May B. Kass v. Commissioner
60 T.C. 218 (1973)
DAWSON, Judge:

[The Atlantic City Racing Association ("ACRA") was a corporation that operated a racetrack. To gain control over ACRA's business, the Levy and Casey families, who owned about 10 percent of ACRA's stock, transferred all of their ACRA shares and cash to a new corporation, Track Associates, Inc. ("TRACK") in exchange for all of the shares of TRACK. TRACK then acquired for cash about 84 percent of the stock of ACRA and liquidated ACRA by means of an upstream merger of ACRA into TRACK. In the merger, all of the ACRA shareholders (other than TRACK) received shares of TRACK in exchange for their ACRA shares. The formation of TRACK, its acquisition of over 80 percent of the stock of ACRA for cash, and the subsequent liquidation of ACRA, all were undertaken to qualify the transaction for tax purposes as an acquisition of the ACRA assets under former section 334(b)(2). This provision (the predecessor to current section 338) enabled TRACK to obtain the equivalent of a cost basis in the ACRA assets.

Taxpayer was an ACRA shareholder who did not tender her shares to TRACK in the initial cash acquisition. Instead, by operation of law, she exchanged her ACRA shares for TRACK shares in the upstream merger. She contended that the merger qualified as a reorganization and therefore she did not recognize any gain or loss on the exchange. The issue came down to whether there was enough continuity of interest in the merger.]

…Reorganization treatment is appropriate when [TRACK]'s stock ownership in [ACRA] was not acquired as a step in a plan to acquire assets of [ACRA]: [TRACK]'s stockholding can be counted as contributing to continuity-of-interest, so that since such holding represented more than 80 percent of the stock of [ACRA], the continuity-of-interest test would be met. Reorganization treatment is inappropriate when [TRACK]'s stock ownership in [ACRA] was purchased as the first step in a plan to acquire [ACRA]'s assets in conformance with the provisions of section 334(b)(2) **[current section 338]**. [TRACK]'s stockholding could not be counted towards continuity-of-interest, so in the last example there would be a continuity-of-interest of less than 20 percent. (Less than 20-percent continuity would be significantly less continuity-of-interest than that allowed in John A. Nelson Co. v. Helvering, 296 U.S. 374 (1935).) In short, where [TRACK]'s stock interest is "old and cold," it may contribute to continuity-of-interest. Where [TRACK]'s interest is not "old and cold," the sale of shares by the majority of shareholders actually detracts from continuity-of-interest.

In petitioner's case, TRACK's stock in ACRA was acquired as part of an integrated plan to obtain control over ACRA's business. The plan called for, first, the purchase of stock and, second, the subsidiary-into-parent merger. Accordingly, continuity-of-interest must be measured by looking to all the pre-tender offer stockholders rather than to the parent (TRACK) and the nontendering stockholders only; and by that measure the merger fails and petitioner must recognize her gain.…

[P]etitioner makes the following arguments, which we will deal with separately.

One, the continuity-of-interest doctrine should not be applied because TRACK was formed by a few stockholders in ACRA in order to purchase the business and, in the process, to acquire a stepped-up basis for as many of the assets as possible via section 334(b)(2). "In effect, the situation was the same as the sale of stock by some shareholders to other shareholders." The petitioner meets herself coming, so to speak, when making this argument. Confronted with the problem of how to characterize the second event in the present two-event transaction, she contends that the transaction was a true statutory merger in both form and substance, at least insofar as she, a minority shareholder, was concerned. Now, confronted with the continuity-of-interest problem, she would have us treat the transaction in a manner inconsistent with the characterization previously given to the transaction, that of a merger. Furthermore, the parties to these events (the selling shareholders of ACRA, the organizers of TRACK, and the nontendering, nondissenting shareholders such as the petitioner) chose the steps that were followed.1 To allow one of them in a separate proceeding to characterize the facts as being in substance something else would lay the groundwork for an enormous amount of "whipsawing" by and against both taxpayers and the Government.

Two, in applying the continuity-of-interest test, if it is applied, the purchase of stock by TRACK and the subsequent merger should not be viewed as steps in an integrated transaction because the choice of merger over liquidation as a second step had independent significance to the minority shareholders and either choice would have suited TRACK. By so arguing, the petitioner attempts in effect to avoid the step-transaction doctrine and thus to limit the application of the continuity-of-interest test. If the merger can be separated from the stock purchase, the continuity-of-interest test might be applicable only with regard to ACRA's shareholders at the time of the statutory merger, namely, the parent corporation, TRACK, and the minority shareholders, including petitioner. We note at least one flaw: The choice—liquidation or merger—did make a difference to TRACK. If it had liquidated ACRA, TRACK would not have received all of ACRA's assets. Some of the assets would have gone to the minority shareholders, and it would have had to have purchased them from these shareholders at an additional price. By choosing to merge ACRA into itself, it was able to avoid this and other problems.

Three, if the purchase and merger are to be viewed as parts of a single transaction for continuity and reorganization purposes, then the incorporation of TRACK should also be integrated into the transaction for section 351 purposes; thus the petitioner should be viewed as having participated in a tax-free section 351 transaction along with the Levys and Caseys. Briefly, the answer to this argument is that while the purchase and the merger were interdependent events, petitioner's exchange of ACRA stock for TRACK stock was not "mutually interdependent" with the incorporation transfers made by the Levys [and] Caseys.…This result merely illustrates the truism that the step-transaction doctrine, even when worded consistently…and applied to identical facts, may result in integration in one case and "separateness" in another case simply because the legal question to be answered has changed.…

Four, assuming that the continuity-of-interest test is applied, it is met where all 16 percent of the stockholders of ACRA exchanged their stock for a total of 35 percent of the stock of TRACK. The 16-percent figure (really 16.04 percent) is the sum of the percentage of ACRA stock transferred to TRACK at the time of TRACK's formation (10.22 percent) plus the percentage of ACRA stock exchanged for TRACK stock following the statutory merger (5.82 percent). Fortunately, we need not engage in a game of percentages since the continuity figure argued for by petitioner, 16 percent, is not "tantalizingly" high. The plain fact that more than 80 percent of the shareholders of ACRA sold out for cash is sufficient to prevent this merger from meeting the quantitative test [of COI].…

Finally, we emphasize that the petitioner is not any worse off than her fellow shareholders who sold their stock. She could have also received money instead of stock had she chosen to sell or to dissent from the merger. The nonrecognition of a realized gain is always an important matter. We hold that petitioner is not entitled to such favorable treatment in this case.…

J.E. Seagram Corp. v. Commissioner
104 T.C. 75 (1995)

[*On May 6, 1981, Dome Petroleum Ltd. (Dome) commenced a tender offer for approximately 20 percent of the common stock of Conoco, Inc. (Conoco), a corporation engaged in the oil and gas business. The tender offer was dramatically oversubscribed, so that by May 27, Dome announced that about 50 percent of the Conoco stock had been tendered pursuant to the offer. On June 1, Conoco agreed to buy out Dome's interest in Conoco in exchange for all of the stock of one of Conoco's valuable subsidiaries plus cash.*

The effect of the Dome transaction was to "put into play" the stock of Conoco. Other potential buyers noted how receptive Conoco's shareholders appeared to be to an acquisition of the company. As a result, three different corporations, J.E. Seagram Corp. (Seagram), E.I. DuPont de Nemours & Co. (DuPont), and Mobil Corp. (Mobil), all proceeded to make a series of competing offers for the acquisition of Conoco.

Of the three competitors, the Conoco board favored DuPont and negotiated a two-step purchase and sale agreement with that corporation. According to the agreement, a newly-formed wholly-owned subsidiary of DuPont ("DuPont Tenderor") would first offer to acquire all of the stock of Conoco in exchange for either shares of DuPont or cash. Second, following consummation of the tender offer, there would be a squeeze-out merger of Conoco into Dupont Tenderor in which any Conoco shares not acquired in the tender offer would be acquired. The obligation of DuPont Tenderor to go forward with the transaction was subject to several conditions, including (1) a minimum (at least 51 percent) of the Conoco shares being tendered in the initial step, (2) a maximum (40 percent) of cash being paid for the Conoco stock, and (3) various state and regulatory approvals being obtained.

Following execution of the agreement, the other suitors, Seagram and Mobil, continued their efforts to acquire Conoco. Eventually, however, thanks in part to an option granted to Dupont Tenderor to acquire some Conoco stock directly from Conoco, DuPont Tenderor succeeded in obtaining a majority of the Conoco shares. As of that time, Seagram had acquired about 32 percent of the Conoco shares for cash. Mobil's offers were all contingent on its receiving at least 51 percent of Conoco's shares, so it did not end up purchasing any of those shares.

In recognition of DuPont's victory and pursuant to the DuPont tender offer, Seagram tendered its Conoco shares to DuPont Tenderor in exchange for DuPont stock. Ultimately, DuPont Tenderor acquired 94 percent of the Conoco stock in the tender offer (including the 32 percent interest of Seagram) and the remaining 6 percent of that stock in the subsequent squeeze-out merger. The consideration paid by DuPont Tenderor for the Conoco stock in the two steps consisted of the following:

Thus, a total of 54 percent of Conoco was acquired by DuPont Tenderor for DuPont stock.

In the exchange of Conoco stock for DuPont stock, Seagram realized a $530 million loss. Although it did not report the loss for financial accounting purposes, it claimed the loss on its tax return. When the Commissioner disallowed the loss, Seagram (the petitioner in this case) brought suit.]

NIMS, J.

…The ultimate issue for decision is whether, for tax purposes, petitioner had a recognized loss upon the exchange of its Conoco stock for DuPont stock. Whether such a loss is to be recognized depends upon the effect to be given section 354(a)(1) under the above facts. Section 354(a)(1) provides…"No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization." Thus, if DuPont, DuPont Tenderor, and Conoco were parties to a reorganization, and if the statutory merger of Conoco into DuPont Tenderor was in pursuance of a plan of reorganization, then no loss is to be recognized by petitioner upon the exchange of its Conoco stock for DuPont stock.

[The excerpt omits the court's conclusion that the two-step acquisition constituted a single integrated transaction (i.e., a merger) undertaken pursuant to a plan of reorganization.]

Petitioner also argues that even if the DuPont tender offer and merger were to be treated as an integrated transaction, the merger does not qualify as a reorganization because it fails the "continuity of interest" requirement.

…Petitioner is essentially arguing that because it acquired approximately 32 percent of [the Conoco] shares for cash pursuant to its own tender offer, and DuPont acquired approximately 46 percent of these shares for cash pursuant to its tender offer, the combined 78 percent of Conoco shares acquired for cash after the date of the Agreement destroyed the continuity of interest requisite for a valid reorganization. We think petitioner's argument, and the logic that supports it, miss the mark.

Pursuant to its two-step tender offer/merger plan of reorganization, DuPont acquired approximately 54 percent of the…Conoco stock in exchange for DuPont stock, which included petitioner's recently acquired Conoco shares that it tendered pursuant to DuPont's tender offer. If the 54 percent had been acquired by DuPont from Conoco shareholders in a "one-step" merger-type acquisition, there would be little argument that continuity of interest had been satisfied.

…The parties stipulated that petitioner and DuPont, through their wholly owned subsidiaries, were acting independently of one another and pursuant to competing tender offers. Furthermore, there is of course nothing in the record to suggest any prearranged understanding between petitioner and DuPont that petitioner would tender the Conoco stock purchased for cash if petitioner by means of its own tender offer failed to achieve control of Conoco. Consequently, it cannot be argued that petitioner, although not a party to the reorganization, was somehow acting in concert with DuPont, which was a party to the reorganization. If such had been the case, the reorganization would fail because petitioner's cash purchases of Conoco stock could be attributed to DuPont, thereby destroying continuity.

The cases cited by petitioner in support of its argument that DuPont's plan of reorganization failed for lack of continuity of interest are not germane.… In Superior Coach of Fla., Inc. v. Comm'r, [80 T.C. 895 (1983),] the majority shareholders of P purchased all of the shares of T and merged T into P. We held that the P shareholders' acquisition of the T stock was "inextricably interwoven" with the intent to effect the merger, and since the "historic shareholders" of T retained no proprietary interest in P, the merger did not qualify as a reorganization under section 368(a)(1)(A). In other words, the reorganization failed because the majority shareholders of P were acting on its behalf when they bought the T stock for cash, and there was no continuity of interest on the part of the acquired corporation's previous shareholders. In the case before us, DuPont's shareholders did not purchase Conoco stock for cash (or for any other consideration) to facilitate the merger, and except for approving the Plan of Reorganization and the merger did not act on DuPont's behalf. Superior Coach of Fla., Inc. is therefore not apposite on its facts.

Petitioner cites Yoc Heating Corp. v. Comm'r, 61 T.C. 168, 177 (1973) for the proposition that continuity requires looking at shareholders "immediately prior to the inception of the series of transactions" in an integrated transaction. Again, we ook at the facts: R, the acquiring corporation, purchased for cash over 85 percent of the stock of O, and then caused O to transfer its assets, subject to its liabilities, to R's wholly owned subsidiary, N. N issued one share of its stock to R in exchange for every three shares of O held by R plus cash to be paid to the minority shareholders of O.

…We held…that the acquisition by N of O's assets constituted a purchase under the "integrated transaction" (step transaction) doctrine, rather than a reorganization.…Yoc Heating's comparison of stock ownership immediately prior and immediately after the series of transactions is perfectly appropriate to the facts of that case, where the acquiring corporation acquired control of the target for cash and then effected the corporate combination, because the shareholders of O before the acquisition by R lacked the requisite continuing interest in the affairs of O after the acquisition.

…Respondent points out, correctly we believe, that the concept of continuity of interest advocated by petitioner would go far toward eliminating the possibility of a tax-free reorganization of any corporation whose stock is actively traded. Because it would be impossible to track the large volume of third party transactions in the target's stock, all completed transactions would be suspect. Sales of target stock for cash after the date of the announcement of an acquisition can neither be predicted nor controlled by publicly held parties to a reorganization. A requirement that the identity of the acquired corporation's shareholders be tracked to assume a sufficient number of "historic" shareholders to satisfy some arbitrary minimal percentage receiving the acquiring corporation's stock would be completely unrealistic.…

In the "integrated" transaction before us petitioner, not DuPont, "stepped into the shoes" of 32 percent of the Conoco shareholders when petitioner acquired their stock for cash via the…competing tender offer, held the 32 percent transitorily, and immediately tendered it in exchange for DuPont stock. For present purposes, there is no material distinction between petitioner's tender of the Conoco stock and a direct tender by the "old" Conoco shareholders themselves. Thus, the requirement of continuity of interest has been met.

Petitioner extended its tender offer even after DuPont had been tendered a "significant majority" of the outstanding shares of Conoco.…[P]etitioner, in connection with its tender of its just-acquired Conoco stock, issued a press release quoting Edgar M. Bronfman, Seagram's chairman and CEO, as saying that Seagram's was pleased at the prospect of becoming "a large stockholder of the combined DuPont and Conoco." We also noted that petitioner did not report a loss on the exchange of its Conoco stock for DuPont stock for financial accounting purposes. Instead, petitioner ascribed its carrying cost for its Conoco stock to the DuPont stock. None of these acts is consistent with the recognized loss petitioner claimed on its tax return.

For the reasons stated in this Opinion, we hold that a loss cannot be recognized by petitioner on its exchange of Conoco stock for DuPont stock, made pursuant to the DuPont-Conoco plan of reorganization.…

NOTES

1. **Epilogue**. Seagram appealed the Tax Court's decision to the Second Circuit but settled the matter prior to any further decision. The settlement was apparently on terms favorable to Seagram because of

conflicting precedents regarding both the integration of the tender offer with the subsequent merger and the failure to integrate Seagram's purchase of Conoco stock into the transaction. The settlement, however, was not Seagram's last dispute with the tax authorities as a result of its attempt to acquire Conoco. By 1995 (about the time of the Tax Court's decision), Seagram had decided to dispose of its DuPont shares, then worth about $10 billion (including about $7 billion of gain). Rather than pay a 35 percent capital gains tax on the gain, Seagram arranged for DuPont to buy back its shares in a corporate redemption. The key was Seagram's retention of an option to repurchase a like number of DuPont shares. Seagram claimed that the option (and application of the option-attribution rule in section 318(a)(4)) meant that the transaction was a $10 billion dividend for which it was entitled to a dividends-received deduction. Cf. Heinz (p. 240) involving a similar claim to dividend treatment. Seagram's claim was challenged and settled, apparently again on terms favorable to Seagram. Section 1059(e)(1)(A)(iii) now bars Seagram's claim by expressly treating such a redemption as an extraordinary dividend; this provision was enacted in part in response to the Seagram-DuPont transaction.

2. **Yoc Heating**. The regulations have changed the result of a Yoc Heating transaction where there is a qualified stock purchase of a target corporation, no section 338 election is made, and the target's assets are subsequently transferred to the purchasing corporation (or a member of its affiliated group) in a transaction potentially qualifying as a reorganization. Reg. §1.338-3(d). In that case, the transfer of the target's assets may qualify as a reorganization to each of those corporations notwithstanding the prior cash purchases of the target's stock as part of the overall acquisition. The purpose of the regulation is to prevent any change in the basis of the target's assets when there is a qualified stock purchase of the target but no section 338 election is made. As in Kass, however, qualification of the transaction as a reorganization to any other party, including a minority shareholder of the target, must take into account the effect on COI of prior cash purchases that were part of the overall plan.

3. **Step-transaction doctrine**. As illustrated by Kass and Seagram, reorganization cases frequently require application of the step-transaction doctrine. Because the conditions for reorganization status vary with the taxpayer's acquisition pattern, there is a premium placed on identifying which pattern actually transpired, and the step-transaction doctrine is often invoked to make that determination. Three common formulations of the step-transaction doctrine are the "binding commitment," "mutual interdependence," and "end result" tests. The binding commitment test combines formally independent steps only if, at the time of the first step, there was a binding commitment to undertake the others. It is the test least likely to result in integration of steps. Under the mutual interdependence test, individual steps are collapsed if they are so interdependent as to be fruitless without the completion of all of them. Finally, under the end result test, separate steps with independent legal significance are, nevertheless, integrated if they were all intended from the outset to be undertaken in order to achieve a particular end result. In general, the end result test is the one most likely to combine nominally independent steps. Unfortunately, the law in this area is very uncertain; no settled understanding exists regarding when the step-transaction doctrine should be invoked, which test should be used, and how a test should be applied to a given set of facts.

Kass and Seagram concern the significance for COI purposes of events occurring prior to a potential reorganization. Other cases have raised similar questions with regard to events occurring after a potential reorganization. Read Reg. §1.368-1(e)(1), (3), (4) and (8) (exs. 1-5, 7-9), and the following excerpt from the preamble to the regulations to understand the resolution of these and other questions. Problem 11-1 requires you to apply these regulations.

T.D. 8760

1998-1 C.B. 803

…The purpose of the continuity of interest requirement is to prevent transactions that resemble sales from qualifying for nonrecognition of gain or loss available to corporate reorganizations. The final regulations provide that the COI requirement is satisfied if in substance a substantial part of the value of the proprietary interest in the target corporation (T) is preserved in the reorganization. A proprietary interest in T is preserved if, in a potential reorganization, it is exchanged for a proprietary interest in the issuing corporation (P), it is exchanged by the acquiring corporation for a direct interest in the T enterprise, or it otherwise continues as a proprietary interest in T. The issuing corporation means the acquiring corporation (as the term is used in section 368(a)), except that, in determining whether a reorganization qualifies as a triangular reorganization (as defined in section 1.358-6(b)(2)), the issuing corporation means the corporation in control of the acquiring corporation. However, a proprietary interest in T is not preserved if, in connection with the potential reorganization, it is acquired by P for consideration other than P stock, or P stock furnished in exchange for a proprietary interest in T in the potential reorganization is redeemed. All facts and circumstances must be considered in determining whether, in substance, a proprietary interest in T is preserved.…

The…final regulations permit former T shareholders to sell P stock received in a potential reorganization to third parties without causing the reorganization to fail to satisfy the COI requirement. Some commentators have questioned whether the regulations are consistent with existing authorities.

The COI requirement was applied first to reorganization provisions that did not specify that P exchange a proprietary interest in P for a proprietary interest in T. Supreme Court cases imposed the COI requirement to further Congressional intent that tax-free status be accorded only to transactions where P exchanges a substantial proprietary interest in P for a proprietary interest in T held by the T shareholders rather than to transactions resembling sales.…

None of the Supreme Court cases establishing the COI requirement addressed the issue of whether sales by former T shareholders of P stock received in exchange for T stock in the potential reorganization cause the COI requirement to fail to be satisfied. Since then, however, some courts have premised decisions on the assumption that sales of P stock received in exchange for T stock in the potential reorganization may cause the COI requirement to fail to be satisfied. McDonald's Restaurants of Illinois, Inc. v. Comm'r, 688 F.2d 520 (7th Cir. 1982).…The apparent focus of these cases is on whether the T shareholders intended on the date of the potential reorganization to sell their P stock and the degree, if any, to which P facilitates the sale. Based on an intensive inquiry into nearly identical facts, some of these cases held that as a result of the subsequent sale the potential reorganization did not satisfy the COI requirement; others held that satisfaction of the COI requirement was not adversely affected by the subsequent sale. The IRS and Treasury Department have concluded that the law as reflected in these cases does not further the principles of reorganization treatment and is difficult for both taxpayers and the IRS to apply consistently.

Therefore, consistent with Congressional intent and the Supreme Court precedent which distinguishes between sales and reorganizations, the final regulations focus the COI requirement generally on exchanges between the T shareholders and P. Under this approach, sales of P stock by former T shareholders generally are disregarded.

The final regulations will greatly enhance administrability in this area by both taxpayers and the government. The regulations will prevent "whipsaw" of the government, such as where the former T shareholders treat the transaction as a tax-free reorganization, and P later disavows reorganization treatment to step up its basis in the T assets based on the position that sales of P stock by the former T shareholders did not satisfy the COI requirement. See, e.g., McDonald's Restaurants, supra. In addition, this approach will prevent unilateral sales of P stock by former majority T shareholders from adversely affecting the section 354 nonrecognition treatment expected by former minority T shareholders.

…The IRS and Treasury Department believe that issues concerning the COI requirement raised by dispositions of T stock before a potential reorganization correspond to those raised by subsequent dispositions of P stock furnished in exchange for T stock in the potential reorganization.…Cf. J.E. Seagram Corp. v. Comm'r, 104 T.C. 75 (1995) (sales of T stock prior to a potential reorganization do not affect COI if not part of the plan of reorganization). The final regulations provide that, for COI purposes, a mere disposition of T stock prior to a potential reorganization to persons not related to P is disregarded and a mere disposition of P stock received in a potential reorganization to persons not related to P is disregarded.…

[W]here the step transaction doctrine applies to link T stock purchases with later acquisitions of T, the final regulations provide that a proprietary interest in T is not preserved if, in connection with the potential reorganization, it is acquired by P for consideration other than P stock. Whether a stock acquisition is made in connection with a potential reorganization will be determined based on the facts and circumstances of each case.…