

Changes to the Zero-Basis Problem

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Zero-basis stock problems typically occur when parent stock is used by a subsidiary or related company in a multi-step stock transfer transaction. This problem is nothing new, but there are new developments once again thrusting this issue into the forefront. On October 16, 2006, the New York State Bar Association (“NYSBA”) Tax Section submitted comments to the IRS concerning possible solutions to the problems associated with zero-basis stock. The NYSBA report was sparked by the IRS’s issuance of Rev. Rul. 2006-2, IRB 2006-2, 261, which revoked Rev. Rul. 74-503, 1974-2 CB 117, and announced that the “zero basis” conclusions set forth in the 1974 ruling are under study.

Background

The revocation of Rev. Rul. 74-503 signaled a sea change in the IRS’s longstanding position on the tax consequences of a corporation’s transfer of its own stock in a tax-free transaction. In that ruling, a parent corporation transferred its shares (which had been previously purchased from its shareholders for less than fair market value) to its subsidiary in exchange for newly issued shares of the subsidiary. The transfer of the parent stock was tax-free under Code Sec. 351.

According to the ruling, the subsidiary’s basis in the parent stock and the parent’s basis in the newly issued subsidiary stock were both zero. The IRS reasoned that when the parent and the subsidiary transfer their own stock in exchange for the other’s stock, the carryover basis rules of Code Sec. 362(a) apply. Thus, the basis of the parent’s stock received by the subsidiary was the same as it was in the hands of the parent corporation immediately prior to the exchange.

Similarly, the basis of the newly issued stock of the subsidiary received by the parent was the same as it was in the hands of the subsidiary immediately prior to the exchange. In both cases, the IRS ruled that the basis was zero.

Problems with Zero-Basis

Assigning a zero-basis to a corporation’s own stock can cause problems. When zero-basis stock is transferred in a carryover basis transaction, the result is the potential for tax on fictitious gains. Moreover, there can be inconsistent tax treatment for economically equivalent transactions.

For example, there would be no tax if a parent corporation sells its own stock under Code Sec. 1032. If, on the other hand, the parent transfers its stock to its subsidiary, such stock traditionally took a zero-basis. If the subsidiary later sells the parent’s stock, the subsidiary would realize gain for the full fair market value of the shares. Obviously, this presents serious challenges to avoid gains when structuring transactions.

Limited Relief

M&A TAX REPORT readers probably know that the Code provides limited relief to the zero-basis problem. Unfortunately, the key here is that the relief is limited. Over the years, Congress and the IRS have provided relief only for a few situations. For example, in the context of a triangular reorganization, when a subsidiary uses its parent stock to acquire a target’s stock or assets, a parent corporation is generally treated as if it had exchanged its stock for the target’s stock or assets directly, followed by a contribution of the target’s stock or assets by the parent to the subsidiary. [See Reg. §1.1032-2(b).]

Another example where the zero-basis problem has been fixed occurs where a subsidiary uses parent stock to compensate its employees for services rendered. [See Reg. §1.1032-3, *obsoleting* Rev. Rul. 80-76, 1980-1 CB 15.] The consolidated return rules used to provide relief to zero-basis problems when a member of a consolidated group disposed of the shares in the common parent. [See Reg. §1.1502-13(f)(6)(ii).] Recently,

these consolidated return rules were expanded to provide broader relief beyond just the consolidated return context. [See Reg. §1.1032-3(b).]

NYSBA Recommendations

Even though Congress and the IRS have provided limited relief to alleviate the zero-basis problem, it appears that the IRS may be ready to undertake a more thorough revamping of this area. Indeed, Rev. Rul. 2006-2 states that the zero-basis issue is under study. To assist the IRS in its study, the NYSBA has produced a zero-basis report which includes numerous recommendations. Below is a highlight of these recommendations:

1. Stock of a corporate shareholder contributed to a corporation should have a fair market value basis in the hands of the transferee (and not a zero-basis), and the basis of the shares received in exchange should also have a fair market value basis (and not a zero-basis).
2. A set of basis adjustment rules should be provided so that a sale of parent stock by a subsidiary does not give rise to a taxable gain or a deductible loss, and so that changes in the value of parent shares held by the subsidiary are not taken into account in determining gain or loss on a sale of subsidiary stock by the parent.
3. These basis adjustment rules should apply in full where the subsidiary is at least 80 percent owned by the parent, and otherwise should apply on a proportionate basis. Below some lower threshold (between 20 percent and 50

percent), the basis adjustment rules should not apply at all.

4. Stock of a corporate shareholder contributed to a partnership should have a fair market value basis in the hands of the transferee (and not a zero-basis), and the basis of the partnership interest received in exchange should also have a fair market value basis (and not a zero-basis).
5. Code Sec. 1032 should be extended so that changes in value of a partner's stock held by the partnership are not taken into account in determining gain or loss from a sale of the partner's partnership interest.
6. The rules proposed above for a fair market value basis, and for subsequent basis adjustments, should apply regardless of whether the entities involved are domestic or foreign.

Besides these six recommendations concerning stock transfers, there are analogous proposals for transfers of debt. All in all, the NYSBA report contains an excellent summary of the history of the zero-basis problem, including many examples of how it has wreaked havoc on taxpayers over the years. The NYSBA report should be required reading for anyone who wants to fully understand the history of the zero-basis problem, the patchwork of fixes made over the years, and the traps for the unwary created by this patchwork of fixes. Unfortunately, though, notwithstanding the reach and nearly universal acceptance of the NYSBA as an influential bellwether, these zero-basis fixes are at this point just proposed.