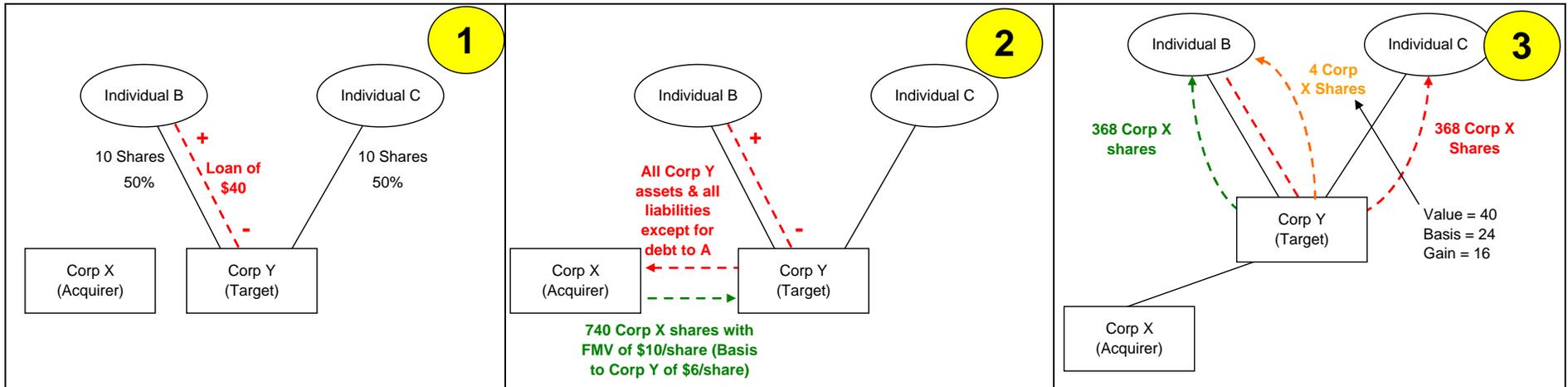


C Reorg: Gain on Stock Used To Discharge Liabilities

Initial Structure

C Reorganization (Step 1)

C Reorganization (Step 2)



Individuals B and C each owned ten of the twenty shares of corporation Y's only class of outstanding stock. Corporation X, pursuant to a plan of reorganization described in section 368(a)(1)(C), acquired all the assets of corporation Y solely in exchange for 740 shares of X voting stock having a fair market value of 10x dollars per share and the assumption by X of all but one of the liabilities of Y. Y's basis in the shares of X was 6x dollars per share pursuant to the provisions of section 358. Pursuant to the plan Y dissolved. B had previously loaned the corporation 40x dollars in an arm's-length transaction. After the exchange of its assets for the stock of X, Y transferred 372 shares of X stock, 4 of which were in payment of the loan, to B. B surrendered his Y shares for cancellation. C received the remaining 368 shares of X stock from Y and surrendered his Y shares for cancellation.

Part of the X stock transferred to B was in satisfaction of the indebtedness owing to him and was not in exchange for his Y stock. See *The Northern Coal & Dock Company*, 12 T.C. 42 (1949) (Acquiescence C.B. 1949-1, 3), in which it was held that a transfer of assets by a subsidiary indebted to its parent corporation must first be applied in satisfaction of the indebtedness and to the extent so applied does not constitute a distribution in liquidation but rather results in the recognition of gain or loss to the distributor. Thus, four shares of X stock were transferred to B in his capacity as a creditor. Y realized gain on the transfer measured by the difference between its basis in the four shares of X stock (24x dollars) and the fair market value at the time of transfer (40x dollars). Such gain is taxable as provided in sections 1001 and 1002.