# Notice of Proposed Rulemaking

## Transactions Involving the Transfer of No Net Value

## REG–163314–03

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations providing guidance regarding corporate formations, reorganizations, and liquidations of insolvent corporations. These regulations provide rules requiring the exchange (or, in the case of section 332, a distribution) of net value for the nonrecognition rules of subchapter C to apply to the transaction. The regulations also provide guidance on determining when and to what extent creditors of a corporation will be treated as proprietors of the corporation in determining whether continuity of interest is preserved in a potential reorganization. Finally, the regulations provide guidance on whether a distribution in cancellation or redemption of less than all of the shares one corporation owns in another corporation satisfies the requirements of section 332. The proposed regulations affect corporations and their shareholders.

DATES: Written and electronic comments and requests for a public hearing must be received by June 8, 2005.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–163314–03), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. to 4 p.m. to CC:PA:LPD:PR (REG–163314–03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC or sent electronically, via the IRS internet site at *www.irs.gov/regs* or via the Federal eRulemaking Portal at *www.regulations.gov* (IRS and REG–163314–03).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations on the reorganization provisions and regarding issues raised by the proposed regulations with respect to provisions other than those related to corporate liquidations and subchapter K, Jean Brenner, (202) 622–7790; concerning the proposed regulations on corporate liquidations, Sean McKeever, (202) 622–7750; concerning the application of the principles of the proposed regulations to transfers of property to partnerships under subchapter K, Jeanne Sullivan or Michael Goldman, (202) 622–3070; concerning submissions of comments and/or requests for a public hearing, Treena Garrett, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

## General Background

The IRS and the Treasury Department believe that there is a need to provide a comprehensive set of rules addressing the application of the nonrecognition rules of subchapter C of the Internal Revenue Code (Code) to transactions involving insolvent corporations and to other transactions that raise similar issues. The proposed regulations provide three sets of rules, the principal one of which is that the nonrecognition rules of subchapter C do not apply unless there is an exchange (or, in the case of section 332, a distribution) of net value (the "net value requirement"). The proposed regulations also provide guidance on the circumstances in which (and the extent to which) creditors of a corporation will be treated as proprietors of the corporation in determining whether continuity of interest is preserved in a potential reorganization. The proposed regulations further provide guidance on whether a distribution in cancellation or redemption of less than all of the shares one corporation owns in another corporation satisfies the requirements of section 332. Each of these rules is discussed separately in this preamble.

## Explanation of Provisions

*Exchange of Net Value Requirement*

*Background*

In subchapter C, each of the rules described below that provides for the general nonrecognition of gain or loss refers to a distribution in cancellation or redemption of stock or an exchange for stock. Section 332 provides, in part, that "[n]o gain or loss shall be recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation . . . only if . . . the distribution is by such other corporation *in complete cancellation or redemption of all its stock*." Section 351 provides, in part, that "[n]o gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely *in exchange for stock* in such corporation." Section 354 provides, in part, that "[n]o gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are . . . *exchanged solely for stock or securities* . . . in another corporation a party to the reorganization." Finally, section 361 provides that "[n]o gain or loss shall be recognized to a corporation if such corporation is a party to a reorganization and *exchanges property . . . solely for stock or securities* in another corporation a party to the reorganization."

The authorities interpreting section 332 have consistently concluded that the language of the statute referring to a distribution in complete cancellation or redemption of stock requires a distribution of net value. Section 1.332–2(b) provides that section 332 applies only if a parent receives at least partial payment for the stock that it owns in the liquidating corporation. Such payment could not occur unless there were a distribution of net value. The courts have focused in numerous cases on the effect of liabilities on the distribution requirement of section 332. In *H. G. Hill Stores, Inc. v. Commissioner*, 44 B.T.A. 1182 (1941), a subsidiary liquidated and distributed its assets and liabilities to its parent in cancellation of its indebtedness to its parent. The court interpreted the phrase "in complete cancellation or redemption of all its stock" as requiring that a distribution be made to the parent in its capacity as a stockholder in order for section 112(b)(6) (the predecessor of section 332) to apply and, thus, held that section 112(b)(6) did not apply because the parent corporation received payment in its capacity as a creditor and not in its capacity as a stockholder. See also Rev. Ruls. 2003–125, 2003–2 C.B. 1243, 70–489, 1970–2 C.B. 53, and 59–296, 1959–2 C.B. 87.

Rev. Rul. 59–296 holds that the principles relevant to liquidations under section 332 also apply to reorganizations under section 368. However, other authorities are not consistent with the approach of Rev. Rul. 59–296. Most notably, in *Norman Scott, Inc. v. Commissioner*, 48 T.C. 598 (1967), the Tax Court held that a transaction involving an insolvent target corporation qualified as a reorganization under section 368(a)(1)(A).

The IRS and the Treasury Department have decided to resolve the uncertainties by generally adopting a net value requirement for each of the described nonrecognition rules in subchapter C. The net value requirement generally requires that there be an exchange of property for stock, or in the case of section 332, a distribution of property in cancellation or redemption of stock. The IRS and the Treasury Department believe that the net value requirement is the appropriate unifying standard because it is more consistent with the statutory framework of subchapter C, case law, and published guidance than any other approach considered. In addition, the IRS and the Treasury Department believe that the net value requirement is the appropriate standard because transactions that fail the requirement, that is, transfers of property in exchange for the assumption of liabilities or in satisfaction of liabilities, resemble sales and should not receive nonrecognition treatment.

The IRS and the Treasury Department considered several other approaches to unify and rationalize the nonrecognition rules of subchapter C as they applied to transactions involving insolvent corporations. The IRS and the Treasury Department considered whether there should be special rules for potential nonrecognition transactions between members of a consolidated group. Such rules might disregard the various exchange requirements in the statute because of the single entity principles generally applicable to corporations joining in the filing of a consolidated return. This approach was rejected because there is no consolidated return policy that compels a different set of rules for potential nonrecognition transactions between members of a consolidated group. Cf. §1.1502–35T(f)(1); Notice 94–49, 1994–1 C.B. 358. The current intercompany transaction rules (in particular those regarding successors in §1.1502–13(j)) could be modified to extend deferral of gain and loss to additional situations as long as the assets remained in the consolidated group pending later acceleration events that befall the assets or successor entities. However, no such rules are being proposed because the case for treating the transferor and transferee members as a single entity seems weakest when the group's equity investment in the transferor has been eliminated.

The IRS and the Treasury Department also considered whether satisfying the words of the relevant statutory provisions that describe the relationship of the parties to a transaction should be sufficient for applying the nonrecognition rules to a transaction between the parties. This approach would essentially take the position that the words of distribution or exchange in the statute do not state a separate requirement but merely describe the most common form of the transaction to which the provision is intended to apply. For example, under this approach, it would be sufficient for a transaction to qualify as a distribution in complete liquidation under section 332 if the corporation to which assets are transferred owned stock meeting the requirements of section 1504(a)(2) at the time of the transfer. Also, under this approach, it would be sufficient for a transaction to qualify as a transfer under section 351 if a transferor of assets were in control (as defined in section 368(c)) of the corporation to which assets are transferred immediately after the transaction. However, this approach would require distinguishing, when the structure of the statute does not, between parts of a statute that impose requirements and other parts that do not.

*Explanation of rules*

*Net Value Requirement*

For potential liquidations under section 332, the net value requirement is effected by the partial payment rule in §1.332–2(b) of the current regulations. The proposed regulations make no modifications to this rule, except, as discussed below, for transactions in which the recipient corporation owns shares of multiple classes of stock in the dissolving corporation. The proposed regulations also make minor changes to other sections of the regulations under section 332 to conform those regulations to changes in the statute.

For potential transactions under section 351, the proposed regulations add §1.351–1(a)(1)(iii)(A), which requires a surrender of net value and, in paragraph (a)(1)(iii)(B), a receipt of net value. This rule is similar to that for potential asset reorganizations, discussed below. The proposed regulations make minor changes to other sections of the regulations under section 351 to conform those regulations to changes in the statute.

For potential reorganizations under section 368, the proposed regulations modify §1.368–1(b)(1) to add the requirement that there be an exchange of net value. Section 1.368–1(f) of the proposed regulations sets forth the rules for determining whether there is an exchange of net value. These rules require, in paragraph (f)(2)(i) for potential asset reorganizations and paragraph (f)(3)(i) for potential stock reorganizations, a surrender of net value and, in paragraph (f)(2)(ii) for potential asset reorganizations and paragraph (f)(3)(ii) for potential stock reorganizations, a receipt of net value. In a potential asset reorganization (one in which the target corporation would not recognize gain or loss under section 361), the target corporation surrenders net value if the fair market value of the property transferred by it to the acquiring corporation exceeds the sum of the amount of liabilities of the target corporation that are assumed by the acquiring corporation and the amount of any money and the fair market value of any property (other than stock permitted to be received under section 361(a) without the recognition of gain) received by the target corporation. This rule ensures that a target corporation transfers property in exchange for stock. The IRS and the Treasury Department believe that the proposed rule better identifies whether a target corporation transfers property in exchange for stock than a rule that looks to the issuance or failure to issue stock because, when the parties are related, the issuance or failure to issue stock might be meaningless.

In a potential stock reorganization (one which would be described in section 368(a)(1)(B) or section 368(a)(1)(A) by reason of section 368(a)(2)(E)), the rules are modified to reflect the fact that the target corporation remains in existence. A potential reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(E) must satisfy the asset reorganization test for the merger of the controlled corporation into the target corporation (for which test the controlled corporation is treated as the target corporation) and the stock reorganization test for the acquisition of the target corporation.

In a potential asset reorganization, the target corporation receives net value if the fair market value of the assets of the issuing corporation exceeds the amount of its liabilities immediately after the exchange. This rule ensures that the target corporation receives stock (or is deemed to receive stock under the "meaningless gesture" doctrine) having value. This rule is necessary because the IRS and the Treasury Department believe that the receipt of worthless stock in exchange for assets cannot be part of an exchange for stock.

*Scope of Net Value Requirement*

The proposed regulations provide in §1.368–1(b)(1) that the net value requirement does not apply to reorganizations under section 368(a)(1)(E) and 368(a)(1)(F). The IRS and the Treasury Department recently issued final regulations (T.D. 9182, 2005–11 I.R.B. 713 [70 FR 9219] (Feb. 25, 2005)) stating that a continuity of business enterprise and a continuity of interest are not required for a transaction to qualify as a reorganization under section 368(a)(1)(E) or (F) because applying the requirements in those contexts is not necessary to protect the policies underlying the reorganization provisions. Because the purpose underlying the net value requirement is the same as that underlying the continuity of interest requirement, the IRS and the Treasury Department have similarly concluded that applying the net value requirement to transactions under section 368(a)(1)(E) or (F) is not necessary to protect the policies underlying the reorganization provisions.

The proposed regulations also provide in §1.368–1(b)(1) and §1.368–1(f)(4) that the net value requirement does not apply to a limited class of transactions that qualify as reorganizations under section 368(a)(1)(D). That class of transactions are the transactions exemplified by *James Armour, Inc. v. Commissioner*, 43 T.C. 295 (1964), and Rev. Rul. 70–240, 1970–1 C.B. 81. The IRS and the Treasury Department acknowledge that the conclusions of the described authorities are inconsistent with the principles of the net value requirement. Nevertheless, the IRS and the Treasury Department currently desire to preserve the conclusions of these authorities while they more broadly study issues relating to acquisitive reorganizations under section 368(a)(1)(D), including the continuing vitality of various liquidation-reincorporation authorities after the enactment of the Tax Reform Act of 1986, Public Law 99–514 (100 Stat. 2085 (1986)). Consistent with the described authorities, the exception is limited to acquisitive reorganizations of solvent target corporations. The proposed regulations provide no specific guidance (other than in an example incorporating the facts of

Rev. Rul. 70–240, 1970–1 C.B. 81), other than with regard to the application of the net value requirement, on when a transaction will qualify as a reorganization under section 368(a)(1)(D). In this regard, compare *Armour* with *Warsaw Photographic Associates, Inc. v. Commissioner*, 84 T.C. 21 (1985).

*Definition of Liabilities*

In applying the proposed regulations, taxpayers must determine the amount of liabilities of the target corporation that are assumed by the acquiring corporation. Although the proposed regulations do not define the term liability, the IRS and the Treasury Department intend that the term be interpreted broadly. Thus, for purposes of the proposed regulations, a liability should include any obligation of a taxpayer, whether the obligation is debt for federal income tax purposes or whether the obligation is taken into account for the purpose of any other Code section. Generally, an obligation is something that reduces the net worth of the obligor. The IRS and the Treasury Department have proposed adopting a similar definition of liability for purposes of implementing section 358(h) in subchapter K. See Prop. Reg. §1.752–1(a)(1)(ii) and Prop. Reg. §1.752–7(b)(2)(ii) (REG–106736–00, 2003–2 C.B. 60 [68 FR 37434]) (June 24, 2003).

*Amount of Liabilities*

The proposed regulations provide no specific guidance on determining the amount of a liability. The IRS and the Treasury Department are currently considering various approaches to determining the amount of a liability. One approach would be to treat the amount of a liability represented by a debt instrument as its adjusted issue price determined under sections 1271 through 1275 of the Code (the OID rules) (perhaps with exceptions for certain contingent payment debt instruments) while treating the amount of other liabilities as the value of such liabilities. Another approach would be to treat the amount of all liabilities as the value of such liabilities. Other approaches could borrow in whole or in part from other authorities such as those relevant to the determination of insolvency under section 108(d)(3). One method for valuing liabilities is to determine the amount of cash that a willing assignor would pay to a willing assignee to assume the liability in an arm's-length transaction. Cf. Prop. Reg. §1.752–7(b)(2)(ii).

In the course of developing these regulations, the IRS and the Treasury Department considered special issues related to the assumption of nonrecourse liabilities in the context of a transaction to which section 332, 351, or 368 might apply. The IRS and the Treasury Department are considering a rule similar to the one in Rev. Rul. 92–53, 1992–2 C.B. 48, that would disregard the amount by which a nonrecourse liability exceeds the fair market value of the property securing the liability when determining the amount of liabilities that are assumed. For example, under such a rule, if an individual transfers an apartment building with a fair market value of $175x subject to a nonrecourse obligation of $190x and an adjacent lot of land with a fair market value of $10x to a corporation, the transferor will have surrendered net value because the fair market value of the assets transferred ($175x + $10x) exceeds the amount of the liabilities assumed ($190x - $15x, the amount of the excess nonrecourse indebtedness). Any rule disregarding excess nonrecourse indebtedness would be limited to the application of the net value requirement and would have no relevance for other federal income tax purposes, such as the determination of the amount realized under section 1001. Comments are requested regarding the treatment of nonrecourse indebtedness and the effect of such treatment when both property subject to the nonrecourse indebtedness and other property are transferred.

*Assumption of Liabilities*

In general, the IRS and the Treasury Department believe that the principles of section 357(d) should be applied to determine whether a liability is assumed when more than one person might bear responsibility for the liability. Comments are requested regarding whether and to what extent the principles of section 357(d) should be incorporated into the regulations.

The IRS and the Treasury Department believe that transfers of assets in satisfaction of liabilities should be treated the same as transfers of assets in exchange for the assumption of liabilities. Accordingly, in determining whether there is a surrender of net value, the proposed regulations treat any obligation of the target corporation for which the acquiring corporation is the obligee as a liability assumed by the acquiring corporation.

*In Connection With*

The proposed regulations take into account not only liabilities assumed in the exchange, but also liabilities assumed "in connection with" the exchange. The proposed regulations include this rule so that the timing of an acquiring corporation's assumption of a target corporation's liability (or a creditor's discharge of a target corporation's indebtedness), whether before an exchange, in the exchange, or after the exchange, will have the same effect in determining whether there is a surrender of net value in the exchange. The proposed regulations also take into account, in determining whether there is a surrender of net value, money and other nonstock consideration received by the target corporation in connection with the exchange.

The IRS and the Treasury Department intend that the substance-over-form doctrine and other nonstatutory doctrines be used in addition to the "in connection with" rule in determining whether the purposes and requirements of the net value requirement are satisfied. Cf. Rev. Rul. 68–602, 1968–2 C.B. 135 (holding that a parent corporation's cancellation of a wholly-owned subsidiary's indebtedness to it that is an integral part of a liquidation is transitory and, therefore, disregarded).

*Section 368(a)(1)(C)*

The proposed regulations remove the statement in §1.368–2(d)(1) that the assumption of liabilities may so alter the character of a transaction as to place the transaction outside the purposes and assumptions of the reorganization provisions. Because the proposed regulations provide more specific guidance regarding when the assumption of liabilities will prevent a transaction from qualifying as a reorganization under section 368(a)(1)(C), the IRS and the Treasury Department believe the statement is unnecessary.

*Section 721*

The IRS and the Treasury Department recognize that the principles in the proposed rules under section 351 may be applied by analogy to other Code sections that are somewhat parallel in scope and effect, such as section 721, dealing with the contribution of property to a partnership in exchange for a partnership interest. The IRS and the Treasury Department request comments on whether rules similar to the rules of the proposed regulations should be proposed in the context of subchapter K and the considerations that might justify distinguishing the relevant provisions in subchapter K from those provisions that are the subject of these proposed regulations.

*Continuity of Interest*

*Background*

The Code provides general nonrecognition treatment for reorganizations described in section 368. A transaction must comply with both the statutory requirements of the reorganization provisions and various nonstatutory requirements, including the continuity of interest requirement, to qualify as a reorganization. See §1.368–1(b). The purpose of the continuity of interest requirement is to ensure that reorganizations are limited to readjustments of continuing interests in property under modified corporate form and to prevent transactions that resemble sales from qualifying for nonrecognition of gain or loss available to corporate reorganizations. See §§1.368–1(b), 1.368–1(e)(1). Continuity of interest requires that a substantial part of the value of the proprietary interests in the target corporation be preserved in the reorganization. See §1.368–1(e)(1); see also *LeTulle v. Scofield*, 308 U.S. 415 (1940); *Helvering v. Minnesota Tea Co.*, 296 U.S. 378 (1935); *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933); *Cortland Specialty Co. v. Commissioner*, 60 F.2d 937 (2d Cir. 1932), cert. denied, 288 U.S. 599 (1933).

Generally, it is the shareholders who hold the proprietary interests in a corporation. However, when a corporation is in bankruptcy, the corporation's stock may be worthless and eliminated in the restructuring. In this case, when the corporation engages in a potential reorganization, its creditors may receive acquiring corporation stock in exchange for their claims and its shareholders may receive nothing. Thus, without special rules, most potential reorganizations of corporations in bankruptcy would fail the continuity of interest requirement. The Supreme Court addressed this problem in *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942), in which it held that, for practical purposes, the old continuity of interest in the shareholders shifted to the creditors not later than the time "when the creditors took steps to enforce their demands against the insolvent debtor. In this case, that was the date of the institution of bankruptcy proceedings. From that time on, they had effective command over the property." See also *Palm Springs Holding Corp. v. Commissioner*, 315 U.S. 185 (1942) (holding that the legal procedure employed by the creditors to obtain effective command over a corporation's property was not material when the corporation was insolvent). Notwithstanding *Palm Springs*, it is not clear when creditors of an insolvent corporation not in a title 11 or similar case may be considered proprietors for purposes of satisfying the continuity of interest requirement.

In *Atlas Oil & Refining Corp. v. Commissioner*, 36 T.C. 675 (1961), the court held that only creditors who in fact receive stock in the acquiring corporation, by relation back, can be deemed to have been equity owners at the time of the transfer. The court stated that the fact that a more senior class of creditors may have had "effective command" over the assets in the case will not make them proprietors if they do not in fact exercise their right to receive stock in the acquiring corporation.

In the Bankruptcy Tax Act of 1980, Public Law 96–589 (94 Stat. 3389 (1980)), Congress added section 368(a)(1)(G), providing for a new type of reorganization applicable to corporations in title 11 or similar cases. In the legislative history to that statute, Congress stated its expectation that the courts and the Treasury Department would determine whether the continuity of interest requirement is satisfied in a potential reorganization under section 368(a)(1)(G) by treating as proprietors the most senior class of creditors who received stock, together with all interests equal and junior to them, including shareholders. See S. Rep. No. 1035, 96th Cong., 2d Sess. 36–37 (1980). This formulation is similar to the relation back analysis that the Tax Court used in *Atlas Oil*.

*Explanation of provisions*

The proposed regulations add new §1.368–1(e)(6), which describes the circumstances in which creditors of a corporation generally, and which creditors in particular, will be treated as holding a proprietary interest in a target corporation immediately before a potential reorganization. In general, the proposed rules adopt the standard for reorganizations under section 368(a)(1)(G) recommended in the Senate Finance Committee Report to the Bankruptcy Tax Act of 1980. The proposed regulations also provide that creditors of an insolvent target corporation not in a title 11 or similar case may be treated as holding a proprietary interest in the corporation even though they take no steps to obtain effective command over the corporation's property, other than their agreement to receive stock in the potential reorganization. The proposed regulations, at §1.368–1(e)(6)(ii), provide specific guidance on how to quantify the proprietary interest of the target corporation so that taxpayers may determine whether a substantial part of the value of the proprietary interests in the target corporation is preserved in the potential reorganization. Because a creditor of a corporation may hold claims in more than one class, the proposed regulations generally refer to claims of a particular class of creditors rather than to creditors in a particular class.

The proposed regulations treat claims of the most senior class of creditors to receive a proprietary interest in the issuing corporation and claims of all equal classes of creditors (together, the senior claims) differently from the claims of classes of creditors junior to the senior claims (the junior claims). The proposed regulations treat senior claims as representing, in part, a creditor claim against the corporation, and, in part, a proprietary interest in the corporation. This rule mitigates the adverse effect on continuity of interest of senior creditors seeking payment primarily in nonstock consideration while still taking some payment in shares of stock of the acquiring corporation. The determination of what part of a senior claim is a proprietary interest in the target corporation is made by calculating the average treatment for all senior claims. Thus, the proposed regulations, at §1.368–1(e)(2)(ii)(B), provide that the value of a proprietary interest in the target corporation represented by a senior claim is determined by multiplying the fair market value of the creditor's 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 senior claims, 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. The effect of this rule is that there is 100 percent continuity of interest if each senior claim is satisfied with the same ratio of stock to nonstock consideration and no junior claim is satisfied with nonstock consideration.

The proposed regulations, at §1.368–1(e)(6)(ii)(A), provide that the entire amount of a junior claim represents a proprietary interest in the target corporation immediately before the potential reorganization. Thus, the value of the proprietary interest represented by that claim is the fair market value of the claim (which value is generally determined by reference to the amount of money and the fair market value of the consideration received in exchange therefor).

The rules in the proposed regulations are intended to work in conjunction with the current continuity of interest rules. Accordingly, the proposed regulations modify §1.368–1(e)(1)(ii), relating to the effect on continuity of interest of distributions or redemptions before a potential reorganization, and §1.368–1(e)(2), relating to the effect on continuity of interest of acquisitions of proprietary interests by persons related to the issuing corporation, to ensure that the purpose of these rules is effected when creditors' claims represent the proprietary interests in the target corporation.

*Section 332*

*Background*

Section 332 requires that a subsidiary's liquidating distribution to its parent corporation be in complete cancellation or redemption of all its stock. In *Spaulding Bakeries, Inc. v. Commissioner*, 252 F.2d 693 (2d Cir. 1958), aff'g 27 T.C. 684 (1957), the Second Circuit concluded that for a distribution to be made in cancellation or redemption of "all the stock," payment must be made on each class of stock. See also *H. K. Porter Co. v. Commissioner,* 87 T.C. 689 (1986).

*Explanation of provisions*

The current regulations provide that section 332 applies only to those cases in which the recipient corporation receives at least partial payment for the stock that it owns in the liquidating corporation. The proposed regulations clarify that section 332 applies only to those cases in which the recipient corporation receives at least partial payment for each class of stock that it owns in the liquidating corporation, an interpretation consistent with the Second Circuit's holding in *Spaulding Bakeries* and the Tax Court's holding in *H. K. Porter*. The IRS and the Treasury Department have adopted this approach because they believe that it is appropriate for a taxpayer to recognize loss when it fails to receive a distribution on a class of stock in liquidation of its subsidiary. The recipient corporation would recognize such a loss if the distribution qualified as a reorganization.

The proposed regulations also confirm that when the liquidation fails to qualify under section 332 because the recipient corporation did not receive at least partial payment for each class of stock but did receive at least partial payment for at least one class of stock, the transaction may qualify as a corporate reorganization under section 368.

**Proposed Effective Date**

These proposed regulations will apply to transactions that occur after the date they are published as final regulations in the **Federal Register**.

**Special Analyses**

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

**Comments and Requests for Public Hearing**

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

**Drafting Information**

The principal authors of these proposed regulations are Jean Brenner and Sean McKeever of the Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and the Treasury Department participated in their development.

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**Proposed Amendments to the Regulations**

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

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by revising the entry for "Section 1.351–1" to read, in part, as follows:

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

Section 1.351–1 also issued under 26 U.S.C. 351. * * *

Par. 2. Section 1.332–2 is amended by:

1. Revising the first sentence of paragraph (a).

2. Revising paragraph (b).

3. Revising the heading of the Example in paragraph (e).

4. Adding *Example 2* to paragraph (e).

The revisions and addition read as follows:

*§1.332–2 Requirements for nonrecognition of gain or loss.*

(a) The nonrecognition of gain or loss is limited to the receipt of property by a corporation that is the actual owner of stock (in the liquidating corporation) meeting the requirements of section 1504(a)(2). * * *

(b) Section 332 applies only when the recipient corporation receives at least partial payment for each class of stock that it owns in the liquidating corporation. If section 332 does not apply, see section 165(g) regarding the allowance of losses for worthless securities for a class of stock for which no payment is received. Further, if section 332 does not apply and the recipient corporation receives partial payment for at least one class of stock that it owns in the liquidating corporation, see section 368(a)(1) regarding potential qualification of the distribution as a reorganization. If section 332 does not apply and the distribution does not qualify as a reorganization, see section 331 for those classes of stock for which partial payment is received.

* * * * *

(e) * * *

*Example 1*. * * *

*Example 2*. P Corporation owns all of the outstanding preferred and common stock of Q Corporation. The preferred stock is not stock described in section 1504(a)(4). The fair market value of Q Corporation's assets exceeds the amount of its liabilities but does not exceed the liquidation preference on the Q Corporation's preferred stock. Q Corporation liquidates and distributes all of its assets to P Corporation. P Corporation receives partial payment for its Q Corporation preferred stock but receives nothing for its Q Corporation common stock. The receipt by P Corporation of the properties of Q Corporation is not a distribution received by P Corporation in complete liquidation of Q Corporation within the meaning of section 332. Thus, under section 165(g), P Corporation is entitled to a worthless security deduction for its Q Corporation common stock. The transaction may qualify as a reorganization under section 368(a)(1)(C). If the transaction does not qualify as a reorganization, P Corporation will recognize gain or loss on its Q Corporation preferred stock under section 331.

Par. 3. Section 1.351–1 is amended by:

1. Revising the first sentence of paragraph (a)(1) introductory text.

2. Adding a sentence after the last sentence in paragraph (a)(1) introductory text and revising the phrase "For purposes of this section" at the end of paragraph (a)(1) introductory text to read "In addition, for purposes of this section".

3. Revising paragraphs (a)(1)(i) and (a)(1)(ii).

4. Removing the concluding text immediately following paragraph (a)(1)(ii).

5. Adding paragraphs (a)(1)(iii) and (a)(1)(iv).

6. Adding *Example 4* at the end of paragraph (a)(2).

7. Revising paragraph (b)(1).

The revisions, removal, and additions read as follows:

*§1.351–1 Transfer to corporation controlled by transferor.*

(a)(1) Section 351(a) provides, in general, for the nonrecognition of gain or loss upon the transfer by one or more persons of property to a corporation solely in exchange for stock of such corporation if, immediately after the exchange, such person or persons are in control of the corporation to which the property was transferred. * * * For purposes of this section, stock rights and stock warrants are not included in the term *stock*. In addition, for purposes of this section —

(i) Stock will not be treated as issued for property if it is issued for services rendered or to be rendered to or for the benefit of the issuing corporation;

(ii) Stock will not be treated as issued for property if it is issued for property which is of relatively small value in comparison to the value of the stock already owned (or to be received for services) by the person who transferred such property and the primary purpose of the transfer is to qualify under this section the exchanges of property by other persons transferring property; and

(iii) Stock will not be treated as issued for property if either —

(A) The fair market value of the transferred property does not exceed the sum of the amount of liabilities of the transferor that are assumed by the transferee in connection with the transfer and the amount of any money and the fair market value of any other property (other than stock permitted to be received under section 351(a) without the recognition of gain) received by the transferor in connection with the transfer. For this purpose, any obligation of the transferor for which the transferee is the obligee that is extinguished for federal income tax purposes in connection with the transfer is treated as a liability assumed by the transferee; or

(B) The fair market value of the assets of the transferee does not exceed the amount of its liabilities immediately after the transfer;

(iv) Paragraph (a)(1)(iii) of this section applies to transfers occurring after the date these proposed regulations are published as final regulations in the **Federal Register**.

(2) * * *

* * * * *

*Example 4*. A, an individual, transfers an apartment building with a fair market value of $175x to Corporation X. The building is subject to a nonrecourse obligation of $190x and no other asset is subject to that liability. A receives 10 shares of Corporation X stock in the exchange. Immediately after the exchange, Corporation X is solvent and A owns 100% of its outstanding stock. Under paragraph (a)(1)(iii) of this section, the 10 shares of Corporation X stock received by A will not be treated as issued for property because the fair market value of the apartment building does not exceed the amount of A's liabilities assumed by Corporation X. Therefore, section 351 does not apply to the exchange.

* * * * *

(b)(1) When property is transferred to a corporation by two or more persons in exchange for stock, as described in paragraph (a) of this section, and the stock received is received in disproportion to the transferor's prior interest in such property, the entire transaction will be given tax effect in accordance with its true nature, and the transaction may be treated as if the stock had first been received in proportion and then some of such stock had been used to make gifts (section 2501 *et seq.*), to pay compensation (sections 61(a)(1) and 83(a)), or to satisfy obligations of the transferor of any kind.

* * * * *

Par. 4. Section 1.368–1 is amended by:

1. Removing the last sentence of paragraph (a).

2. Redesignating paragraph (b) as paragraph (b)(1).

3. Removing the third sentence of paragraph (b)(1) and adding two sentences in its place.

4. Removing the seventh sentence of paragraph (b)(1).

5. Adding paragraph (b)(2).

6. Adding a sentence after the fifth sentence of paragraph (e)(1)(i).

7. Adding a sentence at the end of paragraph (e)(1)(ii).

8. Revising the text of paragraph (e)(2).

9. Redesignating paragraphs (e)(6) and (e)(7) as paragraphs (e)(7) and (e)(8), respectively, and adding a new paragraph (e)(6).

10. Adding *Example 10* to the end of paragraph (e)(7).

11. Adding a sentence at the end of paragraph (e)(8).

12. Adding paragraph (f).

The additions and revisions read as follows:

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

* * * * *

(b)(1) * * * Requisite to a reorganization under the Internal Revenue Code are a continuity of business enterprise through the issuing corporation under the modified corporate form as described in paragraph (d) of this section, a continuity of interest as described in paragraph (e) of this section (except as provided in section 368(a)(1)(D)), and an exchange of net value as described in paragraph (f) of this section. Notwithstanding the requirements of this paragraph (b)(1), an exchange of net value is not required for a transaction to qualify as a reorganization under section 368(a)(1)(E) or (F) and, to the extent provided in paragraph (f)(4), for a transaction to qualify as a reorganization under section 368(a)(1)(D). * * *

(2) *Effective dates.* The third and fourth sentences of paragraph (b)(1) of this section apply to transactions occurring after the date these proposed regulations are published as final regulations in the **Federal Register**. The fifth and sixth 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.

* * * * *

(e) * * *

(1) * * *

(i) * * * 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. * * *

(ii) * * * 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.

(2) * * * 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)(3) of this section) to the issuing corporation acquires 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 for consideration other than stock of the issuing 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.

* * * * *

(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.

(ii) *Value of proprietary interest*—(A) *In general.* Generally, if a creditor's claim is a proprietary interest in the target corporation, the value of the proprietary interest is the fair market value of the creditor's claim.

(B) *Claims of creditors of most senior classes.* 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.

(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) * * *

* * * * *

*Example 10. Creditors treated as owning a proprietary interest.* T has assets with a fair market value of $150x and liabilities of $200x. T has two classes of creditors, the senior creditors with claims of $50x, and the junior creditors with claims of $150x. T transfers all of its assets to P in exchange for $95x and shares of P stock with a fair market value of $55x. The T senior creditors receive in the aggregate $40x and P stock with a fair market value of $10x in exchange for their claims. Each T senior creditor receives stock and nonstock consideration in the same proportion. The T junior creditors receive $55x and P stock with a fair market value of $45x in exchange for their claims. 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 claims of the junior creditors and the T shareholders are treated as proprietary interests in T immediately prior to the transaction. Under paragraph (e)(6)(ii) of this section, the value of the senior creditors' proprietary interests in T is $10x, the value of the proprietary interests in P that they received in exchange for their claims. In addition, the value of the junior creditors' proprietary interests in T immediately prior to the transaction is $100x, the value of their claims. Because P is treated as acquiring 50 percent of the value of the proprietary interests in T in exchange for P stock ($55x/$110x), a substantial part of the value of the proprietary interests in T is preserved. Therefore, the continuity of interest requirement is satisfied.

(8) * * * The sixth sentence of paragraph (e)(1)(i) of this section, the last sentence of paragraph (e)(1)(ii) of this section, paragraph (e)(2) of this section, paragraph (e)(6) of this section, and *Example 10* of paragraph (e)(7) of this section apply to transactions occurring after the date these proposed regulations are published as final regulations in the **Federal Register**.

(f) *Exchanges of net value*—(1) *General rule*. An exchange of net value requires that there be both a surrender of net value and a receipt of net value. Whether there is a surrender of net value is determined by reference to the assets and liabilities of the target corporation. Whether there is a receipt of net value is determined by reference to the assets and liabilities of the issuing corporation (as defined in paragraph (b) of this section). The purpose of the exchange of net value requirement is to prevent transactions that resemble sales (including transfers of assets in satisfaction of liabilities) from qualifying for nonrecognition of gain or loss available to corporate reorganizations.

(2) *Asset transactions*. There is an exchange of net value in a potential reorganization to which section 361 would apply only if —

(i) *Surrender of net value*. The fair market value of the property transferred by the target corporation to the acquiring corporation exceeds the sum of the amount of liabilities of the target corporation that are assumed by the acquiring corporation in connection with the exchange and the amount of any money and the fair market value of any other property (other than stock permitted to be received under section 361(a) without the recognition of gain) received by the target corporation in connection with the exchange. For this purpose, any obligation of the target corporation for which the acquiring corporation is the obligee that is extinguished for federal income tax purposes in connection with the exchange is treated as a liability assumed by the acquiring corporation; and

(ii) *Receipt of net value*. The fair market value of the assets of the issuing corporation exceeds the amount of its liabilities immediately after the exchange.

(3) *Stock transactions*. There is an exchange of net value in a potential reorganization under section 368(a)(1)(B) or section 368(a)(1)(A) by reason of section 368(a)(2)(E) only if —

(i) *Surrender of net value*. The fair market value of the assets of the target corporation exceeds the sum of the amount of the liabilities of the target corporation immediately prior to the exchange and the amount of any money and the fair market value of any other property (other than stock permitted to be received under section 354 without the recognition of gain and nonqualified preferred stock within the meaning of section 351(g)) received by the shareholders of the target corporation in connection with the exchange. For this purpose, assets of the target corporation that are not held immediately after the exchange and liabilities of the target corporation that are extinguished for federal income tax purposes in the exchange other than ones, if any, to the corporation into which the target corporation merges in the case of a potential reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(E) are disregarded; and

(ii) *Receipt of net value*. The fair market value of the assets of the issuing corporation exceeds the amount of its liabilities immediately after the exchange.

(4) *Exception*. The requirement that there be an exchange of net value does not apply to a transaction that would otherwise qualify as a reorganization under section 368(a)(1)(D) by reason of section 354 or so much of section 356 as relates to section 354, provided that the fair market value of the property transferred to the acquiring corporation by the target corporation exceeds the amount of liabilities of the target corporation immediately before the exchange (including any liabilities cancelled, extinguished, or assumed in connection with the exchange), and the fair market value of the assets of the acquiring corporation equals or exceeds the amount of its liabilities immediately after the exchange.

(5) *Examples*. For purposes of the examples in this paragraph (f)(5), each of P, S, and T is a corporation; all corporations have only one class of stock outstanding; A, B, C, and D are individuals; and the transaction is not otherwise subject to recharacterization. Except as otherwise provided, no person is related to any other person and the fair market value of the assets of each corporation exceeds the amount of its liabilities immediately prior to the transaction described in the example. The following examples illustrate the application of this paragraph (f).

*Example 1*. T has assets with a fair market value of $50x and liabilities of $75x, all of which are owed to A. T transfers all of its assets to S in exchange for S stock with a fair market value of $50x. T distributes the S stock to A in exchange for the T debt owed to A. T dissolves. T's shareholders receive nothing in exchange for their T stock. Under paragraph (f)(2)(i) of this section, T surrenders net value because the fair market value of the property transferred by T ($50x) exceeds the sum of the amount of liabilities that are assumed by S in connection with the exchange ($0x) and the amount of any money and the fair market value of any other property (other than stock permitted to be received under section 361(a) without the recognition of gain) received by T in connection with the exchange ($0x). In addition, under paragraph (f)(2)(ii) of this section, T receives net value because the fair market value of the assets of S exceeds the amount of its liabilities immediately after the exchange. Therefore, under paragraph (f) of this section, there is an exchange of net value.

*Example 2*. P owns all of the stock of both S and T. T has assets with a fair market value of $100x and liabilities of $160x, all of which are owed to P. T transfers all of its assets to S in exchange for S stock with a fair market value of $100x. T distributes the S stock to P in exchange for the T debt owed to P. T dissolves. P receives nothing in exchange for its T stock. Under paragraph (f)(2)(i) of this section, T surrenders net value because the fair market value of the property transferred by T ($100x) exceeds the sum of the amount of liabilities of T assumed by S in connection with the exchange ($0x) and the amount of any money and the fair market value of any other property (other than stock permitted to be received under section 361(a) without the recognition of gain) received by T in connection with the exchange ($0x). In addition, under paragraph (f)(2)(ii) of this section, T receives net value because the fair market value of the assets of S exceeds the amount of its liabilities immediately after the exchange. Therefore, under paragraph (f) of this section, there is an exchange of net value. The result would be the same if no S stock were issued.

*Example 3*. The facts are the same as in *Example 2*, except that T's debt is owed to B. T transfers all of its assets to S in exchange for the assumption of T's liabilities. T dissolves. The obligation to B is outstanding immediately after the transfer. P receives nothing in exchange for its T stock. Under paragraph (f)(2)(i) of this section, T does not surrender net value because the fair market value of the property transferred by T ($100x) does not exceed the sum of the amount of liabilities of T assumed by S in connection with the exchange ($160x). Therefore, under paragraph (f) of this section, there is no exchange of net value. The result would be the same if S stock were issued.

*Example 4*. The facts are the same as in *Example 3*, except that S first assumes the T debt owed to B and subsequently T transfers all of its assets to S in exchange for S stock with a fair market value of $100x. If S's assumption of the T debt is made in connection with the subsequent transfer of T assets to S, under paragraph (f)(2)(i) of this section, T does not surrender net value because the fair market value of the property transferred by T ($100x) does not exceed the sum of the amount of liabilities of T assumed by S in connection with the exchange ($160x). Therefore, under paragraph (f) of this section, there is no exchange of net value.

*Example 5*. P owns 70% of the stock of T. A owns the remaining 30% of the stock of T. T has assets with a fair market value of $100x and liabilities of $160x, all of which are owed to P. T merges into P. A receives nothing in exchange for its T stock. Under (f)(2)(i) of this section, even though T's obligation to P is extinguished in the transaction, it is treated as a liability assumed by P. Thus, under paragraph (f)(2)(i) of this section, T does not surrender net value because the fair market value of the property transferred by T ($100x) does not exceed the sum of the amount of liabilities of T assumed by P in connection with the exchange ($160x). Therefore, under paragraph (f) of this section, there is no exchange of net value.

*Example 6*. A owns all of the stock of S. S has assets with a fair market value of $200x and liabilities of $500x, all of which are owed to T. The S debt has a fair market value of $200x. In addition to the S debt, T has other assets that have a fair market value of $700x. T has no liabilities. T transfers all of its assets to S in exchange for S stock with a fair market value of $900x. T distributes the S stock to its shareholders in exchange for their T stock. T dissolves. S cancels all of its stock held by its shareholders immediately prior to the exchange. Under paragraph (f)(2)(i) of this section, T surrenders net value because the fair market value of the property transferred by T ($900x) exceeds the sum of the amount of liabilities of T assumed by S in connection with the exchange ($0x) and the amount of any money and the fair market value of any other property (other than stock permitted to be received under section 361(a) without the recognition of gain) received by T in connection with the exchange ($0x). In addition, under paragraph (f)(2)(ii) of this section, T receives net value because the fair market value of the assets of S ($900x) exceeds the amount of the liabilities of S ($0x) immediately after the exchange. Therefore, under paragraph (f) of this section, there is an exchange of net value.

*Example 7*. P owns all of the stock of S. T has assets with a fair market value of $300x and liabilities of $650x, $500x of which are owed to P and $150x of which are owed to A. T merges into S. In the merger, P stock is issued to A in satisfaction of the debt owed to A by T. Also in the merger, P contributes to the capital of T the debt P is owed. Assume the merger would qualify as a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(D) if the exchange of net value requirement in paragraph (f)(1) of this section did not apply. Whether there is a surrender of net value is determined by reference to the actual merger of T into S. Thus, T surrenders net value because the fair market value of the property transferred by T ($300x) exceeds the sum of the amount of liabilities of T assumed by S in connection with the exchange ($0x) and the amount of any money and the fair market value of any other property (other than stock permitted to be received under section 361(a) without the recognition of gain) received by T in connection with the exchange ($0x). Whether there is a receipt of net value is determined by reference to the issuing corporation, in this case, P. T receives net value because the fair market value of the assets of P exceeds the amount of the liabilities of P immediately after the exchange. Therefore, under paragraph (f) of this section, there is an exchange of net value.

*Example 8*. P owns all of the stock of both S and T. T transfers all of its assets to S in exchange for $34x, the assets' fair market value. Following this transfer, T pays its debts of $2x and dissolves, distributing the remaining $32x to P. Assume the transaction would qualify as a reorganization under section 368(a)(1)(D) by reason of section 354 or so much of section 356 as relates to section 354 if the net value requirement in paragraph (f)(1) of this section did not apply. Under paragraph (f)(2) of this section, there is no exchange of net value because the fair market value of the property transferred by T ($34x) does not exceed the amount of money received by T in connection with the exchange ($34x). However, under paragraph (f)(4) of this section, because the transaction would otherwise qualify as a reorganization under section 368(a)(1)(D) and the other requirements of paragraph (f)(4) of this section are satisfied, the exchange of net value requirement does not apply. Accordingly, the transaction qualifies as a reorganization under section 368(a)(1)(D).

*Example 9*. A and B own all of the stock of T. T has assets with a fair market value of $500x and liabilities of $900x, all of which are owed to C and D, security holders of T. P acquires all of the stock and securities of T in exchange for P voting stock. In the transaction, A and B receive nothing in exchange for their stock of T. C and D exchange all of their securities of T for stock of P. Under paragraph (f)(3)(i) of this section, there is a surrender of net value because the fair market value of the assets of T held immediately prior to the exchange that are held immediately after the exchange ($500x) exceeds the sum of the amount of liabilities of T immediately prior to the exchange ($0x, disregarding the liabilities of $900x extinguished in the exchange) and the amount of any money and the fair market value of any other property (other than stock permitted to be received under section 354 without the recognition of gain and nonqualified preferred stock within the meaning of section 351(g)) received by the shareholders of T ($0x). In addition, under paragraph (f)(3)(ii) of this section, there is a receipt of net value because the fair market value of the assets of P exceeds the amount of the liabilities of P immediately after the exchange. Therefore, under paragraph (f) of this section, there is an exchange of net value.

*Example 10*. A and B own all of the stock of P, and C and D own all of the stock of T. P has assets with a fair market value of $400x and liabilities of $500x, and T has assets with a fair market value of $1000x and liabilities of $600x. P acquires all of the stock of T. C and D exchange all of their T stock, with a fair market value of $400x, for P stock with a fair market value of $300x immediately after the transaction. P cancels all of the stock held by A and B immediately prior to the exchange. Under paragraph (f)(3)(i) of this section, there is a surrender of net value because the fair market value of the assets of T held immediately prior to the exchange that are held immediately after the exchange ($1000x) exceeds the amount of liabilities of T ($600x) immediately prior to the exchange and the amount of any money and the fair market value of any other property (other than stock permitted to be received under section 354 without the recognition of gain and nonqualified preferred stock within the meaning of section 351(g)) received by the shareholders of T ($0x). In addition, under paragraph (f)(3)(ii) of this section, there is a receipt of net value because the fair market value of the assets of P ($800x), which includes the fair market value of the stock of T, exceeds the amount of its liabilities ($500x) immediately after the exchange. Therefore, under paragraph (f) of this section, there is an exchange of net value. To the extent that C and D surrender T stock with a value in excess of the value of the P stock they receive, the tax consequences of the surrender of the additional stock are determined based on the facts and circumstances.

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

Par. 5. Section 1.368–2 is amended by revising paragraph (d)(1) to read as follows:

*§1.368–2 Definition of terms.*

* * * * *

(d) * * *

(1)(i) One corporation must acquire substantially all the properties of another corporation solely in exchange for all or 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. 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.

(ii) Paragraph (d)(1)(i) of this section applies to transactions occurring after the date these proposed regulations are published as final regulations in the **Federal Register**.

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Mark E. Matthews,
*Deputy Commissioner for Services and Enforcement*.

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