1986

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Recommended Citation
Daniel Q. Posin, Treatment of the Participants in a Reorganization: Policy after the 1986 Act, 40 Sw L.J. 1169 (1986)
https://scholar.smu.edu/smulr/vol40/iss5/4

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TREATMENT OF THE PARTICIPANTS IN A REORGANIZATION: POLICY AFTER THE 1986 ACT

by

Daniel Q. Posin*

This Article reviews the present rules for taxation of participants in tax-free corporate reorganizations. It discusses the changes brought to this area by the Tax Reform Act of 1986. The discussion demonstrates that even after the 1986 Act, the rules in this area are a patchwork collection; the rules frequently lead to results that are not sensible and that are contradictory and unpredictable. This Article then examines a number of proposals for reform of these rules, including the proposals for reform propounded by the staff of the Senate Finance Committee, which were developed from the work of the American Law Institute, the American Bar Association Committee on Corporate Stockholder Relations, and other professional organizations. These Senate staff proposals were adopted as part of the draft tax reform bill considered by the Senate Finance Committee, but the proposals were not incorporated in the final version of the 1986 Act. Nevertheless, these proposals are still of great importance since they seem likely to serve as a major point of departure for the Treasury study on

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The author would like to express his appreciation to Professor Alan R. Bromberg, University Distinguished Professor of Law, Southern Methodist University, for his interest in this work.


3. Joint Committee on Taxation, Tax Reform Proposals in Connection with Committee on Finance Markup 53-54 (Joint Comm. Print 1986).


I. IMPACT OF THE TAX REFORM ACT OF 1986

The Tax Reform Act of 1986 effected major changes in various areas of the tax law in general and corporate taxation in particular. The basic structure of the corporate reorganization provisions, however, was not changed by the Act. Nevertheless, some significant changes were made to the corporate reorganization rules, including the rules concerning the treatment of the participants in a reorganization.

One of the most important changes brought about by the new tax law was the repeal of the favorable rules for taxing capital gains. Reorganizations typically involve modification or elimination of capital investment. Thus, whether a recognized gain is a capital gain has always been a major point of contention in this area of the tax law.

Repealing the favorable treatment of capital gains raised the top rate of tax on capital gains to 28% from 20% for individuals and generally to 34% from 28% for corporations. While the 1986 Act eliminated favorable treatment of capital gains, capital gain still remains an important part of this nation's tax system in general and of the reorganizations area in particular. There are several reasons for this.

First of all, although the favorable treatment of capital gains was repealed for individuals and corporations, the 1986 Act still treats capital losses for both individuals and corporations unfavorably. For individuals, the unfavorable treatment of capital losses is the same as under prior law except that the new law repeals the rule that only one-half of long-term capital losses could be deducted against ordinary income. Thus, under the 1986 Act, both long- and short-term capital losses for individuals can only be deducted against ordinary income to the extent of capital gains plus an additional

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5. Id. at II-207.
6. Id. at II-105 to -106. For the 1987 transition year the top rate for corporations is 40%. Id. at II-159. The top 1987 rate for individuals' short-term capital gains could be 35% or 38.5%. Id. at II-103 to -104. For individuals the 1987 long-term capital gains rate is capped at 28%. Id. at II-106.
8. Under the rules prior to the 1986 Act, corporations' favorable capital gain treatment was an alternative rate of 28% which applied if that rate was lower than the applicable regular graduated corporate rates. Id. § 1201(a) (1982) (amended 1986).
9. Under prior law, individuals' capital losses were deductible only to the extent of capital gains plus $3000. Only one-half of net long-term capital losses in excess of net short-term capital gain could be used for this purpose. Net short-term capital losses were used against the $3000 limit before net long-term capital losses. Thus, a capital loss that was large relative to capital gains could not be deducted in full in the year in which it was incurred. Unused capital losses could be carried forward indefinitely until they were used up. I.R.C. §§ 1211(b), 1212(b) (1982) (amended 1986); see D. Posin, FEDERAL INCOME TAXATION OF INDIVIDUALS § 4.06 (1983).
$3000. Any unused capital losses are carried forward indefinitely. For corporations, the unfavorable treatment of capital losses is the same as under prior law, namely that capital losses are deductible only to the extent of capital gains. Excess capital losses may be carried back three years and forward five years.

It is not possible to compute net capital losses properly without also taking account of any capital gains of the taxpayer during the year. Even after the 1986 Act, the entire panoply of capital gain and loss rules must still be brought to bear on any transaction, including a reorganization, in order to determine whether the taxpayer has capital gains against which capital losses can be taken, and whether a net capital loss exists, which must be subject to the $3000 limitation.

The second reason why capital gains and losses are still an important part of the nation's tax system in general and the reorganizations area in particular stems from some interesting language in the legislative history of the 1986 Act. That legislative history states: “The current statutory structure for capital gains is retained in the Code to facilitate reinstatement of a capital gains rate differential if there is a future tax rate increase.” In this era of large federal budget deficits, a tax increase will likely be in the offing within the next several years; therefore, the favorable treatment for capital gains may soon return to center stage to rejoin its sister, the unfavorable treatment of capital losses.

Several other reasons explain why capital gains and losses are still an important part of the nation's tax system including the reorganizations area. A number of transactions were consummated prior to January 1, 1987, the effective date of the new rules. The results of these transactions may be in dispute for the next several years. Also, capital gains are still important because for the transitional year of 1987 a capital gain rate does exist. The top rate on long-term capital gains for individuals is capped at 28%, even though ordinary income and short-term capital gains can be taxed at the higher brackets of 35% or 38.5%. Finally, capital gains remain an important aspect of the nation's tax system because some states, in their state income tax, provide favorable treatment for capital gains as defined in the federal system. Thus, for at least each of these independent reasons, the question of whether a transaction gives rise to a capital gain or loss remains a central issue in the tax field in general and the field of corporate reorganizations in particular.

12. See id. § 1212(b).
13. Id. § 1211(a).
14. Id. § 1212(a).
16. Id. at II-106.
17. Id. at II-105 to -106.
18. Id. at II-3 to -4.
II. General Background

In general, the American income tax system taxes the appreciation in value of an asset only at the time of a realizing event, such as a sale or other disposition of the asset.\(^\text{19}\) A broad variety of transactions exist that, although they constitute realizing events under established case law, nevertheless are exempted from taxation by the Internal Revenue Code. These exempted transactions, generally referred to as nonrecognition transactions,\(^\text{20}\) involve an exchange of an asset for another asset of a particular type that qualifies for nonrecognition of gain. The nonrecognition of gain, or loss, on the transaction is only temporary, however, as basis adjustments to the property received in the exchange insure that the unrecognized gain or loss will be accounted for on a subsequent disposition of the property.\(^\text{21}\)

Since relatively early in the history of the American tax system, provisions have existed for nonrecognition to shareholders and corporations involved in various corporate restructurings or reorganizations.\(^\text{22}\) The theory of this treatment is similar to the theory of other nonrecognition provisions such as a like-kind exchange\(^\text{23}\) or rollover of gain on a principal residence:\(^\text{24}\) the fact that the taxpayer has reinvested in an asset that is somewhat similar to the one disposed of means that the system should not impose a tax on the transaction. To impose a tax on the transaction, so the theory goes, would discourage taxpayers from shifting their investments and thus introduce tax-generated rigidities into the capital markets.\(^\text{25}\) This logic for nonrecognition treatment is not of overpowering persuasiveness when applied to corporate reorganization transactions.\(^\text{26}\)

\(^{19}\) See Eisner v. Macomber, 252 U.S. 189, 202-04 (1920) (involving taxability of a pro rata stock dividend, an issue currently governed by I.R.C. § 305 (1986)); see also Marr v. United States, 268 U.S. 536, 539-40 (1924) (holding General Motors' change of state of incorporation from New Jersey to Delaware a realizing event). Some exceptions to the realization requirement are the taxation of undistributed profits of a controlled foreign corporation to United States shareholders, I.R.C. § 951(a)(1) (1986), and the treatment of commodity and stock option tax straddles, id. § 1256(a).

\(^{20}\) See, e.g., I.R.C. §§ 354, 361, 721, 1031, 1033, 1034 (1986). Exchanges for cash, i.e., sales, are always taxable. See id. § 1001(c) (in the absence of an applicable nonrecognition provision, gain or loss on sale or exchange of property recognized); see also D. Posin, supra note 9, ch. 4.

\(^{21}\) See, e.g., I.R.C. §§ 358, 1031(d), 1033(b), 1034(e) (1986). The basis rules that purport to insure later taxation of gain on property received in a nonrecognition transaction may be circumvented if the taxpayer is so astute as to die holding the property, since the taxpayer's death would be the occasion for a step up in the basis of the asset to its fair market value. I.R.C. § 1014 (1986); see generally D. Posin, supra note 9, §§ 4.03(2)(e) (basis in property acquired from decedent).


\(^{23}\) I.R.C. § 1031 (1986).

\(^{24}\) Id. § 1034.

\(^{25}\) Under this theory, the receipt of cash is always taxed since the taxpayer has withdrawn his investment and may thereafter apply the proceeds to a completely different type of investment or use the proceeds for personal purposes.

\(^{26}\) For example, the sole stockholder of a fast food restaurant may, under the corporate reorganization rules, exchange the stock of his corporation for stock of International Telephone & Telegraph Corporation in a nonrecognition transaction, despite the fact that the na-
PARTICIPANTS IN A REORGANIZATION

Perhaps because the treatment for taxing corporate reorganizations lacks a cohesive rationale, the field has evolved into a patchwork collection of complex and sometimes contradictory rules. The problems are most evident in the treatment of the taxation of the participants in a reorganization: the corporations involved in the reorganization and the shareholders and security holders, or creditors, of the corporations.

III. THE FRAMEWORK OF THE REORGANIZATION PROVISIONS

The participants in a corporate reorganization are the corporations involved in the transaction and the stockholders and security holders, or creditors, of the corporations. A transaction is not taxable to reorganization participants only if it meets both of two tests. First, the transaction must meet the definition of a corporate reorganization. Second, the participants in the reorganization must qualify for nonrecognition treatment under the operating rules. This section briefly discusses the definition of a reorganization; later sections of this Article discuss the operating rules. Section 368(a)(1)(A) through (G) sets forth the definition of a corporate reorganization; it provides a list of seven qualifying transactions. The transaction defined in section 368(a)(1)(A) is called in the trade a type A reorganization; the transaction defined in section 368(a)(1)(B) is called a type B reorganization, and so forth down the "alphabet soup." These seven types of transactions really break down into three basic patterns. There are acquisitive transactions that involve one corporation acquiring another. Type A, B, and C reorganizations are included in this category. A second pattern is the restructuring transaction that involves one corporation changing its form or capital structure. This category includes type E, F, and G reorganizations and nondissive type D reorganizations. The third pattern of transaction is the type D divisive reorganization.

IV. NONRECOGNITION OF GAIN TO THE TRANSFEROR IN A REORGANIZATION

A. Prior to the 1986 Act

Under prior law, the target corporation in a reorganization, the corporation that transferred business assets, recognized no gain or loss on the transaction if it exchanged its property solely for stock or securities of the acquiring corporation. This general rule of nonrecognition applied regard-
less of the type of property that the target transferred to the acquiring corporation. The target could transfer physical operating assets, stock or securities, or intangible property, such as good will or patents.33

1. Receipt and Distribution of Boot

Prior to the Tax Reform Act of 1986, the Code provided that the general rule of nonrecognition of gain would be lifted if the target corporation received not only stock or securities, but also other property or money, that is, boot.34 Loss, however, was still not recognized on the receipt of boot.35 The pre-1986 statute provided further that in the event the target received money or other property as boot, the target still had the opportunity to avoid recognition of gain if it distributed the other property or money to its shareholders pursuant to the plan of reorganization.36 If the boot was property other than cash, it would then have had a cost or fair market value basis in the hands of the target corporation prior to its distribution.37 The Code was unclear, however, whether the target would have had gain or loss recognized on the distribution of the property, as opposed to the receipt of the property, if the property's fair market value changed prior to the distribution to the shareholders. Probably section 336, prior to amendment by the 1986 Act, would have protected the corporation in this setting. Section 336 provided for nonrecognition of gain on the distribution of property in complete liquidation.38

Prior to the 1986 Act, however, the protective rule with respect to distribution of boot did not apply to distributions of boot to creditors, including security or bond holders. If the target distributed boot to creditors, the distribution was not considered as made in pursuance of the plan of reorganization.39 The target corporation, therefore, would have been taxed on the receipt of boot that was distributed to creditors. If the boot was property other than cash, it would then have taken a cost or fair market value basis in the hands of the target corporation.40 The distribution of the boot to the creditors would be subject to further gain or loss if its fair market value

at II-198 to -207. The rules discussed in this Section with regard to the treatment of the target do not apply to the type B and type E reorganizations, since those types do not involve the shift of corporate assets from one corporation to another. The rules discussed below concerning the treatment of stockholders and security holders of the target do apply to the type B and E reorganizations as well as to the other types.

34. Id. § 361(b) (amount of gain recognized is lesser of (1) realized gain or (2) total of money and fair market value of other property received).
35. Id. § 361(b)(2).
36. Id. § 361(b)(1). As a general rule, the transferor in an A or a C reorganization would always have been able to avoid recognition of gain on the transaction even though it received boot. In the case of an A reorganization, a statutory merger or consolidation, id. § 368(a)(1)(A) (1986), the transferor corporation disappears by operation of law and therefore always distributes its properties to its shareholders. Similarly, in a C reorganization, the transferor corporation is required to liquidate as part of the transaction. Id. § 368(a)(2)(G).
37. Id. § 1012.
38. Id. § 336(a) (1982) (amended 1986); cf. infra note 51.
subsequently changed in the hands of the target prior to the distribution.  

2. Distribution of Qualifying Consideration

Aside from boot, a target corporation may distribute qualifying consideration, that is, stock or securities of the acquiring corporation, received in a reorganization. The basis of qualifying consideration received without recognition of gain by the target corporation is the basis of the property transferred, a substituted basis. A question may be raised whether the distribution of the qualifying consideration to shareholders would itself have been taxable, even though the initial receipt of the qualifying consideration was not taxable for the reasons discussed above. Presumably section 336 would protect the corporation from taxation on the transaction, which is in effect a complete liquidation.

Even if the target received only qualifying consideration under the reorganization, a threat still existed that the target may have been taxed on the subsequent distribution of the qualifying consideration to creditors. The IRS ruled in Revenue Ruling 70-271 that in a type C reorganization in which the target liquidated, the distribution of qualified consideration to a creditor of the target resulted in realization and recognition of gain to the target. The target recognized gain regardless of whether the creditor was also a shareholder in the target. When the creditor was also a shareholder in the target, however, the gain on the transaction was calculated by reference to the qualifying consideration attributable to the extinguishment of the debt. The qualifying consideration attributable to the surrender of the creditor-shareholder's stock did not give rise to gain to the target corporation, in accordance with the general rule of nonrecognition in this area.

The result in Revenue Ruling 70-271 of taxing the target on the distribution of qualifying consideration to a creditor was surprising in view of the language of section 361(a) and (b). Section 361(a) provided that no gain or loss would be recognized on the receipt by the target in a reorganization of stock or securities of the acquiring corporation. Thus, Revenue Ruling 70-271 seemed to violate the policy of section 361(a) by holding that gain would be recognized to the target if it distributed the qualifying consideration to a creditor. Moreover, section 361(b) provided that no gain would be recognized on the receipt of boot by the target corporation if it distributed the

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41. See id. § 1001(c).
42. Id. § 358.
43. See id. § 336(a) (1982) (amended 1986); cf. infra note 51.
44. 1970-1 C.B. 166.
45. Id. at 167.
46. Id. (situations 1 and 2). The gain to the target would be calculated by determining, under I.R.C. § 358 (1986), the basis of the qualified consideration received, i.e., a substitution of the basis of the property transferred onto the qualifying consideration received.
47. 1970-1 C.B. at 167; see also Northern Coal & Dock Co. v. Commissioner, 12 T.C. 42, 48 (1949) (transfer of assets by a subsidiary indebted to its parent must first be applied to satisfaction of the indebtedness and thus does not constitute a distribution in liquidation but rather results in recognition of gain or loss to the subsidiary), acq. in result, 1949-1 C.B. 3.
boot pursuant to the plan of reorganization. Yet, Revenue Ruling 70-271 held that the distribution of qualifying consideration could give rise to gain if it was distributed to a creditor.

A further criticism of Revenue Ruling 70-271 might be that a target corporation should be protected by the liquidation provision of section 337 from recognition of gain on the distribution of qualifying consideration to creditors. Section 337 provided generally that corporations that liquidated within a twelve-month period, pursuant to a plan of liquidation, would not recognize gain or loss on the sale or exchange of property within that twelve-month period. The authorities are split on the question of whether former section 337 is available to the target corporation in a reorganization, although the better view would seem to be that section 337 is not available.

B. After the 1986 Act

The Tax Reform Act of 1986 altered the reorganization nonrecognition rules to some degree. As a result of the 1986 Act, a target corporation will recognize no gain or loss on the transfer of property pursuant to the plan of reorganization. The transferor, that is, target, will not recognize gain regardless of the type of boot it receives, and regardless of whether it distributes the boot pursuant to the plan of reorganization. Thus, the transferor corporation could receive cash, short-term notes, real estate, frozen pork bellies, or any other type of property from the acquiring corporation, and the transferor corporation will still not recognize gain or loss on the transaction. The transferor corporation may, however, recognize gain or loss on the subsequent distribution of the boot it receives in the transaction.

49. Id. § 361(b).
50. Id. § 337(a).

The FEC Liquidating view appears to be better, for several reasons. Congress did not seem to want § 337 to apply when shareholders were otherwise allowed nonrecognition on a liquidation. For example, § 337(c)(1)(B) denied use of § 337 to the corporation when the shareholders took advantage of § 333, which allowed only limited recognition of gain in certain liquidations. Also, § 337(c)(2) denied use of § 337 to the corporation when the shareholders took advantage of § 332, which allowed nonrecognition in liquidation of subsidiary corporations. Moreover, the legislative history of the Tax Reform Act of 1984 suggests that Congress supported the FEC Liquidating view. The General Explanation prepared by the Staff of the Joint Committee on Taxation states that sale by the transferor of property received on a type C reorganization does not disqualify the transaction from being a type C reorganization, but adds an important caveat: “There is no inference, however, that any such sale or exchange would itself be tax-free.” STAFF, JOINT COMM. ON TAXATION, GENERAL EXPLANATION TO THE TAX REFORM ACT OF 1984, at 190 (P-H 1985).

53. Id.; see H.R. CONF. REP. NO. 841, supra note 1, at II-198 to -208.
1. **Distribution of Qualifying Consideration**

As to the disposition of property received by the transferor corporation in the reorganization, the 1986 Act provides that provisions dealing with liquidations will not apply to the transferor corporation with respect to any liquidation pursuant to the plan of reorganization.\(^{56}\) This means that any nonrecognition granted to the transferor on the subsequent distribution of property received in the reorganization is governed by the amended section 361. Section 361 provides that the transferor corporation will not recognize gain or loss on any disposition, pursuant to the plan of reorganization, of stock or securities that were received pursuant to the plan and that are in another corporation that is a party to the reorganization.\(^{57}\) Moreover, the new statute makes clear that the target corporation does not recognize gain or loss on the subsequent distribution of such stock or securities to creditors.\(^{58}\)

2. **Distribution of Nonqualifying Consideration**

Under the 1986 Act, the distribution of nonqualifying consideration, property that is not stock or securities in a corporation a party to the reorganization,\(^{59}\) gives rise to recognition of gain or loss to the transferor corporation. Gain or loss is recognized in the same manner as if the transferor had sold the property to the distributee for fair market value.\(^{60}\) Such a distribution triggering recognition of gain could take place either as part of the liquidation of the transferor corporation or as a simple distribution of property by the transferor to its shareholders.\(^{61}\)

Under the new law, the transferor-target corporation takes a transferred basis in nonqualifying consideration, that is, a basis equal to the basis that the acquiring corporation had in the property. This basis is then adjusted by the amount of gain or loss recognized to the acquiring corporation on the transaction.\(^{62}\) From this adjusted basis the gain or loss on any distribution of the nonqualifying consideration may be calculated.

Consider the following example: Corporation $T$ has assets of $1$ million. Corporation $A$ acquires the assets of Corporation $T$ in a type C reorganization.\(^{63}\) As consideration, Corporation $A$ transfer to Corporation $T$ $900,000

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56. *Id.* § 361(b)(1).
57. *Id.* § 361(b)(3).
58. *Id.* § 361(b) (flush language). The amended statute thus lays to rest the *FEC Liquidating-General Housewares* controversy that existed before the 1986 amendments. See supra note 51.
59. "Nonqualifying consideration" is defined a little more technically in the statute as property "other than property permitted by section 354, 355, or 356 to be received without the recognition of gain." I.R.C. § 361(c) (1986) (as amended).
60. *Id.*
61. See H.R. CONF. REP. No. 841, supra note 1, at II-198 to -208 (I.R.C. § 336 (1982), which provided for nonrecognition on distributions of appreciated property in liquidation, was repealed and *id.* § 311(b) was amended by the 1986 Act to provide for recognition of gain on the nonliquidating distribution of appreciated property).
63. *Id.* § 368(a)(1)(C) (a so-called stock for assets acquisition).
of stock and a building with a basis of $50,000 and a fair market value of $100,000. Corporation A recognizes no gain on the transfer of its stock under section 1032. Corporation A, however, does recognize $50,000 gain on the transfer of the building, since no nonrecognition provisions are applicable. Corporation T recognizes no gain on the transaction. Corporation T takes a substituted basis in the stock. As to the building, Corporation T takes Corporation A's basis of $50,000, increased by the $50,000 gain recognized to Corporation A, or $100,000. This basis then applies in computing further recognized gain or loss to Corporation T on any subsequent distribution of the building.

C. Recapture

1. Depreciation

The 1986 Act eliminated depreciation recapture for real property while continuing it for personal property. Any depreciation recapture on property transferred from a target to an acquiring corporation does not override the nonrecognition rules of section 361. Rather, only to the extent that gain is recognized on account of the receipt of boot will the recapture provisions bite to alter the character of the gain from capital to ordinary.

In a type A reorganization, because the reorganization is in the nature of a merger or consolidation, the target corporation disappears. The target, therefore, inevitably satisfies the requirement of section 361 for not recognizing gain on receipt of boot; the target distributes the money or other property that it received to its shareholders. Thus, rarely if ever would a type A reorganization trigger the taxation of depreciation recapture to the target. Likewise, rarely would type B and C reorganizations trigger depreciation recapture. In the B reorganization the target remains in existence, but receives no boot; therefore, depreciation recapture is not triggered under prior law. In the C reorganization the target must be liquidated pursuant to the plan of reorganization; therefore, no gain is recognized to the target because it has to distribute all of its properties to its shareholders in order to qualify as a C reorganization.

This avoidance of depreciation recapture is not accomplished without a price, however. The depreciation recapture that is avoided on the occasion of reorganization follows the property over and becomes part of the basis of the property in the hands of the acquiring corporation. The recapture is then triggered upon a subsequent disposition of the property by the acquiring corporation.

64. Id. § 1032(a).
65. See id. § 1001(c).
67. For a discussion of the major depreciation recapture provisions, §§ 1250 and 1245, see D. Posin, supra note 9, § 4.06(3)(a)(vii), at 248-54.
69. See id. § 368(a)(2)(G).
70. Treas. Reg. § 1.1245-2(c)(2) (as amended in 1978); id. § 1.1250-3(c)(1)-(3) (as amended in 1976).
2. Investment Credit

Recapture of the investment credit to the target was not triggered by reorganizations under prior law. Rather, the acquiring corporation simply comes to stand in the shoes of the target corporation for calculation of time periods applicable to possible future recapture of the investment credit. Such recapture would occur upon a subsequent disposition of the property by the acquiring corporation.

The Tax Reform Act of 1986 repealed the investment credit for property placed in service after December 31, 1985. Thus, for such property no investment credit exists to recapture on early disposition of the property.

V. Treatment of Liabilities of the Target Under Section 357

In a reorganization, the target will likely have liabilities that may be shifted to the acquiring corporation. The tax treatment of the shift of liabilities in reorganizations has proven troublesome, as the ensuing discussion indicates. The area is now governed by section 357 of the Code, which provides as a general rule that the transfer of a liability incident to a reorganization does not result in recognition of gain to the target. This rule, however, has some significant exceptions. Before the details of these rules are examined, however, it is useful to focus on the meaning of the term “liability.”

A. Scope of the Term “Liability”

Long-term debt obligations such as bonds or mortgages are clearly liabilities for purposes of section 357. A variety of other types of liabilities exist, however, whose inclusion within the scope of section 357 is less clear. The term “liability” apparently includes contingent liabilities, although authority on the subject is surprisingly sparse. In Revenue Ruling 68-6376 the acquiring corporation in a type C reorganization assumed responsibility for satisfying warrants and stock options of the target corporation outstanding at the time of the merger by obligating itself to issue an appropriate amount of its own stock upon any exercise of the warrants or options after the merger. The question the IRS addressed was whether this arrangement violated the requirement that the consideration in a C reorganization be solely voting.

71. The technical reason for this is that I.R.C. § 47(b)(2) (1986) provides that the investment credit is not recaptured in transactions to which id. § 381, providing for the transfer of tax attributes in corporate reorganizations, applies. Section 381 applies to A, C, D, F, and G reorganizations. Id. § 381(a)(2). The investment credit recapture also is not triggered by the B reorganization because the target remains in existence under such a reorganization. The E reorganization does not trigger recapture either, because no transfer of property takes place in an E reorganization, a recapitalization of a single corporation.
73. Id.
74. H.R. CONF. REP. NO. 841, supra note 1, at II-51 to -52.
75. I.R.C. § 357(a) (1986).
76. 1968-2 C.B. 158.
stock, thus disqualifying the transaction from C reorganization treatment. The IRS held that the solely for voting stock requirement was not violated because the assumption by the acquiring corporation of the target corporation's outstanding warrants and stock options constituted a contractual liability and could therefore be disregarded in testing whether the solely for voting stock requirement was met.

The ruling was interpreting the concept "liability" for purposes of the C reorganization. Presumably, this same definition would hold for "liability" under section 357. Thus, it would appear that contingent liabilities are liabilities for purposes of section 357.

Another troublesome area in defining the scope of section 357 liabilities is that of current liabilities, that is expense-type items such as obligations to pay wages, rent, interest, and royalties. These items are currently deductible, unlike long-term debt obligations such as bonds or mortgages. Some authority suggested that obligations giving rise to current deductions are liabilities for purposes of the statute. Section 357(c)(3), enacted by the Revenue Act of 1978, however, provided a special rule for liabilities with respect to transactions under section 351 involving transfers to controlled corporations. The rule is generally that liabilities, the payment of which would give rise to a current deduction, are excluded in determining the amount of liabilities transferred to the controlled corporation. Although section 357(c)(3) by its terms applies only to section 351 transactions, courts may well use this same approach in dealing with current liabilities in a reorganization.

Apart from the definitional considerations associated with section 357 liabilities, terminology is important. For many purposes, the Internal Revenue Code recognizes only two basic types of liabilities: liabilities in which the borrower has personal responsibility for the debt; and liabilities in which the borrower is not personally responsible for the debt, the lender only able to look to the property securing the debt for satisfaction. Practitioners frequently refer to the first type of liability as recourse debt because the lender has recourse to the borrower personally. The second type of liability is fre-

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78. 1968-2 C.B. at 159.
79. Bonds and mortgages are loans; therefore, repayment of these items is never deductible.
83. Id. § 357(c)(3). If § 357(c)(3) applies to the transfer of a liability in the § 351 setting, then the basis of the stock received by the transferor is not reduced. Id. § 358(d).

The courts' problems with the treatment of current liabilities prior to the enactment of § 357(c)(3) are illustrated by Bongiovanni v. Commissioner, 470 F.2d 921, 923-25 (2d Cir. 1972) (cash method taxpayer had accounts payable that exceeded basis in accounts receivable; held no gain under § 357(c)). See Del Cotto, Section 357(c): Some Observations on Tax Effects to the Cash Basis Transferor, 24 BUFFALO L. REV. 1, 9-15 (1974).
PARTICIPANTS IN A REORGANIZATION

B. General Rule for Treatment of Liabilities

1. Under the Tax Reform Act of 1986

   a. General Rule of Section 357. In an A or C reorganization the target is likely to have liabilities, which may be shifted to the acquiring corporation. Such a shift of liabilities would, in the absence of any statutory provisions to the contrary, be treated as the receipt of money by the transferor.⁸⁶ Section 357(a), however, provides that such a transfer of liabilities will not be treated as money and will not prevent the transaction from coming within section 361 nonrecognition provisions.⁸⁷ This makes sense from a policy standpoint. Since the assets of a target corporation are often subject to liabilities, it would tend to defeat the purposes of the reorganization provisions if the transfer of liabilities triggered the recognition of gain.

   Section 357(b) contains an apparent exception to the general rule of section 357(a), however. This exception provides that if the principal purpose of the taxpayer with respect to the transfer of the liability was an attempt to avoid federal income tax or was not a bona fide business purpose, then the transfer of the liability will be treated as the receipt of money by the transferor.⁸⁸ The receipt of money might have resulted in recognition of gain to the transferor before the 1986 Act. The definition language of amended section 361, however, is that no gain or loss is recognized to the transferor corporation in a reorganization.⁸⁹ Thus, section 357(b) has no application to the target corporation after the 1986 Act.

   b. Basis Considerations. Section 358(d) provides that when the acquiring corporation acquires a recourse or nonrecourse liability of the target, that acquisition causes a reduction in the basis of the stock or securities permitted to be received by the target corporation without recognition of gain.⁹⁰ Nevertheless, as far as A and C reorganizations are concerned, this provision is usually unimportant because the target, by definition, is liquidated in these types of reorganizations. Thus, the target generally does not have the occasion to make a taxable disposition of the stock or securities of the acquiring corporation. Problems could occur, however. If liabilities of the target cor-

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⁸⁴. See D. Posin, supra note 9, § 8.02(1), at 376-77.
⁸⁵. See I.R.C. § 357(a) (1986).
⁸⁸. Id. § 357(b).
⁸⁹. Id. § 361(a).
⁹⁰. Id. § 358(d).
poration transferred exceed the basis of the property the target corporation transfers, the consideration received in a C reorganization, for example, may possibly have a negative basis. If the consideration were then sold by the target prior to its liquidation a gain might be calculated by reference to a negative basis. This would only add to the other potential problems that can arise when the target in a type C reorganization disposes of the stock or securities of the acquiring corporation.

c. **Liabilities in Excess of Basis in the Type D Reorganization.** In the type D reorganization, if aggregate liabilities exceed aggregate basis of property transferred, gain to the extent of that excess is recognized to the target. This requirement of recognition of gain to the extent of excess of liabilities over basis only applies to the type D reorganization and not to any other type. This rule existed under prior law and was not changed by the 1986 Act.

d. **Problems of Large Liabilities.** If the amount of liabilities transferred to the acquiring corporation is very large relative to the stock involved in the transaction, then the transaction may violate the continuity of interest requirement despite compliance of the transaction with the terms of the statute. Continuity of interest requires that a large percentage of the consideration in a reorganization be equity. For example, the IRS has asserted in Regulations concerning C reorganizations that relatively large amounts of liabilities may so alter the character of a transaction as to cause it to be taxable, although it would not be taxable under the specific terms of the statute. It would not be surprising if the IRS attempted to employ this same approach to attack an A or D reorganization involving substantial liabilities.

e. **Planning for Treatment of Target Liabilities.** If the target has liabilities, they may be handled in five basic ways, none of which, after the 1986 Act, give rise to recognition of gain to the target. Thus, the way to handle the liabilities will depend primarily on nontax considerations. The five basic ways to handle target liabilities are: (1) the acquiring corporation may assume the liabilities of the target or take property subject to target liabilities;

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91. See supra note 51 and accompanying text & text accompanying note 56.
92. I.R.C. § 357(c)(1)(B) (1986). Gain to the extent of excess of liabilities over basis is also recognized to the transferor in § 351 transactions. Id. § 357(c)(1)(A).
93. Id. § 357(c)(1).
94. See infra text accompanying note 138.
95. At least 50% of the consideration in a reorganization should be equity in order to obtain a favorable ruling from the IRS. Rev. Proc. 77-37, § 3.02, 1977-2 C.B. 568, 569. Case law has generally established at least a 38% equity requirement. See John A. Nelson Co. v. Helvering, 296 U.S. 374, 377 (1935). The Code, in several types of reorganizations, provides for significantly higher percentages of stock. In the B reorganization the consideration must be solely voting stock of the acquiring corporation. I.R.C. § 368(a)(1)(B) (1986). In the C reorganization the statute provides for consideration of solely voting stock, id. § 368(a)(1)(C), although a boot relaxation rule allows boot of up to 20%, id. § 368(a)(2)(B).
PARTICIPANTS IN A REORGANIZATION

(2) the shareholders of the target corporation may assume the indebtedness of the target; (3) the target corporation may retain enough cash or other liquid assets to satisfy its liabilities; (4) the target may distribute qualifying consideration to creditors; or (5) the target may distribute boot to creditors.

Caution should be exercised in using the last approach mentioned, distributing boot to creditors. Such an approach will not cause gain to be recognized to the target as far as the receipt of the boot is concerned. If, however, the boot is appreciated property in the hands of the target, as it might be, the act of distributing the boot to the creditors would cause the target to recognize income.

2. Under Prior Law

a. General Rule of Section 357. Under the law prior to the Tax Reform Act of 1986, which will still control many transactions and disputes with the IRS, the general rule, still given by section 357(a), provided that when the acquiring corporation assumes a liability of the target or acquires property of the target subject to a liability, such assumption or acquisition is not treated as money transferred to the target and does not prevent the transaction from coming within the nonrecognition purview of section 361(a). Under section 358(d), when the acquiring corporation acquires a recourse or nonrecourse liability of the target, that acquisition causes a reduction in the basis of the stock or securities permitted to be received by the target corporation without the recognition of gain. As under current law, the section 358(d)

97. Rev. Rul. 70-271, 1970-1 C.B. 166, 167 (situation 3) held that this assumption of indebtedness constitutes a nontaxable contribution of capital by the shareholders to the target corporation.

98. See supra text accompanying notes 59-61.

99. This general rule of § 357(a) was itself an exception to the Code. Usually the assumption of a liability by a transferee of property or the taking of property subject to a liability is treated as the receipt of money by the transferor. See Commissioner v. Tufts, 461 U.S. 300, 317 (1983); Crane v. Commissioner, 331 U.S. 1, 12-16 (1947).

Section 357, under prior and current law, is the descendent of Congress's response to United States v. Hendler, 303 U.S. 564, 566-67 (1938), which sustained the IRS's position that when a taxpayer transferred encumbered property to a controlled corporation that assumed the liability, that assumption was equivalent to "other property or money" and required recognition of gain to the transferor. Barely a year later the IRS realized the pyrrhic nature of its triumph when the taxpayer in Bickford's, Inc. v. Helvering, 98 F.2d 568 (2d Cir. 1938), attempted to use Hendler to argue that the basis of assets it had acquired from a transferor should be increased by the amount of assumed liabilities. The taxpayer lost in Bickford's, but Judge Learned Hand's opinion suggested that if the taxpayer had paid the liabilities, it would have won. Id. at 569. Hendler, therefore, standing alone apparently allowed taxpayers to structure incorporation and reorganization transactions to taste: taxpayers could introduce large liabilities when a step up in basis was important to the acquiring corporation and recognition of gain was less important to the transferor, perhaps because of offsetting losses, or taxpayers could eliminate liabilities prior to the transfer when avoidance of recognition of gain was important to the transferor and basis considerations to the acquiring corporation were less important. Moreover, even in transactions in which taxpayers were not scheming to obtain a particular tax advantage, Hendler threatened to undermine the usefulness of the reorganization provisions. Since assets are frequently encumbered, the Hendler decision undermined the tax-free character of many incorporations and reorganizations. Congress thus responded with § 112(k) of the Internal Revenue Code of 1939, the predecessor to § 357(a). See Surrey, Assumption of Indebtedness in Tax Free Exchanges, 50 YALE L.J. 1 (1940).
provisions would usually be unimportant to type A and C reorganizations because the target, by definition, liquidates in these types of reorganizations; the target generally does not have the occasion to make a taxable disposition of the stock or securities of the acquiring corporation. Problems may arise, however, when the target in a type C reorganization does dispose of the stock or securities of the acquiring corporation.¹⁰⁰

b. Application of Section 357(b) to Reorganizations

(i) Transactions that Trigger Section § 357(b). One of the major exceptions to the general rule of section 357(a), just as under current law, arose under section 357(b). If the target corporation has as its principal purpose with respect to the liability the avoidance of federal income tax, or alternatively, if the target does not in any event have a bona fide business purpose with respect to the liability, then section 357(b)(1) provides that the shift of the liability to the acquiring corporation be treated as money received by the target corporation on the exchange. Section 357(b) applies most frequently to taxpayers transferring property to their controlled corporation under section 351. Under the law prior to the Tax Reform Act of 1986, however, section 357(b) could trigger taxation to the target corporation in a reorganization under certain circumstances.

The question may reasonably be asked: what tax avoidance motive could exist for incurring large liabilities in a reorganization since, as discussed earlier, the target is not taxed on the reorganization because the target inevitably distributes any boot it receives? Since the target is never taxed on such a reorganization, it could apparently never have a tax avoidance motive for incurring liabilities. Section 357(b), therefore, would seemingly never apply to reorganizations. One major transaction pattern could trigger the application of section 357(b) in the reorganization area, however. The basic case would arise when the proceeds of a liability that is shifted to the acquiring corporation are distributed to the shareholders of the target as boot, and the amount of the boot is greater than the shareholders' realized gain. In such an event the shareholders are not taxed on the boot to the extent it exceeds their realized gain.¹⁰¹ Rather, the basis of the stock the shareholders receive in the transaction is lowered by the amount of the untaxed boot.¹⁰²

This transaction could have had very attractive results prior to 1987 since the stock might be sold later for a capital gain, whereas the boot might otherwise have been taxable as a dividend.¹⁰³ Moreover, the stock could, instead of being sold, be held until the shareholder's death, at which time the basis would be stepped up to the stock's fair market value at no tax cost.¹⁰⁴ For transactions after 1986, these results might be less attractive with the repeal of the preferential treatment for capital gains by the 1986 Act.¹⁰⁵

¹⁰⁰. See supra note 51 and accompanying text.
¹⁰¹. See infra text accompanying note 156.
¹⁰². See infra text accompanying notes 238-39.
¹⁰³. See infra text accompanying note 157.
¹⁰⁴. I.R.C. § 1014 (1986); see D. Pozin, supra note 9, § 4.03, at 162-63.
(ii) Results of Application of Section 357(b) to Reorganizations. Thus, a target corporation, in some circumstances, could have a tax avoidance motive with respect to the liabilities it transfers prior to the 1986 Act. If such a motive existed, section 357(b) came into play. The question then arose as to what happened to the target on those occasions when section 357(b) was triggered.

On account of the wording of section 357(b)(1), the taxpayer was obligated to demonstrate, first, that the transfer of the liability did not have as its principal purpose the avoidance of federal income tax, and second, that the transfer did have a bona fide business purpose. Failing either step meant the transaction was subject to the rule of section 357(b)(1). Moreover, the taxpayer under the statute has the burden of proof, which must be sustained by a clear preponderance of the evidence.106

When the section 357(b) exception applied, it operated in a surprisingly draconian fashion. If the shift of any debt at all was tainted with a tax avoidance purpose or lacked a bona fide business purpose, all the debt shifted by the target to the acquiring corporation was treated as cash, triggering recognition of gain.107 A target could attempt to escape taxation at the hands of section 357(b) by asserting that it distributed the money that section 357(b)(1) deemed the target to have received and that, therefore, the target is not taxable, pursuant to section 361(b).108

Apparently, however, a target corporation in a reorganization could not distribute the phantom money created by section 357(b)(1) as easily as it could distribute real money received in the reorganization. The IRS in Revenue Ruling 75-450109 addressed a similar problem with respect to a C reorganization. In that ruling the IRS dealt with a case in which the shareholders of the target corporation assumed a liability of the target corporation to pay a finder's fee in stock of the acquiring corporation. The shareholders of the target corporation received stock of the acquiring corporation to satisfy this obligation in addition to the stock of the acquiring corporation they received as consideration for their shares in the target.

The IRS ruled that the shareholders were merely intermediaries in the transfer of the stock to the finder; that the target corporation could just as well have transferred the finder's fee stock directly to the finder.110 Thus, the IRS concluded that the target would be treated as though it had transferred the finder's stock directly to the finder in satisfaction of the finder's fee liability.111 The target would recognize gain or loss on that transaction, calculated from the target's basis in the stock transferred to the finder and

106. I.R.C. § 357(b)(2) (1986). In civil tax cases generally, the taxpayer has the burden of proof, TAX COURT RULE OF PROCEDURE 142(a), but presumably the taxpayer's burden is higher under § 357(b)(2) than in the usual case.
107. I.R.C. § 357(b)(1) (parenthetical language) (1986). In 1954 Congress added the word "total" to the parenthetical language to provide explicitly that all the liabilities would be deemed to be money received. Pub. L. No. 83-591, § 357(b), 68 Stat. 1, 116-17 (1954).
108. See supra text accompanying notes 34-36.
110. Id.
111. Id.
the amount of the finder’s fee liability.\textsuperscript{112}

Revenue Ruling 75-450 did not speak directly to the case of an acquiring corporation assuming liabilities of the target in a situation in which a tax avoidance purpose was present or a bona fide business purpose was absent. Even so, the IRS’s approach suggests a willingness to find taxability to the target when the target is relieved of a liability. Moreover, when the taxpayer is found to have a tax avoidance purpose or lack a bona fide business purpose, the taxpayer is not in a favored position vis-à-vis the IRS; the taxpayer would likely face an aggressive approach.

A target corporation that realized a loss on the reorganization transaction might attempt to turn the above arguments to advantage by asserting that because of the presence of a tax avoidance motive or the lack of a bona fide business purpose, the loss should be recognized. Such an attempt would be futile, however. Prior law provided that in any event, no loss would be recognized to the target on a reorganization.\textsuperscript{113}

The harsh results of the application of section 357(b) and the inability of taxpayers to escape those results formed a trap for the unwary in that the target might engage in some small amount of last minute financing that could be found to be tainted before the reorganization. The debt could be found to be tainted if the shareholders of the target received the proceeds of the debt tax-free.\textsuperscript{114} The tainting of this last minute debt could lead to other massive, longstanding, and perfectly legitimate target debt, which was shifted to the acquiring corporation, being treated as boot, thus triggering recognition of great amounts of gain to the target. Under prior law, the heavily leveraged target had to be extremely careful that all of its debt passed muster as not having a tax avoidance purpose and as having a bona fide business purpose when its shareholders could possibly receive the proceeds of financing tax-free because the proceeds of the financing exceeded the stockholders’ realized gain.

(iii) \textit{Defining Tax Avoidance Purpose and Bona Fide Business Purpose.}

The statute was not particularly informative on just what constituted not having a tax avoidance purpose and having a bona fide business purpose. Of course, the tests only concerned reorganizations when the shareholders of the target received boot in excess of their realized gain. For those transactions that are concerned with meeting the section 357(b) tests, the statute did provide that “the nature of the liability and the circumstances in the light of which the arrangement . . . was made” would be taken into consideration.\textsuperscript{115}

A number of cases were decided under both the 1939 and 1954 Codes on

\textsuperscript{112} Id.; cf. Rev. Rul. 70-271, 1970-1 C.B. 166 (situation 3) (IRS ruled that assumption of a liability of the target by the target’s shareholders did not cause gain to be recognized to the target). The IRS distinguished situation 3 of Rev. Rul. 70-271 from Rev. Rul. 75-450, discussed in the text, on the insubstantial grounds that the shareholders in situation 3 of Rev. Rul. 70-271 did not assume the liability of the target with an obligation to satisfy it with assets received concurrently with the assumption of the liability. 1975-2 C.B. at 330.


\textsuperscript{114} See supra text accompanying notes 101-02.

\textsuperscript{115} I.R.C. § 357(b)(1) (1986).
just what constituted not having a principal purpose to avoid federal income tax or having a bona fide business purpose, under section 357(b)(1). Most of the authority that exists involves liabilities transferred to newly formed, controlled corporations under section 351. That authority is valid, however, for purposes of reorganizations that, for the reasons just mentioned, were subject to section 357(b).

In *Bryan v. Commissioner*, 116 decided under the predecessor of section 357(b) in the 1939 Code, the Fourth Circuit had little trouble in concluding that an FHA-insured loan for an amount greater than that needed to finance the taxpayer’s housing construction costs triggered the rule when the financing occurred shortly before the transfer of the liability.117 In *Easson v. United States*, 118 however, the Ninth Circuit held for the taxpayer and declined to examine either the reasons for incurring the mortgage or the use to which the proceeds were put, holding that the test was simply whether a good business reason existed for transferring the liability.119 The taxpayer’s desire to remain liquid in order to take advantage of an expected business recession was a good business reason for not discharging the mortgage prior to the transfer.120

Because of the wording of section 357(b)(1), the taxpayer must demonstrate, first, that the transfer of the liability does not have as its principal purpose the avoidance of federal income tax, and second, that the transfer did have a bona fide business purpose. Failing either step means the transaction is subject to the rule of section 357(b)(1) if the target’s stockholders are receiving boot in excess of their realized gain.

This two-step approach was illustrated in *Estate of Stoll*, 121 which involved two liabilities incurred by the taxpayer prior to the transfer of his business assets to his controlled corporation. The court concluded that the corporation did not assume either liability for the purpose of tax avoidance; thus, the taxpayer successfully navigated the first step.122 The court held, however, that the assumption of one of the liabilities by the corporation did not serve a bona fide business purpose of the corporation, but rather that such assumption was inimical to the business interests of the corporation.123 The court so held because the responsibility to pay off the liability had no relation to the business of the corporation and because insurance policies that were security for the indebtedness were not transferred to the corporation.124

116. 281 F.2d 238 (4th Cir. 1960).
117. Id. at 241-43.
118. 294 F.2d 653 (9th Cir. 1961), rev’g 33 T.C. 963 (1960), nonacq., 1964-2 C.B. 8.
119. Id. at 659-60.
120. Id. at 659.
122. 38 T.C. at 243.
123. Id. at 245.
124. Id. The finding that one of the liabilities was tainted in *Stoll* did not, under the 1939 Code, require all of the liabilities assumed to be treated as money on the exchange. See also *Jewell v. United States*, 330 F.2d 761, 767 (9th Cir. 1964) (principal purpose of assumption of liability was not tax avoidance and transaction had bona fide business purpose).
Campbell v. Wheeler,\textsuperscript{125} the first of this type of case decided under the 1954 Code, concerned a taxpayer who borrowed money to pay income taxes and three days later transferred the property securing the debt to a corporation, which also assumed the liability. The court held that the transaction triggered section 357(b), in finding that the taxpayer's purpose of paying his federal income taxes was not a bona fide business purpose.\textsuperscript{126} Although this case appeared to stand for the proposition that the original purpose of the indebtedness would be examined, it is no doubt significant that the transfer of the debt to the corporation occurred three days after it was incurred. As the Drybrough v. Commissioner\textsuperscript{127} case discussed below demonstrates, the time that elapsed between the incursion of the debt and its transfer to the corporation was critical under prior law.\textsuperscript{128}

The leading case of Drybrough\textsuperscript{129} illustrated the problems and planning opportunities in this area under prior law. The taxpayer in Drybrough, a real estate operator in the Louisville area, borrowed $700,000 against his real estate holdings in 1953. He used approximately one-half of the proceeds to purchase tax-exempt bonds. In 1957 he transferred the properties securing this mortgage into four separate corporations, each corporation assuming a share of the mortgage. Several months before the 1957 transaction, he borrowed an additional $150,000 against a piece of property he owned free and clear. He transferred that property and its associated liability into a fifth corporation at the same time he made the other transfers. He invested the proceeds from that fifth borrowing in tax-exempt bonds.

The Sixth Circuit held that the transfer of the property and the transfer of the liability to the fifth corporation came within the purview of section 357(b) as a transfer to avoid federal income taxes and gave rise to $150,000 of boot, thus triggering recognition of gain to the taxpayer.\textsuperscript{130} The court reversed the Tax Court as to the transfers to the other four corporations and held that they did not come within the rule of section 357(b).\textsuperscript{131} The four years between the borrowing and the transfer of liability to the four corporations was a factor in the court's determination that a tax avoidance purpose was not present in the four exchanges.\textsuperscript{132}

In Simpson v. Commissioner\textsuperscript{133} the Tax Court held that the manner in which a liability may subsequently be discharged was not to be considered in ascertaining whether the transfer of the liability ran afoul of section

\begin{itemize}
\item\textsuperscript{125} 342 F.2d 837 (5th Cir. 1965).
\item\textsuperscript{126} Id. at 840-41.
\item\textsuperscript{127} 376 F.2d 350 (6th Cir. 1967).
\item\textsuperscript{128} Id. at 356; see also Thompson v. Campbell, 353 F.2d 787, 788 (5th Cir. 1965) (substantial borrowing one day before transferring liability and assets securing it to corporation; loan proceeds used to buy tax-exempt securities and home; held taxpayer did not carry his burden of proof).
\item\textsuperscript{129} 376 F.2d at 356-59.
\item\textsuperscript{130} Id. at 360.
\item\textsuperscript{131} Id.; see also Weaver v. Commissioner, 32 T.C. 411, 436 (1959), aff'd sub nom. Bryan v. Commissioner, 281 F.2d 238 (4th Cir. 1960), cert. denied, 364 U.S. 931 (1961).
\item\textsuperscript{132} 376 F.2d at 356.
\item\textsuperscript{133} 43 T.C. 900 (1965).
\end{itemize}
357(b). In that case it was clear that the contemplated method of discharge of the liability would lead to a tax advantage. Nevertheless, section 357(b) was still not triggered.

**c. Liabilities in Excess of Basis in the Type D Reorganization.** Before the 1986 Act in the type D reorganization, if aggregate liabilities exceeded aggregate basis of property transferred, the target recognized gain to the extent of that excess. Just as under current law, this requirement of recognition of gain to the extent of excess of liabilities over basis only applied to the type D reorganization and not to any other type. If, however, the shift of the liabilities to the acquiring corporation had a tax avoidance purpose, then the entire amount of the liabilities shifted, not just the excess over basis, was taxable to the target. Thus, the anti-tax avoidance rule controlled over the liabilities in excess of basis rule for type D reorganizations.

The liabilities in excess of basis rule in the type D reorganization was needed to prevent the target from obtaining a negative basis in the stock received on the transaction. The basis rule correlating to section 361 provided that the target's basis in stock received on the reorganization would equal the basis in the property transferred, decreased by liabilities transferred. Thus, excess liabilities could have caused a negative stock basis.

The absence of the liabilities in excess of basis rule in the A reorganization might appear at first blush to have a problem of negative basis, too. In the A reorganization, however, the target necessarily disappears by operation of law. The target's basis in the stock it receives is of no consequence since the stock is immediately distributed to the shareholders. Negative basis is usually not a problem in the C reorganization, either. In the C reorganization the target must be liquidated pursuant to the plan of reorganization.

**d. Problems of Large Liabilities.** If the amount of liabilities transferred to the acquiring corporation was very large relative to the stock involved in the transaction, the transfer may have violated the continuity of interest requirement. Such a problem could occur even though the transfer complied with the terms of the statute. The continuity of interest requirement continues under current law.

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134. Id. at 916.
135. Id. at 916-17. The particular advantage was that as the liability was paid off, the value of the taxpayer's stock would increase, but tax on the appreciation would be deferred.
136. Id.
137. I.R.C. § 357(c)(1)(B) (1986). Gain to the extent of the excess of liabilities over basis is also recognized to the transferor in § 351 transactions. Id. § 357(c)(1)(A).
138. Id. § 357(a)(1).
139. Id. § 357(c)(1), (c)(2)(A).
140. Id. § 358(a), (d).
141. Id. § 368(a)(2)(G).
142. See supra notes 95-96 and accompanying text.
143. Id.
3. Expenses of the Reorganization

As part of a reorganization, the acquiring corporation frequently agrees to pay the reorganization expenses of the target corporation, including such items as legal and accounting fees, and appraisal expenses. The IRS ruled in Revenue Ruling 73-54 that the payment by the acquiring corporation of the target corporation's valid reorganization expenses is treated as an assumption of a liability of the target. Payment by the acquiring corporation, therefore, would not cause recognition of gain to the target or to the target's shareholders.

Curiously, after reaching this relatively reasonable conclusion, which facilitates nontaxable transactions, the IRS in Revenue Ruling 73-54 then propounded a rule that needlessly exalts form over substance in this area. The IRS stated in Revenue Ruling 73-54 that if the acquiring corporation passed money or other property to the target or its shareholders so that the target or its shareholders paid the reorganization expenses, then the payment of the liabilities was taxable to the target or the shareholders. Thus is created a trap for the unwary. If the money for paying the target corporation's direct reorganization expenses is passed directly to the creditors, then the target or its shareholders are not taxed. If the money is passed to the target or the shareholders to make the payment to the creditors, then the target or its shareholders are taxed. Unfortunately, for no particular reason, Revenue Ruling 73-54 causes form to control over substance in this area.

Although Revenue Ruling 73-54 was directed only to B and C reorganizations, presumably the same logic would apply to other types of reorganizations. Some differences exist, however, in applying Revenue Ruling 73-54 to, for example, the A reorganization. Less danger exists of falling into the reorganization expenses trap with the A reorganization. Since in an A reorganization, which is a statutory merger or consolidation, the target corporation disappears by operation of law and always distributes its properties to its shareholders, the target would never be taxed, regardless of the niceties of the form concerning how reorganization expenses were paid.

Niceties of form, however, still control treatment of the shareholders in the A reorganization, based on Revenue Ruling 73-54. If the form indicates that the acquiring corporation transferred to the shareholders the money for payment of the direct reorganization expenses, and then the shareholders paid the creditors, then the shareholders would be taxed on that money. This result could also happen if, for example, the acquiring corporation transfers the money to pay the direct reorganization expenses to the target, and the target then liquidates. The target in that situation is deemed to have distributed the money to the shareholders. The shareholders would thus

144. Other expenses of the target that the acquiring corporation might pay would include expenses for clerical work, printing, telephone and telegraph, security underwriting and registration fees and expenses, transfer taxes, and transfer agents' fees and expenses. See Rev. Rul. 73-54, 1973-1 C.B. 187, 187.
146. Id. at 187.
147. Id.
have taxable boot, notwithstanding they were not going to retain the boot, but were obligated to use it to pay creditors of the target for reorganization expenses. Thus when the acquiring corporation is going to pay the direct reorganization expenses of the target, care should be taken to structure the transaction so that the acquiring corporation pays those expenses directly, rather than passing funds to the target or the shareholders of the target.

Even if the transaction is structured properly, however, the ride is by no means free. Only certain expenses qualify as direct reorganization expenses. Revenue Ruling 73-54 specifically limited the tax-free treatment to expenses that are "solely and directly related to the reorganization, the transfer of the property of the acquired corporation for stock of the acquiring corporation, or the exchange of the equity interests of the shareholders of the acquired corporation for stock of the acquiring corporation . . . ." Examples of expenses that would not qualify for this treatment include: fees incurred for investment or estate planning advice; expenses incurred by shareholders for professional advice relating to the reorganization; and the payment of a state transfer tax that is solely the obligation of a shareholder.

Because tax-free treatment applies only to direct reorganization expenses, the A and C reorganizations could have an advantage over B reorganizations. If payment of an item by the acquiring corporation constitutes boot to the target, then under the A and C reorganizations, liquidation of the target would mean that the item would not be taxable to the target by virtue of section 361(b). In the B reorganization, the target corporation is not liquidated; therefore, it could not make use of section 361(b) to avoid taxation in these circumstances.

VI. TREATMENT OF STOCKHOLDERS AND SECURITY HOLDERS OF THE TARGET

Once the definition of a reorganization has been satisfied, certain consequences flow to the parties to the reorganization. The preceding sections have mainly discussed consequences to the target corporation. This section

148. Id.
149. Id. The ruling also held that the acquiring corporation's payment of the target's reorganization expenses did not violate the solely for voting stock requirement of the B or C reorganizations. Id. This ruling represented a change of position by the IRS, which had long argued that the payment by the acquiring corporation of the target's direct reorganization expenses was additional consideration, or boot, thus violating the solely for voting stock requirement of a C reorganization. See Helvering v. Southwest Consol. Corp., 315 U.S. 194, 198-99 (1942); Stoddard v. Commissioner, 141 F.2d 76, 79 (2d Cir. 1944). Several court decisions, however, held that the acquiring corporation's payment of the target's reorganization expenses did not constitute additional consideration. See Roosevelt Hotel Co. v. Commissioner, 13 T.C. 399, 408 (1949), acq., 1950-1 C.B. 4; Alcazar Hotel Inc. v. Commissioner, 1 T.C. 872, 879 (1943), acq., 1943 C.B. 1; Claridge Apartments Co. v. Commissioner, 1 T.C. 163, 170 (1942), acq., 1943 C.B. 4, rev'd on other grounds, 138 F.2d 962 (1943), rev'd on other grounds, 323 U.S. 141 (1944).
150. For a valid C reorganization, the target must distribute all the consideration it received plus any other assets pursuant to the plan of reorganization. I.R.C. § 368(a)(2)(G) (1986) (as amended effective for transactions pursuant to plans adopted after July 18, 1984, Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 63(c), 98 Stat. 494, 584).
discusses the treatment of the stockholders and security holders of the
target.

Section 354(a)(1) provides for nonrecognition of gain to stockholders and
security holders of the target provided they receive only qualifying consider-
ation.\textsuperscript{151} If they receive any nonqualifying property or money, that is, boot,
along with the qualifying consideration, section 356 then governs the trans-
action. Section 356 provides for recognition of gain to the extent of the boot,
and also provides a rule for when the gain is characterized as capital or
ordinary. Section 358 provides rules for determining the basis of the stock
or securities of the acquiring corporation received by the stockholders or
security holders of the target. An important aspect of the statutory structure
in this area is that sections 354, 356, and 358 apply individually to each
stockholder and security holder of the target. Indeed, the provisions may
well apply in different ways to the individual stockholders and security
holders.

\textbf{A. Nonrecognition of Gain, Boot, and Basis}

The basic nonrecognition rule of section 354(a)(1) provides: "In Gen-
eral.—No gain or loss shall be recognized if stock or securities in a corpora-
tion a party to a reorganization are, in pursuance of the plan of
reorganization, exchanged solely for stock or securities in such corporation
or in another corporation a party to the reorganization."\textsuperscript{152} This provision
sets forth a seemingly broad rule of nonrecognition with respect to stock-
holders and security holders of corporations involved in reorganizations.
The rule in essence is that the stockholders or security holders of the target
do not recognize gain or loss if, in pursuance of the plan of reorganization,
they receive stock or securities in the acquiring corporation in exchange for
the surrender of stock or securities in the target. This broad rule, however,
is subject to some important exceptions.

\textbf{1. Limitations for Accrued Interest and Discount}

One significant exception to the general rule for nonrecognition relates to
accrued interest, original issue discount, and market discount. To the extent
that stock or securities received by the stockholders or security holders of
the target is attributable to accrued interest on the securities surrendered,
including original issue discount and market discount, gain will be recog-
nized.\textsuperscript{153} The gain with respect to market discount may be avoided if the
taxpayer receives in the exchange another bond that also is a market dis-
count bond. In that event the market discount carries over and applies to
the bond received.\textsuperscript{154} The market discount will then be recognized as ordi-

\begin{itemize}
\item \textsuperscript{151} I.R.C. § 354(a)(1) (1986).
\item \textsuperscript{152} Id. As a matter of terminology, the term "securities" in this context, as in most cir-
cumstances of tax law, means debt instruments and not equity.
\item \textsuperscript{153} Id. §§ 354(a)(2)(B), 1276.
\item \textsuperscript{154} Id. § 1276(c)(2), (d)(1)(B).
\end{itemize}
nary income on a later disposition.\textsuperscript{155}

2. \textit{Limitations for Boot}

\textit{a. Receipt of Cash or Other Property.} The nonrecognition rule of section 354(a)(1) applies if the target stockholders and security holders receive only stock or securities of the acquiring corporation in exchange for the surrender of the stock or securities of the target. Thus, if anything in addition to stock or securities of the acquiring corporation, such as cash, frozen turkeys, technology, or gold coins, is received by the stockholders of the target in a reorganization, section 354(a)(1) by its terms does not apply. The receipt of such boot in addition to qualifying consideration will instead trigger the application of section 356. Section 356(a)(1) provides generally for recognition of gain to the extent of fair market value of boot received.\textsuperscript{156} Section 356(a)(2) provides that the gain recognized will be treated as a dividend if it has the "effect of a distribution of a dividend."\textsuperscript{157}

Of course, under the language of section 356(a)(1), that provision is not triggered for any individual stockholder or security holder unless the stockholder or security holder receives at least some qualifying consideration along with the boot. Those stockholders or security holders who do not receive any qualifying consideration along with the boot must look elsewhere for their treatment. Thus, some stockholders or security holders of the target in a reorganization may be subject to section 356(a)(1) and some may well look elsewhere.

Those stockholders of the target corporation who do not receive any qualifying consideration along with the boot they receive do not qualify for the nonrecognition rules of sections 354(a)(1) and 356(a)(1). Moreover, no other nonrecognition provision applies to those stockholders. Thus, they recognize all realized gain.\textsuperscript{158} The IRS has ruled that the character of the gain to the stockholders is determined by reference to section 302.\textsuperscript{159}

Section 302 provides the basic rules for the treatment of redemptions of stock by a corporation. Generally reference to section 302 in the reorganization context will mean that the stockholders of the target receiving only boot on the exchange will have a capital gain or loss\textsuperscript{160} because the transaction will qualify as a complete termination of interest under section 302(b)(3).

\textsuperscript{155} \textit{Id.} § 1276(a).

\textsuperscript{156} \textit{Id.} § 356(a)(1). \textit{Id.} § 453(f)(6) provides rules for reporting gain recognized under § 356 on the installment method. These rules are similar to the rules used in \textit{id.} § 1031 exchanges, namely that the contract price and the gross profit are reduced by the amount of the nonrecognition property received. These installment reporting rules would be most relevant to the B and D reorganizations where the transferor, unlike in the A and C reorganizations, remains in existence.

\textsuperscript{157} \textit{Id.} § 356(a)(2).

\textsuperscript{158} \textit{Id.} § 1001(c).

\textsuperscript{159} Rev. Rul. 74-515, 1974-2 C.B. 118, 119-20 (some of target's preferred stockholders exchanged their preferred stock solely for cash in a type A reorganization; tax consequences ascertained under § 302, including use of § 318 attribution rules); see also Treas. Reg. § 1.354-l(d), example 3 (as amended in 1979).

\textsuperscript{160} For a discussion of the continuing significance of capital gains after the Tax Reform Act of 1986 see supra text accompanying notes 7-18.
Security holders of the target corporation in a reorganization who do not receive any qualifying consideration along with the boot they receive likewise do not qualify for the nonrecognition rules of sections 354(a)(1) and 356(a)(1). Again, no other nonrecognition provision applies to those security holders, and they will recognize all their realized gain. No specific authority provides rules for characterizing the gain or loss recognized, so general principles would govern. If, as would usually be the case, the securities surrendered constituted capital assets in the security holder’s hands, the transaction would yield a capital gain or loss.

b. Receipt of Securities

(i) Qualifying Consideration Received. As discussed above, the general nonrecognition rule of section 354(a)(1) seems to indicate that the receipt of any stock or securities of the acquiring corporation in exchange for the surrender of any stock or securities of the target qualifies for nonrecognition. Section 354(a)(2) sets forth important limitations on this broad rule of nonrecognition. If the principal amount of securities received in a reorganization exceeds the principal amount of securities surrendered, or securities are received in a reorganization without securities being surrendered, then the section 354(a)(1) nonrecognition provision does not apply.

The general theme of this important limitation is that if a stockholder or security holder moves upstream to a more senior position than that held before the transaction, such a move will cause the exchange not to be covered by section 354(a)(1). Such a move to a more senior position involves either receiving securities with a greater principal amount than securities surrendered or receiving securities when surrendering only stock. The question then naturally arises as to what are the tax consequences of such an upstream move. Section 354(a)(3) points toward the answer by providing a cross-reference to section 356 for treatment of these cases that are outside the rule of section 354(a)(1).

As discussed above, section 356 provides for recognition of realized gain to the extent of the boot. As the earlier discussion also pointed out, however, section 356 by its terms only takes hold if the stockholder or security holder receives some consideration qualifying for nonrecognition under section 354 in addition to nonqualifying consideration or other property. Thus, only if an upstream move occurs that involves the receipt of some qualifying consideration, would section 356 come into play.

In the case of an upstream move in which some qualifying consideration is received, section 356(a)(1) provides for recognition of gain to the extent of

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161. I.R.C. § 1001(c) (1986).
162. Id. §§ 1221, 1222.
163. Id. § 354(a)(2).
164. Id. § 356(d).
165. Id. § 354(a)(3)(A).
166. Id. § 356(a)(1).
167. Id.
the fair market value of the boot.\textsuperscript{168} When securities are received, but no securities are surrendered, the statute provides that the amount of boot is the fair market value of the principal amount of the securities received.\textsuperscript{169} If securities are received and securities are also surrendered, section 356(d)(2) provides that the amount of boot is the fair market value of the excess of the principal amount of securities received over the principal amount of the securities surrendered.\textsuperscript{170}

This approach requires some explanation. The principal amount of a security is its face amount. The principal amount or face amount will not, however, necessarily be the same as the fair market value of the security. The fair market value of the security will be influenced by the interest rate on the security relative to current interest rates in the economy. Fair market value will also depend on the creditworthiness of the acquiring corporation.

Thus, when securities are received and no securities are surrendered, determining the amount of boot involves merely valuing the securities received. When securities are surrendered and securities of a greater principal amount are received, then under the statute the excess principal amount constitutes boot and must be valued. The approach taken in the Regulations is to treat as boot the same proportion of the fair market value of the securities received as the excess principal amount of the securities received bears to the total principal amount of the securities received. This ratio is applied separately to each security received.\textsuperscript{171}

The following examples illustrate application of the rules for determining the amount of boot:

\textit{Example (1): Stock Surrendered for Stock and Securities.} B, a stockholder in the target corporation in a reorganization, surrenders 500 shares of stock in the target for 600 shares of stock in the acquiring corporation plus a security with a principal amount of $200 and a fair market value of $250. B has boot in the amount of $250.\textsuperscript{172} If B had received only a security and no stock, these rules concerning boot would not apply since B would not have received any qualifying consideration.

\textit{Example (2): Stock and Securities Surrendered for Stock and Securities of Greater Principal Amount.} B, a stockholder in a target corporation, surrenders 300 shares of stock in the target and a security in the target with a principal amount of $400 for 600 shares of stock in the acquiring corporation plus a security of the acquiring corporation with a principal amount of $500 and a fair market value of $600. B has boot in the amount of $120.\textsuperscript{173} One-fifth of the principal amount of the security received was in excess of the principal amount of the security

\textsuperscript{168} Id.
\textsuperscript{169} Id. § 356(d)(2) (flush language).
\textsuperscript{170} Id. § 356(d)(2). Sections 1273(b)(3), 1274, and 1275(a)(4) create original issue discount with respect to securities. The application of these rules may change the principal amount of the securities and thus affect the computation of boot under § 356.
\textsuperscript{171} Treas. Reg. § 1.356-3 (1960).
\textsuperscript{172} See Treas. Reg. § 1.356-3(b), example 1 (as amended in 1979).
\textsuperscript{173} Id., example 2.
surrendered. Therefore, one-fifth of the fair market value of the security received is treated as boot.

Example (3): Securities Surrendered for Securities of Lesser Principal Amount. B, a stockholder in a target corporation, surrenders 500 shares of stock in the target and a security with a principal amount of $150 and a fair market value of $145 for 100 shares of stock in the acquiring corporation plus a security with a principal amount of $140 and a fair market value of $155. No part of the consideration received by B is treated as boot.\(^\text{id., example 3}\) The Regulations mandate this interesting, though possibly questionable result. The transaction is not an upstream move by B since B received a security of lesser principal amount than the security that B surrendered. The fact that the security B received had a greater fair market value than the principal amount of the security that B surrendered is irrelevant under the Regulations. That the security B received had a greater fair market value than the fair market value of the security that B surrendered is likewise irrelevant. B still receives no boot.

Example (4): Securities Surrendered for Stock and Securities of Greater Principal Amount. B, a security holder in the target corporation in a reorganization, surrenders a security in the target with a principal amount of $300 for 100 shares of stock in the acquiring corporation plus a security with a principal amount of $400 and a fair market value of $350. B has boot in the amount of $87.50.\(^\text{id., examples 4, 5}\) This example shows a simultaneous downstream and upstream move. As usual, the upstream move generates boot. One-fourth of the principal amount of the security received is in excess of the principal amount of the security surrendered. Thus, one-fourth of the fair market value of the security received is treated as boot.

Example (5): One Security Surrendered for Several Securities of Aggregate Greater Principal Amount. B, a stockholder in a target corporation, surrenders a security of the target with a principal amount of $450 for two securities of the acquiring corporation, one with a principal amount of $300 and a fair market value of $400 and one with a principal amount of $200 and a fair market value of $200. B has boot in the amount of $60, determined in the following manner. The aggregate principal amount of the securities received is $500. Fifty dollars of that aggregate amount is in excess of the principal amount of the security surrendered. Therefore, 10% of the fair market value of the securities received is boot. This 10% figure applies on a security by security basis: 10% of $400 is boot, and 10% of $200 is boot, for a total of $60.

(ii) No Qualifying Consideration Received. An upstream move involving no qualifying consideration can only occur if the taxpayer is a stockholder of the target and not a security holder. If the taxpayer is a security holder, then the only upstream move that could occur would involve receipt of securities with a greater principal amount than the securities the taxpayer received.
surrendered. In that event, however, the taxpayer would be treated as hav-
ing received some consideration qualifying for nonrecognition under section
354. The amount of consideration qualifying for nonrecognition would be
the principal amount of the securities received to the extent of the principal
amount of the securities surrendered. The excess of the principal amount
of the securities received over the principal amount of the securities surren-
dered would be treated as taxable boot.

In the case in which the taxpayer is only a stockholder and not a security
holder, the pattern for an upstream move would be that the stockholder
surrenders stock and receives only securities in return. In that event, neither
section 354 nor section 356 would apply to the transaction. The transac-
tion would be treated under section 302, probably qualifying for capital
gain.

3. Character of Gain Recognized

The Tax Reform Act of 1986 made the receipt of long-term capital gains
much less attractive than under prior law. Yet, capital gains are still impor-
tant to taxpayers. The ensuing discussion of the question of whether rec-
ognized gain or loss is capital gain or dividend in character is, therefore, of
importance for transactions after the 1986 Act as well as before.

The preceding discussion has shown that the basic pattern of treatment of
the stockholders and security holders of the target corporation in a reorgani-
zation is that no gain or loss is recognized if the exchange is within the
general rule of section 354(a). If, however, consideration not qualifying for
nonrecognition of gain under section 354 is received, further rules requiring
recognition of gain are triggered. These further rules break down into two
branches, depending on whether or not some qualifying consideration is re-
ceived along with the nonqualifying consideration.

a. Qualifying Consideration Received

(i) Use of Section 302 Standards in General. If some consideration
qualifying for nonrecognition is received along with the nonqualifying con-
sideration in the exchange, section 356 governs the transaction. The realized
gain is then recognized to the extent of the boot. As to the question of the
character of the gain, section 356(a)(2) provides:

Treatment as dividend.—If an exchange is described in paragraph (1)

177. Id. § 356(d).
178. Section 354 would not apply because of § 354(a)(2)(A)(ii) providing that § 354 does
not apply if securities are received and no securities are surrendered. Section 356 would not
apply because of the requirement of § 356(a)(1) that some consideration qualifying for nonrec-
ognition must be received under § 354 in order for § 356 to apply to the transaction.
exchanged their preferred stock solely for cash in a type A reorganization; tax consequences
ascertained under § 302, including use of § 318 attribution rules).
180. See supra text accompanying notes 7-18.
but has the effect of the distribution of a dividend (determined with the application of section 318(a)), then there shall be treated as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be treated as gain from the exchange of property.  

The meaning of this relatively cryptic language has been the subject of litigation, and the matter is still somewhat unsettled. One of the earliest interpretations of this rule seemed to suggest that section 356(a)(2) created an automatic dividend rule to the extent of earnings and profits of the distributing corporation. Subsequent cases did not follow that approach, which did not appear to be justified by the statute, and the IRS abandoned it.

An alternative approach that gained support was using section 302 redemption standards to ascertain dividend equivalence under section 356(a)(2). This approach could work clearly in the case of a reorganization involving only one corporation, such as a type E recapitalization or a type F change in identity, form, or place of organization of one corporation. The application of section 302 standards to transactions involving two or more corporations is uncertain. In a type A or type C reorganization, do the section 302 redemption standards apply with reference to the target corporation or the acquiring corporation, or are both corporations involved in the computation?

The current state of the law is unsettled on this important issue. The Eighth Circuit case of Wright v. United States held that section 302 standards were to be used to ascertain dividend equivalence by reference to the acquiring corporation. The Fifth Circuit case of Shimberg v. United States held that section 302 standards were to be used to ascertain dividend equivalence by reference to the target corporation. The IRS has ruled it will follow the Shimberg approach. The Tax Court has recently muddied the waters in this area in the case of Clark v. Commissioner in which the court followed the Wright case on the particular facts before it, but indicated that on different facts it might follow Shimberg.

182. Id. § 356(a)(2).
188. Id. § 368(a)(1)(F).
189. 482 F.2d 600 (8th Cir. 1973).
190. Id. at 607.
191. 577 F.2d 283 (5th Cir. 1978).
192. Id. at 287-88.
195. Id. at 156-57.
Specifically, the Shimberg and the IRS approach is hypothetically to regard the boot as having been distributed by the target corporation to its shareholders prior to the merger in exchange for some of the shares of the target.\textsuperscript{196} This approach then applies section 302 to that hypothetical transaction.\textsuperscript{197} The Wright approach, on the other hand, views the hypothetical redemption for boot to have been made by the acquiring corporation after the merger.\textsuperscript{198}

These varying approaches may be illustrated by examples. First, consider an example based on the Shimberg case and the example given in Revenue Ruling 75-83,\textsuperscript{199} which sets forth the IRS position in this area. Suppose Target Corporation has outstanding 60 shares of voting common stock all of which are owned by \( V \), an individual. The fair market value of each share of Target common stock is $100. Target Corporation has accumulated earnings and profits of $4000. Acquiring Corporation has outstanding 40 shares of voting common stock. The Acquiring Corporation stock is owned 10 shares each by four individuals, \( W, X, Y, \) and \( Z \). As it happens, Acquiring Corporation's stock also has a fair market value of $100 per share. \( W, X, Y, \) and \( Z \) are not related to one another or to \( V \) within the meaning of the section 318 ownership attribution rules.

Target merged into Acquiring Corporation in a valid type A reorganization. The consideration given to \( V \), the sole shareholder of Target, was 35 shares of voting stock of Acquiring Corporation plus a note with a fair market value of $2500. \( V \)'s basis in the Target stock he exchanged was $2000. \( V \), therefore, had a realized gain of $4000: The amount realized was $3500 fair market value of stock received plus the $2500 bond, or $6000. Subtracting the $2000 basis in the stock exchanged from the $6000 amount realized yields a $4000 gain realized.

Section 356(a)(1) applies to this transaction, since \( V \) received qualifying consideration as well as boot. \( V \)'s $4000 realized gain is, therefore, recognized to the extent of the $2500 boot. The character of \( V \)'s gain is determined under section 356(a)(2). In making this determination, reference is made to section 302. Applying the principles of section 302, the distribution is treated as though the target made the distribution prior to the reorganization.

\( V \) is thus treated as having received a note with a fair market value of $2500 in exchange for 25 of the 60 shares of Target Corporation stock. While this exchange reduced the number of shares of Target stock \( V \) held, it did not reduce \( V \)'s percentage ownership in Target. The redemption, therefore, does not meet any of the tests set forth in section 302(b),\textsuperscript{200} and the redemption consequently receives dividend treatment under section 301.

\textsuperscript{196} 577 F.2d at 285; 1975-1 C.B. at 113.
\textsuperscript{197} 577 F.2d at 285; 1975-1 C.B. at 113.
\textsuperscript{199} 1975-1 C.B. 112; \textit{see also} Rev. Rul. 74-515, 1974-2 C.B. 118.
\textsuperscript{200} Briefly, the I.R.C. § 302(b) (1986) tests for determining whether a redemption will be
Thus, V's recognized gain of $2500 is taxed as a dividend under section 356(a)(2), since, as stated in the facts above, Target Corporation has accumulated earnings and profits of $4000.

The same facts as given in the Shimberg/IRS example may be used to illustrate the different results that obtain under the Wright approach to section 302 standards. Indeed, Revenue Ruling 75-83, which sets forth the IRS position on using section 302 standards in the reorganizations context, uses these same facts to illustrate the different results under Wright. Application of the Wright approach to the facts of the preceding example would yield the following result.201 The transaction would be treated as though V had first received all the consideration as stock, and then the Acquiring Corporation redeemed the stock in the amount of the boot. On these facts, V hypothetically received 60 shares of Acquiring Corporation stock and then had 25 shares redeemed in exchange for the $2500 note. Under this analysis, V's interest in Acquiring Corporation reduces from 60 shares to 35 shares. Prior to the reorganization transaction Acquiring Corporation had outstanding 40 shares of voting common stock, owned 10 shares each by four individuals.

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W, X, Y, and Z. With the hypothetical receipt of 60 shares of Acquiring Corporation, V becomes a 60% owner of Acquiring Corporation. With the hypothetical redemption, V then becomes a 46.6% (35/75) owner of Acquiring Corporation. This reduction in ownership meets the three tests of section 302(b)(2), and thus, the transaction is a substantially disproportionate redemption.\(^{202}\)

Using the Wright analysis, therefore, the exchange does not have the effect of a dividend. Section 356(a)(2) thus treats the gain as a gain from the exchange of property. Note that since usually boot is given pro rata to the shareholders of the target in a reorganization, the Shimberg/IRS approach is much more likely to give rise to dividend treatment than the Wright approach.

The recent Tax Court decision in Clark v. Commissioner\(^{203}\) seemed to favor the Wright case, but left the door open to follow Shimberg at times. If the Clark case were appealed, it would be heard by the Fourth Circuit. The Wright case was decided by the Eighth Circuit and the Shimberg case was decided by the Fifth Circuit. If the Fourth Circuit affirms Clark, three circuits would have different approaches to this matter, raising the possibility of a Supreme Court decision in the Clark case, if the parties pursue it to that level.\(^{204}\)

In Clark the taxpayer owned all the stock of Basin Surveys, Inc. Immediately before the transaction in question, Basin had earnings and profits of about $2.32 million. The book value of its assets was $2.76 million. NL Industries, Inc. wanted to acquire Basin and offered Clark a choice of 425,000 NL shares and no cash, or 300,000 NL shares plus $3.25 million cash. Clark chose the stock and cash; thus, the cash alone that Clark received was nearly $1/2 million more than the book value of Basin's assets. Clark reported the cash that he received as long-term capital gain, in reliance on the Wright case.

Following the Wright analysis, Clark was correct in concluding that the transaction met the test of section 302: the hypothetical redemption was substantially disproportionate under section 302(b)(2).\(^{205}\) The hypothetical cash distribution from NL to Clark following the transaction reduced Clark's interest in NL from 1.3% to .92%. Thus, Clark clearly owned less than 50% of the stock of NL after the hypothetical redemption, satisfying the first test of section 302(b)(2). In addition, the reduction in Clark's inter-

\(^{202}\) For a discussion of the § 302(b) tests see supra note 200. Since the redemption reduces V's percentage ownership from 60% of the stock outstanding prior to the redemption (60/100) to 46.6% of the stock outstanding after the redemption (35/75), the redemption meets the first test under § 302(b)(2). Also, 46.6% is less than 80% of 60%; so the second and third tests of § 302(b)(2) are met.

\(^{203}\) 86 T.C. 138 (1986).

\(^{204}\) The amount of tax at stake in Clark is high: the difference between the tax under § 301 or a capital gain on a distribution of $3.25 million. The IRS and the taxpayer may not therefore be inclined to settle, particularly since each has substantial authority on its side. Moreover, the taxpayer in Clark has shown himself not to be faint-hearted, in that he took the Wright approach even though the IRS has ruled that it will follow Shimberg.

\(^{205}\) 86 T.C. at 141; see also supra note 200 (discussing test).
est in NL from 1.3% to .92% because of the hypothetical redemption left him with about 71% of his previous position, which satisfied the second and third tests of section 302(b)(2) that the taxpayer should own less than 80% of the previous position in the voting and common stock of the redeeming corporation after the redemption. Thus, in Clark's view of the matter, the $3.25 million cash distribution was taxable as a long-term capital gain exchange. Not only was the $3.25 million subject to the much lower capital gain tax, but the amount subject to tax was reduced by Clark's basis in the stock that was hypothetically redeemed.

The IRS approach under Shimberg was of course to the contrary. Under Shimberg the hypothetical redemption occurs prior to the reorganization. In that event, Clark, as the sole shareholder of Basin, received a cash distribution that did not reduce his proportion of stock ownership at all. Thus, in the IRS's view of the matter, the entire $3.25 million, without any basis adjustment, was subject to a dividend tax to the extent of earnings and profits.

The Tax Court came down on Clark's side and concluded that Wright was the correct approach. The court did not agree with the IRS argument that using Wright would always yield a capital gain to the taxpayer. In point of fact, however, the Wright case will almost always result in capital gain to a shareholder of the target corporation when that shareholder winds up as a small-percentage owner of the stock of the acquiring corporation. This result occurs because the IRS has established that a reduction in percentage ownership of minority shareholders usually qualifies under section 302(b)(1) as being not essentially equivalent to a dividend.

If the Tax Court had stopped here, Clark would have been a case following Wright and would have been interesting only in that regard. The court said, however, that if the facts were different, it might follow Shimberg. In particular, the facts the court would look to would be whether persuasive evidence existed of an equivalence between the amount of the cash distribution, the earnings and profits of the target corporation, and the available liquid assets of the target. Thus the court seemed to say that it would look at all the facts to ascertain whether the cash distribution could have come from the target as a distribution of liquid assets prior to the reorganization.

This foray by the Tax Court is unfortunate. Although taxpayers may ap-

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206. Clark would have gotten the benefit of the $100 dividend received deduction. I.R.C. § 116 (1982) (repealed 1986).
207. 86 T.C. at 153.
208. Id. at 154. The court said that the result depended on the facts and circumstances of individual cases. Id.
209. See Rev. Rul. 75-512, 1975-2 C.B. 112 (reduction of minority shareholder's ownership to 81% of its ownership before redemption met § 302(b)(1) test); see also Rev. Rul. 75-502, 1975-2 C.B. 111 (on facts presented reduction of ownership from 57% to 50% constituted meaningful reduction under Davis and met § 302(b)(1) test).
210. 86 T.C. at 153.
211. Id. n.18.
212. Id. at 155.
plaud the new life Clark appears to give to the Wright case, the Clark approach has certainly raised the level of uncertainty in this area. How liquid must the liquid assets be before the Tax Court would move to the Shimberg approach? Suppose that most of the assets of the target consisted of inventory. Would inventory as a matter of law qualify as liquid assets, or would further examination be made to see whether the inventory could be easily liquidated? Suppose most of the assets are plant and equipment. Are such assets presumptively not liquid, or would further examination have to be made to ascertain whether the particular type of plant and equipment can be easily sold? The flat rule either of Wright or Shimberg seems preferable to the approach in Clark, which provides for a case-by-case approach with its attendant uncertainty and litigation.

If the Clark approach eventually prevails, however, some planning possibilities would open up that are generally not available under the flat rule of Shimberg. If the target corporation is awash in liquid assets, the cash distribution is, under Clark, at risk of being treated under the Shimberg rule, thus resulting in a dividend to the shareholders. In some circumstances the target corporation might be able to invest its liquid assets into physical operating assets that might be of use in any event to the prospective acquiring corporation. This maneuver would perhaps be effective in avoiding Clark-Shimberg treatment and obtaining Wright treatment.

(ii) Differences From the Normal Dividend/Earnings and Profits Rules. It is well established that, under section 356(a)(2), section 302 standards are to be used to ascertain the character of any gain recognized when boot is received along with qualifying consideration. Section 302 standards determine whether some part of a gain is a dividend for section 356(a)(2) purposes. When such a dividend exists, this dividend within a gain differs in a number of respects from a normal dividend and presents some policy problems.

Section 356(a)(2) measures the amount of the gain that may be characterized as a dividend differently than does section 301, which covers normal corporate distributions. First, in section 301, the amount of the cash or other property distributed is not reduced by the basis of any of the stock the shareholder holds. Section 356(a)(2), however, is concerned with characterizing an exchange of stock in the target for stock in the acquiring corporation, plus boot. Section 356(a)(2), therefore, allows a basis offset that may well cause the gain recognized to be less than the amount of the boot. An example illustrates this point.

Target Corporation, with earnings and profits of $4000, merged into Acquiring Corporation in a valid type A reorganization. The consideration given to V, the sole shareholder of Target, was 35 shares of voting stock of

213. Planning is not a big concern under the Wright rule either, since Wright is already generally giving the right answer for taxpayers, namely capital gains.
215. Id. § 301(b)(1).
Acquiring Corporation, with a fair market value of $100 per share, plus a note with a fair market value of $2500. V’s basis in the Target stock he exchanged was $5000. V thus had a realized gain of $1000, computed as follows: The amount realized was $3500, the fair market value of stock received, plus the $2500 bond, for a total of $6000. Subtracting the $5000 basis in the stock exchanged from the $6000 amount realized left V with a $1000 realized gain.

Section 356(a)(1) applies to this transaction, since V received qualifying consideration as well as boot. V therefore recognizes the $1000 realized gain since it is more than covered by the $2500 boot. Under the Shimberg/IRS approach, which would treat Target Corporation as having distributed the boot to V before the reorganization, V’s recognized gain of $1000 is taxed as a dividend under section 356(a)(2). The gain receives dividend treatment because of section 302 principles and because Target Corporation has accumulated earnings and profits of $4000.

Had the transaction been a straight section 301 distribution of the $2500 note, V would have been taxed in full on the $2500.216 Also, the full $2500 would have been taxed as a dividend since the earnings and profits of Target Corporation were $4000.217 Sections 301(c)(1) and 316(a) so mandate.

This example demonstrates some planning possibilities for the closely held corporation. When a desire exists to distribute a substantial amount to a shareholder, it may be advantageous to structure, if possible, the transaction as a merger rather than a dividend payment. Of course, care must be taken to avoid application of the substance over form and step transaction doctrines.218

A second way in which section 356(a)(2) measures the amount of gain that may be characterized as a dividend differently than does section 301 relates to the distribution of property to a corporate shareholder. Under section 301, when a corporation distributes property to a corporate shareholder, the amount distributed is the lesser of the fair market value or the basis of the property in the hands of the distributing corporation.219 That lesser of fair market value or basis rule does not apply to a section 356(a)(2) dividend.220

Because of the various differences between regular section 301 dividends and section 356(a)(2) dividends, the IRS for some time maintained that section 356(a)(2) dividends did not qualify for the 80% or 100% intercorporate

216. See id.
217. See id. §§ 301(c)(1), 316(a).
218. See Gregory v. Helvering, 293 U.S. 465 (1935); McDonald’s Restaurants of Ill., Inc. v. Commissioner, 688 F.2d 520 (7th Cir. 1982).
219. I.R.C. § 301(b)(1)(B) (1986). The basis of such distributed property in the hands of the distributee is also, appropriately, the lesser of the fair market value or the basis of the property in the hands of the distributing corporation. Id. § 301(d). The purpose of these rules is to prevent the distributee corporation from getting a stepped-up basis in appreciated property in the hands of the distributing corporation. Without the rules the distributee corporation would incur a minimum tax cost on the distribution on account of the dividend received deduction rules of id. § 243.
dividends received deduction of section 243. The IRS has now bowed to the weight of judicial authority and concedes that the section 243 intercorporate dividends received deduction applies to section 356(a)(2) dividends. The application of the intercorporate dividend received deduction to section 356(a)(2) dividends creates an excellent planning opportunity for corporations that are target shareholders in reorganizations.

If a corporate shareholder of a target corporation might incur a section 356(a)(2) boot dividend, that shareholder should, if possible, receive boot property that has appreciated in the hands of the acquiring corporation. The amount distributed would be the fair market value of the property, and the basis in the hands of the recipient would also be the fair market value of the property since the lesser of fair market value or adjusted basis rules do not apply. The corporation would incur only a minimal amount of tax because of the section 243 intercorporate dividend received deduction. The transaction steps up the basis of appreciated property to its fair market value, but at a negligible tax cost. This stepped-up basis could then support substantial future depreciation deductions. This entire attractive package has been approved by the IRS.

Still another difference in the determination of dividends under section 356(a)(2), as opposed to section 301, involves earnings and profits. Earnings and profits are used as a measuring rod to characterize distributions from corporations. Distributions by a corporation are generally unattractive dividends to the extent the distributions are out of earnings and profits.

Section 356(a)(2) only characterizes boot as a dividend to the extent of accumulated earnings and profits, but the provision does not also use the corporation's current year earnings and profits. Section 301, on the other hand, uses both accumulated and current earnings and profits. Since under section 356(a)(2) the current year's earnings and profits are not counted, the corporation would generally have less earnings and profits available to characterize a distribution as a dividend. Also, the stockholder's dividend income under section 356(a)(2) is, attractively, limited ex-

223. I.R.C. § 301(b)(1), (d)(1) (1986). The basis of property other than nonrecognition property is fair market value. Id. § 358(a)(2).
224. Id. § 168.
227. Id. § 316(a).
228. Moreover, the phenomenon of nimble dividends would not occur with a § 356(a)(2) distribution. A nimble dividend is a distribution under § 301 at a time when both a deficit in accumulated earnings and profits and a positive amount of current earnings and profits exist. Even though a net deficit exists in the two earnings and profits accounts, a distribution in the current year would be characterized as a dividend to the extent of current earnings and profits in such a case. Section 316(a)(2) mandates this result under § 301.
plicitly to the stockholder's ratable share of earnings and profits.\textsuperscript{229} This limit apparently does not apply to section 301 distributions.

Questions arise under section 356 concerning whose earnings and profits measure the amount to be treated as a dividend. Do the earnings and profits of only the target corporation control, or do the earnings and profits of both the target and the acquiring corporation contribute to the dividend measure? Controversy exists on this matter.\textsuperscript{230}

The rule that the amount distributed to corporate distributees is the lower of the basis or the fair market value of the property distributed in section 301 distributions\textsuperscript{231} does not apply in section 356 distributions.\textsuperscript{232} This different rule for determining the amount distributed can affect whether a distribution is out of earnings and profits.

b. No Qualifying Consideration Received. As discussed previously, that a stockholder receives no qualifying consideration means one of the following: (1) surrendering stock and receiving bonds, cash, and other property; or (2) surrendering securities and receiving cash and other property. Thus, receiving no qualifying consideration means receiving no stock back in the exchange. This concept is important because if no qualifying consideration is received along with the nonqualifying consideration, the redemption rules of section 302 govern the transaction.\textsuperscript{233}

One of the provisions of section 302 is that a redemption is treated as a sale or exchange of stockholders' stock if the redemption constitutes a complete termination of the interest of the stockholders who are redeemed.\textsuperscript{234} If the stockholder receives no qualifying consideration, the stockholder's interest as a stockholder has, by hypothesis, been terminated; therefore, the complete termination of interest test would always be met unless the constructive ownership rules of section 318 applied.\textsuperscript{235} Consequently, when no qualifying consideration is received, the stockholder of the target will be treated as having sold or exchanged the target stock under section 302. Assuming that the stock is a capital asset in the stockholder's hands, the stockholder would be entitled to capital gain, or capital loss, treatment on the transaction.\textsuperscript{236} This gain would be eligible to be reported on the installment method.\textsuperscript{237}

\textsuperscript{229} I.R.C. § 356(a)(2) (1986).
\textsuperscript{230} See Atlas Tool Co. v. Commissioner, 614 F.2d 860 (3d Cir. 1980) (earnings and profits of only transferor corporation used); Davant v. Commissioner, 366 F.2d 874 (5th Cir. 1966), cert. denied, 386 U.S. 1022 (1967) (nondispositive reorganization, earnings and profits of both corporations used); Rev. Rul. 70-240, 1970-1 C.B. 81 (earnings and profits of both corporations used).
\textsuperscript{231} I.R.C. § 301(b)(1)(B) (1986); see also id. § 301(d)(2) (the basis of the property in the hands of the distributee is also the lower of the fair market value or the basis in the hands of the distributor).
\textsuperscript{232} Treas. Reg. § 1.356-1(d) (as amended in 1979).
\textsuperscript{233} See I.R.C. § 356(a) (1986).
\textsuperscript{234} Id. § 302(b)(3).
\textsuperscript{235} The constructive ownership rules of § 318 also apply to the § 356 situation. Id. § 356(a)(2).
\textsuperscript{236} A capital gain or loss arises from the sale or exchange of a capital asset. Id. § 1222; see D. Posin, supra note 9, § 4.06, at 198-262.
\textsuperscript{237} Prop. Treas. Reg. § 1.453-1(f)(2), 49 Fed. Reg. 18,866 (1984); see Friedman, An Anal-
4. Basis of Property Received

a. General. The basis rule applicable in the reorganizations context, that of section 358, provides that the basis of the stock or securities of the acquiring corporation permitted to be received by the stockholders of the target without the recognition of gain or loss is the same as the basis of the stock or securities of the target corporation that the stockholder surrendered. That substituted basis is adjusted for certain other factors. The basis decreases by the amount of the boot received and increases by the amount of gain recognized on the transaction.

Section 358 also determines the basis of boot, property received by the stockholder on which gain is recognized. Except for money, the basis of any other property received is the fair market value of the property. In effect, however, the basis of money received is also its fair market value since it is axiomatic in tax law that money always has a basis equal to its face amount.

b. Allocation of Basis Among Nonrecognition Property. The stockholder or security holder of a target may receive more than one type of nonrecognition property. For example, the stockholder could receive common stock and preferred stock of the acquiring corporation in exchange for common stock of the target corporation, or could receive two classes of bonds of the acquiring corporation in exchange for bonds of the target corporation. In such a case, the basis for such nonrecognition property is allocated among the classes of nonrecognition property according to relative fair market values.

For example, suppose X is a stockholder in T Corporation. X's stock has a basis of $100 and a fair market value of $400. A Corporation acquires T Corporation in a type C reorganization. In consideration for X's stock in T Corporation, X receives $300 of common stock of A Corporation and $100 of preferred stock of A Corporation. X's basis in the common stock of A Corporation is $75 (300/400 of $100) and X's basis in the preferred stock of A Corporation is $25 (100/400) of $100.242

If a stockholder or security holder of the target owns more than one class of stock, more than one class of securities, or both stock and securities of the target, then the allocation becomes somewhat more complex. Each class or type of stock or securities owned is considered to have been involved in a separate exchange for stock or securities of the acquiring corporation, and any allocation of basis must be done with respect to each such separate transaction.243 The facts determine what the stockholder or security holder

239. Id.
240. Id. § 358(a)(2).
241. Id. § 358(b)(1); Treas. Reg. § 1.358-2 (as amended in 1979).
242. For several additional examples see Treas. Reg. § 1.358-2(c) (as amended in 1979).
243. Id. § 1.358-2(a)(4).
received for each class of stock or securities surrendered.244

For example, suppose X, an individual, owns stock of T Corporation with a basis of $5000 and owns a security of T Corporation with a principal amount of $5000 and a basis of $5000. In a type A reorganization X surrenders the stock for A Corporation stock with a value of $6000, and surrenders the security of T Corporation for A Corporation stock worth $1500 and a security of A Corporation with a principal amount of $4500. X recognizes no gain on either exchange. The basis of the A Corporation stock received for the stock of T Corporation is $5000. The bases of the stock and security of A Corporation received in exchange for the T Corporation security are $1250 (1500/6000 of $5000) and $3750 (4500/6000 of $5000), respectively.245

5. Holding Period

Because of the continuing significance of the holding period in capital gains and losses through 1987,246 the rules in the reorganizations area concerning the holding period for property exchanged by a stockholder are important. The holding period of nonrecognition property received in a reorganization tacks on to the holding period of the property given up.247 The holding period of recognition property starts with the time the taxpayer acquires it.248

B. Examples Illustrating Treatment Given Stockholders in Reorganizations

Example: Stock Exchanged for Stock. Acquiring Corporation acquires Target Corporation in a transaction that qualifies as a C reorganization. S, a shareholder of Target Corporation, surrenders Target stock with a basis of $100 and a fair market value of $200. S receives in exchange stock of Acquiring Corporation with a fair market value of $200. S realizes a gain of $100 on the exchange, but has no gain recognized under section 354(a)(1). S's basis in the new Acquiring Corporation stock is, under section 358(a), $100, the basis of the Target stock. No correction factors for the basis are present since the stockholder received no boot and recognized no gain.

Example: Stock Exchanged for Stock and Securities. Target Corporation merges into Acquiring Corporation in a transaction that qualifies as an A reorganization. S, a shareholder of Target, surrenders Target stock with a

244. Id.
245. Id. § 1.358-2(c), example 3. If the stockholder or security holder surrenders stock or securities acquired at different times, the calculation of the basis is generally made using the average cost for the stock or securities. Bloch v. Commissioner, 148 F.2d 452 (9th Cir. 1945) (average cost rule may not apply if specific stock or securities are exchanged for specific stock or securities); Rev. Rul. 55-355, 1955-1 C.B. 418. Realized or recognized gain on the sale of the stock or securities must still be computed using the usual rule of first-in, first-out unless the particular stock or securities can be identified. See D. Postin, supra note 9, § 4.03(f).
246. See supra text accompanying notes 7-18.
248. This is the general rule and no special reorganization provision overrides it.
basis of $100 and a fair market value of $200. S receives in exchange stock of Acquiring Corporation with a fair market value of $150 and securities of Acquiring Corporation with a fair market value of $50. S realizes a gain of $100 on the exchange. Since S received nonqualifying property, section 356 governs the transaction instead of section 354(a)(1). Under section 356(a)(1), S has $50 of gain recognized. The character of that gain as dividend or capital gain would be determined under section 356(a)(2) and the tests appurtenant thereto. S’s basis in the new Acquiring Corporation stock would be $100, that is, $100, the basis of the Target stock, decreased by the $50 amount of boot received and increased by the $50 amount of gain recognized. S’s basis in the Acquiring Corporation securities would be the $50 fair market value.

Example: Stock Exchanged for Securities. Target Corporation transfers property to Acquiring Corporation in a transaction that qualifies as a type D reorganization. S, a shareholder of Target, surrenders Target stock with a basis of $100 and a fair market value of $200. S receives in exchange securities of Acquiring Corporation with a principal amount of $200 and a fair market value of $200. S realizes a gain of $100 on the exchange. The exchange, however, is outside the rules of section 354(a)(1) and section 356 because S received no qualifying consideration: S surrendered only stock and received only securities. S, therefore, recognizes the entire $100 gain as a capital gain, under section 302. S has a basis in the securities received as boot equal to the fair market value of the securities, $200.

Example: Securities Exchanged for Securities. The stock of Target Corporation is acquired by Acquiring Corporation in a transaction that qualifies as a type B reorganization. X, a security holder of Target, surrenders securities of Target with a principal amount of $170, a fair market value of $200, and a basis in X’s hands of $180. X receives in exchange securities of Acquiring Corporation with a principal amount of $210 and a fair market value of $200. X realizes a gain of $20 on the exchange, the $200 fair market value of the securities received less the $180 basis in the securities surrendered. X recognizes a gain. The amount of gain recognized is ascertained first by determining the amount of boot received. The amount of boot received is the fair market value of the amount by which the principal amount of the securities received exceeds the principal amount of the securities surrendered.249

Thus, employing this approach, the amount of the boot received is calculated as follows: The excess principal amount of $40 ($210-$170) has a fair market value of $38.09 (the proportion of $40 that $200 bears to $210). X’s realized gain is $20 (the amount realized of $200 less X’s basis of $180). X, therefore, recognizes the entire $20 of realized gain since the amount of boot, $38.09, exceeds the realized gain.

249. See I.R.C. § 356(a), (d)(2) (1986). The Regulations treat as boot the same proportion of the fair market value of the securities received as the excess principal amount of the securities received bears to the total principal amount of the securities received. See supra note 171 and accompanying text.
The calculation of the basis of the security received by $X$ breaks down into two steps. The basis of the portion that was considered boot or other property is its fair market value, $38.09. The basis of the portion that was received tax-free is $161.91, the basis of the security surrendered, $180, decreased by the $38.09 of boot received, and increased by the $20 of gain recognized. Thus, the basis of the security is the total of $38.09 and $161.91, or $200. This result makes sense in that the value of the security received was $200 and $X$ did recognize all the gain realized ($20).

VII. TREATMENT OF THE ACQUIRING CORPORATION

A corporation does not recognize gain on the issuance of its own stock, whether or not that issuance is in connection with a reorganization.\(^{250}\) The issuance of securities by a corporation also does not give rise to taxation because the transaction is in the nature of borrowing money, which is not a taxable event. Thus, the acquiring corporation in a reorganization does not incur tax liability upon issuing stock or securities as part of a reorganization exchange.

Nevertheless, the acquiring corporation may transfer appreciated property that is not its own stock or securities, such as appreciated real estate, to the target corporation or its shareholders as part of the consideration it gives in the transaction. In such a case the acquiring corporation will recognize gain or loss on that transfer since no nonrecognition provision applies.\(^{251}\)

The basis of the property obtained by the acquiring corporation in a reorganization is the basis of the property in the hands of the target corporation, increased by gain recognized to the target.\(^{252}\) Such a basis is a so-called carryover basis.

VIII. RECEIPT OF SECTION 306 STOCK

One final section of the Code should be of concern in a reorganization. Section 306 was enacted into the Code to combat the so-called preferred stock bail out of earnings and profits at capital gains rates. Such a bail out would be accomplished by having the corporation declare a pro rata dividend of preferred stock, which would be received tax-free by the common stockholders by virtue of the stock dividend rules of section 305.\(^{253}\) This transaction would then be followed by a sale of the preferred stock for a capital gain.\(^{254}\) After the sale the stockholder would have cash in hand that was taxed at only capital gains rates; yet, the stockholder would have retained the same proportional position in the corporation since the stock-

\(^{250}\) I.R.C. § 1032 (1986).
\(^{251}\) See id. § 1001(c).
\(^{253}\) I.R.C. § 305(a) (1986).
\(^{254}\) The taxpayer must allocate part of the basis of the underlying common stock to the preferred stock. Id. § 307.
PARTICIPANTS IN A REORGANIZATION

The most obvious legislative response to this maneuver would have been to have amended the stock dividend rules to render a pro rata preferred stock dividend taxable on receipt. Legitimate and important business planning uses exist however, for preferred stock dividends. The dividends may be used for estate planning purposes, or may be used to transfer control within a family corporation from one group to another. Thus, Congress's response to the preferred stock dividend was the enactment of section 306.

Section 306 stock is preferred stock that is received tax-free as a stock dividend by virtue of the stock dividend rules of section 305 at a time when the distributing corporation has earnings and profits. The stock carries a taint, however. Upon sale, the amount realized on the stock is taxed as ordinary income to the extent of its ratable share of earnings and profits. A taxpayer can accomplish a bail out in ways other than by just a direct dividend of preferred stock. For example, upon the merger of two corporations under common control, preferred stock could be dished out pro rata to the target shareholders as part of the consideration for the stock of the target. The subsequent sale of the preferred stock would yield capital gains whereas, perhaps, a pro rata receipt of cash directly would have been taxed as a dividend under the normal rules of section 356. Hence, Congress provided that the definition of section 306 stock includes stock that the stockholder received in a corporate reorganization with respect to which gain was not recognized by reason of the corporate organization and reorganization provisions.

In the case of a type A or type C reorganization of two corporations under common control, the pro rata receipt of preferred stock of the acquiring corporation along with common stock of the acquiring corporation in exchange for the stock of the target would meet this section 306 definition. The preferred stock would thus carry a tax taint. This result seems reasonable. The Regulations, however, go somewhat further, creating the possibil-

256. For example: A, who is getting on in years, owns all the common stock of X Corporation; the common stock is the only class of stock outstanding. A has two daughters. One daughter has an interest in the business, and the other daughter wishes to become a ballet dancer. A causes X Corporation to declare a dividend of nonvoting preferred stock equal in value to the common stock he already holds. He then provides in his will that the business daughter will inherit the common stock and the ballet daughter will inherit the preferred stock.
257. I.R.C. § 306(c) (1986).
258. Id. § 306(a)(1). If the preferred stock is redeemed instead of sold, the amount distributed to the shareholder on the redemption will be taxed under the dividend rules of § 301. Id. § 306(a)(2).
259. Id. § 306(c)(1)(B).
260. Id. § 306(c)(1)(B)(ii).
261. Another common way to meet the definition of § 306 stock in the corporate reorganization area is by pro rata issuance of preferred stock to shareholders in a type E reorganization, a recapitalization under § 368(a)(1)(E).
ity that, even if the acquiring corporation and the target are not under common control, receipt of preferred and common stock by stockholders of the target in a reorganization could fall within section 306. The regulations provide: "Ordinarily, section 306 stock includes stock which is not common stock received in pursuance of a plan of reorganization . . . if cash received in lieu of such stock would have been treated as a dividend under section 356(a)(2) . . . ."262 As discussed above, under the leading authority of Shimberg the shareholders of the target can very well have dividend treatment on the receipt of cash even if the target and the acquiring corporations are not under common control.

The preferred stock bail out maneuver is primarily a creature of the closely held corporation. Thus, the IRS will generally rule that the disposition of section 306 stock in a publicly held corporation is exempt from section 306(a) ordinary income treatment because the disposition is not a tax avoidance device.263 Such a ruling could be useful to publicly held corporations in a reorganizations context. The historical background of the ruling indicates, however, that a corporation should have at least some colorable business reason for the issuance of the preferred stock.264

IX. CRITIQUE OF THE RULES FOR TAXING PARTICIPANTS

The strange collection of rules described in this Article for taxing participants in a reorganization merits some criticism. The rules are complex, often contradictory, and frequently without sound policy underpinnings. This section discusses various proposals that might simplify or at least rationalize these rules.

A. Liabilities

The Senate Finance Committee Staff proposals for reform265 advocate limiting nonrecognition of gain on the transfer of target liabilities to those liabilities that are either: (1) purchase money indebtedness; or (2) liabilities that are assumed or acquired by the acquiring corporation incident to the acquiring corporation's acquisition, holding, or operation of the property

264. Rulings that predate the current IRS position suggest that publicly held companies do not necessarily have carte blanche when it comes to § 306 stock. See Rev. Rul. 57-212, 1957-1 C.B. 114 (although preferred stock was issued in the merger of two publicly held corporations, the 3% per year that would be redeemed under a sinking fund provision would not be subject to § 306(a) treatment because of the exception of § 306(b)(4); question: what about the other sales or redemptions of this preferred stock?); Rev. Rul. 56-116, 1956-1 C.B. 164 (preferred stock issued in a merger of two publicly held corporations was not subject to § 306(a) when legitimate business reasons existed for the issuance of the preferred stock, i.e., limiting the ability of the shareholders of the target to share in the growth of the combined entity and limiting the dilution of voting power of shareholders of the acquiring corporation).
transferred in the ordinary course of business. These proposals were incorporated into the Senate Finance Committee's working draft version of the 1986 tax reform bill, but the proposals were dropped from the final version of the bill. The Treasury Department will probably reconsider these proposals in its study of the reform of subchapter C, a study that is required by the legislative history of the 1986 Act.

The effect of the Senate staff proposal would be to disallow the tax-free shift of liabilities incurred by the target with respect to property after the property has been acquired by the target. Thus, the target would not be able to wring cash out of the transaction tax-free by borrowing prior to the shift of the property to the acquiring corporation. As discussed previously, section 357(b) provides some anti-tax avoidance rules against such maneuvers, but the impact of section 357(b) is uncertain; section 357(b) may not apply at all after the 1986 Act. The Senate Finance Committee Staff's proposals would obviate the need for possible application of section 357(b) rules and make the results in this area much more predictable. Thus, the Senate Finance Committee Staff proposals seem well conceived and should be enacted.

B. Securities as Boot

The rules for determining the amount of gain when securities are received in exchange for the surrender of securities give rise to some anomalous results. The securities received may have a greater fair market value than the securities surrendered, and yet, there will be no boot. This result occurs because the present boot rules compare the principal amount of securities received with the principal amount of the securities surrendered, rather than comparing their fair market values. The fair market values of the securities, of course, are affected by such factors as the rate of interest carried by the securities and the creditworthiness of the issuer. Thus, a more realistic approach would be to compare fair market values rather than principal amounts. If the fair market value of the securities received exceeds the fair market value of the securities surrendered (as when the taxpayer also surrenders stock), then the taxpayer is truly moving upstream, or cashing out, and deserves to be charged with the receipt of boot in the amount of that excess.

C. Recognition and Character of Boot Gain

Probably no single aspect of the scheme for taxing participants in reorganizations has attracted more attention than the issue of the character of boot gain recognized under section 356(a)(2) to a stockholder or security holder in a reorganization. The commentators have plumbed a variety of technical

266. Id. at 57.
269. See supra text accompanying note 89.
arguments to conclude that either the *Wright* approach is right, the test under section 302 being conducted with reference to the acquiring corporation, or that the *Shimberg* approach is correct, the test under section 302 being conducted with reference to the target corporation.\(^{271}\) The *Clark* case is too new to have yet drawn admirers, but no doubt it will.

The Senate Finance Committee Staff proposals address the boot gain recognition and character issue. A major tenet of these proposals is to create a supposedly optional system for determining whether a transaction is tax-free or taxable at the corporate level.\(^{272}\) Curiously enough, under the proposals, making that choice at the corporate level has no bearing on the treatment of the stockholders. Rather, under the proposals, stockholders of the target corporation would be entitled to nonrecognition if they receive stock or securities of the acquiring corporation.\(^{273}\) Securities, that is, debt, could be received tax-free, however, only to the extent that the issue price of the securities received did not exceed the basis of the securities surrendered.\(^{274}\) If any nonqualifying or recognition property is received, it would be characterized under amended section 356 by reference to the acquiring corporation.\(^{275}\) This approach would follow the approach of *Wright* and reject the *Shimberg/IRS* approach and the *Clark* approach.

These proposals for changing the rules of recognition and character of gain to recipients of boot in corporate reorganizations do not appear to have a conceptual basis that is markedly superior to that of the present rules. Regarding the question of recognition of gain, a major problem with the Senate Finance Committee Staff’s proposals is that, by allowing gain to go unrecognized on the receipt of stock, the proposals retain reliance on the continuity of interest doctrine, a doctrine that is outstanding in the feature that absolutely no one will defend it.\(^{276}\) No policy supports allowing, for

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\(^{272}\) For a critique of these proposals see Posin, *supra* note 22, at 1391-1405.

\(^{273}\) STAFF OF SENATE FINANCE COMM., *supra* note 265, at 83.

\(^{274}\) *Id.* at 85. As discussed above, the present system allows securities to be received tax-free only to the extent the principal amount of the securities received does not exceed the principal amount, rather than the basis, of the securities surrendered. *See supra* text accompanying note 163.

\(^{275}\) STAFF OF SENATE FINANCE COMM., *supra* note 265, at 97.

\(^{276}\) See Hutton, *Musings on Continuity of Interest—Recent Developments*, 56 TAXES 904, 911 (1978); Wolfman, *“Continuity of Interest” and the American Law Institute Study*, 57 TAXES 840, 842 (1979).
example, a stockholder of a closely held, small corporation to sell out and receive stock of IBM tax-free. The stockholder in such a case has no particular connection with the assets of the closely held business any longer, and the stockholder's new investment is completely liquid.

Beyond the question of recognition of gain, the question of the character of the gain recognized is also not satisfactorily dealt with in the Senate Finance Committee Staff's proposals. No particular reason exists to prefer the *Wright* test of applying section 302 after the transaction over the *Shimberg/IRS* test of applying section 302 before the transaction, or over the *Clark* approach of usually using *Wright* and sometimes using *Shimberg/IRS*. The *Shimberg/IRS* test is much more likely to yield dividend treatment to the stockholders, whereas the *Wright* test is much more likely to yield capital gain. The fundamental question is whether the receipt of boot in an acquisitive corporate reorganization is an appropriate place to accord capital gains treatment. Since the stockholder receiving the boot is being cashed out to some extent, the three leading cases of *Wright*, *Shimberg*, and *Clark* have, reasonably enough, looked to the section 302 redemption rules as a standard to determine whether the transaction should be accorded capital gains treatment.

The clear theme of section 302(b) is that surrender of voting control and economic position in the corporation is the touchstone of taxability. 277 If such a surrender of position has occurred, then property has been sold and capital gain is vouchsafed. If such an approach is followed in the acquisitive reorganization setting, the appropriate question would seem to be whether the stockholder, as a result of the transaction, has surrendered a significant percentage position with respect to his or her previous business. From that point of view, a test that would make sense would be an approach that applies section 302 by comparing the stockholder's percentage position in the acquired target corporation before the transaction with the stockholder's percentage position in the acquiring corporation after the transaction. This comparison would give, for example, capital gain to a sole stockholder of a

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277. Thus § 302(b)(1)'s test of whether a redemption is substantially equivalent to a dividend is ascertained by whether the redemption caused a significant decline in the stockholder's percentage ownership of the corporation. See Rev. Rul. 75-512, 1975-2 C.B. 112, 113 (reduction of ownership of minority shareholder to a position that constituted 81% of its ownership prior to the redemption met § 302 test); see also Rev. Rul. 75-502, 1975-2 C.B. 111 (reduction of ownership of majority shareholder from 57% to 50% would not meet redemption test). Section 302(b)(2)'s test of whether a redemption warrants capital gain treatment turns on whether certain percentage reductions in the stockholder's position have occurred as a result of the redemption. To qualify, the stockholder must own, after the redemption, less than 50% of the total combined voting power of all classes of stock entitled to vote. I.R.C. § 302(b)(2)(C) (1986). In addition, after the redemption, the stockholder must have less than 80% of a previous position in the voting stock, and less than 80% of a previous position in the common stock, whether voting or not voting. Id. Under § 302(b)(3) the stockholder receives capital gain on the redemption if the redemption constitutes a complete termination of the stockholder's interest in the corporation. Section 302(b)(4), unlike the other three tests, looks to the effect of the redemption on the corporation, rather than on the stockholders. If the redemption constitutes a partial liquidation of the corporation, generally the distribution of the assets of a trade or business while the corporation continues to conduct another trade or business, § 302(e), the stockholders receive capital gains on the redemption. Id. § 302(b)(4)(B).
corporation that is acquired by a much larger corporation, that is, when a
whale swallows a minnow.

Interestingly, this before and after approach is one that finds no support in
any of the cases or commentators. That in itself may be a reason to consider
the approach; something everyone opposes cannot be all bad. The conven-
tional wisdom is that this approach is invalid because it compares apples
with oranges;\textsuperscript{278} it compares positions in two different corporations. If, how-
ever, a taxpayer surrenders apples in exchange for oranges, comparing ap-
ples and oranges seems appropriate.

In particular, considering the whale swallowing the minnow example, the
criticism of the before and after approach is that the stockholder’s diminu-
tion in position is due to the fact that the stockholder has become a stock-
holder in a much larger corporation; the change in position is not due to the
receipt of boot. The fact remains, however, that as a result of the transaction
the stockholder has surrendered substantial voting and economic position
with respect to his or her former business. That is the touchstone of taxabil-
ity of section 302.

In determining the character of boot gain fictitious transactions are very
popular: the Shimberg/IRS approach assumes a hypothetical redemption by
the acquired corporation before the transaction, and the Wright approach
assumes a hypothetical redemption after the transaction. One little virtue of
the before and after approach advocated here is that it is the one test that
does not conjure up a fictitious transaction; it looks to the reality. The real-
ity is that the stockholder in the target corporation became a stockholder in
the acquiring corporation, and thus, the appropriate test is the one that looks
at that reality.

A broader approach could be taken toward the whole issue of characteriz-
ing boot gain in corporate reorganizations. The underlying theory for ac-
cording nonrecognition of gain to qualifying corporate reorganizations is
that the stockholder is still invested in the business in which the stockholder
was invested before. As a factual matter, however, this theory may be
wholly inaccurate in the case of, for example, a multibillion dollar corpora-
tion such as IBM acquiring a small, family software company for stock.
Nevertheless, that is the theory. If that theory, however, is to be taken seri-
ously, the question may be asked whether the rule should be that the entire
amount of any boot distributed should be taxed, rather than the present rule
of just taxing the boot to the extent of the realized gain. If, for example, no
reorganization had occurred, but rather just a simple distribution of cash
had taken place, the treatment would take a three-step approach as follows:
The entire amount of the cash is taxed as a dividend to the extent of earnings
and profits.\textsuperscript{279} To the extent the distribution exceeds earnings and profits, it
reduces the basis of the stock held.\textsuperscript{280} If the distribution also exceeds basis,

\textsuperscript{278} See Kyser, supra note 271, at 340.
\textsuperscript{279} I.R.C. §§ 301(c)(1), 316 (1986).
\textsuperscript{280} Id. § 301(c)(2).
the balance is treated as a capital gain.281

A very important point with regard to this treatment of distributions is that no offset of basis is allowed. Thus, when substantial earnings and profits exist, the entire amount of the distribution is taxed as a dividend to the shareholder. On the other hand, under current law if the distribution is made as part of an acquisitive corporate reorganization, then the amount of the cash that is taxed is limited to the amount of the gain that the stockholder is calculated to have received on the exchange of stock. But if the transaction is truly a continuation of the stockholder's previous investment, then limiting taxation of boot to realized gain is inappropriate. The theory of treatment should be that the reorganization is a continuation of the stockholder's previous investment; therefore, any cash distributions should be treated as dividend distributions from one ongoing corporation.282

X. CONCLUSION

This Article has demonstrated that when it comes to simplification and rationality, the rules for the treatment of participants in a reorganization have a long way to go. The Tax Reform Act of 1986 made some minor changes to this area that effected some modest simplification. The rules in this area remain, however, a patchwork collection; they lead to results that are not particularly sensible and that are contradictory and unpredictable. The proposals of the Senate Finance Committee for changing the rules of recognition and character of gain to recipients of boot in corporate reorganizations do not appear to constitute a marked improvement over the present treatment.

A major overhaul of the rules in this area is in order. In recognition of that fact, the legislative history of the Tax Reform Act of 1986 directs the Treasury Department to consider whether changes should be made to subchapter C and to report on or before January 1, 1988.283 It will be interesting to see the Treasury study's response concerning the treatment of participants in a reorganization.

281. Id. § 301(c)(3).
282. Cf. STAFF OF JOINT COMM. ON TAXATION, 99TH CONG., 1ST SESS., TAX REFORM PROPOSALS: CORPORATE TAXATION 63 (Comm. Print 1985) (theory by which shareholders can withdraw corporate earnings at capital gain rates if distribution is part of reorganization, although amount would be fully taxable as dividend if distributed apart from reorganization, is inconsistent with principle that shareholder's continued interest in same corporate enterprise deserves tax-free treatment).
283. H.R. CONF. REP. NO. 841, supra note 1, at II-207.