CHAPTER 10 – ACQUISITIVE REORGANIZATIONS

Problems, pages 355-356

10-1 Treas. Reg. §1.368-1(e) does not directly change the result in Kass. The problem in *Kass* was that the acquiring corporation used cash to acquire most of the shares. The regulation clarifies that a sale of that stock by target shareholders before or after the purported reorganization will not generally disqualify the transaction as a reorganization. (Sales to the target corporation before the transaction or to the acquiring corporation or a related corporation before or after the transaction might disqualify the transaction as a reorganization, however.) That is, as long as the acquiring corporation doesn't use too much non-stock consideration directly or indirectly to acquire stock of the target, pre- or post-reorganization sales of stock by the target shareholders will not violate continuity of interest requirements.

If Mrs. Kass had participated in the formation of TRACK under §351, it appears that she would have enjoyed nonrecognition treatment. She argued that her stock transfer was part of the §351 transfer of property to TRACK, but her argument was rejected by the court, because she had not in fact participated in the §351 transaction.

l0-2a. In the merger of X into Y, the shareholders of X will tender all 100 of their X shares in exchange for 20 shares of Y (aggregate value of $2,000) and ten 20-year notes of Y (aggregate value of $8,000). This merger will not be an A reorganization unless it meets the continuity of interest requirement, that is, unless a "material" part of the consideration received by the X shareholders was Y stock. In *John A. Nelson & Co. v. Helvering,* discussed at page 343 of the text, the Supreme Court upheld a reorganization in which approximately 40% of the consideration was stock. Treasury regulations now endorse a 40% standard. *See* Treas. Reg. §1.368-1(e)(2)(v) (example 1). On the other hand, the Third Circuit Court of Appeals in the *Kass* case held that 16% stock consideration was insufficient. The Treasury regulations also conclude that 28.57% continuity is insufficient. *See* Treas. Reg. §1.368-1(e)(2)(v) (example 11). Thus, 20% is insufficient, at least if the regulation is valid in this regard (which it almost certainly is).

Whether the stock is received pro-rata or only by C is irrelevant: the continuity of interest test is applied to the transaction as a whole. Indeed, that is the lesson of *Kass*. Note also that it is irrelevant whether the 20-year notes in this problem are "securities." See *LeTulle v. Scofield* and *Roebling v. Commissioner,* both discussed at page 343 of the text.

However, if the 20-year notes are considered equity for tax purposes (and the fact that the historic Y shareholders hold the notes in proportion to their stock suggests that it could be), the X shareholders would then be deemed to received solely equity consideration for their X stock, satisfying the continuity of interest requirement. We would need much more information before we could conclude that the notes should be treated as equity for tax purposes. In any case, a responsible tax planner would not structure a transaction relying on a characterization of the notes as equity for tax purposes, a point that you may discuss with students.

10-2b. This consolidation will be an A reorganization so long as the continuity of interest requirement is met. When some of the stock received in the transaction is redeemable shortly after the transaction, such stock might appropriately be considered as cash or a cash equivalent. If the stock is redeemed "in connection with" the consolidation, the cash received in the redemption will be treated as the consideration received by the redeemed shareholders in the consolidation. See Treas. Regs. §1.368-1(e)(1)(i).

When two corporations consolidate into a new corporation, each corporation is treated as a target that combines with the new corporation for purposes of §368(a)(1)(A). *See* Treas. Regs. §1.368-2(b)(1)(iii) (example 12). Thus, the judicial requirements, including continuity of interest, should be met separately for each set of shareholders. Accordingly, if the redemption of the G's B shares is in connection with the consolidation, the combination of N and O will not meet the continuity of interest requirement, and that combination cannot qualify as an A reorganization. If the redemption of the F's A shares is in connection with the consolidation, the combination of M and O will not meet the continuity of interest requirement, and that combination cannot qualify as an A reorganization.

If G's B shares can be redeemed for 80 percent of their fair market value, it makes the redemption much more likely at the time of the consolidation. Thus, it is more likely that any redemption would be considered to be "in connection with" the consolidation.

10-2c. The merger of L into P will not qualify as an A reorganization because the continuity of business enterprise requirement, doctrine discussed at pages 351 and 352 of the text, will not be met. *See* Treas. Regs. §1.368-1(d)(5) (example 5). P will neither continue L's historic business nor use a significant portion of L's historic assets in a business. However, if P merges into L (*i.e.,* the merger's direction is reversed), the merger *will* qualify as an A reorganization, because of the asymmetry of the continuity of business enterprise requirement: as defined in Regs. §1.368-1(d), the requirement is concerned only with the continuation of the *acquired* corporation's business or business assets. Note that the continuity of interest also has a directional bias.

Because, in a consolidation, each consolidating corporation is treated as a target, the continuity of business enterprise requirement applies separately to each target corporation, and the combination of L and the new corporation will not meet the continuity of business enterprise requirement, while the consolidation of P and the new corporation will.

10-3. This problem illustrates that Treas. Regs. §1.368-1(e) does not require shareholders to continue to hold the stock of the acquiring corporation for any specified time. They are free to sell the stock immediately so long as the sale is not directly or indirectly financed by the acquiring corporation or a related corporation.

10-3a. If X is an individual, X's purchase of the A stock is disregarded, unless A Corp. funds the purchase (*e.g.*, through a redemption some of X's other A shares). If X is a corporation and X Corp. and A Corp. are not members of the same affiliated group (or X Corp. does not have a §304(a)(2) relationship with A Corp.) before or after the stock purchase, the result is the same. *See* Treas. Regs. §1.368-1(e)(4)(i) (defining related persons). However, if X and A Corp. are members of the same affiliated group and the purchase occurs in connection with the merger, the historic T shareholders will be deemed to receive the purchase consideration for their T stock. Accordingly, if the sale is to X Corp., the parent of A Corp., then the transaction will violate the continuity of interest requirement. Not only will the selling shareholders recognize gain or loss in the merger, but any non-selling shareholders will as well. An immediate sale by all the shareholders also means that T Corp. will recognize gain or loss on its transfer of assets to A Corp in the merger, since nonrecognition under §361 is not available.

10-3b. The continuity of business enterprise requirement is met if the issuing corporation is considered either to continue a significant historic business of the target or to use a significant portion of the target's historic assets in a business. Treas. Regs. §1.368-1(d)(1). For this purpose, an issuing corporation is treated as owning the assets of, and conducting the businesses of, each member of its qualified group. *Id*. at (4)(i). Its qualified group includes (i) the issuing corporation, (ii) any corporation in which the issuing corporation directly owns stock meeting the requirements of §368(c), and (iii) any other corporation in which qualified group members together own that amount of the corporation's stock. *Id*. at (d)(4)(ii).

A Corp. is the issuing corporation in the merger, since its stock is issued as qualifying consideration in the reorganization. If A Corp. owns all of the stock of S Corp., A Corp. will control S Corp., and S Corp. will be a member of the A Corp. qualified group. Because A Corp. is treated as conducting all businesses and holding all assets of its qualified group, it is treated as conducting S Corp.'s businesses and holding its assets, including the T assets that S Corp. acquires. Thus, A Corp. will be treated as acquiring and holding all of the T assets (through its ownership of the S stock), and the continuity of business enterprise requirement will be met.

If, however, S Corp. has a common and nonvoting preferred stock and A Corp. owns all of the common stock but none of the preferred stock, A Corp. will not control S Corp. *Cf*. §1504(a)(2) and (4) (measuring affiliation by excluding pure vanilla preferred stock). Thus, S Corp. will not be a member of the A Corp. qualified group. If the drop-down of the T assets is part of the plan that includes the merger, the merger will therefore lack continuity of business enterprise.

Problems, page 357

10-4. Problem 10-4 explores when a merger satisfies the statutory definition of an A reorganization, in particular when the merger involves a disregarded entity. To satisfy that definition, under applicable law, a corporation (the "acquiring" corporation) must succeed to all assets and liabilities of a second corporation (the "target") and, simultaneously, the target must cease to exist.

10-4a. This question illustrates the "classic" merger. It meets the statutory definition, because under applicable law, X, a corporation, succeeds to all assets and liabilities of T, a second corporation, and simultaneously, T ceases to exist..

10-4b. Because X is a disregarded entity wholly owned by Y, all X assets and liabilities are treated as Y assets and liabilities. Thus, the merger meets the statutory definition, because under applicable law, Y, a corporation, through X, succeeds to all assets and liabilities of T, a second corporation, and simultaneously, T ceases to exist. *See* Treas. Regs. §1.368-2(b)(1)(iii) (example 2) (illustrating this case).

10-4c. This transaction does not meet the statutory definition of an A reorganization, because Y, the entity deemed to acquire the target assets in the merger, is a partnership, not a corporation. *See id.* at (b)(1)(iii) (example 5) (illustrating this case).

10-4d. This transaction also does not meet the statutory definition of an A reorganization for two reasons. First, the target corporation (*i.e.*, Z) does not cease to exist under applicable law on the merger of T into X. Second, all of the Z assets do not become assets of X by operation of law. Only the assets of T become X assets. *See id*. at (b)(1)(iii) (example 6) (illustrating this case).

10-5. Although X would be deemed to acquire all T assets in the transaction, it would be treated first as acquiring the T stock and then as if T liquidated into S. Treas. Regs. §301.7701-3(g)(1)(iii) (treating the acquired target as distributing its assets and liabilities to the acquiror in liquidation). Further, T would not cease its separate legal existence. Thus, X would not acquire the T assets in one step by operation of a statute necessary to effect a merger or consolidation, and T would not simultaneously cease to exist. *See* § 1.368-2(b)(1)(iii), *(example 9)* (illustrating this case). Accordingly, neither merger requirement appears met. Note, however, that in an appropriate case, the transaction may qualify as a C reorganization. *See* Rev. Rul. 67-274, 1967-2 C.B. 141 (treating a stock purchase followed by a planned liquidation as an asset purchase in applying §368(a)(1)(C)).

Problems, pages 370-371

10-6a. This problem illustrates a possible "creeping" B reorganization. So long as the initial stock purchase is not part of the same transaction as the subsequent stock exchange (that is, so long as the stock purchased for cash is "old and cold"), the stock-for-stock exchange should qualify as a B reorganization. Precisely what constitutes a single transaction (or reorganization "plan") remains an open question, the question that the remand in *Chapman* was to decide.

News Corp. can use the voting stock of its parent and still qualify the acquisition as a B reorganization - the transaction will simply become a parenthetical B. On the other hand, the transaction cannot meet the definition in §368(a)(1)(B) if News Corp. uses its subsidiary's stock or its own non-voting stock. Payment by News Corp. of the costs associated with registering the shares received by the former shareholders of Paper Co. will not disqualify the transaction: such expenses are properly borne by the acquiring corporation because they promote the orderly marketing of its stock. Rev. Rul. 67-275, 1967-2 C.B. 145. In Rev. Rul. 73-54, 1973-1 C.B. 187, the Service published its position about reorganization expenses that can be paid by the acquiring corporation in a B reorganization as opposed to those whose payment will constitute impermissible boot.

10-6b. This case presents the *Hendler* issue in the context of a B reorganization. (See page 357 of the text for a discussion of this issue in the context of a C reorganization.) Since no boot is permitted to be used in a B reorganization, this transaction fails to qualify as a B reorganization. See, e.g., Rev. Rul. 79-4, 1979-1 C.B. 150. Since nonrecourse debt is treated like recourse debt for other purposes, presumably the result should be the same if the corporation takes the property subject to the debt rather than assumes the debt, at least if the corporation is expected to satisfy the liability. *Cf.* §357(d)(2) (for when a nonrecourse liability is deemed assumed for purposes of §368(a)(1)(C)).

Problems, pages 373-374

10-7a. If Target Corp. transfers all of its assets to Acquiring Corp. in exchange for voting stock of Acquiring Corp. as well as the assumption of a liability, the transaction is a C reorganization. (Note that the provision in §357(b) relating to the assumption of a liability for a tax avoidance purpose is not relevant in this context - so long as no actual boot is used in a C reorganization, the assumption of *all* liabilities is ignored pursuant to §368(a)(1)(C).)

If Acquiring Corp. transfers cash of $50,000 in lieu of assuming the debt, the transaction will not qualify as a C reorganization. While some boot can be used in a C reorganization, voting stock worth at least 80% of the value of the Target Corp.'s assets must be part of the consideration. §368(a)(2)(B). Since the assets are worth $200,000, at least $160,000 of voting stock must be used. Further, the transaction will fail to qualify as a C reorganization if Acquiring Corp. uses cash of $25,000 and assumes half the debt because, under §368(a)(2)(B), stock worth at least $160,000 must be provided if *any* boot is used.

If the debt is only $30,000, then Acquiring Corp. can pay off the debt in cash because it will be providing its own voting stock worth $170,000. Thus, whether the debt is assumed, paid in full with cash, or paid partially in cash will not matter.

10-7b. The taxation of a C reorganization is not affected if the acquiring corporation uses voting stock of its parent instead of its voting stock, because of the parenthetical language in §368(a)(2)(C). Further, the transfer of the assets to a subsidiary of the acquiring corporation will not disqualify the asset acquisition as a C reorganization, because of §368(a)(2)(C). Therefore, the answers to this problem are the same as the answers to problem 10-7a.

10-7c. In Rev. Rul. 70-224, 1970-1 C.B. 79, a target transferred all of its assets to a second corporation (the "subsidiary") in exchange for voting stock of a corporation (the "parent") that controlled the subsidiary. The parent also assumed all of the target's liabilities. The assets were transferred under an acquisition agreement (and plan of reorganization) negotiated by the parent and the target, and in the agreement, the parent directed the target to transfer its assets directly to the subsidiary. The Service concluded that, in substance, the parent had acquired the assets and dropped those assets to the subsidiary, because it had the economic control over the disposition of the assets.

Following Rev. Rul. 70-224, if the acquisition agreement provides that Acquiring Corp. will acquire the Target assets but directs the Target to transfer the assets to Holding Corp., for federal income tax purposes, the Target should be deemed to transfer its assets to Acquiring Corp. and Acquiring Corp. should be deemed to drop those assets down to Holding Corp. Thus, the answers to this problem are the same as the answers to problem 7a and 7b.

Problems, page 383

10-8. This may seem to be a C reorganization problem to many students. In fact, because P has no liabilities, when P transfers all of its assets to Q in exchange for stock worth $800,000 and cash of $200,000, the transaction will constitute a C reorganization *if* the common stock is voting stock. See §368(a)(2)(B) (boot relaxation rule for C reorganizations). However, the transaction also is a non-divisive D reorganization if F and S are related within the meaning of §318(a), and, when a transaction is both, it is treated as a D. See §368(a)(2)(A).

The transaction is a non-divisive D reorganization when F and S are related because F will be in "control" of Q within the meaning of §304(c). For the non-divisive D reorganization, "control" is not the usual 80% test of §368(c) but rather is the 50% control test *with attribution* of §304(c). See §368(a)(2)(H). The effect of this transaction being a (C or D) reorganization is (1) F can receive the stock of Q without recognizing gain or loss under §354, and (2) gain to the extent of the $300,000 boot can be classified as ordinary dividend income under §356(a)(2). *Cf.* §1(h)(11) (for preferential treatment of qualified dividend income). At the corporate level, P does not recognize gain or loss on its asset transfer to Q or on its distribution of the Q stock and cash to F, while Q takes a transferred basis in the P assets. §361(b) and (c); §362(b).

If P does not transfer the real estate, does the transaction remain a D reorganization? If "substantially all" refers only to business assets as the court in *Smothers* held, then the transaction will keep its D reorganization status. If not, then the transaction will be treated as a sale at the corporate level and as a complete liquidation at the shareholder level.

Problems, pages 386-387

10-9a. Assuming that the judicial requirements are met, this transaction is a forward subsidiary merger as described in §368(a)(1)(A) and (a)(2)(D). To ensure a continuity of interest in such transactions, §368(a)(2)(D) refers to type A reorganizations: mergers and consolidations. This reference requires that, as in all A reorganizations, a meaningful and substantial portion of the consideration used be stock (not necessarily voting stock). Section 368(a)(2)(D) allows the qualified stock to be stock of the *parent* of the acquiring corporation; i.e., stock of BQ. Since 50% stock is sufficient in an A reorganization, see, e.g., Treas. Regs. §1.368-1(e)(2)(v) (example 1) discussed at page 349 of the text, this transaction should qualify as a statutory reorganization. Changing the debentures to debentures of the subsidiary has no effect - cash or other boot could be used, as could nonvoting stock instead of voting stock.

10-9b. The transaction has now been structured as a reverse subsidiary merger. Under §368(a)(2)(E), two requirements must be met. First, the surviving corporation (here, Corner Grocery) must end up owning substantially all of the assets of both merging corporations other than stock of the controlling corporation previously held by the merged corporation. Second, the former shareholders of the surviving corporation (that is, the Corner Grocery shareholders) must transfer a controlling stock interest of the surviving corporation in exchange for voting stock of the parent corporation (that is, of BQ). Here, requirement one is met, and requirement two also is met *if* the preferred stock received by the former Corner Grocery shareholders is *voting* stock of BQ.

If the former shareholders of Corner Grocery retain nonvoting preferred stock, then the transaction will not qualify under §368(a)(2)(E). The shareholders will not have given up "control" in Corner Grocery because they continue to own all outstanding nonvoting preferred shares of Corner Grocery. See the final clause in §368(c).

Problems, page 397

10-10a. This transaction is a C reorganization because, in the absence of boot, the assumption of the liability is disregarded. Thus, the transaction is an exchange of "substantially all" (really 100%) of T's assets in exchange for voting stock of P Corp. It is immaterial that the voting stock is preferred and not common stock.

T recognizes no gain or loss on its transfer of its assets to P in exchange for P stock. §361(a). *See also* §357(a) (disregarding P's assumption of liabilities for purposes of §361). T also recognizes no gain or loss on its distribution of the P stock to its shareholders. §361(c). (Thus, we need not consider T's basis in the stock received from P. If T did not promptly liquidate, see §368(a)(2)(G), its basis in that stock might be important. Presumably we look to §358.)

P recognizes no gain or loss on its acquisition of the T assets for its stock (§1032) and the assumption of T's liabilities (general principles). Because T recognizes no gain on its asset transfer, P's basis in the acquired assets is the same as T's basis. §362(b).

A and B each recognize no gain or loss on the exchange of T stock for P stock. §354(a). Each shareholder's basis in the P stock received is the same as his or her basis in the T stock surrendered in the exchange. §358(a)(1). Assuming, as is likely, that A and B each held the T stock as a capital asset, each shareholder would tack her holding period for the T stock on to the holding period for the P stock. §1223(1).

10-10b. Assuming, as is likely, that P is treated as acquiring substantially all of the T assets, this transaction is a C reorganization. (Note that the 90% net asset test of Rev. Proc. 77-37 is not met, however.) The tax consequences to P are unchanged. T recognizes no gain on its transfer of assets to P for the reasons noted in the previous answer. However, because T distributes inventory with a $50,000 adjusted basis and $100,000 fair market value, and the inventory is not qualified property, under §36l(c)(2), T recognizes a $50,000 gain.

Because A and B each receive inventory (*i.e.,* boot) as well as P stock, §354 applies to neither shareholder. Under §356(a)(1), each recognizes gain equal to the smaller of (i) his or realized gain or (ii) the value of the boot received. A's realized gain on the transaction is $240,000 ($300,000 amount realized less $60,000 adjusted basis) and receives boot worth $60,000 (60% of $100,000). Assuming that the boot is allocated pro rata among all shares of A and B, A recognizes a $60,000 gain. B's realized gain on the transaction is $160,000 ($200,000 amount realized less $40,000 adjusted basis) and receives boot worth $40,000 (40% of $100,000). Thus B recognizes a $60,000 gain. The fair market value of the boot received by A is $60,000 (60% of $100,000, assuming that the inventory is distributed pro rata), so that A will recognize a gain on the distribution of $60,000 under §356(a)(1). (The character of that gain is determined under §356(a)(2).) After *Clark,* page 401, it may be capital gain depending on the shareholder's percentage ownership of P Corp. after the transaction. Characterization is better postponed until discussing problem 10-12.)

Note that the agreement may provide that the boot is allocated to specific shares owned by A and B, and if that allocation is economically reasonable, it will be respected and not allocated pro rata. Suppose that the agreement provides that A exchanges $60,000 worth of T stock (with a $12,000 basis) for $60,000 worth of inventory and B exchanges $40,000 worth of T stock (with an $8,000 basis) for $40,000 worth of inventory and each exchanges his or her remaining T stock for P stock. Those exchanges would be economically reasonable. Therefore A's recognized gain would be $48,000 and B's recognized gain would be $32,000, the amount of their realized gain.

10-10c. This transaction fails to qualify as a C reorganization because some non-stock consideration is furnished and the stock consideration does not equal or exceed 80% of the fair market value of the assets of T Corp. See §368(a)(2)(B). Thus, the transaction is treated as a taxable sale at the corporate level and as a taxable liquidation at the shareholder level.

10-10d. Now the transaction is a C reorganization because the requirements of the boot relaxation rule in §368(a)(2)(B) have been met. Note that, although securities of T are nonqualifying property for the definitional section of a C reorganization, see §368(a)(1)(C), they are not for purposes of §361(a) and may not be boot for purposes of §354(a)(1). Thus, the results to T are the same as are described in the answer to questions 10-10a. However, the securities are treated as boot to A and B. Section 354 does not apply to either shareholder's exchange, because the shareholder receives securities in the exchange but surrenders no securities. §354(a)(2)(A)(ii). Under §356(d)(1), the securities are treated as other property (*i.e.*, boot). Since the recognition of gain under §356(a)(2) is limited to the fair market value of boot received, A and B will be taxed as in problem 10-10b**.**

If P Corp. uses appreciated Microsoft stock instead of its securities, P Corp. will recognize $50,000 gain on its exchange of the stock for T assets under §1001(a). T is not taxed on receipt of the Microsoft stock, because it is distributed as part of the reorganization, see §361(b)(1)(A). T also does not recognize any gain or loss on the distribution of that stock, because T's basis in that property equals its fair market value under §358(a)(2) (assuming that the distribution occurs right after T receives the stock). Shareholders A and B are taxed as above, because once again they receive boot. The only change is that the taxing provision applicable to A and B is §356(a)(1) without the help of §356(d).

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10-11. In problem 10-10a, the shareholders' taxation is governed by §354(a)(1). Because A and B exchange stock for stock without the receipt of any boot, the exchange is tax free. Basis carries over under §358(a)(1).

In problem 10-10b, at the shareholder level, both A and B receive inventory as well as P stock. This inventory constitutes boot, so that gain can be recognized but not in an amount in excess of the fair market value of the boot received. See §356(a)(1). For the reasons noted in the answer to problem 10-10b, A recognizes a $60,000 gain, and B recognizes a $40,000 gain. (The character of that gain is determined under §356(a)(2). After *Clark,* page 401, it may be capital gain depending on A's percentage ownership of P Corp. after the transaction. Characterization is better postponed until discussing problem 10-12.) As to both A and B, they take the inventory with basis equal to fair market value, see §358(a)(2), leaving a carryover basis for the P stock received, see §358(a)(1).

In problem 10-10c, this transaction fails to qualify as a C reorganization, because some non-stock consideration is furnished and the stock consideration does not equal or exceed 80% of the fair market value of the assets of T Corp. See §368(a)(2)(B). Thus, the transaction is treated as a taxable sale at the corporate level and as a taxable liquidation at the shareholder level.

In problem 10-10d, each shareholder is also treated as receiving boot, equal to the value of the securities each receives. Thus, A and B will be taxed in the same manner as in problem 10-10b**.** If P Corp. uses appreciated Microsoft stock instead of securities, shareholders A and B are taxed as above because once again they receive boot. The only change is that the taxing provision applicable to A and B is §356(a)(1) without the help of §356(d).

10-12. The merger of X into Y qualifies as an A/D reorganization because 50% (by value) of the consideration received is stock of Y, and B controls both X and Y. A realizes a gain on the transaction of $1,500, because A's amount realized equals $2,500 (of which $1,000 is cash and $1,500 is stock) while his adjusted basis was $1,000. B realizes a gain of $2,000, because B's amount realized equals $2,500 (of which $1,500 is in cash and $1,000 is in stock) while his adjusted basis was $500. Under §356(a)(1), A and B must recognize gain on the transaction up to the amount of the boot received. Accordingly, A must recognize a $1,000 gain while B must recognize a $1,500 gain. Under §358(a), because the boot received by each shareholder equals the shareholder's recognized gain, each shareholder will take a basis in the stock received equal to his basis in the stock given up. The only difficult issue to be resolved is the *character* of the gain recognized.

Under the approach accepted by the Supreme Court in *Clark*, page 401, we act as if the shareholders received only Y stock as part of the reorganization and then as if the excess shares were redeemed for the boot received. From the facts of the problem, each share of Y stock is worth $50. Accordingly, we act as if A and B each received 50 shares of Y stock, and then as if 20 of A's shares and 30 of B's shares are redeemed.

If A and B had each received 50 shares of Y, there would have been 200 shares outstanding. Of those 200 shares, A would have owned 25% (50 of 200) while B would have owned 65% (130 of 200). As a result of the redemption, A's ownership would drop to 20% (30 of 150) but B's ownership would increase to 66.7% (100 of 150). Thus, neither shareholder qualifies for exchange treatment under §302(b)(2) (although A comes as close as one can!). Arguably, however, the deemed redemption of A's Y stock is described in §302(b)(1), because A has no meaningful control of Y. The application of §302(b)(1) is far from clear, however.

Assume that each shareholder treats the exchange as having the effect of a dividend under §356(a)(2). Of the combined $2,500 received by A and B, how much is a dividend? The Supreme Court did not address the earnings and profits issue, but it seems as if the earnings and profits accounts of both corporations should be available. Under §356(a)(2), each shareholder takes into account his ratable share of earnings and profits, or $625 (25% of $2,500) for A and $1,625 (65% of $2,500) for B. Thus, all of A's gain and $625 of B's gain would be treated as a dividend. The remainder of B's gain would be capital gain. The taxpayers may argue, though, that only the earnings and profits of Y Corp. should be used, in which case only ratable shares $1,500 of the amount distributed would a dividend ($375 for A and $975 for B), with the remainder being capital gain.

Problems, page 408

10-13. Is this transaction a tax-free bankruptcy reorganization under §368(a)(1)(G)? The answer is yes. Under Treas. Regs. §1.368-1(e)(6), a creditor's claim against a target corporation may be treated as a target proprietary interest if the target is in a title 11 or similar case (*i.e.,* is bankrupt) or is insolvent (*i.e.,* its liabilities exceed the value of its assets immediately before the potential reorganization).

The proprietary interests in a bankrupt or insolvent target are divided into two groups: (i) the most senior class of target creditors that receives issuing corporation (*i.e.,* qualified) stock in the potential reorganization (the "senior creditors") and (ii) all junior target creditors and target shareholders. *See id*. at (e)(6)(ii). A senior creditor's interest is treated as in part debt and in part a proprietary interest if the senior creditors as a whole receive a mix of qualified stock and other assets in the potential reorganization. The percentage of each senior creditor's interest that is treated as a proprietary interest equals the percentage of qualified stock (by value) that is received by senior creditors as a whole. *Id.* at (e)(6)(ii)(A). Each junior creditor interest and target stock interest is also treated as a proprietary interest, with a value equal to the interest holder's claim. *Id.* at (e)(6)(ii)(B). *See also id.* at (e)(6)(iii) (discussing the bifurcation of a claim between secured and unsecured components); *id.* at (e)(6)(iv) (for a de minimis rule).

Thus, a potential reorganization will have 100% continuity of interest if (i) each senior creditor of a bankrupt or insolvent corporation receives solely stock (or the same ratio of stock to non-stock consideration) for its claim and (ii) no junior claim receives non-stock consideration. *See id*. at (e)(6)(ii)(A).

The L Corp. acquisition satisfies the continuity of interest requirement, because L Corp. is in bankruptcy and H, L Corp.'s sole creditor, receives Big Corp. stock in partial satisfaction of his $100,000 debt to L Corp. H's debt is bifurcated between debt and proprietary interest components, and H receives solely Big Corp. stock for the proprietary interest piece. Thus, the transaction has 100% continuity of interest and qualifies as a G reorganization.

Because the transaction is a tax-free reorganization, L Corp. recognizes no gain or loss on its asset transfer to Big Corp. (§361(a)) or on the distribution of the Big Corp. stock to L's creditor, H (§361(c)). However, L Corp. will recognize a $3,000 gain on its distribution of the short-term certificates of deposit. *Id*. Big Corp. will not recognize gain or loss on its acquisition of L Corp. assets for its stock (§1032), and it will take a transferred basis in the L Corp. assets (§362(b)), and will succeed to many of L Corp.'s tax attributes, including its NOLs (§381). Assuming H's basis in his debt is $100,000, he realizes and recognizes no gain or loss on the complete satisfaction of the debt for Big Corp. stock and the certificates of deposit. §356(a) and (c). H's basis in the L Corp. preferred stock equals $75,000 (his $100,000 basis in the debt minus $25,000 value of the boot received). §358(a). H takes a $25,000 basis in the certificates of deposit. §358(a)(2). Presumably, H can take a worthless stock deduction for his L Corp. stock. *See* §165(g).