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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

TD 9303

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Corporate Reorganizations; Distributions under sections 368(a)(1)(D) and 354(b)(1)(B)

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains temporary regulations under section 368 of the Internal Revenue Code of 1986 (Code). The temporary regulations provide guidance regarding the qualification of certain transactions as reorganizations described in section 368(a)(1)(D) where no stock and/or securities of the acquiring corporation is issued and distributed in the transaction. These regulations affect corporations engaging in such transactions and their shareholders. The text of the temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in the Proposed Rules section in this issue of the **Federal Register**.

DATES: Effective Date: These regulations are effective on December 19, 2006.

Applicability Date: For dates of applicability, see §1.368-2T(l)(4)(i).

FOR FURTHER INFORMATION CONTACT: Bruce A. Decker at (202) 622-7550 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

The IRS and Treasury Department have received requests for immediate guidance regarding whether certain acquisitive transactions can qualify as reorganizations described in section 368(a)(1)(D) where no stock of the transferee corporation is issued and distributed in the transaction. Currently, the IRS and Treasury Department are undertaking a broad study of issues related to acquisitive section 368(a)(1)(D) reorganizations. In the interest of efficient tax administration, the IRS and Treasury Department are issuing these temporary regulations to provide the requested certainty for taxpayers regarding these acquisitive transactions pending the broader study of issues. Although these rules also are being proposed in the Proposed Rules section in this issue of the **Federal Register**, the IRS and Treasury Department contemplate that the proposed rules may change upon completion of this broader study and the comments received.

The Code provides general nonrecognition treatment for reorganizations specifically described in section 368(a). Section 368(a)(1)(D) describes as a reorganization a transfer by a corporation (transferor corporation) of all or a part of its assets to another corporation (transferee corporation) if, immediately after the transfer, the transferor corporation or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the transferee corporation; but only if stock or securities of the controlled corporation are distributed in pursuance of a

plan of reorganization in a transaction that qualifies under section 354, 355, or 356.

Section 354(a)(1) provides that no gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization. Section 354(b)(1)(B) provides that section 354(a)(1) shall not apply to an exchange in pursuance of a plan of reorganization described in section 368(a)(1)(D) unless the transferee corporation acquires substantially all of the assets of the transferor corporation, and the stock, securities, and other properties received by such transferor corporation, as well as the other properties of such transferor corporation, are distributed in pursuance of the plan of reorganization.

Further, section 356 provides that if section 354 or 355 would apply to an exchange but for the fact that the property received in the exchange consists not only of property permitted by section 354 or 355 without the recognition of gain or loss but also of other property or money, then the gain, if any, to the recipient shall be recognized, but not in excess of the amount of money and fair market value of such other property. Accordingly, in the case of an acquisitive transaction, there can only be a distribution to which section 354 or 356 applies where the target shareholder(s) receive at least some property permitted to be received by section 354.

Notwithstanding the requirement in section 368(a)(1)(D) that “stock or securities of the corporation to which the assets are transferred are distributed in

a transaction which qualifies under section 354, 355, or 356”, the IRS and the courts have not required the actual issuance and distribution of stock and/or securities of the transferee corporation in circumstances where the same person or persons own all the stock of the transferor corporation and the transferee corporation. In such circumstances, the IRS and the courts have viewed an issuance of stock to be a “meaningless gesture” not mandated by sections 368(a)(1)(D) and 354(b).

In Revenue Ruling 70-240, 1970-1 CB 81 (see § 601.601(d)(2) of this chapter), B owned all of the stock of both corporation X and corporation Y. X sold its operating assets to Y for \$34x dollars, which represented the fair market value of X's assets. X had \$33x of other assets, consisting generally of cash, accounts receivables, and investments in stocks and bonds, so that the assets sold by X to Y constituted approximately 51% of X's total assets. Following the sale to Y, X paid its debts, which amounted to \$38x, and then liquidated, distributing \$29x to B, while Y continued to conduct the business formerly operated by X. The IRS concluded that “although no actual shares of the stock of Y were distributed to B as a result of the transaction, B is treated as having received Y stock since he already owned all the stock of Y.” Accordingly, the IRS held that the sale of the operating assets by X to Y, followed by the liquidation and distribution of X's assets to B, resulted in a reorganization under section 368(a)(1)(D) and a distribution under section 356(a), despite the absence of an actual issuance and distribution of Y stock.

When considering a similar transaction between two corporations owned in identical proportions by a husband and wife, the Tax Court concluded that there was in substance an exchange of stock which meets the requirements of section 354 and 356, and stated, “[t]he issuance of further stock would have been a meaningless gesture, and we cannot conclude that the statute requires such a vain act.” James Armour, Inc. v. Commissioner, 43 T.C. 295, 307 (1964). See also Wilson v. Commissioner, 46 T.C. 334 (1966). The IRS has also applied this meaningless gesture doctrine to circumstances where the transferor corporation and the transferee corporation are wholly owned by a single party directly or indirectly through subsidiaries, or as a result of family attribution pursuant to section 318(a)(1).

However, the application of this meaningless gesture doctrine has generally been limited to situations in which there is identical shareholder identity and proportionality of interest in the transferor corporation and the transferee corporation. For example, in Warsaw Photographic Associates, Inc. v. Commissioner, 84 T.C. 21 (1985), there was no issuance of stock by the transferee corporation to the transferor corporation, and the stock ownership in the two corporations was not identical. On the basis of these facts, the Tax Court concluded that the distribution of stock would not be a mere formality and refused to apply the meaningless gesture doctrine. Accordingly, the transaction failed to qualify as a section 368(a)(1)(D) reorganization because there was no distribution of stock of the transferee corporation under sections 368(a)(1)(D) and 354(b)(1)(B).

Explanation of Provisions

These temporary regulations provide guidance regarding the circumstances in which the distribution requirement under sections 368(a)(1)(D) and 354(b)(1)(B) is deemed satisfied despite the fact that no stock and/or securities are actually issued in a transaction otherwise described in section 368(a)(1)(D). In cases where the same person or persons own, directly or indirectly, all of the stock of the transferor and transferee corporations in identical proportions, these temporary regulations provide that the distribution requirement under sections 368(a)(1)(D) and 354(b)(1)(B) will be treated as satisfied even though no stock is actually issued in the transaction. For purposes of determining whether the same person or persons own all of the stock of the transferor and transferee corporations in identical proportions, these temporary regulations provide that an individual and all members of his family that have a relationship described in section 318(a)(1) will be treated as one individual.

The temporary regulations also provide that the distribution requirement under sections 368(a)(1)(D) and 354(b)(1)(B) will be treated as satisfied in the absence of any issuance of stock and/or securities where there is a de minimis variation in shareholder identity or proportionality of ownership in the transferor and transferee corporations. Further, stock described in section 1504(a)(4) is disregarded for purposes of determining whether the same person or persons own all of the stock of the transferor and transferee corporations in identical proportions.

Under these temporary regulations, in each case where it is determined that the same person or persons own all of the stock of the transferor and transferee corporations in identical proportions, a nominal share of stock of the transferee corporation will be deemed issued in addition to the actual consideration exchanged in the transaction. The nominal share of stock in the transferee corporation will then be deemed distributed by the transferor corporation to its shareholders and, in appropriate circumstances, further transferred to the extent necessary to reflect the actual ownership of the transferor and transferee corporations.

These temporary regulations are being issued in response to requests for immediate guidance regarding whether transactions otherwise described in section 368(a)(1)(D) qualify as reorganizations where no stock and/or securities of the transferee corporation are actually issued in the transaction. The IRS and Treasury Department currently are undertaking a broad study of issues related to acquisitive reorganizations, including issues addressed by these temporary regulations. The IRS and Treasury Department are issuing these temporary regulations in order to provide certainty for taxpayers while these issues are under study.

The IRS and Treasury Department believe that these temporary regulations are a reasonable interpretation of section 368(a)(1)(D) and section 354(b)(1)(B) given the history of those provisions and the manner in which they have previously been interpreted by the courts and the IRS. However, no inference should be drawn from these temporary regulations regarding the law

prior to the effective date of these temporary regulations. In the Proposed Rules section in this issue of the **Federal Register**, the IRS and Treasury Department are requesting comments on several issues relating to acquisitive reorganizations described in section 368(a)(1)(D).

In addition, the IRS and Treasury Department note that these temporary regulations do not expressly implement Prop. Reg. §1.368-1(f)(4) (FR 70, 11903-11912), which provides that there must be an exchange of net value except in the case of a transaction that would otherwise qualify as a reorganization described in section 368(a)(1)(D), provided that the fair market value of the property transferred to the acquiring corporation by the target corporation exceeds the amount of liabilities of the target corporation immediately before the exchange (including any liabilities cancelled, extinguished, or assumed in connection with the exchange), and the fair market value of the assets of the acquiring corporation equals or exceeds the amount of its liabilities immediately after the exchange. The solvency requirement remains the IRS's and Treasury Department's proposal but the IRS and Treasury Department continue to consider whether this solvency requirement should be applied to the transactions described in these temporary regulations.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these

regulations. For the applicability of the Regulatory Flexibility Act, please refer to the cross-reference notice of proposed rulemaking published elsewhere in this **Federal Register**. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is Bruce A. Decker of the Office of the Associate Chief Counsel (Corporate).

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

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

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

Par. 2. Section 1.368-2 is amended by revising paragraph (l) to read as follows:

§1.368-2 Definition of terms.

* * * * *

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

Par. 3. Section 1.368-2T is added to read as follows:

§1.368-2T Definition of terms (temporary).

(a) through (k) [Reserved]. For further guidance, see §1.368-2(a) through (k).

(l) Certain transactions treated as reorganizations described in section 368(a)(1)(D)--(1) General rule. In order to qualify as a reorganization under section 368(a)(1)(D), a corporation (transferor corporation) must transfer all or part of its assets to another corporation (transferee corporation) and immediately after the transfer the transferor corporation, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, must be in control of the transferee corporation; but only if, in pursuance of the plan, stock or securities of the transferee are distributed in a transaction which qualifies under section 354, 355, or 356.

(2) Distribution requirement--(i) In general. For purposes of paragraph (l)(1) of this section, a transaction otherwise described in section 368(a)(1)(D) will be treated as satisfying the requirements of sections 368(a)(1)(D) and 354(b)(1)(B) notwithstanding that there is no actual issuance of stock and/or securities of the transferee corporation if the same person or persons own, directly or indirectly, all of the stock of the transferor and transferee corporations in identical proportions. In such cases, the transferee corporation will be deemed to issue a nominal share of stock to the transferor corporation in addition to the actual consideration exchanged for the transferor corporation's assets. The nominal share of stock in the transferee corporation will then be deemed distributed by the transferor corporation to its shareholders and, where appropriate, further transferred through chains of ownership to the extent

necessary to reflect the actual ownership of the transferor and transferee corporations.

(ii) Attribution. For purposes of paragraph (l)(2)(i) of this section, ownership of stock will be determined by applying the principles of section 318(a)(2) without regard to the 50 percent limitation in section 318(a)(2)(C). In addition, an individual and all members of his family described in section 318(a)(1) shall be treated as one individual.

(iii) De minimis variations in ownership and certain stock not taken into account. For purposes of paragraph (l)(2)(i) of this section, the same person or persons will be treated as owning, directly or indirectly, all of the stock of the transferor and transferee corporations in identical proportions notwithstanding the fact that there is a de minimis variation in shareholder identity or proportionality of ownership. Additionally, for purposes of paragraph (l)(2)(i) of this section, stock described in section 1504(a)(4) is not taken into account.

(3) Examples. The following examples illustrate the principles of paragraph (l) of this section. For purposes of these examples, each of A, B, C, and D is an individual, T is the acquired corporation, S is the acquiring corporation, P is the parent corporation, and each of S1, S2, S3, and S4 is a direct or indirect subsidiary of P. Further, all of the requirements of section 368(a)(1)(D) other than the requirement that stock or securities be distributed in a transaction to which section 354 or 356 applies are satisfied. The examples are as follows:

Example 1. A owns all the stock of T and S. The T stock has a fair market value of \$100x. T sells all of its assets to S in exchange for \$100x of

cash and immediately liquidates. Because there is complete shareholder identity and proportionality of ownership in T and S, under paragraph (l)(2)(i) of this section, the requirements of sections 368(a)(1)(D) and 354(b)(1)(B) are treated as satisfied notwithstanding the fact that no S stock is issued. Pursuant to paragraph (l)(2)(i) of this section, S will be deemed to issue a nominal share of S stock to T in addition to the \$100x of cash actually exchanged for the T assets, and T will be deemed to distribute all such consideration to A. The transaction qualifies as a reorganization described in section 368(a)(1)(D).

Example 2. The facts are the same as in Example 1 except that C, A's son, owns all of the stock of S. Under paragraph (l)(2)(ii) of this section, A and C are treated as one individual. Accordingly, there is complete shareholder identity and proportionality of ownership in T and S. Therefore, under paragraph (l)(2)(i) of this section, the requirements of sections 368(a)(1)(D) and 354(b)(1)(B) are treated as satisfied notwithstanding the fact that no S stock is issued. Pursuant to paragraph (l)(2)(i) of this section, S will be deemed to issue a nominal share of S stock to T in addition to the \$100x of cash actually exchanged for the T assets, and T will be deemed to distribute all such consideration to A. A will be deemed to transfer the nominal share of S stock to C. The transaction qualifies as a reorganization described in section 368(a)(1)(D).

Example 3. P owns all of the stock of S1 and S2. S1 owns all of the stock of S3, which owns all of the stock of T. S2 owns all of the stock of S4, which owns all of the stock of S. The T stock has a fair market value of \$70x. T sells all of its assets to S in exchange for \$70x of cash and immediately liquidates. Under paragraph (l)(2)(ii) of this section, there is indirect, complete shareholder identity and proportionality of ownership in T and S. Accordingly, the requirements of sections 368(a)(1)(D) and 354(b)(1)(B) are treated as satisfied notwithstanding the fact that no S stock is issued. Pursuant to paragraph (l)(2)(i) of this section, S will be deemed to issue a nominal share of S stock to T in addition to the \$70x of cash actually exchanged for the T assets, and T will be deemed to distribute all such consideration to S3. S3 will be deemed to distribute the nominal share of S stock to S1, which, in turn, will be deemed to distribute the nominal share of S stock to P. P will be deemed to transfer the nominal share of S stock to S2, which, in turn, will be deemed to transfer such share of S stock to S4. The transaction qualifies as a reorganization described in section 368(a)(1)(D).

Example 4. A, B, and C own 34%, 33%, and 33%, respectively, of the stock of T. The T stock has a fair market value of \$100x. A, B, and C each own 33% of the stock of S. D owns the remaining 1% of the stock of S. T sells all of its assets to S in exchange for \$100x of cash and immediately liquidates. For purposes of determining whether the distribution requirement of sections 368(a)(1)(D) and 354(b)(1)(B) is met, under paragraph (l)(2)(iii) of this section, D's ownership of a de minimis amount of stock of S is disregarded and the transaction is treated as if there is complete shareholder identity and proportionality of ownership in T and S. Because there is complete shareholder

identity and proportionality of ownership in T and S, under paragraph (l)(2)(i) of this section, the requirements of sections 368(a)(1)(D) and 354(b)(1)(B) are treated as satisfied notwithstanding the fact that no S stock is issued. Pursuant to paragraph (l)(2)(i) of this section, S will be deemed to issue a nominal share of S stock to T in addition to the \$100x of cash actually exchanged for the T assets, T will be deemed to distribute all such consideration to A, B, and C, and the nominal S stock will be deemed transferred among the S shareholders to the extent necessary to reflect their actual ownership of S. The transaction qualifies as a reorganization described in section 368(a)(1)(D).

Example 5. The facts are the same as in Example 4 except that A, B, and C own 34%, 33%, and 33%, respectively, of the common stock of T and S. D owns preferred stock in S described in section 1504(a)(4). For purposes of determining whether the distribution requirement of sections 368(a)(1)(D) and 354(b)(1)(B) is met, under paragraph (l)(2)(iii) of this section, D's ownership of S stock described in section 1504(a)(4) is ignored and the transaction is treated as if there is complete shareholder identity and proportionality of ownership in T and S. Because there is complete shareholder identity and proportionality of ownership in T and S, under paragraph (l)(2)(i) of this section, the requirements of sections 368(a)(1)(D) and 354(b)(1)(B) are treated as satisfied notwithstanding the fact that no S stock is issued. Pursuant to paragraph (l)(2)(i) of this section, S will be deemed to issue a nominal share of S stock to T in addition to the \$100x of cash actually exchanged for the T assets, and T will be deemed to distribute all such consideration to A, B, and C. The transaction qualifies as a reorganization described in section 368(a)(1)(D).

Example 6. A and B each own 50% of the stock of T. The T stock has a fair market value of \$100x. B and C own 90% and 10%, respectively, of the stock of S. T sells all of its assets to S in exchange for \$100x of cash and immediately liquidates. Because complete shareholder identity and proportionality of ownership in T and S does not exist, paragraph (l)(2)(i) of this section does not apply. The requirements of sections 368(a)(1)(D) and 354(b)(1)(B) are not satisfied, and the transaction does not qualify as a reorganization described in section 368(a)(1)(D).

(4) Effective date. (i) In general. This section applies to transactions occurring on or after March 19, 2007, except that they do not apply to any transaction occurring pursuant to a written agreement which is binding before December 19, 2006, and at all times thereafter. A taxpayer may apply the provisions of these temporary regulations to transactions occurring before March 19, 2007.

However, the transferor corporation, the transferee corporation, any direct or indirect transferee of transferred basis property from either of the foregoing, and any shareholder of the transferor or transferee corporation may not apply the provisions of these temporary regulations unless all such taxpayers apply the provisions of the temporary regulations.

(ii) Expiration. This section expires on or before December 18, 2009.

Deputy Commissioner for Services and Enforcement.

Approved:

Acting Deputy Assistant Secretary of the Treasury.
(Tax Policy)