

on or after September 7, 1999 or, if taxpayer so elects, to distributions in taxable years ending after August 8, 1999.

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SPECIAL RULE; DEFINITIONS

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

(a) *Reorganizations.* As used in the regulations under parts I, II, and III (section 301 and following), subchapter C, chapter 1 of the Code, the terms *reorganization* and *party to a reorganization* mean only a reorganization or a party to a reorganization as defined in subsections (a) and (b) of section 368. In determining whether a transaction qualifies as a reorganization under section 368(a), the transaction must be evaluated under relevant provisions of law, including the step transaction doctrine. But see §§ 1.368-2 (f) and (k) and 1.338-3(d). The preceding two sentences 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 binding on January 28, 1998, and at all times thereafter. With respect to insolvency reorganizations, see part IV, subchapter C, chapter 1 of the Code.

(b) *Purpose.* Under the general rule, upon the exchange of property, gain or loss must be accounted for if the new property differs in a material particular, either in kind or in extent, from the old property. The purpose of the reorganization provisions of the Code is to except from the general rule certain specifically described exchanges incident to such readjustments of corporate structures made in one of the particular ways specified in the Code, as are required by business exigencies and which effect only a readjustment of continuing interest in property under modified corporate forms. Requisite to a reorganization under the Internal Revenue Code are a continuity of the business enterprise through the issuing corporation under the modified corporate form as described in paragraph (d) of this section, and (except as provided in section 368(a)(1)(D)) a continuity of interest as described in paragraph (e) of this sec-

tion. (For rules regarding the continuity of interest requirement under section 355, see § 1.355-2(c).) For purposes of this section, the term *issuing corporation* means the acquiring corporation (as that term is used in section 368(a)), except that, in determining whether a reorganization qualifies as a triangular reorganization (as defined in § 1.358-6(b)(2)), the issuing corporation means the corporation in control of the acquiring corporation. The preceding three sentences 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 binding on January 28, 1998, and at all times thereafter. The continuity of business enterprise requirement is described in paragraph (d) of this section. Notwithstanding the requirements of this paragraph (b), for transactions occurring on or after February 25, 2005, a continuity of the business enterprise and a continuity of interest are not required for the transaction to qualify as a reorganization under section 368(a)(1)(E) or (F). The Code recognizes as a reorganization the amalgamation (occurring in a specified way) of two corporate enterprises under a single corporate structure if there exists among the holders of the stock and securities of either of the old corporations the requisite continuity of interest in the new corporation, but there is not a reorganization if the holders of the stock and securities of the old corporation are merely the holders of short-term notes in the new corporation. In order to exclude transactions not intended to be included, the specifications of the reorganization provisions of the law are precise. Both the terms of the specifications and their underlying assumptions and purposes must be satisfied in order to entitle the taxpayer to the benefit of the exception from the general rule. Accordingly, under the Code, a short-term purchase money note is not a security of a party to a reorganization, an ordinary dividend is to be treated as an ordinary dividend, and a sale is nevertheless to be treated as a sale even though the mechanics of a reorganization have been set up.

(c) *Scope.* The nonrecognition of gain or loss is prescribed for two specifically described types of exchanges, viz: The exchange that is provided for in section 354(a)(1) in which stock or securities in a corporation, a party to a reorganization, are, in pursuance of a plan of reorganization, exchanged for the stock or securities in a corporation, a party to the same reorganization; and the exchange that is provided for in section 361(a) in which a corporation, a party to a reorganization, exchanges property, in pursuance of a plan of reorganization, for stock or securities in another corporation, a party to the same reorganization. Section 368(a)(1) limits the definition of the term *reorganization* to six kinds of transactions and excludes all others. From its context, the term *a party to a reorganization* can only mean a party to a transaction specifically defined as a reorganization by section 368(a). Certain rules respecting boot received in either of the two types of exchanges provided for in section 354(a)(1) and section 361(a) are prescribed in sections 356, 357, and 361(b). A special rule respecting a transfer of property with a liability in excess of its basis is prescribed in section 357(c). Under section 367 a limitation is placed on all these provisions by providing that except under specified conditions foreign corporations shall not be deemed within their scope. The provisions of the Code referred to in this paragraph are inapplicable unless there is a plan of reorganization. A plan of reorganization must contemplate the bona fide execution of one of the transactions specifically described as a reorganization in section 368(a) and for the bona fide consummation of each of the requisite acts under which nonrecognition of gain is claimed. Such transaction and such acts must be an ordinary and necessary incident of the conduct of the enterprise and must provide for a continuation of the enterprise. A scheme, which involves an abrupt departure from normal reorganization procedure in connection with a transaction on which the imposition of tax is imminent, such as a mere device that puts on the form of a corporate reorganization as a disguise for concealing its real character, and the object and accomplishment of which is

the consummation of a preconceived plan having no business or corporate purpose, is not a plan of reorganization.

(d) *Continuity of business enterprise—*
(1) *General rule.* Continuity of business enterprise (COBE) requires that the issuing corporation (P), as defined in paragraph (b) of this section, either continue the target corporation's (T's) historic business or use a significant portion of T's historic business assets in a business. The preceding sentence 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. The application of this general rule to certain transactions, such as mergers of holding companies, will depend on all facts and circumstances. The policy underlying this general rule, which is to ensure that reorganizations are limited to readjustments of continuing interests in property under modified corporate form, provides the guidance necessary to make these facts and circumstances determinations.

(2) *Business continuity.* (i) The continuity of business enterprise requirement is satisfied if P continues T's historic business. The fact P is in the same line of business as T tends to establish the requisite continuity, but is not alone sufficient.

(ii) If T has more than one line of business, continuity of business enterprise requires only that P continue a significant line of business.

(iii) In general, a corporation's historic business is the business it has conducted most recently. However, a corporation's historic business is not one the corporation enters into as part of a plan of reorganization.

(iv) All facts and circumstances are considered in determining the time when the plan comes into existence and in determining whether a line of business is "significant".

(3) *Asset continuity.* (i) The continuity of business enterprise requirement is satisfied if P uses a significant portion of T's historic business assets in a business.

(ii) A corporation's historic business assets are the assets used in its historic business. Business assets may include stock and securities and intangible operating assets such as good will, patents, and trademarks, whether or not they have a tax basis.

(iii) In general, the determination of the portion of a corporation's assets considered "significant" is based on the relative importance of the assets to operation of the business. However, all other facts and circumstances, such as the net fair market value of those assets, will be considered.

(4) *Acquired assets or stock held by members of the qualified group or partnerships.* The following rules apply in determining whether the COBE requirement of paragraph (d)(1) of this section is satisfied:

(i) *Businesses and assets of members of a qualified group.* The issuing corporation is treated as holding all of the businesses and assets of all of the members of the qualified group, as defined in paragraph (d)(4)(ii) of this section.

(ii) *Qualified group.* A qualified group is one or more chains of corporations connected through stock ownership with the issuing corporation, but only if the issuing corporation owns directly stock meeting the requirements of section 368(c) in at least one other corporation, and stock meeting the requirements of section 368(c) in each of the corporations (except the issuing corporation) is owned directly (or indirectly as provided in paragraph (d)(4)(iii)(D) of this section) by one or more of the other corporations.

(iii) *Partnerships—(A) Partnership assets.* Each partner of a partnership will be treated as owning the T business assets used in a business of the partnership in accordance with that partner's interest in the partnership.

(B) *Partnership businesses.* The issuing corporation will be treated as conducting a business of a partnership if—

(1) Members of the qualified group, in the aggregate, own an interest in the partnership representing a significant interest in that partnership business; or

(2) One or more members of the qualified group have active and substantial management functions as a partner

with respect to that partnership business.

(C) *Conduct of the historic T business in a partnership.* If a significant historic T business is conducted in a partnership, the fact that P is treated as conducting such T business under paragraph (d)(4)(iii)(B) of this section tends to establish the requisite continuity, but is not alone sufficient.

(D) *Stock attributed from certain partnerships.* Solely for purposes of paragraph (d)(4)(ii) of this section, if members of the qualified group own interests in a partnership meeting requirements equivalent to section 368(c) (a section 368(c) controlled partnership), any stock owned by the section 368(c) controlled partnership shall be treated as owned by members of the qualified group. Solely for purposes of determining whether a lower-tier partnership is a section 368(c) controlled partnership, any interest in a lower-tier partnership that is owned by a section 368(c) controlled partnership shall be treated as owned by members of the qualified group.

(iv) *Effective/applicability dates.* Paragraphs (d)(4)(i) and (d)(4)(iii) (other than paragraph (d)(4)(iii)(D)) of this section 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 binding on January 28, 1998, and at all times thereafter. Paragraphs (d)(4)(ii) and (d)(4)(iii)(D) of this section apply to transactions occurring on or after October 25, 2007, except that they do not apply to any transaction occurring pursuant to a written agreement which is binding before October 25, 2007, and at all times after that.

(5) *Examples.* The following examples illustrate this paragraph (d). All the corporations have only one class of stock outstanding. The preceding sentence and 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 which is binding on January 28, 1998, and at all times thereafter. Paragraph (d)(5) *Example 7*, *Example 14*, and *Example 15* apply to transactions occurring on or after October 25, 2007, except that they

do not apply to any transaction occurring pursuant to a written agreement which is binding before October 25, 2007, and at all times after that. The examples read as follows:

Example 1. *T* conducts three lines of business: manufacture of synthetic resins, manufacture of chemicals for the textile industry, and distribution of chemicals. The three lines of business are approximately equal in value. On July 1, 1981, *T* sells the synthetic resin and chemicals distribution businesses to a third party for cash and marketable securities. On December 31, 1981, *T* transfers all of its assets to *P* solely for *P* voting stock. *P* continues the chemical manufacturing business without interruption. The continuity of business enterprise requirement is met. Continuity of business enterprise requires only that *P* continue one of *T*'s three significant lines of business.

Example 2. *P* manufactures computers and *T* manufactures components for computers. *T* sells all of its output to *P*. On January 1, 1981, *P* decides to buy imported components only. On March 1, 1981, *T* merges into *P*. *P* continues buying imported components but retains *T*'s equipment as a backup source of supply. The use of the equipment as a backup source of supply constitutes use of a significant portion of *T*'s historic business assets, thus establishing continuity of business enterprise. *P* is not required to continue *T*'s business.

Example 3. *T* is a manufacturer of boys' and men's trousers. On January 1, 1978, as part of a plan of reorganization, *T* sold all of its assets to a third party for cash and purchased a highly diversified portfolio of stocks and bonds. As part of the plan *T* operates an investment business until July 1, 1981. On that date, the plan of reorganization culminates in a transfer by *T* of all its assets to *P*, a regulated investment company, solely in exchange for *P* voting stock. The continuity of business enterprise requirement is not met. *T*'s investment activity is not its historic business, and the stocks and bonds are not *T*'s historic business assets.

Example 4. *T* manufactures children's toys and *P* distributes steel and allied products. On January 1, 1981, *T* sells all of its assets to a third party for \$100,000 cash and \$900,000 in notes. On March 1, 1981, *T* merges into *P*. Continuity of business enterprise is lacking. The use of the sales proceeds in *P*'s business is not sufficient.

Example 5. *T* manufactures farm machinery and *P* operates a lumber mill. *T* merges into *P*. *P* disposes of *T*'s assets immediately after the merger as part of the plan of reorganization. *P* does not continue *T*'s farm machinery manufacturing business. Continuity of business enterprise is lacking.

Example 6. Use of a significant portion of *T*'s historic business assets by the qualified group.

(i) *Facts.* *T* operates an auto parts distributorship. *P* owns 80 percent of the stock of a holding company (HC). HC owns 80 percent of the stock of ten subsidiaries, S-1 through S-10. S-1 through S-10 each separately operate a full service gas station. Pursuant to a plan of reorganization, *T* merges into *P* and the *T* shareholders receive solely *P* stock. As part of the plan of reorganization, *P* transfers *T*'s assets to HC, which in turn transfers some of the *T* assets to each of the ten subsidiaries. No one subsidiary receives a significant portion of *T*'s historic business assets. Each of the subsidiaries will use the *T* assets in the operation of its full service gas station. No *P* subsidiary will be an auto parts distributor.

(ii) *Continuity of business enterprise.* Under paragraph (d)(4)(i) of this section, *P* is treated as conducting the ten gas station businesses of S-1 through S-10 and as holding the historic *T* assets used in those businesses. *P* is treated as holding all the assets and conducting the businesses of all of the members of the qualified group, which includes S-1 through S-10 (paragraphs (d)(4)(i) and (ii) of this section). No member of the qualified group continues *T*'s historic distributorship business. However, subsidiaries S-1 through S-10 continue to use the historic *T* assets in a business. Even though no one corporation of the qualified group is using a significant portion of *T*'s historic business assets in a business, the COBE requirement of paragraph (d)(1) of this section is satisfied because, in the aggregate, the qualified group is using a significant portion of *T*'s historic business assets in a business.

Example 7. Transfers of acquired stock to members of the qualified group—continuity of business enterprise satisfied. (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 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 (as defined in § 1.358-6(b)(2)(iv)).

(ii) *Continuity of business enterprise.* Under paragraph (d)(4)(i) of this section, *P* is treated as holding the assets and conducting the business of *T* because *T* is a member of the qualified group (as defined in paragraph (d)(4)(ii) of this section). The COBE requirement of paragraph (d)(1) of this section is satisfied.

Example 8. Continuation of the historic T business in a partnership satisfies continuity of business enterprise. (i) *Facts.* *T* manufactures ski boots. *P* owns all of the stock of S-1. S-1 owns all of the stock of S-2, and S-2 owns all of the stock of S-3. *T* merges into *P* and the *T* shareholders receive consideration

consisting of *P* stock and cash. The *T* ski boot business is to be continued and expanded. In anticipation of this expansion, *P* transfers all of the *T* assets to S-1, S-1 transfers all of the *T* assets to S-2, and S-2 transfers all of the *T* assets to S-3. S-3 and *X* (an unrelated party) form a new partnership (PRS). As part of the plan of reorganization, S-3 transfers all the *T* assets to PRS, and S-3, in its capacity as a partner, performs active and substantial management functions for the PRS ski boot business, including making significant business decisions and regularly participating in the overall supervision, direction, and control of the employees of the ski boot business. S-3 receives a 20 percent interest in PRS. *X* transfers cash in exchange for an 80 percent interest in PRS.

(i) *Continuity of business enterprise.* Under paragraph (d)(4)(iii)(B)(2) of this section, *P* is treated as conducting *T*'s historic business because S-3 performs active and substantial management functions for the ski boot business in S-3's capacity as a partner. *P* is treated as holding all the assets and conducting the businesses of all of the members of the qualified group, which includes S-3 (paragraphs (d)(4)(i) and (ii) of this section). The COBE requirement of paragraph (d)(1) of this section is satisfied.

Example 9. Continuation of the historic T business in a partnership does not satisfy continuity of business enterprise. (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) *Continuity of business enterprise.* Under paragraph (d)(4)(iii)(B)(2) of this section, *P* is treated as conducting *T*'s historic business because S-3 performs active and substantial management functions for the ski boot business in S-3's capacity as a partner. The fact that a significant historic *T* business is conducted in PRS, and *P* is treated as conducting such *T* business under (d)(4)(iii)(B) tends to establish the requisite continuity, but is not alone sufficient (paragraph (d)(4)(iii)(C) of this section). The COBE requirement of paragraph (d)(1) of this section is not satisfied.

Example 10. Continuation of the T historic business in a partnership satisfies continuity of business enterprise. (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.

(ii) *Continuity of business enterprise.* Under paragraph (d)(4)(iii)(B)(1) of this section, *P* is treated as conducting *T*'s historic business because S-3 owns an interest in the partnership representing a significant interest in that partnership business. *P* is treated as holding all the assets and conducting the businesses of all of the members of the quali-

fied group, which includes S-3 (paragraphs (d)(4)(i) and (ii) of this section). The COBE requirement of paragraph (d)(1) of this section is satisfied.

Example 11. Use of T's historic business assets in a partnership business. (i) *Facts.* *T* is a fabric distributor. *P* owns all of the stock of S-1. *T* merges into *P* and the *T* shareholders receive solely *P* stock. S-1 and *X* (an unrelated party) own interests in a partnership (PRS). As part of the plan of reorganization, *P* transfers all of the *T* assets to S-1, and S-1 transfers all the *T* assets to PRS, increasing S-1's percentage interest in PRS from 5 to 33 $\frac{1}{3}$ percent. After the transfer, *X* owns the remaining 66 $\frac{2}{3}$ percent interest in PRS. Almost all of the *T* assets consist of *T*'s large inventory of fabric, which PRS uses to manufacture sportswear. All of the *T* assets are used in the sportswear business. No member of *P*'s qualified group performs active and substantial management functions for the sportswear business operated in PRS.

(ii) *Continuity of business enterprise.* Under paragraph (d)(4)(iii)(A) of this section, S-1 is treated as owning 33 $\frac{1}{3}$ percent of the *T* assets used in the PRS sportswear manufacturing business. Under paragraph (d)(4)(iii)(B)(1) of this section, *P* is treated as conducting the sportswear manufacturing business because S-1 owns an interest in the partnership representing a significant interest in that partnership business. *P* is treated as holding all the assets and conducting the businesses of all of the members of the qualified group, which includes S-1 (paragraphs (d)(4)(i) and (ii) of this section). The COBE requirement of paragraph (d)(1) of this section is satisfied.

Example 12. Aggregation of partnership interests among members of the qualified group: use of T's historic business assets in a partnership business. (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 transfer cash to PRS in exchange for partnership interests. After the transfers, *P* owns 11 percent, S-1 owns 22 $\frac{1}{3}$ percent, and *X* owns 66 $\frac{2}{3}$ percent of PRS.

(ii) *Continuity of business enterprise.* Under paragraph (d)(4)(iii)(B)(1) of this section, *P* is treated as conducting the sportswear manufacturing business because members of the qualified group, in the aggregate, own an interest in the partnership representing a significant interest in that business. *P* is treated as owning 11 percent of the assets directly, and S-1 is treated as owning 22 $\frac{1}{3}$ percent of the assets, used in the PRS sportswear business (paragraph (d)(4)(iii)(A) of this section). *P* is treated as holding all the assets of all of the members of the qualified group, which includes S-1, and thus in the aggregate, *P* is treated as owning 33 $\frac{1}{3}$ of the *T* assets (paragraphs (d)(4)(i) and (ii) of this

section). The COBE requirement of paragraph (d)(1) of this section is satisfied because *P* is treated as using a significant portion of *T*'s historic business assets in its sportswear manufacturing business.

Example 13. Tiered partnerships: use of T's historic business assets in a partnership business. (i) *Facts.* *T* owns and manages a commercial office building in state *Z*. Pursuant to a plan of reorganization, *T* merges into *P*, solely in exchange for *P* stock, which is distributed to the *T* shareholders. *P* transfers all of the *T* assets to a partnership, PRS-1, which owns and operates television stations nationwide. After the transfer, *P* owns a 50 percent interest in PRS-1. *P* does not have active and substantial management functions as a partner with respect to the PRS-1 business. *X*, not a member of *P*'s qualified group, owns the remaining 50 percent interest in PRS-1. PRS-1, in an effort to expand its state *Z* television operation, enters into a joint venture with *U*, an unrelated party. As part of the plan of reorganization, PRS-1 transfers all the *T* assets and its state *Z* television station to PRS-2, in exchange for a 75 percent partnership interest. *U* contributes cash to PRS-2 in exchange for a 25 percent partnership interest and oversees the management of the state *Z* television operation. PRS-1 does not actively and substantially manage PRS-2's business. PRS-2's state *Z* operations are moved into the acquired *T* office building. All of the assets that *P* acquired from *T* are used in PRS-2's business.

(ii) *Continuity of business enterprise.* Under paragraph (d)(4)(iii)(A) of this section, PRS-1 is treated as owning 75 percent of the *T* assets used in PRS-2's business. *P*, in turn, is treated as owning 50 percent of PRS-1's interest in the *T* assets. Thus, *P* is treated as owning 37½ percent (50 percent × 75 percent) of the *T* assets used in the PRS-2 business. Under paragraph (d)(4)(iii)(B)(i) of this section, *P* is treated as conducting PRS-2's business, the operation of the state *Z* television station, and under paragraph (d)(4)(iii)(A) of this section, *P* is treated as using 37½ percent of the historic *T* business assets in that business. The COBE requirement of paragraph (d)(1) of this section is satisfied because *P* is treated as using a significant portion of *T*'s historic business assets in its television business.

Example 14. Transfer of acquired stock to a partnership—continuity of business enterprise satisfied. (i) *Facts.* Pursuant to a plan of reorganization, the *T* shareholders transfer all of their *T* stock to a subsidiary of *P*, S-1, solely in exchange for *P* stock. In addition, as part of the plan of reorganization, S-1 transfers the *T* stock to its subsidiary, S-2, and S-2 transfers the *T* stock to its subsidiary, S-3. S-2 and S-3 form a new partnership, PRS. Immediately thereafter, S-3 transfers all of the *T* stock to PRS in exchange for an 80 percent interest in PRS, and S-2 transfers cash

to PRS in exchange for a 20 percent interest in PRS.

(ii) *Continuity of business enterprise.* Members of the qualified group, in the aggregate, own all of the interests in PRS. Because these interests in PRS meet requirements equivalent to section 368(c), under paragraph (d)(4)(iii)(D) of this section, the *T* stock owned by PRS is treated as owned by members of the qualified group. *P* is treated as holding all of the businesses and assets of *T* because *T* is a member of the qualified group (as defined in paragraph (d)(4)(ii) of this section). The COBE requirement of paragraph (d)(1) of this section is satisfied because *P* is treated as continuing *T*'s business.

Example 15. Transfer of acquired stock to a partnership—continuity of business enterprise not satisfied. (i) *Facts.* The facts are the same as in *Example 14*, except that S-3 and *U*, an unrelated corporation, form a new partnership, PRS, and, immediately thereafter, S-3 transfers all of the *T* stock to PRS in exchange for a 50 percent interest in PRS, and *U* transfers cash to PRS in exchange for a 50 percent interest in PRS.

(ii) *Continuity of business enterprise.* Members of the qualified group, in the aggregate, own 50 percent of the interests in PRS. Because these interests in PRS do not meet requirements equivalent to section 368(c), the *T* stock owned by PRS is not treated as owned by members of the qualified group under paragraph (d)(4)(iii)(D) of this section. *P* is not treated as holding all of the businesses and assets of *T* because *T* has ceased to be a member of the qualified group (as defined in paragraph (d)(4)(ii) of this section). The COBE requirement of paragraph (d)(1) of this section is not satisfied because *P* is not treated as continuing *T*'s business or using *T*'s historic business assets in a business.

(e) *Continuity of interest—(1) General rule.* (i) The purpose of the continuity of interest requirement is to prevent transactions that resemble sales from qualifying for nonrecognition of gain or loss available to corporate reorganizations. Continuity of interest requires that in substance a substantial part of the value of the proprietary interests in the target corporation be preserved in the reorganization. A proprietary interest in the target corporation is preserved if, in a potential reorganization, it is exchanged for a proprietary interest in the issuing corporation (as defined in paragraph (b) of this section), it is exchanged by the acquiring corporation for a direct interest in the target corporation enterprise, or it otherwise continues as a proprietary interest in the target corporation.

However, a proprietary interest in the target corporation is not preserved if, in connection with the potential reorganization, it is acquired by the issuing corporation for consideration other than stock of the issuing corporation, or stock of the issuing corporation furnished in exchange for a proprietary interest in the target corporation in the potential reorganization is redeemed. All facts and circumstances must be considered in determining whether, in substance, a proprietary interest in the target corporation is preserved. See paragraph (e)(6) of this section for rules related to when a creditor's claim against a target corporation is a proprietary interest in the corporation. For purposes of the continuity of interest requirement, a mere disposition of stock of the target corporation prior to a potential reorganization to persons not related (as defined in paragraph (e)(4) of this section) determined without regard to paragraph (e)(4)(i)(A) of this section) to the target corporation or to persons not related (as defined in paragraph (e)(4) of this section) to the issuing corporation is disregarded and a mere disposition of stock of the issuing corporation received in a potential reorganization to persons not related (as defined in paragraph (e)(4) of this section) to the issuing corporation is disregarded.

(ii) For purposes of paragraph (e)(1)(i) of this section, a proprietary interest in the target corporation (other than one held by the acquiring corporation) is not preserved to the extent that consideration received prior to a potential reorganization, either in a redemption of the target corporation stock or in a distribution with respect to the target corporation stock, is treated as other property or money received in the exchange for purposes of section 356, or would be so treated if the target shareholder also had received stock of the issuing corporation in exchange for stock owned by the shareholder in the target corporation. A proprietary interest in the target corporation is not preserved to the extent that creditors (or former creditors) of the target corporation that own a proprietary interest in the corporation under paragraph (e)(6) of this section (or would be so treated if they had received the consid-

eration in the potential reorganization) receive payment for the claim prior to the potential reorganization and such payment would be treated as other property or money received in the exchange for purposes of section 356 had it been a distribution with respect to stock.

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

(3) *Related persons acquisitions.* A proprietary interest in the target corporation is not preserved if, in connection with a potential reorganization, a person related (as defined in paragraph (e)(4) of this section) to the issuing corporation acquires, for consideration other than stock of the issuing corporation, either a proprietary interest in the target corporation or stock of the issuing corporation that was furnished in exchange for a proprietary interest in the target corporation. The preceding sentence does not apply to the extent those persons who were the direct or indirect owners of the target corporation prior to the potential reorganization maintain a direct or indirect proprietary interest in the issuing corporation.

(4) *Definition of related person—(i) In general.* For purposes of this paragraph (e), two corporations are related persons if either—

(A) The corporations are members of the same affiliated group as defined in section 1504 (determined without regard to section 1504(b)); or

(B) 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)).

(ii) *Special rules.* The following rules apply solely for purposes of this paragraph (e)(4):

(A) A corporation will be treated as related to another corporation if such relationship exists immediately before or immediately after the acquisition of the stock involved.

(B) A corporation, other than the target corporation or a person related (as defined in paragraph (e)(4) of this section) determined without regard to paragraph (e)(4)(i)(A) of this section) to the target corporation, will be treated

as related to the issuing corporation if the relationship is created in connection with the potential reorganization.

(5) *Acquisitions by partnerships.* For purposes of this paragraph (e), each partner of a partnership will be treated as owning or acquiring any stock owned or acquired, as the case may be, by the partnership in accordance with that partner's interest in the partnership. If a partner is treated as acquiring any stock by reason of the application of this paragraph (e)(5), the partner is also treated as having furnished its share of any consideration furnished by the partnership to acquire the stock in accordance with that partner's interest in the partnership.

(6) *Creditors' claims as proprietary interests—(i) In general.* A creditor's claim against a target corporation may be a proprietary interest in the target corporation if the target corporation is in a title 11 or similar case (as defined in section 368(a)(3)) or the amount of the target corporation's liabilities exceeds the fair market value of its assets immediately prior to the potential reorganization. In such cases, if any creditor receives a proprietary interest in the issuing corporation in exchange for its claim, every claim of that class of creditors and every claim of all equal and junior classes of creditors (in addition to the claims of shareholders) is a proprietary interest in the target corporation immediately prior to the potential reorganization to the extent provided in paragraph (e)(6)(ii) of this section.

(ii) *Value of proprietary interest—(A) Claims of most senior class of creditors receiving stock.* A claim of the most senior class of creditors receiving a proprietary interest in the issuing corporation and a claim of any equal class of creditors will be treated as a proprietary interest in accordance with the rules of this paragraph (e)(6)(ii). For a claim of the most senior class of creditors receiving a proprietary interest in the issuing corporation, and a claim of any equal class of creditors, the value of the proprietary interest in the target corporation represented by the claim is determined by multiplying the fair market value of the claim by a fraction, the numerator of which is the fair market value of the proprietary in-

terests in the issuing corporation that are received in the aggregate in exchange for the claims of those classes of creditors, and the denominator of which is the sum of the amount of money and the fair market value of all other consideration (including the proprietary interests in the issuing corporation) received in the aggregate in exchange for such claims. If only one class (or one set of equal classes) of creditors receives stock, such class (or set of equal classes) is treated as the most senior class of creditors receiving stock. When only one class (or one set of equal classes) of creditors receives issuing corporation stock in exchange for a creditor's proprietary interest in the target corporation, such stock will be counted for measuring continuity of interest provided that the stock issued by the issuing corporation is not de minimis in relation to the total consideration received by the insolvent target corporation, its shareholders, and its creditors.

(B) *Claims of junior classes of creditor receiving stock.* The value of a proprietary interest in the target corporation held by a creditor whose claim is junior to the claims of other classes of target claims which are receiving proprietary interests in the issuing corporation is the fair market value of the junior creditor's claim.

(iii) *Bifurcated claims.* If a creditor's claim is bifurcated into a secured claim and an unsecured claim pursuant to an order in a title 11 or similar case (as defined in section 368(a)(3)) or pursuant to an agreement between the creditor and the debtor, the bifurcation of the claim and the allocation of consideration to each of the resulting claims will be respected in applying the rules of this paragraph (e)(6).

(iv) *Effect of treating creditors as proprietors.* The treatment of a creditor's claim as a proprietary interest in the target corporation shall not preclude treating shares of the target corporation as proprietary interests in the target corporation.

(7) *Successors and predecessors.* For purposes of this paragraph (e), any reference to the issuing corporation or the target corporation includes a reference to any successor or predecessor of such corporation, except that the

target corporation is not treated as a predecessor of the issuing corporation and the issuing corporation is not treated as a successor of the target corporation.

(8) *Examples.* For purposes of the examples in this paragraph (e)(7), P is the issuing corporation, T is the target corporation, S is a wholly owned subsidiary of P, all corporations have only one class of stock outstanding, A and B are individuals, PRS is a partnership, all reorganization requirements other than the continuity of interest requirement are satisfied, and the transaction is not otherwise subject to recharacterization. The following examples illustrate the application of this paragraph (e):

Example 1. Sale of stock to third party. (i) *Sale of issuing corporation stock after merger.* A owns all of the stock of T. T merges into P. In the merger, A receives P stock having a fair market value of \$50x and cash of \$50x. Immediately after the merger, and pursuant to a preexisting binding contract, A sells all of the P stock received by A in the merger to B. Assume that there are no facts and circumstances indicating that the cash used by B to purchase A's P stock was in substance exchanged by P for T stock. Under paragraphs (e)(1) and (3) of this section, the sale to B is disregarded because B is not a person related to P within the meaning of paragraph (e)(4) of this section. Thus, the transaction satisfies the continuity of interest requirement because 50 percent of A's T stock was exchanged for P stock, preserving a substantial part of the value of the proprietary interest in T.

(ii) *Sale of target corporation stock before merger.* The facts are the same as paragraph (i) of this *Example 1*, except that B buys A's T stock prior to the merger of T into P and then exchanges the T stock for P stock having a fair market value of \$50x and cash of \$50x. The sale by A is disregarded. The continuity of interest requirement is satisfied because B's T stock was exchanged for P stock, preserving a substantial part of the value of the proprietary interest in T.

Example 2. Relationship created in connection with potential reorganization. Corporation X owns 60 percent of the stock of P and 30 percent of the stock of T. A owns the remaining 70 percent of the stock of T. X buys A's T stock for cash in a transaction which is not a qualified stock purchase within the meaning of section 338. T then merges into P. In the merger, X exchanges all of its T stock for additional stock of P. As a result of the issuance of the additional stock to X in the merger, X's ownership interest in P increases from 60 to 80 percent of the stock of P. X is

not a person related to P under paragraph (e)(4)(i)(B) of this section, because a purchase of stock of P by X would not be treated as a distribution in redemption of the stock of P under section 304(a)(2). However, X is a person related to P under paragraphs (e)(4)(i)(A) and (ii)(B) of this section, because X becomes affiliated with P in the merger. The continuity of interest requirement is not satisfied, because X acquired a proprietary interest in T 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)(3) of this section.

Example 3. Participation by issuing corporation in post-merger sale. A owns 80 percent of the T stock and none of the P stock, which is widely held. T merges into P. In the merger, A receives P stock. In addition, A obtains rights pursuant to an arrangement with P to have P register the P stock under the Securities Act of 1933, as amended. P registers A's stock, and A sells the stock shortly after the merger. No person who purchased the P stock from A is a person related to P within the meaning of paragraph (e)(4) of this section. Under paragraphs (e)(1) and (3) of this section, the sale of the P stock by A is disregarded because no person who purchased the P stock from A is a person related to P within the meaning of paragraph (e)(4) of this section. The transaction satisfies the continuity of interest requirement because A's T stock was exchanged for P stock, preserving a substantial part of the value of the proprietary interest in T.

Example 4. Redemptions and purchases by issuing corporation or related persons. (i) *Redemption by issuing corporation.* A owns 100 percent of the stock of T and none of the stock of P. T merges into S. In the merger, A receives P stock. In connection with the merger, P redeems all of the P stock received by A in the merger for cash. The continuity of interest requirement is not satisfied, because, in connection with the merger, P redeemed the stock exchanged for a proprietary interest in T, and a substantial part of the value of the proprietary interest in T is not preserved. See paragraph (e)(1) of this section.

(ii) *Purchase of target corporation stock by issuing corporation.* The facts are the same as paragraph (i) of this *Example 4*, except that, instead of P redeeming its stock, prior to and in connection with the merger of T into S, P purchases 90 percent of the T stock from A for cash. The continuity of interest requirement is not satisfied, because in connection with the merger, P acquired a proprietary interest in T 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)(1) of this section. However, see § 1.338-3(d) (which may change the result in this case by providing that, by virtue of section 338, continuity of

interest is satisfied for certain parties after a qualified stock purchase).

(iii) *Purchase of issuing corporation stock by person related to issuing corporation.* The facts are the same as paragraph (i) of this *Example 4*, except that, instead of P redeeming its stock, S buys all of the P stock received by A in the merger for cash. S is a person related to P under paragraphs (e)(4)(i)(A) and (B) of this section. The continuity of interest requirement is not satisfied, because S acquired P stock issued in the merger, and a substantial part of the value of the proprietary interest in T is not preserved. See paragraph (e)(3) of this section.

Example 5. Redemption in substance by issuing corporation. A owns 100 percent of the stock of T and none of the stock of P. T merges into P. In the merger, A receives P stock. In connection with the merger, B buys all of the P stock received by A in the merger for cash. Shortly thereafter, in connection with the merger, P redeems the stock held by B for cash. Based on all the facts and circumstances, P in substance has exchanged solely cash for T stock in the merger. The continuity of interest requirement is not satisfied, because in substance P redeemed the stock exchanged for a proprietary interest in T, and a substantial part of the value of the proprietary interest in T is not preserved. See paragraph (e)(1) of this section.

Example 6. Purchase of issuing corporation stock through partnership. A owns 100 percent of the stock of T and none of the stock of P. S is an 85 percent partner in PRS. The other 15 percent of PRS is owned by unrelated persons. T merges into P. In the merger, A receives P stock. In connection with the merger, PRS purchases all of the P stock received by A in the merger for cash. Under paragraph (e)(5) of this section, S, as an 85 percent partner of PRS, is treated as having acquired 85 percent of the P stock exchanged for A's T stock in the merger, and as having furnished 85 percent of the cash paid by PRS to acquire the P stock. S is a person related to P under paragraphs (e)(4)(i)(A) and (B) of this section. The continuity of interest requirement is not satisfied, because S is treated as acquiring 85 percent of the P stock issued in the merger, and a substantial part of the value of the proprietary interest in T is not preserved. See paragraph (e)(3) of this section.

Example 7. Exchange by acquiring corporation for direct interest. A owns 30 percent of the stock of T. P owns 70 percent of the stock of T, which was not acquired by P in connection with the acquisition of T's assets. T merges into P. A receives cash in the merger. The continuity of interest requirement is satisfied, because P's 70 percent proprietary interest in T is exchanged by P for a direct interest in the assets of the target corporation enterprise.

Example 8. Maintenance of direct or indirect interest in issuing corporation. X, a corpora-

tion, owns all of the stock of each of corporations P and Z. Z owns all of the stock of T. T merges into P. Z receives P stock in the merger. Immediately thereafter and in connection with the merger, Z distributes the P stock received in the merger to X. X is a person related to P under paragraph (e)(4)(i)(A) of this section. The continuity of interest requirement is satisfied, because X was an indirect owner of T prior to the merger who maintains a direct or indirect proprietary interest in P, preserving a substantial part of the value of the proprietary interest in T. See paragraph (e)(3) of this section.

Example 9. Preacquisition redemption by target corporation. T has two shareholders, A and B. P expresses an interest in acquiring the stock of T. A does not wish to own P stock. T redeems A's shares in T in exchange for cash. No funds have been or will be provided by P for this purpose. P subsequently acquires all the outstanding stock of T from B solely in exchange for voting stock of P. The cash received by A in the preorganization redemption is not treated as other property or money under section 356, and would not be so treated even if A had received some stock of P in exchange for his T stock. The preorganization redemption by T does not affect continuity of interest, because B's proprietary interest in T is unaffected, and the value of the proprietary interest in T is preserved.

Example 10. Creditors treated as owning a proprietary interest. (i) *More than one class of creditor receives issuing corporation stock.* T has assets with a fair market value of \$150x and liabilities of \$200x. T has two classes of creditors: two senior creditors with claims of \$25x each; and one junior creditor with a claim of \$150x. T transfers all of its assets to P in exchange for \$95x in cash and shares of P stock with a fair market value of \$55x. Each T senior creditor receives \$20x in cash and P stock with a fair market value of \$5x in exchange for his claim. The T junior creditor receives \$55x in cash and P stock with a fair market value of \$45x in exchange for his claim. The T shareholders receive no consideration in exchange for their T stock. Under paragraph (e)(6) of this section, because the amount of T's liabilities exceeds the fair market value of its assets immediately prior to the potential reorganization, the claims of the creditors of T may be proprietary interests in T. Because the senior creditors receive proprietary interests in P in the transaction in exchange for their claims, their claims and the claim of the junior creditor and the T stock are treated as proprietary interests in T immediately prior to the transaction. Under paragraph (e)(6)(ii)(A) of this section, the value of the proprietary interest of each of the senior creditors' claims is \$5x (the fair market value of the senior creditor's claim, \$25x, multiplied by a fraction, the numerator of which is \$10x, the fair

market value of the proprietary interests in the issuing corporation, P, received in the aggregate in exchange for the claims of all the creditors in the senior class, and the denominator of which is \$50x, the sum of the amount of money and the fair market value of all other consideration (including the proprietary interests in P) received in the aggregate in exchange for such claims). Accordingly, \$5x of the stock that each of the senior creditors receives is counted in measuring continuity of interest. Under paragraph (e)(6)(ii)(B) of this section, the value of the junior creditor's proprietary interest in T immediately prior to the transaction is \$100x, the value of his claim. Thus, the value of the creditors' proprietary interests in total is \$110x and the creditors received \$55x worth of P stock in total in exchange for their proprietary interests. Therefore, P acquired 50 percent of the value of the proprietary interests in T in exchange for P stock. Because a substantial part of the value of the proprietary interests in T is preserved, the continuity of interest requirement is satisfied.

(ii) *One class of creditor receives issuing corporation stock and cash in disproportionate amounts.* T has assets with a fair market value of \$80x and liabilities of \$200x. T has one class of creditor with two creditors, A and B, each having a claim of \$100x. T transfers all of its assets to P for \$60x in cash and shares of P stock with a fair market value of \$20x. A receives \$40x in cash in exchange for its claim. B receives \$20x in cash and P stock with a fair market value of \$20x in exchange for its claim. The T shareholders receive no consideration in exchange for their T stock. The P stock is not de minimis in relation to the total consideration received. Under paragraph (e)(6) of this section, because the amount of T's liabilities exceeds the fair market value of its assets immediately prior to the potential reorganization, the claims of the creditors of T may be proprietary interests in T. Because the creditors of T received proprietary interests in P in the transaction in exchange for their claims, their claims and the T stock are treated as proprietary interests in T immediately prior to the transaction. Under paragraph (e)(6)(ii)(A) of this section, the value of the proprietary interest of each of the senior creditors is \$10x (the fair market value of a senior creditor's claim, \$40x, multiplied by a fraction, the numerator of which is \$20x, the fair market value of the proprietary interests in the issuing corporation, P, received in the aggregate in exchange for the claims of all the creditors in the class, and the denominator of which is \$80x, the sum of the amount of money and the fair market value of all other consideration (including the proprietary interests in P) received in the aggregate in exchange for such claims). Accordingly, \$10x of the cash that was received by A and \$10x of

the P stock that was received by B are counted in measuring continuity of interest. Thus, the value of the creditors' proprietary interests in total is \$20x and the creditors received \$10x worth of P stock in total in exchange for their proprietary interests. Therefore, P acquired 50 percent of the value of the proprietary interests in T in exchange for P stock. Because a substantial part of the value of the proprietary interests in T is preserved, the continuity of interest requirement is satisfied.

(9) *Effective dates*—(i) *In general.* Paragraphs (e)(1) and (e)(3) through (e)(7) of this section 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 binding on January 28, 1998, and at all times thereafter. Paragraph (e)(1)(ii) of this section, however, applies to transactions occurring after August 30, 2000, unless the transaction occurs pursuant to a written agreement that is (subject to customary conditions) binding on that date and at all times thereafter. Taxpayers who entered into a binding agreement on or after January 28, 1998, and before August 30, 2000, may request a private letter ruling permitting them to apply the final regulations to their transaction. A private letter ruling will not be issued unless the taxpayer establishes to the satisfaction of the IRS that there is not a significant risk of different parties to the transaction taking inconsistent positions, for Federal tax purposes, with respect to the applicability of the final regulations to the transaction. The sixth sentence of paragraph (e)(1)(i) of this section, the last sentence of paragraph (e)(1)(ii) of this section, paragraph (e)(3) of this section, paragraph (e)(6) of this section, and *Example 10* of paragraph (e)(8) of this section apply to transactions occurring after December 12, 2008.

(ii) *Signing date rule.* [Reserved]. For further guidance, see § 1.368-1T(e)(8)(ii).

[T.D. 6500, 25 FR 11607, Nov. 26, 1960]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting § 1.368-1, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and on GPO Access.