Office of Chief Counsel
Internal Revenue Service
Memorandum

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to: Angela Nyagu
Internal Revenue Agent
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subject:
Tax Year:
UIL: 368.05

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The advice in this memorandum is conditioned on the accuracy of the facts you presented to us. If you determine that these facts are incorrect, you should not rely on this advice, and should please contact this office.

This document should not be used or cited as precedent.

Issue:

1. Whether a shareholder and CEO of a company is subject to tax on the exchange of old common stock worth $, for new common stock worth $ and preferred stock worth $?
2. If so, what is the character of the gain?

Conclusion:

1. In an E reorganization, if a taxpayer receives new stock having a fair market value in

excess of the fair market value of the stock surrendered, the amount of the excess will not qualify for non-recognition treatment. In this case, since stock having no fair market value was surrendered, the exchange is not an E reorganization and the entire excess amount of $ received in stock is taxable.

2. The $ in excess stock received should be treated as ordinary income, e.g., as compensation, a gift, a payment to satisfy an obligation, an inducement to enter into the transaction or for whatever purpose the facts indicate.

Facts:

is a corporation established in . Originally, there were three shareholders:

. From borrowed funds from

. These loans ranged from three year notes to six year notes. Interest expense on the loans was accrued, never paid and never claimed as a deduction[1].

was also the CEO of during this time period. In , he received $ in wages from his employment at .

In converted its debt to into equity. Under a Restructuring and Exchange Agreement, old common stock and outstanding notes were to be exchanged for two new classes of Non-Voting Preferred Stock (Class A for and Class B for) and new common stock. At the time of the reorganization, debt of $, and old common stock were exchanged

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1 [redacted]

for new common stock valued at $, and Class A preferred stock valued at $. old common stock was exchanged for new common stock valued at $ and Class B preferred stock valued at $.[2] The parties to the reorganization agreed in the Restructuring and Exchange Agreement that the $ in Class B stock was in exchange for ceding his controlling interest in . did not consent to the restructuring. owned shares before and after the reorganization, but its ownership percentage was decreased from .

The company treated the debt to equity conversion as a tax-free “E” reorganization. Immediately after the reorganization, and owned , respectively. No statement was attached to or the Taxpayers’ tax return regarding the fair market value of the old common stock, the basis in the stock, and the value of the controlling interest. The Taxpayer claims this information is not available.[3]

The Service analyzed the fair market value of before the reorganization. The company had approximately $ in debt, and was not making full interest payments. It had total assets of only $. Therefore, the Service determined that before the reorganization had little to no fair market value.

LAW

Section 61(a) provides the general rule that gross income means all income from whatever source derived.

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

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[2] The Taxpayer claims to not know the fair market value of the old common stock surrendered (by both and him) in the exchange.

[3] One reason this information is not available is that the Taxpayer did not attempt to learn it (for example, by having a valuation analysis performed).

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 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 the 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. Section 356(g)(2) provides that section 61(a)(1) applies if a transaction described in section 354, 355, or 356 has the effect of the payment of compensation.

Section 368(a)(1)(E) provides that a recapitalization is a reorganization. Section 368(b) provides that a “party to the reorganization” includes a corporation resulting from a reorganization.

Section 1032(a) provides that no gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation.

Section 1036(a) provides that no gain or loss shall be recognized if common stock in a corporation is exchanged solely for common stock in the same corporation, or if preferred stock in a corporation is exchanged solely for preferred stock in the same corporation.

Treas. Reg. 1.368-1(c) explains that the nonrecognition of gain or loss is prescribed for two specifically described situations: the exchange provided in § 354(a)(1), or the exchange provided for in § 361(a). Certain rules regarding “boot” received in either of those types of exchanges are prescribed in sections 356, 367 and 361(b).

Treas. Reg. 1.368-2(g) provides that the term “plan of reorganization” is not to be taken as broadening the definition of “reorganization”, but is to be taken as limiting the nonrecognition of gain or loss to such exchanges or distributions as are directly a part of the transaction specifically described as a reorganization in section 368(a).

NJSA 14A:9-1 provides that a corporation may amend its certificate of incorporation to increase or decrease the aggregate number of shares or shares of any class or series of any class, which the corporation has authority to issue; to increase or decrease the par value of the authorized shares of any class having a par value, whether issued or unissued; to exchange, classify, reclassify or cancel all or any part of its shares, whether issued or unissued; and to change the designation of all or any part of its shares, whether issued or unissued, and to change the preferences, limitations and the relative rights in respect of all or any part of its shares, whether issued or unissued. NJSA 14A:9-2 provides that the proposed amendment shall be adopted upon receiving the affirmative vote of a majority of the votes cast by the holders of shares entitled to vote thereon.

Rev. Rul. 74-269, 1974–1 C.B. 87, addresses reorganizations which involve the exchange of stock in differing values. To the extent that the fair market value of the stock received is found to be equal to the fair market value of the stock exchanged, the transaction will constitute an exchange pursuant to a reorganization within the meaning of section 368(a)(1)(E) of the Code. However, if shares are received having a fair market value in excess of the fair market value of the stock surrendered, or shares are surrendered having a fair market value in excess of the fair market value of the stock received, the amount representing such excess will be treated as having been used to make gifts, pay compensation, satisfy obligations of any kind, or for whatever purpose the facts indicate.

ANALYSIS

I. To the extent that the fair market value of the stock exchanged did not equal the fair market value of the stock received, the transaction is taxable.

The Internal Revenue Code provides that certain corporate reorganizations and readjustments are exempted from the general rule of taxation upon the exchange of property for other property. If the transaction qualifies as a reorganization under section 368, section 354 provides that no gain or loss is recognized with respect to transactions carried out under a valid plan of reorganization.

To qualify as a "reorganization" under section 368, a transaction must fall into one of the specific transactions listed in section 368. One of these transactions is a "recapitalization". Section 368(a)(1)(E). Although the term "recapitalization" is not defined in the Code or Regulations, a recapitalization involves an exchange between only one corporation and its shareholders or security holders. It involves a "reshuffling of a capital structure within the framework of an existing corporation." *Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194, 202 (1942).

A transaction should be given tax effect in accordance with its substance. *Gregory v. Helvering*, 69 F.2d 809 (2d Cir. 1934), aff'd, 293 U.S. 465 (1935). In a tax-free reorganization, the tax consequences of the transaction are not recognized because the substance and value of the company has not changed, only the way that it is organized, and therefore there is no taxable exchange. In order to qualify for this treatment, the fair market value of the post-reorganization stock must equal the fair market value of the pre-reorganization stock related to the reorganization. *Kohler v. Commissioner*, T.C. Memo 2006-152, Footnote 7 (Tax Ct. 2006) ("We note that the fair market value of the post-reorganization stock must generally equal the fair market value of the pre-reorganization stock for the reorganization to be tax free"). *See* Rev. Rul. 74–269; Rev. Proc. 86–42, 1986–2 C.B. 722 (prerequisite to advance ruling that a type A merger will be tax free is a representation that the fair market value of the acquirer stock and other consideration received will be approximately equal to the fair market value of the target stock surrendered in the exchange); Rev. Proc. 81–60, 1981–2 C.B. 680, 682 (prerequisite to advance ruling that a type E recapitalization will be tax free is a representation that the fair market value of the shares to be surrendered will equal the shares to be received in exchange).

The Service has previously given tax effect to the substance of a transaction in which related parties exchange property of differing values by recasting the transaction as a "value-for-value" tax-free exchange, and accounting for any difference in value by characterizing only the difference as a taxable transaction. *See* Rev. Rul. 79-10, 1979-1 C.B. 140. Revenue Ruling 74-269 describes this more fully as applied to "E" reorganizations, explaining that a recapitalization is an "E" reorganization to the extent that the fair market value of the stock exchanged is the same as the fair market value of the stock received. If the taxpayer receives new stock having a fair market value in excess of the fair market value of the stock surrendered, the amount representing such excess will be treated as compensation, a gift, a payment to satisfy an obligation, or for whatever purpose the facts indicate. This excess amount will not be eligible for nonrecognition treatment.

Section 354 provides that in order to receive nonrecognition treatment, stock and securities in a corporation must be exchanged solely for stock and securities in such corporation. Section 356(g) provides that for transactions described in § 354, but which result in the effect of the payment of compensation, section 61(a)(1) applies. *See* Rev. Proc 81-60, 1981-2 C.B. 680 (requires a taxpayer in a reorganization to furnish a statement that the fair market value of the stock to be received by each exchanging shareholder will be equal to the fair market value of the stock surrendered in the exchange. If the values will not be equal, it requires the taxpayer to provide a full explanation, citing section 356(g)).

In this case, exchanged stock with a fair market value of for stock worth $. Since did not surrender in the exchange stock having any value, section 368(a)(1)(E) does not apply. Instead, the entire excess amount of the stock received must be analyzed under section 61(a).

[redacted] However, the value-for-value analysis will apply to the $ of common stock received in the transaction, despite the fact that an exchange of common stock for common stock generally falls under section 1036. Section 1036 provides that no gain or loss shall be recognized if common stock in a corporation is exchanged solely for common stock in the same corporation. However, an implicit requirement for an exchange to qualify as a nonrecognition transaction within the meaning of section 1036 is that the property surrendered be approximately equal in value to the property received. These provisions assume that parties in an arm's-length transaction would exchange property of approximately equal value. *See* Rev. Rul. 73-233, 1973-1 C.B. 179, Rev. Rul. 74-269. Therefore, as in the case of section 368(a)(1)(E), since did not surrender in the exchange stock having any value, section 1036 would not apply.

The Taxpayer exchanged common stock with a fair market value of zero for common and preferred stock worth $. Therefore, the entire excess amount is not considered to be part of the exchange. Rather, it is treated separately according to its character. Whatever its character, such excess amount is income to the recipient. *See, e.g., Commissioner v. Glenshaw Glass Co.,* 348 U.S. 426 (1955).

II. The amount received is taxable as ordinary income

Since the receipt of the entire $ in stock falls outside any E reorganization, the income must be treated as compensation, a gift, a payment to satisfy an obligation, an inducement to enter into the transaction or for whatever purpose the facts indicate. It is illogical that the Taxpayer received $ in stock in exchange for worthless stock. Although under the current facts it is unclear exactly why the Taxpayer received the stock, there are several reasons that could have issued the $ in stock to the Taxpayer.

First, the $ could have been an inducement for the Taxpayer to agree to the transaction. In order to obtain third-party funding, debt to had to be converted to equity. As part of that transaction, the outstanding stock in was exchanged for new classes of stock and the Taxpayer lost his majority interest in the company. Pursuant to NJSA 14A:9-1, a corporation may generally amend its certificate of incorporation to include provisions that might lawfully be included in the original certificate of incorporation. NJSA 14A:9-1(2) contemplates a variety of amendments, including an amendment to exchange, reclassify or issue new shares. On filed its Second Certificate of Amendment to the Certificate of Incorporation of amending its certificate of incorporation to reflect the changes in the amount and types of stock issued in this transaction. Pursuant to NJSA 14A:9-2(4)(c), a proposed amendment is adopted upon receiving the affirmative vote of a majority of the voting-class shares. Therefore, the Taxpayer's agreement to the reorganization was necessary before could amend its certificate of incorporation and execute the restructuring transaction.

In Rev. Rul. 73-233, a transfer of stock in consideration of voting in favor of a merger, which would transfer control of the company away from the shareholders, was income to the stockholders under section 61. The same analysis applies here. had to convince the Taxpayer to vote to give up his majority interest, as part of the reorganization transaction, in order to receive loans from a third party. The Taxpayer received the income as an inducement for agreeing to the transaction.

In addition, the Taxpayer and , in various reorganization documents, acknowledge that the Taxpayer's receipt of preferred stock was adequate consideration for ceding control of the company. The Restructuring and Exchange Agreement between , states: "[I]t being acknowledged that ceding of his controlling interest in the equity of the Company constitutes adequate consideration for his receipt of the Series B.[4]" . This shows that the Series B stock was intended as payment to induce the Taxpayer into relinquishing his majority interest from the beginning of the transaction.

Second, in a stock for stock exchange in which the stock received has more value than the stock exchanged, if the parties to the transaction are an employee and his corporation, and the employee receives the excess amount, such excess amount could be considered compensation. S*ee* Treas. Reg. § 1.61-2(d)(2)(i). The difference in value of the property received is considered

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4 [redacted]

compensation for services. In this case, the Taxpayer is the CEO of . Under Treas. Reg. § 1.61-2(d)(2)(i), because the Taxpayer received this property in exchange for less than its fair market value, it can also be considered compensation for his services as CEO.

In , the Taxpayer received $ in wages from his employment at . Although the $ in stock received may seem unreasonably high in comparison, as will be discussed below, the Taxpayer has acknowledged in the Restructuring Agreement that the $ in preferred stock is consideration for ceding control of the company. The excess $ received could be reasonable compensation for services as the continuing CEO of a company.

Another possible theory for the payment of the $ in stock is that needed the Taxpayer to remain the CEO and continue running the business. Before the reorganization, the Taxpayer was both the majority shareholder and the CEO of . The payment of $ in stock could be considered as a bonus to retain his services as CEO, even after obtained the majority of shares through their debt conversion. Bonuses to employees are ordinary income to the employee, and constitute allowable deductions from gross income as “ordinary and necessary expenses” when such payments are made in good faith, and as additional compensation for services actually rendered. *University Chevrolet Co. v. C.I.R.*, 199 F.2d 629 (5th Cir. 1952). Therefore, if the receipt of the stock was consideration to retain as CEO of despite his loss of majority shareholder status, it is taxable as ordinary income[5].

The Taxpayer signed the Restructuring Agreement at arms-length, agreeing on the fair

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5 [redacted]

market value of the stock, and stating that the $ in Series B stock was consideration for ceding control of the company. As a general rule, a taxpayer is bound by the form of the transaction that the taxpayer has chosen. *See Commissioner v. Danielson*, 378 F.2d 771 (3rd Cir. 1967). If a court permits the taxpayer to disavow the form of the transaction, the taxpayer must then introduce strong proof to establish the taxpayer's claimed substance of the transaction; a preponderance of credible evidence is not sufficient. *See Estate of Durkin v. Commissioner*, 99 T.C. 561, 572–574, 1992 WL 335900 (1992); *Ill. Power Co. v. Commissioner*, 87 T.C. 1417, 1434, 1986 WL 22067 (1986).

Taxpayer has introduced no evidence that would allow him to disavow the Restructuring Agreement and the valuation on which the transaction was based. The $ in preferred stock is consideration for ceding control of the company, as outlined in the Restructuring Agreement. The $ in common stock is then analyzed separately under any of the above theories.

The Taxpayer received income in the form of excess stock acquired in the reorganization. There are several possible theories indicated by the facts for which the Taxpayer could have received this stock, including as compensation, a gift, a payment to satisfy an obligation, an inducement to enter into the transaction or for whatever purpose the facts indicate. Regardless of which reason the stock was issued to the Taxpayer, the facts indicate that the income is taxable as ordinary income.

Recommendation

Since the Taxpayer received stock having a fair market value and surrendered stock having no fair market value, the exchange does not qualify as an E reorganization. Therefore, the entire excess amount should be taxed as compensation, a gift, a payment to satisfy an obligation, an inducement to enter into the transaction or for whatever purpose the facts indicate.

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