



REG-249819-96

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to the receipt, as part of a reorganization, of rights to acquire stock of a corporation that is a party to the reorganization. This document also provides notice of a public hearing on these regulations.

DATES: Written comments must be received by March 23, 1997. Requests to appear and outlines of topics to be discussed at the public hearing scheduled for March 25, 1997, must be received by March 4, 1997.

ADDRESSES: Send submissions to: CC:DOM:CORP:R [REG-249819-96], room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R [REG-249819-96], Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC, or, electronically, via the IRS Internet site at: http://www.irs.ustreas.gov/prod/tax_regs/comments.html.

The public hearing will be held in the Commissioner's Conference Room, room 3313, 1111 Constitution Avenue NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Michael J. Danbury, (202) 622-7750; concerning submissions and the public hearing, Evangelista Lee at (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

A. General information

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) under sections 354, 355, and 356 of the Internal Rev-

**Notice of Proposed Rulemaking
and Notice of Public Hearing**

**Reorganizations; Receipt of
Securities**

enue Code of 1986 (Code), relating to exchanges of stock and securities in certain reorganizations. In particular, the proposed regulations address the receipt, as part of a reorganization, of rights to acquire stock of a corporation that is a party to the reorganization.

Section 354 generally provides for the nonrecognition of gain or loss from the exchange of stock or securities in a corporation that is a party to a reorganization for stock or securities in the same corporation or in another corporation that is a party to the reorganization. Gain realized on an exchange of securities is not recognized provided that the principal amount of the securities received does not exceed the principal amount of any securities surrendered pursuant to the plan of reorganization.

Section 355 provides for the nonrecognition of gain or loss upon a distribution by a corporation with respect to its stock of stock in a controlled corporation, or an exchange of securities in a controlled corporation for its securities. As in the case of a transaction described in section 354, gain realized on an exchange of securities is not recognized provided that the principal amount of the securities received does not exceed the principal amount of the securities surrendered pursuant to the plan of reorganization.

Section 356 provides rules for recognition of gain, but not loss, if a shareholder or security holder receives nonqualifying property (i.e., boot) as well as qualifying property in a transaction to which section 354 or 355 would otherwise apply. In particular, realized gain is recognized in an amount not in excess of the fair market value of the excess principal amount of the securities received over the principal amount of any securities surrendered as part of the plan of reorganization.

B. Existing regulations

Existing regulations under sections 354 and 355 provide that stock rights and stock warrants are not included in the term “stock or securities.” Prior to the promulgation of these regulations in 1955, the treatment of such instruments was unclear. Although the Supreme Court had held that stock warrants do not constitute “stock” for purposes of determining whether a transaction is a reorganization, the Board of Tax Appeals had held that stock warrants did constitute “securities” for purposes of section 112(b)(3) of the 1932 Act (a

predecessor to section 354 of the Code). Compare *Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194 (1942), with *Raymond v. Commissioner*, 37 B.T.A. 423 (1938).

Since 1955, courts have avoided concluding whether stock rights or stock warrants constitute “securities” for purposes of sections 354 and 355. See, e.g., *Carlberg v. United States*, 281 F.2d 507, 509 n.3 (8th Cir. 1960); *Bateman v. Commissioner*, 40 T.C. 408 (1963); *Estate of Smith v. Commissioner*, 63 T.C. 722 (1975).

C. Reasons for Change

A purpose of the reorganization provisions of the Code is to defer the recognition of gain and loss in certain readjustments of corporate structure. Generally, the Code extends nonrecognition to an exchange of stock which effects only a readjustment of continuing interest in modified corporate form. Although a right to acquire stock is not stock, the IRS and Treasury believe that it may generally represent a form of investment in the capital structure of the corporation that justifies nonrecognition treatment as a security under sections 354 and 355. Other provisions of the Code expressly acknowledge the role that stock rights play in the capital structure of a corporation. See, e.g., sections 317 and 1032. Accordingly, the proposed regulations provide that for purposes of sections 354 and 355 the term securities includes “rights to acquire stock” issued by a corporation that is a party to a reorganization.

Explanation of Provisions

A. Scope of proposed rules

The proposed regulations treat rights to acquire stock issued by a corporation that is a party to a reorganization as securities of the corporation. For this purpose, the term “rights to acquire stock” of an issuing corporation has the same meaning as the term has in sections 305(d)(1) and 317(a). It does not include rights exercisable against persons other than the issuer of the stock, or rights that relate to property other than stock of the issuer of the rights. As under current law, a conversion privilege contained in a stock or debt instrument generally will not be considered a separate property right received as part of the reorganization. See Rev. Rul. 69-265 (1969-1 C.B. 109).

B. Consequences upon receipt of stock rights

For purposes of sections 354, 355 and 356, the proposed regulations treat rights to acquire stock as securities having no principal amount. As a result, a taxpayer will not be required to recognize any gain under section 356 upon the receipt of a stock right. This will generally be the case regardless of whether the taxpayer surrenders stock, stock rights, or debt securities.

C. Effect on other authorities

The proposed rules apply only for the purpose of determining the amount of gain to be recognized in connection with exchanges occurring pursuant to transactions otherwise qualifying under section 368 or 355. They do not address issues concerning the qualification of a transaction under section 368 or 355. For example, the proposed rules do not permit rights to acquire stock to be taken into account in determining continuity of shareholder interest. See *Southwest Consolidated Corp.* (stock options are not stock).

The proposed rules have no effect on other Code provisions governing the treatment of stock options or similar interests for other purposes. Thus, for example, the treatment of an instrument under these rules is not relevant in determining whether the holder of the instrument is treated as holding stock of the issuer for various purposes. See, e.g., sections 318(a)(4), 382(k)(6), and 1504(a)(5). Similarly, an instrument treated as a stock right under these rules may be subject to special rules under other provisions of the Code or regulations relating to compensation related stock options. See, e.g., sections 83 and 421-424 and the regulations thereunder. Nor is any inference intended as to the treatment of an exchange, substitution, or assumption of such options under current law.

D. Proposed effective dates

The proposed regulations change a long-standing regulatory position. To afford taxpayers the opportunity to plan for the change, these regulations are proposed to be effective 60 days after the Treasury decision adopting these rules as final regulations is filed with the Office of the **Federal Register**.

E. Comments regarding need for further guidance

Comments are requested as to whether additional guidance is needed with respect to the scope of these regulations and the general treatment of rights to acquire stock. For example, comments are invited with respect to: the need for additional guidance or special rules to address transactions involving exchanges, substitutions, or assumptions of compensation related stock options; the application of section 306 to the transfer of a right to acquire common stock if the right is received tax-free pursuant to section 305 or 354; whether section 302 should apply to the cash settlement or repurchase of a stock right, for example by treating the holder as having purchased the stock pursuant to the terms of the right and the issuer as having then redeemed that stock for cash; and any other administrative guidance which may be helpful in light of these proposed rules, including suggestions as to existing revenue rulings or revenue procedures that should be modified, reconsidered, or revoked. Note that comments outside of the scope of these regulations will be considered as suggestions for other future guidance.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. Because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments submitted timely (in the manner described under the ADDRESSES caption) to the IRS. All comments will be available for public inspection and copying. A public hearing is scheduled for March 25, 1997, at 10 a.m., in the

Commissioner's Conference Room, room 3313. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons who wish to present oral comments at the hearing must submit an outline of the topics to be discussed by March 4, 1997.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is David B. Friedel, formerly of the Office of Assistant Chief Counsel (Corporate). However, other personnel from the IRS and Treasury Department participated in their development.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par 2. Section 1.354-1 is amended by revising paragraph (e) to read as follows:

§ 1.354-1 Exchanges of stock and securities in certain reorganizations.

(e) For purposes of section 354, the term securities includes rights issued by a party to the reorganization (the issuing corporation) to acquire its stock. For purposes of this section and section 356(d)(2)(B), a right to acquire stock has no principal amount. This paragraph (e) applies to exchanges occurring on or after the day that is 60 days after the Treasury decision adopting these regulations is filed with the Federal Register.

Par 3. Section 1.355-1 is amended by removing the last sentence of paragraph (b) and adding paragraph (c) to read as follows:

§ 1.355-1 Distribution of stock and securities of a controlled corporation.

(c) Stock rights. For purposes of section 355, the term securities includes rights to acquire the stock of the distributing corporation or the controlled corporation (the issuing corporation). For purposes of this section and section 356(d)(2)(B), a right to acquire stock has no principal amount. This paragraph (c) applies to distributions occurring on or after the day that is 60 days after the Treasury decision adopting these regulations is filed with the Federal Register.

Par 4. Section 1.356-3 is amended by:

- 1. Redesignating existing paragraph (b) as paragraph (c).
2. Adding a new paragraph (b) to read as follows:

§ 1.356-3 Rules for treatment of securities as "other property".

(b) For purposes of this section, a right to acquire stock of the issuing corporation is treated as a security with no principal amount. Thus, such right is not other property when received in a transaction to which section 356 applies (regardless of whether securities are surrendered in the exchange). This paragraph (b) applies to transactions occurring on or after the day that is 60 days after the Treasury decision adopting these regulations is filed with the Federal Register.

Margaret Milner Richardson, Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on December 20, 1996, 8:45 a.m., and published in the issue of the Federal Register for December 23, 1996, 61 F.R. 67508)