Notice of Proposed Rulemaking and Notice of Public Hearing

The Solely for Voting Stock Requirement in Certain Corporate Reorganizations

REG–115086–98

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations relating to the solely for voting stock requirement in certain corporate reorganizations under section 368(a)(1)(C) of the Internal Revenue Code. The proposed regulations provide that prior ownership of a portion of a target corporation's stock by an acquiring corporation generally will not prevent the solely for voting stock requirement in a "C" reorganization of the target corporation and the acquiring corporation from being satisfied. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments must be received by September 13, 1999. Requests to speak and outlines of topics to be discussed at the hearing scheduled for October 5, 1999, must be received by September 13, 1999.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–115086–98), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (REG–115086–98), 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/tax_regs/regslist.html. The public hearing will be held in Room 2615, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Marnie Rapaport, (202) 622-7550; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Guy R. Traynor, (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

A. *General Information*

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) under section 368(a)(1)(C) relating to the definition of a "C" reorganization. A "C" reorganization is described as the acquisition by one corporation of substantially all of the properties of a target corporation in exchange solely for voting stock of the acquiring corporation (or solely for voting stock of its parent). See section 368(a)(1)(C). The use of money or other property will not prevent an exchange from qualifying under section 368(a)(1)(C) if at least 80 percent of the gross fair market value of all of the property of the target corporation is acquired for voting stock (the so-called boot relaxation rule). See section 368(a)(2)(B). The proposed regulations provide that prior ownership of a portion of a target corporation's stock by an acquiring corporation generally will not prevent the solely for voting stock requirement in a "C" reorganization of the target corporation and the acquiring corporation from being satisfied. These regulations propose to reverse the IRS's longstanding position that the acquisition of assets of a partially controlled subsidiary does not qualify as a tax-free reorganization under section 368(a)(1)(C).

B. *The Bausch & Lomb Doctrine*

The IRS's position that the acquisition of assets of a partially controlled subsidiary does not qualify as a tax-free reorganization under section 368(a)(1)(C) is articulated in Rev. Rul. 54–396 (1954–2 C.B. 147). This position subsequently was sustained in litigation in *Bausch & Lomb Optical Co. v. Commissioner*, 30 T.C. 602 (1958), *aff'd*, 267 F.2d 75 (2d Cir.), *cert. denied*, 361 U.S. 835 (1959) (the *Bausch & Lomb* doctrine). In Rev. Rul. 54-396, a parent corporation owning 79 percent of the stock of a subsidiary as the result of a prior unrelated cash purchase acquires all of the assets of the subsidiary in exchange for a block of the parent's voting stock. The block of the parent's stock that has been transferred to the subsidiary is then distributed in liquidation pro rata to its shareholders. The ruling concludes that the transaction does not qualify as a "C" reorganization under the 1939 Internal Revenue Code, but rather is a taxable liquidation of the subsidiary. The rationale of the revenue ruling is that the acquisition violates the solely for voting stock requirement, because the parent corporation acquires only 21 percent of the subsidiary's assets in exchange for the parent's voting stock, while the remaining 79 percent of the subsidiary's assets is acquired as a liquidating distribution in exchange for the previously held stock of the subsidiary.

In *Bausch & Lomb* (which had nearly identical facts to Rev. Rul. 54–396), the parent corporation, Bausch & Lomb, owned 79.9 percent of the stock of Riggs Optical Company. In order to acquire the assets of Riggs, Bausch & Lomb exchanged shares of its voting stock for all of the Riggs assets. Pursuant to a prearranged plan, Riggs subsequently was dissolved and distributed its only asset, the Bausch & Lomb shares, pro rata to its shareholders. The Tax Court and the Second Circuit Court of Appeals sustained the Commissioner's contention that the acquisition of the Riggs assets and the dissolution of Riggs should be viewed together as part of a single plan, and that the surrender by Bausch & Lomb of its Riggs stock constituted nonstock consideration in violation of the "C" reorganization requirements.

C. *The Solely for Voting Stock Requirement*

The "C" reorganization first appeared in 1921 when a tax-free reorganization was defined as a merger or consolidation "including the acquisition by one corporation...of substantially all of the properties of another corporation." Revenue Act of 1921, section 202(c)(2), 42 Stat. 227, 230. The statutory language failed to limit the type of permissible consideration, arguably allowing an acquisition for cash to qualify as a merger.

In 1934, Congress restricted the permissible consideration in an acquisition of a target's stock or assets (in other than a statutory merger or consolidation) to voting stock. Revenue Act of 1934, section 112(g)(1), 48 Stat. 680, 705. The stated purpose for this limitation was to "remove the danger that taxable sales [could] be cast into the form of a reorganization." See H.R. Rep. No. 704, 73d Cong., 2d Sess. 12–14 (1934), 1939–1 C.B. (Part 2) 554, 563–565; S. Rep. No. 558, 73d Cong., 2d Sess. 16–17 (1934), 1939–1 C.B. (Part 2) 586, 598-599.

D. *Reasons for Change*

The legislative history of the "C" reorganization provisions provides that the purpose of the solely for voting stock requirement in section 368(a)(1)(C) is to prevent transactions that resemble sales from qualifying for nonrecognition of gain or loss available to corporate reorganizations. The IRS and Treasury Department have concluded that a transaction in which the acquiring corporation converts an indirect ownership interest in assets to a direct interest in those assets does not resemble a sale and, thus, have concluded that Congress did not intend to disqualify a transaction from qualifying under section 368(a)(1)(C) merely because the acquiring corporation has prior ownership of a portion of a target corporation's stock. Because the judicial doctrine of continuity of interest arose from similar concerns, the regulations under §1.368–1(e)(1)(i) reach a similar conclusion with respect to the continuity of interest doctrine.

Moreover, the taxable treatment of the "upstream" "C" reorganization under the *Bausch & Lomb* doctrine contrasts with the tax-free treatment of the "upstream" "A" reorganization under section 368(a)-(1)(A). See also Rev. Rul. 57–278 (1957–1 C.B. 124) (*Bausch & Lomb* does not apply to an asset acquisition by a newly formed corporation in exchange for its parent's stock, even though prior to the acquisition the parent already owned 72 percent of the transferor's stock). In the "upstream" "A" reorganization, the indirect interest of the parent in the assets of its subsidiary (i.e., the target corporation) is converted into a direct interest in the subsidiary's assets. An exchange is deemed to occur for purposes of section 354 even if, in form, one does not occur. The IRS and Treasury Department have concluded that the "upstream" reorganization under section 368(a)(1)(C) (i.e., the *Bausch & Lomb* transaction) should not be treated differently from the "upstream" "A" reorganization solely because the acquiring corporation already owns stock in the target corporation. Accordingly, the IRS and Treasury Department have concluded that the *Bausch & Lomb* doctrine does not further the principles of reorganization treatment.

Explanation of Provisions

The proposed regulations provide that preexisting ownership of a portion of a target corporation's stock by an acquiring corporation generally will not prevent the solely for voting stock requirement in a "C" reorganization from being satisfied. If the boot relaxation rule applies, the sum of (i) the money or other property that is distributed in pursuance of the plan of reorganization to the shareholders of the target corporation other than the acquiring corporation and to the creditors of the target corporation pursuant to section 361(b)(3), and (ii) the assumption of all the liabilities of the target corporation (including liabilities to which the properties of the target corporation are subject), cannot exceed 20 percent of the value of all of the properties of the target corporation. In this regard, the proposed regulations provide that if, in connection with a potential "C" reorganization of a target corporation into an acquiring corporation, the acquiring corporation acquires the target corporation's stock for consideration other than its own voting stock (or voting stock of a corporation in control of the acquiring corporation if such stock is used in the acquisition of the target corporation's properties), whether from a shareholder of the target corporation or from the target corporation itself, such consideration will be treated as money or other property exchanged by the acquiring corporation for the target corporation's assets. Accordingly, the requirements of section 368(a)(1)(C) will not be satisfied unless the transaction can qualify under the boot relaxation rule of section 368(a)(2)(B). The determination of whether there has been an acquisition in connection with a potential "C" reorganization of a target corporation's stock for consideration other than an acquiring corporation's own voting stock (or voting stock of a corporation in control of the acquiring corporation if such stock is used in the acquisition of the target corporation's properties) will be made on the basis of all of the facts and circumstances.

Rev. Rul. 54–396 (1954–2 C.B. 147) will become obsolete when the proposed regulations are issued in final form.

The regulations are proposed to apply to transactions occurring after the date that a Treasury decision adopting these rules is published in the **Federal Register,** except that they do not apply to any transactions occurring pursuant to a written agreement which is (subject to customary conditions) binding on the date the regulations are published as final regulations in the **Federal Register,** and at all times thereafter.

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 proposed regulations and, because the proposed regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations 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 (8) copies) that are timely submitted to the IRS. The IRS and Treasury request comments on the clarity of the proposed rule and how it may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for October 5, 1999, beginning at 10:00 a.m. in Room 2615 of the Internal Revenue Service Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must request to speak, and submit written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by September 13, 1999. A period of ten minutes will be allocated 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 Marnie Rapaport of the Office of the Assistant Chief Counsel (Corporate), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

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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 1.368–2 is amended by adding paragraph (d)(4) to read as follows:

§1.368–2 Definition of terms

* * * * *

(d) * * *

(4) (i) For purposes of paragraphs (d)(1) and (2)(ii) of this section, prior ownership of a portion of the stock of the target corporation by an acquiring corporation will not by itself prevent the solely for voting stock requirement of such paragraphs from being satisfied. In a transaction in which the acquiring corporation has prior ownership of a portion of the stock of the target corporation, the requirement of paragraph (2)(ii) is satisfied only if the sum of the money or other property that is distributed in pursuance of the plan of reorganization to the shareholders of the target corporation other than the acquiring corporation and to the creditors of the target corporation pursuant to section 361(b)(3), and all of the liabilities of the target corporation assumed by the acquiring corporation (including liabilities to which the properties of the target corporation are subject), does not exceed 20 percent of the value of all of the properties of the target corporation. If, in connection with a potential acquisition by an acquiring corporation of substantially all of a target corporation's properties, the acquiring corporation acquires the target corporation's stock for consideration other than the acquiring corporation's own voting stock (or voting stock of a corporation in control of the acquiring corporation if such stock is used in the acquisition of the target corporation's properties), whether from a shareholder of the target corporation or the target corporation itself, such consideration is treated, for purposes of paragraphs (d)(1) and (2) of this section, as money or other property exchanged by the acquiring corporation for the target corporation's properties. Accordingly, the transaction will not qualify under section 368(a)(1)(C) unless, treating such consideration as money or other property, the requirements of section 368(a)(2)(B) and paragraph (d)(2)(ii) of this section are met. The determination of whether there has been an acquisition in connection with a potential reorganization under section 368(a)(1)(C) of a target corporation's stock for consideration other than an acquiring corporation's own voting stock (or voting stock of a corporation in control of the acquiring corporation if such stock is used in the acquisition of the target corporation's properties) will be made on the basis of all of the facts and circumstances.

(ii) The following examples illustrate the principles of this paragraph (d)(4):

Example 1. Corporation P (P) holds 60 percent of the Corporation T (T) stock that P purchased several years ago in an unrelated transaction. T has 100 shares of stock outstanding. The other 40 percent of the T stock is owned by Corporation X (X), an unrelated corporation. T has properties with a fair market value of $110 and liabilities of $10. T transfers all of its properties to P. In exchange, P assumes the $10 of liabilities, and transfers to T $30 of P voting stock and $10 of cash. T distributes the P voting stock and $10 of cash to X and liquidates. The transaction satisfies the solely for voting stock requirement of paragraph (d)(2)(ii) of this section because the sum of $10 of cash paid to X and the assumption by P of $10 of liabilities does not exceed 20% of the value of the properties of T.

Example 2. The facts are the same as in *Example 1* except that P purchased the 60 shares of T for $60 in cash in connection with the acquisition of T's assets. The transaction does not satisfy the solely for voting stock requirement of paragraph (d)(2)(ii) of this section because P is treated as having acquired all of the T assets for consideration consisting of $70 of cash, $10 of liability assumption and $30 of P voting stock, and the sum of $70 of cash and the assumption by P of $10 of liabilities exceeds 20% of the value of the properties of T.

(iii) This paragraph (d)(4) applies to transactions occurring after the date these regulations are published as final regulations in the **Federal Register,** except that this paragraph (d)(4) does not apply to any transactions occurring pursuant to a written agreement which is (subject to customary conditions) binding on the date the regulations are published as final regulations in the **Federal Register**, and at all times thereafter.

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Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.