

be used instead of “domestic liquidating corporation” each time it appears. References in the rules of paragraphs (b)(2)(i)(D) and (E) of this section to various rules in paragraph (b) of this section shall be applied as if such references were to this paragraph (c).

(ii) *Property formerly used in a United States trade or business.* A foreign liquidating corporation that makes a distribution described in paragraph (c)(1) of this section shall recognize gain (but not loss) on the distribution of property (other than U.S. real property interests) that had ceased to be used by the foreign liquidating corporation in the conduct of a U.S. trade or business within the ten-year period ending on the date of distribution and that would have been subject to section 864(c)(7) had it been disposed. Section 864(c)(7) shall govern the treatment of any gain recognized on the distribution of assets described in this paragraph as income effectively connected with the conduct of a trade or business within the United States.

(3) *Other consequences—(i) Distributee basis in property.* The foreign distributee corporation’s basis in property subject to this paragraph (c) shall be the same as the foreign liquidating corporation’s basis in such property immediately before the liquidation, increased by any gain, or reduced by any loss recognized by the foreign liquidating corporation on such property, pursuant to paragraph (c)(2) of this section.

(ii) *Other rules.* For other rules that may apply, see sections 367(b) and 381.

(d) *Anti-abuse rule.* The Commissioner may require a domestic liquidating corporation to recognize gain on a distribution in liquidation described in paragraph (b) of this section (or treat the liquidating corporation as if it had recognized loss on a distribution in liquidation), if a principal purpose of the liquidation is the avoidance of U.S. tax (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 33 $\frac{1}{3}$ percent. After the transfer, X owns the remaining 66 $\frac{2}{3}$ percent interest in PRS. Almost all of the T assets consist of T's large inventory of fabric, which PRS uses to manufacture sportswear. All of the T assets are used in the sportswear business. No member of P's qualified group performs active and substantial management functions for the sportswear business operated in PRS.

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

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

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

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

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

(ii) *Continuity of business enterprise.* Under paragraph (d)(4)(iii)(A) of this section, PRS-1 is treated as owning 75 percent of the T assets used in PRS-2's business. P, in turn, is treated as owning 50 percent of PRS-1's interest in the T assets. Thus, P is treated as owning 37 $\frac{1}{2}$ percent (50 percent \times 75 percent) of the T assets used in the PRS-2 business. Under paragraph (d)(4)(iii)(B)(I) of this section, P is treated as conducting PRS-2's business, the operation of the state Z television station, and under paragraph (d)(4)(iii)(A) of this section, P is treated as using 37 $\frac{1}{2}$ 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 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 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 re-characterization. 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 pre-signing 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 ($[(1/2) \times 80]$) 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 ($60 \times \$.16 / \$.40$) and \$14.40 more cash ($60 \times \$.24$) 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 ($64 \times \$.40$) and \$74.40 of cash and the transaction does not preserve a substan-

tial 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 \times \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 \times \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 \times \$1) - \18) and \$18 less cash ($30 \times \0.60) 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 \times \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 re-

ceived 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