

Department
of the
Treasury

Internal
Revenue
Service

Office of
Chief Counsel

Notice

N(35)000-145

May 15, 1997

Issues Arising Under
Section 368 of the
Subject: Internal Revenue Code Cancellation Date: August 13, 1997

The purpose of this Notice is to request all district counsel and regional counsel attorneys to notify the Assistant Chief Counsel (Field Service), Corporate Branch, of any cases involving the issue of whether the continuity of shareholder interest requirement (COSI) under sections 368 and 355 has been satisfied. The COSI issue is significant and thus is subject to the notification procedures described in Chief Counsel Notice N(35)000-139(a), issued September 24, 1996. This issue will be added to the list of significant issues requiring National Office notification when that list is next updated.

The Internal Revenue Code of 1986 (Code) provides general nonrecognition treatment for reorganizations specifically described in section 368. Literal compliance with the statutory requirements is not sufficient for nonrecognition. For example, to qualify as a reorganization, the COSI requirement must also be satisfied. This requirement was established by the courts to ensure that the consideration furnished by the acquiring corporation represented a proprietary interest in the affairs of the acquiring corporation and that such consideration represented a substantial part of the value of the stock or properties transferred. See Helvering v. Minnesota Tea Co., 296 U.S. 378 (1935); Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462 (1933); Cortland Specialty Co. v. Commissioner, 60 F.2d 937 (2d Cir. 1932), *cert. denied*, 288 U.S. 599 (1933).

Over the years, issues have arisen regarding whether the COSI requirement is satisfied if the target shareholders, as contemplated at the time of the reorganization, subsequently dispose of the stock received from the acquiring corporation. Compare McDonald's Restaurants of Illinois, Inc. v. Commissioner, 688 F.2d 510 (7th Cir. 1982), *rev'g*, McDonald's of Zion v. Commissioner, 76 T.C. 972 (1981), with Penrod v. Commissioner, 88 T.C. 1415 (1987). The Treasury Department and the Internal Revenue Service (IRS) have been asked to provide guidance to clarify existing law and reduce uncertainty in applying COSI

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principles in the context of post-reorganization sales. In a Notice of Proposed Rulemaking, the IRS published proposed amendments to the regulations under section 368, which address these concerns. See 61 Fed. Reg. 67,512 (1996). The proposed regulations provide that the COSI requirement is satisfied if the acquiring corporation furnishes consideration in the reorganization that represents a proprietary interest in the affairs of the acquiring corporation and such consideration represents a substantial part of the value of the stock or properties transferred. Dispositions of stock of the acquiring corporation by a former target shareholder generally are not taken into account in determining whether continuity of shareholder interest has been satisfied. However, the proposed regulations emphasize that all facts and circumstances must be considered in determining whether the acquiring corporation has in substance furnished the required consideration. The proposed regulations also have a broad related party rule, which provides that, if a party related to the acquiring corporation (within the meaning of section 707(b)(1) or section 267(b) (without regard to section 267(e)) purchases acquiring corporation stock shortly after the reorganization, all of the facts and circumstances may indicate that the transaction should be properly recast to treat the acquiring corporation as furnishing cash, in which case, the reorganization would not satisfy the COSI requirement. For example, a prearranged redemption of stock issued in the purported reorganization by the issuing corporation or its prearranged purchase by the issuing corporation's subsidiary would likely be treated as adversely affecting continuity of proprietary interest.

The proposed regulations do not specifically address the effect on COSI of dispositions of target stock before a transaction potentially qualifying as a reorganization. See, e.g., King Enterprises, Inc. v. United States, 418 F.2d 511 (Ct. Cl. 1969); J.E. Seagram Corp. v. Commissioner, 104 T.C. 75 (1995); Superior Coach of Florida, Inc. v. Commissioner, 80 T.C. 895 (1983); Yoc Heating Corp. v. Commissioner, 61 T.C. 168 (1973). The Treasury Department and the IRS are studying this question and also the role of the COSI requirement in section 368(a)(1)(D) reorganizations and section 355 transactions.

The revisions and additions in the proposed regulations are proposed to apply to transactions occurring after the regulations are published as final regulations in the Federal Register (except for transactions occurring pursuant to a written agreement that is (subject to customary conditions) binding on or before the regulations are published as final regulations in the Federal Register).

If you are assisting a revenue agent or appeals officer with a case involving the COSI requirement under sections 368 and 355, please notify Alfred C. Bishop, Jr., Chief, Corporate Branch, Field Service Division, immediately at (202) 622-7930. Information regarding these cases will help the office ensure that the parties to the transaction (the acquiring corporation, the target corporation, and the former shareholders of the target corporation) consistently report their tax position, and will prevent whipsaw. Information regarding these cases will also facilitate the office's study of the role of the COSI requirements in section 368(a)(1)(D) reorganizations and section 355 transactions. In addition, National Office advice should be sought regarding current IRS position in cases where the taxpayer is challenging our interpretation of the COSI requirement or where the taxpayer wants to adopt the more liberal rule of the proposed regulations for cases arising prior to the effective date of the final regulations.

/s/
JUDITH C. DUNN
Associate Chief Counsel
(Domestic)