Back to Basis: Small Tax Mistakes Can Mean Big Taxes

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In this article, Wood and Board discuss opportunities to reduce boot gain by allocating merger cash under the section 358 regulations.

This discussion is not legal advice.

Taxes are complex — perhaps more so under America's incredibly vast, if not downright byzantine, tax system than anywhere else. Tax simplification has long been a storied and lofty goal in the United States. Yet nearly every effort has failed, either in large part or completely. In some cases, *simplification* has made it even worse.

President Trump's ascent has arguably accentuated the big moves that taxes can sometimes involve. And yet it may also help to show that there is often big risk in tax moves, too. That is where one tax story having nothing to do with the president's Russia investigation comes in.

Russian Fast Food

Michael Tseytin, a Soviet émigré, is a cross-border entrepreneur. In 1990, even before the dissolution of the U.S.S.R., Tseytin opened the first store in Moscow selling Western computers. He later came to own 75 percent of US Strategies Inc. (USSI), a U.S. corporation that owned and operated Pizza Hut and KFC franchises throughout the Russian Federation.

In 2007 Tseytin met with AmRest Holdings NV, a Dutch company whose shares were traded on the Warsaw Stock Exchange. AmRest owned and operated its own Pizza Hut, KFC, Burger King, and Starbucks franchises throughout Central and Eastern Europe. AmRest was interested in acquiring USSI, and on May 20, 2007, AmRest, USSI, and Tseytin entered into a merger agreement calling for USSI to be acquired by a newly organized subsidiary of AmRest.

The transaction was expected to qualify as a forward subsidiary merger described in section 368(a)(2)(D). The fuel for the merger would be AmRest stock and cash worth a total of about $54 million. But there was one matter that had to be dealt with first. AmRest insisted on acquiring 100 percent of the shares directly from Tseytin.

So the transaction would not close until Tseytin acquired the remaining 25 percent of USSI. Archer Consulting Corp., organized in the British Virgin Islands, owned the missing 25 percent. Archer was willing to sell its stake for $14 million in cash. That was about $500,000 more than the Archer shares would have fetched in the merger.

Tseytin apparently didn't mind paying a premium to get the deal done. He entered into a purchase and sale agreement with Archer on May 25, 2007. That sale closed June 14. However, Tseytin was not required to pay Archer its $14 million until AmRest completed its acquisition of USSI.

Archer did not have to wait long. The merger became effective on July 2. AmRest issued Tseytin a block of new shares with a market value of about $30.8 million. It also wired him $23.1 million in cash. Tseytin then paid Archer the promised $14 million.

Because of the transaction with Archer, Tseytin went into the merger with two distinct blocks of USSI stock. One was the recently purchased 25 percent block (the Archer shares), in which he had a $14 million basis. The other was his original 75 percent block (the original shares). His basis in the original shares was zero.

Tracing Shares

Before addressing Tseytin's tax mess, it is worth noting that shares of a single class of stock are fungible from an economic perspective. But they may not be when it comes to taxes because identical shares can have different bases. An acquisition agreement might call for a 2-for-1 exchange, in which 100 shares of target common stock are replaced by 200 common shares of the acquirer. If it's a tax-free exchange, how do you connect any given pair of acquirer shares with the target share whose basis is supposed to carry over?

In 2006 Treasury issued new regulations to govern the calculation of gain and the allocation of basis in tax-free reorganizations.[1] The 2006 regulations require each shareholder to designate *which* of his new acquirer shares were received in exchange for *which* shares of the target. How you do that is less clear. But the target shareholder does not have to designate the provenance of a new share until his basis in that share becomes relevant for tax purposes, so there's time to think it through.[2]

Classes of Shares

What happens if the shareholder receives more than one class of stock in exchange for more than one class or block of target shares? Is basis designation permitted in those cases, too? Yes, but the 2006 regulations require that the designation in a multi-class exchange be set forth in the acquisition agreement.[3] That means that target shareholders must do their planning early on.

> **Example:** Alice owns two 100-share blocks of Corp. X common stock. Each block is worth $100. Alice has a basis of $50 in one block and $250 in the other. Corp. Y wants to acquire all of Alice's shares in a reorganization in exchange for 100 shares of Corp. Y common stock (worth $100) and 100 shares of Corp. Y preferred stock (also worth $100).

What if Alice's desired designation does not make it into the acquisition agreement? The default rule is that a pro rata portion of each class of stock received will be treated as received in exchange for each share of target stock, based on the fair market value of the shares surrendered.[4]

Here, Alice is surrendering two blocks of Corp. X common stock with equal FMVs. Under the default rule, Alice will be treated as having received the Corp. Y common stock in exchange for: (1) $50 of Corp. X common stock with a basis of $25; and (2) $50 of Corp. X common stock with a basis of $125. Alice's basis in her Corp. Y preferred shares will be determined the same way.

Boot Allocations

If the property received in a reorganization includes money or property not permitted to be received under section 354, "the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property."[5] Gain has to be addressed one asset at a time. Hence, to determine the amount of taxable boot gain under section 356(a)(1), we need rules allocating boot to specific shares.

The 2006 regulations respect a shareholder's allocation of boot to target shares as long as: (1) it is economically reasonable; and (2) it is set forth in

[1] *See* T.D. 9044.

[2] Reg. section 1.358-2(a)(2)(vii).

[3] Reg. section 1.358-2(a)(2)(ii).

[4] *Id.*

[5] Section 356(a)(1).

the acquisition agreement.[6] Rational tax planning is possible, but target shareholders must get it done before the closing.

Everyone Must File Tax Returns

Tseytin filed his 2007 personal tax return on October 15, 2008. On Schedule D for capital gains and losses, he presented the USSI shares exchanged in the merger as a single block. He treated his receipt of the $23.1 million in cash as taxable, but only to the extent it exceeded $6 million. That was the portion of his $14 million basis Tseytin thought should be set off against the cash he received. He therefore reported a $17.1 million gain.

About a year later, Tseytin filed an amended return. This time, he reported only $9.1 million in gain — $8 million less than he had reported on his original return. Not surprisingly, this triggered an audit. In the tax dispute that followed, the reasoning underlying Tseytin's amended position was opaque, but we will come back to that.

On audit, the IRS analyzed the exchange of each of his two blocks of USSI shares separately. Gain or loss realized for each block had to be determined using the basis of the shares making up that block. The IRS allocated 75 percent of the total consideration (that is, $40.4 million) to the original shares. Tseytin had a zero basis in those shares, so he realized a $40.4 million gain.

The IRS allocated the remaining 25 percent of the consideration to the Archer shares. This came to about $13.5 million. That was less than Tseytin's $14 million basis, so he realized a $500,000 loss on this second exchange. The next step was to apply section 356(a)(1).

The merger agreement had not allocated the $23.1 million in boot between the two blocks of stock. So the IRS allocated 75 percent of the cash ($17.3 million) to the original shares, and 25 percent ($5.8 million) to the Archer shares. Tseytin had a $40.4 million gain on the original shares, so this allocation required him to recognize $17.3 million of boot gain.

Second Chance

After wrestling with the IRS for a while, Tseytin took his case to Tax Court.[7] But the court took him to task for several errors, including computing his gain in a way that ignored his receipt of $30.8 million in AmRest stock.

Back in 2007, Tseytin was negotiating the exchange of two blocks of target stock with different bases for AmRest stock and $23.1 million in boot. This would have been a perfect opportunity to save taxes by allocating boot to the Archer shares, in which he had a $14 million basis. The Archer shares were entitled to 25 percent of the total consideration — about $13.5 million.

Thus, Tseytin should have put language in the merger agreement allocating $13.5 million of the $23.1 million in cash to the Archer shares. The exchange would still have produced a $500,000 loss, but the allocation would have neutralized $13.5 million of boot in the process. This would have been a big improvement over the IRS's pro rata allocation, which attributed only $5.8 million of cash to the Archer shares.

The tax payoff would have come from the reduction in the amount of boot available for allocation to the original shares. Tseytin would still have realized a $40.4 million gain. But now there would have been only $9.6 million in cash (that is, $23.1 million minus $13.5 million) to trigger recognition under section 356(a)(1).

Retroactive Fix

With only $9.6 million of boot allocated to the original shares, Tseytin would have reported just $9.6 million in gain. That is in the same range as the $9.1 million that he reported on his amended return. Is this a coincidence?

Apparently not. If we use actual figures, we see that Tseytin reported $9,099,320 in gain on his amended return. This is just $100 different from the result obtained if we simply subtract Tseytin's $14 million basis in the Archer shares from the $23,099,420 of cash he received.

Compare this with what would have happened if Tseytin had managed to allocate $14 million of boot to the Archer shares in the merger

[6] Reg. section 1.356-1(b).

[7] *Tseytin v. Commissioner*, T.C. Memo. 2015-247, *aff'd*, 698 Fed. Appx. 720 (3d Cir. 2017).

agreement. His $14 million basis would have absorbed the $14 million in cash without triggering any boot gain — a tax planner's delight.

This would have left only $9,099,420 in boot to allocate to the original shares. Hence, Tseytin would have reported $9,099,420 in gain on his exchange of the original shares. That is almost the same amount Tseytin reported on his amended return.

It would not be surprising if Tseytin or his advisers had realized, after the closing, that his failure to allocate boot to the Archer shares in the merger agreement had been a serious mistake. The oversight forced Tseytin to recognize an additional $7.7 million in gain (that is, $17.3 million minus $9.6 million) for no good reason. The amended return almost seems like a substitute for the boot allocation that was omitted from the merger agreement.

The amended return began by allocating the $23.1 million in cash pro rata to the two blocks of shares he had surrendered. Hence, $5.8 million was allocated to the Archer shares and $17.3 million to the original shares. The next step should have been to recognize the gain, if any, realized on the exchange of each block to the extent of the boot allocated to that block.

Instead, Tseytin calculated brand new figures for his gain and loss. But he did it as if he had received nothing but cash for his shares. This is what the Tax Court was referring to when it said that Tseytin had "ignored" the $30.8 million in stock he had received in the merger.

Tseytin concluded that he had realized a $17.3 million long-term capital gain when he exchanged his zero-basis original shares for $17.3 million in cash. But he claimed that he had suffered an $8.2 million short-term capital loss when he swapped his newly acquired Archer shares (basis: $14 million) for a mere $5.8 million in cash. Netting the alleged gain and loss figures, Tseytin reported a long-term capital gain of $9,099,320.

This calculation may seem like madness, yet there is a method in it. By calculating gain and loss solely with respect to the cash received, then netting the results, the amended return let Tseytin apply 100 percent of his basis to avoiding recognition of boot gain under section 356(a)(1). The goal, apparently, was to produce the result he would have gotten if the parties had allocated $14 million of cash to the Archer shares in the merger agreement.

What If?

But even if the merger agreement *had* allocated $14 million of cash to the Archer shares, $500,000 of this allocation would not have been "economically reasonable" for purposes of reg. section 1.356-1(b). The Archer shares were entitled to only $13.5 million of the total merger consideration (that is, 25 percent of $54 million). Hence, the maximum cash allocation to the Archer shares would have been limited to $13.5 million.

But this was all moot. The Tax Court rejected Tseytin's unorthodox calculation. It also agreed with the IRS that it warranted a penalty for disregarding rules and regulations. The Third Circuit affirmed per curiam.

Who Can Allocate?

There seems little chance that an acquisition agreement would try to allocate basis or boot when the target is a publicly traded company. In theory, a public target might try to draft allocations to benefit some influential insiders. But it is hard to imagine the securities lawyers signing off on such a plan.

The drafters of the 2006 regulations assumed that only closely held targets would press to include allocations in acquisition agreements. But you have to actually do it — and think about the share basis issues and what might happen — in advance. And many private company deals sign and close at the same time. If the target and its shareholders cannot consider allocations until after the deal is signed, it will be too late.

Russian Roulette

It is not clear what went wrong in the Russian fast food case. The transaction was not signed and closed at the same time, so that adds to the mystery. Tseytin signed the merger agreement on May 20, 2007, but the deal did not close until July 2.

That was more than a month, during which Tseytin was able to negotiate for and complete the purchase of the Archer shares. Presumably, he or his advisers *could* have drafted an amendment to the merger agreement. At that point, he was the only shareholder, so there was nobody to disagree with how he chose to allocate the $23.1 million.

Was this issue simply overlooked? Maybe. In a hectic, high-pressure M&A transaction, the target and its shareholders might not have the time or inclination to pursue allocation issues. But even in that context — in which there does not seem to be time — it might be a good idea for the tax adviser to raise the issue and to put it in writing. ■