§ 1.356–7 Rules for treatment of non-qualified preferred stock and other preferred stock received in certain transactions.

(a) Stock issued prior to effective date. Stock described in section 351(g)(2) is nonqualified preferred stock (NQPS) regardless of the date on which the stock is issued. However, sections 351(g), 354(a)(2)(C), 355(a)(3)(D), 356(e), and 1036(b) do not apply to any transaction occurring prior to June 9, 1997, or to any transaction occurring after June 8, 1997, that is described in section 1014(f)(2) of the Taxpayer Relief Act of 1997, Public Law 105–34 (111 Stat. 378, 921). For purposes of this section, preferred stock that is not NQPS is referred to as Qualified Preferred Stock (QPS).

(b) Receipt of preferred stock in exchange for (or distribution on) substantially identical preferred stock—(1) General rule. For purposes of sections 354(a)(2)(C)(i), 355(a)(3)(D), and 356(e)(2), preferred stock is QPS, even though it is described in section 351(g)(2), if it is received in exchange for (or in a distribution with respect to) preferred stock (the original preferred stock) that is QPS, provided—

(i) The original preferred stock is QPS solely because, on its issue date, either a right or obligation described in clause (i), (ii), or (iii) of section 351(g)(2)(A) was not exercisable until after a 20-year period beginning on the issue date, or the right or obligation was exercisable within the 20-year period beginning on the issue date but was subject to a contingency which made remote the likelihood of the redemption or purchase, or the issuer’s (or a related party’s) right to redeem or purchase the stock was not more likely than not to be exercised within a 20-year period beginning on the issue date, or because of any combination of these reasons; and

(ii) The stock received is substantially identical to the original preferred stock.

(2) Substantially identical. The stock received is substantially identical to the original preferred stock if—

(i) The stock received does not contain any term or terms that, in relation to any term or terms of the original preferred stock, either decrease the period in which a right or obligation described in clause (i), (ii), or (iii) of section 351(g)(2)(A) can be exercised, or increase the likelihood that such a right or obligation will be exercised, or accelerate the timing of the returns from the stock instrument, including the timing of actual or deemed dividends or other distributions received on the stock; and

(ii) As a result of the exchange or distribution, exercise of the right or obligation does not become more likely than not to occur within a 20-year period beginning on the issue date of the original preferred stock.

(3) Treatment of stock received. The stock received will continue to be treated as QPS in subsequent transactions involving such stock, and the principles of this paragraph (b) apply to such transactions as though the stock received is the original preferred stock issued on the same date as the original preferred stock.

(c) Stock transferred for services. For purposes of sections 351(g)(1), 354(a)(2)(C)(i), 355(a)(3)(D), and 356(e)(2), preferred stock containing a right or
obligation described in clause (i), (ii) or (iii) of section 351(g)(2)(A) that is exer-
sizable only upon the holder’s separation
from service from the issuer or a
related person (as described in section
351(g)(3)(B)) will be treated as trans-
ferred in connection with the perform-
ce of services (and representing rea-
sonable compensation) within the
meaning of section 351(g)(2)(C)(i)(II). If
such preferred stock is received in ex-
change for (or in a distribution with re-
spect to) existing stock containing a
similar right or obligation (exercisable
only upon separation from service) and
the existing stock was transferred in
connection with the performance of
services for the issuer or a related
person (and represented reasonable com-
pensation when transferred). In apply-
ning the rules relating to NQPS, the pre-
ferrred stock received will continue to
be treated as transferred in connection
with the performance of services (and
representing reasonable compensation)
in subsequent transactions involving
such stock, and the principles of this
paragraph (c) apply to such trans-
actions.

(d) Rights to acquire stock. For pur-
poses of §1.356–6, the principles of para-
graphs (a), (b), and (c) of this section
apply.

(e) Examples. In the examples in this
paragraph (e), T and P are corpora-
tions, A is a shareholder of T, and A
surrenders and receives (in addition to
the stock exchanged in the examples)
common stock in the reorganizations
described. The following examples il-
lustrate paragraphs (a), (b), and (c) of
this section:

Example 1. In 1995, A transfers property
to T and receives T preferred stock that is de-
scribed in section 351(g)(2) in a transaction
under section 351. In 2002, pursuant to a reor-
ganization under section 368(a)(1)(B), A surren-
ders the T preferred stock in exchange for
P NQPS. Under paragraph (a) of this section,
the T preferred stock issued to A in 1995 is
NQPS. However, because section 351(g) does
not apply to transactions occurring before
June 9, 1997, the T NQPS was not “other
property” within the meaning of section
351(b) when issued in 1995. Under sections
354(a)(2)(C) and 356(e)(2), the P NQPS re-
ceived by A in 2002 is not “other property”
within the meaning of section 356(a)(1)(B) be-
cause it is received in exchange for NQPS.

Example 2. T issues QPS to A on January 1,
2000 that is not NQPS solely because the
holder cannot require T to redeem the stock
until January 1, 2022. In 2007, pursuant to a reor-
ganization under section 368(a)(1)(A) in
which T merges into P, A surrenders the T
preferred stock in exchange for P preferred
stock with terms that are identical to the
terms of the T preferred stock, including the
term that the holder cannot require the re-
demption of the stock until January 1, 2022.
Because the P stock and the T stock have
identical terms, and because the redemption
did not become more likely than not to
occur within the 20-year period that begins
on January 1, 2000 (which is the issue date
of the T preferred stock) as a result of the ex-
change, under paragraph (b) of this section,
the P preferred stock received by A is treated
as QPS. Thus, the P preferred stock re-
ceived is not “other property” within the
meaning of section 356(a)(1)(B).

Example 3. The facts are the same as in Ex-
ample 2, except that, in addition, in 2010, pur-
suant to a recapitalization of P under sec-
tion 368(a)(1)(E), A exchanges the P preferred
stock above for P NQPS that permits the
holder to require P to redeem the stock in
2020. Under paragraph (b) of this section, the
P preferred stock surrendered by A is treated
as QPS. Because the P preferred stock re-
ceived by A in the recapitalization is not
substantially identical to the P preferred
stock surrendered, the P preferred stock re-
ceived by A is not treated as QPS. Thus, the
P preferred stock received is “other prop-
erty” within the meaning of section
356(a)(1)(B).

Example 4. T issues preferred stock to A on
January 1, 2000 that permits the holder to re-
quire T to redeem the stock on January 1,
2018, or at any time thereafter, but which is
not NQPS solely because, as of the issue
date, the holder’s right to redeem is subject
to a contingency that makes the remote
likelihood of redemption on or before Janu-
ary 1, 2020. In 2007, pursuant to a reor-
ganization under section 368(a)(1)(A) in which T
merges into P, A surrenders the T preferred
stock in exchange for P preferred stock with
terms that are identical to the terms of the
T preferred stock. Immediately before the
exchange, the contingency to which the
holder’s right to cause redemption of the T
stock is subject makes the remote likelihood
of redemption before January 1, 2020, but the
P stock, although subject to the same con-
tingency, is more likely than not to be re-
deeded before January 1, 2020. Because, as a
result of the exchange of T stock for P stock,
the exercise of the redemption right became
more likely than not to occur within the 20-
year period beginning on the issue date of the
T preferred stock, the P preferred stock re-
ceived by A is not substantially identical
to the T stock surrendered, and is not treat-
ed as QPS. Thus, the P preferred stock re-
ceived is “other property” within the
meaning of section 356(a)(1)(B).
§ 1.357–1 Assumption of liability.

(a) General rule. Section 357(a) does not affect the rule that liabilities assumed are to be taken into account for the purpose of computing the amount of gain or loss realized under section 1001 upon an exchange. Section 357(a) provides, subject to the exceptions and limitations specified in section 357 (b) and (c), that—

(1) Liabilities assumed are not to be treated as “other property or money” for the purpose of determining the amount of realized gain which is to be recognized under section 351, 361, 371, or 374, if the transactions would, but for the receipt of “other property or money” have been exchanges of the type described in any one of such sections; and

(2) If the only type of consideration received by the transferor in addition to that permitted to be received by section 351, 361, 371, or 374, consists of an assumption of liabilities, the transaction, if otherwise qualified, will be deemed to be within the provisions of section 351, 361, 371, or 374.

(b) Application of general rule. The application of paragraph (a) of this section may be illustrated by the following example:

Example. A, an individual, transfers to a controlled corporation property with an adjusted basis of $10,000 in exchange for stock of the corporation with a fair market value of $8,000, $3,000 cash, and the assumption by the corporation of indebtedness of A amounting to $4,000. A’s gain is $5,000, computed as follows:

<table>
<thead>
<tr>
<th>Stock received, fair market value</th>
<th>$8,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash received</td>
<td>3,000</td>
</tr>
<tr>
<td>Liability assumed by transferee</td>
<td>4,000</td>
</tr>
<tr>
<td><strong>Total consideration received</strong></td>
<td>15,000</td>
</tr>
<tr>
<td>Less: Adjusted basis of property transferred</td>
<td>10,000</td>
</tr>
<tr>
<td><strong>Gain realized</strong></td>
<td>5,000</td>
</tr>
</tbody>
</table>

Assuming that the exchange falls within section 351 as a transaction in which the gain to be recognized is limited to “other property or money” received, the gain recognized to A will be limited to the $3,000 cash received, since, under the general rule of section 357(a), the assumption of the $4,000 liability does not constitute “other property.”

(c) Tax avoidance purpose. The benefits of section 357(a) do not extend to any exchange involving an assumption of liabilities where it appears that the principal purpose of the taxpayer with respect to such assumption was to avoid Federal income tax on the exchange, or, if not such purpose, was not a bona fide business purpose. In such cases, the total amount of liabilities assumed or acquired pursuant to such exchange (and not merely a particular liability with respect to which the tax avoidance purpose existed) shall, for the purpose of determining the amount of gain to be recognized upon the exchange in which the liabilities are assumed or acquired, be treated as money received by the taxpayer upon the exchange. Thus, if in the example set forth in paragraph (b) of this section, the principal purpose of the assumption of the $4,000 liability was to avoid tax on the exchange, or was not a bona fide business purpose, then the amount