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Internal Revenue Service (I.R.S.)

Revenue Ruling

CORPORATE REORGANIZATIONS

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Section 356.--Receipt of Additional Consideration, 26 CFR 1.356-1: Receipt of additional consideration in connection with an exchange.

(Also section 355; 1.355-1.)

Corporate reorganizations. Effect of the Supreme Court's decision in Commissioner v. Clark, 489 U.S. 726 (1989), 1989-2 C.B. 68, on the analysis of whether gain recognized on the receipt of cash in an exchange of stock that otherwise qualifies under section 355 of the Code is treated as a dividend distribution under section 356(a)(2). Rev. Rul. 74-516 superseded.

ISSUE

Whether gain recognized on the receipt of cash in an exchange of stock that otherwise qualifies under section 355 of the Internal Revenue Code is treated as a dividend distribution under section 356(a)(2).

FACTS

Distributing is a corporation with 1,000 shares of a single class of stock outstanding. Each share has a fair market value of $1x. A, one of five unrelated individual shareholders, owns 400 shares of Distributing stock. Distributing owns all of the outstanding stock of a subsidiary corporation, Controlled. The Controlled stock has a fair market value of $200x.

Distributing distributes all the stock of Controlled plus $200x cash to A in exchange for all of A's Distributing stock. The exchange satisfies the requirements of section 355 but for the receipt of the cash.

LAW AND ANALYSIS

Section 355(a)(1) of the code provides, in general, that the shareholders of a distributing corporation will not recognize gain or loss on the exchange of the distributing corporation's stock or securities solely for stock or securities of a controlled subsidiary if the requirements of section 355 are satisfied.

Section 356(a)(1) of the Code provides for recognition of gain on exchanges in which gain would otherwise not be recognized under section 354 (relating to tax-free acquisitive reorganizations) or section 355 if the property received in the exchange consists of property permitted to be received without gain recognition and other property or money ("boot"). The amount of gain recognized is limited to the sum of the money and the fair market value of the other property.

Under section 356(a)(2) of the Code, gain recognized in an exchange described in section 356(a)(1) that "has the effect of the distribution of a dividend" is treated as a dividend to the extent of the distributee's ratable share of the undistributed earnings and profits accumulated after February 28, 1913. Any remaining gain is treated as gain from the exchange of property.

Determinations of whether the receipt of boot has the effect of a dividend are made by applying the principles of section 302 of the Code. Commissioner v. Clark, 489 U.S. 726 (1989), 1989-2 C.B. 68. Section 302 contains rules for determining whether payments in redemption of stock are treated as payments in exchange for the stock or as distributions to which section 301 applies.

Under section 302(a) of the Code, a redemption will be treated as an exchange if it satisfies one of the tests of section 302(b). Section 302(b)(2) provides exchange treatment for substantially disproportionate redemptions of stock. A distribution is substantially disproportionate if (1) the shareholder's voting stock interest and common stock interest in the corporation immediately after the redemption are each less than 80 percent of those interests immediately before the redemption, and (2) the shareholder owns less than 50 percent of the voting power of all classes of stock immediately after the redemption.

In Clark, the Supreme Court determined whether gain recognized under section 356 of the Code on the receipt of boot in an acquisitive reorganization under section 368(a)(1)(A) and (a)(2)(D) should be treated as a dividend distribution. In that case, the sole shareholder of the target corporation exchanged his target stock for stock of the acquiring corporation and cash. In applying section 302 to determine whether the boot payment had the effect of a dividend distribution, the Court considered whether section 302 should be applied to the boot payment as if it were made (i) by the target corporation in a pre-reorganization hypothetical redemption of a portion of the shareholder's target stock, or (ii) by the acquiring corporation in a post-reorganization hypothetical redemption of the acquiring corporation stock that the shareholder would have received in the reorganization exchange if there had been no boot distribution.

The Supreme Court stated that the treatment of boot under section 356(a)(2) of the Code should be determined "by examining the effect of the exchange as a whole," and concluded that treating the boot as received in a redemption of target stock would improperly isolate the boot payment from the overall reorganization by disregarding the effect of the subsequent merger. Consequently, the Court tested whether the boot payment had the effect of a dividend distribution by comparing the interest the taxpayer actually received in the acquiring corporation with the interest the taxpayer would have had if solely stock in the acquiring corporation had been received in the reorganization exchange.

Prior to the decision in Clark, the Service considered the facts and issue presented in this revenue ruling in Rev. Rul. 74-516, 1974-2 C.B. 121. The determination of whether the exchange of Distributing stock for Controlled stock and boot under section 355 of the Code had the effect of a dividend distribution under section 356(a)(2) was made by comparing A's interest in Distributing prior to the exchange with the interest A would have retained if A had not received Controlled stock and had only surrendered the Distributing stock equal in value to the boot. The Court's decision in Clark does not change the conclusion in Rev. Rul. 74-516, because, like Clark, the ruling determined whether the exchange in question had the effect of a dividend distribution based on an analysis of the overall transaction.

The exchange of A's Distributing stock for stock of Controlled qualifies for non-recognition treatment under section 355 of the Code in part because the overall effect of the exchange is an adjustment of A's continuing interest in Distributing in a modified corporate form. See section 1.355-2(c) of the Income Tax Regulations. The Controlled stock received by A represents a continuing interest in a portion of Distributing's assets that were formerly held by A as an indirect equity interest. The boot payment has reduced A's proportionate interest in the overall corporate enterprise that includes both Distributing and Controlled. Thus, the boot is treated as received in redemption of A's Distributing stock, and A's interest in Distributing immediately before the exchange is compared to the interest A would have retained if A had surrendered only the Distributing shares equal in value to the boot.

Under the facts presented here, before the exchange, A owned 400 of the 1,000 shares, or 40 percent, of the outstanding Distributing stock. If A had surrendered only the 200 shares for which A received boot, A would still hold 200 of the 800 shares, or 25 percent, of the Distributing stock outstanding after the exchange. This 25 percent stock interest would represent 62.5 percent of A's pre-exchange stock interest in Distributing. Therefore, the deemed redemption would be treated as an exchange because it qualifies as substantially disproportionate under section 302(b)(2) of the Code.

HOLDING

In an exchange of stock that otherwise qualifies under section 355 of the Code, whether the payment of boot is treated as a dividend distribution under section 356(a)(2) is determined prior to the exchange. This determination is made by treating the recipient shareholder as if the shareholder had retained the distributing corporation stock actually exchanged for controlled corporation stock and received the boot in exchange for distributing corporation stock equal in value to the boot.

EFFECT ON OTHER RULINGS

Rev. Rul. 74-516 is superseded.

Rev. Rul. 93-62, 1993-30 I.R.B. 10, 1993 WL 339699 (IRS RRU), 1993-2 C.B. 118

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