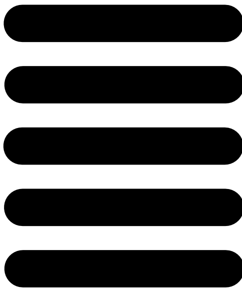
VOLUME 14, NUMBER 9
APRIL 2006



THE M&A Tax Report
THE MONTHLY REVIEW OF
TAXES, TRENDS & TECHNIQUES

EDITOR-IN-CHIEF
Robert W. Wood
Wood & Porter
San Francisco

ASSOCIATE EDITOR
Joanna Schaller
Tax Institute
San Francisco

ADVISORY BOARD

Dominic L. Daher
University of San Francisco
San Francisco

Paul L. Davies III
The Cambria Group
Menlo Park

Jonathan R. Flora
Lindquist & Vennum
Minneapolis

David R. Gerson
Wilson Sonsini
Goodrich & Rosati
San Francisco

Lawrence B. Gibbs
Miller & Chevalier
Washington

Steven K. Matthias
Deloitte & Touche
San Francisco

Mark A. Muntean
Wood & Porter
San Francisco

Matthew A. Rosen
Skadden, Arps, Slate,
Meagher & Flom
New York

Mark J. Silverman
Steptoe & Johnson
Washington

Robert Willens
Lehman Brothers
New York

Stock Basis Allocation Regulations

By Richard C. Morris • Wood & Porter • San Francisco

On January 26, 2006, the IRS published final regulations under Internal Revenue Code Section ("Code Sec.") 358 that provide rules to allocate stock basis for shares received in certain nonrecognition exchanges and Code Sec. 355 distributions. [*See* T.D. 9244, Jan. 23, 2006.] Although allocation regulations were first issued in 1955, the 2006 regulations contain significant changes, many of which build upon proposed regulations issued in May 2004. [*See* REG-116564-03.]

Notably, the IRS simultaneously published temporary regulations under Code Sec. 1502 that govern certain basis determinations and adjustments of subsidiary stock in certain transactions involving members of a consolidated group. Both sets of regulations are effective on January 23, 2006. This article will focus exclusively on the Code Sec. 358 regulations.

As M&A TAX REPORT readers know, Code Sec. 358 contains a lengthy formula to determine stock basis for property received pursuant to a nonrecognition exchange. Generally speaking, the starting point is the basis of the property exchanged.

On the other hand, the basis is decreased by the fair market value of any property and money received and by any loss recognized on the exchange. This basis is increased by any amount treated as a dividend and by any gain recognized on the exchange. Finally, the basis must be allocated among the properties received in the exchange or distribution.

It's All About Tracing

The 2004 proposed regulations adopted a tracing method to allocate basis to shares received in a nonrecognition exchange. In particular, the basis of each share of stock received in a reorganization is traced to the basis of each share surrendered. Additionally, each share received in a distribution under Code Sec. 355 is allocated basis from a share of stock

(continued on page 2)

ALSO IN THIS ISSUE

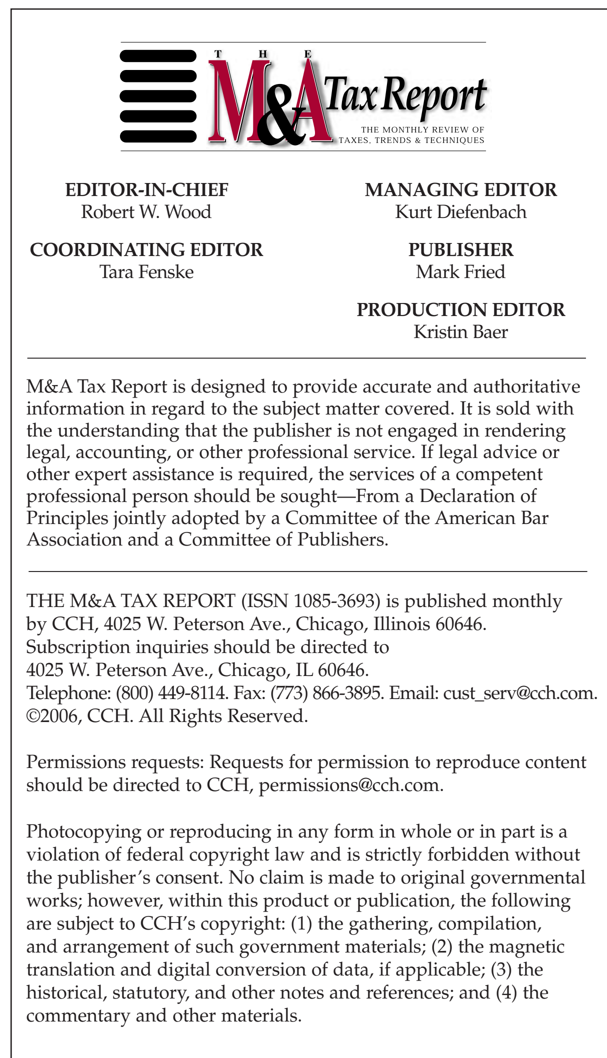
Book Review: NEGOTIATED ACQUISITIONS OF COMPANIES, SUBSIDIARIES AND DIVISIONS, by Lou R. Kling and Eileen T. Nugent 5
Second Helpings on Sandwiches 6
(Not So) Golden Parachutes 7

of the distributing corporation. (Note that the rules apply equally to shares and securities, but for brevity, we'll refer only to shares here.)

Although the IRS considered whether an averaging method should be used, it adopted the tracing method, noting that a reorganization was not an event justifying averaging the bases of exchanged stock purchased at different times and at different prices. Plus, the IRS was concerned that averaging the bases of exchanged blocks of stock could inappropriately limit the ability of some taxpayers to arrange their affairs, and could afford other taxpayers undesired tax-savings opportunities.

The basic tracing rule is that the basis of each share of stock received in a nonrecognition exchange is generally the same as the basis of the share (or shares) exchanged. In the case of a distribution to which Code Sec. 355 applied, the basis of each share of stock of the distributing corporation was allocated between the stock of the distributing corporation and the distributed corporation in proportion to their fair market values.

If a shareholder is unable to identify which particular share (or portion of a share) was exchanged for a particular share (or portion of a share), the shareholder can designate which share was received in exchange for which share. This designation, however, must be consistent with the terms of the exchange or distribution, and must be made on or before the first date on which the basis of a share received was relevant. For example, the first relevant date could be when a share received is sold or transferred in an exchange described in Code Sec. 351 or Code Sec. 721, or in a reorganization described in Code Sec. 368.


THE M&A Tax Report
THE MONTHLY REVIEW OF TAXES, TRENDS & TECHNIQUES

EDITOR-IN-CHIEF
Robert W. Wood

MANAGING EDITOR
Kurt Diefenbach

COORDINATING EDITOR
Tara Fenske

PUBLISHER
Mark Fried

PRODUCTION EDITOR
Kristin Baer

M&A Tax Report is designed to provide accurate and authoritative information in regard to the subject matter covered. It is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional service. If legal advice or other expert assistance is required, the services of a competent professional person should be sought—From a Declaration of Principles jointly adopted by a Committee of the American Bar Association and a Committee of Publishers.

THE M&A TAX REPORT (ISSN 1085-3693) is published monthly by CCH, 4025 W. Peterson Ave., Chicago, Illinois 60646. Subscription inquiries should be directed to 4025 W. Peterson Ave., Chicago, IL 60646. Telephone: (800) 449-8114. Fax: (773) 866-3895. Email: cust_serv@cch.com.
©2006, CCH. All Rights Reserved.

Permissions requests: Requests for permission to reproduce content should be directed to CCH, permissions@cch.com.

Photocopying or reproducing in any form in whole or in part is a violation of federal copyright law and is strictly forbidden without the publisher's consent. No claim is made to original governmental works; however, within this product or publication, the following are subject to CCH's copyright: (1) the gathering, compilation, and arrangement of such government materials; (2) the magnetic translation and digital conversion of data, if applicable; (3) the historical, statutory, and other notes and references; and (4) the commentary and other materials.

Allocating Consideration

The final regulations retain the proposed regulation's tracing method, with modifications. They continue to allow a shareholder to designate which share is received in exchange for which share, as long as the designation is consistent with the terms of the exchange or distribution. If more than one block (or class) of stock is received in exchange for more than one block (or class) of stock, more than one designation may be consistent.

Thus, if the terms of the exchange specify which shares are received in exchange for a particular share or class of stock, those terms will control for purposes of determining the basis of the stock received, provided that these terms are economically reasonable.

If the terms of the exchange do not specify which shares of stock are received in the exchange, a *pro rata* portion of each class of stock received will be treated as received in exchange for each share of stock surrendered, based on the fair market value of the surrendered stock. Similar rules apply to distributions under Code Sec. 355.

> **Example.** A owns two 100 share blocks of Corporation X common stock. Each block has a value of $100. A has a basis of $50 in one block and a basis of $250 in the other block. Under the terms of a reorganization, A transfers both blocks in exchange for 100 shares of Corporation Y common stock with a value of $100 and 100 shares of preferred stock with a value of $100.
>
> A's designation could reflect the fact that Corporation Y common stock and preferred

stock are allocated to the shares exchanged in proportion to their fair market values. Therefore, Corporation Y common stock with a fair market value of $50 and preferred stock with a fair market value of $50 would be treated as received for each block of Corporation X common stock. Alternatively, A's designation could reflect that the low basis Corporation X shares were exchanged for Corporation Y common stock, and the high basis Corporation X shares were exchanged for Corporation Y preferred stock or *vice versa.*

Allocating Boot

Transactions often require allocating boot among the stock surrendered in an exchange or the stock with respect to which a distribution is made. An allocation of boot may be necessary to compute a taxpayer's gain and its basis in stock received. The final regulations adopt reasonable rules governing the allocation of boot among stock surrendered (or with respect to which a distribution is made).

Thus, when computing gain recognized on an exchange, to the extent the terms of the exchange specify the boot that is received in exchange for a particular share of stock surrendered, such terms control. However, these terms must be economically reasonable. This position is consistent with Rev. Rul. 74-515, 1974-2 CB 118 (suggesting that the terms of the exchange governed for purposes of computing gain recognized under Code Sec. 356—the terms of which provided for the exchange of common stock for common stock and preferred stock for cash).

If the terms of the exchange do not specify the other property or money received in exchange for a particular share of stock surrendered, a *pro rata* portion of the boot is treated as received in exchange for each share of stock surrendered, based on the fair market value of such surrendered share of stock.

Example. A holds 100 shares of Corporation T common stock and 100 shares of its preferred stock. The common shares have a basis of $10 and a fair market value of $100. The preferred shares have a basis of $20 and a fair market value of $100. Corporation T merges into Corporation X. In the reorganization, A exchanges its shares of Corporation T common and preferred stock for 100 shares of Corporation X common stock with a fair market value of $100 and $100 of cash.

If the cash were allocated proportionately between the common and preferred shares based on their relative values, A would recognize $50 of gain on its common shares and $50 of gain on its preferred shares. If the cash were allocated solely to the common shares, A would recognize $90 of gain. If the cash were allocated solely to the preferred shares, A would recognize $80 of gain.

Allocating Losses

Unfortunately, the final regulations do not address the proper treatment of the basis of stock exchanged for boot when there is a loss. Generally, realized losses cannot be recognized in a reorganization. Yet, circumstances can arise under these basis allocation rules where it may be equitable to allow a loss.

Example. A holds 100 shares of Corporation T common stock and 100 shares of its preferred stock. The common shares have a basis of $10 and a fair market value of $100. The preferred shares have a basis of $150 and a fair market value of $100. Corporation T merges into Corporation X. The terms of the exchange specify that A exchanges its shares of Corporation T common stock for 100 shares of Corporation X common stock with a fair market value of $100 and exchanges its shares of Corporation T preferred stock for $100 of cash.

Under the final regulations, the terms of the exchange control for purposes of determining gain (under Code Sec. 356) and basis (under Code Sec. 358). A realizes a gain of $90 on the exchange of Corporation T common stock for Corporation X common stock, none of which is recognized, and A takes a basis of $10 in the shares of Corporation X common stock received. However, A realizes a loss of $50 on the exchange of Corporation T preferred stock for cash, and A is not entitled to recognize this loss.

This conclusion is consistent with Rev. Rul. 74-515. In that ruling, a shareholder surrenders common stock of the target corporation in exchange for common stock of the acquiring corporation, and preferred stock of the target in exchange for cash. The ruling concludes that the tax consequences of the shareholder's exchange of preferred shares for cash are governed by

Code Sec. 356 and any loss realized is not recognized by reason of Code Sec. 356(c).

For the moment, taxpayers will have to be wary of this trap. Yet, the IRS says it is considering whether regulations should be adopted to permit a taxpayer, such as A in the above example, to recognize the loss. Of course, if loss recognition is not allowed, then an issue arises as to the proper treatment of the basis of the shares with respect to which the loss is realized but not recognized, at least to the extent that such basis exceeds the cash received in respect of such shares.

Stockless Reorganizations

Before the final regulations, it was not clear how basis should be determined in a reorganization in which no stock was issued. This might occur in reorganizations involving commonly controlled acquiring and target corporations, where the issuance of additional stock would constitute a meaningless gesture. Additional problems arose when the exchanging stockholder received property with a fair market value less than that of the stock surrendered in the transaction.

Consistent with the tracing rules, the final regulations create fictional transactions to allocate basis. Thus, the acquiring corporation is deemed to issue stock equal to the fair market value of the stock surrendered. The basis of the deemed issued stock is traced from the shares surrendered under rules that would have applied had the shareholder actually received such stock.

Then, the shareholder's stock in the acquiring corporation is treated as recapitalized. In the recapitalization, the shareholder is treated as surrendering all of its shares of the acquiring corporation (including those shares owned immediately prior to the reorganization and those shares the shareholder is deemed to receive) in exchange for the shares that the shareholder actually holds immediately after the reorganization. The basis of the shares the shareholder actually owns is determined as if the recapitalization actually occurred, using both actual and deemed owned shares.

Example. P wholly owns S1 and S2. P owns 100 shares of S1, each of which has a basis of $1 and was acquired on Date 1, and 100 shares of S2, each of which has a basis of $2 and was acquired on Date 2. The fair market value of each share of the stock of each of S1 and S2 is $1. S1 merges into S2 in a reorganization under Code Sec. 368(a)(1)(D) in which P does not receive any additional stock of S2.

P is treated as receiving 100 shares of S2, each of which has a fair market value of $1. The basis of the additional 100 shares is determined as if P had actually received those shares. Therefore, each of the shares would have a basis of $1. Then, to reflect that P has only 100 shares of S2 stock rather than 200 shares, S2 would be treated as undergoing a reverse stock split in which it exchanges two shares of its stock for one share. The basis of each of the 100 shares would be determined as if the reverse stock split had actually occurred. Therefore, 50 shares of P's S2 stock would each have a basis of $2 and would be treated as having been acquired on Date 1 and the remaining 50 shares of P's S2 stock would each have a basis of $4 and would be treated as having been acquired on Date 2.

Single vs. Split Basis Approaches

The proposed regulations tried not to create shares with split holding periods. Thus, if one share of stock was received in exchange for more than one share of stock (or a fraction of a share of stock), the basis of the shares surrendered would have had to have been allocated to the shares received to reflect that the share received was received in exchange for shares that were acquired on the same date and at the same price. The proposed regulations, however, did not answer the question whether a share that reflects the basis of several shares with differing bases had a single aggregated basis or a split basis.

Example. B has two shares of stock of T. One of those shares had a basis of $1 and was acquired on Date 1. The other share had a basis of $2 and was acquired on Date 2. A corporation acquires the assets of T in a statutory merger. In the reorganization, B exchanges its two shares of T stock for one share of A stock, and the question arises as to B's basis in the shares of A stock. One possibility is that B has a single, undivided $3 basis in its share of A stock. Another possibility is that B has a split basis in its share of A stock, so half of the share is treated as having a basis of $1 and the other half as having a basis of $2.

The final regulations require B to take a split basis in the share of A stock received in the merger. Since a share of stock can have a

split holding period, the split basis approach is a logical corollary. In contrast, the single aggregated basis approach has the effect of averaging the basis of more than one share. Thus, it is inconsistent with the tracing regime.

Coordination with Code Sec. 1036

Code Sec. 1036 provides that no gain or loss is recognized if common stock is exchanged for common stock (or preferred stock is exchanged for preferred stock) in the same corporation. Code Sec. 1031 provides rules for determining the basis of the common (or preferred stock) received in an exchange described in Code Sec. 1036.

According to the IRS, the same policies that support the tracing regime in reorganization transactions support a tracing regime in transactions governed by both Code Sec. 1036 and Code Sec. 354 and/or 356. Thus, the tracing rules will apply when there is an overlap of these sections. Yet, the IRS has reserved judgment whether the tracing rules should be adopted in regulations under Code Sec. 1036 for transactions governed solely by Code Sec. 1036, but not Code Sec. 354 or 356.

Conclusions

The final regulations, while lengthy and complex, are at least logical. Little of the new rules should entirely surprise practitioners, and many of us have probably been following and even advising on these types of rules prior to the proposed regulations being issued two years ago. Although the final regulations expressly disavow the averaging method, this should presumably not come as a surprise, since averaging is not consistent with reorganizations and Code Sec. 355 distributions. Overall, these regulations should be a welcome relief, as taxpayers can now rely on these coherent and taxpayer-friendly rules.