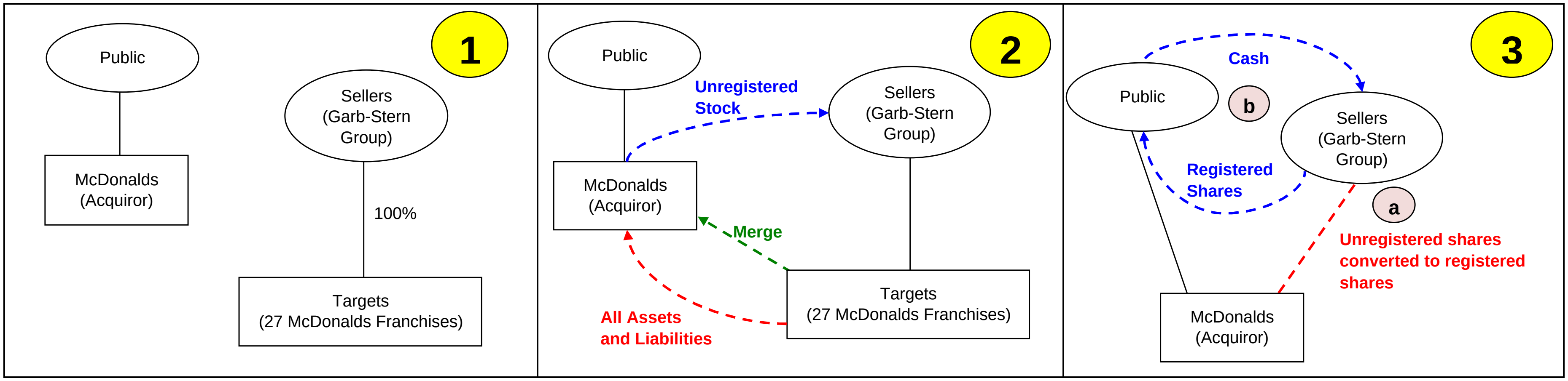
McDonald's Restaurants v. Commissioner
688 F.2d 520 (7th Cir. 1982)

Post-Merger Continuity of Interest

Initial Structure | **Mergers (April 1973)** | **Share Registration & Sale (October 1973)**

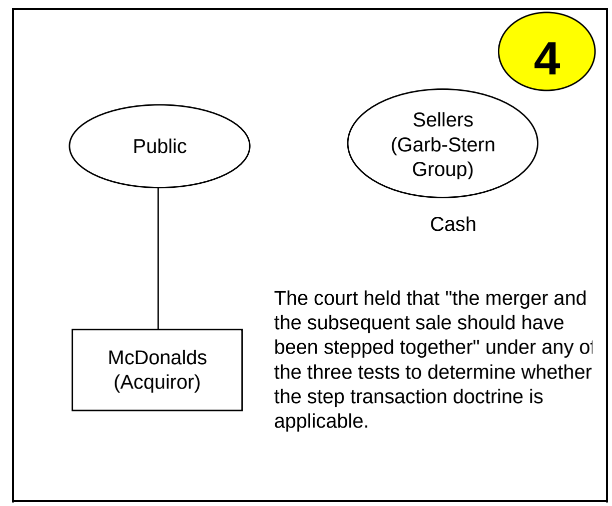


Excerpt from Treasury Decision 8760:

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 . . . 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. . . .

The . . . 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. . . . 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 . . .

Ending Point



[T]he 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 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.