Office of Chief Counsel
Internal Revenue Service

memorandum

Number: **200350016**
Release Date: 12/12/2003
CC:CORP:B02
CLAG-137633-03

UILC: 368.14-00

date: August 28, 2003

to: Associate Area Counsel (LMSB), CC:LM:HMT:NEW:2

from: Associate Chief Counsel (CORP), CC:CORP:B02

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subject: Tax Treatment of Bankruptcy Reorganization

This Chief Counsel Advice responds to your memorandum dated February 25, 2002 and to your supplemental inquiry of August 8th, 2003. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Corp A =

Reorganized Corp A =

Corp B =

Division =

Creditor Representative =

Creditor Classes =

Date 1 =

Date 2 =

Date 3 =

$a =

$b =

$c =

$d =

e% =

f% =

g =

h =

i =

ISSUES

(1) Whether the acquisition by Corp B of a portion of the assets of Corp A in exchange for the distribution of Corp B stock to the former creditors of Corp A, pursuant to the plan of reorganization in a title 11 proceeding, qualifies as a "G" reorganization within the meaning of section 368(a)(1)(G).[1]

(2) Whether the transfer of assets to Corp B in exchange for Corp B stock qualifies for nonrecognition treatment under section 351(a).

CONCLUSIONS

(1) Based upon the information provided, the transaction does not qualify as a 'G' reorganization under section 368(a)(1)(G).

(2) The transfer of assets to Corp B in exchange for Corp B stock does not qualify for nonrecognition treatment under section 351(a).

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[1] The original submission also questioned whether the described transaction qualified as a 'D' reorganization within the meaning of section 368(a)(1)(D) of the Code. After discussions with your office and Examination, it was determined that there was no question as to the application of section 368(a)(1)(D) and this issue was not addressed.

FACTS

On Date 1, Corp A and certain of its wholly-owned subsidiaries filed a voluntary petition under Chapter 11 of the United States Bankruptcy Code. By an order dated Date 2, the Bankruptcy Court approved the Plan of Reorganization. The Plan was consummated on Date 3.

The Plan provided for the consolidation of certain of Corp A's subsidiaries and the transfer of the assets of the Division to a new entity. All prepetition equity interests in Corp A were extinguished, and Corp A continued certain of its business operations as Reorganized Corp A. Under relevant provisions of the Plan, the following transactions were to take place:

- The estates of various subsidiaries (not relevant here) shall be merged with and into Corp A.
- Corp B, a new corporation, will be organized by Corp A.
- Reorganized Corp A will sell the special Division assets to Corp B for cash estimated at $a.
- Reorganized Corp A will sell and transfer to the Creditor Representative an undivided e% interest in the remaining Division assets (subject to e% of the outstanding Division liabilities), in exchange for the cancellation of claims of Creditor Classes in an amount equal to the fair market value of such Division assets (subject to such Division liabilities).
- The Creditor Representative, on behalf of the Creditor Classes, will contribute to Corp B the undivided e% interest in the remaining Division assets received by the Creditor Representative (subject to e% of the outstanding Division liabilities).
- Reorganized Corp A will sell and transfer to Corp B an undivided f% interest in the remaining Division assets (subject to f% of the outstanding Division liabilities).
- Corp B will assume all of the Division liabilities.
- Corp B will issue to the Creditor Representative: (i) on behalf of the Creditor Classes (aa) g shares of Corp B common stock and (bb) $b in aggregate principal amount of Corp B Notes; and (ii) on behalf of the Creditor Classes and at the direction of Reorganized Corp A (aa) h shares of Corp B common stock and (bb) $c in aggregate principal amount of Corp B Notes.

- The Creditor Representative will remit all of the Corp B Notes and shares of the Corp B common stock received under the Plan for distribution to Creditor Classes to the disbursing agent.

- Reorganized Corp A will issue to the Disbursing Agent i shares of Reorganized Corp A common stock for distribution to Creditor Classes.

- Reorganized Corp A will transfer certain of its remaining assets to three subsidiaries (not relevant here) in exchange for all of the issued and outstanding stock of these subsidiaries.

LAW AND ANALYSIS

Issue 1: Section 368(a)(1)(G)

Section 368(a)(1)(G) defines a reorganization to include a transfer by a corporation of all or part of its assets to another corporation in a Title 11 or similar case; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356.

Section 354(a)(1) provides that no gain or loss shall be recognized if stock or securities in a corporation 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.

Section 354(b) provides that section 354(a) shall not apply to an exchange in pursuance of a plan of reorganization within the meaning of subparagraph (D) or (G) of section 368(a)(1) unless the corporation to which the assets are transferred acquires substantially all of the assets of the transferor and the stock, securities, and other property received by the transferor corporation, as well as the other properties of the transferor, are distributed in pursuance of the plan of reorganization.

Section 355(a)(1) provides that if (A) a corporation distributes to a shareholder, with respect to its stock, or distributes to a security holder, in exchange for its securities, solely stock or securities of a corporation which it controls immediately before the distribution, (B) the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both, (C) the active trade or business requirements of § 355(b) are satisfied, and, (D) as part of the distribution, the distributing corporation distributes all of the stock in the controlled corporation held by it immediately before the distribution, or an amount of stock in the controlled corporation constituting control within the meaning of § 368(c),

then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder on the receipt of such stock.

Section 356(a)(1) provides that if section 354 or 355 would apply to an exchange but for the fact that the property received in the exchange consists not only of property permitted by section 354 or 355 to be received without recognition of gain but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

In this case, the described series of transactions fail to qualify as a "G" reorganization. The requirement that the stock of the transferee corporation be distributed in a transaction that qualified under section 354, 355, or 356 was not satisfied.[2]

Under section 354(a)(1), there must be an exchange of stock or securities in a corporation a party to the reorganization solely for stock or securities of such corporation or in another corporation a party to the reorganization. Section 355(a) requires that there be a distribution to a shareholder with respect to its stock or a distribution to a security holder in exchange for its securities. Section 356 applies only where property is distributed in addition to an exchange of stock or securities for other stock and securities.

Based upon the information provided, all prepetition stock interests in the debtor, Corp A, were extinguished in the transaction, and there were no prepetition holders of "securities" within the meaning of sections 354 and 355.[3] The creditors of Corp A that received stock in Corp B were neither stockholders nor security holders. Therefore, the threshold requirement of sections 354,[4] 355, and 356 that there be an exchange by, or

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[2] Because we conclude that the transaction fails under this provision, we have not included an analysis of the other requirements of section 368(a)(1)(G).

[3] It is our understanding that Examination determined, based upon the factors set forth in Camp Wolters Enterprises, Inc. v. Commissioner, that the members of Creditor Classes were not security holders for purposes of sections 354, 355, or 356. See Camp Wolters Enterprises, Inc. v. Commissioner, 22 T.C. 737 (1954), aff'd, 230 F.2d 555 (5th Cir. 1956), cert. denied, 352 U.S. 826 (1956).

[4] We note that the transaction also fails to meet the requirements of section 354(b)(1)(B). This section provides, in pertinent part, that section 354(a) shall not apply to an exchange in pursuance of a plan of reorganization within the meaning of section 368(a)(1)(G), unless "the stock, securities, and other properties received by such transferor, *as well as the other properties of such transferor*, are distributed in pursuance of the plan of reorganization (emphasis added)." This language requires the transferor to liquidate. See generally 15 Collier on Bankruptcy, ¶ 10.03[3] (Matthew

distribution to, a stockholder or security holder has not been met.[5] See generally 15 Collier on Bankruptcy, ¶ 10.03[3] (Matthew Bender 15th Ed. Revised 1996); Tatlock, 540-2nd T.M. A-61, Discharge of Indebtedness, Bankruptcy and Insolvency; Boris I. Bittker & James S. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 12.30[2] (Warren Gorham Lamont 7th Ed. 2000).

Issue 2: Section 351

Section 351(a) provides that no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c) of the corporation. Section 368(c) defines the term "control" to mean the ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation.

Section 351(b) provides that if section 351(a) would apply to an exchange but for the fact that there is received, in addition to the stock permitted to be received under section 351(a), other property or money ("boot"), then gain (if any) to such recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property, and no loss to such recipient shall be recognized.

Section 351(e)(2) provides that section 351 shall not apply to a transfer of property of a debtor pursuant to plan while the debtor is under the jurisdiction of a court in a title 11 or similar case (within the meaning of section 368(a)(3)(A)), to the extent that the stock received in the exchange is used to satisfy the indebtedness of such debtor.

Section 362(a) provides, in pertinent part, that if property is acquired in connection with a transaction to which section 351 applies, then the basis of such

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Bender 15th Ed. Revised 1996); Tatlock, 540-2nd T.M. A-62, Discharge of Indebtedness, Bankruptcy and Insolvency. In this case, the transferor, Reorganized Corp A, retained assets related to the Corp A core business and continued to operate this business through its wholly-owned subsidiaries. Accordingly, the transaction does not qualify under section 354(b).

[5] We note that, in a reorganization under section 368(a)(1)(G), the short-term creditors would be treated as former shareholders of Corp A for purposes of the continuity of interest requirement. See Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179, 183-84 (1942). However, this treatment has not been extended to determine status as a shareholder or security holder for purposes of sections 354 or 355.

property is the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer.

In a supplemental submission, you queried whether the property transfers to newly formed Corp B, would qualify for nonrecognition treatment under section 351(a). Based upon a review of the documents, the asset transfers to Corp B were accomplished by the following transactions: (1) Reorganized Corp A transfers the special Division assets to Corp B for $a; (2) Reorganized Corp A transfers e% of the remaining Division assets to the Creditor Representative (on behalf of Creditor Classes) in satisfaction of the claims of Creditor Classes, and the Creditor Representative transfers such assets to Corp B in exchange for Corp B stock and notes; and (3) Reorganized Corp A transfers the remaining f% of the assets to Corp B in exchange for Corp B stock and notes, which are distributed to the Creditor Representative in satisfaction of claims of Creditor Classes.

Corp A and Corp B have treated these transfers as a sale of assets in exchange for cash, stock and notes. However, in determining the effect of the transaction for federal income tax purposes, the labels attached to the transaction by Corp A do not control. The substance of the transfers, not their form, will control. The issue in the instant case is whether the exchange of Corp A assets for Corp B stock can qualify as an exchange under section 351 so that Corp B takes a carryover basis in these assets under section 362.

We considered whether the described series of transactions could be recast to treat Corp A as having transferred the assets directly to Corp B in exchange for cash, stock, and notes, and distributed the stock and notes to Creditor Classes in satisfaction of their claims against Corp A.[6] This recast fails to meet the requirements of section

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[6] In addition to the recast transaction discussed, we also considered whether Creditor Classes could be treated as the equitable owners of the assets of Corp A and therefore, regarded as the transferors of the assets to Corp B. See Helvering v. Cement Investors, Inc., 316 U.S. 527 (1942) (bondholders of a bankrupt corporation were treated as the equitable owners of its assets and were regarded as the transferors of assets under section 112(b)(5) (the predecessor to section 351).); Overland Corp. v. Commissioner, 42 T.C. 26 (1964), nonacq., 1966-2 C.B. 8 (bondholders and creditors of a bankrupt corporation were treated as the equitable owners of its assets and were regarded as transferors under section 112(b)(5)). In this case, however, there are no prepetition shareholders or security holders (bondholders) that would be treated as the equitable owners of Corp A's assets; only the short-term debt holders (Creditor Classes) would be so treated. We believe this distinction weighs against such treatment. Further, this treatment does not adequately account for the initial transfer of assets to Corp B for which Corp A received (and retained) $a. Lastly, we note that the results obtained under this recast runs counter to that afforded by section 351(d) (enacted by the Bankruptcy Tax Act of 1980). Section 351(d) provides, in pertinent part, that for purposes of section 351, stock issued for indebtedness of the transferee

351 on two separate grounds: (1) Corp A is not a 'transferor' for purposes of section 351(a); and (2) section 351(e)(2) precludes application of section 351 to a transfer of assets by Corp A.

In order to qualify under section 351, the person (or persons) transferring property must receive, in exchange for such property, stock in the transferee corporation that constitutes "control". In general, 'ownership' for purposes of the control requirement is determined by examining the obligations and freedom of action of the taxpayer with respect to the stock received in the exchange. Intermountain Lumber Co. v. Commissioner, 65 T.C. 1025 (1976). The control requirement is generally not satisfied where, at the time of the exchange, the taxpayer is under an obligation to transfer the stock of the corporation acquired in the exchange to another person. See, e.g., S. Klein on the Square, Inc. v. Commissioner, 188 F.2d 127 (2d Cir.), cert. denied, 342 U.S. 824 (1951); Hazeltine Corp. v. Commissioner, 89 F.2d 513 (3d Cir. 1937); Intermountain Lumber Co. v. Commissioner, 65 T.C. 1025 (1976); Rev. Rul. 83-23, 1983-1 C.B. 82; Rev. Rul. 79-194, 1979-1 C.B. 145; Rev. Rul. 79-70, 1979-1 C.B. 144. Where a taxpayer has irrevocably foregone or relinquished the legal right to determine whether to retain the shares acquired in the exchange, ownership in such shares is lacking for purposes of section 351. Intermountain Lumber Co. v. Commissioner, 65 T.C. 1025 (1976).

The recast would treat Corp A as transferring the assets to Corp B in exchange for Corp B stock, notes and cash.[7] In order to comply with the terms of the Plan, Corp A was obligated to immediately transfer the Corp B stock received in the exchange to Creditor Classes. Because Corp A had irrevocably relinquished its right to retain the stock and was under a pre-existing obligation to dispose of the stock, its ownership of such stock is lacking for purposes of the control requirement of section 351(a).

Even if we assume that Corp A was a transferor and the "control" requirement was satisfied, section 351(e)(2) would make section 351 inapplicable under this recast. Section 351(e)(2) provides that section 351 will not apply to a transfer of property of a debtor pursuant to plan while the debtor is under the jurisdiction of a court in a title 11 or similar case, to the extent that the stock received in the exchange is used to satisfy the indebtedness of such debtor. Under the recast, Corp A would be treated as transferring the assets in exchange for stock of Corp B and distributing that stock to

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corporation which is not evidenced by a security is not considered as issued in return for property. The effect of this section is to secure a bad debt deduction for creditors holding short-term indebtedness. By treating Creditor Classes as transferors of the Corp A assets, we would effectively negate this result. We do not believe that this recast is appropriate in light of section 351(d).

[7] The receipt of Corp B notes and cash would be a taxable transaction to Corp A regardless of whether the receipt of stock qualified for nonrecognition treatment under section 351(a). See section 351(b).

Creditor Classes in satisfaction of their claims against Corp A. Accordingly, section 351 does not apply.

Finally, although the conclusions reached above appear to support Reorganized Corp A's and Corp B's treatment of the described transactions as taxable, we note that we have considered other possible recasts that would treat the transactions as nonrecognition events. Due to the lack of needed facts and the unavailability of such facts at this stage, however, we are unable to determine whether any such recasts would be viable in this case.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

If you have any further questions, please call

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