

T.D. 8761

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

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 in T.D. 8760, page 4 of this Bulletin, 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 in REG-120882-97, page 25 of this Bulletin.

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: Phoebe Bennett, (202) 622-7750 (not a toll-free number).

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 po-

tential 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 [1997-1 C.B. 800]) in the **Federal Register** (61 F.R. 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 in T.D. 8760. These temporary regulations supplement the final regulations.

Explanation of Provisions

Final regulations published in T.D. 8760 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 remaining T shareholders receive solely P stock. From the perspective of P, T, and the T shareholders, these two transactions are substantively identical, and the COI requirement is not satisfied in the first transaction. The temporary regulations provide that the second transaction likewise does not satisfy the COI requirement.

In addition, this approach corresponds with the rule of the final regulations that a proprietary interest in T is not preserved if, in connection with the potential reorganization, P stock furnished in exchange for a proprietary interest in T in the potential reorganization is redeemed. Because the final regulations do not inquire, in the case of a subsequent P redemption, whether the source of consideration furnished in the redemption was former T assets or historic P assets, the temporary regulations similarly do not make an inquiry in the case of a prior T redemption. Instead, for purposes of the COI requirement, the temporary regulations treat T and P as a combined economic enterprise. In an asset acquisition, this approach avoids the difficult process of identifying the source of payments as between T and P.

Commentators have suggested that this approach is inconsistent with authorities which hold that redemptions of stock of the target corporation with assets of the target corporation do not violate the solely-for-voting-stock requirement applicable to section 368(a)(1)(B) reorganizations. See, e.g., Rev. Rul. 55-440

(1955-2 C.B. 226). None of these authorities address the effect on continuity of interest of such redemptions. For the reasons stated above, the temporary regulations take such redemptions into account for continuity purposes.

The temporary regulations provide that a proprietary interest in T is not preserved if, in connection with a potential reorganization, it is redeemed or to the extent that, prior to and in connection with a potential reorganization, an extraordinary distribution is made with respect to it. An extraordinary distribution with respect to T stock, followed by a sale of the remaining T stock to P, has the same effect on the value of the proprietary interest in T as a pro rata redemption by T followed by a sale of the outstanding T stock to P.

The temporary regulations do not provide guidance on the determination of whether a distribution will be treated as an extraordinary distribution, except that the rules of section 1059 do not apply for this purpose. The IRS and Treasury Department invite comments on whether the regulations should provide more specific guidance in this area.

A section 355 distribution of controlled corporation stock by T will preserve a proprietary interest in T, except to the extent that the T shareholders receive other property or money to which section 356(a) applies or the distribution is extraordinary in amount and is a distribution of property or money to which section 356(b) applies.

Related Person Rule

In determining whether the COI requirement is satisfied, dispositions of T stock to persons that are not related to T or P are disregarded. The final regulations provide that a proprietary interest in T is not preserved if, in connection with a potential reorganization, a person related 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. Consistent with the final regulations, the temporary regulations provide that a proprietary interest in T is not preserved if, prior to and in connection with a potential reorganization, a person related to T acquires T stock with consideration other than T stock or P stock.

Definition of Related Person of T

The final regulations include as related persons any corporation that is a member of the affiliated group, within the meaning of section 1504, of which P is a member, and any corporation whose purchase of P stock would be treated as a redemption of that stock under section 304(a)(2). The section 1504 test was adopted because the IRS and Treasury Department were concerned that acquisitions of T stock or P stock by P affiliated corporations were no different in substance than acquisitions or redemptions by P. This concern does not generally extend to members of T's affiliated group that are not also considered related to T under section 304(a)(2) because such corporations are T shareholders participating in the potential reorganization along with the other shareholders of the target corporation. The temporary 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)).

Effect on Other Authorities

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, or as to the characterization of a related transaction. See, e.g., §1.301-1(l).

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 temporary regulations.

Effective Date

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.

Special Analyses

It has been determined that these temporary regulations are 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 temporary regulations and, because the temporary 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.

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.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOMETAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805. * * *

Par. 2. Section 1.368-1T is added to read as follows:

§1.368-1T Purpose and scope of exception of reorganization exchanges (temporary).

(a) through (e)(1)(i) [Reserved] For further guidance see §1.368-1(a) through (e)(1)(i).

(e)(1)(ii)(A) *General rule.* A proprietary interest in the target corporation (other than one held by the acquiring corporation) is not preserved if, prior to and in connection with a potential reorganization, it is redeemed or to the extent that, prior to and in connection with a potential reorganization, an extraordinary distribution is made with respect to it. The determination of whether a distribution with respect to stock of the target corporation is an extraordinary distribution for pur-

poses of this paragraph (e)(1)(ii) will be made on the basis of all of the facts and circumstances, but the treatment of the distribution under section 1059 (relating to extraordinary dividends) will not be taken into account.

(B) *Exception.* Paragraph (e)(1)(ii)(A) of this section does not apply to a distribution of stock by the target corporation to which section 355(a) (or so much of section 356 as relates to section 355) applies, except to the extent that—

(1) The target corporation shareholders receive other property or money to which section 356(a) applies; or

(2) The distribution is extraordinary in amount and is a distribution of property or money to which section 356(b) applies.

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

(ii) A proprietary interest in the target corporation is not preserved if, prior to and in connection with a potential reorganization, a person related (as defined in §1.368-1(e)(3) determined without regard to §1.368-1(e)(3)(i)(A)) to the target corporation acquires stock of the target corporation, with consideration other than stock of either the target corporation or the issuing corporation.

(e)(3) through (e)(6) *Example 9.* [Reserved] For further guidance, see §1.368-1(e)(3) through (e)(6) *Example 9.*

(e)(6) *Example 10. Acquisition of target corporation stock before merger.* (i) *Redemption by target corporation.* A owns 85 percent and B owns 15 percent of the stock of T. The fair market value of T is \$100x. Neither A nor B own stock of P. Prior to and in connection with the merger of T into P, T redeems A's T stock for \$85x and issues to A its promissory note in exchange for the stock. At the time of the merger T has a value of \$15x, after giving effect to the redemption of its stock. In the merger, B receives solely P stock. The continuity of interest requirement is not satisfied because T redeemed A's stock, and a substantial part of the value of the proprietary interest in T is not preserved. See paragraph (e)(1)(ii)(A) of this section.

(ii) *Purchase by person related to target corporation.* The facts are the same as paragraph (i) of this *Example 10*, except that X, T's wholly owned subsidiary, acquires A's T stock prior to and in connection with the merger for cash of \$85x. Under paragraph (e)(2)(ii) of this section and §1.368-1(e)(3)(i)(B), X's acquisition of A's T stock is an acquisition by a related person. The continuity of interest requirement is not satisfied, because X acquired T stock, 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)(ii) of this section.

Example 11. Extraordinary distribution before merger. A owns all of the stock of T. The fair mar-

ket value of T is \$100x. Prior to and in connection with the merger of T into P, T pays A an extraordinary distribution of an \$85x note. T merges into P, and A receives solely P stock. P assumes T's obligation on the note. The continuity of interest requirement is not satisfied, because T paid A an extraordinary distribution, and a substantial part of the value of the proprietary interest in T is not preserved. See paragraph (e)(1)(ii)(A) of this section.

(f) *Effective date.* 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 (subject to customary conditions) 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.

(Filed by the Office of the Federal Register on January 23, 1998, 12:15 p.m., and published in the issue of the Federal Register for January 28, 1998, 63 F.R. 4183)