

Notice of Proposed Rulemaking and Notice of Public Hearing

Continuity of Interest

REG-252231-96

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations providing that the continuity of shareholder interest requirement for corporate reorganizations is satisfied if the acquiring corporation

furnishes consideration which 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. This document also provides notice of a public hearing on these proposed regulations.

DATES: Comments must be received by March 24, 1997. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for Wednesday, May 7, 1997 must be received by Wednesday, April 16, 1997.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG-252231-96), 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-252231-96), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. The public hearing will be held in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Phoebe Bennett, (202) 622-7750; concerning submissions and the hearing, Christina Vasquez, (202) 622-6808 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) under section 368. The proposed regulations provide that the continuity of shareholder interest (COSI) requirement is satisfied if the acquiring corporation furnishes consideration which 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.

Background

The Internal Revenue Code of 1986 (Code) provides general nonrecognition treatment for reorganizations specifically described in section 368 of the Code. 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.

The early statutory definitions of reorganizations did not specify the type of consideration required for a transaction to qualify as a reorganization. As a result, a transaction may have satisfied the literal definition of a reorganization even if the transaction resembled a sale. To prevent such transactions from qualifying as reorganizations, the COSI 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). "Reorganization, merger and consolidation are words indicating corporate readjustments of existing interests. They all differ fundamentally from a sale where the vendor corporation parts with its interest for cash and receives nothing more." *Cortland*, 60 F.2d at 939.

The cases that gave rise to the COSI requirement did not involve situations in which shareholders of the target corporation disposed of stock consideration from the acquiring corporation after having received it. In those cases, the relevant inquiry was whether the acquiring corporation furnished the proper type of consideration in the reorganization. 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 520 (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). Various bar associations have asked the Treasury Department and the IRS to provide

guidance to clarify existing law and reduce uncertainty in applying COSI principles in the context of postreorganization sales. See New York State Bar Association Tax Section, *Postreorganization Continuity of Interest*, reprinted in 73 Tax Notes 481 (1996); Committee on Taxation of Corporations of the Association of the Bar of the City of New York, *Postreorganization Transactions and Continuity of Shareholder Interest*, reprinted in 72 Tax Notes 1401 (1996).

Explanation of Proposed Regulations

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 COSI 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. For example, if the acquiring corporation or a related party (within the meaning of section 707(b)(1) or section 267(b) (without regard to section 267(e))) purchases the 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 the reorganization, in which case the reorganization would not satisfy the COSI requirement. This approach refocuses the COSI requirement on its initial purpose of ensuring that the acquiring corporation furnishes the proper type of consideration and also promotes simplicity and administrability in applying the COSI requirement.

Effect on Other Authorities

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. Com-*

missioner, 80 T.C. 895 (1983); *Yoc Heating Corp. v. Commissioner*, 61 T.C. 168 (1973). The Treasury Department and IRS are studying this question and also the role of the COSI requirement in section 368(a)(1)(D) reorganizations and section 355 transactions. See § 1.355-2(c). The Treasury Department and IRS solicit comments on these issues.

Effect on Other Documents

The IRS will modify or obsolete publications as necessary to conform with this regulation as of the date of publication in the **Federal Register** of the final regulations. See, e.g., Rev. Proc. 86-42 (1986-2 C.B. 722); Rev. Proc. 77-37 (1977-2 C.B. 568). The IRS solicits comments as to whether other publications should be modified or obsoleted.

Proposed Effective Date

The revisions and additions in the proposed regulations apply to transactions occurring after these regulations are published as final regulations in the **Federal Register**, except that they shall not apply to any transactions occurring pursuant to a written agreement which is (subject to customary conditions) binding on or before these regulations are published as final regulations in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking 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, 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 written comments (a signed original and eight copies) or comments transmitted via

Internet that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled at 10 a.m. on Wednesday, May 7, 1997, in the Auditorium, Internal Revenue Service, 1111 Constitution Avenue NW, Washington DC. 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 that wish to present oral comments at the hearing must request to speak by Wednesday, April 16, 1997, and submit an outline of the topics to be discussed and the time to be devoted to each topic by Wednesday, April 16, 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 Phoebe Bennett of the Office of the Assistant Chief Counsel (Corporate), IRS. 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 1.368-1 is amended by:

1. Revising the third sentence of paragraph (b).

2. Adding two sentences between the fourth and fifth sentences of paragraph (b).

3. Adding paragraph (e).

The revisions and additions read as follows:

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

* * * * *

(b) * * * Requisite to a reorganization under the Code are a continuity of the business enterprise under the modified corporate form, and (except as provided in section 368(a)(1)(D)) a continuity of shareholder interest. * * * The continuity of shareholder interest requirement is described in paragraph (e) of this section. The third and fifth sentences of this paragraph apply to transactions occurring after these regulations are published as final regulations in the **Federal Register**, except that they shall not apply to any transactions occurring pursuant to a written agreement which is (subject to customary conditions) binding on or before these regulations are published as final regulations in the **Federal Register**. * * *

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(e) *Continuity of shareholder interest*—(1) *General rule*. The purpose of the continuity of shareholder interest requirement is to prevent transactions that resemble sales from qualifying for nonrecognition of gain or loss available to corporate reorganizations. Continuity of shareholder interest requires that the acquiring corporation furnish consideration representing a proprietary interest in the affairs of the acquiring corporation and that such consideration represents a substantial part of the value of the stock or properties transferred. In determining whether the acquiring corporation has furnished such consideration, 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 section 267(b) (without regard to section 267(e))) to redeem or acquire the consideration provided in the reorganization. Thus, for example, if based on all the facts and circumstances the acquiring corporation has furnished solely cash, the continuity of shareholder interest requirement is not satisfied.

(2) *Triangular reorganizations*. For purposes of this paragraph (e), in the case of a triangular reorganization described in § 1.358-6(b), the continuity of shareholder interest requirement will be applied with reference to the stock of the corporation which is in control of the acquiring corporation (in a forward triangular merger) or in control of the merged corporation (in a reverse triangular merger).

(3) *Examples.* The following examples illustrate the application of this paragraph (e):

Example 1. A owns all of the stock of T. T merges into P. In the merger, A receives stock of P having a fair market value of \$50x and cash of \$50x. Immediately after the merger, and pursuant to a preexisting binding contract negotiated by A, A sells all of the stock of P received by A in the merger to B, a party not related to P. The transaction satisfies the continuity of shareholder interest requirement because A received stock of P representing a substantial part of the value of the total consideration transferred in the acquisition.

Example 2. A owns 80 percent of the stock of T and none of the stock of P, which is widely held. T merges into P. In the merger, A receives stock of P. In addition, A obtains registration rights pursuant to an agreement with P to register the P stock and sells such stock shortly after the acquisition in the open market. The transaction satisfies the continuity of shareholder interest requirement.

Example 3. A owns 80 percent of the stock of T and none of the stock of P. T merges into P. In the merger, A receives stock of P. In addition, A arranges with an independent investment banker to hedge the risk of loss on the P stock received in the merger. Neither P nor a party related to P enters directly or indirectly into the hedging transaction. The transaction satisfies the continuity of shareholder interest requirement.

Example 4. A owns 80 percent of the stock of T and none of the stock of P. T merges into P. In the merger, A receives stock of P but with an agreement that it will be redeemed shortly by P. Pursuant to the agreement, shortly after the merger P redeems all of the stock of P received by A in the merger for cash. Under all of the facts and circumstances, the cash is treated as furnished by P in the merger, so that the merger does not satisfy the continuity of shareholder interest requirement. The result is the same if S, P's wholly owned subsidiary, buys all of the stock of P received by A in the merger for cash. The result is also the same if pursuant to a plan between P, its investment banker, and A, P's investment banker buys all of the stock of P received by A in the merger for cash and, shortly thereafter, P redeems the stock held by the investment banker for cash.

(4) *Effective date.* Paragraph (e) applies to transactions occurring after these regulations are published as final regulations in the **Federal Register** except that it shall not apply to any transactions occurring pursuant to a written agreement which is (subject to customary conditions) binding on or before these regulations are published as final regulations in the **Federal Register**.

Par. 3. In § 1.368-2, paragraph (a) is amended by removing the second sentence and adding two new sentences in its place to 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 these regulations are published as final regulations in the

Federal Register except that it shall not apply to any transactions occurring pursuant to a written agreement which is (subject to customary conditions) binding on or before these regulations are published as final regulations in the **Federal Register** * * *

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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. 67512)