CHAPTER 12 – ONE PARTY REORGANIZATIONS

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12-1a. If A is the founder of X Corp. and B is A’s child, the transaction described in problem 11-1(a) is a typical preferred stock estate freeze. Before the transaction, A has an interest in X Corp. worth $8,000 in the form of common stock. After the transaction, A’s interest in X Corp. is worth the same amount but is now in preferred stock. This change in the form of A's interest offers A two main advantages: (1) A’s interest is more secure because preferred stock bears less risk than common stock, and (2) A has shifted potential growth in X Corp. to B. It is this last feature of the transaction that makes it a good estate planning device.

This transaction should qualify as a tax-free recapitalization because there has been a genuine rearrangement of the capital structure of the corporation. In addition, the transaction was not motivated by a desire to avoid income tax. Thus, both A and B should take the new stock tax-free and with a carry-over basis pursuant to §§354(a)(1) and 358(a)(1). Is it relevant whether A and B are related? Historically not.

12-1b. This transaction *may* fail to qualify as a reorganization under *Bazley.* A has converted three-quarters of his interest ($6000) in the corporation from common stock to securities. Were A the only shareholder, surely *Bazley* would control. However, the effect of the transaction on B is to increase his percentage stock ownership of the company from 20% to 50% (with a concomitant decrease in A’s stock ownership percentage). Is this enough to distinguish these facts from *Bazley?* Probably: the Supreme Court based its opinion in *Bazley* on the fact that the effect of the nominal recapitalization was precisely the same as if a dividend of the securities had been declared. In the facts of this problem, that is not the case.

A will be taxed on the transaction under §§354(a)(2)(A), 356(a) and 356(d)(2) because he receives securities without relinquishing any securities in exchange. A’s realized gain in the transaction is $6,400 (amount realized of $8,000 less adjusted basis of $1,600), and the amount of the “boot” under §356(d)(2) is the “entire principal amount” of the securities received, or $6,000. Under §356(a)(1), gain is recognized to the extent of the boot, so that A recognizes only $6,000 of his gain.

The character of that gain is determined under §356(a)(2) and implicates the decision in *Clark* at page 401 of the text. Assuming that A and B are unrelated, A should avoid ordinary income treatment on the gain by looking to the rules of §302(b): the effect of the exchange was to reduce A's interest in the corporation from an 80% to a 50% interest, with one unrelated shareholder owning the remaining 50% interest. Under §302(b)(1), the transaction should *not* have the effect of a dividend. *See* Rev. Rul. 75-502 (discussed at 178 of the text).

The character of the gain is important not only because capital gain can be offset by capital loss without limitation but also because, under §453(f)(6), A can qualify for

installment sale treatment *only if* the effect of the transaction is *not* that of a dividend. Thus, if A wins on the characterization issue under §356(a)(2), he can defer recognition of the $6,000 gain until he receives payment on the securities.

If A fails to qualify for installment sale treatment (or elects out), his basis in the securities received will equal fair market value of $6,000 under §358(a)(2) and his basis in the common shares received will be $1,600 under §§358(a)(1) and 358(b)(1). However, if A qualifies for installment sale treatment, his basis in the securities is zero although his basis in the common stock remains at $1,600. See Prop. Regs. § 1.453- 1(f)(2)(iv) (ex. 1). Note in particular the way in which basis is allocated under this regulation. Basis is allocated first to the qualifying property up to the fair market value of such property, with any excess basis then allocated to the installment obligation. Absent installment sale treatment, basis is first allocated to the boot. See §§358(a)(2), 358(b)(l).

If A's basis in the stock had been $100 per share, then no gain would have been realized on the exchange. Thus, even if the effect of the transaction had been that of a dividend, no gain could be recognized. See §356(a)(2) (discussed at page 397-398 of the text). In such a case, winning the *Bazley* issue would be everything.

12-1c. If B is A's son, two issues will be affected. The first is the threshold issue: does the transaction qualify as a reorganization under §368(a)(1)(E)? A would like to distinguish *Bazley* by noting that *Bazley* involved a pro rata exchange of stock for stock and securities. Here, the non-pro rata nature of the transaction changes A and B's relative stock interests in the corporation vis-a-vis one another. However, if A and B are related, this change in relationship may have little practical significance. Accordingly, A is more likely to be taxed as if he had received the securities as a dividend and then contributed some of his common stock back to the corporation.

Even if A successfully deals with this challenge, he is unlikely to win the §356(a)(2) issue. Because A and B are related, the effect of the transaction- at least under a §302(b) analysis - is that of a dividend because A’s constructive ownership of X Corp. remains at 100% throughout. Thus A will recognize ordinary income of $6,000 in any event.

12-2. Does §1032 protect the corporation from the recognition of income here? No: §1032 provides only that no “gain or loss” is recognized on the exchange, while here there is cancellation of indebtedness (COI) income to the corporation, and COI is *not* “gain or loss.” Assuming the newly-issued shares are worth their par value, the corporation should have cancellation of indebtedness income of $200,000. See §108(e)(8); Treas. Regs. § 1.1001-3(a).

If the exchange were made pursuant to a conversion privilege in the outstanding bonds, there would be no immediate tax consequences to Y because there would be no “disposition” within the meaning of §100l(a). See Treas. Regs. §1.1001-3(c)(2)(ii).

12-3. At issue is whether the new bonds represent a “significant modification” of the old bonds within the meaning of Regs. § 1.001-3(a). Under Regs. §1.1001-3(e)(4)(iv) and (vi), the exchange will be taxable if the modification results in a change in payment

expectations (i.e. if the secured bonds offer a *substantial* enhancement of the obligor's capacity to meet the payment obligations under the instrument and that capacity was primarily speculative before but is adequate after the modification).

If the face value of the bonds is reduced to $70,000, the exchange is taxable under Treas. Regs, §1.1001-3(e)(1). Accordingly, Z Corp. has cancellation of indebtedness income of $30,000.

12.4 This problem and the next illustrate aspects of Regs. § 1.368-2(m) (the "F in the bubble" regulations). Under those regulations, if one corporation transfers its property to another corporation (the "resulting" corporation), the transfer qualifies as an F reorganization if the following six requirements are met:

(i) All stock of the resulting corporation is distributed in exchange for stock of the transferor corporation

(ii) With some exceptions, the persons who own stock of the transferor corporation immediately before the potential F reorganization own stock of the resulting corporation immediately after that reorganization and in the same proportions.

(iii) The resulting corporation generally does not own any property or have any tax attributes immediately before the potential F reorganization.

(iv) The transferor corporation completely liquidates for federal income tax purposes.

(v) The resulting corporation is the only acquiring corporation.

(vi) If the resulting corporation holds property acquired from a corporation other than the transferor corporation immediately after the potential F reorganization, it has not succeeded to tax attributes of the other corporation under §381.

Regs. §1.368-2(m)(1)(i)-(vi).

Further, a potential F reorganization may qualify as a reorganization under § 368(a)(1)(F) even if it occurs before or after other steps in the transaction that effect more than a mere change, and the step-transaction doctrine may apply to those other steps despite the interposition of the potential F reorganization. *Id*. at (m)(3)(ii).

The merger of P into Q qualifies as an F reorganization, even though it is preceded by the merger of T into S (where A, the former T shareholder, receives P stock) and followed by the redemption by Q of A's Q stock. The P-Q merger qualifies as an F reorganization, because the following six requirements were met: As part of the merger, (i) all Q stock was distributed in exchange for the P stock; (ii) the P shareholders immediately before the merger owned Q stock immediately after the merger in the same proportions; (iii) Q was a newly formed corporation with no tax attributes or property immediately before the potential F reorganization; (iv) as a result of the merger, P

completely liquidated for federal income tax purposes; (v) all P assets were acquired by Q in the merger; and (vi) Q held no assets other than the former P assets.

Although the P-Q merger is interposed between the merger of T into S (in which A, the sole T shareholder received P stock) and Q's redemption of A's Q stock received in the P-Q merger, the step-transaction doctrine applies. Because of the redemption, the T-S merger fails to satisfy the continuity of interest requirement and does not qualify as a § 368 reorganization. *See* Regs. § 1.368-2(m)(4), Ex. 7.

12-5. This problem is a variation of Regs. § 1.368-2(m)(4), Ex. 14. Because P owns all S1 and S2 stock, if S2 merges into S1, the merger qualifies as a reorganization under § 368(a)(1)(D), with S1 surviving. Thus, the taxable year of S2 closes. If S1 and S2 simultaneously merge into S3, a newly formed, wholly owned subsidiary of P, the merges each qualify as D reorganizations but the taxable years of both S1 and S2 close. If S1 and S2 merge into S3 sequentially, even if S1's merger precedes S2's merger by only a minute, the merger of S1 into S3 qualifies as an F reorganization (meeting the six requirements spelled out in the answer to problem 12-4), while the S2-S3 merger qualifies as a D reorganization. Thus, the taxable year of S2 closes but the taxable year of S1 does not. *See* § 381(b)(1) (providing that the taxable year of the transferor corporation in an acquisition reorganization other than an F reorganization closes at the end of the date of transfer).

Why might it matter? P may prefer to have S1 and S2 combine with S3 to change the state (or states) of incorporation of those corporations. It might then prefer the last alternative if it anticipates that S3 may have losses or credits that it prefers to carry back to S1's pre-merger taxable years. (Note that currently net operating loss carrybacks are limited to farming losses or net operating losses of a property or casualty insurance company. *See* § 172(b)(1)(B) and (C). However, a corporation's capital losses may be carried back three years. § 1212(a)(1)(A). *See also* § 39(a)(1) (for business credit carrybacks).) Under § 381(b)(3), the acquiring corporation in an acquisitive reorganization (other than an F reorganization) cannot carry back its net operating losses or net capital losses to any taxable years of the transferor corporation.