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GROMAN—OR NAMORG—REVISITED; THE PERSISTING PROBLEM OF REMOTE CONTINUITY OF INTEREST

Daniel M. Schneider*

INTRODUCTION

Continuity of shareholder interest is a familiar and essential element of corporate reorganizations. Simply stated, this doctrine requires the owner of an acquired corporation to retain a continuing proprietary interest in a corporation that acquires his corporation. If he holds such an interest, continuity will exist and, assuming fulfillment of other requirements, a tax-free reorganization will occur. In contrast, an outright sale of a corporation's assets or stock will not qualify as a tax-free reorganization because there is no continuity of interest. As first cautioned by the Second Circuit, a "sale of the assets of one corporation to another for cash without the retention of any interest by the seller in the purchaser is quite outside" the purview of the reorganization statutes.1 Sales and reorganizations are mutually exclusive.

Tax practitioners can easily describe contrasting examples of reorganizations and sales. A shareholder's exchange of stock in a merger under state law will be considered an "A" reorganization of all of the consideration he and the other shareholders receive is stock of the corporation that survives the merger, or, at least if the Internal Revenue Service is to grant a ruling, no more than half the consideration he receives is property other than stock.2 On the other hand, a shareholder's receipt of too much consideration other than stock or, indeed, receipt solely of non-stock consideration will not be considered an exchange that has taken place as part of a reorganization. Instead, the shareholder will have sold his stock.

Tax lawyers also can easily recount less clear situations, cases where the intended corporate acquisition was not readily classified as a reorganization or as a sale of the acquired corporation's assets or stock. This article addresses one aspect of the grey area. It explores the problem of remote continuity, specifically as it arises in successive mergers.

Before proceeding, it is important to clarify the "bottom line" of this

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* A.B., Washington University, 1970; J.D., University of Cincinnati College of Law, 1973; LL.M., New York University School of Law, 1976. Associate Professor of Law, Northern Illinois University. The author would like to thank William Natbony for his comments.


Reorganizations are defined by I.R.C. § 368(a)(1)(1982). An A reorganization is described by § 368(a)(1)(A), a B reorganization is described by § 368(a)(1)(B), and so on through G reorganizations, § 368(a)(1)(G). See generally infra text accompanying notes 19-28.
article. Continuity of interest and concomitant reorganization status are sought—or avoided—only to obtain specific tax goals. Foremost among the benefits of engaging in a reorganization is the nonrecognition of gain to the participants. Neither the corporate transferor, the corporate transferee, nor the shareholders of the acquired corporation recognize gain or loss upon its or their exchange of stock or assets for stock. The tax attributes of the corporate transferor, such as net operating losses and the method of accounting, also are carried over in certain reorganizations. On the other hand, the parties may wish the exchange to be a taxable sale. Then, for example, the transferee corporation can obtain a stepped-up basis in the transferor’s assets and thereby increase the amount of its depreciation deductions. A reorganization cannot take place if there is no continuity of interest and this article analyzes that essential element, especially as that element develops into the problem of remote continuity.

Remote continuity has been used as a catch-all phrase to describe certain transactions that apparently have not been intended to be sales, but which have failed to qualify as reorganizations for Federal income tax purposes. Shareholders of the acquired corporation technically fail to obtain a continuing interest in the acquiring corporation and so there is no continuity of interest. Remote continuity can prevent a reorganization from transpiring or, even if one takes place, can compel gain recognition to shareholders of the acquired corporation with respect to stock used that is not stock of the acquiring corporation. Remote continuity occurs in triangular reorganizations, acquisitions involving not only the acquired and acquiring corporations, but the parent or subsidiary of one of these two corporations as well. For example, in a triangular reorganization the acquiring corporation, whose stock is given as consideration to the acquired corporation, might drop the assets of the acquired corporation into one of its subsidiaries rather than retaining them. At one time, the transaction failed to conform to the condition that the acquiring corporation be a party to a reorganization. As

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3. See I.R.C. §§ 361, 1032, 354, and 355 (1982 & West Supp. 1984); see also infra text accompanying notes 31-38. Ordinarily, a taxpayer will prefer to recognize losses immediately, in order to reduce income upon which he is taxed. On the other hand, he will wish to avoid recognizing gain. See I.R.C. §§ 62, 63, 165, and 1202 (1982 & West Supp. 1984).


8. See Helvering v. Bashford, 302 U.S. 454 (1938), infra notes 104-08; infra note 144 (Bashford statutorily overruled). The acquiring corporation technically need not be a party to a
explained below, continuity in triangular reorganizations can be identified with the need for a party to a reorganization. If stock of a corporation that is not a party to a reorganization is used in a triangular reorganization, the courts and the Internal Revenue Service historically have determined that there is a problem of remote continuity and that continuity does not exist.

Remote continuity is a shorthand term, one that has not been used by the courts nor by the Service. For example, in two early Supreme Court cases that first presented the problem of remote continuity, shareholders of acquired corporations respectively exchanged their stock for stock of an acquiring corporation's parent and for stock of a corporation which then transferred the acquired corporation's assets to a subsidiary.9 Clearly, the Supreme Court thought there was no continuity. It compelled the acquired corporation's shareholders to recognize gain (outside the reorganization statutes) on receipt of the aforementioned stock, but not because of a problem with remote continuity. Rather, it declared that, in both cases, the aforementioned stock had not been stock of "a party to a reorganization,"10 and therefore the benefits of engaging in a reorganization did not adhere to this stock.11 These exchanges, transactions that were not intended to be sales, still failed to be the reorganizations that had been planned because stock of a related corporation, not stock of a "party to a reorganization," had been used.12

The problem of remote continuity can arise when statutory mergers follow one another. As explained below, the legislative neutering of the circumstances where the problem can arise makes successive mergers a likely candidate for remote continuity.13 To illustrate the susceptibility of successive mergers, consider a parent corporation that merges into its subsidiary, a downstream merger, followed by the successor's merger into a third corporation, a lateral merger. (Matters could then be complicated by the acquired subsidiary corporation's receiving stock of the acquiring corporation's parent, not of the acquiring corporation itself. The transaction might still qualify as a reorganization, but the continuity—the acquired parent's shareholders' continuing proprietary interest—would be in a more distant corporation.)14

If the mergers occurred pursuant to a single plan of reorganization, then the shareholders of the acquired parent may not be considered to have re-

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10. See I.R.C. § 368(b) (1982).
11. See Groman, 302 U.S. at 90-98; Bashford, 302 U.S. at 458.
13. See infra text accompanying notes 133-149.
14. See also I.R.C. § 368(a)(1)(A), —(a)(2)(D); Edwards Motor Transport Co. v. Commissioner, 33 T.C.M. (P-H) 2164 (1964) (discussion of a merger of a holding company into a subsidiary).
ceived stock of the acquiring corporation—the acquired subsidiary. Instead, they could be treated as having received stock of a third corporation, the ultimate acquiring corporation, and be compelled to recognize gain, because they do not possess the requisite continuity. If the mergers occur pursuant to two rather than a single plan of reorganization, then target shareholders can avoid recognizing gain in both reorganizations, because of continuity. In the case of each merger, the shareholders of the target corporation will have received stock of the corporation that actually acquired their corporation.\(^\text{15}\)

Business conditions may compel engaging in two successive mergers. For example, an acquiring corporation probably will wish to dismantle the management structure of the target companies, especially if it finds that management to be redundant. Such dismantling can be obtained through the downstream and lateral mergers described in the preceding paragraph.\(^\text{16}\) But despite compelling circumstances for engaging in successive mergers, no reorganization can occur if the problem of remote continuity is found to exist. This article attempts to reconcile the tension between the constraints of business goals and the requirements of federal income tax laws, so that both the downstream and the lateral mergers can qualify as reorganizations under the tax law. This article will initially describe acquisitive reorganizations and define the terms necessary for understanding whether or not a reorganization has occurred and what will happen if there is a reorganization. It then describes the development of continuity of interest by analyzing statutory and interpretative developments. Finally, it reviews the ramifications of several modes of analyzing the problem of remote continuity of interest.

I. THE HISTORY OF CONTINUITY OF SHAREHOLDER INTEREST

A. Types of Reorganizations

A reorganization is a corporate transformation entailing the combina-

\(^{15}\) The benefits of engaging in a reorganization inure to the target corporation and its shareholders only if they exchange their assets or stock pursuant to a “plan of reorganization.” See I.R.C. §§ 354(a), 361(a) (1982); infra text accompanying notes 33-36. Section 354(a) requires the target's shareholders to receive stock of a party to the reorganization, i.e., the acquiring corporation, under the plan of reorganization. Thus, if the plan for the mergers discussed in the text were for the acquired parent to merge into the acquired subsidiary, then the acquired parent's shareholders' receipt of the acquiring corporation's stock would not qualify for nonrecognition under § 354(a). The reason for this is that the acquiring corporation is not a party to the reorganization, nor was its stock received pursuant to an appropriate plan.

Alternatively, it could also be argued that the plan was to merge the acquired parent into the acquiring corporation, and that the stock the acquired parent's shareholders received, that of the acquired subsidiary, was not stock of a party to the reorganization. See Helvering v. Bashford, 302 U.S. 454 (1938).

\(^{16}\) Cf. American Bronze Corp. v. Commissioner, 64 T.C. 1111, 1124-29 (1975) (simplification of business structure is good business purpose). Legal restrictions also may lead to the particular structure of a reorganization. For example, the various regulatory approvals necessary to consummate mergers between commercial banks could lead to engaging in downstream and forward triangular mergers in order to obtain the approval of the Comptroller of the Currency, the part of the U.S. Treasury Department that regulates national banks, rather than that of the Federal Reserve Board of Governors. See Note, The Line of Commerce for Commercial Bank Mergers: A Product-Oriented Redefinition, 96 HARV. L. REV. 907, 909 n.15 (1983). Recently, the Comptroller has held a less rigorous view than the Federal Reserve of what mergers will have anti-competitive effects.
tion, devolution, or division of preexisting corporations. Continuity of interest is an element only of acquisitive and divisive reorganizations, so only these types of reorganizations are discussed.\textsuperscript{17} Corporate rearrangements described in Internal Revenue Code ("I.R.C.") section 368(a)(1)(A), -(B), -(C), and some situations described in section 368(a)(1)(D) are acquisitive types of reorganizations in which one corporation acquires the assets or stock of another corporation.\textsuperscript{18} A divisive reorganization must conform with sections 368(a)(1)(D) and 355.\textsuperscript{19}

In an A reorganization, two corporations merge or consolidate under the corporation laws of the United States, a state, a territory, or the District of Columbia.\textsuperscript{20} Two corporations combine to form a new, third corporation in a consolidation, whereas one of two combining corporations survives in a merger, having acquired the property of the other corporation.\textsuperscript{21} In either case, the target corporation transfers its property to the surviving corporation, and the target’s shareholders obtain stock of the latter corporation. The acquiring corporation need not use voting stock, and it may use greater amounts of non-stock consideration than can be used in other types of reorganizations.\textsuperscript{22}

In contrast, B and C reorganizations depend upon compliance with strict consideration tests. In a B reorganization, shareholders of the acquired corporation exchange their stock solely for voting stock of the acquiring corporation. After the reorganization, the acquiring corporation must own at least eighty percent of the voting stock and at least eighty percent of all other stock of the target corporation.\textsuperscript{23} Thus, the acquiring corporation obtains a subsidiary. In a C reorganization, the acquiring corporation exchanges substantially all of its assets solely for voting stock of the acquiring corporation. Although the acquisition of assets is a shared feature of A and C reorganizations, more stringent requirements are imposed on C reorganizations. Generally, the acquiring corporation must use its voting stock as consideration in a C reorganization, and this stock must constitute at least eighty percent of the consideration paid to the acquired corporation.\textsuperscript{24}


\textsuperscript{19} See generally BITTKER AND EUSTICE, supra note 12, at § 14.


\textsuperscript{21} 15 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 7041 (perm. ed. 1973) [hereinafter cited as FLETCHER].

\textsuperscript{22} See infra text accompanying notes 23-24.

\textsuperscript{23} I.R.C. § 368(a)(1)(B), (c) (1982). The acquiring corporation also can use the voting stock of a corporation that controls it.

In a D reorganization, one corporation transfers some or all of its assets to a second corporation. Immediately after the transfer, the first corporation or one or more of its shareholders controls the second corporation. If the reorganization is acquisitive, the acquired corporation must transfer substantially all its assets and distribute the acquiring corporation's stock to its shareholders, so that it must, in effect, liquidate. Such a reorganization could occur, for example, when a parent corporation wishes to eliminate a subsidiary but not dispose of any of the subsidiary's assets. If section 368(a)(1)(D) is the basis for splitting a corporation with multiple businesses into multiple corporations, then it is a divisive reorganization.

B. The Benefits of Engaging in a Reorganization

Being a "party to a reorganization" or a shareholder of a "party to a reorganization" is a statutory prerequisite to enjoyment of the benefits of a reorganization. A party to a reorganization includes a corporation resulting from the reorganization, and both of the corporations in an acquisitive reorganization. And, since 1954, as various triangular corporate acquisitions have been included in the definition of a reorganization, the meaning of a party to a reorganization also has been expanded to include all of the corporations that participate in these acquisitions.

Section 361 provides that a corporation that is a party to a reorganization shall recognize no gain or loss upon its exchange of property, pursuant to a plan of reorganization, solely for stock or securities in another corporation that also is a party to the reorganization. Thus, section 361 accords nonrecognition treatment to the target corporation, subject only to its receipt of "boot," i.e., consideration other than stock or securities.

26. See I.R.C. § 354(b) (1982). A distribution of the controlled corporation's stock in a divisive D reorganization is made pursuant to § 355, not § 354, so that the transferor's liquidation is unnecessary in the divisive reorganization. See generally BITTKER AND EUSTICE, supra note 12, at ¶ 14.16. See generally BITTKER AND EUSTICE, supra note 12, at ¶ 14.16.
27. Where a reorganization can be characterized as a C or D reorganization, § 368(a)(2)(A) requires the reorganization to be treated as a D reorganization. Under appropriate circumstances, the reorganization also might be considered an A, E, or F reorganization. See BITTKER AND EUSTICE, supra note 12, at ¶ 14.16.
28. E, F, and G reorganizations complete the roster of reorganizations. E and F reorganizations, which are recapitalizations and mere changes in a corporation's identity, form, or place of organization, respectively. Such reorganizations do not involve a substantive combination or division. In a recapitalization, a corporation's capital structure is altered. An F reorganization might be effected to gain, for example, the benefit of organizing under another state's law. Neither of these corporate devolutions, however can be regarded as acquisitive reorganizations. G reorganizations were added to the Code by the Bankruptcy Tax Act of 1980. See I.R.C. § 368(a)(1)(G) (1982). See also I.R.C. § 368(a)(3) (1982). In a G reorganization, one corporation transfers all or some of its assets to another corporation in a Chapter 11 bankruptcy proceeding. As in a D reorganization, the transferor corporation must either transfer substantially all assets and distribute the acquiring corporation's stock or securities to its stock or security holders, or one or more of the holders of its securities or stock must control the transferee corporation after the reorganization. See I.R.C. § 368(a)(1)(G) (1982).
29. See I.R.C. § 368(b) (1982).
30. See I.R.C. § 368(c). See generally infra text accompanying notes 142-45.
32. See I.R.C. § 361(b) (1982).
The treatment of the corporate transferee, the acquiring corporation, does not depend upon its status as a party to a reorganization. A corporation that acquires property in exchange for its stock recognizes neither gain nor loss under section 1032, regardless of whether or not a reorganization has occurred. Its basis in the property that it acquires is determined by reference to the transferor's basis in the property, increased by the amount of gain, if any, the transferor recognizes on the transfer of such property.

Recognition of gain or loss to shareholders of the acquired corporation is determined under section 354 or section 355. Under section 354, the target corporation's shareholders do not recognize loss. They recognize gain, but only to the extent of boot received. They must exchange stock or securities in their corporation solely for stock or securities in another corporation, i.e., the aforementioned acquiring corporation. Both corporations must be parties to the reorganization and the exchange must occur pursuant to a plan of reorganization. A section 355 distribution is made in connection with a divisive reorganization. Generally, holders of stock or securities of a corporation, that owns at least eighty percent of another corporation's voting and other stock, receive the controlled corporation's stock or securities pursuant to the section 355 distribution. Gain is recognized to the extent of boot. Loss is not recognized. Section 358 provides that the basis of stock or securities received by the acquired corporation's shareholders shall be the same as basis of the stock or securities transferred, increased by the amount of any gain recognized and decreased by the amount of any loss recognized and the value of the boot received in the exchange.

Being a party to a reorganization or a shareholder of such a party accords certain benefits. As explained below, not being such a party is a manifestation of the problem of remote continuity.

C. Early Statutory Development

Section 368(a)(1) did not spring forth fully grown like Athena did from Jupiter's forehead. Rather, its pedestrian origin was a 1918 statute, which was much terser than its contemporary descendant. Continuity of interest was not and never has been an explicit statutory requirement. Instead, the
doctrine of continuity has been integrated into the development of reorganiza-
tions, first by judicial sanction, and then by statutory amendments that, in
effect, have imposed specific continuity standards on certain types of
reorganizations.

Section 202(b) of the Revenue Act of 1918 treated property as the
equivalent of cash when it was exchanged for other property, for purposes of
determining gain or loss from the exchange. No gain or loss, however, oc-
curred under the statute upon the exchange by a person of stock or securities
for new stock or securities of no greater aggregate par or face value if the
exchange occurred in connection with "the reorganization, merger, or con-
solidation of a corporation." Only in 1921 did Congress actually define the term "reorganization" as
a merger or consolidation, including the acquisition by one corporation of at
least a majority of the voting stock and of all other stock of an acquired
corporation or of substantially all the assets of the acquired corporation or of
substantially all the assets of the acquired corporation, as a recapitalization,
and as a mere change in identity, form, or place of organization. These
reorganizations find their present counterparts in A, B, C, E, and F reorgani-
izations. The list of reorganizations was expanded by the Revenue Act of
1924, which added modern D reorganizations to the list of events that quali-
fied as tax-free reorganizations.

The year 1924 also marked the introduction of a more comprehensive
reorganization scheme. The term "a party to a reorganization" was first
used in the Revenue Act of 1924. Like its modern day successor, it included
a corporation resulting from a reorganization. It also included both corpora-
tions in the case of an acquisition by one corporation of at least a majority of

Corporation, 64 Cal. L. Rev. 902, 912-14 (1976) (explaining the policy underlying early reorgan-
ization statutes).
the voting and other stock of another corporation. Nonrecognition treatment continued to be allowed to the acquired corporation, but only if it was a party to a reorganization. Nonrecognition treatment also was allowed to that corporation's shareholders if stock or securities of the acquiring corporation was distributed to them pursuant to a plan of reorganization.

For the next ten years, the statutory definition of reorganizations was not otherwise modified. But the terms "reorganization" and "party to a reorganization" were the subjects of judicial analysis.

D. Early Cases—Continuity and Remote Continuity

The Supreme Court first analyzed continuity of interest in 1933 in *Pinellas Ice & Cold Storage Co. v. Commissioner*. Pinellas Ice & Cold Storage Company exchanged its assets with another corporation for $400,000 cash and $1,000,000 of short-term notes due no more than three and one-half months after the exchange. In addressing whether or not the transaction constituted a reorganization under a 1926 statute (which resembled the 1921 statute noted above), the Court stated that "the seller must acquire an interest in the affairs of the purchasing company more definite than that incident of ownership of its short term purchase money notes." The Court was unable to distinguish between an exchange of assets for cash—a taxable sale—and an exchange of assets for cash and short-term notes. Accordingly, the exchange was taxable.

Although the requirements of a statutory reorganization were not clearly defined by the Court, it squelched what it perceived to be a taxable nonstatutory reorganization.

In reaching its decision, the Supreme Court relied upon *Cortland Specialty Co. v. Commissioner*. Cortland had been decided the year before Pinellas by the Second Circuit Court of Appeals. In Cortland, one corporation ex-

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47. Revenue Act of 1924, supra note 46, § 203(h)(2). Introduction of the term was intended to codify the Service's interpretation of the law. See H.R. REP. NO. 179, 68th Cong., 1st Sess. (1924), reprinted in 1939-1 (Pt. 2) C.B. 241, 251; S. REP. NO. 398, 68th Cong., 1st Sess. (1924), reprinted in 1939-1 (Pt. 2) C.B. 266, 275. See generally Magill, Notes on the Revenue Act of 1924, 24 COLUM. L. REV. 836, 844-55 (1924). Unlike I.R.C. § 368(b), a party to a reorganization did not include both parties to an acquisitive reorganization under § 203(h)(2). Since both parties could qualify only if one acquired a majority of the other corporation's stock (then, a B reorganization), seemingly the acquired corporation in an A or C reorganization was not a party to a reorganization. However, the statute was not so interpreted. See, e.g., Helvering v. Minnesota Tea Co., 296 U.S. 378 (1935) (this point not raised in A reorganization).


49. Revenue Act of 1924 § 203(b)(2). H.R. REP. NO. 179, 68th Cong., 1st Sess. (1924), reprinted in 1939-1 (Pt. 2) C.B. 241, 251, states that § 203(b)(2) did not modify earlier law. The earlier statute—§ 202(c)(2) of the Revenue Act of 1921—provided nonrecognition treatment for stock or securities "in a corporation a party to or resulting from such reorganization" received by the acquired corporation's shareholders.

50. 287 U.S. 462 (1933).

51. See id. at 464.

52. The statute under examination was § 203 of the Revenue Act of 1926, ch. 27, 44 Stat. 9 (1926). See supra note 44 (1921 statute).

53. 287 U.S. at 470. The Court also distinguished between A, B and C reorganizations. An A reorganization was a distinct reorganization, not just a term that was void of meaning other than to distinguish B and C reorganizations. See id. at 469. See supra note 45.

54. See 287 U.S. at 469.

55. 60 F.2d 937 (2d Cir. 1932), cert. denied, 288 U.S. 599 (1933).
changed its operating assets for cash of $53,000 and $160,000 of notes of another corporation. The notes matured at varying times, none more than 14 months after the exchange. The taxpayer argued that even though the transaction was not a merger under state law, it was a reorganization (under the same 1926 statute under which Pinellas would be decided). But the Second Circuit distinguished between a cash sale and a statutory reorganization. It held that a "sale of the assets of one corporation to another for cash without the retention of any interest by the seller in the purchaser is quite outside the objects of merger and consolidation statutes" of the state where the transaction had occurred and was not a reorganization under federal statute. Instead, "section 203 of the Revenue Act [of 1926] gives the widest room for all kinds of changes in corporate structure, but does not abandon the primary requisite that there must be some continuity of interest on the part of transferor corporation or its stockholders in order to secure exemption." Such continuity was evident in the state laws under which the exchange was effected and, therefore, was required by federal law as well. As would be true of Pinellas, reorganizations were defined negatively: regardless of what constituted a reorganization, the exchange of assets for cash and short-term notes was not such a creature.

Two years after Pinellas, the Supreme Court again addressed continuity of interest, this time defining it positively. The Court spoke in four simultaneous decisions. In the best known of these cases, Helvering v. Minnesota Tea Co., the Court held that a corporation's exchange of all its assets for cash and voting trust certificates constituted a reorganization because the transferor had acquired a substantial enough proprietary interest in the acquiring corporation. The voting trust certificates, which were deemed to be the equivalent of stock, represented 56 percent of the consideration and the cash represented 44 percent. The Court stated:

The transaction here was no sale, but partook of the nature of the reorganization in that the seller acquired a definite and substantial interest in the purchaser. . . . [A] large part of the consideration was cash. This, we think, is permissible so long as the taxpayer received an interest in the affairs of the transferee which represented a material part of the value of the transferred assets.
Simultaneously, the Court held in *John A. Nelson Co. v. Helvering*, that continuity of interest existed where 38 percent of the acquiring corporation's consideration paid to the target corporation was nonvoting preferred stock, even though cash constituted the rest of the consideration. The acquired corporation's shareholders obtained a "definite interest" in the acquiring corporation, so that a reorganization was considered to have occurred. In the third case, *Helvering v. Watts*, the Supreme Court concluded that a reorganization had occurred where a corporation exchanged its assets for stock and long-term bonds of the acquiring corporation. There, the stock represented 45 percent of the consideration. Although the bonds were held to be "securities" within the intendment of the law, the Court refrained from addressing whether or not these securities alone would have created continuity of interest. The fourth opinion, regarding parties to a reorganization, is discussed below.

Subsequently, the Supreme Court addressed continuity of interest in *Le Tulle v. Scofield*. In *Le Tulle*, a corporation exchanged all its assets for cash of $50,000 and bonds of the acquiring corporation in the amount of $750,000. The bonds were payable from one to twelve years after the exchange. The Court decided that the long-term bonds did not establish a continuity of interest, thereby answering the unspoken question asked in *Watts*. Regardless of the term of the bonds, their holder becomes a creditor of the acquiring corporation, not the holder of a proprietary interest in it. Because of the absence of proprietary consideration, no reorganization had occurred.

Two aspects of continuity of shareholder interest were developed by these cases that have become entrenched in current law. First, the quality of the consideration must be proprietary. Under Pinellas and *Le Tulle*, neither short- nor long-term debt creates continuity. Rather, stock, even non-voting preferred stock, as in Nelson, must constitute all or a sufficiently large portion of the consideration. Of course, B and C reorganizations specifically require that the stock used be voting stock.

68. 296 U.S. 374 (1935).
69. See id. at 376.
70. Id. at 377. The transaction effected was a C reorganization, under § 203 of the Revenue Act of 1926 supra note 52.
71. 296 U.S. 387 (1935). This was a B reorganization that was effected under § 203 of the Revenue Act of 1924, supra note 46.
72. See 296 U.S. at 388.
73. See id.
74. See infra text accompanying notes 86-90.
75. 308 U.S. 415 (1940).
76. See id. at 416.
77. See id.
78. See id. at 420-21.
79. See id.
80. See id. at 421.
81. As noted at the start of this article, continuity of interest can be viewed as the continuing interest of the acquired corporation's shareholder in the acquiring corporation. See, e.g., Rev. Proc. 77-37, 1977-2 C.B. 568. Commentators, however, have argued variably that continuity should be measured against the acquiring corporation's shareholders, See Turnier, supra note 41, at 928-41, and that continuity is unnecessary, Faber, Continuity of Interest and Business Enterprise: Is It Time To Bury Some Sacred Cows, 36 Tax Law. 239 (1981).
Secondly, the amount of the proprietary interest must be substantial. The Supreme Court delineated between statutory reorganizations and other transactions by whether or not the acquired corporation's shareholders' interest was "definite and substantial." 82 Fifty-six percent was definite and substantial, as was 38 percent. 83 It follows that receipt of a greater percentage of stock also qualifies as the requisite proprietary interest that will establish continuity. The proportion measured is of the amount of stock received against the total consideration received. 84 Regardless of these lesser standards, however, the Internal Revenue Service presently states that it will not issue rulings unless shareholders of the target corporation obtain and retain stock of the acquiring corporation at least equal to 50 percent of the value of all outstanding stock of the acquired corporation on the effective date of the reorganization. 85

The Supreme Court also decided at an early time that remote continuity of interest was an inadequate form of continuity. It first reviewed the issue entwined with the problem of remote continuity, whether or not a corporation was a party to a reorganization, in 1935 in Bus & Transport Securities v. Helvering. 86 There, the controlling shareholder of the two acquired corporations formed another corporation whose stock he acquired in exchange for stock of the first two corporations. 87 He then caused the new corporation to exchange the stock of the other two corporations for the assets of the acquiring corporation's newly formed subsidiary. 88 These assets consisted of some of its parent's stock. 89

The Supreme Court concluded that neither of the exchanging parties were parties to a reorganization since neither "acquired any definite immediate interest in the other." 90 The opinion summarily suggests that effecting a merger through newly created corporations precludes those corporations

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84. This comparison would be skewed if the consideration received were not the same amount as the consideration given. Perhaps for this reason, Rev. Proc. 77-37, 1977-2 C.B. 568, measures the stock of the acquiring corporation that was received by the acquired corporation's shareholders against the value of the stock of the acquired corporation that they relinquished, in stating how much stock they must retain. As noted by Bittker and Eustice, supra note 12, at § 14.11, "a whale can swallow a minnow" because the quantitative comparison necessary to determine continuity is as stated above, not as the percentage of stock that the acquired corporation's shareholders have received of the acquiring corporation's outstanding stock. Compare Helvering v. Minnesota Tea Co., 296 U.S. 378 (56% stock; 44% cash) and Helvering v. Watts, 296 U.S. 387 (45% stock; 55% long-term bonds) with Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462 (1933). Reorganizations occurred in the first two cases, but not the third. The combination of stock with one type or another of non-stock consideration is irrelevant. Bittker and Eustice, supra note 12, at § 14.11; McGaffey & Hunt, Continuity of Shareholder Interest in Acquisitive Reorganizations, 59 Taxes 659, 661-65 (1981). See also McGaffey & Hunt at 665-70 (effect of valuation upon meeting Rev. Proc. 77-37, see supra note 2).
86. 296 U.S. 387 (1933).
87. See id. at 392.
88. Id.
89. Id.
90. Id. at 393.
from being parties to a reorganization. The Court appeared to sense that the real merger occurred between the newly created corporations’ ancestors (the acquiring corporation’s parent and the acquired corporations’ subsidiaries). And, since newly formed corporations had been interposed that were not parties to a reorganization, no reorganization resulted.

The problem of remote continuity was reviewed again two years later in the better known case of *Groman v. Commissioner.* There, continuity did not exist because shareholders of the acquired corporation exchanged their stock for (i) preferred stock of the newly formed acquiring corporation, (ii) stock of its parent, and (iii) cash. The acquiring corporation was immediately liquidated by its parent. The Court determined that the parent was not “a party to a reorganization.” Although the Court interpreted the statutory definition of the term “party to a reorganization” expansively, it strongly implied that receipt of stock or assets was necessary for a corporation to become a party to a reorganization. This reading of the statute is superficially attractive, because the statute defined a party to a reorganization to include a corporation resulting from a reorganization and, in effect, both corporations in a B reorganization. Such corporations would receive something in a reorganization, and the acquiring parent in *Groman* did not. Upon closer inspection, this reading of the statute falters. If the conditions that continuity was intended to satisfy were met—if continuity existed—then the parent should have been considered to be a party to a reorganization.

The subsidiary and the target corporation were parties to a reorganization because shareholders of the target and the subsidiary exchanged stock and had engaged in a reorganization. The parent corporation, however, acted as a mere “agent” in effecting the reorganization. The Court rejected the argument of the taxpayer (a shareholder of the target) that the subsidiary was the alter ego of the parent. The parent participated in the reorganization, but had not received anything directly as a result of its subsidiary’s acquisition of the acquired corporation’s stock. The Court held that stock of the parent corporation used in the exchange was not under the nonrecognition aegis of section 354’s predecessor. Therefore, receipt of the parent’s stock was taxable to the acquired corporation’s shareholders just as if the acquiring subsidiary had transferred cash, not stock of its parent.

Remote continuity was condemned again the next year in *Helvering v.*

91. 302 U.S. 82 (1937).
92. See id. at 83-84.
93. See id. at 84.
94. Id. at 90.
95. Id. at 87-88.
96. See id. at 85.
97. See infra text accompanying notes 128-31.
98. See 302 U.S. at 88.
99. See id. at 89.
100. Id.
101. 302 U.S. at 85-90.
102. See infra text accompanying notes 35-36.
103. An A reorganization between the acquired corporation and the acquiring subsidiary occurred. It was premised upon the acquired corporation’s shareholders’ receipt of the subsidiary stock equalling 41% of the total consideration received. See 302 U.S. at 83-84.
There, the acquiring parent obtained the assets of several corporations and transferred them to its newly-formed subsidiary. The parent's possession of the acquired corporations' assets was determined to be temporary and, therefore, was disregarded by the Supreme Court. In a brief opinion, the Court held that the parent was not a party to a reorganization, relying upon Groman. Although this transaction was considered to be a reorganization, as in Groman, receipt of the parent corporation's stock was taxable to the acquired corporation's shareholders under section 354's predecessor, because the parent was not a party to the reorganization.

Remote continuity also has been analyzed in several lower court decisions, most of which were rendered about the time the Supreme Court decided Bus & Transport Securities, Groman and Bashford. Some of the cases are garden variety variations of Groman or Bashford—stock or assets of the acquired corporation were exchanged for stock of a related corporation that was not a party to a reorganization. Some of the cases, however, articulated certain themes also found in Groman and Bashford in denying party-to-a-reorganization status to a participant in the acquisition.

The agency theory that later would be rejected by the Groman court was rejected earlier in Beech v. Commissioner. In Beech, the acquiring corporation proposed a stock-for-stock exchange with the shareholders of the target corporation. The former corporation then used two other, independent, corporations to effect the exchange after deciding that the original plan could be delayed by a required application for government approval. Curiously, shareholders of the acquired corporation were not informed of the new plan. The independent corporations acquired 76 percent of the acquired corporation's stock for cash and the rest for stock of the acquiring corporation.

The court concluded that no reorganization had occurred. The independent corporations could not be considered to be the agents of the acquiring corporation and, therefore, were not parties to a reorganization. Consequently, the acquired corporation's shareholders were outside the scope of section 354's predecessor.

Arguably, the parent and wholly-owned subsidiary participants in Gro-

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104. 302 U.S. 454 (1938).
105. See id. at 455.
106. See id. at 458.
107. See id. at 456-57.
108. See supra text accompanying notes 35-36. The reorganization was an A reorganization.
109. See supra text accompanying notes 86-108.
110. E.g., Lawrence v. Commissioner, 123 F.2d 555 (7th Cir. 1941) (complicated factual setting, in which stock of acquiring parent held to be taxable boot because parent was not a party to a reorganization).
111. 82 F.2d 42 (3d Cir. 1936).
112. See id. at 43.
113. See id. at 44.
114. See id. at 43-44.
115. See id. at 44.
116. See id. at 45.
117. See id. at 44.
118. See id. at 45.
man present a stronger agency case than the unrelated parties in Beech. Parent and subsidiary combinations have been vindicated by amendments to the reorganization statutes.119 Aside from the statutes, however, the control factor of this setting should raise a presumption of agency. On the other hand, it could be contended that unrelated parties can be hired as agents in specific circumstances, although apparently not in Beech. If so, the agents can be ignored and the exchange could be treated as a reorganization.120

The relevance of the parent and subsidiary connection can be seen in another case, Hedden v. Commissioner.121 The Hedden taxpayer unsuccessfully argued another Groman theory, that there was an identity between the acquiring parent and its subsidiaries.122 The acquiring corporation exchanged its bonds and cash for assets of the acquired corporation and then transferred those assets to two of its subsidiaries.123 The taxpayer, a shareholder of the acquired corporation, argued that the acquiring parent was the real party in interest.124 Citing Groman, however, the court concluded that the acquiring parent could not be identified with its subsidiaries.125 The subsidiaries had lives separate from their parent and, in fact, became indebted to their parent for the consideration used in the acquisition.126 Therefore, the parent was not a party to the reorganization.127

As can be seen, continuity can be roughly equated with being a party to a reorganization. The above cases indicated that if stock of a corporation that is not a party to a reorganization is used, continuity will be too remote to sustain a reorganization for tax purposes. This equivalence probably is less apparent in the typical continuity cases where the type and amount of the consideration and not the status of the contributing corporation are at issue.128

The doctrine of continuity of interest was developed to bestow certain tax benefits only in bona fide reorganizations. It should follow that whenever there is a problem with remote continuity, these benefits should be denied because a true reorganization has not occurred. Remote continuity, however, rests on a baroque foundation. Groman intimates that a corporation cannot be a party to a reorganization unless it receives stock or assets.129 Mere receipt is little more than a formalistic objection. If the Bashford court could disregard the formal step of transferring assets to the acquiring par-

119. See infra text accompanying notes 142-49.
120. Although intermediate steps are frequently ignored when taken by related parties, see, e.g., Helvering v. Bashford, 302 U.S. 454 (1938), they certainly can be ignored even when taken by unrelated parties, see, e.g., American Bantam Car Co. v. Commissioner, 11 T.C. 397 (1948). aff'd per curiam, 177 F.2d 513 (3d Cir. 1949), cert. denied, 339 U.S. 920 (1950). See also infra text accompanying notes 212-23 (discussion of step transaction doctrine).
121. 105 F.2d 311 (3d Cir.) cert. denied, 308 U.S. 575 (1939).
122. See id. at 313.
123. Interestingly, the quality of the consideration, bonds, was not addressed.
124. See 105 F.2d at 313.
125. See id. at 313-14.
126. See id. at 315.
127. Id. at 315.
128. See supra text accompanying notes 81-85.
129. See supra note 95.
ent, then remote continuity also can entertain disregard of other matters of form. Substantive theories, such as agency and parent-subsidiary identity, should be and were raised in some of the older remote continuity cases in order to ascertain whether or not continuity existed in a remote continuity context. These points and others are developed below.

E. Development of a Statutory Continuity of Interest

Courts, not Congress, imbued the early federal tax statutes with the requirement of continuity of interest. Congress’s subsequent amendments to the reorganization statutes promoted continuity by requiring shareholders of the acquired corporation to receive a specified proprietary interest in the acquiring corporation. These amendments diminished instances in which remote continuity could destroy a reorganization.

Congress first required that a statutory continuity requirement be fulfilled with the Revenue Act of 1924, by permitting a transfer of assets to a corporation that was controlled by the transferor (the acquisitive type of D reorganization). Continuity was fostered because the transferor was required to own at least 80 percent of the corporation to which it transferred assets.

Congress again expanded continuity when it enacted the Revenue Act of 1934. There, Congress required that in the acquisition of stock for stock or the acquisition of assets for stock—a modern B and a somewhat modern C reorganization—the acquiring corporation must use solely voting stock to acquire either (i) at least 80 percent of the voting stock and at least 80 percent of all other stock of the acquired corporation or (ii) substantially all the assets of the acquired corporation. (Only in 1954 did C reorganizations assume their current form.) This restriction markedly increased the quantity and quality of qualifying consideration that the acquiring corporation had to provide. Under the 1921 predecessor of the 1934 statute, the acquiring corporation needed only to obtain a majority of a corporation’s voting and other stock in a B reorganization. Neither B nor C reorganizations heretofore had required use of voting stock.

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130. See supra text accompanying note 106.
131. See supra text accompanying notes 111-23.
132. See infra text accompanying notes 152-302.
133. See infra text accompanying notes 26, 46.
134. See Revenue Act of 1924, supra note 46, § 203(h)(1)(D).
135. See Revenue Act of 1934, ch. 277, § 112(g), 48 Stat. 705 (1934).
136. I.R.C. § 368(a)(2)(B) (1982). The definition of a C reorganization was expanded in 1954 to permit the acquiring corporation to use voting stock to acquire no less than 80% of the assets of the acquired corporation. Liabilities of the acquired corporation that the acquiring corporation assumes are treated as money paid for the acquired corporation’s assets.
137. See generally supra notes 44-45. The 1934 expansion was the result of a congressional dialectic in which a House Ways and Means subcommittee proposed repeal of the reorganization provisions. Ultimately, the Ways and Means Committee severely restricted reorganizations, and the more moderate stance of the Senate Finance Committee prevailed. See PRELIMINARY REP. OF A SUBCOMM. ON THE COMM. ON WAYS AND MEANS, 73d Cong., 2d Sess., PREVENTION OF TAX AVOIDANCE 8-9 (Comm. Print 1933); H. R. REP. NO. 704, 73d Cong., 2d Sess. (1934), reprinted in 1939-1 (Pt. 2) C.B. 554, 564; S. REP. NO. 558, 73d Cong., 2d Sess (1934), reprinted in 1939-1 (Pt. 2) C.B. 586, 598-99.
Thus, by 1934, B, C, and D reorganizations were removed from the judicial tests used to detect continuity. If, for example, an acquired corporation’s shareholders had received any consideration in a reorganization consummated in 1935, other than the acquiring corporation’s voting stock, a C reorganization could not take place. Applying the lesser numerical or qualitative standards of *Minnesota Tea* or *Nelson* to these reorganizations became irrelevant.\(^{139}\)

As the definition of reorganization was tightened in 1934, the term “a party to a reorganization” was modified to resemble its present-day successor, without the triangular reorganization additions.\(^{140}\) In 1934, the term was defined as a corporation resulting from a reorganization and both corporations in an acquisitive reorganization.\(^{141}\)

Instances of statutorily imposed continuity swelled in 1954 and instances in which the problem of remote continuity could arise simultaneously diminished. The Code was amended to overcome the effects of *Groman* and *Bashford*. C reorganizations were modified to allow the acquiring corporation to use the voting stock of its parent, thereby emasculating that holding of *Groman* which prohibited the parent corporation’s stock from being tendered as part of the consideration.\(^{142}\)

In *Bashford*, the intermediate step of transferring assets of the target corporation to the acquiring corporation’s parent was ignored and, because the parent was not a party to a reorganization, the target shareholders’ receipt of this stock was taxable.\(^{143}\) *Bashford* also was gutted. Under the 1954 changes to the Internal Revenue Code, A and C reorganizations could occur even if the acquiring corporation transferred all or some of the acquired corporation’s assets to its controlled subsidiary.\(^{144}\)

Finally, the definition of a party to a reorganization was expanded to include the parent and subsidiary corporations in all of the situations described in the above two paragraphs.\(^{145}\)

The problem of remote continuity has diminished as a result of other subsequent statutory modifications. Voting stock of the acquiring corporation’s parent can be used in a B reorganization and all or some of the acquired corporation’s stock can be dropped into the acquiring corporation’s

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139. See supra note 135. The reorganizations in *Minnesota Tea Co.*, *Watts*, and *John A. Nelson Co.* could not have qualified as reorganizations after 1934, because the acquired corporation’s shareholders did not receive solely voting stock of the acquiring corporation. See supra text accompanying note 135.

140. See supra text accompanying note 30.

141. Revenue Act of 1934, supra note 135, § 112(g)(2).

142. I.R.C. § 368(a)(1)(C) ("the acquisition by one corporation, in exchange solely for . . . its voting stock (or in exchange solely for . . . the voting stock of a corporation which is in control of the acquiring corporation), of substantially all of the properties of another corporation . . . "). See infra note 149. See generally Lurie, Namorg or Groman Reversed 10 TAX L. REV. 119, 134-42 (1954). The author is indebted to Lurie’s article for the title to this article.

143. See supra text accompanying notes 104-08.


145. See I.R.C. § 368(c) (1982). As Lurie notes, the holdings of many pre-1954 remote continuity cases would not have been affected by the 1954 Internal Revenue Code. Lurie, supra note 142, at 134. It follows that their holdings remained relevant.
A corporation also is permitted to use its parent's stock (but none of its own) to acquire the assets of the acquired corporation by merger. Lastly, mergers were again modified to permit the acquiring corporation to merge its subsidiary into the acquired corporation.

From a historical perspective, remote continuity is not as much of a problem as it used to be. Reorganizations that failed for some of the participants because they were not parties were recognized as bona fide reorganizations for these participants after enactment of the 1954 Code. Still, problems of remote continuity do arise. All of the preceding statutory amendments do not help a target parent merge downstream into a subsidiary which is immediately merged into the acquiring corporation. Instead, we must review the authority that has developed around continuity and the problem of remote continuity.

II. REMOTE CONTINUITY OF INTEREST IN ACQUISTIVE REORGANIZATIONS

As can be seen, remote continuity is an irritant to tax planners. It also is a formalistic problem. Continuity depends upon the type and amount of consideration received. Remote continuity further hampers reorganizations when it arises because it emphasizes the identity of the recipient, which must be a party to a reorganization. The balance of this article analyzes methods of grappling with the problem of remote continuity. The objectives sought by denying reorganization status when only remote continuity exists can be satisfied by current authority that emphasizes the substance of the remote continuity problem rather than meeting formalistic conditions. Denying reorganization status to transactions in which there is remote continuity is unnecessary to insure execution of a bona fide reorganization. The reasons for which it is unnecessary are set forth below.

146. See I.R.C. § 368(a)(1)(B), (a)(2)(C) as amended by Pub. L. No. 88-272, 78 Stat. 19 (1964) (current version at I.R.C. § 368(a)(1)(B),(a)(2)(C)). The definition of a party to a reorganization also was amended to reflect these changes.


148. See I.R.C. § 368(a)(2)(E), as amended by Pub. L. No. 91-693, 84 Stat. 2075 (1971). The definition of a party to a reorganization was amended accordingly. See generally, Ferguson & Ginsburg, Triangular Reorganizations, 28 Tax. L. Rev. 159 (1973). G reorganizations, unlike other reorganizations, have sprung forth (so far) fully-grown from Congress. When G reorganizations were added to the Code in 1980, variations allowed in other types of reorganizations were permitted. All or some of the acquired corporation's assets can be transferred to the acquiring corporation's subsidiary, § 368(a)(2)(C), and stock of the acquiring corporation's parent can be exchanged by the acquiring corporation for substantially all of the acquired corporation's assets, § 368(a)(2)(D).

149. As Lurie notes, supra note 145, at 134, many of the pre-1954 holdings were unaffected by the 1954 amendments. Groman would still fail, because stock of the acquiring parent and subsidiary were used. In order for I.R.C. § 368(a)(1)(A) and (a)(2)(D) to apply, stock of only one of these corporations can be used. Bashford was legitimized only in 1968. See I.R.C. § 368(a)(2)(D), supra note 147.

150. Cf. supra text accompanying note 129.

151. See supra text accompanying notes 81-85.
A. Identity Between Parent and Subsidiary

A feature common to Groman and Bashford is that the acquiring corporate groups were parent corporations and their wholly-owned subsidiaries. As has been observed, this hermetic environment enhances the identification of the acquiring parent and subsidiary and diminishes any problem of remote continuity. The same can be said when the acquired corporation is the wholly-owned subsidiary of another corporation.

Common sense supports identifying a parent corporation and its wholly-owned subsidiary. Subsidiary corporations often are created solely to expedite triangular reorganizations. Stock of an acquiring corporation received and retained by shareholders of the acquired corporation received and retained by shareholders of the acquired corporation will lead to their continuing interest whether the acquiring corporation retains the stock or assets of the acquired company or transfers them to its subsidiary. Indeed, the Code permits the acquiring parent both to place the stock or assets in a subsidiary or withdraw them tax-free, thereby suggesting an identity between the parent and subsidiary. Penalizing this transaction for failing to establish a continuing proprietary interest is inconsistent with the fluidity that otherwise characterizes the event. Conversely, assets or stock acquired by a subsidiary in exchange for its parent's stock could be transmitted to and from its parent without taxation. Should not it follow that parent and subsidiary are sufficiently identical to overcome the problem of remote continuity?

The Service's position is that a parent and subsidiary cannot be wholly identified with one another. The regulations provide that the "term 'reorganization' . . . imports a continuity of interest on the part of the transferor or its shareholders in the properties transferred." The regulations continue, stating that ")[r]equisite to a reorganization . . . [is] a continuity of interest . . . on the part of those persons who, directly or indirectly, were the owners of the enterprise prior to the reorganization.

Although the regulation seemingly condones remote continuity (where, for example, an acquired parent merges into its subsidiary, which then merges into an acquiring corporation, so that shareholders of the acquired parent receive stock of the acquiring corporation), early cases do not support such a broad interpretation. Groman denied the legitimacy of remote continuity where the initial acquiring corporation, a wholly-owned subsidiary,

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152. See supra text accompanying notes 91-108.
155. The parent's dropping of property into a subsidiary can be accomplished tax-free as a contribution to capital or as a transfer of property to a controlled corporation under I.R.C. §§ 118 or 351, respectively. A subsidiary's distribution to its parent is eliminated from the parent's separately calculated taxable income. Treas. Reg. § 1.1502-14(a) (dividend paid to another member of an affiliated group is to be eliminated). See also I.R.C. § 243(a) (1982) (85 percent dividend-received deduction outside an affiliated group).
156. See supra note 155.
was immediately liquidated and assets of the acquired corporation passed to the acquiring parent. Nor has later authority, with one exception, approved of remote continuity in acquisitive reorganizations.

Developments in tax law since *Groman* may modify the above answer. Seemingly, the law surrounding affiliated groups might be one source for creating a parent-subsidiary identity. The consolidated return regulations, however, treat an affiliated group of corporations—a parent corporation and one or more 80 percent controlled subsidiaries—as a single entity for some purposes, but not for others.

Recent attacks on captive insurance companies provide stronger grounds for imposing an indivisible identity on a parent and its subsidiary. In Revenue Ruling 77-316, the Internal Revenue Service analyzed a corporation's ability to insure itself through a captive insurance company. At issue was whether or not the insured corporation could deduct premiums paid for insurance to a wholly owned subsidiary. The ruling observed that no risk-shifting or risk-distributing, the hallmarks of insurance, had occurred. Though the insured and insuring corporations were separate entities, the ruling noted that they "represent one economic family with the result that those who bear the ultimate economic loss are the same persons who suffer the loss." No risk spreading occurred because the parent and subsidiary had identical interests. In a similar litigated case, the Tax Court and Ninth Circuit decided in the Service's favor, but without expressly relying on the economic family theory.

Revenue Ruling 77-316 mentions a leading nominee corporation case in acknowledging that the parent and insurer subsidiary were independent corporate entities. The "nominee" corporation theory, to the extent that one is recognized, has been used to attach the tax consequences of a corporation to its owner where the corporation is a "'dummy' or alter ego of its shareholders, serving no other function and engaging in no significant business activity." Application of the nominee theory would permit identifi-

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159. See supra text accompanying notes 91-103.
161. Compare Treas. Reg. § 1.1501-11 (1983) (group's income is consolidated) and -77(a) (parent is agent for subsidiaries) with Treas. Reg. § 1.1502-11, -12 (1983) (consolidated taxable income depends upon each group member's separate taxable income). See also *Bennett Paper Corp. v. Commissioner*, 699 F.2d 450 (8th Cir. 1983) (subsidiary's activities cannot be attributed to affiliated group to which it belongs).
163. Id. at 54.
164. Id.
165. See id.
cation of a parent and its subsidiary. Application of the theory, however, often depends upon the nominee’s action as its owner’s agent and relative lack of business activity, conditions which will not necessarily be true in all reorganizations.170

Upon first impression, captive insurance companies seem far afield from remote continuity. But the common thread between the two areas is their need, when appropriate, to identify parent and subsidiary corporations. Identification is appropriate in the area of insurance, because risk-shifting and risk-distributing are indicia of insurance and using a captive insurer apparently precludes them from happening. Similarly, parent and subsidiary corporations might be identified for continuity purposes. Subsidiaries enable acquiring corporations to do what they would prefer not to do or cannot do directly. As the subsidiary’s independence from its parent grows, as measured by the parent’s ownership of the subsidiary, the utility of the economic family theory diminishes in the captive insurance area.171 Seemingly, increasing independence of a subsidiary should render this theory less useful in the remote continuity context as well.

Of the various legal approaches for resolving a parent and subsidiary’s identity, an approach akin to the economic family theory of Revenue Ruling 77-316 appears to be the most sensible. A parent can and often does control its wholly owned subsidiary. For the sole purpose of determining whether an acquired corporation’s shareholder retains a continuing interest in the acquiring corporation, this control ensures that the interest will not be diluted whether the acquiring corporation drops property into its subsidiary, uses its parent’s stock, or is subsequently absorbed by its parent.

B. Step Transaction Doctrine

Another method for analyzing whether or not both of two successive reorganizations will be recognized as independent events is by determining whether they should be stepped together. The step transaction doctrine, which would allow two mergers to be treated as one, combines two events if they are viewed as interrelated steps of a single transaction. If two events are not interdependent, the separate effect of each step must be recognized.172

The point of departure into an analysis of the step transaction doctrine and continuity of interest is Revenue Procedure 77-37.173 Revenue Procedure 77-37 indicates that the Service will not issue advance rulings concerning whether or not a reorganization has occurred unless:

170. See Kurtz and Kopp, Taxability of Straw Corporations in Real Estate Transactions, 22 TAX LAW. 647, 652 (1969); Bittker and Eustice, supra note 12, at ¶ 2.10. Indeed, it seems more likely that the acquired parent will be a dummy corporation if its only asset is its subsidiary and that subsidiary is an operating company.
171. To the extent that the captive insurer did not insure its parent’s risks, both Rev. Rul. 77-316 and the Carnation courts allowed the parent a deduction for insurance premiums paid, because those premiums were paid to outsiders for real insurance.
172. The origin of the step transaction doctrine is unclear, but at least one commentator has suggested that it can be traced back to a 1932 case. See B. Bittker, FEDERAL TAXATION OF INCOME ESTATES AND GIFTS § 4.3.5 n.74 (1981).
there is a continuing interest through stock ownership in the acquiring or transferee corporation (or a corporation in "control" thereof within the meaning of section 368(c) of the Code) on the part of the former shareholders of the acquired or transferor corporation which is equal in value, as of the effective date of the reorganization, to at least 50 percent of the value of all of the formerly outstanding stock of the acquired or transferor corporation as of the same day. . . . Sales, redemptions, and other dispositions of stock occurring prior or subsequent to the exchange which are part of the plan or reorganization will be considered in determining whether there is a 50 percent continuing interest through stock ownership as of the effective date of the reorganization.

Even if an acquired corporation's shareholders holding 50 percent of the acquiring corporation's stock received in a reorganization sell this stock the very day of the reorganization, the parties still can obtain a favorable ruling. But they cannot sell one share more if they wish to obtain a ruling, unless the sale of that share is "unrelated" to the reorganization. Furthermore, the potentially disqualifying disposition of one share can occur in a variety of ways. It may occur directly, as in a cash sale by a dissenting shareholder who refuses to accept the acquiring corporation's offer of a stock-for-stock exchange. Or the disposition may occur indirectly, because some of the acquired corporation's shareholders redeem their stock shortly before their corporation is acquired.

Revenue Procedure 77-37 lists, but does not amplify, types of dispositions occurring in proximity to a reorganization (sales, redemptions) that may be considered part of the plan of reorganization. Rather, the tainted types of dispositions are revealed by rulings and case law. A recent case highlights application of the step transaction doctrine to continuity in a sale following a merger.

In McDonald's of Zion v. Commissioner, out-of-favor franchisees sold their McDonald's restaurants to the franchisor, McDonald's. The franchises were closely held by three individuals and other related persons who held their franchises through several corporations, all of which McDonald's wanted to acquire. Although the target corporations' shareholders insisted upon being bought out for cash, they acquiesced to receiving McDonald's stock, after receiving McDonald's apparent promise to enable them to sell the stock to the public three months later. McDonald's gave the

174. Id. at 569. See generally McGaffey & Hunt, supra note 84, at 665-70.
177. See generally McGaffey & Hunt, supra note 84, at 670-80; Freling and Martin, Current Reorganization Techniques, 55 TAXES 852, 863-66 (1977); Blum, Corporate Acquisitions under the Income Tax: Another Approach, 50 TAXES 85, 90-93 (1972).
179. 76 T.C. 972 (1981), rev'd, 688 F.2d 520 (7th Cir. 1982).
180. See 76 T.C. at 975-76.
181. See id. at 982.
shareholders unregistered stock, which barred them from subsequently transferring the stock until it either was registered or conformed to another securities law rule that required the shareholders to hold the stock for at least two years. McDonald's also gave the shareholders "piggy back" rights to register and sell their stock when McDonald's next registered its stock for sale. At the time of the negotiations, McDonald's expected to register stock in three months. Although the shareholders actually did not sell their McDonald's stock as quickly as they wished, they were able to register and sell it six months after they received it.

The Tax Court concluded the mergers of the acquired corporations into McDonald's were A reorganizations, even though the acquired corporations' shareholders consistently intended to and did sell their McDonald's stock as soon as they could. Therefore, McDonald's subsidiaries, the taxpayers, were unsuccessful in claiming a cost basis in their newly acquired assets and, instead, took a lower carry-over basis. The court considered whether or not continuity of interest had been maintained by the acquired corporations' shareholders, concluding that there was no continuity because the merger in which the stock was received and the stock's subsequent sale could not be stepped together. Thus, the acquired corporations' shareholders maintained a continuing interest in the acquiring corporation for a sufficient amount of time, even though they sold the acquiring corporation's stock as soon as they could. The court found the step transaction doctrine to be inapplicable.

The Seventh Circuit reversed the Tax Court. It set forth three variations of the step transaction doctrine, and found that all three could be applied. In the first variation, the "end result test," "purportedly separate transactions will be amalgamated with a single transaction when it appears that they were really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result." This test also has been phrased as an intent test—did the parties always intend to accomplish the end result? The court concluded that all of the steps were taken to cash out the franchisees and to do so to benefit McDonald's. Therefore, the end result test was satisfied.

182. See id.
183. See id. at 985.
184. See id. at 979-80.
185. Id. at 986-87.
186. See id. at 998-1000 & n.49.
188. See id. at 998-99.
189. See id. at 1000 n.58.
190. See id. at 998.
191. 688 F.2d 520, 528 (7th Cir. 1982).
192. See id. at 524-25.
193. 688 F.2d at 524, citing the Tax Court's McDonald's opinion, 76 T.C. at 994. But see infra text accompanying note 212 (step transaction doctrine not neatly divisible into three variations).
195. See 688 F.2d at 524.
In the second test, the "(mutual) interdependence test," "the steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series." The appellate court rejected the Tax Court's conclusion that interdependence was to be determined on the basis of whether or not the taxpayer was legally bound to take all the steps. Instead, it asked whether or not the mergers would have taken place without McDonald's guarantee to the franchisees of the salability of its stock, and concluded that it would not. The franchisees had consistently indicated their desire to sell the McDonald's stock. They negotiated for the right to force the registration of stock (which allowed the stock to be sold) after a year. Therefore, the mergers and subsequent sales were interdependent.

Under the last test, the "binding commitment test," "if one transaction is to be characterized as a 'first step' there [is] a binding commitment to take the later steps." The court noted that this is the most limiting statement of the step transaction doctrine and originally had been formulated in order to analyze steps separated by several years. In contrast, in the case before it, the court concluded that the transactions were separated by a period of six months and that application of the binding commitment test was unnecessary. Were it applied, however, it would have been met because the parties were bound to carry through on the stock registration. The franchisees could not transfer the stock if it was not registered and McDonald's could not be forced to register the stock. McDonald's and the franchisees were bound to take both steps.

The Tax Court had taken a narrower view of the step transaction doctrine. The taxpayer had argued that application of the end result test was appropriate, while the government countered that McDonald's non-involvement in the franchisees' sale of McDonald's stock precluded the doctrine's application. In fact, the court reasoned that application of the step transaction doctrine might be appropriate, but only upon careful analysis. It continued, stating that because post-merger continuity is not required for any specific amount of time, the mutual interdependence test (which does not require fulfillment of a time period either) is the most fitting variation of the step transaction doctrine. The end result and intent tests, which the

196. 688 F.2d at 524 (citing Redding v. Commissioner, 630 F.2d 1169, 1177 (7th Cir. 1980), cert. denied, 450 U.S. 913 (1981)).
197. See 688 F.2d at 524.
198. Id.
199. See id.
200. See id.
201. 688 F.2d at 525 (citing Redding v. Commissioner, 630 F.2d at 1178 (quoting Commissioner v. Gordon, 391 U.S. 83, 96 (1968))).
202. 688 F.2d at 525.
203. Id.
204. See id.
205. See id.
206. See id.
207. See 76 T.C. at 994.
208. See id. at 995.
209. See id. at 997.
court distinguished from the interdependence test and also from one another, were alternatively too simplistic and too difficult to administer. The court determined that the mergers and the franchisees' subsequent sales were not mutually interdependent, and the mergers did qualify as reorganizations.

The Seventh Circuit approached McDonald's with an expansive view of the applicability of the step transaction doctrine, while the Tax Court applied the doctrine more discreetly and reasonably. As explained below, the few cases that have applied the doctrine to post-merger dispositions all have used the mutual interdependence test employed by the Tax Court. Recently, this test has been used with greater frequency, so that its application comports with current trends in tax law.

The step transaction doctrine was designed to deal with problems in other areas of the tax law. A seminal article regarding the doctrine written thirty years ago concluded that most cases concerning the doctrine arise under sections 351 or 368(a)(1)(D). Both sections require control of the corporate transferee by the corporate transferor (or by or in conjunction with its shareholders, under the latter section) "immediately after" the transfer, in order to effect a transfer to a controlled corporation (section 351) or in a divisive reorganization (section 368(a)(1)(D)). The genesis of the doctrine in the sections 351 and 368(a)(1)(D) areas naturally indicates a cautious application of the doctrine to a foreign area, such as post-reorganization continuity.

Few cases actually have applied the step transaction doctrine to post-merger dispositions. Those cases did not articulate their theoretical basis but, to the extent that one exists, it appears to be that the steps at issue were mutually interdependent.

The test of mutual interdependence is best illustrated by American Bantam Car Co. v. Commissioner. There, owners of a business transferred the business's assets to a new corporation in exchange for all of its common stock. The incorporation was part of the owners' plan to sell the new company's preferred stock to the public as well as to transfer some of the common stock to the underwriters if they sold the preferred stock. The owners' contract to transfer common stock to the underwriters, contingent upon the underwriters' sale of preferred stock, was not executed until five days after the owners received the new company's stock, and the under-

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210. See id. at 998 n.48.
211. See id. at 998, 1000.
212. Mintz & Plumb, supra note 194, at 250. See also Paul & Zimet, Step Transactions, in SELECTED STUDIES IN FEDERAL TAXATION 200 (2d series 1938) (earlier treatment of the doctrine); Chirelstein & Lopata, Recent Developments in the Step Transaction Doctrine, 60 TAXES 970, 971 (1982) (increasing use of interdependence test).
214. 11 T.C. at 399.
215. See id.
216. See id. at 400.
writers did not receive the common stock for another five months, after they sold the preferred stock.217 Because the underwriters received over 20 percent of the corporation's common stock, the owners would not be considered to have received the stock under section 351's predecessor if all of the steps were collapsed into one.218

The Tax Court held that the owners controlled the corporation immediately after they exchanged their business's assets for the corporation's stock.219 Therefore, section 351's predecessor applied:

The standard required by the courts to enable them to say that a series of steps are interdependent and thus should be viewed as a single transaction do not exist here. It is true that all the steps may have been contemplated under the same general plan . . . yet the contemplated arrangement for the sale of preferred stock to the public was entirely secondary and supplemental to the principal goal of the plan—to organize the new corporation and exchange its stock for the [transferor's] assets. The understanding with the underwriters for disposing of the preferred stock, however important, was not a sine qua non in the general plan, without which no other step would have been taken. While the incorporation and exchange of assets would have been purposeless one without the other, yet both would have been carried out even though the contemplated methods of marketing the preferred stock might fail. The very fact that in the contracts of June 8, 1936 [made five days after the assets-for-stock exchange], the associates retained the right to cancel the marketing order and, consequently the underwriters' means to own common stock issued to the associates, refutes the proposition that the legal relations resulting from the steps of organizing the corporation and transferring assets to it would have been fruitless without the sale of the preferred stock in the manner contemplated.220

Whether or not control exists immediately after an exchange intended to qualify under section 351 has been litigated extensively.221 The hallmark of the interdependence of steps, as illustrated in the Section 351 area—whether "the steps are so interdependent that the legal relations created by one transaction would be meaningless without a completion of the series"222—appears to be whether the transferor was bound to dispose of enough stock, when he received it, that would result in his loss of control (notwithstanding the Seventh Circuit's contrary opinion in McDonald's.)223

With this background, the few cases that have analyzed post-merger dispositions can be addressed. The earliest of these cases is Anheuser-Busch,
Inc. v. Commissioner. 224 There, the taxpayer exchanged assets of an ice cream company it operated through a subsidiary with the Borden Company for Borden stock. 225 Anheuser-Busch transferred its subsidiary’s assets to Borden and to a newly formed Borden subsidiary, to which Borden quickly transferred the assets it had received. 226

The Board of Tax Appeals determined that Anheuser-Busch and Borden had not engaged in a reorganization. 227 Because the plan of reorganization contemplated the transfer of assets to Borden’s subsidiary, the subsidiary and not Borden was a party to a reorganization. 228 Use of Borden’s stock by the subsidiary was fatal. The court premised its conclusion that Borden was not a party to a reorganization on Anheuser-Busch’s knowledge that Borden intended to transfer the ice cream business assets to its subsidiary. 229 Initially, the evidence supporting this conclusion appears to be slender. Borden’s offer to Anheuser-Busch to acquire its ice cream business stated only that Borden was at liberty to organize a new corporation with which to continue the ice cream business. 230 As the court explained, “the intervention of a subsidiary will be treated as a part of the plan, if it is a contemplated possibility under the plan and actually eventuates.” 231 The court’s conclusion seems justified, however, partly because Anheuser-Busch’s transfer of some of its ice cream company assets directly to Borden’s subsidiary implies that Anheuser-Busch knew the destination of its subsidiary’s assets.

In Goldwasser v. Commissioner, 232 two corporate transfers occurred back-to-back. One corporation acquired another corporation’s stock in a stock-for-stock exchange. 233 The acquiring corporation decided one month later to liquidate the target corporation and have the target’s assets acquired by another of its subsidiaries, and effected this decision two months later. 234 The Board of Tax Appeals determined that the corporation that initially acquired the target corporation’s stock was not a party to a reorganization, so that use of its stock was fatal to the existence of a reorganization. 235 Again, a letter that was part of the negotiations evidenced the acquiring corporation’s intent to liquidate the acquired corporation and transfer its assets to another of its subsidiaries. 236

In a third case, Campbell v. Commissioner, 237 Bethlehem Steel agreed to a

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225. See 40 B.T.A. at 1102-03.
226. See id. at 1104.
227. See id. at 1106.
228. Id.
229. See id. at 1107.
230. See id. at 1103.
233. See 47 B.T.A. at 447.
234. See id. at 449.
235. See id. at 454.
236. See id. at 453.
stock-for-stock exchange in order to acquire a small steel manufacturer. The target corporation's shareholders were interested in having their company acquired only if the acquisition were a tax-free reorganization. In September, 1943, the two companies agreed to effect the reorganization. The following month, Bethlehem Steel acquired another company and, at this time, first thought of disposing of the corporation it had just acquired because possession of both companies created antitrust problems. In a series of transactions that occurred in late 1943 and early 1944: Bethlehem Steel acquired the stock of the first corporation; Bethlehem Steel sold the acquired corporation's stock to one of its subsidiaries; the subsidiary sold the acquired corporation's stock to another subsidiary of Bethlehem Steel; and the acquired corporation was dissolved.

The Tax Court questioned whether or not the Bethlehem Steel stock received by the acquired corporation's shareholders was stock of a party to a reorganization. Unlike its decisions in the preceding cases, however, the court determined that Bethlehem Steel was a party to a reorganization. In the court's view, the acquired corporation's shareholders had bargained for and obtained stock in the company that they expected would acquire their company. Bethlehem Steel's subsequent disposition of the stock of the acquired corporation was not part of a plan of reorganization, and so Bethlehem Steel was a party to a reorganization.

One other case bears noting because it addresses the question of continuity in a statutory merger. In Heintz v. Commissioner, as in McDonald's, shareholders of the acquired corporation wished to sell their stock for cash rather than stock of the acquiring corporation. The court denied reorganization status to the merger, due to a lack of continuity. As reasoned by the Tax Court in McDonald's, however, the acquired corporation's shareholders in Heintz agreed to accept stock only because the acquiring corporation agreed to arrange a sale soon after the reorganization. In other words, the Heintz shareholders "committed themselves to sell" their stock. In contrast, in McDonald's, the acquiring corporation acted passively, merely aiding the acquired corporation's shareholders to sell their stock through piggyback rights.

The appellate court disagreed with the Tax Court in McDonald's, re-
garding its case and *Heintz* as being indistinguishable. The Tax Court’s perception appears to be more accurate. The sellers received an oral promise in *Heintz* that their stock in the acquiring corporation would be sold in a public offering although, in fact, private sales were made. In contrast, the sellers in *McDonald’s* obtained only a written promise that their stock could be registered in the next public offering. The purchaser in *McDonald’s* was not as active a participant in the sale of the stock as it was in *Heintz*.

The common thread of the post-merger continuity cases is the interdependence of the merger and a subsequent step. The interdependence of successive mergers depends upon development of surrounding facts. On the one hand, successive mergers within an affiliated group necessarily will be interdependent, because the group’s parent will control the events. Indeed, application of the end result test of the step transaction doctrine might be more appropriate than the interdependence test since the key to applying the doctrine will be the parent’s control of all of the events. Documentation surrounding the transactions might suggest the interdependence of the mergers. Even if the mergers appear to be independent of one another, this independence could be illusory since the parent would not have its subsidiaries engage in the first merger if it did not expect them to engage in the second one as well.

The independence of successive mergers can be established more easily if the acquired and acquiring groups of corporations are unrelated. If an acquired parent merges downstream and the surviving subsidiary then merges into an unrelated corporation, the steps might be treated as being independent of one another because shareholders’ approval must be obtained twice. The shareholders of the acquired corporations will be roughly the same shareholders in both situations—the shareholders of the target parent will become the shareholders of the target subsidiary, less any dissenters. Presumably, they will approve the second merger if they can be convinced to approve the first. But, if the shareholders of the acquiring corporations also must approve the mergers, they will be different from one another. The shareholders of the acquiring corporation will be the shareholders of the acquired subsidiary in the first merger and the shareholders of the unrelated acquiring corporation in the second. Obviously, a stronger case can be made for independence when shareholder approval of the acquiring corporation is necessary to effect the merger.

253. See *Heintz*, 25 T.C. at 137, 139.
254. See *McDonald’s*, 688 F.2d at 522.
255. Cf. *Campbell v. Commissioner*, 15 T.C. 312 (1950) *acq.*, 1951-1 C.B. 1 (court relied partly on documents to find that subsequent disposition of stock was not part of the plan, and therefore was independent).
256. Generally, a majority of the acquired corporation’s shareholders must approve the merger. See 15 Fletcher, *supra* note 21, § 7063. In some cases, shareholders of the acquiring corporation also must approve the merger. See, e.g., *Ohio Rev. Code Ann.* § 1701.78(D) (approval necessary when, for example, articles or by-laws of the acquiring corporation will change or the target shareholders will acquire more than one-sixth of the voting power of the acquiring corporation).
257. See 15 Fletcher, *supra* note 21, § 7157 (discussion of the rights of dissenting stockholders).
Another way in which to discern the independence of a merger from a second merger is to question whether or not all of the participants engage in both events. The critical feature in *Campbell* and *McDonald's*, at least in the Tax Court's eyes, was that one of the parties engaging in post-merger events acted independently of the other. In *Campbell*, the acquiring corporation took actions without consulting the acquired corporation's shareholders.\(^{258}\)

In *McDonald's*, the acquired corporations' shareholders acted without the consent of the acquiring corporation (although the corporation possessed knowledge of the acquired corporations' shareholders' plans).\(^{259}\) The other cases reveal prior agreement about the post-merger steps by all of the participants.\(^{260}\)

Another line of authority deserves mention, if only as an illustration of the type of evidence that can sustain—or defeat—continuity of interest. Whether or not a subsequent disposition of stock acquired in a reorganization was part of an earlier plan of reorganization can be inferred from the time that has lapsed between the stock's acquisition and disposition. The disposition of stock is more likely to be part of a plan of reorganization if it is disposed of ten days rather than ten years after its acquisition.\(^ {261}\)

The Service has demarked holding stock for five years after a reorganization as a length of time that will establish continuity. In Revenue Ruling 66-23,\(^ {262}\) one corporation entered into an antitrust consent decree in which it agreed to merge its subsidiary into an unrelated corporation, in exchange for stock of the acquiring corporation. As part of the decree, the parent also was required to divest itself of the acquiring corporation's stock within seven years of acquiring it, although it was free to hold or dispose of the stock as it wished during this seven year period. Revenue Ruling 66-23 held that the merger of the subsidiary into the unrelated corporation was an A reorganization. It held that continuity of interest is met if an acquired corporation's shareholder receives stock of the acquiring corporation

without any preconceived plan or arrangement for disposing of any of the stock and with unrestricted rights of ownership for a period of time sufficient to warrant the conclusion that such ownership is definite and substantial, notwithstanding that at the time of the reorganization the shareholder is required by a court decree to dispose of the stock before the end of such period. Ordinarily, the Service will treat 5 years of unrestricted rights of ownership as a

\(^{258}\) *Campbell*, 15 T.C. at 318.

\(^{259}\) *See McDonald's*, 76 T.C. at 986, 988-99 n.50. *Cf. infra* note 269 and accompanying text.


\(^{261}\) *But cf.* Mintz & Plumb, *supra* note 194, at 249 (time is not necessarily determinative; the temporal relationship is merely one scrap of evidence assisting the courts in applying their test).

\(^{262}\) 1966-1 C.B. 67.
sufficient period for the purpose of satisfying the continuity of interest requirements of a reorganization.\footnote{263} It would appear that to a reorganization that requires a disposition of stock, even though no plan of disposition has been formulated, is innocuous if purged by time.\footnote{264}

This theme has been expanded by subsequent rulings. In Revenue Ruling 68-22,\footnote{265} ten percent of an acquiring corporation's preferred stock received in a merger could be redeemed annually, although the acquiring corporation had no present intention to redeem the stock. The ruling held that an A reorganization had occurred, although this ruling also must be read in conjunction with Revenue Procedure 77-37.\footnote{266} Since at least 50 percent of the acquired corporation's shareholders would receive and retain stock of the acquiring corporation for at least five years, continuity exists, even for ruling purposes under Revenue Procedure 77-37.\footnote{267}

In an analogous ruling, more reminiscent of the rationale of the Tax Court's decision in \textit{McDonald's},\footnote{268} the Service considered a statutory merger to be an A reorganization where the acquired corporation's shareholders could rescind the merger agreement upon the occurrence of certain financial contingencies, because the contingencies were beyond the control of the shareholders.\footnote{269}

Thus, if successive mergers are independent of one another, both can qualify as A reorganizations.

C. \textbf{Remote Continuity of Interest and Divisive Reorganizations}

Another method for analyzing continuity in successive mergers lies in the area of divisive reorganizations. Certain rulings in this area have avoided a problem with remote continuity. These rulings have recently been extended to acquisitive reorganizations as well.

A divisive reorganization occurs when the owners of a corporation that runs two businesses decide to break the corporation into two corporations, each of which will own one of the businesses. This division entails use of sections 355 and 368(a)(1)(D).\footnote{270} In a section 355 transaction, shareholders or security holders of one corporation receive stock or securities in another corporation without recognizing gain or loss.\footnote{271} Section 355 requires that a corporation that owns at least 80 percent of another corporation's stock (vot-
ing stock as well as all other stock) "immediately before [a] distribution" to distribute stock of the other corporation to one or more of its shareholders.\(^{272}\) Nor can the distribution be used "principally as device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both."\(^{273}\) In a D reorganization, a corporation must transfer all or a portion of its assets to another corporation if "immediately after the transfer," the first corporation or one or more of its shareholders, or any combination thereof owns at least 80 percent of the controlled corporation's stock (both voting stock and all other stock).\(^{274}\) Because such control must be acquired in a distribution to which section 355 applies,\(^{275}\) a D reorganization always will entail a distribution of the controlled corporation's stock to the distributing corporation's shareholders.\(^{276}\)

In other words, if a corporation owns two businesses, it could transfer the second business to its shareholders by dropping the second business into a subsidiary under section 368(a)(1)(D) and distributing the second corporation's stock to its shareholders under section 355. On the other hand, if it already operates the second business through a wholly-owned subsidiary, it could simply distribute the stock of that subsidiary to its shareholders under section 355.

Any reorganization, including a divisive D reorganization, is subject to the continuity of interest test set forth in Treasury Regulation section 1.368-1(b).\(^{277}\) This regulation provides that: "Requisite to a reorganization under the Code . . . [is] a continuity of interest therein on the part of those persons who, directly or indirectly, were the owners of the enterprise prior to the reorganization."\(^{278}\) Any section 355 distribution, including one that is part of a D reorganization, is subject to the continuity of interest test set forth in Treasury Regulation section 1.355-2(c).\(^{279}\) This regulation "contemplates . . . a continuity of interest in all or part of such business enterprise on the part of those persons who, directly or indirectly, were the owners of the enterprise prior to the distribution or exchange."\(^{280}\) But for certain cosmetic changes, the two regulations use identical language.\(^{281}\) Therefore, if a trans-
action meets the terms of one of these regulations, it follows that it should meet the terms of the other.

The genesis of these regulations does not direct one to a contrary result. The regulations were promulgated simultaneously under the 1954 Code. Before that, the regulations issued under section 355 and section 368's predecessors required continuity, but they were silent regarding indirect continuity.

On the other hand, Treasury Regulation section 1.368-1(b) does provide that "[r]equisite to a reorganization under the Code . . . [i]s (except as provided in section 368(a)(1)(D)) a continuity of interest. . . ." What type of continuity is required in a D reorganization? It must be the continuity required of a divisive reorganization since nothing indicates that an acquisitive reorganization must be accorded special treatment simply because it is a D reorganization.

Technically, continuity of interest in a section 355 distribution might be distinguished from another condition, that the distribution not be used principally as a device for distributing a corporation's earnings and profits. Factually, however, they appear to overlap. If a person arranges to sell or exchange his stock prior to its distribution to him, the distribution probably will be regarded as a device and therefore be excluded from the benefits of section 355. Assuming that the continuity and device conditions can be equated in a section 355 distribution, then roughly the same purpose is accomplished by the continuity-device condition in such a distribution as by continuity in an acquisitive reorganization. The continuity-device condition restricts the sale of stock acquired in a section 355 distribution. Even if continuity can be distinguished from the device condition in a divisive distribution, section 355 continuity seemingly would preclude a post-distribution sale, just as continuity limits the sale of stock acquired in an acquisitive reorganization.

Theories that overcome the problem of remote continuity in an acquisitive reorganization have not been explicitly condoned. Cases like Groman illustrate this. On the other hand, remote continuity has been permitted by the Internal Revenue Service in divisive distributions. If the requirements of

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284. Treas Reg. § 1.368-1(b) (emphasis added).
287. See Treas. Reg. § 1.355-2(b)(1); Bittker & Eustice, supra note 12, at ¶ 13.06.
289. But see Murray, supra note 160, at 10-11 (continuity under section 355 is different from continuity in acquisitive reorganizations).
continuity are the same in both sections, then it follows that this interpreta-
tion can be applied to acquisitive reorganizations. Recently, the Service did
tentatively extend this rationale to acquisitive reorganizations.

The Service's concession of remote continuity under section 355 is clear-
est in Revenue Ruling 62-138.290 There, a bank was required by govern-
ment regulators to divest itself of real estate held by one of its subsidiaries.
The bank acceded to this demand by having the subsidiary create its own
subsidiary into which the first-tier subsidiary placed the real estate. The
subsidiary distributed the stock of the second-tier subsidiary to the bank
rather than retaining it. The second-tier subsidiary was created under sec-
tion 351 and its stock distributed under section 355. As part of the same
transaction, however, the second-tier subsidiary's stock was then distributed
by the bank to its shareholders. The second distribution also qualified under
section 355.

The ruling analyzed whether continuity existed in realistic terms. Sec-
tion 355 requires continuity, but it may be remote continuity. The ruling
states:

In the instant case, there is no change in the aggregate interests
held by the [bank's] shareholders, no new parties in interest were
added as a result of the transaction and none were eliminated. The
shareholders after the transaction held the same enterprises in
modified corporate form as before the transaction and the corpo-
rate enterprises were continued as such.

Less persuasive authority also exists. Stock of the distributing corpora-
tion was owned by a partnership in Revenue Ruling 76-528.291 The partner-
ship consisted of four individuals who decided to liquidate the partnership
for good business reasons. The distributing corporation transferred assets of
one of its two businesses to a new corporation and then distributed stock of
the new corporation to two of the partners in exchange for their stock in the
distributing corporation. The partnership was immediately dissolved, at
which time two of the partners owned stock of the distributing corporation
and the other two owned the stock of the new corporation. The ruling held
that distribution of the second corporation's stock to two of the shareholders
was a section 355 transaction because the partners stood in the shoes of the
partnership as the only parties who were qualified to receive and continue
the stock interests of the two corporations. As in Revenue Ruling 62-138,
interposition of a juristic entity—a partnership rather than a corporation—
did not stifle continuity of interest in a section 355 distribution.

In other rulings, the Service has ruled that an acquisitive reorganization
can follow a section 355 spin-off.292 These rulings, however, do not strongly
support remote continuity. In two of the three rulings, a corporation spun
off stock of a subsidiary which then was acquired by another corporation.293

292. Rev. Rul. 78-251, 1978-1 C.B. 89 (section 355 spin-off followed by B reorganization);
In the third, the corporation spun off stock of a subsidiary and was itself then acquired by another corporation. On first impression there appears to be remote continuity since shareholders of a corporation acquired and then disposed of its subsidiary's stock. This remote continuity, however, is unlike the remote continuity in successive acquisitive reorganizations, where shareholders of the first corporation to be acquired are separated by another corporation from the corporation in which their proprietary interest survives. Section 355 forces the distribution of the corporation's subsidiary's stock up to its shareholders. As that happens, nothing offensive occurs. These Revenue Rulings were factually no different. The shareholders of the spun-off corporations transferred stock or the assets of their corporation to an acquiring corporation. They retained an interest in the acquiring corporation.

In contrast, something offensive does happen in successive acquisitive reorganizations (without conceding that the offense, remote continuity, should bar either reorganization from qualifying under section 368(a)(1) or should prevent the participants from benefiting). A corporation is interposed between the shareholders of the first acquired corporation and the one in which they ultimately acquire stock. Similarly, something offensive occurs when there are successive section 355 spin-offs, as in Revenue Ruling 62-138 (again, without conceding the disqualification of either spin-off from treatment under section 355). Section 355 requires a distribution up to a corporation's shareholders. It does not require, nor does it even permit, another distribution up to the corporation's shareholders' shareholders.

The Service has analogized some of the remote continuity it acknowledges in divisive distributions to acquisitive reorganizations. In Revenue Ruling 84-30, one corporation (Y) acquired substantially all of the assets of its sister's (Z's) wholly-owned subsidiary (N) in exchange for Y stock in a C reorganization. Z liquidated N and distributed N's assets, Y stock, to its and Y's parent, X.

The ruling held that the indirect continuity mandated by Treasury Regulation 1.368-1(b) was satisfied, since the indirect owner of N's business enterprise before the reorganization, X, continued to possess an interest in the enterprise after the reorganization. As in Revenue Ruling 62-138, on which this ruling relied, X's aggregate interests did not change. The ruling also cautioned that the relationships within this group had existed for many years.

The issuance of Revenue Ruling 84-30 offers a toehold in the attempt to apply divisive distribution remote continuity concepts to acquisitive reorganizations. It signals the Service's concession to reasoning it has long resisted: stock can be passed up a chain of owners, albeit an established chain, following an acquisitive reorganization without damaging continuity. Other divisive distribution concepts also could be applied. For example, the Serv-

298. See Murray, supra note 160, at 9-10.
ice has ruled that an acquisitive reorganization can follow a divisive one if the shareholders of the spun-off corporation retain stock of the acquiring corporation. By analogy, one acquisitive reorganization should be able to follow another if the shareholders of the first acquiring company obtain and retain stock of the second acquiring company. The Service can be expected to resist this comparison since it limited Revenue Ruling 84-30 to an already established group of corporations, yet no clear reason exists for refusing to extend the rationale used in divisive distribution rulings. If the reasoning were extended, it would enable the parties involved in two successive mergers to enjoy the benefits of engaging in a reorganization.

E. Recharacterization

The last method for analyzing the problem of remote continuity is recharacterization. If two successive reorganizations present a problem of remote continuity, that problem might be avoided if both target corporations are acquired directly by the acquiring Service corporation. The Service accepted this theory in Revenue Ruling 68-526. In this ruling, one corporation owned sixty percent of another corporation. Pursuant to one plan of reorganization, both corporations simultaneously transferred all their assets to and had their liabilities assumed by a third, unrelated, corporation. Each of the transactions qualified as a C reorganization.

Without much imagination, it can be seen that Revenue Ruling 68-526 presents an alternative mode for successive reorganizations. The target parent and subsidiary corporations will disappear in successive reorganizations, just as they did in the ruling. Remote continuity is unimportant, or at least surmountable, in the ruling. If the parent had merged into its subsidiary and the survivor had merged into the acquiring corporation, the aforementioned problem of remote continuity would have to be confronted. If both target parent and subsidiary are acquired directly by the acquiring corporation, then one still must ask about continuity. Do shareholders of both acquired corporations obtain and retain stock of the acquiring corporation? Arguably not, since the acquired subsidiary's shareholder, the parent, has disposed of whatever it received in its final distribution to its shareholders. However, Revenue Ruling 68-526 determined that continuity should be scrutinized and decided that it did exist, because the only persons entitled to the acquiring corporation's stock received by the acquired parent, had it survived, were the parent's shareholders.

It is unlikely that Revenue Ruling 68-526's rationale could be applied to successive stock-for-stock exchanges, since the most likely route for eliminating an acquired parent is through a downstream merger. The more profitable analogy might lie in holding that successive mergers can be

299. See supra notes 292-94.
300. 1968-2 C.B. 156.
301. See also supra text at notes 290-91. Furthermore, the Service might favor application of Rev. Rul. 68-526 if the parent is an operating, rather than a holding, company. Compare 82-4 TAX MGMT. MEM. (BNA) 9 (Feb. 22, 1982) with 83-15 TAX. MGMT MEM. (BNA) 6 (July 25, 1983).
recharacterized as the merger of both corporations into the acquiring corporation.\textsuperscript{302}

**Conclusion**

Continuity of interest remains a necessary element of any reorganization, although recommendations have been made for the elimination of the continuity test.\textsuperscript{303} In some cases, continuity can be satisfied by meeting certain statutory tests. Continuity can be satisfied in other cases, such as statutory mergers, by meeting well-established, if nevertheless sometimes elusive, indicia of continuity. The problem of remote continuity of interest in successive statutory mergers, even if infrequently encountered, also must be analyzed.

\textsuperscript{302} These reorganizations could be A or C reorganizations. See I.R.C. § 368(a)(1)(A), (C).

\textsuperscript{303} See supra note 6; Faber, supra note 81 at 261-67.