

Section 354.—Exchanges of Stock and Securities in Certain Reorganizations

26 CFR 1.354-1: Exchanges of stocks and securities in certain reorganizations.

T.D. 8752

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Reorganizations/Treatment of Warrants as Securities

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations

SUMMARY: This document contains final regulations that in certain instances provide for nonrecognition of gain or loss on the receipt, in pursuance of a reorganization, of rights to acquire stock of a corporation that is a party to the reorganization. These regulations change the existing rules for such rights under sections 354, 355, and 356 of the Internal Revenue Code. These regulations will affect holders of these rights who are involved in corporate reorganizations under sections 355 and 368.

DATES: These regulations are effective March 9, 1998.

FOR FURTHER INFORMATION CONTACT: Michael J. Danbury, (202) 622-7750 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On December 23, 1996, the IRS and Treasury Department published a notice of proposed rulemaking (REG-249819-96 [1997-1 C.B. 793]) in the **Federal Register** (61 F.R. 67508) containing proposed amendments to the Income Tax Regulations (26 CFR part 1) under sections 354, 355, and 356, relating to exchanges of stock and securities in certain reorganizations and corporate divisions. Written and oral comments responding to this notice were received. There were no requests to attend a public hearing and none was held.

After consideration of all comments received, the proposed amendments are adopted as revised by this Treasury decision. The principal changes to the regulations, as well as the major comments and suggestions, are discussed below.

Explanation of Provisions

A. *The Proposed Regulations*

In general, sections 354, 355, and 356 provide for nonrecognition of gain or loss, in whole or in part, to a stockholder or security holder on the exchange of stock or securities of parties to a reorganization and in pursuance of a plan of reorganization.

The proposed regulations would extend the nonrecognition rule of sections 354, 355, and 356 to certain rights to acquire stock. Thus, for purposes of sections 354, 355, and 356, the proposed regulations would treat rights to acquire stock issued by a corporation that is a party to a reorganization as securities of the corporation with no principal amount. The preamble to the proposed regulations provided that, for this purpose, the term *rights to acquire stock* issued by that corporation would have the same meaning as the term has in sections 305(d)(1) and 317(a). In addition, the preamble stated that the proposed regulations would have no effect on other Internal Revenue Code rules that pertain to securities, including sections 83 and 421 through 424 and the regulations thereunder.

B. *Comments on the Proposed Regulations*

1. *Elaboration on the Definition of "Rights To Acquire Stock"*

Commentators recommended that the final regulations include an explicit definition of *rights to acquire stock*. They submitted particular examples for inclusion in the definition.

The final regulations add a cross-reference to sections 305 and 317(a) in defining *rights to acquire stock*. This cross-reference should provide sufficient guidance in most cases for taxpayers to determine the consequences on a receipt of rights. The IRS and Treasury believe that illustrating the terms of sections 305 and 317 is outside the scope of these regulations. Accordingly, the final regulations

provide no definition other than the cross-reference.

2. *Treatment of Stock-For-Warrant Exchanges*

Section 1.354-1(d), *Example 3*, states that section 354 does not apply to a shareholder's receipt of solely debt securities in exchange for stock. Commentators requested confirmation that section 354 also does not apply to a shareholder's receipt of solely securities that are rights to acquire stock in exchange for stock. The final regulations confirm this result in *Example 4* to §1.354-1(d).

3. *Effective Date*

These final regulations are effective March 9, 1998. This accords with the delayed effective date in the proposed regulations. Commentators requested more immediate effectiveness.

The IRS and Treasury are concerned that taxpayers who have planned transactions based on the proposed regulations' delayed effective date could be disadvantaged by a change in the effective date. Accordingly, the final regulations retain the delayed effective date.

4. *Interrelationship With Section 83*

The preamble to the proposed regulations noted that the rules would apply to rights to acquire stock only for purposes of sections 354 through 356, and that such rights may remain subject to other special rules under the Internal Revenue Code and the regulations including sections 83 and 421 through 424.

Commentators recommended an explicit statement to that effect in the final regulations. The regulations adopt this recommendation.

5. *Effect in "B" Reorganizations*

Commentators requested a review of published guidance that concerns exchanges of rights to acquire stock as part of a larger transaction that includes a stock-for-stock reorganization under section 368(a)(1)(B). The IRS intends to address this issue in the near future.

6. *No Principal Amount*

Commentators sought clarification of the proposed rule that rights to acquire stock would have no principal amount.

The IRS and Treasury add *Examples 7, 8, and 9* to §1.356-3(b) to illustrate the effect of a right to acquire stock having no principal amount.

7. *Comments Not Addressed in the Final Regulations*

Comments were received with regard to the tax issues of rights to acquire stock under sections 302, 305, 306, and 351. Resolution of these issues is beyond the scope of this project and they are not addressed herein.

8. *Interrelationship With Nonqualified Preferred Stock Provisions*

In connection with the finalization of these regulations, the IRS and Treasury became aware that additional rules were needed to coordinate these regulations with the treatment of rights to acquire nonqualified preferred stock and new sections 354(a)(2)(C), 355(a)(3)(D), and 356(e). See §1.356-6T (T.D. 8753) on page 6 of this Bulletin.

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 has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and, because these regulations do not impose a collection of information requirement 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 Michael J. Danbury of the Office of Assistant Chief Counsel (Corporate). 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 1.354-1 is amended by:

- 1. In paragraph (d), redesignating *Example (1)* through *Example (3)* as *Example 1* through *Example 3*.
- 2. Adding *Example 4* to paragraph (d).
- 3. Revising paragraph (e).

The addition and revision read as follows:

§1.354-1 Exchanges of stock and securities in certain reorganizations.

* * * * *

(d) * * *

Example 4. The facts are the same as in *Example 3* of this paragraph (d), except that C receives solely rights to acquire stock in Corporation Z. Section 354 does not apply.

(e) Except as provided in §1.356-6T, for purposes of section 354, the term *securities* includes rights issued by a party to the reorganization to acquire its stock. For purposes of this section and section 356(d)(2)(B), a right to acquire stock has no principal amount. For this purpose, rights to acquire stock has the same meaning as it does under sections 305 and 317(a). Other Internal Revenue Code provisions governing the treatment of rights to acquire stock may also apply to certain exchanges occurring in connection with a reorganization. See, for example, sections 83 and 421 through 424 and the regulations thereunder. This paragraph (e) applies to exchanges occurring on or after March 9, 1998.

Par 3. Section 1.355-1 is amended by removing the last sentence of paragraph (b) and adding paragraph (c) to read as follows:

§1.355-1 Distribution of stock and securities of a controlled corporation.

* * * * *

(c) *Stock rights.* Except as provided in §1.356-6T, for purposes of section 355, the term *securities* includes rights issued by the distributing corporation or the controlled corporation to acquire the stock of that corporation. For purposes of this section and section 356(d)(2)(B), a right to acquire stock has no principal amount. For this purpose, rights to acquire stock has the same meaning as it does under sections 305 and 317(a). Other Internal Revenue Code provisions governing the treatment of rights to acquire stock may also apply to certain distributions occurring in connection with a transaction described in section 355. See, for example, sections 83 and 421 through 424 and the regulations thereunder. This paragraph (c) applies to distributions occurring on or after March 9, 1998.

Par 4. Section 1.356-3 is amended by:

- 1. Redesignating paragraph (b) as paragraph (c).
- 2. Adding a new paragraph (b).
- 3. In newly designated paragraph (c), redesignating *Example (1)* through *Example (6)* as *Example 1* through *Example 6*.
- 4. Revising paragraph (c) introductory text.
- 5. Adding *Example 7* through *Example 9* to paragraph (c).

The revisions and additions read as follows:

§1.356-3 Rules for treatment of securities as “other property.”

* * * * *

(b) Except as provided in §1.356-6T, for purposes of this section, a right to acquire stock that is treated as a security for purposes of section 354 or 355 has no principal amount. Thus, such right is not *other property* when received in a transaction to which section 356 applies (regardless of whether securities are surrendered in the exchange). This paragraph (b) applies to transactions occurring on or after March 9, 1998.

(c) In the examples in this paragraph (c), *stock* means common stock and *warrants* means rights to acquire common stock. The following examples illustrate the rules of paragraph (a) of this section:

* * * * *

Example 7. G, an individual, exchanged stock for stock and a warrant. The warrant had no principal amount. Thus, G received no excess principal amount within the meaning of section 356(d).

Example 8. H, an individual, exchanged a warrant for stock and a warrant. The warrants had no principal amount. Thus, H received no excess principal amount within the meaning of section 356(d).

Example 9. I, an individual, exchanged a warrant for stock and a debt security. The warrant had no principal amount. The debt security had a \$100 principal amount. I received \$100 of excess principal amount within the meaning of section 356(d).

Michael P. Dolan,
*Deputy Commissioner of
Internal Revenue.*

Approved December 17, 1997.

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

(Filed by the Office of the Federal Register on January 5, 1998, 8:45 a.m., and published in the issue of the Federal Register for January 6, 1998, 63 F.R. 409)
