12

One-Party Reorganizations

A. RECAPITALIZATIONS

A recapitalization, in general, refers to a readjustment of the capital structure of a single, existing corporation. As with other tax-free reorganizations, discussed in Chapters 10 and 11, the assumptions underlying nonrecognition are that the stock received in a recapitalization is a continuation of the old investment with a mere change in form and that gain or loss consequently should not be recognized, except as to boot received in the exchange. Unlike other non-divisive reorganizations, continuity of business enterprise and continuity of interest are not required for a recapitalization (or a reincorporation). Treas. Regs. §1.368-1(b).

The term "recapitalization" is not defined in the Code, and consequently its scope at the margins may be uncertain. Many types of conversions have been swept into its meaning by cases and rulings.

The classic recapitalization occurs when a closely held family corporation has older owners close to retirement age who wish to transfer the opportunity for growth to younger managers, often their children. Typically, the recapitalization in that case will involve an exchange of the older owners' common stock for preferred. This exchange, sometimes called an "estate freeze," suits the estate planning needs of the retiring owners by keeping future equity appreciation out of their estates while retaining for them, in more secure form, their capital in the corporation. In addition, dividends on the preferred stock may provide the older owners with a stable retirement income. The recapitalization also suits the younger managers, who are eager to be rewarded for their efforts with the equity growth of the corporation but are unable to buy significant amounts of the old common stock. Risk of future loss also will be transferred to the new equityholders because the preferred stock has a preferred position over the common.

Another common type of recapitalization, filling a much different need and with a host of problems beyond the scope of this discussion, occurs with a financially distressed corporation. In such a case, the debtors and shareholders may together recapitalize the company's debt and equity structure, or they may contribute their debt and equity interests to a new corporation. See pages 404-408 infra.

If an exchange of stock for stock is treated as a tax-free recapitalization, the exchanged-basis rules of §358 apply so that the basis of the stock received remains the same as the stock surrendered. In a recapitalization, the corporation usually retains all of its tax attributes—e.g., no change in the basis of its assets, no effect on its earnings and profits. The corporation's tax existence, in other words, continues without interruption. Thus, there is no special provision for the carryover of tax attributes (such as a net operating loss), and the rules of §381 applicable to most reorganizations generally do not apply to recapitalizations.

Section 305(b) and (c) can make taxable certain disproportionate recapitalization exchanges when the effect of the transaction is a non–pro rata stock dividend. See, e.g., Treas. Regs. §1.368-2(e)(5). The Service does not, however, usually raise the §305(b) and (c) problems in the isolated recapitalization of a closely held corporation. See Rev. Rul. 75-93, 1975-1 C.B. 101, in which a disproportionate recapitalization exchange did not trigger §305(c) because it was not part of a plan to periodically increase equity interests. To the same effect, see Gen. Couns. Mem. 39088 (Dec. 7, 1983). See also Treas. Regs. §1.305-3(e) (examples 10, 11, and 12).

Recapitalizations can cover a variety of stock exchanges. For examples, see Treas. Regs. §1.368-2(e) as well as the following: common stock for preferred stock, Rev. Rul. 74-269, 1974-1 C.B. 87, and preferred stock for common stock, Rev. Rul. 77-238, 1977-2 C.B. 115. Recall from page 246 supra that an exchange of common stock for preferred stock may cause the preferred to be §306 stock under §306(c)(1)(B).

Recapitalizations also can include exchanges of bonds as well as of stock. The Service has ruled that convertible bonds may be exchanged for stock of the same corporation without recognition. See Rev. Rul. 72-265, 1972-1 C.B. 122 (applying the open-transaction doctrine). Non-convertible bonds may be exchanged for stock or bonds. See also §1273; §1274 (to determine whether a bond received in an exchange has original issue discount). In Rev. Rul. 77-437, 1977-2 C.B. 28, the Service ruled that a debtor corporation recognized income from the cancellation of indebtedness on a bond exchange to the extent that the face value of the old bonds exceeded the face value of the new bonds.

A controversial problem in the recapitalization area has been how to treat the exchange of stock for bonds, as illustrated in *Bazley* below. It always has been clear that if a corporation simply distributes its own debt securities on its stock and has adequate earnings and profits, the distribution is a taxable dividend. See page 120 supra. But the status of debt securities issued by a corporation in the course of a corporate recapitalization has been less clear. The 1939 Code provided (as does the "general rule" laid down in §354(a)(1) of the 1954 Code) that no gain or loss was recognized if stock or securities of a corporation that was a party to a "reorganization" were exchanged for stock and securities of the same corporation; the 1939 Code, like §368(a)(1)(E) of the current Code, defined a "reorganization" to include a recapitalization. Suppose, then, that a corporation "recapitalized" by calling in its outstanding common stock and issuing in exchange other common stock (with a different par value or some other alteration of rights) plus bonds, debentures, or notes. Should the transaction be a tax-free exchange of the old stock for the new stock and bonds or other debt instruments? Should it be treated as a taxable sale or exchange? As a dividend of the debt instruments? *Bazley* considers this problem. For the effect of §354(a)(2) enacted in 1954, see the Note following *Bazley*.

Bazley v. Commissioner

331 U.S. 737 (1947)

Mr. Justice FRANKFURTER delivered the opinion of the Court.…

[T]he 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 a plan of reorganization," and as such no gain is recognized for income tax purposes. [§§368(a)(1)(E) and 354(a)(1).[*]] 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(a)], any exchange of "stock or securities" in connection with such transaction, cannot be "in pursuance of the plan of reorganization" under [§354]. 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.…Congress has never defined it and the Treasury Regulations shed only limited light. Treas. Regs. [§1.368-2(e)(1)-(4)]. 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

[*] Section 354(a)(2), which greatly limits the general rule of §354(a)(1), was not enacted until 1954.—EDS.

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.…

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 [§354], 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.…

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.…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.…

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.…

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 [§356(a)(1) and (2)]. Commissioner v. Estate of Bedford, 325 U.S. 283.…

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.

NOTES

1. *The 1954 changes in §354*. Although the 1954 Code continued the general nonrecognition rule for shareholder exchanges incident to reorganizations, it added §354(a)(2) limiting nonrecognition to cases in which the principal amount of securities (debt instruments) received does not exceed the principal amount of debt instruments surrendered. By virtue of §354(a)(2), in conjunction with §356(a) and (d), the debentures in *Bazley* would have been treated as boot even if the transaction had been treated as a

reorganization, because no debt instruments were surrendered.

Does §354(a)(2) render *Bazley* obsolete? Securities constituting boot received in a reorganization may be taxed under the installment sale provisions. See §453(f)(6) (last sentence). If such taxation is available, gain will be deferred until payment on the securities is received. See §453(c). But if under *Bazley* an exchange is held to be a distribution taxable under §301 rather than a recapitalization, installment sale treatment is unavailable and the securities will be taxable on receipt. Accordingly, *Bazley* is still important for its gloss on the definition of a "recapitalization." Note that installment sale treatment is not available for securities that are "readily tradable."§453(f)(4)-(5).

Securities received as boot in a reorganization will not qualify for installment sale treatment under §453(f)(6) if receipt of the securities has the effect of a dividend. See §356(a)(2). Recall *Clark*, page 401 supra, defining dividend equivalency. For a discussion of the relationship between the reorganizations provisions and the installment sale provisions, see Siegel, Installment Sales—Relationship to Section 385 Regulations, Section 337 Sales, and Other Concepts, 40 N.Y.U. Inst. Fed. Tax. ch. 46, at §46.06 (1982). See also Prop. Regs. §1.453-1(f)(2).

2. *The effect of* Bedford. *Bedford*, cited by the Supreme Court in *Bazley*, involved these facts: Under a recapitalization plan, a shareholder exchanged 3,000 shares of cumulative preferred stock (par value $100) for 3,500 shares of cumulative preferred stock (par value $75), 1,500 shares of common stock (par value $1), and $45,240 of cash. The shareholder's gain (the difference between the adjusted basis of the shares given up and the value of the stock plus cash received) was $139,740. The corporation's earnings and profits were sufficient to cover the entire cash distribution. The government admitted that the transaction was a reorganization exchange, and the taxpayer admitted that the cash was property not permitted to be received tax free—i.e., boot. The only issue was whether under what is now §356(a)(1) and (2) the boot should be taxed as capital gain—like a sale of stock for cash—or as a dividend. The Court, conceding that the matter was not "wholly free from doubt," concluded that because the corporation had earnings and profits, the distribution of cash had "the effect of the distribution of a taxable dividend." The result of *Bedford* became generally known as the automatic dividend rule, a rule that

is now discredited. See pages 401-402 supra.

3. *The "dividend limited to gain" rule of §356*. In citing §356 and *Bedford* as an alternative route to the same result reached by the "no reorganization" route, the Court in *Bazley* may have overlooked the fact that §356(a) requires boot to be treated as a dividend only if, and to the extent that, the taxpayer realizes a gain on the exchange itself. For example, suppose individual *A* owns the 100 outstanding shares of *X* Corp. with an adjusted basis and fair market value of $100 per share. What are the tax consequences under §§354 and 356 if *A* exchanges all the stock for 50 shares of newly issued common stock worth $40 per share plus securities with a fair market value of $8,000, assuming that the exchange constitutes a "recapitalization" within the meaning of §368(a)(1)(E)? Because there is no gain (within the meaning of §1001(a)) on the exchange, *A* recognizes no income under §356 despite the presence of boot.

Turning to *Bazley*, the value of the stock and securities received may well have exceeded the taxpayer's basis for the stock surrendered, but the Tax Court made no finding to this effect. Even if there had been such a finding, the amount of the taxpayer's gain might have been less than the value of the distributed securities. Under the Supreme Court's holding in *Bazley*, the taxpayer recognized the full value of the securities received as income without any offset for his basis in the stock turned in. Accordingly, even a taxpayer captured by the excess securities rule of §354(a)(2) may profit by arguing in favor of reorganization treatment for the exchange.

4. *Use of debt in a corporation's capital structure*. On incorporation, corporations often issue bonds or debentures to the incorporators, in addition to stock, so that the corporation can lay a foundation for the deduction of interest under §163. See pages 89-104 supra. Moreover, the bonds can be retired at the capital gain rate under §1271, while the redemption of stock would be open to the Pandora's box of §302. See pages 155-187 supra. In addition, an accumulation of surplus by the corporation to pay off the indebtedness, unlike an accumulation for the purpose of redeeming stock, may be permissible under §531, see pages 489-490 infra. *Bazley* and §354(a)(2) mean that a corporation that does not issue debt securities for these purposes to its shareholders at the time of incorporation may not find it easy to rectify its error in a tax-free manner later.

5. *Bankruptcy workouts and other debt restructurings*. When a corporation's financial health becomes impaired, the rights of creditors often are increased. For example, the failure of a corporation to make interest payments when due may entitle bondholders to take control of the company's board of directors. If the corporation's fortunes do not improve, the creditors may seek to restructure their interests in the enterprise; in the extreme case, the creditors may seek to oust the shareholders entirely.

Consider the situation in which a corporation replaces its outstanding debt with new debt having different terms. For example, short-term, low-interest notes might be replaced with long-term, higher-interest bonds. What are the tax consequences of such a debt swap?

Under Treas. Regs. §1.1001-3, "a significant modification of a debt instrument…is deemed to result in an exchange of the original instrument." Accordingly, except as provided in §354 or §356, gain or loss may be recognized by the debtholder. Thus, if the value of the debt received exceeds the holder's adjusted basis in the debt surrendered, gain may be recognized on the exchange. This might be the case when the corporation's distress has been reflected in the market price of its notes so that current holders of those notes may have paid significantly less than face value. The definition of a "significant modification" is contained in Treas. Regs. §1.1001-3(e).

The transaction may also result in cancellation of indebtedness income to the corporation if it substitutes current low value debt for outstanding obligations initially issued for face value. For example, if a corporation exchanges bonds with an $800 issue price for each $1,000 short-term note outstanding, the corporation will recognize $200 of cancellation of indebtedness income on each exchange. See §108(e)(10)(A). Generally, unless the exchange occurs while the corporation is insolvent or in a bankruptcy proceeding, the cancellation of indebtedness income will be included in gross income immediately. See §§61(a)(12), 108(a). If the insolvency exception applies, the amount included in gross income will be limited to the extent of the debtor corporation's insolvency. Section §108(a)(3).

A corporation might also swap stock for debt. To the extent that the value of such stock is less than the adjusted issue price of the surrendered debt, once again the corporation will recognize cancellation of indebtedness income, except to the extent that §108 applies. See §108(e)(8). Further, if application of §108 to an insolvent or bankrupt corporation permits the corporation to exclude some or all of its cancellation of indebtedness income, the corporation will be forced to reduce its tax attributes (including its tax credits, net operating loss carryovers, and adjusted basis) as the tax "payment" for the exclusion. See §108(b).

B. REINCORPORATIONS

Suppose a corporation changes the state of its incorporation. Formally, the shareholders must relinquish their old shares in exchange for new ones. Should such an exchange be a taxable event? In a case that antedated special statutory treatment for corporate reorganizations, the Supreme Court held that the reincorporation of General Motors Corporation from New Jersey to Delaware (coupled with a transfer of $5 million from the corporation's earned surplus account to its capital account and minor changes in the terms of the corporation's preferred stock) was a taxable event to shareholders exchanging General Motors (New Jersey) common stock for General Motors (Delaware) common stock. Marr v. United States, 268 U.S. 536 (1925).

The definition of a "reorganization" now includes such reincorporations and other changes in the identity or form of one corporation. See §368(a)(1)(F). The taxable year of any corporation reincorporated under §368(a)(1)(F) does not end, and as with recapitalizations, the limitations applicable to the carryover of tax attributes in a reorganization are generally not applicable to such reincorporations. See, e.g., §381(b) and pages 456-457 infra. Note that continuity of business enterprise and continuity of interest are not required for an F reorganization. Treas. Regs. §1.368-2(m)(2).

Until the Tax Equity and Fiscal Responsibility Act of 1982, F reorganizations were not expressly limited to mere changes in the form, identity, or place of incorporation of a *single* corporation, and case law had treated the amalgamation of multiple corporations as an F reorganization so long as there was a sufficiently high percentage of common ownership. See, e.g., Davant v. Commissioner, 366 F.2d 874 (5th Cir. 1966); Reef Corp.

v. Commissioner, 368 F.2d 125 (5th Cir. 1966). The Conference Report accompanying TEFRA of 1982 included the following:

> This limitation [added to §368(a)(1)(F)] does not preclude the use of more than one entity to consummate the transaction provided only one operating company is involved. The reincorporation of an operating company in a different State, for example, is an F reorganization that requires that more than one corporation be involved.

H.R. Conf. Rep. No. 760, 97th Cong., 2d Sess. 541 (1982). *Cf.* 1996 WL 33320990 (IRS FSA) (Mar. 4, 1996) (suggesting that an F reorganization can involve two corporations if one of the corporations has no "tax history"). Accordingly, regardless of the extent of common ownership or control, the amalgamation of two or more operating corporations cannot be an F reorganization. See pages 374-383 supra for application of the D reorganization in such circumstances.

Finally, a corporation generally does not engage in an F reorganization if its existing shareholders or assets change. See Rev. Rul. 96-29, 1996-1 C.B. 50 (also stating that a recapitalization "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 in existence prior to the reorganization"). But how is a potential F reorganization treated if it is part of a larger transaction in which those changes occur? Could it be tested separately from the other parts of the transaction? The answer is generally yes, under what is often called the "F in the bubble" principle. See *id*.

That principle is now incorporated in Treas. Regs. §1.368-2(m). 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 (except for a de minimis amount of resulting corporation stock issued to facilitate its organization or to maintain its corporate existence).

ii. With some exceptions, those 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.[1]

iii. The resulting corporation generally does not own any property or have any tax attributes immediately before the potential F reorganization.[2]

iv. The transferor corporation completely liquidates for federal income tax purposes. Note that it does not have to dissolve and may continue to hold a de minimis amount of assets for the sole purpose of preserving its corporate existence.

v. The resulting corporation is the only acquiring corporation. Thus, another corporation may not hold property previously held by the transferor corporation if the other corporation would succeed to transferor items under §381.

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.

Treas. Regs. §1.368-2(m)(1)(i)-(vi).

Those six requirements are tested during the period that begins when the transferor corporation first transfers assets to the resulting corporation and ends when the transferor corporation liquidates. Steps that occur during that period may be re-characterized under the step-transaction doctrine. *Id*. at (m)(3)(i). However, to implement the "F in a bubble" principle, related events occurring outside of that period generally will not affect whether those requirements are met (*i.e.*, whether the relevant steps qualify as an F reorganization). *Id*. at (m)(3)(ii). For example, a transaction may qualify as an F reorganization even if the resulting corporation has a transitory existence.

---

[1] This requirement is not violated if some transferor shareholders exchange their transferor stock for resulting corporation stock of equivalent value but having different terms. It is also not violated if some transferor shareholders receive distributions of money or other property from the transferor or resulting corporation, including in exchange for stock. See Treas. Regs. §1.368-2(m)(1)(ii). See also *id*. at (m)(3)(iii). If a shareholder receives a distribution (including as a redemption) from the transferor or resulting corporation as part of an F reorganization, the receipt of money or other property is treated as a transaction separate from and unrelated to the F reorganization. *Id.*

[2] However, it may hold a de minimis amount of assets necessary to facilitate its organization or to maintain its corporate existence and may hold the proceeds of borrowings undertaken in connection with the potential F reorganization.

If a potential F reorganization could qualify as both an F reorganization and another reorganization under §368(a)(1), the following overlap rules apply: If a corporation in control of the resulting corporation is a party to such other reorganization, the transaction is *not* treated as an F reorganization. *Id*. at (m)(3)(iv)(A). In other cases, if the transaction may also qualify as an A, C, or D reorganization it is treated as an F reorganization. *Id*. at (m)(3)(iv)(B).[3]

To illustrate the regulations, consider example 5 in Treas. Regs. §1.368-2(m)(4). In that example, P, a corporation, owns all stock of S1, a state A corporation. As part of an integrated plan, P forms S2, a state B corporation, P contributes its S1 stock to S2, and S1 merges into S2. Under the step-transaction doctrine, those steps are treated as if S1 transferred its assets to S2 and distributed the S2 stock to P in liquidation. See Rev. Rul. 67-274, 1967-2 C.B. 141.

Those steps meet all six requirements under Treas. Reg. §1.368-2(m)(1) and qualify as an F reorganization. Under the step-transaction doctrine, S1, the transferor corporation, is deemed to completely liquidate, distributing the stock of S2, the resulting corporation, to P in exchange for P's S1 stock, thus satisfying requirements (i) and (iv). In addition, P owned all S1 stock before the transaction and owns all S2 stock thereafter, satisfying requirement (ii). Finally, S2 had no assets or tax attributes before the transaction and its sole assets thereafter are all former S1 assets, satisfying the remaining requirements.

Note that the merger of S1 into S2 could also qualify as an A or D reorganization, but because P would not be a party to that reorganization, under the overlap rule, the transaction is treated as an F reorganization. Treas. Regs. §1.368-2(m)(3)(iv)(B).

As a variation of the preceding example, suppose that as part of the same plan but after S1 merged into S2, S2 distributed cash to P or P sold the S2 stock to an unrelated person. Because the distribution or sale would occur after S1 was deemed to liquidate, the distribution or sale would be considered separate from the earlier steps, and the earlier steps would still be treated as an F reorganization. See *id*. at (m)(4) (examples 2

[3] Thus, if the transaction could qualify as an F or G reorganization, it will be treated as a G reorganization. See §368(a)(3)(C) (providing that priority). Further E and F reorganizations may continue to overlap.

and 6).

PROBLEMS

12-1. *X* Corp. has 100 shares of common stock outstanding, 80 owned by *A* and 20 by *B*. The fair market value of the *X* Corp. stock is $100 per share, and *X* Corp. has substantial earnings and profits. *A*'s basis in the *X* Corp. stock is $20 per share, while *B*'s basis in the *X* Corp. stock is $40 per share. What are the tax consequences to *A*, *B*, and *X* Corp. of the following alternative transactions?

a. As part of a single transaction, *A* exchanges all her *X* Corp. stock for 800 shares of newly issued, nonvoting preferred stock (worth $10 per share), and *B* exchanges all his *X* Corp. stock for 100 shares of newly issued common stock.

b. As part of a single transaction, *A* exchanges her *X* Corp. stock for 20 shares of a new class of common stock and long-term bonds with face amount and fair market value of $6,000. *B* exchanges his *X* Corp. stock for 20 shares of the newly issued common stock. How would your answer change if *A*'s basis in the *X* Corp. stock were $100 per share?

c. How would your answers to (b) change if *B* were *A*'s son?

12-2. *Y* Corp., doing poorly but not yet insolvent, acquires its outstanding, long-term bonds having an issue price of $1 million in exchange for 800 shares of newly issued preferred stock with par value and fair market value of $1,000 per share. What are the tax consequences of the exchange to *Y* Corp.? How would your answer change if the exchange were made pursuant to a conversion privilege in the cancelled bonds?

12-3. *Z* Corp. has outstanding 20-year unsecured bonds with a face value of $100,000 and fair market value of $70,000. What are the tax consequences to *Z* Corp. and to its bondholders if it exchanges these instruments for secured bonds having the same face value and bearing the same interest rate and maturity? What is the result if the new secured bonds have a face value and fair market value of $70,000?

12-4. *A* owns all *T* stock and *P* Corp. own all *S* stock. As part of a single plan, *T*

Corp. merges into *S* Corp. and *A* receives solely *P* stock; *P* Corp. merges into *Q* Corp., a newly formed corporation incorporated in a different state and the *P* shareholders exchange their *P* stock solely proportionately for *Q* stock having the same terms; finally, *Q* redeems all of *A*'s *Q* stock. Explain how the transaction is characterized for federal income tax purposes. See Treas. Regs. §1.368-2(m)(4) (example 7).

12-5. *P* Corp. owns all stock of two subsidiaries, *S1* Corp. and *S2* Corp. How would the merger of *S2* Corp. into *S1* Corp. be treated? How about if *P* Corp. forms *S3* Corp. and simultaneously merges *S1* Corp. and *S2* Corp. into *S3* Corp.? How about if the merger of *S1* Corp. into *S3* Corp. precedes the merger of *S2* Corp. into *S3* Corp. by one minute? See Treas. Regs. §1.368-2(m)(4) (example 14). Why might *P* Corp. prefer the last alternative?