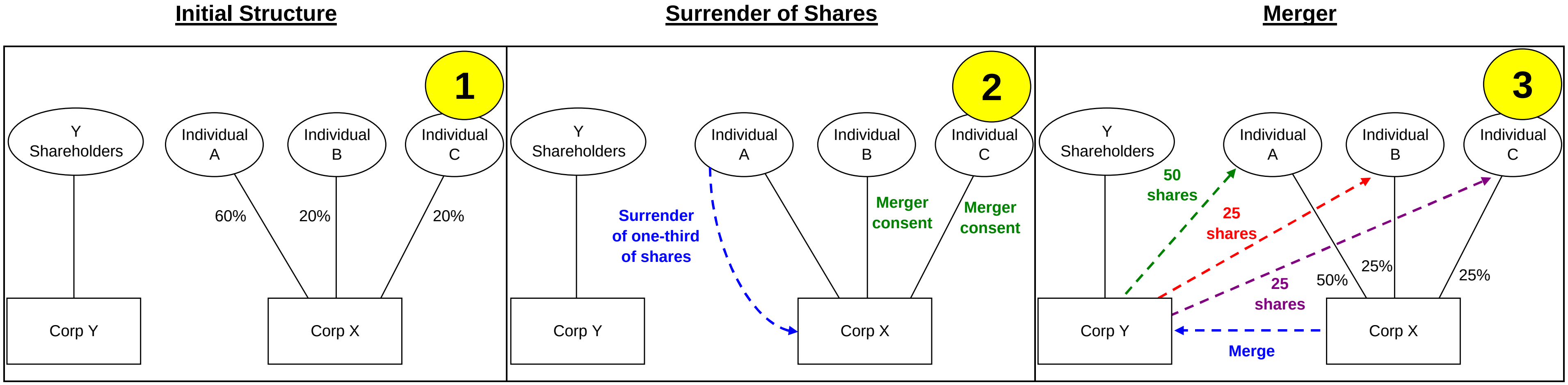
Revenue Ruling 73-233

Surrender of Shares to Induce Consent to a Merger Was a Taxable Exchange



Y corporation wished to acquire by statutory merger all of the assets and liabilities of X corporation in exchange for 100 shares of stock of Y corporation. The stock of X was owned by three individuals, A, B, and C who are unrelated. A owned 60 percent of the stock of X and B and C each owned 20 percent of the stock of X. A two-thirds vote of the acquired corporation's shareholders in favor of the merger was required to meet the applicable merger laws of the State in which X was incorporated. B and C refused to vote in favor of the proposed merger unless they would each receive 25 shares of Y stock. In consideration for B and C voting in favor of the merger A agreed to permit B and C each to receive 25 shares of Y stock instead of the 20 shares of Y stock which they would have been entitled to receive had the distribution of Y stock to the X shareholders been in proportion to their stock ownership of X. In order to effectuate this agreement, A contributed one-third of his stock in X to the capital of X with the result that A's stock interest in X was reduced to 50 percent and B's and C's stock interests were each increased to 25 percent. The X shareholders then voted unanimously in favor of the merger which was thereafter consummated. A, B, and C received, respectively, 50, 25 and 25 shares of Y stock in exchange for their X stock.

The ruling held that the overall transaction will be viewed as (1) a merger of X into Y with a distribution of 60, 20 and 20 shares of Y stock to A, B, and C, respectively, in exchange for their X stock, with no gain or loss being recognized to A, B, or C on this exchange under section 354, and (2) a transfer by A of five shares of Y stock to B and five shares of Y stock to C in consideration for their voting in favor of the merger.

Gain or loss will be recognized to A on his transfer of 10 shares of Y stock, five to B and five to C, to the extent of the difference between the fair market value of the stock and the adjusted basis of the stock in A's hands at the time of the transfer. Since the transfer by A of Y stock to B and C was in satisfaction of B and C voting for the merger which enabled A to acquire the Y stock, such transfer will be considered a capital expenditure and, therefore, not a deductible expense to A. A will be permitted to adjust the basis of his remaining 50 shares of Y stock under section 1016 by increasing his basis in such stock by the fair market value of the 10 shares given up. The fair market value of the five shares of Y stock received by B and C, respectively, from A is includible in their gross incomes under section 61.