Corporation X had outstanding $5 par value common stock of which approximately 99% was owned by corporation Y, the parent of X. The balance of the outstanding X common stock was held by its various minority shareholders, none of whom owned as much as 10 shares of X's stock or any shares of Y, either directly or indirectly. X felt it necessary to simplify its capital structure by eliminating the interest of the Minority. As a means of accomplishing this, X amended its articles of incorporation so that 10 shares of old $5 par value common stock would constitute one share of new $50 par value common stock. X paid cash in lieu of issuing any fractional share interests caused by its capital reclassification so that no fractional shares would be outstanding after the exchange. Thus all of the X Minority interests were eliminated by a cash payment while Y received new X common shares and cash in exchange for its old X common shares. The cash payment represented merely a mechanical rounding off of the fractions in the exchange and was not a separately bargained for consideration.

Section 1036(a) states in part that no gain or loss will be recognized if common stock is exchanged solely for common stock in the same corporation. Where an exchange is not solely in kind, section 1036(b) refers to sections 1031(b) and (c) for the rules relating to recognition of gain or loss. Treas. Reg. § 1.1036-1(a) states in part that a transaction between a shareholder and the corporation may qualify not only under section 1036(a) but also under section 368(a)(1)(E) as a recapitalization. Section 1031(b) provides in part that where an exchange would be within the provisions of section 1036(a) if it were not for the fact that the property received in the exchange consisted not only of property permitted by such section to be received without the recognition of gain but also of other property or money, then the gain, if any, to the recipient will be recognized, but in an amount not in excess of the sum of the money and the fair market value of the other property. Treas. Reg. § 1.1031(b)-1(a)(3) states in part that if the taxpayer receives other property or money in an exchange described in section 1036(a) and not in connection with a corporate reorganization, the gain, if any, to the taxpayer will be recognized under section 1031(b).

Section 368(a)(1)(E) states that a "reorganization" includes a recapitalization. A recapitalization has been defined as a "reshuffling of a capital structure within the framework of an existing corporation" by the Supreme Court of the United States in Helvering v. Southwest Consolidated Corp., 315 U.S. 194. Section 354(a) states in part that no gain or loss will be recognized if stock in a corporation, that is a party to a reorganization, is exchanged solely for stock in such corporation. Revenue Ruling 69-34 states that where cash is received by shareholders in lieu of fractional shares of stock in a reorganization defined in section 368(a)(1)(E) and the cash represents merely a mechanical rounding off of the fractions in the exchange and is not separately bargained for consideration, the cash payments will be tested under section 302. Section 302(a) provides in part, that if a corporation redeems its stock and if section 302(b)(1) or (3) applies such redemption will be treated as a distribution in part or full payment in exchange for the stock. Section 302(b)(1) provides that section 302(a) will apply if the redemption is not essentially equivalent to a dividend. In United States v. Davis, 397 U.S. 301 (1970), the Supreme Court held that for a redemption to qualify under section 302(b)(1) it must result in a meaningful reduction of the shareholder's proportionate interest in the corporation. Section 302(b)(3) provides that section 302(a) will apply if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder.

The question presented was whether the transaction was governed by section 1036(a) and section 1031(b), or section 368(a)(1)(E) and its related sections. X, by amending its articles of incorporation, as described, "reshuffled" its capital structure. Consequently, the resulting exchange was pursuant to a reorganization under section 368(a)(1)(E). The effect of Treas. Reg. § 1.1031(b)-1(a)(3) is that when an exchange involving cash and stock qualifies under section 368 as a reorganization, sections 1036 and 1031(b) are not applicable to the transaction.

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