

Part I

Section 354 – Exchange of Stock and Securities in Certain Reorganizations

26 CFR: 1.354-1: Exchange of stock and securities in certain reorganizations.

Rev. Rul. 2004-78

ISSUE

Under the circumstances described below, whether a debt instrument issued by the acquiring corporation in a reorganization in exchange for a security of the target corporation is a security within the meaning of § 354 of the Internal Revenue Code.

FACTS

On January 1, 2004, Target Corporation issues debt instruments with a stated maturity date of January 1, 2016. On the issue date, the debt instruments provide for a market rate of interest and are securities within the meaning of § 354. Target Corporation has outstanding one class of common stock. On January 1, 2014, pursuant to state law, Target Corporation merges into Acquiring Corporation in a transaction that qualifies as a reorganization under § 368(a)(1)(A). In the merger, the Target Corporation stockholders exchange their Target Corporation common stock for Acquiring Corporation common stock. Also in the merger, the Target Corporation security holders exchange their Target Corporation securities for Acquiring Corporation debt instruments with terms identical to those of the Target Corporation securities (including the maturity date), except that the interest rate is changed (for example, to reflect differences in creditworthiness between Target Corporation and Acquiring Corporation). The modification of the interest rate is a significant modification under § 1.1001-3 of the Income Tax Regulations.

LAW AND ANALYSIS

Section 368(a)(1)(A) provides, in part, that the term "reorganization" includes a statutory merger. Section 368(b) provides that the term "party to a reorganization" includes a corporation resulting from a reorganization and both corporations, in the case of a reorganization resulting from the acquisition by one corporation of stock or properties of another corporation.

Section 354(a)(1) provides, in part, that no gain or loss shall be recognized if securities in a corporation that is a party to a reorganization are, in pursuance of the

plan of reorganization, exchanged solely for securities in such corporation or in another corporation that is a party to the reorganization.

Section 1.368-1(b) sets forth the general rule that, upon an exchange, gain or loss must be recognized if the new property differs materially in kind or extent from the old property. The regulation then explains that the purpose of the reorganization provisions is to except from the general rule certain exchanges incident to readjustments of corporate structures that are required by business exigencies and that effect only a readjustment of continuing interests in property under modified corporate forms. Congress has recognized that when a taxpayer receives stock or securities in exchange for stock or securities owned by the taxpayer incident to a readjustment of a corporate structure, the new stock or securities are treated as taking the place of the stock or securities exchanged therefor. See H.R. Rep. No. 704, at 13-14 (1933).

Neither § 354 nor the regulations under § 354 define the term “securities.” Under case law, an instrument with a term of less than five years generally is not a security. See, e.g., *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933) (holding that short-term notes payable within four months were not securities within the meaning of the reorganization provisions); *Lloyd-Smith v. Commissioner*, 116 F.2d 642 (2d Cir.), *cert. denied*, 313 U.S. 588 (1941) (holding that two-year notes were not securities); *Neville Coke & Chemical Co.*, 148 F.2d 599 (3d Cir.), *cert. denied*, 326 U.S. 726 (1945) (holding that three, four, and five-year notes were not securities).

Under the foregoing authorities, an instrument with a term of two years generally would not qualify as a security. However, because the debt instruments of the Acquiring Corporation are issued in the reorganization in exchange for securities of the Target Corporation and bear the same terms (other than interest rate) as the securities of the Target Corporation, the debt instruments of the Acquiring Corporation represent a continuation of the security holder’s investment in the Target Corporation in substantially the same form. Therefore, the debt instruments of the Acquiring Corporation exchanged for the securities of the Target Corporation are securities within the meaning of § 354.

HOLDING

Under the circumstances described above, a debt instrument issued by the acquiring corporation in a reorganization in exchange for a security of the target corporation is a security within the meaning of § 354.

DRAFTING INFORMATION

The Principal author of this revenue ruling is Ricky Thomas of the Office of Associate Chief Counsel (Corporate). For further information regarding this revenue ruling, contact Ricky Thomas at (202) 622-7750 (not a toll-free call).