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One step forward, one step backward: Recent changes in the nonrecognition treatment and warrants
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Tax Management Memorandum; Apr 27, 1998; 39, 9; ProQuest Research Library
pg. 127

MEMORANDUM

One Step Forward, One Step Backward: Recent Changes in the Nonrecognition Treatment of Preferred Stock and Warrants

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Major References: I.R.C. §§351(g), 354, 355, 356; Regs. §1.354-1; Rev. Rul. 98-10, 1998-10 I.R.B. 11; Rev. Rul. 78-408, 1978-2 C.B. 203.

INTRODUCTION

Recent developments in the reorganization area have altered the landscape as to the scope of the nonrecognition provisions with regard to differing equity instruments. The Treasury Department has recently taken a step forward by promulgating regulations which reverse the long standing position of the Internal Revenue Service ("Service") reflected in Regs. §1.354-1(e), that stock warrants are not included in the term "stock or securities" for purposes of §354.[1] Unfortunately, Congress has recently taken a considerably larger step backward by enacting §1014 of the Taxpayer Relief Act of 1997 (P.L. 105-34), which amends §§351, 354, 355, 356, and 1036 to treat certain preferred stock as "boot."

TREATMENT OF WARRANTS

History

Section 354 generally provides for the nonrecognition of gain or loss from the exchange of stock or securities in a corporation that is a party to a reorganization for stock or securities in the same corporation or in another corporation that is a party to the reorganization. Gain realized on an exchange of securities is not recognized provided that the principal amount of the securities received does not exceed the principal amount of any securities surrendered pursuant to the plan of reorganization.

Section 355 provides for the nonrecognition of gain or loss upon a distribution by a corporation with respect to its stock of stock in a controlled corporation, or an exchange of securities in a controlled corporation for its securities. As in the case of a transaction described in §354, gain realized on an exchange of securities is not recognized provided that the principal amount of the securities received does not exceed the principal amount of the securities surrendered pursuant to the plan of reorganization.

Section 356 provides rules for recognition of gain, but not loss, if a shareholder or security holder receives nonqualifying property (*i.e.*, boot) as well as qualifying property in a transaction to which §354 or §355 would otherwise apply. With regard to the topic under discussion, realized gain is recognized in an amount not in excess of the fair market value of the excess principal amount of the securities received over the principal amount of any securities surrendered as part of the plan of reorganization.

Prior to the issuance of the recent regulations, it was well-established that warrants were not entitled to tax free treatment under §354 in a tax free reorganization.[2] The Service, in Rev. Rul. 78-408,[3] ruled that an exchange of warrants in connection with a tax-free reorganization will not be considered an exchange of "stock or securities" for purposes of §354 and the exchange of such warrants was taxable under §1001(a). The ruling also stated that an exchange of a warrant in the target corporation for stock of the acquiring corporation in a reorganization also constitutes a taxable exchange. In order to get tax-free treatment, a warrant holder would have to exercise the warrant prior to the reorganization, and exchange the underlying target stock for acquiring corporation stock in a tax free §354 exchange.

The Proposed Regulations

On December 23, 1996, the Service promulgated proposed regulations under §§354, 355 and 356. For purposes of §§354, 355, and 356, the proposed regulations treated rights to acquire stock as securities having no principal amount. As a result, a taxpayer would not be required to recognize any gain under §356 upon the receipt of a stock right. For this purpose, the term "rights to acquire stock" of an issuing corporation has the same meaning as the term has in §§305(d)(1) and 317(a).[4] It does not include rights exercisable against persons other than the issuer of the stock, or rights that relate to property other

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[1] Unless otherwise stated, all section references contained herein are to the Internal Revenue Code of 1986, as amended (the "Code") and the regulations promulgated thereunder.

[2] Regs. §1.354-1(c); *Bateman v. Comr.*, 40 T.C. 408 (1963), *nonacq.*, 1965-2 C.B. 6.

[3] 1978-2 C.B. 203.

[4] See preamble to the proposed regulations. REG-249819-96, 61 Fed. Reg. 67508 (12/23/96). The definitions in these sections are not specific. Section 305(d) provides "(1) RIGHTS TO ACQUIRE STOCK-For purposes of this section, the term "stock" includes rights to acquire such stock." This language is merely parroted in the regulations. Regs. §1.305-1(d). Section 317 similarly refrains from providing any definition.

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than stock of the issuer of the rights. Thus, for example, warrants issued by an acquiring corporation exercisable into stock of its parent will not qualify, unless the parent is a party to the reorganization whose securities could otherwise be issued under §§354 and 356.

In this regard, it is interesting to note that, in a forward triangular merger reorganization under §368(a)(1)(A) and §368(a)(2)(D), there is a prohibition on utilizing stock of the acquiring corporation but not on the use of securities of the acquiring corporation. As a result, it may be permissible (although not often desirable) to utilize a combination of stock of the parent and warrants to acquire stock in the acquiring subsidiary. Of course, in such case, care must be taken that the issuance of the warrants not disrupt the §368(c) control relationship between parent and acquiring subsidiary.

The proposed regulations represented a major change of the Service's position with respect to the taxation of warrants in connection with an otherwise tax-free reorganization. The proposed regulations were favorably received by tax practitioners. Comments were received by the Service, several of which were incorporated into the final regulations.

The Final Regulations

On January 6, 1998, the Treasury Department promulgated final regulations under §§354, 355, and 356.[5] The final regulations are effective with respect to transactions closing on or after March 6, 1998.

Clarifying a possible ambiguity in the statute, Regs. §1.354-1(d), Ex. 3 of the existing regulations states that §354 does not apply to a shareholder's receipt of solely debt securities in exchange for stock. In response to comments, the final regulations explicitly confirm that the same result occurs where a shareholder exchanges solely stock for stock rights.[6] This is in puzzling contrast to the analysis provided under amended Regs. §1.356-3. Regs. §1.356-3(b) provides that stock rights will not be treated as other property under §356, regardless of whether stock rights or debt securities are surrendered in the exchange. Thus, new Example 7 provides that a shareholder recognizes no gain on the exchange of stock for stock and a warrant.[7]

The preamble to the proposed regulations had stated that the proposed regulations would have no effect on other Code provisions, and that other provisions such as the compensatory rules under §§83 and 421-424 (nonqualified and qualified stock options, respectively) would continue unaffected. In response to comments, however, the final regulations make such point explicit.[8]

The final regulations do not change the definition of a reorganization under §368. The regulations only affect a taxpayer's receipt of warrants in connection with an otherwise valid reorganization.

In connection with the finalization of these regulations, the Service and the Treasury Department became aware of a loophole which, unless corrected, would permit warrants to acquire nonqualified preferred stock (as defined in new §351(g)) to be received tax free in exchange for stock in connection with a reorganization. In general, as discussed below, nonqualified preferred stock that is received in a reorganization will be treated as boot. Accordingly, it was recognized that additional rules were needed to coordinate these regulations with the treatment of rights to acquire nonqualified preferred stock and new §§354(a)(2)(C), 355(a)(3)(D), and 356(e). In this regard, the Service has issued temporary and proposed regulations under §356(e) to coordinate the final regulations with the treatment of rights to acquire nonqualified preferred stock.

Inapplicability to §351

The changes only apply to reorganizations under §368 (or spin-offs under §355). As a result, it now makes a considerable difference in transactions involving warrants or other stock rights whether nonrecognition is sought under §351 or under the reorganization rules. Such a distinction is undoubtedly a result of the fact that §§354 and 356 allow generally for tax-free exchanges of securities without defining that term, while §351, in its more recently stingy form, applies only to the receipt of stock.[9]

The situations are fairly common where a choice can be made as to whether to fit within §351 or the

[5] T.D. 8752, 63 Fed. Reg. 409 (1/6/98).

[6] Regs. §1.354-1(d), *Ex. 4*.

[7] Regs. §1.356-3(c), *Ex. 7*.

[8] Regs. §1.354-1(e). Often, in corporate reorganizations, employees of the target corporation hold options on target stock, and new options on stock of the acquirer replace these options. The cancellation of compensatory options in the target and the substitution of compensatory options in the acquiring corporation is ordinarily tax free to the holders of such options. *See* Regs. §1.83-7. On the other hand, an exchange of a compensatory option for stock of the acquiring corporation is generally a taxable transaction. *Id; LeVant v. Comr.*, 45 T.C. 185, 194 (1965), *rev'd on other grounds*, 376 F.2d 434 (7th Cir. 1967). Commenters stated that the policy considerations underlying the treatment of compensatory options differ considerably from those underlying the treatment of stockholders and security holders in tax-free reorganizations. Congress has enacted a detailed statutory regime which sets forth the consequences of the grant, exercise or transfer of compensatory options. This system, rather than the reorganization provisions, should be the exclusive means of determining the taxability of the transfer and receipt of compensatory options. The final regulations make this point. It should be noted that §§354 and 356 may apply after the compensatory transaction is completed for federal income tax purposes. For example, suppose an employee of a corporation exercises a non-statutory compensatory option and receives unrestricted stock in such corporation. Under §83, the employee has ordinary income equal to the excess of the value of the stock received over the exercise price. Thereafter, the employee generally may surrender such stock in a reorganization and §§354 and 356 should govern the tax consequence of such a transaction.

[9] P.L. 101-239 (1989) removed "securities" from the scope of the nonrecognition provisions of §351(a).

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reorganization rules. The most common and innocuous is the formation of a holding company, such as was done by hundreds of banks during the 1980s. Parent is an operating company which, for regulatory or other reasons, wishes to set up a holding company to hold the shares of Parent. Assume Parent has outstanding some warrants which it would like to exchange for holding company warrants. If Parent is private with only a few shareholders, the simplest approach would presumably be for the shareholders to exchange their Parent shares for 100% of the stock of newly formed Holdco.[10] Such transaction may qualify under either §351 or as a reorganization under §368(a)(1)(B). Because the warrant for warrant exchange will be tax-free under §354 and not under §351, reorganization treatment will be important.

If Parent has outstanding some nonvoting preferred stock which will be exchanged for Holdco nonvoting preferred, the "B" reorganization will be unavailable due to the "solely for voting stock" requirement. Holdco could form a special purpose subsidiary Mergerco to merge into Parent, with the Parent shares being converted into Holdco shares and the Mergerco shares being converted into Parent shares. This transaction would qualify under §368(a)(1)(A) and (a)(2)(E) but for the fact that control of Parent will not be acquired solely for Holdco voting stock. If feasible from a non-tax standpoint, it will be necessary to merge Parent into Mergerco in a reorganization under §368(a)(1)(A) and (a)(2)(D), thus allowing not only the stock but the warrants to be exchanged on a tax-free basis under §354.[11]

Effect On "B" Reorganization

History

In Rev. Rul. 78-408,[12] pursuant to a plan of reorganization involving a "B" reorganization, the acquiring corporation issued warrants to acquire its stock in exchange for warrants to purchase stock of the target corporation. The Service noted that there was a large number of stockholders of the target corporation that did not hold warrants. The Service stated that while the exchange of voting stock for voting stock qualified as a "B" reorganization, "other exchanges of property in connection with the plan of reorganization may be treated as separable transactions." The Service concluded that the exchange of stock qualified for nonrecognition treatment under §354(a), but that the exchange of warrants was a separable transaction to which no nonrecognition provision applied and should be governed by §1001.

[10] Where Parent is a public company, a statutory merger will usually be necessary to bring about a transaction that ensures that all Parent shares are exchanged for Holdco shares.

[11] *See* Rev. Rul. 77-428, 1977-2 C.B. 117; Rev. Rul. 72-274, 1972-1 C.B. 97, describing the use of §368(a)(2)(D) and §368(a)(2)(E) to form a holding company.

[12] 1978-2 C.B. 203.

Rev. Rul. 98-10

On February 23, 1998, the Service issued Rev. Rul. 98-10,[13] which specifically modifies Rev. Rul. 78-408, and *inter alia,* that an exchange of rights to acquire stock and other securities of a party to a reorganization, although separate from the exchange set forth in the statutory definition under §368 may also be in pursuance of the plan of reorganization. In such cases, any gain or loss realized by the holder of such rights as a result of the exchange will not be recognized because of §354(a)(1). The ruling applies to warrant exchanges occurring on or after March 9, 1998.

The issue that the Service ruled on in Rev. Rul. 98-10 was "where a stock for stock acquisition otherwise qualifying under §368(a)(1)(B) of the Internal Revenue Code is accompanied by an exchange of securities, how should the transaction be treated?"

The facts of Rev. Rul. 98-10, were as follows: Pursuant to a plan of reorganization under §368(a)(1)(B), the acquiring corporation issued debentures and exchanged these debentures for all the outstanding debentures of the target corporation. Some of the debentures of the target were held by its shareholders, but a substantial proportion of the target's debentures were held by persons who owned no stock. The Service stated that although the acquisition by the acquiring corporation of the debentures of the target in exchange for debentures of the acquiring corporation occurred as part of the overall transaction, it was not a part of the stock for stock exchange which qualifies as a "B" reorganization. It was, however, an exchange of securities in parties to a reorganization which occurred in pursuance of the plan of reorganization, and, therefore, met all the conditions of §354(a)(1). Accordingly, any gain or loss realized by the debenture holders of the target corporation, as a result of their exchange of the target corporation debentures for an equal principal amount of debentures of the acquiring corporation, was not recognized by reason of §354(a)(1).

In the Service's view, the fact that a substantial proportion of the target corporation's debentures was held by holders who owned no stock in the target ensured that the value of the debentures issued by the acquiring corporation in exchange for the debentures of the target realistically reflected the value of the target's debentures alone and did not constitute indirect nonqualifying consideration for the target corporation's stock. Because the target's shareholders, in their capacity as shareholders, received only the acquiring corporation's voting stock, the transaction constituted a reorganization within the meaning of §368(a)(1)(B). With respect to warrants, the Service stated that Rev. Rul. 78-408 "is modified such that section 354 applies to the exchange of warrants provided that the warrants constitute securities. See section 1.354-1(e)." The Service, by issuing Rev. Rul.

[13] 1998-10 I.R.B. 11.

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98-10, has kept the announced promise to provide guidance involving the exchange of warrants in connection with a plan of reorganization quickly after the promulgation of the final regulations.

Cashless Exercise of Warrants

As noted above, the proposed regulations do not purport to affect whether a transaction meets the requirements of a reorganization under §368. It becomes more important, under the new regime, to consider whether certain exchanges occurring within a single corporation may qualify as a recapitalization under §368(a)(1)(E).

Suppose an individual lender invests $1,000 in X corporation and receives $1,000 of debt and 100 warrants with an exercise price of $10. After 18 months, the lender wants to exercise the warrants and immediately sell the stock for its appreciated value of $5,000. If the lender pays the exercise price of $1,000 and receives stock worth $5,000, the lender has an economic gain of $4,000. Under §1223(5), the lender's holding period for the stock received begins on the exercise date. If the lender immediately sells the stock he has short-term capital gain subject to tax at ordinary income rates. If, instead, the lender did not exercise but sold the warrants, his holding period for the warrants is 18 months and the lender will be taxed on the gain at long-term capital gains rates.

If the lender instead exchanges all 100 warrants for $4,000 worth of stock he will receive 80 shares of stock without paying any cash (a "cashless" exercise). In other words, the lender has in effect received a credit for the "spread" that is built into the warrants. Under prior law this would be a taxable exchange to the extent of such credit because no nonrecognition provision applies to this transaction.[14] The result was that the lender obtained long-term capital gain treatment on the exchange, because the relevant holding period was the 18-month period he held the warrants.

The changes made by the final regulations suggest that there may be a better solution to this issue. The definition of a recapitalization is quite broad, even including an isolated exercise of a conversion right contained in a convertible security.[15] Provided the exchange of warrants for stock can qualify as a recapitalization, then the exchange will be tax-free under §354. Correspondingly, there will be a substituted basis under §358 and a tacked holding period under §1223(1). Note that a planned sale of the stock should not generally disqualify reorganization treatment.[16]

To the extent there is any concern about whether the bare exchange of warrants for stock constitutes a reorganization, the lender may use $1,000 worth of debentures to pay the exercise price. The exchange of debentures and warrants for stock more specifically fits within the traditional definition of a reorganization, such that §354 may apply to the exchange of warrants for stock.

TREATMENT OF CERTAIN PREFERRED STOCK AS "BOOT"

History

In reorganizations, transactions within the meaning of §368 and certain other restructurings, no gain or loss is recognized except to the extent "other property" (property other than qualifying consideration, or "boot") is received. Under prior law, preferred stock could be received tax free in a reorganization under §§354 and 356. Upon the receipt of boot, gain is recognized. A special rule permits debt securities to be received tax free, but only to the extent debt securities of no lesser principal amount are surrendered in the exchange. Other than this securities-for-securities rule, similar rules generally apply to transactions under §351.

New §351(g)

Section 1014 of P.L. 105-34 amends §§351, 354, 355, 356, and 1036 to treat certain preferred stock, (*i.e.*, "nonqualified preferred stock") as boot, subject to certain exceptions. Thus, when a taxpayer exchanges property for nonqualified preferred stock in a transaction that qualifies under either §351, 355, 368, or 1036, gain is recognized.

For purposes of §351, nonqualified preferred stock is treated as boot under §351(b). The transferor receiving such stock thus is not treated as receiving nonrecognition treatment under §351(a). However, the nonqualified preferred stock continues to be treated as stock received by a transferor for purposes of qualification of a transaction under §351(a), unless and until regulations provide otherwise. It is noteworthy that the House passed a technical corrections bill (currently being considered by the Senate) to amend §351(g) to provide that §351(b) will apply to nonqualified preferred stock only if the transferor received qualifying stock as well (*i.e.*, common or participating preferred).[17] Thus, a transferor who receives solely

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[14] It is not quite clear whether gain would be recognized on the entire exchange of warrants for stock under §1001, or only with respect to an amount equal to the exercise price of the warrants, which is being paid with appreciated property, *i.e.*, the warrants themselves.

[15] The Code defines a §368(a)(1)(E) reorganization simply as "a recapitalization." Neither the Code nor the regulations attempts to further define the term. A frequently quoted generalization describes the term as involving a "reshuffling of a capital structure within the framework of an existing corporation." In Rev. Rul. 77-238, 1977-2 C.B. 115, the Service ruled that the isolated exercise of conversion rights in a convertible stock will be a reorganization under §368(a)(1)(E).

[16] *See* Regs. §1.368-2; Rev. Rul. 77-415, 1977-2 C.B. 311.

[17] *See* H.R. 2676, House-passed version of IRS Restructuring and Reform and Technical Corrections Act of 1997, §609(c).

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nonqualified preferred stock will be taxable under §1001, rather than §351(b), and, may, therefore, recognize loss as well as gain.

Note as well that the legislation made no change to the definition of property under §317. That section defines "property" to exclude stock in the corporation making a distribution. As a result, the use of nonqualified preferred stock can not cause a transaction to be subject to the provisions of §304. For example, if individual A sells shares in one wholly-owned corporation, X, to his other wholly-owned corporation Y, in exchange for nonqualified preferred stock in Y, the exchange will be taxable to A, but, unlike the use of cash, debt securities or other property of Y, the gain will be taxed as capital gain rather than as a dividend under the §304 rules. Note also that, because the nonqualified preferred was taxable rather than tax-free under §351, it will presumably not be §306 stock.

Additionally, Congress did not amend the provisions of §305. As a result, nonqualified preferred stock may still be distributed on a tax-free basis to the holder of common stock under the provisions of that section.

What is Nonqualified Preferred Stock?

Nonqualified preferred stock is generally stock which is not entitled to vote, is limited and preferred as to dividends, and does not participate in corporate growth to any significant extent, but only if any one of the four following tests is met:

- The holder has a right to "put" the stock to an issuer or related party (within the meaning of §§267(b) and 707(b));
- The issuer or a related party is obligated to buy the stock back;
- The issuer or related party has the right to buy the stock back and, as of the issue date, it is more likely than not that such right will be exercised; or
- The dividend rate is based on interest rates, commodity prices or other similar indices.

Exceptions to the Above Definition

There are exceptions to these rules. The first three items listed will give rise to nonqualified preferred stock only if the right or obligation may be exercised within a 20-year period; and the likelihood of such exercise is not remote.

A right or obligation is disregarded if it may be exercised only upon the death, disability, or mental incompetence of the holder; but only if neither the stock surrendered nor the stock received in the exchange is publicly traded. Moreover, a right or obligation is disregarded in the case of stock transferred in connection with the performance of services if it may be exercised only upon the holder's separation from service.

Conversion Privilege

For purpose of determining whether stock participates in corporate growth to any significant extent (which would exclude the stock from being "preferred stock"), neither a conversion privilege into stock of the issuer nor stock that is convertible or exchangeable into stock of a corporation, other than the issuer (including, for example, stock of a parent corporation or other related corporation), will be automatically considered to constitute such participation.[18]

Certain Exchanges Excluded from Gain Recognition and Not Treated as Boot

Under §354(a)(2)(C)(ii), nonqualified preferred stock may be received tax free in a recapitalization of a family-owned corporation. A family-owned corporation is defined as any corporation if at least 50% of the total voting power and value of the stock of such corporation is owned by members of the same family for five years preceding the recapitalization. In addition, a recapitalization does not qualify for the exception if the same family does not own 50% of the total voting power and value of the stock throughout the three-year period following the recapitalization. Members of the same family are defined by reference to the definition in §447(e). Thus, a family includes children, parents, brothers, sisters, and spouses, with a limited attribution for directly and indirectly owned stock for the corporation.

Notwithstanding the existence of nonqualified preferred stock, according to the Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 105th Congress*[19] the following additional exchanges are excluded from gain recognition under the provisions of §§354, 355, and 356:

- exchanges of nonqualified preferred stock for comparable nonqualified preferred stock of the same or lesser value;
- certain exchanges of debt securities for nonqualified preferred stock of the same or lesser value.

These exclusions result from the fact that nonqualified preferred stock is treated as "other property" under §§354, 355 and 356 only if received in exchange for stock or, under §355, with respect to stock that is not nonqualified preferred stock.

Examples of How §351(g) Might be Applied

General Operation of §351(g)

A and B form X corporation. A transfers to X Corporation appreciated property in exchange for 90% of the common stock. B transfers to X Corporation appreciated property for 10% of the common

[18] H.R. Rep. No. 220. 105th Cong., 1st Sess. 545 (1997).
[19] JCS-23-97 (12/17/97) (Blue Book).

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stock and nonqualified preferred stock. Prior to the enactment of §351(g) this would be a completely tax-free transaction to A and B under §351(a) because the transferors are in control of X corporation immediately after the property transfers. The transaction is still tax free to A, however, as a result of the enactment of §1014 of P.L. 105-34, this transaction is no longer completely tax free to B. As to B, who receives nonqualified preferred stock, §351(a) does not apply. The nonqualified preferred stock is boot, §351(b) applies, and B's realized gain is recognized to the extent of the value of the nonqualified preferred stock. B's basis in the nonqualified preferred stock is determined under §358(a)(2), its fair market value. The basis of the common stock under §358(a)(1) is the basis of the property transferred plus the gain minus the boot received. The basis of the property received from B by X corporation is, under §362(a), a carryover basis plus the gain recognized by B.

Operation of §351(g) with Respect to a Transfer of Loss Property

A transfers to X Corporation property for 100% of the common stock. B transfers to X Corporation property with $100 value and $500 basis in exchange for a nonqualified preferred stock. Receipt of the nonqualified preferred stock is §351(b) boot. There is a realized loss, but it is not recognized. Because it is boot, B's basis in the nonqualified preferred stock received is its $100 fair market value. Under §362(a), X Corporation, however, takes a carryover basis in the property it received from B of $500.

The technical corrections bill changes this result. The technical corrections bill provides that since B received only nonqualified preferred stock, §351(b) does not apply, it is a straightforward exchange transaction. B has sold the built-in loss property to the corporation, realizing and recognizing a loss of $400. The corporation takes a $100 basis in the property.

Suppose B takes back $99 of nonqualified preferred stock, and $1 of common stock. Section 351(b) applies and there is realized loss which is not recognized. B's basis in the preferred is its fair market value, $99. B's basis in the common stock is $401. Even though B only received one share of common stock, it has a substituted basis of $500 minus the boot of $99 or $401. Upon a sale of the common for its $1 value, B's $400 loss is fully recognized. X Corporation takes the carryover basis of $500. The technical corrections bill does not change this answer. Because B has received qualifying property ($1 of common stock) §351(b) continues to apply.

Application of §351(g) to §§354, 355, and 356

S Corporation owns the stock of T. The T stock has a fair market value of $200 and a basis to S of $100. S exchanges the T stock for voting nonqualified preferred stock of P. Historically, this transaction was a qualifying "B" reorganization and therefore tax free. As a result of P.L. 105-34 it is no longer tax free to the shareholder. It would appear, however, to still qualify as a reorganization under §368(a)(1)(B). Section 354 does not apply to the receipt of the nonqualified preferred stock in exchange for stock of T because it is no longer treated as stock for such purposes. Section 356 doesn't apply either. Section 356 can only apply if the shareholder gets some qualifying property under §354. If the shareholder gets all nonqualifying property, §356 is inapplicable. This is a fully taxable exchange to S. The fair market value of the consideration received is $200. Since S's basis in the T stock was $100, S has $100 of gain. P's basis in the T stock received presumably is $200. Is this pursuant to §1012 or §362?

For purposes of §§354, 355, and 356 this nonqualified preferred stock is not treated as stock. However this conclusion does not mean that the transaction will not qualify as a reorganization under §368. The Conference Report makes reference to §351(a) and states that for purposes of §368(c) nonqualified preferred stock is still stock.[20] If P acquired T solely in exchange for P voting stock, and it is in control immediately after this appears to be a "B" reorganization, even though S is fully taxed in the transaction.

Can this transaction also be a qualified stock purchase ("QSP") for purposes of §338? In order to have a QSP there must be a purchase of 80% of the T stock. A purchase is defined under §338(h)(3)(A) as any acquisition of stock, provided it is not acquired in a carryover basis-transaction; it is not acquired in an exchange under §§351, 354, 355 or 356, or in any other nonrecognition transaction; and is not acquired from a related party. In our hypothetical, S and P are unrelated. Is P's basis determined in whole or in part by reference to the transferor's basis? This depends upon whether P's basis is determined by §362(b). If so, then basis is determined in whole or in part by reference to the transferor's basis. Because, however, it is concluded that S's transfer of the T stock to P is not covered under §§354, 355, or 356, then it is reasonable to conclude that P's basis in the T stock is determined under §1012. If the technical correction bill passes, and all P receives is nonqualified preferred stock, §351(a) will not apply to P. Therefore, it would appear that P will have purchased the stock of T, with the result that a "B" reorganization may qualify as a QSP.[21]

Some Planning Suggestions

Section 351(g) may be avoided by simply issuing preferred that is not redeemable for 20 years. As to

[20] H.R. Rep. No. 220 at 545.

[21] While an interesting magic trick, we have not yet been able to identify an anomalous or unwarranted result that would ensue from having a valid §338 election for a transaction that technically met the requirements for a reorganization under §368 — indeed, one that ordinarily does not allow even a peppercorn of boot.

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whether a call right can ever successfully be used within the 20-year period and not run afoul of the section we are presently skeptical. In order to have a call provision pass muster, one would presumably have to be comfortable that it was improbable that there would be any point within the next 20 years when it would be economically desirable for the issuing company to exercise the call.

Alternatively, one can focus on removing the stock in question from the category of "preferred stock," particularly, be giving it some meaningful degree of participation in dividends or in liquidation.

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