



**(i) Facts.** P, T, and X are domestic corporations. T and X each operate a trade or business. A and K, individuals unrelated to P, own 85 and 15 percent, respectively, of the stock of T. P owns all of the stock of X. The total adjusted basis of T's property exceeds the sum of T's liabilities plus the amount of liabilities to which T's property is subject. P purchases all of A's T stock for cash in a qualified stock purchase. P does not make an election under section 338(g) with respect to its acquisition of T stock. Shortly after the acquisition date, and as part of the same plan, T merges under applicable state law into X in a transaction that, but for the question of continuity of interest, satisfies all the requirements of section 368(a)(1)(A). In the merger, all of T's assets are transferred to X. P and K receive X stock in exchange for their T stock. P intends to retain the stock of X indefinitely

**(ii) 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 represents an interest on the part of a person who was an owner of T's business enterprise prior to the transfer that can be continued in a reorganization through P's continuing ownership of X. Thus, the continuity of interest requirement is satisfied and the merger of T into X is a reorganization within the meaning of section 368(a)(1)(A). Moreover, by virtue of section 338, the requirement of section 368(a)(1)(D) that a target shareholder control the transferee immediately after the transfer is satisfied because P controls X immediately after the transfer. In addition, all of T's assets are transferred to X in the merger and P and K receive the X stock exchanged therefor in pursuance of the plan of reorganization. Thus, the merger of T into X is also a reorganization within the meaning of section 368(a)(1)(D).

**(iii) Treatment of T and X.** Under section 361(a), T recognizes no gain or loss in the merger. Under section 362(b), X's basis in the assets received in the merger is the same as the basis of the assets in T's hands. X succeeds to and takes into account the items of T as provided in section 381.

**(iv) Treatment of P.** By virtue of section 338, the transfer of T assets to X is a reorganization. Pursuant to that reorganization, P exchanges its T stock solely for stock of X, a party to the reorganization. Because P is the purchasing corporation, section 354 applies to P's exchange of T stock for X stock in the merger of T into X. Thus, P recognizes no gain or loss on the exchange. Under section 358, P's basis in the X stock received in the exchange is the same as the basis of P's T stock exchanged therefor.

**(v) Treatment of K.** Because K is not the purchasing corporation (or an affiliate thereof), section 354 cannot apply to K's exchange of T stock for X stock in the merger of T into X unless the transfer of T's assets is pursuant to a reorganization as determined without regard to this paragraph (d). Under general principles of tax law applicable to reorganizations, the continuity of interest requirement is not satisfied because P's stock purchase and the merger of T into X are pursuant to an integrated transaction in which A, the owner of 85 percent of the stock of T, received solely cash in exchange for A's T stock. See, e.g., § 1.368-1(e)(1)(i); *Yoc Heating v. Commissioner*, 61 T.C. 168 (1973); *Kass v. Commissioner*, 60 T.C. 218 (1973), *aff'd*, 491 F.2d 749 (3d Cir. 1974). Thus, the requisite continuity of interest under § 1.368-1(b) is lacking and section 354 does not apply to K's exchange of T stock for X stock. K recognizes gain or loss, if any, pursuant to section 1001(c) with respect to its T stock.