Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:NR:HOU:2
DQCao

date: July 5, 2002

to: Mona Collins, Revenue Agent, LMSB Group 7510

from: Area Counsel
(Natural Resources: Houston)

---

subject: **Recapitalization**

Legend

[redacted] = [redacted]
[redacted] = [redacted]
[redacted] = [redacted]
[redacted] Trust = [redacted], as Trustee of the [redacted] Trust
[redacted] Trust = [redacted], as Trustee of the [redacted] Trust
[redacted] Trust = [redacted], as Trustee of the [redacted] Trust.
[redacted] Trust = [redacted], as Trustee of the [redacted] Trust.
[redacted] = [redacted]
[redacted] = [redacted]
[redacted] = [redacted]
[redacted] = [redacted]
[redacted] = [redacted]
Shareholders = All of the above collectively
Shareholder = Any one of Shareholders
[redacted] = [redacted]

Issues

Issue 1: Under Bazley v. CIR, 331 U.S. 737, when shareholders of a closely held corporation surrender their common stock in pro rata exchange for newly issued common stock and bonds, a taxable distribution, rather than a tax free recapitalization, occurs. Under Treas. Reg. § 1.301-1(l), a distribution of bonds and stock in exchange for stock is a section 301 distribution even if the distribution qualifies as a tax free recapitalization.
In [redacted], each Shareholder owned [redacted] common stock and preferred stock in the same percentage. [redacted], in an alleged recapitalization, issued promissory notes to Shareholders
in exchange for all their preferred stock. The principal amount of the notes represented $[redacted] for each share of the preferred stock

surrendered. Were these promissory notes taxable ordinary income?

Brief answer: Yes.

Issue 2: If taxpayers omit from gross income more than 25% of the income stated on the tax return, the Service can assess the appropriate tax within 6 years after the return is filed. I.R.C. § 6501(e)(1). [redacted] Shareholders filed their [redacted] tax returns on April 15, [redacted] without reporting as gross income the notes they received in [redacted]. The principal amount of these notes exceeded [redacted]% of these Shareholder's stated gross income for [redacted]. Can the Service assess their taxes?

Brief answer: Yes, if, for each of these Shareholders, the fair market value, not the principal amount, of the notes received exceeded [redacted]% of the stated income.

Facts

1. In [redacted], [redacted] was a C corporation. On [redacted] [redacted]'s ownership structure was:

Shareholder	Common Stock (Shares)	Preferred Stock (Shares)
[redacted]	[redacted]	[redacted]
Trust	[redacted]	[redacted]
Trust		
Trust		
Trust		
[redacted]	[redacted]	[redacted]
Total	[redacted]	[redacted]

2. On [redacted] [redacted] and the Shareholders executed a Recapitalization Agreement. On the same day, [redacted], under the Recapitalization Agreement, issued a series of promissory notes to the Shareholders in exchange for all their preferred stock. The principal amount of the promissory notes represented $[redacted] for each share of preferred surrendered, illustrated as follows:

Shareholder	Shares of Preferred Stock Surrendered	Principal Amount of Notes Received
[redacted]	[redacted]	$[redacted]

Trust		
Trust		
Trust		
Trust		
Total		$

The interest rate on each note was %, payable semi-annually. The notes would mature on . (repaid % of the notes in the amount of $ on .)

3. For had current earnings and profits of $ and accumulated earnings and profits of $, totaling $.

4. None of the Shareholders reported the notes received as income for .

5. **The § 6501(a) 3-year statute of limitations will run on for**; on for; and on for and .

6. For all the other Shareholders, the 3-year statute of limitations has already run.

7. Except for and , the principal amount of the promissory notes the Shareholders received exceeded % of the gross income stated on their tax returns.

On their tax returns, the Shareholders reported the following gross income:

	$
Trust	
Trust	
Trust	
Trust	

Analysis

I. Taxability of the promissory notes.

Statutory Law

Section 1.301-1(l)of the Income Tax Regulations provides that a distribution[1] to shareholders with respect to their stock is a distribution within the terms of section 301 of the Internal Revenue Code even though the distribution results from a section 368(a)(1)(E) recapitalization. Treas. Reg. § 1.301-1(l). Since [redacted] distributed promissory notes to the Shareholders, section 301 applies whether or not the promissory note/preferred stock exchange qualifies as a recapitalization under section 368(a)(1)(E).

Section 301(a) and section 301(c)(1) together provide that the portion of a distribution that qualifies as a dividend (as defined by section 316) is to be included in gross income. I.R.C. §§ 301(a) and 301(c)(1). The amount of distribution is any money received plus the fair market value of other property received. I.R.C. § 301(b)(1). In the present case, the Shareholders received notes, which is property under section 317(a). The amount received therefore was the fair market value of the notes under section 301(b). The next question is whether this distribution of property qualifies as a dividend.

Under section 316(a) a dividend is a distribution by a corporation to its shareholders out of its earning and profits accumulated after February 28, 1913, or out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by the distribution) without regard to the amount of earnings and profits available at the time of distribution. I.R.C. § 316(a).

Section 316(a) further provides that ordinarily every distribution is deemed to be made from the earnings and profits to the extent available and from the most recent accumulated earnings and profits. Here, the facts show that in [redacted] [redacted]'s total current and accumulated earnings and profits amounted to $[redacted], greater than the $[redacted] principal amount of the notes received. Therefore, under section 316(a), the whole distribution should be deemed made from its current and accumulated earnings and profits and accordingly constituted a dividend. The Shareholders must include the fair market value of the notes received in gross income under section 301(c)(1).

The amount of the fair market value of the notes received is a question of fact. **We recommend that you immediately request the**

---

[1] Under I.R.C. 301-1(a) distribution refers to distribution of property defined by section 317. Section 317(a) defines "property" as money, securities or any other property.

assistance of an in-house economist to determine that amount before July 15, [redacted], when the 3-year statute of limitations will run for [redacted].

Case Law

The same conclusion, that the notes are a taxable distribution, is found under case law. We provide this case-law analysis for completion.

Under Bazley v. CIR, 331 U.S. 737, when all the shareholders of a closely held corporation surrender their common stock in pro rata exchange for newly issued common stock and bonds, a taxable distribution, rather than a tax free recapitalization, occurs. In Bazley, the shareholders of a family corporation surrendered all their 1,000 shares of common stock in exchange for debenture bonds with total face value of $400,000 and 5,000 shares of new common stock. For each old share, the taxpayers received 5 shares of the new stock and debenture bonds worth $400. At that time the corporation had earned surplus of $855,784. The Commissioner imposec tax on the full value of the debentures the major shareholder, Bazley, had received. Bazley contended that the exchange was a recapitalization and thus a tax-free reorganization under § 112(g)(1)(E) [predecessor of § 368(a)(1)(E)]; and that the debentures should be tax-free [under the predecessor of § 354] because they were (1) securities of a corporation that was a party to a reorganization and (2) exchanged solely for stock or securities of that corporation pursuant to the reorganization plan. The Tax Court held for the Commissioner and the Court of Appeals affirmed the Tax Court decision. Bazley, 331 U.S. at 739.
The Supreme Court affirmed the lower courts' decisions. The Court reasoned that if a corporation has undistributed earnings, and, in the mere form of a recapitalization-reorganization, transfers its newly created corporate obligations to the same shareholders in relation to their corporate holdings to produce the result of a distribution, it cannot obtain tax immunity. Id. at 742. The Court also indicated that there should be no tax benefit where there is only a mere new form of previous participation in an enterprise with no substantive change in the relative rights among the interested parties or their rights to the corporate assets. Id. at 740.

In analyzing the facts of that case, the Court stated that if the corporation had issued the debentures to the taxpayers without any recapitalization, it would have made a taxable distribution. The distribution was made pursuant to a recapitalization/reorganization only because such an arrangement could claim tax immunity.
Id. at 742-43.

Bazley applies to the present case because the facts in the two cases are similar. In the present case, [redacted] had ample earnings and profits in [redacted]; the Shareholders received promissory notes worth $[redacted] for eac

share of preferred stock surrendered. The only differences here are that the Shareholders surrendered preferred stock rather than common stock and received promissory notes rather than stock and bonds. These differences, however, do not affect the result of the analysis because, as in Bazley, the transaction in the present case resulted i no change in the relative rights among the shareholders or their rights to the corporate assets.

It therefore follows that the promissory notes/preferred stock exchange does not qualify as a tax-free recapitalization. Rather, it was a distribution of earnings and profits. Like in Bazley, had [redacted] issued the notes to the Shareholders without any recapitalization, th Shareholders would have had a taxable distribution. But because the arrangement took the form of a recapitalization, the Shareholders received the notes tax free. Should the Shareholders dispose of thei common stock in the future, they would obtain the benefits of both ta deferment and a capital gain tax rate.[2]

II. Statute of limitations.

1. The Service still has time to assess the [redacted] taxes of [redacted], [redacted], [redacted] and [redacted] under the 3-year statute of sectic 6501(a). The fair market value of the notes received should be the amount of deficiency.

2. For the other Shareholders, if, at the time of the distribution, the ***fair market value*** of the notes received exceeded 25% of their stated gross income, the Service can assess that Shareholder's [redacted] tax under the 6-year statute of section 6501(e)(1).

Conclusion/Advice

Under case law, the Internal Revenue Code and the Federal Income Regulations, the alleged recapitalization was a distribution taxable

---

[2] To Illustrate, assume T invests $100X in Company Y's common stock and $100X in Y's preferred stock. Further assume T is Y's only shareholder. In year 1, Y has earnings and profits (E&P) of $100X. If Y distributes the $100X E&P to T, T will have ordinary income of $100X. But if Y issues to T a note with the fair market value of $100X in exchange for T's preferred stock in a recapitalization, T receives the $100X note tax free. T's basis in the note is the same basis in the preferred stock ($100X). If T sells the note for $100X cash, his gain is 0. In year 2, T can sell his common stock in Y for $200X since Y has net assets of $200X. T's basis in the common stock is $100X; his amount realized is $200X. Now, instead of ordinary income of $100X in year 1, T only has capital gain of $100X in year 2 at a favorable rate (assuming T falls into a tax bracket the tax rate of which is above the capital gain rate).

as ordinary income. The Service should timely seek an in-house economist's assistance to quantify the fair market value of the notes received to determine the amount of deficiency for each Shareholder and to determine whether the 6-year statute of limitations of section 6501(e)(1) applies.

ELIZABETH G. CHIRICH
Associate Area Counsel
(Large and Medium Sized Business)

By:_____
DAVID Q. CAO
Attorney (LMSB)