

§ 1.306-3

26 CFR Ch. I (4-1-04 Edition)

section 351, 355, or section 1036 (relating to exchanges of stock for stock in the same corporation) to the extent that gain or loss is not recognized to the shareholder as the result of the exchange of the stock (see paragraph (d) of § 1.306-3 relative to the receipt of other property), and

(3) A disposition or redemption, if it is established to the satisfaction of the Commissioner that the distribution, and the disposition or redemption, was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax. However, in the case of a prior or simultaneous disposition (or redemption) of the stock with respect to which the section 306 stock disposed of (or redeemed) was issued, it is not necessary to establish that the distribution was not in pursuance of such a plan. For example, in the absence of such a plan and of any other facts the first sentence of this subparagraph would be applicable to the case of dividends and isolated dispositions of section 306 stock by minority shareholders. Similarly, in the absence of such a plan and of any other facts, if a shareholder received a distribution of 100 shares of section 306 stock on his holdings of 100 shares of voting common stock in a corporation and sells his voting common stock before he disposes of his section 306 stock, the subsequent disposition of his section 306 stock would not ordinarily be considered a disposition one of the principal purposes of which is the avoidance of Federal income tax.

[T.D. 6500, 25 FR 11607, Nov. 26, 1960, as amended by T.D. 6969, 33 FR 11998, Aug. 23, 1968]

§ 1.306-3 Section 306 stock defined.

(a) For the purpose of subchapter C, chapter 1 of the code, the term *section 306 stock* means stock which meets the requirements of section 306(c)(1). Any class of stock distributed to a shareholder in a transaction in which no amount is includible in the income of the shareholder or no gain or loss is recognized may be section 306 stock, if a distribution of money by the distributing corporation in lieu of such stock would have been a dividend in whole or in part. However, except as provided in section 306(g), if no part of a distribu-

tion of money by the distributing corporation in lieu of such stock would have been a dividend, the stock distributed will not constitute section 306 stock.

(b) For the purpose of section 306, rights to acquire stock shall be treated as stock. Such rights shall not be section 306 stock if no part of the distribution would have been a dividend if money had been distributed in lieu of the rights. When stock is acquired by the exercise of rights which are treated at section 306 stock, the stock acquired is section 306 stock. Upon the disposition of such stock (other than by redemption or within the exceptions listed in section 306(b)), the proceeds received from the disposition shall be treated as ordinary income to the extent that the fair market value of the stock rights, on the date distributed to the shareholder, would have been a dividend to the shareholder had the distributing corporation distributed cash in lieu of stock rights. Any excess of the amount realized over the sum of the amount treated as ordinary income plus the adjusted basis of the stock, shall be treated as gain from the sale of the stock.

(c) Section 306(c)(1)(A) provides that section 306 stock is any stock (other than common issued with respect to common) distributed to the shareholder selling or otherwise disposing thereof if, under section 305(a) (relating to distributions of stock and stock rights) any part of the distribution was not included in the gross income of the distributee.

(d) Section 306(c)(1)(B) includes in the definition of section 306 stock any stock except common stock, which is received by a shareholder in connection with a reorganization under section 368 or in a distribution or exchange under section 355 (or so much of section 356 as relates to section 355) provided the effect of the transaction is substantially the same as the receipt of a stock dividend, or the stock is received in exchange for section 306 stock. If, in a transaction to which section 356 is applicable, a shareholder exchanges section 306 stock for stock and money or other property, the entire amount of such money and of the fair market

value of the other property (not limited to the gain recognized) shall be treated as a distribution of property to which section 301 applies. Common stock received in exchange for section 306 stock in a recapitalization shall not be considered section 306 stock. Ordinarily, section 306 stock includes stock which is not common stock received in pursuance of a plan of reorganization (within the meaning of section 368(a)) or received in a distribution or exchange to which section 355 (or so much of section 356 as relates to section 355) applies if cash received in lieu of such stock would have been treated as a dividend under section 356(a)(2) or would have been treated as a distribution to which section 301 applies by virtue of section 356(b) or section 302(d). The application of the preceding sentence is illustrated by the following examples:

Example (1). Corporation A, having only common stock outstanding, is merged in a statutory merger (qualifying as a reorganization under section 368(a)) with Corporation B. Pursuant to such merger, the shareholders of Corporation A received both common and preferred stock in Corporation B. The preferred stock received by such shareholders is section 306 stock.

Example (2). X and Y each own one-half of the 2,000 outstanding shares of preferred stock and one-half of the 2,000 outstanding shares of common stock of Corporation C. Pursuant to a reorganization within the meaning of section 368(a)(1)(E) (recapitalization) each shareholder exchanges his preferred stock for preferred stock of a new issue which is not substantially different from the preferred stock previously held. Unless the preferred stock exchanged was itself section 306 stock the preferred stock received is not section 306 stock.

(e) Section 306(c)(1)(C) includes in the definition of section 306 stock any stock (except as provided in section 306(c)(1)(B)) the basis of which in the hands of the person disposing of such stock, is determined by reference to section 306 stock held by such shareholder or any other person. Under this paragraph common stock can be section 306 stock. Thus, if a person owning section 306 stock in Corporation A transfers it to Corporation B which is controlled by him in exchange for common stock of Corporation B in a transaction to which section 351 is applicable, the common stock so received by

him would be section 306 stock and subject to the provisions of section 306(a) on its disposition. In addition, the section 306 stock transferred is section 306 stock in the hands of Corporation B, the transferee. Section 306 stock transferred by gift remains section 306 stock in the hands of the donee. Stock received in exchange for section 306 stock under section 1036(a) (relating to exchange of stock for stock in the same corporation) or under so much of section 1031(b) as relates to section 1036(a) becomes section 306 stock and acquires, for purposes of section 306, the characteristics of the section 306 stock exchanged. The entire amount of the fair market value of the other property received in such transaction shall be considered as received upon a disposition (other than a redemption) to which section 306(a) applies. Section 306 stock ceases to be so classified if the basis of such stock is determined by reference to its fair market value on the date of the decedent-stockholder's death or the optional valuation date under section 1014.

(f) If section 306 stock which was distributed with respect to common stock is exchanged for common stock in the same corporation (whether or not such exchange is pursuant to a conversion privilege contained in section 306 stock), such common stock shall not be section 306 stock. This paragraph applies to exchanges not coming within the purview of section 306(c)(1)(B). Common stock which is convertible into stock other than common stock or into property, shall not be considered common stock. It is immaterial whether the conversion privilege is contained in the stock or in some type of collateral agreement.

(g) If there is a substantial change in the terms and conditions of any stock, then, for the purpose of this section—

(1) The fair market value of such stock shall be the fair market value at the time of distribution or the fair market value at the time of such change, whichever is higher;

(2) Such stock's ratable share of the amount which would have been a dividend if money had been distributed in lieu of stock shall be determined by reference to the time of distribution or by reference to the time of such

change, whichever ratable share is higher; and

(3) Section 306(c)(2) shall be inapplicable if there would have been a dividend to any extent if money had been distributed in lieu of the stock either at the time of the distribution or at the time of such change.

(h) When section 306 stock is disposed of, the amount treated under section 306(a)(1)(A) as ordinary income, for the purposes of part I, subchapter N, chapter 1 of the Code, be treated as derived from the same source as would have been the source if money had been received from the corporation as a dividend at the time of the distribution of such stock. If the amount is determined to be derived from sources within the United States, the amount shall be considered to be fixed or determinable annual or periodic gains, profits, and income within the meaning of section 871(a) or section 881(a), relating, respectively, to the tax on non-resident alien individuals and on foreign corporations not engaged in business in the United States.

(i) Section 306 shall be inapplicable to stock received before June 22, 1954, and to stock received on or after June 22, 1954, in transactions subject to the provisions of the Internal Revenue Code of 1939.

[T.D. 6500, 25 FR 11607, Nov. 26, 1960, as amended by T.D. 7281, 38 FR 18540, July 12, 1973; T.D. 7556, 43 FR 34128, Aug. 3, 1978]

§ 1.307-1 General.

(a) If a shareholder receives stock or stock rights as a distribution on stock previously held and under section 305 such distribution is not includible in gross income then, except as provided in section 307(b) and § 1.307-2, the basis of the stock with respect to which the distribution was made shall be allocated between the old and new stocks or rights in proportion to the fair market values of each on the date of distribution. If a shareholder receives stock or stock rights as a distribution on stock previously held and pursuant to section 305 part of the distribution is not includible in gross income, then (except as provided in section 307(b) and § 1.307-2) the basis of the stock with respect to which the distribution is made shall be allocated between (1) the

old stock and (2) that part of the new stock or rights which is not includible in gross income, in proportion to the fair market values of each on the date of distribution. The date of distribution in each case shall be the date the stock or the rights are distributed to the stockholder and not the record date. The general rule will apply with respect to stock rights only if such rights are exercised or sold.

(b) The application of paragraph (a) of this section is illustrated by the following example:

Example A taxpayer in 1947 purchased 100 shares of common stock at \$100 per share and in 1954 by reason of the ownership of such stock acquired 100 rights entitling him to subscribe to 100 additional shares of such stock at \$90 a share. Immediately after the issuance of the rights, each of the shares of stock in respect of which the rights were acquired had a fair market value, ex-rights, of \$110 and the rights had a fair market value of \$19 each. The basis of the rights and the common stock for the purpose of determining the basis for gain or loss on a subsequent sale or exercise of the rights or a sale of the old stock is computed as follows:

100 (shares)×\$100=\$10,000, cost of old stock (stock in respect of which the rights were acquired).
 100 (shares)×\$110=\$11,000, market value of old stock.
 100 (rights)×\$19=\$1,900, market value of rights.
 $11,000/12,900$ of \$10,000=\$8,527.13, cost of old stock apportioned to such stock.
 $1,900/12,900$ of \$10,000=\$1,472.87, cost of old stock apportioned to rights.

If the rights are sold, the basis for determining gain or loss will be \$14.7287 per right. If the rights are exercised, the basis of the new stock acquired will be the subscription price paid therefor (\$90) plus the basis of the rights exercised (\$14.7287 each) or \$104.7287 per share. The remaining basis of the old stock for the purpose of determining gain or loss on a subsequent sale will be \$85.2713 per share.

§ 1.307-2 Exception.

The basis of rights to buy stock which are excluded from gross income under section 305(a), shall be zero if the fair market value of such rights on the date of distribution is less than 15 percent of the fair market value of the old stock on that date, unless the shareholder elects to allocate part of the basis of the old stock to the rights as provided in paragraph (a) of § 1.307-1.