Internal Revenue
bulletin

Bulletin No. 1998–14
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HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

Rev. Rul. 98–18, page 22.
Federal rates; adjusted federal rates; adjusted federal long-term rate, and the long-term exempt rate. For purposes of sections 1274, 1288, 382, and other sections of the Code, tables set forth the rates for April 1998.

T.D. 8760, page 4.
T.D. 8761, page 13.
REG–120882–97, page 25.
Final, temporary, and proposed regulations under section 368 of the Code provide guidance regarding satisfaction of the continuity of interest and continuity of business enterprise requirements for corporate reorganizations. A public hearing on the proposed regulations will be held on May 26, 1998.

T.D. 8762, page 15.
Final regulations under section 453 of the Code relate to the use of the installment method to report the gain recognized by a shareholder who receives, in exchange for the shareholder's stock, certain installment obligations that are distributed upon the complete liquidation of a corporation.

EXEMPT ORGANIZATIONS

Announcement 98–26, page 28.
A list is given of organizations now classified as private foundations.

ADMINISTRATIVE

REG–209373–81, page 26.
Proposed regulations under section 195 of the Code provide rules and procedures for electing to amortize start-up expenditures. A public hearing will be held on June 2, 1998.

Finding Lists begin on page 32.
Index for January-March begins on page 34.

Department of the Treasury
Internal Revenue Service

Mission of the Service

The purpose of the Internal Revenue Service is to collect the proper amount of tax revenue at the least cost; serve the public by continually improving the quality of our products and services; and perform in a manner warranting the highest degree of public confidence in our integrity, efficiency, and fairness.

Statement of Principles of Internal Revenue Tax Administration

The function of the Internal Revenue Service is to administer the Internal Revenue Code. Tax policy for raising revenue is determined by Congress.

With this in mind, it is the duty of the Service to carry out that policy by correctly applying the laws enacted by Congress; to determine the reasonable meaning of various Code provisions in light of the Congressional purpose in enacting them; and to perform this work in a fair and impartial manner, with neither a government nor a taxpayer point of view.

At the heart of administration is interpretation of the Code. It is the responsibility of each person in the Service, charged with the duty of interpreting the law, to try to find the true meaning of the statutory provision and not to adopt a strained construction in the belief that he or she is “protecting the revenue.” The revenue is properly protected only when we ascertain and apply the true meaning of the statute.

The Service also has the responsibility of applying and administering the law in a reasonable, practical manner. Issues should only be raised by examining officers when they have merit, never arbitrarily or for trading purposes. At the same time, the examining officer should never hesitate to raise a meritorious issue. It is also important that care be exercised not to raise an issue or to ask a court to adopt a position inconsistent with an established Service position.

Administration should be both reasonable and vigorous. It should be conducted with as little delay as possible and with great courtesy and considerateness. It should never try to overreach, and should be reasonable within the bounds of law and sound administration. It should, however, be vigorous in requiring compliance with law and it should be relentless in its attack on unreal tax devices and fraud.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents of a permanent nature are consolidated semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.

This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.

This part is divided into two subparts as follows: Subpart A, Tax Conventions, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.

To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.

With the exception of the Notice of Proposed Rulemaking and the disbarment and suspension list included in this part, none of these announcements are consolidated in the Cumulative Bulletins.

The first Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis and are published in the first Bulletin of the succeeding semiannual period, respectively.

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Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 42.—Low-Income Housing Credit

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 1998. See Rev. Rul. 98–18, page 22.

Section 280G.—Golden Parachute Payments

Federal short-term, mid-term, and long-term rates are set forth for the month of April 1998. See Rev. Rul. 98–18, page 22.

Section 368.—Definitions Relating to Corporate Reorganizations

26 CFR 1.368–1: Purpose and scope of exception of reorganization exchanges.

T.D. 8760

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Continuity of Interest and Continuity of Business Enterprise

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations providing guidance regarding satisfaction of the continuity of interest and continuity of business enterprise requirements for corporate reorganizations. The final regulations affect corporations and their shareholders.

DATES: These regulations are effective January 28, 1998.

Applicability: These regulations 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 (subject to customary conditions) binding on January 28, 1998, and at all times thereafter.

FOR FURTHER INFORMATION CONTACT: Regarding §1.368–1(e) (continuity of interest), §§1.338–2 and 1.368–1(a) and (b): Phoebe Bennett, (202) 622-7750 (not a toll-free number); regarding §1.368–1(d) (continuity of business enterprise), §§1.368–1(a) and (b), and 1.368–2(k): Marlene Peake Oppenheim, (202) 622-7750 (not a toll free number).

SUPPLEMENTARY INFORMATION:

Background

On December 23, 1996, the IRS published a notice of proposed rulemaking (REG–252231–96 [1997–1 C.B. 800]) in the **Federal Register** (61 F.R. 67512) relating to the continuity of interest (COI) requirement (proposed COI regulations). On January 3, 1997, the IRS published a notice of proposed rulemaking (REG–252233–96 [1997–1 C.B. 802]) in the **Federal Register** (62 F.R. 36101) (proposed COBE regulations) relating to (1) the continuity of business enterprise (COBE) requirement; and (2) transfers of acquired assets or stock following certain otherwise qualifying reorganizations (remote continuity of interest). Many written comments were received in response to these notices of proposed rulemaking. A public hearing on both proposed regulations was held on May 7, 1997. After consideration of all comments, the regulations proposed by REG–252231–96 and REG–252233–96 are adopted as revised by this Treasury decision, along with temporary regulations and proposed regulations cross-referencing the temporary regulations regarding COI published in T.D. 8761, page 13 of this Bulletin.

Explanation of Provisions

The Internal Revenue Code of 1986 provides general nonrecognition treatment for reorganizations specifically described in section 368. In addition to complying with the statutory requirements and certain other requirements, a transaction generally must satisfy the continuity of interest requirement and the continuity of business enterprise requirement.

A. *Continuity of Interest*

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. The final regulations provide that the COI requirement is satisfied if in substance a substantial part of the value of the proprietary interest in the target corporation (T) is preserved in the reorganization. A proprietary interest in T is preserved if, in a potential reorganization, it is exchanged for a proprietary interest in the issuing corporation (P), it is exchanged by the acquiring corporation for a direct interest in the T enterprise, or it otherwise continues as a proprietary interest in T. The *issuing corporation* means the acquiring corporation (as the 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. However, a proprietary interest in T is not preserved if, in connection with the potential reorganization, it is acquired by P for consideration other than P stock, or P stock furnished in exchange for a proprietary interest in T in the potential reorganization is redeemed. All facts and circumstances must be considered in determining whether, in substance, a proprietary interest in T is preserved.

Rationale for the COI regulations

The proposed and final regulations permit former T shareholders to sell P stock received in a potential reorganization to third parties without causing the reorganization to fail to satisfy the COI requirement. Some commentators have questioned whether the regulations are consistent with existing authorities.

The COI requirement was applied first to reorganization provisions that did not specify that P exchange a proprietary interest in P for a proprietary interest in T. Supreme Court cases imposed the COI requirement to further Congressional intent that tax-free status be accorded only to transactions where P exchanges a substantial proprietary interest in P for a proprietary interest in T held by the T shareholders rather than to transactions resembling sales. See *LeTulle v. Scofield*, 308 U.S. 415 (1940); *Helvering v. Minnesota Tea Co.*, 296 U.S. 378 (1935); *Pinellas Ice & Cold Storage Co. v. Com-*

missioner, 287 U.S. 462 (1933). See also *Cortland Specialty Co. v. Commissioner,* 60 F.2d 937 (2d Cir. 1932), *cert. denied* 288 U.S. 599 (1933).

None of the Supreme Court cases establishing the COI requirement addressed the issue of whether sales by former T shareholders of P stock received in exchange for T stock in the potential reorganization cause the COI requirement to fail to be satisfied. Since then, however, some courts have premised decisions on the assumption that sales of P stock received in exchange for T stock in the potential reorganization may cause the COI requirement to fail to be satisfied. *McDonald's Restaurants of Illinois, Inc. v. Commissioner,* 688 F.2d 520 (7th Cir. 1982); *Penrod v. Commissioner,* 88 T.C. 1415 (1987); *Heintz v. Commissioner,* 25 T.C. 132 (1955), *nonacq.,* 1958–2 C.B. 9; *Estate of Elizabeth Christian v. Commissioner,* 57 T.C.M. (CCH) 1231 (1989). The apparent focus of these cases is on whether the T shareholders intended on the date of the potential reorganization to sell their P stock and the degree, if any, to which P facilitates the sale. Based on an intensive inquiry into nearly identical facts, some of these cases held that as a result of the subsequent sale the potential reorganization did not satisfy the COI requirement; others held that satisfaction of the COI requirement was not adversely affected by the subsequent sale. The IRS and Treasury Department have concluded that the law as reflected in these cases does not further the principles of reorganization treatment and is difficult for both taxpayers and the IRS to apply consistently.

Therefore, consistent with Congressional intent and the Supreme Court precedent which distinguishes between sales and reorganizations, the final regulations focus the COI requirement generally on exchanges between the T shareholders and P. Under this approach, sales of P stock by former T shareholders generally are disregarded.

The final regulations will greatly enhance administrability in this area by both taxpayers and the government. The regulations will prevent "whipsaw" of the government, such as where the former T shareholders treat the transaction as a tax-free reorganization, and P later disavows reorganization treatment to step up its basis in the T assets based on the position that sales of P stock by the former T shareholders did not satisfy the COI requirement. See, e.g., *McDonald's Restaurants, supra.* In addition, this approach will prevent unilateral sales of P stock by former majority T shareholders from adversely affecting the section 354 nonrecognition treatment expected by former minority T shareholders.

Dispositions of T stock

The proposed COI regulations do not specifically address the effect upon COI of dispositions of T stock prior to a potential reorganization, but ask for comments on that issue. The IRS and Treasury Department believe that issues concerning the COI requirement raised by dispositions of T stock before a potential reorganization correspond to those raised by subsequent dispositions of P stock furnished in exchange for T stock in the potential reorganization. As requested by commentators, the final regulations apply the rationale of the proposed COI regulations to transactions occurring both prior to and after a potential reorganization. Cf. *J.E. Seagram Corp. v. Commissioner,* 104 T.C. 75 (1995) (sales of T stock prior to a potential reorganization do not affect COI if not part of the plan of reorganization). The final regulations provide that, for COI purposes, a mere disposition of T stock prior to a potential reorganization to persons not related to P is disregarded and a mere disposition of P stock received in a potential reorganization to persons not related to P is disregarded. But see §1.368–1T(e)(1)(ii)(A) and (B).

In soliciting comments on the effect upon COI of dispositions of T stock prior to a potential reorganization, the preamble to the proposed COI regulations specifically requests comments on *King Enterprises, Inc. v. United States,* 418 F.2d 511 (Ct. Cl. 1969) (COI requirement satisfied where, pursuant to a plan, P acquires the T stock for 51 percent P stock and 49 percent debt and cash, and T merges upstream into P), and *Yoc Heating Corp. v. Commissioner,* 61 T.C. 168 (1973) (COI requirement not satisfied where, pursuant to a plan, P acquires 85 percent of the T stock for cash and notes, and T merges into P's newly formed subsidiary with minority shareholders receiving cash). Consistent with these cases, where the step transaction doctrine applies to link T stock purchases with later acquisitions of T, the final regulations provide that a proprietary interest in T is not preserved if, in connection with the potential reorganization, it is acquired by P for consideration other than P stock. Whether a stock acquisition is made in connection with a potential reorganization will be determined based on the facts and circumstances of each case. See generally §1.368–1(a). This regulation does not address the effect, if any, of section 338 on corporate transactions (except for conforming changes to §1.338–2(c)(3)). See generally §1.338–2(c)(3) (certain tax effects of a qualified stock purchase without a section 338 election on the post-acquisition elimination of T).

Related person rule

The proposed COI regulations provide that "[i]n determining whether [COI is satisfied], all facts and circumstances must be considered, including any plan or arrangement for the acquiring corporation or its successor corporation (or a person related to the acquiring corporation or its successor corporation within the meaning of section 707(b)(1) or 267(b) (without regard to section 267(e))) to redeem or acquire the consideration provided in the reorganization." The final regulations provide a more specific rule that a proprietary interest in T is not preserved if, in connection with a potential reorganization, a person related (as defined below) to P acquires, with consideration other than a proprietary interest in P, T stock or P stock furnished in exchange for a proprietary interest in T in the potential reorganization. The IRS and Treasury Department believe, however, that certain related party acquisitions preserve a proprietary interest in T and therefore, the rule includes an exception to the related party rule. Under this exception, a proprietary interest in T is preserved to the extent those persons who were the direct or indirect owners of T prior to the potential reorganization maintain a direct or indirect proprietary interest in P. See, e.g., Rev. Rul. 84–30 (1984–1 C.B. 114).

Commentators stated that the proposed COI regulations' rule, which employs sections 707(b)(1) and 267(b) to define persons related to P, is too broad. In response, the final regulations adopt a narrower related person definition which has two components in order to address two separate concerns.

First, the IRS and Treasury Department were concerned that acquisitions of T or P stock by a member of P's affiliated group were no different in substance from an acquisition or redemption by P, because of the existence of various provisions in the Code that permit members to transfer funds to other members without significant tax consequences. Accordingly, §1.368–1(e)(3)(i)(A) includes as related persons corporations that are members of the same affiliated group under section 1504, without regard to the exceptions in section 1504(b).

Second, because the final regulations take into account whether, in substance, P has redeemed the stock it exchanged for T stock in the potential reorganization, the final regulations treat two corporations as related persons if 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)).

Because the final regulations focus generally on the consideration P exchanges, related persons do not include individual or other noncorporate shareholders. Thus, the IRS will no longer apply the holdings of *South Bay Corporation v. Commissioner*, 345 F.2d 698 (2d Cir. 1965), and *Superior Coach of Florida, Inc. v. Commissioner*, 80 T.C. 895 (1983), to transactions governed by these regulations.

T stock not acquired in connection with a potential reorganization

Commentators requested clarification of whether P must actually furnish stock to T shareholders that own T stock which was not acquired in connection with a potential reorganization. The final regulations provide that a proprietary interest in T is preserved if it is exchanged by the acquiring corporation (which may or may not also be P) for a direct interest in the T enterprise, or otherwise continues as a proprietary interest in T.

Redemptions of T stock or extraordinary distributions with respect to T stock

In addition to the final regulations, the IRS and Treasury Department are contemporaneously issuing temporary regulations and proposed regulations cross-referencing the temporary regulations published in T.D. 8761 with the same effective date as these final regulations. The temporary and proposed regulations provide that a proprietary interest in T is not preserved if, in connection with a potential reorganization, it is redeemed or acquired by a person related to T, or to the extent that, prior to and in connection with a potential reorganization, an extraordinary distribution is made with respect to it.

Transactions following a qualified stock purchase

As stated above, these final regulations focus the COI requirement generally on exchanges between the T shareholders and P. Accordingly, the language of §1.338–2(c)(3) is conformed to these final COI regulations to treat the stock of T acquired by the purchasing corporation in the qualified stock purchase as though it was not acquired in connection with the transfer of the T assets.

Effect on other authorities

The IRS and Treasury Department continue to study the role of the COI requirement in section 368(a)(1)(D) reorganizations and section 355 transactions. Therefore, these final COI regulations do not apply to section 368(a)(1)(D) reorganizations and section 355 transactions. See §1.355–2(c).

These COI regulations apply solely for purposes of determining whether the COI requirement is satisfied. No inference should be drawn from any provision of this regulation as to whether other reorganization requirements are satisfied, for example, whether P has issued solely voting stock for purposes of section 368(a)(1)(B) or (C).

Effect on other documents

Rev. Proc. 77–37 (1977–2 C.B. 568) and Rev. Proc. 86–42 (1986–2 C.B. 722) will be modified to the extent inconsistent with these regulations.

Rev. Rul. 66–23 (1966–1 C.B. 67) is hereby obsoleted because it indicates that a plan or arrangement in connection with a potential reorganization for disposition of stock to unrelated persons does not satisfy the COI requirement.

B. *Continuity of Business Enterprise*

The COBE requirement is fundamental to the notion that tax-free reorganizations merely readjust continuing interests in property. In §1.368–1(d), as effective prior to these final regulations, COBE generally required the acquiring corporation to either continue a significant historic T business or use a significant portion of T's historic business assets in a business. However, a valid reorganization may qualify as tax-free even if the acquiring corporation does not directly carry on the historic T business or use the historic T assets in a business. See section 368(a)(2)(C). See also Rev. Rul. 68–261 (1968–1 C.B. 147); Rev. Rul. 81–247 (1981–1 C.B. 87).

Consistent with the view that the acquiring corporation need not directly conduct the T business or use the T assets, the final regulations provide rules under which, in an otherwise qualifying corporate reorganization, the assets and the businesses of the members of a qualified group of corporations are treated as assets and businesses of the issuing corporation. Accordingly, in the final regulations, COBE requires that the issuing corporation either continue T's historic business or use a significant portion of T's historic business assets in a business.

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 of the corporations, and stock meeting the requirements of section 368(c) in each of the corporations is owned directly by one of the other corporations.

The judicial continuity of interest doctrine historically included a concept commonly known as remote continuity of interest. Commonly viewed as arising out of *Groman v. Commissioner*, 302 U.S. 82 (1937), and *Helvering v. Bashford*, 302 U.S. 454 (1938), remote continuity of interest focuses on the link between the T shareholders and the former T business assets following the reorganization. In §1.368–1(d), as effective prior to these final regulations, COBE focuses on the continuation of T's business, or the use of

T's business assets, by the acquiring corporation. Section 1.368–1(d), as revised herein, expands this concept by treating the issuing corporation as conducting a T business or owning T business assets if these activities are conducted by a member of the qualified group or, in certain cases, by a partnership that has a member of the qualified group as a partner.

The proposed COBE regulations separately address COBE (§1.368–1(d)) and remote continuity of interest (§1.368–1(f)). The IRS and Treasury Department believe the COBE requirements adequately address the issues raised in *Groman* and *Bashford* and their progeny. Thus, these final regulations do not separately articulate rules addressing remote continuity of interest.

Definition of the qualified group

The proposed COBE regulations define the qualified group using a control test based on section 368(c). The IRS and Treasury Department received comments suggesting the replacement of the section 368(c) definition of control by the affiliated group definition of control stated in section 1504, without regard to section 1504(b). However, because section 368 generally determines control by reference to section 368(c), the final regulations retain the approach of the proposed COBE regulations.

Rules for aggregation of interests in historic T assets and businesses held in partnership solution

In determining whether COBE is satisfied, the proposed COBE regulations aggregate the interests of the members of a qualified group. In addition, the proposed COBE regulations attribute a business of a partnership to a corporate transferor partner if the partner has a sufficient nexus with that partnership business. However, the proposed COBE regulations only consider the transferor partner's interest in the partnership business, and do not aggregate this interest with interests in the partnership held by other members of the qualified group.

In response to comments requesting a partnership aggregation rule, the final regulations, through a system of attribution, aggregate the interests in a partnership business held by all the members of a qualified group. The final regulations provide rules under which a corporate partner may be treated as holding assets of a business of a partnership. Additionally, P is treated as holding all the assets, and conducting all the businesses of its qualified group. Furthermore, in certain circumstances, P will be treated as conducting a business of a partnership. Once the relevant T businesses and T assets are attributed to P, COBE is tested under the general rule of the final COBE regulations. See §1.368–1(d)(1).

The proposed COBE regulations do not discuss tiered partnerships. In response to comments, the final regulations provide guidance on this issue. See §1.368–1(d)(5), *Example 12.*

C. *Transfers of Assets or Stock to Controlled Corporations as Part of a Plan of Reorganization*

The proposed COBE regulations are limited in their application to COBE and remote continuity of interest. The rules of the proposed COBE regulations provide that for certain reorganizations, transfers of acquired assets or stock among members of the qualified group, and in certain cases, transfers of acquired assets to partnerships, do not disqualify a transaction from satisfying the COBE and remote continuity of interest requirements. The preamble to the proposed COBE regulations states that these rules do not address any other issues concerning the qualification of a transaction as a reorganization.

Comments suggest that the proposed COBE regulations are ambiguous as they could be interpreted to mean that a transfer of stock or assets to a qualified group member after an otherwise tax-free reorganization would be given independent significance and the step transaction doctrine would not apply. Under such an interpretation, the potential reorganization would not be recast as a taxable acquisition or another type of reorganization. To eliminate this ambiguity, §1.368–1(a) of the final regulations provides that, 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. Section 1.368–1(d) of the final regulations is limited to a discussion of the COBE requirement, and does not address satisfaction of the explicit statutory requirements of a reorganization, which is the subject of §1.368–2. However, §1.368–2(k) of the final regulations does provide guidance in this regard, extending the application of section 368(a)(2)(C) to certain successive transfers.

Section 1.368–2(k) of the final regulations states that a transaction otherwise qualifying under section 368(a)(1)(A), (B), (C), or (G) (where the requirements of sections 354(b)(1)(A) and (B) are met) shall not be disqualified by reason of the fact that part or all of the acquired assets or stock acquired in the transaction are transferred or successively transferred to one or more corporations controlled in each transfer by the transferor corporation. Control is defined under section 368(c). The final regulations also provide a rule for transfers of assets following a reorganization qualifying under section 368(a)(1)(A) by reason of section 368(a)(2)(E). No inference is to be drawn as to whether transactions not described in §1.368–2(k) otherwise qualify as reorganizations.

The final regulations also provide that, if a transaction otherwise qualifies as a reorganization, a corporation remains a party to the reorganization even though stock or assets acquired in the reorganization are transferred in a transaction described in §1.368–2(k). See §1.368–2(f). Furthermore, if a transaction otherwise qualifies as a reorganization, a corporation shall not cease to be a party to the reorganization solely because acquired assets are transferred to a partnership in which the transferor is a partner if the COBE requirement is satisfied.

Section 368(a)(1)(D), 368(a)(1)(F), and 355 transactions

The proposed COBE regulations, applying only to the COBE and remote continuity of interest requirements, are limited to transactions otherwise qualifying for reorganization treatment under section 368(a)(1)(A), (B), (C), or (G) (where the requirements of sections 354(b)(1)(A) and (B) are met). The IRS and Treasury Department received comments stating that the final regulations should apply to reorganizations qualifying under section 368(a)(1)(D) or (F) or to transactions qualifying under section 355.

The final regulations do not limit the application of §1.368–1(d) to the transactions enumerated in section 368(a)(2)(C). The COBE provisions in the final regulations apply to all reorganizations for which COBE is relevant.

Section 1.368–2(k)(1) of the final regulations, however, is limited in its application to the transactions described in section 368(a)(2)(C), and does not apply in determining whether a reorganization qualifies under section 368(a)(1)(D), section 368(a)(1)(F), or section 355. The IRS and Treasury Department believe that further study is needed prior to extending §1.368–2(k)(1) to one or more of these provisions.

Effective Date

The amendments to these regulations 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 (subject to customary conditions) binding on January 28, 1998, and at all times thereafter. Commentators requested that the effective date be changed to allow these regulations to apply to transactions occurring on or before January 28, 1998. The IRS and Treasury Department believe that adopting an earlier effective date increases the likelihood that T, P, and each of the former T shareholders would report the transaction inconsistently (in some cases using hindsight), and would reduce administrability of the regulation. No inference should be drawn from any provision of this regulation as to application of the COI or COBE requirements to transactions occurring on or before January 28, 1998.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, 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, the notices of proposed rulemaking preceding these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal authors of these regulations are Phoebe Bennett, regarding §1.368–1(e) (continuity of interest), and Marlene Peake Oppenheim, regarding §1.368–1(d) (continuity of business enterprise) and §1.368–2(k), both of the Office of the Assistant Chief Counsel (Corporate), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.338-2 is amended:

1. By revising paragraph (c)(3)(ii).

2. In paragraph (c)(3)(iv) Example by revising the first sentence of paragraph (B).

The revisions read as follows:

§1.338–2 Miscellaneous issues under section 338.

* * * * *

(c) * * *

(3) * * *

(ii) *Continuity of interest.* By virtue of section 338, in determining whether the continuity of interest requirement of §1.368–1(b) and (e) is satisfied on the transfer of assets from target to the transferee, the purchasing corporation's target stock acquired in the qualified stock purchase shall be treated as though it was not acquired in connection with the transfer of target assets.

* * * * *

(iv) *Example.* * * *

(B) *Status of transfer as a reorganization*. By virtue of section 338, for the purpose of determining whether the continuity of interest requirement of §1.368–1(b) is satisfied, P's T stock acquired in the qualified stock purchase shall be treated as though it was not acquired in connection with the transfer of T assets to X. * * *

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Par. 3. Section 1.368–1 is amended by:

1. Adding three sentences immediately following the first sentence of paragraph (a).

2. Removing the third sentence and adding four sentences in its place to paragraph (b).

3. Removing paragraph (d)(1).

4. Redesignating paragraphs (d)(2), (d)(3), and (d)(4) as paragraphs (d)(1), (d)(2), and (d)(3), respectively.

5. Removing the first sentence of newly designated paragraph (d)(1) and adding two sentences in its place.

6. Adding new paragraph (d)(4).

7. Paragraph (d)(5) is amended by:

a. Adding two sentences to the end of paragraph (d)(5) introductory text.

b. Removing the parentheses around the numbers in the paragraph headings for *Example (1)* through *Example (5)*.

c. Adding *Example 6* through *Example 12*.

8. Adding paragraph (e).

The additions and revisions read as follows:

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

(a) * * * 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 1.338–2(c)(3). 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. * * *

(b) * * * 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. * * *

* * * * *

(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. * * *

* * * * *

(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 by one 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.

(iv) *Effective date.* This paragraph (d)(4) 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.

(5) * * * All corporations have only one class of stock outstanding. The preceding sentence and paragraph (d)(5) *Example 6* through *Example 12* 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.

* * * * *

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. 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 8. 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 7* 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 9. Continuation of the T historic business in a partnership satisfies continuity of business enterprise. (i) *Facts.* The facts are the same as *Example 7* 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 10. Use of T's historic business assets in a partnership business. (i) *Facts.* T is a fabric distributor. P owns all of the stock of S–1. T merges into P and the T shareholders receive solely P stock. S–1 and X (an unrelated party) own interests in a partnership (PRS). As part of the plan of reorganization, P transfers all of the T assets to S–1, and S–1 transfers all the T assets to PRS, increasing S–1's percentage interest in PRS from 5 to 33⅓ percent. After the transfer, X owns the remaining 66⅔ percent interest in PRS. Almost all of the T assets consist of T's large inventory of fabric, which PRS uses to manufacture sportswear. All of the T assets are used in the sportswear business. No member of P's qualified group performs active and substantial management functions for the sportswear business operated in PRS.

(ii) *Continuity of business enterprise.* Under paragraph (d)(4)(iii)(A) of this section, S–1 is treated as owning 33⅓ percent of the T assets used in the PRS sportswear manufacturing business. Under paragraph (d)(4)(iii)(B)(1) of this section, P is treated as conducting the sportswear manufacturing business because S–1 owns an interest in the partnership representing a significant interest in that partnership business. P is treated as holding all the assets and conducting the businesses of all of the members of the qualified group, which includes S–1 (paragraphs (d)(4)(i) and (ii) of this section). The COBE requirement of paragraph (d)(1) of this section is satisfied.

Example 11. 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 10, except that S–1 transfers all the T assets to PRS, and P and X each transfer cash to PRS in exchange for partnership interests. After the transfers, P owns 11 percent, S–1 owns 22⅓ percent, and X owns 66⅔ percent of PRS.

(ii) *Continuity of business enterprise.* Under paragraph (d)(4)(iii)(B)(*1*) of this section, P is treated as conducting the sportswear manufacturing business because members of the qualified group, in the aggregate, own an interest in the partnership representing a significant interest in that business. P is treated as owning 11 percent of the assets directly, and S–1 is treated as owning 22⅓ percent of the assets, used in the PRS sportswear business (paragraph (d)(4)(iii)(A) of this section). P is treated as holding all the assets of all of the members of the qualified group, which includes S–1, and thus in the aggregate, P is treated as owning 33⅓ of the T assets (paragraph (d)(4)(i) and (ii) of this section). The COBE requirement of paragraph (d)(1) of this section is satisfied because P is treated as using a significant portion of T's historic business assets in its sportswear manufacturing business.

Example 12. Tiered partnerships: use of T's historic business assets in a partnership business. (i) *Facts.* T owns and manages a commercial office building in state Z. Pursuant to a plan of reorganization, T merges into P, solely in exchange for P stock, which is distributed to the T shareholders. P transfers all of the T assets to a partnership, PRS–1, which owns and operates television stations nationwide. After the transfer, P owns a 50 percent interest in PRS–1. P does not have active and substantial management functions as a partner with respect to the PRS–1 business. X, not a member of P's qualified group, owns the remaining 50 percent interest in PRS–1. PRS–1, in an effort to expand its state Z television operation, enters into a joint venture with U, an unrelated party. As part of the plan of reorganization, PRS–1 transfers all the T assets and its state Z television station to PRS–2, in exchange for a 75 percent partnership interest. U contributes cash to PRS–2 in exchange for a 25 percent partnership interest and oversees the management of the state Z television operation. PRS–1 does not actively and substantially manage PRS–2's business. PRS–2's state Z operations are moved into the acquired T office building. All of the assets that P acquired from T are used in PRS–2's business.

(ii) *Continuity of business enterprise.* Under paragraph (d)(4)(iii)(A) of this section, PRS–1 is treated as owning 75 percent of the T assets used in PRS–2's business. P, in turn, is treated as owning 50 percent of PRS–1's interest the T assets. Thus, P is treated as owning 37½ percent (50 percent × 75 percent) of the T assets used in the PRS-2 business. Under paragraph (d)(4)(iii)(B)(*1*) of this section, P is treated as conducting PRS–2's business, the operation of the state Z television station, and under paragraph (d)(4)(iii)(A) of this section, P is treated as using 37½ percent of the historic T business assets in that business. The COBE requirement of paragraph (d)(1) of this section is satisfied because P is treated as using a significant portion of T's historic business assets in its television business.

(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. 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)(3) of this section determined without regard to paragraph (e)(3)(i)(A) of this section) to the target corporation or to persons not related (as defined in paragraph (e)(3) 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)(3) of this section) to the issuing corporation is disregarded.

(ii) [Reserved] For further guidance see §1.368–1T(e)(1)(ii)(A) and (B).

(2) *Related person acquisitions.* (i) 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, with consideration other than a proprietary interest in the issuing corporation, stock of the target corporation or stock of the issuing corporation furnished in exchange for a proprietary interest in the target corporation in the potential reorganization, except 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.

(ii) [Reserved] For further guidance see §1.368–1T(e)(2)(ii).

(3) *Definition of related person*—(i) *In general.* For purposes of this para-

graph (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)(3):

(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)(3) of this section determined without regard to paragraph (e)(3)(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.

(4) *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)(4), 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.

(5) *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.

(6) *Examples.* For purposes of the examples in this paragraph (e)(6), 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 (2) of this section, the sale to B is disregarded because B is not a person related to P within the meaning of paragraph (e)(3) 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. A owns all of the stock of T. X, a corporation which owns 60 percent of the P stock and none of the T stock, buys A's T stock for cash prior to the merger of T into P. X exchanges the T stock solely for P stock in the merger which, when combined with X's prior ownership of P stock, constitutes 80 percent of the stock of P. X is a person related to P under paragraphs (e)(3)(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)(2) 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)(3) of this section. Under paragraphs (e)(1) and (2) 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)(3) of this section. The transaction satisfies the continuity of interest requirement because A's T stock was exchanged for P stock, preserving a substantial part of the value of the proprietary interest in T.

Example 4. Redemptions and purchases by issuing corporation or related persons. (i) *Redemption by issuing corporation.* A owns 100 percent of the stock of T and none of the stock of P. T merges into S. In the merger, A receives P stock. In connection with the merger, P redeems all of the P stock received by A in the merger for cash. The continuity of interest requirement is not satisfied, because, in connection with the merger, P redeemed the stock exchanged for a proprietary interest in T, and a substantial part of the value of the proprietary interest in T is not preserved. See paragraph (e)(1) of this section.

(ii) *Purchase of target corporation stock by issuing corporation.* The facts are the same as paragraph (i) of this *Example 4*, except that, instead of P redeeming its stock, prior to and in connection with the merger of T into S, P purchases 90 percent of the T stock from A for cash. The continuity of interest requirement is not satisfied, because in connection with the merger, P acquired a proprietary interest in T for consideration other than P stock, and a substantial part of the value of the proprietary interest in T is not preserved. See paragraph (e)(1) of this section. However, see §1.338–2(c)(3) (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)(3)(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)(2) 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)(4) 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)(3)(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)(2) 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. Effect of general stock repurchase program. T merges into P, a corporation whose stock is widely held and publicly traded and that has one class of common stock outstanding. In the merger, T shareholders receive common stock of P. Immediately after the merger, P repurchases a small percentage of its common stock in the open market as part of its ongoing stock repurchase program. The repurchase program was not created or modified in connection with the acquisition of T. Continuity of interest is satisfied, because based on all of the facts and circumstances, the redemption of a small percentage of the P stock does not affect the T shareholders' proprietary interest in T, because it was not in connection with the merger, and the value of the proprietary interest in T is preserved. See paragraph (e)(1) of this section.

Example 9. 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)(3)(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)(2) of this section.

(7) *Effective date.* This paragraph (e) 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.

Par. 4. Section 1.368–2 is amended by:

1. Removing the second sentence of paragraph (a) and adding two sentences in its place.

2. Removing the second sentence of paragraph (f) and adding four sentences in its place.

3. Removing the second sentence in paragraph (j)(1).

4. Revising paragraph (j)(3)(ii).

5. Revising the first sentence in paragraph (j)(3)(iii).

6. Adding paragraph (j)(3)(iv).

7. Removing paragraph (j)(4).

8. Redesignating paragraphs (j)(5), (j)(6), and (j)(7) as (j)(4), (j)(5), and (j)(6), respectively.

9. Removing the parentheses around the numbers in the paragraph headings for *Example (1)* through *Example (9)* in newly designated paragraph (j)(6).

10. Adding paragraph (k).

The additions and revisions read as follows:

§1.368–2 Definition of terms.

(a) * * * The term does not embrace the mere purchase by one corporation of the properties of another corporation. The preceding sentence applies to transactions occurring after January 28, 1998, except that it does not apply to any transaction occurring pursuant to a written agreement which is binding on January 28, 1998, and at all times thereafter. * * *

* * * * *

(f) * * * If a transaction otherwise qualifies as a reorganization, a corporation remains a party to the reorganization even though stock or assets acquired in the reorganization are transferred in a transaction described in paragraph (k) of this section. If a transaction otherwise qualifies as a reorganization, a corporation shall not cease to be a party to the reorganization solely by reason of the fact that part or all of the assets acquired in the reorganization are transferred to a partnership in which the transferor is a partner if the continuity of business enterprise requirement is satisfied. See §1.368–1(d). The preceding three sentences apply to transactions occurring after January 28, 1998, except that they do not apply to any transaction occurring pursuant to a written agreement which is binding on January 28, 1998, and at all times thereafter. * * *

* * * * *

(j) * * *

(3) * * *

(ii) Except as provided in paragraph (k)(2) of this section, the controlling corporation must control the surviving corporation immediately after the transaction.

(iii) After the transaction, except as provided in paragraph (k)(2) of this section, the surviving corporation must hold substantially all of its own properties and substantially all of the properties of the merged corporation (other than stock of the controlling corporation distributed in the transaction). * * *

(iv) Paragraphs (j)(3)(ii) and (iii) 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.

* * * * *

(k) *Transfer of assets or stock in section 368(a)(1)(A), (B), (C), or (G) reorganizations*—(1) *General rule for transfers to controlled corporations.* Except as otherwise provided in this section, a transaction otherwise qualifying under section 368(a)(1)(A), (B), (C), or (G) (where the requirements of sections 354(b)(1)(A) and (B) are met) shall not be disqualified by reason of the fact that part or all of the acquired assets or stock acquired in the transaction are transferred or successively transferred to one or more corporations controlled in each transfer by the transferor corporation. Control is defined under section 368(c).

(2) *Transfers following a reverse triangular merger.* A transaction qualifying under section 368(a)(1)(A) by reason of the application of section 368(a)(2)(E) is not disqualified by reason of the fact that part or all of the stock of the surviving corporation is transferred or successively transferred to one or more corporations controlled in each transfer by the transferor corporation, or because part or all of the assets of the surviving corporation or the merged corporation are transferred or successively transferred to one or more corporations controlled in each transfer by the transferor corporation.

(3) *Examples.* The following examples illustrate the application of this paragraph (k). P is the issuing corporation and T is the target corporation. P has only one class of stock outstanding. The examples are as follows:

Example 1. Transfers of acquired assets to controlled corporations. (i) *Facts.* T operates a bakery which supplies delectable pastries and cookies to local retail stores. The acquiring corporate group produces a variety of baked goods for nationwide distribution. P owns 80 percent of the stock of S–1. Pursuant to a plan of reorganization, T transfers all of its assets to S–1 solely in exchange for P stock, which T distributes to its shareholders. S–1 owns 80 percent of the stock of S–2; S–2 owns 80 percent of the stock of S–, which also makes and supplies pastries and cookies. Pursuant to the plan of reorganization, S–1 transfers the T assets to S–2; S–2 transfers the T assets to S–3.

(ii) *Analysis.* Under this paragraph (k), the transaction, otherwise qualifying as a reorganization under section 368(a)(1)(C), is not disqualified by reason of the fact of the successive transfers of all of the acquired assets from S–1 to S–2, and from S–2 to S–3 because in each transfer, the transferee corporation is controlled by the transferor corporation. Control is defined under section 368(c).

Example 2. Transfers of acquired stock to controlled corporations. (i) *Facts.* The facts are the same as Example 1 except that S–1 acquires all of the T stock rather than the T assets, and as part of the plan of reorganization, S–1 transfers all of the T stock to S–2, and S–2 transfers all of the T stock to S–3.

(ii) *Analysis.* Under this paragraph (k), the transaction, otherwise qualifying as a reorganization under section 368(a)(1)(B), is not disqualified by reason of the fact of the successive transfers of all of S–2, and from S–2 to S–3 because in each transfer, the transferee corporation is controlled by the transferor corporation.

Example 3. Transfers of acquired stock to partnerships. (i) *Facts.* The facts are the same as in *Example 2.* However, as part of the plan of reorganization, 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 partnership interest, and S–2 transfers cash to PRS in exchange for a 20 percent partnership interest.

(ii) *Analysis.* This paragraph (k) describes the successive transfer of the T stock to S–3, but does not describe S–3's transfer of the T stock to PRS. Therefore, the characterization of this transaction must be determined under the relevant provisions of law, including the step transaction doctrine. See §1.368–1(a). The transaction fails to meet the control requirement of a reorganization described in section 368(a)(1)(B) because immediately after the acquisition of the T stock, the acquiring corporation does not have control of T.

(4) This paragraph (k) 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.

Michael P. Dolan,
Deputy Commissioner of Internal Revenue.

Approved January 12, 1998.

Donald C. Lubick,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on January 23, 1998, 12:15 p.m., and published in the issue of the Federal Register for January 28, 1998, 63 F.R. 4174)

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26 CFR 1.368–1T: Purpose and scope of exception of reorganization exchanges (temporary).

T.D. 8761

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Continuity of Interest

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations providing guidance regarding satisfaction of the continuity of interest requirement for corporate reorganizations. The temporary regulations affect corporations and their shareholders. Final regulations published in T.D. 8760, page 4 of this Bulletin, also provide guidance regarding satisfaction of the continuity of interest requirement for corporate reorganizations. These temporary regulations amplify the final regulations. The text of these temporary regulations also serves as the text of proposed regulations published in REG–120882–97, page 25 of this Bulletin.

DATES: These regulations are effective January 28, 1998.

Applicability: These regulations 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 (subject to customary conditions) binding on January 28, 1998, and at all times thereafter.

FOR FURTHER INFORMATION CONTACT: Phoebe Bennett, (202) 622-7750 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

This document contains amendments to the Income Tax Regulations (26 CFR part 1) under section 368. These temporary regulations provide that, in determining whether the continuity of interest requirement for corporate reorganizations is satisfied with respect to a potential reorganization, a proprietary interest in the target corporation is not preserved if, in connection with a potential reorganization, it is redeemed or acquired by a person related to the target corporation, or to the extent that, prior to and in connection with a potential reorganization, an extraordinary distribution is made with respect to it.

Background

On December 23, 1996, the IRS published a notice of proposed rulemaking (REG–252231–96 [1997–1 C.B. 800]) in the **Federal Register** (61 F.R. 67512) relating to the continuity of interest requirement. Many written comments were received in response to this notice of proposed rulemaking. A public hearing on the proposed regulations was held on May 7, 1997. After consideration of all comments, the regulations proposed by REG–252231–96 are adopted as final regulations, and published in T.D. 8760. These temporary regulations supplement the final regulations.

Explanation of Provisions

Final regulations published in T.D. 8760 provide that in determining whether the continuity of interest (COI) requirement for corporate reorganizations is satisfied, dispositions of stock of the target corporation (T) by a T shareholder generally are not taken into account.

Redemptions of T Stock or Extraordinary Distributions with Respect to T Stock

Commentators requested guidance on the circumstances under which a redemption by T of its stock would adversely affect satisfaction of the COI requirement.

Some commentators suggested that the IRS and Treasury Department adopt an approach that would identify either the issuing corporation (P) or T as the source of the funds for the redemption. If, in connection with an acquisition of T, the facts and circumstances indicate that P did not directly or indirectly furnish funds used by T to redeem T shareholders, these commentators suggested that satisfaction of the COI requirement should not be adversely affected. In many transactions, however, such a tracing approach would be extremely difficult to administer. For example, if P acquired the assets, rather than the stock, of T or if T redeemed stock for a note, it would be unclear in many circumstances whether in substance T or P assets were used to fund the redemption or to repay the note.

Another commentator suggested that redemptions by T in connection with a potential reorganization should adversely affect satisfaction of the COI requirement because the effect on COI is the same as if P had furnished the redemption consideration in the transaction. The temporary regulations generally adopt this approach because it reflects that T and P will be combined economically and because of the difficulties of administering a tracing approach, as previously described.

Treatment of stock redeemed by T as proprietary interests that are not preserved in the reorganization also accords the same tax result to transactions that reach the same result by different steps. For example, T could merge into P for a combination of consideration, of which 30 percent is P stock and 70 percent is a P promissory note. Conversely, T could issue its promissory note to redeem 70 percent of the T stock and then P would assume the T note in the merger, in which the remaining T shareholders receive solely P stock. From the perspective of P, T, and the T shareholders, these two transactions are substantively identical, and the COI requirement is not satisfied in the first transaction. The temporary regulations provide that the second transaction likewise does not satisfy the COI requirement.

In addition, this approach corresponds with the rule of the final regulations that a proprietary interest in T is not preserved if, in connection with the potential reorganization, P stock furnished in exchange for a proprietary interest in T in the potential reorganization is redeemed. Because the final regulations do not inquire, in the case of a subsequent P redemption, whether the source of consideration furnished in the redemption was former T assets or historic P assets, the temporary regulations similarly do not make an inquiry in the case of a prior T redemption. Instead, for purposes of the COI requirement, the temporary regulations treat T and P as a combined economic enterprise. In an asset acquisition, this approach avoids the difficult process of identifying the source of payments as between T and P.

Commentators have suggested that this approach is inconsistent with authorities which hold that redemptions of stock of the target corporation with assets of the target corporation do not violate the solely-for-voting-stock requirement applicable to section 368(a)(1)(B) reorganizations. See, e.g., Rev. Rul. 55–440 (1955–2 C.B. 226). None of these authorities address the effect on continuity of interest of such redemptions. For the reasons stated above, the temporary regulations take such redemptions into account for continuity purposes.

The temporary regulations provide that a proprietary interest in T is not preserved if, in connection with a potential reorganization, it is redeemed or to the extent that, prior to and in connection with a potential reorganization, an extraordinary distribution is made with respect to it. An extraordinary distribution with respect to T stock, followed by a sale of the remaining T stock to P, has the same effect on the value of the proprietary interest in T as a pro rata redemption by T followed by a sale of the outstanding T stock to P.

The temporary regulations do not provide guidance on the determination of whether a distribution will be treated as an extraordinary distribution, except that the rules of section 1059 do not apply for this purpose. The IRS and Treasury Department invite comments on whether the regulations should provide more specific guidance in this area.

A section 355 distribution of controlled corporation stock by T will preserve a proprietary interest in T, except to the extent that the T shareholders receive other property or money to which section 356(a) applies or the distribution is extraordinary in amount and is a distribution of property or money to which section 356(b) applies.

Related Person Rule

In determining whether the COI requirement is satisfied, dispositions of T stock to persons that are not related to T or P are disregarded. The final regulations provide that a proprietary interest in T is not preserved if, in connection with a potential reorganization, a person related to P acquires, with consideration other than a proprietary interest in P, T stock or P stock furnished in exchange for a proprietary interest in T in the potential reorganization. Consistent with the final regulations, the temporary regulations provide that a proprietary interest in T is not preserved if, prior to and in connection with a potential reorganization, a person related to T acquires T stock with consideration other than T stock or P stock.

Definition of Related Person of T

The final regulations include as related persons any corporation that is a member of the affiliated group, within the meaning of section 1504, of which P is a member, and any corporation whose purchase of P stock would be treated as a redemption of that stock under section 304(a)(2). The section 1504 test was adopted because the IRS and Treasury Department were concerned that acquisitions of T stock or P stock by P affiliated corporations were no different in substance than acquisitions or redemptions by P. This concern does not generally extend to members of T's affiliated group that are not also considered related to T under section 304(a)(2) because such corporations are T shareholders participating in the potential reorganization along with the other shareholders of the target corporation. The temporary regulations treat two corporations as related persons if 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)).

Effect on Other Authorities

These COI regulations apply solely for purposes of determining whether the COI requirement is satisfied. No inference should be drawn from any provision of this regulation as to whether other reorganization requirements are satisfied, or as to the characterization of a related transaction. See, e.g., §1.301–1(l).

Effect on Other Documents

Rev. Proc. 77–37 (1977–2 C.B. 568) and Rev. Proc. 86–42 (1986–2 C.B. 722) will be modified to the extent inconsistent with these temporary regulations.

Effective Date

These regulations 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 (subject to customary conditions) binding on January 28, 1998, and at all times thereafter.

Special Analyses

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

Drafting Information

The principal author of these regulations is Phoebe Bennett of the Office of the Assistant Chief Counsel (Corporate), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.368–1T is added to read as follows:

§1.368–T Purpose and scope of exception of reorganization exchanges (temporary).

(a) through (e)(1)(i) [Reserved] For further guidance see §1.368–1(a) through (e)(1)(i).

(e)(1)(ii)(A) *General rule.* A proprietary interest in the target corporation (other than one held by the acquiring corporation) is not preserved if, prior to and in connection with a potential reorganization, it is redeemed or to the extent that, prior to and in connection with a potential reorganization, an extraordinary distribution is made with respect to it. The determination of whether a distribution with respect to stock of the target corporation is an extraordinary distribution for purposes of this paragraph (e)(1)(ii) will be made on the basis of all of the facts and circumstances, but the treatment of the distribution under section 1059 (relating to extraordinary dividends) will not be taken into account.

(B) *Exception.* Paragraph (e)(1)(ii)(A) of this section does not apply to a distribution of stock by the target corporation to which section 355(a) (or so much of section 356 as relates to section 355) applies, except to the extent that—

(*1*) The target corporation shareholders receive other property or money to which section 356(a) applies; or

(*2*) The distribution is extraordinary in amount and is a distribution of property or money to which section 356(b) applies.

(2)(i) [Reserved] For further guidance, see §1.368–1(e)(2)(i).

(ii) A proprietary interest in the target corporation is not preserved if, prior to and in connection with a potential reorganization, a person related (as defined in §1.368–1(e)(3) determined without regard to §1.368–1(e)(3)(i)(A)) to the target corporation acquires stock of the target corporation, with consideration other than stock of either the target corporation or the issuing corporation.

(e)(3) through (e)(6) *Example 9.* [Reserved] For further guidance, see §1.368-1(e)(3) through (e)(6) *Example 9.*

(e)(6) *Example 10. Acquisition of target corporation stock before merger.* (i) *Redemption by target corporation.* A owns 85 percent and B owns 15 percent of the stock of T. The fair market value of T is $100x. Neither A nor B own stock of P. Prior to and in connection with the merger of T into P, T redeems A's T stock for $85x and issues to A its promissory note in exchange for the stock. At the time of the merger T has a value of $15x, after giving effect to the redemption of its stock. In the merger, B receives solely P stock. The continuity of interest requirement is not satisfied because T redeemed A's stock, and a substantial part of the value of the proprietary interest in T is not preserved. See paragraph (e)(1)(ii)(A) of this section.

(ii) *Purchase by person related to target corporation.* The facts are the same as paragraph (i) of this *Example 10*, except that X, T's wholly owned subsidiary, acquires A's T stock prior to and in connection with the merger for cash of $85x. Under paragraph (e)(2)(ii) of this section and §1.368–1(e)(3)(i)(B), X's acquisition of A's T stock is an acquisition by a related person. The continuity of interest requirement is not satisfied, because X acquired T stock, 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)(2)(ii of this section.

Example 11. Extraordinary distribution before merger. A owns all of the stock of T. The fair market value of T is $100x. Prior to and in connection with the merger of T into P, T pays A an extraordinary distribution of an $85x note. T merges into P, and A receives solely P stock. P assumes T's obligation on the note. The continuity of interest requirement is not satisfied, because T paid A an extraordinary distribution, and a substantial part of the value of the proprietary interest in T is not preserved. See paragraph (e)(1)(ii)(A) of this section.

(f) *Effective date.* This section applies to transactions occurring after January 28, 1998, except that it does not apply to any transaction occurring pursuant to a written agreement which is (subject to customary conditions) binding on January 28, 1998, and at all times thereafter.

Michael P. Dolan,
Deputy Commissioner of Internal Revenue.

Approved January 12, 1998.

Donald C. Lubick,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on January 23, 1998, 12:15 p.m., and published in the issue of the Federal Register for January 28, 1998, 63 F.R. 4183)

Section 382.—Limitation on Net Operating Loss Carryforwards and Certain Built-In Losses Following Ownership Change

The adjusted federal long-term rate is set forth for the month of April 1998. See Rev. Rul. 98–18, page 22.

Section 412.—Minimum Funding Standards

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 1998. See Rev. Rul. 98–18, page 22.

Section 453.—Installment Method

26 CFR 1.453–11: Installment obligations received from a liquidation corporation.

T.D. 8762

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Installment Obligations Received From Liquidating Corporations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the use of the installment method to report the gain recognized by a shareholder who receives, in exchange for the shareholder's stock, certain installment obligations that are distributed upon the complete liquidation of a corporation. Changes to the applicable tax law were made by the Installment Sales Revision Act of 1980 and the Tax Reform Act of 1986. These regulations affect taxpayers who receive installment obligations in exchange for their stock upon the complete liquidation of a corporation.

DATES: This regulation is effective January 28, 1998.

For dates of applicability, see §1.453–11(e) of these regulations.

FOR FURTHER INFORMATION CONTACT: George F. Wright, (202) 622-4950 (not a toll-free number).

SUPPLEMENTARY INFORMATION

Background

Section 453(h), relating to the tax treatment of installment obligations received by a shareholder from a liquidating corporation, was added to the Internal Revenue Code of 1954 by the Installment Sales Revision Act of 1980, Public Law 96–471, 94 Stat. 2247, 2250. Proposed regulations under section 453(h) were published in the **Federal Register** for January 13, 1984 (49 F.R. 1742). Subsequently, section 453(h) was amended as part of the Tax Reform Act of 1986, Public Law 99-514, 100 Stat. 2085, 2274, pursuant to which both C and S corporations became subject to tax upon making liquidating distributions of installment obligations to shareholders. The Technical and Miscellaneous Revenue Act of 1988, Public Law 100–647, 102 Stat. 3342, 3403, added section 453B(h), which provides that no gain or loss is recognized by S corporations with respect to certain liquidating distributions of installment obligations. The regulations proposed on January 13, 1984 (49 F.R. 1742), were withdrawn by the notice of proposed rulemaking published on January 22, 1997 (62 F.R. 3244), except for paragraph (e) relating to liquidating distributions received in more than one taxable year, and paragraph (g) containing the effective date provision. The notice of proposed rulemaking published in the **Federal Register** for January 22, 1997, reserved paragraph (d) for liquidating distributions received in more than one taxable year. Written comments responding to this notice were received. No public hearing was held because no hearing was requested. After consideration of all comments received, the proposed regulations are adopted as revised by this Treasury decision.

Explanation of Provisions

A. *Overview of Provisions*

Prior to the Installment Sales Revision Act of 1980, a shareholder recognized gain or loss on receipt of an installment obligation that was distributed by a liquidating corporation in exchange for the shareholder's stock. Gain could not be reported under the installment sale provisions of section 453 as payments were received on the obligation distributed by the corporation in the liquidation.

As enacted by the Installment Sales Revision Act of 1980 and amended by the Tax Reform Act of 1986, section 453(h) provides a different treatment for certain installment obligations that are distributed in a complete liquidation to which section 331 applies. Under section 453(h), a shareholder that does not elect out of the installment method treats the payments under the obligation, rather than the obligation itself, as consideration received in exchange for the stock. The shareholder then takes into account the income from the payments under the obligation using the installment method. In this manner, the shareholder generally is treated as if the shareholder sold the shareholder's stock to an unrelated purchaser on the installment method.

This treatment under section 453(h) applies generally to installment obligations received by a shareholder (in exchange for the shareholder's stock) in a complete liquidation to which section 331 applies if (a) the installment obligations are qualifying installment obligations, i.e., the installment obligations are acquired in respect of a sale or exchange of property by the corporation during the 12-month period beginning on the date a plan of complete liquidation is adopted, and (b) the liquidation is completed within that 12-month period. However, an installment obligation acquired in a sale or exchange of inventory, stock in trade, or property held for sale in the ordinary course of business qualifies for this treatment only if the obligation arises from a single bulk sale of substantially all of such property attributable to a trade or business of the corporation. If an installment obligation arises from both a sale or exchange of inventory, etc., that does not comply with the requirements of the preceding sentence and a sale or exchange of other assets, the portion of the installment obligation that is attributable to the sale or exchange of other assets is a qualifying installment obligation.

B. *Discussion of Comments*

Interaction of section 453(h) and limitations on the installment method

The regulations provide that, if the stock of a liquidating corporation is traded on an established securities market, an installment obligation received by a shareholder from that corporation as a liquidating distribution is not a qualifying installment obligation and does not qualify for installment reporting, regardless of whether the requirements of section 453(h) are otherwise satisfied. However, if an installment obligation is received by a shareholder from a liquidating corporation whose stock is not publicly traded, and the obligation arose from a sale by the corporation of stock or securities that are traded on an established market, then the obligation generally is a qualifying installment obligation in the hands of the transferor. An exception to the above rule applies if the liquidating corporation is formed or availed of for a principal purpose of avoiding limitations on the availability of installment sales treatment, such as section 453(k), through the use of a related party.

One commentator suggested that the anti-abuse rule directed at cases in which there is a principal purpose to avoid section 453(k) is not necessary. The commentator suggests that the effect of a contribution of publicly-traded stock to a nonpublicly-traded corporation, followed by the sale of the publicly-traded stock for an installment obligation and the liquidation of the nonpublicly-traded corporation, is the creation of two levels of tax because the liquidating corporation must recognize gain on the distribution of the installment obligation. Accordingly, the commentator does not believe that the transaction offers any tax avoidance opportunities that warrant a specific anti-abuse rule.

The anti-abuse rule is directed at circumvention of the prohibition in section 453(k) against the use of the installment method for a sale of publicly-traded securities. It is designed to prevent a shareholder from indirectly entering into such a sale on the installment method when the shareholder could not have done so through a direct sale. Accordingly, the anti-abuse rule has been retained.

Liquidating distributions received in more than one year

Under §1.453–2(e) proposed on January 13, 1984, if liquidating distributions, including qualifying installment obligations, are received in more than one taxable year, a shareholder must file an amended return if the reallocation of basis required under section 453(h)(2) affects the computation of gain recognized in an earlier year. If the shareholder has transferred the installment obligation to a person whose basis in the obligation is determined by reference to the shareholder's basis, then the transferee generally is required to reallocate basis and, if necessary, file an amended return. The proposed effective date applied to distributions of qualifying installment obligations made after March 31, 1980.

In the preamble to the 1997 proposed regulations, the IRS and Treasury Department suggested that an alternative to the amended return requirement would be to require the shareholder to recognize in the current year the additional amount of gain that would have been recognized in the earlier year had the total amount of the liquidating distributions been known in the earlier year. Comments were requested regarding these and any other methods of accomplishing the basis reallocation. Proposed §1.453–11(d) relating to liquidating distributions received in more than one taxable year was reserved.

One commentator questioned whether amended returns were necessary and noted that the alternative method discussed in the preamble is simpler and less burdensome for taxpayers. The commentator then suggested an ordering rule as another method of achieving the intended purpose. Under the proposed ordering rule, basis first would be allocated to assets other than installment obligations distributed in the liquidation with the remainder allocated to the installment obligations. The commentator acknowledged that it might not be appropriate to implement this approach by regulation without amending the statute.

The proposed ordering rule does not satisfy the basis reallocation requirement of section 453(h)(2) and would require complex provisions to implement it. Accordingly, the suggested approach is not adopted in the final regulations.

The purpose underlying section 453(h)(2) is to ensure that gain is recognized in the appropriate year when liquidating distributions are received in more than one taxable year. The IRS and Treasury Department believe that this purpose can be substantially fulfilled without imposing the burden of filing amended returns. Accordingly, the final regulations incorporate a current-year recognition rule. Under the current-year recognition rule, a shareholder is required to recognize in the current year the additional amount of gain that would have been recognized in the earlier year had the total amount of the liquidating distributions been known in the earlier year. In allocating basis to calculate the gain to be reported in the first year in which a liquidating distribution is received, a shareholder is required to reasonably estimate the anticipated aggregate distributions. For this purpose, the shareholder must take into account distributions and other events occurring up to the time at which the return for the first taxable year is filed. Section §1.453–2(e) of the 1984 proposal is adopted as revised by this Treasury decision. The effective date provision in §1.453–2(g) of the proposal is not adopted.

Recognition of gain or loss to the distributing corporation under section 453B

Under section 453B, the disposition of an installment obligation generally results in the recognition of gain or loss to the transferor. Thus, in accordance with sections 453B and 336, a C corporation generally recognizes gain or loss upon the distribution of an installment obligation to a shareholder in exchange for the shareholder's stock, including complete liquidations covered by section 453(h). Section 453B(d) provides an exception to this general rule if the installment obligation is distributed in a liquidation to which section 337(a) applies (regarding certain complete liquidations of 80 percent or more owned subsidiaries). However, that exception does not apply to liquidations under section 331.

In the case of a liquidating distribution by an S corporation, however, section 453B(h) provides that if an S corporation distributes an installment obligation in exchange for a shareholder's stock, and payments under the obligation are treated as consideration for the stock pursuant to section 453(h)(1), then the distribution generally is not treated as a disposition of the obligation by the S corporation. Thus, except for purposes of sections 1374 and 1375 (relating to certain built-in gains and passive investment income), the S corporation does not recognize gain or loss on the distribution of the installment obligation to a shareholder in a complete liquidation covered by section 453(h). One commentator believed that it is inequitable to allow a shareholder to recognize gain on the installment basis while the liquidating C corporation has immediate recognition upon distribution of an obligation. As an alternative, the commentator suggested that the corporation's tax liability arising from the distribution of an obligation carry over to the shareholders and be taken into account by them as payments are received on the obligation. The suggested approach would be inconsistent with the statutory provisions of sections 336 and 453B and, accordingly, is not adopted in the final regulations.

Another commentator requested that the regulations provide relief from a bunching of income that occurs for shareholders receiving liquidating distributions from S corporations. The bunching can occur, for example, by virtue of the interrelationship of the S corporation and installment sale provisions if, in the year in which assets are sold, an S corporation receives a payment on an installment obligation arising from the sale before the corporation liquidates. The commentator suggested that the regulations allow a shareholder first to apply the basis in the stock against the initial payment received, with any remaining basis allocated to any additional payments to be received. Since the bunching of income results from the successive application of section 453(c) at the corporate and shareholder levels and no statutory exception for shareholders of S corporations is provided, this issue cannot be appropriately addressed in these final regulations.

Incorporation of guidance on section 338(h)(10) elections

Three commentators suggested that the regulations be expanded to address the use of the installment method to the sale of stock of a corporation with respect to which an election under section 338(h)(10) has been made. This issue does not arise under section 453(h) and is beyond the scope of these regulations.

Special Analyses

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

Drafting Information

The principal author of these regulations is George F. Wright of the Office of Assistant Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and Treasury Department participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read as follows:

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

§1.453–11 also issued under 26 U.S.C. 453(j)(1) and (k). * * *

Par. 2. Section 1.453–11 is added to read as follows:

§1.453–11 Installment obligations received from a liquidating corporation.

(a) *In general*—(1) *Overview.* Except as provided in section 453(h)(1)(C) (relating to installment sales of depreciable property to certain closely related persons), a qualifying shareholder (as defined in paragraph (b) of this section) who receives a qualifying installment obligation (as defined in paragraph (c) of this section) in a liquidation that satisfies section 453(h)(1)(A) treats the receipt of payments in respect of the obligation, rather than the receipt of the obligation itself, as a receipt of payment for the shareholder's stock. The shareholder reports the payments received on the installment method unless the shareholder elects otherwise in accordance with §15a.453–1(d) of this chapter.

(2) *Coordination with other provisions*—(i) *Deemed sale of stock for installment obligation.* Except as specifically provided in section 453(h)(1)(C), a qualifying shareholder treats a qualifying installment obligation, for all purposes of the Internal Revenue Code, as if the obligation is received by the shareholder from the person issuing the obligation in exchange for the shareholder's stock in the liquidating corporation. For example, if the stock of a corporation that is liquidating is traded on an established securities market, an installment obligation distributed to a shareholder of the corporation in exchange for the shareholder's stock does not qualify for installment reporting pursuant to section 453(k)(2).

(ii) *Special rules to account for the qualifying installment obligation*—(A) *Issue price.* A qualifying installment obligation is treated by a qualifying shareholder as newly issued on the date of the distribution. The issue price of the qualifying installment obligation on that date is equal to the sum of the adjusted issue price of the obligation on the date of the distribution (as determined under §1.1275–1(b)) and the amount of any qualified stated interest (as defined in §1.1273–1(c)) that has accrued prior to the distribution but that is not payable until after the distribution. For purposes of the preceding sentence, if the qualifying installment obligation is subject to §1.446–2 (e.g., a debt instrument that has unstated interest under section 483), the adjusted issue price of the obligation is determined under §1.446–2(c) and (d).

(B) *Variable rate debt instrument.* If the qualifying installment obligation is a variable rate debt instrument (as defined in §1.1275–5), the shareholder uses the equivalent fixed rate debt instrument (within the meaning of §1.1275–5(e)(3)(ii)) constructed for the qualifying installment obligation as of the date the obligation was issued to the liquidating corporation to determine the accruals of original issue discount, if any, and interest on the obligation.

(3) *Liquidating distributions treated as selling price.* All amounts distributed or treated as distributed to a qualifying shareholder incident to the liquidation, including cash, the issue price of qualifying installment obligations as determined under paragraph (a)(2)(ii)(A) of this section, and the fair market value of other property (including obligations that are not qualifying installment obligations) are considered as having been received by the shareholder as the selling price (as defined in §15a.453–1(b)(2)(ii) of this chapter) for the shareholder's stock in the liquidating corporation. For the proper method of reporting liquidating distributions received in more than one taxable year of a shareholder, see paragraph (d) of this section. An election not to report on the installment method an installment obligation received in the liquidation applies to all distributions received in the liquidation.

(4) *Assumption of corporate liability by shareholders.* For purposes of this section, if in the course of a liquidation a shareholder assumes secured or unsecured liabilities of the liquidating corporation, or receives property from the corporation subject to such liabilities (including any tax liabilities incurred by the corporation on the distribution), the amount of the liabilities is added to the shareholder's basis in the stock of the liquidating corporation.

These additions to basis do not affect the shareholder's holding period for the stock. These liabilities do not reduce the amounts received in computing the selling price.

(5) *Examples*. The provisions of this paragraph (a) are illustrated by the following examples. Except as otherwise provided, assume in each example that A, an individual who is a calendar-year taxpayer, owns all of the stock of T corporation. A's adjusted tax basis in that stock is $100,000. On February 1, 1998, T, an accrual method taxpayer, adopts a plan of complete liquidation that satisfies section 453(h)(1)(A) and immediately sells all of its assets to unrelated B corporation in a single transaction. The examples are as follows:

Example 1. (i) The stated purchase price for T's assets is $3,500,000. In consideration for the sale, B makes a down payment of $500,000 and issues a 10-year installment obligation with a stated principal amount of $3,000,000. The obligation provides for interest payments of $150,000 on January 31 of each year, with the total principal amount due at maturity.

(ii) Assume that for purposes of section 1274, the test rate on February 1, 1998, is 8 percent, compounded semi-annually. Also assume that a semi-annual accrual period is used. Under §1.1274–2, the issue price of the obligation on February 1, 1998, is $2,368,450. Accordingly, the obligation has $631,550 of original issue discount ($3,000,000 – $2,368,450). Between February 1 and July 31, $19,738 of original issue discount and $75,000 of qualified stated interest accrue with respect to the obligation and are taken into account by T.

(iii) On July 31, 1998, T distributes the installment obligation to A in exchange for A's stock. No other property is ever distributed to A. On January 31, 1999, A receives the first annual payment of $150,000 from B.

(iv) When the obligation is distributed to A on July 31, 1998, it is treated as if the obligation is received by A in an installment sale of shares directly to B on that date. Under §1.1275–1(b), the adjusted issue price of the obligation on that date is $2,388,188 (original issue price of $2,368,450 plus accrued original issue discount of $19,738). Accordingly, the issue price of the obligation under paragraph (a)(2)(ii)(A) of this section is $2,463,188, the sum of the adjusted issue price of the obligation on that date ($2,388,188) and the amount of accrued but unpaid qualified stated interest ($75,000).

(v) The selling price and contract price of A's stock in T is $2,463,188, and the gross profit is $2,363,188 ($2,463,188 selling price less A's adjusted tax basis of $100,000). A's gross profit ratio is thus 96 percent (gross profit of $2,363,188 divided by total contract price of $2,463,188).

(vi) Under §§1.446–2(e)(1) and 1.1275–2(a), $98,527 of the $150,000 payment is treated as a payment of the interest and original issue discount that accrued on the obligation from July 31, 1998, to January 31, 1999 ($75,000 of qualified stated interest and $23,527 of original issue discount). The balance of the payment ($51,473) is treated as a payment of principal. A's gain recognized in 1999 is $49,414 (96 percent of $51,473).

Example 2. (i) T owns Blackacre, unimproved real property, with an adjusted tax basis of $700,000. Blackacre is subject to a mortgage (underlying mortgage) of $1,100,000. A is not personally liable on the underlying mortgage and the T shares held by A are not encumbered by the underlying mortgage. The other assets of T consist of $400,000 of cash and $600,000 of accounts receivable attributable to sales of inventory in the ordinary course of business. The unsecured liabilities of T total $900,000.

(ii) On February 1, 1998, T adopts a plan of complete liquidation complying with section 453(h)(1)(A), and promptly sells Blackacre to B for a 4-year mortgage note (bearing adequate stated interest and otherwise meeting all of the requirements of section 453) in the face amount of $4 million. Under the agreement between T and B, T (or its successor) is to continue to make principal and interest payments on the underlying mortgage. Immediately thereafter, T completes its liquidation by distributing to A its remaining cash of $400,000 (after payment of T's tax liabilities), accounts receivable of $600,000, and the $4 million B note. A assumes T's $900,000 of unsecured liabilities and receives the distributed property subject to the obligation to make payments on the $1,100,000 underlying mortgage. A receives no payments from B on the B note during 1998.

(iii) Unless A elects otherwise, the transaction is reported by A on the installment method. The selling price is $5 million (cash of $400,000, accounts receivable of $600,000, and the B note of $4 million). The total contract price also is $5 million. A's adjusted tax basis in the T shares, initially $100,000, is increased by the $900,000 of unsecured T liabilities assumed by A and by the obligation (subject to which A takes the distributed property) to make payments on the $1,100,000 underlying mortgage on Blackacre, for an aggregate adjusted tax basis of $2,100,000. Accordingly, the gross profit is $2,900,000 (selling price of $5 million less aggregate adjusted tax basis of $2,100,000). The gross profit ratio is 58 percent (gross profit of $2,900,000 divided by the total contract price of $5 million). The 1998 payments to A are $1 million ($400,000 cash plus $600,000 receivables) and A recognizes gain in 1998 of $580,000 (58 percent of $1 million).

(iv) In 1999, A receives payment from B on the B note of $1 million (exclusive of interest). A's gain recognized in 1999 is $580,000 (58 percent of $1 million).

(b) *Qualifying shareholder*. For purposes of this section, *qualifying shareholder* means a shareholder to which, with respect to the liquidating distribution, section 331 applies. For example, a creditor that receives a distribution from a liquidating corporation, in exchange for the creditor's claim, is not a qualifying shareholder as a result of that distribution regardless of whether the liquidation satisfies section 453(h)(1)(A).

(c) *Qualifying installment obligation*—(1) *In general*. For purposes of this section, *qualifying installment obligation* means an installment obligation (other than an evidence of indebtedness described in §15a.453–1(e) of this chapter, relating to obligations that are payable on demand or are readily tradable) acquired in a sale or exchange of corporate assets by a liquidating corporation during the 12-month period beginning on the date the plan of liquidation is adopted. See paragraph (c)(4) of this section for an exception for installment obligations acquired in respect of certain sales of inventory. Also see paragraph (c)(5) of this section for an exception for installment obligations attributable to sales of certain property that do not generally qualify for installment method treatment.

(2) *Corporate assets*. Except as provided in section 453(h)(1)(C), in paragraph (c)(4) of this section (relating to certain sales of inventory), and in paragraph (c)(5) of this section (relating to certain tax avoidance transactions), the nature of the assets sold by, and the tax consequences to, the selling corporation do not affect whether an installment obligation is a qualifying installment obligation. Thus, for example, the fact that the fair market value of an asset is less than the adjusted basis of that asset in the hands of the corporation; or that the sale of an asset will subject the corporation to depreciation recapture (e.g., under section 1245 or section 1250); or that the assets of a trade or business sold by the corporation for an installment obligation include depreciable property, certain marketable securities, accounts receivable, installment obligations, or cash; or that the distribution of assets to the shareholder is or is not taxable to the corporation under sections 336 and 453B, does not affect whether installment obligations received in exchange for those assets are treated as qualifying installment obligations by the shareholder. However, an obligation received by the corporation in exchange for cash, in a transaction unrelated to a sale or exchange of noncash assets by the corporation, is not treated as a qualifying installment obligation.

(3) *Installment obligations distributed in liquidations described in section 453(h)(1)(E)*—(i) *In general*. In the case of a liquidation to which section 453(h)(1)(E) (relating to certain liquidating subsidiary corporations) applies, a

qualifying installment obligation acquired in respect of a sale or exchange by the liquidating subsidiary corporation will be treated as a qualifying installment obligation if distributed by a controlling corporate shareholder (within the meaning of section 368(c)) to a qualifying shareholder. The preceding sentence is applied successively to each controlling corporate shareholder, if any, above the first controlling corporate shareholder.

(ii) *Examples.* The provisions of this paragraph (c)(3) are illustrated by the following examples:

Example 1. (i) A, an individual, owns all of the stock of T corporation, a C corporation. T has an operating division and three wholly-owned subsidiaries, X, Y, and Z. On February 1, 1998, T, Y, and Z all adopt plans of complete liquidation.

(ii) On March 1, 1998, the following sales are made to unrelated purchasers: T sells the assets of its operating division to B for cash and an installment obligation. T sells the stock of X to C for an installment obligation. Y sells all of its assets to D for an installment obligation. Z sells all of its assets to E for cash. The B, C, and D installment obligations bear adequate stated interest and meet the requirements of section 453.

(iii) In June 1998, Y and Z completely liquidate, distributing their respective assets (the D installment obligation and cash) to T. In July 1998, T completely liquidates, distributing to A cash and the installment obligations respectively issued by B, C, and D. The liquidation of T is a liquidation to which section 453(h) applies and the liquidations of Y and Z into T are liquidations to which section 332 applies.

(iv) Because T is in control of Y (within the meaning of section 368(c)), the D obligation acquired by Y is treated as acquired by T pursuant to section 453(h)(1)(E). A is a qualifying shareholder and the installment obligations issued by B, C, and D are qualifying installment obligations. Unless A elects otherwise, A reports the transaction on the installment method as if the cash and installment obligations had been received in an installment sale of the stock of T corporation. Under section 453B(d), no gain or loss is recognized by Y on the distribution of the D installment obligation to T. Under sections 453B(a) and 336, T recognizes gain or loss on the distribution of the B, C, and D installment obligations to A in exchange for A's stock.

Example 2. (i) A, a cash-method individual taxpayer, owns all of the stock of P corporation, a C corporation. P owns 30 percent of the stock of Q corporation. The balance of the Q stock is owned by unrelated individuals. On February 1, 1998, P adopts a plan of complete liquidation and sells all of its property, other than its Q stock, to B, an unrelated purchaser for cash and an installment obligation bearing adequate stated interest. On March 1, 1998, Q adopts a plan of complete liquidation and sells all of its property to an unrelated purchaser, C, for cash and installment obligations. Q immediately distributes the cash and installment obligations to its shareholders in completion of its liquidation. Promptly thereafter, P liquidates, distributing to A cash, the B installment obligation, and a C installment obligation that P received in the liquidation of Q.

(ii) In the hands of A, the B installment obligation is a qualifying installment obligation. In the hands of P, the C installment obligation was a qualifying installment obligation. However, in the hands of A, the C installment obligation is not treated as a qualifying installment obligation because P owned only 30 percent of the stock of Q. Because P did not own the requisite 80 percent stock interest in Q, P was not a controlling corporate shareholder of Q (within the meaning of section 368(c)) immediately before the liquidation. Therefore, section 453(h)(1)(E) does not apply. Thus, in the hands of A, the C obligation is considered to be a third-party note (not a purchaser's evidence of indebtedness) and is treated as a payment to A in the year of distribution. Accordingly, for 1998, A reports as payment the cash and the fair market value of the C obligation distributed to A in the liquidation of P.

(iii) Because P held 30 percent of the stock of Q, section 453B(d) is inapplicable to P. Under sections 453B(a) and 336, accordingly, Q recognizes gain or loss on the distribution of the C obligation. P also recognizes gain or loss on the distribution of the B and C installment obligations to A in exchange for A's stock. See sections 453B and 336.

(4) *Installment obligations attributable to certain sales of inventory*—(i) *In general.* An installment obligation acquired by a corporation in a liquidation that satisfies section 453(h)(1)(A) in respect of a broken lot of inventory is not a qualifying installment obligation. If an installment obligation is acquired in respect of a broken lot of inventory and other assets, only the portion of the installment obligation acquired in respect of the broken lot of inventory is not a qualifying installment obligation. The portion of the installment obligation attributable to other assets is a qualifying installment obligation. For purposes of this section, the term *broken lot of inventory* means inventory property that is sold or exchanged other than in bulk to one person in one transaction involving substantially all of the inventory property attributable to a trade or business of the corporation. See paragraph (c)(4)(ii) of this section for rules for determining what portion of an installment obligation is not a qualifying installment obligation and paragraph (c)(4)(iii) of this section for rules determining the application of payments on an installment obligation only a portion of which is a qualifying installment obligation.

(ii) *Rules for determining nonqualifying portion of an installment obligation.* If a broken lot of inventory is sold to a purchaser together with other corporate assets for consideration consisting of an installment obligation and either cash, other property, the assumption of (or taking property subject to) corporate liabilities by the purchaser, or some combination thereof, the installment obligation is treated as having been acquired in respect of a broken lot of inventory only to the extent that the fair market value of the broken lot of inventory exceeds the sum of unsecured liabilities assumed by the purchaser, secured liabilities which encumber the broken lot of inventory and are assumed by the purchaser or to which the broken lot of inventory is subject, and the sum of the cash and fair market value of other property received. This rule applies solely for the purpose of determining the portion of the installment obligation (if any) that is attributable to the broken lot of inventory.

(iii) *Application of payments.* If, by reason of the application of paragraph (c)(4)(ii) of this section, a portion of an installment obligation is not a qualifying installment obligation, then for purposes of determining the amount of gain to be reported by the shareholder under section 453, payments on the obligation (other than payments of qualified stated interest) shall be applied first to the portion of the obligation that is not a qualifying installment obligation.

(iv) *Example.* The following example illustrates the provisions of this paragraph (c)(4). In this example, assume that all obligations bear adequate stated interest within the meaning of section 1274(c)(2) and that the fair market value of each nonqualifying installment obligation equals its face amount.

The example is as follows:

Example. (i) P corporation has three operating divisions, X, Y, and Z, each engaged in a separate trade or business, and a minor amount of investment assets. On July 1, 1998, P adopts a plan of complete liquidation that meets the criteria of section 453(h)(1)(A). The following sales are promptly made to purchasers unrelated to P: P sells all of the assets of the X division (including all of the inventory property) to B for $30,000 cash and installment obligations totalling $200,000. P sells substantially all of the inventory property of the Y division to C for a $100,000 installment obligation, and sells all of the other assets of the Y division (excluding cash but including installment receivables previously acquired in the ordinary course of the business of the Y division) to D for a $170,000 installment obligation. P sells 1/3 of the inventory property of the Z division to E for $100,000 cash, 1/3 of the inventory property of the Z division to F for a $100,000 installment obligation, and all of the other assets of the Z division (including the remaining 1/3 of the inventory property worth $100,000) to G for $60,000 cash, a $240,000 installment obligation, and the assumption by G of the liabilities of the Z division. The liabilities assumed by G, which are unsecured liabilities and liabilities encumbering the inventory property acquired by G, aggregate $30,000. Thus, the total purchase price G pays is $330,000.

(ii) P immediately completes its liquidation, distributing the cash and installment obligations, which otherwise meet the requirements of section 453, to A, an individual cash-method taxpayer who is its sole shareholder. In 1999, G makes a payment to A of $100,000 (exclusive of interest) on the $240,000 installment obligation.

(iii) In the hands of A, the installment obligations issued by B, C, and D are qualifying installment obligations because they were timely acquired by P in a sale or exchange of its assets. In addition, the installment obligation issued by C is a qualifying installment obligation because it arose from a sale to one person in one transaction of substantially all of the inventory property of the trade or business engaged in by the Y division.

(iv) The installment obligation issued by F is not a qualifying installment obligation because it is in respect of a broken lot of inventory. A portion of the installment obligation issued by G is a qualifying installment obligation and a portion is not a qualifying installment obligation, determined as follows: G purchased part of the inventory property (with a fair market value of $100,000) and all of the other assets of the Z division by paying cash ($60,000), issuing an installment obligation ($240,000), and assuming liabilities of the Z division ($30,000). The assumed liabilities ($30,000) and cash ($60,000) are attributed first to the inventory property. Therefore, only $10,000 of the $240,000 installment obligation is attributed to inventory property. Accordingly, in the hands of A, the G installment obligation is a qualifying installment obligation to the extent of $230,000, but is not a qualifying installment obligation to the extent of the $10,000 attributable to the inventory property.

(v) In the 1998 liquidation of P, A receives a liquidating distribution as follows:

Item	*Qualifying Installment Obligations*	*Cash and Other Property*
cash		$190,000
B note	$200,000	
C note	$100,000	
D note	$170,000	
F note		$100,000
G note[1]	$230,000	$ 10,000
Total	$700,000	$300,000

(vi) Assume that A's adjusted tax basis in the stock of P is $100,000. Under the installment method, A's selling price and the contract price are both $1 million, the gross profit is $900,000 (selling price of $1 million less adjusted tax basis of $100,000), and the gross profit ratio is 90 percent (gross profit of $900,000 divided by the contract price of $1 million). Accordingly, in 1998, A reports gain of $270,000 (90 percent of $300,000 payment in cash and other property). A's adjusted tax basis in each of the qualifying installment obligations is an amount equal to 10 percent of the obligation's respective face amount. A's adjusted tax basis in the F note, a nonqualifying installment obligation, is $100,000, i.e., the fair market value of the note when received by A. A's adjusted tax basis in the G note, a mixed obligation, is $33,000 (10 percent of the $230,000 qualifying installment obligation portion of the note, plus the $10,000 nonqualifying portion of the note).

(vii) With respect to the $100,000 payment received from G in 1999, $10,000 is treated as the recovery of the adjusted tax basis of the nonqualifying portion of the G installment obligation and $9,000 (10 percent of $90,000) is treated as the recovery of the adjusted tax basis of the portion of the note that is a qualifying installment obligation. The remaining $81,000 (90 percent of $90,000) is reported as gain from the sale of A's stock. See paragraph (c)(4)(iii) of this section.

[1]Face amount $240,000.

(5) *Installment obligations attributable to sales of certain property*—(i) *In general.* An installment obligation acquired by a liquidating corporation, to the extent attributable to the sale of property described in paragraph (c)(5)(ii) of this section, is not a qualifying obligation if the corporation is formed or availed of for a principal purpose of avoiding section 453(b)(2) (relating to dealer dispositions and certain other dispositions of personal property), section 453(i) (relating to sales of property subject to recapture), or section 453(k) (relating to dispositions under a revolving credit plan and sales of stock or securities traded on an established securities market) through the use of a party bearing a relationship, either directly or indirectly, described in section 267(b) to any shareholder of the corporation.

(ii) *Covered property.* Property is described in this paragraph (c)(5)(ii) if, within 12 months before or after the adoption of the plan of liquidation, the property was owned by any shareholder and—

(A) The shareholder regularly sold or otherwise disposed of personal property of the same type on the installment plan or the property is real property that the shareholder held for sale to customers in the ordinary course of a trade or business (provided the property is not described in section 453(l)(2) (relating to certain exceptions to the definition of dealer dispositions));

(B) The sale of the property by the shareholder would result in recapture income (within the meaning of section 453(i)(2)), but only if the amount of the recapture income is equal to or greater than 50 percent of the property's fair market value on the date of the sale by the corporation;

(C) The property is stock or securities that are traded on an established securities market; or

(D) The sale of the property by the shareholder would have been under a revolving credit plan.

(iii) *Safe harbor.* Paragraph (c)(5)(i) of this section will not apply to the liquidation of a corporation if, on the date the plan of complete liquidation is adopted and thereafter, less than 15 percent of the fair market value of the corporation's assets is attributable to property described in paragraph (c)(5)(ii) of this section.

(iv) *Example.* The provisions of this paragraph (c)(5) are illustrated by the following example:

Example. Ten percent of the fair market value of the assets of T is attributable to stock and securities traded on an established securities market. T owns no other assets described in paragraph (c)(5)(ii) of this section. T, after adopting a plan of complete liquidation, sells all of its stock and securities holdings to C corporation in exchange for an installment obligation bearing adequate stated interest, sells all of its other assets to B corporation for cash, and distributes the cash and installment obligation to its sole shareholder, A, in a complete liquidation that satisfies section 453(h)(1)(A). Because the C installment obligation arose from a sale of publicly traded stock and securities, T cannot report the gain on the sale under the installment method pursuant to section 453(k)(2). In the hands of A, however, the C installment obligation is treated as having arisen out of a sale of the stock of T corporation. In addition, the general rule of paragraph (c)(5)(i) of this section does not apply, even if a principal purpose of the liquidation was the avoidance of section 453(k)(2), because the fair market value of the publicly traded stock and securities is less than 15 percent of the total fair market value of T's assets. Accordingly, section 453(k)(2) does not apply to A, and A may use the installment method to report the gain recognized on the payments it receives in respect of the obligation.

(d) *Liquidating distributions received in more than one taxable year.* If a qualifying shareholder receives liquidating distributions to which this section applies in more than one taxable year, the shareholder must reasonably estimate the gain attributable to distributions received in each taxable year. In allocating basis to calculate the gain for a taxable year, the shareholder must reasonably estimate the anticipated aggregate distributions. For this purpose, the shareholder must take into account distributions and other relevant events or information that the shareholder knows or reasonably could know up to the date on which the federal income tax return for that year is filed. If the gain for a taxable year is properly taken into account on the basis of a reasonable estimate and the exact amount is subsequently determined the difference, if any, must be taken into account for the taxable year in which the subsequent determination is made. However, the shareholder may file an amended return for the earlier year in lieu of taking the difference into account for the subsequent taxable year.

(e) *Effective date*. This section is applicable to distributions of qualifying installment obligations made on or after January 28, 1998.

Michael P. Dolan,
Deputy Commissioner of Internal Revenue.

Approved December 18, 1997.

Donald C. Lubick,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on January 27, 1998, 8:45 a.m., and published in the issue of the Federal Register for January 28, 1998, 63 F.R. 4168)

Section 467.—Certain Payments for the Use of Property or Services

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 1998. See Rev. Rul. 98–18, page 22.

Section 468.—Special Rules for Mining and Solid Waste Reclamation and Closing Costs

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 1998. See Rev. Rul. 98–18, page 22.

Section 482.—Allocation of Income and Deductions Among Taxpayers

Federal short-term, mid-term, and long-term rates are set forth for the month of April 1998. See Rev. Rul. 98–18, page 22.

Section 483.—Interest on Certain Deferred Payments

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 1998. See Rev. Rul. 98–18, page 22.

Section 642.—Special Rules for Credits and Deductions

Federal short-term, mid-term, and long-term rates are set forth for the month of April 1998. See Rev. Rul. 98–18, page 22.

Section 807.—Rules for Certain Reserves

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 1998. See Rev. Rul. 98–18, page 22.

Section 846.—Discounted Unpaid Losses Defined

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 1998. See Rev. Rul. 98–18, page 22.

Section 1274.—Determination of Issue Price in the Case of Certain Debt Instruments Issued for Property

(Also Sections 42, 280G, 382, 412, 467, 468, 482, 483, 642, 807, 846, 1288, 7520, 7872.)

Federal rates; adjusted federal rates; adjusted federal long-term rate, and the long-term exempt rate. For purposes of sections 1274, 1288, 382, and other sections of the Code, tables set forth the rates for April 1998.

Rev. Rul. 98–18

This revenue ruling provides various prescribed rates for federal income tax purposes for April 1998 (the current month.) Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month. Finally, Table 5 contains the federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520.

REV. RUL. 98–18 TABLE 1

Applicable Federal Rates (AFR) for April 1998

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	5.51%	5.44%	5.40%	5.38%
110% AFR	6.07%	5.98%	5.94%	5.91%
120% AFR	6.64%	6.53%	6.48%	6.44%
130% AFR	7.19%	7.07%	7.01%	6.97%
Mid-Term				
AFR	5.70%	5.62%	5.58%	5.56%
110% AFR	6.28%	6.18%	6.13%	6.10%
120% AFR	6.85%	6.74%	6.68%	6.65%
130% AFR	7.44%	7.31%	7.24%	7.20%
150% AFR	8.61%	8.43%	8.34%	8.29%
175% AFR	10.08%	9.84%	9.72%	9.64%
Long-Term				
AFR	5.98%	5.89%	5.85%	5.82%
110% AFR	6.58%	6.48%	6.43%	6.39%
120% AFR	7.19%	7.07%	7.01%	6.97%
130% AFR	7.81%	7.66%	7.59%	7.54%

REV. RUL. 98–18 TABLE 2

Adjusted AFR for April 1998

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	3.67%	3.64%	3.62%	3.61%
Mid-term adjusted AFR	4.24%	4.20%	4.18%	4.16%
Long-term adjusted AFR	5.04%	4.98%	4.95%	4.93%

REV. RUL. 98–18 TABLE 3

Rates Under Section 382 for April 1998

Adjusted federal long-term rate for the current month	5.04%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months.)	5.04%

REV. RUL. 98–18 TABLE 4

Appropriate Percentages Under Section 42(b)(2) for April 1998

Appropriate percentage for the 70% present value low-income housing credit	8.37%
Appropriate percentage for the 30% present value low-income housing credit	3.59%

REV. RUL. 98–18 TABLE 5

Rate Under Section 7520 for April 1998

Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest	6.8%

Section 1288.—Treatment of Original Issue Discount on Tax-Exempt Obligations

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 1998. See Rev. Rul. 98–18, page 22.

Section 7520.—Valuation Tables

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 1998. See Rev. Rul. 98–18, page 22.

Section 7872.—Treatment of Loans with Below-Market Interest Rates

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of April 1998. See Rev. Rul. 98–18, page 22.

Part IV. Items of General Interest

Notice of Proposed Rulemaking and Notice of Public Hearing

Continuity of Interest

REG–120882–97

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations and notice of public hearing.

SUMMARY: In T.D. 8761, page 13 of this Bulletin, the IRS is issuing temporary regulations providing guidance regarding satisfaction of the continuity of interest requirement for corporate reorganizations. The temporary regulations affect corporations and their shareholders. The text of those temporary regulations also serves as the text of these proposed regulations. In addition, this document provides notice of a public hearing on these proposed regulations.

DATES: Written comments and outlines of topics to be discussed at the hearing scheduled for Tuesday, May 26, 1998, must be received by Tuesday, May 5, 1998.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–120882–97), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (REG–120882–97), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. The public hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Phoebe Bennett, (202) 622-7750; concerning submissions and the hearing, LaNita Van Dyke, (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

In T.D. 8761, temporary regulations amend the Income Tax Regulations (26 CFR part 1) under section 368. The temporary regulations provide that in determining whether the continuity of interest requirement for corporate reorganizations is satisfied with respect to a potential reorganization, a proprietary interest in the target corporation is not preserved if, in connection with a potential reorganization, it is redeemed or acquired by a person related to the target corporation, or to the extent that, prior to and in connection with a potential reorganization, an extraordinary distribution is made with respect to it.

The text of the temporary regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations describes the temporary regulations.

The temporary regulations do not provide guidance on the determination of whether a distribution will be treated as an extraordinary distribution, except that the rules of section 1059 do not apply for this purpose. The IRS and Treasury Department invite comments on whether the regulations should provide more specific guidance in this area.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, 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 Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled at 10 a.m. on Tuesday, May 26, 1998, in room 2615, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments by Tuesday, May 5, 1998 and submit an outline of the topics to be discussed and the time to be devoted to each topic (a signed original and eight (8) copies) by Tuesday, May 5, 1998.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Proposed Effective Date

These regulations are proposed to 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 (subject to customary conditions) binding on January 28, 1998, and at all times thereafter.

* * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.368–1 is amended as follows:

1. Revising paragraphs (e)(1)(ii)(A), (e)(1)(ii)(B), (e)(2)(ii), and (f).

2. Adding paragraph (e)(6) *Example 10* and *Example 11*.

The addition and revisions read as follows:

§1.368— Purpose and scope of exception of reorganization exchanges.

[The text of proposed paragraphs (e)(1)(ii)(A) and (B), (e)(2)(ii), (e)(6) *Example 10* and *Example 11*, and (f) is the same as the text of §1.368–1T published in T.D. 8761.]

Michael P. Dolan,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on January 23, 1998, 12:15 p.m., and published in the issue of the Federal Register for January 28, 1998, 63 F.R. 4204)

Notice of Proposed Rulemaking and Notice of Public Hearing

Election to Amortize Start-Up Expenditures

REG–209373–81

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations concerning start-up expenditures under section 195. The proposed regulations provide rules and procedures for electing to amortize start-up expenditures under section 195. The regulations affect all taxpayers wishing to amortize start-up expenditures under section 195. This document also provides notice of a public hearing on these proposed regulations.

DATES: Comments and outlines of topics to be discussed at the public hearing scheduled for June 2, 1998, at 10 a.m., must be received by April 13, 1998.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (PS–36–81), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand-delivered between the hours of 8:15 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG–209373–81), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC, or electronically, via the IRS Internet site at: http://www.irs.ustreas.gov/prod/tax_regs/comments.html. The public hearing will be held in the NYU Classroom, Room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, David Selig, (202) 622-3040; concerning submissions and the hearing, LaNita VanDyke, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the **Office of Management and Budget** for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)).

Comments on the collection of information should be sent to the **Office of Management and Budget,** Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service,** Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224. Comments on the collection of information should be received by March 16, 1998.

Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the Internal Revenue Service, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs of operation, maintenance, and purchase of services to provide information.

The requirement for the collection of information in this notice of proposed rulemaking is in §1.195-1(c). This information is required by the IRS to establish that a taxpayer properly has made an election to amortize start-up expenditures under section 195. This information will be used to determine whether the amount amortized under section 195 has been computed properly. The likely respondents are businesses and other for-profit organizations. Responses to this collection of information are required to make an election to amortize start-up expenditures under section 195.

Estimated total annual reporting burden: 37,500 hours.

The estimated annual burden per respondent varies from .10 hours to .50 hour, depending on individual circumstances, with an estimated average of .25 hours.

Estimated number of respondents : 150,000.

Estimated annual frequency of responses: one-time election.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) to provide regulations under section 195 of the Internal Revenue Code. Section 195 was added to the Internal Revenue Code of 1954 by section 102 of the Miscellaneous Revenue Act of 1980, and amended by section 94 of the Tax Reform Act of 1984.

Section 195 generally provides that no deduction is allowed for start-up expenditures unless the taxpayer elects to amortize the expenditures. If the taxpayer elects to amortize start-up expenditures under section 195(b)(1), the expenditures are amortizable over a period of not less than 60 months beginning with the month when the active trade or business begins. Under section 195(d), an election to amortize start-up expenditures must be made not later than the time prescribed by law for filing the return for the taxable year in which the active trade or business begins (including extensions thereof). Announcement 81–43 (1981–1 I.R.B. 52) described the time and manner for making this election.

An expense is a start-up expenditure if it satisfies two conditions. First, the expense must be paid or incurred in connection with any one of the following: (1) creating an active trade or business, (2) investigating the creation or acquisition of an active trade or business, or (3) any activity entered into for profit and for the production of income before the day on which the active trade or business begins, in anticipation of the activity becoming an active trade or business (expenditures in this last category are start-up expenditures only if they are attributable to periods after June 30, 1984).

Second, the expenditure must be of the type that, if paid or incurred in connection with the operation of an existing active trade or business in the same field as that being entered into by the taxpayer, would be allowable as a deduction for the taxable year when paid or incurred.

Explanation of Provisions

The proposed regulations provide that an election to amortize start-up expenditures is made by attaching a statement to the taxpayer's income tax return. The income tax return and statement must be filed not later than the date prescribed by law for filing the income tax return (including any extensions of time) for the taxable year when the active trade or business begins.

The IRS is interested in ways to simplify the filing of elections. The proposed regulations are intended to simplify the filing of section 195 elections in two ways. First, the proposed regulations clarify that a taxpayer who is uncertain as to the year in which the active trade or business begins need not file an election for each possible taxable year. Rather, a section 195 election for a particular trade or business will be effective if the trade or business becomes active in the year for which the election is filed or in any subsequent year. In developing this notice of proposed rulemaking, more burdensome methods of making the election were considered and rejected. For example, an approach that would have required taxpayers to file an election statement each year was rejected. Second, the proposed regulations also allow taxpayers who have made timely elections under section 195 to file a revised statement with a subsequent return to include any start-up expenditures not included in the original statement.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations do not have a significant impact on a substantial number of small entities. This certification is based upon the fact that the time required to prepare and file the election statement is minimal and will not have a significant impact on those small entities that choose to make the election. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. 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 Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted (in the manner described in the ADDRESSES caption) timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for Tuesday, June 2, 1998, at 10 a.m. in the NYU Classroom, Room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit comments by April 13, 1998 and submit an outline of the topics to be discussed and the time to be devoted to each topic by April 13, 1998.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is David Selig, Office of the Assistant Chief Counsel (Passthroughs and Special Industries), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.195–1 is added to read as follows:

§1.195–1 Election to amortize start-up expenditures.

(a) *In general.* Under section 195(b), a taxpayer may elect to amortize start-up expenditures (as defined in section 195(c)(1)). A taxpayer who elects to amortize start-up expenditures must, at the time of the election, select an amortization period of not less than 60 months, beginning with the month the active trade or business begins. The election applies to all of the taxpayer's start-up expenditures. The election is irrevocable and the amortization period selected by the taxpayer in making the election may not subsequently be changed.

(b) *Time and manner of making election.* The election to amortize start-up expenditures under section 195 shall be made by attaching a statement containing the information described in paragraph (c) of this section to the taxpayer's return. The statement must be filed no later than the date prescribed by law for filing the return (including any extensions of time) for the taxable year when the active trade or business begins. The statement may be filed with a return for any taxable year prior to the year in which the taxpayer's active trade or business begins, but no later than the date prescribed in the preceding sentence. Accordingly, an election under section 195 filed in a taxable year prior to the year in which the taxpayer's active trade or business begins will become effective in the month for the later year in which the taxpayer's active trade or business begins.

(c) *Information required.* The statement shall set forth a description of the trade or business to which it relates with sufficient detail so that expenses relating to the trade or business can be identified properly for the taxable year in which the statement is filed and for all future taxable years to which it relates. To the extent known at the time the statement is filed, the statement also shall include a description of each start-up expenditure incurred (whether or not paid); the month when the active trade or business began (or was acquired); and the number of months (not less than 60) over which the expenditures are to be amortized. A revised statement to include any start-up expenditures not included in the taxpayer's original election statement may be filed with a return filed after the return that contained the election.

(d) *Effective date.* This section applies to elections filed on or after the date final regulations are published in the **Federal Register.**

Michael P. Dolan,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on January 12, 1998, 8:45 a.m., and published in the issue of the Federal Register for January 13, 1998, 63 F.R. 1933)

Foundations Status of Certain Organizations

Announcement 98–26

The following organizations have failed to establish or have been unable to maintain their status as public charities or as operating foundations. Accordingly, grantors and contributors may not, after this date, rely on previous rulings or designations in the Cumulative List of Organizations (Publication 78), or on the presumption arising from the filing of notices under section 508(b) of the Code. This listing does *not* indicate that the organizations have lost their status as organizations described in section 501(c)(3), eligible to receive deductible contributions.

Former Public Charities. The following organizations (which have been treated as organizations that are not private foundations described in section 509(a) of the Code) are now classified as private foundations:

Centro De Intercambio Cultural Mexico-Americano, Brownsville, TX
Century Plaza Housing Corporation of Topeka, Topeka, KS
CFIDS Central Support Network, West Chester, PA
Chaldean Assyrian Foundation, Ferndale, MI
Challengers Baseball Booster Club Inc., Miami, FL
Chamber Foundation Inc., Kissimmee, FL
Chamber Music Outreach Foundation, Chicago, IL
Chamber Orchestra Arizona Limited, Phoenix, AZ
Chambers & Valentine Daycare Inc., Baton Rouge, LA
Champaign Free Press Inc., Champaign, IL
City of Lakes Girls Basketball, Minneapolis, MN
Cityvision Services Inc., Fort Worth, TX
Civitas Associates Inc., St. Louis, MO
Clarendon School District Two Education Foundation, Manning, SC
Clarksdale Law Enforcement Association, Inc., Clarksdale, MS
Clarksville-Montgomery County Council of Commuity Services, Clarksville, TN
Class of 1937, Lexington, MI
Clay Center Day Care Inc., Clay Center, NE
Clean Air Vehicle Association Inc., Atlanta, GA
Clear Creek Education Foundation, League City, TX
Daybreak Inc., Jackson, MS
Dayspring Ministries Inc., Greenville, MS
Daystar Foundation Inc., Toledo, OH
Dayton Academy Boosters Club, Fairborn, OH
Deaf and Hard of Hearing Outreach Services Inc., Anderson, IN
Dearborn Fire Fighters Burn Drive, Dearborn, MI
Decatur Cadet Core Inc., Decatur, AL
Deep East Texas Fine Arts Series Inc., Jasper, TX
Deer Park Christian Child Development Center Inc., Cincinnati, OH
Defense Readiness Foundation, Washington, DC
Dekalb Co-Ops Inc., Atlanta, GA
Del City Youth Park Inc., Del City, OK
Delaware Action for Families and Children Inc., Wilmington, DE
Delaware Foundation for Literacy Inc., Wilmington, DE
Deloach Ministries Inc., Houston, TX
De Novo Systems Inc., Tempe, AZ
Earthdance Institute Inc., Asheville, NC
Earth Education Council Inc., Miami, FL
Earth Shakers Inc., Blytheville, AR
Earth Shuttle Foundation Inc., Reston, VA
Earth Village Foundation, Houston, TX
East Bay Senior Housing Inc., Denver, CO
East Central Community Arts, Cambridge, MN
East Denver Eruv Committee, Denver, CO
East End Ball Association Emma St., Bigelow, AR
East Green Bay Lightning Soccer Club, Green Bay, WI
East Green Enrichment Center Inc., Wilson, NC
East Liverpool Area Youth, E. Liverpool, OH
East Post Oak Volunteer Fire Department, Detroit, TX
East St. Louis Community Athletic Club Inc., E. St. Louis, IL
East West Oneness Foundation, Houston, TX
Eastern Chester County EMS Committee, Richburg, SC
Eastern Europe Outreach, Pueblo West, CO
Eastern Shore Womens Fast Pitch, Salisbury, MD
Eastern Wildlife Center Inc., Greensville, NC
Echos of Life Inc., Irving, TX
Family Ancestral Research Association, Sandy, UT

Family Church of God Inc., Columbus, IN
Family Complex East Inc., Pittsburgh, PA
Family Counseling and Resource of Mississippi Inc., Brandon, MS
Family Health Services of Lumberton Inc., Lumberton, MS
Family Leadership Project Inc., Little Rock, AR
Family-Owned Business Institute, Denver, CO
Family Rescue Coalition of Citrus County Inc., Homosassa Springs, FL
Family Strategies Inc., Clancy, MT
Family Tree Ministries Inc., Wichita, KS
Family YMCA of McNairy & Hardin Counties, Adamsville, TN
Famli First Inc., Richmond, VA
Fannin County Youth Softball Association Inc., Blue Ridge, GA
Far Northeast Neighbors Inc., Denver, CO
Far South Side Community Health Center, Chicago Heights, IL
Gem City Senior Olympics Inc., Quincy, IL
Gemini Nutriential Services Inc., Bellaire, TX
General Baptist Home Mission Center, Detroit, MI
Generations United of Michigan, Southfield, MI
Genesis House, Richmond, VA
Genesius Guild West Theatre Inc., Salt Lake City, UT
Georgetown Sportfishing Association Inc., Georgetown, SC
Georgia Foundation for Athletic Excellence Inc., Atlanta, GA
Georgia Hooved Animal Humane Society Inc., Canton, GA
Georgia Legal Foundation Inc., Atlanta, GA
Georgia Metros Athletic Foundation Inc., Decatur, GA
Georgia Providers for Non Profits Inc., Sandy Springs, GA
Georgia Veterinary Medical Association Foundation Inc., Norcross, GA
Georgia Youth Leadership Council Inc., Fairfax Station, VA
Germantown Touchdown Club, Germantown, TN
Get a Life Inc., Fort Worth, TX
Ghana Neurological Foundation Inc., Tampa, FL
Gilbert and Sullivan Society of Rochester, Rochester, MN
Giles County Humane Association Inc., Pulaski, TN
Gill Creek Baptist Church Inc., Columbia, SC
Gillespie County Law Enforcement Youth Activities League, Fredericksburg, TX
Gillis Foundation, Biloxi, MS
Gils Professional Youth Services, Albuquerque, NM
Ginosko Ministries Inc., Charlotte, NC
Girls Incorporated of Orange County, Orlando, FL
Glad Tiding Ministries Inc., Lebanon, MO
Gladiators Inc., Stone Mtn, GA
Glasgow Independent Schools Education Foundation Inc., Glasgow, KY
Gleaning for Jesus Recycling Year 2000, Saginaw, MI
Akademeia Inc., Cleveland, OH
Ambassadors in Mashiyach, Azle, TX
Avicultural Society of Tucson, Tucson, AZ
Canaday Ministries, Inc., Fort Smith, AR
Catholic Evidence Guild, Ann Arbor, MI
Catholic Radio Broadcasting, Saint Johns, MI
Catoosa Senior Citizens Association Inc., Catoosa, OK
Cedar Social, St. Paul, MN
Celebrate Kids Inc., Fort Worth, TX
Celebrate Two in 92, Ashdown, AR
Celebration of Pianos, Denver, CO
Celtic-American Heritage Society, Jackson, MS
Celuni Inc., Miami, FL
Center for Disfigured Children, Ann Arbor, MI
Center for Health Care Access & Reform, St. Paul, MN
Center for Jewish Medical Heritage, Cleveland, OH
Center for Media in the Public Interest at the Grosvener Institute, Carlisle, PA
Center for Research in Human Ecology, Houston, TX
Center for Sustainable Living Inc., Shenandoah Junction, WV
Center for the Development of Pluralistic Leadership, Inc., Eden Prairie, MN
Center for Trauma Information and Education, Inc., Cincinnati, OH
Center of Perpetual Help Inc., Stow, OH
Center-Peace Ministries Inc., Palm City, FL
Central Florida Earth Alliance Inc., Orlando, FL
Central Florida Police Stress Unit Inc., Winter Park, FL
Central Iowa Mens Chorus Inc., Des Moines, IA
Central Surgical Association Foundation, Ann Arbor, MI
Central Texas Hot Spurs Soccer Club, Georgetown, TX
Central Texas Quality Quorum Inc., Temple, TX
Central Texas Volunteer Firefighters Association, Blanket, TX
Centro Cultural Mexicano, Denver, CO
Dallas County Education Fund Inc., Selma, AL
Dallas County Save Our Communities Inc., Rockwall, TX
Dallas CV Inc., Dallas, TX
Dallas Life Ministries Inc., Dallas, TX
Dallas Neighbors a Non-Profit Corporation, Dallas, TX
Dalton Stewart Evangelistic Music, Abilene, TX
Dalton Village Outreach Center, Charlotte, NC
Dance Expressions Inc., Florissant, MO
Dance Project Inc., Tampa, FL
Dancer Scholarship Foundation Inc., Coconut Grove, FL
Daniel Catarisano Ministries, Houston, TX
Danny Hood Evangelistic Association, Kingsford, MI
Danville Literacy Council, Danville, VA
Darla Johnson Andrew Long and Company, Austin, TX
Darrons Oak Inc., Oklahoma City, OK
Dartmouth Club of Houston Inc., Houston, TX
David L. Stone Wildlife Rehab Clinc Inc., Lordsburg, NM
Davids Mighty Men, Beaumont, TX
Davidson Transit Organization, Nashville, TN
Dawson Foundation Inc., Lynwood, IL
Developmental Planning Associates of Greater New York Inc., Staten Island, NY
E.J. Charities Inc., Little Rock, AR
Each One Teach One Learning Center Inc., Nashville, TN
Eagle Star Inc., Scottsbluff, NE
Eagle-Union Youth Soccer Association Inc., Zionsville, IN
Eagle Wing Estates Inc., Jackson, MS
Earl Carl Institute for Legal and Social Policy Inc., Houston, TX
Early Bird Child Care Food Program Inc., Baton Rouge, LA
Early Childhood Autism Project Inc., Overland Park, KS

Earning by Learing of Mississippi Bucks for Books, Jackson, MS
Earth Day Arizona Earth Day Phoenix, Phoenix, AZ
Facility Committee, Jackson, AL
Fair Havens Missionary Mission Inc., Pompano Beach, FL
Fairfield Ambulance Service Inc., Fairfield, TX
Fairhope Historical Museum Inc., Fairhope, AL
Fairview Dixie Youth Inc., Grant, LA
Faith Out Reach Center Inc., Kenova, WV
Falls City Community Art Gallery Inc., Louisville, KY
Families Access Inc., Atlanta, GA
Families Against Drugs Inc., Osceola, MO
Families of Truckers Support Group, Joplin, MO
Gabriel Foundation Inc., Wall, NJ
Gainsville Volleyball Officials Association Inc., Gainesville, FL
Galveston Club Inc., Galveston, TX
Galveston County Medical Society Inc., Galveston, TX
Gangbusters, Inc., Tucson, AZ
Garden County Community Foundation Inc., Oshkosk, NE
Garfield Development Corporation, Grand Rapids, MI
Gary Accord Inc., Gary, IN
Gary Freedom House Inc., Gary, IN
Gary Oliver Ministries Inc., Nashville, TN
Gathering Place of Wilmington NC Inc., Wilmington, NC
Gay and Lesbian Organization of Professional Inc., Huntsville, AL
Gays and Lesbians United for Equality Inc., Louisville, KY
G I F T Non Profit, Jackson, MS
G P H S Alumni Association Inc., Grand Praire, TX
Greater Atlanta Billy Graham Crusade Inc., Atlanta, GA
Guntersville VOA Elderly Housing, Inc., Metairie, LA
High Aspirations Home for Teens, Los Angeles, CA
Infinite Sun Recycling, Kansas City, MO
Interamerica Institute for Border Health & Environment, El Paso, TX
Manitowoc County Crimestoppers Inc., Manitowoc, WI
Mills Station Foundation, Sacramento, CA
Nicaraguan Atlantic Development Association Inc., Miami, FL
Sexton Mountain Parent Teacher Club, Beaverton, OR
Vaad Hakashruth of San Antonio, San Antonio, TX
Vitamin E Research and Information Service, Inc., LaGrange, IL
Wekaf USA World Eskrima Kali Arnis, Torrance, CA
World Cultural Exchange Foundation, Burbank, CA

If an organization listed above submits information that warrants the renewal of its classification as a public charity or as a private operating foundation, the Internal Revenue Service will issue a ruling or determination letter with the revised classification as to foundation status. Grantors and contributors may thereafter rely upon such ruling or determination letter as provided in section 1.509(a)–7 of the Income Tax Regulations. It is not the practice of the Service to announce such revised classification of foundation status in the Internal Revenue Bulletin.

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in law or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in the new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C.—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contribution Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign Corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statements of Procedral Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

Numerical Finding List[1]

Bulletins 1998–1 through 1998–13

Announcements:

98–1, 1998–2 I.R.B. *38*
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Key to Abbreviations:

RR	Revenue Ruling
RP	Revenue Procedure
TD	Treasury Decision
CD	Court Decision
PL	Public Law
EO	Executive Order
DO	Delegation Order
TDO	Treasury Department Order
TC	Tax Convention
SPR	Statement of Procedural Rules
PTE	Prohibited Transaction Exemption

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