

CONTINUITY OF BUSINESS ENTERPRISE (COBE)

PRIMER

Introduction

Generally, any gain recognized on the sale or exchange of property is taxable, but the Internal Revenue Code (IRC) provides that certain sales or exchanges are not federally taxable events. One example is a § 368 corporate reorganization. The rationale for allowing § 368 corporate reorganizations to be non-taxable events is that they are, pursuant to Treas. Reg. 1.368-1(b): "... required by business exigencies and... effect only a readjustment of continuing interest in property under modified corporate forms."

"Continuity of business enterprise," or "COBE," is one of the requirements that a reorganization must fulfill in order to be "tax-free" pursuant to IRC § 368.

After reviewing key concepts and legislation relating to the COBE requirement for tax-free reorganizations, this primer identifies and discusses relevant considerations in the determination of whether COBE exists in a particular reorganization.

Key Concepts and Legislation

Tax Free Reorganizations

IRC § 354(a)(1) provides that, in general:

[n]o 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.

IRC §§ 368(a)(1)(A) through (G) inclusive define “reorganization” in the context of § 354(a)(1) exhaustively. In brief, the transactions that can be considered “reorganizations” eligible for tax-free treatment are:

- Statutory mergers and consolidations - § 368(a)(1)(A)
- Stock-for-stock exchanges - § 368(a)(1)(B)
- Stock-for-asset exchanges - § 368(a)(1)(C)
- Divisive reorganizations - § 368(a)(1)(D)
- Recapitalization - § 368(a)(1)(E)
- Changes in place or form of organization - § 368(a)(1)(F)
- Insolvency reorganizations - § 368(a)(1)(G)

Continuity of Business Enterprise

Treas. Reg. 1.368-1(d) indicates that for § 368 reorganizations occurring after January 28, 1998, COBE can be shown if the reorganization exhibits one of the following:

1. “business continuity,” where the “issuing corporation” (as defined at 1.368-1(b), generally the acquiring corporation or a corporation in control of an acquiring corporation, and including corporations which the issuing corporation owns an interest as described at § 368(c)) continues the historic business of the acquired corporation; or
2. “asset continuity,” where the issuing corporation uses a significant part of the acquired corporation’s assets in its business.

Treas. Reg. 1.368-1(d)(2) further clarifies that with respect to business continuity, being in the same line of business tends to establish COBE, but that alone is not sufficient. If the acquired company had more than one line of business, COBE only requires that the acquiring company continue a significant line. The acquired company’s “historic business” is the one it conducted most recently and not the one it enters into as part of the plan of reorganization. The IRS will consider all the facts and circumstances in determining whether a business line is “significant.”

As for asset continuity, Treas. Reg. 1.368-1(d)(3) notes that a corporation’s “historic business assets” are the assets used in its “historic business” and may include stock, securities, and intangibles, whether or not they have a tax basis. Whether they are “significant” is based on their relative importance to the operation of the business, but the IRS will also consider other facts and circumstances, such as the net fair market value of the assets.

Relevant Considerations in Determining COBE

Personnel and Physical Location

Continuity between two corporations' personnel and physical location is relevant to determining whether there is COBE. For example, in *Atlas Tool v. Commissioner*, 614 F.2d 860 (3rd Cir. 1980), aff'g 70 T.C. 86 (1978), the appellate court affirmed that there was COBE between two corporations who had effected an asset transfer. In reaching this conclusion, the court pointed out that the asset recipient retained all of the transferring corporation's employees, the transferor's machinery and equipment remained in the same place, ready for use, and the asset recipient did indeed use that machinery and equipment in that place shortly after the transfer (at 864).

Duration of Operations

The duration of the operations after the reorganization can also be relevant to COBE. For example, in *Honbarrier v. Commissioner*, 115 T.C. 300 (2000), the "historic business assets" were found to be the acquired corporation's bonds and bond fund; and the "historical business" was "acquiring and holding [bonds]." The acquirer liquidated almost all of the bonds within days of the merger and distributed the proceeds to shareholders. The acquirer liquidated the last bond, with a relatively small value, 4 months later. On both the business continuity and asset continuity analyses, the short time these bonds were held factored into the court's findings (at 313-314) that the acquirer did not continue the business of holding bonds and did not use a significant portion of the bonds in any business.

Customers and Suppliers

Continuity in clients, customers and suppliers can be relevant to a finding of COBE. For example, in *Simon v. Commissioner*, 644 F.2d 339 (5th Cir. 1981), besides all of the transferor's operating assets being transferred to the acquiring company, and operations continuing as before with the same personnel, facilities and address except under the acquiring company's name, the transferee had the same supplier and dealt with the same clients, as though nothing had occurred apart from the name change to the business. In describing this transaction, the court found (at 342) that it evinced the "most complete continuity of enterprise... that is basic to a corporate reorganization." It was "identical to that [situation] in previous cases in which reorganizations have been found."

Assets transferred

Whether the issuing corporation is using a "significant part" of the acquired corporation's assets in its business can depend on the used assets' importance to the issuing corporation's business as well as their dollar value in relation to the total value of the assets transferred. In *Appeal of Laure*, 653 F.2d 253 (6th Cir. 1981), the reorganization saw the sale of the old company's planes, inventory, prepaid insurance, accounts receivable and equipment, but the new company retained the land lease and an airplane hangar. These two retained assets were found to be of "crucial importance" to the new company's ability to obtain reliable air charter and repair services (at 261). As for their value relative to the total assets transferred in the transaction, the land lease and airplane hangar appeared to comprise about 27.25% of the total. The court held the value of the land lease and hangar was substantial in these circumstances, and that it was not necessary that a transferee use all or a majority of assets for there to be COBE.

Tax Foresight

Does your client's corporate reorganization meet the continuity of business enterprise requirement for a § 368 tax-free reorganization? Find out!

Tax Foresight's **Continuity of Business Enterprise**

Classifier asks you to complete a questionnaire about the facts of your case. Each of the questions represents a factor or factors found to inform court decisions about continuity of business enterprise. Once you answer all the questions, Tax Foresight will compute the likelihood of a finding of continuity of business enterprise, comparing your scenario to previous relevant cases.