

(5) *Installment obligations attributable to sales of certain property*—(i) *In general.* An installment obligation acquired by a liquidating corporation, to the extent attributable to the sale of property described in paragraph (c)(5)(ii) of this section, is not a qualifying obligation if the corporation is formed or availed of for a principal purpose of avoiding section 453(b)(2) (relating to dealer dispositions and certain other dispositions of personal property), section 453(i) (relating to sales of property subject to recapture), or section 453(k) (relating to dispositions under a revolving credit plan and sales of stock or securities traded on an established securities market) through the use of a party bearing a relationship, either directly or indirectly, described in section 267(b) to any shareholder of the corporation.

(ii) *Covered property.* Property is described in this paragraph (c)(5)(ii) if, within 12 months before or after the adoption of the plan of liquidation, the property was owned by any shareholder and—

(A) The shareholder regularly sold or otherwise disposed of personal property of the same type on the installment plan or the property is real property that the shareholder held for sale to customers in the ordinary course of a trade or business (provided the property is not described in section 453(l)(2) (relating to certain exceptions to the definition of dealer dispositions));

(B) The sale of the property by the shareholder would result in recapture income (within the meaning of section 453(i)(2)), but only if the amount of the recapture income is equal to or greater than 50 percent of the property's fair market value on the date of the sale by the corporation;

(C) The property is stock or securities that are traded on an established securities market; or

(D) The sale of the property by the shareholder would have been under a revolving credit plan.

(iii) *Safe harbor.* Paragraph (c)(5)(i) of this section will not apply to the liquidation of a corporation if, on the date the plan of complete liquidation is adopted and thereafter, less than 15 percent of the fair market value of the corporation's assets is attributable to property described in paragraph (c)(5)(ii) of this section.

(iv) *Example.* The provisions of this paragraph (c)(5) are illustrated by the following example:

Example. Ten percent of the fair market value of the assets of T is attributable to stock and securities traded on an established securities market. T owns no other assets described in paragraph (c)(5)(ii) of this

section. T, after adopting a plan of complete liquidation, sells all of its stock and securities holdings to C corporation in exchange for an installment obligation bearing adequate stated interest, sells all of its other assets to B corporation for cash, and distributes the cash and installment obligation to its sole shareholder, A, in a complete liquidation that satisfies section 453(h)(1)(A). Because the C installment obligation arose from a sale of publicly traded stock and securities, T cannot report the gain on the sale under the installment method pursuant to section 453(k)(2). In the hands of A, however, the C installment obligation is treated as having arisen out of a sale of the stock of T corporation. In addition, the general rule of paragraph (c)(5)(i) of this section does not apply, even if a principal purpose of the liquidation was the avoidance of section 453(k)(2), because the fair market value of the publicly traded stock and securities is less than 15 percent of the total fair market value of T's assets. Accordingly, section 453(k)(2) does not apply to A, and A may use the installment method to report the gain recognized on the payments it receives in respect of the obligation.

(d) *Liquidating distributions received in more than one taxable year.* If a qualifying shareholder receives liquidating distributions to which this section applies in more than one taxable year, the shareholder must reasonably estimate the gain attributable to distributions received in each taxable year. In allocating basis to calculate the gain for a taxable year, the shareholder must reasonably estimate the anticipated aggregate distributions. For this purpose, the shareholder must take into account distributions and other relevant events or information that the shareholder knows or reasonably could know up to the date on which the federal income tax return for that year is filed. If the gain for a taxable year is properly taken into account on the basis of a reasonable estimate and the exact amount is subsequently determined the difference, if any, must be taken into account for the taxable year in which the subsequent determination is made. However, the shareholder may file an amended return for the earlier year in lieu of taking the difference into account for the subsequent taxable year.

(e) *Effective date.* This section is applicable to distributions of qualifying installment obligations made on or after January 28, 1998.

Michael P. Dolan,

Deputy Commissioner of Internal Revenue.

Approved: December 18, 1997.

Donald C. Lubick,

Acting Assistant Secretary of the Treasury.

[FR Doc. 98-1820 Filed 1-27-98; 8:45 am]

BILLING CODE 4830-01-U

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 8760]

RIN 1545-AU72 and 1545-AU73

Continuity of Interest and Continuity of Business Enterprise

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations providing guidance regarding satisfaction of the continuity of interest and continuity of business enterprise requirements for corporate reorganizations. The final regulations affect corporations and their shareholders.

DATES: These regulations are effective January 28, 1998.

Applicability: These regulations apply to transactions occurring after January 28, 1998, except that they do 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: Regarding § 1.368-1(e) (continuity of interest) §§ 1.338-2 and 1.368-1 (a) and (b): Phoebe Bennett, (202) 622-7750 (not a toll-free number); regarding § 1.368-1(d) (continuity of business enterprise) and, §§ 1.368-1 (a) and (b), 1.368-2(k): Marlene Peake Oppenheim, (202) 622-7750 (not a toll free number).

SUPPLEMENTARY INFORMATION:

Background

On December 23, 1996, the IRS published a notice of proposed rulemaking (REG-252231-96) in the **Federal Register** (61 FR 67512) relating to the continuity of interest (COI) requirement (proposed COI regulations). On January 3, 1997, the IRS published a notice of proposed rulemaking (REG-252233-96) in the **Federal Register** (62 FR 36101) (proposed COBE regulations) relating to (1) the continuity of business enterprise (COBE) requirement; and (2) transfers of acquired assets or stock following certain otherwise qualifying reorganizations (remote continuity of interest). Many written comments were received in response to these notices of proposed rulemaking. A public hearing on both proposed regulations was held on May 7, 1997. After consideration of all comments, the regulations proposed by REG-252231-96 and REG-252233-96 are adopted as revised by this

Treasury decision, along with temporary regulations and proposed regulations cross-referencing the temporary regulations regarding COI published elsewhere in this issue of the **Federal Register**.

Explanation of Provisions

The Internal Revenue Code of 1986 provides general nonrecognition treatment for reorganizations specifically described in section 368. In addition to complying with the statutory requirements and certain other requirements, a transaction generally must satisfy the continuity of interest requirement and the continuity of business enterprise requirement.

A. Continuity of Interest

The purpose of the continuity of interest requirement is to prevent transactions that resemble sales from qualifying for nonrecognition of gain or loss available to corporate reorganizations. The final regulations provide that the COI requirement is satisfied if in substance a substantial part of the value of the proprietary interest in the target corporation (T) is preserved in the reorganization. A proprietary interest in T is preserved if, in a potential reorganization, it is exchanged for a proprietary interest in the issuing corporation (P), it is exchanged by the acquiring corporation for a direct interest in the T enterprise, or it otherwise continues as a proprietary interest in T. The *issuing corporation* means the acquiring corporation (as the term is used in section 368(a)), except that, in determining whether a reorganization qualifies as a triangular reorganization (as defined in § 1.358-6(b)(2)), the *issuing corporation* means the corporation in control of the acquiring corporation. However, a proprietary interest in T is not preserved if, in connection with the potential reorganization, it is acquired by P for consideration other than P stock, or P stock furnished in exchange for a proprietary interest in T if the potential reorganization is redeemed. All facts and circumstances must be considered in determining whether, in substance, a proprietary interest in T is preserved.

Rationale for the COI Regulations

The proposed and final regulations permit former T shareholders to sell P stock received in a potential reorganization to third parties without causing the reorganization to fail to satisfy the COI requirement. Some commentators have questioned whether the regulations are consistent with existing authorities.

The COI requirement was applied first to reorganization provisions that did not specify that P exchange a proprietary interest in P for a proprietary interest in T. Supreme Court cases imposed the COI requirement to further Congressional intent that tax-free status be accorded only to transactions where P exchanges a substantial proprietary interest in P for a proprietary interest in T held by the T shareholders rather than to transactions resembling sales. See *LeTulle v. Scofield*, 308 U.S. 415 (1940); *Helvering v. Minnesota Tea Co.*, 296 U.S. 378 (1935); *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933). See also *Cortland Specialty Co. v. Commissioner*, 60 F.2d 937 (2d Cir. 1932), *cert. denied* 288 U.S. 599 (1933).

None of the Supreme Court cases establishing the COI requirement addressed the issue of whether sales by former T shareholders of P stock received in exchange for T stock in the potential reorganization cause the COI requirement to fail to be satisfied. Since then, however, some courts have premised decisions on the assumption that sales of P stock received in exchange for T stock in the potential reorganization may cause the COI requirement to fail to be satisfied. *McDonald's Restaurants of Illinois, Inc. v. Commissioner*, 688 F.2d 520 (7th Cir. 1982); *Penrod v. Commissioner*, 88 T.C. 1415 (1987); *Heintz v. Commissioner*, 25 T.C. 132 (1955), *nonacq.*, 1958-2 C.B. 9; *Estate of Elizabeth Christian v. Commissioner*, 57 T.C.M. (CCH) 1231 (1989). The apparent focus of these cases is on whether the T shareholders intended on the date of the potential reorganization to sell their P stock and the degree, if any, to which P facilitates the sale. Based on an intensive inquiry into nearly identical facts, some of these cases held that as a result of the subsequent sale the potential reorganization did not satisfy the COI requirement; others held that satisfaction of the COI requirement was not adversely affected by the subsequent sale. The IRS and Treasury Department have concluded that the law as reflected in these cases does not further the principles of reorganization treatment and is difficult for both taxpayers and the IRS to apply consistently.

Therefore, consistent with Congressional intent and the Supreme Court precedent which distinguishes between sales and reorganizations, the final regulations focus the COI requirement generally on exchanges between the T shareholders and P. Under this approach, sales of P stock by former T shareholders generally are disregarded.

The final regulations will greatly enhance administrability in this area by both taxpayers and the government. The regulations will prevent "whipsaw" of the government, such as where the former T shareholders treat the transaction as a tax-free reorganization, and P later disavows reorganization treatment to step up its basis in the T assets based on the position that sales of P stock by the former T shareholders did not satisfy the COI requirement. See, e.g., *McDonald's Restaurants, supra*. In addition, this approach will prevent unilateral sales of P stock by former majority T shareholders from adversely affecting the section 354 nonrecognition treatment expected by former minority T shareholders.

Dispositions of T Stock

The proposed COI regulations do not specifically address the effect upon COI of dispositions of T stock prior to a potential reorganization, but ask for comments on that issue. The IRS and Treasury Department believe that issues concerning the COI requirement raised by dispositions of T stock before a potential reorganization correspond to those raised by subsequent dispositions of P stock furnished in exchange for T stock in the potential reorganization. As requested by commentators, the final regulations apply the rationale of the proposed COI regulations to transactions occurring both prior to and after a potential reorganization. Cf. *J.E. Seagram Corp. v. Commissioner*, 104 T.C. 75 (1995) (sales of T stock prior to a potential reorganization do not affect COI if not part of the plan of reorganization). The final regulations provide that, for COI purposes, a mere disposition of T stock prior to a potential reorganization to persons not related to P is disregarded and a mere disposition of P stock received in a potential reorganization to persons not related to P is disregarded. But see § 1.368-1T(e)(1)(ii)(A) and (B).

In soliciting comments on the effect upon COI of dispositions of T stock prior to a potential reorganization, the preamble to the proposed COI regulations specifically requests comments on *King Enterprises, Inc. v. United States*, 418 F.2d 511 (Ct. Cl. 1969) (COI requirement satisfied where, pursuant to a plan, P acquires the T stock for 51 percent P stock and 49 percent debt and cash, and T merges upstream into P), and *Yoc Heating Corp. v. Commissioner*, 61 T.C. 168 (1973) (COI requirement not satisfied where, pursuant to a plan, P acquires 85 percent of the T stock for cash and notes, and T merges into P's newly formed subsidiary with minority

shareholders receiving cash). Consistent with these cases, where the step transaction doctrine applies to link T stock purchases with later acquisitions of T, the final regulations provide that a proprietary interest in T is not preserved if, in connection with the potential reorganization, it is acquired by P for consideration other than P stock. Whether a stock acquisition is made in connection with a potential reorganization will be determined based on the facts and circumstances of each case. See generally § 1.368-1(a). This regulation does not address the effect, if any, of section 338 on corporate transactions (except for conforming changes to § 1.338-2(c)(3)). See generally § 1.338-2(c)(3) (certain tax effects of a qualified stock purchase without a section 338 election on the post-acquisition elimination of T).

Related Person Rule

The proposed COI regulations provide that "[i]n determining whether [COI is satisfied], all facts and circumstances must be considered, including any plan or arrangement for the acquiring corporation or its successor corporation (or a person related to the acquiring corporation or its successor corporation within the meaning of section 707(b)(1) or 267(b) (without regard to section 267(e))) to redeem or acquire the consideration provided in the reorganization." The final regulations provide a more specific rule that a proprietary interest in T is not preserved if, in connection with a potential reorganization, a person related (as defined below) to P acquires, with consideration other than a proprietary interest in P, T stock or P stock furnished in exchange for a proprietary interest in T in the potential reorganization. The IRS and Treasury Department believe, however, that certain related party acquisitions preserve a proprietary interest in T and therefore, the rule includes an exception to the related party rule. Under this exception, a proprietary interest in T is preserved to the extent those persons who were the direct or indirect owners of T prior to the potential reorganization maintain a direct or indirect proprietary interest in P. See, e.g., Rev. Rul. 84-30 (1984-1 C.B. 114).

Commentators stated that the proposed COI regulations' rule, which employs sections 707(b)(1) and 267(b) to define persons related to P, is too broad. In response, the final regulations adopt a narrower related person definition which has two components in order to address two separate concerns.

First, the IRS and Treasury Department were concerned that

acquisitions of T or P stock by a member of P's affiliated group were no different in substance from an acquisition or redemption by P, because of the existence of various provisions in the Code that permit members to transfer funds to other members without significant tax consequences. Accordingly, § 1.368-1(e)(3)(i)(A) includes as related persons corporations that are members of the same affiliated group under section 1504, without regard to the exceptions in section 1504(b).

Second, because the final regulations take into account whether, in substance, P has redeemed the stock it exchanged for T stock in the potential reorganization, the final regulations treat two corporations as related persons if a purchase of the stock of one corporation by another corporation would be treated as a distribution in redemption of the stock of the first corporation under section 304(a)(2) (determined without regard to § 1.1502-80(b)).

Because the final regulations focus generally on the consideration P exchanges, related persons do not include individual or other noncorporate shareholders. Thus, the IRS will no longer apply the holdings of *South Bay Corporation v. Commissioner*, 345 F.2d 698 (2d Cir. 1965), and *Superior Coach of Florida, Inc. v. Commissioner*, 80 T.C. 895 (1983), to transactions governed by these regulations.

T Stock Not Acquired in Connection With a Potential Reorganization

Commentators requested clarification of whether P must actually furnish stock to T shareholders that own T stock which was not acquired in connection with a potential reorganization. The final regulations provide that a proprietary interest in T is preserved if it is exchanged by the acquiring corporation (which may or may not also be P) for a direct interest in the T enterprise, or otherwise continues as a proprietary interest in T.

Redemptions of T Stock or Extraordinary Distributions With Respect to T Stock

In addition to the final regulations, the IRS and Treasury Department are contemporaneously issuing temporary regulations and proposed regulations cross-referencing the temporary regulations published elsewhere in this issue of the **Federal Register** with the same effective date as these final regulations. The temporary and proposed regulations provide that a proprietary interest in T is not preserved

if, in connection with a potential reorganization, it is redeemed or acquired by a person related to T, or to the extent that, prior to and in connection with a potential reorganization, an extraordinary distribution is made with respect to it.

Transactions Following a Qualified Stock Purchase

As stated above, these final regulations focus the COI requirement generally on exchanges between the T shareholders and P. Accordingly, the language of § 1.338-2(c)(3) is conformed to these final COI regulations to treat the stock of T acquired by the purchasing corporation in the qualified stock purchase as though it was not acquired in connection with the transfer of the T assets.

Effect on Other Authorities

The IRS and Treasury Department continue to study the role of the COI requirement in section 368(a)(1)(D) reorganizations and section 355 transactions. Therefore, these final COI regulations do not apply to section 368(a)(1)(D) reorganizations and section 355 transactions. See § 1.355-2(c).

These COI regulations apply solely for purposes of determining whether the COI requirement is satisfied. No inference should be drawn from any provision of this regulation as to whether other reorganization requirements are satisfied, for example, whether P has issued solely voting stock for purposes of section 368(a)(1)(B) or (C).

Effect on Other Documents

Rev. Proc. 77-37 (1977-2 C.B. 568) and Rev. Proc. 86-42 (1986-2 C.B. 722) will be modified to the extent inconsistent with these regulations.

Rev. Rul. 66-23 (1966-1 C.B. 67) is hereby obsoleted because it indicates that a plan or arrangement in connection with a potential reorganization for disposition of stock to unrelated persons does not satisfy the COI requirement.

B. Continuity of Business Enterprise

The COBE requirement is fundamental to the notion that tax-free reorganizations merely readjust continuing interests in property. In § 1.368-1(d), as effective prior to these final regulations, COBE generally required the acquiring corporation to either continue a significant historic T business or use a significant portion of T's historic business assets in a business. However, a valid reorganization may qualify as tax-free even if the acquiring corporation does

not directly carry on the historic T business or use the historic T assets in a business. See section 368(a)(2)(C). See also Rev. Rul. 68-261 (1968-1 C.B. 147); Rev. Rul. 81-247 (1981-1 C.B. 87).

Consistent with the view that the acquiring corporation need not directly conduct the T business or use the T assets, the final regulations provide rules under which, in an otherwise qualifying corporate reorganization, the assets and the businesses of the members of a qualified group of corporations are treated as assets and businesses of the issuing corporation. Accordingly, in the final regulations, COBE requires that the issuing corporation either continue T's historic business or use a significant portion of T's historic business assets in a business.

A qualified group is one or more chains of corporations connected through stock ownership with the issuing corporation, but only if the issuing corporation owns directly stock meeting the requirements of section 368(c) in at least one of the corporations, and stock meeting the requirements of section 368(c) in each of the corporations is owned directly by one of the other corporations.

The judicial continuity of interest doctrine historically included a concept commonly known as remote continuity of interest. Commonly viewed as arising out of *Groman v. Commissioner*, 302 U.S. 82 (1937), and *Helvering v. Bashford*, 302 U.S. 454 (1938), remote continuity of interest focuses on the link between the T shareholders and the former T business assets following the reorganization. In § 1.368-1(d), as effective prior to these final regulations, COBE focuses on the continuation of T's business, or the use of T's business assets, by the acquiring corporation. Section 1.368-1(d), as revised herein, expands this concept by treating the issuing corporation as conducting a T business or owning T business assets if these activities are conducted by a member of the qualified group or, in certain cases, by a partnership that has a member of the qualified group as a partner.

The proposed COBE regulations separately address COBE (§ 1.368-1(d)) and remote continuity of interest (§ 1.368-1(f)). The IRS and Treasury Department believe the COBE requirements adequately address the issues raised in *Groman* and *Bashford* and their progeny. Thus, these final regulations do not separately articulate rules addressing remote continuity of interest.

Definition of the Qualified Group

The proposed COBE regulations define the qualified group using a control test based on section 368(c). The IRS and Treasury Department received comments suggesting the replacement of the section 368(c) definition of control by the affiliated group definition of control stated in section 1504, without regard to section 1504(b). However, because section 368 generally determines control by reference to section 368(c), the final regulations retain the approach of the proposed COBE regulations.

Rules for Aggregation of Interests in Historic T Assets and Businesses Held in Partnership Solution

In determining whether COBE is satisfied, the proposed COBE regulations aggregate the interests of the members of a qualified group. In addition, the proposed COBE regulations attribute a business of a partnership to a corporate transferor partner if the partner has a sufficient nexus with that partnership business. However, the proposed COBE regulations only consider the transferor partner's interest in the partnership business, and do not aggregate this interest with interests in the partnership held by other members of the qualified group.

In response to comments requesting a partnership aggregation rule, the final regulations, through a system of attribution, aggregate the interests in a partnership business held by all the members of a qualified group. The final regulations provide rules under which a corporate partner may be treated as holding assets of a business of a partnership. Additionally, P is treated as holding all the assets, and conducting all the businesses of its qualified group. Furthermore, in certain circumstances, P will be treated as conducting a business of a partnership. Once the relevant T businesses and T assets are attributed to P, COBE is tested under the general rule of the final COBE regulations. See § 1.368-1(d)(1).

The proposed COBE regulations do not discuss tiered partnerships. In response to comments, the final regulations provide guidance on this issue. See § 1.368-1(d)(5), *Example 12*.

C. Transfers of Assets or Stock to Controlled Corporations as Part of a Plan of Reorganization

The proposed COBE regulations are limited in their application to COBE and remote continuity of interest. The rules of the proposed COBE regulations provide that for certain reorganizations,

transfers of acquired assets or stock among members of the qualified group, and in certain cases, transfers of acquired assets to partnerships, do not disqualify a transaction from satisfying the COBE and remote continuity of interest requirements. The preamble to the proposed COBE regulations states that these rules do not address any other issues concerning the qualification of a transaction as a reorganization.

Comments suggest that the proposed COBE regulations are ambiguous as they could be interpreted to mean that a transfer of stock or assets to a qualified group member after an otherwise tax-free reorganization would be given independent significance and the step transaction doctrine would not apply. Under such an interpretation, the potential reorganization would not be recast as a taxable acquisition or another type of reorganization. To eliminate this ambiguity, § 1.368-1(a) of the final regulations provides that, in determining whether a transaction qualifies as a reorganization under section 368(a), the transaction must be evaluated under relevant provisions of law, including the step transaction doctrine. Section 1.368-1(d) of the final regulations is limited to a discussion of the COBE requirement, and does not address satisfaction of the explicit statutory requirements of a reorganization, which is the subject of § 1.368-2. However, § 1.368-2(k) of the final regulations does provide guidance in this regard, extending the application of section 368(a)(2)(C) to certain successive transfers.

Section 1.368-2(k) of the final regulations states that a transaction otherwise qualifying under section 368(a)(1) (A), (B), (C), or (G) (where the requirements of sections 354(b)(1) (A) and (B) are met) shall not be disqualified by reason of the fact that part or all of the acquired assets or stock acquired in the transaction are transferred or successively transferred to one or more corporations controlled in each transfer by the transferor corporation. Control is defined under section 368(c). The final regulations also provide a rule for transfers of assets following a reorganization qualifying under section 368(a)(1)(A) by reason of section 368(a)(2)(E). No inference is to be drawn as to whether transactions not described in § 1.368-2(k) otherwise qualify as reorganizations.

The final regulations also provide that, if a transaction otherwise qualifies as a reorganization, a corporation remains a party to the reorganization even though stock or assets acquired in the reorganization are transferred in a transaction described in § 1.368-2(k).

See § 1.368-2(f). Furthermore, if a transaction otherwise qualifies as a reorganization, a corporation shall not cease to be a party to the reorganization solely because acquired assets are transferred to a partnership in which the transferor is a partner if the COBE requirement is satisfied.

Section 368(a)(1)(D), 368(a)(1)(F), and 355 Transactions

The proposed COBE regulations, applying only to the COBE and remote continuity of interest requirements, are limited to transactions otherwise qualifying for reorganization treatment under section 368(a)(1) (A), (B), (C), or (G) (where the requirements of sections 354(b)(1) (A) and (B) are met). The IRS and Treasury Department received comments stating that the final regulations should apply to reorganizations qualifying under section 368(a)(1) (D) or (F) or to transactions qualifying under section 355.

The final regulations do not limit the application of § 1.368-1(d) to the transactions enumerated in section 368(a)(2)(C). The COBE provisions in the final regulations apply to all reorganizations for which COBE is relevant.

Section 1.368-2(k)(1) of the final regulations, however, is limited in its application to the transactions described in section 368(a)(2)(C), and does not apply in determining whether a reorganization qualifies under section 368(a)(1)(D), section 368(a)(1)(F), or section 355. The IRS and Treasury Department believe that further study is needed prior to extending § 1.368-2(k)(1) to one or more of these provisions.

Effective Date

The amendments to these regulations apply to transactions occurring after January 28, 1998, except that they do 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. Commentators requested that the effective date be changed to allow these regulations to apply to transactions occurring on or before January 28, 1998. The IRS and Treasury Department believe that adopting an earlier effective date increases the likelihood that T, P, and each of the former T shareholders would report the transaction inconsistently (in some cases using hindsight), and would reduce administrability of the regulation. No inference should be drawn from any provision of this regulation as to application of the COI

or COBE requirements to transactions occurring on or before January 28, 1998.

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 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 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 authors of these regulations are Phoebe Bennett, regarding § 1.368-1(e) (continuity of interest), and Marlene Peake Oppenheim, regarding § 1.368-1(d) (continuity of business enterprise) and § 1.368-2(k), both of the Office of the Assistant Chief Counsel (Corporate), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

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. Section 1.338-2 is amended:

1. By revising paragraph (c)(3)(ii).

2. In paragraph (c)(3)(iv) example, by revising the first sentence of paragraph (B).

The revisions read as follows:

§ 1.338-2 Miscellaneous issues under section 338.

* * * * *

(c) * * *

(3) * * *

(ii) *Continuity of interest.* By virtue of section 338, in determining whether the continuity of interest requirement of § 1.368-1 (b) and (e) is satisfied on the

transfer of assets from target to the transferee, the purchasing corporation's target stock acquired in the qualified stock purchase shall be treated as though it was not acquired in connection with the transfer of target assets.

* * * * *

(iv) *Example.* * * *

(B) *Status of transfer as a reorganization.* By virtue of section 338, for the purpose of determining whether the continuity of interest requirement of § 1.368-1(b) is satisfied, P's T stock acquired in the qualified stock purchase shall be treated as though it was not acquired in connection with the transfer of T assets to X. * * *

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Par. 3. Section 1.368-1 is amended by:

1. Adding three sentences immediately following the first sentence of paragraph (a).

2. Removing the third sentence and adding four sentences in its place to paragraph (b).

3. Removing paragraph (d)(1).

4. Redesignating paragraphs (d)(2), (d)(3), and (d)(4) as paragraphs (d)(1), (d)(2), and (d)(3), respectively.

5. Removing the first sentence of newly designated paragraph (d)(1) and adding two sentences in its place.

6. Adding new paragraph (d)(4).

7. Paragraph (d)(5) is amended by:

a. Adding two sentences to the end of paragraph (d)(5) introductory text.

b. Removing the parentheses around the numbers in the paragraph headings for *Example (1)* through *Example (5)*.

c. Adding *Example 6* through *Example 12*.

8. Adding paragraph (e).

The additions and revisions read as follows:

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

(a) * * * In determining whether a transaction qualifies as a reorganization under section 368(a), the transaction must be evaluated under relevant provisions of law, including the step transaction doctrine. But see §§ 1.368-2 (f) and (k) and 1.338-2(c)(3). The preceding two sentences apply to transactions occurring after January 28, 1998, except that they do not apply to any transaction occurring pursuant to a written agreement which is binding on January 28, 1998, and at all times thereafter. * * *

(b) * * * Requisite to a reorganization under the Internal Revenue Code are a continuity of the business enterprise through the issuing corporation under the modified corporate form as described in paragraph (d) of this

section, and (except as provided in section 368(a)(1)(D)) a continuity of interest as described in paragraph (e) of this section. (For rules regarding the continuity of interest requirement under section 355, see § 1.355-2(c).) For purposes of this section, the term *issuing corporation* means the acquiring corporation (as that term is used in section 368(a)), except that, in determining whether a reorganization qualifies as a triangular reorganization (as defined in § 1.358-6(b)(2)), the issuing corporation means the corporation in control of the acquiring corporation. The preceding three sentences apply to transactions occurring after January 28, 1998, except that they do not apply to any transaction occurring pursuant to a written agreement which is binding on January 28, 1998, and at all times thereafter.

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* * * * *

(d) *Continuity of business enterprise*—

(1) *General rule.* Continuity of business enterprise (COBE) requires that the issuing corporation (P), as defined in paragraph (b) of this section, either continue the target corporation's (T's) historic business or use a significant portion of T's historic business assets in a business. The preceding sentence 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 binding on January 28, 1998, and at all times thereafter. * * *

* * * * *

(4) *Acquired assets or stock held by members of the qualified group or partnerships.* The following rules apply in determining whether the COBE requirement of paragraph (d)(1) of this section is satisfied:

(i) *Businesses and assets of members of a qualified group.* The issuing corporation is treated as holding all of the businesses and assets of all of the members of the qualified group, as defined in paragraph (d)(4)(ii) of this section.

(ii) *Qualified group.* A qualified group is one or more chains of corporations connected through stock ownership with the issuing corporation, but only if the issuing corporation owns directly stock meeting the requirements of section 368(c) in at least one other corporation, and stock meeting the requirements of section 368(c) in each of the corporations (except the issuing corporation) is owned directly by one of the other corporations.

(iii) *Partnerships*—(A) *Partnership assets.* Each partner of a partnership will be treated as owning the T business

assets used in a business of the partnership in accordance with that partner's interest in the partnership.

(B) *Partnership businesses.* The issuing corporation will be treated as conducting a business of a partnership if —

(1) Members of the qualified group, in the aggregate, own an interest in the partnership representing a significant interest in that partnership business; or

(2) One or more members of the qualified group have active and substantial management functions as a partner with respect to that partnership business.

(C) *Conduct of the historic T business in a partnership.* If a significant historic T business is conducted in a partnership, the fact that P is treated as conducting such T business under paragraph (d)(4)(iii)(B) of this section tends to establish the requisite continuity, but is not alone sufficient.

(iv) *Effective date.* This paragraph (d)(4) 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 binding on January 28, 1998, and at all times thereafter.

(5) * * * All corporations have only one class of stock outstanding. The preceding sentence and paragraph (d)(5) *Example 6* through *Example 12* apply to transactions occurring after January 28, 1998, except that they do not apply to any transaction occurring pursuant to a written agreement which is binding on January 28, 1998, and at all times thereafter.

* * * * *

Example 6. Use of a significant portion of T's historic business assets by the qualified group. (i) *Facts.* T operates an auto parts distributorship. P owns 80 percent of the stock of a holding company (HC). HC owns 80 percent of the stock of ten subsidiaries, S-1 through S-10. S-1 through S-10 each separately operate a full service gas station. Pursuant to a plan of reorganization, T merges into P and the T shareholders receive solely P stock. As part of the plan of reorganization, P transfers T's assets to HC, which in turn transfers some of the T assets to each of the ten subsidiaries. No one subsidiary receives a significant portion of T's historic business assets. Each of the subsidiaries will use the T assets in the operation of its full service gas station. No P subsidiary will be an auto parts distributor.

(ii) *Continuity of business enterprise.* Under paragraph (d)(4)(i) of this section, P is treated as conducting the ten gas station businesses of S-1 through S-10 and as holding the historic T assets used in those businesses. P is treated as holding all the assets and conducting the businesses of all of the members of the qualified group, which includes S-1 through S-10 (paragraphs (d)(4)(i) and (ii) of this section). No member

of the qualified group continues T's historic distributorship business. However, subsidiaries S-1 through S-10 continue to use the historic T assets in a business. Even though no one corporation of the qualified group is using a significant portion of T's historic business assets in a business, the COBE requirement of paragraph (d)(1) of this section is satisfied because, in the aggregate, the qualified group is using a significant portion of T's historic business assets in a business.

Example 7. Continuation of the historic T business in a partnership satisfies continuity of business enterprise. (i) *Facts.* T manufactures ski boots. P owns all of the stock of S-1. S-1 owns all of the stock of S-2, and S-2 owns all of the stock of S-3. T merges into P and the T shareholders receive consideration consisting of P stock and cash. The T ski boot business is to be continued and expanded. In anticipation of this expansion, P transfers all of the T assets to S-1. S-1 transfers all of the T assets to S-2, and S-2 transfers all of the T assets to S-3. S-3 and X (an unrelated party) form a new partnership (PRS). As part of the plan of reorganization, S-3 transfers all the T assets to PRS, and S-3, in its capacity as a partner, performs active and substantial management functions for the PRS ski boot business, including making significant business decisions and regularly participating in the overall supervision, direction, and control of the employees of the ski boot business. S-3 receives a 20 percent interest in PRS. X transfers cash in exchange for an 80 percent interest in PRS.

(ii) *Continuity of business enterprise.* Under paragraph (d)(4)(iii)(B)(2) of this section, P is treated as conducting T's historic business because S-3 performs active and substantial management functions for the ski boot business in S-3's capacity as a partner. P is treated as holding all the assets and conducting the businesses of all of the members of the qualified group, which includes S-3 (paragraphs (d)(4)(i) and (ii) of this section). The COBE requirement of paragraph (d)(1) of this section is satisfied.

Example 8. Continuation of the historic T business in a partnership does not satisfy continuity of business enterprise. (i) *Facts.* The facts are the same as *Example 7* except that S-3 transfers the historic T business to PRS in exchange for a 1 percent interest in PRS.

(ii) *Continuity of business enterprise.* Under paragraph (d)(4)(iii)(B)(2) of this section, P is treated as conducting T's historic business because S-3 performs active and substantial management functions for the ski boot business in S-3's capacity as a partner. The fact that a significant historic T business is conducted in PRS, and P is treated as conducting such T business under (d)(4)(iii)(B) tends to establish the requisite continuity, but is not alone sufficient (paragraph (d)(4)(iii)(C) of this section). The COBE requirement of paragraph (d)(1) of this section is not satisfied.

Example 9. Continuation of the T historic business in a partnership satisfies continuity of business enterprise. (i) *Facts.* The facts are the same as *Example 7* except that S-3 transfers the historic T business to PRS in

exchange for a 33⅓ percent interest in PRS, and no member of P's qualified group performs active and substantial management functions for the ski boot business operated in PRS.

(ii) *Continuity of business enterprise.* Under paragraph (d)(4)(iii)(B)(I) of this section, P is treated as conducting T's historic business because S-3 owns an interest in the partnership representing a significant interest in that partnership business. P is treated as holding all the assets and conducting the businesses of all of the members of the qualified group, which includes S-3 (paragraphs (d)(4)(i) and (ii) of this section). The COBE requirement of paragraph (d)(1) of this section is satisfied.

Example 10. Use of T's historic business assets in a partnership business. (i) *Facts.* T is a fabric distributor. P owns all of the stock of S-1. T merges into P and the T shareholders receive solely P stock. S-1 and X (an unrelated party) own interests in a partnership (PRS). As part of the plan of reorganization, P transfers all of the T assets to S-1, and S-1 transfers all the T assets to PRS, increasing S-1's percentage interest in PRS from 5 to 33⅓ percent. After the transfer, X owns the remaining 66⅔ percent interest in PRS. Almost all of the T assets consist of T's large inventory of fabric, which PRS uses to manufacture sportswear. All of the T assets are used in the sportswear business. No member of P's qualified group performs active and substantial management functions for the sportswear business operated in PRS.

(ii) *Continuity of business enterprise.* Under paragraph (d)(4)(iii)(A) of this section, S-1 is treated as owning 33⅓ percent of the T assets used in the PRS sportswear manufacturing business. Under paragraph (d)(4)(iii)(B)(I) of this section, P is treated as conducting the sportswear manufacturing business because S-1 owns an interest in the partnership representing a significant interest in that partnership business. P is treated as holding all the assets and conducting the businesses of all of the members of the qualified group, which includes S-1 (paragraphs (d)(4)(i) and (ii) of this section). The COBE requirement of paragraph (d)(1) of this section is satisfied.

Example 11. Aggregation of partnership interests among members of the qualified group: use of T's historic business assets in a partnership business. (i) *Facts.* The facts are the same as *Example 10*, except that S-1 transfers all the T assets to PRS, and P and X each transfer cash to PRS in exchange for partnership interests. After the transfers, P owns 11 percent, S-1 owns 22⅓ percent, and X owns 66⅔ percent of PRS.

(ii) *Continuity of business enterprise.* Under paragraph (d)(4)(iii)(B)(I) of this section, P is treated as conducting the sportswear manufacturing business because members of the qualified group, in the aggregate, own an interest in the partnership representing a significant interest in that business. P is treated as owning 11 percent of the assets directly, and S-1 is treated as owning 22⅓ percent of the assets, used in the PRS sportswear business (paragraph (d)(4)(iii)(A) of this section). P is treated as holding all the assets of all of the members

of the qualified group, which includes S-1, and thus in the aggregate, P is treated as owning 33⅓ percent of the T assets (paragraphs (d)(4)(i) and (ii) of this section). The COBE requirement of paragraph (d)(1) of this section is satisfied because P is treated as using a significant portion of T's historic business assets in its sportswear manufacturing business.

Example 12. Tiered partnerships: use of T's historic business assets in a partnership business. (i) *Facts.* T owns and manages a commercial office building in state Z. Pursuant to a plan of reorganization, T merges into P, solely in exchange for P stock, which is distributed to the T shareholders. P transfers all of the T assets to a partnership, PRS-1, which owns and operates television stations nationwide. After the transfer, P owns a 50 percent interest in PRS-1. P does not have active and substantial management functions as a partner with respect to the PRS-1 business. X, not a member of P's qualified group, owns the remaining 50 percent interest in PRS-1. PRS-1, in an effort to expand its state Z television operation, enters into a joint venture with U, an unrelated party. As part of the plan of reorganization, PRS-1 transfers all the T assets and its state Z television station to PRS-2, in exchange for a 75 percent partnership interest. U contributes cash to PRS-2 in exchange for a 25 percent partnership interest and oversees the management of the state Z television operation. PRS-1 does not actively and substantially manage PRS-2's business. PRS-2's state Z operations are moved into the acquired T office building. All of the assets that P acquired from T are used in PRS-2's business.

(ii) *Continuity of business enterprise.* Under paragraph (d)(4)(iii)(A) of this section, PRS-1 is treated as owning 75 percent of the T assets used in PRS-2's business. P, in turn, is treated as owning 50 percent of PRS-1's interest in the T assets. Thus, P is treated as owning 37½ percent (50 percent x 75 percent) of the T assets used in the PRS-2 business. Under paragraph (d)(4)(iii)(B)(I) of this section, P is treated as conducting PRS-2's business, the operation of the state Z television station, and under paragraph (d)(4)(iii)(A) of this section, P is treated as using 37½ percent of the historic T business assets in that business. The COBE requirement of paragraph (d)(1) of this section is satisfied because P is treated as using a significant portion of T's historic business assets in its television business.

(e) *Continuity of interest—(1) General rule.* (i) The purpose of the continuity of interest requirement is to prevent transactions that resemble sales from qualifying for nonrecognition of gain or loss available to corporate reorganizations. Continuity of interest requires that in substance a substantial part of the value of the proprietary interests in the target corporation be preserved in the reorganization. A proprietary interest in the target corporation is preserved if, in a potential reorganization, it is exchanged

for a proprietary interest in the issuing corporation (as defined in paragraph (b) of this section), it is exchanged by the acquiring corporation for a direct interest in the target corporation enterprise, or it otherwise continues as a proprietary interest in the target corporation. However, a proprietary interest in the target corporation is not preserved if, in connection with the potential reorganization, it is acquired by the issuing corporation for consideration other than stock of the issuing corporation, or stock of the issuing corporation furnished in exchange for a proprietary interest in the target corporation in the potential reorganization is redeemed. All facts and circumstances must be considered in determining whether, in substance, a proprietary interest in the target corporation is preserved. For purposes of the continuity of interest requirement, a mere disposition of stock of the target corporation prior to a potential reorganization to persons not related (as defined in paragraph (e)(3) of this section determined without regard to paragraph (e)(3)(i)(A) of this section) to the target corporation or to persons not related (as defined in paragraph (e)(3) of this section) to the issuing corporation is disregarded and a mere disposition of stock of the issuing corporation received in a potential reorganization to persons not related (as defined in paragraph (e)(3) of this section) to the issuing corporation is disregarded.

(ii) [Reserved] For further guidance see § 1.368-1T(e)(1)(ii)(A) and (B).

(2) *Related person acquisitions.* (i) A proprietary interest in the target corporation is not preserved if, in connection with a potential reorganization, a person related (as defined in paragraph (e)(3) of this section) to the issuing corporation acquires, with consideration other than a proprietary interest in the issuing corporation, stock of the target corporation or stock of the issuing corporation furnished in exchange for a proprietary interest in the target corporation in the potential reorganization, except to the extent those persons who were the direct or indirect owners of the target corporation prior to the potential reorganization maintain a direct or indirect proprietary interest in the issuing corporation.

(ii) [Reserved] For further guidance see § 1.368-1T(e)(2)(ii).

(3) *Definition of related person—(i) In general.* For purposes of this paragraph (e), two corporations are related persons if either—

(A) The corporations are members of the same affiliated group as defined in

section 1504 (determined without regard to section 1504(b)); or

(B) A purchase of the stock of one corporation by another corporation would be treated as a distribution in redemption of the stock of the first corporation under section 304(a)(2) (determined without regard to § 1.1502-80(b)).

(ii) *Special rules.* The following rules apply solely for purposes of this paragraph (e)(3):

(A) A corporation will be treated as related to another corporation if such relationship exists immediately before or immediately after the acquisition of the stock involved.

(B) A corporation, other than the target corporation or a person related (as defined in paragraph (e)(3) of this section determined without regard to paragraph (e)(3)(i)(A) of this section) to the target corporation, will be treated as related to the issuing corporation if the relationship is created in connection with the potential reorganization.

(4) *Acquisitions by partnerships.* For purposes of this paragraph (e), each partner of a partnership will be treated as owning or acquiring any stock owned or acquired, as the case may be, by the partnership in accordance with that partner's interest in the partnership. If a partner is treated as acquiring any stock by reason of the application of this paragraph (e)(4), the partner is also treated as having furnished its share of any consideration furnished by the partnership to acquire the stock in accordance with that partner's interest in the partnership.

(5) *Successors and predecessors.* For purposes of this paragraph (e), any reference to the issuing corporation or the target corporation includes a reference to any successor or predecessor of such corporation, except that the target corporation is not treated as a predecessor of the issuing corporation and the issuing corporation is not treated as a successor of the target corporation.

(6) *Examples.* For purposes of the examples in this paragraph (e)(6), P is the issuing corporation, T is the target corporation, S is a wholly owned subsidiary of P, all corporations have only one class of stock outstanding, A and B are individuals, PRS is a partnership, all reorganization requirements other than the continuity of interest requirement are satisfied, and the transaction is not otherwise subject to recharacterization. The following examples illustrate the application of this paragraph (e):

Example 1. Sale of stock to third party. (i) *Sale of issuing corporation stock after*

merger. A owns all of the stock of T. T merges into P. In the merger, A receives P stock having a fair market value of \$50x and cash of \$50x. Immediately after the merger, and pursuant to a preexisting binding contract, A sells all of the P stock received by A in the merger to B. Assume that there are no facts and circumstances indicating that the cash used by B to purchase A's P stock was in substance exchanged by P for T stock. Under paragraphs (e)(1) and (2) of this section, the sale to B is disregarded because B is not a person related to P within the meaning of paragraph (e)(3) of this section. Thus, the transaction satisfies the continuity of interest requirement because 50 percent of A's T stock was exchanged for P stock, preserving a substantial part of the value of the proprietary interest in T.

(ii) *Sale of target corporation stock before merger.* The facts are the same as paragraph (i) of this *Example 1*, except that B buys A's T stock prior to the merger of T into P and then exchanges the T stock for P stock having a fair market value of \$50x and cash of \$50x. The sale by A is disregarded. The continuity of interest requirement is satisfied because B's T stock was exchanged for P stock, preserving a substantial part of the value of the proprietary interest in T.

Example 2. Relationship created in connection with potential reorganization. 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 solely 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. 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.

Example 3. Participation by issuing corporation in post-merger sale. A owns 80 percent of the T stock and none of the P stock, which is widely held. T merges into P. In the merger, A receives P stock. In addition, A obtains rights pursuant to an arrangement with P to have P register the P stock under the Securities Act of 1933, as amended. P registers A's stock, and A sells the stock shortly after the merger. No person who purchased the P stock from A is a person related to P within the meaning of paragraph (e)(3) of this section. Under paragraphs (e)(1) and (2) of this section, the sale of the P stock by A is disregarded because no person who purchased the P stock from A is a person related to P within the meaning of paragraph (e)(3) of this section. The transaction satisfies the continuity of interest requirement because A's T stock was exchanged for P stock, preserving a substantial part of the value of the proprietary interest in T.

Example 4. Redemptions and purchases by issuing corporation or related persons. (i) *Redemption by issuing corporation.* A owns 100 percent of the stock of T and none of the

stock of P. T merges into S. In the merger, A receives P stock. In connection with the merger, P redeems all of the P stock received by A in the merger for cash. The continuity of interest requirement is not satisfied, because, in connection with the merger, P redeemed the stock exchanged for a proprietary interest in T, and a substantial part of the value of the proprietary interest in T is not preserved. See paragraph (e)(1) of this section.

(ii) *Purchase of target corporation stock by issuing corporation.* The facts are the same as paragraph (i) of this *Example 4*, except that, instead of P redeeming its stock, prior to and in connection with the merger of T into S, P purchases 90 percent of the T stock from A for cash. The continuity of interest requirement is not satisfied, because in connection with the merger, P 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)(1) of this section. However, see § 1.338-2(c)(3) (which may change the result in this case by providing that, by virtue of section 338, continuity of interest is satisfied for certain parties after a qualified stock purchase).

(iii) *Purchase of issuing corporation stock by person related to issuing corporation.* The facts are the same as paragraph (i) of this *Example 4*, except that, instead of P redeeming its stock, S buys all of the P stock received by A in the merger for cash. S is a person related to P under paragraphs (e)(3)(i)(A) and (B) of this section. The continuity of interest requirement is not satisfied, because S acquired P stock issued in the merger, and a substantial part of the value of the proprietary interest in T is not preserved. See paragraph (e)(2) of this section.

Example 5. Redemption in substance by issuing corporation. A owns 100 percent of the stock of T and none of the stock of P. T merges into P. In the merger, A receives P stock. In connection with the merger, B buys all of the P stock received by A in the merger for cash. Shortly thereafter, in connection with the merger, P redeems the stock held by B for cash. Based on all the facts and circumstances, P in substance has exchanged solely cash for T stock in the merger. The continuity of interest requirement is not satisfied, because in substance P redeemed the stock exchanged for a proprietary interest in T, and a substantial part of the value of the proprietary interest in T is not preserved. See paragraph (e)(1) of this section.

Example 6. Purchase of issuing corporation stock through partnership. A owns 100 percent of the stock of T and none of the stock of P. S is an 85 percent partner in PRS. The other 15 percent of PRS is owned by unrelated persons. T merges into P. In the merger, A receives P stock. In connection with the merger, PRS purchases all of the P stock received by A in the merger for cash. Under paragraph (e)(4) of this section, S, as an 85 percent partner of PRS, is treated as having acquired 85 percent of the P stock exchanged for A's T stock in the merger, and as having furnished 85 percent of the cash paid by PRS to acquire the P stock. S is a person related to P under paragraphs

(e)(3)(i)(A) and (B) of this section. The continuity of interest requirement is not satisfied, because S is treated as acquiring 85 percent of the P stock issued in the merger, and a substantial part of the value of the proprietary interest in T is not preserved. See paragraph (e)(2) of this section.

Example 7. Exchange by acquiring corporation for direct interest. A owns 30 percent of the stock of T. P owns 70 percent of the stock of T, which was not acquired by P in connection with the acquisition of T's assets. T merges into P. A receives cash in the merger. The continuity of interest requirement is satisfied, because P's 70 percent proprietary interest in T is exchanged by P for a direct interest in the assets of the target corporation enterprise.

Example 8. Effect of general stock repurchase program. T merges into P, a corporation whose stock is widely held and publicly traded and that has one class of common stock outstanding. In the merger, T shareholders receive common stock of P. Immediately after the merger, P repurchases a small percentage of its common stock in the open market as part of its ongoing stock repurchase program. The repurchase program was not created or modified in connection with the acquisition of T. Continuity of interest is satisfied, because based on all of the facts and circumstances, the redemption of a small percentage of the P stock does not affect the T shareholders' proprietary interest in T, because it was not in connection with the merger, and the value of the proprietary interest in T is preserved. See paragraph (e)(1) of this section.

Example 9. Maintenance of direct or indirect interest in issuing corporation. X, a corporation, owns all of the stock of each of corporations P and Z. Z owns all of the stock of T. T merges into P. Z receives P stock in the merger. Immediately thereafter and in connection with the merger, Z distributes the P stock received in the merger to X. X is a person related to P under paragraph (e)(3)(i)(A) of this section. The continuity of interest requirement is satisfied, because X was an indirect owner of T prior to the merger who maintains a direct or indirect proprietary interest in P, preserving a substantial part of the value of the proprietary interest in T. See paragraph (e)(2) of this section.

(7) **Effective date.** This paragraph (e) 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 binding on January 28, 1998, and at all times thereafter.

Par. 4. Section 1.368-2 is amended by:

1. Removing the second sentence of paragraph (a) and adding two sentences in its place.

2. Removing the second sentence of paragraph (f) and adding four sentences in its place.

3. Removing the second sentence in paragraph (j)(1).

4. Revising paragraph (j)(3)(ii).

5. Revising the first sentence in paragraph (j)(3)(iii).

6. Adding paragraph (j)(3)(iv).

7. Removing paragraph (j)(4).

8. Redesignating paragraphs (j)(5), (j)(6), and (j)(7) as (j)(4), (j)(5), and (j)(6), respectively.

9. Removing the parentheses around the numbers in the paragraph headings for *Example (1)* through *Example (9)* in newly designated paragraph (j)(6).

10. Adding paragraph (k).

The additions and revisions read as follows:

§ 1.368-2 Definition of terms.

(a) * * * The term does not embrace the mere purchase by one corporation of the properties of another corporation. The preceding sentence 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 binding on January 28, 1998, and at all times thereafter. * * *

(f) * * * If a transaction otherwise qualifies as a reorganization, a corporation remains a party to the reorganization even though stock or assets acquired in the reorganization are transferred in a transaction described in paragraph (k) of this section. If a transaction otherwise qualifies as a reorganization, a corporation shall not cease to be a party to the reorganization solely by reason of the fact that part or all of the assets acquired in the reorganization are transferred to a partnership in which the transferor is a partner if the continuity of business enterprise requirement is satisfied. See § 1.368-1(d). The preceding three sentences apply to transactions occurring after January 28, 1998, except that they do not apply to any transaction occurring pursuant to a written agreement which is binding on January 28, 1998, and at all times thereafter. * * *

* * *

(j) * * *

(3) * * *

(ii) Except as provided in paragraph (k)(2) of this section, the controlling corporation must control the surviving corporation immediately after the transaction.

(iii) After the transaction, except as provided in paragraph (k)(2) of this section, the surviving corporation must hold substantially all of its own properties and substantially all of the properties of the merged corporation (other than stock of the controlling corporation distributed in the transaction). * * *

(iv) Paragraphs (j)(3)(ii) and (iii) of this section apply to transactions

occurring after January 28, 1998, except that they do not apply to any transaction occurring pursuant to a written agreement which is binding on January 28, 1998, and at all times thereafter.

* * *

(k) **Transfer of assets or stock in section 368(a)(1)(A), (B), (C), or (G) reorganizations—**(1) **General rule for transfers to controlled corporations.** Except as otherwise provided in this section, a transaction otherwise qualifying under section 368(a)(1)(A), (B), (C), or (G) (where the requirements of sections 354(b)(1)(A) and (B) are met) shall not be disqualified by reason of the fact that part or all of the acquired assets or stock acquired in the transaction are transferred or successively transferred to one or more corporations controlled in each transfer by the transferor corporation. Control is defined under section 368(c).

(2) **Transfers following a reverse triangular merger.** A transaction qualifying under section 368(a)(1)(A) by reason of the application of section 368(a)(2)(E) is not disqualified by reason of the fact that part or all of the stock of the surviving corporation is transferred or successively transferred to one or more corporations controlled in each transfer by the transferor corporation, or because part or all of the assets of the surviving corporation or the merged corporation are transferred or successively transferred to one or more corporations controlled in each transfer by the transferor corporation.

(3) **Examples.** The following examples illustrate the application of this paragraph (k). P is the issuing corporation and T is the target corporation. P has only one class of stock outstanding. The examples are as follows:

Example 1. Transfers of acquired assets to controlled corporations. (i) **Facts.** T operates a bakery which supplies delectable pastries and cookies to local retail stores. The acquiring corporate group produces a variety of baked goods for nationwide distribution. P owns 80 percent of the stock of S-1. Pursuant to a plan of reorganization, T transfers all of its assets to S-1 solely in exchange for P stock, which T distributes to its shareholders. S-1 owns 80 percent of the stock of S-2; S-2 owns 80 percent of the stock of S-3, which also makes and supplies pastries and cookies. Pursuant to the plan of reorganization, S-1 transfers the T assets to S-2; S-2 transfers the T assets to S-3.

(ii) **Analysis.** Under this paragraph (k), the transaction, otherwise qualifying as a reorganization under section 368(a)(1)(C), is not disqualified by reason of the fact of the successive transfers of all of the acquired assets from S-1 to S-2, and from S-2 to S-3 because in each transfer, the transferee corporation is controlled by the transferor

corporation. Control is defined under section 368(c).

Example 2. Transfers of acquired stock to controlled corporations. (i) *Facts.* The facts are the same as Example 1 except that S-1 acquires all of the T stock rather than the T assets, and as part of the plan of reorganization, S-1 transfers all of the T stock to S-2, and S-2 transfers all of the T stock to S-3.

(ii) *Analysis.* Under this paragraph (k), the transaction, otherwise qualifying as a reorganization under section 368(a)(1)(B), is not disqualified by reason of the fact of the successive transfers of all of the acquired stock from S-1 to S-2, and from S-2 to S-3 because in each transfer, the transferee corporation is controlled by the transferor corporation.

Example 3. Transfers of acquired stock to partnerships. (i) *Facts.* The facts are the same as in Example 2. However, as part of the plan of reorganization, S-2 and S-3 form a new partnership, PRS. Immediately thereafter, S-3 transfers all of the T stock to PRS in exchange for an 80 percent partnership interest, and S-2 transfers cash to PRS in exchange for a 20 percent partnership interest.

(ii) *Analysis.* This paragraph (k) describes the successive transfer of the T stock to S-3, but does not describe S-3's transfer of the T stock to PRS. Therefore, the characterization of this transaction must be determined under the relevant provisions of law, including the step transaction doctrine. See § 1.368-1(a). The transaction fails to meet the control requirement of a reorganization described in section 368(a)(1)(B) because immediately after the acquisition of the T stock, the acquiring corporation does not have control of T.

(4) This paragraph (k) 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 binding on January 28, 1998, and at all times thereafter.

Michael P. Dolan,

Deputy Commissioner of Internal Revenue.

Approved: January 12, 1998.

Donald C. Lubick,

Acting Assistant Secretary of the Treasury.

[FR Doc. 98-1819 Filed 1-23-98; 12:15 pm]

BILLING CODE 4830-01-U

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 8761]

RIN 1545-AV80

Continuity of Interest

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations providing guidance regarding satisfaction of the continuity of interest requirement for corporate reorganizations. The temporary regulations affect corporations and their shareholders. Final regulations published elsewhere in this issue of the **Federal Register** also provide guidance regarding satisfaction of the continuity of interest requirement for corporate reorganizations. These temporary regulations amplify the final regulations. The text of these temporary regulations also serves as the text of proposed regulations published elsewhere in this issue of the **Federal Register**.

DATES: These regulations are effective January 28, 1998.

Applicability: These regulations apply to transactions occurring after January 28, 1998, except that they do 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:

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SUPPLEMENTARY INFORMATION: This document contains amendments to the Income Tax Regulations (26 CFR part 1) under section 368. These temporary regulations provide that, in determining whether the continuity of interest requirement for corporate reorganizations is satisfied with respect to a potential reorganization, a proprietary interest in the target corporation is not preserved if, in connection with a potential reorganization, it is redeemed or acquired by a person related to the target corporation, or to the extent that, prior to and in connection with a potential reorganization, an extraordinary distribution is made with respect to it.

Background

On December 23, 1996, the IRS published a notice of proposed rulemaking (REG-252231-96) in the **Federal Register** (61 FR 67512) relating to the continuity of interest requirement. Many written comments were received in response to this notice of proposed rulemaking. A public hearing on the proposed regulations was held on May 7, 1997. After consideration of all comments, the regulations proposed by REG-252231-96 are adopted as final regulations, and published elsewhere in this issue of the **Federal Register**. These temporary

regulations supplement the final regulations.

Explanation of Provisions

Final regulations published elsewhere in this issue of the **Federal Register** provide that in determining whether the continuity of interest (COI) requirement for corporate reorganizations is satisfied, dispositions of stock of the target corporation (T) by a T shareholder generally are not taken into account.

Redemptions of T Stock or Extraordinary Distributions With Respect to T Stock

Commentators requested guidance on the circumstances under which a redemption by T of its stock would adversely affect satisfaction of the COI requirement.

Some commentators suggested that the IRS and Treasury Department adopt an approach that would identify either the issuing corporation (P) or T as the source of the funds for the redemption. If, in connection with an acquisition of T, the facts and circumstances indicate that P did not directly or indirectly furnish funds used by T to redeem T shareholders, these commentators suggested that satisfaction of the COI requirement should not be adversely affected. In many transactions, however, such a tracing approach would be extremely difficult to administer. For example, if P acquired the assets, rather than the stock, of T or if T redeemed stock for a note, it would be unclear in many circumstances whether in substance T or P assets were used to fund the redemption or to repay the note.

Another commentator suggested that redemptions by T in connection with a potential reorganization should adversely affect satisfaction of the COI requirement because the effect on COI is the same as if P had furnished the redemption consideration in the transaction. The temporary regulations generally adopt this approach because it reflects that T and P will be combined economically and because of the difficulties of administering a tracing approach, as previously described.

Treatment of stock redeemed by T as proprietary interests that are not preserved in the reorganization also accords the same tax result to transactions that reach the same result by different steps. For example, T could merge into P for a combination of consideration, of which 30 percent is P stock and 70 percent is a P promissory note. Conversely, T could issue its promissory note to redeem 70 percent of the T stock and then P would assume the T note in the merger, in which the