McDonald's of Zion, 432, Ill. , Inc. v. Commissioner, 76 T. C. 972 (1981)

The continuity of interest principle in corporate reorganizations is not violated by a shareholder's post-merger sale of stock if the sale is not part of the merger agreement or a preconceived plan.

Summary

McDonald's acquired franchised restaurants owned by the Garb-Stern group through a merger, paying solely with its common stock. The group sold nearly all their McDonald's stock shortly after the merger. The Tax Court held that the merger qualified as a tax-free reorganization under IRC Section 368(a). The court determined that the Garb-Stern group's intent to sell and their subsequent sale of the stock did not violate the continuity of interest principle because the sale was not part of the merger agreement, and McDonald's was indifferent to the sale. The decision emphasizes that post-merger sales by shareholders do not retroactively disqualify a reorganization if they are discretionary and independent of the merger.

Facts

McDonald's Corp. acquired multiple franchised restaurants owned primarily by Melvin Garb, Harold Stern, and Lewis Imerman (the Garb-Stern group) through a merger effective April 1, 1973. The group received 361,235 shares of unregistered McDonald's common stock in exchange. The merger agreement included "piggyback" registration rights, allowing the group to sell their shares in McDonald's future stock offerings. The Garb-Stern group intended to sell their McDonald's stock from the outset and sold all but 100 shares on October 3, 1973, at the earliest opportunity after the merger. McDonald's was indifferent to whether the group sold or retained their shares.

Procedural History

The Commissioner determined deficiencies in the petitioners' 1973 federal income tax, treating the merger as a tax-free reorganization under IRC Section 368(a). The petitioners argued that the Garb-Stern group's intent to sell and their subsequent sale of the McDonald's stock meant the merger should be treated as a taxable transaction. The case was heard by the United States Tax Court, which ruled in favor of the Commissioner, upholding the tax-free status of the reorganization.

Issue(s)

1. Whether the merger of the Garb-Stern group's companies into McDonald's qualified as a tax-free reorganization under IRC Section 368(a)?
2. Whether the Garb-Stern group's intent to sell and their subsequent sale of the McDonald's stock violated the continuity of interest principle?

Holding

1. Yes, because the merger satisfied the statutory requirements of IRC Section 368(a) and the continuity of interest principle was not violated by the subsequent sale of stock.
2. No, because the Garb-Stern group's sale was discretionary and not part of the merger agreement or a preconceived plan with McDonald's.

Court's Reasoning

The court applied the continuity of interest test, which requires that shareholders of the acquired company receive a substantial proprietary interest in the acquiring company. The court found that the Garb-Stern group's receipt of McDonald's common stock satisfied this test at the time of the merger. The court then addressed whether the subsequent sale of the stock violated this principle. The court noted that the group's intent to sell and their actual sale were not part of the merger agreement, and McDonald's was indifferent to the sale. The court rejected the application of the step transaction doctrine, which would have combined the merger and the sale into a single taxable transaction, because the sale was discretionary and independent of the merger. The court emphasized that the continuity of interest principle does not require a post-merger holding period for the stock received.

Practical Implications

This decision clarifies that a shareholder's post-merger sale of stock does not retroactively disqualify a reorganization as tax-free if the sale is not part of the merger agreement or a preconceived plan. For legal practitioners, this means that clients can structure mergers with confidence that subsequent sales by shareholders will not automatically trigger tax consequences, provided the sales are discretionary. Businesses engaging in mergers should ensure that any shareholder agreements do not include mandatory sell-back provisions that could be seen as part of the reorganization plan. The ruling also highlights the importance of documenting the independence of any post-merger transactions to maintain the tax-free status of the reorganization. Subsequent cases have applied this principle in similar contexts, reinforcing its significance in corporate tax planning.

