholders.¹⁹⁸ Such mergers would most likely trigger dramatic downward shifts in a Target shareholder's proportionate ownership interest (by vote or value).¹⁹⁹ Returning to an example from Part IV, Farmer Brown's exchange of Small Cheesecorp stock for Big Cheesecorp stock—where his percentage interest plummeted from 100 percent to .001 percent—should not be deemed a purely paper transaction. Farmer Brown's voice in corporate affairs and his proportionate rights to the assets of the enterprise are completely different as a result of the merger. If a general goal of the tax system is to identify realization events (where taxpayers exchange property for "materially different property"),²⁰⁰ then this type of exchange ought to be considered an event that merits current taxation.

¹⁹⁷ For an excellent discussion of the difference between voting and non-voting stock for purposes of I.R.C. §§ 368(c), 1504 (2005), see Stuart Lazar, *The Definition of Voting Stock and the Computation of Voting Power Under Sections 368(c) and 1504(a): Recent Developments and Tax Lore*, 17 VA. TAX REV. 103 (1997).

¹⁹⁸ The Proposal is significantly simpler than alternatives offered in the past that would have required an Acquiror to be similar in size to the Target, based on a number of factors, in order for special tax treatment to apply. See, e.g., H.R. REP. NO. 83-1337, § 359(a)(1) (1954) (which would have caused a merger to be wholly taxable in any transaction where the Acquiror was significantly greater in size than the Target).

¹⁹⁹ Note that the Proposal is not restricted to mergers where the Acquiror is a public corporation, as others have suggested. Rather, it would apply whenever there is such a disproportionate reduction in percentage interest, irrespective of the public or private nature of the Acquiror.

²⁰⁰ See Schenk, *supra* note 58.

The tax law already uses the disproportionate-reduction-in-percentage-interest concept in other areas of the Code. For example, when a corporation redeems a portion of a shareholder's stock, the Code requires a determination of whether the shareholder should be treated as having sold his stock to the corporation (resulting in capital gain treatment) or as having merely received a distribution from the corporation (resulting in dividend treatment).²⁰¹ To answer this question, the Code looks to whether the shareholder has experienced a "substantially disproportionate redemption of stock," such that the shareholder's proportionate interest in the corporation's non-voting and voting stock undergoes a dramatic reduction as a result of the redemption.²⁰² In that type of redemption, the shareholder is deemed to have engaged in a sale rather than received a dividend distribution.²⁰³ The Proposal borrows this concept and uses it to determine whether a shareholder's block of stock following a merger is significantly different than before the merger.

b. Contrasts with the A.L.I. Report

In contrast to the Proposal, the A.L.I. Report does not require that a Target shareholder exchange stock of the same voting character (i.e., voting or non-voting) in order to receive non-recognition treatment. Instead, it would allow a Target shareholder to exchange voting common stock in a Target for redeemable non-voting preferred stock in an Acquiror without being subject to tax.²⁰⁴ The A.L.I. Report

²⁰¹ I.R.C. § 302(b)(2) (2005).

²⁰² *Id.* In other contexts, the Code also considers changes to particular shareholders' proportionate interests as a result of a variety of corporate actions, and it taxes these increases. See I.R.C. § 305(c) (2005) (asserting that if a shareholder's proportionate interest in the earnings and profits or assets of a corporation is increased as a result of a particular transaction, a stock distribution is deemed to have occurred).

²⁰³ I.R.C. § 302(a) (2005).

²⁰⁴ See A.L.I., *supra* note 20, at 163. This result highlights a fiction that the Target shareholder has engaged in a purely paper transaction in the same way that the continuity of interest doctrine treats the exchange

rejects out of hand any requirement that an Acquiror deliver voting stock to Target shareholders, contending that “the requirement for voting stock constitutes an arbitrary, formal requirement, an occasional stumbling block . . . rather than an effective aid to any sensible policy objective.”²⁰⁵

The A.L.I. Report’s implicit characterization of non-voting stock and voting stock as equivalent types of property ignores key differences that may affect certain shareholders as a result of a merger.²⁰⁶ If a large shareholder of a Target (who would also be a large shareholder of an Acquiror following a merger) exchanges all of his voting stock for non-voting stock, this shareholder’s influence over the business enterprise is dramatically different following the merger.²⁰⁷ Whereas the shareholder may have possessed the ability to “hand pick” the Target’s directors and to authorize a variety of corporate actions prior to the merger, the shareholder will play no such role following the merger.²⁰⁸ The A.L.I. Report ignores this distinction by opting to apply its shareholder non-recognition treatment to *all* exchanges of stock pursuant to a merger.

The A.L.I. Report also falls short by rejecting a significant downward shift in a Target shareholder’s proportionate ownership interest following a merger as a factor that should determine shareholder-level tax consequences. Although the A.L.I. Report does consider the issue, it ultimately argues

of meaningful equity for significantly less meaningful equity as a continuation of a shareholder’s proprietary interest. *See also* discussion in Part IV *supra*; Rev. Rul. 78-142, 1978-1 C.B. 111 (stating that mandatorily redeemable preferred stock provides sufficient continuity of interest); *Schweitzer & Conrad, Inc. v. Comm’r*, 41 B.T.A. 533 (1940).

²⁰⁵ *See* A.L.I., *supra* note 20, at 163.

²⁰⁶ In fairness, the A.L.I. Report addresses all forms of reorganizations under current law, not just statutory mergers. As a consequence of this broader scope, the A.L.I. Report focuses significant attention on the disparate solely-for-voting stock requirement that is applicable to certain reorganizations, but not others. *Id.* at 170.

²⁰⁷ *See* Bebchuk, *supra* note 193.

²⁰⁸ Without voting stock, a shareholder generally will not be entitled to vote for directors, but may nonetheless, be entitled to approve certain extraordinary transactions as a matter of state law. *See id.*

against taking such changes into account.²⁰⁹ The A.L.I. Report comments that “it is doubtful whether large, publicly traded corporations often go to the trouble of arranging tax free reorganizations for the acquisition of very small or regional enterprises.”²¹⁰ Perhaps this statement was accurate in 1980 when the A.L.I. Report was issued. However, in the wake of the dot-com era and with the increased use of corporate stock as acquisition currency that has occurred since the late 1990s, this argument may no longer be persuasive.²¹¹

Last, the A.L.I. Report severs the link between corporate- and shareholder-level tax treatment in a merger. It allows an Acquiror to make an express election to treat a merger as taxable or tax-deferred at the corporate level, but then creates a default non-recognition rule at the shareholder level regardless of the election made by the Acquiror.²¹² Consequently, under the A.L.I. Report, there is no connection between a Target shareholder’s tax treatment and the election (or, for that matter, any other changes that a Target has undergone in the merger) at the corporate level. This approach serves no apparent policy objectives other than administrative convenience and simplicity.

The Proposal, however, links the tax treatment at the corporate- and shareholder-levels. It expressly conditions a Target shareholder’s enjoyment of non-recognition treatment on a qualifying merger having occurred at the corporate level. These requirements include continuing to conduct the Target’s historic business for at least two years following the

²⁰⁹ See A.L.I., *supra* note 20, at 162.

²¹⁰ See *id.*

²¹¹ See Bank, *supra* note 57 (“One of the distinguishing features of the 1990s merger movement is that, in contrast to the junk-bond financed takeovers of the 1980s, its primary currency is stock. . . . While stock only comprised seven percent of the acquirer’s consideration in 1988, it comprised sixty-seven percent in 1998.”).

²¹² See A.L.I., *supra* note 20, at 167.

merger.²¹³ That an Acquiror must continue the Target's historic business for such a substantial period of time after a merger means that the former Target shareholder ultimately holds stock in a corporation that could be described accurately as a modified form of the Target.

If the Acquiror fails to satisfy the historic business requirement of the Proposal at any time during the two-year period following the merger, *all* former Target shareholders lose the benefit of any non-recognition treatment.²¹⁴ This effect also serves the objective of delivering tax-favored treatment to mere changes in corporate form because, faced with the possibility of retroactive shareholder-level taxation (and resulting litigation), Acquirors will likely take extra precautions to guarantee that they do not violate the historic business requirement of the Proposal.

C. Illustrative Examples

The following examples illustrate the terms of the Proposal and its underlying policy justifications:

Example 1 (Base Case): Farmer Brown owns 100 percent of the voting common stock of Small Cheesecorp, which operates a local dairy business. Farmer Brown enters into a merger agreement with Delaware Dairy, Inc. ("Delaware Dairy"), another local dairy business. Small Cheesecorp will merge into Delaware Dairy in a transaction constituting a merger under Delaware law, and Farmer Brown will receive \$70,000 cash and \$30,000 worth of Delaware Dairy voting common stock in exchange for all of his voting common stock in Small Cheesecorp, Inc. In the merger agreement, Delaware Dairy represents that it will continue to operate the business of Small Cheesecorp as a separate business or will use substantially all of the assets of

²¹³ As a result of this condition, a Target shareholder's tax treatment on the receipt of Acquiror stock in a merger is linked to the Acquiror's satisfaction of the corporate-level requirements of the Proposal.

²¹⁴ The qualifying merger condition for shareholder non-recognition would not be satisfied in this case.

Small Cheesecorp in the dairy business of Delaware Dairy for the entire two-year period following the closing of the merger. Immediately after the merger is consummated, Farmer Brown's percentage ownership interest in Delaware Dairy is 45 percent, measured in terms of vote and value.

Under the Proposal, the merger in this example would result in tax-deferred treatment at both the corporate and shareholder levels.

First, no tax would be imposed at the corporate level on the transfer of assets by Small Cheesecorp to Delaware Dairy because the merger would be a qualifying merger. Assuming that Delaware Dairy's representation is accurate, Delaware Dairy would continue the historic business of Small Cheesecorp or would use its assets in a "like kind" business of Delaware Dairy (its dairy business) for the entire two-year period following the merger.²¹⁵

Second, at the shareholder level, Farmer Brown would not recognize gain or loss on the receipt of the Delaware Dairy stock, but would recognize gain with respect to the cash he receives to the extent of his realized gain on the exchange. Under the Proposal, it is irrelevant that only 30 percent of the aggregate consideration paid to Farmer Brown is Delaware Dairy stock.²¹⁶ Farmer Brown also exchanges voting stock for voting stock and does not experience a greater-than-eighty-percent decrease in his percentage ownership interest.²¹⁷

²¹⁵ This example highlights that, under the Proposal, taxpayers often will be forced to rely on representations from an Acquiror regarding its future plans for the Target's historic business. A merger agreement may provide that former Target shareholders could seek an indemnity from the Acquiror in the event that a qualifying merger is recharacterized as a taxable merger due to the Acquiror's breach of such representations.

²¹⁶ The Proposal contains no requirements regarding composition of merger consideration paid to Target shareholders.

²¹⁷ Farmer Brown's percentage interest drops from 100 percent in the Target to 45 percent in the Acquiror. In order to implicate the substantially disproportionate reduction rule of the Proposal, Farmer Brown would need to own less than 20 percent of the Target (by vote or value) following the merger.

Example 2 (Failed Historic Business Requirement):

Assume the same facts as Example 1, except that within one year of the closing of the merger, Delaware Dairy sells all of the Small Cheesecorp assets acquired in the merger to a third party for cash.

This variation causes the transaction to be taxable at both the corporate and shareholder levels under the Proposal. At the corporate level, a taxable sale would be deemed to have occurred because the transaction would fail to satisfy the requirements of a qualifying merger.²¹⁸ The two-year requirement that Delaware Dairy continue the historic business of Small Cheesecorp would be violated as a result of the third-party sale.²¹⁹ At the shareholder level, Farmer Brown would be taxed on *both* the stock and cash he receives because the stock would not be stock of an Acquiror that is a party to a qualifying merger. This variation illustrates that under the Proposal, corporate-level actions that cause a merger to be something more than a mere change in form directly affect shareholder-level tax treatment.

Example 3 (Voting Stock for Non-Voting Stock):

Assume the same facts as Example 1, except that Delaware Dairy pays Farmer Brown non-voting stock, instead of voting stock.

This merger would result in tax-deferred treatment at the corporate level, but taxable treatment at the shareholder level. Delaware Dairy would still receive tax-deferred treatment because it would satisfy the requirements of a qualifying merger. Unlike the continuity of interest doctrine, the Proposal disregards the type of consideration that Delaware Dairy pays to Farmer Brown in determining

²¹⁸ This consequence is identical to the corporate-level tax consequences of a failed I.R.C. § 368(1)(A) (2005) reorganization under current law.

²¹⁹ A sale to a third party of the Target's historic business assets constitutes a per se cessation of the Target's historic business by the Acquiror.

whether a mere change in form at the corporate level has occurred.

Farmer Brown, however, would be taxed under the Proposal on his receipt of the non-voting stock for two reasons. First, he exchanges his voting stock in Small Cheesecorp for non-voting stock in Delaware Dairy. Second, because Farmer Brown receives cash and solely non-voting stock in Delaware Dairy, his percentage interest in terms of voting rights decreases from 100 percent in Small Cheesecorp to 0 percent in Delaware Dairy.²²⁰ Under the Proposal, both of these effects warrant treating Farmer Brown as having experienced something more than a purely paper transaction.

Example 4 (Disproportionate Reduction in Percentage Interest): Assume the same facts as Example 1, except that instead of merging into Delaware Dairy, Small Cheesecorp merges into Big Cheesecorp, a national, publicly traded dairy corporation with millions of shareholders. After the merger, Farmer Brown's percentage interest (by vote and value) shrinks from a 100 percent interest in Small Cheesecorp to a .001 percent interest in Big Cheesecorp.

This transaction would receive tax-deferred treatment at the corporate level, but taxable treatment at the shareholder level. The merger would meet the qualifying merger requirements. However, Farmer Brown experiences a greater-than-eighty-percent reduction in his percentage interest as a result of the merger.²²¹ This variation illustrates that under the Proposal, a greater-than-eighty-percent reduction indicates that Farmer Brown has so drastically altered his percentage interest as a result of the

²²⁰ Farmer Brown owned 100 percent of Small Cheesecorp prior to the merger measured by vote as a result of his ownership of all of Small Cheesecorp's outstanding voting stock. After the merger, when Farmer Brown holds solely non-voting stock of Big Cheesecorp, Farmer Brown owns 0 percent of Small Cheesecorp measured by vote.

²²¹ In other words, Farmer Brown's percentage interest in the Acquiror (.001 percent) is less than 20 percent of his interest in the Target (100 percent) immediately prior to the merger.

merger that he should not be treated as having experienced a purely paper transaction.

D. Potential Criticism of the Proposal

While it is an improvement over the continuity of interest doctrine, the Proposal will not be immune to criticism. Some may argue that the Proposal would unduly favor corporate taxpayers to the government's detriment, increase the complexity of the tax provisions governing mergers, and subject business agreements to unreasonable uncertainty. The discussion below addresses each of these claims in turn.

1. A Corporate Windfall in Disguise?

A likely criticism of the Proposal is that it would result in a significant increase in favorable tax treatment for corporate taxpayers in comparison to current law. The Proposal would create a regime in which all statutory mergers of a Target into an Acquiror or its subsidiary would be free from current corporate-level tax as long as the requirements of a qualifying merger were satisfied. Critics may argue that this default tax-deferred treatment would be available to corporate taxpayers under the Proposal, even if a substantial amount of the merger consideration paid to Target shareholders is cash or other non-stock property.²²² Under current law, an Acquiror is at least saddled with an obligation to issue a certain amount of its equity to Target shareholders.²²³ The Proposal would eliminate that requirement entirely and, in doing so, critics may contend that it would make it easy for an Acquiror to enjoy tax-deferred treatment. Critics may argue that this increased

²²² This criticism reflects an inherent bias towards current law, where we have been indoctrinated to believe that a tax-deferred corporate transaction can only occur where at least *some* corporate stock is issued in the transaction. *See* I.R.C. § 368 (2005).

²²³ In a forward statutory merger, an Acquiror must be willing to pay merger consideration consisting of at least 40 percent Acquiror stock in order to achieve reorganization status under current law. *See* Treas. Reg. 1.368-1(e)(2)(v), ex. 1 (as amended in 2005).

tax deferral could mean a significant loss of tax revenue for the government.

This criticism can be addressed by highlighting some of the differences between current law and the Proposal. It is true that the Proposal would eliminate any requirement that an Acquiror pay a minimum amount of Acquiror stock to Target shareholders. However, the Proposal contains an equally onerous set of conditions for tax-deferred treatment. A merger would not be treated as a qualifying merger under the Proposal unless an Acquiror continued the historic business of the Target in a specified manner for the two-year period following the merger. In many ways, the Proposal is *tougher* than current law because current law mandates only that an Acquiror pay certain consideration at the time of a merger and, after that point, the Acquiror enjoys relative flexibility in its operations.²²⁴ By contrast, the Proposal governs *future* actions of the Acquiror in order to ensure that a merger receiving tax-favored treatment is, as much as possible, a mere change in form.

The corporate windfall criticism also ignores the double-sided nature of the Proposal. Because the Proposal would create a default regime of tax-deferred treatment for qualifying mergers, taxpayers in certain instances would lose the ability to recognize taxable losses. For example, if a Target shareholder holds Target stock with a basis in excess of its fair market value, the shareholder would not be entitled to recognize a current taxable loss in a qualifying merger. Also, at the corporate level, if a merger satisfies the qualifying merger requirements, the Acquiror would hold the Target's assets with a carryover basis from the Target rather than a fair market value basis. The consequence of carryover basis treatment is that, in the future, the Acquiror would have a diminished opportunity to claim depreciation

²²⁴ As discussed above, the continuity of business enterprise rules under current law are relatively easy to satisfy and do not contain any temporal restrictions. See Treas. Reg. § 1.368-1(d) (as amended in 2005); BLOCK, *supra* note 43, at 347.

deductions with respect to the Target's assets.²²⁵ This diminution of potential tax benefits demonstrates that the Proposal has the potential to cut both ways. The Proposal would either defer current taxable gain or deny current taxable losses.²²⁶ In either case, the treatment is justified by the policy that special types of mergers (qualifying mergers under the Proposal) should be treated as mere changes in form and not realization events.

The claim that the Proposal would result in large losses of revenue is likely exaggerated. Under current law, if parties to a merger cannot satisfy the continuity of interest doctrine, there are still a variety of other techniques available that achieve essentially the same beneficial tax effects as a reorganization. For example, if these parties desire corporate- or shareholder-level tax deferral upon a corporate combination, they can achieve this treatment by restructuring a statutory merger as a tax-deferred incorporation of assets.²²⁷ Because current law allows parties to achieve tax-deferral with somewhat relative ease, the

²²⁵ Corporate taxpayers are generally entitled to claim depreciation deductions for a particular asset as its utility declines over time. See I.R.C. §§ 167, 168 (2005).

²²⁶ The Proposal does not allow inconsistent treatment at the corporate- and shareholder-levels. Under the A.L.I. Report, a merger can result in taxable loss recognition at the corporate-level (as a result of an election) and tax-deferred treatment at the shareholder-level. Query whether it is possible to justify this potential double benefit to the owners of a corporate enterprise on any policy grounds?

²²⁷ It is possible to structure a merger as a tax-deferred incorporation of assets under I.R.C. § 351 (2005) and to achieve substantially similar tax results as in a reorganization. The key difference is that § 351 does not contain any limits on the amount of cash that Target shareholders may receive in such a transaction. See Rev. Rul. 84-71, 1984-1 C.B. 106 (stating that minority shareholders receive tax-deferred treatment on receipt of holding company stock under § 351 without regard to whether or not there is continuity of interest). This transaction is also commonly referred to as a "horizontal double dummy" merger or a "top hat" merger. For a few examples of this transaction structure, see Richard W. Bailine, *Long Live the Horizontal Double Dummy*, 29 CORP. TAX'N 30 (2002).

Proposal should not result in additional tax revenue loss.²²⁸ Similar levels of tax deferral should occur under the Proposal as under current law, even if parties utilize the qualifying merger as their transaction structure of choice.²²⁹

2. Increased Complexity

Another likely criticism of the Proposal is that it would increase the complexity of the tax rules governing mergers. The Proposal would require taxpayers to perform both a corporate- and shareholder-level analysis not required by current law in order to determine if a merger is eligible for tax-favored treatment. Parties to a merger would likely seek representations from an Acquiror that would address the amount of time, and the manner in which, the Acquiror intends to operate the Target's business. Further, if the Acquiror desires to use the Target's business assets in its own business, the parties would need to compare the business of the Target with the business of the Acquiror and to reach a conclusion regarding their "like kind" nature. Target shareholders would also face increased complexity to some extent, because they would be required to calculate whether downward shifts in their percentage interests were significant enough to trigger gain under the Proposal. These added layers of complexity may make the Proposal less desirable than current law or the A.L.I. Report's proposed alternative.

It is true that the Proposal requires analysis that current law and other alternatives do not. The Proposal is more complex than current law and other proposals because its primary function is to identify unique characteristics of a

²²⁸ For a discussion of the many ways available under current law to avoid gain recognition when the continuity of interest doctrine cannot be satisfied, see Robert Willens, *Techniques Abound for Avoiding Difficult Continuity of Interest Determinations*, 84 J. TAX'N 342 (1996).

²²⁹ If the Proposal were enacted, parties would likely shift from such other techniques as the horizontal double dummy merger (which can pose regulatory and other non-tax constraints) to the qualifying merger as a means for combining businesses in a tax-efficient manner.

merger that is a mere change in form or a purely paper transaction.²³⁰ A new set of rules and factors is needed in order to serve this purpose. By comparison, the proposal offered by the A.L.I. Report, with its corporate election mechanism and default shareholder non-recognition rule, takes a relatively simple approach.²³¹

Although the Proposal creates detailed new requirements, the transition to its set of rules should not be overly cumbersome. First, the Proposal would only replace the tax provisions governing statutory mergers of a Target into an Acquiror or its subsidiary. Effectively, these are the only transactions that are subject to the judicial continuity of interest doctrine under current law.²³² The Proposal is not intended to replace all provisions of the Code governing the tax treatment of stock acquisitions, asset transfers or other combinations. Implementing the Proposal by statute, therefore, would not be as burdensome as other alternatives, such as the A.L.I. Report's proposal.²³³

Second, the complexity argument is undercut by the Proposal's use of concepts—such as “like kind” nature and disproportionate ownership reductions—that already exist elsewhere in the Code.²³⁴ The government and taxpayers, therefore, would at least have familiarity with these concepts

²³⁰ For the many reasons discussed herein, the continuity of interest doctrine does not serve such an objective successfully.

²³¹ Indeed, the A.L.I. Report comments that its proposal creates “a radical simplification both in practice and in the definition and conception of more particular issues to be dealt with.” A.L.I., *supra* note 20, at 7.

²³² The judicially created continuity of interest requirement is only applicable to transactions governed by I.R.C. §§ 368(a)(1)(A) (2005) (statutory mergers of Target into Acquiror) and 368(a)(2)(D) (statutory mergers of Target into Acquiror's subsidiary).

²³³ Repeal or fundamental modification of the continuity of interest doctrine should occur by statute rather than by administrative regulation. If the Treasury attempts to make such significant changes to the tax treatment of corporate reorganizations, it is possible that a court or taxpayers could question whether it has the authority to do so.

²³⁴ See I.R.C. §§ 1031 (like kind exchange), 302(b)(2) (2005) (substantially disproportionate redemption of stock).

as utilized in the Proposal and would be able to employ this knowledge in answering questions that might arise.

Last, an Acquiror could be required to deliver sufficient information to Target shareholders regarding their ownership interests in order to enable them to determine whether their stock-for-stock exchanges would result in taxable disproportionate reductions in percentage interest.²³⁵

3. Interference with Business Deals

Critics may charge that the Proposal is undesirable because uncertainty associated with it may chill taxpayers from entering into business combinations. If a Target's shareholders desire to merge their Target with the Acquiror in a tax-deferred manner, they may be wary that the Acquiror could fail the two-year historic business requirement (contrary to the Acquiror's representations at the time of the merger). Due to the uncertain tax outcomes that the Proposal effects, critics may contend that the Proposal would inhibit parties from entering into mergers where certain tax consequences are desired or may interfere with the parties' business negotiations.²³⁶

This criticism is best addressed by an explicit acknowledgement that the Proposal does create a degree of uncertainty. This uncertainty, however, is not entirely detrimental. The requirements of the Proposal are designed to enable tax-favored treatment to be enjoyed only in transactions where a mere change in corporate form occurs. The uncertainty that the Proposal may provoke would likely motivate taxpayers to take *extra* precautions to guarantee that the merger continues to be a qualifying merger from the

²³⁵ Under current law, corporations engaging in reorganizations already distribute documentation to participating shareholders that is required to be incorporated in shareholders' tax returns. *See* Treas. Reg. § 1.368-2(b) (as amended in 2005).

²³⁶ There appears to be a consensus that "uncertainty" is one of the continuity of interest doctrine's greatest problems. *See, e.g.*, Hutton, *supra* note 10; Miller, *supra* note 15; Posin, *supra* note 11; Wolfman, *supra* note 4.

time of the closing throughout the following two-year period. After the merger, an Acquiror might even retain legal counsel or accountants to ensure that the Acquiror continues the Target's business in the proper way and that the intended tax treatment of the merger would be respected by the IRS.²³⁷

The Proposal thus evokes the classic struggle between a rules-based and a standards-based approach to tax compliance.²³⁸ In a rules-based system, the government and the taxpayers are guided by definite rules that dictate the outcome of a particular transaction or position. If the Proposal were to follow the direction of the A.L.I. Report by adopting an expressly elective mechanism for determining the tax treatment of a merger, it would utilize a rules-based approach. By making an election, the taxpayer would know in advance exactly how the transaction would be treated for tax purposes.

In a standards-based system, the rules are not as clear-cut, but instead describe a set of guidelines or factors that determine the outcome. The Proposal adopts a standards-based approach because it details the steps that an Acquiror must take to continue a Target's historic business, but it does not provide the taxpayer with certainty that its steps will be respected. For example, if an Acquiror could not satisfy the historic business requirement of the Proposal by conducting a Target's historic business directly, it could use substantially all of its assets in a "like kind" business. However, the Proposal does not contain a definitive, bright line rule for what types of businesses are "like kind."

²³⁷ See Herlihy, *supra* note 73.

²³⁸ For a thorough discussion of rules-based versus standards-based approaches to tax compliance, see David A. Weisbach, *Ten Truths About Tax Shelters*, 55 TAX L. REV. 215 (2002). For a more general discussion of the role of uncertainty in law, see Tom Baker et al., *The Virtues of Uncertainty in Law: An Experimental Approach*, 89 IOWA L. REV. 443 (2004). See also Kyle Logue, *The Problem of Tax Law Uncertainty and the Role of Tax Insurance*, 25 VA. TAX REV. 339, 349 (2005) (discussing the role of uncertainty in a taxpayer's analysis of whether to avoid or to evade tax law).

Consequently, this uncertainty could lead the taxpayer to take extra precautions. Such actions would only strengthen the argument that a merger qualifying for special tax treatment under the Proposal represents a mere change in form.

Another positive aspect of the uncertainty effect of the Proposal is that the government would retain flexibility to recharacterize transactions that are abusive.²³⁹ The lack of bright lines and clearly defined terms would empower the government to address mergers on a transaction-by-transaction basis. The A.L.I. Report's purely elective mechanism, however, generally prevents the government from rescinding tax-favored treatment claimed by corporate taxpayers where it is unwarranted.²⁴⁰

The uncertainty obstacle that the Proposal presents is thus justifiable. The tax-favored treatment of a qualifying merger (or reorganization under current law) is an extraordinary exception from the general realization rule. If uncertainty results in stricter compliance with a set of rules that distinguish an ordinary sale from a special merger, it should be viewed as an integral element of the Proposal.

²³⁹ The IRS often seeks to recharacterize treatment of a transaction on the basis of "substance-over-form" principles by arguing that a court should look to the substance of the transaction and disregard the taxpayer's chosen form. See Peter C. Canellos, *Tax Practitioner's Perspective on Substance, Form and Business Purpose in Structuring Business Transactions in Tax Shelters*, 54 SMU L. Rev. 47 (2001); Lewis R. Steinberg, *Form, Substance and Directionality in Subchapter C*, 52 TAX LAW. 457 (1999) (commenting that the fundamental question of corporate tax practice is "when will the transactional form selected by the parties control the tax consequences to them?").

²⁴⁰ An express taxpayer election may inhibit the government's ability to apply a substance-over-form analysis in recharacterizing transactions. For example, under current law, when an Acquiror purchases the stock of a Target and makes a "Section 338(h)(10) Election" (which enables the Acquiror to achieve a step-up in basis in the Target's assets), the IRS generally will not apply step transaction principles to integrate a subsequent merger or liquidation of Target with the stock purchase. See Treas. Reg. § 1.338(h)(10)-1T (as amended in 2003).

E. Interaction with Other Reorganization Provisions

The Proposal is intended to replace the types of reorganizations over which the continuity of interest doctrine currently governs—statutory mergers of a Target into an Acquiror or its subsidiary. The Proposal is necessarily limited in this regard because its aim is to serve as an alternative for the flawed doctrine that determines the tax treatment of these types of combinations.

However, there are a number of other types of transactions that currently may be classified as reorganizations under different provisions of the Code.²⁴¹ These types of reorganizations, such as stock-for-stock²⁴² or assets-for-stock²⁴³ exchanges, are subject to their own sets of statutory requirements that explicitly state the type and composition of consideration that an Acquiror must pay to a Target to qualify for reorganization treatment.²⁴⁴ Those types of transactions are not subject to the judicially created continuity of interest doctrine that is the focus of this Article.

An interesting question for the future is whether the Proposal could or should be applied to *all* transactions that may qualify as reorganizations under the Code, rather than just those that are subject to the continuity of interest

²⁴¹ See I.R.C. §§ 368(a)(1)(B), (C), (D), (E), (F), (G), (a)(2)(E) (2005).

²⁴² An exchange of the Acquiror's voting stock for Target stock (also referred to as a "Type B" reorganization) will qualify as a reorganization if the Target stock is exchanged solely for the Acquiror voting stock and after the exchange the Acquiror (or a corporate subsidiary of the Acquiror) owns at least 80 percent of the Target's voting stock and 80 percent of each class of the Target's non-voting stock. I.R.C. § 368(a)(1)(B) (2005).

²⁴³ The acquisition of "substantially all" of the properties of the Target in exchange "solely for voting stock" of Acquiror (also referred to as a "Type C" reorganization) followed by the liquidation of the Target will qualify as a reorganization. In determining whether the exchange is "solely for voting stock," the statute provides that the assumption by the Acquiror of the Target's liabilities is disregarded. An exception to the "solely for voting stock" requirement is that the Acquiror may transfer boot to the Target if at least 80 percent of the fair market value of Target's properties are acquired solely for voting stock. I.R.C. § 368(a)(1)(C) (2005).

²⁴⁴ See I.R.C. §§ 368(a)(1)(B), (C) (2005).

doctrine. Has Congress created specific consideration requirements for these other types of reorganizations for a reason? If one is inclined to view the tax treatment of all corporate combinations (regardless of transaction structure) as raising the same basic policy concerns, then perhaps the Proposal could be viewed as a prototype that could be expanded beyond forward statutory mergers.²⁴⁵ Alternatively, if one finds unique policies justifying disparate tax treatment for different types of corporate combinations (or otherwise desires partial renovation of the reorganization provisions of the Code rather than wholesale demolition), the Proposal could be enacted as presented in this Article and limited to transactions subject to the continuity of interest doctrine.

VI. CONCLUSION

This Article has offered a new justification for repeal of the continuity of interest doctrine. The typical criticisms that commentators have offered in the past—that the doctrine is unclear, inefficient, and unfair—are largely irrelevant and unpersuasive. Rather, this Article has examined the role of the doctrine in determining whether a particular merger merits special tax treatment. This Article has argued that the continuity of interest doctrine is an ineffective means of distinguishing between mergers that represent mere changes in form and those that are the equivalent of ordinary sales. It has demonstrated that the end that the continuity of interest doctrine serves—an aggregate group of Target shareholders continuing their

²⁴⁵ If the Proposal is expanded to cover stock or asset acquisitions (as opposed to solely mergers), the Proposal would presumably need to include additional rules governing the amount of a Target's assets or stock that an Acquiror or its shareholders must obtain in order for a mere change in form to be deemed to have occurred. In a forward merger, that inquiry is relatively simple because substantially all of the assets held by a Target (at least immediately prior to the merger) are transferred to the Acquiror.

proprietary interests as shareholders of the Acquiror—is fiction.²⁴⁶

Further, this Article has offered an alternative to the continuity of interest doctrine that differs significantly from current law and from proposals that have been offered in the past. By conditioning tax-deferred treatment on the Acquiror's continuation of the Target's historic business for two years following a merger, the Proposal creates a set of rules that more effectively identifies a merger that is akin to a mere change in form. Likewise, the shareholder non-recognition requirements of the Proposal distinguish purely paper transactions from ordinary stock-for-stock exchanges.

Like many traditions, the continuity of interest doctrine has been passed down from generation to generation without being subjected to serious reconsideration. Unless this reconsideration occurs in the near future, the Treasury and IRS will likely continue to issue administrative relief that exacerbates the fiction of continuity of interest in an attempt to make the requirement more practical. A doctrine supported by such a foundation is as shaky as that famous fiddler.²⁴⁷ Rather than await its demise, it is time to end this tradition.

²⁴⁶ Stated differently, this Article has proclaimed that the continuity of interest emperor is not wearing any clothes.

²⁴⁷ See BOCK, *supra* note 1.