Notice of Proposed Rulemaking

Reorganizations Under Section 368(a)(1)(E) or (F)

REG–106889–04

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations that provide guidance regarding the requirements for a transaction to qualify as a reorganization under section 368(a)(1)(E) or (F) of the Internal Revenue Code. The proposed regulations will affect corporations and their shareholders.

DATES: Written or electronic comments and requests for a public hearing must be received by November 10, 2004.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–106889–04), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–106889–04), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically, via the Internal Revenue Service Internet site at *www.irs.gov/regs* or via the Federal eRulemaking Portal at *www.regulations.gov* (IRS — REG–106889–04).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Robert B. Gray, (202) 622–7550; concerning submissions of comments, Guy R. Traynor, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

In general, upon the exchange of property, gain or loss must be accounted for if the new property differs materially, in kind or extent, from the old property. See Internal Revenue Code (Code) §1001; §1.368–1(b). The purpose of the reorganization provisions of the Internal Revenue Code (the Code) is to except from the general rule certain specifically described exchanges that are required by business exigencies and effect only a readjustment of continuing interests in property under modified corporate forms. See §1.368–1(b).

Section 368(a)(1)(E) provides that the term reorganization includes a recapitalization (an E reorganization). A recapitalization has been defined as a "reshuffling of a capital structure within the framework of an existing corporation." *Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194 (1942).

Section 368(a)(1)(F) provides that the term reorganization includes a mere change in identity, form, or place of organization of one corporation, however effected (an F reorganization). One court has described the F reorganization as follows:

> [The F reorganization] encompass[es] only the simplest and least significant of corporate changes. The (F)-type reorganization presumes that the surviving corporation is the same corporation as the predecessor in every respect, except for minor or technical differences. For instance, the (F) reorganization typically has been understood to comprehend only such insignificant modifications as the reincorporation of the same corporate business with the same assets and the same stockholders surviving under a new charter either in the same or in a different State, the renewal of a corporate charter having a limited life, or the conversion of a U.S.-chartered savings and loan association to a State-chartered institution.

Berghash v. Commissioner, 43 T.C. 743, 752 (1965) (citation and footnotes omitted), *aff'd*, 361 F.2d 257 (2nd Cir. 1966).

To qualify as a reorganization, a transaction must generally satisfy not only the statutory requirements of the reorganization provisions but also certain nonstatutory requirements, including the continuity of interest and continuity of business enterprise requirements. See §1.368–1(b). The purpose of the continuity requirements is to ensure that reorganizations are limited to readjustments of continuing interests in property under modified corporate form and to prevent transactions that resemble sales from qualifying for nonrecognition of gain or loss available to corporate reorganizations. §1.368–1(d)(1) and (e)(1); see also *LeTulle v. Scofield*, 308 U.S. 415 (1940); *Helvering v. Minnesota Tea Co.*, 296 U.S. 378 (1935); *Pinellas Ice & Cold Storage Co. v. Commissioner,* 287 U.S. 462 (1933).

Despite the general rule, the courts and the Service have taken the position that the continuity of interest and continuity of business enterprise requirements need not be satisfied for a transaction to qualify as an E reorganization. See *Hickok v. Commissioner*, 32 T.C. 80 (1959); Rev. Rul. 82–34, 1982–1 C.B. 59; Rev. Rul. 77–415, 1977–2 C.B. 311. In Revenue Rulings 77–415 and 82–34, the IRS reasoned that the continuity of interest and continuity of business enterprise requirements are necessary in an acquisitive reorganization to ensure that the transaction does not involve an otherwise taxable transfer of stock or assets, but that they are not necessary when the transaction involves only a single corporation.

Although an F reorganization may involve an actual or deemed transfer of assets from one corporation to another, such a transaction effectively involves only one corporation. In this way, an F reorganization is much like an E reorganization, which can only involve one corporation even in form. As a result, an F reorganization is treated for most purposes of the Code as if the reorganized corporation were the same entity as the corporation in existence before the reorganization. Consequently, the taxable year of the corporation does not end on the date of the transfer, and the losses of the reorganized corporation can be carried back to offset income of its predecessor. See §1.381(b)–1(a)(2). Nonetheless, courts have applied the continuity requirements in determining whether a transaction qualifies as an F reorganization. See, *e.g.*, *Pridemark, Inc. v. Commissioner*, 345 F.2d 35 (4th Cir. 1965)

(stating that the application of the F reorganization statute is limited to cases where the corporate enterprise continues uninterrupted, except perhaps for a distribution of some of its liquid assets); *Yoc Heating Corp. v. Commissioner*, 61 T.C. 168 (1973) (holding that continuity of interest is required for an F reorganization).

The Service and the Treasury Department have considered whether continuity of interest and continuity of business enterprise should be requirements of an F reorganization. Because F reorganizations involve only the slightest change in a corporation and do not resemble sales, the Service and the Treasury Department have concluded that applying the continuity of interest and continuity of business enterprise requirements to transactions that would otherwise qualify as F reorganizations is not necessary to protect the policies underlying the reorganization provisions. Therefore, these proposed regulations provide that a continuity of interest and a continuity of business enterprise are not required for a transaction to qualify as an F reorganization. In addition, to reflect the IRS' position in Revenue Rulings 77–415 and 82–34, these proposed regulations provide that a continuity of interest and a continuity of business enterprise are not required for a transaction to qualify as an E reorganization.

In light of the proposed rules regarding the application of the continuity requirements to transactions that otherwise qualify as F reorganizations, the IRS and the Treasury Department believe it is desirable to provide guidance regarding the characteristics of F reorganizations. These regulations propose such criteria.

Consistent with section 368(a)(1)(F), the proposed regulations provide that, to qualify as an F reorganization, a transaction must result in a mere change in identity, form, or place of organization of one corporation. The proposed regulations further provide that a transaction that involves an actual or deemed transfer is a mere change only if four requirements are satisfied. First, all the stock of the resulting corporation, including stock issued before the transfer, must be issued in respect of stock of the transferring corporation. Second, there must be no change in the ownership of the corporation in the transaction, except a change that has no effect other than that of a redemption of less than all the shares of the corporation. Third, the transferring corporation must completely liquidate in the transaction. Fourth, the resulting corporation must not hold any property or have any tax attributes (including those specified in section 381(c)) immediately before the transfer.

The first two requirements reflect the Supreme Court's holding in *Helvering v. Southwest Consolidated*, 315 U.S. 194 (1942), that a transaction that shifts the ownership of the proprietary interests in a corporation cannot be a mere change. These requirements prevent a transaction that involves the introduction of a new shareholder or new capital into the corporation from qualifying as an F reorganization. Such an introduction may occur, for example, when a new shareholder contributes assets to the resulting corporation in exchange for stock before a merger of the transferring corporation into the resulting corporation. Notwithstanding these requirements, the proposed regulations permit the resulting corporation's issuance of a nominal amount of stock not in respect of stock of the transferring corporation to facilitate the organization of the resulting corporation. This rule is designed to permit reincorporation in a jurisdiction that requires, for example, minimum capitalization, two or more shareholders, or ownership of shares by directors. It is also intended to permit a transfer of assets to certain pre-existing entities.

The second requirement allows changes of ownership that have no effect other than a redemption of less than all the shares of the corporation to reflect the case law holding that certain transactions qualify as F reorganizations even if shareholders are redeemed in the transaction. See *Reef Corp. v. U.S.*, 368 F.2d 125 (5th Cir. 1966) (holding that a redemption of 48 percent of the stock of a corporation that occurred during a change in place of incorporation did not cause the transaction to fail to qualify as an F reorganization); cf. *Casco Products Corp. v. Commissioner*, 49 T.C. 32 (1967) (holding that the surviving corporation in a merger was the continuation of the merging corporation for purposes of allowing a loss carryback, despite the forced redemption of nine percent of the stock of the merging corporation).

The third requirement (providing for the liquidation of the transferring corporation) and the fourth requirement (limiting the assets the resulting corporation may hold immediately before the transfer) reflect the statutory requirement that an F reorganization involve only one corporation. Although the proposed regulations generally require that the transferring corporation completely liquidate in the transaction, they do not require the transferring corporation to legally dissolve, thereby facilitating preservation of the value of the transferring corporation's charter. Further, to accommodate transactions in jurisdictions where it is customary to preserve pre-existing entities for future use rather than create new ones, the proposed regulations permit the retention of a nominal amount of assets for the sole purpose of preserving the transferring corporation's legal existence.

Although the proposed regulations generally require that the resulting corporation not hold any property or have any tax attributes immediately before the transfer, they do allow the resulting corporation to hold or to have held a nominal amount of assets to facilitate its organization or preserve its existence, and to have tax attributes related to these assets. In addition, to accommodate transactions involving the refinancing of debt or the leveraged redemption of shareholders, the proposed regulations provide that this requirement will not be violated if, before the transfer, the resulting corporation holds the proceeds of borrowings undertaken in connection with the transaction.

As described above, section 368(a)(1)(F) provides that an F reorganization includes a mere change in identity, form, or place of organization of one corporation, however effected. The IRS and the Treasury Department believe that the inclusion of the words "however effected" in the statutory definition of an F reorganization reflects a Congressional intent to treat as an F reorganization a series of transactions that together result in a mere change. The proposed regulations reflect this view by providing that a series of related transactions that together result in a mere change may qualify as an F reorganization.

The IRS and the Treasury Department also recognize that a reorganization qualifying under section 368(a)(1)(F) may be

a step in a larger transaction that effects more than a mere change. For example, in Revenue Ruling 96–29, 1996–1 C.B. 50, the IRS ruled that a reincorporation qualified as an F reorganization even though it was a step in a transaction in which the reincorporated entity issued common stock in a public offering and redeemed stock having a value of 40 percent of the aggregate value of its outstanding stock before the offering. In the same ruling, the IRS ruled that a reincorporation of a corporation in another state qualified as an F reorganization even though it was a step in a transaction in which the reincorporated entity acquired the business of another entity.

Consistent with Revenue Ruling 96–29, the proposed regulations provide that related events preceding or following the transaction or series of transactions that constitute a mere change do not cause that transaction or series of transactions to fail to qualify as an F reorganization. The proposed regulations further provide that the qualification of the mere change as an F reorganization does not alter the treatment of the larger transaction. For example, if a redemption of stock occurs in a transaction that qualifies as an F reorganization and the F reorganization is part of a plan that includes a subsequent merger, the step or series of steps constituting the F reorganization will not alter the tax consequences of the subsequent merger.

A number of commentators have questioned whether distributions of money or other property in an F reorganization are distributions to which section 356 applies. The IRS and the Treasury Department believe it is appropriate to treat such distributions as transactions separate from the F reorganization, even if they occur during the F reorganization. See, *e.g.*, §1.301–1(*l*). Accordingly, these proposed regulations provide that if a shareholder receives money or other property (including in exchange for its shares) from the transferring or resulting corporation in a transaction that constitutes an F reorganization, the money or other property is treated as distributed by the transferring corporation immediately before the transaction. The tax treatment of such distributions is governed by sections 301 and 302, and section 356 does not apply to such distributions. The IRS and the Treasury Department believe that the same rule should apply in the context of E reorganizations. Comments are requested on whether there are some E reorganizations to which this treatment should not apply.

These regulations are proposed to be effective for transactions that occur on or after the date these regulations are published as final regulations in the **Federal Register**.

Effect on Other Documents

Upon the issuance of these regulations as final regulations, Rev. Rul. 66–284, 1966–2 C.B. 115, Rev. Rul. 74–36, 1974–1 C.B. 85, Rev. Rul. 77–415, 1977–2 C.B. 311, Rev. Rul. 77–479, 1977–2 C.B. 119, Rev. Rul. 79–250, 1979–2 C.B. 156, Rev. Rul. 82–34, 1982–1 C.B. 59, and Rev. Rul. 96–29, 1996–1 C.B. 50, will be obsoleted.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses.

Comments and Requests for a Public Hearing

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

Drafting Information

The principal author of these proposed regulations is Robert B. Gray of the Office of Associate Chief Counsel (Corporate). However, other personnel from the Service and Treasury Department participated in their development.

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Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.368–1(b) is amended by adding a sentence after the third sentence to read as follows:

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

* * * * *

(b) *Purpose*. * * * Notwithstanding the previous sentence, for transactions on or after the date these regulations are published as final regulations in the **Federal Register**, a continuity of the business enterprise and a continuity of interest are not required for a transaction to qualify as a reorganization under section 368(a)(1)(E) or (F). * * *

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

1. Adding and reserving new paragraph (l).

2. Adding new paragraph (m).

The addition reads as follows:

§1.368–2 Definition of terms.

* * * * *

(l) [Reserved].

(m) *Qualification as a reorganization under section 368(a)(1)(F)* — (1) *Mere change* — (i) *In general*. To qualify as a reorganization under section 368(a)(1)(F), a transaction must result in a mere change in identity, form, or place of organization of

one corporation ("mere change"). A transaction that involves an actual or deemed transfer is a mere change only if —

(A) All the stock of the resulting corporation, including stock issued before the transfer, is issued in respect of stock of the transferring corporation;

(B) There is no change in the ownership of the corporation in the transaction, except a change that has no effect other than that of a redemption of less than all the shares of the corporation;

(C) The transferring corporation completely liquidates in the transaction; and

(D) The resulting corporation does not hold any property or have any tax attributes (including those specified in section 381(c)) immediately before the transfer.

(ii) *Exceptions and special rules* — (A) *Transferring corporation*. Legal dissolution of the transferring corporation is not required, and the mere retention of a nominal amount of assets for the sole purpose of preserving the corporation's legal existence will not disqualify the transaction as a mere change.

(B) *Resulting corporation*. A transaction will not fail to be a mere change solely because the resulting corporation, to facilitate its organization, issues a nominal amount of stock other than in respect of stock of the transferring corporation. At the time of or before the transfer, the resulting corporation may hold or have held a nominal amount of assets to facilitate its organization or preserve its existence as a corporation, and may have tax attributes related to holding such assets. Moreover, the resulting corporation may hold the proceeds of borrowings undertaken in connection with the transaction.

(2) *Non-application of continuity of interest and continuity of business enterprise requirements*. A continuity of the business enterprise and a continuity of interest are not required for a transaction to qualify as a reorganization under section 368(a)(1)(F). See §1.368–1(b).

(3) *Related transactions* — (i) *Series of transactions*. A series of related transactions that together result in a mere change may qualify as a reorganization under section 368(a)(1)(F).

(ii) *Mere change within a larger transaction*. A reorganization under section 368(a)(1)(F) may occur within a larger transaction that effects more than a mere change. Related events that precede or follow the transaction or series of transactions that constitutes a mere change will not cause that transaction or series of transactions to fail to qualify as a reorganization under section 368(a)(1)(F). Qualification of the mere change as a reorganization under section 368(a)(1)(F) will not alter the treatment of the larger transaction.

(4) *Treatment of distributions*. If a shareholder receives money or other property (including in exchange for its shares) from the transferring or resulting corporation in a transaction that constitutes a reorganization under section 368(a)(1)(F), the money or other property is treated as distributed by the transferring corporation immediately before the transaction, and section 356(a) does not apply to such distribution. See, *e.g.*, §1.301–1(*l*).

(5) *Examples*. The following examples illustrate the application of this paragraph (m). In all examples, assume that each transaction is entered into for a valid business purpose and that all corporations are domestic corporations, unless stated otherwise. The examples are as follows:

Example 1. C owns all of the stock of W, a State A corporation. The net value of W's assets and liabilities is $1,000,000. V, a State B corporation, seeks to acquire the assets of W. To effect the acquisition, V and W enter into an agreement under which V will contribute $1,000,000 to U, a newly formed corporation of which V is the sole shareholder, and W will merge into U. In the merger, C surrenders his W stock in exchange for the $1,000,000 V contributed to U. After the merger, U holds all of the assets and liabilities of W. However, the U stock is not issued in respect of the W stock as required by paragraph (m)(1)(i)(A) of this section, and the transaction results in a change in the ownership of W that has an effect other than that of a redemption of some of the W shares in violation of paragraph (m)(1)(i)(B) of this section. Therefore, the merger of W into U is not a mere change and does not qualify as a reorganization under section 368(a)(1)(F).

Example 2. A and B own 75 and 25 percent, respectively, of the stock of X, a State A corporation. The management of X determines that it would be in the best interest of X to reorganize under the laws of State B. Accordingly, X forms Y, a State B corporation, and X and Y enter into an agreement under which X will merge into Y. A does not wish to own stock in Y. In the merger, A surrenders her X stock in exchange for cash from X from X's cash reserves, and B exchanges all of his X stock for all the stock of Y. Without regard to A's surrender of her stock in X, the merger of X into Y is a mere change of X. The change in ownership caused by A's surrender of her stock in X has no effect other than that of a redemption of less than all the X shares as described in paragraph (m)(1)(i)(B) of this section. Therefore, the merger of X into Y is a mere change and qualifies as a reorganization under section 368(a)(1)(F).

Example 3. D owns all of the stock of S, a Country A corporation. The management of S determines that it would be in the best interest of S to reorganize under the laws of Country B. Under Country B law, a corporation must have at least two shareholders to enjoy limited liability. D is advised by a Country B attorney that the new corporation should issue one percent of its stock to a shareholder that is not D's nominee to assure satisfaction of the two-shareholder requirement. As part of an integrated plan, E organizes T, a Country B corporation with 1,000 shares of common stock authorized, and contributes cash to T in exchange for ten of the common shares. S then merges into T under the laws of Country A and Country B. Pursuant to the plan of merger, D surrenders his shares of stock in S in exchange for 990 shares of T common stock. Without regard to the prior issuance of T stock to E, the merger of S into T is a mere change of S. The ten shares of stock issued to E not in respect of the S stock are nominal and used to facilitate the organization of T within the meaning of paragraph (m)(1)(ii)(B) of this section. Therefore, the issuance of this stock to a new shareholder does not cause the merger of S into T to fail to be a mere change. Accordingly, the merger is a reorganization under section 368(a)(1)(F).

Example 4. A owns all of the stock of H, a corporation that owns all of the stock of S, a corporation engaged in a manufacturing business. H has owned the stock of S for many years. H owns no assets other than the stock of S. A decides to eliminate the holding company structure by merging H into S. Because it operates a manufacturing business, the resulting corporation, S, holds property and has tax attributes immediately before the transfer. Therefore, under paragraph (m)(1)(i)(D) of this section, the merger of H into S is not a mere change and does not qualify as a reorganization under section 368(a)(1)(F). The same result would occur if, instead of H merging into S, S merged into H.

Example 5. Corporation P owns all of the stock of S1, a State X corporation. The management of P determines that it would be in the best interest of S1 to change its place of incorporation to State Y. Accordingly, under an integrated plan, P forms S2, a new State Y corporation, P contributes the S1 stock to S2, and S1 merges into S2 under the laws of State X and State Y. Under paragraph (m)(3)(i) of this section, a series of transactions that together result in a mere change of one corporation may qualify as a reorganization under section 368(a)(1)(F). The contribution of S1 stock to S2 and the merger of S1 into S2 together constitute a mere change of S1. Therefore, the transaction qualifies as a reorganization under section 368(a)(1)(F). S1 is treated as transferring its assets to S2 in exchange for the S2 stock and distributing the S2 stock to P in exchange for P's S1 stock.

Example 6. Corporation P owns all of the stock of S, a State X corporation. The management of P determines that it would be in the best interest of S to change its place of incorporation to State Y. Accordingly, P forms New S, a State Y corporation. S then merges into New S under the laws of State X and State Y. As part of the same plan, P sells all of its stock in New S to an unrelated party. Without regard to the sale of New S stock, the merger of S into New S is a mere change within the meaning of paragraph (m)(1)

of this section. Under paragraph (m)(3)(ii) of this section, related events that precede or follow the transaction or series of transactions that constitute a mere change do not cause that transaction to fail to qualify as a reorganization under section 368(a)(1)(F). Therefore, the sale of the New S stock is disregarded in determining whether the merger of S into New S is a mere change. Accordingly, the merger of S into New S is a reorganization under section 368(a)(1)(F).

Example 7. A owns all of the stock of T and none of the stock of P. P owns all of the stock of S. T and S are State M corporations engaged in manufacturing businesses. The following transactions occur pursuant to a single plan. First, T merges into S with A receiving solely stock in P. Second, P changes its state of incorporation to State N by merging into newly organized New P under the laws of State M and State N. Third, P redeems all the stock issued to A in respect of his T stock for cash. Without regard to the other steps, the merger of T into S qualifies as a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(D). Without regard to the other steps, the merger of P into New P qualifies as a reorganization under section 368(a)(1)(F). Under paragraph (m)(3)(ii) of this section, related events that precede or follow the transaction or series of transactions that constitute a mere change do not cause that transaction to fail to qualify as a reorganization under section 368(a)(1)(F). Therefore, the merger of P into New P qualifies as a reorganization under section 368(a)(1)(F). However, under paragraph (m)(3)(ii) of this section, the qualification of the merger of P into New P as a reorganization under section 368(a)(1)(F) does not alter the tax treatment of the merger of T into S. Because the P shares received by A in respect of the T shares are redeemed for cash pursuant to the plan, the merger of T into S does not satisfy the continuity of interest requirement and does not qualify as a reorganization under section 368(a)(1)(A).

Example 8. Corporation P owns all of the stock of S, a State A corporation. The management of P determines that it would be in the best interest of S to change its form from a State A corporation to a State A limited partnership. Accordingly, P contributes one percent of the S stock to newly formed LLC, a limited liability company, in exchange for all of the membership interests in LLC. Under §301.7701–3 of this chapter, LLC is disregarded as an entity separate from its owner, P. Under a State A statute, S converts to a State A limited partnership. In the conversion, P's interest as a 99 percent shareholder of S is converted into a 99 percent limited partner interest, and LLC's interest as a one percent shareholder of S is converted into a one percent general partner interest. S then elects, under §301.7701–3(c), to be classified as a corporation for federal income tax purposes, effective on the date of the conversion. The conversion of S from a State A corporation to a State A limited partnership, together with the election to treat S as a corporation for federal tax purposes, constitutes a mere change and is a reorganization under section 368(a)(1)(F).

(6) *Effective Date.* This paragraph (m) applies to transactions occurring on or after the date these regulations are published as final regulations in the **Federal Register**.

Linda M. Kroening,
Acting Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on August 11, 2004, 8:45 a.m., and published in the issue of the Federal Register for August 12, 2004, 69 F.R. 49836)