Proposed Regulations Treat Basis Adjustments Following Triangular Mergers

by Robert W. Wood • San Francisco

Proposed regulations have been published under Sections 358, 1032 and 1502 dealing with basis adjustments of a controlling corporation in subsidiary stock following a triangular reorganization in which the controlling corporation's stock is used as consideration. The proposed regs (CO-993-71) also treat the use of the controlling corporation's stock in a forward triangular merger, according disposition treatment for those shares. Proposed regulations had been published originally on January 2, 1981, and these were withdrawn by the January 1995 release. The IRS indicates that the new rules will produce tax effects similar to the now withdrawn "mechanical" regulations. The new regulations are proposed to be effective for all triangular reorganizations occurring on or after December 23, 1994.

Triangular Merger

The regulations cover only triangular reorganizations. The paradigm transaction involves a subsidiary (S) that acquires the assets or stock of a target (T) or merges into T. The T shareholders receive parent (P) stock in exchange for their T stock.

The 1981 proposed regulations had employed mechanical rules affecting basis as if P had acquired the T assets or stock directly, and then transferred the assets or stock to S. In this so-called "over-the-top" model, S would not recognize any gain or loss on its use of P stock in a forward triangular merger, or in a triangular B or C reorganization. In the new regulations, however, the IRS explained that Congress did not provide explicit statutory rules concerning various effects of triangular reorganizations. For example, Congress provides no rules regarding what adjustments (if any) may have to be made to P's basis in its S or T stock following a triangular reorganization. Likewise, there are no statutory rules indicating that S would not recognize gain on its exchange of P stock for T assets or stock in a triangular reorganization.

The new proposed regulations set forth general rules for adjusting basis, providing that P's basis in its S stock immediately after a forward triangular merger described in Section 368(a)(1)(A) and (a)(2)(D) is adjusted as if P acquired the T assets (and any liabilities assumed) directly from T in a transaction in which P's basis in the T assets was determined under Section 362(b), and then P transferred the T assets (again with liabilities) to S in a transaction in which P's basis in the S stock was adjusted under Section 358.

Mechanical vs. General?

Although the IRS acknowledges that it is changing from mechanical rules to general rules, the new proposed regulations are meant to produce effects that are similar to the 1981 proposed rules. The Service acknowledges that there will be limited differences, but the effect is to be generally the same. The Service also noted that the so-called "over-the-top" model is not intended to impute a transfer of T assets or stock from P to S for any purpose of the Code except the determination of P's basis in its S or T stock. ■