

Section 368.—Definitions Relating to Corporate Reorganizations

26 CFR 1.368-1: Purpose and scope of exception of reorganization exchanges.

T.D. 8783

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Continuity of Interest Requirement for Corporate Reorganizations

AGENCY: Internal Revenue Service
(IRS), Treasury

ACTION: Amendment to final regulations.

SUMMARY: This document amends final regulations providing guidance regarding satisfaction of the continuity of interest requirement for corporate reorganizations. The amendment to the final regulations affects corporations and their shareholders. This amendment to the final regulations is necessary to provide clarification regarding an example illustrating a relationship created in connection with a potential reorganization.

DATES: *Effective date:* This amendment is effective September 23, 1998.

Applicability date: This amendment applies to transactions occurring after January 28, 1998, except that it does not apply to any transaction occurring pursuant to a written agreement which is (subject to customary conditions) binding on January 28, 1998, and at all times thereafter.

FOR FURTHER INFORMATION CONTACT: Phoebe Bennett, (202) 622-7750 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On January 28, 1998, the IRS published final regulations (REG-252231-96) in the **Federal Register** (63 F.R. 4174) relating to the continuity of interest (COI) requirement.

Explanation of Provisions

The final COI regulation provides that acquisitions of target (T) stock for cash by a corporation related to the issuing corporation (P) generally do not preserve continuity of interest. See §1.368-1(e)(2). Two corporations are related if they are members of the same affiliated group as defined in section 1504, or if a purchase of P stock by another corporation would be treated as a distribution in redemption of P stock under section 304(a)(2). See §1.368-1(e)(3). A corporation will be treated as related to another corporation if such relationship exists immediately before or immediately after the acquisition of T stock, or if the relationship is created in connection with the potential reorganization. See §1.368-1(e)(3)(ii). Thus, a purchase by a corporation that was not initially related to P, but purchased T stock and became related to P in the potential reorganization, would not preserve continuity to the extent of the purchase.

Section 1.368-1(e)(6), *Example 2* was intended to illustrate this principle. In the example, A owns all of the stock of T. X, a corporation which owns 60 percent of the P stock and none of the T stock, buys A's T stock for cash prior to the merger of T into P. X exchanges the T stock for P stock in the merger which, when combined with X's prior ownership of P stock, constitutes 80 percent of the stock of P. The example shows that X is related to P because X becomes affiliated with P in the merger.

Section 1.338-2(c)(3) provides that, by virtue of section 338, COI is satisfied for certain persons if, following a qualified stock purchase (QSP) of T by the purchasing corporation, the purchasing corporation or a member of the purchasing corporation's affiliated group acquired the T assets. Commentators have questioned whether §1.338-2(c)(3) applies to the transaction described in *Example 2*. It is not intended that these final regulations provide guidance under section 338. To avoid any such implication, *Example 2* is amended so that X's acquisition of A's T stock is not a QSP.

In addition, the amendment to the final regulation illustrates the proper application of the related party rule that treats

two corporations as related if a purchase of P stock by another corporation would be treated as a distribution in redemption of P stock under section 304(a)(2). See §1.368-1(e)(3)(i). Commentators have questioned why, in *Example 2*, X is not already related to P under the section 304(a)(2) rule even before the merger, because X owned more than 50 percent of the P stock. Section 304(a)(2) requires that the issuing corporation control the acquiring corporation (within the meaning of section 304(c)). In *Example 2*, P is the issuing corporation and X is the acquiring corporation. X is not related to P under section 304(a)(2) because P does not control X; instead, X controls P. A sentence is added to *Example 2* to illustrate this point.

Applicability Date

The amendment to these final regulations applies to transactions occurring after January 28, 1998, except that it does not apply to any transaction occurring pursuant to a written agreement which is (subject to customary conditions) binding on January 28, 1998, and at all times thereafter.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because these regulations do 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 Internal Revenue Code, the notices of proposed rulemaking preceding these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of this amendment to the final regulations is Phoebe Bennett of the Office of the Assistant Chief Counsel (Corporate), IRS. However, other per-

sonnel from the IRS and Treasury Department participated in its development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is 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. In §1.368–1, paragraph (e)(6) Example 2 is revised to read as follows:

§1.368–1 Purpose and scope of exception of reorganization exchanges.

* * * * *

(e) * * *

(6) * * *

Example 2. Relationship created in connection with potential reorganization. Corporation X owns 60 percent of the stock of P and 30 percent of the stock of T. A owns the remaining 70 percent of the stock of T. X buys A's T stock for cash in a transaction which is not a qualified stock purchase within the meaning of section 338. T then merges into P. In the merger, X exchanges all of its T stock for additional stock of P. As a result of the issuance of the additional stock to X in the merger, X's ownership interest in P increases from 60 to 80 percent of the stock of P. X is not a person related to P under paragraph (e)(3)(i)(B) of this section, because a purchase of stock of P by X would not be treated as a distribution in redemption of the stock of P under section 304(a)(2). However, X is a person related to P under paragraphs (e)(3)(i)(A) and (ii)(B) of this section, because X becomes affiliated with P in the merger. The continuity of interest requirement is not satisfied, because X acquired a proprietary interest in T for consideration other than P stock, and a substantial part of the value of the proprietary interest in T is not preserved. See paragraph (e)(2) of this section.

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Michael P. Dolan,
*Deputy Commissioner of
Internal Revenue.*

Approved September 14, 1998.

Donald C. Lubick,
*Assistant Secretary of
the Treasury.*

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