CHAPTER 11

NONACQUISITIVE, NONDIVISIVE REORGANIZATIONS

A. TYPE E: RECAPITALIZATIONS

1. INTRODUCTION

Code: §§ 368(a)(1)(E); 354; 356; 358; 1032; 1036; 1223(1). Skim §§ 305; 306.

Regulations: §§ 1.301–1(*l*); 1.305–7(c); 1.368–2(e).

A tax-free reorganization sometimes involves only a single corporation undergoing a readjustment to its capital structure. The most common form of nonacquisitive, nondivisive reorganization is the recapitalization, which qualifies as a Type E reorganization if certain requirements are met. Recapitalizations traditionally have been used for a variety of business and tax objectives. A corporation may reshuffle its capital structure by exchanging stock for bonds in order to improve its debt/equity ratio and calm the nerves of creditors or as a condition to borrowing additional funds. Alternatively, it may exchange debt instruments for stock in order to reduce corporate-level tax by paying deductible interest rather than nondeductible dividends. For closely held corporations, recapitalizations also may be used as a device to shift control among the shareholders.

Because a recapitalization is a nonacquisitive transaction involving only a single corporation, neither continuity of proprietary interest nor continuity of business enterprise is required to qualify as a Type E reorganization.[1] To be tax free, however, a recapitalization must serve a corporate business purpose.[2] The courts have been tolerant in this area, and the business objectives set forth in the preceding paragraph generally are acceptable. In analogous situations, the courts have recognized that it may be unrealistic and impractical to distinguish corporate from shareholder purposes in a closely held corporation.[3] Thus,

1 Rev. Rul. 77–415, 1977–2 C.B. 311; Rev. Rul. 82–34, 1982–1 C.B. 59.

2 Rev. Proc. 81–60, § 4.04, 1981–2 C.B. 680.

3 Lewis v. Commissioner, 176 F.2d 646 (1st Cir.1949); Estate of Parshelsky v. Commissioner, 303 F.2d 14 (2d Cir.1962). But see Reg. § 1.355–2(b)(2), requiring a corporate business purpose in a tax-free division under Section 355.

shareholder objectives germane to the corporation's business have been sufficient to satisfy the business purpose requirement.[4]

2. TYPES OF RECAPITALIZATIONS

Recapitalizations fall into four broad categories depending upon the consideration exchanged. These categories raise different issues and are best studied separately.

a. BONDS EXCHANGED FOR STOCK

If a corporation discharges outstanding bonds by issuing preferred or common stock to the bondholders, the transaction qualifies as a Type E reorganization.[5] Under Section 354(a), the bondholders generally will recognize no gain or loss on the exchange of their debt instruments solely for stock. Section 354(a)(2)(B) creates an exception to nonrecognition to the extent stock received is attributable to accrued and untaxed interest on the bonds. This interest component will be taxed as ordinary income under Section 61.[6] The basis of the stock received in a bonds-for-stock recapitalization will be determined under the familiar rules of Section 358, and the new shareholder will be entitled to a tacked holding period on the stock under Section 1223(1).

On the corporate side, matters are fairly routine. Since the corporation is issuing its stock, it initially will be excused from recognizing gain or loss by Section 1032. However, a debtor corporation that transfers its stock in satisfaction of its debt is treated as if it satisfied the debt with an amount of money equal to the fair market value of the transferred stock.[7] Only an insolvent or bankrupt corporation may exclude any resulting discharge of indebtedness income under Section 108 and must make a corresponding reduction in its tax attributes.[8] Thus, a bonds-for-stock recapitalization may result in gross income for the corporation.

b. BONDS FOR BONDS

After initially contesting the issue,[9] the Service now concedes that if a creditor exchanges outstanding bonds for newly issued bonds in the

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4 Cf. Rafferty v. Commissioner, 452 F.2d 767 (1st Cir.1971), cert. denied, 408 U.S. 922, 92 S.Ct. 2489 (1972).

5 Reg. § 1.368–2(e)(1). A recapitalization should be distinguished from conversion of a bond into stock pursuant to a conversion privilege in the bond. The Service has held that the latter situation does not constitute a taxable event as long as the bond is converted into stock of the same corporation. Rev. Rul. 72–265, 1972–1 C.B. 222; Rev. Rul. 79–155, 1979–1 C.B. 153.

6 I.R.C. § 354(a)(3)(B).

7 I.R.C. § 108(e)(8).

8 See I.R.C. § 108(a)(1)(A), (a)(1)(B), (b).

9 See I.T. 2035, III–1 C.B. 55 (1924); Commissioner v. Neustadt's Trust, 131 F.2d 528, 530 (2d Cir.1942), affirming 43 B.T.A. 848 (1941), nonacq. 1941–1 C.B. 17, nonacq. withdrawn, acq. 1951–1 C.B. 2.

same corporation, the transaction qualifies as a Type E reorganization.[10] The bondholder in a bonds-for-bonds exchange generally does not recognize gain or loss unless the bonds received are attributable to accrued and untaxed interest[11] or the principal amount of the bonds received in the exchange exceeds the principal amount of the bonds surrendered.[12] Income attributable to interest will be ordinary in character while gain recognized as a result of receipt of excess bonds generally will be either short-or long-term capital gain.[13] The bondholder's basis in the new bonds will be determined under Section 358 and the new bonds will take a tacked holding period under Section 1223(1).

On the corporate side, the primary concern in a bonds-for-bonds recapitalization will be the discharge of indebtedness rules in Section 108.[14] In addition, a bonds-for-bonds recapitalization may subject the corporation and bondholders to the intricate original issue discount provisions.[15]

c. STOCK FOR STOCK

The regulations provide three examples of stock-for-stock exchanges which qualify as reorganizations. Two examples involve exchanges of outstanding preferred stock for common stock and the third involves an exchange of outstanding common for preferred.[16] Thus, virtually all equity-for-equity exchanges will qualify as Type E reorganizations.[17] In addition, exchanges of common stock in a corporation for common stock in the same corporation or preferred stock for preferred stock will qualify for nonrecognition under Section 1036.[18]

Sections 354 and 356 govern the shareholder level tax consequences of a stock-for-stock recapitalization. The shareholders will recognize gain to the extent they receive boot in the exchange, and the gain will be characterized as gain from the exchange of the stock unless the

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10 See I.T. 4081, 1952–1 C.B. 65; Rev. Rul. 77–415, 1977–2 C.B. 311.

11 I.R.C. § 354(a)(2)(B). Cf. I.R.C. § 354(a)(3)(B).

12 I.R.C. §§ 354(a)(2)(A), 356(a)(1), (d).

13 I.R.C. §§ 354(a)(3)(A), 356(a)(1). See Rev. Rul. 71–427, 1971–2 C.B. 183.

14 See I.R.C. § 108(e)(10).

15 In particular, see I.R.C. §§ 163(e), 1272–1275. See Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 12.27[4][c].

16 Reg. § 1.368–2(e)(2)–(4).

17 It is unlikely that a conversion of preferred stock into common stock in the same corporation, or vice versa, pursuant to a conversion privilege in the stock would be a taxable event under the theory of Rev. Rul. 72–265, 1972–1 C.B. 222, which deals with convertible debt instruments. Rev. Rul. 77–238, 1977–2 C.B. 115, however, holds that conversion of stock in furtherance of a corporate business purpose pursuant to a privilege contained in the corporation's certificate of incorporation is a recapitalization under Section 368(a)(1)(E).

18 Section 1036 also applies to exchanges between two individual stockholders. Reg. § 1.1036–1(a). For this purpose, boot generally includes "debt-like" nonqualified preferred stock within the meaning of Section 351(g) unless such preferred stock is exchanged for comparable preferred of the same or lesser value, or in certain recapitalizations of "family-owned" corporations. I.R.C. § 354(a)(1)(C).

transaction has "the effect of the distribution of a dividend."[19] The shareholders' basis in the stock received in the exchange will be determined under Section 358 and will take a tacked holding period under Section 1223(1). The corporation will be entitled to nonrecognition under Section 1032 on the exchange of its stock.

Sections 305 and 306 also may come into play in a stock-for-stock recapitalization. The regulations provide that a recapitalization will be deemed to result in a distribution to which Section 305(c) applies if it is (1) pursuant to a plan to periodically increase a shareholder's proportionate interest in the assets or earnings and profits of the corporation or (2) with respect to preferred stock with dividend arrearages and the preferred shareholder increases his proportionate interest in the corporation as a result of the exchange.[20] The second alternative essentially precludes recapitalizations designed to remedy preferred stock dividend arrearages by taxing them under Sections 305(c) and (b)(4).[21]

Stock received in a recapitalization constitutes "Section 306 stock" under Section 306(c)(1)(B) if: (1) it is not common stock, (2) it was received pursuant to a plan of reorganization, (3) on its receipt gain or loss was not recognized to any extent under Sections 354 and 356, and (4) the effect of the transaction was substantially the same as the receipt of a stock dividend or the stock was received in exchange for Section 306 stock. The regulations provide a cash substitute test for determining whether the transaction has the effect of a dividend.[22] If cash received in lieu of the stock obtained in the recapitalization would have been a dividend under Section 356(a)(2), the transaction has substantially the same effect as a dividend. Thus, if the shareholders exchange common stock for common stock and a proportionate amount of preferred stock, the preferred shares will be Section 306 stock.

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ISSUE

When nonvoting preferred stock and cash are received in an integrated transaction by a shareholder in exchange for voting common stock in a recapitalization described in section 368(a)(1)(E) of the

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[19] I.R.C. § 356(a)(2). See Rev. Rul. 84–114, below.

[20] Reg. § 1.305–7(c). A preferred shareholder's proportionate interest increases if the greater of the fair market value or liquidation preference of the stock received in the exchange exceeds the issue price of the preferred stock surrendered. In such an exchange, the amount considered distributed to the preferred shareholder under Section 305(c) is the lesser of (1) the greater of the fair market value or liquidation preference of the preferred stock received over the issue price of the preferred stock surrendered or (2) the amount of the dividend arrearages.

[21] Reg. § 1.305–5(d) Example (1). See also Reg. § 1.305–3(e) Example (12); Reg. § 1.305–5(d) Examples (2), (3) and (6).

[22] Reg. § 1.306–3(d).

Internal Revenue Code, does the receipt of cash have the effect of the distribution of a dividend within the meaning of section 356(a)(2)?

FACTS

Corporation X had outstanding 420 shares of voting common stock of which A owned 120 shares and B, C and D each owned 100 shares. A, B, C and D were not related within the meaning of section 318(a) of the Code. X adopted a plan of recapitalization that permitted a shareholder to exchange each of 30 shares of voting common stock for either one share of nonvoting preferred stock or cash. Pursuant to the plan, A first exchanged 15 shares of voting common stock for cash and then exchanged 15 shares of voting common stock for 15 shares of nonvoting preferred stock. The facts and circumstances surrounding these exchanges were such that the exchanges constituted two steps in a single integrated transaction for purposes of sections 368(a)(1)(E) and 356(a)(2). The nonvoting preferred stock had no conversion features. In addition, the dividend and liquidation rights payable to A on 15 shares of nonvoting preferred stock were substantially less than the dividend and liquidation rights payable to A on 30 shares of voting common stock. B, C, and D did not participate in the exchange and will retain all their voting common stock in X. X had a substantial amount of post-1913 earnings and profits.

The exchange by A of voting common stock for nonvoting preferred stock and cash qualified as a recapitalization within the meaning of section 368(a)(1)(E) of the Code.

LAW AND ANALYSIS

Section 354(a)(1) of the Code provides that no gain or loss will be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

Section 356(a)(1) of the Code provides that if section 354 would apply to an exchange but for the fact that the property received in the exchange consists not only of property permitted by section 354 to be received without the recognition of gain but also of other property or money, then the gain, if any, will be recognized, but in an amount not in excess of the sum of the money and fair market value of the other property. Section 356(a)(2) provides that if such exchange has the effect of the distribution of a dividend (determined with the application of section 318(a)), then there will be treated as a dividend to each distributee such an amount of the gain recognized under section 356(a)(1) as is not in excess of each distributee's ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913.

Under section 302(b)(1) and section 302(a) of the Code a redemption will be treated as a distribution in part or full payment in exchange for stock if it is not essentially equivalent to a dividend to the shareholder.

Rev. Rul. 74–515, 1974–2 C.B. 118, and Rev. Rul. 74–516, 1974–2 C.B. 121, state that whether a reorganization distribution to which section 356 of the Code applies has the effect of a dividend must be determined by examining the facts and circumstances surrounding the distribution and looking to the principles for determining dividend equivalency developed under section 356(a)(2) and other provisions of the Code. See Ross v. United States, 173 F.Supp. 793 (Ct.Cl.1959), cert. denied, 361 U.S. 875 (1959). Rev. Rul. 74–516 indicates that in making a dividend equivalency determination under section 356(a)(2), it is proper to analogize to section 302 in appropriate cases. In Shimberg v. United States, 577 F.2d 283 (5th Cir.1978), cert. denied, 439 U.S. 1115 (1979), the courts indicated that in making a dividend equivalency determination under section 356(a)(2), an analogy to section 302 may be appropriate in cases involving single entity reorganizations.

In United States v. Davis, 397 U.S. 301 (1970), rehearing denied, 397 U.S. 1071 (1970), 1970–1 C.B. 62, the Supreme Court of the United States held that a redemption must result in a meaningful reduction of the shareholder's proportionate interest in the corporation in order not to be essentially equivalent to a dividend under section 302(b)(1) of the Code.

Rev. Rul. 75–502, 1975–2 C.B. 111, sets forth factors to be considered in determining whether a reduction in a shareholder's proportionate interest in a corporation is meaningful within the meaning of Davis. The factors considered are a shareholder's right to vote and exercise control, to participate in current earnings and accumulated surplus, and to share in net assets on liquidation. The reduction in the right to vote is of particular significance when a redemption causes a redeemed shareholder to lose the potential for controlling the redeeming corporation by acting in concert with only one other shareholder. See Rev.Rul. 76–364, 1976–2 C.B. 91.

The specific issue is whether, in determining dividend equivalency under section 356(a)(2) of the Code, it is proper to look solely at the change in A's proportionate interest in X that resulted from A's exchange of voting common stock for cash, or instead, whether consideration should be given to the total change in A's proportionate interest in X that resulted from the exchange of voting common stock for both cash and nonvoting preferred stock.

In Rev. Rul. 55–745, 1955–2 C.B. 223, the Internal Revenue Service announced that for purposes of section 302(b)(3) of the Code, it would follow the decision in Zenz v. Quinlivan, 213 F.2d 914 (6th Cir.1954), that a complete termination of shareholder interest may be achieved when a shareholder's entire stock interest in a corporation is disposed of partly through redemption and partly through sale. See also Rev. Rul. 75–447, 1975–2 C.B. 113, in which the Zenz rationale was applied to section 302(b)(2).

Since the exchange of voting common stock for cash and the exchange of voting common stock for nonvoting preferred stock constitute an integrated transaction, in this situation involving a single corporation, it is proper to apply the Zenz rationale so that both exchanges are taken into consideration in determining whether there has been a meaningful reduction of A's proportionate interest in X within the meaning of Davis. Compare Rev. Rul. 75–83, 1975–1 C.B. 112, which holds that a distribution in connection with a transaction qualifying under section 368(a)(1)(A) of the Code will be viewed as having been made by the acquired or transferor corporation and not by the acquiring or transferee corporation for purposes of making a dividend equivalency determination under section 356(a)(2).

If the exchange of voting common stock for preferred stock and cash in this situation had been tested under section 302 of the Code as a redemption, it would not have qualified under section 302(b)(2) or (3) because there was neither an adequate reduction in A's voting stock interest nor a complete termination of that interest. In determining whether this situation is analogous to a redemption meeting the requirements of section 302(b)(1), it is significant that A's interest in the voting common stock of X was reduced from 28.57 percent ($^{120}/_{420}$) to 23.08 percent ($^{90}/_{390}$) so that A went from a position of holding a number of shares of voting common stock that afforded A control of X if A acted in concert with only one other shareholder, to a position where such action was not possible. Moreover, it is significant that A no longer holds the largest voting stock interest in X. In addition, although A received dividend and liquidation rights from the 15 shares of nonvoting preferred stock, these were substantially less than the dividend and liquidation rights of the 30 shares of voting common stock A surrendered. Accordingly, the requirements of section 302(b)(1) would have been met if the transaction had been tested under section 302, and, therefore, the cash received by A did not have the effect of the distribution of a dividend within the meaning of section 356(a)(2).

HOLDING

When A received cash and nonvoting preferred stock of X in an integrated transaction in exchange for voting common stock of X in a recapitalization described in section 368(a)(1)(E) of the Code, the receipt of cash did not have the effect of the distribution of a dividend within the meaning of section 356(a)(2).

d. STOCK EXCHANGED FOR BONDS

Bazley v. Commissioner

Supreme Court of the United States, 1947.
331 U.S. 737, 67 S.Ct. 1489.

■ MR. JUSTICE FRANKFURTER delivered the opinion of the Court.

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In the *Bazley* case, No. 287, the Commissioner of Internal Revenue assessed an income tax deficiency against the taxpayer for the year 1939. Its validity depends on the legal significance of the recapitalization in that year of a family corporation in which the taxpayer and his wife owned all but one of the Company's one thousand shares. These had a par value of $100. Under the plan of reorganization the taxpayer, his wife, and the holder of the additional share were to turn in their old shares and receive in exchange for each old share five new shares of no par value, but of a stated value of $60, and new debenture bonds, having a total face value of $400,000, payable in ten years but callable at any time. Accordingly, the taxpayer received 3,990 shares of the new stock for the 798 shares of his old holding and debentures in the amount of $319,200. At the time of these transactions the earned surplus of the corporation was $855,783.82.

The Commissioner charged to the taxpayer as income the full value of the debentures. The Tax Court affirmed the Commissioner's determination, against the taxpayer's contention that as a "recapitalization" the transaction was a tax-free "reorganization" and that the debentures were "securities in a corporation a party to a reorganization," "exchanged solely for stock or securities in such corporation" "in pursuance of the plan of reorganization," and as such no gain is recognized for income tax purposes. Internal Revenue Code, §§ 112(g)(1)(E) [the predecessor of § 368(a)(1)(E)] and 112(b)(3). The Tax Court found that the recapitalization had "no legitimate corporate business purpose" and was therefore not a "reorganization" within the statute. The distribution of debentures, it concluded, was a disguised dividend, taxable as earned income under §§ [61(a) and 301]. 4 T.C. 897. The Circuit Court of Appeals for the Third Circuit, sitting en banc, affirmed, two judges dissenting. 155 F.2d 237.

Unless a transaction is a reorganization contemplated by § [368], any exchange of "stock or securities" in connection with such transaction, cannot be "in pursuance of the plan of reorganization." While § [368(a)] informs us that "reorganization" means, among other things, "a recapitalization," it does not inform us what "recapitalization" means. "Recapitalization" in connection with the income tax has been part of the revenue laws since 1921. 42 Stat. 227, 230, § 202(c)(2). Congress has never defined it and the Treasury Regulations shed only limited light. Treas. Reg. 103, § 19.112(g). One thing is certain. Congress did not incorporate some technical concept, whether that of accountants or of other specialists, into § [368(a)], assuming that there is agreement among specialists as to the meaning of recapitalization. And so, recapitalization as used in § [368(a)] must draw its meaning from its function in that section. It is one of the forms of reorganization which obtains the privileges afforded by § [368(a)]. Therefore, "recapitalization" must be construed with reference to the presuppositions and purpose of § [368(a)]. It was not the purpose of the reorganization provision to exempt from payment of a tax what as a practical matter is realized gain. Normally, a distribution by a corporation, whatever form it takes, is a definite and rather unambiguous event. It furnishes the proper occasion for the determination and taxation of gain. But there are circumstances where a formal distribution, directly or through exchange of securities, represents merely a new form of the previous participation in an enterprise, involving no change of substance in the rights and relations of the interested parties one to another or to the corporate assets. As to these, Congress has said that they are not to be deemed significant occasions for determining taxable gain.

These considerations underlie § [368(a)] and they should dominate the scope to be given to the various sections, all of which converge toward a common purpose. Application of the language of such a revenue provision is not an exercise in framing abstract definitions. In a series of cases this Court has withheld the benefits of the reorganization provision in situations which might have satisfied provisions of the section treated as inert language, because they were not reorganizations of the kind with which § [368], in its purpose and particulars, concerns itself. See Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462; Gregory v. Helvering, 293 U.S. 465; LeTulle v. Scofield, 308 U.S. 415.

Congress has not attempted a definition of what is recapitalization and we shall follow its example. The search for relevant meaning is often satisfied not by a futile attempt at abstract definition but by pricking a line through concrete applications. Meaning frequently is built up by assured recognition of what does not come within a concept the content of which is in controversy. Since a recapitalization within the scope of § [368] is an aspect of reorganization, nothing can be a recapitalization for this purpose unless it partakes of those characteristics of a reorganization which underlie the purpose of Congress in postponing the tax liability.

No doubt there was a recapitalization of the Bazley corporation in the sense that the symbols that represented its capital were changed, so that the fiscal basis of its operations would appear very differently on its books. But the form of a transaction as reflected by correct corporate accounting opens questions as to the proper application of a taxing statute; it does not close them. Corporate accounting may represent that correspondence between change in the form of capital structure and essential identity in fact which is of the essence of a transaction relieved from taxation as a reorganization. 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. The governing legal rule can hardly be stated more narrowly. To attempt to do so would only challenge astuteness in evading it. And so it is hard to escape the conclusion that whether in a particular case a paper recapitalization is no more than an admissible attempt to avoid the consequences of an outright distribution of earnings turns on details of corporate affairs, judgment on which must be left to the Tax Court. See Dobson v. Commissioner, 320 U.S. 489.

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.

The Commissioner, the Tax Court and the Circuit Court of Appeals agree that nothing was accomplished that would not have been accomplished by an outright debenture dividend. And since we find no misconception of law on the part of the Tax Court and the Circuit Court of Appeals, whatever may have been their choice of phrasing, their application of the law to the facts of this case must stand. A "reorganization" which is merely a vehicle, however elaborate or elegant, for conveying earnings from accumulations to the stockholders is not a reorganization under § [368]. This disposes of the case as a matter of law, since the facts as found by the Tax Court bring them within it. And even if this transaction were deemed a reorganization, the facts would equally sustain the imposition of the tax on the debentures under § [354 and 356]. Commissioner v. Estate of Bedford, 325 U.S. 283.

In the *Adams* case, the taxpayer owned all but a few of the 5914 shares of stock outstanding out of an authorized 6000, par value \$100. By a plan of reorganization, the authorized capital was reduced by half, to $295,700, divided into 5914 shares of no par value but having a stated value of $50 per share. The 5914 old shares were cancelled and the corporation issued in exchange therefor 5914 shares of the new no-par common stock and 6 per cent 20 year debenture bonds in the principal amount of $295,700. The exchange was made on the basis of one new share of stock and one $50 bond for each old share. The old capital account was debited in the sum of $591,400, a new no-par capital account was credited with $295,700, and the balance of $295,700 was credited to a "Debenture Payable" account. The corporation at this time had accumulated earnings available for distribution in a sum not less than $164,514.82, and this account was left unchanged. At the time of the exchange, the debentures had a value not less than $164,208.82.

The Commissioner determined an income tax deficiency by treating the debenture bonds as a distribution of the corporation's accumulated earnings. The Tax Court sustained the Commissioner's determination, 5 T.C. 351, and the Circuit Court of Appeals affirmed. 155 F.2d 246. The case is governed by our treatment of the *Bazley* case. The finding by the Tax Court that the reorganization had no purpose other than to achieve the distribution of the earnings, is unaffected by the bookkeeping detail of leaving the surplus account unaffected. * * *

Other claims raised have been considered but their rejection does not call for discussion.

Judgments affirmed.

■ MR. JUSTICE DOUGLAS and MR. JUSTICE BURTON dissent in both cases for the reasons stated in the joint dissent of JUDGES MARIS and GOODRICH in the court below. Bazley v. Commissioner, 3 Cir., 155 F.2d 237, 244.

NOTE

The *Bazley* case involved a pro rata exchange of common stock for common stock and bonds. For noncorporate shareholders, its significance diminishes whenever most dividends and long-term capital gains are taxed at the same preferential rate. Later cases have offered some hope for qualifying a stock-for-stock-and-bonds exchange under Section 368(a)(1)(E) if the exchange is not pro rata.[23] Several tax problems remain for an exchanging shareholder even if the transaction constitutes a Type E reorganization. The rules in Section 356(a)(2) and (d) will likely result in characterization of gain as a dividend to the extent of the fair market value of bonds received and the corporation's earnings and profits. Even if the shareholder does not realize a gain on the exchange, the regulations suggest that a stock-for-stock-and-bonds recapitalization may be separately analyzed

23 See Seide v. Commissioner, 18 T.C. 502 (1952).

with the receipt of bonds being treated simply as a Section 301 distribution.[24] Stock-for-bonds exchanges also may give rise to original issue discount.[25]

PROBLEMS

1. Recap Corporation has \$100,000 of accumulated earnings and profits and makes a pro rata distribution to each of its ten shareholders of new common voting stock worth \$20,000 and new callable preferred stock worth \$10,000 in exchange for each shareholder's old common voting stock worth \$30,000. Assume that the new Recap preferred stock is not nonqualified preferred stock.

(a) What result to the shareholders on the exchange?

(b) What result when Recap calls the preferred stock?

(c) What result if a shareholder sells his preferred stock?

(d) What result if Recap had a deficit in its earnings and profits account at the time of the distribution but it foresaw future potential profits?

2. The ten equal shareholders of Shuffle Corporation each have a \$10,000 basis in their Shuffle common voting stock which has a \$50,000 fair market value. Shuffle has \$250,000 of earnings and profits. What result if the ten shareholders each transfer all their common voting stock in return for common voting stock worth \$25,000 and bonds worth \$25,000.

3. Leverage Corporation has 8% interest bonds outstanding with a face amount of \$1,000,000 and a fair market value of \$800,000. It redeems these bonds and issues new 12% interest bonds with a fair market value and a face amount of \$800,000.

(a) Will the transaction qualify as a reorganization?

(b) What result in (a), above, if 12% interest bearing bonds with a face amount of \$800,000 are redeemed for 8% interest bonds with a face amount of \$1,000,000 and both sets of bonds have the same fair market value of \$800,000?

4. Does an exchange of bonds for stock qualify as an "E" reorganization? Why would a corporation engage in such an exchange?

B. NONDIVISIVE TYPE D REORGANIZATIONS

Code: §§ 368(a)(1)(D), (a)(2)(H); 354(b); 381(a)(2). Skim §§ 331; 336; 354(a); 356(a); 358; 361; 1032.

Regulations: § 1.368–2(*l*)(1), (2), (3) Example 1.

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[24] Reg. § 1.301–1(*l*); see also Prop. Reg. § 1.301–1(j), which is identical to Reg. § 1.301–1(*l*). Reg. § 1.354–1(d) Example (3) provides that if a shareholder surrenders all of his stock solely for bonds, the tax consequences of the exchange are determined under Section 302 whether or not the transaction is a recapitalization under Section 368(a)(1)(E).

[25] See I.R.C. §§ 163(e), 1272–1275. See generally Bittker & Eustice, supra note 15, ¶ 12.27[5][d].

Type D reorganizations come in two basic forms. The "divisive D" involves a transfer by one corporation of some of its assets to a newly formed controlled subsidiary followed by a distribution of the stock of the subsidiary in a corporate division that qualifies under Section 355. This transaction has been examined in Chapter 10 along with the other aspects of corporate divisions. The second form of Type D reorganization is "nondivisive." It involves the transfer by one corporation of all or part of its assets to a corporation controlled immediately after the transfer by the transferor or its shareholders (or any combination) provided that the stock or securities of the controlled corporation are distributed in a transaction that qualifies under Section 354. For this purpose, "control" means ownership of at least 50 percent of the voting power or value of the transferee corporation.[26] Section 354(b) requires the transferor corporation to transfer "substantially all" of its assets to the controlled corporation and the stock, securities and other properties that it receives must be distributed, along with its other properties, to its shareholders pursuant to a plan of reorganization.

The "nondivisive" D reorganization has always been an odd character in the reorganization alphabet. As illustrated by the *Smothers* case, which follows, it historically was invoked by the Service as a weapon to attack the liquidation-reincorporation transaction, a technique utilized by taxpayers in the days when the *General Utilities* doctrine and a capital gains preference worked in tandem to encourage bailouts of corporate earnings at capital gains rates without any corporate-level tax on distributions in liquidation or sales of assets pursuant to a liquidation plan. To appreciate why, consider a gambit that might have been used in the "good old days" by Profit Corp., a family company with $800,000 of accumulated earnings and profits and a $2 million net worth, consisting of $1.5 million of operating assets and $500,000 of investment securities. Assume the shareholders wish to extract the securities from corporate solution without the sting of a dividend (then taxable at higher ordinary income rates) but to otherwise continue operating their business in a new corporation with fresh tax attributes (e.g., no earnings and profits) and no immediate exposure to the accumulated earnings tax.

One classic plan to accomplish these objectives was for the Profit Corp. shareholders to liquidate the corporation, retain the investment securities and, after an appropriate interval, reincorporate the operating assets under Section 351. Alternatively, Profit Corp. might transfer its operating assets to a new subsidiary in exchange for its stock and then liquidate, distributing the new stock and the investment securities to the shareholders. Whatever the format, the basic objective was to achieve what were then the tax benefits of a liquidation: capital gains at the shareholder level, nonrecognition at the corporate level, a step-up in basis of the assets in the reincorporated enterprise, and a fresh start for the earnings and profits account. The Service countered by arguing, with

26 I.R.C. § 368(a)(2)(H)(i).

limited success, that the transaction was a reorganization coupled with the receipt of boot that should be taxed as a dividend.[27]

A liquidation-reincorporation rarely makes sense under current law if its form is respected for tax purposes. Liquidating sales of assets for cash are fully taxable and distributions of appreciated property in complete liquidation will trigger corporate-level gain under Section 336 and significantly raise the tax cost of the strategy. Indeed, if the classic liquidation-reincorporation were carried out, it is now *taxpayers* who may prefer to characterize the transactions as a reorganization. Although they would recognize dividend income to the extent of the boot received, the good news is that noncorporate shareholders likely will qualify for the preferential qualified dividend rate, and the transferor corporation would avoid recognizing gain on its assets under Section 361 because the asset bases would carry over to the transferee. The liquidation-reincorporation strategy may retain its vitality, however, in a few limited situations, such as when the corporation has losses to shelter the gains resulting from the distribution of appreciated assets, where the appreciation in the corporation's assets is negligible, or where the corporation has losses that it is trying to accelerate without removing the loss assets from corporate solution.

Smothers v. United States

United States Court of Appeals, Fifth Circuit, 1981.
642 F.2d 894.

■ WISDOM, CIRCUIT JUDGE:

J.E. and Doris Smothers filed this civil action to obtain a refund of federal income taxes they paid under protest. This dispute arises from the dissolution of one of their wholly-owned business corporations. The taxpayers contend that the assets distributed to them by that corporation should be taxed at the capital gain rate applicable to liquidating distributions. The Internal Revenue Service (IRS) counters by characterizing the dissolution as part of a reorganization, thereby rendering the taxpayers' receipt of the distributed assets taxable at ordinary income rates. The district court viewed the transaction as a reorganization and ruled for the IRS. We affirm.

I.

[Mr. and Mrs. Smothers owned all the outstanding stock of Texas Industrial Laundries of San Antonio, Inc. ("TIL"), a company engaged in the business of renting industrial uniforms and cleaning equipment. They also were the sole shareholders of Industrial Uniform Services, Inc. ("IUS"), which they formed to oppose a particular competitor in the San Antonio industrial laundry market. IUS, which owned no equipment, contracted with an unrelated company to launder uniforms it rented to

[27] See, e.g., Davant v. Commissioner, 366 F.2d 874 (5th Cir.1966), cert. denied, 386 U.S. 1022, 87 S.Ct. 1370 (1967).

customers. Mr. Smothers managed both companies but only drew a salary from TIL.

IUS succeeded in weakening the business of competing firms, ultimately enabling TIL to purchase its main competitor. Four years later, taxpayers decided that IUS, having served its purpose, should sell all its non-liquid assets and dissolve. IUS adopted a plan of complete liquidation and sold its $23,000 of operating assets, which represented about 15 percent of the company's net value, to TIL for cash. Under the law in effect at that time, IUS recognized no gain because the sale of its assets was made pursuant to a plan of complete liquidation. IUS then distributed its remaining $149,000 of net assets to the taxpayers and dissolved under state law. The distributed assets consisted primarily of cash and receivables.

On their personal income tax returns, taxpayers treated the IUS transaction in accordance with its form (i.e., as a complete liquidation) and reported a $148,000 long-term capital gain, representing the difference between the $149,000 of assets they received in the liquidating distribution and the $1,000 basis in their IUS stock. On audit, the IRS characterized the sale by IUS of its operating assets to TIL as a Type D reorganization and treated the IUS distribution as equivalent to a dividend under Section 356(a)(2). Dividends then were taxed as ordinary income rather than at the lower long-term capital gains rates.

After paying the $71,840.84 deficiency asserted by the IRS, the taxpayers filed a refund suit in federal district court. The court upheld the IRS's position, finding that the transaction constituted a Type D reorganization. Ed.]

II.

Subchapter C of the Internal Revenue Code broadly contemplates that the retained earnings of a continuing business carried on in corporate form can be placed in the hands of its shareholders only after they pay a tax on those earnings at ordinary income rates. That general rule is, of course, primarily a consequence of § 301, which taxes dividend distributions as ordinary income. The Code provides for capital gain treatment of corporate distributions in a few limited circumstances, but only when there is either a significant change in relative ownership of the corporation, as in certain redemption transactions, or when the shareholders no longer conduct the business themselves in corporate form, as in true liquidation transactions. The history of Subchapter C in large part has been the story of how Congress, the courts, and the IRS have been called upon to foil attempts by taxpayers to abuse these exceptional provisions. Ingenious taxpayers have repeatedly devised transactions which formally come within these provisions, yet which have the effect of permitting shareholders to withdraw profits at capital gain rates while carrying on a continuing business enterprise in corporate form without substantial change in ownership. This is just such a case.

The transaction in issue here is of the genus known as liquidation-reincorporation, or reincorporation. The common denominator of such transactions is their use of the liquidation provisions of the Code, which permit liquidating distributions to be received at capital gain rates, as a device through which the dividend provisions may be circumvented. Reincorporations come in two basic patterns. In one, the corporation is dissolved and its assets are distributed to its shareholders in liquidation. The shareholders then promptly reincorporate all the assets necessary to the operation of the business, while retaining accumulated cash or other surplus assets. The transaction in this case is of the alternate form. In it, the corporation transfers the assets necessary to its business to another corporation owned by the same shareholders in exchange for securities or, as here, for cash, and then liquidates. If the minimal technical requirements of § [former § 337] are met, as they indisputably were here, the exchange at the corporate level will not result in the recognition of gain by the transferor corporation. [Current law would require recognition of gain on these facts. Ed.] If formal compliance with the liquidation provisions were the only necessity, both patterns would enable shareholders to withdraw profits from a continuing corporate business enterprise at capital gain rates by paper-shuffling. Unchecked, these reincorporation techniques would eviscerate the dividend provisions of the Code.

That result can be avoided by recharacterizing such transactions, in accordance with their true nature, as reorganizations. A reorganization is, in essence, a transaction between corporations that results merely in "a continuance of the proprietary interests in the continuing enterprise under modified corporate form"—a phrase that precisely describes the effect of a reincorporation. Lewis v. Commissioner, 1 Cir.1949, 176 F.2d 646, 648. Congress specifically recognized that the throw-off of surplus assets to shareholders in the course of a reorganization can be equivalent to a dividend, and if so, should be taxed as such. §§ 356(a)(1)–(2). The reincorporation transactions described above result in a dividend payment to the shareholders in every meaningful financial sense. The assets retained by the shareholders therefore should be taxed as dividends as long as the transaction can be fitted within the technical requirements of one of the six classes of reorganizations recognized by § 368(a)(1).

In general, reincorporation transactions are most easily assimilated into § 368(a)(1)(D) ("D reorganization"), as the IRS attempted to do in this case. A transaction qualifies as a D reorganization only if it meets six statutory requirements:

(1) There must be a transfer by a corporation (§ 368(a)(1)(D));

(2) of substantially all of its assets (§ 354(b)(1)(A));

(3) to a corporation controlled by the shareholders of the transferor corporation, or by the transferor corporation itself (§ 368(a)(1)(D));

(4) in exchange for stock or securities of the transferee corporation (§ 354(a)(1));

(5) followed by a distribution of the stock or securities of the transferee corporation to the transferor's shareholders (§ 354(b)(1)(B));

(6) pursuant to a plan of reorganization (§ 368(a)(1)(D)).

On this appeal, the taxpayers concede that the transaction in issue meets every technical prerequisite for characterization as a D reorganization, except for one. They argue that since the assets sold by IUS to TIL amounted to only 15% of IUS's net worth, TIL did not acquire "substantially all of the assets" of IUS within the meaning of § 354(b)(1)(A).

We hold to the contrary. The words "substantially all assets" are not self-defining. What proportion of a corporation's assets is "substantially all" in this context, and less obviously, what "assets" are to be counted in making this determination, cannot be answered without reference to the structure of Subchapter C. To maintain the integrity of the dividend provisions of the Code, "substantially all assets" in this context must be interpreted as an inartistic way of expressing the concept of "transfer of a continuing business". As this Court implied in Reef Corp. v. Commissioner, 5 Cir.1966, 368 F.2d 125, 132, cert. denied, 1967, 386 U.S. 1018, 87 S.Ct. 1371, 18 L.Ed.2d 454, it is in a sense simply a limited codification of the general nonstatutory "continuity of business enterprise" requirement applicable to all reorganizations.

This interpretation finds support in the history of § 368(a)(1)(D) and § 354(b)(1)(A). The Internal Revenue Code of 1939 had no provision equivalent to the "substantially all assets" requirement, and courts almost uniformly approved attempts by the IRS to treat reincorporation transactions as reorganizations within the predecessor of § 368(a)(1)(D) in the 1939 Code. The "substantially all assets" requirement of § 354(b)(1)(A) and the amendment of § 368(a)(1)(D) incorporating that requirement were added during the 1954 recodification as part of a package of amendments aimed at plugging a different loophole—the bail-out of corporate earnings and profits at capital gains rates through divisive reorganizations. There is no indication that Congress wished to relax the application of the reorganization provisions to reincorporation transactions. Indeed, the committee reports indicate the contrary. The Senate report accompanying the bill that contained the "substantially all assets" requirement of § 354(b)(1)(A) and the parallel amendment to § 368(a)(1)(D) stated that the purpose of those changes was only "to insure that the tax consequences of the distribution of stocks or securities to shareholders or security holders in connection with divisive reorganizations will be governed by the requirements of section 355". The report expressly noted that except with respect to divisive reorganizations, the reorganization provisions "are the same as under existing law and are stated in substantially the same form". Even more significantly, the original House version of the 1954 Code contained a provision specifically dealing with reincorporation transactions. That provision was dropped in conference because the conferees felt that such transactions "can appropriately be disposed of by judicial decision or by regulation within the framework of the other provisions of the bill". As the court said in Pridemark, Inc. v. Commissioner, 4 Cir.1965, 345 F.2d 35, 40, this response shows that "the committee was aware of the problem and thought the present statutory scheme adequate to deal with it". By implication, this passage approved the IRS's use of the predecessor of § 368(a)(1)(D) to meet the problem, and shows that the "substantially all assets" amendment was not thought to restrict its use.

Courts have almost unanimously so interpreted the "substantially all assets" language. Moreover, they have also interpreted the other technical conditions for a D reorganization in ways that accomplish the congressional intent to reach reincorporation transactions. For example, the literal language of § 368(a)(1)(D) and §§ 354(a), 354(b)(1)(B) requires that the transferee corporation "exchange" some of its "stock or securities" for the assets of the transferor, and that those items be "distributed" to the shareholders of the transferor, before a D reorganization can be found. Yet both of those requirements have uniformly been ignored as "meaningless gestures" in the reincorporation context, in which the same shareholders own all the stock of both corporations.[14] Smothers does not even challenge the applicability of that principle here.

Properly interpreted, therefore, the assets looked to when making the "substantially all assets" determination should be all the assets, and only the assets, necessary to operate the corporate business—whether or not those assets would appear on a corporate balance sheet constructed according to generally accepted accounting principles. Two errors in particular should be avoided. Inclusion of assets unnecessary to the operation of the business in the "substantially all assets" assessment would open the way for the shareholders of any enterprise to turn dividends into capital gain at will. For example, if we assume that "substantially all" means greater than 90%, then a corporation need only cease declaring dividends and accumulate surplus liquid assets until their value exceeds 10% of the total value of all corporate assets. The shareholders could then transfer the assets actively used in the business to a second corporation owned by them and liquidate the old corporation. Such a liquidating distribution would be a dividend in any meaningful sense, but an interpretation of "substantially all assets" that took surplus assets into account would permit the shareholders to treat it as capital gain. Indeed, such an interpretation would perversely treat a merely nominal distribution of retained earnings as a dividend, but would permit substantial distributions to be made at capital gain rates. Courts

[14] The "meaningless gesture" language is from James Armour, Inc., 1964, 43 T.C. 295, 307. * * *

therefore have invariably ignored all surplus assets and have focused on the operating assets of the business—the tangible assets actively used in the business—when making the "substantially all assets" assessment.[15]

Second, exclusion of assets not shown on a balance sheet constructed according to generally accepted accounting principles from the "substantially all assets" assessment would offer an unjustified windfall to the owners of service businesses conducted in corporate form. The most important assets of such a business may be its reputation and the availability of skilled management and trained employees, none of which show up on a standard balance sheet. Other courts have correctly recognized that in appropriate cases those intangible assets alone may constitute substantially all of the corporate assets. Otherwise, for example, a sole legal practitioner who owns nothing but a desk and chair could incorporate himself, accumulate earnings, and then set up a new corporation and liquidate the old at capital gain rates—as long as he is careful to buy a new desk and chair for the new corporation, rather than transferring the old.

When these principles are applied to this case, it is plain that "substantially all of the assets" of IUS were transferred to TIL, and that the transaction as a whole constituted a reorganization. TIL and IUS were both managed and wholly owned by Smothers. By the nature of its business, IUS was wholly a service enterprise; indeed, the parties stipulated that none of the tangible assets of IUS were necessary to the operation of its business. The extent to which those tangible assets were transferred to TIL is therefore entirely irrelevant. IUS's most important assets—its reputation, sales staff, and the managerial services of Smothers—were all transferred to TIL. TIL rehired all three of IUS's employees immediately after IUS's liquidation, and continued to serve IUS's old customers. The same business enterprise was conducted by the same people under the same ownership, and the only assets removed from corporate solution were accumulated liquid assets unnecessary to the operation of the business. To treat this transaction as other than a reorganization would deny economic reality; to permit Smothers to extract the retained earnings of IUS at capital gain rates would make a mockery of the dividend provisions of the Internal Revenue Code.

We do not perceive ordinary income treatment here to be particularly harsh, or a "tax trap for the unwary". It places the Smothers' only in the position they would have been in if they had extracted the retained earnings of IUS as the Code contemplates they should have—by periodically declaring dividends.

Affirmed.

■ GARZA, CIRCUIT JUDGE, dissenting:

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[15] Note that liquid assets are "necessary" to the extent they represent working capital. See Swanson v. United States, 9th Cir.1973, 479 F.2d 539, 545–46; Ross Michael Simon Trust v. United States, Ct.Cl. 1968, 402 F.2d 272, 280.

After carefully reading the majority's opinion, I find that I must respectfully dissent. Unlike my Brothers, who apparently feel that it is their duty to "plug loopholes", I would remain content in applying the tax law as it reads leaving the United States Congress to deal with the consequences of the tax law as it has been drafted. The only issue before this Court on appeal is whether or not IUS transferred "substantially all of its assets" to TIL. Instead of dealing with this straightforward question, the majority has made a case of evil against liquidation-reincorporation abuses and, in an attempt to remedy every such perceived abuse, they have relieved the Congress of its burden to change the law heretofore requiring that "substantially all" of a corporation's assets be transferred to now read that "only those assets necessary to operate the corporate business" be transferred in order to meet the "D reorganization" requirements. Essentially, the majority has changed the definition of "substantially all assets" to mean only "necessary operating assets." I believe if Congress had meant "necessary operating assets" it would have said so instead of specifically requiring that "substantially all" of the assets be transferred. In my mind "substantially all" plainly means all of the assets except for an insubstantial amount. Under such a definition, the sale of 15% of IUS's assets to TIL could hardly be defined as "substantially all" of IUS's assets.

However, even after having redefined "substantially all" to mean "necessary operating assets", the IUS liquidation still falls short of the "D reorganization" requirements because the stipulated facts are that absolutely none of the assets sold from IUS to TIL were necessary operating assets for either corporation. Faced with an absence of a proper factual setting, the majority goes on to define necessary operating assets as including a corporation's intangible assets. Now while a sale of intangible assets might be an appropriate consideration in determining whether or not "substantially all" assets of a corporation have been transferred, such a consideration simply has no bearing in this case. All of the assets transferred to TIL were depreciated tangible objects sold at book value after which IUS completely ceased all business operations. There simply was no other transfer of IUS's intangible assets as a continuing business.

* * *

* * * Although the Internal Revenue Service has never questioned the bona fides of IUS's liquidation, the majority has gone beyond the stipulated facts by characterizing the liquidation as a tax avoidance scam. I simply cannot agree. After starting from scratch, Mr. Smothers worked for over a dozen years refraining from drawing salary in order that IUS could pay its taxes, employees and other operating expenses and in order for IUS to become a successful self-sustaining business enterprise. Mr. Smothers was successful but, now that he no longer could devote his service to IUS, his years of labor are now labeled by the majority as a mere "paper shuffle." I do not share the majority's attitude.

[The dissent then reviewed the "bottom-line facts" to support its view that the form of the transaction should be respected. Ed.]

* * *

It seems to me that in its attempt to "plug" a perceived "loophole," the majority is giving this Court's imprimatur to a variation of the same so-called "mockery" of the tax laws sought to be prevented by its opinion.

For these reasons, I respectfully dissent.

NOTE

All-Cash Reorganizations. The IRS has been rethinking its approach to nondivisive Type D reorganizations. It recently has focused its attention on the "all-cash" D reorganization, in which one corporation purchases substantially all the assets of another corporation solely for cash (or debt) and without issuing any stock. All-cash D reorganizations are used in a variety of situations involving commonly controlled corporations that wish to rearrange and simplify their corporate structure for valid business reasons. They also occur in the international setting, or between corporations filing a consolidated return, where the transaction raises additional issues that are well beyond the scope of our coverage here. From the taxpayer's perspective, the consequences of having this type of asset acquisition characterized as a reorganization rather than a taxable sale can be either good or bad depending on the context and planning agenda.

At first glance, the concept of a tax-free reorganization where the target corporation receives entirely cash consideration in exchange for assets of equal value is counter-intuitive. But the IRS has taken the position that reorganization treatment is appropriate in light of the history of nondivisive Type D reorganizations, interpretations by the courts, and the need for a neutral rule to provide certainty in planning. This result is consistent with the underlying policy of the reorganization scheme, which provides for nonrecognition of gain or loss for transactions that represent a mere change in the form of an investment, which in this case are the assets that remain in corporate solution. This is particularly appropriate when both parties to the transaction are controlled by the same shareholders.

The IRS position evolved from a much discussed private ruling[28] involving a transaction where a corporation owned equally by two unrelated corporate shareholders (A and B) sold all its assets for installment notes in an amount equal to the fair market value of the assets to a new corporation (Newco) owned 90 percent by B and 10 percent by a corporation unrelated to A and B. In holding that Newco took a cost basis in the acquired assets (which is what it wanted for purposes of determining Section 197 amortization deductions on acquired goodwill), the ruling inferred that the transaction was *not* a D reorganization despite the presence of substantial (but not identical) overlapping ownership of the two corporations. If Newco had issued some stock as consideration for the assets, the literal statutory requirements for a D reorganization would have been satisfied, however, and

[28] P.L.R. 20551018 (Dec. 23, 2005).

Newco would have been required to take a lower transferred basis in the acquired assets. By simply not issuing any stock, the taxpayer avoided this undesired result, leading to the possibility that taxpayers could elect the outcome they desired depending on whether or not any stock was issued.

The ruling created a commotion in the mergers and acquisitions tax bar over the issue of whether the issuance of stock is an essential prerequisite for a nondivisive D reorganization. Some commentators argued that a transaction could qualify as a D reorganization even though Newco issued no stock or securities because, in similar cases of overlapping ownership, the Service and the courts had held that issuance of stock was unnecessary under what is known as the "meaningless gesture" doctrine.[29] Others contended that the statutory language could not permit such a result if no stock or securities were issued.[30]

The regulations now address this esoteric issue. They provide that an acquisition can qualify as a Type D reorganization even where no stock of the transferee corporation is issued and distributed in the transaction when the same person or persons own, directly and indirectly, all of the stock of the transferor and transferee corporations in "identical proportions."[31] For this purpose, an individual and all members of his family having a relationship described in Section 318(a)(1) are treated as one individual.[32] In addition, the distribution requirement under Sections 368(a)(1)(D) and 354(b)(1)(B) is treated as satisfied in the absence of any issuance of stock or securities where there is a de minimis variation in shareholder identity or proportionality of ownership in the transferor and transferee corporations.[33] In these all-cash D reorganizations, the transferee is treated as having issued a nominal share of stock in addition to the actual consideration exchanged, and the transferor corporation is deemed to have distributed that share to its shareholders and, as appropriate, to have further transferred it to the extent necessary to reflect the actual ownership of the two corporations.[34]

The regulations are taxpayer-friendly insofar as they facilitate legitimate restructurings involving asset transfers within a commonly controlled corporate group. Reorganization treatment ensures that a transfer of assets between commonly controlled corporations is not a taxable event whether or not actual stock is issued by the acquiring corporation but, as a trade-off, the transferee takes a transferred basis in the assets it

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[29] See James Armour, Inc. v. Commissioner, 43 T.C. 295 (1964); Wilson v. Commissioner, 46 T.C. 334 (1966); Rev. Rul. 70–240, 1970–1 C.B. 81.

[30] See, e.g., "Attorneys Question Ruling That Transaction Wasn't a D Reorganization," 111 Tax Notes 241 (April 10, 2006); Schler, Letter to the Editor, "More on the 'All Cash D' Reorganization," 111 Tax Notes 383 (April 17, 2006). See also Ginsburg, Levin & Rocap, Mergers, Acquisitions, and Buyouts ¶ 406.1.1 (April 2018).

[31] Reg. § 1.368–2(*l*)(2)(i). The regulations thus would not change the result in P.L.R. 20551018, supra note 28, because ownership in the two corporations was not identical.

[32] Reg. § 1.368–2(*l*)(2)(ii).

[33] Reg. § 1.368–2(*l*)(3)(iii).

[34] Reg. § 1.368–2(*l*)(2)(i). The regulations also clarify the tax consequences if no consideration is received for the target's assets, or if the value of the consideration received is less than the fair market value of the target's assets. Id. For the basis consequences to the target corporation's shareholders, see Reg. § 1.358–2(a)(2)(iii).

acquires. But what about the transferor's shareholders? Recall that, after selling its assets, the transferor corporation will liquidate and distribute the cash consideration and the nominal share of stock it received in the transaction to its shareholders. Does it matter if the shareholders are individuals or corporations? Problem 2, below, provides an opportunity to consider these shareholder-level consequences, which are not directly addressed in the all-cash D reorganization regulations.

Internal Restructuring Transactions. The IRS has issued two revenue rulings that apply Section 368(a)(1)(D) to provide flexibility and certainty with respect to certain commonly used internal restructuring transactions.

Revenue Ruling 2015–9[35] involved a transaction known as a "drop and sideways merger." In the ruling, P, a domestic corporation, owned all the stock of two foreign subsidiaries, S-1 and S-2. S-1 directly operated a business while S-2 was a holding company that owned all the stock of three foreign operating companies, X, Y and Z. All of P's subsidiaries were incorporated in the same country. As part of a prearranged plan with a valid business purpose, P's agenda was to combine the operating companies (S-1, X, Y, and Z) into N, a new foreign subsidiary of S-2. To achieve that result, P first transferred all the stock of S-1 to S-2 in exchange for additional shares of S-2 stock. Immediately after that transfer, S-1, X, Y, and Z then liquidated, distributing all the N stock to S-2. The IRS ruled that the first step of the transaction (P's transfer of S-1 to S-2) was a nontaxable Section 351 exchange. The subsequent transfers and liquidations of S-1, X, Y, and Z were treated as tax-free reorganizations under Section 368(a)(1)(D).

The restructuring in Revenue Ruling 2015–10[36] is known as a "triple drop and check." A domestic corporation, P, transferred its interest in a limited liability company that had elected to be taxed as a corporation, to a subsidiary, S-1, in exchange for S-1 stock. S-1 then transferred the LLC interest to another subsidiary, S-2, for S-2 stock, and S-2 next transferred the LLC interest (this was the third "drop") to yet another subsidiary, S-3, for S-3 stock. No later than one day after S-2's transfer, the LLC "checked the box," electing to be a disregarded entity for tax purposes. The IRS ruled that the transfers by P and S-1 were nontaxable Section 351 exchanges. The election by the LLC to be a disregarded entity and the transfer by S-2, however, were characterized as an acquisitive Type D reorganization followed by a tax-free Section 332 liquidation of a subsidiary.

The outcome of these rulings is hardly surprising because no assets were removed from corporate solution in either transaction and control of P was unchanged. The reasoning reflects the IRS's policy to respect the form of a Section 351 exchange even it if is followed by subsequent transfers of the contributed property as part of a prearranged integrated plan. But the rulings also confirm that the IRS will apply the step transaction doctrine to deny Section 351 nonrecognition or otherwise recast the separate steps of an integrated transaction if "a different treatment is warranted to reflect the

[35] 2015–21 I.R.B. 972.

[36] 2015–21 I.R.B. 973.

substance of the transaction as a whole."[37] Presumably, this means that the IRS does not want to be precluded from applying the step transaction doctrine when necessary to avoid what it believes to be an improper tax outcome, but without specific examples it is difficult to know exactly when this different approach would be used.

PROBLEMS

1. Brother and Sister Corporation are owned by the same shareholders in the same proportionate amounts. The shareholders have a $200,000 basis in their Brother stock and Brother Corporation has operating assets with a value of $500,000 and basis of $150,000 as well as $200,000 of cash and $250,000 of earnings and profits. Sister Corporation, which has $300,000 of earnings and profits, purchases the operating assets for $500,000 cash and Brother Corporation immediately liquidates.

(a) What are the consequences of these transactions to the shareholders and to both corporations?

(b) Will the arguments of the taxpayers and the Service concerning the transactions differ from those advanced in the Smothers case?

(c) Is there any simpler way for the taxpayers to achieve their objectives?

2. A, an individual, owns all the stock of T, Inc. and B, A's son, owns all the stock of S, Inc. A has a $200,000 adjusted basis in his T stock. T sells all its assets, in which it has a $100,000 aggregate adjusted basis, to S for $1,000,000 cash and then liquidates, distributing the cash to A. What are the tax consequences of the transaction to all relevant parties?

C. TYPE F: MERE CHANGE IN IDENTITY, FORM, OR PLACE OF ORGANIZATION

Code: §§ 368(a)(1)(F); 381(b). Skim §§ 331; 351; 354(a); 356(a); 358; 361; 1032.

A Type F reorganization is defined by the Code as "a mere change in identity, form, or place of organization of one corporation, however effected." An example would be a merger of a closely held New York corporation into a newly formed Delaware corporation with the same shareholders in order to take advantage of Delaware corporate law in anticipation of a public offering of the company's stock.[38] Nearly eighty years ago a noted commentator stated that the Type F reorganization "is so little relied upon by taxpayers that this part of the statute has indeed perished through lack of use."[39] It has survived calls for repeal, however,

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[37] Id.

[38] See, e.g., Rev. Rul. 96–29, 1996–1 C.B. 50.

[39] Paul, Studies in Federal Taxation 82 (3d Ed. 1940). But see Pugh, "The F Reorganization: Reveille for a Sleeping Giant?" 24 Tax L. Rev. 437 (1969).

and experienced a brief renaissance before resuming its historical role as a relatively dead letter in the tax-free reorganization alphabet.[40]

The resurgence of interest in the Type F reorganization was the result of attempts by taxpayers to carry back the post-acquisition losses of corporations which previously had been operated as an affiliated corporate group to pre-acquisition years of an acquired corporation. Since Section 381(b) only permits such a carryback of net operating losses in an F reorganization, the shareholders argued that the fusion of affiliated corporations qualified as an F reorganization. Although the language of the applicable statute implied that an F reorganization was limited to structural changes in a single corporation, the Commissioner, in his attempt to combat the liquidation-reincorporation bailout device, bolstered the argument that the F reorganization also applied to the merger of two or more active corporations. In the *Davant* case, the Commissioner asserted and the Court accepted the argument that an F reorganization could involve two operating corporations.[41] The Commissioner's argument, together with a ruling in which the Service acknowledged that a reorganization meeting the definition of an F reorganization and some other type of reorganization would be treated as an F reorganization for purposes of Section 381(b),[42] opened the floodgates. The only remaining question was how far shareholders could push combinations of operating corporations into the F reorganization category.[43] In the 1970s, the Service conceded that a combination of active corporations under common control could qualify as an F reorganization if there was a complete continuity of shareholder and proprietary interests.[44] But Congress later slammed the door shut by limiting F reorganization status to a single operating corporation through the addition of the words "of one corporation" to Section 368(a)(1)(F). The Type F reorganization thus once again was relegated to its prior role as a minor provision governing reincorporations in another state and other merely formal changes. To finally put a capstone on this historical interlude on F reorganizations, the broad disallowance in Section 172 of carrybacks of net operating losses after the Tax Cuts and

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[40] F reorganization issues occasionally resurface, usually in specialized situations. See, e.g., Rev. Rul. 2003–19, 2003–1 C.B. 468 (involving the conversion of a mutual insurance company to a stock insurance company). See also Prop. Reg. § 1.368–2(m), which specifies the F reorganization qualification requirements and provides that continuity of business enterprise and continuity of proprietary interest are not required for a transaction to qualify as an F reorganization.

[41] Davant v. Commissioner, 366 F.2d 874 (5th Cir.1966), cert. denied 386 U.S. 1022, 87 S.Ct. 1370 (1967). Actually the Commissioner made the argument at the trial court level, 43 T.C. 540 (1965), and it was adopted by the appellate court in its opinion.

[42] Rev. Rul. 57–276, 1957–1 C.B. 126.

[43] Compare Movielab, Inc. v. United States, 204 Ct.Cl. 6, 494 F.2d 693 (1974), and Stauffer's Estate v. Commissioner, 403 F.2d 611 (9th Cir.1968), with Berger Machine Products, Inc. v. Commissioner, 68 T.C. 358 (1977), and Romy Hammes, Inc. v. Commissioner, 68 T.C. 900 (1977).

[44] See Rev. Rul. 75–561, 1975–2 C.B. 129.

Jobs Act now generally forecloses carrybacks even in qualifying F reorganizations of a single corporation.

To limit the F reorganization to its narrow purpose and prevent acquisitive and divisive transactions from qualifying, the regulations impose six requirements for a transaction to be a "mere change in identity, form, or place of organization" within the meaning of Section 368(a)(1)(F). In applying these tests, the regulations use the term "potential F reorganization"[45] and refer to the parties involved in the transaction as the "transferor corporation" ("T") and the "resulting corporation ("R").

The six requirements are:

(1) Immediately after the transaction, all the stock of R must have been distributed (or deemed to have been distributed) in exchange for stock of T. This requirement is not violated if a de minimis amount of stock is issued by R to facilitate its organization.[46]

(2) The same persons generally must own T immediately before the transaction and R immediately after the transaction in identical proportions.[47]

(3) R generally may not hold any property or have any tax attributes immediately before the transaction.[48]

(4) T must completely liquidate for federal tax purposes.[49]

(5) Immediately after the transaction, R must be the only corporation holding the property previously held by T.[50]

(6) Immediately after the transaction, R may not hold property acquired from a corporation other than T.[51]

Based on these requirements, the regulations logically provide that the continuity of interest and continuity of business enterprise tests do not have to be met for a transaction to qualify as an F reorganization.[52]

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45 Reg. § 1.368–2(m)(1). For simplicity, the discussion in the text refers to a "potential F reorganization" as the "transaction."

46 Reg. § 1.368–2(m)(1)(i).

47 Reg. § 1.368–2(m)(1)(ii).

48 Reg. § 1.368–2(m)(1)(iii).

49 Reg. § 1.368–2(m)(1)(iv). The complete liquidation requirement is not violated, however, if R stays alive as an entity under state law and retains a de minimis amount of assets for the sole purpose of preserving its legal existence.

50 Reg. § 1.368–2(m)(1)(v). More specifically, no corporation other than R may hold property previously held by T if such other corporation would, as a result, succeed to tax attributes of T described in Section 381(c) (e.g., net operating loss carryovers). This rule reflects the policy that an F reorganization should not include transactions that divide up the property of the transferor corporation and eliminates the possibility that more than one corporation would have a claim to T's tax attributes.

51 Reg. § 1.368–2(m)(1)(vi). Reflecting the policy that an F reorganization should only involve one corporation, R may not hold property acquired from another corporation if R would succeed to that other corporation's tax attributes described in Section 381(c).

52 Reg. § 1.368–2(m)(2).

The regulations also envision the step transaction doctrine applying to a series of related transactions that together meet the requirements of an F reorganization.[53] And, as illustrated in Revenue Ruling 96–29, below, an F reorganization may occur before, within, or after other transactions, and the related events that precede or follow the F reorganization generally will not cause it to fail under Section 368(a)(1)(F).[54]

Finally, the regulations sort out statutory jurisdiction under Section 368 in overlap situations. They generally provide that if a transaction meets the requirements of both a potential F reorganization and another type of asset reorganization (e.g., a Type A, C or D), it qualifies only as an F reorganization. But if a transaction qualifies as both a triangular reorganization and an F reorganization and the corporation with "control" (as determined by the 80 percent tests in Section 368(c)) of R is a party to the triangular reorganization, it will not qualify as an F reorganization.[55]

Revenue Ruling 96–29

1996–1 Cum. Bull. 50.

ISSUE

Do the transactions described below qualify as reorganizations under § 368(a)(1)(F) of the Internal Revenue Code?

FACTS

Situation 1. Q is a manufacturing corporation all of the common stock of which is owned by twelve individuals. One class of nonvoting preferred stock, representing 40 percent of the aggregate value of Q, is held by a variety of corporate and noncorporate shareholders. Q is incorporated in state M. Pursuant to a plan to raise immediate additional capital and to enhance its ability to raise capital in the future by issuing additional stock, Q proposes to make a public offering of newly issued stock and to cause its stock to become publicly traded. Q entered into an underwriting agreement providing for the public offering and a change in its state of incorporation. The change in the state of incorporation was undertaken, in part, to enable the corporation to avail itself of the advantages that the corporate laws of state N afford to public companies and their officers and directors. In the absence of the public offering, Q would not have changed its state of incorporation. Pursuant to the underwriting agreement, Q changed its place of incorporation by merging with and into R, a newly organized corporation incorporated in state N. The shares of Q stock were converted into the right to receive an identical number of shares of R stock. Immediately thereafter, R sold additional shares of its stock to the public and redeemed all of the outstanding

53 Reg. § 1.368–2(m)(3)(i).

54 Reg. § 1.368–2(m)(3)(ii).

55 Reg. § 1.368–2(m)(3)(iv)(a).

shares of nonvoting preferred stock. The number of new shares sold was equal to 60 percent of all the outstanding R stock following the sale and redemption.

Situation 2. W, a state M corporation, is a manufacturing corporation all of the stock of which is owned by two individuals. W conducted its business through several wholly owned subsidiaries. The management of W determined that it would be in the best interest of W to acquire the business of Z, an unrelated corporation, and combine it with the business of Y, one of its subsidiaries, and to change the state of incorporation of W. In order to accomplish these objectives, and pursuant to an overall plan, W entered into a plan and agreement of merger with Y and Z. In accordance with the agreement, Z merged with and into Y pursuant to the law of state M, with the former Z shareholders receiving shares of newly issued W preferred stock in exchange for their shares of Z stock. Immediately following the acquisition of Z, W changed its place of organization by merging with and into N, a newly organized corporation incorporated in state R. Upon W's change of place of organization, the holders of W common and preferred stock surrendered their W stock in exchange for identical N common and preferred stock, respectively.

LAW AND ANALYSIS

Section 368(a)(1)(F) provides that a reorganization includes a mere change in identity, form, or place of organization of one corporation, however effected. This provision was amended * * * in order to limit its application to one corporation. Certain limitations contained in § 381(b), including those precluding the corporation acquiring property in a reorganization from carrying back a net operating loss or a net capital loss for a taxable year ending after the date of transfer to a taxable year of the transferor, do not apply to reorganizations described in § 368(a)(1)(F) "in recognition of the intended scope of such reorganizations as embracing only formal changes in a single operating corporation." H.R.Rep. No. 760, 97th Cong., 2d Sess. 540, 541 (1982). Although a change in the place of organization usually must be effected through the merger of one corporation into another, such a transaction qualifies as a reorganization under § 368(a)(1)(F) because it involves only one operating corporation. The 1982 amendment of § 368(a)(1)(F) thus overruled several cases in which a merger of two or more operating corporations could be treated as a reorganization under § 368(a)(1)(F). See, e.g., Estate of Stauffer v. Commissioner, 403 F.2d 611 (9th Cir.1968); Associated Machine, Inc. v. Commissioner, 403 F.2d 622 (9th Cir.1968); and Davant v. Commissioner, 366 F.2d 874 (5th Cir.1966).

A transaction does not qualify as a reorganization under § 368(a)(1)(F) unless there is no change in existing shareholders or in the assets of the corporation. However, a transaction will not fail to qualify as a reorganization under § 368(a)(1)(F) if dissenters owning fewer than

1 percent of the outstanding shares of the corporation fail to participate in the transaction. Rev. Rul. 66–284, 1966–2 C.B. 115.

The rules applicable to corporate reorganizations as well as other provisions recognize the unique characteristics of reorganizations qualifying under § 368(a)(1)(F). In contrast to other types of reorganizations, which can involve two or more operating corporations, a reorganization of a corporation under § 368(a)(1)(F) is treated for most purposes of the Code as if there had been no change in the corporation and, thus, as if the reorganized corporation is the same entity as the corporation that was in existence prior to the reorganization. See § 381(b); § 1.381(b)–1(a)(2); see also Rev. Rul. 87–110, 1987–2 C.B. 159; Rev. Rul. 80–168, 1980–1 C.B. 178; Rev. Rul. 73–526, 1973–2 C.B. 404; Rev. Rul. 64–250, 1964–2 C.B. 333.

In Rev. Rul. 69–516, 1969–2 C.B. 56, the Internal Revenue Service treated as two separate transactions a reorganization under § 368(a)(1)(F) and a reorganization under § 368(a)(1)(C) undertaken as part of the same plan. Specifically, a corporation changed its place of organization by merging into a corporation formed under the laws of another state and immediately thereafter, it transferred substantially all of its assets in exchange for stock of an unrelated corporation. The ruling holds that the change in place of organization qualified as a reorganization under § 368(a)(1)(F).

Accordingly, in Situation 1, the reincorporation by Q in state N qualifies as a reorganization under § 368(a)(1)(F) even though it was a step in the transaction in which Q was issuing common stock in a public offering and redeeming stock having a value of 40 percent of the aggregate value of its outstanding stock prior to the offering.

In Situation 2, the reincorporation by W in state N qualifies as a reorganization under § 368(a)(1)(F) even though it was a step in the transaction in which W acquired the business of Z.

HOLDING

On the facts set forth in this ruling, in each of Situations 1 and 2, the reincorporation transaction qualifies as a reorganization under § 368(a)(1)(F), notwithstanding the other transactions effected pursuant to the same plan.

* * *

PROBLEM

Golden State Corporation is incorporated in California. It forms a new corporation in Arizona, Cactus Corporation, transferring all of its assets to Cactus Corporation in exchange for all of the Cactus stock. Golden State Corporation is then liquidated with the Golden State shareholders receiving proportionate amounts of Cactus stock. What are the tax consequences to the Golden State shareholders?

D. TYPE G: INSOLVENCY REORGANIZATIONS

Code: §§ 368(a)(1)(G); 354(b). Skim §§ 354; 355; 356.

Report of Senate Finance Committee on Bankruptcy Tax Bill of 1980*

S.Rep. No. 96–1035, 96th Cong., 2d Sess. 34–38, reprinted in 1980–2 Cum. Bull. 620, 637.

Present Law

Definition of reorganization

A transfer of all or part of a corporation's assets, pursuant to a court order in a proceeding under chapter X of the Bankruptcy Act (or in a receivership, foreclosure, or similar proceeding), to another corporation organized or utilized to effectuate a court-approved plan may qualify for tax-free reorganization treatment under special rules relating to "insolvency reorganizations" (secs. 371–374 of the Internal Revenue Code).

These special rules for insolvency reorganizations generally allow less flexibility in structuring tax-free transactions than the rules applicable to corporate reorganizations as defined in section 368 of the Code. Also, the special rules for insolvency reorganizations do not permit carryover of tax attributes to the transferee corporation, and otherwise differ in important respects from the general reorganization rules.[1] While some reorganizations under chapter X of the Bankruptcy Act may be able to qualify for nonrecognition treatment under Code section 368, other chapter X reorganizations may be able to qualify only under the special rules of sections 371–374 and not under the general reorganization rules of section 368.

Triangular reorganizations

In the case of an insolvency reorganization which can qualify for nonrecognition treatment only under the special rules of Code sections 371–374, the stock or securities used to acquire the assets of the corporation in bankruptcy must be the acquiring corporation's own stock or securities. This limitation generally precludes corporations in bankruptcy from engaging in so-called triangular reorganizations, where the acquired corporation is acquired for stock of the parent of the

* Some footnotes omitted.

[1] Under present law, it is not clear to what extent creditors of an insolvent corporation who receive stock in exchange for their claims may be considered to have "stepped into the shoes" of former shareholders for purposes of satisfying the nonstatutory "continuity of interest" rule, under which the owners of the acquired corporation must continue to have a proprietary interest in the acquiring corporation. Generally, the courts have found the "continuity of interest" test satisfied if the creditors' interests were transformed into proprietary interests prior to the reorganization (e.g., Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179 (1942); Treas. Reg. § 1.371–1(a)(4)). It is unclear whether affirmative steps by the creditors are required or whether mere receipt of stock is sufficient.

acquiring corporation. By contrast, tax-free triangular reorganizations generally are permitted under the general rules of Code section 368.

Transfer to controlled subsidiary

In the case of an insolvency reorganization which can qualify for nonrecognition treatment only under the special rules of Code sections 371–374, it is not clear under present law whether and to what extent the acquiring corporation may transfer assets received into a controlled subsidiary. In the case of other corporate reorganizations, the statute expressly defines the situations where transfers to subsidiaries are permitted (Code sec. 368(a)(2)(C)).

Carryover of tax attributes

In the case of an insolvency reorganization which can qualify for nonrecognition treatment only under the special rules of Code sections 371–374, court cases have held that attributes (such as net operating losses) of the corporation in bankruptcy do not carry over to the new corporation. In the case of other corporate reorganizations, however, specific statutory rules permit carryover of tax attributes to the surviving corporation (Code sec. 381).

Reasons for change

The committee believes that the provisions of existing Federal income tax law which are generally applicable to tax-free corporate reorganizations should also apply to reorganizations of corporations in bankruptcy or similar proceedings, in order to facilitate the rehabilitation of financially troubled businesses.

Also, the committee believes that a creditor who exchanges securities in a corporate reorganization (including an insolvency reorganization) should be treated as receiving interest income on the exchange to the extent the creditor receives new securities, stock, or any other property for accrued but unpaid interest on the securities surrendered.

Explanation of provisions

Section 4 of the bill generally conforms the tax rules governing insolvency reorganizations with the existing rules applicable to other corporate reorganizations. These provisions are the same as section 4 of the House bill.

Definition of reorganization

In general

The bill adds a new category—"G" reorganizations—to the general Code definition of tax-free reorganizations (sec. 368(a)(1)). The new category includes certain transfers of assets pursuant to a court-approved reorganization plan in a bankruptcy case under new title 11 of the U.S. Code, or in a receivership, foreclosure, or similar proceeding in a Federal or State court.

* * *

In order to facilitate the rehabilitation of corporate debtors in bankruptcy, etc., these provisions are designed to eliminate many requirements which have effectively precluded financially troubled companies from utilizing the generally applicable tax-free reorganization provisions of present law. To achieve this purpose, the new "G" reorganization provision does not require compliance with State merger laws (as in category "A" reorganizations), does not require that the financially distressed corporation receive solely stock of the acquiring corporation in exchange for its assets (category "C"), and does not require that the former shareholders of the financially distressed corporation control the corporation which receives the assets (category "D").

The "G" reorganization provision added by the bill requires the transfer of assets by a corporation in a bankruptcy or similar case, and the distribution (in pursuance of the court-approved reorganization plan) of stock or securities of the acquiring corporation in a transaction which qualifies under sections 354, 355, or 356 of the Code. This distribution requirement is designed to assure that either substantially all of the assets of the financially troubled corporation, or assets which consist of an active business under the tests of section 355, are transferred to the acquiring corporation.

"Substantially all" test

The "substantially all" test in the "G" reorganization provision is to be interpreted in light of the underlying intent in adding the new "G" category, namely, to facilitate the reorganization of companies in bankruptcy or similar cases for rehabilitative purposes. Accordingly, it is intended that facts and circumstances relevant to this intent, such as the insolvent corporation's need to pay off creditors or to sell assets or divisions to raise cash, are to be taken into account in determining whether a transaction qualifies as a "G" reorganization. For example, a transaction is not precluded from satisfying the "substantially all" test for purposes of the new "G" category merely because, prior to a transfer to the acquiring corporation, payments to creditors and asset sales were made in order to leave the debtor with more manageable operating assets to continue in business.[5]

Relation to other provisions

A transaction which qualifies as a "G" reorganization is not to be treated as also qualifying as a liquidation under section 332, an

[5] Because the stated intent for adding the new "G" category is not relevant to interpreting the "substantially all" test in the case of other reorganization categories, the comments in the text as to the appropriate interpretation of the "substantially all" test in the context of a "G" reorganization are not intended to apply to, or in any way to affect interpretations under present law of, the "substantially all" test for other reorganization categories.

incorporation under section 351, or a reorganization under another category of section 368(a)(1) of the Code.[6]

A transaction in a bankruptcy or similar case which does not satisfy the requirements of new category "G" is not thereby precluded from qualifying as a tax-free reorganization under one of the other categories of section 368(a)(1). For example, an acquisition of the stock of a company in bankruptcy, or a recapitalization of such a company, which transactions are not covered by the new "G" category, can qualify for nonrecognition treatment under sections 368(a)(1)(B) or (E), respectively.

Continuity of interest rules

The "continuity of interest" requirement which the courts and the Treasury have long imposed as a prerequisite for nonrecognition treatment for a corporate reorganization must be met in order to satisfy the requirements of new category "G". Only reorganizations—as distinguished from liquidations in bankruptcy and sales of property to either new or old interests supplying new capital and discharging the obligations of the debtor corporation—can qualify for tax-free treatment.

It is expected that the courts and the Treasury will apply to "G" reorganizations continuity-of-interest rules which take into account the modification by P.L. 95–598 of the "absolute priority" rule. As a result of that modification, shareholders or junior creditors, who might previously have been excluded, may now retain an interest in the reorganized corporation.

For example, if an insolvent corporation's assets are transferred to a second corporation in a bankruptcy case, the most senior class of creditor to receive stock, together with all equal and junior classes (including shareholders who receive any consideration for their stock), should generally be considered the proprietors of the insolvent corporation for "continuity" purposes. However, if the shareholders receive consideration other than stock of the acquiring corporation, the transaction should be examined to determine if it represents a purchase rather than a reorganization.

Thus, short-term creditors who receive stock for their claims may be counted toward satisfying the continuity of interest rule, although any gain or loss realized by such creditors will be recognized for income tax purposes. [For regulations regarding the treatment of creditors' claims as proprietary interests, see Reg. § 1.368–1(e)(6). Ed.]

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[6] However, if a transfer qualifying as a "G" reorganization also meets the requirements of section 351 or qualifies as a reorganization under section 368(a)(1)(D) of the Code, the "excess liability" rule of section 357(c) applies if any former shareholder of the transferor corporation receives consideration for his stock, but does not apply if no former shareholder of the transferor corporation receives any consideration for his stock (i.e., if the corporation is insolvent). This rule parallels present law, under which insolvency reorganizations under sections 371 or 374 are excluded from the application of section 357(c).

Triangular reorganizations

The bill permits a corporation to acquire a debtor corporation in a "G" reorganization in exchange for stock of the parent of the acquiring corporation rather than for its own stock.

In addition, the bill permits an acquisition in the form of a "reverse merger" of an insolvent corporation (i.e., where no former shareholder of the surviving corporation receives any consideration for his stock) in a bankruptcy or similar case if the former creditors of the surviving corporation exchange their claims for voting stock of the controlling corporation which has a value equal to at least 80 percent of the value of the debt of the surviving corporation.

Transfer to controlled subsidiary

The bill permits a corporation which acquires substantially all the assets of a debtor corporation in a "G" reorganization to transfer the acquired assets to a controlled subsidiary without endangering the tax-free status of the reorganization. This provision places "G" reorganizations on a similar footing with other categories of reorganizations.

Carryover of tax attributes

Under the bill, the statutory rule generally governing carryover of tax attributes in corporate reorganizations (Code sec. 381) also applies in the case of a "G" reorganization. This eliminates the so-called "clean slate" doctrine.

"Principal amount" rule; "boot" test

Under the bill, "G" reorganizations are subject to the rules governing the tax treatment of exchanging shareholders and security holders which apply to other corporate reorganizations.

Accordingly, an exchanging shareholder or security holder of the debtor company who receives securities with a principal amount exceeding the principal amount of securities surrendered is taxable on the excess, and an exchanging shareholder or security holder who surrenders no securities is taxed on the principal amount of any securities received. Also, any "boot" received is subject to the general dividend-equivalence test of Code section 356.

Treatment of accrued interest

Under the bill, a creditor exchanging securities in any corporate reorganization described in section 368 of the Code (including a "G" reorganization) is treated as receiving interest income on the exchange to the extent the security holder receives new securities, stock, or any other property attributable to accrued but unpaid interest (including accrued original issue discount) on the securities surrendered. This provision, which reverses the so-called *Carman* rule, applies whether or not the exchanging security holder realizes gain on the exchange overall. Under this provision, a security holder which had previously accrued the interest (including original issue discount) as income recognizes a loss to the extent the interest is not paid in the exchange.

Example

The reorganization provisions of the bill are illustrated in part by the following example.

Assume that Corporation A is in a bankruptcy case commenced after December 31, 1980. Immediately prior to a transfer under a plan of reorganization, A's assets have an adjusted basis of $75,000 and a fair market value of $100,000. A has a net operating loss carryover of $200,000. A has outstanding bonds of $100,000 (on which there is no accrued but unpaid interest) and trade debts of $100,000.

Under the plan of reorganization, A is to transfer all its assets to Corporation B in exchange for $100,000 of B stock. Corporation A will distribute the stock, in exchange for their claims against A, one-half to the security holders and one-half to the trade creditors. A's shareholders will receive nothing.

The transaction qualifies as a reorganization under new section 368(a)(1)(G) of the Code, since all the creditors are here treated as proprietors for continuity of interest purposes. Thus, A recognizes no gain or loss on the transfer of its assets to B (Code sec. 361). B's basis in the assets is $75,000 (sec. 362), and B succeeds to A's net operating loss carryover (sec. 381).

Under the bill, the pro-rata distribution of B stock to A's creditors does not result in income from discharge of indebtedness [But see I.R.C. § 108(e)(8), which now makes stock-for-debt exchanges subject to Section 108. Ed.]

Assume the same facts as above except that B also transfers $10,000 in cash, which is distributed by A to its creditors. Although A would otherwise recognize gain on the receipt of boot in an exchange involving appreciated property, the distribution by A of the $10,000 cash to those creditors having a proprietary interest in the corporation's assets for continuity of interest purposes prevents A from recognizing any gain (Code sec. 361(b)(1)(A)).[10]

PROBLEM

Debtor Corporation is in bankruptcy. Debtor's assets have an adjusted basis of $75,000 and a value of $100,000, and the corporation has a net operating loss of $200,000, bonds outstanding (with no accrued unpaid interest) of $100,000 and trade debts of $100,000. Debtor transfers all of its assets to Relief Corporation in return for $100,000 of Relief stock which will pass half to the security holders and half to trade creditors. Debtor's

10 See Code sec. 371(a)(2)(A) and Treas. Reg. § 1.371–1(b) for a similar rule relating to distribution of boot to creditors in an insolvency reorganization under present law.

shareholders will receive nothing. What are the tax consequences to the parties?