(including, but not limited to, the distribution of a liquidating corporation's earnings and profits with a principal purpose of avoiding U.S. tax). A liquidation may have a principal purpose of tax avoidance even though the tax avoidance purpose is outweighed by other purposes when taken together.

(e) *Effective date.* This section shall be applicable to distributions occurring on or after September 7, 1999 or, if taxpayer so elects, to distributions in taxable years ending after August 8, 1999.

[T.D. 8834, 64 FR 43077, Aug. 9, 1999; 65 FR 11467, Mar. 3, 2000, as amended by T.D. 9066, 68 FR 39452, July 2, 2003]

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 section. (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.

(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. *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 33⅓ 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 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 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 33⅓ percent. After the transfer, *X* owns the remaining 66⅔ 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 33⅓ 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 22⅓ percent, and *X* owns 66⅔ 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 22⅓ 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 33⅓ 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 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)(*1*) 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 consideration 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) *Measuring continuity of interest*—(i) *In general*. In determining whether a proprietary interest in the target corporation is preserved, the consideration to be exchanged for the proprietary interests in the target corporation pursuant to a contract to effect the potential reorganization shall be valued on the last business day before the first date such contract is a binding contract (the pre-signing date), if such contract provides for fixed consideration. If a portion of the consideration provided for in such a contract consists of other property identified by value, then this specified value of such other property is used for purposes of determining the extent to which a proprietary interest in the target corporation is preserved. If the contract does not provide for fixed consideration, this paragraph (e)(2)(i) is not applicable.

(ii) *Binding contract*—(A) *In general*. A binding contract is an instrument enforceable under applicable law against the parties to the instrument. The presence of a condition outside the control of the parties (including, for example, regulatory agency approval) shall not prevent an instrument from being a binding contract. Further, the fact that insubstantial terms remain to be negotiated by the parties to the contract, or that customary conditions remain to be satisfied, shall not prevent an instrument from being a binding contract.

(B) *Modifications*—(*1*) *In general*. If a term of a binding contract that relates to the amount or type of the consideration the target shareholders will receive in a potential reorganization is modified before the closing date of the potential reorganization, and the contract as modified is a binding contract, the date of the modification shall be treated as the first date there is a binding contract.

(*2*) *Modification of a transaction that preserves continuity of interest.* Notwithstanding paragraph (e)(2)(ii)(B)(*1*) of this section, a modification of a term that relates to the amount or type of consideration the target shareholders will receive in a transaction that would have resulted in the preservation of a substantial part of the value of the target corporation shareholders' proprietary interests in the target corporation if there had been no modification will not be treated as a modification if—

(*i*) The modification has the sole effect of providing for the issuance of additional shares of issuing corporation stock to the target corporation shareholders;

(*ii*) The modification has the sole effect of decreasing the amount of money or other property to be delivered to the target corporation shareholders; or

(*iii*) The modification has the effect of decreasing the amount of money or other property to be delivered to the target corporation shareholders and providing for the issuance of additional shares of issuing corporation stock to the target corporation shareholders.

(*3*) *Modification of a transaction that does not preserve continuity of interest.* Notwithstanding paragraph (e)(2)(ii)(B)(*1*) of this section, a modification of a term that relates to the amount or type of consideration the target shareholders will receive in a transaction that would not have resulted in the preservation of a substantial part of the value of the target corporation shareholders' proprietary interests in the target corporation if there had been no modification will not be treated as a modification if—

(*i*) The modification has the sole effect of providing for the issuance of fewer shares of issuing corporation stock to the target corporation shareholders;

(*ii*) The modification has the sole effect of increasing the amount of money or other property to be delivered to the target corporation shareholders; or

(*iii*) The modification has the effect of increasing the amount of money or other property to be delivered to the target corporation shareholders and providing for the issuance of fewer shares of issuing corporation stock to the target corporation shareholders.

(C) *Tender offers.* For purposes of this paragraph (e)(2), a tender offer that is subject to section 14(d) of the Securities and Exchange Act of 1934 [15 U.S.C. 78n(d)(1)] and Regulation 14D (17 CFR 240.14d–1 through 240.14d–101) and is not pursuant to a binding contract, is treated as a binding contract made on the date of its announcement, notwithstanding that it may be modified by the offeror or that it is not enforceable against the offerees. If a modification (not pursuant to a binding contract) of such a tender offer is subject to the provisions of Regulation 14d–6(c) (17 CFR 240.14d–6(c)) and relates to the amount or type of the consideration received in the tender offer, then the date of the modification shall be treated as the first date there is a binding contract.

(iii) *Fixed consideration*—(A) *In general.* A contract provides for fixed consideration if it provides the number of shares of each class of stock of the issuing corporation, the amount of money, and the other property (identified either by value or by specific description), if any, to be exchanged for all the proprietary interests in the target corporation, or to be exchanged for each proprietary interest in the target corporation. A shareholder's election to receive a number of shares of stock of the issuing corporation, money, or other property (or some combination of stock of the issuing corporation, money, or other property) in exchange for all of the shareholder's proprietary interests in the target corporation, or each of the shareholder's proprietary interests in the target corporation, will not prevent a contract from satisfying the definition of fixed consideration provided for in this paragraph (e)(2)(iii)(A).

(B) *Shareholder elections.* A contract that provides a target corporation shareholder with an election to receive a number of shares of stock of the issuing corporation, money, or other property (or some combination of stock of the issuing corporation, money, or other property) in exchange for all of the shareholder's proprietary interests in the target corporation, or each of the shareholder's proprietary interests in the target corporation, provides for fixed consideration if the determination of the number of shares of issuing corporation stock to be provided to the target corporation shareholder is determined using the value of the issuing corporation stock on the last business day before the first date there is a binding contract. This is the case even though the shareholder election may preclude a determination, prior to the closing date, of the number of shares of each class of the issuing corporation, the amount of money, and the other property (or the combination of shares, money and other property) to be exchanged for each proprietary interest in the target corporation.

(C) *Contingent adjustments to the consideration*—(*1*) *In general.* Except as provided in paragraph (e)(2)(iii)(C)(*2*) of this section, a contract that provides for contingent adjustments to the consideration will be treated as providing for fixed consideration if it would satisfy the requirements of paragraph (e)(2)(iii)(A) of this section without the contingent adjustment provision.

(*2*) *Exceptions.* A contract will not be treated as providing for fixed consideration if the contract provides for contingent adjustments to the consideration that prevent (to any extent) the target corporation shareholders from being subject to the economic benefits and burdens of ownership of the issuing corporation stock after the last business day before the first date the contract is a binding contract. For example, a contract will not be treated as providing for fixed consideration if the contract provides for contingent adjustments to the consideration in the event that the value of the stock of the issuing corporation, the value of the assets of the issuing corporation, or the value of any surrogate for either the value of the stock of the issuing corporation or the assets of the issuing corporation increases or decreases after the last business day before the first date there is a binding contract. Similarly, a contract will not be treated as providing for fixed consideration if the contract provides for contingent adjustments to the number of shares of the issuing corporation stock to be provided to the target corporation shareholders computed using any value of the issuing corporation shares after the last business day before the first date there is a binding contract.

(D) *Escrows.* Placing part of the consideration to be exchanged for proprietary interests in the target corporation in escrow to secure target's performance of customary pre-closing covenants or customary target representations and warranties will not prevent a contract from being treated as providing for fixed consideration.

(E) *Anti-dilution clauses.* The presence of a customary anti-dilution clause will not prevent a contract from being treated as providing for fixed consideration. However, the absence of such a clause will prevent a contract from being treated as providing for fixed consideration if the issuing corporation alters its capital structure between the first date there is an otherwise binding contract to effect the transaction and the effective date of the transaction in a manner that materially alters the economic arrangement of the parties to the binding contract. If the number of shares of the issuing corporation to be issued to the target corporation shareholders is altered pursuant to a customary anti-dilution clause, the value of the shares determined under paragraph (e)(2)(i) of this section must be adjusted accordingly.

(F) *Dissenters' rights.* The possibility that some shareholders may exercise dissenters' rights and receive consideration other than that provided for in the binding contract will not prevent the contract from being treated as providing for fixed consideration.

(G) *Fractional shares.* The fact that money may be paid in lieu of issuing fractional shares will not prevent a contract from being treated as providing for fixed consideration.

(iv) *New issuances.* For purposes of applying paragraph (e)(2)(i) of this section, any class of stock, securities, or indebtedness that the issuing corporation issues to the target corporation shareholders pursuant to the potential reorganization and that does not exist before the first date there is a binding contract to effect the potential reorganization is deemed to have been issued on the last business day before the first date there is a binding contract to effect the potential reorganization.

(v) *Examples*. For purposes of the examples in this paragraph (e)(2)(v), 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 is an individual, no transactions other than those described occur, and the transactions are not otherwise subject to recharacterization. The following examples illustrate the application of this paragraph (e)(2):

Example 1. Application of signing date rule. On January 3 of year 1, P and T sign a binding contract pursuant to which T will be merged with and into P on June 1 of year 1. Pursuant to the contract, the T shareholders will receive 40 P shares and $60 of cash in exchange for all of the outstanding stock of T. Twenty of the P shares, however, will be placed in escrow to secure customary target representations and warranties. The P stock is listed on an established market. On January 2 of year 1, the value of the P stock is $1 per share. On June 1 of year 1, T merges with and into P pursuant to the terms of the contract. On that date, the value of the P stock is $.25 per share. None of the stock placed in escrow is returned to P. Because the contract provides for the number of shares of P and the amount of money to be exchanged for all of the proprietary interests in T, under this paragraph (e)(2), there is a binding contract providing for fixed consideration as of January 3 of year 1. Therefore, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on the pre-signing date. Because, for continuity of interest purposes, the T stock is exchanged for $40 of P stock and $60 of cash, the transaction preserves a substantial part of the value of the proprietary interest in T. Therefore, the transaction satisfies the continuity of interest requirement.

Example 2. Treatment of forfeited escrowed stock. (i) Escrowed stock. The facts are the same as in *Example 1* except that T's breach of a representation results in the escrowed consideration being returned to P. Because the contract provides for the number of shares of P and the amount of money to be exchanged for all of the proprietary interests in T, under this paragraph (e)(2), there is a binding contract providing for fixed consideration as of January 3 of year 1. Therefore, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on the pre-signing date. Pursuant to paragraph (e)(1)(i) of this section, for continuity of interest purposes, the T stock is exchanged for $20 of P stock and $60 of cash, and the transaction does not preserve a substantial part of the value of the proprietary interest in T. Therefore, the transaction does not satisfy the continuity of interest requirement.

(ii) *Escrowed stock and cash.* The facts are the same as in paragraph (i) of this *Example 2* except that the consideration placed in escrow consists solely of eight of the P shares and $12 of the cash. Because the contract provides for the number of shares of P and the amount of money to be exchanged for all of the proprietary interests in T, under this paragraph (e)(2), there is a binding contract providing for fixed consideration as of January 3 of year 1. Therefore, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on the pre-signing date. Pursuant to paragraph (e)(1)(i) of this section, for continuity of interest purposes, the T stock is exchanged for $32 of P stock and $48 of cash, and the transaction preserves a substantial part of the value of the proprietary interest in T. Therefore, the transaction satisfies the continuity of interest requirement.

Example 3. Redemption of stock received pursuant to binding contract. The facts are the same as in *Example 1* except that A owns 50 percent of the outstanding stock of T immediately prior to the merger and receives 10 P shares and $30 in the merger and an additional 10 P shares upon the release of the stock placed in escrow. In connection with the merger, A and S agree that, immediately after the merger, S will purchase any P shares that A acquires in the merger for $1 per share. Shortly after the merger, S purchases A's P shares for $20. Because the contract provides for the number of shares of P and the amount of money to be exchanged for all of the proprietary interests in T, under this paragraph (e)(2), there is a binding contract providing for fixed consideration as of January 3 of year 1. Therefore, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on the pre-signing date. In addition, S is a person related to P under paragraph (e)(4)(i)(A) of this section. Accordingly, A is treated as exchanging his T shares for $50 of cash. Because, for continuity of interest purposes, the T stock is exchanged for $20 of P stock and $80 of cash, the transaction does not preserve a substantial part of the value of the proprietary interest in T. Therefore, the transaction does not satisfy the continuity of interest requirement.

Example 4. Modification of binding contract—continuity not preserved. The facts are the same as in *Example 1* except that on April 1 of year 1, the parties modify their contract. Pursuant to the modified contract, which is a binding contract, the T shareholders will receive 50 P shares (an additional 10 shares) and $75 of cash (an additional $15 of cash) in exchange for all of the outstanding T stock. On March 31 of year 1, the value of the P stock is $.50 per share. Under this paragraph (e)(2), although there was a binding contract providing for fixed consideration as of January 3 of year 1, terms of that contract relating to the consideration to be provided to the target shareholders were modified on April 1 of year 1. The execution of the transaction without modification would have resulted in the preservation of a substantial part of the value of the target corporation shareholders' proprietary interests in the target corporation if there had been no modification. However, because the modified contract provides for additional P stock and cash to be exchanged for all the proprietary interests in T, the exception in paragraph (e)(2)(ii)(B)(*2*) of this section does not apply to preserve the original signing date. Therefore, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on March 31 of year 1. Because, for continuity of interest purposes, the T stock is exchanged for $25 of P stock and $75 of cash, the transaction does not preserve a substantial part of the value of the proprietary interest in T. Therefore, the transaction does not satisfy the continuity of interest requirement.

Example 5. Modification of binding contract disregarded—continuity preserved. The facts are the same as in *Example 4* except that, pursuant to the modified contract, which is a binding contract, the T shareholders will receive 60 P shares (an additional 20 shares as compared to the original contract) and $60 of cash in exchange for all of the outstanding T stock. In addition, on March 31 of year 1, the value of the P stock is $.40 per share. Under this paragraph (e)(2), although there was a binding contract providing for fixed consideration as of January 3 of year 1, terms of that contract relating to the consideration to be provided to the target shareholders were modified on April 1 of year 1. Nonetheless, the modification has the sole effect of providing for the issuance of additional P shares to the T shareholders. In addition, the execution of the terms of the contract without regard to the modification would have resulted in the preservation of a substantial part of the value of the T shareholders' proprietary interest in T because, for continuity of interest purposes, the T stock would have been exchanged for $40 of P stock and $60 of cash. Pursuant to paragraph (e)(2)(ii)(B)(*2*) of this section, the modification is not treated as a modification for purposes of paragraph (e)(2)(ii)(B)(*1*) of this section. Accordingly, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on the pre-signing date. Because, for continuity of interest purposes, the T stock is exchanged for $60 of P stock and $60 of cash, the transaction preserves a substantial part of the value of the proprietary interest in T. Therefore the transaction satisfies the continuity of interest requirement.

Example 6. New issuance. The facts are the same as in *Example 1*, except that, instead of cash, the T shareholders will receive a new class of P securities that will be publicly traded. In the aggregate, the securities will have a stated principal amount of $60 and bear interest at the average LIBOR (London Interbank Offered Rates) during the 10 days prior to the potential reorganization. If the T shareholders had been issued the P securities on January 2 of year 1, the P securities would have had a value of $60 (determined by reference to the value of comparable publicly traded securities). Whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock and the P securities to be issued to the T shareholders on January 2 of year 1. Under paragraph (e)(2)(iv) of this section, for purposes of valuing the new P securities, they will be treated as having been issued on the pre-signing date. Because, for continuity of interest purposes, the T stock is exchanged for $40 of P stock and $60 of other property, the transaction preserves a substantial part of the value of the proprietary interest in T. Therefore, the transaction satisfies the continuity of interest requirement.

Example 7. Fixed consideration—continuity not preserved. On January 3 of year 1, P and T sign a binding contract pursuant to which T will be merged with and into P on June 1 of year 1. Pursuant to the contract, 60 shares of the T stock will be exchanged for $80 of cash and 40 shares of the T stock will be exchanged for 20 shares of P stock. On January 2 of year 1, the value of the P stock is $1 per share. On June 1 of year 1, T merges with and into P pursuant to the terms of the contract. This contract provides for fixed consideration and therefore whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on the pre-signing date. However, applying the signing date rule, the P stock represents only 20 percent of the value of the total consideration to be received by the T shareholders. Accordingly, based on the economic realities of the exchange, the transaction does not preserve a substantial part of the value of the proprietary interest in T. Therefore, the transaction does not satisfy the continuity of interest requirement.

Example 8. Anti-dilution clause. (i) *Absence of anti-dilution clause.* On January 3 of year 1, P and T sign a binding contract pursuant to which T will be merged with and into P on June 1 of year 1. Pursuant to the contract, the T shareholders will receive 40 P shares and $60 of cash in exchange for all of the outstanding stock of T. The contract does not contain a customary anti-dilution provision. The P stock is listed on an established market. On January 2 of year 1, the value of the P stock is $1 per share. On April 10 of year 1, P issues its stock to effect a stock split; each shareholder of P receives an additional share of P for each P share that it holds. On April 11 of year 1, the value of the P stock is $.50 per share. Because P altered its capital structure between January 3 and June 1 of year 1 in a manner that materially alters the economic arrangement of the parties, under paragraph (e)(2)(iii)(E) of this section, the contract is not treated as a binding contract that provides for fixed consideration. Accordingly, whether the transaction satisfies the continuity of interest requirement cannot be determined by reference to the value of the P stock on January 2 of year 1.

(ii) *Adjustment for anti-dilution clause.* The facts are the same as in paragraph (i) of this *Example 8* except that the contract contains a customary anti-dilution provision, and the T shareholders receive 80 P shares and $60 of cash in exchange for all of the outstanding stock of T. Under paragraph (e)(2)(iii)(E) of this section, the contract is treated as a binding contract that provides for fixed consideration as of January 3 of year 1. Therefore, whether the transaction satisfies the continuity of interest requirement is generally determined by reference to the value of the P stock on January 2 of year 1. However, under paragraph (e)(2)(iii)(E) of this section, the value of the P stock on the presigning date must be adjusted to take the stock split into account. For continuity of interest purposes, the T stock is exchanged for $40 of P stock (($1/2) × 80) and $60 of cash. Therefore, the transaction satisfies the continuity of interest requirement.

Example 9. Shareholder election. On January 3 of year 1, P and T sign a binding contract pursuant to which T will be merged with and into P on June 1 of year 1. On January 2 of year 1, the value of the P stock and the T stock is $1 per share. Pursuant to the contract, at the shareholders' election, each share of T's 100 shares will be exchanged for cash of $1, or alternatively, P stock. The contract provides that the determination of the number of shares of P stock to be exchanged for a share of T stock is made using the value of the P stock on the last business day before the first date there is a binding contract (that is, $1 per share). The contract further provides that, in the aggregate, 40 shares of P stock and $60 will be delivered, and contains a proration mechanism in the event that either item of consideration is oversubscribed. On the closing date, the value of the P stock is $.20 per share, and all target shareholders elect to receive cash. Pursuant to the proration provision, each target share is exchanged for $.60 of cash and $.08 of P stock. Pursuant to paragraph (e)(2)(iii)(A) of this section, the contract provides for fixed consideration because it provides for the number of shares of P stock and the amount of money to be exchanged for all the proprietary interests in the target corporation. Furthermore, pursuant to paragraph (e)(2)(iii)(B) of this section, the contract provides for fixed consideration because the number of shares of issuing corporation stock to be provided to the target corporation shareholders is determined using the pre-signing date value of P stock. Accordingly, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on January 2 of year 1. Because, for continuity purposes, the T stock is exchanged for $40 of P stock and $60 of cash, the transaction preserves a substantial part of the value of the proprietary interest in T. Therefore, the transaction satisfies the continuity of interest requirement.

Example 10. Contingent adjustment based on the value of the issuing corporation stock—continuity not preserved. On January 3 of year 1, P and T sign a binding contract pursuant to which T will be merged with and into P on June 1 of year 1. On January 2 of year 1, the value of the P stock is $1 per share. Pursuant to the contract, if the value of the P stock does not decrease after January 2 of year 1, the T shareholders will receive 40 P shares and $60 of cash in exchange for all of the outstanding stock of T. Furthermore, the contract provides that the T shareholders will receive $.16 of additional P shares and $.24 for every $.01 decrease in the value of one share of P stock after January 2 of year 1. On June 1 of year 1, T merges with and into P pursuant to the terms of the contract. On that date, the value of the P stock is $.40 per share. Pursuant to the terms of the contract, the consideration is adjusted so that the T shareholders receive 24 more P shares ((60 × $.16)/$.40) and $14.40 more cash (60 × $.24) than they would absent an adjustment. Accordingly, at closing the T shareholders receive 64 P shares and $74.40 of cash. Because the contract provides that additional P shares and cash will be delivered to the T shareholders if the value of the stock of P decreases after January 2 of year 1, under paragraph (e)(2)(iii)(C)(*2*) of this section, the contract is not treated as providing for fixed consideration, and therefore whether the transaction satisfies the continuity of interest requirement cannot be determined by reference to the value of the P stock on January 2 of year 1. For continuity of interest purposes, the T stock is exchanged for $25.60 of P stock (64 × $.40) and $74.40 of cash and the transaction does not preserve a substantial part of the value of the proprietary interest in T. Therefore, the transaction does not satisfy the continuity of interest requirement.

Example 11. Contingent adjustment to boot based on the value of the target corporation stock—continuity not preserved. On January 3 of year 1, P and T sign a binding contract pursuant to which T will be merged with and into P on June 1 of year 1. On January 2 of year 1, T has 100 shares outstanding, and each T share is worth $1. On January 2 of year 1, each P share is worth $1. Pursuant to the contract, if the value of the T stock does not increase after January 3 of year 1, the T shareholders will receive 40 P shares and $60 of cash in exchange for all of the outstanding stock of T. Furthermore, the contract provides that the T shareholders will receive $1 of additional cash for every $.01 increase in the value of one share of T stock after January 3 of year 1. On June 1 of year 1, the value of the T stock is $1.40 per share and the value of the P stock is $.75 per share. Pursuant to the terms of the contract, the consideration is adjusted so that the T shareholders receive $40 more cash (40 × $1) than they would absent an adjustment. Accordingly, at closing the T shareholders receive 40 P shares and $100 of cash. Because the contract provides the number of shares of P stock and the amount of money to be exchanged for all the proprietary interests in T, and the contingent adjustment to the cash consideration is not based on changes in the value of the P stock, P assets, or any surrogate thereof, after January 2 of year 1, there is a binding contract providing for fixed consideration as of January 3 of year 1. Therefore, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on January 2 of year 1. For continuity of interest purposes, the T stock is exchanged for $40 of P stock (40 × $1) and $100 of cash. Therefore, the transaction does not satisfy the continuity of interest requirement.

Example 12. Contingent adjustment to stock based on the value of the target corporation stock—continuity preserved. On January 3 of year 1, P and T sign a binding contract pursuant to which T will be merged with and into P on June 1 of year 1. On that date T has 100 shares outstanding, and each T share is worth $1. On January 2 of year 1, each P share is worth $1. Pursuant to the contract, if the value of the T stock does not decrease after January 3 of year 1, the T shareholders will receive 40 P shares and $60 of cash in exchange for all of the outstanding stock of T. Furthermore, the contract provides that the T shareholders will receive $.40 less P stock and $.60 less cash for every $.01 decrease in the value of one share of T stock after January 3 of year 1. The contract also provides that the number of P shares by which the consideration will be reduced as a result of this adjustment will be determined based on the value of the P stock on January 2 of year 1. On June 1 of year 1, T merges with and into P pursuant to the terms of the contract. On that date, the value of the T stock is $.70 per share and the value of the P stock is $.75 per share. Pursuant to the terms of the contract, the consideration is adjusted so that the T shareholders receive 12 fewer P shares ((30 × $.40)/$1) and $18 less cash (30 × $.60) than they would absent an adjustment. Accordingly, at closing the T shareholders receive 28 P shares and $42 of cash. Because the contract provides for the number of shares of P stock and the amount of money to be exchanged for all of the proprietary interests in T, the contract does not provide for contingent adjustments to the consideration based on a change in value of the P stock, P assets, or any surrogate thereof, after January 2 of year 1, and the adjustment to the number of P shares the T shareholders receive is determined based on the value of the P shares on January 2 of year 1, there is a binding contract providing for fixed consideration as of January 3 of year 1. Therefore, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on January 2 of year 1. For continuity of interest purposes, the T stock is exchanged for $28 of P stock (28 × $1) and $42 of cash. Accordingly, the transaction satisfies the continuity of interest requirement.

(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 interests 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 corporation, 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 prereorganization 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 prereorganization 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/applicability 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) *COI measurement date.* Paragraph (e)(2) of this section applies to transactions occurring pursuant to binding contracts entered into after December 19, 2011. For transactions entered into after March 19, 2010, and occurring pursuant to binding contracts entered into on or before December 19, 2011, the parties to the transaction may elect to apply the provisions of §1.368–1T as contained in 26 CFR, Part 1, §§1.301–1.400, revised as of April 1, 2009. However, the target corporation, the issuing corporation, the controlling corporation of the acquiring corporation if stock thereof is provided as consideration in the transaction, and any direct or indirect transferee of transferred basis property from any of the foregoing, may not elect to apply the provisions of §1.368–1T as contained in 26 CFR, Part 1, §§1.301–1.400, revised as of April 1, 2009, unless all such taxpayers elect to apply such provisions. This election requirement will be satisfied if none of the specified parties adopts inconsistent treatment. For transactions entered into on or before March 19, 2010, see §1.368–1T as contained in 26 CFR, Part 1, §§1.301–1.400, revised as of April 1, 2009.

[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 at *www.fdsys.gov*.

§ 1.368–2 Definition of terms.

(a) The application of the term *reorganization* is to be strictly limited to the specific transactions set forth in section 368(a). The term does not embrace the mere purchase by one corporation of the properties of another corporation. 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. If the properties are transferred for cash and deferred payment obligations of the transferee evidenced by short-term notes, the transaction is a sale and not an exchange in which gain or loss is not recognized.

(b)(1)(i) *Definitions.* For purposes of this paragraph (b)(1), the following terms shall have the following meanings:

(A) *Disregarded entity.* A disregarded entity is a business entity (as defined in §301.7701–2(a) of this chapter) that is disregarded as an entity separate from its owner for Federal income tax purposes. Examples of disregarded entities include a domestic single member limited liability company that does not elect to be classified as a corporation for Federal income tax purposes, a corporation (as defined in §301.7701–2(b) of this chapter) that is a qualified REIT subsidiary (within the meaning of section 856(i)(2)), and a corporation that is a qualified subchapter S subsidiary (within the meaning of section 1361(b)(3)(B)).

(B) *Combining entity.* A combining entity is a business entity that is a corporation (as defined in §301.7701–2(b) of this chapter) that is not a disregarded entity.

(C) *Combining unit.* A combining unit is composed solely of a combining entity and all disregarded entities, if any, the assets of which are treated as owned by such combining entity for Federal income tax purposes.

(ii) *Statutory merger or consolidation generally.* For purposes of section

368(a)(1)(A), a statutory merger or consolidation is a transaction effected pursuant to the statute or statutes necessary to effect the merger or consolidation, in which transaction, as a result of the operation of such statute or statutes, the following events occur simultaneously at the effective time of the transaction—

(A) All of the assets (other than those distributed in the transaction) and liabilities (except to the extent such liabilities are satisfied or discharged in the transaction or are nonrecourse liabilities to which assets distributed in the transaction are subject) of each member of one or more combining units (each a transferor unit) become the assets and liabilities of one or more members of one other combining unit (the transferee unit); and

(B) The combining entity of each transferor unit ceases its separate legal existence for all purposes; provided, however, that this requirement will be satisfied even if, under applicable law, after the effective time of the transaction, the combining entity of the transferor unit (or its officers, directors, or agents) may act or be acted against, or a member of the transferee unit (or its officers, directors, or agents) may act or be acted against in the name of the combining entity of the transferor unit, provided that such actions relate to assets or obligations of the combining entity of the transferor unit that arose, or relate to activities engaged in by such entity, prior to the effective time of the transaction, and such actions are not inconsistent with the requirements of paragraph (b)(1)(ii)(A) of this section.

(iii) *Examples*. The following examples illustrate the rules of paragraph (b)(1) of this section. In each of the examples, except as otherwise provided, each of R, V, Y, and Z is a C corporation. X is a domestic limited liability company. Except as otherwise provided, X is wholly owned by Y and is disregarded as an entity separate from Y for Federal income tax purposes. The examples are as follows:

Example 1. Divisive transaction pursuant to a merger statute. (i) *Facts*. Under State W law, Z transfers some of its assets and liabilities to Y, retains the remainder of its assets and liabilities, and remains in existence for Federal income tax purposes following the transaction. The transaction qualifies as a merger under State W corporate law.

(ii) *Analysis*. The transaction does not satisfy the requirements of paragraph (b)(1)(ii)(A) of this section because all of the assets and liabilities of Z, the combining entity of the transferor unit, do not become the assets and liabilities of Y, the combining entity and sole member of the transferee unit. In addition, the transaction does not satisfy the requirements of paragraph (b)(1)(ii)(B) of this section because the separate legal existence of Z does not cease for all purposes. Accordingly, the transaction does not qualify as a statutory merger or consolidation under section 368(a)(1)(A).

Example 2. Merger of a target corporation into a disregarded entity in exchange for stock of the owner. (i) *Facts*. Under State W law, Z merges into X. Pursuant to such law, the following events occur simultaneously at the effective time of the transaction: all of the assets and liabilities of Z become the assets and liabilities of X and Z's separate legal existence ceases for all purposes. In the merger, the Z shareholders exchange their stock of Z for stock of Y.

(ii) *Analysis*. The transaction satisfies the requirements of paragraph (b)(1)(ii) of this section because the transaction is effected pursuant to State W law and the following events occur simultaneously at the effective time of the transaction: all of the assets and liabilities of Z, the combining entity and sole member of the transferor unit, become the assets and liabilities of one or more members of the transferee unit that is comprised of Y, the combining entity of the transferee unit, and X, a disregarded entity the assets of which Y is treated as owning for Federal income tax purposes, and Z ceases its separate legal existence for all purposes. Accordingly, the transaction qualifies as a statutory merger or consolidation for purposes of section 368(a)(1)(A).

Example 3. Merger of a target S corporation that owns a QSub into a disregarded entity. (i) *Facts*. The facts are the same as in *Example 2*, except that Z is an S corporation and owns all of the stock of U, a QSub.

(ii) *Analysis*. The deemed formation by Z of U pursuant to §1.1361–5(b)(1) (as a consequence of the termination of U's QSub election) is disregarded for Federal income tax purposes. The transaction is treated as a transfer of the assets of U to X, followed by X's transfer of these assets to U in exchange for stock of U. See §1.1361–5(b)(3) *Example 9*. The transaction will, therefore, satisfy the requirements of paragraph (b)(1)(ii) of this section because the transaction is effected pursuant to State W law and the following events occur simultaneously at the effective time of the transaction: all of the assets and liabilities of Z and U, the sole members of the transferor unit, become the assets and liabilities of one or more members of the transferee unit that is comprised of Y, the combining entity of the transferee unit, and X, a disregarded entity the assets of which Y is treated as owning for Federal income tax purposes, and Z ceases its separate legal existence for all purposes. Moreover, the deemed transfer of the assets of U in exchange for U stock does not cause the transaction to fail to qualify as a statutory merger or consolidation. See §368(a)(2)(C). Accordingly, the transaction qualifies as a statutory merger or consolidation for purposes of section 368(a)(1)(A).

Example 4. Triangular merger of a target corporation into a disregarded entity. (i) *Facts.* The facts are the same as in *Example 2,* except that V owns 100 percent of the outstanding stock of Y and, in the merger of Z into X, the Z shareholders exchange their stock of Z for stock of V. In the transaction, Z transfers substantially all of its properties to X.

(ii) *Analysis.* The transaction is not prevented from qualifying as a statutory merger or consolidation under section 368(a)(1)(A), provided the requirements of section 368(a)(2)(D) are satisfied. Because the assets of X are treated for Federal income tax purposes as the assets of Y, Y will be treated as acquiring substantially all of the properties of Z in the merger for purposes of determining whether the merger satisfies the requirements of section 368(a)(2)(D). As a result, the Z shareholders that receive stock of V will be treated as receiving stock of a corporation that is in control of Y, the combining entity of the transferee unit that is the acquiring corporation for purposes of section 368(a)(2)(D). Accordingly, the merger will satisfy the requirements of section 368(a)(2)(D).

Example 5. Merger of a target corporation into a disregarded entity owned by a partnership. (i) *Facts.* The facts are the same as in *Example 2,* except that Y is organized as a partnership under the laws of State W and is classified as a partnership for Federal income tax purposes.

(ii) *Analysis.* The transaction does not satisfy the requirements of paragraph (b)(1)(ii)(A) of this section. All of the assets and liabilities of Z, the combining entity and sole member of the transferor unit, do not become the assets and liabilities of one or more members of a transferee unit because neither X nor Y qualifies as a combining entity. Accordingly, the transaction cannot qualify as a statutory merger or consolidation for purposes of section 368(a)(1)(A).

Example 6. Merger of a disregarded entity into a corporation. (i) *Facts.* Under State W law, X merges into Z. Pursuant to such law, the following events occur simultaneously at the effective time of the transaction: all of the assets and liabilities of X (but not the assets and liabilities of Y other than those of X) become the assets and liabilities of Z and X's separate legal existence ceases for all purposes.

(ii) *Analysis.* The transaction does not satisfy the requirements of paragraph (b)(1)(ii)(A) of this section because all of the assets and liabilities of a transferor unit do not become the assets and liabilities of one or more members of the transferee unit. The transaction also does not satisfy the requirements of paragraph (b)(1)(ii)(B) of this section because X does not qualify as a combining entity. Accordingly, the transaction cannot qualify as a statutory merger or consolidation for purposes of section 368(a)(1)(A).

Example 7. Merger of a corporation into a disregarded entity in exchange for interests in the disregarded entity. (i) *Facts.* Under State W law, Z merges into X. Pursuant to such law, the following events occur simultaneously at the effective time of the transaction: all of the assets and liabilities of Z become the assets and liabilities of X and Z's separate legal existence ceases for all purposes. In the merger of Z into X, the Z shareholders exchange their stock of Z for interests in X so that, immediately after the merger, X is not disregarded as an entity separate from Y for Federal income tax purposes. Following the merger, pursuant to §301.7701–3(b)(1)(i) of this chapter, X is classified as a partnership for Federal income tax purposes.

(ii) *Analysis.* The transaction does not satisfy the requirements of paragraph (b)(1)(ii)(A) of this section because immediately after the merger X is not disregarded as an entity separate from Y and, consequently, all of the assets and liabilities of Z, the combining entity of the transferor unit, do not become the assets and liabilities of one or more members of a transferee unit. Accordingly, the transaction cannot qualify as a statutory merger or consolidation for purposes of section 368(a)(1)(A).

Example 8. Merger transaction preceded by distribution. (i) *Facts.* Z operates two unrelated businesses, Business P and Business Q, each of which represents 50 percent of the value of the assets of Z. Y desires to acquire and continue operating Business P, but does not want to acquire Business Q. Pursuant to a single plan, Z sells Business Q for cash to parties unrelated to Z and Y in a taxable transaction, and then distributes the proceeds of the sale pro rata to its shareholders. Then, pursuant to State W law, Z merges into Y. Pursuant to such law, the following events occur simultaneously at the effective time of the transaction: all of the assets and liabilities of Z related to Business P become the assets and liabilities of Y and Z's separate legal existence ceases for all purposes. In the merger, the Z shareholders exchange their Z stock for Y stock.

(ii) *Analysis.* The transaction satisfies the requirements of paragraph (b)(1)(ii) of this section because the transaction is effected pursuant to State W law and the following events occur simultaneously at the effective time of the transaction: all of the assets and liabilities of Z, the combining entity and sole member of the transferor unit, become the assets and liabilities of Y, the combining entity and sole member of the transferee unit, and Z ceases its separate legal existence for all purposes. Accordingly, the transaction qualifies as a statutory merger or consolidation for purposes of section 368(a)(1)(A).

Example 9. State law conversion of target corporation into a limited liability company. (i) *Facts.* Y acquires the stock of V from the V shareholders in exchange for consideration that consists of 50 percent voting stock of Y and 50 percent cash. Immediately after the stock acquisition, V files the necessary documents to convert from a corporation to a limited liability company under State W law. Y's acquisition of the stock of V and the conversion of V to a limited liability company are steps in a single integrated acquisition by Y of the assets of V.

(ii) *Analysis.* The acquisition by Y of the assets of V does not satisfy the requirements of paragraph (b)(1)(ii)(B) of this section because V, the combining entity of the transferor unit, does not cease its separate legal existence. Although V is an entity disregarded from its owner for Federal income tax purposes, it continues to exist as a juridical entity after the conversion. Accordingly, Y's acquisition of the assets of V does not qualify as a statutory merger or consolidation for purposes of section 368(a)(1)(A).

Example 10. Dissolution of target corporation. (i) *Facts.* Y acquires the stock of Z from the Z shareholders in exchange for consideration that consists of 50 percent voting stock of Y and 50 percent cash. Immediately after the stock acquisition, Z files a certificate of dissolution pursuant to State W law and commences winding up its activities. Under State W dissolution law, ownership and title to Z's assets does not automatically vest in Y upon dissolution. Instead, Z transfers assets to its creditors in satisfaction of its liabilities and transfers its remaining assets to Y in the liquidation stage of the dissolution. Y's acquisition of the stock of Z and the dissolution of Z are steps in a single integrated acquisition by Y of the assets of Z.

(ii) *Analysis.* The acquisition by Y of the assets of Z does not satisfy the requirements of paragraph (b)(1)(ii) of this section because Y does not acquire all of the assets of Z as a result of Z filing the certificate of dissolution or simultaneously with Z ceasing its separate legal existence. Instead, Y acquires the assets of Z by reason of Z's transfer of its assets to Y. Accordingly, Y's acquisition of the assets of Z does not qualify as a statutory merger or consolidation for purposes of section 368(a)(1)(A).

Example 11. Merger of corporate partner into a partnership. (i) *Facts.* Y owns an interest in X, an entity classified as a partnership for Federal income tax purposes, that represents a 60 percent capital and profits interest in X. Z owns an interest in X that represents a 40 percent capital and profits interest. Under State W law, Z merges into X. Pursuant to such law, the following events occur simultaneously at the effective time of the transaction: all of the assets and liabilities of Z become the assets and liabilities of X and Z ceases its separate legal existence for all purposes. In the merger, the Z shareholders exchange their stock of Z for stock of Y. As a result of the merger, X becomes an entity that is disregarded as an entity separate from Y for Federal income tax purposes.

(ii) *Analysis.* The transaction satisfies the requirements of paragraph (b)(1)(ii) of this section because the transaction is effected pursuant to State W law and the following events occur simultaneously at the effective time of the transaction: all of the assets and liabilities of Z, the combining entity and sole member of the transferor unit, become the assets and liabilities of one or more members of the transferee unit that is comprised of Y, the combining entity of the transferee unit, and X, a disregarded entity the assets of which Y is treated as owning for Federal income tax purposes immediately after the transaction, and Z ceases its separate legal existence for all purposes. Accordingly, the transaction qualifies as a statutory merger or consolidation for purposes of section 368(a)(1)(A).

Example 12. State law consolidation. (i) *Facts.* Under State W law, Z and V consolidate. Pursuant to such law, the following events occur simultaneously at the effective time of the transaction: all of the assets and liabilities of Z and V become the assets and liabilities of Y, an entity that is created in the transaction, and the existence of Z and V continues in Y. In the consolidation, the Z shareholders and the V shareholders exchange their stock of Z and V, respectively, for stock of Y.

(ii) *Analysis.* With respect to each of Z and V, the transaction satisfies the requirements of paragraph (b)(1)(ii) of this section because the transaction is effected pursuant to State W law and the following events occur simultaneously at the effective time of the transaction: all of the assets and liabilities of Z and V, respectively, each of which is the combining entity of a transferor unit, become the assets and liabilities of Y, the combining entity and sole member of the transferee unit, and Z and V each ceases its separate legal existence for all purposes. Accordingly, the transaction qualifies as the statutory merger or consolidation of each of Z and V into Y for purposes of section 368(a)(1)(A).

Example 13. Transaction effected pursuant to foreign statutes. (i) *Facts.* Z and Y are entities organized under the laws of Country Q and classified as corporations for Federal income tax purposes. Z and Y combine. Pursuant to statutes of Country Q the following events occur simultaneously: all of the assets and liabilities of Z become the assets and liabilities of Y and Z's separate legal existence ceases for all purposes.

(ii) *Analysis.* The transaction satisfies the requirements of paragraph (b)(1)(ii) of this section because the transaction is effected pursuant to statutes of Country Q and the following events occur simultaneously at the effective time of the transaction: all of the assets and liabilities of Z, the combining entity of the transferor unit, become the assets and liabilities of Y, the combining entity and sole member of the transferee unit, and Z ceases its separate legal existence for all purposes. Accordingly, the transaction qualifies as a statutory merger or consolidation for purposes of section 368(a)(1)(A).

Example 14. Foreign law amalgamation using parent stock. (i) *Facts.* Z and V are entities organized under the laws of Country Q and classified as corporations for Federal income tax purposes. Z and V amalgamate. Pursuant to statutes of Country Q, the following events occur simultaneously: all the assets and liabilities of Z and V become the assets and liabilities of R, an entity that is created in the transaction and that is wholly owned by Y immediately after the transaction, and Z's and V's separate legal existences cease for all purposes. In the transaction, the Z and V shareholders exchange their Z and V stock, respectively, for stock of Y.

(ii) *Analysis.* With respect to each of Z and V, the transaction satisfies the requirements of paragraph (b)(1)(ii) of this section because the transaction is effected pursuant to Country Q law and the following events occur simultaneously at the effective time of the transaction: all of the assets and liabilities of Z and V, respectively, each of which is the combining entity of a transferor unit, become the assets and liabilities of R, the combining entity and sole member of the transferee unit, with regard to each of the above transfers, and Z and V each ceases its separate legal existence for all purposes. Because Y is in control of R immediately after the transaction, the Z shareholders and the V shareholders will be treated as receiving stock of a corporation that is in control of R, the combining entity of the transferee unit that is the acquiring corporation for purposes of section 368(a)(2)(D). Accordingly, the transaction qualifies as the statutory merger or consolidation of each of Z and V into R, a corporation controlled by Y, and is a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(D).

(v) *Effective date*—(A) *In general.* This paragraph (b)(1) applies to transactions occurring on or after January 23, 2006. For rules regarding statutory mergers or consolidation occurring before January 23, 2006, see §1.368–2T as contained in 26 CFR part 1, revised April 1, 2005, and §1.368–2(b)(1) as in effect before January 24, 2003 (see 26 CFR part 1, revised April 1, 2002).

(B) *Transitional rule.* A taxpayer may elect to apply the provisions of §1.368–2T(b) as contained in 26 CFR part 1, revised April 1, 2005 (the temporary regulations), instead of the provisions of this paragraph (b), to a transaction that occurs on or after January 23, 2006, pursuant to a written agreement which is (subject to customary conditions) binding on January 22, 2006, and at all times thereafter, or pursuant to a tender offer announced prior to January 23, 2006. However, the combining entity of the transferor unit, the combining entity of the transferee unit, any controlling corporation of the combining entity of the transferee unit if stock thereof is provided as consideration in the transaction, and any direct or indirect transferee of transferred basis property from any of the foregoing, may not elect to apply the provisions of the temporary regulations unless all such taxpayers elect to apply the provisions of the temporary regulations.

(2) In order for the transaction to qualify under section 368(a)(1)(A) by reason of the application of section 368(a)(2)(D), one corporation (the acquiring corporation) must acquire substantially all of the properties of another corporation (the acquired corporation) partly or entirely in exchange for stock of a corporation which is in control of the acquiring corporation (the controlling corporation), provided that (i) the transaction would have qualified under section 368(a)(1)(A) if the merger had been into the controlling corporation, and (ii) no stock of the acquiring corporation is used in the transaction. The foregoing test of whether the transaction would have qualified under section 368(a)(1)(A) if the merger had been into the controlling corporation means that the general requirements of a reorganization under section 368(a)(1)(A) (such as a business purpose, continuity of business enterprise, and continuity

of interest) must be met in addition to the special requirements of section 368(a)(2)(D). Under this test, it is not relevant whether the merger into the controlling corporation could have been effected pursuant to State or Federal corporation law. The term *substantially all* has the same meaning as it has in section 368(a)(1)(C). Although no stock of the acquiring corporation can be used in the transaction, there is no prohibition (other than the continuity of interest requirement) against using other property, such as cash or securities, of either the acquiring corporation or the parent or both. In addition, the controlling corporation may assume liabilities of the acquired corporation without disqualifying the transaction under section 368(a)(2(D), and for purposes of section 357(a) the controlling corporation is considered a party to the exchange. For example, if the controlling corporation agrees to substitute its stock for stock of the acquired corporation under an outstanding employee stock option agreement, this assumption of liability will not prevent the transaction from qualifying as a reorganization under section 368(a)(2)(D) and the assumption of liability is not treated as money or other property for purposes of section 361(b). Section 368(a)(2)(D) applies whether or not the controlling corporation (or the acquiring corporation) is formed immediately before the merger, in anticipation of the merger, or after preliminary steps have been taken to merge directly into the controlling corporation. Section 368(a)(2)(D) applies only to statutory mergers occurring after October 22, 1968.

(3) For regulations under section 368(a)(2)(E), see paragraph (j) of this section.

(c) In order to qualify as a ''reorganization'' under section 368(a)(1)(B), the acquisition by the acquiring corporation of stock of another corporation must be in exchange solely for all or a part of the voting stock of the acquiring corporation (or, in the case of transactions occurring after December 31, 1963, solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), and the acquiring corporation must be in control of the other corporation immediately after the transaction. If, for example, Corporation X in one transaction exchanges nonvoting preferred stock or bonds in addition to all or a part of its voting stock in the acquisition of stock of Corporation Y, the transaction is not a reorganization under section 368(a)(1)(B). Nor is a transaction a reorganization described in section 368(a)(1)(B) if stock is acquired in exchange for voting stock both of the acquiring corporation and of a corporation which is in control of the acquiring corporation. The acquisition of stock of another corporation by the acquiring corporation solely for its voting stock (or solely for voting stock of a corporation which is in control of the acquiring corporation) is permitted tax-free even though the acquiring corporation already owns some of the stock of the other corporation. Such an acquisition is permitted tax-free in a single transaction or in a series of transactions taking place over a relatively short period of time such as 12 months. For example, Corporation A purchased 30 percent of the common stock of Corporation W (the only class of stock outstanding) for cash in 1939. On March 1, 1955, Corporation A offers to exchange its own voting stock for all the stock of Corporation W tendered within 6 months from the date of the offer. Within the 6-months' period Corporation A acquires an additional 60 percent of stock of Corporation W solely for its own voting stock, so that it owns 90 percent of the stock of Corporation W. No gain or loss is recognized with respect to the exchanges of stock of Corporation A for stock of Corporation W. For this purpose, it is immaterial whether such exchanges occurred before Corporation A acquired control (80 percent) of Corporation W or after such control was acquired. If Corporation A had acquired 80 percent of the stock of Corporation W for cash in 1939, it could likewise acquire some or all of the remainder of such stock solely in exchange for its own voting stock without recognition of gain or loss.

(d) In order to qualify as a reorganization under section 368(a)(1)(C), the transaction must be one described in subparagraph (1) or (2) of this paragraph:

(1) One corporation must acquire substantially all the properties of another corporation solely in exchange for all or a part of its own voting stock, or solely in exchange for all or a part of the voting stock of a corporation which is in control of the acquiring corporation. For example, Corporation P owns all the stock of Corporation A. All the properties of Corporation W are transferred to Corporation A either solely in exchange for voting stock of Corporation P or solely in exchange for less than 80 percent of the voting stock of Corporation A. Either of such transactions constitutes a reorganization under section 368(a)(1)(C). However, if the properties of Corporation W are acquired in exchange for voting stock of both Corporation P and Corporation A, the transaction will not constitute a reorganization under section 368(a)(1)(C). In determining whether the exchange meets the requirement of ''solely for voting stock'', the assumption by the acquiring corporation of liabilities of the transferor corporation, or the fact that property acquired from the transferor corporation is subject to a liability, shall be disregarded. Though such an assumption does not prevent an exchange from being solely for voting stock for the purposes of the definition of a reorganization contained in section 368(a)(1)(C), it may in some cases, however, so alter the character of the transaction as to place the transaction outside the purposes and assumptions of the reorganization provisions. Section 368(a)(1)(C) does not prevent consideration of the effect of an assumption of liabilities on the general character of the transaction but merely provides that the requirement that the exchange be solely for voting stock is satisfied if the only additional consideration is an assumption of liabilities.

(2) One corporation:

(i) Must acquire substantially all of the properties of another corporation in such manner that the acquisition would qualify under (1) above, but for the fact that the acquiring corporation exchanges money, or other property in addition to such voting stock, and

(ii) Must acquire solely for voting stock (either of the acquiring corporation or of a corporation which is in control of the acquiring corporation) properties of the other corporation having a fair market value which is at least 80 percent of the fair market value of all the properties of the other corporation.

(3) For the purposes of subparagraph (2)(ii) only, a liability assumed or to which the properties are subject is considered money paid for the properties. For example, Corporation A has properties with a fair market value of $100,000 and liabilities of $10,000. In exchange for these properties, Corporation Y transfers its own voting stock, assumes the $10,000 liabilities, and pays $8,000 in cash. The transaction is a reorganization even though a part of the properties of Corporation A is acquired for cash. On the other hand, if the properties of Corporation A worth $100,000, were subject to $50,000 in liabilities, an acquisition of all the properties, subject to the liabilities, for any consideration other than solely voting stock would not qualify as a reorganization under this section since the liabilities alone are in excess of 20 percent of the fair market value of the properties. If the transaction would qualify under either subparagraph (1) or (2) of this paragraph and also under section 368(a)(1)(D), such transaction shall not be treated as a reorganization under section 368 (a)(1)(C).

(4)(i) For purposes of paragraphs (d)(1) and (2)(ii) of this section, prior ownership of stock of the target corporation by an acquiring corporation will not by itself prevent the solely for voting stock requirement of such paragraphs from being satisfied. In a transaction in which the acquiring corporation has prior ownership of stock of the target corporation, the requirement of paragraph (d)(2)(ii) of this section is satisfied only if the sum of the money or other property that is distributed in pursuance of the plan of reorganization to the shareholders of the target corporation other than the acquiring corporation and to the creditors of the target corporation pursuant to section 361(b)(3), and all of the liabilities of the target corporation assumed by the acquiring corporation (including liabilities to which the properties of the target corporation are subject), does not exceed 20 percent of the value of all of the properties of the target corporation. If, in connection with a potential acquisition by an acquiring corporation of substantially all of a target corporation's properties, the acquiring corporation acquires the target corporation's stock for consideration other than the acquiring corporation's own voting stock (or voting stock of a corporation in control of the acquiring corporation if such stock is used in the acquisition of the target corporation's properties), whether from a shareholder of the target corporation or the target corporation itself, such consideration is treated, for purposes of paragraphs (d)(1) and (2) of this section, as money or other property exchanged by the acquiring corporation for the target corporation's properties. Accordingly, the transaction will not qualify under section 368(a)(1)(C) unless, treating such consideration as money or other property, the requirements of section 368(a)(2)(B) and paragraph (d)(2)(ii) of this section are met. The determination of whether there has been an acquisition in connection with a potential reorganization under section 368(a)(1)(C) of a target corporation's stock for consideration other than an acquiring corporation's own voting stock (or voting stock of a corporation in control of the acquiring corporation if such stock is used in the acquisition of the target corporation's properties) will be made on the basis of all of the facts and circumstances.

(ii) The following examples illustrate the principles of this paragraph (d)(4):

Example 1. Corporation P (P) holds 60 percent of the Corporation T (T) stock that P purchased several years ago in an unrelated transaction. T has 100 shares of stock outstanding. The other 40 percent of the T stock is owned by Corporation X (X), an unrelated corporation. T has properties with a fair market value of $110 and liabilities of $10. T transfers all of its properties to P. In exchange, P assumes the $10 of liabilities, and transfers to T $30 of P voting stock and $10 of cash. T distributes the P voting stock and $10 of cash to X and liquidates. The transaction satisfies the solely for voting stock requirement of paragraph (d)(2)(ii) of this section because the sum of $10 of cash paid to X and the assumption by P of $10 of liabilities does not exceed 20% of the value of the properties of T.

Example 2. The facts are the same as in *Example 1* except that P purchased the 60 shares of T for $60 in cash in connection with the acquisition of T's assets. The transaction does not satisfy the solely for voting stock requirement of paragraph (d)(2)(ii) of this section because P is treated as having acquired all of the T assets for consideration consisting of $70 of cash, $10 of liability assumption and $30 of P voting stock, and the sum of $70 of cash and the assumption by P of $10 of liabilities exceeds 20% of the value of the properties of T.

(iii) This paragraph (d)(4) applies to transactions occurring after December 31, 1999, unless the transaction occurs pursuant to a written agreement that is (subject to customary conditions) binding on that date and at all times thereafter.

(e) A ''recapitalization'', and therefore a reorganization, takes place if, for example:

(1) A corporation with $200,000 par value of bonds outstanding, instead of paying them off in cash, discharges them by issuing preferred shares to the bondholders;

(2) There is surrendered to a corporation for cancellation 25 percent of its preferred stock in exchange for no par value common stock;

(3) A corporation issues preferred stock, previously authorized but unissued, for outstanding common stock;

(4) An exchange is made of a corporation's outstanding preferred stock, having certain priorities with reference to the amount and time of payment of dividends and the distribution of the corporate assets upon liquidation, for a new issue of such corporation's common stock having no such rights;

(5) An exchange is made of an amount of a corporation's outstanding preferred stock with dividends in arrears for other stock of the corporation. However, if pursuant to such an exchange there is an increase in the proportionate interest of the preferred shareholders in the assets or earnings and profits of the corporation, then under § 1.305–7(c)(2), an amount equal to the lesser of (i) the amount by which the fair market value or liquidation preference, whichever is greater, of the stock received in the exchange (determined immediately following the recapitalization) exceeds the issue price of the preferred stock surrendered, or

(ii) the amount of the dividends in arrears, shall be treated under section 305(c) as a deemed distribution to which sections 305(b)(4) and 301 apply.

(f) The term *a party to a reorganization* includes a corporation resulting from a reorganization, and both corporations, in a transaction qualifying as a reorganization where one corporation acquires stock or properties of another corporation. If a transaction otherwise qualifies as a reorganization, a corporation remains a party to the reorganization even though stock or assets acquired in the reorganization are transferred in a transaction described in paragraph (k) of this section. If a transaction otherwise qualifies as a reorganization, a corporation shall not cease to be a party to the reorganization solely by reason of the fact that part or all of the assets acquired in the reorganization are transferred to a partnership in which the transferor is a partner if the continuity of business enterprise requirement is satisfied. See §1.368–1(d). 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. A corporation controlling an acquiring corporation is a party to the reorganization when the stock of such controlling corporation is used in the acquisition of properties. Both corporations are parties to the reorganization if, under statutory authority, Corporation A is merged into Corporation B. All three of the corporations are parties to the reorganization if, pursuant to statutory authority, Corporation C and Corporation D are consolidated into Corporation E. Both corporations are parties to the reorganization if Corporation F transfers substantially all its assets to Corporation G in exchange for all or a part of the voting stock of Corporation G. All three corporations are parties to the reorganization if Corporation H transfers substantially all its assets to Corporation K in exchange for all or a part of the voting stock of Corporation L, which is in control of Corporation K. Both corporations are parties to the reorganization if Corporation M transfers all or part of its assets to Corporation N in exchange for all or a part of the stock and securities of Corporation N, but only if (1) immediately after such transfer, Corporation M, or one or more of its shareholders (including persons who were shareholders immediately before such transfer), or any combination thereof, is in control of Corporation N, and (2) in pursuance of the plan, the stock and securities of Corporation N are transferred or distributed by Corporation M in a transaction in which gain or loss is not recognized under section 354 or 355, or is recognized only to the extent provided in section 356. Both Corporation O and Corporation P, but not Corporation S, are parties to the reorganization if Corporation O acquires stock of Corporation P from Corporation S in exchange solely for a part of the voting stock of Corporation O, if (1) the stock of Corporation P does not constitute substantially all of the assets of Corporation S, (2) Corporation S is not in control of Corporation O immediately after the acquisition, and (3) Corporation O is in control of Corporation P immediately after the acquisition. If a transaction otherwise qualifies as a reorganization under section 368(a)(1)(B) or as a reverse triangular merger (as defined in §1.358–6(b)(2)(iii)), the target corporation (in the case of a transaction that otherwise qualifies as a reorganization under section 368(a)(1)(B)) or the surviving corporation (in the case of a transaction that otherwise qualifies as a reverse triangular merger) remains a party to the reorganization even though its stock or assets are transferred in a transaction described in paragraph (k) of this section. If a transaction otherwise qualifies as a forward triangular merger (as defined in §1.358–6(b)(2)(i)), a triangular B reorganization (as defined in §1.358–6(b)(2)(iv)), a triangular C reorganization (as defined in §1.358–6(b)(2)(ii)), or a reorganization under section 368(a)(1)(G) by reason of section 368(a)(2)(D), the acquiring corporation remains a party to the reorganization even though its stock is transferred in a transaction described in paragraph (k) of this section. The two preceding sentences apply to transactions occurring 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.

(g) The term *plan of reorganization* has reference to a consummated transaction specifically defined as a reorganization under section 368(a). The term is not to be construed as broadening the definition of *reorganization* as set forth in section 368(a), but is to be taken as limiting the nonrecognition of gain or loss to such exchanges or distributions as are directly a part of the transaction specifically described as a reorganization in section 368(a). Moreover, the transaction, or series of transactions, embraced in a plan of reorganization must not only come within the specific language of section 368(a), but the readjustments involved in the exchanges or distributions effected in the consummation thereof must be undertaken for reasons germane to the continuance of the business of a corporation a party to the reorganization. Section 368(a) contemplates genuine corporate reorganizations which are designed to effect a readjustment of continuing interests under modified corporate forms.

(h) As used in section 368, as well as in other provisions of the Internal Revenue Code, if the context so requires, the conjunction ''or'' denotes both the conjunctive and the disjunctive, and the singular includes the plural. For example, the provisions of the statute are complied with if ''stock and securities'' are received in exchange as well as if ''stock or securities'' are received.

(i) [Reserved]

(j)(1) This paragraph (j) prescribes rules relating to the application of section 368 (a)(2)(E).

(2) Section 368(a)(2)(E) does not apply to a consolidation.

(3) A transaction otherwise qualifying under section 368(a)(1)(A) is not disqualified by reason of the fact that stock of a corporation (the controlling corporation) which before the merger was in control of the merged corporation is used in the transaction, if the conditions of section 368(a)(2)(E) are satisfied. Those conditions are as follows:

(i) In the transaction, shareholders of the surviving corporation must surrender stock in exchange for voting stock of the controlling corporation. Further, the stock so surrendered must constitute control of the surviving corporation. Control is defined in section 368(c). The amount of stock constituting control is measured immediately before the transaction. For purposes of this subdivision (i), stock in the surviving corporation which is surrendered in the transaction (by any shareholder except the controlling corporation) in exchange for consideration furnished by the surviving corporation (and not by the controlling corporation of the merged corporation) is considered not to be outstanding immediately before the transaction. For effect on ''substantially all'' test of consideration furnished by the surviving corporation, see paragraph (j)(3)(iii) of this section.

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

(iii) After the transaction, the surviving corporation must hold substantially all of its own properties and substantially all of the properties of the merged corporation (other than stock of the controlling corporation distributed in the transaction). The surviving corporation may transfer such properties as provided in paragraph (k) of this section. After the transaction, except as provided in paragraph (k)(2) of this section, the surviving corporation must hold substantially all of its own properties and substantially all of the properties of the merged corporation (other than stock of the controlling corporation distributed in the transaction). The term *substantially all* has the same meaning as in section 368(a)(1)(C). The ''substantially all'' test applies separately to the merged corporation and to the surviving corporation. In applying the ''substantially all'' test to the surviving corporation, consideration furnished in the transaction by the surviving corporation in exchange for its stock is property of the surviving corporation which it does not hold after the transaction. In applying the ''substantially all'' test to the merged corporation, assets transferred from the controlling corporation to the merged corporation in pursuance of the plan of reorganization are not taken into account. Thus, for example, money transferred from the controlling corporation to the merged corporation to be used for the following purposes is not taken into account for purposes of the ''substantially all'' test:

(A) To pay additional consideration to shareholders of the surviving corporation;

(B) To pay dissenting shareholders of the surviving corporation;

(C) To pay creditors of the surviving corporation;

(D) To pay reorganization expenses; or

(E) To enable the merged corporation to satisfy state minimum capitalization requirements (where the money is returned to the controlling corporation as part of the transaction).

(iv) Paragraph (j)(3)(ii) and the first two sentences of paragraph (j)(3)(iii) 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 thereafter. The remainder of paragraph (j)(3)(iii) of this section applies to transactions occurring after January 28, 1998, except that it does not apply to any transaction occurring pursuant to a written agreement which is binding on January 28, 1998, and at all times after that.

(4) The controlling corporation may assume liabilities of the surviving corporation without disqualifying the transaction under section 368(a)(2)(E). An assumption of liabilities of the surviving corporation by the controlling corporation is a contribution to capital by the controlling corporation to the surviving corporation. If, in pursuance of the plan of reorganization, securities of the surviving corporation are exchanged for securities of the controlling corporation, or for other securities of the surviving corporation, see sections 354 and 356.

(5) In applying section 368(a)(2)(E), it makes no difference if the merged corporation is an existing corporation, or is formed immediately before the merger, in anticipation of the merger, or after preliminary steps have been taken to otherwise acquire control of the surviving corporation.

(6) The following examples illustrate the application of this paragraph (j). In each of the examples, Corporation P owns all of the stock of Corporation S and, except as otherwise stated, Corporation T has outstanding 1,000 shares of common stock and no shares of any other class. In each of the examples, it is also assumed that the transaction qualifies under section 368(a)(1)(A) if the conditions of section 368(a)(2)(E) are satisfied.

Example 1. P owns no T stock. On January 1, 1981, S merges into T. In the merger, T's shareholders surrender 950 shares of common stock in exchange for P voting stock. The holders of the other 50 shares (who dissent from the merger) are paid in cash with funds supplied by P. After the transaction, T holds all of its own assets and all of S's assets. Based on these facts, the transaction qualifies under section 368(a)(1)(A) by reason of the application of section 368(a)(2)(E). In the transaction, former shareholders of T surrender, in exchange for P voting stock, an amount of T stock (950/1,000 shares or 95 percent) which constitutes control of T.

Example 2. The facts are the same as in *Example (1)* except that holders of 100 shares in corporation T, who dissented from the merger, are paid in cash with funds supplied by T (and not by P or S) and in the merger, T's remaining shareholders surrender 720 shares of common stock in exchange for P voting stock and 180 shares of common stock for cash supplied by P. The requirements of section 368(a)(2)(E)(ii) are satisfied since, in the transaction, former shareholders of T surrender, in exchange for P voting stock, an amount of T stock (720/900 shares or 80 percent) which constitutes control of T. The T stock surrendered in exchange for consideration furnished by T is not considered outstanding for purposes of determining whether the amount of T stock surrendered by T shareholders for P stock constitutes control of T.

Example 3. T has outstanding 1,000 shares of common stock, 100 shares of nonvoting preferred stock, and no shares of any other class. On January 1, 1981, S merges into T. Prior to the merger, as part of the transaction, T distributes its own cash in redemption of the 100 shares of preferred stock. In the transaction, T's remaining shareholders surrender their 1,000 shares of common stock in exchange for P voting stock. The requirements of section 368(a)(2)(E)(ii) are satisfied since, in the transaction, former shareholders of T surrender, in exchange for P voting stock, an amount of T stock (1,000/1,000 shares or 100 percent) which constitutes control of T. The preferred stock surrendered in exchange for consideration furnished by T is not considered outstanding for purposes of determining whether the amount of T stock surrendered by T shareholders for P stock constitutes control of T. However, the consideration furnished by T for its stock is property of T which T does not hold after the transaction for purposes of the substantially all test in paragraph (j)(3)(iii) of this section.

Example 4. On January 1, 1971, P purchased 201 shares of T's stock. On January 1, 1981, S merges into T. In the merger, T's shareholders (other than P) surrender 799 shares of T stock in exchange for P voting stock. Based on these facts, in the transaction, former shareholders of T do not surrender, in exchange for P voting stock, an amount of T stock which constitutes control of T (799/1,000 shares being less than 80 percent). Therefore, the transaction does not qualify under section 368(a)(1)(A). However, if S is a transitory corporation, formed solely for purposes of effectuating the transaction, the transaction may qualify as a reorganization described in section 368(a)(1)(B) provided all of the applicable requirements are satisfied.

Example 5. On January 1, 1971, P purchased 200 shares of T's stock. On January 1, 1981, S merges into T. Prior to the merger, as part of the transaction, T distributes its own cash in redemption of 1 share of T stock from a T shareholder other than P. In the merger, T's remaining shareholders (other than P) surrender 799 shares of T stock in exchange for P voting stock. Based on these facts, in the transaction, former shareholders of T do not surrender, in exchange for P voting stock, an amount of T stock which constitutes control of T (799/999 shares being less than 80 percent). Therefore, the transaction does not qualify under section 368(a)(1)(A). However, if S is a transitory corporation, formed for purposes of effectuating the transaction, the transaction may qualify as a reorganization described in section 368(a)(1)(B) provided all of the applicable requirements are satisfied.

Example 6. The stock of S has a value of $25,000. The stock of T has a value of $75,000. On January 1, 1984, S merges into T. In the merger, T's shareholders surrender all of their T stock in exchange for P voting stock. After the transaction, T holds all of its own assets and all of S's assets. Based on these facts, the transaction qualifies under section 368(a)(1)(A) by reason of the application of section 368(a)(2)(E). In the transaction, former shareholders of T surrender, in exchange for P voting stock, an amount of T stock (1,000/1,000 shares or 100 percent) which constitutes control of T. The stock of T received by P in exchange for P's prior interest in S is not taken into account for purposes of section 368(a)(2)(E)(ii) since the amount of T stock constituting control of T is measured before the transaction.

Example 7. The stock of T has a value of $75,000. On January 1, 1984, S merges into T. In the merger, T's shareholders surrender all of their T stock in exchange for P voting stock. As part of the transaction, P contributes $25,000 to T in exchange for new shares of T stock. None of the cash received by T is distributed or otherwise paid out to former T shareholders. After the transaction, T holds all of its own assets and all of S's assets. Based on these facts, the transaction qualifies under section 368(a)(1)(A) by reason of the application of section 368(a)(2)(E). In the transaction, former shareholders of T surrender, in exchange for P voting stock, an amount of T stock (1,000/1,000 shares or 100 percent) which constitutes control of T. The T stock received by P in exchange for its contribution to T is not taken into account for purposes of section 368(a)(2)(E)(ii) since the amount of T stock constituting control of T is measured before the transaction.

Example 8. The facts are the same as in *Example (7)* except that, as part of the transaction, corporation R, instead of P, contributes $25,000 to T in exchange for T stock. Based on these facts, the transaction does not qualify under section 368(a)(1)(A) by reason of section 368(a)(2)(E) since P does not control T immediately after the transaction.

Example 9. T stock has a value of $75,000. P owns 500 shares (½) of that stock with a value of $37,500. The stock of S has a value of $125,000. On January 1, 1984, S merges into T. In the merger, T's shareholders (other than P) surrender their T stock in exchange for P voting stock. Based on these facts, in the transaction, former shareholders of T do not surrender, in exchange for P voting stock, an amount of T stock which constitutes control of T (500/1,000 shares being less than 80 percent). Therefore, the transaction does not qualify under section 368(a)(1)(A). The stock of T received by P in exchange for P's prior interest in S does not contribute to satisfaction of the requirement of section 368(a)(2)(E)(ii).

(k) *Certain transfers of assets or stock in reorganizations*—(1) *General rule.* A transaction otherwise qualifying as a reorganization under section 368(a) shall not be disqualified or recharacterized as a result of one or more subsequent transfers (or successive transfers) of assets or stock, provided that the requirements of § 1.368–1(d) are satisfied and the transfer(s) are described in either paragraph (k)(1)(i) or (k)(1)(ii) of this section. However, this paragraph (k) shall not apply to a transfer to the former shareholders of the acquired corporation (other than a former shareholder that is also the acquiring corporation) or the surviving corporation, as the case may be, to the extent it constitutes the receipt of consideration for a proprietary interest in the acquired corporation or the surviving corporation, as the case may be. Similarly, this paragraph (k) shall not apply to a transfer by the former shareholders of the acquired corporation (other than a former shareholder that is also the acquiring corporation) or the surviving corporation, as the case may be, of consideration initially received in the potential reorganization to the issuing corporation or a person related to the issuing corporation (see definition of ''related person'' in §1.368–1(e)).

(i) *Distributions.* One or more distributions to shareholders (including distribution(s) that involve the assumption of liabilities) are described in this paragraph (k)(1)(i) if—

(A) The property distributed consists of—

(*1*) Assets of the acquired corporation, the acquiring corporation, or the surviving corporation, as the case may be, or an interest in an entity received in exchange for such assets in a transfer described in paragraph (k)(1)(ii) of this section;

(*2*) Stock of the acquired corporation provided that such distribution(s) of stock do not cause the acquired corporation to cease to be a member of the qualified group (as defined in §1.368–1(d)(4)(ii)); or

(*3*) A combination thereof; and

(B) The aggregate of such distributions does not consist of—

(*1*) An amount of assets of the acquired corporation, the acquiring corporation (disregarding assets held prior to the potential reorganization), or the surviving corporation (disregarding assets of the merged corporation), as the case may be, that would result in a liquidation of such corporation for Federal income tax purposes; or

(*2*) All of the stock of the acquired corporation that was acquired in the transaction.

(ii) *Transfers Other Than Distributions.* One or more other transfers are described in this paragraph (k)(1)(ii) if—

(A) The transfer(s) do not consist of one or more distributions to shareholders;

(B) The property transferred consists of—

(*1*) Part or all of the assets of the acquired corporation, the acquiring corporation, or the surviving corporation, as the case may be;

(*2*) Part or all of the stock of the acquired corporation, the acquiring corporation, or the surviving corporation, as the case may be, provided that such transfer(s) of stock do not cause such corporation to cease to be a member of the qualified group (as defined in §1.368–1(d)(4)(ii)); or

(3) A combination thereof; and

(C) The acquired corporation, the acquiring corporation, or the surviving corporation, as the case may be, does not terminate its corporate existence for Federal income tax purposes in connection with the transfer(s).

(2) *Examples.* The following examples illustrate the application of this paragraph (k). Except as otherwise noted, P is the issuing corporation, and T is an unrelated target corporation. All corporations have only one class of stock outstanding. T operates a bakery that supplies delectable pastries and cookies to local retail stores. The acquiring corporate group produces a variety of baked goods for nationwide distribution. Except as otherwise noted, P owns all of the stock of S–1 and 80 percent of the stock of S–4, S–1 owns 80 percent of the stock of S–2 and 50 percent of the stock of S–5, S–2 owns 80 percent of the stock of S–3, and S–4 owns the remaining 50 percent of the stock of S–5. The examples are as follows:

Example 1. Transfers of acquired assets to members of the qualified group after a reorganization under section 368(a)(1)(C). (i) *Facts.* Pursuant to a plan of reorganization, T transfers all of its assets to S–1 solely in exchange for P stock, which T distributes to its shareholders, and S–1's assumption of T's liabilities. In addition, pursuant to the plan, S–1 transfers all of the T assets to S–2, and S–2 transfers all of the T assets to S–3.

(ii) *Analysis.* Under this paragraph (k), the transaction, which otherwise qualifies as a reorganization under section 368(a)(1)(C), is not disqualified by the successive transfers of all of the T assets to S–2 and from S–2 to S–3 because the transfers are not one or more distributions to shareholders, the transfers consist of part or all of the assets of the acquiring corporation, the acquiring corporation does not terminate its corporate existence for Federal income tax purposes in connection with the transfers, and the transaction satisfies the requirements of §1.368–1(d).

Example 2. Distribution of acquired assets to a member of the qualified group after a reorganization under section 368(a)(1)(C). (i) *Facts.* Pursuant to a plan of reorganization, T transfers all of its assets to S–1 solely in exchange for P stock, which T distributes to its shareholders, and S–1's assumption of T's liabilities. In addition, pursuant to the plan, S–1 distributes half of the T assets to P, and P assumes half of the T liabilities.

(ii) *Analysis.* Under this paragraph (k), the transaction, which otherwise qualifies as a reorganization under section 368(a)(1)(C), is not disqualified by the distribution of half of the T assets from S–1 to P, or P's assumption of half of the T liabilities from S–1, because the distribution consists of assets of the acquiring corporation, the distribution does not consist of an amount of S–1's assets that would result in a liquidation of S–1 for Federal income tax purposes (disregarding S–1's assets held prior to the acquisition of T), and the transaction satisfies the requirements of §1.368–1(d).

Example 3. Indirect distribution of acquired assets to a member of the qualified group after a reorganization under section 368(a)(1)(C). (i) *Facts.* The facts are the same as *Example 2*, except that, instead of S–1 distributing half of the T assets to P and having P assume half of the T liabilities, S–1 contributes half of the T assets to newly formed S–6, S–6 assumes half of the T liabilities, and S–1 distributes all of the S–6 stock to P.

(ii) *Analysis.* Under this paragraph (k), the transaction, which otherwise qualifies as a reorganization under section 368(a)(1)(C), is not disqualified by the transfer of half of the T assets to S–6 and the distribution of the S–6 stock to P because the transfer of half of the T assets to S–6 is described in paragraph (k)(1)(ii) of this section, the distribution of the S–6 stock to P is an indirect distribution of assets of the acquiring corporation, the distribution does not consist of an amount of S–1's assets that would result in a liquidation of S–1 for Federal income tax purposes (disregarding S–1's assets held prior to the acquisition of T), and the transaction satisfies the requirements of §1.368–1(d).

Example 4. Distribution of acquired stock to a controlled partnership after a reorganization under section 368(a)(1)(B). (i) *Facts.* P owns 80 percent of the stock of S–1, and an 80-percent interest in PRS, a partnership. S–4 owns the remaining 20-percent interest in PRS. PRS owns the remaining 20 percent of the stock of S–1. Pursuant to a plan of reorganization, the T shareholders transfer all of their T stock to S–1 solely in exchange for P stock. In addition, pursuant to the plan, S–1 distributes 90 percent of the T stock to PRS in redemption of 5 percent of the stock of S–1 owned by PRS.

(ii) *Analysis.* Under this paragraph (k), the transaction, which otherwise qualifies as a reorganization under section 368(a)(1)(B), is not disqualified by the distribution of 90 percent of the T stock from S–1 to PRS because the distribution consists of less than all of the stock of the acquired corporation that was acquired in the transaction, the distribution does not cause T to cease to be a member of the qualified group (as defined in §1.368–1(d)(4)(ii)), and the transaction satisfies the requirements of §1.368–1(d).

Example 5. Transfer of acquired stock to a non-controlled partnership. (i) *Facts.* Pursuant to a plan, the T shareholders transfer all of their T stock to S–1 solely in exchange for P stock. In addition, as part of the plan, T distributes half of its assets to S–1, S–1 assumes half of the T liabilities, and S–1 transfers the T stock to S–2. S–2 and U, an unrelated corporation, form a new partnership, PRS. Immediately thereafter, S–2 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) *Analysis.* Under this paragraph (k), the transaction, which otherwise qualifies as a reorganization under section 368(a)(1)(B), is not disqualified by the distribution of half of the T assets from T to S–1, or S–1's assumption of half of the T liabilities from T, because the distribution consists of assets of the acquired corporation, the distribution does not consist of an amount of T's assets that would result in a liquidation of T for Federal income tax purposes, and the transaction satisfies the requirements of §1.368–1(d). Further, this paragraph (k) describes the transfer of the acquired stock from S–1 to S–2, but does not describe the transfer of the acquired stock from S–2 to PRS because such transfer causes T to cease to be a member of the qualified group (as defined in §1.368–1(d)(4)(ii)). Therefore, the characterization of this transaction must be determined under the relevant provisions of law, including the step transaction doctrine. See §1.368–1(a). The transaction fails to meet the control requirement of a reorganization described in section 368(a)(1)(B) because immediately after the acquisition of the T stock, the acquiring corporation does not have control of T.

Example 6. Transfers of acquired assets to members of the qualified group after a reorganization under section 368(a)(1)(D). (i) *Facts.* P owns all of the stock of T. Pursuant to a plan of reorganization, T transfers all of its assets to S–1 solely in exchange for S–1 stock, which T distributes to P, and S–1's assumption of T's liabilities. In addition, pursuant to the plan, S–1 transfers all of the T assets to S–2, and S–2 transfers all of the T assets to S–3.

(ii) *Analysis*. Under this paragraph (k), the transaction, which otherwise qualifies as a reorganization under section 368(a)(1)(D), is not disqualified by the successive transfers of all the T assets from S–1 to S–2 and from S–2 to S–3 because the transfers are not one or more distributions to shareholders, the transfers consist of part or all of the assets of the acquiring corporation, the acquiring corporation does not terminate its corporate existence for Federal income tax purposes in connection with the transfers, and the transaction satisfies the requirements of §1.368–1(d).

Example 7. Transfer of stock of the acquiring corporation to a member of the qualified group after a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(D). (i) *Facts*. Pursuant to a plan of reorganization, S–1 acquires all of the T assets in the merger of T into S–1. In the merger, the T shareholders receive solely P stock. Also, pursuant to the plan, P transfers all of the S–1 stock to S–4.

(ii) *Analysis*. Under this paragraph (k), the transaction, which otherwise qualifies as a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(D), is not disqualified by the transfer of all of the S–1 stock to S–4 because the transfer is not a distribution to shareholders, the transfer consists of part or all of the stock of the acquiring corporation, the transfer does not cause S–1 to cease to be a member of the qualified group (as defined in §1.368–1(d)(4)(ii)), the acquiring corporation does not terminate its corporate existence for Federal income tax purposes in connection with the transfer, and the transaction satisfies the requirements of §1.368–1(d).

Example 8. Transfer of acquired assets to a partnership after a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(D). (i) *Facts*. Pursuant to a plan of reorganization, S–1 acquires all of the T assets in the merger of T into S–1. In the merger, the T shareholders receive solely P stock. In addition, pursuant to the plan, S–1 transfers all of the T assets to PRS, a partnership in which S–1 owns a 33⅓-percent interest. PRS continues T's historic business. S–1 does not perform active and substantial management functions as a partner with respect to PRS' business.

(ii) *Analysis*. Under this paragraph (k), the transaction, which otherwise qualifies as a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(D), is not disqualified by the transfer of T assets from S–1 to PRS because the transfer is not a distribution to shareholders, the transfer consists of part or all of the assets of the acquiring corporation, the acquiring corporation does not terminate its corporate existence for Federal income tax purposes in connection with the transfers, and the transaction satisfies the requirements of §1.368–1(d).

Example 9. Sale of acquired assets to a member of the qualified group after a reorganization under section 368(a)(1)(C). (i) *Facts*. Pursuant to a plan of reorganization, T transfers all of its assets to S–1 in exchange for P stock, which T distributes to its shareholders, and S–1's assumption of T's liabilities. In addition, pursuant to the plan, S–1 sells all of the T assets to S–5 for cash equal to the fair market value of those assets.

(ii) *Analysis*. Under this paragraph (k), the transaction, which otherwise qualifies as a reorganization under section 368(a)(1)(C), is not disqualified by the sale of all of the T assets from S–1 to S–5 because the transfer is not a distribution to shareholders, the transfer consists of part or all of the assets of the acquiring corporation, the acquiring corporation does not terminate its corporate existence for Federal income tax purposes in connection with the transfer, and the transaction satisfies the requirements of §1.368–1(d).

(3) *Effective/applicability dates*. This paragraph (k) applies to transactions occurring on or after *May 9, 2008*, except that it does not apply to any transaction occurring pursuant to a written agreement which is binding before *May 9, 2008*, and at all times after that.

(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 cases where no consideration is received or the value of the consideration received in the transaction is less than the fair market value of the transferor corporation's assets, the transferee corporation will be treated as issuing stock with a value equal to the excess of the fair market value of the transferor corporation's assets over the value of the consideration actually received in the transaction. In cases where the value of the consideration received in the transaction is equal to the fair market value of the transferor corporation's assets, 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 the shareholders of the transferor corporation, as part of the exchange for the stock of such shareholders. Where appropriate, the nominal share will be further transferred through chains of ownership to the extent necessary to reflect the actual ownership of the transferor and transferee corporations. Similar treatment to that of the preceding two sentences shall apply where the transferee corporation is treated as issuing stock with a value equal to the excess of the fair market value of the transferor corporation's assets over the value of the consideration actually received in the transaction.

(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.

(iv) *Exception.* Paragraph (l)(2) of this section does not apply to a transaction otherwise described in § 1.358–6(b)(2).

(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/applicability date*—(i) *In general.* This section applies to transactions occurring on or after *December 18, 2009.* For rules regarding transactions occurring before *December 18, 2009,* see section 1.368–2T(l) as contained in 26 CFR part 1.

(ii) *Transitional rule.* A taxpayer may apply the provisions of these regulations to transactions occurring before *December 18, 2009.* 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 regulations unless all such taxpayers apply the provisions of the regulations.

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

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting § 1.368–2, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and at *www.fdsys.gov.*

§ 1.368–3 Records to be kept and information to be filed with returns.

(a) *Parties to the reorganization.* The plan of reorganization must be adopted by each of the corporations that are parties thereto. Each such corporation must include a statement entitled, ''STATEMENT PURSUANT TO § 1.368–3(a) BY [INSERT NAME AND EMPLOYER IDENTIFICATION NUMBER (IF ANY) OF TAXPAYER], A CORPORATION A PARTY TO A REORGANIZATION,'' on or with its return for the taxable year of the exchange. If any such corporation is a controlled foreign corporation (within the meaning of section 957), each United States shareholder (within the meaning of section 951(b)) with respect thereto must include this statement on or with its return. However, it is not necessary for any taxpayer to include more than one such statement on or with the same return for the same reorganization. The statement must include—

(1) The names and employer identification numbers (if any) of all such parties;

(2) The date of the reorganization;

(3) The aggregate fair market value and basis, determined immediately before the exchange, of the assets, stock or securities of the target corporation transferred in the transaction; and

(4) The date and control number of any private letter ruling(s) issued by the Internal Revenue Service in connection with this reorganization.

(b) *Significant holders.* Every significant holder, other than a corporation a party to the reorganization, must include a statement entitled, ''STATEMENT PURSUANT TO § 1.368–3(b) BY [INSERT NAME AND TAXPAYER IDENTIFICATION NUMBER (IF ANY) OF TAXPAYER], A SIGNIFICANT HOLDER,'' on or with such holder's return for the taxable year of the exchange. If a significant holder is a controlled foreign corporation (within the meaning of section 957), each United States shareholder (within the meaning of section 951(b)) with respect thereto must include this statement on or with its return. The statement must include—

(1) The names and employer identification numbers (if any) of all of the parties to the reorganization;

(2) The date of the reorganization; and

(3) The fair market value, determined immediately before the exchange, of all the stock or securities of the target corporation held by the significant holder that is transferred in the transaction and such holder's basis, determined immediately before the exchange, in the stock or securities of such target corporation.

(c) *Definitions.* For purposes of this section:

(1) *Significant holder* means—

(i) A holder of stock of the target corporation that receives stock or securities in an exchange described in section 354 (or so much of section 356 as relates to section 354) if, immediately before the exchange, such holder—

(A) Owned at least five percent (by vote or value) of the total outstanding stock of the target corporation if the stock owned by such holder is publicly traded; or

(B) Owned at least one percent (by vote or value) of the total outstanding stock of the target corporation if the stock owned by such holder is not publicly traded; or

(ii) A holder of securities of the target corporation that receives stock or securities in an exchange described in section 354 (or so much of section 356 as relates to section 354) if, immediately before the exchange, such holder owned securities in such target corporation with a basis of $1,000,000 or more.

(2) *Publicly traded stock* means stock that is listed on—

(i) A national securities exchange registered under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f); or

(ii) An interdealer quotation system sponsored by a national securities association registered under section 15A of the Securities Exchange Act of 1934 (15 U.S.C. 78o–3).

(d) *Substantiation information.* Under § 1.6001–1(e), taxpayers are required to retain their permanent records and make such records available to any authorized Internal Revenue Service officers and employees. In connection with the reorganization described in this section, these records should specifically include information regarding the amount, basis, and fair market value of all transferred property, and relevant facts regarding any liabilities assumed or extinguished as part of such reorganization.

(e) *Effective/applicability date.* This section applies to any taxable year beginning on or after May 30, 2006. However, taxpayers may apply this section to any original Federal income tax return (including any amended return filed on or before the due date (including extensions) of such original return) timely filed on or after May 30, 2006. For taxable years beginning before May 30, 2006, see §1.368–3 as contained in 26 CFR part 1 in effect on April 1, 2006.

[T.D. 9329, 72 FR 32800, June 14, 2007]

INSOLVENCY REORGANIZATIONS

CARRYOVERS

§ 1.381(a)–1 General rule relating to carryovers in certain corporate acquisitions.

(a) *Allowance of carryovers.* Section 381 provides that a corporation which acquires the assets of another corporation in certain liquidations and reorganizations shall succeed to, and take into account, as of the close of the date of distribution or transfer, the items described in section 381(c) of the distributor or transferor corporation. These items shall be taken into account by the acquiring corporation subject to the conditions and limitations specified in sections 381, 382(b), and 383 and the regulations thereunder.

(b) *Determination of transactions and items to which section 381 applies*—(1) *Qualified transactions.* Except to the extent provided in section 381(c)(20), relating to the carryover of unused pension trust deductions in certain liquidations, the items described in section 381(c) are required by section 381 to be carried over to the acquiring corporation (as defined in subparagraph (2) of this paragraph) only in the following liquidations and reorganizations:

(i) The complete liquidation of a subsidiary corporation upon which no gain or loss is recognized in accordance with the provisions of section 332;

(ii) A statutory merger or consolidation qualifying under section 368(a)(1)(A) to which section 361 applies;

(iii) A reorganization qualifying under section 368(a)(1)(C);

(iv) A reorganization qualifying under section 368(a)(1)(D) if the requirements of section 354(b)(1)(A) and (B) are satisfied; and

(v) A mere change in identity, form, or place of organization qualifying under section 368(a)(1)(F).

(2) *Acquiring corporation defined.* (i) Only a single corporation may be an acquiring corporation for purposes of section 381 and the regulations thereunder. The corporation which acquires the assets of its subsidiary corporation in a complete liquidation to which section 381(a)(1) applies is the acquiring corporation for purposes of section 381. Generally, in a transaction to which section 381(a)(2) applies, the acquiring corporation is that corporation which, pursuant to the plan of reorganization, ultimately acquires, directly or indirectly, all of the assets transferred by the transferor corporation. If, in a transaction qualifying under section 381(a)(2), no one corporation ultimately acquires all of the assets transferred by the transferor corporation, that corporation which directly acquires the assets so transferred shall be the acquiring corporation for purposes of section 381 and the regulations thereunder, even though such corporation ultimately retains none of the assets so transferred. Whether a corporation has acquired all of the assets transferred by the transferor corporation is a question of fact to be determined on the basis of all the facts and circumstances.

(ii) The application of this subparagraph may be illustrated by the following examples:

Example 1. Y Corporation, a wholly-owned subsidiary of X Corporation, directly acquired all the assets of Z Corporation solely in exchange for voting stock of X Corporation in a transaction qualifying under section 368(a)(1)(C). Y Corporation is the acquiring corporation for purposes of section 381.

Example 2. X Corporation acquired all the assets of Z Corporation solely in exchange for voting stock of X Corporation in a transaction qualifying under section 368(a)(1)(C). Thereafter, pursuant to the plan of reorganization X Corporation transferred all the assets so acquired to Y Corporation, its