TAX MANAGEMENT PORTFOLIOS™

U.S. INCOME

Single Entity Reorganizations: Recapitalizations and F Reorganizations

by

Michael J. Kliegman, Esq.
Akin Gump Strauss Hauer & Feld LLP
New York, New York

Michael J. Kliegman, A.B., University of Pennsylvania; J.D., Boston University School of Law, LL.M. (Taxation), Georgetown University Law Center; Adjunct Professor, Fordham University School of Business, New York Law School; former chair, American Bar Association Section of Business Law, Taxation Committee; member, American Bar Association, Tax Section (Corporate Tax Committee; Task Force on Acquisitions Involving S Corporations); New York State Bar Association, Tax Section (Committee on Reorganizations); Advisory Board, Bloomberg Tax; Partner (retired), PricewaterhouseCoopers LLP; formerly, Internal Revenue Service, Office of Chief Counsel, Reorganization Branch (1981–85), Group Chief (1984–85).

This Portfolio revises and supersedes previous versions of 774-4th T.M., *Single Entity Reorganizations: Recapitalizations and F Reorganizations*.

ISBN 978-1-63359-255-1

ISBN 978-1-63359-255-1

TAX MANAGEMENT
PORTFOLIOS™

U.S. INCOME

Single Entity Reorganizations: Recapitalizations and F Reorganizations

PORTFOLIO DESCRIPTION

Tax Management Portfolio, *Single Entity Reorganizations: Recapitalizations and F Reorganizations*, No. 774-4th, describes the special features and analyzes the tax consequences of corporate reorganizations involving a single company, specifically, a recapitalization under §368(a)(1)(E) and a mere change in identity, form or place of organization under §368(a)(1)(F).

The Portfolio discusses each type of reorganization separately, and in relation to one another and to the other types of reorganizations under §368. With respect to recapitalizations, the Portfolio compares transactions technically qualifying under §368(a)(1)(E) with those that, while possibly not qualifying, are commonly referred to as recapitalizations. With regard to the F reorganization, special attention is paid to distinguishing the F reorganization reincorporation transaction from other types of reorganizations and analyzing the final regulations.

A significant portion of the Portfolio is devoted to describing the tax consequences of recapitalizations and F reorganizations both to the corporations involved and to their shareholders and security holders. In addition, the Portfolio provides a detailed analysis of the tax consequences of various types of recapitalization transactions. The Portfolio also discusses mutual to stock conversions and issues that arise under §305 and §306.

The Worksheets include diagrams of an F reorganization reincorporation transaction, an S Corporation Asset Sale involving an F reorganization, an S corporation conversion to a limited liability company using an F reorganization, as well as sample corporate documents related to a reincorporation.

This Portfolio may be cited as Kliegman, 774-4th T.M., *Single Entity Reorganizations: Recapitalizations and F Reorganizations*.

ISBN 978-1-63359-255-1

TABLE OF CONTENTS

	PAGE
DETAILED ANALYSIS	
I. Introduction	A-1
A. Scope of Portfolio	A-1
B. Distinguished from Other Reorganizations	A-1
C. Summary of Tax Consequences	A-1
D. Common Uses of Single-Entity Reorganizations	A-2
E. Availability of Private Letter Rulings	A-2
II. Determining Whether a Transaction Qualifies as an F Reorganization	A-3
A. Statutory Requirements	A-3
1. Definition	A-3
2. Mere Change — Six Regulatory Requirements	A-3
3. Absence of Continuity of Interest and Continuity of Business Enterprise Requirements	A-5
4. Related Transactions	A-5
a. Current Rules	A-5
b. Transactions Before September 21, 2015	A-7
c. Related Transactions in the Bubble	A-7
B. Specific Types of F Reorganizations	A-8
1. Single-Entity Transactions	A-8
2. Reincorporations	A-8
3. Changes in Form of Business Organization	A-9
4. Transactions Involving Disregarded Entities	A-9
a. Foreign Disregarded Entity	A-9
b. S Corporation Asset Sale	A-10
c. Joint Venture	A-11
d. Substitute for Corporate Spin-Off	A-11
C. Business Purpose	A-11
III. Determining Whether a Transaction Qualifies as an E Reorganization	A-13
A. Definition	A-13
B. Business Purpose	A-15
C. Absence of Continuity of Interest and Continuity of Business Enterprise Requirements	A-16
IV. Tax Consequences of E and F Reorganizations	A-17
A. Introduction	A-17
B. Party to a Reorganization	A-17
C. Plan of Reorganization	A-17
D. Treatment of Corporation in Recapitalization	A-18
1. Issuance and Retirement of Stock	A-18
2. Issuance and Retirement of Debt	A-18
E. Treatment of Old Corporation in F Reorganization	A-19
F. Treatment of New Corporation in F Reorganization/Employer ID Number	A-20
G. Treatment of Stockholders and Security Holders	A-21
1. Definition of Security	A-21
2. General Nonrecognition Rule on Exchange of Stock or Securities	A-22
a. Exchange of Stock for Securities	A-22
b. Exchange of Securities for Securities	A-22
c. Nonqualified Preferred Stock (NQPS)	A-23
d. Rights to Acquire Stock	A-23
e. Accrued Interest on Surrendered Securities	A-24
3. Receipt of Other Property or "Boot"	A-24
a. General Recognition Rule upon Receipt of Other Property	A-24
b. Securities as Boot	A-25
c. Nonqualified Preferred Stock as Boot	A-25
(1) Definition	A-25
(2) Exception Applicable to Family-Owned Corporations	A-26
(3) Exception Applicable to Certain Exchanges of Substantially Identical Preferred Stock	A-26
(4) Effect of Receipt of NQPS Treated as Boot	A-26
d. Dividend Equivalency	A-27
e. Separable Distributions	A-28
f. Cash in Lieu of Fractional Shares	A-28
4. Application of §305 to Recapitalizations	A-29
a. General Rule and Exceptions	A-29
b. Distinguishing Exchange from Distribution	A-29
c. When Is a Recapitalization Treated as a §305 Distribution?	A-29
d. Preferred Stock and Redemption Premium	A-30
5. Section 306 Stock	A-31
a. Definition of §306 Stock	A-31
b. Treatment of Shareholder on Disposition of §306 Stock	A-32
(1) Redemptions	A-32

ISBN 978-1-63359-255-1

	PAGE
(2) Dispositions Other than Redemptions	A-32
(3) Exception for Transactions Not in Avoidance	A-33
H. Carryover of Tax Attributes	A-33
I. Treatment of Transaction Costs	A-34
J. Corporate Alternative Minimum Tax	A-34
1. Recapitalizing Corporation in a Covered Transaction	A-35
2. Recapitalizing Corporation Shareholder or Security Holder in Covered Transactions	A-35
V. Consequences of Specific Types of Recapitalization Exchanges	A-37
A. Introduction	A-37
B. Exchanges of Preferred Stock	A-37
1. Preferred for Common	A-37
2. Preferred with Dividend Arrearages	A-37
C. Exchanges of Common Stock or Stock Generally	A-38
1. Common for Common	A-38
2. Common for Preferred	A-38
3. Common for Debt	A-38
D. Exchanges of Debt for Debt	A-39
1. In General	A-39
2. Securities for Securities	A-40
a. Treatment of Holder	A-40
b. Treatment of Issuer	A-41
3. Securities with Interest Arrearages	A-42
4. Exchange of Nonsecurity Debt	A-42
5. Reacquisition of a Debt Instrument in 2009 or 2010: Deferral of Cancellation of Indebtedness Income	A-42
E. Exchanges of Debt for Stock	A-43
1. Current Rules	A-43
2. Prior Rules	A-44
F. Exchanges of Warrants for Stock	A-44
G. Estate Freeze Recapitalizations	A-46
H. Corporate Alternative Minimum Tax	A-48
1. CAMT Consequences to Transferor Corporation in Nonrecognition Transactions	A-49
2. CAMT Consequences to Resulting Corporation in Nonrecognition Transactions	A-49
3. CAMT Consequences to Transferor Corporation Shareholder or Security Holder in Covered Transactions	A-49
VI. Mutual-to-Stock Conversions	A-51
A. Savings and Loan Conversions	A-51
B. Insurance Company Demutualizations	A-52

	PAGE
1. In General	A-52
2. Tax-Free Reorganization	A-53
a. E Reorganization	A-53
b. A Reorganization	A-53
c. F Reorganization	A-53
3. Treatment for Tax Purposes	A-54
a. For Former Policyholders of Mutual Insurance Companies	A-54
b. For Demutualized Insurance Company	A-54
4. Other Considerations	A-55
a. Holders of §408 IRAs, §401(k) Plans, and §403(b) Tax-Sheltered Annuities (TSAs)	A-55
b. Foreign Policyholders — Withholding Issues	A-55
c. Consolidated Tax Return Issues	A-55
d. Closed Block	A-55
e. Grandfathering of Existing Policies	A-55
f. Mutual Insurance Holding Companies	A-55
VII. Cross-Border F Reorganizations	A-57
A. Introduction	A-57
B. Scope of Cross-Border F Reorganizations	A-57
C. Special Rules Governing Outbound Reincorporations	A-58
1. Possible Inversion Treatment	A-58
2. Application of §367	A-58
a. Application of §367(d) to Transfers of Intangibles	A-58
b. Application of §367(a) to Transfers of Other Property	A-59
D. Inbound Reincorporations	A-59
1. Application of §367(b)	A-59
2. Recognition of Certain FIRPTA Gain	A-60
VIII. Reporting Requirements	A-63
A. Reporting Requirements Under §368	A-63
1. Recordkeeping	A-63
2. Plan of Reorganization and Party to the Reorganization Statement	A-63
3. "Significant Holder" Statement	A-63
B. Reporting Requirements Under §6043(c)	A-64
C. Reporting Requirements Under §6043A	A-65
D. Reporting Requirements Under §6045B	A-65
1. In General	A-65
2. Issuer Information Return	A-66
TABLE OF WORKSHEETS	B-1

ISBN 978-1-63359-255-1

DETAILED ANALYSIS

I. Introduction

A. Scope of Portfolio

The corporate reorganization provisions of the Internal Revenue Code ("Code")[1] generally accord tax-free treatment to certain enumerated types of corporate amalgamations and realignments. To qualify as a tax-free reorganization, a transaction must first satisfy the definitional requirements. This Portfolio combines a discussion of two types of tax-free reorganizations that, unlike the others defined in §368, do not directly involve acquisitive or divisive transactions. They are called "single-entity reorganizations" because they each involve only a single taxpayer corporation. They include (1) a §368(a)(1)(E) reorganization (an "E" reorganization), defined as a recapitalization; and (2) a §368(a)(1)(F) reorganization (an "F" reorganization), defined as "a mere change in identity, form, or place of organization of one corporation, however effected."

B. Distinguished from Other Reorganizations

The E and F reorganizations are each distinguished from the other types of reorganizations in §368 in that they, by definition, involve only a single corporation and do not in and of themselves bring about a business combination or division.

The distinctions between single-entity reorganizations and other types of reorganizations are based, for the most part, on the fact that the E and F reorganizations do not involve the amalgamation of two or more separate corporations. Thus, for example, the continuity of shareholder interest requirement, which originated in an effort to distinguish a reorganization from a sale, generally does not apply to single-entity reorganizations.[2]

For a period beginning in the mid-1960s and ending with a statutory amendment in 1982, §368(a)(1)(F) came to be used to combine multiple corporations under common ownership; multiple F reorganizations overlapped with one or more of the acquisitive types of reorganizations.[3] Since the elimination of the multiple F reorganization in 1982, it is less common to find the F reorganization overlapping with another type of reorganization under §368(a)(1).

However, the F reorganization can still overlap with other types of reorganizations. This commonly occurs in reincorporation transactions, in which an existing corporation (Oldco), in order to change its form or place of incorporation, merges into a newly formed corporation (Newco), in which the former Oldco shareholders become the sole shareholders in Newco. Such a transaction qualifies as a statutory merger under §368(a)(1)(A) (an "A" reorganization) and as a nondivisive transfer to a controlled corporation under §368(a)(1)(D) (a "D" reorganization) and §354. In the case of such an overlap, the IRS has ruled that, generally, the ancillary tax consequences particular to F reorganizations prevail.[4] In other words, if a transaction qualifies as both an F reorganization and as another type of reorganization, the transaction is generally treated as an F reorganization for federal tax purposes. However, final regulations under §368 provide that if a potential F reorganization or a step that occurs as part of a potential F reorganization qualifies as a reorganization or a part of a reorganization under another provision of §368(a)(1) *and* if a corporation in control of the resulting corporation is a party to that other reorganization, the potential F reorganization will not qualify as a reorganization under §368(a)(1)(F).[5] Thus, as an example, a potential F reorganization that also qualifies as a forward triangular A or an A reorganization with a drop-down will not qualify under §368(a)(1)(F) because a corporation in control of the resulting corporation is a party to the other reorganization (the A reorganization).[6]

Under §368(a)(3)(C), if a transaction meets the requirements of both an F and a "G" reorganization,[7] the G reorganization takes precedence.[8] Thus, the transaction is subject to the G reorganization rules. The G reorganization requirements are essentially the same as those of a D reorganization, with the additional requirement that the reorganization occur in a "title 11 or similar case."

As discussed above, before 1982, F reorganizations could be used to combine multiple corporations. Because this is no longer the case, it is sometimes difficult to determine the judicial authority of IRS published rulings from the pre-1982 period and determine whether and/or how they pertain to current transactions. In certain cases, doctrines that evolved out of efforts to limit the scope of the multiple F reorganization, although arguably irrelevant to the single-entity transaction, remain as possible pitfalls for the tax planner.

C. Summary of Tax Consequences

The subchapter C provisions applicable to reorganizations generally apply as well to single-entity reorganizations. Under §361, there is no gain or loss to the corporation on the transfer of its assets to a new corporation in exchange for stock of the new corporation in an F reorganization, and, under §354, ordinarily no gain or loss to the shareholders upon the exchange of old stock for new stock, old debt securities for new debt securities, or securities for stock. The corporation's basis in its as-

[1] All section references herein are to the Internal Revenue Code of 1986, as amended, and the regulations thereunder, unless otherwise stated.

[2] Reg. §1.368-1(b), §1.368-2(m)(2).

[3] In *Gordon v. Commissioner*, 424 F.2d 378 (2d Cir. 1970), *cert. denied*, 400 U.S. 848 (1970), the Second Circuit held that a divisive transaction that could not meet the restrictive qualifications of §368(a)(1)(D) and §355 could not qualify for tax-free treatment as an F reorganization. The court stated that to hold otherwise would undermine congressional policy distinguishing between divisive and acquisitive reorganizations.

[4] Rev. Rul. 57-276. In Rev. Rul. 79-289, the IRS ruled that §357(c) would not apply when a reorganization qualified under both §368(a)(1)(D) and §368(a)(1)(F).

[5] Reg. §1.368-2(m)(3)(iv)(A).

[6] *See* Reg. §1.368-2(m)(4) *Ex.* 13.

[7] §368(a)(1)(G).

[8] *See* FSA 200145009.

ISBN 978-1-63359-255-1

sets generally remains the same,[9] and the shareholders and security holders take a basis in their new stock or securities equal to their basis in the old stock or securities.[10] When, as in the case of a §368(a)(1)(F) change of place of incorporation, assets are nominally transferred from Oldco to Newco, §381 results in a carryover of tax attributes from Oldco to Newco.[11] In this case, however, consistent with the single-entity model, Newco is treated as a continuation of Oldco; Oldco's taxable year does not end, and Newco may carry back net operating losses to a taxable year of Oldco.[12]

Qualification of a transaction as a reorganization may be unnecessary in some cases. For example, nonrecognition of gain or loss to the corporation and carryover of attributes are unnecessary in an E or an F reorganization that does not involve an actual or constructive transfer of assets from one corporation to another. On the other hand, the fact that an exchange of corporate debt securities for stock or other securities qualifies as a tax-free reorganization does not prevent the corporation from incurring cancellation of indebtedness income on the exchange.[13]

The tax consequences of E and F reorganizations are discussed in detail in IV., below.

D. Common Uses of Single-Entity Reorganizations

In practice, single-entity reorganizations are utilized in a variety of ways. The following is a list of common types of E and F reorganizations, and the contexts in which they arise.

F Reorganization —

- a corporation's name change;
- a change in the form of a corporation (e.g., from a business trust taxable as a corporation to a state law corporation);
- a change in a corporation's state of incorporation, executed by way of a statutory merger of Oldco (incorporated in the old state) into Newco (incorporated in the new state);
- a change in form of business entity (e.g., a state law corporation converting under state law to a limited liability company electing to be classified as an association taxable as a corporation); and
- a conversion of a mutual savings and loan association into a stock savings and loan association.

The ability to create both domestic and foreign legal entities that are disregarded for U.S. income tax purposes ("disregarded entities") has led to the development of new and interesting uses for the F reorganization. These types of transactions are discussed in II.B.4., below.

Recapitalization (E Reorganization) —

- a "reverse stock split" in which shareholders' common shares are exchanged pro rata for a fewer number of common shares — for example, a "two for one" split, pursuant to which half the previous number of shares remain outstanding, but pro rata ownership remains the same;
- an exchange of older-generation managers' or shareholders' common stock for preferred stock, with receipt by the younger generation of common stock (although the enactment of §2701–§2704 have made these exchanges less attractive in many cases);
- in connection with a cash purchase of target corporation's stock, an exchange by selling shareholders of a portion of their common stock for preferred stock in the target corporation; and
- in the debt restructuring of a troubled company, an exchange by various classes of creditors and shareholders of their interests for new classes of stock and debt securities.

E. Availability of Private Letter Rulings

As in the reorganization area generally, the IRS may indicate its approach to the treatment of E and F reorganizations in private letter rulings.

Under §6110(k), private letter rulings have no precedential value.[14]

Note: For requests received on or after January 2, 2024, the Associate Chief Counsel (Corporate) has eliminated the "significant issue" practice, under which the IRS would issue rulings only on a significant issue presented in a multitude of nonrecognition transactions, including a §368 or §1036 transaction, rather than a ruling on the entire transaction.[15] The IRS will issue "comfort rulings" on issues under §368 and §1036, meaning a ruling will be issued even if the issue is "clearly and adequately addressed" by statute, regulation, court decision, revenue ruling, revenue procedure, notice or other authority published in the Internal Revenue Bulletin.[16]

---

[9] §362(b).

[10] §358.

[11] §381(a).

[12] §381(b); Reg. §1.381(b)-1(a)(1), §1.381(b)-1(a)(2). *See also* PLR 200320013 (continuation of Oldco's tax attributes, including tax year, applies when Newco and Oldco are S corporations). Note, however, in certain cross-border F reorganizations, the Oldco tax year will end on the date of the transfer.

[13] *See* §108(e)(10). Under the provision, regardless of whether a debt-for-debt exchange occurs in a reorganization or otherwise, the debtor is treated as satisfying the old debt with an amount of money equal to the issue price of the new debt instrument. For this purpose, the issue price is determined under the rules of §1273 and §1274. *See also* Rev. Rul. 77-437.

[14] *See* 621 T.M., *IRS National Office Procedures — Rulings, Closing Agreements*.

[15] Rev. Proc. 2024-3, §1.02, *superseding* Rev. Proc. 2023-3, §3.01(60), §4.01(30); Rev. Proc. 2024-1, §16, Rev. Proc. 2025-3, §1.02, superseding Rev. Proc. 2024-3, §3.01(122), and also applicable to §332, §351, and §355 transactions.

[16] Rev. Proc. 2026-1, §6.11.

ISBN 978-1-63359-255-1

II. Determining Whether a Transaction Qualifies as an F Reorganization

A. *Statutory Requirements*

1. *Definition*

An F reorganization is defined in §368(a)(1)(F) as "a mere change in identity, form, or place of organization of one corporation, however effected."

Note: The current statutory definition of an F reorganization specifically refers to "one corporation." This was not always the case.[17] Thus, rulings and case law relevant to F reorganizations may relate to a time period when the statute did not include this language. Further, although the statutory definition now refers to "one corporation," it is common to employ more than one legal entity to bring about this type of "single entity" reorganization.

The legislative history provides that the fact that the statutory definition specifically refers to "one corporation" does not mean that a corporation is precluded from using more than one entity to consummate a transaction, provided that only one *operating company* is involved.[18] The legislative history does not, however, expand upon the term "operating company." Thus, could a merger of an operating subsidiary into a passive parent holding company still qualify as an F reorganization? The 2015 regulations under §368 provide that a transaction does not qualify as an F reorganization unless, among other requirements, the resulting corporation (Newco) does not hold any property or have any tax attributes immediately before the potential F reorganization (other than (1) a de minimis amount of assets (and tax attributes related to those assets) held to facilitate its organization or maintain its legal existence or (2) the proceeds of borrowings related to the potential F reorganization).[19] Thus, under the final regulations, the merger of an operating subsidiary into a passive parent holding company would not qualify as an F reorganization.[20]

Comment: The Committee's use of the term "operating company" probably was not intended to refer to companies that are directly engaged in business activities, but rather, to distinguish corporations with separate tax histories from newly formed entities without separate tax histories.

In FSA 200117008, a liquidation was treated as a reorganization under §368(a)(1)(D) where shareholders agreed to dissolve one corporation and then transfer assets for no consideration to a commonly controlled corporation. The IRS summarily noted that the reorganization did not qualify under §368(a)(1)(F) because of the existence of two operating companies.

2. *Mere Change — Six Regulatory Requirements*

Regulations under §368 provide guidance on when a transaction, or series of transactions, may qualify as an F reorganization.[21] The preamble to the final regulations includes the following excellent articulation of the underlying philosophy with respect to the rules:[22]

> A corporation that continues to inhabit its corporate shell can change in many respects. Although these changes may have federal income tax consequences, they do not result in the corporation being treated for federal income tax purposes as a new corporation or as transferring assets. Nor do these changes cause the corporation's taxable year to close. Unlike a partnership that might terminate for federal income tax purposes upon the transfer of a given percentage of the partnership interests, a corporation that continues to inhabit a single corporate shell continues to exist for federal tax purposes, independent of the identity of its shareholders or the composition of its assets.

The regulations require that, in order to qualify as an F reorganization, a transaction must result in a "mere change in identity, form, or place of organization of one corporation, however effected" (referred to as a "mere change").[23] A "mere change" can involve an actual or deemed transfer of property from one corporation to another but is only considered a "mere change" (and, therefore, a qualifying F reorganization) if six specific requirements are met. These requirements must all be met within the time period beginning with the date that the transferor corporation begins transferring (or is deemed to begin transferring) its assets (directly or indirectly) to the resulting corporation and ending on the date of the transferor corporation's complete liquidation for federal income tax purposes.[24] While the regulations use the terms "transferor corporation" and "resulting corporation" to refer to the two entities involved, this Portfolio substitutes the terms "Oldco" and "Newco," respectively.

The six requirements include:

- *Resulting corporation stock must be distributed in exchange for transferor corporation stock*: All of the stock of Newco, including stock issued before the transfer, must be distributed (or deemed distributed) in exchange for stock of Oldco (although a de minimis amount of Newco stock may be issued other than in respect of Oldco in order to

[17] F reorganizations were introduced by the Revenue Act of 1921. Pub. L. No. 67-98. As late as 1965, the F reorganization was referred to "as encompassing only the simplest and least significant of corporate changes." *Berghash v. Commissioner*, 43 T.C. 743, 752 (1965), *aff'd*, 361 F.2d 257 (2d Cir. 1966). In the mid-1960s, however, the IRS began to use the F reorganization in its attack on liquidation-reincorporation transactions. Once the IRS had initiated the use of the F reorganization in nontraditional areas, the courts were quick to expand the scope of the F reorganization to include combinations of multiple operating corporations. However, in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Congress again amended the definition of F reorganizations by adding the phrase "of one corporation" to the statutory definition. *See* Pub. L. No. 97-248, §225. This provision was not contained in either the House or Senate version of TEFRA and only was added to the bill by the Conference Committee. Although the legislative history for this provision is limited, it appears to have been a response to the IRS's concerns about the possible application of certain ancillary benefits of the F reorganization — in particular, the ability to carry back post-reorganization net operating losses to pre-reorganization tax years — to an amalgamation of several taxpayer corporations. *See* Staff of the J. Comm. on Tax'n, *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982*, JCS-38-82, at 141 (1982).

[18] *See* H.R. Rep. No. 97-760, at 530, 540–41 (1982) (Conf. Rep.).

[19] Reg. §1.368-2(m)(1)(iii).

[20] *See* Reg. §1.368-2(m)(4), *Ex.* 4.

[21] T.D. 9739, 80 Fed. Reg. 56,904 (Sept. 21, 2015).

[22] Preamble to T.D. 9739, 80 Fed. Reg. at 56,905.

[23] Reg. §1.368-2(m)(1).

[24] Reg. §1.368-2(m)(1).

ISBN 978-1-63359-255-1

facilitate the organization of Newco or maintain its legal existence).[25]

• *Identity of stock ownership*: The same persons must own all of the Oldco and Newco stock in identical proportions. The regulations permit the Newco and Oldco stock to have different terms and also permit distributions of money or other property from either corporation, whether or not those distribution are in exchange for stock in either corporation.[26]

• *Prior assets or attributes of resulting corporation*: Newco may not hold any property or have any tax attributes before the potential F reorganization. The regulations allow Newco to hold or to have held a nominal amount of assets to facilitate its organization or preserve its existence and Newco can have tax attributes related to those assets. In addition, to accommodate transactions involving the refinancing of debt or the leveraged redemption of shareholders, the regulations provide that this requirement would not be violated if, before the transfer, the resulting corporation holds the proceeds of borrowings undertaken in connection with the transaction.[27]

• *Liquidation of transferor corporation*: Oldco must liquidate completely in the transaction. As is the case in the liquidation provisions generally, dissolution of the entity's legal existence is not absolutely required. In addition, Oldco may retain a de minimis amount of assets for the sole purpose of preserving its legal existence.[28]

• *Resulting corporation is the only acquiring corporation*: Immediately after the potential F reorganization, no corporation other than Newco may hold property that was held by Oldco immediately before the potential F reorganization, if such other corporation would, as a result, succeed to tax attributes under §381(c).[29]

• *Transferor corporation is the only acquired corporation*: Immediately after the potential F reorganization, Newco may not hold property acquired from a corporation other than Oldco if, as a result, Newco would inherit tax attributes of the other corporation under §381(c).[30]

Despite the fairly strict requirements enumerated above, the regulations take a very liberal approach to redemptions and other distributions occurring in the course of a potential F reorganization. Specifically, the regulations provide that a mere change may occur even if a holder of stock in Newco receives a distribution of cash or other property from either Newco or Oldco (whether or not in exchange for its shares).[31] The receipt of money or other property (including any exchanged for shares in a redemption), is treated as an unrelated, separate transaction from the F reorganization.[32] This is true regardless of whether the distribution is connected to the reorganization in any formal sense.[33] Thus, a redemption of less than 100% of the stock is permissible, while an infusion of new equity occurring during the potential F reorganization will likely disqualify the transaction from F reorganization treatment.[34]

The regulations' liberal distribution requirement effectively eliminates the need under prior law for a de minimis redemption exception to the "identity of shareholder" requirement, for example, in a case in which an F reorganization effected pursuant to a statutory merger involves a less-than-1% group of shareholders that dissent and, consequently, have their shares redeemed for cash.[35]

Under the law in effect before the regulations, the IRS applied to F reorganizations an "identity of shareholders" and "identity of assets" requirement.[36] The regulations have retained an identity of shareholders requirement, though the regulations liberally allow changes to the capital structure of Newco compared to that of Oldco, so that, for example, an Oldco common shareholder can receive preferred stock in Newco; this essentially allows a recapitalization to occur contemporaneous with the F reorganization.[37] As noted above, the identity of assets/shareholder requirement is also diluted by the fact that the regulations apparently allow an unlimited amount of distributions of corporate assets to shareholders, whether pro rata or in disproportionate redemption of shareholders; any distributions are treated separately from the reorganization, which is to say, not viewed under §356 but under §301 or §302.[38]

The regulations do not contain an identity of assets requirement, but only a prohibition on Newco holding any but de minimis assets other than those acquired from Oldco in the reorganization.[39] It is paradoxical that the D reorganization rules include (by statute) a requirement that substantially all of the transferor's assets be transferred to the transferee,[40] while the F reorganization rules, which are overall looking for complete identity between Oldco and Newco, do not.

Both in the regulations and under prior law, little light is shed on what, if anything, needs to happen to liabilities of Oldco in a putative F reorganization. In the normal course, such as in a merger or conversion, all liabilities continue from Oldco to Newco. But what if Oldco transfers all of its assets and a portion of its liabilities to Newco in exchange for Newco stock, retaining certain liabilities, and liquidates pursuant to the plan, thereby having Oldco's shareholder(s) assume those liabilities?

---

[25] Reg. §1.368-2(m)(1)(i).

[26] Reg. §1.368-2(m)(1)(ii).

[27] Reg. §1.368-2(m)(1)(iii).

[28] Reg. §1.368-2(m)(1)(iv). In an unusual reversal of the typical liquidation facts, PLR 200835002 held that even though Oldco had been dissolved as a result of its failure to file its doing business registration, it would be considered an ongoing corporation before its merger into Newco in a qualifying F reorganization. While predating the promulgation of regulations, there is no reason to consider them as changing the result in this unusual fact pattern.

[29] Reg. §1.368-2(m)(1)(v).

[30] Reg. §1.368-2(m)(1)(vi).

[31] Reg. §1.368-2(m)(1)(ii).

[32] Reg. §1.368-2(m)(3)(iii).

[33] Reg. §1.368-2(m)(3)(iii).

[34] *See* Reg. §1.368-2(m)(1)(ii), §1.368-2(m)(3)(iii), §1.368-2(m)(4) *Exs.* 1 and 2.

[35] *See* Rev. Rul. 66-284, *obsoleted by* T.D. 9739.

[36] *See, e.g.,* Rev. Rul. 58-422 (indicating that the F reorganization is available in cases "where there is no change in the existing stockholders or change in the assets of the corporations involved"); *see also* Rev. Rul. 66-284 (allowing "a de minimis change in the corporation's shareholders and its assets"). Both rulings were obsoleted by the promulgation of the final regulations in T.D. 9739.

[37] Reg. §1.368-2(m)(1)(ii).

[38] Reg. §1.368-2(m)(1)(ii), §1.368-2(m)(3)(iii) (not incorporating Reg. §1.368-1(e)).

[39] Reg. §1.368-2(m)(1)(iii).

[40] §354(b)(1).

ISBN 978-1-63359-255-1

On its face at least, this does not appear to run afoul of any of the requirements in the regulations. However, it may be argued that this transaction would fail to meet the first requirement, that all the stock of Newco must be distributed in exchange for stock of Oldco.[41] If the Oldco shareholders assume a liability in connection with the liquidation of Oldco, they would presumably be viewed as "purchasing" some of the Newco shares in exchange for the assumption of that Oldco liability, arguably failing to satisfy the regulations. The fact that Oldco assets can be retained and distributed to shareholders but liability "retention" may be problematic is an illustration of the inexplicable disparity between distributions and contributions.

3. *Absence of Continuity of Interest and Continuity of Business Enterprise Requirements*

A judicially created doctrine incorporated into law through regulations and applicable to most reorganizations is the "continuity of proprietary interest," or simply, "continuity of interest," requirement, which requires that the former shareholders of the target corporation acquire a substantial continuing proprietary interest in the issuing corporation.[42] However, regulations provide that the continuity of interest requirement does not apply to an F reorganization.[43]

An F reorganization is treated for most purposes of the Code as if the reorganized corporation were the same entity as the corporation in existence before the reorganization. The IRS and Treasury, in considering whether continuity of interest should be a requirement for an F reorganization, concluded that because F reorganizations involve only the slightest change in a corporation and do not resemble sales, applying such requirement to transactions that would otherwise qualify as F reorganizations is not necessary to protect the policies underlying the reorganization provisions.[44]

It is important to note that although the continuity of interest doctrine does not apply to F reorganizations as a separate judicial doctrine, the regulations impose requirements that must be met in order for a transaction or series of transactions to qualify as an F reorganization (a "mere change"), as discussed in II.A.2., above. One of these requirements is that all the stock of Newco, including stock issued before the transfer, be distributed (or deemed distributed) in exchange for stock of Oldco.[45] In addition, the same persons must own all of the stock of Newco and Oldco in identical proportions.[46] Thus, there can be no change in the ownership of the corporation in the transaction, except a change that has no effect other than that of a redemption of less than all the shares of the corporation. These two requirements reflect the Supreme Court's holding in *Helvering v. Southwest Consolidated Corp.*[47] that a transaction that shifts the ownership of the proprietary interests in a corporation cannot be a mere change. These requirements would prevent a transaction that involves the introduction of a new shareholder or new capital into the corporation from qualifying as an F reorganization.

In addition, under the regulations, the continuity of business enterprise requirement, which requires that the issuing corporation either continue the target's historic business or use a significant portion of the target's historic business assets in a business,[48] does not apply to an F reorganization.[49] The reasoning behind the elimination of this requirement for F reorganizations is the same as the reasoning behind eliminating the continuity of interest requirement, as discussed above.[50]

4. *Related Transactions*

a. *Current Rules*

Equally important to the enumeration of the above specific requirements, the regulations put to rest a long-vexing dilemma in the F reorganization area, namely, determining when and how to apply step transaction principles to qualify, or disqualify, an F reorganization. More specifically, the regulations seek to reconcile an apparent paradox that developed in the area: while steps in a plan of reorganization intended to bring about a "mere change" are routinely integrated, an F reorganization occurring as part of a series of steps in a larger transaction will tend to be separated out from the larger transaction. The regulations adopt the metaphor of an "F in a bubble" to explain the approach. Reading the words "however effected" in the statute to provide wide latitude in determining how to bring about the "mere change" reorganization, the preamble explains that the regulations circumscribe those steps and analyze them collectively as a "potential F reorganization."[51] Transactions that may occur before or after those potential F reorganization steps will generally not be taken into account in determining whether there is an F reorganization, and the F reorganization steps will not impact the treatment of the larger transaction. There will, however, be instances in which a potential F reorganization will qualify both as an F reorganization and as a reorganization or part of a reorganization under another provision of §368(a)(1). If this is the case, there are special rules that apply to determine if the potential F reorganization qualifies under §368(a)(1)(F).

Specifically, the regulations provide that a series of related transactions that together result in a mere change (as defined in Reg. §1.368-2(m)(1)) may qualify as an F reorganization regardless of whether or not certain steps in the series, when

---

[41] Reg. §1.368-2(m)(1)(i).

[42] Reg. §1.368-1(e). For further discussion of the continuity of interest requirement in general, see 771 T.M., *Corporate Acquisitions — (A), (B), and (C) Reorganizations*, and 772 T.M., *Corporate Acquisitions — D Reorganizations.*

[43] Reg. §1.368-1(b), §1.368-2(m)(2).

[44] *See* Preamble to REG-106889-04, 69 Fed. Reg. 49,836, 49,837 (Aug. 12, 2004).

[45] Reg. §1.368-2(m)(1)(i). A de minimis amount of stock of Newco may be issued other than in respect of stock of Oldco to facilitate the organization of Newco or maintain its legal existence. *Id.*

[46] Reg. §1.368-2(m)(1)(ii), applicable to transactions occurring on or after September 21, 2015. The regulations permit the stock to have different terms and also permit distributions of money or other property from either corporation, whether or not those distribution are in exchange for stock in either corporation. *Id.*

[47] 315 U.S. 194 (1942).

[48] Reg. §1.368-1(d). For additional discussion of the continuity of business enterprise requirement in general, see 771 T.M., *Corporate Acquisitions — (A), (B), and (C) Reorganizations*, and 772 T.M., *Corporate Acquisitions — D Reorganizations.*

[49] Reg. §1.368-1(b), §1.368-2(m)(2).

[50] *See* Preamble to REG-106889-04, 69 Fed. Reg. at 49,837 (citing T.D. 9182, 70 Fed. Reg. 9219).

[51] Preamble to T.D. 9739, 80 Fed. Reg. at 56,909–10.

ISBN 978-1-63359-255-1

viewed in isolation, could be subject to other Code provisions (e.g., §304(a), §331, §332, or §351).[52]

This approach — that a series of steps comprising a single plan to accomplish a "mere change" is integrated — is not new and is a largely unremarkable proposition. Thus, for example, the formation of a Newco in another state followed by the merger of Oldco into it, would be regarded in an integrated manner as a reincorporation of Oldco into another state qualifying as an F reorganization.[53] The regulations contain several other examples of groups of steps that have the purpose of effectuating a change of jurisdiction or form of an entity.

> *Example:* Corporation P owns all of the stock of S, a State A corporation. In order to change S into a State A limited partnership, P contributes one percent of S to a newly formed, wholly owned LLC, which is treated as a disregarded entity for federal income tax purposes. S then converts from a State A corporation to a State A limited partnership, which elects to be treated as a corporation for federal income tax purposes. The regulations treat the steps as an F reorganization of S.[54]

In addition, a potential F reorganization could occur before, within, or after other transactions that effect more than a mere change (in other words, the mere change could occur within a larger transaction) even if Newco has only transitory existence. In that case, the regulations provide that related events that precede or follow the potential F reorganization generally will not cause that potential F reorganization to fail to qualify as an F reorganization and the fact that it does qualify will not affect the character of the other transactions that occur.[55] The step transaction doctrine can be applied to the other transactions without regard to whether certain of the steps qualify as a reorganization or part of a reorganization under §368(a)(1)(F).[56]

> *Example:* Parent wishes to sell the stock of its wholly owned subsidiary, Oldco, and to change Oldco's state of incorporation. Parent forms Newco in the new state and merges Oldco into Newco. Immediately thereafter, P sells all of the Newco stock to an unrelated party. The merger of Oldco into Newco qualifies as an F reorganization under the regulations. Under Reg. §1.368-2(m)(3)(ii), the post-transaction stock sale does not cause the potential F reorganization to fail to qualify under §368(a)(1)(F). The sale is disregarded for purposes of determining whether the merger is a mere change.[57]

While the regulations permit even significant changes in stock ownership resulting from a redemption or post-reorganization shareholder sales (as illustrated in the example above), they do not permit changes via primary issuance of shares by the corporation.

> *Example:* Compare the same fact pattern as the preceding example, except that the transaction is effectuated by Parent forming Newco, initially acquiring all of the Newco stock in exchange for an infusion of cash, followed by a merger of Oldco into Newco, with Parent receiving cash and 10% of the Newco stock. Though the result and purpose are the same as in the preceding example, this one runs afoul of the definitional requirements of an F reorganization under the regulations. Under Reg. §1.368-2(m)(1)(i), all stock in Newco, "including stock issued before the potential F reorganization," must be issued in respect of stock of Oldco, and, under Reg. §1.368-2(m)(1)(ii), the same persons must own all of the stock of Oldco and of Newco in identical proportions. Under the model chosen for the regulations, the virtues of clarity as to the boundaries of the F reorganization and other transactions outweigh the appeal of being able to distill from steps not on their face qualifying for F reorganization treatment a transaction that would so qualify.

The regulations also provide rules for determining the characterization of transactions that could qualify as an F reorganization and also qualify under other provisions of §368(a)(1) (overlapping qualifications). The regulations provide that if a potential F reorganization or a step that occurs as part of a potential F reorganization qualifies as a reorganization or a part of a reorganization under another provision of §368(a)(1) *and* if a corporation in control of Newco is a party to that other reorganization, the potential F reorganization will not qualify as a reorganization under §368(a)(1)(F).[58] If this provision does not apply and the potential F reorganization would qualify as both a reorganization under §368(a)(1)(F) and a reorganization under §368(a)(1)(A), §368(a)(1)(C) or §368(a)(1)(D), the potential F reorganization will qualify only under §368(a)(1)(F).[59]

> *Example:* P corporation acquires all of the stock of unrelated T corporation for 50% cash and 50% P stock. Immediately thereafter, pursuant to an integrated plan, P causes T to merge into S, a newly formed, wholly owned subsidiary of P, with S as the surviving corporation. As an exception to the "in a bubble" approach, here the acquisition of T stock by P and subsequent merger of T into S are integrated to treat the entire series of steps as a reorganization under §368(a)(1)(A) and §368(a)(2)(D) (i.e., a forward triangular merger), instead of a taxable purchase of T stock by P followed by an F reorganization of T into S. Under the step transaction doctrine, P's transitory ownership of T stock is disregarded and the transaction is treated as a statutory merger of T into S in exchange for 50% cash and 50% P stock (and S's assumption of T's liabilities). P, the corporation in control of S, is a party to the reorganization such that the transfer of property from T to S does not

[52] Reg. §1.368-2(m)(3)(i).

[53] *See, e.g.*, Reg. §1.368-2(m)(4) *Ex.* 5; Rev. Rul. 80-168; Rev. Rul. 64-250.

[54] Reg. §1.368-2(m)(4) *Ex.* 8.

[55] Reg. §1.368-2(m)(3)(ii).

[56] Reg. §1.368-2(m)(3)(ii).

[57] Reg. §1.368-2(m)(4) *Ex.* 6. The example provides that the result would be the same if, instead of Newco's stock being sold by Parent, Newco merged into a previously unrelated corporation and terminated its separate existence. *Id.*

[58] Reg. §1.368-2(m)(3)(iv)(A).

[59] Reg. §1.368-2(m)(3)(iv)(B).

ISBN 978-1-63359-255-1

qualify as an F reorganization under Reg. §1.368-2(m)(3)(iv)(A).[60]

This approach reflects a decided and pervasive bias on the part of the IRS to find a reorganization rather than a taxable transaction, if the former can be comfortably accommodated by reference to well-established step transaction principles. This approach, not unique to the F reorganization context, is articulated in a series of published rulings.[61] Thus, in the above example, separating the acquisition of the T stock by P from the subsequent merger would result in P's stock acquisition being taxable to the former T shareholders. Under established step transaction principles, the two steps are instead treated as a single acquisitive reorganization.[62]

b. Transactions Before September 21, 2015

As discussed above, the regulations issued under §368 provide guidance on the application of the step transaction doctrine to F reorganizations. before the issuance of those regulations, in Rev. Rul. 96-29, the IRS ruled that an F reorganization could occur in conjunction with other transactions that went beyond a mere change. Specifically, the IRS ruled that a reincorporation qualified as an F reorganization even though it was a step in a transaction in which the reincorporated entity issued common stock in a public offering and redeemed stock having a value of 40% of the aggregate value of its outstanding stock before the offering. In the same ruling, the IRS ruled that a reincorporation of a corporation in another state qualified as an F reorganization even though it was a step in a transaction in which the reincorporated entity acquired the business of another entity.

In Rev. Rul. 2003-48,[63] the IRS continued to analyze F reorganizations separately from other, connected transactions — this time in the context of conversions of mutual banks to stock banks. As part of an integrated business plan to convert a mutual bank to a stock bank and create a holding company structure, the following transactions occurred in Rev. Rul. 2003-48: (1) the mutual bank incorporated a mutual holding company; (2) the mutual holding company, in turn, incorporated two wholly owned subsidiaries, a stock holding company and a transitory corporation; (3) the mutual bank exchanged its mutual bank charter for a stock savings bank charter; (4) the transitory corporation merged into the stock bank, with the stock bank surviving as a wholly owned subsidiary of the mutual holding company and the mutual bank's members receiving mutual holding company membership interests in place of their mutual bank interests; (5) the mutual holding company transferred all of its stock bank stock to the stock holding company in exchange for voting stock of the stock holding company; and (6) the stock holding company made a public offering of its common stock. Citing Rev. Rul. 96-29, the IRS ruled that neither the transfer of stock bank stock to the stock holding company (transaction 5) nor the stock offering (transaction 6) prevented the conversion itself (transaction 3) from qualifying as an F reorganization.

Note, however, that Rev. Rul. 96-29 did not overrule decisions of courts that had declined to find an F reorganization because of significant changes to the corporation or its shareholders in connection with the transaction, particularly if there had been a shift in proprietary interest.[64]

c. Related Transactions in the Bubble

The way in which the regulations draw a bright line between the steps comprising the F reorganization (in the bubble) and absolutely anything that occurs before or after (outside the bubble) is a nearly unmitigated blessing for tax planners, because it substantially eliminates any concerns about the ability to comfortably insert an F reorganization in the middle of transactions that would potentially disqualify the reorganization. However, there is a flipside to the approach in the regulations, particularly, the otherwise strict requirements for an F reorganization coupled with the approach to related transactions that seems to change some prior law in which an F reorganization is plucked out from simultaneous transactions. There are times when several transaction steps are occurring and although you "know in your bones" that there is an F reorganization in there, the fact that there is a disqualifying related fact occurring between steps of the F reorganization prevents you from identifying the F reorganization.

One example of a prior F reorganization ruling disqualified under the regulations is Rev. Rul. 61-156. That ruling involved a "liquidation-reincorporation" transaction in which Oldco adopted a plan of liquidation and sold all of its assets to Newco for cash, notes, and 45% of Newco's stock, the remaining 55% of which was issued for cash in a public offering. The ruling held that the transaction was an F reorganization of Oldco to Newco, and the IPO of Newco, even though occurring before or simultaneously with the other steps should be viewed as unrelated to the valid F reorganization. This transaction would be disqualified from F reorganization treatment under the regulations. At a minimum, this transaction violates the identity of stock ownership requirement of Reg. §1.368-2(m)(1)(ii), the requirement in Reg. §1.368-2(m)(1)(i) that immediately after the putative reorganization all of the Newco stock must be distributed to the Oldco shareholders, and the prohibition in Reg. §1.368-2(m)(1)(iii) that Newco hold any assets before the reorganization.

[60] *See* Reg. §1.368-2(m)(4) *Ex.* 13.

[61] *See* Rev. Rul. 2008-25; Rev. Rul. 2001-46; Rev. Rul. 2001-26.

[62] *See also J.E. Seagram Corp. v. Commissioner*, 104 T.C. 75 (1995); *King Enters., Inc. v. United States*, 418 F.2d 511 (Ct. Cl. 1969).

[63] *See also* CCA 201340016 (citing Rev. Rul. 96-29 in advising that taxpayer's multiple reorganizations of its foreign subsidiaries under §368(a)(1)(F) and §368(a)(1)(C) should not be stepped together notwithstanding their closeness in proximity); PLR 201322008 (cash distribution and downstream merger did not preclude conversion of stock insurance company to reciprocal insurer from qualifying as F reorganization, citing Rev. Rul. 96-29); PLR 201250004 (citing Rev. Rul. 96-29, implementation of proposed transaction, after completed reincorporation that resulted in F reorganization, will not preclude reincorporation from qualifying as F reorganization); PLR 201115016 (citing Rev. Rul. 96-29, sale of OldCo stock to a third-party purchaser did not affect the treatment of a transaction between OldCo and NewCo as an F reorganization); PLR 200937005 (citing Rev. Rul. 96-29, multistep transaction proposed by parent (O) of consolidated group, by which O will transfer its assets to newly formed holding company (H) in exchange for H's stock and distribute that stock to shareholders in liquidation, will constitute F reorganization); PLR 200825031 (citing Rev. Rul. 96-29, foreign parent's proposed foreign separation transaction to separate business lines results in F reorganization).

[64] *See Helvering v. Sw. Consol. Corp.*, 315 U.S. 194 (1942); *Berghash v. Commissioner*, 43 T.C. 743 (1965), *aff'd*, 361 F.2d 257 (2d Cir. 1966).

ISBN 978-1-63359-255-1

A fact pattern that has arisen more than once in the author's experience illustrates how delineating the bubble can sometimes be a challenge.

Example: Two or more shareholders (the Shareholders) own the shares of Parent, a "checkable entity" that is a corporation for U.S. tax purposes, and Parent's sole asset is all of the equity in Sub, which is a disregarded entity for U.S. tax purposes. For valid business reasons, an entity classification election is made to treat Sub as a corporation, following which an election is made to treat Parent as a pass-through entity for U.S. tax purposes. From a tax standpoint, the steps are viewed as Parent corporation transferring all of its assets to newly formed Sub corporation in exchange for all of Sub's stock, followed by Parent's distribution of the Sub stock in liquidation of Parent.[65] Because Parent is a pass-through entity with more than one owner, it is treated as a partnership for U.S. tax purposes.[66] While the form may be somewhat ambiguous as to exactly when the partnership arises as owner of the Sub/Newco stock, it seems reasonably clear that the Parent shareholders should be viewed as receiving the Sub stock in the F reorganization and immediately contributing it to the new Parent partnership.[67] Thus, the partnership contribution occurs outside the bubble.[68]

B. Specific Types of F Reorganizations

1. Single-Entity Transactions

The early cases and rulings involving F reorganizations dealt with formalistic changes in the structure of a "single" corporation. For instance, the IRS ruled that F reorganizations include the amendment of a corporate charter, a change of corporate name, an exchange of new stock certificates for old certificates,[69] and a corporation's surrender of its special charter when the corporation continued to exist under a state's general corporate law.[70]

Practice Point: In the above rulings, it is questionable whether reorganization status, although conferred on the transaction, in fact alters the tax treatment of either the corporation or its shareholders. Absent an actual or constructive transfer of corporate assets from one entity to another, the various nonrecognition, carryover of basis and tax attributes consequences are largely irrelevant. Likewise, only if the shareholders or security holders undergo an exchange of old instruments for new instruments will reorganization status be determinative of their tax treatment. In this regard, note, however, that a constructive exchange of debt securities may occur where there is a modification of one or more of the terms.[71]

2. Reincorporations

Perhaps the most common type of F reorganization involves the reincorporation of a corporation in the same or a different state.[72] A reincorporation can be accomplished by:

- a merger of the transferor Oldco corporation into the transferee Newco corporation under state law;[73]
- a transfer by the Oldco shareholders of their Oldco stock to Newco in exchange for the newly issued stock of Newco, followed by a liquidation of Oldco into Newco;[74] or
- a transfer by Oldco of all of its properties to Newco in exchange for the newly issued Newco stock, followed by a distribution of the Newco shares by Oldco to its shareholders in liquidation.[75]

A change of state of incorporation may also be accomplished under a reincorporation statute, pursuant to which a corporation's status as a State X corporation is, by operation of law, converted to that of a State Y corporation upon the filing of a certificate of reincorporation.[76] Irrespective of the formal steps taken to effect the transaction, all reincorporations are treated in the same manner for tax purposes.

Note: Reincorporations involving jurisdictions outside the United States have always been considered differently from purely domestic transactions. For information on inbound and outbound F reorganizations, see the discussion of cross-border F reorganizations in VII., below.

---

[65] *See* Reg. §301.7701-3(g)(1)(ii), §301.7701-3(g)(1)(iv).

[66] *See* Reg. §301.7701-3(a).

[67] *See* Reg. §301.7701-3(g)(1)(ii).

[68] It is not necessarily the case that a partnership contribution somewhere in the middle of the F reorganization steps should be a disqualifier, but there is significant motivation to keep the table as clean as possible for the steps comprising the F reorganization.

[69] Rev. Rul. 66-171, *declared obsolete on other grounds by* Rev. Rul. 78-381. *See also* Rev. Rul. 72-206.

[70] Rev. Rul. 54-269.

[71] *See* Reg. §1.1001-3; *see, e.g.,* Rev. Rul. 87-19 (a waiver of certain interest on an obligation was held to result in a significant modification and, therefore, a constructive exchange of an old obligation for a new obligation). *Compare* Rev. Rul. 73-160 (extension of maturity and execution of subordination agreements was not material modification). For a discussion of the factors determining whether modifications to the terms of a debt instrument will be deemed materially significant and, therefore, result in a deemed exchange, see 541 T.M., *Tax Aspects of Restructuring Financially Troubled Businesses*, at III. For further discussion, see V.D.2., below.

[72] *Newmarket Mfg. Co. v. United States*, 233 F.2d 493 (1st Cir. 1956); *Ahles Realty Corp. v. Commissioner*, 71 F.2d 150 (2d Cir. 1934) (same state); *George Whittell & Co. v. Commissioner*, 34 B.T.A. 1070 (1936), nonacq., 1937-1 C.B. 53; *Dunlap & Assoc., Inc. v. Commissioner*, 47 T.C. 542 (1967); Rev. Rul. 57-276. *See also Assocs., Inc. v. Commissioner*, 47 T.C. 542 (1967); Rev. Rul. 57-276. In PLR 202031002, pursuant to an F reorganization, the taxpayer was domesticating to another state. The taxpayer's plan of reorganization called for domestication to a certain state, but the taxpayer actually reincorporated in a different state (because domestication to the originally designated state was not allowed). The IRS ruled that the reincorporation qualified as an F reorganization despite the midstream change in the plan of reorganization.

[73] *See* Reg. §1.368-2(m)(4) *Ex.* 2; *Newmarket Mfg. Co. v. United States*, 233 F.2d 493 (1st Cir. 1956); *Dunlap & Assocs., Inc. v. Commissioner*, 47 T.C. 542 (1967); Rev. Rul. 57-276.

[74] *George Whittell & Co. v. Commissioner*, 34 B.T.A. 1070 (1936), nonacq., 1937-1 C.B. 53. For a variation on this type of reincorporation, in the S corporation context, see PLR 200320013 (S corporation Oldco incorporated Newco, which incorporated Merger Sub; Merger Sub merged into Oldco, with Oldco surviving; 100% shareholder of Oldco became 100% shareholder of Newco; Newco made S corporation election for itself and qualified subchapter S subsidiary (QSub) election for Oldco, which was, thus, disregarded entity for tax purposes).

[75] *Ahles Realty Corp. v. Commissioner*, 71 F.2d 150 (2d Cir. 1934).

[76] For an example of such a reincorporation statute, see Del. Code Ann. tit. 8, §265.

ISBN 978-1-63359-255-1

3. *Changes in Form of Business Organization*

A change in form of organization from a corporation to a business trust, taxable as a corporation, and from a business trust to a corporation, have been approved as F reorganizations.[77] Further, the IRS ruled in PLR 8551017 and PLR 8448080 that changes from a national banking association to a state banking association, and from a joint stock company to a professional association, were F reorganizations. The IRS ruled that a foreign corporation's amendment of its articles of association to change from a public to a private or limited company and its shareholders' exchange of their stock certificates for registered shares or quotas constituted an F reorganization.[78] In addition, the conversion of a corporation to a limited partnership that elects to be treated as a corporation for tax purposes may qualify as an F reorganization.[79] The IRS also ruled, in PLR 200839017, that the conversion of an S corporation to an LLC, followed by an election to be treated as an association taxable as a corporation, will qualify as an F reorganization.

Although the IRS also ruled that the conversion of a for-profit corporation to a nonprofit corporation may qualify as an F reorganization,[80] the regulations under §337(d) generally provide that gain is recognized on a transfer of assets from a taxable to a tax-exempt entity.[81] For this purpose, the change in tax status of a corporation will be treated as a constructive transfer of all of its assets to a new tax-exempt entity as if the assets were sold at fair market value.[82] As a result, while it technically may be accurate to conclude that the conversion from taxable to tax-exempt status qualifies as an F reorganization, the nonrecognition ordinarily enjoyed under §361 is overridden by the §337(d) regulation.[83]

Practice Point: In many of these situations involving a change in the form of organization, the classification of both entities as corporations under §7701(a)(3) is crucial. If a corporation is converted into an entity not treated as a corporation for tax purposes, the transaction ordinarily will be treated as a liquidation of the Oldco corporation, rather than a reorganization. In the context of a non-U.S. entity, other than *per se* entities identified in the entity classification regulations,[84] it is not always clear whether an entity will default to classification as a corporation for U.S. tax purposes.[85] Accordingly, a check-the-box election can be filed to obtain certainty.

The preamble to the final regulations states that:

> [c]ertain entities may be treated as corporations for federal tax purposes even though they do not have owners that could be treated as shareholders for federal tax purposes to whom the profits of the corporation would inure (for example, some charitable organizations described in section 501(c)(3)). Nevertheless, these entities may be able to engage in corporate reorganizations. Thus, no inference should be drawn from the use of the terms 'stock' or 'shareholders' … .[86]

One particular type of change-of-form F reorganization that became prevalent and important during the 1980s is the conversion of a mutual savings and loan association into a stock savings and loan association.[87] This type of transaction is discussed in detail in VI., below.

4. *Transactions Involving Disregarded Entities*

Under a well-established principle in the reorganization area, if shareholders transfer 100% of T corporation stock to P corporation in exchange for qualifying reorganization consideration — for example, solely T voting stock — and pursuant to the plan of reorganization, T is completely liquidated, the steps are integrated and treated as an asset reorganization in which T has transferred all of its assets to P in exchange for the acquisition consideration and assumption of the T liabilities, followed by T's distribution of the acquisition consideration to its shareholders in liquidation. In Rev. Rul. 67-274, the IRS ruled that this transaction qualified as a reorganization under §368(a)(1)(C).[88]

Pursuant to the regulations which apply to determine the classification of an entity for federal tax purposes, domestic and foreign business entities other than per se corporate entities may be treated either as corporations or as pass-through entities based on an effective "check-the-box" election filed by the taxpayer.[89] When such an eligible entity is treated as a pass-through and has only a single equity owner, it is treated as entirely disregarded as separate from its owner for federal income tax purposes (i.e., a disregarded entity).[90] These check-the-box regulations have given rise to myriad domestic and international planning techniques involving disregarded entities. Outlined below are a few that directly involve F reorganizations.

a. *Foreign Disregarded Entity*

FC1 is a German GmbH that is treated as a corporation for U.S. income tax purposes. For valid business reasons, USP, the sole shareholder of FC1, transfers all of its FC1 shares to newly formed FC2, a wholly owned Dutch BV that will be treat-

---

[77] *See* Rev. Rul. 70-241, Rev. Rul. 67-376; PLR 200209049, PLR 8517053.

[78] Rev. Rul. 79-150; Rev. Rul. 72-420, *declared obsolete on other grounds by* Rev. Rul. 78-381.

[79] PLR 200335019. *See also* PLR 200750009 (merger of subsidiary into common parent of consolidated group, together with immediately subsequent conversion of parent into LLC wholly owned by corporation of which parent was sole shareholder and that wholly owned subsidiary, was F reorganization), PLR 200505010, PLR 200450012. *See also* FSA 200237017.

[80] *See, e.g.*, PLR 9044074. The ruling noted, however, that any finding that the corporation is tax-exempt under §501(c)(7) had to await a conclusion in regulations to be promulgated under §337(d) (concerning the avoidance of the repeal of the *General Utilities* doctrine in the Tax Reform Act of 1986) that such status may be obtained without a recognition of corporate-level gain at the time of conversion. *See also* PLR 199935034, PLR 9545014 (conversion of nonprofit, nonstock entity to for-profit, stock corporation qualifies as E reorganization).

[81] Reg. §1.337(d)-4(a)(1).

[82] Reg. §1.337(d)-4(a)(2).

[83] *See* Reg. §1.337(d)-4.

[84] Reg. §301.7701-2(b) generally defines the term "corporation" for federal tax purposes and includes a list of foreign business entities that are *per se* corporations.

[85] *See* Reg. §301.7701-3.

[86] *See* Preamble to T.D. 9739, 80 Fed. Reg. 56,904, 56,915 (Sept. 21, 2015), corrected, 80 Fed. Reg. 76,205 (Dec. 18, 2015).

[87] *See* Rev. Rul. 80-105; *see also* Rev. Rul. 2003-48.

[88] *See also* Rev. Rul. 2008-25, Rev. Rul. 2004-83.

[89] *See* Reg. §301.7701-1 to §301.7701-3. For a detailed discussion of the check-the-box regulations, see the Worksheets, below, and 700 T.M., *Choice of Entity: Business and Tax Considerations.*

[90] Reg. §301.7701-3(a).

ISBN 978-1-63359-255-1

ed as a corporation for U.S. income tax purposes. As part of the plan, USP will elect to treat FC1 as a pass-through entity for U.S. income tax purposes (and, because FC1 has a single equity owner, it will be considered a disregarded entity). This transaction may qualify as an F reorganization in which FC1 is transformed, for U.S. income tax purposes, from a German corporation to a Dutch corporation.[91]

b. S Corporation Asset Sale

A traditional sticking point between buyers and sellers is whether a sale of stock or assets will take place. An offer to purchase stock often has a lower price associated with it because the buyer will not be able to obtain a fair market value tax basis for the assets inside the corporation (and stock is not depreciable for a buyer). Sellers, on the other hand, will realize higher after-tax cash proceeds if they are able to sell stock because two levels of tax are avoided if the corporation is a C corporation. Even if the target corporation is an S corporation, however, sellers like to dispose of their business as a whole, including latent liabilities, by selling stock and realizing capital gains tax rates on the transaction as a major selling objective as well.

The shareholders of a target S corporation have historically been able to sell their stock (highly desirable from the sellers' standpoint) by agreeing to make a §338(h)(10) election with the buyer, thereby providing the buyer with a fair market value basis in the assets.[92] A §338(h)(10) election causes a sale of S corporation stock to be treated as an asset sale for federal income tax purposes.[93] In such a transaction, sellers typically ask to be made "whole" from an economic standpoint because a deemed sale of assets pursuant to the §338(h)(10) election typically does not provide the sellers with 100% capital gain treatment, although oftentimes substantially all of the gain from such a sale may be capital gain related to appreciated intangible assets. It is commonplace for such sellers to experience higher than capital gains rates applicable to depreciation recapture items and cash basis accounts receivables. A §338(h)(10) election is effective, however, only if all selling shareholders agree to the treatment and if the target corporation has never inadvertently terminated its S corporation status.[94]

If a termination of the target's S corporation status has knowingly or even unknowingly occurred, the §338(h)(10) election will be ineffective and the buyer will not obtain a fair market value basis in the target's assets notwithstanding the filing of the §338(h)(10) election. This can be a significant risk for a buyer and the following paragraphs describe a common technique for avoiding this risk. This technique also provides the sellers with the exact same tax consequences as if they had sold their S corporation stock with a §338(h)(10) election (therefore, sellers will want to be made "whole" just as if a §338(h)(10) election had been required in the transaction).

Under this technique, the selling shareholders first create a new holding company (as a corporation under state law) and immediately transfer all of the stock of the target corporation to the new holding company in exchange for all of the stock of the new holding company.[95] A QSub election is made for the target corporation (now a wholly owned subsidiary of the new holding corporation). The target corporation (now a QSub) becomes a disregarded entity for federal income tax purposes.[96] This transaction should qualify as an F reorganization and should not trigger a taxable event. Rev. Rul. 64-250[97] provides that when an S corporation merges into a newly formed corporation that also meets the requirements of an S corporation in a transaction qualifying as an F reorganization, the S corporation election does not terminate. Thus, the S election remains in effect for the surviving corporation.[98] Additionally, Rev. Rul. 2008-18 describes two situations involving an F reorganization. Situation 1 is relevant in determining the procedures to follow when completing an F reorganization in connection with the current example. Situation 1 determines that the S corporation election for the target corporation continues for the new holding corporation specifically. Also, the target corporation (now a QSub) continues to retain its federal employer identification number (EIN) and the new holding corporation must obtain a new federal EIN.[99]

A timely QSub election (Form 8869) must be filed with the IRS to treat the target corporation as a QSub for federal income tax purposes owned 100% by a new holding company. Line 14 of Form 8869 should be checked "Yes" to indicate that the election is being made in combination with an F reorganization and Rev. Rul. 2008-18.[100] As indicated above, the new holding corporation will be an S corporation. A separate S corporation election is not required for the new holding corporation.[101] Situation 2 of Rev. Rul. 2008-18 contains another technique for undertaking this effort to position the target corporation as a QSub under a holding company taxed as an S corporation.

Thereafter, the target corporation (which is a QSub at this point) can either (i) file a state law certificate of conversion to become a limited liability company (if the state of incorporation has an appropriate conversion statute), or (ii) the new holding corporation can create a new limited liability company as a wholly owned entity which will be the surviving entity when the target corporation merges with and into this limited liability company.[102] Under either mechanism, the target corporation becomes a single-member limited liability company under state law. For federal income tax purposes, this transactional step is disregarded. That is, the target entity was a disregarded QSub before this step, and continues as a disregarded single-member limited liability company at the conclusion of this step.

---

[91] *See, e.g.*, PLR 200710003 (the desire to sell an interest in a foreign legal entity, while treating the transaction as an asset sale for U.S. income tax purposes, provided a sufficient business purpose), PLR 201115016 (addressing a QSub election in the context of an F reorganization).

[92] Reg. §1.338(h)(10)-1(c)(1), §1.338(h)(10)-1(d)(2).

[93] Reg. §1.338(h)(10)-1(d)(3).

[94] Reg. §1.338(h)(10)-1(c)(3). For a detailed discussion of the §338(h)(10) election, see 788 T.M., *Stock Purchases Treated as Asset Acquisitions — Section 338.*

[95] For diagrams illustrating this transaction, see the Worksheets.

[96] Reg. §1.1361-4(a)(1).

[97] *Amplified by* Rev. Rul. 2008-18.

[98] Rev. Rul. 64-250, *amplified by* Rev. Rul. 2008-18.

[99] Rev. Rul. 2008-18 (Situation 1).

[100] *See* Instructions to Form 8869.

[101] Rev. Rul. 2008-18 (Situation 1).

[102] For diagrams illustrating these options, see the Worksheets.

ISBN 978-1-63359-255-1

Practice Point: The target entity can retain its EIN through this transactional step.[103] Although not specifically required, it is common practice to send an EIN retention letter to the IRS informing the IRS that after an F reorganization, the entity was a QSub that then converted to a single-member limited liability company and is retaining its EIN. If the state does not allow conversions and requires the entity to re-register, the taxpayer is allowed to keep the EIN if it maintains the same structure.[104] The taxpayer should attach the certificate of conversion, if applicable, to the letter. It is not necessary to file Form 8832.[105]

As restructured, a buyer can now acquire the ownership interests of the target limited liability company. The buyer's acquisition of the limited liability company ownership interests of the target will be treated as a direct acquisition of assets for federal income tax purposes. The advantage to the buyer is that it will obtain a fair market value basis in the assets without the need to file a §338(h)(10) election, and irrespective of whether the target had previously suffered an event that terminated its S corporation election. Well-advised buyers will require target S corporations to undertake this technique as a measure of protection for the buyers to ensure their attainment of a fair market value tax basis in the assets acquired.

Another convenient use of this technique in an S corporation setting would be when a seller has one or more assets in the S corporation that are not supposed to be sold. As an example, assume that Target is an S corporation owned by individual A and wishes to sell its main business operations to Buyer. Both parties desire asset sale and purchase treatment. Target also owns real estate unrelated to the business. Accordingly, A transfers all of the Target stock to Newco in exchange for Newco stock. As a wholly owned subsidiary of Newco, Target becomes a QSub treated as disregarded for income tax purposes. Target distributes the unrelated real estate to Newco and Newco sells the Target shares to Buyer. This series of steps may be treated as an F reorganization of Target into Newco followed by the S corporation's sale of the assets of the business while retaining the real estate.[106]

c. Joint Venture

FP, a foreign corporation, owns US Sub, whose business is to be contributed to a joint venture structured as a partnership for U.S. tax purposes. FP would like to continue to own its interest in the joint venture through a U.S. subsidiary. In order to avoid difficulties in transferring the assets and liabilities of the U.S. business, FP transfers its stock in US Sub to new US Holdco and converts US Sub from a corporation to a LLC, which is treated as a disregarded entity for federal income tax purposes. These steps may be treated as an F reorganization of US Sub into US Holdco. US Holdco then transfers its interests in US Sub LLC to the new joint venture partnership.

d. Substitute for Corporate Spin-Off

FP, a foreign corporation, owns US1, a U.S. operating company that owns all of the stock of another U.S. operating company, US2. FP desires to have US1 and US2 as brother sister companies and for one reason or another, §355 may be unavailable. Accordingly, FP transfers its US1 shares to newly formed US Holdco and converts US1 to a LLC, which is treated as a disregarded entity for federal income tax purposes. US1 LLC then distributes its shares in US2 to US Holdco. The transfer of US1 stock to US Holdco followed by the conversion of US1 to a LLC may qualify as an F reorganization of US1 into US Holdco. The distribution of US2 stock would be disregarded for federal income tax purposes.

C. Business Purpose

In addition to complying with express statutory requirements, certain reorganizations also must meet the requirements of judicially imposed doctrines before the transaction can qualify for tax-free treatment. One such requirement, the "business purpose" doctrine, was established in *Gregory v. Helvering*[107] and is now codified in the regulations.[108] In the context of a reorganization, the business purpose doctrine requires that, in order to be tax-free, a transaction must have a bona fide business purpose other than the avoidance of tax. Ordinarily, the burden is on the taxpayer to prove the business purpose.

The IRS may assert the business purpose doctrine to strike down purported reorganizations if the motive is found to be tax avoidance.[109] However, the existence of a tax motive for a transaction does not necessarily mean that the business purpose doctrine has been violated. In CCA 201340016, the IRS specifically stated that the business purpose doctrine "does not entirely proscribe the existence of a tax motive" and also pointed out that the business purpose doctrine is applied with less rigor in the context of a §368 transaction than in the context of a §355 transaction. For a §368 transaction, if there is at least one reasonable business purpose that is not tax-related, the business purpose doctrine is satisfied. In CCA 201340016, the IRS upheld the validity of an F reorganization where the taxpayer's putative business purpose was insulation from economic instability in a foreign country as well as avoidance of adverse foreign tax exposure.

Note: Although the regulations require a valid business purpose for all sorts of reorganizations, this requirement is substantially greater for a divisive reorganization under §368(a)(1)(D) and §355 than for any of the other transactions listed under §368(a)(1).[110] Previously, under Rev. Proc. 96-30, the IRS required extensive documentation to establish the urgency of a business purpose for rulings under §355, but required only

[103] *See* IRM 3.13.2.10.18(1).

[104] *See* IRM 3.13.2.10.18(1).

[105] The Internal Revenue Manual instructs IRS employees to prepare a "dummy" Form 8832 with the state paperwork attached. IRM 3.13.2.10.18(1). The Manual states that *if* the taxpayer submits a Form 8832, the IRS should use it as the source document rather than preparing a "dummy" document, but the Form 8832 is not required to be filed by the taxpayer. The EIN retention letter suffices.

[106] See PLR 201115016 (involving similar facts, an F reorganization was used to facilitate retention of some assets and sale of the remaining business assets to an unrelated purchaser). For diagrams illustrating this transaction, see the Worksheets.

[107] 293 U.S. 465 (1935).

[108] Reg. §1.368-1(b), §1.368-1(c), §1.368-2(g).

[109] For discussion, see *Wortham Mach. Co. v. United States*, 521 F.2d 160, 163 (10th Cir. 1975).

[110] *See* Reg. §1.355-2(b), §1.355-2(e), §1.368-1(b).

ISBN 978-1-63359-255-1

a "complete statement of the business reasons for the transaction" for ordinary rulings.[111]

[111] *Compare* Rev. Proc. 96-1, §8.01 (first annual revenue procedure applicable at that time; providing general instructions for requesting letter rulings and determination letters) *with* Rev. Proc. 96-30, §4.04, Appendix A (providing information and representations regarding whether a distribution satisfies the business purpose requirement, which must be included in requests for rulings under §355), superseded by Rev. Proc. 2017-52, modified by Rev. Proc. 2025-30. For discussion of the IRS's ruling policy regarding §355 transactions, including a discussion of Rev. Proc. 2017-52 and subsequent guidance, see 776 T.M., *Corporate Separations*, at I.E.

ISBN 978-1-63359-255-1

III. Determining Whether a Transaction Qualifies as an E Reorganization

A. Definition

The statute defines a §368(a)(1)(E) reorganization simply as "a recapitalization." Neither the Code nor the regulations attempt to further define the term, but Reg. §1.368-2(e) contains several examples of stock and securities exchanges that will qualify as tax-free recapitalizations. A frequently quoted generalization describes the term as involving a "reshuffling of a capital structure within the framework of an existing corporation."[112]

There is perhaps more meaning contained in the statutory definition by way of negative implication. By its nature, a recapitalization involves only a single corporation, and involves nothing more than a change in its capital structure. Therefore, many of the issues, concerns and consequences relating to the multi-party reorganizations, and even the F reorganization, do not pertain to the E reorganization.

A number of companies undergo so-called "leveraged recapitalizations," in which a company borrows funds from one or more third-party lenders and distributes the cash to shareholders through a dividend or redemption transaction. More often than not, such transactions do not qualify as recapitalizations under §368(a)(1)(E). This is ironic, because they do involve rather significant changes in the capital structure of the corporation, typically converting equity to debt. There are, however, certain circumstances in which a leveraging transaction can qualify as a §368(a)(1)(E) recapitalization, for example, where the corporation arranges for some or all shareholders to exchange stock for debt securities.[113]

Unlike the other types of reorganizations, recapitalization status does not per se affect the tax treatment of the corporation itself. Because there is no transfer of assets, actual or constructive, from one corporation to another, there is no reason to look to §368 reorganization status to determine whether the corporation recognizes any gain or loss, or what effect the transaction may have on the corporation's tax attributes. The corporation is protected by §1032 from recognition of income on the receipt of any property in exchange for the issuance of its stock, and pursuant to less clear, but nevertheless well-established authority, on the issuance of its own debt obligations.[114] Qualification of the transaction as a reorganization is, however, often a prerequisite to treatment of shareholder and security holder exchanges under §354 and §356. In this connection, it is important to note that an exchange may be taxable to the shareholder or security holder in spite of reorganization status, such as where a stockholder exchanges stock for debt securities. It should likewise be remembered that under §1036, an exchange of common for common or preferred for preferred in the same corporation is tax-free, without regard to whether the exchange occurs within the context of a recapitalization.

There are a number of tax concerns pertaining to the corporation undergoing a recapitalization that do not depend upon whether the transaction qualifies under §368(a)(1)(E). If a loss corporation undergoes a recapitalization, there is often a shift in stock ownership that may bring about an ownership change subject to the limitation rules of §382. Of even wider significance, if there is an exchange or modification of a corporation's debt securities, there will often be cancellation of indebtedness issues involving §108. Of course, in any case involving debt instruments, the complex rules governing original issue discount come into play. Similarly, the rules under §305 must be consulted if preferred or convertible stock is issued or retired.

As noted above, the closest one can get to a definition of "recapitalization" is the "reshuffling of a capital structure" language from *Helvering v. Southwest Consolidated Corp.*[115] The regulations provide the following nonexclusive list of examples of what comes within the statutory definition:

> (1) a corporation with $200,000 par value of bonds outstanding, instead of paying them off in cash, discharges them by issuing preferred shares to the bondholders;
>
> (2) there is surrendered to a corporation for cancellation 25% of its preferred stock in exchange for no par value common stock;
>
> (3) a corporation issues preferred stock, previously authorized but unissued, for outstanding common stock;
>
> (4) an exchange of a corporation's outstanding preferred stock for a new issue of the corporation's common stock; and
>
> (5) an exchange of an amount of a corporation's outstanding preferred stock with dividends in arrears for other stock of the corporation.[116]

Practice Point: The regulations note, however, that, in Reg. §1.368-2(e)(5), if there is an increase in the proportionate interest of the preferred shareholders in the corporation, then, under Reg. §1.305-7(c)(2), there will be a deemed taxable stock distribution under §305(c) and §305(b)(4). The application of the §305 rules to purported recapitalizations is discussed at IV.G.4., below, and in 765 T.M., *Stock Rights and Stock Dividends — Sections 305 and 306.*

The above examples are noteworthy in several respects. One, they all involve exchanges in which stock, rather than a debt security, is issued. Second, there seems to be little concern evidenced by the IRS as to the purpose for the transaction. As will be explained below, there is a business purpose requirement for recapitalizations, as there is for all reorganizations. Nevertheless, there is great latitude to the corporation in fashioning the business purpose; it seems that a corporation may simply declare that it wishes to conserve cash as a purpose for paying off its bonds with stock instead of cash.

Third, while examples (2) and (4) are largely indistinguishable, it would appear that the regulations seek to illustrate

---

[112] *Helvering v. Sw. Consol. Corp.*, 315 U.S. 194, 202 (1942).

[113] For a discussion of various leveraged recapitalization transactions, see Kliegman & McDade, *Leveraged Recapitalizations — Tax and Accounting Strategies*, PLI Tax Strategies for Corporate Acquisitions, Dispositions, etc. (2008).

[114] For further discussion, see IV.D.2., below.

[115] 315 U.S. 194, 202 (1942).

[116] Reg. §1.368-2(e). *See* PLR 200236008 (equity rights in nonstock membership corporation treated as stock so that conversion to holding company structure qualifies as §368(a)(1)(E) reorganization), PLR 200208017 (exchange of membership interests in nonstock mutual life insurance company for newly authorized stock qualifies as §368(a)(1)(E) reorganization).

ISBN 978-1-63359-255-1

that a recapitalization may involve all or only a portion of an outstanding class of stock. A more extreme example of this principle is contained in Rev. Rul. 77-238, in which the IRS ruled that the isolated exercise of conversion rights in a convertible stock will be a reorganization under §368(a)(1)(E).

Note: In another ruling, Rev. Rul. 72-265, the IRS concluded that an exchange of a convertible bond for the issuer's preferred stock pursuant to the conversion right is a nonrealization event. Thus, the holder of convertible stock may be indifferent as to whether recapitalization treatment is available. Note, however, that if there were a conversion of common stock into preferred, the possible treatment of the preferred as "section 306 stock" under §306(c)(1)(B) would depend upon whether there was a reorganization. Additionally, the recapitalization approach would presumably implicate the reorganization reporting requirements under Reg. §1.368-3, discussed in VIII.A., below. It is undoubtedly the case, however, that such conversions are not the subject of detailed tax return reporting in most instances, and that such reporting would not be insisted upon by the IRS.

Other types of exchanges that generally qualify as recapitalizations are:

(1) exchanges of common for common of the same corporation,[117] which may occur in the form of a "reverse stock split," in which each shareholder receives fewer shares than the shareholder surrenders;[118]

(2) exchanges of preferred for preferred of the same corporation; and

(3) exchanges of bonds for bonds of the same corporation.

The IRS has ruled that the conversion of a nonprofit, nonstock entity to a for-profit, stock corporation can qualify as an E reorganization.[119]

Under the 1939 Code, but not the 1954 Code or the 1986 Code, it was possible to exchange stock for debt securities tax-free under the predecessor to §354. Therefore, the controversial issue was presented as to whether a shareholder's exchange of stock for bonds or other debt securities could qualify as a recapitalization. Several arguments were made by the IRS against qualification of such transactions, such as the failure to meet continuity of interest criteria, as well as an argument that only recapitalizations that strengthened (i.e., debt to equity) rather than weakened (equity to debt) the corporate balance sheet were eligible; these arguments were generally rejected by the courts.[120]

In *Bazley v. Commissioner*,[121] the shareholders of a closely held family corporation exchanged their 1,000 shares of $100 par value common stock for 5,000 shares of no par value common with a stated value of $60 per share plus $400,000 of debentures. The Supreme Court held that the transaction did not qualify as a recapitalization, explaining:

> What is controlling is that a new arrangement intrinsically partake of the elements of reorganization which underlie the Congressional exemption and not merely give the appearance of it to accomplish a distribution of earnings. In the case of a corporation which has undistributed earnings, the creation of new corporate obligations which are transferred to stockholders in relation to their former holdings, so as to produce, for all practical purposes, the same result as a distribution of cash earnings of equivalent value, cannot obtain tax immunity because cast in the form of a recapitalization-reorganization … . What have we here? No doubt, if the Bazley corporation had issued the debentures to Bazley and his wife without any recapitalization, it would have made a taxable distribution. Instead, these debentures were issued as part of a family arrangement, the only additional ingredient being an unrelated modification of the capital account. The debentures were found to be worth at least their principal amount, and they were virtually cash because they were callable at the will of the corporation which in this case was the will of the taxpayer. One does not have to pursue the motives behind actions, even in the more ascertainable forms of purpose, to find, as did the Tax Court, that the whole arrangement took this form instead of an outright distribution of cash or debentures, because the latter would undoubtedly have been taxable income whereas what was done could, with a show of reason, claim the shelter of the immunity of a recapitalization-reorganization.[122]

The precise bounds of the *Bazley* holding are uncertain. To a significant extent, the protections that the case offers to the IRS are no greater than now exist in the Code and regulations. Thus, as will be discussed further below, §354 only provides nonrecognition to a shareholder on the receipt of stock, not securities. This is imperfect, inasmuch as §356(a) only imposes a tax on the receipt of boot to the extent of gain realized. Reg. §1.301-1(j) provides a greater weapon to the IRS, more directly focused on the *Bazley* situation. That regulation specifically contemplates §301 treatment for a distribution of cash or bonds occurring in connection with a recapitalization or reincorporation reorganization.[123]

Several cases have distinguished *Bazley* to conclude that a recapitalization did occur when a corporation exchanged its debt securities for its stock. Thus, for example, in *Davis v. Pen-*

[117] *See, e.g.*, PLR 9412007 (exchange of a company's common stock for its ESOP common stock qualified as a recapitalization).

[118] *See, e.g.*, Rev. Rul. 72-57 (10:1 reverse stock split was carried out, with cash issued to minority shareholders in lieu of fractional shares). *See also* PLR 200004026 (ruling 44), PLR 7745040.

[119] PLR 200317019, PLR 9545014.

[120] *See, e.g.*, *Hickok v. Commissioner*, 32 T.C. 80 (1959), nonacq., 1959-2 C.B. 3, nonacq. withdrawn, 1977-2 C.B. 3, and cases cited therein.

[121] 331 U.S. 737 (1947).

[122] 331 U.S. 737, 742–743 (1947).

[123] *See, e.g.*, TAM 200335032 (distribution of cash taxable as dividend; even if step transaction applied to treat distribution and recapitalization as occurring simultaneously, Reg. §1.301-1(j) (redesignated by T.D. 9954, 86 Fed. Reg. 52,612 (Sep. 22, 2021)) would apply to treat distribution as separate transaction). *See also* PLR 201014048 (CFC's redemption of stock from what had been its sole shareholder would be treated under §301 separately from its related pro rata §301 distribution made immediately thereafter to that shareholder and new shareholder), PLR 200752014 (pro rata distribution to former target shareholders after merger is taxed under §301, not as money received in merger under §356).

ISBN 978-1-63359-255-1

field,[124] *Bazley* was distinguished in an exchange of preferred stock for debentures, in part because the corporation was more widely held, and the debentures were not more marketable than the preferred stock exchanged therefor. Similarly, in *Seide v. Commissioner*,[125] the Tax Court distinguished *Bazley* in an exchange of preferred stock for debentures, where the preferred was not held in proportion to the common, and the financial condition of the company seemed to preclude an early retirement of the debentures.

It also should be noted that §368(a)(1)(E) is limited to recapitalizations within the framework of a single corporate entity.[126] This appears to be the law, notwithstanding an occasional suggestion by the IRS in liquidation-reincorporation cases that a transaction involving a reincorporation can be characterized as a recapitalization.[127]

B. Business Purpose

As noted in II.C., above, Reg. §1.368-1(b), §1.368-1(c), and §1.368-2(g) all set forth a requirement that any reorganization be undertaken for a valid business purpose. This is as true for an E reorganization as for an F reorganization. Although the decision does not speak directly in such terms, the *Bazley* case discussed in III.A., above, might be said to turn upon a finding by the court that the transaction lacked a business purpose and was concocted solely for the purpose of saving taxes.[128]

The regulations speak in terms of a corporate business purpose. Many reorganizations involve valid, non-tax avoidance motives of both the corporation and the shareholders, and it is often difficult to distinguish between the two. Because it does not involve a combination of one business enterprise with another, but only a change in the types of securities held by the investors, the recapitalization transaction in particular is the sort of reorganization where the line between corporate and shareholder business purposes will blur.

In *Lewis v. Commissioner*,[129] a liquidation-reincorporation case, the court rejected the taxpayer's argument that the transaction was not a reorganization because it lacked a corporate business purpose, finding it sufficient that there was a sufficient shareholder business purpose. Perhaps of greater significance, because it was the IRS arguing against reorganization treatment, in *Estate of Parshelsky v. Commissioner*,[130] the court held that both corporate and shareholder business purposes could be taken into account in testing a reorganization.

The applicability of the business purpose rule in a particular case will depend upon an analysis of its facts. The requisite bona fide business purpose may be found, for example, in the desire to simplify the corporation's capital structure,[131] or to strengthen the company's financial condition by changing the terms of indebtedness or by eliminating dividend[132] or interest arrearages.[133]

In *Commissioner v. Neustadt's Trust*,[134] an exchange of debentures for convertible debentures was sustained as a valid recapitalization for the purpose of strengthening the company's financial condition. The court pointed out that reducing the interest rate, shortening the maturity date, and adding a conversion feature fully complied with congressional policy objectives. In *Lorch v. Commissioner*,[135] an exchange of debentures for preferred stock was found to qualify as a §368(a)(1)(E) recapitalization when undertaken to permit a brokerage house to reduce its debt so as to avoid involuntary liquidation; as a result, the taxpayer was prevented from recognizing a loss on the exchange.

The IRS has ruled that a "reverse stock split," in which a corporation forces an exchange of a large number of shares for a smaller number, will qualify for reorganization treatment if, in the judgment of the majority shareholder, the recapitalization is undertaken for the benefit of the business by eliminating minority interests. This was the case in Rev. Rul. 72-57, where corporation X, holding 99% of the common stock in corporation Y, "felt it necessary to simplify its capital structure by eliminating the interest of its minority shareholders," and, accordingly, caused Y to amend its articles of incorporation to substitute one share of $50 par value common stock for each 10 shares of $5 common stock. By paying cash in lieu of fractional shares, the transaction resulted in the redemption of the entire 1% minority.[136]

A recapitalization will satisfy the business purpose test even though undertaken solely for purposes of qualifying a corporate spin-off under §355, provided the spin-off otherwise satisfies the rigorous business purpose test under those rules.[137] In Rev. Rul. 69-407, Distributing owned only 70% of the stock of Controlled, which it wished to spin off to its shareholders for valid business reasons. In order to allow Distributing to meet

[124] 205 F.2d 798 (5th Cir. 1953). *See also Berner v. United States*, 282 F.2d 720 (Ct. Cl. 1960).

[125] 18 T.C. 502 (1952).

[126] *Role v. Commissioner*, 70 T.C. 341, 349–50 (1978); *Gallagher v. Commissioner*, 39 T.C. 144, 162 (1962), acq. and nonacq., 1964-2 C.B. 5.

[127] *See* Rev. Rul. 61-156. Note that the Tax Court itself has gone so far as to disregard the substitution of a new corporate entity in lieu of another, treating the latter as merely the "alter ego" of the former. *See Tel. Answering Serv. Co. v. Commissioner*, 63 T.C. 423 (1974), *aff'd per curiam*, 546 F.2d 423 (4th Cir. 1976), *cert. denied*, 431 U.S. 914 (1977); *Casco Prods. Corp. v. Commissioner*, 49 T.C. 32 (1967). *Compare* Rev. Rul. 54-269 (IRS concluded on the facts that under a Connecticut reincorporation statute, a reincorporated entity was a continuation of the former entity). *See also* Rev. Rul. 2003-48 (conversion of mutual bank to stock bank incorporated in same state could qualify as E reorganization when state law treated stock bank as continuation of mutual bank; but conversion would not qualify as E reorganization if mutual bank and stock bank were incorporated in different states).

[128] *See Bazley v. Commissioner*, 331 U.S. 737 (1947).

[129] 176 F.2d 646 (1st Cir. 1949).

[130] 303 F.2d 14 (2d Cir. 1962).

[131] This might be inferred from the approval of an exchange of outstanding preferred stock for common stock in Reg. §1.368-2(e). A change in capital structure to conform to changes in the law is a valid business purpose. *See, e.g.*, PLR 200311002 (exchange of existing class of stock for two new classes of stock was undertaken for valid business purpose of enabling company to satisfy risk-based capital requirements in new congressional act and to access short-term capital).

[132] Rev. Rul. 70-199; Rev. Rul. 56-586, *obsoleted by* Rev. Rul. 2003-99. *See also* PLR 200211035 (swap of preferred stock for preferred stock in order to reduce annual dividend payments qualifies as §368(a)(1)(E) reorganization).

[133] Rev. Rul. 59-98; Rev. Rul. 58-546.

[134] 131 F.2d 528 (2d Cir. 1942).

[135] 70 T.C. 674 (1978), *aff'd*, 605 F.2d 657 (2d Cir. 1979), *cert. denied*, 444 U.S. 1076 (1980).

[136] The ruling, as modified by Rev. Rul. 78-351, explains the treatment of the minority shareholders under §302 and the treatment of the majority shareholder under the §356 boot rules.

[137] For a detailed discussion of the business purpose test under the §355 rules, see 776 T.M., *Corporate Separations*.

ISBN 978-1-63359-255-1

the definition of "control" under §368(c), Controlled was recapitalized, issuing shares of different classes of common stock to Distributing and the minority shareholders such that Distributing met the 80% voting power test for control. The IRS ruled that the spin-off qualified for nonrecognition treatment under §355.

One of the more controversial recapitalization transactions is the preferred stock "freeze." The foundation for such transactions was laid in two court decisions, *Hartzel v. Commissioner*[138] and *Dean v. Commissioner*.[139] These cases involved closely held corporations owned and controlled by an older generation of stockholders, with a younger generation of managers seeking both equity interests and control over the business. The key aspect of the transaction is for the older stockholders to exchange their common stock for preferred of equal value. Where, as in the *Hartzel* case, there are younger owner-managers, they exchange their common stock for new common. Alternatively, or in conjunction with this exchange, management is permitted to purchase shares of the post-recapitalization common.

The essence of the transaction is that, as a result of the recapitalization exchanges, the older stockholders hold a frozen, nonvoting interest, while the younger managers own a large percentage of common, which can be purchased at a lower price than before. The cases find a proper business purpose in the transaction in that it prevents control of the business from passing through the estates of the older generation to uninvolved beneficiaries, and also allows the managers to acquire significant interests in future growth via the common stock at a relatively lower cost than without the recapitalization.

As the above discussion indicates, the preferred stock freeze recapitalization mixes elements of personal estate planning with concerns pertaining directly to the business. The key to the strategic success of the transaction is to avoid significant gift taxes by assigning a very low value to the common stock that is transferred to the younger generation and also avoid significant estate taxes by having the rights associated with the preferred (which is retained by the older generation) lapse upon death so that the value for estate tax purposes is reduced. However, both of these goals have been significantly affected (and undermined) by the enactment of the valuation rules in §2701–§2704. The effect of these rules and the use of the estate freeze recapitalization is further discussed in V.G., below.

C. Absence of Continuity of Interest and Continuity of Business Enterprise Requirements

Neither the continuity of interest requirement nor the continuity of business enterprise requirement applies to reorganizations under §368(a)(1)(E).[140] The absence of continuity of interest as a requirement in recapitalizations does not affect transactions in which shareholders exchange their stock for debt securities; in any case, the exchange will be taxable. It does allow for the flexible use of the recapitalization rules in the following situations:

- security holders may exchange their securities for stock or new securities, without regard to the extent of "cashing out" by shareholders;
- shareholders may exchange their stock for other stock without regard to the extent of cashing out by other shareholders; and
- in the context of an overall sale of the stock of a corporation, the shareholders may exchange some of their common stock for preferred, and sell the majority of their stock to the buyer, and obtain nonrecognition treatment to the extent that they retain the new preferred stock.

Practice Point: Under Reg. §1.368-1(e), the sale of stock to an unrelated buyer after a recapitalization would not violate the continuity of interest requirement even if it applied to recapitalizations.

[138] 40 B.T.A. 492 (1939).

[139] 10 T.C. 19 (1948), acq., 1949-1 C.B. 1. *Cf.* Rev. Rul. 55-112, finding a valid recapitalization under §112(g)(1)(E) of the 1939 Code where three of five shareholders, in order to cease activity in the business, exchanged their common stock for preferred, leaving all of the common in the hands of the two remaining shareholders.

[140] Reg. §1.368-1(b).

ISBN 978-1-63359-255-1

IV. Tax Consequences of E and F Reorganizations

A. Introduction

Section 368 is strictly definitional, and much of the law of reorganizations is directed at the often detailed, and always extensive, requirements for qualification under the reorganization definitions. The technical rules for determining the treatment of the various parties to such a reorganization are found elsewhere. The tax law regards all acquisitive asset acquisition reorganizations in the same manner, whether they take the form of a statutory merger under state law or (as in the case of the C or D reorganization) a physical transfer of assets. In all cases, the transferor — or acquired — corporation transfers its assets to the acquiring corporation in exchange for stock or other consideration, followed by the distribution of this consideration by the transferor pursuant to the plan of reorganization.

In the case of a classic F reorganization reincorporation transaction, Oldco transfers its assets to Newco in exchange for Newco stock and Newco's assumption of Oldco's liabilities, and immediately thereafter, Oldco distributes the Newco stock to its shareholders in cancellation of their Oldco stock. But for the existence of nonrecognition provisions, Oldco would be treated as undergoing a taxable sale of its assets, followed by a liquidating distribution of the Newco stock.

In the case of an E reorganization or an F reorganization not involving a Newco replacing the Oldco (such as a change of name), there is no corporate level event, and the sole tax consequences are at the level of the shareholder or security holder. For an F reorganization that does involve a Newco, regardless of what form the transaction takes, the above asset for stock followed by liquidation sequence is the way the transaction is characterized for tax purposes. So, for example, if the Oldco shareholders contribute their Oldco stock to Newco in exchange for Newco stock and then Oldco is liquidated into Newco, the transaction is treated as a transfer by Oldco of its assets and liabilities to Newco in exchange for Newco stock followed by Oldco's distribution of the Newco stock in liquidation to its shareholders. This part of the Portfolio discusses the sections of the Code detailing the treatment of the participants to the E and F reorganizations. It should be noted that, except for those provisions unique to divisive reorganizations under §368(a)(1)(D) and §355, these provisions are applicable to all of the reorganizations set forth in §368(a). For a more detailed discussion of the collateral tax consequences associated with various specific types of recapitalization exchanges, see V., below.

B. Party to a Reorganization

The term "party to a reorganization" is a term of art defined in §368(b). Although problematic in certain other contexts, the term has a fairly straightforward meaning for E or F reorganizations. The statute defines party to a reorganization as either a corporation resulting from a reorganization, or both corporations in the case of an acquisition by one of stock or properties of the other.[141] Thus, in the case of a recapitalization, there is only one party to the reorganization, i.e., the corporation undergoing the recapitalization. This is also true for an F reorganization involving only a single legal entity, such as a change of name. For an F reorganization involving a second legal entity, such as a reincorporation through merger or conversion, both the old entity and the new entity are parties to the reorganization. In no case are the shareholders or security holders parties to a reorganization, even if they themselves are corporations.

[141] §368(b); Reg. §1.368-2(f).

C. Plan of Reorganization

For an exchange or distribution to be subject to the reorganization provisions, it must be found to have occurred pursuant to the plan of reorganization. Thus, nonrecognition treatment for stock and security holders under §354, and for participant corporations under §361, is linked to the plan of reorganization.

Reg. §1.368-2(g) provides, in part:

> The term "plan of reorganization" has reference to a consummated transaction specifically defined as a reorganization under section 368(a). The term is not to be construed as broadening the definition of "reorganization" as set forth in section 368(a), but is to be taken as limiting the nonrecognition of gain or loss to such exchanges or distributions as are directly a part of the transaction specifically described as a reorganization in section 368(a).

Although this description adds little to the definition of "plan of reorganization," it does seem to state that the plan of reorganization is the essence of a particular reorganization transaction. For an exchange to obtain nonrecognition treatment, one must be able to find that the exchange was a part of that essential transaction.

The plan of reorganization must be adopted by each of the corporations that are parties thereto, and each such corporation must include a prescribed statement on or with its return for the taxable year of the transaction.[142]

While most plans of reorganization are formal and are in writing, a plan of reorganization need not be embodied in a formal written document (although, as mentioned above, a statement must be included on the corporations' returns). A taxpayer's phraseology is not controlling if a transaction is in substance a reorganization.[143]

In PLR 202031002, the IRS ruled that the plan of reorganization requirement was met notwithstanding a midstream change to that plan. Pursuant to an F reorganization, the taxpayer was domesticating to another state. The taxpayer's plan of reorganization called for domestication to a certain state but the taxpayer actually reincorporated in a different state (because domestication to the originally designated state was not allowed). The IRS ruled that the reincorporation qualified as an F reorganization despite this change in plan.

[142] Reg. §1.368-3(a). For further discussion of the reporting requirements, *see* VIII., below.

[143] *Smothers v. United States*, 642 F.2d 894 (5th Cir. 1981), *aff'g* 79-1 USTC ¶9216 (S.D. Tex. 1979); *Simon v. Commissioner*, 644 F.2d 339 (5th Cir. 1981), *rev'g and rem'g* 71 T.C. 416 (1978); *Atlas Tool Co. v. Commissioner*, 614 F.2d 860 (3d Cir. 1980), *aff'g* 70 T.C. 86 (1978), *cert. denied*, 449 U.S. 836 (1980); *Wilson v. Commissioner*, 46 T.C. 334 (1966).

ISBN 978-1-63359-255-1

D. Treatment of Corporation in Recapitalization

In a recapitalization, there is no event that occurs that would require a corporation to apply the nonrecognition rules in subchapter C. The corporation has not actually or constructively transferred its assets to another entity, and it does not receive and is not deemed to receive assets from another entity. The only corporate act having tax significance in a recapitalization is the corporation's receipt of an old instrument and the issuance of a new instrument in exchange therefor. In most cases, particularly where only stock is involved, the tax treatment of the issuer corporation is both clear and benign. In other cases, particularly if the corporation's debt is involved, the treatment may be less clear and less benign.

1. Issuance and Retirement of Stock

Section 1032(a) provides that a corporation recognizes no gain or loss on the receipt of money or other property in exchange for its own stock, or upon the lapse or acquisition of an option or a §1234B securities futures contract to buy or sell its stock. Additionally, pursuant to §311 and the regulations thereunder, there is no income to the corporation upon the reacquisition of its stock in exchange for cash or its own stock. Gain is recognized under §311(b) only to the extent appreciated property (other than stock in the distributing corporation) is distributed.[144]

> *Example:* In Year 1, corporation X issues $100 preferred stock for $100 cash. In Year 3, when the value of the preferred stock has declined to $40, X issues new preferred or common stock with a fair market value of $40 in exchange for the old preferred. In this case, X realizes no taxable income. As discussed below, the results differ if, instead of initially issuing preferred stock, X issues a debt instrument.

Section 4501(a) imposes a nondeductible 1% excise tax based on the fair market value (FMV) of stock repurchased during the taxable year by a "covered corporation" after December 31, 2022.[145] Generally, a covered corporation is any publicly traded, domestic corporation.[146] Repurchase means a redemption, as defined in §317(b), of the covered corporation's stock and any other transaction that Treasury determines is economically similar.[147] Treasury and the IRS have identified the exchange of stock as part of an E reorganization by the shareholders of a recapitalizing corporation that is a covered corporation as a transaction economically similar to a §317(b) redemption.[148] However, a covered corporation's excise tax base is reduced by the FMV of repurchased shares that are exchanged for qualifying property (i.e., property permitted under §355 to be received without the recognition of gain or loss).[149] As a result, a recapitalizing corporation is subject to the stock repurchase excise tax only to the extent of the FMV of its shares that are repurchased in exchange for nonqualifying property (if any).

2. Issuance and Retirement of Debt

No statutory provision comparable to §1032 applies with respect to a corporation's issuance of debt, although §108 deals extensively with the treatment of debt after it has already been issued. Additionally, the provisions of §1271–§1275 purport to characterize transactions involving the issuance of debt obligations, but even they do not provide a rule of nonrecognition for the issuer of a debt obligation.

When funds or property are received by the corporation (or any other taxpayer) as a loan, there is no taxable income, because the offsetting liability of the loan ensures that the taxpayer's net worth has not been increased.[150] When the loan is subsequently repaid, both the assets and liabilities of the corporation are correspondingly reduced and, thus, there is no income or loss. To the extent, however, that the borrower is able to reduce or extinguish the debt without reducing its assets by a like amount, the net increase in the borrower's net worth generally constitutes taxable income as cancellation of indebtedness. In accounting terms, if the liability is debited there must be a corresponding credit on the asset side; if not, the credit results in income. This rule is codified in §61(a)(12), is described in Reg. §1.61-12, and was validated by the Supreme Court in *United States v. Kirby Lumber Co.*[151]

As noted above, §311 and §1032 govern the treatment of the issuing corporation on the distribution of its own stock or other property to reacquire its outstanding stock. As in the case of debt issuance generally, no statute governs the treatment of the corporation when it uses its own stock or any other property to reacquire its outstanding debt. If a taxpayer uses property (rather than cash) to repay its debt, however, it is treated as selling that property for the amount of debt that it retires (i.e., the fair market value of the property).[152]

> *Example:* A taxpayer has outstanding a $100 debt, which it discharges with property having a value of $100 but a tax basis of $40. There is no income from cancellation of indebtedness because the debt is paid in full, but the taxpayer will recognize $60 of gain under §1001 upon the disposition of the $40 basis property for $100.

[144] Section 311(a) provides that no gain or loss is recognized to a corporation on the distribution of its stock or property with respect to its stock. Section 311(b) sets forth the exception for gain recognition with respect to distributions of appreciated property (described in §317(a) as excluding stock in the distributing corporation). *See also* TAM 200443032 (§311(b) gain determined with reference to assets transferred, not to partnership interests distributed).

[145] Added by the Inflation Reduction Act, Pub. L. No. 117-169, §10201, §4501 applies generally to repurchases of a covered corporation's stock occurring after December 31, 2022, during taxable years ending after that date. For a detailed discussion of the stock repurchase excise tax, see 767 T.M., *Redemptions*, at X.G.1.

[146] §4501(b). The stock of a covered corporation must be traded on an established securities market within the meaning of §7704(b)(1), which includes foreign and U.S. national securities exchanges, as well as certain secondary and other markets.

[147] §4501(c)(1).

[148] *See* Reg. §58.4501-2(e)(4)(i), T.D. 10037, 90 Fed. Reg. 53,144 (Nov. 24, 2025).

[149] Reg. §58.4501-3(c), T.D. 10037. Qualifying property is property permitted under §355 to be received without the recognition of gain or loss.

[150] *Cf.* Reg. §1.61-12(c). Generally speaking, this proposition seems to be so obvious that it appears not to have been the subject of litigation. The IRS will not rule on whether an amount is excluded from income under §61 because the taxpayer receives the amount subject to an unconditional obligation to repay the amount. Rev. Proc. 2026-3, §3.01(15).

[151] 284 U.S. 1 (1931).

[152] *Simms v. Commissioner*, 28 B.T.A. 988, 1029 (1933).

ISBN 978-1-63359-255-1

Section 1032(a) provides nonrecognition treatment for this gain when a corporate debtor uses its stock to discharge its outstanding debt. For example, if a corporation issues $100 worth of its own stock in exchange for its outstanding debt with an adjusted issue price of $100, there is neither cancellation of indebtedness income nor taxable gain upon the "disposition" of its stock. As stated above, although no statutory equivalent to §1032 applies to the issuance of debt, a corporation issuing a new debt obligation worth $100 in exchange for an outstanding debt obligation of $100 has no taxable income.

For the most part, the effect of these principles has been limited to distributions by the corporation of cash, new debt, stock, or other property in exchange for outstanding debt when the value of the newly issued consideration is equal to the amount of the outstanding debt. A complex body of tax law has developed with regard to the treatment of situations in which the newly issued consideration is less than the amount of the debt, as to whether, to what extent, and with what effects there is cancellation of indebtedness income to the issuing corporation. This subject, discussed at length in 540 T.M., *Discharge of Indebtedness, Bankruptcy and Insolvency*, and 541 T.M., *Tax Aspects of Restructuring Financially Troubled Businesses*, is briefly outlined below.

Section 108 contains the rules governing the consequences of a taxpayer's partial or complete discharge of indebtedness for less than full consideration. Inasmuch as *Kirby Lumber* and §61(a)(12) set forth the fundamental rule that the discharge of indebtedness for less than the borrowed amount is taxable income, the principal function of §108 is to carve out exceptions and modifications to the rule of income inclusion.

Under §108(a), cancellation of indebtedness is not taxable if it occurs in a Title 11 bankruptcy proceeding, or when — and to the extent — the taxpayer is insolvent.[153] Section 108(b) sets forth rules under which a taxpayer must reduce favorable tax attributes — such as net operating losses, business credits, capital losses, tax basis in assets, and foreign tax credit carryovers — to compensate for the elimination of debt cancellation income under §108(a). A number of other exceptions and modifications are provided under §108(e). These include a special rule under §108(e)(5) treating reductions in purchase money debt as purchase price adjustments; a rule under §108(e)(4) treating a purchase of debt by a party related to the issuer as if it were acquired by the issuer; and special treatment for the contribution of indebtedness to the capital of the issuer, under §108(e)(6).

Section 108(e) also contains a number of special rules governing the treatment of a corporation's issuance of stock or debt in exchange for its outstanding indebtedness. These rules are discussed in connection with specific exchange transactions in V., below.

E. Treatment of Old Corporation in F Reorganization

Section 361(a) sets forth the rule for nonrecognition to the Oldco transferor upon the exchange of its assets solely for stock or securities of the Newco transferee. Section 361(b) sets forth the rules governing the receipt of "boot" (i.e., other property) by the Oldco transferor. Under §361(b)(2), no loss is recognized under any circumstances. Under §361(b)(1) and §361(b)(3), the transferor recognizes no gain on the receipt of boot, provided it distributes the boot to its shareholders or creditors. Gain is recognized under §361(b)(1)(B) to the extent of any boot not distributed in pursuance of the plan of reorganization. Because there can be no surviving Oldco after an F reorganization,[154] the only instance in which there can be boot that is not distributed in the reorganization is when the boot arises in connection with the assumption of liabilities.

Under §357(a), except as provided otherwise, the Newco transferee's assumption of an Oldco transferor's liabilities in an exchange covered by §361 or §351 is not treated as the transfer of money or other property. The main exception to this rule is found in §357(c), which provides that, in a transfer under §351 or in a divisive D reorganization, if the sum of liabilities assumed plus liabilities to which the transferred assets are subject exceeds the aggregate adjusted basis of the transferred assets, this excess is gain to the transferor.[155] The IRS has long ruled that §357(c) does not apply to an F reorganization, even

[153] Section 108(a)(1)(C) and §108(g) provide special rules for the relief of certain kinds of farm indebtedness, and §108(a)(1)(D) and §108(c) provide special rules for the relief of qualified real property business indebtedness for taxpayers other than C corporations. Section 108(a)(1)(e), as extended by the Further Consolidated Appropriations Act, 2020, Pub. L. No. 116-94, Div. Q, §101, and amended by Taxpayer Certainty and Disaster Tax Relief Act of 2020, Pub. L. No. 116-260, Div. EE, §114, provides special rules for the relief of "qualified principal residence indebtedness" (defined in §108(h)) discharged after 2006 and before 2026 or subject to an arrangement that was entered into and evidenced in writing before 2021. *See also* the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), Pub. L. No. 116-136, §1106(i). This provision of the CARES Act does not amend §108, but, provides that Paycheck Protection Program (PPP) loans authorized under §1102 of the CARES Act for certain payroll costs, utility payments, rent obligations and mortgage interest, forgiven under the program administered by the Small Business Administration are excluded from gross income as income from debt forgiveness. The COVID-related Tax Relief Act of 2020 redesignated §1106 of the CARES Act as §7A of the Small Business Act. Pub. L. No. 116-260, Div. N, Title III, §276, §304(b). As redesignated, the section continues to provide that amounts forgiven under the Paycheck Protection Program are excluded from gross income for federal income tax purposes. The section is also amended to provide that (i) no deduction will be denied, no tax attribute will be reduced, and no basis increase will be denied as a result of that exclusion from gross income, and (ii) in the case of a partnership or S corporation, any amount excluded will be treated as tax-exempt income. The amended section also extends these provisions to new PPP loans for tax years ending after December 27, 2020. Pub. L. No. 116-260, Div. N, Title II, Subtitle B, §276(b). Taxpayers may treat tax-exempt income resulting from the partial or complete forgiveness of a PPP loan as being received or accrued: (1) as eligible expenses are paid or incurred, (2) when an application for PPP loan forgiveness is filed, or (3) when PPP loan forgiveness is granted. Rev. Proc. 2021-48, §3.01. If a PPP loan is not fully forgiven, the taxpayer must make appropriate adjustments on an amended federal return for the taxable year(s) in which the taxpayer treated tax-exempt income from the forgiveness of a PPP loan as received or accrued. Rev. Proc. 2021-48, §3.03, effective for any taxable year in which a taxpayer paid or incurred eligible expenses, applied for forgiveness of a PPP loan, or was granted forgiveness of a PPP loan. *See also Paycheck Protection Program Loans Frequently Asked Questions (FAQs)*, https://home.treasury.gov/system/files/136/Paycheck-Protection-Program-Frequently-Asked-Questions.pdf.

[154] Reg. §1.368-2(m)(1)(iv). Oldco is not required, however, to dissolve for state law purposes and is allowed to retain a de minimis amount of assets for the sole purpose of preserving its legal existence. *Id. See also* PLR 200320013 (Oldco survived F reorganization for state law purposes, but as qualified subchapter S subsidiary (QSub) of Newco and, thus, disregarded entity for federal tax purposes).

[155] A D reorganization is a transfer by a corporation of assets to another corporation if immediately after the transfer the transferor or one or more of its shareholders is in control of the transferee, provided the stock or securities of the transferee are distributed in a transaction qualifying under §354, §355, or §356, pursuant to the plan of reorganization. §368(a)(1)(D). For this purpose, §368(a)(2)(H)(i) incorporates the definition of control set forth in §304(c).

ISBN 978-1-63359-255-1

if the reorganization also meets the technical requirements under §368(a)(1)(D).[156]

The other exception to the nonrecognition rule for liabilities is in §357(b), which treats the assumption of a liability or the transfer of assets subject to a liability as the receipt of other property if the principal purpose for the assumption or acquisition was to avoid federal income tax, or the transaction was not for a bona fide business purpose.

Comment: There is little authority on the scope of this provision. In light of the apparent restraint the IRS has shown in asserting this rule, and the very nature and requirements of an F reorganization, it seems extremely unlikely that it could come into play in an F reorganization.

Section 361(c) addresses the treatment of the Oldco transferor with respect to the distribution of property to shareholders or creditors. In general, the statute permits the Oldco transferor to distribute, without recognition of gain, stock, stock rights, and debt obligations of itself or of another party to the reorganization (typically the Newco transferee corporation) (qualified property). All other property (nonqualified property), either its own or received from the Newco transferee as consideration in the exchange, gives rise to recognition of gain upon distribution to the extent the fair market value of the property exceeds its adjusted basis in the hands of the transferor/distributing corporation. A loss cannot be recognized.

The basis of the Oldco transferor in property received in the §361 exchange is determined under §358. Section 358(a)(1) provides, in relevant part, that the Oldco transferor takes a basis in the stock and securities of the Newco transferee received in the exchange equal to Oldco's basis in the property transferred to Newco, decreased by the fair market value of any other property and the amount of money received in the exchange, and increased by the amount of any gain recognized to Oldco. Because the stock and securities are immediately distributed to the shareholders or creditors, and such distribution is nontaxable under §361(c)(1), this basis rule is generally academic.

Note that under the 2015 regulations, any distribution occurring in connection with an F reorganization is treated not as boot under §356 but as a separate distribution under §301 or §302.[157] Even under prior law, however, it was unusual to see boot issued in an F reorganization.

The only type of property distribution that is probable in an F reorganization involves property previously held by Oldco. The above-described rules under §361(c)(2) lead to the same result as for a distribution outside the context of a reorganization under §311(b).

There is ordinarily no depreciation recapture in an F reorganization,[158] and no recapture of investment credit in an F reorganization.[159]

As discussed in IV.D.1., above, §4501(a)[160] imposes a nondeductible 1% excise tax on the fair market value (FMV) of stock repurchased during the taxable year by a "covered corporation" after December 31, 2022. F reorganizations in which the transferor corporation's shareholders receive only qualifying property are not treated as repurchases and are not required to be reported on the corporation's stock repurchase excise tax return.[161] Qualifying property is property permitted under §355 to be received without the recognition of gain or loss.[162] As a result, the transferor corporation is subject to the stock repurchase excise tax only to the extent of the FMV of its shares that are repurchased with nonqualifying property (if any).

F. *Treatment of New Corporation in F Reorganization/ Employer ID Number*

The transferee Newco in an F reorganization is treated as acquiring the assets of the transferor Oldco in exchange for the issuance of Newco stock and the assumption of Oldco's liabilities.[163] Nonrecognition is provided to Newco under §1032(a) upon the receipt of assets in exchange for its stock, and under the general rules governing the issuance of debt in exchange for property, which treats the assumption of a liability as consideration paid to acquire the assets.[164] To the extent that assets are acquired in exchange for property other than Newco stock or securities, gain or loss may be recognized. This does not occur, however, in an F reorganization because of the nature of the "acquiring" corporation.

Under §362(b), Newco takes a "carryover basis" from Oldco, i.e., it takes a basis in each asset received equal to the basis of that asset in the hands of Oldco. In the unusual event that Oldco recognized gain in connection with the transfer, §362(b) provides that the carryover basis is increased by the amount of such gain. This basis increase rule does not apply, however, if gain is recognized only to the shareholders (rather than the transferor corporation). Under §1223(2), the holding period of the assets in the hands of Newco includes the period during which they were held by Oldco (a "tacked" holding period).

Subject to an important exception discussed below, the surviving Newco in an F reorganization should use the same tax identification number as the Oldco transferor; the surviving Newco and the Oldco transferor are treated as the same corporation for federal tax purposes.[165] As discussed above, it is now common for an F reorganization to be executed whereby Newco acquires the stock of Oldco followed by a liquidation of Oldco. If this liquidation occurs only as a tax fiction while the legal entity remains in existence, Oldco retains its EIN and Newco is to obtain a new one. The deemed liquidation may occur under the subchapter S rules for a qualified subchapter S

---

[156] Rev. Rul. 87-27; Rev. Rul. 79-289.

[157] Reg. §1.368-2(m)(3)(iii).

[158] §1245(b)(3), §1250(d)(3); Reg. §1.1245-4(c), §1.1250-3(c).

[159] §50(a)(5); Reg. §1.47-3(e), §1.47-3(f).

[160] Added by the Inflation Reduction Act, Pub. L. No. 117-169, §10201, §4501 applies generally to repurchases of a covered corporation's stock occurring after December 31, 2022, during taxable years ending after that date. For a detailed discussion of the stock repurchases excise tax, see 767 T.M., *Redemptions*, at X.G.1.

[161] *See* Preamble to T.D. 10037, 90 Fed. Reg. 53,144, 53,150 (Nov. 24, 2025).

[162] Reg. §58.4501-3(c), T.D. 10037.

[163] *See* PLR 200209049 (regarding the carryover of tax attributes to Newco), PLR 200320013 (regarding the carryover of tax attributes to Newco in the S corporation context). *See also* PLR 201201004 (although attorney, asked to execute name change following S corporation's acquisition, instead mistakenly dissolved Oldco and filed articles of incorporation for Newco (in new name), transaction would be treated as §368(a)(1)(F) reorganization and Newco could continue to use Oldco's previously assigned taxpayer identification number).

[164] *See* Reg. §1.61-12(c). *Cf. Crane v. Commissioner*, 331 U.S. 1 (1947). *See* PLR 200209049 (regarding the carryover of tax attributes to Newco).

[165] Rev. Rul. 73-526.

ISBN 978-1-63359-255-1

subsidiary (QSub) or under the general "check the box" entity election rules; in either case, regulations indicate that while for federal income tax purposes the EIN of the regarded owner (parent) applies, for all other purposes, including employment taxes, the disregarded entity retains its EIN.[166]

G. Treatment of Stockholders and Security Holders

Although the nature of the transactions and exchanges may differ between recapitalizations and F reorganizations, the same provisions of the Code govern the treatment of shareholders and security holders in both. Set forth below is a general description of the tax treatment of stock and security holders in connection with a transaction qualifying as a reorganization under either §368(a)(1)(E) or §368(a)(1)(F). For a more detailed description of the treatment of all parties to various specific recapitalization transactions, see V., below.

The treatment of stockholders and security holders is set forth in §354 and §356. Section 354 provides the rules governing nonrecognition treatment on the receipt of qualifying consideration, and §356 provides the rules for determining the treatment of nonqualifying consideration, i.e., boot.

Section 354(a)(1) provides that no gain or loss is recognized if stock or securities in another corporation that is a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in another corporation that is also a party to the reorganization. While this provision makes no apparent distinction between stock and securities, the remainder of the statute does provide differing tax treatment on the surrender, and receipt, of stock and securities.

An actual physical exchange is not required to generate a realization event or a nonrecognition exchange in a reorganization. In Rev. Rul. 56-654, for example, the IRS ruled that charter amendments altering the redemption and liquidation value of preferred stock were sufficiently substantial to constitute a constructive exchange of preferred and common for new preferred under §368(a)(1)(E).

1. Definition of Security

The Code does not define the term "securities," and accordingly, the courts have had to do so. However, little authority, judicial or administrative, exists on the scope of the term, and the existing interpretations have not been entirely consistent.[167] Until its amendment in 1989, §351(a) conferred nonrecognition treatment on transferors who received either stock or securities in the controlled transferee. Although there are numerous differences between the treatment of securities in §351 and the reorganization provisions, authorities construing the meaning of the term in both provisions are essentially interchangeable.

In holding that unsecured, interest-bearing "land notes," due in installments payable from five to nine years after issuance, were securities, the Fifth Circuit in *Camp Wolters Enterprises, Inc. v. Commissioner*[168] approved the following language of the Tax Court:

> The test as to whether notes are securities is not a mechanical determination of the time period of the note. Though time is an important factor, the controlling consideration is an overall evaluation of the nature of the debt, degree of participation and continuing interest in the business, the extent of proprietary interest compared with the similarity of the note to a cash payment, the purpose of the advances, etc. It is not necessary for the debt obligation to be the equivalent of stock since Sec. 112(b)(5) specifically includes both "stock" and "securities."[169]

Notwithstanding the above directive to eschew mechanical tests based on the time period of the instrument, the courts generally have focused on an instrument's maturity date in evaluating whether to call it a security. In *Helvering v. Watts*,[170] bonds payable serially with maximum maturity dates of seven years were held by the Supreme Court to be securities. The Seventh Circuit in *Burnham v. Commissioner*[171] treated 10-year 3 1/4% convertible debentures, six-year bonds, and 10-year promissory notes as securities. In Rev. Rul. 59-98, the IRS ruled that secured bonds with an average life of 6 1/2 years were securities. In contrast, several cases have held that debt obligations maturing in less than five years do not qualify as securities.[172] In some cases, however, more thoroughgoing analyses of the terms of the instruments and the circumstances under which they were issued have led to results at odds with the maturity date principle.[173] In Rev. Rul. 2004-78, a target corporation merged into an acquiring corporation in a §368(a)(1)(A) transaction. In the merger, the target corporation's security holders exchanged their securities (with a term of two years remaining out of 12 original years) for the acquiring corporation's debt instruments with terms identical to those of the target corporation's securities (including the maturity date), except that the interest rate changed. The modification of the interest rate was a significant modification under Reg. §1.1001-3. The IRS acknowledged that an instrument with a term of less

[166] *See* Reg. §301.6109-1(h), §301.6109-1(i); Reg. §1.1361-4(a)(7), §1.1361-4(a)(8); Rev. Rul. 2008-18.

[167] Adding to the difficulty is the fact that much of the case law on the subject developed at a time when nonrecognition treatment in a reorganization was equally available to stockholders whether they received stock or debt securities. Not surprisingly, in some cases in which the courts early on were developing the notion of continuity of shareholder interest, they were also examining the meaning of the term "security." *See, e.g.*, *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933) (short-term purchase money notes at 45, 75 or 105 days were held not to satisfy "continuity" or "securities" requirement).

[168] 230 F.2d 555 (5th Cir. 1956), *cert. denied*, 352 U.S. 826 (1956).

[169] *Camp Wolters Enters., Inc. v. Commissioner*, 230 F.2d 555, 560 (*quoting* 22 T.C. 737, 751 (1954)).

[170] 296 U.S. 387 (1935).

[171] 86 F.2d 776 (7th Cir. 1936), *cert. denied*, 300 U.S. 683 (1937).

[172] *Pac. Pub. Serv. Co. v. Commissioner*, 154 F.2d 713 (9th Cir. 1946) (demand notes); *Commissioner v. Sisto Fin. Corp.*, 139 F.2d 253 (2d Cir. 1943) (demand notes); *Lloyd-Smith v. Commissioner*, 116 F.2d 642 (2d Cir. 1941) (unsecured two-year notes held not to be securities under predecessor to §351(a)); *L&E Stirn, Inc. v. Commissioner*, 107 F.2d 390 (2d Cir. 1939) (bonds with average maturity of 2 1/2 years); *Cortland Specialty Co. v. Commissioner*, 60 F.2d 937 (2d Cir. 1932), *cert. denied*, 288 U.S. 599 (1933) (14-month promissory notes). See also *Neville Coke & Chem. Co. v. Commissioner*, 148 F.2d 599 (3d Cir. 1945), which took the unusual approach of denying reorganization treatment to holders of three-, four- and five-year notes who exchanged them for stock and securities, on the basis that the notes surrendered did not qualify as securities.

[173] *See, e.g.*, *Lagerquist v. Commissioner*, T.C. Memo 1987-185 (holding notes to be securities based upon elements of risk; one note called for principal repayment over four years, another called for interest only for five years, with amortization of principal over ensuing five years).

ISBN 978-1-63359-255-1

than five years generally is not a security and, thus, an instrument with a term of two years generally does not qualify as a security. However, the IRS ruled that a debt instrument issued by the acquiring corporation in a reorganization in exchange for the target corporation's securities was a §354 "security" if it represents a continuation of the security holders' investment in the target corporation and bears substantially the same terms as the target's securities.

In general, notes with a term of five years or less have difficulty qualifying as securities, while those with a term of 10 years or more almost invariably qualify. Other facts should be taken into account, in determining whether the interest represented thereby represents some greater degree of investment in the corporation than a typical promissory note.

Reg. §1.354-1(e) provides that warrants and other rights to acquire stock are treated as securities under §354, §355, and §356. These rules are discussed at IV.G.2.d., below.

Practice Point: The term "security" as used in the Code does not always carry the same definition. As discussed above, the concept of a security under the earlier version of §351 is indistinguishable from that in the reorganization provisions. The term is also used and defined in §165 with regard to the worthless security loss; this definition is important because, under §166(e), a debt that constitutes a security under §165 may not qualify for a partial bad debt deduction under §166. In short, §165(g)(2) defines a security as including "a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form."[174] An instrument can meet the definition of "security" under §165(g)(2) while not meeting the definition under the reorganization provisions, and vice-versa.

2. General Nonrecognition Rule on Exchange of Stock or Securities

Section 354(a)(1) provides that no gain or loss is recognized on an exchange of stock or securities of parties to a reorganization in pursuance of a plan of reorganization. Thus, under the general rule, if stock or securities in a corporation that is a party to a reorganization are exchanged for stock or securities in that same corporation or another corporation that is a party to the reorganization and the exchange is in pursuance of the plan of reorganization, the exchange is tax-free. In the case of a §368(a)(1)(E) reorganization, this means simply exchanging old stock or securities in the corporation undergoing the recapitalization for its newly issued stock or securities. In the case of an F reorganization, this often means exchanging stock or securities in Oldco for stock or securities in Newco.

Although the general nonrecognition rule appears straightforward, there are several caveats and nuances to the rule. First, as discussed in IV.G.2.a., below, the general nonrecognition rule does not apply to an exchange of stock for securities. Second, as discussed in IV.G.2.b., below, securities may be received tax-free under §354 only to the extent that securities of the same or greater principal amount are surrendered in exchange therefor. Third, as discussed in IV.G.2.c., below, "nonqualified preferred stock" (NQPS) (as defined in §351(g)(2)) received in exchange for (or, in a distribution with respect to) stock other than NQPS is not treated as stock or securities for purposes of the nonrecognition rule, with the result that it is treated as "other property" or "boot."[175] There are also special rules that apply to rights to acquire stock (discussed in IV.G.2.d., below) and accrued interest on surrendered securities (discussed in IV.G.2.e., below).

a. Exchange of Stock for Securities

The language in §354(a)(1) may be thought to imply that there is no distinction between exchanges of stock for stock, securities for securities, and stock for securities. Section 354(a)(2)(A)(ii) provides, however, that the general nonrecognition rule in §354(a)(1) does not apply if securities are received in a reorganization and none are surrendered. In other words, the nonrecognition rule does not apply to an exchange of stock for securities.

b. Exchange of Securities for Securities

Section 354(a)(2)(A)(i) provides that securities may be received tax-free under §354 only to the extent that securities of the same or greater principal amount are surrendered in exchange therefor. A security holder surrendering securities with a principal amount of $1,000 cannot under §354 receive back more than $1,000 in principal amount of new securities on a tax-free basis.

Note: Section 354(a)(2) refers to "principal amount" rather than "issue price," as used in §1273 and §1274.

> *Example 1:* Corporation X has outstanding publicly traded debentures that were issued for $1,000 and are now trading for $1,100, primarily as a result of a drop in interest rates since the debentures were issued. In a recapitalization, the debentures are exchanged for new debentures that have a maturity value of $1,000, but that, because of favorable interest rate and other features, have a fair market value of $1,100. Putting aside the tax treatment to the issuer, the tax treatment to the holders depends on whether the term "principal amount," as used in §354(a)(2), refers to the amount payable at maturity, $1,000, or the issue price, which, under §1273(b)(3)(A) and Reg. §1.1273-2(b), is $1,100. In the former case, the exchange is tax-free to the holders; in the latter case, gain of $100 may be recognized.

> *Example 2:* In a recapitalization, corporation Y issues a publicly traded bond with a stated maturity value of $1,000 and a trading value of $800 to a holder in exchange for a bond with a stated maturity value and adjusted issue price of $800. If the maturity value controls, then nonrecognition will not be available under §354(a)(2)(A) and the holder may recognize up to $200 of gain. If, instead, the issue price of the new bond controls, the exchange qualifies for nonrecognition. Note that the holder is particularly disadvantaged by the former treatment, because the new instrument apparently is issued with $200 of original issue

[174] For an analysis of these rules, and in particular, the meaning of the phrase "in registered form," see 527 T.M., *Loss Deductions.*

[175] §354(a)(2)(C).

ISBN 978-1-63359-255-1

discount and the holder must accrue this amount into income while holding the new bond.

Note: In the absence of a statutory amendment, or at least a clarifying regulation, the plain meaning of the statute should be followed. The "principal amount" is the stated principal amount payable at maturity. Nevertheless, the argument in favor of interpreting the phrase to refer to the instrument's issue price is strong. The rules governing the treatment of holder and issuer under §1271–§1275 focus on the issue price of an instrument, and the tax consequences to an issuer under §108 and Reg. §1.163-7(c) (regarding repurchase premium) are based on this determination. Similarly, the amortizable bond premium measurement under §171 is based on a determination of the issue price of the new instrument. Policy reasons aside, it is reasonable to interpret the phrase "principal amount" to mean "the amount borrowed," for which the issue price is a much closer definition than the amount payable at maturity. The term used in the statute is effectively obsolete from the standpoint of corporate finance and the rules by which instruments are taxed.

c. *Nonqualified Preferred Stock (NQPS)*

As discussed more fully in IV.G.3.c., below, certain preferred stock instruments are treated as "boot" for purposes of a reorganization (as well as a corporate formation or division). Section 354(a)(2)(C)(i) provides that nonqualified preferred stock (NQPS) received in exchange for stock other than NQPS is not treated as "stock or securities" for purposes of the §354(a)(1) nonrecognition rule.[176] Thus, in the context of a reorganization, the nonrecognition rule will apply to the receipt of NQPS in exchange for stock that is also NQPS or in exchange for securities but will not apply to the receipt of NQPS in exchange for any other type of stock (e.g., common stock or qualified preferred stock).

There is a special provision pursuant to which stock that would otherwise meet the definition of NQPS is treated as qualified preferred stock (QPS) and, therefore, qualifies for nonrecognition under §354(a)(1). Reg. §1.356-7(b)(1) provides that preferred stock is QPS (regardless of the fact that it meets the NQPS definitional requirements in §351(g)(2)) if it is received in exchange for (or, in a distribution with respect to) preferred stock (referred to as "the original preferred stock") that meets certain requirements.[177]

d. *Rights to Acquire Stock*

Overriding prior case law treating warrants and other rights to acquire stock as taxable consideration, the regulations provide that, generally, for purposes of §354, §355 and §356, rights issued by a party to a reorganization to acquire its stock are treated as securities with no principal amount.[178] However, because rights to acquire stock are treated as "securities," the nonrecognition rule in §354(a)(1) does not apply to an exchange of solely stock for rights to acquire stock. As discussed above, §354(a)(2)(A)(ii) provides that the nonrecognition rule does not apply if "securities" (in this instance, rights to acquire stock, treated as "securities") are received but none are surrendered. This conclusion is confirmed by an example in the §354 regulations.[179] This shifts the analysis to §356 and the regulations thereunder. Specifically, Reg. §1.356-3(b) provides that stock rights will not be treated as other property under §356, regardless of whether stock rights or debt securities are surrendered in the exchange. Thus, the §356 regulations provide that a shareholder recognizes no gain on the exchange of stock for stock and a warrant; however, it does seem that if the taxpayer does not receive at least one share of stock in exchange for the surrendered stock, the stock rights are taxable consideration.[180]

The treatment of rights to acquire stock as "securities" does not apply to a right to acquire NQPS in exchange for (or in a distribution with respect to) stock, or a right to acquire stock, other than NQPS,[181] except in the case of a §368(a)(1)(E) recapitalization of a family-owned business (as defined in §354(a)(2)(C)(ii)(II)).[182]

For purposes of §354, §355 and §356, the term "rights to acquire stock" of an issuing corporation has the same meaning as the term has in §305(d)(1) and §317(a).[183] It does not include rights exercisable against persons other than the issuer of the stock, or rights that relate to property other than stock of the issuer of the rights. Thus, for example, warrants issued by an acquiring corporation exercisable into stock of its parent would not qualify, unless the parent was a party to the reorganization whose securities could otherwise be issued under §354 and §356.

Practice Point: In this regard, it is interesting to note that, in a forward triangular merger reorganization under §368(a)(1)(A) and §368(a)(2)(D), there is a prohibition on using stock of the acquiring corporation but not on the use of securities of the acquiring corporation. As a result, it may be permissible (although not often desirable) to use a combination of stock of the parent and warrants to acquire stock in the acquiring subsidiary. Of course, in such case, care must be taken that the issuance of the warrants does not disrupt the §368(c) control relationship between parent and acquiring subsidiary.

The regulations make it clear that other Code provisions related to the treatment of rights to acquire stock, such as the compensatory rules under §83 and §421–§424 (nonqualified and qualified stock options, respectively) continue to apply, unaffected, to certain exchanges in connection with a reorganization.[184]

[176] NQPS is defined in §351(g)(2), as discussed in IV.G.3.c.(1), below.

[177] See additional discussion in IV.G.3.c.(3), below.

[178] *See* Reg. §1.354-1(e); Reg. §1.356-3(b). Before the issuance of these regulations, it was well-established that the receipt of warrants was not entitled to tax-free treatment under §354 in a tax-free reorganization. Former Reg. §1.354-1(e); *Bateman v. Commissioner*, 40 T.C. 408 (1963), nonacq., 1965-2 C.B. 7. *See also* Rev. Rul. 78-408, *modified by* Rev. Rul. 98-10.

[179] Reg. §1.354-1(d) *Ex.* 4.

[180] Reg. §1.356-3(c) *Ex.* 7.

[181] Reg. §1.356-6(a)(2).

[182] Reg. §1.356-6(b)(1).

[183] The definitions in these sections are not specific. Section 305(d) provides "(1) RIGHTS TO ACQUIRE STOCK — For purposes of this section, the term 'stock' includes rights to acquire such stock." This language is merely parroted in the regulations. Reg. §1.305-1(d). Proposed regulations would provide more specific definitions. *See* Prop. Reg. §1.305-1(d)(1), §1.305-1(d)(3), REG-133673-15, 81 Fed. Reg. 21,795 (April 13, 2016), proposed to apply to deemed distributions under §305(b) and §305(c) occurring on or after the date the regulations are finalized. Prop. Reg. §1.305-1(e). Section 317 similarly refrains from providing any definition.

[184] Reg. §1.354-1(e).

ISBN 978-1-63359-255-1

Practice Point: Often, in corporate reorganizations, employees of the target corporation hold options on target stock, and new options on stock of the acquirer replace these options. The cancellation of compensatory options in the target and the substitution of compensatory options in the acquiring corporation is ordinarily tax-free to the holders of the options.[185] On the other hand, an exchange of a compensatory option for stock of the acquiring corporation is generally a taxable transaction.[186] The policy considerations underlying the treatment of compensatory options differ considerably from those underlying the treatment of stockholders and security holders in tax-free reorganizations. Congress has enacted a detailed statutory regime that sets forth the consequences of the grant, exercise, or transfer of compensatory options. This system, rather than the reorganization provisions, should be and is the exclusive means of determining the taxability of the transfer and receipt of compensatory options. It should be noted that §354 and §356 may apply after the compensatory transaction is completed for federal income tax purposes. For example, suppose an employee of a corporation exercises a nonstatutory compensatory option and receives unrestricted stock in such corporation. Under §83, the employee has ordinary income equal to the excess of the value of the stock received over the exercise price. Thereafter, the employee generally may surrender such stock in a reorganization and §354 and §356 should govern the tax consequence of such a transaction.

Practice Point: Since this Portfolio deals with the so-called single entity reorganizations, it should be noted that treating stock rights as taxable consideration should bring §305 into play. Although this result has less clear technical support for a recapitalization, the F reorganization regulations state explicitly that where a shareholder in an F reorganization receives cash or other property, the money or property is treated as received in an "unrelated, separate transaction."[187] The regulation mentions Reg. §1.301-1(j), which provides in part that a distribution to shareholders is treated under §301 even though it takes place at the same time as another transaction, for example, in a recapitalization or reincorporation. As yet, there is no definitive rule for recapitalizations comparable to the provision in the F reorganization regulations. In the absence of a comparable provision, despite the obvious incongruity with the F reorganization regulation, it is an open question whether nonqualifying consideration received in a recapitalization is properly treated under §356 or the distribution provisions of §301 and §302. Assuming one is thrown out of §356 and into the normal distribution provisions, if the nonqualifying consideration is a warrant or similar stock right in the distributing corporation, the treatment of the distribution should be governed by §305, which is discussed in IV.G.4., below. This can often result in tax-free treatment under §305(a) and §305(d).

e. Accrued Interest on Surrendered Securities

Under §354(a)(2)(B), nonrecognition treatment is not available to a security holder to the extent that any stock, securities, or other property received is attributable to interest which has accrued on securities during the period for which they were held by the exchanging party. The legislative history makes clear that §354(a)(2)(B) applies regardless of whether the holder realizes gain on the exchange. Furthermore, a holder that had previously accrued the interest income may recognize a loss "to the extent the interest is not paid in the exchange."[188]

Under §358(a)(1), the holder takes a basis in the nonrecognition property equal to its basis in the property exchanged therefor, decreased by the amount of money and fair market value of any other property received, and increased by the amount of income recognized under §356.[189] If a shareholder owning stock of only one class before the transaction receives stock of two or more classes after the transaction, the basis of the stock held before the transaction is allocated among the stock of all classes held immediately after the transaction.[190] Under §1223(1), the holding period of the nonrecognition property includes the period during which the property exchanged therefor was held.[191]

3. Receipt of Other Property or "Boot"

a. General Recognition Rule upon Receipt of Other Property

On its face, §354(a) seems to leave no leeway for the receipt of property other than stock or securities in a reorganization exchange. Section 356(a)(1), however, provides that, if the exchange involves the receipt of money or other property in addition to nonrecognition property, then any gain realized to the recipient is recognized, but in an amount not in excess of the sum of the money and the fair market value of the other property. This additional consideration is commonly referred to as "boot."[192] As stated above, §356(a) taxes the entire gain realized on a reorganization exchange, to the extent of the boot received. Essentially the same as the treatment of boot under §351(b), this approach leads to a result very different from that where the transaction is bifurcated into a part taxable and part nontaxable transaction. In contrast, the bifurcation approach has been adopted for property transferred to a partnership in circumstances in which, under §707(a)(2)(B), there is a part disguised sale and part partnership contribution.[193]

> *Example:* In a recapitalization, shareholder B exchanges common stock with a basis of $400 and a fair market value of $1,000 for $500 cash and preferred stock (that is not nonqualified preferred stock) worth $500. Under §356(a), B has realized gain of $600 ($1,000 worth of consideration less B's basis of $400), which must be recognized to the extent of the cash received of $500. In contrast, if the transaction is bifurcated, B is treated as selling one-half of the stock for $500 cash and exchanging one-half for the

[185] *See* Reg. §1.83-7.

[186] Reg. §1.356-3(c) *Ex. 7*; *LeVant v. Commissioner*, 45 T.C. 185, 194 (1965), *rev'd on other grounds*, 376 F.2d 434 (7th Cir. 1967).

[187] Reg. §1.368-2(m)(3)(iii).

[188] S. Rep. No. 96-1035, at 38 (1980).

[189] *See, e.g.*, PLR 200320013 (F reorganization).

[190] *See* Reg. §1.358-2(a)(2). *See, e.g.*, PLR 200311002 (E reorganization).

[191] *See, e.g.*, PLR 200311002 (E reorganization), PLR 200320013 (F reorganization).

[192] For a more thorough discussion of the treatment of boot, see 782 T.M., *Boot Distributions and Assumption of Liabilities.*

[193] Reg. §1.707-3(a).

ISBN 978-1-63359-255-1

preferred; B, therefore, recognizes only $300 of gain ($500 cash less $200 basis).

Under §356(c), in no event may loss be recognized in a reorganization exchange. Section 354 and §356, moreover, do not apply to a stockholder receiving only cash or other property for stock in connection with a reorganization. Such an exchange is treated as a sale or, if the stock is surrendered to the issuing corporation, as a redemption of the stock by the corporation.[194]

Under §358(a)(1), the shareholder or security holder takes a basis in the nonrecognition property equal to the basis in the property surrendered, decreased by the amount of money and the fair market value of any other property received, decreased further by any loss recognized on the exchange, and increased by the amount of income recognized (as gain, or as a dividend taxed as either gain or ordinary income) on the exchange. Under §358(a)(2), the basis in any other property received is its fair market value.

b. *Securities as Boot*

Section 356(d)(1) provides that "other property" includes securities. This inclusion is limited, however, by §356(d)(2)(A), which provides that "other property" does not include any securities to the extent that their receipt is permitted under §354 (or §355) without the recognition of gain. Thus, in a transaction to which §354 applies, if the principal amount of securities received exceeds the principal amount of securities surrendered, "other property" includes the fair market value of that excess principal amount (rather than the excess principal amount itself).[195] If no securities are surrendered, then the entire principal amount of the securities received is considered "other property."[196]

As discussed above, the right to acquire the stock of a party to a reorganization is generally (although not always) treated as "securities" having no principal amount. Thus, the rules in §356(d) apply to the receipt of stock rights in a reorganization. The receipt of stock rights will result in gain recognition if no securities are surrendered in the transaction.

c. *Nonqualified Preferred Stock as Boot*

(1) *Definition*

Section 354(a)(2)(C)(i) provides that, generally, "nonqualified preferred stock" (NQPS) (as defined in §351(g)(2)) received in exchange for stock other than NQPS, is not treated as stock or securities for purposes of the §354(a)(1) nonrecognition rules, with the result that it is treated as "other property" (boot). Pursuant to this definition, only NQPS received in exchange for *stock other than NQPS* is treated as "other property." Thus, the receipt of NQPS in exchange for comparable NQPS or in exchange for debt securities does not trigger the recognition of gain.

Under §351(g), stock is considered NQPS if it (1) is preferred stock within the §351(g)(3) definition (i.e., stock that is limited and preferred as to dividends, and does not participate in corporate growth to any significant extent);[197] and (2) meets any one of the following tests:[198]

(a) the holder has a right to "put" the stock to an issuer or related party (within the meaning of §267(b) and §707(b));

(b) the issuer or a related party is obligated to buy the stock back;

(c) the issuer or related party has the right to buy the stock back and, as of the issue date, it is more likely than not that such right will be exercised; or

(d) the dividend rate is based on interest rates, commodity prices or other similar indices.

The tests described in (a), (b), and (c), above, are met only if the right or obligation may be exercised within a 20-year period; and the likelihood of such exercise is not remote.[199] Moreover, a right or obligation is disregarded if it may be exercised only upon the death, disability, or mental incompetence of the holder; but only if neither the stock surrendered nor the stock received in the exchange is publicly traded.[200] In addition, a right or obligation to redeem or purchase stock is disregarded if it is transferred in connection with the performance of services for the issuer or a related person (i.e., it is reasonable compensation) if it may be exercised only upon the holder's separation from service.[201] With respect to this rule, the regulations provide that preferred stock containing a right or obligation described in the three clauses listed above that is exercisable only upon the holder's separation from service from the issuer or a related person will be treated as transferred in connection with the performance of services (and representing reasonable compensation) if the preferred stock is received in exchange for (or in a distribution with respect to) existing stock containing a similar right or obligation (exercisable only upon separation from service) and the existing stock was transferred in connection with the performance of services for the issuer or a related person (and represented reasonable compensation when transferred).[202] In applying the rules related to NQPS, the preferred stock received will continue to be treated as transferred in connection with the performance of services (and representing reasonable compensation) in subsequent transactions involving such stock.[203] This rule applies regardless of whether the old compensation stock is common or preferred stock.

In determining whether stock is "preferred" for purposes of §351(g), stock is not treated as participating in corporate growth to any significant extent unless there is a real and meaningful likelihood of the shareholder actually participating in the earnings and growth of the corporation.[204] If there is not a re-

[194] Reg. §1.354-1(d) *Ex.* (3); Rev. Rul. 74-515.
[195] §356(d)(2)(B). *See also* Reg. §1.356-3(a).
[196] §356(d)(2)(B).

[197] §351(g)(3)(A).
[198] §351(g)(2)(A). *See, e.g.*, PLR 200311002. *Cf.* PLR 200440003, PLR 200440004 (professional corporation's preferred stock will not constitute "nonqualified preferred stock" within meaning of §351(g)(2); licensure agreements make it unlikely that corporation will redeem shares, and no agreement grants redemption rights or requires redemption).
[199] §351(g)(2)(B).
[200] §351(g)(2)(C)(i)(I).
[201] §351(g)(2)(C)(i)(II).
[202] Reg. §1.356-7(c).
[203] Reg. §1.356-7(c).
[204] §351(g)(3)(A).

ISBN 978-1-63359-255-1

al and meaningful likelihood that dividends beyond any limitation or preference actually will be paid, the possibility of such payments will be disregarded in determining whether stock is limited and preferred as to dividends.[205]

For purposes of determining whether stock participates in corporate growth to any significant extent, neither a conversion privilege into stock of the issuer nor stock that is convertible or exchangeable into stock of a corporation, other than the issuer (including, for example, stock of a parent corporation or other related corporation), will be automatically considered to constitute such participation.[206]

Stock described in §351(g)(2) is considered NQPS regardless of the date on which the stock was issued (i.e., the stock could have been issued in a transaction before the effective date of the NQPS provisions but would still be considered NQPS).[207]

> *Example:* Assume that corporation (T) issues preferred stock described in §351(g)(2) to shareholder (X) in 1996, and that X surrenders the T stock and receives NQPS of acquiring corporation (P) in a reorganization occurring after June 8, 1997. If the T preferred stock received in 1996 was not treated as NQPS for purposes of the reorganization, X could recognize gain on the exchange. This result is unwarranted because X is not receiving a more secure type of investment in exchange for a relatively risky type of investment. However, under Reg. §1.356-7(a), the T stock received in 1996 qualifies as NQPS, such that the subsequent receipt of NQPS in exchange therefor is not taxable under §354(a)(2)(C)(i).

(2) Exception Applicable to Family-Owned Corporations

The general rule treating NQPS as boot does not apply in the context of a §368(a)(1)(E) recapitalization of a family-owned corporation.[208] For purposes of this provision, a corporation is a "family-owned corporation" if at least 50% of the total combined voting power of all classes of stock entitled to vote and at least 50% of the value of all other classes of stock is owned by members of the same family throughout the eight-year period beginning on the date which is five years before the date of the recapitalization.[209] Thus, the corporation must meet the definition of a family-owned corporation for five years preceding the recapitalization as well as a three-year period following the recapitalization. Members of the same family are defined by reference to the definition in §447(e). Thus, a family includes children, parents, brothers, sisters, and spouses, with a limited attribution for directly and indirectly owned stock for the corporation.

(3) Exception Applicable to Certain Exchanges of Substantially Identical Preferred Stock

Preferred stock that would otherwise be considered NQPS (i.e., meets the §351(g)(2) definition of NQPS) is treated as qualified preferred stock (QPS) if it is received in exchange for QPS (referred to as the "original preferred stock") as long as the following two requirements are met:[210]

- the original preferred stock is QPS (i.e., is not NQPS) solely because, at the time it was issued a right or obligation described in §351(g)(2)(A)(i) through §351(g)(2)(A)(iii) was (1) not exercisable until after a 20-year period beginning on the issue date; (2) exercisable within a 20-year period but was subject to a contingency that made the likelihood of exercise remote; (3) not more likely than not to be exercised within a 20-year period beginning on the issue date; or (4) any combination of these three reasons; and

- the stock received is substantially identical to the original preferred stock.

The stock received is considered to be substantially identical to the original preferred stock if two conditions are met: (1) the stock received does not contain any terms that, in relation to the terms of the original preferred stock, decrease the period in which a redemption or purchase right will be exercised, increase the likelihood that such a right will be exercised, or accelerate the timing of the returns from the stock instrument (including the receipt of dividends or other distributions),[211] and (2) as a result of the exchange (or distribution), the exercise of the right or obligation does not become more likely than not to occur within a 20-year period beginning on the issue date of the original preferred stock.[212]

> *Example:* Assume that on January 1, Year 1, corporation (T) issues preferred stock to shareholder (X) that permits the holder to require T to redeem the stock on demand, but not before the stock is held for 22 years. This original preferred stock is QPS. Seven years later, the T stock is exchanged in a reorganization for acquiring corporation (P) preferred stock with substantially identical terms that permit the holder to redeem the stock after 15 years. Although this transaction appears to be a taxable exchange of NQPS for stock other than NQPS, the substantially identical rule under Reg. §1.356-7(b) allows nonrecognition treatment because the P stock is a continuation of the original investment in the T stock.

(4) Effect of Receipt of NQPS Treated as Boot

As in the case of any other type of nonqualifying consideration, if a shareholder receives solely NQPS in a reorganization, the exchange is simply a taxable sale or exchange; in the context of a recapitalization, the exchange presumably ought to be treated as a redemption subject to the limitations of §302. If it were simply a sale or exchange not subject to §302, then a shareholder could obtain capital gain treatment notwithstanding the fact that the exchange would have failed to qualify under one of the provisions of §302(b). Note, however, that the advantage of obtaining capital gain treatment has been lessened by §1(h)(11), which generally taxes an individual's "qualified

---

[205] §351(g)(3)(A).

[206] H.R. Rep. No. 105-220, at 545 (1997) (Conf. Rep.).

[207] Reg. §1.356-7(a).

[208] §354(a)(2)(C)(ii)(I).

[209] §354(a)(2)(C)(ii)(II) (reference to the definition of "family-owned corporation" in §447(d)(2)(C)(i)).

[210] Reg. §1.356-7(b).

[211] Reg. §1.356-7(b)(2)(i).

[212] Reg. §1.356-7(b)(2)(ii).

ISBN 978-1-63359-255-1

dividend income" as net capital gain rather than ordinary income.

This should be the result; however, there appears to be a formidable technical argument to the contrary. The §302 redemption rules are tied directly to the definitions contained in §317. Section 317(b) states that "stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property … ." Section 317(a) defines property as "money, securities, and any other property, except that such term does not include stock in the corporation making the distribution … ." On a technical basis, nonqualified preferred is nowhere excluded from the definition of stock generally, and therefore, stock issued in a recapitalization is not property for purposes of applying the redemption rules under §302. Thus, on the one hand, the exchange is taxable; on the other hand, arguably, it is simply a taxable exchange under §1001 and not subject to being characterized as a §301 distribution under §302(b) and §302(d). One may not feel very comfortable embracing this technical argument in a case where §302 would clearly put the shareholder into §301; this could be one of the relatively rare instances where *Bazley*[213] might be resurrected to take the taxpayer out of the reorganization provisions.

Note also that NQPS receives no special treatment under the §305 rules. Therefore, it ordinarily is possible for a shareholder to obtain nonrecognition treatment upon the distribution of a pro rata stock dividend in NQPS under circumstances where an exchange of common (even on a pro rata basis) for the preferred would be taxable under §354 and §351(g).

Practice Point: Section 351(g) may be avoided by simply issuing preferred stock that is not redeemable for 20 years.[214] It seems unlikely that a call right could ever be used successfully within the 20-year period and not run afoul of the NQPS rules. To have a call provision pass muster, one presumably would have to be comfortable that it was improbable that at any point within the next 20 years it would be desirable economically for the issuing company to exercise the call.

d. Dividend Equivalency

Section 356(a)(2) provides that, if the receipt of boot in the exchange "has the effect of the distribution of a dividend … then there shall be treated as a dividend to each distributee such an amount of the gain recognized under [§356(a)(1)] as is not in excess of his ratable share of the undistributed earnings and profits of the corporation … . The remainder, if any, of the gain recognized … shall be treated as gain from the exchange of property." The issue of the treatment of boot as a dividend versus capital gain is less significant than it used to be, because §1(h)(11) taxes a noncorporate shareholder's "qualified dividend income" (i.e., dividends from domestic corporations and certain foreign corporations) as net capital gain rather than ordinary income for the affected years. For corporate taxpayers, there is an incentive to characterize distributions as dividends due to the availability of the dividends received deduction.[215]

There are two main issues that have arisen in the context of determining whether a distribution of boot has the effect of a dividend. The first, which is an important issue in the context of a recapitalization, is whether and the extent to which the rules in §302 apply for purposes of §356(a)(2). Both the courts and the IRS have held that the §302 principles should be applied as guidelines when determining dividend equivalency under §356(a)(2) and that this determination should be made by examining the effect of the exchange as a whole.[216]

The second issue is whether the redemption rules in §302 should be applied as if the shareholders of the target corporation received the boot (1) in a hypothetical redemption by the target immediately before the reorganization (referred to as the "pre-reorganization test) or (2) in a hypothetical redemption by the acquiring corporation of that portion of its stock that the shareholder would have received if they had not received boot (referred to as the "post-reorganization" test).[217] In *Clark v. Commissioner*,[218] the Supreme Court adopted the post-reorganization redemption approach in determining whether boot received in a reorganization is equivalent to a dividend.

Once dividend equivalency is established, the next issue is which corporation's earnings and profits should be relevant. While §356(a)(2) refers to "undistributed" earnings and profits, several courts have included current earnings and profits within this calculation.[219] This appears to be the IRS position as well.[220] Generally, this provision has been understood to refer to the undistributed earnings and profits of the transferor corporation.[221] In *Davant v. Commissioner*,[222] however, the Fifth Circuit, finding under pre-TEFRA law that a combination of multiple operating companies qualified as an F reorganization, stated: "Where there is complete identity of stockholders, the use of the earnings and profits of both corporations is the only logical way to test which distributions have the effect of a dividend."[223]

The same issue has been involved in a number of other cases decided since *Davant*.[224] These cases have held that the amount of the dividend distribution under §356(a)(2) is limited by the undistributed earnings and profits of the transferor corporation. Although the Court in *Clark* did not address the issue of which corporation's earnings and profits is relevant when determining the amount of a boot distribution treated as a dividend, the holding in *Clark* that a post-reorganization test is appropriate certainly leaves open the question of whether

[213] *Bazley v. Commissioner*, 331 U.S. 737 (1947).
[214] §351(g)(2)(B).
[215] *See* §243.

[216] *See* Rev. Rul. 93-62. *See also Clark v. Commissioner*, 489 U.S. 726 (1989).
[217] This test was first applied in *Wright v. United States*, 482 F.2d 600 (8th Cir. 1973).
[218] 489 U.S. 726 (1989).
[219] *Vesper Co. v. Commissioner*, 131 F.2d 200 (8th Cir. 1942); *Weaver v. Commissioner*, 25 T.C. 1067 (1956); *James Armour, Inc. v. Commissioner*, 43 T.C. 295 (1964).
[220] Rev. Rul. 70-240.
[221] *See James Armour, Inc. v. Commissioner*, 43 T.C. 295 (1964).
[222] 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967).
[223] 366 F.2d 874, 889. In Rev. Rul. 70-240, the IRS followed *Davant* and ruled that, when there is complete shareholder identity, both corporations are considered "distributing" corporations and the amount of the dividend is computed on combined earnings and profits.
[224] *See Atlas Tool Co. v. Commissioner*, 70 T.C. 86 (1978), *aff'd*, 614 F.2d 860 (3d Cir. 1980), *cert. denied*, 449 U.S. 836 (1980); *Am. Mfg. Co. v. Commissioner*, 55 T.C. 204 (1970).

ISBN 978-1-63359-255-1

the combined post-reorganization earnings and profits is appropriate for determining available earnings and profits under §356(a)(2).

With respect to the attribution rules, §356(a)(2) specifically provides that the constructive ownership rules of §318 apply in determining whether a distribution has the effect of a dividend under §356.

e. *Separable Distributions*

In the case of an ordinary redemption that is treated as an exchange under §302(a), the shareholder computes gain based upon the consideration received against the basis in the shares surrendered. In a reorganization, gain is first determined based upon the excess of the value of all consideration received over the basis in all shares surrendered, and the gain is recognized to the extent of the boot. The different computations can lead to differing results.

> *Example:* In a recapitalization, shareholder B surrenders old common stock with a basis of $100 and a fair market value of $200 for new common stock and cash of $50. Under §356(a)(1), B recognizes gain of $50 (the entire amount of the boot) because B's realized gain is $100 ($200 total consideration less $100 basis). If, instead, no reorganization occurs and B redeems only 25% of the common stock for $50, B recognizes gain of only $25 ($50 amount realized less $25 basis in the shares redeemed).

In the case of a C corporation, an ordinary distribution under §301 is treated as a dividend to the extent of current or accumulated earnings and profits.[225] Provided there are sufficient earnings and profits, it is irrelevant how much basis the shareholder may have in the stock. Under §356(a)(2), on the other hand, a shareholder may only have dividend treatment to the extent gain was realized and recognized on the exchange. Once it is determined, however, that a particular amount of boot is treated as a dividend under §356(a)(2), that characterization holds for all purposes, such as the dividends received deduction under §243.[226]

These differences in treatment between distributions in connection with a reorganization (boot) and those not in connection with a reorganization make it important to determine whether and when a pre- or post-reorganization redemption or dividend will be integrated with a reorganization so as to treat the corporate distribution as other property subject to the rules of §356. The *Bazley* case, discussed in III.A., above, represents one instance in which a distribution in a purported recapitalization was treated as a dividend.[227] Along similar lines, Reg. §1.301-1(j), also discussed in III.A., above, specifically authorizes the IRS to treat a purported boot distribution in an E or an F reorganization as a dividend distribution separate from the reorganization.

The final regulations regarding F reorganizations address whether distributions of money or other property in an F reorganization are distributions to which §356 applies. Citing Reg. §1.301-1(j), the regulations provide that it is appropriate to treat such distributions as transactions separate from the F reorganization, even if they occur during the F reorganization. Accordingly, the regulations provide that if a shareholder receives money or other property from either Oldco or Newco in the course of an F reorganization, the receipt of the money or other property is treated as an "unrelated, separate transaction from the reorganization, whether or not connected in a formal sense."[228] Thus, §356 does not apply to distributions related to an F reorganization; the distributions are subject to §301 and §302.

Practice Point: Oddly, there is not a comparable regulation that specifically indicates the same treatment for a cash or property distribution occurring in connection with a recapitalization. With the Reg. §1.301-1(j) regulation and the expression of IRS and Treasury's approach to the other single entity reorganization in the F reorganization regulations, one would expect that the distribution rules of §301 and §302, rather than the boot rules under §356, should be applied to other property received by shareholders in a recapitalization. Indeed the IRS has said as much, but never in an authoritative way.[229] Nevertheless, we are aware of respected practitioners that regard the absence of a regulation or ruling on the matter as leaving in place the presumption that boot in a §368(a)(1)(E) recapitalization is treated under §356 rather than §301 and §302. Further, especially with nothing directly on point and only the §301 regulation to guide us, there may be some circumstances where separate distribution treatment is more clearly appropriate and others where the "boot" rule may make more sense. In any case, it is good to keep in mind that the principal difference is that, while in either case the §302(b) tests come into play to determine whether there is a sale or a dividend, §356 will limit the amount of income to gain in the exchanged shares, while under §301 there is generally no basis recovery (provided there is sufficient E&P).

f. *Cash in Lieu of Fractional Shares*

In a reorganization in which stock is the principal or sole consideration, it is usually desirable to avoid the issuance of fractional shares. This is typically dealt with by issuing cash in lieu of the fractional share interest. For a number of years, the IRS has been quite liberal in facilitating such arrangements, even to the point of stating that the cash in lieu of fractional shares will not violate the "solely for voting stock" requirement

---

[225] §301(c)(1), §316(a).

[226] *King Enters., Inc. v. United States*, 418 F.2d 511 (Ct. Cl. 1969); Rev. Rul. 72-327. *See also* Rev. Rul. 74-387 (dividend characterization applied for purposes of deemed paid foreign tax credit under former §902).

[227] *Bazley v. Commissioner*, 331 U.S. 737 (1947).

[228] Reg. §1.368-2(m)(3)(iii).

[229] In the preamble to the 2004 F reorganization proposed regulations (69 Fed. Reg. at 49,838), the IRS stated: "A number of commentators have questioned whether distributions of money or other property in an F reorganization are distributions to which section 356 applies. The IRS and the Treasury Department believe it is appropriate to treat such distributions as transactions separate from the F reorganization, even if they occur during the F reorganization. *See, e.g.*, §1.301-1(j). Accordingly, these proposed regulations provide that if a shareholder receives money or other property (including in exchange for its shares) from the transferring or resulting corporation in a transaction that constitutes an F reorganization, the money or other property is treated as distributed by the transferring corporation immediately before the transaction. The tax treatment of such distributions is governed by sections 301 and 302, and section 356 does not apply to such distributions. The IRS and the Treasury Department believe that the same rule should apply in the context of E reorganizations. Comments are requested on whether there are some E reorganizations to which this treatment should not apply." (Emphasis added).

ISBN 978-1-63359-255-1

of a B reorganization.[230] In such cases, the cash is not treated as boot, but instead, the transaction is treated as if the fractional share interest had been issued, and then redeemed in a transaction qualifying as an exchange under §302(a). To meet this requirement, the payment of cash in lieu of fractional share interests must represent a mere mechanical rounding off of the fractions in the exchange rather than separately bargained for consideration.[231]

The IRS has applied this rule to the treatment of fractional shares in both recapitalizations and F reorganizations.[232]

Instead of paying cash directly for fractional share interests, a corporation may instead issue and aggregate all of the fractional shares, sell them on the open market, and distribute the cash proceeds ratably among the shareholders entitled to the fractional share interests. In this case, the cash is not treated as distributed in redemption of stock. Instead, the shareholder is treated as receiving the fractional share interest and selling it on the open market.[233]

The payment of cash in lieu of fractional shares can be the means of squeezing out minority shareholders, through a transaction called a reverse stock split. In such a transaction, the corporation adopts a plan of recapitalization calling for a pro rata reduction in the number of common shares outstanding. For example, every 1,000 common shares would be automatically converted into one new common share. By also providing that no fractional shares will be issued, and cash will be issued in lieu thereof, such a plan has the effect of cashing out all holders of fewer than 1,000 shares of stock.[234] Note that a shareholder receiving both stock and cash in a reverse stock split will likely not come within the liberal rule of the IRS subjecting the shareholder to automatic exchange treatment under §302(a). This is because the payment of cash represents more than a mere mechanical rounding incident to the recapitalization.

4. *Application of §305 to Recapitalizations*

a. *General Rule and Exceptions*

Section 305 governs distributions by a corporation of its own stock to its shareholders. Under §305(d), the rules may apply to distributions of rights to acquire stock, and the distributees may include the holders of stock rights or convertible securities.

The general rule, in §305(a), is that gross income does not include the amount received by a shareholder in a distribution by a corporation of its own stock. Section 305(b) sets forth exceptions; if an exception applies, the distribution of stock is a distribution of property subject to §301. The exceptions all involve situations in which the effect of the stock distribution is an increase in the proportionate interests of some shareholders.

Almost any recapitalization exchange other than one involving purely debt holders may implicate §305, and a principal concern of a tax adviser analyzing a proposed recapitalization transaction is to ensure that the apparently tax-free §354 recapitalization exchange is not treated as a taxable §305(b) distribution.

b. *Distinguishing Exchange from Distribution*

Section 305 applies to a “distribution” of the stock of a corporation. In Rev. Rul. 86-25, a closely held corporation underwent a recapitalization in which each common share could be exchanged for one new voting common and 99 nonvoting common shares or one new voting common and six nonvoting preferred shares. The IRS concluded that the transaction should not be bifurcated into a §1036 exchange of one old voting common share for one new voting common share and a §305 distribution of nonvoting common stock to some shareholders and nonvoting preferred to other shareholders. Instead, the transaction should be treated in accordance with its form as a single integrated exchange qualifying as a recapitalization under §368(a)(1)(E). The ruling conceded that the transaction might have been effected by a distribution of preferred and nonvoting common with respect to the old common stock. It went on, however, to state the following rule:

> [A] transaction that effects a reshuffling of a corporation’s capital structure will be respected as a recapitalization exchange to which section 305(b)(3) of the Code does not apply so long as it has a bona fide business purpose and is an isolated transaction and not part of a plan to increase periodically the proportionate interest of any shareholder in the assets or earnings and profits of a corporation.

Thus, as a practical matter, the IRS does not apply §305 to a recapitalization merely because the same result could have been achieved through a stock distribution.

c. *When Is a Recapitalization Treated as a §305 Distribution?*

Reg. §1.305-7 generally sets forth the criteria under §305(c) for determining when certain transactions not formally involving stock distributions are characterized under §305.[235] Under Reg. §1.305-7(a), a distribution under §305(b) and §301 occurs when (a) the proportionate interest of any shareholder in the assets or earnings and profits of the corporation is increased and (b) the deemed distribution would have the result described in §305(b)(2), §305(b)(3), §305(b)(4), or §305(b)(5).[236]

This standard adds little to the statute, and is too broad to be useful. As a result, the IRS has generally determined whether §305 applies to a recapitalization by applying the “isolated transaction” test found in Example (12) of Reg. §1.304-3(e). Pursuant to that test, a recapitalization exchange

[230] Rev. Rul. 66-365. The ruling is based on *Mills v. Commissioner*, 331 F.2d 321 (5th Cir. 1964).

[231] Rev. Rul. 66-365.

[232] Rev. Rul. 69-34 (recapitalizations); Rev. Rul. 74-36 (F reorganizations).

[233] *See* Rev. Rul. 78-375.

[234] Such a recapitalization has been approved by the IRS. *See* Rev. Rul. 72-57, *modified by* Rev. Rul. 78-351.

[235] For a more extensive discussion of the rules under §305, see 765 T.M., *Stock Rights and Stock Dividends — Sections 305 and 306*.

[236] The IRS and Treasury have issued proposed regulations under §305(c) that would purportedly (1) resolve ambiguities regarding the amount and timing of deemed distributions that are or result from adjustments to rights to acquire stock (including convertible debt instruments); and (2) provide additional guidance to withholding agents regarding their current withholding and information reporting obligations with respect to deemed distributions. *See* preamble to REG-133673-15, 81 Fed. Reg. 21,795 (Apr. 13, 2016), generally proposed to apply to (1) deemed distributions occurring on or after the date the regulations are finalized and (2) payments made on or after the date the regulations are finalized.

ISBN 978-1-63359-255-1

generally is not treated as a taxable distribution under §305(b) and §305(c) if it is an isolated transaction and not part of a plan to periodically increase the proportionate interest of any shareholder in the assets or earnings and profits of the corporation.[237]

In the example in the regulations, there is a "single and isolated" recapitalization in connection with the retirement of the major shareholders, in which the older shareholders exchange their common for common and preferred, and the younger shareholders exchange their common solely for new common. The example concludes that the exchanges are not within the purview of §305.[238]

It is not enough, however, for a recapitalization to be an isolated transaction. Under Reg. §1.305-7(c)(1), a recapitalization (whether or not an isolated transaction) is treated as a §305 distribution if either: (1) it is pursuant to a plan to periodically increase a shareholder's proportionate interest in the assets or earnings and profits of the corporation; or (2) there is an exchange of preferred with dividend arrearages for stock whose value exceeds the issue price of the preferred.[239]

Section 305 can also affect so-called leveraged recapitalizations and similar transactions. As in the case of the E reorganization recapitalization, the §305 regulations generally do not cause a "single and isolated" redemption to give rise to §305 treatment to those nonredeeming shareholders whose proportionate interests in the corporation are increased by the redemption.[240]

d. Preferred Stock and Redemption Premium

Although §305 may not present a problem in the recapitalization exchange itself, it may pose problems with respect to instruments issued in the transaction on an ongoing basis.

Under §305(b)(4), any distribution of stock with respect to preferred stock is treated as a distribution of property subject to §301, except for an increase in the conversion ratio of convertible preferred to take into account stock dividends or stock splits on the common. The regulations define preferred stock in terms of its limited participation in corporate growth. This determination, however, is made without regard to the convertibility of the stock into another class.[241]

In certain circumstances, if a corporation issues preferred stock that may be redeemed at a price higher than the issue price, the difference is treated as a constructive distribution (or series of constructive distributions) of additional stock on preferred stock.[242] Constructive distribution treatment does not result, however, if the redemption premium does not exceed a de minimis amount.[243] The amount of the constructive distribution is taken into income under principles similar to those in §1272(a).[244]

Constructive distribution treatment applies to stock if the issuer is required to redeem the stock at a specified time or the holder has the option to require the issuer to redeem the stock.[245]

If preferred stock may be acquired by a person other than the issuer (a third person), the regulations treat the third person as the issuer if acquisition of the stock by the third person would be treated as a redemption for federal income tax purposes.[246] In addition, if the issuer and the third person are members of the same affiliated group, "issuer" includes the third person if a principal purpose of the arrangement is to avoid the application of §305 and the regulations thereunder. Furthermore, an agreement or other arrangement for a person other than the issuer of the stock to acquire the stock may create a conversion transaction within the meaning of §1258.[247]

However, these rules do not apply to an obligation to redeem or to a holder's ability to require redemption that is subject to a contingency beyond the legal or practical control of either the holder or the holders as a group if, based on all of the facts and circumstances as of the issue date, the likelihood of redemption is remote.[248]

Constructive distribution treatment also is required with respect to an issuer call only if, based on all of the facts and circumstances as of the issue date, redemption pursuant to the call right is more likely than not to occur.[249] A safe harbor is provided under which constructive distribution treatment does not result from an issuer call if the issuer and holder are unrelated, no arrangements effectively require or are intended to compel the issuer to redeem the stock, and exercise of the option to redeem would not reduce the yield of the stock.[250]

Practice Point: In determining whether parties are related, the rules of §267(b) and §707(b) apply. For purposes of applying those sections (including §267(f)(1)), the phrase 20% is substituted for 50%. The yield of the stock is determined under principles similar to the principles of §1272(a) and the regulations under §1271–§1275.[251]

---

[237] *See also* Rev. Proc. 81-60, §4.06; PLR 200311002 (representation (d)), PLR 9212013 (representation (e)), PLR 9146021 (representation (e)). *See also* TAM 200116002 (advising that general rule of §305(a) applied to transaction in which shareholders recapitalized Target before merger and held same amount of common stock after recapitalization but in which common stock was converted to Newco preferred stock as part of merger; all three shareholders received, pro rata, 100% of Newco preferred stock without increase in their proportionate interest in earnings and profit or assets, either as class of shareholders or relative to one another).

[238] *See also* PLR 199946002 (same conclusion when corporation offered older shareholders choice of trading common stock for either new common and preferred or for only preferred stock and gave bonus in value to those exchanging solely for preferred stock, so that some older shareholders received stock with disproportionately greater value in recapitalization).

[239] *See* additional discussion of the §305 treatment of dividend arrearages in V.B.2., below.

[240] Reg. §1.305-3(e) *Ex.* (10). *See, e.g.*, PLR 200428023, PLR 200428024 (redemption of stock pursuant to tender offer undertaken to increase stock value was single, isolated transaction; tender offer did not result in deemed distribution under §305).

[241] Reg. §1.305-5(a). *See also* TAM 200116002 (acknowledging that receipt of preferred stock with liquidation preference greatly in excess of issue price and with mandatory liquidation date could be characterized as redemption premium, but advising that §305(a) excludes deemed distribution from income because distribution was made with respect to stock held by shareholder and preferred stock significantly participated in Newco's growth when liquidation preference was based upon value of available Newco assets on liquidation date, preference exceeded then value of Newco's assets, and preference exceeded value of all assets that Newco was likely to accumulate by liquidating date).

[242] Reg. §1.305-5(b)(1).

[243] Reg. §1.305-5(b)(1). Whether or not an amount is de minimis is determined under the principles of §1273(a)(3).

[244] Reg. §1.305-5(b)(1).

[245] Reg. §1.305-5(b)(2).

[246] Reg. §1.305-5(b)(1).

[247] Preamble to T.D. 8643, 60 Fed. Reg. 66,134 (Dec. 21, 1995).

[248] Reg. §1.305-5(b)(2).

[249] Reg. §1.305-5(b)(3)(i).

[250] Reg. §1.305-5(b)(3)(ii).

[251] Reg. §1.305-5(b)(3)(ii)(C).

ISBN 978-1-63359-255-1

When multiple redemptions are possible, the time and price at which redemption is most likely to occur must be determined based on all of the facts and circumstances as of the issue date. If the redemption does not occur at that identified time, the amount of any additional premium payable on any later redemption date, to the extent not previously treated as distributed, is treated as a constructive distribution over the period from the missed call or put date to that later date, to the extent required under the general principles of Reg. §1.305-5(b).[252]

The issuer's determination as to whether there is a constructive distribution is binding on all holders of the stock, other than a holder explicitly disclosing that its determination as to whether there is a constructive distribution differs from that of the issuer. The disclosure must be made on a statement attached to the holder's timely filed federal income tax return for the taxable year that includes the date the holder acquired the stock. The issuer must provide the relevant information to the holder in a reasonable manner (i.e., the issuer may provide the name or title and either the address or telephone number of a representative of the issuer who will make the required information available to holders).[253]

5. Section 306 Stock

No discussion of reorganizations in general, and of recapitalizations in particular, could be complete without some attention to §306 stock. Indeed, whenever one is considering a transaction involving preferred stock, one should give some consideration to the possibility that the stock will be treated as §306 stock, and to the consequences of such characterization.

Section 306 was introduced in the 1954 Code in response to an earnings and profits bailout technique exemplified by the transaction in *Chamberlin v. Commissioner*.[254] In summary, the taxpayers caused their corporation to distribute as a tax-free stock dividend shares of redeemable preferred stock, followed immediately by a prearranged sale of the preferred by the shareholders to an unrelated insurance company. The Sixth Circuit held that the taxpayers successfully had received a tax-free stock distribution followed by a capital gain sale of the distributed stock.

Section 306 is based upon the view that, although the distribution of preferred stock may be tax-free under §305 or the reorganization provisions, the gain to the shareholder upon a subsequent sale of the preferred stock should be taxed as a dividend because, due to the debt-like qualities of the preferred stock, a shareholder may dispose of that stock to third parties without any fear of diminishing the shareholder's real interest in the corporation. With certain exceptions, §306 provides that, if a corporation distributes preferred stock to its shareholders in a tax-free distribution (i.e., stock received in a tax-free stock dividend under §305, stock received tax-free in a corporate reorganization under §368, or a corporate division under §355, and stock that has an adjusted basis determined by reference to §306 stock), the shareholders recognize ordinary income (and not capital gain) when they dispose of that stock (in a transaction other than a redemption within the definition of §317(b)). Section 306 does not tax the receipt of the preferred stock; it re-characterizes the gain upon the subsequent disposition of the stock as ordinary income.

This characterization of gain on §306 stock as ordinary income has historically been significant because capital gains had been taxed at lower rates than ordinary income. However, for taxable years beginning after 2002, individuals are taxed at the capital gains rate on "qualified dividend income," which generally includes (1) dividends received from a domestic corporation; and (2) dividends received from a foreign corporation if (a) the foreign corporation is incorporated in a U.S. possession, or (b) the foreign corporation is eligible for the benefits of an income tax treaty with the United States that includes an information-exchange program and that the IRS determines is satisfactory for the purposes of §1(h)(11), or (c) the stock with respect to which the dividends are paid is tradable on an established U.S. securities market.[255] Amounts treated as ordinary income under §306 are treated as dividends and, therefore, qualify for the reduced capital gain tax rates.[256] Thus, the impact of §306 is significantly reduced under current law. The impact is not, however, eliminated. Capital gain treatment can be important, for example, to an individual with large capital losses. A sale or exchange giving rise to capital gain treatment has the additional benefit in that it allows the taxpayer to reduce the amount realized by the taxpayer's basis in the stock. Also, corporate shareholders will normally prefer dividend treatment to claim the dividends-received deduction.

This Section provides a discussion of §306 in the context of a reorganization. For additional, detailed discussion of §306, see 765 T.M., *Stock Rights and Stock Dividends — Sections 305 and 306.*

a. Definition of §306 Stock

Once a share of stock has been characterized as "§306 stock," special treatment is provided to the holder thereof under §306(a). Therefore, it is important to determine whether any given share of stock is §306 stock.

In summary, §306(c) defines §306 stock as stock other than common stock, that is either:

(1) distributed tax-free under §305(a); or

(2) received in a nonrecognition reorganization exchange or in a §355 distribution, but only to the extent that the effect of the transaction was substantially the same as the receipt of a stock dividend, or the stock was received in exchange for §306 stock.

In addition, §306(c)(1)(C) provides that §306 stock also includes any stock received by a shareholder in which the shareholder's basis is determined by reference to §306 stock. Section 306(c)(3) provides §306 stock characterization for "other than common" stock received in certain §351 transfers, in which the receipt of cash would have been treated as a dividend to any extent. This provision explicitly is linked to the rules under §304.

[252] Reg. §1.305-5(b)(4).

[253] Reg. §1.305-5(b)(5).

[254] 207 F.2d 462 (6th Cir. 1953), *rev'g* 18 T.C. 164 (1952). *See* H.R. Rep. No. 83-1337, at 36 (1954).

[255] §1(h)(11). For further discussion of "qualified dividend income," see 764 T.M., *Current Distributions — Cash and Property.*

[256] §306(a)(1)(D).

ISBN 978-1-63359-255-1

For purposes of stock received in a reorganization, the core definition is found in §306(c)(1)(B). Pursuant to that guidance, for stock to be considered §306 stock it must first be stock which is "not common stock."[257] Unlike the extensive definition of preferred stock contained in the §305 regulations,[258] the regulations under §306 provide little guidance regarding the circumstances under which stock is not considered common stock. Guidance is limited to the statement that §306 stock "is usually preferred stock received either as a nontaxable dividend or in a transaction in which no gain or loss is recognized."[259] Published rulings indicate that stock is not common stock to the extent it can be disposed of by the shareholder without a loss in voting control and without a diminution in the shareholder's unrestricted interest in corporate growth.[260] This has been refined further to mean that common stock, as that term is used in §306, must possess an unrestricted right to share both in dividends and in liquidation proceeds. Thus, if a class of stock is restricted as to either dividends or liquidation proceeds, irrespective of whether it is formally denominated common or preferred, it is not common stock for purposes of §306.[261] This is true even if the stock has voting rights, and even if there is no other class of stock possessing voting rights.[262] On the other hand, in a situation in which a corporation had two classes of stock (Class A and Class B), identical except that dividends could be paid on Class B without paying a dividend on Class A and the Class A was convertible into Class B, the IRS ruled that neither class was "stock other than common stock" under §306(c).[263] Note also that common stock that is redeemable at a fixed price at the discretion of the corporation also will be treated as other than common.[264]

Once it has been concluded that stock issued in a reorganization is not common stock, one must determine whether the effect of the transaction was substantially the same as the receipt of a stock dividend.[265] The regulations indicate that this involves a determination of whether, if cash had been distributed in lieu of the preferred stock, it would have been treated as a dividend in whole or in part.[266] This involves testing the transaction directly under the rules of §302(b), or indirectly via the boot rules under §356(a)(2).

> *Example 1:* The stock of corporation X, consisting solely of common, is held equally by S1 and S2, who are spouses. In a tax-free recapitalization, S1 exchanges all of S1's X common stock for new X preferred stock. Applying the "cash in lieu of" test under §306(c)(1)(B) and Reg. §1.306-3(a) and §1.306-3(d), if cash had been received instead of the X preferred, S1 would have undergone a redemption, to be tested under §302(b). Section 306(c)(4) explicitly provides that §318 should be applied in making this determination. Since, under §318(a)(1)(A)(i), S1 is treated as owning 100% of the outstanding X stock both before and after the transaction, the "redemption" will not qualify under any of the provisions of §302(b). As a result, the X preferred stock will be §306 stock.

> *Example 2:* The stock of corporation Y, consisting solely of common, is wholly owned by individual C. In a tax-free recapitalization, C exchanges all of his Y common for Y nonvoting preferred and a new class of Y common. Immediately thereafter, pursuant to an integrated plan, C sells the common shares to D, a key employee of Y who is unrelated to C. Applying the "cash in lieu of" test under §306(c)(1)(B), C owned 100% of Y immediately before the exchange and immediately after the exchange but before selling his common shares to D. Under *Zenz v. Quinlivan*,[267] one would evaluate C's ownership in Y following the sale of common stock to D. As a result, the redemption qualifies as a complete termination of interest under §302(b)(3), and the preferred stock is, therefore, not §306 stock.

It is important to note that §306 stock does not include stock no part of the distribution of which would have been a dividend at the time of the distribution if the corporation had distributed cash in lieu of the stock.[268] Thus, pursuant to this exception, if a corporation has no earnings and profits at the time it distributes stock, that stock cannot be characterized as §306 stock.

Note that under §306(c)(1)(C), if §306 stock is exchanged for other stock, either in the same or a different corporation, and the basis of the new stock is determined by reference to the basis of the §306 stock, the new stock will be considered §306 stock even if it is common stock.[269]

b. *Treatment of Shareholder on Disposition of §306 Stock*

(1) *Redemptions*

If §306 stock is redeemed by the issuing corporation, §306(a)(2) provides that the amount realized is treated as a distribution of property under §301.

An exception to the above treatment is provided in §306(b)(1)(B). Under that provision, if the redemption qualifies as a complete termination of interest under §302(b)(3) or a partial liquidation from an individual shareholder under §302(b)(4), then the §301 treatment mandated by §306(a)(2) will not apply.

Exceptions are also provided in §306(b)(2) and §306(b)(3), under which §306(a) treatment will not apply to, respectively, redemptions in complete liquidation, or to redemption exchanges subject to nonrecognition treatment under the Code.

(2) *Dispositions Other than Redemptions*

If §306 stock is disposed of other than in a redemption, the amount realized is treated as ordinary income, but only to

[257] §306(c)(1)(B).
[258] Reg. §1.305-5(a), discussed in IV.G.4.d., above. *See also* 765 T.M., *Stock Rights and Stock Dividends — Sections 305 and 306.*
[259] Reg. §1.306-1(a).
[260] Rev. Rul. 76-387.
[261] Rev. Rul. 79-163.
[262] Rev. Rul. 75-236; Rev. Rul. 82-191.
[263] Rev. Rul. 75-222.
[264] Rev. Rul. 57-132.
[265] §306(c)(1)(B)(ii).
[266] Reg. §1.306-3(a), §1.306-3(d).
[267] 213 F.2d 914 (6th Cir. 1954). *See also* Rev. Rul. 75-447.
[268] §306(c)(2).
[269] Reg. §1.306-3(e).

ISBN 978-1-63359-255-1

the extent of such stock's ratable share of the amount which would have been a dividend at the time of the issuance of the §306 stock if money (in an amount equal to the stock's fair market value at the earlier date) had been distributed in lieu of the stock.[270] Any excess amount realized over the ordinary income amount is first applied against the basis of the §306 stock, and the excess is treated as gain from the sale of the stock.[271] As discussed above, amounts treated as "ordinary income" under §306(a)(1) may be taxed at capital gain rates. Section 306(a)(1)(D) treats §306(a) "ordinary income" as a dividend for purposes of determining if it is includible in net capital gain rather than ordinary income. Pursuant to §306(a)(1)(C), no loss may be recognized on the disposition of §306 stock.

As indicated above, under §306(b)(2) and §306(b)(3), the provisions of §306(a) (including loss disallowance under §306(a)(1)(C)) do not apply to, respectively, redemptions or other dispositions in complete liquidation of the issuing corporation, or dispositions subject to nonrecognition treatment under the Code.

Under §306(b)(1), where a nonredemption disposition is to a person who is not related to the shareholder under §318(a), and the disposition terminates the shareholder's entire stock interest in the corporation, §306(a) will not apply to the disposition. The attribution rules of §318(a) apply to determine whether there is a termination of interest. The procedure for waiver of family attribution provided in §302(c)(2) applies for purposes of making this determination.[272]

(3) Exception for Transactions Not in Avoidance

The exception to §306(a) treatment that has received the most attention is contained in §306(b)(4). That exception applies if it is established to the satisfaction of the IRS that the distribution and disposition (or redemption) were not in pursuance of a plan having as one of its principal purposes the avoidance of federal income tax.

Reg. §1.306-2(b)(3) provides two examples of situations in which the exception presumptively will apply. One is for dividends and isolated dispositions of §306 stock by minority shareholders. The second example is of a shareholder receiving a distribution of 100 shares of §306 stock on the shareholder's holdings of 100 shares of voting common. The regulations state that if the shareholder sells the common stock before disposing of the §306 stock, the latter disposition ordinarily will not be considered a disposition having a tax avoidance purpose.

For many years, it was believed, on the basis of several older revenue rulings, that §306(b)(4) easily was available to noncontrolling shareholders of a widely held corporation.[273] In Rev. Rul. 89-63, the IRS revoked the earlier rulings, declaring that the fact that §306 stock is issued by a corporation whose stock is widely held is not sufficient grounds for the application of §306(b)(4).

Section 5 of Rev. Proc. 77-37[274] sets forth guidelines for the issuance of advance rulings under §306(b)(4). It indicates that a favorable ruling usually will be issued as to §306 stock issued other than in a §305 distribution or a recapitalization having the effect of a pro rata stock dividend, where the issuing corporation is widely held, the stock is not by its terms redeemable for at least five years, and it is represented that there will be no redemption of the stock within five years. Where the stock is redeemable within five years, or the taxpayer will not represent that there will be no redemption within five years, a favorable ruling will still usually be issued where the stock is disposed of other than by way of redemption.

In a rare case where §306(b)(4) was addressed by the courts, the Third Circuit held for the IRS, concluding that, although there were valid business reasons for the distribution of the preferred stock, the taxpayer did not sustain his burden of proving that avoidance of the income tax on dividends was not also a principal purpose for the distribution.[275]

H. Carryover of Tax Attributes

In a recapitalization, there is only a single corporate entity involved, and therefore, there is no issue regarding the "carryover" of its corporate tax attributes following the reorganization. Of course, this does not mean that the recapitalized company will be unaffected by the transaction. For example, it may have issued sufficient stock to cause it to undergo an "ownership change," subjecting it to the limitations under §382.[276] Further, it may suffer a reduction in tax attributes as a result of debt cancellation under the application of the §108 rules. But fundamentally, because there is no break in the chain of the existence of the single corporation, no special carryover rule is required.

It makes sense, therefore, that §381(a)(2) lists only those reorganization provisions that may involve a transfer of assets from one corporation to another as being subject to the carryover of tax attributes. Among these provisions is §368(a)(1)(F).

In general, §381 is applied to F reorganizations in the same manner as to the other types of reorganizations. However, consistent with the notion that the Newco transferee corporation is truly no more and no less than the alter ego of the Oldco trans-

[270] §306(a)(1)(A).

[271] §306(a)(1)(B).

[272] Reg. §1.306-2(a).

[273] *See* Rev. Rul. 57-212 *revoked by* Rev. Rul. 89-63; Rev. Rul. 57-103 *revoked by* Rev. Rul. 89-63; Rev. Rul. 56-116 *revoked by* Rev. Rul. 89-63. *Compare* Rev. Rul. 80-33 (denying §306(b)(4) relief to controlling shareholder, citing legislative history for limiting relief to minority shareholders).

[274] *See also* PLR 200311002 (corporation issuing new, redeemable class of stock in response to changes in law represented that it had no plan to redeem stock except in case of isolated shareholder requests and that, to the best of management's knowledge, shareholders had no plan to dispose of new stock; IRS expressed no opinion as to whether stock was §306 stock, but ruled that any shareholder's disposition of stock would not be in avoidance of federal income tax).

[275] *Fireoved v. United States*, 462 F.2d 1281 (3d Cir. 1972). For other instances where the IRS has declined to apply §306(b)(4), see Rev. Rul. 77-455 and Rev. Rul. 75-247. For further discussion of §306(b)(4), see 765 T.M., *Stock Rights and Stock Dividends — Sections 305 and 306.*

[276] An "ownership change" occurs if: (1) a corporation is a loss corporation on a "testing date," and (2) immediately after the testing date the percentage of the corporation's stock owned by one or more 5% shareholders has increased by more than 50% over the lowest percentage of the corporation's stock owned by such shareholder(s) at any time during the "testing period." Reg. §1.382-2T(a). In PLR 200317019, the IRS ruled that the distribution of a corporation's stock pursuant to the corporation's conversion from a nonprofit, nonstock entity to a for-profit stock corporation, characterized as an E reorganization, did not result in an ownership change. For a thorough discussion and analysis of the §382 rules, see 780 T.M., *Net Operating Losses and Other Tax Attributes — Sections 381, 382, 383, 384, and 269.*

ISBN 978-1-63359-255-1

feror corporation, certain special rules are applicable to F reorganizations.

First, the following rules contained in §381(b) apply to all acquisitive reorganizations *other than* the F reorganization:

(1) the taxable year of the transferor corporation ends on the date of the transfer; and

(2) the transferee corporation may not carry back a post-acquisition net operating loss or net capital loss to a taxable year of the transferor corporation.

More broadly, the regulations under §381 provide that where a reorganization qualifies under §368(a)(1)(F), "the acquiring corporation shall be treated … just as the transferor corporation would have been treated if there had been no reorganization." Thus, there is no interruption of the taxable year; net operating losses of the Newco transferee may be carried back to tax years of the Oldco transferor; and the tax attributes carry over "as if there had been no reorganization." As a result, the detailed provisions and limitations under §381(c) generally do not apply to the post-TEFRA F reorganization.[277]

It is important to note that the carryover rules for F reorganizations apply even where the reorganization also qualifies under another reorganization provision. Thus, where a change of state of incorporation is effected through a statutory merger of Oldco into Newco, the merger qualifies as a reorganization under §368(a)(1)(A) as well as §368(a)(1)(F). Note that such a transaction also will meet the definition of a reorganization under §368(a)(1)(D) and §354. The F reorganization is supreme, however, and any ancillary consequences will be governed by that characterization.[278]

I. *Treatment of Transaction Costs*

Taxpayers must capitalize amounts paid to facilitate (1) a restructuring, recapitalization, or reorganization of the capital structure of a business entity; (2) acquisitions of capital; and (3) borrowings, including any issuance of debt in an acquisition of capital or recapitalization.[279] An amount is paid to facilitate a transaction if it is paid in the process of investigating or otherwise pursuing the transaction, taking into account all facts and circumstances.[280] Certain exceptions do apply: employee compensation,[281] overhead, and de minimis costs[282] are treated as amounts that do not facilitate such transactions.[283]

J. *Corporate Alternative Minimum Tax*

For taxable years beginning after December 31, 2022, a corporate alternative minimum tax (CAMT) is imposed on an applicable corporation that has annual adjusted financial statement income (AFSI) in excess of $1 billion over a three-taxable-year period.[284]

The CAMT is the amount by which an applicable corporation's tentative minimum tax for the taxable year exceeds the

[277] Reg. §1.381(b)-1(a)(2). *See* Rev. Rul. 2003-48 (in conversion of mutual bank to stock bank qualifying as F reorganization, mutual bank's tax attributes — including bad debt reserve and suspended reserve — continue as tax attributes of stock bank); PLR 200403030 (C corporation may offset surplus in accumulated earnings and profits by its REIT predecessor's cumulative deficit in earnings and profits for purposes of §857(a)(2)(B)), PLR 200320013 (carryover of tax attributes applies as well when Oldco and Newco are S corporations). *See also* Rev. Rul. 2004-85 (election to treat wholly owned subsidiary of S corporation as QSub, as described in §1361(b)(3)(B), does not terminate solely because S corporation engages in transaction that qualifies as reorganization under §368(a)(1)(F); in F reorganization, entity classification election of eligible entity, as described in Reg. §301.7701-3(b), does not terminate solely because owner transfers all of membership interest in eligible entity to another person); Rev. Rul. 2008-18 (S election remains in effect when S corporation merges into newly formed corporation in reorganization qualifying under §368(a)(1)(F) and newly formed surviving corporation also meets requirements of S corporation). Special rules are provided for F reorganizations involving a foreign corporation. *See* Reg. §1.381(b)-1(a), §1.367(a)-1(e), §1.367(b)-2(f). These rules are discussed in VII., below. Note that in *Bercy Indus., Inc. v. Commissioner*, 640 F.2d 1058 (9th Cir. 1981), *rev'g* 70 T.C. 29 (1978), the Ninth Circuit held that an acquiring corporation could carry back post-merger losses to pre-merger years of the transferor corporation following a forward triangular merger even though the transaction did not qualify as an F reorganization, where the transferee corporation was newly formed. *See also* TAM 9351002 (net operating losses realized by new corporation in post-restructuring taxable years could not be carried back to consolidated returns of predecessor because transaction failed to qualify as F reorganization).

[278] Reg. §1.381(b)-1(a)(2); Rev. Rul. 57-276. *See* PLR 201001002 (proposed transaction designed to transfer interests of domestic parent's foreign subsidiary to new foreign entity qualifies as F reorganization and, therefore, avoids closing of subsidiary's taxable year and §381 restrictions).

[279] Reg. §1.263(a)-5. Amounts paid to facilitate a borrowing, even if part of another transaction, are considered not to facilitate any transaction other than the borrowing. Reg. §1.263(a)-5(a)(9), §1.263(a)-5(c)(1). *See* Reg. §1.446-5 (providing rules for allocating debt issuance costs over a debt's term). *See also* Reg. §1.263(a)-4(e) (requiring taxpayers to capitalize amounts paid to facilitate acquisition or creation of intangibles including ownership interests in corporations, limited liability companies, and certain other entities if, immediately after transaction, taxpayer and entity are not related within meaning of §267(b) or §707(b)). *Cf.* Reg. §1.263(a)-5(a)(2) (imposing parallel requirements to capitalize amounts paid to facilitate acquisition of ownership interest in business entity if taxpayer and entity are related under §267(b) or §707(b) immediately after acquisition). *But see* PLR 201105016 (excess of adjusted issue prices of notes repurchased in tender offer was deductible as interest in taxable year of repurchase; because Reg. §1.163-7(c) applied, §263 did not affect deductibility of repurchase premium), PLR 201220004 (explaining treatment of debt issuance costs as OID under Reg. §1.446-5 is limited to determination of amount of costs deductible each year over term of debt instrument).

[280] Reg. §1.263(a)-5(b). Under this test, that an amount would or would not have been paid "but for" the transaction is a relevant but not determinative factor, an amount paid to determine the value or price of a transaction is considered an amount paid to facilitate the transaction, and an amount paid in exchange for tangible or intangible property is not considered an amount paid to facilitate the exchange. *See, e.g.*, Reg. §1.263(a)-5(l) *Exs.* 1 through 3. An amount paid that is contingent on the successful closing of an applicable transaction must be capitalized except to the extent the taxpayer maintains sufficient documentation to establish otherwise. Reg. §1.263(a)-5(f).

[281] Reg. §1.263(a)-5(d)(2) defines "employee compensation" as compensation paid to an employee of the taxpayer, guaranteed payments to a partner in a partnership, annual compensation paid to the director of a corporation, amounts paid to persons who are not employees of the taxpayer if the amounts are paid for certain administrative support services, and payments by one consolidated group member to another for services provided by an employee of the second group member.

[282] Reg. §1.263(a)-5(d)(3) defines "de minimis costs" as amounts (other than employee compensation, commissions, and overhead) paid in the process of facilitating a transaction if, in the aggregate, the amounts (or fair market value of property) do not exceed $5,000 (or greater as set forth in future guidance). If the amounts do exceed $5,000, none of the amounts are de minimis costs.

[283] Reg. §1.263(a)-5(d)(1). Taxpayers may, however, elect to capitalize these costs. Reg. §1.263(a)-5(d)(4). Exceptions also apply to stock distributions that are required by law, regulatory mandate, or court order, and to certain costs associated with bankruptcy proceedings. *See* Reg. §1.263(a)-5(c)(3), §1.263(a)-5(c)(4).

[284] §55(b)(2)(A), §59(k) (defining "applicable corporation"), as amended and added, respectively, by the Inflation Reduction Act, Pub. L. No. 117-169, §10101(a)(1).

ISBN 978-1-63359-255-1

sum of the corporation's regular tax liability plus any base erosion and anti-abuse tax (BEAT) liability.[285] An applicable corporation's tentative minimum tax is equal to the excess of 15% of AFSI over the corporate AMT foreign tax credit.[286] AFSI is the net income or loss of the taxpayer as set forth on the taxpayer's applicable financial statement (AFS) covering such taxable year, with adjustments.[287]

AFSI includes all items reflected in the taxpayer's financial statement income (FSI) regardless of whether they are taken into account for regular tax purposes.[288]

For a detailed discussion of the post-2022 CAMT, see 752 T.M., *Corporate Alternative Minimum Tax*, at IX.

1. Recapitalizing Corporation in a Covered Transaction

The CAMT consequences of a recapitalization depend on whether the transaction is a covered recognition transaction or a covered nonrecognition transaction (collectively, covered transactions).[289] Under the proposed regulations, a covered nonrecognition transaction is a component transaction that, with regard to a party, (i) qualifies for nonrecognition treatment for regular tax purposes under a specific Code section or combination of Code sections, (ii) is not treated as resulting in the recognition of *any amount* of gain or loss for regular tax purposes solely with regard to that party, and (iii) is not treated as a covered recognition transaction.[290] A covered recognition transaction, by contrast, is a component transaction consisting of a transfer, sale, contribution, distribution, or other disposition of property that, with regard to a party, does not qualify as a covered nonrecognition transaction solely with regard to that party and, therefore, could result in the recognition of gain or loss for regular tax purposes to that party.[291]

In the case of a covered nonrecognition transaction, the proposed regulations would define a recapitalizing corporation as a corporate party that recapitalizes its capital structure in a transaction that qualifies as an E reorganization or an exchange to which §1036 applies. In the case of a covered recognition transaction, a recapitalizing corporation would be defined as a corporate party through which the party recapitalizes its capital structure.[292]

If a recapitalizing corporation transfers solely stock to a recapitalizing corporation shareholder or creditor in an E reorganization or §1036 exchange that qualifies as a covered nonrecognition transaction, the recapitalizing corporation:

- determines its AFSI resulting from the transaction by —
  - — disregarding any resulting gain or loss reflected in the corporation's FSI, and
  - — applying §1032(a) or §1036, as appropriate (that is, no AFSI is recognized by the recapitalizing corporation), and
- adjusts its CAMT earnings, rather than its AFS retained earnings, resulting from the transaction by applying §312.[293]

If a qualifying E reorganization transaction includes a transfer of money or property (other than stock of the recapitalizing corporation) to a shareholder or security holder of the recapitalizing corporation, then each component transaction that qualifies as a covered nonrecognition transaction and each component transaction that is treated as a distribution of property by the recapitalizing corporation to a shareholder or security holder is treated separately.[294]

In Notice 2025-46, Treasury and the IRS announced their intention to propose amendments to Prop. Reg. §1.56A-18 and Prop. Reg. §1.56A-19 consistent with the guidance provided in the Notice. The proposed amendments would allow a CAMT entity to determine (i) the amount of its AFSI resulting from its ownership of stock of a domestic corporation that is not a member of the same tax consolidated group as the CAMT entity, and (ii) the AFSI and CAMT basis consequences of certain transactions involving domestic corporations. In response to comments received regarding the proposed regulations, the Notice is intended to reduce compliance burdens by eliminating the "cliff effect" and more closely following the rules that apply for regular tax purposes, while incorporating a more limited set of CAMT inputs.[295]

The Notice introduces the term "domestic covered asset transaction," defined, in part, to include a transaction (other than a covered asset transaction, as defined in Prop. Reg. §1.56A-4(b)(1)) in which one or more assets are stock or securities of a domestic corporation that is a party to a reorganization and the stock or securities are transferred in a transfer (including an issuance or redemption) to which §354 or §356 applies.[296] Accordingly, an E reorganization is a domestic covered asset transaction.

2. Recapitalizing Corporation Shareholder or Security Holder in Covered Transactions

In an E reorganization, a recapitalizing corporation shareholder or security holder is a CAMT entity that receives stock or securities of the corporation under §354, or money or other property (in addition to stock or securities) of the corporation under §301, in exchange for recapitalizing corporation stock or securities. The proposed regulations would require a recapitalizing corporation shareholder or security holder to:

- determine its AFSI from a covered transaction by disregarding any resulting gain or loss reflected in its FSI, applying the relevant Code section, and using the distribu-

[285] §55(a), as amended by Pub. L. No. 117-169, §10101(a)(1).

[286] §55(b)(2)(A). *See* §59(l), added by Pub. L. No. 117-169, §10101(c) (corporate AMT foreign tax credit). If a corporation does not meet the definition of an "applicable corporation," the tentative minimum tax for the taxable year is zero. §55(b)(2)(B).

[287] §56A(a)–§56A(d), added by Pub. L. No. 117-169, §10101(b). *See* §451(b)(3) (defining "applicable financial statement").

[288] Notice 2023-64, §5.02(3)(b); *see* Prop. Reg. §1.56A-1(b)(1), REG-112129-23, 89 Fed. Reg. 75,062 (Sept. 13, 2024).

[289] Prop. Reg. §1.56A-18(b)(11), REG-112129-23.

[290] Prop. Reg. §1.56A-18(b)(9). This rule has been described as having a "cliff effect," treating a transaction resulting in even a single dollar of gain as a recognition transaction.

[291] Prop. Reg. §1.56A-18(b)(10).

[292] Prop. Reg. §1.56A-18(b)(22).

[293] Prop. Reg. §1.56A-19(e)(1), REG-112129-23.

[294] Prop. Reg. §1.56A-19(e)(2).

[295] Notice 2025-46, §3.01; *see* Prop. Reg. §1.56A-1(b)(22) (definition of "for regular tax purposes").

[296] Notice 2025-46, §3.02(1)(c), §3.02(4) (definition of "transfer").

ISBN 978-1-63359-255-1

tion amount reflected on its AFS, taking into account the CAMT basis in its recapitalizing corporation stock;

• determine the characterization of the distribution by applying the relevant Code section based on the CAMT earnings, rather than on earnings and profits, of the corporation;

• determine its CAMT basis in the stock of the corporation resulting from the exchange by applying the relevant Code section using its CAMT basis in the stock, rather than basis for regular tax purposes;

• determine its CAMT basis in the property received from the corporation by applying the relevant Code section, using CAMT basis rather than AFS basis; and

• adjust its CAMT earnings, rather than AFS retained earnings, resulting from the exchange by applying §312 based on its AFSI.[297]

Under Notice 2025-46, if a CAMT entity directly owns stock of a domestic corporation that is not a member of the same tax consolidated group as the CAMT entity, the CAMT entity's AFSI with respect to such stock ownership is adjusted by:

• disregarding any items of income, expense, gain, and loss resulting from such stock ownership, including any items that result from acquiring or transferring the stock reflected in the CAMT entity's FSI; and

• including any items of income, deduction, gain, and loss for regular tax purposes resulting from such stock ownership, including any items that result from acquiring or transferring the stock.[298]

The amount of each item included in the CAMT entity's AFSI is computed by substituting the CAMT entity's CAMT basis in the domestic corporation stock for the basis in that stock for regular tax purposes.[299] In addition, the amount and character of any distribution is determined using earnings and profits as determined for regular tax purposes.[300]

If a CAMT entity transfers an asset, other than stock of a domestic corporation, in a domestic covered asset transaction, the CAMT entity's AFSI is adjusted by:

• disregarding any items of income, expense, gain, and loss with respect to the transferred asset resulting from the domestic covered asset transaction reflected in the CAMT entity's FSI; and

• including any items of income, deduction, gain, and loss for regular tax purposes with respect to the transferred asset resulting from the domestic covered asset transaction.[301]

The amount of each item included in the CAMT entity's AFSI is computed by substituting the CAMT entity's CAMT basis in the transferred asset for the basis in that transferred asset for regular tax purposes.[302]

A recapitalizing corporation shareholder determines its basis in stock or securities received in the reorganization by applying §358, substituting the shareholder's CAMT basis in the assets exchanged for the basis in those assets for regular tax purposes and substituting the amount of income or loss included in AFSI for the amount of gain or loss recognized for regular tax purposes.[303]

The proposed regulations applicable to recapitalizations, as originally published, generally would apply to taxable years ending after the date of publication of final rules in the Federal Register, although Prop. Reg. §1.56A-1 would apply to taxable years ending after September 13, 2024.[304] It is anticipated that the proposed amendments described in Notice 2025-46 will apply for taxable years beginning on or after the date the relevant final regulations are published in the Federal Register.[305] In the interim, taxpayers may rely on the guidance provided in Notice 2025-46, §3 through §6, including for purposes of filing amended returns. A taxpayer's reliance on any such guidance will not cause the corporation to become subject to, or to violate, the reliance rules, including the consistency requirements, provided in the Preamble to the CAMT proposed regulations.[306]

[297] Prop. Reg. §1.56A-19(e)(3). *See* Prop. Reg. §1.56A-18(b)(23) (defining recapitalizing corporation shareholder or security holder).

[298] Notice 2025-46, §3.03(1)(a).

[299] Notice 2025-46, §3.03(1)(a).

[300] Notice 2025-46, §3.03(1)(b).

[301] Notice 2025-46, §3.03(2).

[302] Notice 2025-46, §3.03(2).

[303] Notice 2025-46, §3.04(1)(e).

[304] Prop. Reg. §1.56A-1(i), Prop. Reg. §1.56A-18(i), Prop. Reg. §1.56A-19(h).

[305] Notice 2025-46, §7. The forthcoming proposed amendments are expected to clarify that no section (e.g., Prop. Reg. §1.56A-1) of the CAMT proposed regulations and the forthcoming amendments would be applicable for any taxable years beginning before the date a corresponding section of a final regulation is published in the Federal Register. Notice 2025-49, §3.01.

[306] Notice 2025-46, §7; *see* Preamble to REG-112129-23, 89 Fed. Reg. at 75,127.

ISBN 978-1-63359-255-1

V. Consequences of Specific Types of Recapitalization Exchanges

A. Introduction

This portion of the Portfolio summarizes the federal income tax treatment of various exchanges of financial instruments in connection with recapitalization transactions. In most cases, qualification of the transaction as a recapitalization under §368(a)(1)(E) will not be problematic. As indicated in IV.D., above, however, such qualification will have little impact upon the treatment of the issuing corporation that is undergoing the recapitalization. Unless otherwise indicated in the discussion, it may be assumed that each transaction does qualify as a reorganization. Certain exchanges are described that either do not qualify as reorganization exchanges, or whose tax consequences are essentially indifferent to such qualification; these transactions are discussed because they are broadly viewed as involving significant changes in a corporation's capital structure, and thus, should reasonably be considered in a discussion of recapitalizations.

Note: Where the treatment of the exchanging stock or security holder is subject to the regular rules, see the relevant portions of the discussion in IV.G., above. The focus of the analyses below will be on issues raised that are peculiar to the particular transaction involved.

The headings in this section will refer to the exchanging holder, rather than the issuing corporation. Thus, for example, "Preferred for Common" refers to a surrender by a shareholder of its preferred stock for newly issued common; "Common for Debentures" refers to a surrender by a shareholder of common stock for newly issued debentures.

B. Exchanges of Preferred Stock

1. Preferred for Common

The ordinary preferred for common recapitalization presents no real obstacle to tax-free recapitalization treatment. Indeed, exchanges of preferred for common stock are set out in the regulations as examples of tax-free recapitalizations.[307] If the preferred stock does not have dividend arrearages, i.e., accumulated, undeclared and unpaid dividends, the exchange will not ordinarily result in a deemed dividend distribution under the rules of §305.[308]

Note that where the preferred stock surrendered was §306 stock in the hands of the exchanging shareholder, this taint will not carry over to the common stock received.[309]

The exchange of preferred for common pursuant to the exercise of a conversion right in the preferred stock will be treated as a tax-free exchange pursuant to a recapitalization.[310]

2. Preferred with Dividend Arrearages

The regulations contemplate that a shareholder may exchange preferred stock with dividend arrearages for "other stock of the corporation."[311] The regulations go on, however, to explain:

> [I]f pursuant to such an exchange there is an increase in the proportionate interest of the preferred shareholders in the assets or earnings and profits of the corporation, then under §1.305-7(c)(2), an amount equal to the lesser of (i) the amount by which the fair market value or liquidation preference, whichever is greater, of the stock received in the exchange (determined immediately following the recapitalization) exceeds the issue price of the preferred stock surrendered, or (ii) the amount of the dividends in arrears, shall be treated under §305(c) as a deemed distribution to which §305(b)(4) and §301 apply.[312]

The statutory and regulatory scheme under §305, and the manner in which it interacts with the reorganization provisions, is discussed at some length in IV.G.4., above. A more extensive discussion of §305 may be found in 765 T.M., *Stock Rights and Stock Dividends: Sections 305 and 306*. For purposes of this discussion, the following should be recalled. First, under §305(b)(4), any distribution of stock with respect to preferred stock is treated as a taxable distribution of property. Second, §305(c) grants regulatory authority to Treasury to promulgate regulations to treat, where appropriate, "any transaction (including a recapitalization)" as a distribution of stock where the transaction brings about an increase in a shareholder's proportionate interest in the corporation.

Reg. §1.305-7(c) repeats the same language as Reg. §1.368-2(e)(5) about there being a deemed stock distribution where the exchanging preferred stockholder increases its proportionate interest in the assets or earnings and profits of the corporation.[313] The regulations go on to explain however, that such an increase will occur wherever, and to the extent, that the fair market value or liquidation preference of the new stock received (whichever is greater) exceeds the issue price of the preferred stock surrendered.[314]

The result may be illustrated by the following examples:

> *Example 1:* Shareholder B holds preferred stock in corporation X with an issue price of $1,000 and accumulated undeclared and unpaid dividends of $300. In a recapitalization, B exchanges the X preferred for new preferred with a liquidation and redemption value of $1,200 and a fair market value of $900. Under Reg. §1.305-7(c)(1)(ii) and §1.305-7(c)(2), B is treated as receiving a distribution of X preferred stock in the amount of $200, i.e., the excess of

---

[307] Reg. §1.368-2(e)(2), §1.368-2(e)(4).

[308] *See* Reg. §1.305-7(c)(1), §1.305-5(c) *Ex.* (2). *See also* Prop. Reg. §1.305-7(d)(1), REG-133673-15, 81 Fed. Reg. 21,795 (Apr. 13, 2016). The §305 issues are discussed at greater length in IV.G.4., above, and V.B.2., below.

[309] Reg. §1.306-3(d).

[310] Rev. Rul. 77-238. Note, however, that an alternative characterization as a nonrealization event is also available. *See* Rev. Rul. 72-265.

[311] Reg. §1.368-2(e)(5).

[312] Reg. §1.368-2(e)(5). *See also* Prop. Reg. §1.305-7(d)(2), REG-133673-15, 81 Fed. Reg. 21,795 (Apr. 13, 2016).

[313] *See also* Prop. Reg. §1.305-7(d)(1).

[314] Reg. §1.305-7(c)(1)(ii). *See also* Prop. Reg. §1.305-7(d)(1)(ii). Before the extensive amendments to §305 in 1969, it was possible to capitalize accumulated dividends in a tax-free recapitalization. *See S. Atl. S.S. Line v. Commissioner*, 42 B.T.A. 705 (1940).

ISBN 978-1-63359-255-1

the liquidation preference of the new preferred over the issue price of the old. The regulations state to use either the liquidation preference or the fair market value of the new stock, whichever is greater. In any case, the deemed distribution is not to exceed the amount of the dividends in arrears.

Example 2: The same facts as above, except that B exchanges the old X preferred for X common stock with no liquidation preference and a fair market value of $1,100. In this case, there will be a deemed §305 distribution of $100.

In these cases, note that the amount deemed distributed will be treated as a stock dividend under §305(b)(4). As such, it will be treated as a distribution of property under §301. The ultimate taxability of the distribution will depend, under §301(c), upon the amount of available earnings and profits.

Where the preferred stock does not have dividend arrearages, there is generally no deemed distribution under §305(c) and §305(b)(4), as long as the recapitalization is not pursuant to a plan to periodically increase a shareholder's proportionate interest in the assets or earnings and profits of the corporation.[315]

If a shareholder receives preferred stock tax-free under §354, the new preferred may constitute §306 stock.[316]

Although before the 1954 Code there was controversy over the ability to exchange dividend arrearages for bonds,[317] such an exchange has been rendered taxable directly under the provisions of §354(a)(2)(A) and §356(d) enacted in the 1954 Code and continued in the 1986 Code.

C. Exchanges of Common Stock or Stock Generally

1. Common for Common

Although also granted nonrecognition treatment under §1036, a recapitalization exchange of common stock for common stock qualifies for nonrecognition treatment under §354.[318]

2. Common for Preferred

In general, a shareholder's exchange of common for preferred stock may qualify as a tax-free recapitalization.[319] In many such cases, however, the preferred stock to be received will carry the taint of §306 stock.[320] Additionally, the receipt of the preferred stock will not be tax-free if the preferred is nonqualified preferred as defined in §351(g).[321]

Many closely held corporations have undergone recapitalizations in which the majority or sole shareholder exchanges common for preferred stock in order to facilitate the passage of control to or creation of affordable stock incentives for younger executives in the form of lower cost common stock. Often, a significant motivation for such transactions is estate planning, i.e., to freeze the current value of the corporation in the preferred stock, and to effectively transfer the future growth to the owner's children with minimal gift and estate tax costs. The use of these so-called estate freeze recapitalizations has been significantly affected by the enactment of the rules in §2701–§2704, as further discussed in V.G., below.

If a shareholder exchanges common stock for common and preferred, the possible application of §305(b)(2) by reason of §305(c) must be considered. This issue is discussed in IV.G.4., above. For further discussion of §305, see 765 T.M., *Stock Rights and Stock Dividends: Sections 305 and 306.*

3. Common for Debt

Under §354(a)(2)(A) and §356(d), a shareholder's exchange of stock for debt securities will not qualify for nonrecognition treatment. Instead, the security will be received as nonqualifying consideration, and treated in the same manner as a nonsecurity debt instrument. Such an exchange is a redemption subject to the rules under §302. Note that if the redemption is treated as an exchange under §302(a), rather than as a §301 distribution under §302(d), the exchange will be eligible for installment sale treatment under §453. A thorough discussion of the redemption rules under §302 may be found in 767 T.M., *Redemptions.*

If a debt instrument is received in addition to stock in a qualifying recapitalization exchange, the rules of §356, rather than the §302 redemption rules, will ordinarily govern the treatment of the debt. However, as discussed in IV.G.3.e., above, it is currently an open question whether the receipt of any taxable consideration in a recapitalization, whether cash or debt securities, in addition to qualifying consideration, is properly treated under the boot rules of §356, or as a separate distribution under §302. The difference in result will generally involve how basis recovery is dealt with, especially if the result of the redemption analysis in either case is dividend treatment rather than capital gain.

---

[315] Reg. §1.305-7(c)(1), §1.305-5(c) *Ex.* (2). *See also* Prop. Reg. §1.305-7(d)(1).

[316] §306(c)(1)(B), §306(c)(1)(C).

[317] *See S. Atl. S.S. Line v. Commissioner*, 42 B.T.A. 705 (1940); *Skenandoa Rayon Corp. v. Commissioner*, 42 B.T.A. 1287 (1940), *aff'd*, 122 F.2d 268 (2d Cir. 1941), *cert denied*, 314 U.S. 696 (1941); *Morainville v. Commissioner*, 135 F.2d 201 (6th Cir. 1943); *Globe-News Publ'g Co. v. Commissioner*, 3 T.C. 1199 (1944); *Hooks v. Commissioner*, 3 T.C.M. 899 (1944).

[318] Reg. §1.1036-1(a). See Rev. Rul. 69-407, where a 70% corporate shareholder exchanged its common stock for a "super" voting stock and the minority shareholders exchanged their common for a lesser voting stock in order to facilitate a tax-free spin-off for the purpose of making stock available to key employees. *See also* Rev. Rul. 56-117.

[319] Rev. Rul. 72-206. *See* Rev. Rul. 74-269 (ruling that the exchange of common for preferred qualified as a recapitalization, but also that to the extent the fair market value of the stock received exceeded the value of the stock surrendered, or vice-versa, such excess would be treated as a gift, compensation, or other ancillary transaction as determined under the facts and circumstances). *See also* §356(f) (alluding to same concern); CCA 201315020 (value of stock received in reorganization that is in excess of value of stock surrendered is treated as received separately from reorganization and taxed accordingly, e.g., as compensation, gift, payment to satisfy obligation, or inducement to enter into transaction); FAA 20131601F (because taxpayer received stock having fair market value and surrendered stock having no fair market value, exchange does not qualify as E reorganization; thus, excess amount must be treated as compensation, gift, payment to satisfy obligation, inducement to enter into transaction or for whatever purpose facts indicate). For a discussion of the factors used for determining the fair market value of preferred and common stock received in the recapitalization of a closely held corporation, see Rev. Rul. 83-120, *amplifying* Rev. Rul. 59-60. *See also* §2701 et seq. containing special statutory valuation rules for estate and gift tax purposes.

[320] *See* IV.G.5., above, and 765 T.M., *Stock Rights and Stock Dividends: Sections 305 and 306.*

[321] *See* Reg. §1.1036-1(d). For a discussion of nonqualified preferred stock, see IV.G.3.c., above.

ISBN 978-1-63359-255-1

Under the law before 1954, a pro rata exchange of common stock for common and debt securities could literally comply with the statutory requirements for nonrecognition as an exchange of stock for stock or securities.[322] Assuming one could establish good business reasons for such an exchange, it would qualify as a tax-free recapitalization exchange.[323]

The tax-free issuance of readily saleable debentures to the common stockholders of a closely held corporation with ample earnings and profits could serve as an attractive method of retaining corporate control while converting corporate earnings into capital gains. Viewed in this light, it is immaterial whether the debentures are distributed as a dividend or via recapitalization. The Supreme Court held that such an exchange would not qualify as a reorganization, but would be treated as a distribution of the debt as a dividend.[324]

Since 1954, the case law is largely irrelevant, as §354(a)(2) and §356(d) make the debt securities "other property," and the pro rata exchange will certainly receive dividend treatment under §356(a)(2). It remains possible for shareholders to seek to utilize this type of recapitalization to avoid dividend treatment where the shareholders have a high basis in their common stock and the corporation has significant amounts of earnings and profits.

> *Example:* Individual B owns 100 shares of common stock in corporation X, constituting all of the outstanding stock of X. B's common stock has a tax basis and fair market value of $1,000. X has earnings and profits of $500. B exchanges the 100 common shares for 50 new common shares and a $500 debenture. If the exchange qualifies as a recapitalization, although the debenture will be treated as boot, there will be no taxable income realized by B because the amount realized equals B's tax basis. Since B has not realized gain on the overall exchange, the receipt of the debenture will not be treated, under §356(a)(2), as a dividend.

In such a case, the IRS may still wish to apply the *Bazley* doctrine, or Reg. §1.301-1(j), which allows the IRS to find a §301 distribution if the distribution is in the form of boot. As discussed in IV.G.3.e., above, the F reorganization regulations make it clear that a property distribution in connection with an F reorganization is disintegrated and treated as a separate §301 distribution (not subject to §356); presumably, this only strengthens the case for the same treatment in a recapitalization transaction.[325]

Note: Section 1(h)(11), which taxes a noncorporate taxpayer's "qualified dividend income" as net capital gain rather than ordinary income, has reduced the reasons for which a noncorporate taxpayer might seek to avoid dividend treatment and the interest that the IRS might have in finding a §301 distribution.

D. Exchanges of Debt for Debt

1. In General

As discussed in IV.D.2., above, a corporation may realize cancellation of indebtedness income upon the discharge of any indebtedness — including indebtedness qualifying as a security — for consideration that is less than the amount of the debt.[326] If, in connection with a recapitalization exchange, a corporation issues a new stock or debt instrument in exchange for an outstanding debt instrument, it is important to differentiate between the treatment of the issuer and the treatment of the holder, and it is similarly important to differentiate between the treatment of the issuer with respect to the issuance of the new instrument and with respect to the retirement of the old instrument. In particular, the corporation is protected from recognizing any income on the issuance of the new stock[327] or the new debt.[328] What is problematic for the corporation is whether and to what extent it may recognize cancellation of indebtedness income with respect to the outstanding debt obligation that is being surrendered by the holder in the exchange. One must keep in mind the general rule that "[a] taxpayer may realize income by the payment or purchase of his obligations at less than their face value."[329] In each case, the corporation is "paying off" or "purchasing" its outstanding obligation with the new stock or debt obligation.

Thus, the principal inquiry must involve:

(1) What is the "face value" of the outstanding obligation?

(2) What value will be accorded the new instrument being issued in exchange therefor?

(3) Is there an overriding rule providing nonrecognition for the particular exchange?

The first two questions posed above involve the common issue of the interaction between the discharge of indebtedness rules and the original issue discount rules. In general, the terms "issue price" and "adjusted issue price," as defined in §1273(b) and §1272(a)(4), respectively, seem to be reasonable contemporary substitutes for the term "face value" used in the §61 regulations. This is most obviously the case if a corporation issues a zero coupon obligation with a face value of $1,000, payable in 20 years, and an issue price of $300. If, after the adjusted issue price has risen to $400, the issuer repurchases the obligation for $440, there certainly will not be cancellation of indebtedness income of $560. Rather, the transaction will be analyzed with reference to the adjusted issue price of the obligation.

---

322 §112(b)(3) and §112(g)(1)(E) of the 1939 Code.

323 *See Clyde Bacon, Inc. v. Commissioner*, 4 T.C. 1107 (1945), acq., 1945 C.B. 1, holding that the interest on such debentures was deductible. In dictum, the Tax Court stated that good business reasons existed for the creation of the debentures. Apparently, the taxpayer's stated purpose had been to give debentures to his daughters and place the stock with trusted managers of the company.

324 *Bazley v. Commissioner*, and *Adams v. Commissioner*, 331 U.S. 737 (1947), *reh'g denied and prior opin. amended*, 332 U.S. 752 (1947). *See also Heady v. Commissioner*, 162 F.2d 699 (7th Cir. 1947).

325 *See* Reg. §1.368-2(m)(3)(iii).

326 §61(a)(12); Reg. §1.61-12; *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931).

327 §1032(a).

328 Reg. §1.61-12(c).

329 Reg. §1.61-12(a).

ISBN 978-1-63359-255-1

More problematic is the extent to which the OID rules will be looked to in valuing the amount of consideration paid by the issuer to redeem the old obligation if the consideration is in the form of a new obligation. This issue will be discussed in V.D.2., below.

The treatment of the holder in a recapitalization exchange is subject to the rules under §354 and §356. If the exchange involves the surrender of an instrument that is not stock or a security, it will be governed by the general law under §1001 and related provisions. The succeeding sections will look at some of these provisions and identify some areas of uncertainty. It is beyond the scope of this Portfolio, however, to fully examine the treatment of the issuer or the holder in all types of corporate restructurings.

For further discussion of these topics, see 540 T.M., *Bankruptcy and Insolvency Restructurings; Discharge of Indebtedness Activities* and 541 T.M., *Tax Aspects of Restructuring Financially Troubled Businesses.*

2. Securities for Securities

This discussion assumes that the debt instrument surrendered — such as a bond, debenture, or note — and the debt instrument received will each be a security qualifying under §354 and §356. Although Reg. §1.368-2(e) does not set out a bond-for-bond exchange as an example of a tax-free recapitalization, the Committee Reports under the 1954 Code[330] specifically approved a bond-for-bond exchange by adopting the *Neustadt* rule. In *Commissioner v. Neustadt's Trust*,[331] the IRS contended that an exchange of old bonds for new bonds was a "financing operation" rather than a recapitalization. The court disagreed, stating:

> By changing the interest rate and date of maturity of its old bonds and adding a conversion option to the holders of the new, the corporation could strengthen its financial condition, while the bondholders would not substantially change their original investments by making the exchange. "Recapitalization" seems a most appropriate word to describe that type of reorganization and it is the very kind of transaction where Congress meant the recognition of gain or loss to be held in suspense until a more substantial change in the taxpayer's original investment should occur.[332]

a. Treatment of Holder

In the *Neustadt* case, the exchange was for bonds in the same principal amount. Where the principal amount of the securities received exceeds the principal amount of those surrendered, §354(a)(2)(A) and §356(d)(2)(B) require the recognition of any gain on the exchange, but only to the extent of this excess amount. As there would seem to be no basis for finding that such an exchange had the effect of a dividend under §356(a)(2), the gain will be a capital gain.[333]

Consider the following example. T holds a corporation X bond with a stated principal and issue price of $1,000 and an interest coupon of 10%. In a recapitalization, T exchanges the old bond for a new X bond with a stated principal of $1,200 and an interest rate of 8%. The old and new bonds are not publicly traded, but at the time of the exchange, it is determined that the fair market value of the old bond and the new bond are each $1,100. Because the bonds are not publicly traded, the issue price of the new bond under §1273 and §1274 will be the $1,200 maturity value, provided the bond pays adequate stated interest. Thus, regardless of how one resolves the issue, discussed in IV.G.2.b., above, nonrecognition is limited under §356(d)(2)(B) to $1,000 of principal amount on the new bond. The remaining amount of consideration will be taxable to T.

How much gain does T recognize? The obvious answer would seem to be $200, which is the excess principal amount of the new bond over that of the old bond. Technically, however, §356(d)(2) treats as boot the "fair market value" of the excess principal amount. Where, due to interest rate and other market factors, the newly issued obligation has a fair market value that is different from its principal amount, there will also be a difference between the excess principal amount and the fair market value of the excess principal amount. In the above example, the new security has a value that is only 91.67% (1,100/1,200) of the principal amount. Therefore, the amount of boot should be 91.67% × $200, or $183.33. Assuming T's basis in the old bond was also $1,000, it would recognize gain of $183.33, i.e., the fair market value of the excess principal amount. Note that, on a going forward basis, the bond will have an issue price to T of $1,200, but a tax basis of $1,183.33.

Instead of attempting to determine the fair market value of the excess principal amount, why not seek to determine the issue price of this excess amount? Reg. §1.1001-1(g) provides, in part, that where a debt instrument is received in exchange for property, "the amount realized attributable to the debt instrument is the issue price of the debt instrument as determined under §1.1273-2 or §1.1274-2, whichever is applicable." In the example, the new bond's issue price happened to be $1,200, its stated value at maturity, so that the issue price of the excess amount would be $200.

In IV.G.2.b., above, the question whether the phrase "principal amount" as used in §354(a)(2) should be interpreted to refer to the amount payable at maturity or to the issue price of the new instrument is discussed. Assuming that the correct answer is the issue price, or that the statute was amended to so provide, the results in the above example would be as follows: For a privately held instrument, the issue price and stated maturity value are the same, $1,200. If, however, the new bond were publicly traded, then the issue price would be its fair market value, or $1,100. As a result, T would recognize $100 of gain.

What if the principal amount of the new security is less than that of the old? This does not, in and of itself, have any direct tax consequences. Assuming the fair market value of the new instrument is the same as that of the old, the holder simply has nonrecognition treatment under §354(a)(1). Under §358, the holder takes a basis in the new security equal to the holder's

[330] S. Rep. No. 83-1622, at 51 (1954).

[331] 131 F.2d 528 (2d Cir. 1942).

[332] 131 F.2d 528, 530 (2d Cir. 1942).

[333] *See* Rev. Rul. 71-427 (IRS ruled that §356(a)(2) was inapplicable to the receipt of boot by a debenture holder). However, the effect of §356(a)(2) may not be significant due to the application of §1(h)(11), which taxes a noncorporate taxpayer's "qualified dividend income" as net capital gain rather than ordinary income.

ISBN 978-1-63359-255-1

basis in the old security. This does leave open, then, the question of the OID status of the new instrument.

Example: T holds a corporation X bond with a principal amount of $1,000 and an interest coupon of 8%. T's basis in the bond is $1,000. In a recapitalization, T exchanges the bond for a new bond with a principal amount of $800 and an interest coupon of 10%. At the time of the exchange, the fair market value of the old and the new bond is $900. Under §354(a)(1), T will recognize no gain or loss on the exchange. The new bond, with a principal of $800 and a fair market value of $900, will have a basis in T's hands of $1,000 determined under §358.

Assuming the old bond or the new bond is publicly traded, pursuant to §1273(b), the issue price of the new bond will be the fair market value of $900. Because this exceeds the maturity value of $800, there will be no OID. Under §171, T will have amortizable bond premium equal to the excess of T's $1,000 basis over the $800 maturity value.

b. *Treatment of Issuer*

For the issuer, the tax issues in question involve cancellation of indebtedness with respect to the old instrument and OID with respect to the new instrument. The somewhat anomalous rule under §354 and §356 that looks to principal amount rather than issue price in characterizing the exchange to the holder is not directly relevant to the treatment of the issuer.

Example: T holds a corporation X bond with an adjusted issue price of $1,000 and a maturity value of $1,000. At a time when the fair market value of the bond has depreciated to $800, T exchanges the bond for a new X bond with a maturity value of $1,000, but with certain other terms changed — such as interest rate, maturity date, covenants — in a material fashion.

One issue raised by the facts above is when an exchange of debt instruments is deemed to occur for tax purposes. While it is beyond the scope of this Portfolio to collect and analyze the authorities on this question, it should be noted that there has been a great deal of uncertainty as to the criteria for determining when there has been an exchange. Ordinarily, this issue arises when there is a modification of an existing instrument, without a formal surrender of the old piece of paper and issuance of a new piece of paper. Although disagreeing on when the modification is so material as to be treated as an exchange, the authorities seem to agree that the determination must be the same for the issuer and the holder.[334] Further, the IRS has determined that different standards apply for testing a taxable exchange from those governing whether there has been a "disposition" of an installment obligation under §453B.[335]

Reg. §1.1001-3 provides rules for determining whether a modification of the terms of a debt instrument results in an exchange of the debt instrument under Reg. §1.1001-1(a). In general, this regulation provides that a significant modification of a debt instrument results in an exchange of the original debt instrument for a modified instrument that differs materially either in kind or in extent.[336] A modification includes any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or a holder of a debt instrument, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise. In general, an alteration of a legal right or obligation that occurs by operation of the terms of a debt instrument is not a modification.[337]

The regulation provides specific rules for determining whether the following types of modifications constitute a significant modification: change in yield, change in the timing of payments, change in obligor or security, change in the nature of a debt instrument (i.e., change from debt to equity, or from recourse debt to nonrecourse debt), and change in accounting or financial covenants.[338] For modifications not specifically addressed in the regulation, the general rule for determining the significance of modifications focuses on whether the legal rights or obligations that are altered and the degree to which they are altered are economically significant.[339]

Assuming there is an actual exchange, or a significant modification treated as an exchange, the issuer must determine its issue price in the new instrument in order to determine whether it has debt cancellation income.[340] Pursuant to §108(e)(10), regardless of whether a debt-for-debt exchange occurs in a reorganization or otherwise, the debtor is treated as satisfying the old debt with an amount of money equal to the issue price of the new debt instrument. For this purpose, the issue price is determined under the rules of §1273 and §1274.

Because the new bond is issued in exchange for property (i.e., the old bond), the issue price will be determined under §1273(b)(3) if either bond is publicly traded, or under §1274 if not. The rule under §1273(b)(3) is that if either the old instrument or the new is publicly traded, the issue price will be fair market value. If neither instrument is publicly traded, the mechanical rules under §1274 are applied. In summary, §1274 provides that where the new instrument carries interest at least equal to the applicable federal rate, the issue price will be the stated principal amount.[341] Where the instrument does not carry adequate stated interest, the issue price is determined by com-

---

[334] For examples of the variety of fact patterns and conclusions, compare Rev. Rul. 73-160 (extension of term and subordination by one holder not treated as exchange); GCM 37884 (Mar. 19, 1979) (suggesting that extension of maturity date might in some circumstances result in an exchange); Rev. Rul. 87-19 (waiver of interest rate adjustment is material change resulting in exchange treatment); Rev. Rul. 89-122 (change in principal is material change).

[335] GCM 39225 (Apr. 27, 1984).

[336] Reg. §1.1001-3(b). For a detailed discussion of the significant modification rules under Reg. §1.1001-3, see 182 T.M., *Time Value of Money — Issuers of Debt Instruments*.

[337] Reg. §1.1001-3(c)(1). Under Rev. Proc. 99-18, *modified by* Rev. Proc. 2000-29, an issuer and exchanging holders in certain substitutions of new public debt for two or more issues of old public debt may elect to treat the modification as a realization event accounted for over the life of the new instrument.

[338] Reg. §1.1001-3(e).

[339] Reg. §1.1001-3(e)(1).

[340] Under Reg. §1.1275-1(b)(1), one must first determine, as always, whether the newly issued instrument should be characterized as debt or equity for federal income tax purposes. *See* 702 T.M., *Capitalizing a Business Entity: Debt vs Equity*.

[341] *See* §1274(a)(1), §1274(c)(2).

ISBN 978-1-63359-255-1

puting the present value of the instrument utilizing the applicable federal rate as the discount rate.[342]

Example: T holds a corporation X bond with an adjusted issue price of $1,000 and a maturity value of $1,000. At a time when the fair market value of the bond has depreciated to $800, T exchanges the bond for a new X bond with a trading value of $800 and a maturity value of $1,000. If neither bond is publicly traded, the issue price of the new bond will be $1,000 under §1274, and therefore, under §108(e)(10), there will be no cancellation of indebtedness. Because the issue price and maturity value of the new bond are each $1,000, there will be no OID.

If, instead, the bonds are publicly traded, there will be debt cancellation income. Specifically, the issue price of the new bond will be $800, its trading value. As a result, X will have cancellation of indebtedness of $200, equal to the excess of the $1,000 adjusted issue price of the old bond over the $800 issue price of the new bond. Assuming that X is neither insolvent nor in bankruptcy,[343] and that no other exception under §108 applies, X will have taxable income of $200 even though the exchange occurred in a so-called tax-free reorganization, and even though the holder had nonrecognition under §354.

Finally, because the issue price of the new bond is $800 and the maturity value is $1,000, there will be OID of $200.

3. Securities with Interest Arrearages

Section 354(a)(2)(B) provides that a creditor exchanging securities for new securities, stock, or any other property attributable to accrued but unpaid interest (including accrued original issue discount) is treated as receiving interest income on the accrued but unpaid interest. Note that this rule, unlike the regular boot rules, applies irrespective of whether there is any gain realized on the exchange. This provision is generally of concern only to a cash basis holder. As to an accrual basis holder, it will ordinarily have already included accrued interest in income. One exception would be for a holder that has ceased accruing interest, due to an evaluation of the financial predicament of the issuer and the unlikelihood of receiving the interest. Except in the more obvious cases, it is not always easy to determine how much, if any, of the consideration received by a holder is "attributable to interest which has accrued" on the securities surrendered. One rule that is not set forth explicitly in the statute but that an accrual basis holder should bear in mind allows the recognition of a loss to the extent that amounts previously accrued as interest income are eventually not paid in the exchange. This rule, set forth in the legislative history,[344] is very interesting, because it applies notwithstanding the general rule under §354(a)(1) and §356(c) that will not allow the recognition of a loss on the exchange.

Example: Holder, an accrual basis taxpayer, owns a $1,000 debenture issued by Issuer, on which there is accrued interest of $200. In a recapitalization, Holder exchanges the old debenture for preferred stock with a fair market value of $900. Although no gain or loss is recognized to Holder on the exchange under §354(a)(1), Holder should be permitted to recognize a loss of $200 to the extent of the previously accrued but unpaid interest.

Note: In TAM 9538007, the National Office advised that holders of debt instruments having OID must include the OID in income so long as they hold the debt instruments, regardless of the financial condition of the issuer. According to the reasoning in the TAM, there is no "doubtful collectibility" exception from the OID income inclusion rule as there is for non-OID interest by holders on the accrual method of accounting.

4. Exchange of Nonsecurity Debt

If a creditor holding a debt instrument that is not a security, such as a short-term note or trade debt, exchanges the instrument for another, the treatment to the issuing corporation will be the same under §108(e)(10) as where the debt retired is a security. As to the holder, because nonrecognition will not apply under the reorganization provisions, the exchange will generally give rise to gain or loss under §1001. As to the amount realized to the holder in such an exchange, there may be some uncertainty as to whether one should determine the fair market value of the new instrument, or apply the rules under §1273 and §1274.[345]

5. Reacquisition of a Debt Instrument in 2009 or 2010: Deferral of Cancellation of Indebtedness Income

In 2009, Congress added §108(i),[346] which permitted a business to elect to defer cancellation of indebtedness income arising from a reacquisition of an applicable debt instrument after December 31, 2008, and before January 1, 2011.[347] Income deferred under the election had to be included in the taxpayer's gross income ratably in the five taxable years beginning with (1) for repurchases in 2009, the fifth taxable year following the taxable year in which the repurchase occurred or (2) for repurchases in 2010, the fourth taxable year following the taxable year in which the repurchase occurred.[348]

---

[342] *See* §1274(a)(2), §1274(b).

[343] Under §108(a), cancellation of indebtedness is excluded from gross income where the debtor is in bankruptcy or to the extent the debtor is insolvent.

[344] S. Rep. No. 96-1035, at 38 (1980).

[345] For a discussion of these issues, see Adrion & Blasi, *Renegotiated Debt: The Search for Standards*, 44 Tax Law. 967 (1991).

[346] American Recovery and Reinvestment Act of 2009 (2009 ARRA), Pub. L. No. 111-5, Div. B, §1231(a).

[347] An "applicable debt instrument" is any debt instrument issued by a C corporation or any other person in connection with the conduct of a trade or business by such person. §108(i)(3)(A). "Debt instrument" means a bond, debenture, note, certificate, or any other instrument or contractual arrangement constituting indebtedness (under §1275(a)(1)). §108(i)(3)(B). A "reacquisition" is any "acquisition" of an applicable debt instrument by the debtor that issued (or is otherwise the obligor under) such instrument or any person related to the debtor under §108(e)(4). §108(i)(4)(A). An "acquisition" includes, without limitation: (1) an acquisition of a debt instrument for cash; (2) the exchange of a debt instrument for another debt instrument (including an exchange resulting from an instrument's modification); (3) the exchange of corporate stock or a partnership interest for a debt instrument; (4) the contribution of a debt instrument to the issuer's capital; and (5) the complete forgiveness of a debt instrument by the instrument's holder. §108(e)(4), §108(i)(4)(B).

[348] §108(i)(1).

ISBN 978-1-63359-255-1

If a taxpayer made the election for a debt-for-debt exchange in which the newly issued debt instrument issued for the applicable debt instrument being reacquired had OID, then any otherwise allowable deduction for OID with respect to the newly issued debt instrument was disallowed with respect to the portion of OID which (1) accrued before the first taxable year of the five-taxable-year period in which the related, deferred discharge of indebtedness income was included in the taxpayer's gross income and (2) did not exceed such related, deferred discharge of indebtedness income.[349] The aggregate amount of deductions disallowed and deferred under this rule were allowed as a deduction ratably over the same five-taxable-year period in which the deferred discharge of indebtedness income is included in gross income.[350]

Section 108(i)(5)(D)(i) provides that cancellation of indebtedness income and any related deduction for OID that was deferred by an electing taxpayer (and not previously taken into account) generally is accelerated and taken into income in the taxable year in which the taxpayer: (1) dies; (2) liquidates or sells substantially all of its assets (including in a title 11 or similar case); (3) ceases to do business; or (4) is in similar circumstances. This acceleration rule also applies in the case of the sale, exchange, or redemption of an interest in a partnership, S corporation, or other pass-through entity by a partner, shareholder, or other person holding an ownership interest in such entity.[351] However, the regulations do not require acceleration in every instance enumerated in the statute.[352] Instead, they provide for acceleration in a limited number of circumstances in which corporations have impaired their ability to pay their incipient tax liability and generally reflect a narrower interpretation of the statutory acceleration events. Specifically, the regulations generally provide that an electing corporation will accelerate deferred cancellation of indebtedness income under §108(i)(5)(D) if the electing corporation (i) changes its tax status; (ii) ceases its corporate existence in a transaction to which §381(a) does not apply; or (iii) engages in a transaction that impairs its ability to pay the tax liability associated with its deferred cancellation of indebtedness income. Under these regulations, the foregoing three rules are the only events that accelerate an electing corporation's deferred cancellation of indebtedness income. In addition to these regulations, however, the rules under Reg. §1.108(i)-2 apply to C corporations that are direct or indirect partners of a partnership.

If a taxpayer made the election, the exclusions under §108(a)(1)(A), §108(a)(1)(B), §108(a)(1)(C), and §108(a)(1)(D) do not apply to the income from the discharge of indebtedness for the year in which the taxpayer made the election or any subsequent year.[353] A taxpayer made the election by including with its return for the taxable year in which the reacquisition of the debt instrument occurred a statement that (1) clearly identified the debt instrument and (2) included the amount of deferred income to which the provision applied and such other information as was prescribed by the Secretary.[354] Once made, the election was irrevocable.[355]

For a detailed discussion of §108(i) and the mechanics of the election, see 541 T.M., *Tax Aspects of Restructuring Financially Troubled Businesses.*

E. Exchanges of Debt for Stock

1. Current Rules

As discussed above, recapitalization status does not offer any inherent protection from recognizing cancellation of indebtedness (COD) income.[356] Where the issuer exchanges its stock for outstanding indebtedness, neither §1032(a) nor any other Code provision indicates that the issuer will have any different treatment than if it used some other form of property to retire its debt. Under §61(a)(12), it will ordinarily realize COD income to the extent the amount of the debt exceeds the value of any property paid to the creditor. Section 108(e)(8) provides that if a debtor corporation transfers stock in exchange for debt, the corporation will generally be treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock. Thus, any excess of the adjusted issue price of the indebtedness over the fair market value of the stock will generally give rise to COD income. Note, however, that under §108(a), the COD income will be excluded from gross income if the discharge occurs in a Title 11 case or if the discharge occurs when the corporation is insolvent. In the case of insolvency, the §108(a) exclusion cannot exceed the amount by which the corporation is insolvent.[357] COD income excluded under §108(a) reduces the corporation's tax attributes.[358]

> *Example:* A corporation issues stock with a fair market value of $28,000 in complete satisfaction of an outstanding debt with an adjusted issue price of $40,000. Even though this transaction qualifies as a recapitalization, the corporation is treated as having discharged its $40,000 debt with a payment of $28,000 under §108. As a result, the corporation realizes $12,000 of COD income. If the corporation's recapitalization occurs in the context of a Title 11 case, or to the extent that the corporation was insolvent before the recapitalization, the corporation will exclude the COD income from gross income and reduce

[349] §108(i)(2)(A)(i).

[350] §108(i)(2)(A)(ii).

[351] §108(i)(5)(D)(ii).

[352] See Reg. §1.108(i)-1 and §1.108(i)-3, noting that the IRS and Treasury believe that it is appropriate to provide different acceleration rules for pass-thru entities and electing corporations. For example, a sale of substantially all of the assets of a pass-thru entity is an acceleration event for an S corporation while that transaction, standing alone, is not an acceleration event for an electing corporation. *See* Reg. §1.108(i)-1(b); *cf.* Reg. §1.108(i)-2(c)(3).

[353] §108(i)(5)(C).

[354] §108(i)(5)(B)(i). Rev. Proc. 2009-37 sets forth the exclusive procedure for making the §108(i) election. Significantly, the revenue procedure provided that a taxpayer could make a partial §108(i) election for any portion of debt-discharge income realized from a reacquisition, including with respect to different portions of income arising from different instruments. Also, a protective §108(i) election was allowed under Rev. Proc. 2009-37 in case a taxpayer determined that a transaction did not result in debt-discharge income and reported the transaction as such but the IRS found that the taxpayer's conclusion was incorrect. Also, it appears that the §108(i) election could be filed with an amended return as long as the amended return was filed within 12 months of the extended due date for the return on which the election should have been made. CCA 201218011.

[355] §108(i)(5)(B)(ii).

[356] Rev. Rul. 77-437.

[357] §108(a)(3).

[358] *See* §108(b).

ISBN 978-1-63359-255-1

tax attributes (e.g., net operating losses) by the excluded amount.

For further discussion of §108(e)(8), see 540 T.M., *Bankruptcy and Insolvency Restructurings; Discharge of Indebtedness Activities.*

2. Prior Rules

Under a longstanding line of case law, there existed a common law exception to the general rule of taxability where a corporation exchanged its own stock for outstanding debt.[359] This was commonly known as the "stock for debt" exception. Under the rule, a corporation did not recognize COD income upon the issuance of its stock in exchange for its debt.

In 1984, Congress statutorily restricted the scope of this judicial doctrine to corporations that were in bankruptcy or were insolvent. Pre-1993 RRA §108(e)(10) was amended to provide that, except for a debtor in a title 11 case or a debtor to the extent of its insolvency, where a debtor corporation transferred its stock to a creditor in satisfaction of its debt, the debtor was treated as having satisfied the debt with an amount of money equal to the fair market value of the stock.

As discussed above, the 1993 RRA revamped §108.[360] Consequently, regardless of whether a debtor corporation is insolvent or in bankruptcy, the transfer of its stock in satisfaction of its debt is treated as if the corporation satisfied the debt with an amount of money equal to the fair market value of the stock transferred.

F. Exchanges of Warrants for Stock

The tax treatment of exchanges of warrants for stock presents a landscape appearing tranquil at first but which, upon closer examination, reveals significant pockets of uncertainty. This uncertainty has been notably lessened by the IRS's promulgation in 1998 of regulations, discussed in IV.G.2.d., above, treating stock rights as securities for purposes of §354.[361]

Under §1032, gain or loss is not recognized to the issuing corporation that trades in its stock and warrants to acquire its stock. Other than that, the treatment to a holder in dealings with respect to warrants has generally been thought to be governed by the same rules as apply to an investor's dealings with respect to any other call right. Those rules, along with those applying broadly to issuers and holders of puts, calls and straddles, are set forth in Rev. Rul. 78-182. That ruling provides that the holder of a call option, such as a warrant, realizes no taxable income upon the exercise of the option, and its basis in the call is added to the basis of the property purchased through the exercise. When the grantor of the call is also the issuer of the stock into which it is exercisable, this nonrealization conclusion is further supported by the conclusion in Rev. Rul. 72-265. In that ruling, the IRS determined that a holder of a convertible debenture does not realize taxable income upon the conversion of the debenture into stock of the issuer pursuant to the conversion feature.

It is quite important to first determine whether one is dealing with an option held by an investor or by a service provider. The discussion herein is limited to the holder of a warrant or similar option who received it in connection with an investment transaction and not in a compensatory context. The treatment of a taxpayer who receives a stock option in connection with the performance of services is governed either by §421 *et seq.* with respect to incentive (qualified) stock options, or by §83 with respect to nonqualified options. Generally, under Reg. §1.83-7, a service provider (whether an employee or independent contractor, individual, partnership, or corporation) receives open transaction treatment on the receipt of a nonqualified option, and is taxed upon exercise in an amount equal to the spread between the stock's fair market value and the exercise price. For incentive stock options, provided there is not a disqualifying event, the holder is not taxed upon receipt or exercise, and receives long-term capital gain treatment upon a sale of the stock.

Turning back to the investor holding a warrant, there has been some uncertainty surrounding the tax treatment of a "cashless exercise" of a warrant, i.e., a transaction where, instead of the holder exercising the warrant directly in accordance with its terms by paying the exercise price to the grantor of the option, the warrant is exchanged for a lesser number of shares such that the economic results to the grantor and holder are substantially the same.

> *Example:* X corporation has issued to individual B a warrant to purchase 100 shares of X stock at a price of $50 per share. X stock is now trading at $200 per share. B could exercise the warrant by paying to X the exercise price of $5,000 and receiving 100 shares of X stock with a fair market value of $20,000. Instead, the parties agree to enter into a cashless exercise transaction, in which B exchanges its warrant solely for 75 shares worth $15,000. The two transactions are economically equivalent. In both cases, B's warrant, worth $15,000 (based solely on the spread between the $20,000 value of the X stock and the $5,000 exercise price) is being exchanged for X stock. If, in the cashless exercise transaction, B wanted to end up with a total of 100 shares worth $20,000, B could purchase an additional 25 shares on the market for $5,000. If, in the basic exercise transaction, B wished to replenish the $5,000 spent on the exercise price, B could sell 25 shares for $5,000, leaving B with 75 shares worth a total of $15,000.
>
> As noted above, B does not realize any income on the exercise of the warrant in accordance with its terms. But what about the cashless exercise, where a warrant is simply exchanged for stock? The fact that the grantor of the warrant is also the issuer of the stock into which it is exercisable could be relevant. Consider the case where a regular call is the subject of a cashless exercise. It is difficult to find explicit authority for the proposition that this is a taxable exchange; however, in the absence of direct authority

---

[359] *See Commissioner v. Capento Secs. Corp.*, 47 B.T.A. 691 (1942), nonacq., 1943 C.B. 28, *aff'd*, 140 F.2d 382 (1st Cir. 1944); *Claridge Apts. Co. v. Commissioner*, 1 T.C. 163 (1942), acq., 1947-1 C.B. 2, *rev'd in part*, 138 F.2d 962 (7th Cir. 1943), *rev'd on other grounds and rem'd*, 323 U.S. 141 (1944); *Alcazar Hotel, Inc. v. Commissioner*, 1 T.C. 872 (1943), acq., 1947-1 C.B. 1; *Motor Mart Tr. V. Commissioner*, 4 T.C. 931 (1945), *aff'd*, 156 F.2d 122 (1st Cir. 1946), acq., 1947-1 C.B. 3; *Tower Bldg. Corp. v. Commissioner*, 6 T.C. 125 (1946), acq., 1947-1 C.B. 4. *See also* Rev. Rul. 59-222.

[360] The 1993 RRA deleted §108(e)(10), as discussed above, and amended §108(e)(8) to read as pre-1993 RRA §108(e)(10)(A). In addition, pre-1993 RRA §108(e)(11) was redesignated as §108(e)(10).

[361] Reg. §1.354-1(e).

ISBN 978-1-63359-255-1

providing that the exchange of an option for the underlying property is nontaxable, one is presumably left with an exchange as to which gain or loss is recognized under §1001.

The original authority for the analysis in Rev. Rul. 78-182 seems to be *Helvering v. San Joaquin Fruit & Investment Co.*,[362] in which the U.S. Supreme Court held that the exercise of an option to purchase real property did not constitute an exchange of the option and the option premium for the real property, but rather should simply be treated as an acquisition of the property on the date the option was exercised. This is in contrast, perhaps, to an analysis that would explicitly state that there was an exchange of the option in such a case, but gain was not recognized on such exchange. Thus, the ruling simply treats the exercise of a call as a purchase of the underlying property for consideration equal to the exercise price plus the earlier premium to acquire the call.

Granted that the exchange of an option for the underlying property without payment of the exercise price is a taxable event, what is the proper amount of gain to be recognized? In the above example, assuming for simplicity purposes that B had no tax basis in the warrant, a fully taxable exchange of the warrant for 75 shares in X corporation involves a realization of $15,000 gain. Such a result could be avoided by B and X if B issued a $5,000 note to X to pay the exercise price, received the entire 100 shares with a value of $20,000, and sold 25 of those shares in order to pay off the note. In this case, B would recognize a gain of only $3,750, i.e., $5,000 proceeds less tax basis of $1,250 (25% of $5,000) in the sold shares.

In addition to the question of taxable recognition of gain, an important element to consider in connection with the optimal transaction with respect to warrants is holding period. Under §1223(4), an investor's holding period in stock received on the exercise of a warrant begins on the date of exercise. Thus, in the above example, B's $3,750 of gain from the sale of the stock would be short-term capital gain. The fact that B has a long-term holding period in the warrants is of no utility unless a nonrecognition provision applies.

In principle, in a cashless exercise, the entire amount of the gain in the options should not be considered recognized, but only an amount attributable to the portion of the option value that the holder is "using" to pay the exercise price. In the above example, this amount would be $3,750, a far more reasonable result than the entire $15,000 of inherent gain in the option. Despite the reasonableness of this approach, the authorities seem to limit themselves to the proposition that the exercise of a call option does not involve a disposition of the option, but merely the payment of the lesser purchase price for the underlying asset that the holder is privileged to pay by virtue of the call option. Where there is a direct exchange of option for property, the risk of full gain recognition is, therefore, high.

It would be quite reasonable to treat the holder in a cashless exercise transaction as utilizing some of the surrendered options as consideration to pay the exercise price on the remainder of the options. In the above example, assume that one could treat the warrant as comprising 100 options to purchase one share of stock for $50, with each such option having a value of $15 ($20 stock value less $5 exercise price).[363] The cashless exercise would be treated as the exercise of 75 of these options (total exercise price of $3,750) by the payment to the grantor of 25 options (worth $3,750), with gain recognized on the deemed sale of the 25 options. Note that the assumption about breaking the warrant into 100 mini options is unnecessary in any real set of facts where one deals with lots of warrants — for example, simply multiply the numbers in the example by 100.

The above analysis, while reasonable, is problematic. First, if the form of the transaction is simply an exchange of options for stock, it is not at all clear that the IRS or a court would construct a deemed exercise of some options and sale of the rest. Therefore, if one were to attempt such an approach, one would be well advised to explicitly document the exchange in just such a manner, as a payment with certain options to exercise others. The only question, then, would be whether the stated characterization would be respected, or recast into a fully taxable exchange.

If the call option is actually a warrant to acquire stock of the grantor, is the case for nonrecognition on a cashless exercise any stronger? Rev. Rul. 72-265 concluded that the exercise of a conversion feature in a convertible debenture is not a realization event. There is little elaboration on the reasoning or the scope of the ruling, except the notation that it does not apply to a case where the debenture is convertible into stock of a corporation other than the issuer of the debenture. One might deduce that the IRS's analysis underlying the ruling is that the conversion is not a realization event because the conversion was an event clearly contemplated in the original instrument, so that we have something more akin to a change in the form of the same instrument than an exchange of one instrument for another. It might be argued that a similar principle underlies the nonrealization conclusion with respect to the exercise of a warrant, and that a cashless exercise is inherently a nonrealization event because the ability to convert the warrant into stock was inherent in the warrant and not a new transaction. This approach is belied, however, to the extent that the terms of the cashless exercise are not explicitly contemplated in the terms of the warrant, but must be negotiated between issuer and holder at the time of exercise.

What if nonrecognition property is used to pay the exercise price for the warrant? In Rev. Rul. 84-121, the IRS considered the treatment under §1031 of a transaction in which B, the holder of an option to buy land owned by A, purchased other real property and used it to pay the exercise price under the option. The IRS ruled that the exchange qualified under §1031 as to A, but did not qualify as to B only because B had not used the property in a trade or business.[364]

---

[362] 297 U.S. 496 (1936).

[363] Outside the world of §83, it is well recognized that an option has inherent value above and beyond the spread between exercise price and the trading price of the underlying security. This valuation point may be relevant to this discussion in certain contexts, but here, at least, neither the analysis nor the actual arithmetical results should be altered by taking the option value into account.

[364] See also Rev. Rul. 82-144, wherein the IRS sanctioned the exercise of compensatory options using stock previously received through the exercise of incentive stock options. No gain or loss was recognized under §1036 on the use of the stock to exercise for the option exercise.

ISBN 978-1-63359-255-1

In many cases, the holder of stock warrants is a lender who invested in debentures or other debt securities, or an investor in preferred stock, and received the warrants as part of an investment unit. In such a case, for example, the holder could utilize a portion of the debentures or preferred stock to "pay" the exercise price for the warrants.

> *Example:* Fund holds $10,000 face amount debentures and 10 warrants issued by Y corporation with an exercise price of $5 per share. Fund wishes to exercise the warrants, at a time when the Y stock's trading value is $20 per share. In order to exercise all of the warrants, Fund would have to pay an exercise price of $5,000 (10 warrants, each warrant for 100 shares, at an exercise price of $5 per share). Accordingly, Fund and Y enter into a transaction in which Fund exchanges one-half of its debentures, with a face amount (and assume fair value) of $5,000, along with the warrants, for 1,000 shares of Y stock, with a fair market value of $20,000.

The exchange in the above example is tax-free to the Fund, provided that the debentures are treated as securities under §354, and provided that the exchange will qualify as a recapitalization under §368(a)(1)(E). As discussed in III.B., above, nearly any alteration of the capital structure of a corporation may qualify as a recapitalization, provided there is at least a minimal degree of business purpose for the transaction. Ordinarily, the business purpose requirement is met by virtue of the fact that the transaction has brought about some change to the corporation's capital structure. Certainly, a transaction in which Y corporation retires debt before maturity without having a cash expenditure, instead issuing equity in conjunction with the exchange of outstanding warrants, should meet this test. Whatever legal documentation is executed to memorialize this exchange should meet the requirement for a "plan of reorganization" under the statute and regulations under §368.

As a result of the revisions to the regulations under §354 and §356, under which warrants are now treated as qualifying consideration in reorganizations,[365] exchanges of warrants for warrants and stock for warrants are generally permissible in the context of a §368 reorganization. Thus, the question presents itself squarely whether a nonrecognition result can be attained with respect to a cashless exercise of warrants under the reorganization provisions. Specifically, can a simple exchange by a holder of warrants for stock, without a payment of the exercise price, qualify as a recapitalization under §368(a)(1)(E), and as a result, the exchange be considered a tax-free exchange of securities with a principal amount of zero for stock in the corporation undergoing the recapitalization? In the author's view, the answer is yes.

In Rev. Rul. 77-238, the IRS ruled that the exercise of a conversion feature in a convertible stock pursuant to its original terms would qualify as a recapitalization. As to the business purpose, the IRS stated that "[t]he purpose of the conversion privilege is to encourage the conversion of preferred stock into common stock in order to simplify the capital structure of the corporation by eliminating the preferred stock." Essentially, where the original transaction that gave rise to the issuance of the warrants had an apparent business purpose, any reasonable transaction that subsequently occurs with respect to those warrants should meet the test for a recapitalization. Indeed, one would think that the case for treating an isolated cashless exercise transaction would present a stronger case for recapitalization treatment than in the ruling, where hundreds of investors individually exercising their conversion rights at random would be deemed to meet all of the requirements for a tax-free reorganization.

Recall that the holding period consequences of a regular option exercise are generally unfavorable: the holding period begins on the date of exercise. In contrast, if the exchange occurs under §354, there is a tacking of holding periods under §1223(1), and so the investor can take a holding period in the shares that refer back to the date of the original investment in the warrants.

G. *Estate Freeze Recapitalizations*

During the late 1970s and early 1980s, the IRS issued numerous private letter rulings on recapitalizations that were used as a "freezing" technique to shift future appreciation in appreciating and income-producing assets (including closely-held businesses) from one generation to another. To accomplish this shift, a business would be recapitalized with two new types of equity interests — senior preferred stock (entitled to a fixed annual payment and a fixed amount upon liquidation or redemption) and subordinate common stock (entitled to neither of these amounts). The older family member would exchange his or her existing common stock for these new interests and then transfer the new common stock to younger family members.

> *Example:* The stock of corporation X consists only of common, all of which is owned by S1, its founder. S1 has a spouse, S2, and one child, C. In order to retain most of the current value of the corporation, but transfer the future value to C, S1 will exchange the X common stock for (1) newly authorized X preferred stock with a liquidation value of $1,000x, equal to the appraised fair market value of S1's present common stock interest and (2) newly issued common stock. The preferred stock will have a 10% per annum cumulative dividend. S1 will either sell or gift to C the newly issued shares of X common stock for $10x.
>
> The success of the transaction is premised upon the factual determination that the fair market value of the preferred stock is equal to its liquidation value, which, in turn, is equal to the total fair market value of the company immediately before the recapitalization. Assuming that this is correct, S1's exchange of the X common for X preferred stock and common stock will be tax-free under §354(a). In addition, the value of the stock either sold or gifted to C will be relatively nominal. Assume further that at the time of S1's death, 15 years after the above transaction, X is worth a total of $2,000x. Again, assuming that all was done correctly in the original recapitalization, the value of the X stock in S1's estate is limited to the $1,000x of preferred that S1 held. All of the post-recapitalization appreciation in the value of the company is successfully passed on to C with no tax ramifications.

[365] *See* Reg. §1.354-1(e), §1.356-3(b).

ISBN 978-1-63359-255-1

Valuation of the stock interests is critical to the estate freeze recapitalization technique. Gift tax is avoided by assigning a very low value to the common stock that is transferred to the younger generation and estate tax is avoided by having the rights associated with the preferred (which is retained by the older generation) lapse upon death so that the value for estate tax purposes is reduced. However, both of these goals have been significantly affected by the enactment of the valuation rules in §2701–§2704. Section 2701–§2704 provide special valuation rules that apply in this, and other, contexts. These provisions respect the basic concept of freezing value in the preferred stock and transferring the relatively low-value growth via the common stock. They provide, however, specific rules for valuing the respective preferred and common interests to ensure that the proper gift and estate tax consequences are accorded the transaction.

Until the enactment of §2701–§2704, discussed below, the IRS addressed this issue on the merits in rulings and litigation. The most complete statement of the IRS's valuation approach, before the enactment of §2701–§2704, is set forth in Rev. Rul. 83-120. In general, the ruling indicates a healthy skepticism by the IRS as to any corporation's ability to provide sufficient liquidation, redemption, and dividend rights in the preferred stock as to compensate for the fact that its holder is forfeiting any possibility of growth in the value. Rev. Rul. 83-120 was quite blunt in describing its main objective. The ruling first noted that it concerned a common estate planning transaction in which an individual exchanged all of the individual's corporate stock for preferred and common, with the preferred having a par value equal to all or most of the value in the old stock, with the common having only a small or nominal value. An introductory section of the ruling stated:

> The approach and factors described in this Revenue Ruling are directed toward ascertaining the true fair market value of the common and preferred stock and will usually result in the determination of a substantial fair market value for the common stock and a fair market value for the preferred stock which is substantially less than its par value.

With respect to the valuation of the preferred stock, the ruling lists several factors. The most important factors are yield, dividend coverage, and protection of the liquidation preference. With respect to yield, the ruling suggests comparing the preferred stock's dividend rate to that of high-grade publicly traded preferred stocks. In conjunction with this comparison, one should compare the corporation's borrowing rate to that charged to the most creditworthy borrowers (if the corporation's borrowing rate is higher than the rate charged to the most creditworthy borrowers, then the yield on the preferred stock should be correspondingly higher than the yield on high-quality preferred stock). The ruling also looks to certain financial ratios and compares them to those of high-quality issuers of preferred stock in order to determine the adequacy of dividend coverage. Similarly, asset ratios are compared with those of high-quality companies to assess the corporation's ability to pay the full liquidation preference. Other factors, such as voting rights, special covenants, and redemption rights, are to be taken into account as well.

With respect to valuation of the common stock, the ruling indicates that if the preferred stock has a fixed rate of dividend and is nonparticipating, the common stock has the exclusive right to the benefits of future appreciation of the value of the corporation and that such a right is valuable. The ruling further indicates that the actual value of this right will vary depending on such factors as past growth experience, economic factors affecting the industry in which the company operates, and the corporation's past policies as to reinvestment of dividends. In addition, the revenue ruling indicates that another factor to be considered in determining the value of the common stock is whether the preferred stock also has voting rights (such voting rights could increase the value of the preferred stock and reduce the value of the common stock).

Section 2701–§2704 set forth rules governing the valuation of retained rights in corporations and partnerships, the valuation of split temporal interests in property, the effect of buy-sell agreements and options on the valuation of property, and the transfer tax consequences of lapsing rights. The provisions are complex, but for purposes of this discussion, the most important aspects of the rules relate to the value of retained rights in business entities and the effect of lapsing rights on valuation for estate tax purposes.

Pursuant to §2701, the value of residual interests, such as common stock, is determined by subtracting the value of the preferred interests from the fair market value of the entire entity. The basic rule is that if a person transfers stock to a family member and the person retains an "applicable retained interest" immediately after the transfer, then, except to the extent provided in the statute, the value of the applicable retained interest will be deemed to be zero.[366] Preferred stock will ordinarily constitute an applicable retained interest, as defined in §2701(b), provided the transferor and specified family members control the company.[367] The time for imposition of the consequences of §2701 is at the time of transfer, with the result being a larger gift tax in connection with the transfer of the common.

The statutory valuation rule does not apply where market value is readily available on an established securities market.[368] It also does not apply with respect to stock of the same class as that transferred, or where the stock retained carries similar rights to the interest transferred, but in a different proportion.[369] Thus, for example, where there are two classes of common stock, with Class A having twice the dividend and liquidation rights of the Class B, if either is transferred, the retained stock will not be subject to the special valuation rule.[370]

The specific rules for valuation of the preferred interest are set forth in §2701(a)(3). Under that provision, if the preferred stock confers a "distribution right" consisting of the right to a "qualified payment," and there are one or more liquidation, put, call, or conversion rights, then the value of all such rights is to be determined as if each liquidation, put, call, or conversion right were exercised in a manner resulting in the lowest possible value for such rights. Qualified payments generally correspond to fixed, cumulative dividends payable on a regular ba-

[366] §2701(b); Reg. §25.2701-2(a)(1), §25.2701-2(b).
[367] §2701(b)(1)(A).
[368] §2701(a)(2)(A).
[369] §2701(a)(2)(B), §2701(a)(2)(C).
[370] §2701(a)(2). *See, e.g.*, PLR 9811024.

ISBN 978-1-63359-255-1

sis.[371] They also include such dividends where the rate varies with a specified market rate.[372]

> *Example:* B transfers all of the common stock in corporation X to B's child, C, and retains cumulative preferred stock with a cumulative dividend of $100 per year and which may be redeemed at any time after two years for $1,000. Under the statute, the value of the preferred stock is the lesser of: (1) the present value of two years of $100 of dividends plus the present value of the $1,000 redemption proceeds at the end of year 2; or (2) the present value of $100 received every year in perpetuity.

Under §2701(c)(3)(C)(i), a transferor may irrevocably elect to treat payments as not qualified payments, with the result that the retained interest will be valued at zero, and the value of the transferred interest will be correspondingly greater. In addition, under §2701(c)(3)(C)(ii), the transferor may irrevocably elect to treat any distribution right as a qualified payment, and specify in the election the amounts and times of the qualified payments, but only to the extent that the elected treatment is not inconsistent with the underlying legal instrument.

> *Example:* C owns all of the common stock of Company. In a recapitalization, C exchanges most of C's stock for a new preferred with a noncumulative dividend of $100 per share, and C transfers the common shares to C's children. Since the dividend is not cumulative, it does not meet the definition of a qualified payment under §2701(c)(3)(A). Absent a special election, C's retained preferred stock will be valued at zero. Under §2701(c)(3)(C)(ii), C may elect to treat the $100 noncumulative dividend as a $100 cumulative dividend, and therefore, a qualified payment allowing a valuation of the preferred under §2701(a)(3). C may not, however, elect to treat the dividend as a $110 cumulative dividend, since that exceeds the amount that may legally be distributed under the terms of the stock. Further, to the extent that the dividend distributions are not actually made on the prescribed dates, C will be subject to the special compounding rules under §2701(d).

Section 2701(d) addresses the situation in which, although qualified payments are taken into account in determining the valuation of retained and transferred interests, it turns out that such payments are not, in fact, made as expected. The statutory rule is based on an assumption that the delayed distributions have the effect of increasing the value of the transferred interest in an amount equal to the time value of the delay. For this purpose, the statute allows a four-year grace period for each distribution, i.e., any payment made within four years of its stated due date is treated as made on a timely basis.[373]

In such a case, §2701(d) increases the amount of the transferor's taxable gift or taxable estate at such time as a "taxable event" occurs.[374] A taxable event is the death of the transferor, a transfer of the retained interest, or, at the taxpayer's election, the making of the qualified payment.[375] Where the transferor dies and the estate passes to the transferor's spouse, there is no taxable event, and the spouse "inherits" the transferor's position under §2701(d).[376] The taxable gift or taxable estate is increased by an amount equal to the excess of the value of all qualified payments if made on a timely basis over the value of such payments when actually made. In each case, the determination of value is made as of the date of the original transfer, using the discount rate used at such time.[377]

Reflecting the view that common stock inherently has value due to its exclusive right to future appreciation, §2701(a)(4) sets forth a rule for minimum valuation of "junior equity interests." Under this rule, the junior equity interest (common stock or equivalent equity in a partnership) may in no event be valued at less than 10% of the total equity value of the entity plus any debt outstanding that is owed to the transferor.

Section 2704 essentially provides that lapsing rights are not taken into consideration when retained interests are valued for estate tax purposes. In other words, if the preferred stock retained by the older generation has voting, dividend, or liquidation rights that lapse upon death, the fact that those rights lapse is ignored for purposes of valuation and, therefore, the value of the stock is not reduced for estate tax purposes due to the lapse of those rights. If this section applies, one of the main benefits of the estate freeze recapitalization is gone. Thus, in order to be successful, this type of recapitalization must be structured in a manner that avoids application of §2704.

Although the enactment of §2701 and §2704 have made the use of estate freeze recapitalizations less attractive in many instances, there are still situations in which this type of transaction, if structured carefully, can be beneficial. In some cases, a reverse freeze could work, pursuant to which the older generation gifts the preferred stock (which has dividend rights but no voting rights) and retains the common stock. This structure avoids application of §2701, because the common stock is junior to the preferred.

Chapter 14 contains numerous other rules dealing with the estate and gift tax treatment of ownership interests in business entities. For more comprehensive discussions of these rules, see 835 T.M., *Transfers of Interests in Family Entities Under Chapter 14 — Sections 2701, 2703 and 2704 (Estates, Gifts and Trust Series).*

H. Corporate Alternative Minimum Tax

For taxable years beginning after December 31, 2022, a corporate alternative minimum tax (CAMT) is imposed on an applicable corporation that has annual adjusted financial statement income (AFSI) in excess of $1 billion over a three-taxable-year period.[378]

The CAMT is the amount by which an applicable corporation's tentative minimum tax for the taxable year exceeds the sum of the corporation's regular tax liability plus any base erosion and anti-abuse (BEAT) liability.[379] An applicable corpora-

[371] §2701(c)(3)(A).
[372] §2701(c)(3)(B).
[373] §2701(d)(2)(C).
[374] §2701(d)(1).
[375] §2701(d)(3)(A).
[376] §2701(d)(3)(B)(i).
[377] §2701(d)(2)(A)(i).
[378] §55(b)(2)(A), §59(k) (defining "applicable corporation"), as amended and added, respectively, by the Inflation Reduction Act, Pub. L. No. 117-169, §10101(a)(1).
[379] §55(a), as amended by Pub. L. No. 117-169, §10101(a).

ISBN 978-1-63359-255-1

tion's tentative minimum tax is equal to the excess of 15% of AFSI over the corporate AMT foreign tax credit.[380] AFSI is the net income or loss of the taxpayer as set forth on the taxpayer's applicable financial statement (AFS) covering such taxable year, with adjustments.[381] AFSI includes all items reflected in the taxpayer's financial statement income (FSI) regardless of whether they are taken into account for regular tax purposes.[382]

For a detailed discussion of the post-2022 CAMT, see 752 T.M., *Corporate Alternative Minimum Tax*, at IX.

The CAMT consequences of an F reorganization depend on whether the transaction is a covered recognition transaction or a covered nonrecognition transaction (collectively, covered transactions).[383] Under the proposed regulations, a covered nonrecognition transaction is a component transaction that, with regard to a party, (i) qualifies for nonrecognition treatment for regular tax purposes under a specific Code section or combination of Code sections, (ii) is not treated as resulting in the recognition of *any amount* of gain or loss for regular tax purposes solely with regard to that party, and (iii) is not treated as a covered recognition transaction.[384] A covered recognition transaction, by contrast, is a component transaction consisting of a transfer, sale, contribution, distribution, or other disposition of property that, with regard to a party, does not qualify as a covered nonrecognition transaction solely with regard to that party and, therefore, could result in the recognition of gain or loss for regular tax purposes to that party.[385]

In the case of a covered nonrecognition transaction, the proposed regulations would define a resulting corporation and a transferor corporation as corporations within the meaning given in Reg. §1.368-2(m)(1) (i.e., with regard to an F reorganization) that are parties to the covered nonrecognition transaction.[386] In the case of a covered recognition transaction, a resulting corporation is a corporate party to a covered nonrecognition transaction qualifying as an F reorganization that makes a distribution of property to a transferor corporation shareholder or security holder.[387]

1. *CAMT Consequences to Transferor Corporation in Nonrecognition Transactions*

If a transferor corporation transfers property to a resulting corporation in an F reorganization that qualifies the transferor corporation solely for nonrecognition treatment, the transferor corporation determines its AFSI from the transaction by disregarding any resulting gain or loss reflected in its FSI and applying §361. In other words, no AFSI is recognized by the transferor corporation. Further, the transferor corporation determines its CAMT basis, rather than AFS basis, in any property received from the resulting corporation by applying §358 using the CAMT basis of the property transferred by the transferor corporation to the resulting corporation. Finally, the transferor corporation must adjust its CAMT earnings, rather than retained earnings, resulting from the transaction by applying §312.[388]

If a qualifying F reorganization transaction includes a transfer of money or property (other than stock) to a shareholder or security holder of the transferor corporation, then each component transaction that qualifies as a covered nonrecognition transaction and each component transaction that is treated as a distribution of property by the transferor corporation to a shareholder or security holder is treated separately.[389]

2. *CAMT Consequences to Resulting Corporation in Nonrecognition Transactions*

If a resulting corporation transfers solely stock, or stock and money or other property, to a transferor corporation in an F reorganization qualifying for nonrecognition treatment under §1032(a), the resulting corporation determines its AFSI from the transaction by disregarding any resulting gain or loss reflected in the corporation's FSI and applying §1032(a). Similar to the CAMT consequences for a transferor corporation, no AFSI is recognized by the resulting corporation. Further, the resulting corporation determines its CAMT basis in the property received by the transferor corporation by applying §362 using the CAMT basis, rather than the AFS basis, of the property. Finally, the resulting corporation must adjust its CAMT retained earnings, rather than AFS retained earnings, resulting from the transaction by applying §381(c)(2) and §312.[390]

3. *CAMT Consequences to Transferor Corporation Shareholder or Security Holder in Covered Transactions*

In an F reorganization, a transferor corporation shareholder or security holder is a CAMT entity that receives stock or securities under §354, or money or other property of the resulting corporation under §301 or §302 (in addition to stock or securities of the acquiror corporation), in exchange for transferor corporation stock or securities. The proposed regulations would require a transferor corporation shareholder or security holder to:

- determine its AFSI from a covered transaction by disregarding any resulting gain or loss reflected in its FSI, applying the relevant Code section, and using the distribution amount reflected on its AFS, taking into account the CAMT basis in its transferor corporation stock;
- determine the characterization of the distribution by applying the relevant Code section based on the CAMT earnings, rather than AFS earnings and profits, of the transferor corporation;

[380] §55(b)(2)(A). *See* §59(l), added by Pub. L. No. 117-169, §10101(c) (corporate AMT foreign tax credit). If a corporation does not meet the definition of an "applicable corporation," the tentative minimum tax for the taxable year is zero. §55(b)(2)(B).

[381] §56A(a)–§56A(d), added by Pub. L. No. 117-169, §10101(b). *See* §451(b)(3) (defining "applicable financial statement").

[382] Notice 2023-64, §5.02(3)(b); *see* Prop. Reg. §1.56A-1(b)(1), REG-112129-23, 89 Fed. Reg. 75,062 (Sept. 13, 2024).

[383] Prop. Reg. §1.56A-18(b)(11), REG-112129-23.

[384] Prop. Reg. §1.56A-18(b)(9). This rule has been described as having a "cliff effect," treating a transaction resulting in even a single dollar of gain as a recognition transaction.

[385] Prop. Reg. §1.56A-18(b)(10).

[386] Prop. Reg. §1.56A-18(b)(24)(i), Prop. Reg. §1.56A-18(b)(31).

[387] Prop. Reg. §1.56A-18(b)(24)(ii). *See* Prop. Reg. §1.56A-18(d)(1)(ii) (addressing rules for nonliquidating corporate distributions).

[388] Prop. Reg. §1.56A-19(f)(1).

[389] Prop. Reg. §1.56A-19(f)(2).

[390] Prop. Reg. §1.56A-19(f)(3).

ISBN 978-1-63359-255-1

• determine its CAMT basis in the stock of the resulting corporation resulting from the exchange by applying the relevant Code section using its CAMT basis in the stock, rather than basis for regular tax purposes;

• determine its CAMT basis in the property received by applying the relevant Code section, using CAMT basis instead of AFS basis; and

• adjust its CAMT earnings, rather than AFS retained earnings, resulting from the exchange by applying §312 based on its AFSI.[391]

In Notice 2025-46, Treasury and the IRS announced their intention to propose amendments to Prop. Reg. §1.56A-18 and Prop. Reg. §1.56A-19 consistent with the guidance provided in the Notice. The proposed amendments would allow a CAMT entity to determine (i) the amount of its AFSI resulting from its ownership of stock of a domestic corporation that is not a member of the same tax consolidated group as the CAMT entity, and (ii) the AFSI and CAMT basis consequences of certain transactions involving domestic corporations. In response to comments received regarding the proposed regulations, the Notice is intended to reduce compliance burdens by eliminating the "cliff effect" and more closely following the rules that apply for regular tax purposes, while incorporating a more limited set of CAMT inputs.[392]

The Notice introduces the term "domestic covered asset transaction," defined, in part, to include a transaction (other than a covered asset transaction, as defined in Prop. Reg. §1.56A-4(b)(1)) in which one or more assets are stock or securities of a domestic corporation that is a party to a reorganization and the stock or securities are transferred in a transfer (including an issuance or redemption) to which §354 or §356 applies.[393] Accordingly, an F reorganization is a domestic covered asset transaction.

Under Notice 2025-46, if a CAMT entity owns stock of a domestic corporation that is not a member of the same tax consolidated group as the CAMT entity, the CAMT entity's AFSI with respect to such stock ownership is adjusted by:

• disregarding any items of income, expense, gain, and loss resulting from such stock ownership, including any items that result from acquiring or transferring the stock, reflected in the CAMT entity's FSI; and

• including any items of income, deduction, gain, and loss for regular tax purposes resulting from such stock ownership, including any items that result from acquiring or transferring the stock.[394]

The amount of each item included in the CAMT entity's AFSI is computed by substituting the CAMT entity's CAMT basis in the domestic corporation stock for the basis in that stock for regular tax purposes.[395] In addition, the amount and character of any distribution is determined using earnings and profits as determined for regular tax purposes.[396]

If a CAMT entity transfers an asset, other than stock of a domestic corporation, in a domestic covered asset transaction, the CAMT entity's AFSI is adjusted by:

• disregarding any items of income, expense, gain, and loss with respect to the transferred asset resulting from the domestic covered asset transaction reflected in the CAMT entity's FSI; and

• including any items of income, deduction, gain, and loss for regular tax purposes with respect to the transferred asset resulting from the domestic covered asset transaction.[397]

The amount of each item included in the CAMT entity's AFSI is computed by substituting the CAMT entity's CAMT basis in the transferred asset for the basis in that transferred asset for regular tax purposes.[398]

A transferor corporation shareholder determines its basis in stock or securities received in an F reorganization by applying §358, substituting the shareholder's CAMT basis in the assets exchanged for the basis in those assets for regular tax pruposes, and substituting the amount of income or loss included in AFSI for the amount of gain or loss recognized for regular tax purposes.[399]

The proposed regulations applicable to F reorganizations, as originally published, generally would apply to taxable years ending after the date of publication of final rules in the Federal Register, although Prop. Reg. §1.56A-1 would apply to taxable years ending after September 13, 2024.[400] It is anticipated that the proposed amendments described in Notice 2025-46 will apply for taxable years beginning on or after the date the relevant final regulations are published in the Federal Register.[401] In the interim, taxpayers may rely on the guidance provided in Notice 2025-46, §3 through §6, including for purposes of filing amended returns. A taxpayer's reliance on any such guidance will not cause the corporation to become subject to, or to violate, the reliance rules, including the consistency requirements, provided in the Preamble to the CAMT proposed regulations.[402]

---

[391] Prop. Reg. §1.56A-19(f)(4). *See* Prop. Reg. §1.56A-18(b)(32) (defining transferor corporation shareholder or security holder).

[392] Notice 2025-46, §3.01; *see* Prop. Reg. §1.56A-1(b)(22) (definition of "for regular tax purposes").

[393] Notice 2025-46, §3.02(1)(c), §3.02(4) (definition of "transfer").

[394] Notice 2025-46, §3.03(1)(a).

[395] Notice 2025-46, §3.03(1)(a).

[396] Notice 2025-46, §3.03(1)(b).

[397] Notice 2025-46, §3.03(2).

[398] Notice 2025-46, §3.03(2)

[399] Notice 2025-46, §3.04(1)(e).

[400] Prop. Reg. §1.56A-1(i), Prop. Reg. §1.56A-18(i), Prop. Reg. §1.56A-19(h).

[401] Notice 2025-46, §7. The forthcoming proposed amendments are expected to clarify that no section (e.g., Prop. Reg. §1.56A-1) of the CAMT proposed regulations and the forthcoming amendments would be applicable for any taxable years beginning before the date a corresponding section of the final regulations is published in the Federal Register. Notice 2025-49, §3.01.

[402] Notice 2025-46, §7; *see* Preamble to REG-112129-23, 89 Fed. Reg. at 75,127.

ISBN 978-1-63359-255-1

VI. Mutual-to-Stock Conversions

A. Savings and Loan Conversions

The IRS has sanctioned a type of F reorganization that stands apart from the more common varieties discussed previously in this Portfolio — specifically, the conversion of mutual institutions into stock corporations. The IRS has set forth a body of law concerning these transactions in a series of administrative actions to which no court has addressed itself. For the most part, these positions have developed and evolved in a pragmatic fashion, with the desirable results more clearly obvious than the technical route to achieving those results.

Far and away the most numerous transactions in this area have involved mutual savings and loans. Briefly, a mutual savings and loan association (and its relative, the mutual savings bank) is a federal or state chartered savings institution that is owned by its depositors. The "interest" paid on a savings account is, in fact, paid as fixed dividends. In the event of a liquidation of a mutual institution, the residual assets left after payment of all deposit and other liabilities is distributable pro rata among the depositors. As a result, the IRS has long ruled that for purposes of the reorganization provisions, the account holders of a mutual institution are its proprietors. Thus, a merger of two mutual savings and loans in which savings accounts in the acquired institution are exchanged for savings accounts in the acquiring institution qualifies as an A reorganization.[403] The Supreme Court has held, however, that where shareholders in an acquired stock savings and loan association exchange their common stock for savings accounts in an acquiring mutual institution, the continuity of interest requirement is not met.[404]

In Rev. Rul. 80-105, the IRS ruled that the conversion of a mutual savings and loan association into a stock savings and loan association qualified as a reorganization under §368(a)(1)(F). In the ruling, as in nearly all conversion transactions that have occurred since that time, the depositors receive three types of consideration. First, each depositor receives a deposit in the converted institution with the same terms as the deposit in the mutual institution. In effect, this is consideration for the creditor's piece of the former savings accounts. Additionally, the depositor receives nontransferable subscription rights to purchase stock in the newly converted institution at a price equal to the price at which unsubscribed-for shares will be sold in a public offering. Finally, an amount equal to the book net worth of the mutual institution is frozen in a special liquidation account on the books of the stock institution. The liquidation account represents a preferred liquidation right with priority over the common stockholders, but which is subordinate to the payment of all creditors' claims.

Immediately after the conversion, all of the common stock in the converted entity will be owned by common shareholders who purchased their stock pursuant to the exercise of subscription rights or in the public offering. The depositors per se receive only deposits and their shares in the liquidation account. In effect, the ruling found such a transaction to be *sui generis*. Specifically, the ruling noted that the financial structure and control of savings and loan associations were "unique among business organizations," and accordingly, "the law and analysis as applied to these conversions is peculiar to such associations."

By way of analysis, the ruling states as follows:

> If X converts itself from a federal mutual savings and loan association to a state stock savings and loan association the changes at the corporate level, other than its place of organization and form of organization described above, will be insubstantial. X will continue its business in the same manner. It will have the same savings accounts and loans; it will continue its membership in the FSLIC; and it will remain subject to the regulatory authority of the FHLBB. Since the equity interest of a depositor in a mutual savings and loan association is more nominal than real, unlike that of a shareholder in a corporation, the conversion into a state stock savings and loan association is a mere change in identity, form, or place of organization within the meaning of §368(a)(1)(F).[405]

In subsequent PLRs, the IRS has approved further extensions of the ruling. Thus, in a number of PLRs, the IRS has found F reorganization treatment where, instead of receiving subscription rights in the converted institution itself, the account holders receive subscription rights to purchase stock in a holding company that, in turn, infuses the cash into the newly converted institution in exchange for all of the newly issued common stock.[406] In an even more striking extension of the ruling, the IRS has ruled that F reorganization treatment was available for a conversion in which no subscription rights were issued at all.[407] The largely unstated technical basis for such findings was that as the equity interest in an account was so minimal, the requirement for continuity of interest in an F reorganization involving a mutual institution was provided by the liquidation account.[408]

In one PLR, the IRS concluded that a conversion of a state mutual savings bank to a stock savings bank in the same state would be treated as a recapitalization under §368(a)(1)(E).[409] In the ruling, immediately following the conversion, in which account holders were offered stock or cash in exchange for their proprietary interests, the newly issued stock was purchased by

[403] Rev. Rul. 78-286; Rev. Rul. 69-3.

[404] *Paulsen v. Commissioner*, 469 U.S. 131 (1985). *See also* Rev. Rul. 69-6.

[405] Rev. Rul. 80-105.

[406] PLR 8824036, PLR 8819038. In another variation, the mutual institution undergoes a merger conversion, in which it both converts to and merges into an existing stock institution, with the account holders receiving subscription rights in the acquiring institution. *See, e.g.*, PLR 8714021. *See also* PLR 200013009, PLR 9640020 (citing Rev. Rul. 80-105, in which the IRS ruled that former Reg. §1.368-1(b) requirement of continuity of ownership interest in F reorganizations was met by constructive exchange of depositors' ownership interests in mutual savings bank for stock and liquidation account interests in entity after its conversion to stock savings bank, notwithstanding fact that depositors constructively exchanged, immediately thereafter, stock for ownership interests in mutual holding company that was set up as part of same transaction); *Multi-step Conversion of Mutual Bank to Stock Savings Bank Qualifies as Type 'F' Reorganization*, 37 Tax Mgmt. Memo. 381 (Nov. 25, 1996) (for discussion of PLR 9640020).

[407] PLR 9125025, PLR 8637142. *See also* Rev. Rul. 2003-48 (discussed below); PLR 200051006 (demutualization followed by multiple mergers qualifies as F reorganization).

[408] The continuity of interest requirement for F reorganizations has since been eliminated. *See* Reg. §1.368-1(b), §1.368-2(m)(2).

[409] PLR 9207028.

ISBN 978-1-63359-255-1

an unrelated bank holding company via a reverse subsidiary merger. Presumably, as this was before the elimination of the F reorganization continuity of interest requirement,[410] it was necessary to accord E reorganization status to the conversion, because there would be no continuity of interest as a result of the prearranged sale of all of the newly issued stock. The PLR, following upon the IRS's willingness to apply the recapitalization approach in the insurance company area (see below), may indicate a further degree of flexibility on the part of the IRS in facilitating bank conversions.

In Rev. Rul. 2003-48, the IRS ruled that the conversion of a state mutual bank to a stock bank in the same state qualified as both a recapitalization under §368(a)(1)(E) and a reorganization under §368(a)(1)(F). In Rev. Rul. 2003-48, a number of transactions took place pursuant to an integrated business plan to convert the mutual bank to a stock bank and to create a holding company structure.[411] The stock bank (formerly the mutual bank) emerged from the conversion and related steps as a wholly owned subsidiary of a mutual holding company. The mutual holding company then transferred all of its stock bank stock to a stock holding company (also a wholly owned subsidiary of the mutual holding company) in exchange for voting stock of the stock holding company and the stock holding company made a public offering of its common stock. Under applicable state law, the stock bank's corporate existence as a stock savings bank was a continuation of the mutual bank's corporate existence as a mutual savings bank. For this reason, the IRS ruled that the conversion qualified as a tax-free reorganization under §368(a)(1)(E) *and* §368(a)(1)(F). Noting that continuity of business enterprise and continuity of interest are not required for reorganizations under §368(a)(1)(E), the IRS ruled that neither the subsequent transfer of stock bank stock to the stock holding company nor the public stock offering affected the conversion's qualification as an E reorganization.[412] Nor did these subsequent transactions affect the conversion's qualification as an F reorganization, the IRS ruled. The IRS did not discuss this part of its ruling in Rev. Rul. 2003-48 but cited Rev. Rul. 96-29, thus indicating that the IRS tested F reorganizations separately from other transactions connected to them.

The IRS cautioned in Rev. Rul. 2003-48 that, if the mutual bank and the stock bank were incorporated in different jurisdictions, the conversion would *not* qualify as an E reorganization but would still qualify as an F reorganization. For a discussion of the limitation of §368(a)(1)(E) to single corporate entities, see III.A., above. For a discussion of the qualification under §368(a)(1)(F) of a reincorporation in a different jurisdiction, see II.B.2., above.

In PLR 201112004, a wholly owned stock insurance company proposed to convert into a mutual insurance company and immediately after its conversion, create a new mutual insurance holding company. Upon the creation of the new mutual insurance holding company, the converted mutual insurance company would be converted back into a stock insurance company as a wholly owned subsidiary of the new mutual insurance holding company, and the policyholders would become members of the new mutual insurance holding company. Immediately after the formation of the new mutual insurance holding company, the parent company (of the re-converted stock insurance company) would merge with and into the new mutual insurance holding company, with the new mutual insurance holding company surviving. In the merger, certain shares of the parent company would be cancelled and replaced by shares of the new mutual insurance holding company. Citing Rev. Rul. 2003-48, the IRS ruled that the proposed transaction would be a reorganization within the meaning of §368(a)(1)(E) and that the new mutual insurance holding company would be treated as a continuation of the original parent company.

Practice Point: This issue could be academic, insofar as there may not be any more mutual savings institutions left to convert, but there is no reason to doubt that Rev. Rul. 80-105 remains good law with respect to mutual-to-stock conversion transactions despite the fact that it predates the current regulations. Focusing in on the relevant changes in law, while there is no longer a continuity of interest requirement, the ruling's approach of viewing the liquidation account as preserving the account holders' equity interest in the converted institution can be regarded as satisfying the "identity of stock ownership" requirement in the regulations.[413] Subsequent issuance of common stock to both subscribing account holders and new investors is properly regarded as a related but separate transaction occurring outside the F reorganization "bubble."[414]

B. Insurance Company Demutualizations

1. In General

The insurance industry is divided into two forms of insurers: stock companies and mutual companies. For several reasons, mutual companies may decide to convert to stock companies. This conversion generally is referred to as a demutualization. Reasons for demutualization include better access to capital and improved management.[415]

The principal tax consequences of a demutualization depend on whether the transaction is structured as a tax-free reorganization or as a taxable acquisition of a mutual company's assets. Demutualizations have been structured successfully as tax-free reorganizations under §368.

---

410 *See* Reg. §1.368-1(b), §1.368-2(m)(2).

411 For a discussion of the mechanics and benefits of a mutual holding company reorganization in the conversion of a mutual insurance company to a stock company, see VI.B.4.f., below.

412 Note that for transactions occurring on or after February 25, 2005, the continuity of interest and continuity of business enterprise requirements do not apply to F reorganizations. *See* Reg. §1.368-1(b). *See also* Reg. §1.368-2(m)(2). Rev. Rul. 2003-48 also discusses the treatment under §368(a)(1)(A) and §368(a)(1)(B) of the other transactions undertaken as part of the integrated plan. The IRS noted that, under §368(a)(2)(C) and Reg. §1.368-2(k), an A or B reorganization is not disqualified by the subsequent transfer or transfers of the stock acquired in the reorganization to one or more corporations controlled in each transfer by the transferor corporation. Reg. §1.368-2(k) has since been amended to broaden even further the permissibility of post-reorganization transfers.

413 Reg. §1.368-2(m)(1)(ii). For further discussion of this requirement, see II.A.2., above.

414 Reg. §1.368-2(m)(3)(ii). For further discussion of the F reorganization "bubble," see II.A.4.c., above.

415 Generally, mutual insurer managers are not subject to most market forces and have less incentive than a stock insurer manager to maximize the company's financial performance. *See Developing a Demutualization Acquisition Strategy for Private Equity Firms*, 110 Harv. L. Rev. 1904, 1905–1906 (1997).

ISBN 978-1-63359-255-1

2. Tax-Free Reorganization

Demutualizations have been held to qualify as E reorganizations. While E reorganizations tend to be the dominant form of tax-free reorganizations for demutualizing companies, the IRS has previously allowed demutualizations to qualify as A or F reorganizations as well.

a. E Reorganization

In several rulings, the IRS has allowed demutualizations to be structured as E reorganizations.[416] In an E reorganization, the certificate of incorporation and bylaws of the mutual insurance company are amended and restated in accordance with applicable state law. The membership interests of the policyholders are terminated in exchange for stock. Typically, an E reorganization is used as part of a comprehensive strategy by which the mutual insurance company is converted to a stock insurance company, and a holding company is created.[417]

An E reorganization does not require satisfaction of a continuity of interest requirement.[418] Thus, a demutualization can qualify as an E reorganization even if the former policyholders of the mutual insurance company collectively do not possess a continuing interest in the resulting stock company. Likewise, continuity of business enterprise is not required for an E reorganization.[419]

In Rev. Rul. 2003-19, the IRS ruled that the conversion of a state mutual insurance company to a stock insurance company qualified as both a recapitalization under §368(a)(1)(E) and a reorganization under §368(a)(1)(F). In the ruling, the IRS addressed three scenarios wherein members of the mutual insurance company exchanged their membership interests for: (1) stock in a stock insurance company; or (2) in cases where the conversion was accompanied by the creation of a mutual holding company, membership interests in the mutual holding company. In each case, the IRS ruled that, because the stock company was the same corporation as the mutual insurance company under the relevant state law, the stock company was a continuation of the mutual insurance company's corporate existence. In the case where mutual holding company stock was ultimately received, the IRS stated that its conclusion was not altered by the fact that there was a subsequent change in the direct ownership of the converted company.[420]

In PLR 9834019, the IRS ruled that a conversion of a mutual company to a stock company and the exchange by its members of their membership rights for stock constitutes a recapitalization under §368(a)(1)(E). The mutual insurance company (X) had proposed a demutualization transaction which included forming a mutual holding company and a stock holding company. X's members would receive the mutual holding company's rights in exchange for their member rights. X would become the stock holding company's wholly owned subsidiary and amend its employee benefits plan to provide for employer matching contributions in the form of stock holding company shares.

In PLR 9540004, a mutual insurance company, in anticipation of a demutualization, created a holding company as a wholly owned subsidiary pursuant to state law. Participating policyholders of the mutual company would exchange their membership rights for stock in the mutual company, which would be transferred to the holding company in exchange for newly issued common shares of the holding company. The IRS ruled that the mutual insurance company's change in form to a stock company and the deemed exchange by participating policyholders of their membership rights in the mutual company for voting common shares of the mutual company qualified as a recapitalization under §368(a)(1)(E).

In PLR 9835009, a demutualization was regarded, for tax purposes, as a two-step transaction in which a mutual insurance company was restructured as a subsidiary of a holding company and converted to a stock company. The first step, which involved a transfer of the membership interests of the mutual company's policyholders, a transfer of cash by the underwriters in exchange for voting common shares of the holding company, and a transfer of property by a third party for various securities of the holding company, was treated as an exchange pursuant to §351. The second step, through which the mutual company was converted to a stock company, was treated as a nontaxable E reorganization whereby membership interests in the mutual company were exchanged for voting shares of the demutualized company.

b. A Reorganization

In an A reorganization, the mutual insurance company is merged into a new stock insurance company under state law. The former policyholders of the mutual insurance company may receive stock, cash, or policy credits in exchange for their membership interests in the mutual insurance company.

The general requirements applicable to an A reorganization must be satisfied. For instance, the merger transaction must be effected under the corporation law of the applicable state. If state law does not permit demutualizations, the transaction will not qualify as an A reorganization. Furthermore, the continuity of business enterprise and continuity of interest requirements must be satisfied. Additional requirements may need to be satisfied if stock of a controlling corporation is used to effectuate the merger.[421]

In Rev. Rul. 71-233, a mutual insurance company merged into a stock insurance company, which had been newly created under state law. The former mutual policyholders exchanged their ownership interests for nonvoting preferred shares of the new stock company. The IRS ruled that the transaction qualified as a tax-free A reorganization.

c. F Reorganization

In Rev. Rul. 73-510, a mutual casualty insurance company was converted to a stock casualty insurance company. As part of the conversion, a new company was formed. Stock in the new company was exchanged for all the assets and liabilities of the mutual company, and the stock was distributed to the mutu-

[416] *See, e.g.*, PLR 201416002, PLR 200935002, PLR 200544006, PLR 200240051, PLR 200011035. *See also* Rev. Rul. 2003-19.

[417] See the discussion of mutual holding companies in VI.B.4.f., below.

[418] *See* Reg. §1.368-1(b), §1.368-2(m)(2).

[419] Reg. §1.368-1(b), §1.368-2(m)(2).

[420] *See* Reg. §1.368-1(e)(1); Rev. Rul. 96-29.

[421] *See* §368(a)(2)(D), §368(a)(2)(E).

ISBN 978-1-63359-255-1

al company policyholders in exchange for their equity interests in the mutual company. Stock of the new company was issued only to the policyholders of the mutual company. Upon completion of the conversion, the mutual company no longer existed. The IRS ruled that the conversion constituted an F reorganization.[422]

3. *Treatment for Tax Purposes*

a. *For Former Policyholders of Mutual Insurance Companies*

No gain or loss is recognized if stock in a corporation that is a party to a reorganization is exchanged solely for stock in such corporation or in another corporation that is also a party to the reorganization.[423] Thus, the former policyholders of the mutual insurance company will not recognize gain or loss on the exchange of their membership interests in the mutual company for stock only.

In Rev. Rul. 71-233, payments of premiums by former policyholders of a mutual insurance company represented payments for insurance and investments in insurance contracts rather than investments in the underlying assets of the mutual company. The policyholders, therefore, had a zero basis in their membership interests. This zero basis was carried over to the stock received by the former policyholders in exchange for their membership interests.[424]

In *Fisher v. United States*,[425] as part of the conversion of a mutual insurance company to a stock insurance company, the taxpayer received stock in the stock insurance company in exchange for its voting and liquidation rights, which the taxpayer subsequently sold. The taxpayer argued that a portion of the premiums it paid was for the voting and liquidation rights that it exchanged for the stock and as such, it should have basis in the stock received equal to its basis in the ownership rights surrendered. The court agreed that the voting and liquidation rights did have value constituting basis to the taxpayer and ruled that the taxpayer did not realize income on the sale of the stock.

In *Dorrance v. United States*,[426] the taxpayers made premium payments before demutualization and then elected to receive stock rather than a cash payment upon demutualization. The taxpayers held the stock for a number of years and sold the stock at a gain. The taxpayers argued that the open transaction doctrine should apply and all of the proceeds from the taxpayers' sale of the stock would be considered a return of capital from their premiums. The IRS argued that the taxpayer should have zero basis in the stock. Denying both parties' motions for summary judgment, the court stated that neither party had presented evidence from which it could equitably apportion, as required by Reg. §1.61-6(a), the premiums paid before demutualization as basis in the mutual rights and basis in the policies themselves.[427] Subsequently, after trial the district court did engage in factual analysis to apportion premiums paid between policy and equity rights; the Ninth Circuit subsequently reversed, concluding that nothing had been paid for equity rights, resulting in zero basis.[428]

A former policyholder typically is subject to taxes on any cash received as part of the demutualization transaction in the year in which the cash is received.[429] The cash payment will constitute a long-term or short-term capital gain, depending on when the former policyholder acquired the underlying contract in reference to the effective date of the demutualization. In certain limited circumstances, however, the former policyholder will be required to treat the receipt of cash as a dividend payment.[430]

b. *For Demutualized Insurance Company*

Pursuant to §361(a), no gain or loss will be recognized by a party to a reorganization that exchanges property in order to effect the reorganization solely for stock in another party to the reorganization. The basis and holding period of the assets of the former mutual company are carried over to the new stock company.[431] In addition, the stock company succeeds to and can utilize the tax characteristics of the mutual company, including carryovers of net operating losses and capital losses.[432]

Dividends paid by mutual insurance companies to policyholders are deductible by the insurance company,[433] whereas dividends paid by stock insurance companies to shareholders are not deductible. Mutual companies that undergo a demutualization process argue that they should be able to deduct cash or other distributions made to policyholders as part of the demutualization process. The IRS's position is that such cash and other distributions are not deductible as policyholder dividends under

---

[422] *See also* Rev. Rul. 2003-48; PLR 201416002.

[423] §354(a).

[424] §358(a)(1). Note that the holding period during which the policyholders held the membership interests would be tacked on to the holding period over which they hold the stock received in exchange for such interests. §1223(1).

[425] 82 Fed. Cl. 780 (2008), *aff'd per curiam*, 333 Fed. Appx. 572 (Fed. Cir. 2009). The court ruled that the value of the ownership rights of the stock acquired during the demutualization was not discernible, and applied the "open transaction doctrine" to determine that the taxpayer did not realize income on the sale of the stock. However, noting that the value of the stock and the value of the policy on the secondary market were both ascertainable at the time of demutualization, and a ratio from which to apportion basis could be calculated, one commentator has argued that apportionment "through the use of current and readily ascertainable fair market value data seems reasonable." *See* Galindo, *Revisiting the 'Open Transaction' Doctrine: Exploring Gain Potential and the Importance of Categorizing Amounts Realized*, 63 Tax Law. 221, 234 (2009). For a discussion of the open transaction doctrine, see 561 T.M., *Capital Assets*.

[426] 877 F. Supp. 2d 827 (D. Ariz. 2012), *rev'd*, 809 F.3d 479 (9th Cir. 2015). *See also* Robert Willens, *District Court Denies Use of 'Open Transaction' Doctrine for Demutualization*, 152 DTR J-1 (Aug. 8, 2012). For a discussion of the significant factual distinctions between historical open transaction cases and those involving the demutualization of life insurance companies, see Olsen, *Chuck v. Goliath: Basis of Stock Received in Demutualization of Mutual Insurance Companies*, 9 Hous. Bus. & Tax L.J. 360 (2009).

[427] The court noted that the taxpayers had met their burden of showing they paid something for the mutual rights by proving that they paid premiums for policies that included the policy rights and the mutual rights. However, the court was troubled that applying the open transaction doctrine would allow the taxpayers to realize an untaxed gain that post-dated demutualization.

[428] *Dorrance v. United States*, No. CV-09-1284-PHX-GMS, 2013 BL 382881 (D. Ariz. Mar. 19, 2013), *rev'd*, 807 F.3d 1210 (9th Cir. 2015). *See also Reuben v. United States*, No. 2:11-cv-09448-SJO-PJW, 2013 BL 77909 (C.D. Cal. Jan. 15, 2013), *aff'd*, 628 F. App'x 509 (9th Cir. 2016), (also concluding that the basis in the equity rights was zero).

[429] *See* PLR 9235009 (citing Rev. Rul. 71-233).

[430] *See* §356(a)(2).

[431] §362(b), §1223(2).

[432] §381(a).

[433] §808(c), §832(c)(11).

ISBN 978-1-63359-255-1

§808(c) and §832(c)(11).[434] However, in an earlier TAM that subsequently was withdrawn, the IRS had viewed cash distributions made to policyholders of a mutual insurance company in connection with the merger of the mutual company into a stock insurance company as deductible policyholder dividends.[435]

In *UNUM Corp. v. United States*,[436] the taxpayer filed an amended tax return to claim a deduction for cash and stock distributions made in connection with its conversion from a mutual insurance company to a stock insurance company. In submissions related to a letter ruling request, the taxpayer stated that cash received by policyholders as part of the conversion process could be viewed as either capital gains arising from the policyholders' redemptions of their equity interests or as policyholder dividends taxable to policyholders as ordinary income and deductible by the taxpayer. In the letter ruling subsequently issued by the IRS, the IRS concluded that cash payments to policyholders constituted redemptions of their equity interests, not policyholder dividends.

The taxpayer's principal argument was that the cash and stock distributed during the demutualization constitute "policyholder dividends" under the plain language of §808(b) and, thus, are deductible under §805. The taxpayer further argued that, beyond the Code's plain language, the legislative history and public policy behind the Code's treatment of life insurance companies support this result.

The IRS argued that general corporate tax provisions apply to insurance companies in the absence of specific provisions to the contrary in the Code's insurance tax section, and that, under those corporate tax provisions, the taxpayer was not entitled to any deduction for its reorganization. The IRS argued that nothing in §808 or its legislative history indicates that Congress envisioned §808 as encompassing capital transactions such as the taxpayer's demutualization. Rather, placed in proper context, §808 was not relevant to the value-for-value exchanges for which the taxpayer sought a deduction.

The First Circuit agreed with the IRS's position, and held that stock and cash distributed to policyholders in exchange for their mutual ownership interests as part of a statutory demutualization do not constitute "policyholder dividends" under §808 and, therefore, were not deductible under §805(a)(3).

4. Other Considerations

a. Holders of §408 IRAs, §401(k) Plans, and §403(b) Tax-Sheltered Annuities (TSAs)

Distributions of stock or cash to the holder of an IRA, §401(k) plan, or TSA could result in adverse federal tax consequences to the holder, such as disqualification and various penalties.[437] The IRS has issued several letter rulings concluding that such adverse tax consequences do not occur in demutualizations treated as E reorganizations.[438]

b. Foreign Policyholders — Withholding Issues

The IRS ruled in PLR 8913010 that the receipt of cash or stock by a foreign policyholder in exchange for its membership interest in a mutual insurance company is not a "designated distribution" within the meaning of §3405(d) because the distribution is not made from or under the policy or contract within the meaning of §3405(e)(1), but rather the distribution is made in exchange for the policyholder's membership interest in the demutualizing company. Thus, such receipt of cash or stock is not subject to withholding.[439] Further support for the exclusion from withholding of stock received by a former policyholder pursuant to a tax-free reorganization is provided by §3405(e)(1)(B)(ii), which states that a "designated distribution" does not include the portion of a distribution "which it is reasonable to believe is not includible in gross income."[440]

c. Consolidated Tax Return Issues

In a demutualization, the election to file a life-non-life consolidated return remains effective, and the requirement of a new five-year membership period is disregarded.[441]

d. Closed Block

A few states require the creation of a "closed block," which is a pool of funds administered for the exclusive benefit of the mutual company's existing and recent policyholders.[442]

e. Grandfathering of Existing Policies

A demutualization will not cause insurance policies issued by the mutual insurance company before the demutualization to be reissued or exchanged for new policies for purposes of various Code sections, particularly §72, §7702, and §7702A.[443] The terms and conditions of the insurance contracts issued before the demutualization will not be affected by the demutualization for purposes of these sections.

f. Mutual Insurance Holding Companies

A mutual insurance holding company structure offers a new option to a mutual insurance company that chooses to generate new capital or pursue mergers and acquisitions. The structure specifically provides mutual property/casualty insurance companies with the ability to access capital. The structure also

---

[434] *See* PLR 9142014, PLR 8711121.

[435] *See* TAM 8409003, *revoked by* TAM 9010003.

[436] 130 F.3d 501 (1st Cir. 1997).

[437] *See* §72(t), §408(e)(2).

[438] *See* PLR 9745013, PLR 9540004, PLR 9339024, PLR 9230033. *See also* Rev. Rul. 2003-19 (providing guidance on tax consequences that occur when mutual insurance company converts to stock insurance company and ruling that conversion from mutual insurance company to stock insurance company is reorganization under §368(a)(1)(E) and/or §368(a)(1)(F)); PLR 200820009 (other tax results of policy value credits to tax-qualified insurance contracts as compensation for extinguishment of mutual membership interests in transaction involving transfer of contracts to new company by assumption reinsurance).

[439] PLR 8913010.

[440] PLR 8913010.

[441] *See* PLR 9745013, PLR 9540004, PLR 9235009.

[442] *See* PLR 9835039, PLR 9834019, PLR 9540004, PLR 9335007.

[443] In Rev. Rul. 2003-19, the IRS consolidated its rulings on this topic, ruling that in an insurance company demutualization undertaken using any of three described scenarios, there is no effect on the date each life insurance and annuity contract of the mutual company was issued, entered into, purchased or came into existence for purposes of §72, §101, §264, §7702, and §7702A. Furthermore, the demutualizations do not require retesting or the starting of new test periods for contracts under §264(d)(1), §7702(f)(7)(B)–§7702(f)(7)(E), and §7702A(c)(3)(A). The demutualizations have no effect on each life insurance or annuity contract that is part of a qualified plan. Finally, the demutualizations do not result in a distribution for purposes of §72, §4973, §4979, or §3405. *See also* PLR 9835039, PLR 9834019, PLR 9540004, PLR 9235007.

ISBN 978-1-63359-255-1

permits a gradual demutualization with the possibility of a full demutualization at a later stage.

In a mutual holding company reorganization, a mutual insurance company is formed, the mutual life company is reorganized into a stock life company and is renamed.[444] The stock life insurance company becomes a wholly owned subsidiary of the mutual insurance holding company.[445] The reorganization separates the contract rights and membership interests of the owners of insurance policies so that the contract rights of policyholders remain with the reorganized stock company while the membership interests of the policyholders become vested in the new mutual holding company.[446] The reorganization does not change the premiums, policy benefits, or other policy obligations.[447] The IRS has treated the use of a mutual holding company in a demutualization as E and F reorganizations.[448]

[444] *See, e.g.*, PLR 9834019. *See also* Rev. Rul. 2003-19, discussed in VI.B.4.e., above.

[445] *See, e.g.*, PLR 9834019.

[446] *See, e.g.*, PLR 9834019.

[447] *See, e.g.*, PLR 9834019.

[448] *See* PLR 9834019, PLR 9745013, PLR 9540004. *See also* Rev. Rul. 2003-4, discussed in VI.A., above. Note that in PLR 201112004, discussed in more detail above, the IRS, citing Rev. Rul. 2003-48, ruled that a conversion of a stock insurance holding company into a mutual insurance holding company qualified as an E reorganization. Under both the revenue ruling and the PLR, the transitory existence of a mutual company as a stock company or vice versa was necessitated by law and beyond the parties' control.

ISBN 978-1-63359-255-1

VII. Cross-Border F Reorganizations

A. Introduction

Given the cryptic statutory definition of an F reorganization, one potential question is whether — and, if so, how — §368(a)(1)(F) can apply to transactions beyond the borders of the United States. The bare bones statutory "mere change in … place of organization" standard has traditionally been applied to a migration of a corporation from one state to another within the United States. Inasmuch as such a corporation continues to be equally subject to the tax laws of the United States irrespective of this change, there is little reason not to treat the post-reorganization entity as a mere continuation of the pre-reorganization entity.

Notwithstanding that, in an "outbound" reincorporation, the transferor corporation is generally governed by U.S. corporate law before the transaction and the resulting corporation is generally governed by non-U.S. corporate law afterward; and in an "inbound" reincorporation, the transferor corporation is generally governed by foreign corporate law before the transaction while the resulting corporation is generally governed by U.S. corporate law afterward, it is fairly settled law that cross-border transactions can qualify for F reorganization treatment if the continuing corporation succeeds to virtually all of the transferor corporation's assets and is owned by the shareholders of the transferor corporation in virtually the same proportion.[449]

Practice Point: Although there is no mention in the F reorganization regulations about a cross-border transaction, there is nothing in the specific definitional requirements that would limit the category to domestic transactions.

The cross-border nature of such a transaction does, however, implicate the corporate inversion rules, §367, and certain other provisions designed to protect the U.S. tax base. This section of the Portfolio provides a discussion of some of the major considerations that are special to cross-border F reorganizations.

B. Scope of Cross-Border F Reorganizations

Before the finalization in 2015 of Reg. §1.368-2(m),[450] the IRS issued several rulings holding that certain cross-border restructurings constituted F reorganizations, some of which involved unusual circumstances. However, as part of the finalization of those regulations, the IRS made it clear that, in order for a cross-border corporate reorganization to constitute an F reorganization, the transaction would have to satisfy the six criteria set forth in those regulations.[451]

In Rev. Rul. 87-27, the IRS ruled that the reincorporation of X, a U.S. corporation that was managed and controlled in the U.K., that was effected through (i) the liquidation of Y, X's U.S.-organized but U.K.-managed subsidiary; (ii) the contribution of the stock of X to Newco, a new U.K. corporation; and (iii) the liquidation of X into Newco, qualified as an F reorganization of X. However, presumably because the liquidation of Y into X left Newco with the assets of both X and Y, Rev. Rul. 87-27 was declared obsolete at the time the 2015 regulations were finalized on the issue of whether the transaction qualified as an F reorganization.[452]

Rev. Rul. 88-25 involved an inbound reorganization effected by way of the operation of a state domestication statute. In the ruling, a foreign corporation, F, converted to a corporation chartered in the relevant U.S. state through the filing of a certificate of domestication and a certificate of incorporation. Under the applicable state law, the domestic corporation, F-D, was deemed to be a continuation of the foreign entity. The ruling stated that the domestication was treated as the transfer by F of its assets and liabilities to F-D in exchange for F-D stock, followed by a distribution by F of the F-D stock to its shareholders. The ruling concluded that the transaction would qualify as an F reorganization. However, because F did not in fact liquidate as part of the transaction, Rev. Rul. 88-25 was, like Rev. Rul. 87-27, declared obsolete at the time Reg. §1.368-2(m) was finalized on the issue of whether the transaction qualified as an F reorganization.[453]

But assuming that the principles of Reg. §1.368-2(m) are not violated, cross-border F reorganizations can take several different forms — some of which need not involve any change in corporate form or corporate jurisdiction. For example, in Rev. Rul. 89-103, a mix of U.S. and foreign shareholders owned equal amounts of the stock of two corporations, D, a U.S. corporation, and F, a foreign corporation that was engaged in a U.S. trade or business. At some point, an agreement was concluded prohibiting the shareholders from disposing of stock in either corporation without disposing of an equal amount of stock in the other. Adoption of this agreement triggered the application of §269B, which provides that, if more than 50% of the value of the stock in both a U.S. and a foreign corporation are subject to a restriction on transfer under which a transfer of an interest in one corporation requires that an interest in the other be transferred, the "stapled" foreign corporation is treated as a U.S. corporation for U.S. tax purposes.[454] As a result, the IRS ruled that this deemed conversion of F to a U.S. corporation should be treated as if F had transferred all of its assets to a new U.S. corporation, distributed stock in that "new" corporation to its shareholders, who exchanged their F stock for shares in the "new" corporation. Because the "new" U.S. corporation succeeded to all of F's assets and business, and was owned by the same shareholders in the same proportion as was F, the deemed conversion was treated as an inbound F reorganization.

A similar deemed inbound F reorganization can occur without any change in corporate form or corporate jurisdiction if a U.S. corporate shareholder elects to treat a qualifying pre-existing wholly owned Canadian or Mexican subsidiary as a U.S. corporation under §1504(d).[455]

Practice Point: While we focus here on outbound and inbound F reorganizations, far more common are foreign-to-for-

[449] *See, e.g.*, former Reg. §7.367(b)-4(d), adopted by T.D. 7530, 42 Fed. Reg. 65,159 (Dec. 30, 1977), removed by T.D. 8862, 65 Fed. Reg. 3589 (Jan. 24, 2000).

[450] T.D. 9739, 80 Fed. Reg. 56,904 (Sept. 21. 2015).

[451] *See* Reg. §1.368-2(m)(1). The six requirements under the F reorganization regulations are discussed in II.A.2., above.

[452] T.D. 9739, 80 Fed. Reg. 56,904, 56,911 (Sept. 21. 2015).

[453] T.D. 9739, 80 Fed. Reg. 56,904, 56,911 (Sept. 21, 2015).

[454] §269B(a)(1).

[455] Reg. §1.367(b)-2(i).

ISBN 978-1-63359-255-1

eign F reorganizations, for example from one foreign country to another. While related transactions that occur before or after the F reorganization may trigger the application of §367, the §367 rules will ordinarily not be implicated in the reorganization itself.[456]

C. Special Rules Governing Outbound Reincorporations

1. Possible Inversion Treatment

Under the anti-corporate inversion rules of §7874, if a U.S. corporation transfers substantially all of its properties to a foreign corporation at least 80% of whose stock (measured by vote or value) is owned by the owners of the transferor corporation by virtue of their pre-transaction ownership of that corporation, the transferee foreign corporation will be treated as a U.S. corporation unless it, along with all 50%-related entities as a whole (the "expanded affiliated group" or EAG), has business activities in the transferee corporation's country of incorporation that are substantial when compared to the EAG's total worldwide business activities.[457] For this purpose, the IRS has provided that the "substantial business activities" test is met only if at least 25% of the EAG's total employees, total assets, and total income are located in the transferee foreign corporation's country of incorporation.[458]

Virtually every transaction that would qualify as a U.S.-to-foreign F reorganization would satisfy the asset acquisition and continuing stock ownership requirements for corporate inversion treatment, so the remaining issue in such transactions is whether the EAG conducts substantial business activities in the foreign transferee corporation's country of incorporation. The regulatory standard for "substantial business activities" represents a high bar and effectively requires that a significant part of each element of the EAG's integrated business activities be conducted in the resulting foreign corporation's country of incorporation.

Practice Point: Most "single entity" (i.e., not involving a business combination) inversions have not involved F reorganizations, that is, there was not a liquidation of the old U.S. corporation, but rather, a foreign corporation was placed above it. Just the same, it is worth noting that ironically, a putative outbound F reorganization that is treated as a corporate inversion subject to §7874 is not treated as an outbound transaction because of the treatment of the continuing foreign-incorporated corporation as a U.S. corporation. Although legally a foreign corporation, that corporation would remain fully subject to U.S. tax on its worldwide income and its greater-than-50% owned foreign subsidiaries remain "controlled foreign corporations" whose income and earnings are potentially subject to the U.S. subpart F regime.[459]

For a detailed discussion of the corporate inversion rules under §7874, see 6105 T.M., *Corporate Inversions* (Foreign Income Series).

[456] *See* Reg. §1.367(a)-3(d)(1)(v), §1.367(b)-9.
[457] §7874(b).
[458] Reg. §1.7874-3(b).
[459] §951–§965.

2. Application of §367

To prevent the erosion of the U.S. tax base, §367(a) and §367(d) place limitations on the operation of the tax-free reorganization rules on various transfers of property from U.S. persons to foreign corporations that would otherwise be nonrecognition events. For purposes of applying these provisions to an outbound F reorganization (one in which the resulting foreign-incorporated corporation is not treated as a U.S. corporation under §7874, discussed in VII.C.1., above), such a transaction is characterized as follows:

- the U.S. transferor corporation is treated as transferring its assets to the resulting foreign corporation, in exchange for stock in such corporation and the foreign corporation's assumption of any liabilities of the transferor corporation;
- the U.S. transferor corporation is treated as distributing that foreign corporation stock to its shareholders; and
- those shareholders are treated as exchanging their stock in the U.S. transferor corporation for stock in the resulting foreign corporation.[460]

Because the U.S. shareholders of the transferor corporation are not considered to have transferred their stock in the U.S. transferor corporation to a foreign corporation, the operation of §367 does not interfere with tax-free treatment of those shareholders under §354. However, §367(a) and §367(d) do apply to the U.S. transferor corporation's transfer or deemed transfer of its assets to the continuing foreign corporation.

a. Application of §367(d) to Transfers of Intangibles

To the extent that the U.S. transferor corporation has intangible property to which the resulting foreign corporation succeeds, §367(d) requires the U.S. corporation to recognize income as if it had sold such property for payments that are contingent upon the productivity, use, or disposition of the property in amounts that are "commensurate with the income attributable to the intangible."[461] There are no exceptions to this rule of recognition, even when the intangible property has been, and will continue to be, used in a foreign trade or business.[462]

[460] Reg. §1.367(a)-1(f).
[461] *See* §367(d)(1), §367(d)(2). *See also* §367(d)(4) (defining "intangible property," effective for transfers in taxable years beginning after December 31, 2017). The TCJA modified the statutory definition of "intangible property" in former §936(h)(3)(B) (now §367(d)(4)) explicitly to include "goodwill, going concern value, or workforce in place (including its composition and terms and conditions (contractual or otherwise) of its employment)." *See* TCJA, Pub. L. No. 115-97, §14221; 2018 Consolidated Appropriations Act, Pub. L. No. 115-141, Div. U., §401(d)(1)(D)(viii). Moreover, the TCJA amendment to former §936(h)(3)(B) (now §367(d)(4)) added a very broad residual category of intangible property so that the term includes "any other item the value or potential value of which is not attributable to tangible property or the services of any individual." *See* §367(d)(4)(G).
[462] *See TBL Licensing LLC v. Commissioner*, 82 F.4th 12 (1st Cir. 2023), *aff'g* 158 T.C. 1 (2022). In *TBL Licensing*, an outbound F reorganization transaction resulted in a transfer of intangible property, requiring the transferor to recognize gain and pay tax in the year of the transfer, when a domestic LLC treated as a corporation for U.S. income tax purposes was transferred to a newly formed foreign corporation followed by the LLC electing to be disregarded as an entity separate from its owner. The parties agreed with the characterization of the steps as an "F" reorganization and the application of §367(d) to the deemed transfer of the LLC's intangible property to the foreign corporation for one or more contingent payments. The taxpayer took the position that the deemed annual payments should be included in income over the useful life of

ISBN 978-1-63359-255-1

The statute contemplates that such a deemed royalty is to be recognized annually over the useful life of the relevant intangible property, but of course in an outbound F reorganization, the U.S. transferor corporation's existence ceases at the conclusion of the transaction. The regulations under §367(d) appear to provide that, to the extent that the U.S. transferor corporation was owned by U.S. persons "related to the transferor," such shareholders must report the deemed annual royalty that the U.S. transferor would have been required to report.[463] On the other hand, the U.S. transferor corporation itself is required to take into income on its final return the proportion of the difference between the fair market value of the transferred intangible property and its adjusted basis at the time of the transaction that is equal to the proportion of the U.S. transferor's stock held by shareholders other than those 10% U.S. shareholders.[464]

For a detailed discussion of the rules under §367(d), see 6120 T.M., *Transfers Subject to Section 367(b), (d), or (e)* (Foreign Income Series).

b. *Application of §367(a) to Transfers of Other Property*

In addition to the automatic recognition of gain or income attributable to intangible property under §367(d), §367(a) provides as a general rule that a U.S. corporation recognizes gain — but not loss — on its transfer or deemed transfer of other property to a foreign corporation in an outbound F reorganization.[465]

Before 2018, there was an exception to gain recognition for transfers of property that were for the use of the foreign resulting corporation in the active conduct of a foreign trade or business, but only if at least 80% of the voting power and 80% of the shares of each class of nonvoting stock of the U.S. transferor corporation were owned by the same five or fewer U.S. corporations.[466] Even that active foreign trade or business exception did not apply to the transfer or deemed transfer of several types of property: §1221(a)(1) and §1221(a)(3) property, installment obligations and accounts receivable, foreign currency and foreign currency-denominated assets and property with respect to which the U.S. transferor was a lessor.[467] The U.S. transferor also recaptured in income at the time of the transaction the amount of any previously deducted losses incurred by any foreign branch whose assets were transferred to the extent that such losses exceeded the income generated by the branch prior to the F reorganization.[468] The active trade or business exception was repealed by the TCJA.

For detailed discussion of the §367(a) rules, see 6100 T.M., *U.S.-to-Foreign Transfers Under Section 367(a)* (Foreign Income Series).

D. *Inbound Reincorporations*

1. *Application of §367(b)*

An "inbound" F reorganization does not involve any transfers of property by U.S. persons to a foreign corporation that would be governed by §367(a) or §367(d), but the regulation issued under §367(b) has an impact. That provision gives the IRS authority to require recognition of gain realized in cross-border reorganization as necessary or appropriate to prevent tax avoidance. The IRS has exercised its regulatory authority under §367(b) to prevent U.S. shareholders of "controlled foreign corporations" (CFCs) from avoiding, simply by domesticating such corporations, or engaging in reorganizations in which the foreign corporation ceases to be a CFC or the shareholder ceases to be a 10% U.S. shareholder, eventual ordinary income treatment with respect to the CFCs' earnings on which U.S. tax has been deferred. A CFC is a foreign corporation owned (directly, indirectly, or constructively) more than 50% by either vote or value by U.S. persons that own at least 10% of the corporation's voting power or 10% of the value of all classes of stock.[469]

In the case of an inbound F reorganization in which the foreign transferor corporation is a CFC, any U.S. shareholders (and certain U.S.-owned foreign shareholders) that own at least 10% of the voting stock or 10% of the value of shares of all classes of stock of such CFC must include in income the "all earnings and profits amount" with respect to such stock.[470] Any U.S. persons that own less than 10% of the transferor CFC's voting stock or 10% of the value of shares of all classes of stock must include in their gross income the lesser of (i) the amount of gain realized on their stock in the transaction or (ii) the "all earnings and profits amount" attributable to such stock.[471] For these purposes, the "all earnings and profits amount" is defined as the net positive E&P of the CFC attributable to the relevant shareholder's stock that was earned while the shareholder owned stock in the CFC.[472]

The §367(b) treatment of an F reorganization (including F reorganizations that arise solely by virtue of the treatment of a foreign-organized corporation as a U.S. corporation for U.S. tax purposes) of a foreign corporation into a domestic corporation and of foreign-to-foreign reorganizations is discussed in 6120 T.M., *Transfers Subject to Section 367(b), (d), or (e)* (Foreign Income Series).

---

the intangible property under §367(d)(2)(A)(ii)(I). The Firt Circuit, however, upheld the Tax Court's and IRS's treatment of the LLC's deemed distribution of stock in the foreign corporation to its shareholder (a disregarded LLC owned by another foreign corporation) as a "disposition" under §367(d)(2)(A)(ii)(II), requiring an acceleration of the stream of contingent payments. The court was not persuaded by the taxpayer's argument that, under Reg. §1.367(d)-1T(e)(3), only a disposition of the property to an unrelated party would trigger gain recognition in the year of transfer.

[463] Reg. §1.367(d)-1T(e)(1). A 10% shareholder of a U.S. corporate transferor is generally included among the definition of related person under Reg. §1.367(d)-1T(h).

[464] Reg. §1.367(d)-1T(d); *see* CCA 201321018.

[465] *See* Reg. §1.367(a)-1(f)(1).

[466] §367(a)(2), pre-2018 §367(a)(5). The TCJA repealed the active trade or business exception for transfers after December 31, 2017. *See* §367(a)(3)(B), as amended by the TCJA, Pub. L. No. 115-97, §14102(e).

[467] Pre-2018 §367(a)(3)(B).

[468] Pre-2018 §367(a)(3)(C).

[469] *See* §951(b) (U.S. shareholder), §957(a) (CFC). Generally, for tax years before 2018, U.S. shareholder was only so defined with respect to ownership of 10% of the corporation's voting power. *See* pre-2018 §951(b), prior to amendment by the TCJA, Pub. L. No. 115-97, §14214.

[470] Reg. §1.367(b)-3(b).

[471] Reg. §1.367(b)-3(c).

[472] Reg. §1.367(b)-2(d).

ISBN 978-1-63359-255-1

2. *Recognition of Certain FIRPTA Gain*

An inbound F reorganization can also trigger the recognition of certain gain under §897 attributable to U.S. real property interests transferred or deemed to be transferred by the foreign transferor corporation (foreign Oldco) to the resulting U.S. corporation (U.S. Newco). Under §897(a), a foreign corporation generally recognizes gain or loss on the sale or exchange of a U.S. real property interest (USRPI) — including stock in U.S. real property holding corporations (USRPHC) (i.e., U.S. corporations at least 50% of the value of whose real estate and business assets consists of interests in U.S. real property) — as gain that is considered to be effectively connected with the corporation's U.S. trade or business.[473] Under §897(e), nonrecognition under §361(a) with respect to a foreign corporation's transfer of a U.S. real property interest in an inbound F reorganization applies only to the extent that the foreign corporation receives another USRPI in the exchange.[474] Thus, on the foreign Oldco's deemed exchange of any appreciated USRPI for stock in the resulting U.S. Newco, the foreign Oldco will be subject to tax under §897(e) on the amount of gain realized unless the resulting U.S. Newco is a USRPHC immediately after the exchange.[475]

The second stage of what is deemed to occur in the inbound F reorganization involves the foreign Oldco distributing stock in the U.S. Newco (which must be a USRPHC in order for the §361(a) exchange to qualify for nonrecognition). This distribution is taxable under the FIRPTA rules unless it meets the following requirements:

> (A) at the time of the distribution, the distributee shareholder would be subject to U.S. taxation on a subsequent disposition of the stock of U.S. Newco;
>
> (B) the distributee shareholder's adjusted basis in the foreign Oldco stock immediately before the distribution was no greater than the foreign Oldco's basis in the U.S. Newco stock (generally substitute basis determined under §358 by reference to its basis in the transferred assets); and
>
> (C) foreign Oldco complies with regulatory filing requirements.[476]

The IRS has indicated that, in an inbound F reorganization, a public foreign corporation will be considered to have met the first requirement if the shares of the foreign corporation were publicly traded, and after the reorganization, the shareholder would hold 5% or less of the new parent shares.[477] With respect to the second requirement, foreign Oldco must recognize gain only to the extent of the excess of a distributee shareholder's stock basis over foreign Oldco's basis in the distributed stock of domestic Newco.[478]

Notice 89-85 announced a replacement of the second requirement with a "toll charge," requiring the corporation to pay an amount equal to any taxes under §897 on all persons who disposed of their interests in foreign Oldco as if it were a domestic corporation. This rule was modified further by Notice 2006-46, which provided that the lookback period for prior dispositions of stock in foreign Oldco generally would be 10 years before the reorganization.

In Notice 2025-45, Treasury and the IRS announced their intent to issue proposed regulations under §897(d) and §897(e) and to revise Reg. §1.368-2(m). The forthcoming regulations would be applicable to distributions, transfers, or exchanges occurring on or after August 19, 2025, and taxpayers may rely on the rules described in Notice 2025-45.[479] The purpose of the notice is to remove impediments to foreign public companies redomiciling into the U.S.[480] Notice 2025-45 applies to "covered inbound F reorganizations" when a foreign corporation is publicly traded and the resulting corporation is a publicly traded domestic corporation.[481]

First, Notice 2025-45 applies the "publicly traded exception" of §897(c)(3), which generally provides that the stock of publicly traded companies is not a USRPI for shareholders holding 5% or less of the corporation's outstanding stock. The publicly traded exception will be applied for purposes of the toll charge, described above, thus exempting sales of public foreign Oldco stock by foreign shareholders holding 5% or less of Oldco stock. Second, the exception will be applied for purposes of meeting the requirement that the distributee shareholder be subject to U.S. taxation. Last, the filing requirement will apply only with respect to distributees of resulting domestic corporation stock that the foreign transferor corporation knows or has reason to know do not qualify for the exception at the time of distribution.[482]

To provide clarity to the application of the identity of stock ownership requirement when sales or exchanges of transferor or resulting corporation stock occur in close proximity to the plan of reorganization, Notice 2025-45 states that forthcoming proposed amendments to Reg. §1.368-2(m)(1)(ii) would add the following to the end of the section:

> "Satisfaction of the identity of stock ownership requirement under this paragraph (m)(1)(ii) would not be affected by a disposition of stock in either the transferor corporation or the resulting corporation if

[473] *See* §897(c)(2) (U.S. real property holding corporation).

[474] In an inbound F reorganization, the foreign transferor corporation is considered to have transferred its assets to the resulting U.S. corporation in exchange for stock in such corporation. That deemed exchange is deemed to be followed by the foreign corporation's distribution of the stock in the U.S. corporation to the shareholders and the shareholders' receipt of such stock in exchange for the surrender of their stock of the foreign corporation. Reg. §1.367(b)-2(f)(2).

[475] *See* Reg. §1.897-6T(a); Rev. Rul. 89-103.

[476] Reg. §1.897-5T(c)(4).

[477] *See* PLR 201321007.

[478] Reg. §1.897-5T(c)(4).

[479] Notice 2025-45, §5.

[480] Notice 2025-45, §3.01.

[481] Notice 2025-45, §3.02. A transaction is not a covered inbound F reorganization if, pursuant to a plan (or series of related transactions), the resulting corporation transfers property (other than cash) to any of its shareholders with respect to the shareholder's stock in the resulting corporation in connection with the reorganization. There is a de minimis exception to this rule if the aggregate amount of property transferred is less than 1% of the total fair market value of the assets of the foreign transferor corporation at the time of the F reorganization.

[482] *See* Notice 2025-45, §3.03. Also, solely for purposes of inbound F reorganizations, §897(c)(3) applies based on whether the foreign transferor corporation knows or has reason to know that a person at some time during the shorter of the periods described in §897(c)(1)(A)(ii) held more than 5% of the class of stock.

ISBN 978-1-63359-255-1

that disposition is not included in the plan of reorganization."[483]

Additionally, an example, proposed to be added to Reg. §1.368-2(m)(4), would clarify the potential effect on F reorganization qualification of sales or exchanges of resulting corporation stock that occur among the transaction steps.[484]

For a detailed discussion of the FIRPTA rules, see 6540 T.M., *U.S. Taxation of Foreign Investment in U.S. Real Estate* (Foreign Income Series).

[483] Notice 2025-45, §4.02(1). This does no harm, but the F reorganization regulations are already clear that a planned sale of stock occurring immediately before or after the steps of the F reorganization does not disqualify the reorganization.

[484] Notice 2025-45, §4.02(2).

ISBN 978-1-63359-255-1

VIII. Reporting Requirements

A. *Reporting Requirements Under §368*

1. *Recordkeeping*

Under Reg. §1.6001-1(e), taxpayers must retain their permanent records and make them available to authorized IRS officers and employees. In connection with the reorganization, these records should specifically include information regarding the amount, basis, and fair market value of all transferred property, along with relevant facts regarding any liabilities assumed or extinguished as part of the reorganization.[485]

The regulations also require taxpayers involved in a reorganization to include certain documents and statements in their federal income tax returns for the year in which the exchange took place. As discussed below, the documents and statements vary depending on whether the taxpayer is a corporation that is a party to the reorganization or is a "significant holder," other than a corporation that is a party to the reorganization, that received stock or securities and other property in a tax-free exchange.[486]

Note: Failure to comply with the record keeping and reporting requirements does not disqualify a transaction from reorganization treatment.[487] Nonetheless, it is advisable to adhere as closely as possible to these requirements.

2. *Plan of Reorganization and Party to the Reorganization Statement*

The regulations require that each corporation that is a party to the reorganization adopt a plan of reorganization. In addition, each such corporation must include a statement titled, "STATEMENT PURSUANT TO §1.368-3(a) BY [INSERT NAME AND EMPLOYER IDENTIFICATION NUMBER (IF ANY) OF TAXPAYER], A CORPORATION A PARTY TO A REORGANIZATION," on or with its return for the taxable year of the exchange. If any such corporation is a controlled foreign corporation (within the meaning of §957), each U.S. shareholder (within the meaning of §951(b)) with respect thereto must include this statement on or with its return. However, it is not necessary for any taxpayer to include more than one such statement on or with the same return for the same reorganization.[488]

The statement must include:

(1) the name and employer identification number (if any) of each party to the reorganization;

(2) the date of the reorganization;

(3) the fair market value and basis, determined immediately before the exchange, of the assets, stock, or securities of the target corporation transferred in the transaction, aggregated as follows: (i) importation property transferred in a loss importation transaction; (ii) loss duplication property; (iii) property for which any gain or loss was recognized on the transfer; and (iv) other property not described in (i), (ii), or (iii); and

(4) the date and control number of any private letter ruling(s) issued by the IRS in connection with the reorganization.[489]

For a sample statement under Reg. §1.368-3(a), see *Corporation: Party to a Reorganization Statement (§368(a))*, in the Bloomberg Tax Elections & Compliance Statements Library.

3. *"Significant Holder" Statement*

Every "significant holder," other than a corporation a party to the reorganization, must include a statement titled "STATEMENT PURSUANT TO §1.368-3(b) BY [INSERT NAME AND TAXPAYER IDENTIFICATION NUMBER (IF ANY) OF TAXPAYER], A SIGNIFICANT HOLDER," on or with the holder's return for the taxable year of the exchange. If a significant holder is a controlled foreign corporation (within the meaning of §957), each U.S. shareholder (within the meaning of §951(b)) with respect thereto must include this statement on or with its return.[490]

The statement must include:

(1) the name and employer identification number (if any) of each party to the reorganization;

(2) the date of the reorganization; and

(3) the fair market value of all of the stock or securities of the target corporation held by the significant holder that is transferred in the transaction and the holder's basis in that stock or securities, determined immediately before the exchange, aggregated as follows: (i) stock and securities to which a §362(e)(2)(C) election is made; and (ii) stock and securities with respect to which a §362(e)(2)(C) election is not made.[491]

For a sample statement under Reg. §1.368-3(b), see *Corporation: Significant Holder Reorganization Statement (§368(a))*, in the Bloomberg Tax Elections & Compliance Statements Library.

For purposes of this reporting requirement, a "significant holder" is defined as:

• a holder of stock of the target corporation that receives stock or securities in an exchange described in §354 (or so much of §356 as relates to §354) if, immediately before the exchange, the holder (A) owned at least 5% (by vote or value) of the total outstanding stock of the target corporation if the stock owned by the holder is publicly traded or (B) owned at least 1% (by vote or value) of the total outstanding stock of the target corporation if the stock owned by such holder is not publicly traded; or

• a holder of securities of the target corporation that receives stock or securities in an exchange described in §354 (or so much of §356 as relates to §354) if, immediately be-

[485] Reg. §1.368-3(d).

[486] *See* Reg. §1.368-3(a), §1.368-3(b).

[487] *Cf.* Rev. Rul. 65-80 (ruling that shareholder would not be denied favorable partial liquidation treatment under former §331(a)(2) because of failure to timely file Form 966 as required under §6043).

[488] Reg. §1.368-3(a).

[489] Reg. §1.368-3(a)(1)–§1.368-3(a)(4).

[490] Reg. §1.368-3(b).

[491] Reg. §1.368-3(b)(1)–§1.368-3(b)(3).

ISBN 978-1-63359-255-1

fore the exchange, the holder owned securities in the target corporation with a basis of $1 million or more.[492]

"Publicly traded stock" is defined as stock that is listed on (i) a national securities exchange registered under §6 of the Securities Exchange Act of 1934 (15 U.S.C. §78f) or (ii) an inter-dealer quotation system sponsored by a national securities association registered under §15A of the Securities Exchange Act of 1934 (15 U.S.C. §78o-3).[493]

The IRS has issued guidance[494] providing that corporations acquiring target stock in a transferred basis transaction will be treated as satisfying their reporting requirements under Reg. §1.351-3 and §1.368-3 if they include a statement on or with the timely filed original return for the taxable year of the transferred basis transaction that identifies the transferred basis transaction and states that a basis study is pending with respect to the acquired stock. However, to satisfy the requirements of those sections in such cases, the taxpayer must include complete statements as required under those regulations, with basis amounts determined pursuant to the study or otherwise under the revenue procedure, on or with a timely filed original return for a tax year that is no later than the tax year that includes the date that is two years after the date of the transferred basis transaction.

B. Reporting Requirements Under §6043(c)

Section 6043(c) sets forth reporting requirements for transactions involving a change in control or in the capital structure of a corporation. Section 6043(c) specifically provides that if (1) control of a corporation is acquired by any person (or group of persons) in a transaction (or series of related transactions) or (2) there is a recapitalization of a corporation or other substantial change in the capital structure of a corporation, the IRS may require the corporation to file informational returns identifying the parties to the transaction, the fees involved, the changes in the capital structure involved, and any other information required by regulations.

Although both the statutory language and the temporary regulations under §6043 (which have since been withdrawn) specifically provide that this reporting requirement applies to "recapitalizations," the final regulations under §6043(c) removed any reference to recapitalizations and the Preamble to those regulations specifically provided that "[t]he definition of change in capital structure in [former] Reg. §1.6043-4T(d)(2) has been modified to remove the inclusion of recapitalizations … since those transactions would not result in a recognition of gain under §367(a) and the regulations."[495] Thus, recapitalizations are not considered changes in capital structure for purposes of the §6043(c) reporting requirement. Changes in identity, form, or place of organization (F reorganizations) are considered changes in capital structure if the corporation or any shareholder is required to recognize gain (if any) under §367(a) as a result of the transaction.[496] A change in capital structure is "substantial" (and, therefore, subject to the §6043(c) reporting requirements) if the amount of cash and/or the fair market value of property (including stock) provided to the corporation's shareholders in connection with the change is $100 million or more.[497]

If the §6043(c) reporting requirement applies, the corporation must file Form 8806 on or before the earlier of the 45th day following the transaction or January 5th of the year following the calendar year of the transaction.[498] Reporting corporations also must file information returns on Forms 1096 and 1099-CAP with respect to affected shareholders (excluding certain "exempt recipients"),[499] and furnish those shareholders with Forms 1099-CAP reporting the amount of cash and fair market value of property (including stock) provided to the shareholders in the transaction.[500] If on Form 8806 the reporting corporation elects to permit the IRS to publish information regarding the transaction, the reporting corporation is not required to file a Form 1096 or Form 1099-CAP with respect to a clearing organization, or furnish the clearing organization with Form 1099-CAP.[501]

Information reporting is not required under §6043(c) if reporting is otherwise required and properly undertaken pursuant

---

[492] Reg. §1.368-3(c)(1).

[493] Reg. §1.368-3(c)(2).

[494] Rev. Proc. 2011-35 provides procedures that an acquiring corporation may use to establish basis in the stock of a target corporation when it acquires the target stock in a transferred basis transaction. Rev. Proc. 2011-35 adopts the surveying and statistical sampling guidelines in Rev. Proc. 81-70, but updates and revises them to take current market practices into account. Rev. Proc. 2011-35 also adopts the safe harbor methodologies described in Notice 2009-4, but modifies them to reflect the comments received, particularly regarding the need for a model that uses data more readily accessible to acquiring corporations. Finally, the revenue procedure expands the applicability of these provisions by permitting their use in any transferred basis transaction. For further guidance on the use of statistical sampling techniques for basis studies, see Rev. Proc. 2011-42.

[495] *See* preamble to T.D. 9230, 70 Fed. Reg. 72,376 (Dec. 5, 2005). On November 18, 2002, the IRS published temporary regulations under §6043(c) generally requiring information reporting for certain large corporate transactions involving acquisitions of control and substantial changes in corporate structure. T.D. 9022, 67 Fed. Reg. 69,468 (Nov. 18, 2002), *removed by* T.D. 9230, effective December 5, 2005. On December 30, 2003, the 2002 temporary regulations were withdrawn (REG-143321-02, 68 Fed. Reg. 75,182 (Dec. 30, 2003)) and new temporary regulations were issued (the "2003 temporary regulations"). T.D. 9101, 68 Fed. Reg. 75,119 and 75,182 (Dec. 30, 2003); Reg. §1.6043-4T and §1.6045-3T, *removed by* T.D. 9230, effective December 5, 2005. In December 2005, the IRS issued final regulations under §6043(c) effective for transactions occurring on or after December 5, 2005. Reg. §1.6043-4, §1.6045-3, T.D. 9230, 70 Fed. Reg. 72,376 (Dec. 5, 2005).

[496] Reg. §1.6043-4(d)(2)(i)(C).

[497] Reg. §1.6043-4(d)(1).

[498] Reg. §1.6043-4(a)(3). Until further notice, Form 8806 must be sent to the IRS via fax and can no longer be mailed. *Form 8806 Must Be Filed By Fax*.

[499] Reg. §1.6043-4(b)(1). Form 1096, *Annual Summary and Transmittal of U.S. Information Returns*, and Form 1099-CAP must be filed on or before February 28 (March 31 if filed electronically) of the calendar year following the year of the transaction. Reg. §1.6043-4(b)(2). See Reg. §1.6043-4(b)(5) for the list of exempt recipients.

[500] Reg. §1.6043-4(b)(4). Form 1099-CAP must be furnished to a shareholder on or before January 31 of the year following the calendar year during which the shareholder receives cash, stock, or property as a result of the transaction, or, in the case of clearing organizations, January 5 of the year following the year of the transaction. *See also* Reg. §1.6043-4(b)(1).

[501] Reg. §1.6043-4(a)(2), §1.6043-4(b)(1), §1.6043-4(b)(4). IRS publication of this information is intended to inform brokers of the transaction and thereby enable the brokers to satisfy their reporting obligations under Reg. §1.6045-3. Under Reg. §1.6045-3, if a broker holds stock in a corporation on behalf of a customer and knows or has reason to know that the corporation has engaged in a triggering transaction, the broker must file Form 1096 and Form 1099-B on or before February 28 (March 31 if filed electronically) of the following calendar year, and provide the customer with the Form 1099-B on or before January 31 of the year following the calendar year during which the shareholder receives cash, stock, or property as a result of the transaction.

ISBN 978-1-63359-255-1

to §6043(a) (see below),[502] or all of the shareholders for which information reporting would be required are "exempt recipients."[503]

The "reporting corporation" is the domestic corporation that is acquired or that has a substantial change in capital structure.[504] If a transferor transfers all or substantially all of its assets in a transaction that constitutes a substantial change in capital structure and fails to satisfy the reporting requirements, then the transferee must satisfy the reporting requirements.[505] If neither the transferor nor the transferee satisfies the reporting obligations, then the transferor and the transferee are jointly and severally liable for any applicable penalties.[506] Section 6652(l) imposes a $500 penalty per day (limited to $100,000) for failure to comply with the reporting requirements of §6043(c) unless due to reasonable cause.[507]

C. Reporting Requirements Under §6043A

Section 6043A supplements the information reporting provisions of §6043(c) by requiring an acquiring corporation to file an information return if any shareholder of the *acquired* corporation must recognize gain as a result of the acquisition.[508] The acquisition may be a stock or an asset acquisition.

The return must provide the following information:

(1) a description of the transaction;

(2) the name and address of each shareholder of the acquired corporation that is required to recognize gain as a result of the transaction;

(3) the amount of money and the fair market value of stock or other consideration transferred to each such shareholder as part of the acquisition; and

(4) any other information that the Treasury Secretary may require.[509]

The corporation that files the return also must furnish to each shareholder whose name is required on the return, no later than January 31 of the year following the calendar year in which the transaction occurred, a written statement showing:

(1) the name, address, and telephone number of the information contact of the corporation filing the return;

(2) the information required to be shown on the return with respect to that shareholder; and

(3) any other information that the Secretary may require.[510]

If stock in the acquired corporation is held by a nominee for another person, the acquiring corporation must furnish the required information to the nominee and the nominee must furnish the information to the shareholder.[511]

Note: The Treasury and the IRS requested comments on information reporting under §6043A, including comments on: (1) coordination with the temporary regulations under §6043(c) (discussed above); (2) the rules for reporting by nominees; (3) whether dollar thresholds (based on the size of the acquisition or the amount received by a shareholder) should be adopted; (4) the design of forms; and (5) filing deadlines.[512] Although several comments were received before the issuance of the final regulations under §6043(c), regulations have not yet been proposed under §6043A.[513]

D. Reporting Requirements Under §6045B

1. In General

To the extent that a single-entity reorganization affects a taxpayer's basis in a "specified security," the issuer must comply with additional reporting requirements. The issuer of a specified security (as defined in §6045(g)(3)(B)) that takes an organizational action that affects the basis of the specified security must file an information return describing the effect of the action on the basis of the security, including the quantitative effect, and any other information required by Treasury.[514]

For this purpose, §6045(g)(3)(B) defines a "specified security" as encompassing any shares of stock in a corporation, any note, bond, or other evidence of indebtedness, any commodities (including related contracts or derivatives), any digital assets, and any other financial instruments as designated by the Secretary.[515]

Note: The Infrastructure Investment and Jobs Act[516] added digital assets to the definition of "specified security" in §6045(g)(3)(B). For a detailed discussion of the taxation of digital assets, including reporting requirements and basis determinations, see 190 T.M., *Taxation of Cryptocurrencies and Other Digital Assets.*

Reg. §1.6045B-1 applies to:

(1) organizational actions occurring on or after January 1, 2011, that affect the basis of specified securities within the meaning of Reg. §1.6045-1(a)(14)(i), other than stock in a regulated investment company within the meaning of Reg. §1.1012-1(e)(5);

(2) organizational actions occurring on or after January 1, 2012, that affect the basis of stock in a regulated investment company;

(3) organizational actions occurring on or after January 1, 2014, that affect the basis of debt instruments described in Reg. §1.6045-1(n)(2)(i) (not including the debt instruments described in Reg. §1.6045-1(n)(2)(ii));

(4) organizational actions occurring on or after January 1, 2014, that affect the basis of options described in Reg. §1.6045-1(a)(14)(iii);

---

[502] Reg. §1.6043-4(a)(4).

[503] Reg. §1.6043-4(a)(5). See Reg. §1.6043-4(b)(5) for the list of exempt recipients.

[504] Reg. §1.6043-4(a)(1).

[505] Reg. §1.6043-4(e).

[506] Reg. §1.6043-4(e).

[507] §6043(d) (cross-reference to §6652(l)).

[508] §6043A(a).

[509] The Treasury Secretary is authorized to prescribe regulations requiring the acquired corporation, rather than the acquiring corporation, to file the return. *See* §6043A(a) (flush language).

[510] §6043A(d).

[511] §6043A(b).

[512] Notice 2005-7.

[513] *See* Preamble to T.D. 9230, 70 Fed. Reg. 72,376 (Dec. 5, 2005).

[514] *See* §6045B; Reg. §1.6045B-1(a)(1).

[515] *See also* Reg. §1.6045-1(a)(14).

[516] Pub. L. No. 117-58, §80603(b).

ISBN 978-1-63359-255-1

(5) organizational actions occurring on or after January 1, 2014, that affect the basis of securities futures contracts described in Reg. §1.6045-1(a)(14)(iv);

(6) organizational actions occurring on or after January 1, 2016, that affect the basis of debt instruments described in Reg. §1.6045-1(n)(3); and

(7) organizational actions occurring on or after January 1, 2025, that affect the basis of digital assets described in Reg. §1.6045-1(a)(14)(v) or §1.6045-1(a)(14)(vi) that are also described in one or more paragraphs of Reg. §1.6045-1(a)(14)(i) through §1.6045-1(a)(14)(iv).[517]

Note: The IRS and Treasury issued proposed regulations under §6045B that would require an issuer to provide an issuer return to the IRS and a written statement to each holder of record of a specified security (or to the holder's nominee) relating to a deemed distribution under §305(c) on the security, without regard to any of the general exceptions in the current regulations under §6045B or in the instructions to Form 8937, *Report of Organizational Actions Affecting Basis of Securities*.[518]

Exceptions to the reporting requirement under Reg. §1.6045B-1 exist for:

(1) public reporting;

(2) when holders are exempt recipients;

(3) certain money market funds; and

(4) issuers of certain specified securities.[519]

2. *Issuer Information Return*

Under the regulations, the issuer return must include the following information:

(1) the reporting issuer's name and taxpayer identification number;

(2) various identifiers of each security involved in the organizational action;

(3) contact information of a contact person at the reporting issuer;

(4) the type or nature of the organizational action, including the date of the action or the date against which shareholders' ownership is measured for the action; and

(5) a description of the quantitative effect of the organizational action on the basis of the security in the hands of a U.S. taxpayer.[520]

The issuer return must be filed with the IRS on or before the 45th day after the organizational action, or, if earlier, January 15 of the year following the calendar year during which the organizational action occurred. The return may be filed before the date of the organizational action if the quantitative effect on basis is determinable beforehand.[521]

The issuer must also furnish a written statement with the requisite information above to each security holder or their nominees.[522] This issuer statement must be furnished on or before January 15 of the year following the calendar year of the organizational action, although the statement may be furnished before the date of the organizational action if the quantitative effect on basis is determinable beforehand.[523]

Both the requirement to file an issuer return and to furnish issuer statements may be waived if the information is made publicly available on the issuer's primary website and remains accessible there for 10 years.[524]

While an issuer is permitted to use an agent to satisfy reporting requirements on its behalf, the issuer remains liable for penalties for failure to comply under §6721–§6724, unless it can show that failure is due to reasonable cause and not willful neglect.[525]

For further discussion of the issuer reporting requirements under §6045B, or reporting requirements under §6045, §6045A, and §6050W, see 560 T.M., *Income Tax Basis: Overview and Conceptual Aspects*, and 643 T.M., *Information Reporting to U.S. Persons — Payments Subject to Back-up Withholding*, respectively.

[517] *See* Reg. §1.6045B-1(j).

[518] Prop. Reg. §1.6045B-1(i), REG-133673-15, 81 Fed. Reg. 21,795 (Apr. 13, 2016), proposed to apply to a deemed distribution under §305(c) occurring on or after the date the regulations are finalized. An issuer would not have to provide an issuer return to the IRS or a written statement to the holders regarding the deemed distribution if the issuer satisfies the public reporting requirements in Reg. §1.6045B-1(a)(3). Note that Prop. Reg. §1.6045B-1(i) was not finalized by T.D. 10000. For a more detailed discussion of Prop. Reg. §1.6045B-1(i) and REG-133673-15, see 765 T.M., *Stock Rights and Stock Dividends — Sections 305 and 306*, at III.D.7.

[519] Reg. §1.6045B-1(a)(3)–§1.6045B-1(a)(6).

[520] Reg. §1.6045B-1(a)(1)(i)–§1.6045B-1(a)(1)(v).

[521] §6045B(b); Reg. §1.6045B-1(a)(2). If the issuer return relies on reasonable assumptions about the quantitative effect on basis because facts cannot be determined before the due date, a corrected return must be filed within 45 days of the issuer determining facts that result in a different quantitative effect on basis.

[522] §6045B(c); Reg. §1.6045B-1(b)(1).

[523] Reg. §1.6045B-1(b)(2).

[524] §6045B(e); Reg. §1.6045B-1(a)(3), §1.6045B-1(b)(4). An issuer may electronically sign a return that is publicly reported if the electronic signature identifies the individual who attests to the declaration in the jurat.

[525] Reg. §1.6045B-1(f).

ISBN 978-1-63359-255-1

TABLE OF WORKSHEETS

DIAGRAMS OF USE OF F REORGANIZATION

Worksheet 1 — Diagram of F Reorganization Simple Reincorporation.

Worksheet 2 — Diagram of F Reorganization — S Corporation Asset Sale.

Worksheet 3 — Structure Diagram — Conversion of an S Corporation to a Limited Liability Company.

EXAMPLE: REINCORPORATION OF A CORPORATION QUALIFYING AS AN F REORGANIZATION

Worksheet 4 — Fact Pattern for Transaction Described in Sample Documents.

Worksheet 5 — Minutes of Special Meeting of Board of Directors of Widget Manufacturing Corporation.

Worksheet 6 — Unanimous Consent of the Board of Directors and of the Sole Shareholder of Newco, Inc.

Worksheet 7 — Agreement of Merger and Plan of Reorganization.

PRIOR RULES

Worksheet 8 — F Reorganizations: Continuity of Interest & Continuity of Business Enterprise — Prior Law.

Worksheet 9 — Liquidation-Reincorporation — Prior Law.

Working Papers for this Portfolio can be found at https://bloombergtax.com.

ISBN 978-1-63359-255-1