

# Stock Rights Connected with Reorganization Subject of Proposed Regs

by Robert W. Wood • San Francisco

In what seems an undeniable spurt of Subchapter C regulatory activity (see discussion in "Proposed Regulations Issued on Continuity of Interest," p. 1, this issue), in the waning days of 1996 the IRS published a set of proposed regulations under Sections 354, 355 and 356, dealing with the receipt of rights to acquire stock. The question of exactly what treatment should be accorded when a party to a reorganization acquires a right to acquire stock of a corporation has plagued both practitioners and the Service for years. Sections 354, 355 and 356 deal, at least in part, with the nonrecognition of gain or loss that attaches to an exchange of stock or securities in various reorganizations.

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## STOCK RIGHTS

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The existing final regulations under Sections 354 and 355 have excluded stock rights from the definition of stock and securities for purposes of these nonrecognition rules. Now, the proposed regulations would broaden this definition of stock and securities under Sections 354 and 355 to include stock rights that are issued by a corporation that is a party to the reorganization. Furthermore, the proposed regulations would regard stock rights as securities having no principal amount for purposes of Sections 354, 355 and 356.

A purpose of the reorganization provisions of the Code is to defer the recognition of gain and loss in certain readjustments of corporate structures. Generally, the Code extends nonrecognition to an exchange of stock which effects only a readjustment of continuing interest in modified corporate form. Although a right to acquire stock is not stock, the IRS and Treasury now voice their belief that it may generally represent a form of investment in the capital structure of the corporation that justifies nonrecognition treatment as a security under Sections 354 and 355.

Other provisions of the Code expressly acknowledge the role that stock rights play in the capital structure of a corporation. See, *e.g.*, Sections 317 and 1032. Accordingly, the proposed regulations provide that for purposes of Section 354 and 355 the term securities includes "rights to acquire stock" issued by a corporation that is a party to a reorganization.

The proposed regulations treat rights to acquire stock issued by a corporation that is a party to a reorganization as securities of the corporation. For this purpose, the term "rights to acquire stock" of an issuing corporation has the same meaning as the term has in Sections 305(d)(1) and 317(a). It does not include rights exercisable against persons other than the issuer of the stock, or rights that relate to property other than stock of the issuer of the rights. As under current law, a conversion privilege contained in a stock or debt instrument generally will not be considered a separate property right received as part of the reorganization. See Rev. Rul. 69-265 (1969-1 C.B. 109).

For purposes of Sections 354, 355 and 356, the

proposed regulations treat rights to acquire stock as securities having no principal amount. As a result, a taxpayer will not be required to recognize any gain under Section 356 upon the receipt of a stock right. This will generally be the case regardless of whether the taxpayer surrenders stock, stock rights, or debt securities.

The IRS has asked for the usual public comments. However, in addition to comments on the general treatment of stock rights and the scope of the proposed regulations, the Service is especially interested in comments on the need for further guidance about transactions involving exchanges, substitutions or assumptions of compensation related to stock options. Plus, the Service asks for guidance about the application of Section 306 to the transfer of a right when the right is received tax-free under Sections 305 and 354; the application of Section 302 to repurchases or cash settlements of stock rights; and other necessary administrative guidance. ■

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