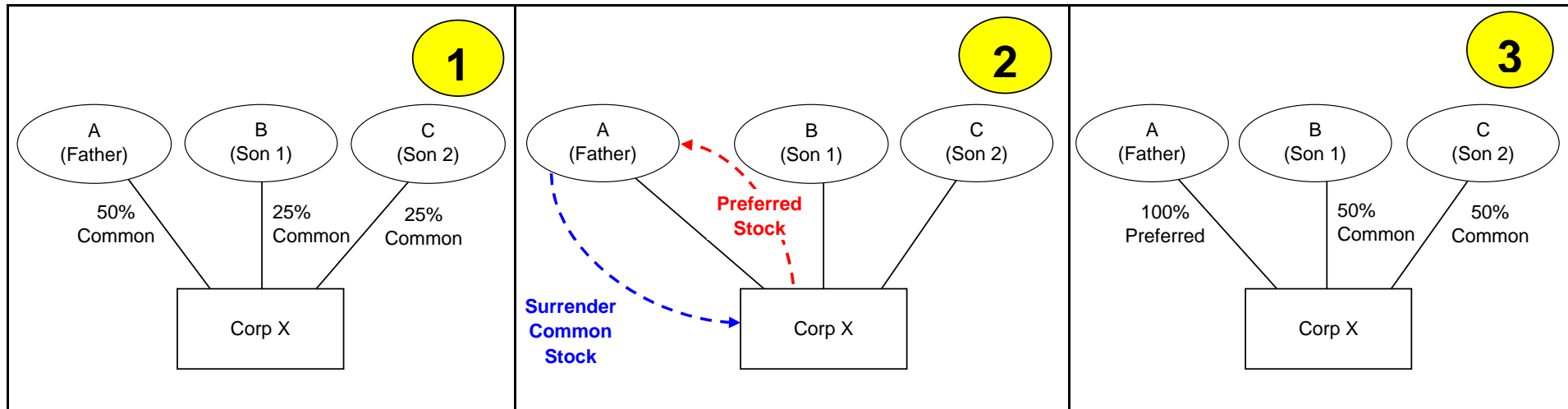


**Recapitalization of
Common For Preferred**

Initial Structure

Recapitalization

Ending Point



A, the founder of X corporation, owns 50 of X's outstanding 100 shares of common stock. B and C, A's sons, each owns 25 shares. In anticipation of A's retirement and pursuant to a plan of recapitalization, X proposes to exchange shares of newly issued \$100 par value six percent cumulative nonvoting preferred stock for all of A's common stock. B and C will not participate in the exchange. The terms of the preferred stock provide that on liquidation, the preferred shareholder will receive the par value of his shares plus accrued dividends. The book value per share of X common stock was calculated to be \$10x, or a total book value of \$500x for the 50 shares held by A. Pursuant to the plan, A will exchange all of his X common stock with a book value of \$500x for five shares of new X preferred stock with a par value of \$500x.

Section 368(a)(1)(E) provides that a recapitalization constitutes a "reorganization." Section 354(a)(1) provides, in part, that no gain or loss will be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation.

The exchange of stock described above will constitute a reorganization within the meaning of section 368(a)(1)(E) and no gain or loss will be recognized to A under section 354 on the exchange of those shares of his common stock which are equal in value to the value of the shares of the preferred stock which are received in exchange therefore. However, if A receives shares of preferred stock having a fair market value in excess of the fair market value of the common stock surrendered, or surrenders shares of common stock having a fair market value in excess of the fair market value of the preferred stock received, the amount representing such excess will be treated as having been used to make gifts, pay compensation, satisfy obligations of any kind, or for whatever purpose the facts indicate. The reorganization will not diminish the accumulated earnings and profits of X corporation available for the subsequent distribution of dividends within the meaning of section 316.