**Tax Treatment of Parties to a Reorganization**

Code: IRC §§ 351(g), 354(a)(1) and (2), 356(a)(1) and (2), 356(c) - (e); 357(a), 358(a) and (b)(1) and (f), 361(a)-(c), 362(b)-(c), 1032; 1223(1) and (2)

Regs: Treas. Reg. §§ 1.354-1(a), (b) and (d), 1.356-1(a) - (c), (d) Examples 1 & 2; 1.358-1; *Skim* 1.358-2.

Bittker & Eustice: ¶¶ 12.40, 12.41[1]-[5], 12.42, 12.43[1][a], [2], [5]; 12.44[1][a]-[f], [2], [3]

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Rev. Rul. 68-23, 1968-1 CB 144

Advice has been requested as to the correct method of computing the gain to be recognized under section 356 of the Internal Revenue Code of 1954 by a shareholder who exchanges two blocks of stock having different adjusted bases in the circumstances described below.

X corporation acquired substantially all of the properties of Y corporation in exchange solely for X voting stock in a transaction qualifying as a reorganization within the meaning of section 368(a)(1)(C) of the Code. Pursuant to the plan of reorganization, Y distributed to each of its shareholders one share of X stock having a fair market value of 500x dollars per share plus other property having a fair market value of 5x dollars in exchange for each share of Y stock outstanding.<Page 145>

At the time of the reorganization, A owned 1,000 shares of the stock of Y which had been acquired in two separate transactions. The adjusted basis to A for each of 600 shares of Y stock was 495x dollars per share and the adjusted basis to A for each of the other 400 shares of Y stock was 525x dollars per share. The following computation reveals that if the transfer of each block were considered separately, then A would realize a gain on the exchange of one block and a loss on the exchange of the other block.

Received in exchange for 600 shares Y stock:

Fair market value of 600 shares of stock of X at 500x dollars per share $300,000x

Fair market value of other property at 5x dollars per share 3,000x

Total fair market value received in exchange for 600 shares 303,000x Adjusted basis of 600 shares of Y stock surrendered (600 times 495x dollars) 297,000x Gain realized on the exchange of 600 shares of Y stock 6,000x

Received in exchange for 400 shares of Y stock:

Fair market value of 400 shares of stock of X at 500x dollars per share $200,000x

Fair market value of other property at 5x dollars per share 2,000x

Total fair market value received in exchange for 400 shares 202,000x Adjusted basis of 400 shares of Y stock surrendered (400 times 525x dollars) 210,000x Loss realized on the exchange of 400 shares of Y stock (8,000x)

Section 356(a)(1) of the Code provides in part that, if money or other property is received in an exchange to which section 354 of the Code would otherwise apply, then gain, if any, to the recipient will be recognized to the extent of the money or the fair market value of the other property received. Section 356(a)(2) of the Code provides that if such exchange has the effect of the distribution of a dividend, then there shall be treated as a dividend to each distributee such an amount of the gain recognized under section 356(a)(1) of the Code as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913, and the remainder, if any, of the reorganized gain will be treated as gain from the exchange of property. Section 356(c) of the Code provides that no loss from the exchange will be recognized.

In determining the gain or loss on a transaction, each item of property transferred is considered separately. In determining the gain or loss realized by the shareholders in an exchange to which section 356 applies, each block of stock transferred which has a different adjusted basis must be treated separately. It is not proper to total the bases of the various blocks of stock and to subtract this total from the total value received in the exchange. Lynn B. Curtis v. The United States, 336 F. 2d 714 (1964), affirming 215 Supp. 885 (1963). Moreover, any other treatment would have the effect of allowing losses which have been specifically disallowed by section 356(c) of the Code.

Accordingly, the loss of 8,000x dollars on one block of stock may not be used to offset the gain of 6,000x dollars on the other block of stock. The gain of 6,000x dollars will be recognized in the amount of 3,000x <Page 146> dollars, the amount of the other property received in the exchange as provided by section 356(a)(1) of the Code, but no loss will be recognized. In this case A's ratable share of the earnings and profits of Y exceeded 3,000x dollars and, accordingly, the 3,000x dollars will be taxable as a dividend under section 356(a)(2) of the Code.

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Rev. Rul. 75-83, 1975-1 CB 112

Advice has been requested concerning the application of section 356(a)(2) of the Internal Revenue Code of 1954 in the circumstances described below.

X, a corporation engaged in manufacturing, had outstanding 60 shares of voting common stock all of which were owned by A, an individual. The fair market value of each share of X common stock was 10X dollars.

Y, a corporation engaged in manufacturing, had outstanding 40 shares of voting common stock. Four individuals, B, C, D, and E (none of whom are related to one another nor to A within the meaning of section 318 of the Code), each owned 10 shares of Y stock.

It was decided that X would be merged with and into Y in a transaction intended to qualify as a reorganization under section 368(a)(1)(A) of the Code. As a result of arms length negotiations it was determined on the basis of fair market values that one share of Y stock should be issued in exchange for one share of X stock. However, certain of the Y shareholders objected to this arrangement because it would give A too much voting power in Y corporation. Therefore, it was agreed that Y would issue 35 shares of its voting common stock to A and, in addition, give A a note of Y with a fair market value of 250X dollars. This exchange was consummated pursuant to a plan of reorganization. A realized gain on the exchange.

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

Section 356(a)(1) of the Code provides, in part, that if money or other property is received in an exchange to which section 354 would otherwise apply, then gain, if any, to the recipient will be recognized to the extent of the sum of the money and fair market value of the other property received. Section 356(a)(2) provides that if such exchange has the effect of the distribution of a dividend, 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 his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913, and the remainder, if any, of the recognized gain will be treated as gain from the exchange of property. Section 356(c) provides that no loss from the exchange will be recognized.

Section 302(a) of the Code provides, in part, that a redemption will be treated as a distribution in part or full payment in exchange for stock if the redemption satisfies the requirements of section 302(b)(1), 302(b)(2), or 302(b)(3); otherwise, pursuant to section 302(d), the redemption is treated as a distribution to which section 301 applies and included in the income of the shareholder as a dividend to the extent provided in section 301.

In the instant case, section 356(a)(1) of the Code applies to the exchange by A because the property he received in the exchange for his X stock consisted not only of Y stock, which is permitted by section 354, but also of other property, Y'S note. Thus, gain is recognized to A under section 356(a)(1) in an amount not in excess of the fair market value of the other property.

However, a determination must be made whether the exchange had the effect of the distribution of a dividend to A within the meaning of section 356(a)(2) of the Code. In making this determination it is appropriate to look to principles developed under section 302 for determining dividend equivalency. See Rev. Rul. 74-515, 1974-2 C.B. 118. Furthermore, in applying the principles of section 302 in this context, the distribution is treated as though it were made by the acquired corporation (X in the instant case) and not the acquiring corporation. See ROSS V. UNITED STATES, 173 F.Supp. 793 (Ct. Cl. 1959), CERT. DENIED, 361 U.S. 875 (1959); HAWKINSON V. COMMISSIONER, 235 F. and 747 (2d Cir. 1956); COMMISSIONER V. OWENS, 69 F.2d 597 (5th Cir. 1934); See also Rev. Rul. 74-516, 1974-2 C.B. 121 and Rev. Rul. 74-515.

Therefore, in the instant case, A is treated as having received a note with a fair market value of 250X dollars from X in exchange for 25 shares of his X stock. While this exchange reduces the number of X shares held by A, it does not reduce his percentage ownership of X stock since he owned all of the X stock before the exchange and he owns all of the X stock after the exchange. In DAVIS V. UNITED STATES, 397 U.S. 301 (1970), 1970-1 C.B. 62, the Supreme Court of the United States held that a distribution of property in exchange for stock was “essentially equivalent to a dividend” within the meaning of section 302(b)(1) of the Code where the shareholder owned, actually and constructively, all of the stock of the corporation both before and after the redemption. Therefore, the redemption did not meet the requirements of section 302(b)(1) and was treated under section 301.

Accordingly, in the instant case, the exchange on which gain is recognized to A under section 356(a)(1) of the Code has the effect of a dividend under section 356(a)(2). Therefore, such gain will be treated as a dividend to extent provided in section 356(a)(2).

In WRIGHT V. UNITED STATES, 482 F.2d 600 (8th Cir. 1973), the United States Court of Appeals held that in determining whether a distribution has the effect of the distribution of a dividend within the meaning of section 356(a)(2) the distribution should be viewed as though it was made by the transferee corporation.

If the WRIGHT decision were applied in the instant case, the transaction would be treated as though the note were issued by Y in exchange for a portion of Y stock (25 shares) A would have received if he had taken Y stock entirely instead of receiving Y stock and Y'S note. Thus, as a result of this deemed exchange, A'S stock interest in Y would be reduced from 60 shares of Y stock to 35 shares, and this reduction in interest would satisfy the substantially disproportionate redemption requirements of section 302(b)(2) of the Code. Therefore, the exchange would not have the effect of a dividend under section 356(a)(2) and would be treated as gain from the exchange of property under section 356(a)(1).

The Internal Revenue Service will not follow the WRIGHT decision because it believes that the court erred in distinguishing a long line of cases holding that, regardless of which corporation makes a distribution, the amount of the dividend is measured by reference to the earnings and profits of the transferor. See ROSS, HAWKINSON, and OWENS, above. The holdings of the above cases are in accord with the committee reports on the predecessor of section 356(a)(2) of the Code which indicate that the purpose of the section is to tax as dividends distributions having the same result as a dividend from the transferor corporation. See H.R. REP. NO. 179, 68th Cong., 1st Sess. 14-15 (1924); and S. REP. NO. 398, 68th Cong., 1st Sess. 15-16 (1924).

Accordingly, the Service in determining dividend equivalency under section 356(a)(2) of the Code will continue to view a distribution as having been made by the acquired or transferor corporation and not by the acquiring or transferee corporation as in the WRIGHT decision.

Rev. Rul. 93-61, 1993-2 CB 118

Part I

Section 356.—Receipt of Additional Consideration

26 CFR 1.356-1: Receipt of additional consideration in

connection with an exchange

(Also Section 7805; 301.7805-1.)

This revenue ruling revokes Rev. Rul. 75-83, 1975-1 C.B. 112.

LAW AND ANALYSIS

Section 354(a) of the Internal Revenue Code provides that no gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization. If section 354 would apply to the exchange except for the receipt of money or property other than stock or securities in a corporate party to the reorganization, referred to as boot, section 356(a)(1) provides that the recipient shall recognize gain, but in an amount not in excess of the sum of the money and the fair market value of the other property. Under section 356(a)(2), if an exchange described in section 356(a)(1) has the effect of the distribution of a dividend, the shareholder must treat the gain recognized on the exchange as a dividend to the extent of the distributee's ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913.

In Rev. Rul. 75-83, X corporation merged into Y corporation in a reorganization under section 368(a)(1)(A) of the Code. The sole shareholder of X corporation received shares of Y corporation stock and a note, which was treated as boot under section 356(a)(1). To determine whether the exchange had the effect of the distribution of a dividend under section 356(a)(2), the Service treated the distribution as though it were made by the acquired corporation (X) and not the acquiring corporation (Y). Therefore, the Service concluded that the exchange had the effect of a dividend under section 356(a)(2).

In Commissioner v. Clark, 489 U.S. 726 (1989), 1989-2 C.B. 68, the sole shareholder of a target corporation exchanged his target stock for stock of an acquiring corporation and cash. The Supreme Court applied the dividend equivalency rules for redemptions contained in section 302 of the Code to determine whether the boot payment had the effect of a dividend distribution under section 356(a)(2). At issue was whether the boot payment should be treated as if it were made (i) by the target corporation in a hypothetical section 302 redemption of a portion of the shareholder's target stock prior to and separate from the reorganization exchange, or (ii) by the acquiring corporation in a hypothetical section 302 redemption of the acquiring stock that the shareholder would have received in the reorganization exchange if there had been no boot distribution. The Court concluded that the treatment of a boot distribution is determined “by examining the effect of the exchange as a whole,” 489 U.S. 726, 737, and held that the second approach better tested the effect of the payment of boot as a component in the overall exchange.

HOLDING

In an acquisitive reorganization, the determination of whether boot is treated as a dividend distribution under section 356(a)(2) of the Code is made by comparing the interest the shareholder actually received in the acquiring corporation in the reorganization exchange with the interest the shareholder would have received in the acquiring corporation if solely stock had been received.

EFFECT ON OTHER RULINGS

Rev. Rul. 75-83 is revoked.

PROSPECTIVE APPLICATION

Pursuant to the authority contained in section 7805(b) of the Code, the Service will not challenge a shareholder's tax treatment of boot received in an acquisitive reorganization if such treatment is consistent with either Clark or with Rev. Rul. 75-83, provided that the boot was received in an acquisitive reorganization consummated on or before March 22, 1989 (the date of the Supreme Court's decision in Clark) or consummated after that date pursuant to terms of a plan of reorganization adopted on or before that date.

DRAFTING INFORMATION

The principal author of this ruling is Diana C. MacKeen of the Office of Assistant Chief Counsel (Corporate). For further information regarding this revenue ruling contact Ms. MacKeen at (202) 622-7550 (not a toll-free call).