

Notice of Proposed Rulemaking

Corporate Reorganizations; Transfers of Assets or Stock Following a Reorganization

REG-130863-04

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations that provide guidance regarding the effect of certain transfers of assets or stock on the qualification of certain transactions as reorganizations under section 368(a). This document also contains proposed regulations that provide guidance on the continuity of business enterprise requirement and the definition of a party to a reorganization. These regulations affect corporations and their shareholders.

DATES: Written or electronic comments must be received by November 15, 2004.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-130863-04), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-130863-04), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically, via the IRS Internet site at www.irs.gov/regs or via the Federal eRulemaking Portal at www.regulations.gov (IRS — REG-130863-04).

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Jeffrey B. Fienberg, (202) 622-7770; concerning submissions and the hearing, LaNita Van Dyke, (202) 622-3215 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

On March 2, 2004, the IRS and Treasury Department published in the **Federal Register** (69 FR 9771) a notice of proposed rulemaking (REG-165579-02, 2004-13 I.R.B. 651) that would amend §1.368-2(k) to provide that a reorganization otherwise qualifying under section 368(a) will not be disqualified as a result of the transfer or successive transfers to one or more corporations controlled in each transfer by the transferor corporation of part or all of (i) the assets of any party to the reorganization or (ii) the stock of any party to the reorganization other than the issuing corporation (hereinafter the March 2004 proposed regulations). The March 2004 proposed regulations also include amendments to the continuity of business enterprise (COBE) regulations under §1.368-1(d) and the definition of a party to a reorganization under §1.368-2(f).

While the March 2004 proposed regulations address transfers of assets and stock to corporations controlled by the transferor corporation, they do not address whether a transaction that otherwise qualifies as a reorganization continues to qualify when, pursuant to the plan of reorganization, assets or stock of the acquired corporation is distributed to a corporation or partnership following the reorganization. In addition, they do not provide guidance on whether a transaction that otherwise qualifies as a reorganization continues to qualify when, pursuant to the plan of reorganization, acquired assets are transferred to a partnership in which the transferor owns an interest. These proposed regulations expand the March 2004 regulations to address these situations.

The IRS and Treasury Department received comments regarding the March 2004 proposed regulations. Comments not addressed in this document are still being considered.

A. Distributions

These proposed regulations provide that a transaction otherwise qualifying as a reorganization under section 368(a) will not be disqualified as a result of a subsequent distribution of the acquired assets or stock if (i) no transferee receives substantially all of the acquired assets, substantially all of the assets of the acquired or surviving corporation in a transaction otherwise qualifying as a reorganization under section 368(a)(1)(B) or section 368(a)(1)(A) by reason of section 368(a)(2)(E), or stock constituting control of the acquired corporation, (ii) the transferee is either a member of the qualified group (as defined in §1.368-1(d)(4)(ii)) or a partnership the business of which is treated as conducted by a member of the qualified group under §1.368-1(d)(4)(iii), and (iii) the COBE requirement is satisfied. For this purpose, the term substantially all as used in this regulation has the same meaning as in section 368(a)(1)(C). The IRS and Treasury Department believe that the types of asset and stock distributions described in these proposed regulations are consistent with the policies underlying the reorganization provisions, which are intended to apply to transactions that effect readjustments of continuing interests in the reorganized business in modified corporate form. See §1.368-1(b); see also H.R. Rep. No. 83-1337, at A134 (1954) (stating that a corporation may not acquire assets with the intention of transferring them to a stranger).

In the course of developing these proposed regulations, the IRS and Treasury Department considered adopting a rule that would permit a distribution of the acquiring, acquired, or surviving corporation's assets as long as the distribution did not cause that corporation to be treated as liquidating for Federal income tax purposes. However, the IRS and Treasury Department are concerned that such a rule might produce inappropriate results. For example, if a pre-existing acquiring subsidiary in a transaction otherwise qualifying under section 368(a) by reason of section 368(a)(2)(D) distributes all of the acquired assets to the issuing corporation and retains all of the previously held assets, the distribution may not constitute either an actual or *de facto* liquidation, even though none of the acquired as-

sets remain in the acquiring corporation. It could be argued that this transaction should be treated as a direct acquisition of the acquired assets by the issuing corporation. See, e.g., Rev. Rul. 72-405, 1972-2 C.B. 217.

The IRS and Treasury Department request comments regarding whether a transaction should continue to qualify as a reorganization under section 368(a) if the distribution, including a distribution to which section 355 applies, is to a person that is not a member of the qualified group (as defined in §1.368-1(d)(4)(ii)) or a partnership the business of which is not treated as conducted by a member of the qualified group under §1.368-1(d)(4)(iii).

B. Contributions to Partnerships

Currently, the operative rules of §1.368-2(k) are silent on the effect of a post-transaction transfer of assets or stock to a partnership on a transaction otherwise qualifying as a reorganization. However, *Example 3* of that regulation involves a transfer of acquired stock to a partnership. In the example, P owns 80 percent of the stock of S-1, S-1 owns 80 percent of the stock of S-2, and S-2 owns 80 percent of the stock of S-3. Pursuant to a plan of reorganization, S-1 acquires the stock of T solely in exchange for P voting stock, S-1 transfers the T stock to S-2, and S-2 transfers the T stock to S-3. Also as part of the plan, S-2 and S-3 form PRS, a partnership, and S-3 transfers the T stock to PRS in exchange for an 80 percent partnership interest. The example states that because this transfer to PRS is not described in §1.368-2(k), the characterization of the transaction must be determined under the relevant provisions of law, including the step transaction doctrine. The transaction therefore fails to qualify as a reorganization under section 368(a)(1)(B) because the acquiring corporation does not have control of T immediately after the acquisition.

The IRS and Treasury Department are studying whether, in the transaction described in *Example 3* of the current §1.368-2(k), S-1 should be treated as having control of T immediately after the acquisition. Consequently, *Example 3* is not included in these proposed regulations. However, the IRS and Treasury Department recognize that certain transfers to

partnerships would cause a transaction to fail the COBE requirement. For example, under the facts of *Example 3* of the current §1.368–2(k), because T is not a member of the qualified group after the stock transfer to PRS, the transaction would not satisfy the COBE requirement. Comments are requested on whether and how the COBE regulations should be amended to permit stock transfers to partnerships.

C. Effective Date

These regulations are proposed to apply to transactions that occur after the date that 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 Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, 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 businesses.

Comments and Requests for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these proposed regulations is Jeffrey B. Fienberg of the Office of Associate Chief Counsel (Corporate). 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 1.368–1 is amended as follows:

1. The text of paragraph (d)(4)(i) is redesignated as paragraph (d)(4)(i)(A) and a paragraph heading is added for (d)(4)(i)(A).

2. Paragraph (d)(4)(i)(B) is added.

3. The text of paragraph (d)(5) is redesignated as paragraph (d)(5)(i), and revised.

4. In newly designated paragraph (d)(5)(i), *Examples 7* through *12* are redesignated as *Examples 8* through *13*, respectively.

5. In newly designated paragraph (d)(5)(i), a new *Example 7* is added.

6. In newly designated paragraph (d)(5)(i), paragraph (i) in redesignated *Example 9*, paragraph (i) in redesignated *Example 10*, and the first sentence in paragraph (i) in redesignated *Example 12* are revised.

7. Paragraph (d)(5)(ii) is added.

The revisions and additions read as follows:

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

* * * * *

(d) * * *

(4) * * *

(i) *Business and assets of members of a qualified group*—(A) *In general.* * * *

(B) *Special rule.* The issuing corporation is treated as holding all of the businesses and assets of the surviving corporation after a reorganiza-

tion that otherwise satisfies the requirements of a reverse triangular merger (as defined in §1.358–6(b)(2)(iii)), the acquired corporation after a reorganization that otherwise satisfies the requirements of section 368(a)(1)(B), and the acquiring corporation after a reorganization that otherwise satisfies the requirements of a forward triangular merger (as defined in §1.358–6(b)(2)(i)), a triangular B reorganization (as defined in §1.358–6(b)(2)(iv)), a triangular C reorganization (as defined in §1.358–6(b)(2)(ii)), or a reorganization under section 368(a)(1)(G) by reason of section (a)(2)(D), provided that members of the qualified group own, in the aggregate, stock of the surviving, acquired, or acquiring corporation meeting the requirements of section 368(c). This paragraph (d)(4)(i)(B) applies to transactions occurring after the date these regulations are published as final in the **Federal Register**.

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(5) *Examples.* (i) The following examples illustrate this paragraph (d). All the corporations have only one class of stock outstanding:

* * * * *

Example 7. (i) *Facts.* The facts are the same as *Example 6*, except that, instead of P acquiring the assets of T, HC acquires all of the outstanding stock of T in exchange solely for voting stock of P. In addition, as part of the plan of reorganization, HC transfers 10 percent of the stock of T to each of subsidiaries S–1 through S–10. T will continue to operate an auto parts distributorship. Without regard to whether the transaction satisfies the COBE requirement, the transaction qualifies as a triangular B reorganization.

(ii) *Continuity of business enterprise.* Under paragraph (d)(4)(i)(B) of this section, P is treated as holding the assets and conducting the business of T because S–1 through S–10, members of the qualified group, together own stock of T meeting the requirements of section 368(c). The COBE requirement of paragraph (d)(1) of this section is satisfied because P is treated as continuing T's business.

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Example 9. * * * (i) *Facts.* The facts are the same as *Example 8*, except that S–3 transfers the historic T business to PRS in exchange for a 1 percent interest in PRS.

(ii) * * *

Example 10. * * * (i) *Facts.* The facts are the same as *Example 8*, except that S–3 transfers the historic T business to PRS in exchange for a 33 $\frac{1}{3}$ 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.

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Example 12. * * * (i) *Facts.* The facts are the same as *Example 11*, except that S-1 transfers all the T assets to PRS, and P and X each transfers cash to PRS in exchange for partnership interests. * * *

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(ii) *Effective dates.* Paragraph (d)(5) *Example 6* and *Example 8* through *Example 13* apply to transactions occurring after January 28, 1998, except that they do not apply to any transaction occurring pursuant to a written agreement that is binding on January 28, 1998, and at all times thereafter. Paragraph (d)(5) *Example 7* applies to transactions occurring after the date these regulations are published as final regulations in the **Federal Register**.

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Par. 3. Section 1.368-2 is amended by:

1. Adding three sentences at the end of paragraph (f).

2. Revising paragraphs (j)(3)(ii) and (iv).

3. Removing the first sentence of paragraph (j)(3)(iii) and adding two new sentences.

4. Revising paragraph (k).

The additions and the revision read as follows:

§1.368-2 *Definition of terms.*

* * * * *

(f) * * * If a transaction otherwise qualifies as a reorganization under section 368(a)(1)(B) or as a reverse triangular merger (as defined in §1.358-6(b)(2)(iii)), the target corporation (in the case of a transaction that otherwise qualifies as a reorganization under section 368(a)(1)(B)) or the surviving corporation (in the case of a transaction that otherwise qualifies as a reverse triangular merger) remains a party to the reorganization even though its stock or assets are transferred in a transaction described in paragraph (k) of this section. If a transaction otherwise qualifies as a forward triangular merger (as defined in §1.358-6(b)(2)(i)), a triangular B reorganization (as defined in §1.358-6(b)(2)(iv)), a triangular C reorganization (as defined in §1.358-6(b)(2)(ii)), or a reorganization under section 368(a)(1)(G) by reason of section 368(a)(2)(D), the acquiring corporation remains a party to the reorganization even though its stock is transferred in a transaction described in paragraph (k) of this section. The two preceding sentences

apply to transactions occurring after the date these regulations are published as final regulations in the **Federal Register**.

* * * * *

(j) * * *

(3) * * *

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

(iii) After the transaction, 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). The issuing corporation may transfer such properties as provided in paragraph (k) of this section. * * *

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(iv) Paragraph (j)(3)(ii) and the first two sentences of paragraph (j)(3)(iii) of this section apply to transactions occurring after the date these regulations are published as final regulations in the **Federal Register**. The remainder of paragraph (j)(3)(iii) of this section 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.

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(k) *Certain transfers of assets or stock in reorganizations—(1) General rule.* A transaction otherwise qualifying as a reorganization under section 368(a) shall not be disqualified as a result of a subsequent transfer (or successive transfers) of assets or stock if—

(i) The transfer is of part or all of—

(A) The assets of any party to the reorganization; or

(B) The stock of any party to the reorganization other than the issuing corporation (as defined in §1.368-1(b)); and

(ii) Either—

(A) In such subsequent transfer or transfers, a person is not the transferee of—

(1) substantially all (within the meaning of section 368(a)(1)(C)) of the acquired assets;

(2) substantially all (within the meaning of section 368(a)(1)(C)) of the assets of the acquired corporation immediately after a transaction otherwise qualifying as a reorganization under section 368(a)(1)(B);

(3) substantially all (within the meaning of section 368(a)(1)(C)) of the assets of the surviving corporation immediately after a transaction otherwise qualifying as a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(E); or

(4) control of the stock of the acquired corporation; or

(B) The transfer is to one or more corporations controlled in each transfer by the transferor corporation or to a partnership in which the transferor has an ownership interest immediately after the transfer; and

(iii) The transferee is either a member of the qualified group (as defined in §1.368-1(d)(4)(ii)) or a partnership the business of which is treated as conducted by a member of the qualified group under §1.368-1(d)(4)(iii); and

(iv) The requirements of §1.368-1(d) are satisfied.

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

(3) *Examples.* The following examples illustrate the application of this paragraph (k). Except as otherwise noted, P is the issuing corporation, and T is the target corporation. T operates a bakery that 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 and 80 percent of the stock of S-4. 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. S-4 owns 80 percent of the stock of S-5. The examples are as follows:

Example 1. Contributions of acquired assets to controlled corporations after a reorganization under section 368(a)(1)(C). (i) *Facts.* 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. In addition, pursuant to the plan of reorganization, S-1 transfers all of the T assets to S-2, and S-2 transfers all of the T assets to S-3.

(ii) *Analysis.* Under this paragraph (k), the transaction, which otherwise qualifies as a reorganization under section 368(a)(1)(C), is not disqualified by the successive transfers of all of the T assets to S-2 and from S-2 to S-3 because, in each transfer, the transferee corporation is controlled by the transferor corporation, S-2 and S-3 are members of the qualified group, and the transaction satisfies the requirements of §1.368-1(d).

Example 2. Distribution of acquired assets to the issuing corporation after a reorganization under section 368(a)(1)(C). (i) *Facts.* 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. In addition, pursuant to the plan of reorganization, S-1 transfers less than substantially all of the T assets to P. T does not have any liabilities.

(ii) *Analysis.* Under this paragraph (k), the transaction, which otherwise qualifies as a reorganization under section 368(a)(1)(C), is not disqualified by the transfer of T assets from S-1 to P because P is transferred less than substantially all of the T assets, P is a member of the qualified group, and the transaction satisfies the requirements of §1.368-1(d).

Example 3. Contributions of acquired assets to controlled corporations after a reorganization under section 368(a)(1)(D). (i) *Facts.* P owns 100 percent of the stock of T. Pursuant to a plan of reorganization, T transfers all of its assets to S-1 solely in exchange for S-1 stock, which T distributes to P. In addition, pursuant to the plan of reorganization, S-1 transfers all of the T assets to S-2, and S-2 transfers all of the T assets to S-3.

(ii) *Analysis.* Under this paragraph (k), the transaction, which otherwise qualifies as a reorganization under section 368(a)(1)(D), is not disqualified by the successive transfers of all 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, S-2 and S-3 are members of the qualified group, and the transaction satisfies the requirements of §1.368-1(d).

Example 4. Contribution of acquiring stock to controlled corporation after a reorganization under section 368(a)(1)(A). (i) *Facts.* Pursuant to a plan of reorganization, S-1 acquires all of the T assets in the merger of T into S-1. In the merger, the T shareholders receive consideration 50 percent of which is P stock and 50 percent of which is cash. Also, pursuant to the plan of reorganization, P transfers all of the S-1 stock to S-4.

(ii) *Analysis.* Under this paragraph (k), the transaction, which otherwise qualifies as a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(D), is not disqualified by the transfer of all of the S-1 stock to S-4 because the transferee corporation is controlled by the transferor corporation, S-4 is a member of the qualified group, and the transaction satisfies the requirements of §1.368-1(d).

Example 5. Contribution of acquired assets to a partnership after a reorganization under section 368(a)(1)(A). (i) *Facts.* Pursuant to a plan of reorganization, S-1 acquires all of the T assets in the merger of T into S-1. In the merger, the T shareholders receive consideration 50 percent of which is P stock and 50 percent of which is cash. In addition, pursuant to the plan of reorganization, S-1 transfers all of the T assets to PRS, a partnership in which S-1 owns a 33¹/₃ percent interest. S-1 does not perform active and substantial management functions as a partner with respect to PRS' business.

(ii) *Analysis.* Under this paragraph (k), the transaction, which otherwise qualifies as a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(D), is not disqualified by the transfer of T assets from S-1 to PRS because S-1 has an ownership interest in PRS immediately after the transfer, S-1 is a member of the qualified group and is treated as conducting the business of PRS under §1.368-1(d)(4)(iii), and the transaction satisfies the requirements of §1.368-1(d).

Example 6. Distribution of acquired assets to a partnership after a reorganization under section

368(a)(1)(A). (i) *Facts.* P owns an 80 percent interest in PRS, a partnership. PRS owns 20 percent of the stock of S-1. Pursuant to a plan of reorganization, S-1 acquires all of the T assets in the merger of T into S-1. In the merger, the T shareholders receive consideration 50 percent of which is P stock and 50 percent of which is cash. In addition, pursuant to the plan of reorganization, S-1 distributes less than substantially all of the T assets to PRS in redemption of 5 percent of the stock of S-1 owned by PRS.

(ii) *Analysis.* Under this paragraph (k), the transaction, which otherwise qualifies as a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(D), is not disqualified by the transfer of T assets from S-1 to PRS because PRS receives less than substantially all of the T assets, P is a member of the qualified group and is treated as conducting the business of PRS under §1.368-1(d)(4)(iii), and the transaction satisfies the requirements of §1.368-1(d).

Example 7. Contributions of acquired stock to controlled corporations after a reorganization under section 368(a)(1)(B). (i) *Facts.* Pursuant to a plan of reorganization, the T shareholders transfer all of their T stock to S-1 solely in exchange for P stock. In addition, pursuant to the plan of reorganization, S-1 transfers 50 percent of the T stock to S-2, and S-2 transfers that T stock to S-3.

(ii) *Analysis.* Under this paragraph (k), the transaction, which otherwise qualifies as a reorganization under section 368(a)(1)(B), is not disqualified by the successive transfers of part 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, S-2 and S-3 are members of the qualified group, and the transaction satisfies the requirements of §1.368-1(d).

Example 8. Contributions of acquiring corporation stock to controlled corporations after a reorganization under section 368(a)(1)(B). (i) *Facts.* Pursuant to a plan of reorganization, the T shareholders transfer all of their T stock to S-1 solely in exchange for P stock. In addition, as part of the plan of reorganization, following the acquisition of T stock by S-1, P transfers 10 percent of the S-1 stock to S-4, and S-4 transfers that S-1 stock to S-5.

(ii) *Analysis.* Under this paragraph (k), the transaction, which otherwise qualifies as a reorganization under section 368(a)(1)(B), is not disqualified by the successive transfers of S-1 stock to S-4 and from S-4 to S-5 because, in each transfer, the transferee corporation is controlled by the transferor corporation, S-4 and S-5 are members of the qualified group, and the transaction satisfies the requirements of §1.368-1(d).

(4) *Effective date.* This paragraph (k) applies to transactions occurring after the date these regulations are published as final regulations in the **Federal Register**.

Deborah M. Nolan,
Acting Deputy Commissioner for
Services and Enforcement.

(Filed by the Office of the Federal Register on August 17, 2004, 8:45a.m., and published in the issue of the Federal Register for August 18, 2004, 69 F.R. 51209)

issue new proposed regulations that provide a more complete set of rules addressing such transfers. Accordingly, the March 2004 proposed regulations are withdrawn.

Drafting Information

The principal author of this withdrawal notice is Jeffrey B. Fienberg of the Office of Associate Chief Counsel (Corporate).

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Withdrawal of Notice of Proposed Rulemaking

Accordingly, under the authority of 26 U.S.C. 7805, the notice of proposed rulemaking (REG-165579-02) published in the **Federal Register** on March 2, 2004 (69 FR 9771), is hereby withdrawn.

Deborah M. Nolan,
*Acting Deputy Commissioner for
Services and Enforcement.*

(Filed by the Office of the Federal Register on August 16, 2004, 8:45 a.m., and published in the issue of the Federal Register for August 17, 2004, 69 F.R. 51026)
