

Section 368.—Definitions Relating to Corporate Reorganizations

26 CFR 1.368-1(e): Continuity of interest.

Continuity of interest on repurchase of issuer's shares. This ruling holds that an open market repurchase of shares through a broker has no effect on continuity of interest in a potential reorganization.

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ISSUE

What is the effect on continuity of interest when a potential reorganization is followed by an open market reacquisition of P's stock?

FACTS

T merges into P, a corporation whose stock is widely held, and is publicly and actively traded. P has one class of common stock authorized and outstanding. In the merger, T shareholders receive 50 percent common stock of P and 50 percent cash. Viewed in isolation, the exchange would satisfy the continuity of interest requirement of § 1.368-1(e) of the Income Tax Regulations. However, in an effort to prevent dilution resulting from the issuance of P shares in the merger, P's pre-existing stock repurchase program is modified to enable P to reacquire a number of its shares equal to the number issued in the acquisition of T. The number of shares repurchased will not exceed the total number of P shares issued and outstanding prior to the merger. The repurchases are made following the merger, on the open market, through a broker for the prevailing market price. P's intention to repurchase shares was announced prior to the T merger, but the repurchase program was not a matter negotiated with T or the T shareholders. There was not an understanding between the T shareholders and P that the T shareholders' ownership of P stock would be transitory. Because of the mechanics of an open market purchase, P does not know the identity of a seller of P stock, nor does a former T shareholder who receives P stock in the merger and

subsequently sells it know whether P is the buyer. Without regard to the repurchase program, a market exists for the newly-issued P stock held by the former T shareholders. During the time P undertakes its repurchase program, there are sales of P stock on the open market, which may include sales of P shares by former T shareholders.

LAW AND ANALYSIS

Requisite to a reorganization under the Internal Revenue Code is a continuity of interest as described in § 1.368-1(e). Section 1.368-1(b). The general 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." Section 1.368-1(e)(1)(i). To achieve this purpose, the regulation provides that a proprietary interest in the target corporation is not preserved to the extent that, "in connection with the potential reorganization, . . . stock of the issuing corporation furnished in exchange for a proprietary interest in the target corporation in the potential reorganization is redeemed." *Id.* However, for purposes of the continuity requirement, "a mere disposition of stock of the issuing corporation received in the potential reorganization to persons not related . . . to the issuing corporation is disregarded." *Id.* The regulation provides that all facts and circumstances will be considered in determining whether, in substance, a proprietary interest in the target corporation is preserved.

Under the facts set forth above, continuity of interest is satisfied. There was not an understanding between the T shareholders and P that the T shareholders' ownership of the P shares would be transitory. Further, because of the mechanics of an open market repurchase, the repurchase program does not favor participation by the former T shareholders. Therefore, even if it could be established that P has repurchased P shares from former T shareholders in the repurchase program, any such purchase would be coincidental. The merger and the stock repurchase together in substance would not resemble a sale of T stock to P by the

former T shareholders and, thus, the repurchase would not be treated as "in connection with" the merger. Under the facts presented, a sale of P stock on the open market by a former T shareholder during the repurchase program will have the same effect on continuity of interest as a mere disposition to persons not related to P.

HOLDING

Under the facts presented, the open market repurchase of shares through a broker has no effect on continuity of interest in the potential reorganization.

DRAFTING INFORMATION

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