

interest attributable to such obligation is not subject to disallowance under section 279(a). However, since the obligation was issued after December 31, 1967, in an acquisition described in section 279(b)(1), under section 279(a)(2) the \$3.5 million of interest attributable to such obligation reduces the \$5 million limitation provided by section 279(a)(1) to \$1.5 million.

Example 3. Assume the same facts as in *Example 2*. Assume further that on January 1, 1970, X Corporation issues more obligations which are classified as corporate acquisition indebtedness and which require X Corporation to pay \$4 million of interest each year. For 1970 the amount of interest paid or accrued on corporate acquisition indebtedness, which may be deducted is \$1.5 million (\$5 million maximum provided by section 279(a)(1) less \$3.5 million, the reduction required under section 279(a)(2)). Thus, \$2.5 million of the \$4 million interest incurred on a corporate acquisition indebtedness is subject to disallowance under section 279(a) for the taxable year 1970.

Example 4. Assume the same facts as in *Example 3*. Assume further that on the last day of each of the taxable years 1971, 1972, and 1973 of X Corporation neither of the conditions described in section 279(b)(4) was present.

Under these circumstances, such obligations for all taxable years after 1973 are not corporate acquisition indebtedness under section 279(d)(4). Therefore, the \$2.5 million of interest previously not deductible is not deductible for all taxable years after 1973. Although such obligations are no longer treated as corporate acquisition indebtedness, the interest attributable thereto must be applied in further reduction of the \$5 million limitation. The \$5 million limitation of section 279(a)(1) is therefore reduced to zero. While the limitation is at the zero level any interest paid or incurred on corporate acquisition indebtedness will be disallowed.

[T.D. 7262, 38 FR 5844, Mar. 5, 1973]

§ 1.279-3 Corporate acquisition indebtedness.

(a) *Corporate acquisition indebtedness.* For purposes of section 279, the term *corporate acquisition indebtedness* means any obligation evidenced by a bond, debenture, note, or certificate or other evidence of indebtedness issued after October 9, 1969, by a corporation (referred to in section 279 and the regulations thereunder as “issuing corporation”) if the obligation is issued to provide consideration directly or indirectly for the acquisition of stock in, or certain assets of, another corporation (as described in paragraph (b) of

this § 1.279-3), is “subordinated” (as described in paragraph (c) of this § 1.279-3), is “convertible” (as described in paragraph (d) of this § 1.279-3), and satisfies either the ratio of debt to equity test (as described in paragraph (f) of § 1.279-5) or the projected earnings test (as described in paragraph (d) of § 1.279-5).

(b) *Acquisition of stock or assets.* (1) Section 279(b)(1) describes one of the tests to be satisfied if an obligation is to be classified as corporate acquisition indebtedness. Under section 279(b)(1), the obligation must be issued to provide consideration directly or indirectly for the acquisition of:

(i) Stock (whether voting or non-voting) in another corporation (referred to in section 279 and the regulations thereunder as “acquired corporation”), or

(ii) Assets of another corporation (referred to in section 279 and the regulations thereunder as “acquired corporation”) pursuant to a plan under which at least two-thirds (in value) of all the assets (excluding money) used in trades or businesses carried on by such corporation are acquired.

The fact that the corporation that issues the obligation is not the same corporation that acquires the acquired corporation does not prevent the application of section 279. For example, if X Corporation acquires all the stock of Y Corporation through the utilization of an obligation of Z Corporation, a wholly owned subsidiary of X Corporation, this section will apply.

(2) *Direct or indirect consideration.* Obligations are issued to provide direct consideration for an acquisition within the meaning of section 279(b)(1) where the obligations are issued to the shareholders of an acquired corporation in exchange for stock in such acquired corporation or where the obligations are issued to the acquired corporation in exchange for its assets. The application of the provisions of this subsection relating to indirect consideration for an acquisition of stock or assets depends upon the facts and circumstances surrounding the acquisition and the issuance of the obligations. Obligations are issued to provide indirect consideration for an acquisition of stock or assets within the meaning of section

279(b)(1) where (i) at the time of the issuance of the obligations the issuing corporation anticipated the acquisition of such stock or assets and the obligations would not have been issued if the issuing corporation had not so anticipated such acquisition, or where (ii) at the time of the acquisition the issuing corporation foresaw or reasonably should have foreseen that it would be required to issue obligations, which it would not have otherwise been required to issue if the acquisition had not occurred, in order to meet its future economic needs.

(3) *Stock acquisition.* (i) For purposes of section 279, an acquisition in which the issuing corporation issues an obligation to provide consideration directly or indirectly for the acquisition of stock in the acquired corporation shall be treated as a stock acquisition within the meaning of section 279(b)(1)(A). Where the stock of one corporation is acquired from another corporation and such stock constitutes at least two-thirds (in value) of all the assets (excluding money) of the latter corporation, such acquisition shall be deemed an asset acquisition as described in section 279(b)(1)(B) and subparagraph (4) of this section. If the issuing corporation acquires less than two-thirds (in value) of all the assets (excluding money) used in trades or businesses carried on by the acquired corporation within the meaning of section 279(b)(1)(B) and subparagraph (4) of this paragraph and such assets include stock of another corporation, the acquisition of such stock is a stock acquisition within the meaning of section 279(b)(1)(A) and of this subparagraph. In such a case the amount of the obligation which is characterized as corporate acquisition indebtedness shall bear the same relationship to the total amount of the obligation issued as the fair market value of the stock acquired bears to the total of the fair market value of the assets acquired and stock acquired, as of the date of acquisition. For rules with respect to acquisitions of stock, where the total amount of stock of the acquired corporation held by the issuing corporation never exceeded 5 percent of the total combined voting power of all classes of stock of

the acquired corporation entitled to vote, see § 1.279-4(b)(1).

(ii) If the issuing corporation acquired stock of an acquired corporation in an acquisition described in section 279(b)(1)(A), and liquidated the acquired corporation under section 334(b)(2) and the regulations thereunder before the last day of the taxable year in which such stock acquisition is made, such obligation issued to provide consideration directly or indirectly to acquire such stock of the acquired corporation shall be considered as issued in an acquisition described in section 279(b)(1)(B).

(4) *Asset acquisition.* (i) For purposes of section 279, an acquisition in which the issuing corporation issues an obligation to provide consideration directly or indirectly for the acquisition of assets of an acquired corporation pursuant to a plan under which at least two-thirds of the gross value of all the assets (excluding money) used in trades and businesses carried on by such acquired corporation are acquired shall be treated as an asset acquisition within the meaning of section 279(b)(1)(B). For purposes of section 279(b)(1)(B), the gross value of any acquired asset shall be its fair market value as of the day of its acquisition. In determining the fair market value of an asset, no reduction shall be made for any liabilities, mortgages, liens, or other encumbrances to which the asset or any part thereof may be subjected. For purposes of this subparagraph, an asset which has been actually used in the trades and businesses of a corporation but which is temporarily not being used in such trades and businesses shall be treated as if it is being used in such manner. For purposes of this paragraph, the day of acquisition will be determined by reference to the facts and circumstances surrounding the transaction.

(ii) For purposes of the two-thirds test described in section 279(b)(1)(B), the stock of any corporation which is controlled by the acquired corporation shall be considered as an asset used in the trades and businesses of such acquired corporation.

(5) *Certain nontaxable transactions.* (i) Under section 279(e), an acquisition of stock of a corporation of which the

issuing corporation is in control in a transaction in which gain or loss is not recognized shall be deemed an acquisition described in section 279(b)(1)(A) only if immediately before such transaction the acquired corporation was in existence, and the issuing corporation was not in control of such corporation. If the issuing corporation is a member of an affiliated group, then in accordance with section 279(g), the affiliated group shall be treated as the issuing corporation. Thus, any stock of the acquired corporation, owned by members of the affiliated group, shall be aggregated in determining whether the issuing corporation was in control of the acquired corporation.

(ii) The \$5 million limitation provided by section 279(a)(1) is not reduced by the interest on an obligation issued in a transaction which, under section 279 (e), is deemed not to be an acquisition described in section 279(b)(1).

(iii) The provisions of this subparagraph may be illustrated by the following examples:

Example 1. On January 1, 1973, W Corporation, a calendar year taxpayer, issues to the public 10,000 10 year convertible bonds each with a principal of \$1,000 for \$9 million. On June 6, 1973, W Corporation transfers the \$9 million proceeds of such bond issue to X Corporation in exchange for X Corporation's common stock in a transaction that satisfies the provisions of section 351(a). On December 31, 1973, W Corporation's ratio of debt to equity is 1 1/2 to 1 and its project earnings exceed three times the annual interest to be paid or incurred. Immediately prior to the transaction between the two corporations W Corporation owned no stock in X Corporation which had been in existence for several years. However, immediately after this transaction W Corporation is in control of X Corporation. Since X Corporation, the acquired corporation, was in existence and W Corporation, the issuing corporation, was not in control of X Corporation immediately before the section 351 transaction (a transaction in which gain or loss is not recognized) and since W Corporation is now in control of X Corporation, the acquisition of X Corporation's common stock by W Corporation is not protected from treatment as an acquisition described in section 279(b)(1)(A). However, the obligation will not be deemed to be corporate acquisition indebtedness since the test of section 279(b)(4) is not met. The interest on the obligation will reduce the \$5 million limitation of section 279(a).

Example 2. Assume the facts are the same as described in *Example (1)*, except that X Corporation was not in existence prior to June 6, 1973, but rather is newly created by W Corporation on such date. Since X Corporation, the acquired corporation, was not in existence before June 6, 1973, the date on which W Corporation, the issuing corporation, acquired control of X Corporation in a transaction on which gain or loss is not recognized, the acquisition is not deemed to be an acquisition described in section 279(b)(1)(A). Thus, under the provisions of subdivision (ii) of this subparagraph, the \$5 million limitation provided by section 279(a)(1) will not be reduced by the yearly interest incurred on the convertible bonds issued by W Corporation.

Example 3. Assume that the facts are the same as described in *Example (1)*, except that W Corporation was in control of X Corporation immediately before the transaction. Since W Corporation was in control of X Corporation immediately before the section 351(a) transaction and is in control of X Corporation after such transaction, the result will be the same as in *Example (2)*.

(c) *Subordinated obligation*—(1) *In general.* An obligation which is issued to provide consideration for an acquisition described in section 279(b)(1) is subordinated within the meaning of section 279(b)(2) if it is either:

(i) Subordinated to the claims of trade creditors of the issuing corporation generally, or

(ii) Expressly subordinated in right of payment to the payment of any substantial amount of unsecured indebtedness, whether outstanding or subsequently issued, of the issuing corporation, irrespective of whether such subordination relates to payment of interest, or principal, or both. In applying section 279 (b)(2) and this paragraph in any case where the issuing corporation is a member of an affiliated group of corporations, the affiliated group shall be treated as the issuing corporation.

(2) *Expressly subordinated obligation.* In applying subparagraph (1)(ii) of this paragraph, an obligation is considered expressly subordinated whether the terms of the subordination are provided in the evidence of indebtedness itself, or in another agreement between the parties to such obligation. An obligation shall be considered to be expressly subordinated within the meaning of subparagraph (1)(ii) of this paragraph if such obligation by its terms can become subordinated in right of

payment to the payment of any substantial amount of unsecured indebtedness which is outstanding or which may be issued subsequently. However, an obligation shall not be considered expressly subordinated if such subordination occurs solely by operation of law, such as in the case of bankruptcy laws. For purposes of this paragraph, the term *substantial amount of unsecured indebtedness* means an amount of unsecured indebtedness equal to 5 percent or more of the face amount of the obligations issued within the meaning of section 279(b)(1).

(d) *Convertible obligation.* An obligation which is issued to provide consideration directly or indirectly for an acquisition described in section 279 (b)(1) is convertible within the meaning of section 279(b)(3) if it is either— (1) Convertible directly or indirectly into stock of the issuing corporation, or (2) Part of an investment unit or other arrangement which includes, in addition to such bond or other evidence of indebtedness, an option to acquire directly or indirectly stock in the issuing corporation. Stock warrants or convertible preferred stock included as part of an investment unit constitute options within the meaning of the preceding sentence. Indebtedness is indirectly convertible if the conversion feature gives the holder the right to convert into another bond of the issuing corporation which is then convertible into the stock of the issuing corporation. In any case where the corporation which in fact issues an obligation to provide consideration for an acquisition described in section 279(b)(1) is a member of an affiliated group, the provisions of section 279(b)(3) and this paragraph are deemed satisfied if the stock into which either the obligation or option which is part of an investment unit or other arrangement is convertible, directly or indirectly, is stock of any member of the affiliated group.

(e) *Ratio of debt to equity and projected earnings test.* For rules with respect to the application of section 279(b)(4) (relating to the ratio of debt to equity and the ratio of projected earnings to annual interest to be paid or incurred), see paragraphs (d), (e), and (f) of § 1.279-5.

(f) *Certain obligations issued after October 9, 1969—*(1) *In general.* Under section 279(i), an obligation shall not be corporate acquisition indebtedness if such obligation is issued after October 9, 1969, to provide consideration for the acquisition of:

(i) Stock or assets pursuant to a binding written contract which was in effect on October 9, 1969, and at all times thereafter before such acquisition, or

(ii) Stock in any corporation where the issuing corporation, on October 9, 1969, and at all times thereafter before such acquisition, owned at least 50 percent of the total combined voting power of all classes of stock entitled to vote of the acquired corporation.

Subdivision (ii) of this subparagraph shall cease to apply when (at any time on or after October 9, 1969) the issuing corporation has acquired control of the acquired corporation. The interest attributable to any obligation which satisfies the conditions stated in the first sentence of this subparagraph shall reduce the \$5 million limitation of section 279(a)(1).

(2) *Examples.* The provisions of this paragraph may be illustrated by the following examples:

Example 1. On September 5, 1969, M Corporation, a calendar year taxpayer, entered into a binding written contract with N Corporation to purchase 20 percent of the voting stock of N Corporation. The contract was in effect on October 9, 1969, and at all times thereafter before the acquisition of the stock on January 1, 1970. Pursuant to such contract M Corporation issued on January 1, 1970, to N Corporation an obligation which satisfies the tests of section 279(b) requiring it to pay \$1 million of interest each year. However, under the provisions of subparagraph (1)(i) of this paragraph, such obligation is not corporate acquisition indebtedness since it was issued to provide consideration for the acquisition of stock pursuant to a binding written contract which was in effect on October 9, 1969, and at all times thereafter before such acquisition. The \$1 million of yearly interest on the obligation reduces the \$5 million limitation provided for in section 279(a)(1) to \$4 million since such interest is attributable to an obligation which was issued to provide consideration for the acquisition of stock in an acquired corporation.

Example 2. On October 9, 1969, O Corporation, a calendar year taxpayer, owned 50 percent of the total combined voting power of

all classes of stock entitled to vote of P Corporation. P Corporation has no other class of stock. On January 1, 1970, while still owning such voting stock O Corporation issued to the shareholders of P Corporation to provide consideration for an additional 40 percent of P Corporation's voting stock an obligation which satisfied the tests of section 279(b) requiring it to pay \$4 million of interest each year. Hence, O Corporation acquired control of P Corporation, and the provisions of subparagraph (1)(ii) of this paragraph ceased to apply to O Corporation. Thus, 75 percent of the obligation issued by O Corporation to provide consideration for the stock of P Corporation is not corporate acquisition indebtedness (that is, of the 40 percent of the voting stock of P Corporation which was acquired, only 30 percent was needed to give O Corporation control). Since 25 percent of the obligation is corporate acquisition indebtedness, \$1 million of interest attributable to such obligation is subject to disallowance under section 279(a) for the taxable year 1970. The remaining \$3 million of interest attributable to the obligation will reduce the \$5 million limitation provided by in section 279(a)(1).

(g) *Exemptions for certain acquisitions of foreign corporations—(1) In general.* Under section 279(f), the term *corporate acquisition indebtedness* does not include any indebtedness issued to any person to provide consideration directly or indirectly for the acquisition of stock in, or assets of, any foreign corporation substantially all the income of which, for the 3-year period ending with the date of such acquisition or for such part of such period as the foreign corporation was in existence, is from sources without the United States. The interest attributable to any obligation excluded from treatment as corporate acquisition indebtedness by reason of this paragraph shall reduce the \$5 million limitation of 279(a)(1).

(2) *Foreign corporation.* For purposes of this paragraph, the term *foreign corporation* shall have the same meaning as in section 7701(a)(5).

(3) *Income from sources without the United States.* For purposes of this paragraph, the term *income from sources without the United States* shall be determined in accordance with sections 862 and 863. If more than 80 percent of a foreign corporation's gross income is derived from sources without the United States, such corporation shall be considered to be deriving substan-

tially all of its income from sources without the United States.

[T.D. 7262, 38 FR 5845, Mar. 5, 1973]

§ 1.279-4 Special rules.

(a) *Special 3-year rule.* Under section 279(d)(4), if an obligation which has been deemed to be corporate acquisition indebtedness for any taxable year would not be such indebtedness for each of any 3 consecutive taxable years thereafter if the ratio of debt to equity and the ratio of projected earnings to annual interest to be paid or incurred of section 279 (b)(4) were applied as of the close of each of such 3 years, then such obligation shall not be corporate acquisition indebtedness for any taxable years after such 3 consecutive taxable years. The test prescribed by section 279(b)(4) shall be applied as of the close of any taxable year whether or not the issuing corporation issues any obligation to provide consideration for an acquisition described in section 279(b)(1) in such taxable year. Thus, for example, if a corporation, reporting income on a calendar year basis, has an obligation outstanding as of December 31, 1975, which was classified as a corporate acquisition indebtedness as of the close of 1972 and such obligation would not have been classified as corporate acquisition indebtedness as of the close of 1973, 1974, and 1975 because neither of the conditions of section 279(b)(4) were present as of such dates, then such obligation shall not be corporate acquisition indebtedness for 1976 and all taxable years thereafter. Such obligation shall not be reclassified as corporate acquisition indebtedness in any taxable year following 1975, even if the issuing corporation issues more obligations (whether or not found to be corporate acquisition indebtedness) in such later years to provide consideration for the acquisition of additional stock in, or assets of, the same acquired corporation with respect to which the original obligation was issued. The interest attributable to such obligation shall reduce the \$5 million limitation provided by section 279(a)(1) for 1976 and all taxable years thereafter.

(b) *Five percent stock rule—(1) In general.* Under section 279(d)(5), if an obligation issued to provide consideration