Individuals A and B each owned one half of each class of the outstanding stock of Z corporation, which consisted of 50,000 shares of voting common stock and 50,000 shares of nonvoting preferred stock. Under a plan to offer some of the Z stock to the public, A and B made arrangements with an investment broker for a secondary offering of 80 percent of their stock. To facilitate the sale by making the stock a more attractive investment, the broker suggested that the existing common and preferred stock be converted into one new class of common stock. Thus, Z effected a recapitalization in which all of its outstanding shares of common and preferred stock were exchanged by A and B for shares of one new class of voting common stock of Z on a share-for-share basis. A and B each then sold 40,000 shares of the new voting common stock to the public through the broker.

Since continuity of interest is not required for the recapitalization of Z to qualify as a reorganization described in section 368(a)(1)(E), the subsequent sale by A and B of the stock received by them as a result of the recapitalization does not affect the qualification of the transaction as a reorganization under section 368(a)(1)(E). Therefore, no gain or loss is recognized to A or B on the exchange of their common and preferred Z stock for new Z common stock pursuant to section 354(a). The basis to A and B of the new common stock is the same as the basis of the Z common and preferred stock exchanged therefor pursuant to section 358(a). Any gain realized or loss sustained by A or B upon the sale of the new Z stock to the public is recognized to them pursuant to section 1001.