***Honbarrier v. Commissioner, T. C. Memo 1999-129 (1999)***

A corporate merger does not qualify as a tax-free reorganization under Section 368(a)(1)(A) if it fails to meet the continuity of business enterprise requirement.

**Summary**

In Honbarrier v. Commissioner, the Tax Court ruled that the merger of Colonial Motor Freight Line, Inc. into Central Transport, Inc. did not qualify as a tax-free reorganization under Section 368(a)(1)(A) of the Internal Revenue Code. The key issue was whether the merger satisfied the continuity of business enterprise requirement. Colonial had ceased its trucking operations years before the merger, and its assets primarily consisted of tax-exempt bonds and a municipal bond fund. Post-merger, Central did not continue Colonial's business or use its assets in any significant way, leading the court to conclude that the continuity of business enterprise was not maintained. Consequently, the exchange of Colonial stock for Central stock was deemed a taxable event, requiring the recognition of capital gain by the shareholder.

**Facts**

Colonial Motor Freight Line, Inc. , a former trucking company, ceased operations in 1988 and sold its assets, retaining only its ICC and North Carolina operating authorities. By 1993, Colonial's assets were primarily tax-exempt bonds and a municipal bond fund. On December 31, 1993, Colonial merged into Central Transport, Inc. , a successful bulk chemical hauling company owned by the same family. Central's shareholders approved the merger, citing reasons such as acquiring Colonial's ICC operating rights and using its cash for expansion. However, Central never used Colonial's ICC authority and quickly distributed Colonial's tax-exempt bonds to shareholders.

**Procedural History**

The IRS determined deficiencies in the federal income tax of Archie L. and Louise B. Honbarrier and Colonial for 1993, asserting that the merger did not qualify as a tax-free reorganization. The Honbarriers and Colonial petitioned the Tax Court for review. The court heard the case and issued its memorandum decision in 1999, focusing on whether the merger met the statutory requirements for a tax-free reorganization under Section 368(a)(1)(A).

**Issue(s)**

1. Whether the merger of Colonial into Central on December 31, 1993, qualifies as a tax-free reorganization under Section 368(a)(1)(A) of the Internal Revenue Code?

**Holding**

1. No, because the merger did not satisfy the continuity of business enterprise requirement, a necessary condition for a tax-free reorganization under Section 368(a)(1)(A).

**Court’s Reasoning**

The court’s decision hinged on the continuity of business enterprise doctrine, which requires that the acquiring corporation either continue the historic business of the acquired corporation or use a significant portion of its historic business assets. The court found that Colonial’s most recent business was holding tax-exempt bonds and a municipal bond fund, not trucking, as it had ceased operations years earlier. Central did not continue this business, nor did it use Colonial’s assets in any meaningful way, as the bonds were quickly distributed to shareholders. The court emphasized that the purpose of the reorganization provisions is to allow adjustments in corporate structure without recognizing gain, but this requires a genuine continuity of business. The court cited precedents like Cortland Specialty Co. v. Commissioner and the income tax regulations to support its interpretation of the continuity requirement. The court concluded that without meeting this requirement, the merger could not be treated as a tax-free reorganization, resulting in a taxable event for the shareholders.

**Practical Implications**

This decision underscores the importance of the continuity of business enterprise requirement in tax-free reorganizations. For practitioners, it highlights the need to ensure that the acquiring corporation either continues the acquired corporation’s historic business or uses its historic business assets significantly. The case also illustrates that even if a merger is valid under state law, it must meet federal tax law requirements to be tax-free. Businesses planning mergers should carefully assess whether the transaction will satisfy the continuity of business enterprise test, as failure to do so can result in significant tax consequences for shareholders. Subsequent cases have cited Honbarrier to clarify the application of the continuity doctrine, emphasizing that passive investment activities can constitute a historic business for these purposes if not acquired as part of a reorganization plan.

 