

Part I

Section 368.--Definitions Relating to Corporate Reorganizations

26 CFR 1.368-2: Definition of terms.
(Also § 354; § 1.354-1.)

Rev. Rul. 98-10

ISSUE

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?

FACTS

The facts are substantially similar to the facts in Rev. Rul. 69-142, 1969-1 C.B. 107.

Corporation X acquires all of the outstanding capital stock of Corporation Y in exchange for voting stock of X. Corporation Y is a solvent corporation. Prior to the exchange, Y has an

issue of six percent fifteen-year debentures outstanding. Pursuant to the plan of reorganization, X acquires all the outstanding debentures of Y in exchange for an equal principal amount of new six percent fifteen-year debentures of X. Some of the debentures of Y are held by its shareholders, but a substantial proportion of the Y debentures are held by persons who own no stock.

X is in control of Y immediately after the acquisition of the Y stock. The X and Y debentures constitute "securities" within the meaning of § 354(a)(1) and, thus, do not represent an equity interest. Disregarding the exchange of debentures, the transaction meets the requirements of § 368(a)(1)(B).

LAW AND ANALYSIS

Section 368(a)(1)(B) provides that a reorganization includes the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation.

Section 1.368-2(c) of the Income Tax Regulations provides:

In order to qualify as a "reorganization" under section 368(a)(1)(B), the acquisition by the acquiring corporation of stock of another corporation must be in exchange solely for all or a part of the voting stock of the acquiring corporation . . . , and the acquiring corporation must be in control of the other corporation immediately after the transaction. If, for example, Corporation X in one transaction exchanges nonvoting preferred stock or bonds in addition to all or a part of its voting stock in the acquisition of stock of Corporation Y, the transaction is not a reorganization under section 368(a)(1)(B).

Section 354(a)(1) provides that no gain or loss will 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 another corporation a party to a reorganization.

In the circumstances set forth above, the Y shareholders receive exclusively voting stock of X as consideration for the exchange of their Y stock. The fact that a substantial proportion of the Y debentures is held by bondholders who own no stock in Y has the effect of ensuring that the value of the debentures issued by X in exchange for the debentures of Y realistically reflects the value of the Y debentures alone and does not constitute indirect nonqualifying consideration for the Y stock. Because the Y shareholders, in their capacity as shareholders, receive only X voting stock, the transaction constitutes a reorganization within the meaning of § 368(a)(1)(B).

Although the acquisition by X of the debentures of Y in exchange for debentures of X occurs as part of the overall transaction, it is not a part of the stock-for-stock exchange which qualifies as a reorganization. It is, however, an exchange of securities in parties to a reorganization which occurs in pursuance of the plan of reorganization, and, therefore, meets all the conditions of § 354(a)(1). Accordingly, any gain or loss realized by the debenture holders of Y as a result of their exchange of their Y debentures for an equal principal amount of debentures of X will not be recognized. Section 354(a)(1). If, under different facts, the principal amount of the debentures of

X was greater than the principal amount of the debentures of Y, §§ 354(a)(2) and 356(d) would apply to require the debenture holders of Y to recognize some or all of any gain realized.

HOLDING

The exchange of Y stock for X stock is a reorganization described in § 368(a)(1)(B); and any gain or loss realized by the shareholders of Y as a result of the exchange will not be recognized. Section 354(a)(1).

The separate exchange of Y debentures for X debentures is an exchange in pursuance of the plan of reorganization described in § 368(a)(1)(B). Thus, any gain or loss realized by the debenture holders of Y as a result of their exchange of their Y debentures for an equal principal amount of debentures of X will not be recognized. Section 354(a)(1).

In certain cases, rights to acquire stock of a party to a reorganization are "securities" for purposes of § 354. See § 1.354-1(e) (as amended by T.D. 8752, 1998-9 I.R.B. 4, effective for exchanges occurring on or after March 9, 1998). An exchange of such rights, although separate from a § 368 exchange, 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. Section 354(a)(1).

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 69-142, which dealt with substantially identical facts, is modified and superseded.

Rev. Rul. 70-41, 1970-1 C.B. 77, deals with a stock-for-

stock exchange accompanied by an exchange of Acquired debentures for Acquiring stock. It is modified such that § 354 applies to the exchange of debentures for stock.

Rev. Rul. 78-408, 1978-2 C.B. 203, deals with a stock-for-stock exchange accompanied by a warrant-for-warrant exchange. It is modified such that § 354 applies to the exchange of warrants provided that the warrants constitute securities. See § 1.354-1(e).

Rev. Ruls. 68-637, 1968-2 C.B. 158, and 70-269, 1970-1 C.B. 82, similarly deal with reorganization exchanges accompanied by exchanges of warrants or options. Each is amplified such that § 354 applies to the exchange of warrants or options, provided that, as in Rev. Rul. 78-408 above, the warrants or options constitute securities.

PROSPECTIVE APPLICATION

Section 7805(b) provides that the Secretary may prescribe the extent, if any, to which any ruling relating to the internal revenue laws shall be applied without retroactive effect. Pursuant to the authority contained in § 7805(b), this revenue ruling will be applied only to corporate reorganizations in which the exchange of securities occurs on or after March 9, 1998, the date this revenue ruling is published in the Internal Revenue Bulletin. Transactions in which the exchange of securities occurs prior to this date will continue to be governed by the rules as they existed prior to publication of this revenue ruling.

DRAFTING INFORMATION

The principal author of this revenue ruling is Michael J. Danbury of the Office of Assistant Chief Counsel (Corporate). For further information regarding this revenue ruling, contact Mr. Danbury on (202) 622-7750 (not a toll-free call).