Report No. 1316

**NEW YORK STATE BAR ASSOCIATION**

**TAX SECTION**

# REPORT ON PROPOSED REGULATIONS REGARDING ALLOCATION OF CONSIDERATION AND ALLOCATION AND RECOVERY OF BASIS IN TRANSACTIONS INVOLVING CORPORATE STOCK OR SECURITIES

**February 6, 2015**

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## I. Introduction

This report ("Report") of the New York State Bar Association Tax Section (the "Tax Section") comments on proposed regulations regarding the allocation of consideration and the allocation and recovery of basis issued by the Internal Revenue Service (the "IRS") and Treasury Department ("Treasury") that were published on January 21, 2009 (the "Proposed Regulations").[2]

The Proposed Regulations clarify and attempt to rationalize the determination of gain or loss and basis and the recovery of basis in certain transactions involving corporate stock and securities.[3] They provide a single model for the recovery of stock basis in distributions under Section 301 and other transactions that are deemed to be or are equivalent to distributions under Section 301. The Proposed Regulations also

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[1] The principal drafters of this Report were Gordon Warnke and Steven Harrison. Significant contributions were made by Michael Knobler, Michelle Lo, Michael Schler, David Schnabel and Karen Gilbreath Sowell. Helpful comments were received from John Barrie, Linda Beale, Neal Barr, Kim Blanchard, Peter Canellos, Robert Cassanos, William Cavanagh, Larry Garrett, John Hart, Stephen Land, Michael Kliegman, Erika Nijenhuis, Debbie Paul, Revital Bar Or, Jodi Schwartz, Eric Solomon and Linda Swartz. This report reflects solely the views of the Tax Section of the New York State Bar Association ("NYSBA") and not those of the NYSBA Executive Committee or the House of Delegates.

[2] REG-143686-07, 74 Fed. Reg. 3509 (Jan. 21, 2009). The Proposed Regulations have been subject to some corrections not relevant to the substance of this Report. See Announcement 2009-40, 2009-1 C.B. 1023; 74 Fed. Reg. 9575 (Mar. 5, 2009). Except as otherwise noted, all "Section" and "§" references in this Report are to sections of the Internal Revenue Code of 1986, as amended (the "Code"), references to "Regulations" or "Reg." are to the Treasury Regulations promulgated thereunder, and references to "Prop. Reg." are to proposed Treasury Regulations. Throughout this Report, unless otherwise noted, the terms "stock" and "securities" are used as in Regulations Section 1.358-2(a)(1) and Proposed Regulations Section 1.358-2(a)(2) to indicate stock and securities that are nonrecognition property under the relevant provisions of Sections 351, 356 and 361 and the term "boot" means property other than nonrecognition property.

[3] Although the Proposed Regulations provide rules with respect to both stock and securities, this Report focuses on the rules in the Proposed Regulations applicable to stock.

provide rules addressing the determination of gain or loss, and the basis of stock or securities received, in reorganizations, Section 351 and Section 355 transactions and capital contributions that are more specific and consistent than current law. The foregoing areas are currently the subject of incomplete and, in certain cases, inconsistent authorities,[4] and the establishment of a comprehensive set of rules informed by unifying principles to be applied consistently in transactions involving corporate stock is a laudable goal.

Since the issuance of the Proposed Regulations, we have had the benefit of a substantial period of time to consider how the interrelated proposals in the Proposed Regulations would apply in a variety of common situations. In general, we believe the Proposed Regulations are a significant improvement over existing law, as existing legal authorities have left many questions unanswered and answered other questions in ways that gave rise to inconsistent treatment of similar transactions. Treasury and the IRS are to be commended for the thoroughness and thoughtfulness of the Proposed Regulations and for their continuing commitment (including through inclusion of this topic on their

[4] The Proposed Regulations address issues that have been the subject of other Regulations and Tax Section Reports, as well as issues that have not been the subject of either other Regulations or Tax Section Reports. For example, the Proposed Regulations address basis recovery in redemptions to which Section 302(d) applies as well as basis determination under Section 358. Basis recovery in redemptions to which Section 302(d) applies was also addressed in proposed Regulations issued in 2002. REG-150313-01, 67 Fed. Reg. 64331 (Oct. 18, 2002) (the "2002 Proposed Regulations"). The 2002 Proposed Regulations were withdrawn in 2006. Announcement 2006-30, 2006-1 C.B. 879. A report of the Tax Section discussed basis recovery in redemptions to which Section 302(d) applies, including the approach adopted in the withdrawn 2002 Proposed Regulations. See New York State Bar Association Tax Section, Report on Basis Recovery in a Dividend Equivalent Redemption (Report No. 1112, June 13, 2006) (the "Section 302 Report"). The IRS and Treasury also issued proposed Regulations in 2004 that addressed primarily the determination under Section 358 of the basis of stock and securities received in reorganizations and Section 355 transactions. See REG-116564-03, 69 Fed. Reg. 24107 (May 3, 2004) (the "2004 Proposed Regulations"). Regulations on such determination were issued in final form in 2006. See T.D. 9244, 2006-1 C.B. 463 (the "2006 Final Regulations"). Each of the 2004 Proposed Regulations and the 2006 Final Regulations was the subject of a separate report of the Tax Section. See New York State Bar Association Tax Section, Report on Final Regulations Regarding Allocation of Basis Under Section 358 and Related Matters (Report No. 1137, Dec. 13, 2007) (the "Second Section 358 Report"); New York State Bar Association Tax Section, Report on Proposed Regulations Regarding Allocation of Basis Under Section 358 (Report No. 1088, May 27, 2005) (the "First Section 358 Report").

current business plan) to developing consistent approaches to transactions in corporate stock. This Report discusses some of the principles underlying the Proposed Regulations and proposes some alternative approaches for the IRS and Treasury to consider as they refine the guidance on transactions involving corporate stock and securities. Given the scope of the Proposed Regulations and the significance of identifying the correct model for stock transactions, this Report does not seek to address specific technical issues raised by the Proposed Regulations. Instead, it considers the conceptual choices underlying the Proposed Regulations and suggests changes that may cause certain provisions to be more consistent with the economics of a transaction or with another provision. To facilitate the conceptual approach of the Report, it focuses on non-consolidated, domestic subchapter C corporations. Considerations specific to foreign corporations, consolidated groups and subchapter S corporations generally are not discussed. This Report also suggests certain exceptions, modifications and alternative approaches designed to make the regime described in the Proposed Regulations easier to administer.

Many of the issues in the Proposed Regulations discussed in this Report arise from choices made in prior regulations, including tracing basis[5] and respecting designations of consideration among shares so long as such designations are economically reasonable. These choices generally are not revisited in this Report. We

[5] In this Report, the terms "tracing" and "traced basis" are used to describe the carrying over of the separate basis of surrendered assets (be they shares of stock, securities or other assets) to specific shares of stock or, in cases where securities can be received without triggering recognition, securities received in exchange for or with respect to the surrendered assets. The terms "averaging" and "averaged basis" are used to describe the combining and commingling of the separate bases in surrendered assets and subsequent allocation of that combined and commingled basis among shares of stock or, in cases where securities can be received without triggering recognition, securities received in proportion to their respective fair market values. The terms "segmenting" and "segmented basis" are used to describe the treatment of a proportionate amount of the separate basis of each surrendered asset as carried over to a portion of each share of stock or, where securities can be received without triggering recognition, each security received in exchange for or with respect to such asset, so that a proportionate amount of the basis (and holding period) of the asset survives as an attribute of a portion of each such share or security.

note, however, that a significant amount of the administrative complexity of the Proposed Regulations and of certain of the recommendations made in this Report, as well as in some cases under current law, stems from the selection of tracing and per-share basis recovery as the basic basis paradigm.[6]

Although we generally support tracing as the basic basis paradigm, we believe that there are circumstances in which deviations from tracing and from per-share basis recovery may be appropriate for at least certain transactions or shareholders even though tracing may be more appropriate for other transactions or shareholders. One's view on this issue may vary depending on what objectives one believes are paramount, be they facilitating broker reporting, minimizing administrative complexity, strictly adhering

[6] Several proposals have been put forth over the years that would adopt averaging rather than tracing as the basic basis paradigm in at least certain circumstances. To date, none of those proposals have been adopted.

The Obama Administration's fiscal year 2016 revenue proposal (the "Obama Proposal") requires the use of basis averaging for all identical shares of portfolio stock held by a taxpayer that have a long-term holding period, whether held in different accounts with the same broker or with different brokers. DEPT. OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2016 REVENUE PROPOSALS 162 (Feb.. 2015). Shares held in a nontaxable account, such as an IRA, would not be subject to the requirement to use average basis. The Obama Proposal would grant the Treasury Secretary the authority to promulgate regulations requiring the use of average basis for stock other than portfolio stock. A similar proposal providing for use of average basis for substantially identical securities was made under the Clinton Administration (the "Clinton Proposal"). See STAFF OF J. COMM. ON TAXATION, DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 1997 BUDGET PROPOSAL, JCS-2-96, at 59 (Comm. Print Mar. 27, 1996); STAFF OF J. COMM. ON TAXATION, DESCRIPTION AND ANALYSIS OF CERTAIN REVENUE-RAISING PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 1998 BUDGET PROPOSAL, JCS-10-97, at 19 (Comm. Print Apr. 16, 1997). The Clinton Proposal was never adopted. For a further discussion of the Clinton Proposal, see Gordon E. Warnke, Developments, Theories and Themes in Stock Basis, 86 TAXES 85, 91 (Mar. 2008) (the "Warnke Article").

The discussion draft of potential legislation released by the U.S. House Ways and Means Committee on February 21, 2014 does not require basis averaging, but rather provides that the basis of specified stock generally will be determined under a "first-in first-out" (FIFO) method. See MAJORITY STAFF OF H. COMM. ON WAYS & MEANS, TAX REFORM ACT OF 2014 DISCUSSION DRAFT SECTION-BY-SECTION SUMMARY 101 (2014). However, the prior discussion draft of potential legislation released by the U.S. House Ways and Means Committee on January 23, 2013 would have required the use of basis averaging for shares of a specified security that are held in the same account. See MAJORITY STAFF OF H. COMM. ON WAYS & MEANS, TECHNICAL EXPLANATION OF THE WAYS AND MEANS COMMITTEE DISCUSSION DRAFT PROVISIONS TO REFORM THE TAXATION OF FINANCIAL INSTRUMENTS 21 (Jan. 24, 2013).

to a single share being the basic unit of property in corporate transactions, or other. This issue is discussed in greater detail in certain sections of Part IV of this Report.

Lastly, we note that the Proposed Regulations do not address earnings and profits, the relationship, if any, between earnings and profits and basis, or the relevance of earnings and profits in determining the appropriate basis recovery regime. In general, this Report does not address earnings and profits either, although earnings and profits is discussed in certain sections in Part IV of this Report where it is of particular relevance to the issue being addressed.

Part II of this Report summarizes our recommendations (in the order such recommendations are discussed in Part IV of the Report). Part III provides a general overview of prior law, the 2006 Final Regulations and the Proposed Regulations. Part IV discusses our comments and recommendations with respect to the Proposed Regulations in greater detail. Finally, Part V briefly considers some other matters related to the Proposed Regulations.

## II. Summary of Recommendations

Provide for averaged basis within individual shares. We recommend that final regulations clarify that a share of stock of a transferee corporation received in a Section 351 transaction in exchange for assets with differing bases has an averaged basis, rather than a segmented basis. We also recommend that the bases of individual shares be averaged rather than segmented in reorganizations, Section 355 transactions and any other transactions addressed by the Proposed Regulations. Exceptions might apply to the extent necessary to track differing holding periods or to address any other overriding policy considerations.

Provide exceptions to the deemed issuance and recapitalization approach. In the interest of administrability, we recommend two exceptions to the deemed issuance and recapitalization approach that the Proposed Regulations would extend to capital contributions. One exception would apply to contributions of property having a de minimis value in relation to the pre-contribution value of the stock in the recipient corporation. The other would apply to contributions of property with respect to which there is no more than a de minimis disparity between basis and fair market value. If either exception applied, the basis of the contributed property generally would be added to, and averaged with, the basis of existing shares. We also recommend the extension of such exceptions to certain other stockless transactions[7] and also potentially to certain transactions in which stock is issued.

Adopt aggregate basis recovery under Section 301(c)(2) in some situations. We recommend that an aggregate approach to basis recovery under Section 301(c)(2) be adopted in some situations. Under this approach, all basis of a shareholder in all shares with respect to which a distribution is made would be recovered before any gain is recognized. However, we believe that it would be appropriate to adopt the per-share approach (taken in the Proposed Regulations with respect to all Section 301 distributions) for small holders of stock in public companies if it were felt important to facilitate broker reporting. We note, moreover, that such holders could be viewed as raising somewhat different policy considerations. Under this approach, distributions would be treated as made ratably with respect to each share in the class with respect to which the distribution is made and basis would be recovered share by share.

[7] The term "stockless transaction" refers to an exchange or transfer in which a taxpayer is treated as receiving stock, at least for some purposes, even though the taxpayer in form receives no additional shares or shares having a value less than that of the property surrendered.

Consider alternative approaches to dividend-equivalent redemptions.[8] We recommend that, in a dividend-equivalent redemption, consideration be given to adopting a "dividend controlling shares" approach or a "bifurcated distribution" approach rather than the "redeemed class" approach adopted by the Proposed Regulations. These three approaches are explored, along with some related concerns and other alternatives, in Part IV.C of this Report.

Consider providing for ratable recovery of losses deferred under Section 302. Where a dividend-equivalent redemption gives rise to a deferred loss as a result of other shares owned by or attributed to the taxpayer, we recommend that consideration be given to providing for such loss to be taken into account ratably as the shares that gave rise to the deferral cease to be owned by or attributed to the taxpayer.

Disregard certain shares sold or otherwise disposed of in connection with certain redemptions. If, pursuant to a plan, some shares are redeemed and other shares to which the basis in the redeemed shares would otherwise have shifted are sold, we recommend the adoption of a rule under which the sold shares would be disregarded for purposes of determining the basis consequences of the redemption, with the result that the unrecovered basis in the redeemed shares would remain fully reflected in retained shares or, if there were no such retained shares, would result in a deferred loss.

Provide for pro rata allocation of consideration within classes in all reorganizations. We recommend that consideration received in exchange for any class of stock or securities surrendered in a reorganization be allocated pro rata to each

8 Throughout this Report, the term "dividend-equivalent redemption" is used to describe a redemption to which Section 302(d) apples; "dividend-equivalent reorganization" is used to describe a reorganization exchange that, as regards a particular shareholder, "has the effect of the distribution of a dividend" within the meaning of Section 356(a)(2); and "dividend-equivalent Section 304 transaction" is used to describe a transaction to which Section 304 applies in which the transferor is treated as receiving a distribution to which Section 301 applies.

surrendered share or security of such class, even if the exchange is not dividend equivalent.

<u>Consider treating certain dividend-equivalent reorganizations as two-step exchanges.</u> For purposes of determining basis consequences, we recommend that if shares exchanged solely for boot in a dividend-equivalent reorganization are treated as outside the scope of Section 356, then consideration be given to treating a reorganization as a two-step transaction in which (i) each class of shares surrendered solely for boot in the exchange is exchanged for a class of stock of the acquiring corporation having the same characteristics as the surrendered class, and (ii) the deemed-issued shares are then redeemed by the acquiring corporation for the consideration actually received by the surrendering shareholder. We also recommend that if the foregoing two-step construct is not adopted, further guidance be provided regarding the basis and loss consequences resulting from treating shares for which solely boot is received in a dividend-equivalent reorganization as being governed by Section 302(d). Lastly, we recommend that guidance be provided as to which corporation's earnings and profits are relevant for purposes of determining dividend, basis recovery and gain consequences in a reorganization with respect to shares governed by Section 302(d).

<u>Treat dividend-equivalent Section 304 transactions as involving an issuance and redemption of common shares by the acquiring corporation.</u> On balance, we agree with the approach taken in the Proposed Regulations of treating a dividend-equivalent Section 304 transaction as involving an issuance and redemption of common shares by the acquiring corporation. As noted in our discussion in Part IV.E of this Report, however, this choice of common shares has implications for choices made in the dividend-equivalent redemption and dividend-equivalent reorganization contexts.

If aggregate basis recovery is not adopted, explore basis averaging for certain shareholders. If aggregate basis recovery is not adopted for Section 301 distributions, a minority of the Executive Committee recommends considering the adoption of a basis averaging regime for certain shareholders. Considerations relating to the adoption of a basis averaging regime are discussed in Part IV.F of this Report.

## III. Background

The provisions of the Code that govern transactions in, or with respect to, corporate stock or securities can have different consequences depending on whether they are applied on a share-by-share (or security-by-security), class-by-class, transaction-by-transaction or shareholder-by-shareholder (or security-holder-by-security-holder) basis. The Code often provides no guidance as to which approach is to be followed. As a result, the issue has been addressed in some cases by Regulations, but most often by rulings and cases that consider only specific transactions. Because the law has developed case-by-case, no single model is consistently used in determining the amount of gain recognized in exchanges of and distributions with respect to corporate stock or the basis of individual shares or securities held after such a transaction. The Proposed Regulations have as their primary objective establishing consistent models for economically similar transactions.[9]

### A. Prior and Current Law

To appreciate the proposals discussed in this Report and the choices made in the Proposed Regulations, it is helpful to understand both certain aspects of prior law and the current state of the law. The following is a brief overview of the prior and

[9] See preamble to the Proposed Regulations, supra note 2.

current law that is most relevant to the aspects of the Proposed Regulations addressed in this Report and our recommendations.[10]

### 1. Dividends and Dividend-Equivalent Transactions

#### a. Aggregate versus Per-Share Basis Recovery in Distributions

If a shareholder receives a taxable distribution of property with respect to stock without surrendering any stock, the tax consequences of the distribution are generally determined under Section 301. Under Section 301(c)(1), the distribution is treated as a dividend to the extent paid from the distributing corporation's current or accumulated earnings and profits (collectively, "earnings and profits"). Under Section 301(c)(2), distributions not made from earnings and profits are "applied against and reduce the adjusted basis of the stock." To the extent such distributions exceed the adjusted basis of the stock, such excess is treated under Section 301(c)(3) as gain from the sale or exchange of property. It is not clear from the statute whether "the stock" referred to in Section 301(c)(2) is all of the stock of the issuer[11] held by the recipient of the distribution (an aggregate approach) or the share of stock with respect to which the distribution was made (a per-share approach). Under existing case law, however, to the extent the issue has been addressed, a per-share approach has been applied.[12]

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[10] A fuller discussion of some of the law summarized here can be found in the First Section 358 Report, supra note 4, the Second Section 358 Report, supra note 4, the Section 302 Report, supra note 4, and Warnke Article, supra note 6.

[11] For ease of discussion in this Report, unless otherwise noted, it is assumed that the issuer has only one class of stock outstanding. Where more than one class of stock is outstanding, the issues become more complex.

[12] The leading case in this regard is Johnson v. United States, 435 F.2d 1257 (4th Cir. 1971), in which the Fourth Circuit concluded that a distribution made with respect to a class of stock is treated as being made pro rata with respect to each share within such class and that, once the portion of a distribution allocable to one share exhausts the basis of that share, the recipient may recognize gain without regard to the amount of basis remaining in the recipient's other shares.

### b. Basis Recovery in Dividend-Equivalent Redemptions

#### *(i) Exchanges versus Dividend-Equivalent Redemptions*

A taxable redemption by a corporation of its own stock may be treated under Section 302 as either an exchange or a distribution. Whether a redemption represents a sufficient reduction in a shareholder's interest in a corporation, or in the business of the corporation, to warrant exchange treatment is determined under the four tests set forth in Section 302(b).[13] If a redemption meets one of the tests, it is treated as a distribution in partial or full payment in exchange for that stock, and the shareholder receiving the distribution recovers its basis in the same manner as in other sales or exchanges. A redemption that does not satisfy any of the tests in Section 302(b) is treated "as a distribution of property to which Section 301 applies" under Section 302(d) (a dividend-equivalent redemption).

#### *(ii) Dividend-Equivalent Redemptions Generally*

The Code leaves unanswered at least two significant questions regarding the tax treatment of dividend-equivalent redemptions. The first question arises from the fictional distribution that is deemed to occur under Section 302(d). Because the Code does not describe this distribution, it is not clear what shares are treated as participating in the distribution. As a result, to the extent the distribution is in excess of earnings and profits, it is not clear under current law what shares are relevant for purposes of recovering basis under Section 301(c)(2) and recognizing gain under Section 301(c)(3).

[13] Those tests are whether the distribution is: essentially equivalent to a dividend, substantially disproportionate with respect to the shareholder, in complete redemption of all of the stock of the corporation owned by the shareholder, or both in redemption of stock held by a non-corporate shareholder and in partial liquidation of the distributing corporation. § 302(b)(1)-(4).

The distribution may be treated as made with respect to the retained shares, the redeemed shares or all shares.[14]

The second question is raised by the disregarding of the actual surrender of shares under Section 302(d). The Code does not address how or whether the redeemed shareholder may recover its remaining basis in the shares that in form are surrendered. Regulations address this question to some extent. Regulations Section 1.302-2(c) provides that, in a dividend-equivalent redemption, "proper adjustment of the basis of the remaining stock will be made with respect to the stock redeemed." Thus, under current law, the basis of a share surrendered in a dividend-equivalent redemption generally is to be reflected in the basis of other shares held by the redeemed shareholder.

*(iii) Basis Shifting*

A shareholder may surrender all of its shares in a corporation in a redemption and still be treated as receiving a dividend under Section 302(d) as a result of a continuing interest in the corporation that the shareholder is deemed to maintain through shares attributed to the shareholder. An example in the Regulations illustrates that, under current law, the basis in shares held by a related party may be increased under Regulations Section 1.302-2(c) to reflect unrecovered basis in the redeemed shares.[15] The IRS and Treasury have been concerned that basis shifting between different taxpayers may be used to reduce taxes inappropriately (for example, by shifting basis from a person that is not subject to U.S. federal income taxation to one that is).[16] Preventing such abuse was one aim of the withdrawn 2002 Proposed Regulations. Those regulations proposed

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14 See generally Section 302 Report, supra note 4.

15 See Reg. § 1.302-2(c) ex. 2.

16 See, e.g., Notice 2001-45, 2001-2 C.B. 129.

to repeal Regulations Section 1.302-2(c) and replace it with a deferred loss regime. Specifically, under the withdrawn 2002 Proposed Regulations, the unrecovered basis of shares redeemed in a dividend-equivalent redemption would not shift to any other shares or property, regardless of whether shares of the same issuer and class were held by the shareholder or only attributed to such shareholder. Instead, the unrecovered basis would become a deferred loss taken into account on any "accelerated loss inclusion date" and/or the "final inclusion date." An accelerated loss inclusion date was a date on which the shareholder recognized gain with respect to the stock of the issuing corporation; in such case, the shareholder would be permitted to offset the gain by taking into account a corresponding amount of the deferred loss. The final inclusion date generally was the date on which the shareholder reduced its actual and constructive ownership interest in the issuing corporation to a level that would have satisfied one of the first three tests of Section 302(b) immediately after the redemption. A final inclusion date would also occur if there was no later date upon which the loss could be taken into account, such as the death of an individual taxpayer or certain liquidating or other transactions involving taxpayers that were entities. In May 2006, the IRS and Treasury withdrew the 2002 Proposed Regulations and announced that they were continuing to study basis shifting in the context of dividend-equivalent redemptions.[17]

#### c. Dividend-Equivalent Reorganizations

The nonrecognition treatment that generally applies to taxpayers exchanging shares in a reorganization generally does not apply to the extent that such shares are exchanged for boot. A shareholder generally recognizes any realized gain, but

[17] Announcement 2006-30, 2006-1 C.B. 879.

not loss, up to the amount of boot that the shareholder receives.[18] Under Section 356(a)(2), if the payment of boot in a reorganization exchange "has the effect of the distribution of a dividend" (a dividend-equivalent reorganization), a recipient is treated as receiving a dividend equal to the lesser of its recognized gain or its ratable share of the "undistributed earnings and profits of the corporation accumulated after February 28, 1913." Any gain not treated as a dividend is treated as gain from a sale or exchange of property.[19]

Several aspects of Section 356(a)(2) have been the subject of controversy. Under current law, it is fairly settled that the rules of Section 302(b) apply in testing the dividend-equivalence of a reorganization exchange. Moreover, under Clark v. Commissioner,[20] it appears to be settled that, in applying such tests, one looks to the position of the shareholder after the exchange to see if it represents a sufficient reduction in interest compared to the position that the shareholder would have been in if the exchange had been solely for stock. Clark, however, concerned a reorganization in which only a single class of stock was exchanged. The scope of the exchange to be tested when multiple classes of stock are exchanged is not clear from Clark.

Other areas of controversy with respect to Section 356(a)(2) include which corporation's earnings and profits are relevant for determining the amount of recognized gain treated as a dividend in a dividend-equivalent reorganization,[21] whether Section

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[18] § 356(a)(1).

[19] § 356(a)(2).

[20] 489 U.S. 726 (1989).

[21] This topic is discussed briefly in Part IV.D.4. Several legislative proposals have been put forth in recent years that would look to the earnings and profits of both the target corporation and the acquiring corporation in certain circumstances. See American Jobs and Closing Tax Loopholes Act of 2010, H.R. 4213, § 422 (2010) (the "House Bill") (specifying that, in the case of an acquisitive reorganization under Section 368(a)(1)(D) (and any other reorganization specified by the Secretary of

356(a)(2) should be modified so that the amount treated as a dividend in a dividend-equivalent reorganization is not limited by the amount of gain recognized[22] and what happens to unrecovered basis in loss shares to which Section 356(a)(2) applies when solely boot is received for such shares.[23]

#### d. Dividend-Equivalent Section 304 Transactions

A dividend-equivalent transaction may also occur under Section 304. Section 304(a)(1) applies to a transaction in which two corporations are under common control and one corporation (the acquiring corporation) acquires stock in the other corporation (the issuing corporation) from the person or persons that control the corporations (the transferor) in return for property.[24] Under Section 304(a)(1), the transferor is treated as if it received the property as a distribution in redemption of stock of the acquiring corporation. To the extent that this deemed redemption distribution is governed by Section 301, the transaction is treated as if the transferor transferred stock of

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the Treasury), the amount treated as a dividend would be determined by taking into account the earnings and profits of each corporation which is a party to the reorganization); International Tax Competitiveness Act of 2013, H.R. 1555, 113th Cong. § 4 (2013) (same).

[22] Numerous proposals have been put forth in recent years that would eliminate the gain limitation on dividends received in reorganization exchanges. See, e.g., DEPT. OF THE TREASURY, *supra* note 6, at 119-21 (similar proposals to repeal gain limitation were included in the administration's revenue proposals for fiscal years 2010, 2011, 2012, 2013, 2014 and 2015); STAFF OF J. COMM. ON TAXATION, DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2013 BUDGET PROPOSAL, JCS-2-12, at 525-537 (Comm. Print June 18, 2012) (similar proposals to repeal gain limitation were included in the President's budget proposals for fiscal years 2010, 2011 and 2012) (collectively, the "Section 356 Proposals"); International Tax Competitiveness Act of 2013, H.R. 1555, 113th Cong. § 4 (2013) (repealing the limitation); House Bill, supra note 21 (same). Resolution of this controversy would require legislative change and is beyond the scope of this Report.

[23] This last question can arise in both dividend-equivalent and non-dividend-equivalent reorganizations and is discussed further in Part IV.D.4, below. For an excellent and exhaustive discussion of the issues involved with respect to Section 356 under current law and proposals for change, see Michael L. Schler, Rebooting Section 356: Part 1 — The Statute, 128 TAX NOTES 285 (July 19, 2010) and Michael L. Schler, Rebooting Section 356: Part 2 — The Regulations, 128 TAX NOTES 379 (July 20, 2010) (the "Second Schler Article").

[24] The discussion of Section 304 in this Report focuses on transactions governed by Section 304(a)(1), not those subject to Section 304(a)(2), because such latter transactions do not involve a deemed issuance of stock and therefore do not implicate the same issues.

the issuing corporation to the acquiring corporation in exchange for stock of the acquiring corporation in a Section 351(a) exchange and the acquiring corporation redeemed these deemed-issued shares. Even though the fictional redemption is of stock of the acquiring corporation, Section 304(b)(1) provides that the Section 302(b) tests are applied in a Section 304 transaction by reference to the stock of the issuing corporation. Moreover, the earnings and profits of both corporations generally are available, although one first looks to the earnings and profits of the acquiring corporation. Under current law, it is not clear what class of stock in the acquiring corporation is deemed issued in the hypothetical issuance in a Section 304 transaction.

### 2. Reorganizations and Section 351 Exchanges

#### a. Allocation of Consideration

In both reorganizations and Section 351 exchanges,[25] realized losses generally are not recognized and realized gains generally are recognized up to the amount of cash and other boot received.[26] In both transactions, the amount of gain realized and recognized generally is determined separately for each share, security and asset surrendered.[27] Therefore, to determine the amount of gain recognized, it is necessary first to determine what consideration is received for each share, security and asset. The rules for allocating consideration in reorganizations and Section 351 transactions are described below.

In the case of a reorganization, the 2006 Final Regulations provide that if economically reasonable terms of an exchange specify that boot or a particular class of

[25] Section 355 transactions involve special considerations, and unless otherwise noted, our recommendations do not apply to them.

[26] See §§ 351(a) and (b), 354(a), 356.

[27] See Rev. Rul. 68-55, 1968-1 C.B. 140; Rev. Rul. 68-23, 1968-1 C.B. 144.

stock or security is received in exchange for or with respect to a particular share of stock or security or a particular class of stock or securities, then such terms shall control for purposes of determining gain and basis.[28] Where the transaction terms do not specify an allocation, each element of the consideration received is allocated pro rata to the shares of stock and securities surrendered according to their fair market values.[29]

In the case of a Section 351 exchange, if a transferor transfers multiple assets to a transferee, the view of the IRS is that the tax consequences to the shareholder are determined by treating each asset as transferred in exchange for a portion of each type of consideration received by the transferor.[30] Revenue Ruling 68-55 requires pro rata allocation for purposes of determining gain and provides that each category of consideration received by the transferor is allocated ratably to the assets that such transferor transfers, in proportion to their fair market value. Revenue Ruling 85-164 is particularly concerned with allocation for purposes of determining basis (gain recognition was not at issue because no boot was received) but clarifies that pro rata allocation applies notwithstanding a contrary contractual allocation.

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[28] Reg. §§ 1.356-1(b), 1.358-2(a)(2)(ii) and (v).

[29] Id.

[30] See Rev. Rul. 85-164, 1985-2 C.B. 117; Rev. Rul. 68-55, 1968-1 C.B. 140. We do not address the supportability of this view in this Report, either as a matter of policy or as an interpretation of current law. Rather we assume this view is applied and address the basis issues that arise from its application. We note, however, that there are at least some authorities that have permitted designated, rather than proportional, allocations of consideration in Section 351 transactions in certain circumstances. See, e.g., Brown v. Comm'r, 27 T.C. 27 (1956), acq. 1957-2 C.B. 4 (respecting a transfer by a partnership to a controlled corporation of certain assets in exchange for stock and other assets in exchange for an installment note). We also note that requiring proportional allocation of consideration in a Section 351 transaction might be viewed as at odds with permitting designated allocations of consideration among (or, under current law, within) classes of shares in a reorganization, although we realize that different policy considerations may apply to Section 351 transactions than to reorganizations. For a discussion of designated allocations of consideration within a class of shares in a reorganization, see Part IV.D.1 of this Report. For a further discussion of Brown v. Commissioner and other designated allocation authorities, primarily in the partnership context, see Monte Jackel & Suzanne Walsh, Disguised Sales Revisited, 114 TAX NOTES 179, 181-84 (Jan. 17, 2007).

### b. Basis Tracing

Under Section 358, a taxpayer's aggregate basis in stock or securities permitted to be received without the recognition of gain or loss under Section 351, 354, 355, 356 or 361 is, in general, the same as the taxpayer's basis in the property exchanged therefor, decreased by the amount of any cash and the fair market value of any boot received by the taxpayer in the exchange, and decreased by any loss or increased by any gain or dividend income recognized by the taxpayer in the exchange.[31] In exchanges and distributions under Section 355, the allocation must take into account the nonrecognition property received and any stock or securities of the distributing corporation retained.[32]

Prior to the 2004 Proposed Regulations, it was not clear how the aggregate basis described above was allocated among the shares or securities received or held after a reorganization or Section 355 transaction. The question of whether a shareholder's basis in stock received in a reorganization was averaged or traced was the subject of seemingly inconsistent case law.[33] Regulations issued under Section 358 in 1955 provided some general guidelines for allocating basis but did not provide any specific guidance regarding allocation among blocks of stock of the same class.[34] The 2004

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31 § 358(a)(1).

32 § 358(b)(2).

33 Some cases applied an averaging approach. See, e.g., Arrott v. Comm'r, 136 F.2d 449 (3d Cir. 1943); Comm'r v. Bolender, 82 F.2d 591 (7th Cir. 1936); Comm'r v. Von Gunten, 76 F.2d 670 (6th Cir. 1935); Helvering v. Stifel, 75 F.2d 583 (4th Cir. 1935). Others applied a tracing approach. See, e.g., Bloch v. Comm'r, 148 F.2d 452 (9th Cir. 1945); Kraus v. Comm'r, 88 F.2d 616 (2d Cir. 1937); Osrow v. Comm'r, 49 T.C. 333 (1968).

34 See T.D. 6152, 1955-2 C.B. 61. These regulations generally provided that upon the exchange of a single class of stock or securities for a combination of stock and securities, or multiple classes of stock or securities, basis was allocated to each class of property held after the transaction in accordance with fair market value. Where both stock and securities, or multiple classes of stock or securities, were held before the transaction, the taxpayer had to determine which property was exchanged for which consideration based on all of the facts and circumstances and then allocate basis based on fair market value from the property surrendered to the property received. The only rule that addressed specific shares within a class pertained to recapitalizations under Section 368(a)(1)(E) and provided that the

Proposed Regulations and the 2006 Final Regulations established a tracing regime, based on the conclusion of the IRS and Treasury that a reorganization did not justify averaging of the bases of separate shares of stock.[35]

Therefore, under current law, a tracing regime exists for reorganizations, in which the basis of each share of stock or security surrendered in a reorganization or split-off is traced to the specific shares or securities, or portions of shares or securities, received therefor.[36] Similarly, the basis of each share or security of a distributing corporation in a spin-off is allocated between that share or security and the specific share or security received with respect thereto.[37] Special rules provide for the allocation of basis from a number of surrendered shares or securities to a larger or smaller number of shares or securities received in exchange therefor or with respect thereto.[38] If one share or security is received in exchange for multiple shares or securities, the 2006 Final Regulations require the received share to reflect to the extent possible the basis of surrendered shares that were acquired on the same date and for the same price and provide a rule for matching shares so as to minimize holding-period disparities when this

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basis of a retained share of the class surrendered in the recapitalization remained unchanged and was not taken into account in determining the basis of the stock or securities received.

35 The adoption of a tracing regime in the 2004 Proposed Regulations and 2006 Final Regulations also appears to have been influenced at least in part by a desire to facilitate determination of basis held in different accounts. See preamble to the 2006 Final Regulations, supra note 4 (rejecting a modified averaging approach for certain Section 355 transactions because it would be "inadministrable, especially in cases in which a shareholder holds stock of the distributing corporation in multiple accounts"). But see the Obama Proposal, supra note 6, which would require the use of basis averaging for all identical shares of portfolio stock held by a taxpayer that have a long-term holding period, whether held in different accounts with the same broker or with different brokers; see also the final broker basis reporting regulations, T.D. 9504, 2010-2 C.B. 670, permitting elective basis averaging (including across accounts) in certain circumstances for shares in regulated investment companies ("RICs") and shares held in dividend reinvestment plans ("DRPs"). Reg. § 1.1012-1(e)(1), -1(e)(11).

36 Reg. § 1.358-2(a)(2)(i) and (ii).

37 Reg. § 1.358-2(a)(2)(iv) and (v).

38 Reg. § 1.358-2(a)(2)(i) and (iv).

is not possible.[39] A more thorough discussion of the tracing regime can be found in the First Section 358 Report and the Second Section 358 Report.

In the case of a Section 351 transaction, as described above, Revenue Ruling 68-55 and Revenue Ruling 85-164 require the pro rata allocation of each element of the consideration received by the transferor to the properties transferred. The 2004 Proposed Regulations and 2006 Final Regulations change these rules, adopting a tracing regime for Section 351 transactions, but only where (i) the exchange is also described in Section 354 or 356, (ii) the shareholder receives no stock or securities in an exchange to which neither Section 354 nor 356 applies in connection with the exchange, and (iii) no liabilities of the taxpayer are assumed in the exchange.[40] Final regulations issued under Section 362(e)(2) in 2013 add as a further condition to tracing in a Section 351 transaction that no election be made under Sections 362(e)(2)(C) with respect to the transaction.[41] Accordingly, for most Section 351 transactions, the pro rata allocation rules of Revenue Ruling 68-55 and Revenue Ruling 85-164 continue to apply.

**c. Segmenting**

Where a share of stock is received in exchange for two or more properties, or allocable portions of two or more properties, the aggregate basis of the share will be the sum of the bases of such properties or allocable portions (after giving effect to

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[39] Id.

[40] Reg. § 1.358-2(a)(2)(viii).

[41] See T.D. 9633, 2013-2 C.B. 227. Although beyond the scope of this Report, it is unclear why it was felt necessary to preserve averaging in a Section 351 transaction with respect to which tracing would otherwise apply where an election under Section 362(e)(2)(C) is made. Such an election permits a transferor in a "loss duplication" Section 351 transaction to reduce the basis in the stock of the transferee corporation received by the transferor by the amount of duplicated loss rather than having the transferee reduce its basis in the transferred assets. Evidently, as a policy matter, it was felt that permitting taxpayer selectivity by continuing to have basis blocks in the shares received in the transferee corporation was undesirable. If so, it seems anomalous that averaging is not required in a loss duplication Section 351 transaction where the Section 362(e)(2)(C) election is not made.

adjustments for any boot received and gain recognized). That basis can be treated either as a single averaged basis or a segmented basis.

Before the 2004 Proposed Regulations, the rules for determining basis in shares held after a reorganization were not clear enough even to raise effectively the question of whether basis in a single share could be segmented or would always be averaged. Under the tracing regime introduced in the 2004 Proposed Regulations, however, there are clearly circumstances in which the basis of a share received will reflect the differing bases of specific surrendered shares. The 2006 Final Regulations provide that, to the extent that a share of stock or security is received in exchange for (or with respect to) more than one share of stock or security with differing bases and/or holding periods, the new share or security will have a segmented basis and/or holding period, so that a portion of the share or security received will reflect the basis and holding period of each share or security exchanged therefor.[42]

As noted above, the tracing regime does not apply to most Section 351 exchanges under current law, and Revenue Ruling 85-164 requires a pro rata allocation of consideration to the transferred assets for purposes of determining the transferor's basis in the stock of the transferee. As a result, upon any transfer of multiple properties to a transferee in a Section 351 transaction, whether for mixed consideration or solely for a single class of the transferee's common stock, each share of stock in the transferee received by the transferor will have a basis determined by reference to a portion of each transferred asset.

Revenue Ruling 85-164 suggests that the basis in such a share under current law is averaged, but is treated as comprising distinct segments for certain

[42] Reg. § 1.358-2(a)(2)(vi).

purposes. In the ruling, a single transferor transferred accounts receivable with a zero basis and two capital assets that had been held for over a year to a corporation in exchange for its stock and securities, which were nonrecognition property under the law as then in effect. The transferor exchanged the capital assets for the securities and the accounts receivable for the stock. As noted above, the ruling disregarded the terms of the exchange and required the aggregate basis of the property transferred to be allocated among the stock and securities in proportion to their fair market values. The ruling also held that the basis and holding period of each share of stock and each security was segmented into two parts, one part having a portion of the basis in the capital assets and including the holding period of such assets and one part corresponding to the accounts receivable, having a zero basis and a holding period beginning on the day after the transaction. Accordingly, if any such stock or securities were disposed of at a time when the segmented holding period would affect tax liability, gain or loss would be determined for each segment as if it were a separate share.[43] It is not clear whether shares received in a Section 351 transaction might be treated as segmented for purposes other than taking into account differing holding periods.[44]

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[43] See also Rev. Rul. 62-140, 1962-2 C.B. 181, amplified by Rev. Rul. 85-164, 1985-2 C.B. 117. Revenue Ruling 62-140 describes a taxpayer's exchange, pursuant to the terms of a debenture, of the debenture plus $50 in cash for a share of common stock of the issuing corporation. Like the Section 351 transaction in Revenue Ruling 85-164, the exchange is a nonrecognition transaction in which mixed consideration is exchanged for a share. As in Revenue Ruling 85-164, Revenue Ruling 62-140 holds that each share so acquired has a split holding period and that the taxpayer would have to determine gain or loss separately for the portion attributable to the cash and the portion attributable to the debenture if the share were "disposed of at a time when the split holding period is relevant in determining his tax liability."

[44] See also Rev. Rul. 67-309, 1967-2 C.B. 263. In Revenue Ruling 67-309, the taxpayer purchased an undivided one-half interest in real property on one date, purchased the other one-half interest several years later for a higher price, and then sold an undivided one-half interest to a third party several months later for an even higher price. The taxpayer determined its gain on the sale by reference to the basis of the later-acquired one-half interest. The ruling, however, required the taxpayer to treat the sale as a transfer of an undivided one-half interest in each of the two one-half interests. The ruling determined each amount separately as if the taxpayer were selling two different assets and explained that the gain with respect to the first-acquired interest was long-term capital gain. However, the ruling

### d. Basis in Stockless Transactions

A transaction may qualify as a reorganization even though a shareholder receives in exchange for its surrendered shares no property or property having a value less than the value of such surrendered shares (a stockless reorganization).[45] Similarly, a transfer may qualify under Section 351 even though a transferor receives in exchange for the transferred assets no property or property having a value less than the value of such transferred assets (a stockless Section 351 transaction).[46]

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did not say that the differing holding periods were the only reason that the sale had to be bifurcated and treated as a sale of segments. On the other hand, the last sentence of Revenue Ruling 85-164 suggests that segmentation only applies so long as holding period differentials are relevant, and recent private letter rulings seem to confirm that result at least on the facts presented. See PLR 201150021 (Sept. 20, 2011) (transferor contributed stock of foreign corporations to a foreign subsidiary in exchange for common and preferred equity in the foreign subsidiary, and the Service ruled that the transferor's aggregate basis in the transferee foreign corporation's shares received was the same as the aggregate basis of the contributed property, with each share within each class of stock received having an identical, averaged basis); PLR 201043021 (June 29, 2010) (same). See also Reg. § 1.362-4(h) ex. 1(ii) (providing that where A transfers two assets with a net built-in loss to corporation X in a loss duplication transaction in exchange for one share of X stock, representing all the outstanding X shares immediately after the transaction, if a Section 362(e)(2)(C) election is made, A's basis in the share of X stock equals the sum of the basis of the assets transferred under Section 358(a), reduced by the net built-in loss, with no indication of segmenting in A's single share of X stock); Reg. § 1.362-4(h) ex. 2 (providing that where P transfers two blocks of S2 shares to S1 in exchange for shares in S1 in a Section 351/Section 368(a)(1)(B) overlap transaction otherwise qualifying for tracing and a Section 362(e)(2)(C) election is made with respect to the transaction, P's basis in each share of the S1 shares received is P's allocable portion of P's aggregate basis in the S2 shares transferred, reduced by the net built-in loss, with no indication of segmenting in the S1 shares).

[45] See, e.g., Davant v. Comm'r, 366 F.2d 874 (5th Cir. 1966) (where the owners of two corporations transferred the stock of one corporation to a third party and, as part of the plan, that party dissolved the corporation and transferred its operating assets to the second corporation, the result was a reorganization under Section 368(a)(1)(D) or (F) even though no stock was issued in the transaction); Reg. § 1.368-2(*l*) and the preamble thereto (T.D. 9475, 2010-1 C.B. 304) (contemplating reorganizations under Section 368(a)(1)(D) even though no stock is issued in the reorganization); Reg. § 1.1502-19(g) ex. 2(iii) (acknowledging the possibility of such a reorganization); Rev. Rul. 75-383, 1975-2 C.B. 127 (finding a reorganization under Section 368(a)(1)(D) even though no stock was issued in the transaction); Rev. Rul. 70-240, 1970-1 C.B. 81 (same); Rev. Rul. 56-654, 1956-2 C.B. 216 (amendment to articles of incorporation that increased the value of preferred stock and decreased the value of the common stock was a recapitalization even though no exchange of shares occurred).

[46] See, e.g., Lessinger v. Comm'r, 85 T.C. 824 (1985), rev'd on other grounds, 872 F.2d 519 (2d Cir. 1989); Reg. § 1.1502-19(g) ex. 2(i) (acknowledging the possibility of a Section 351 transaction in which no stock is issued); Rev. Rul. 64-155, 1964-1 C.B. 138. But see Abegg v. Comm'r, 429 F.2d 1209 (2d Cir. 1970).

Before the publication of the 2004 Proposed Regulations, the allocation of basis in reorganizations generally was unclear, as described above. When the 2004 Proposed Regulations established a tracing regime, it was not clear how it would apply to a shareholder in a stockless reorganization. It appeared possible that a shareholder that was in a position to control the form of a reorganization might be able to elect different basis consequences by electing whether to receive stock in form. The 2006 Final Regulations introduced a rule effectively extending the tracing regime to stockless reorganizations.[47] Under that provision, a shareholder in a stockless reorganization generally is treated as if it (i) received shares equal in value to the shares or securities surrendered (reduced by the value of any property actually received in the exchange) and (ii) surrendered in a recapitalization the shares already owned, any shares actually issued in the exchange and the shares deemed issued in exchange for the number of shares actually held immediately after the transaction.[48] Because a recapitalization is a reorganization subject to the tracing regime, the deemed issuance and recapitalization generally have the effect of preserving the shareholder's separate bases in its retained shares and in the shares and/or securities surrendered for no property in blocks of stock held after the transaction.

The allocation of basis in a stockless Section 351 transaction is not entirely clear, but it appears that the basis of the contributed property is merely added to the shareholder's basis in its existing shares pro rata. In the context of a similar

[47] See Reg. § 1.358-2(a)(2)(iii).

[48] Id.

transaction, a capital contribution described in Section 118(a),[49] there is support for the proposition that the increase in basis resulting from the capital contribution of property is allocated pro rata to all shares.[50] The 2006 Final Regulations did not apply the deemed

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[49] The discussion in this Report generally assumes that no gain or loss is recognized by the shareholder in a capital contribution under Section 118(a) (see Comm'r v. Fink, 483 U.S. 89 (1987)) or a stockless Section 351 transaction.

[50] See, e.g., Kasle v. United States, 75 F. Supp. 340 (N.D. Ohio 1947) (contribution of $23,000 by a holder of 98 shares increased the basis of each share from $100 to $334.694); Rev. Rul. 70-291, 1970-1 C.B. 168 (pro rata surrender by a corporation's shareholders of fifty percent of their stock resulted in the basis of such shares being "added to the basis of the shares retained" by the shareholders), amplified by Rev. Rul. 82-112, 1982-1 C.B. 59 (applying Revenue Ruling 70-291 to a domestic corporation's contribution to its foreign subsidiary of twenty-five percent of the subsidiary's stock). See also Rev. Rul. 74-239, 1974-2 C.B. 269 (decedent's bequest of property to a family corporation treated as a gift to the surviving shareholders in proportion to their respective interests in the corporation, followed by a pro rata contribution of the bequeathed property to the corporation's capital, thereby increasing the surviving shareholders' basis in the stock of the corporation) (citing Diebold v. Comm'r, 194 F.2d 266 (3d Cir. 1952) (bequest by a shareholder of his shares of stock in a family owned corporation to such corporation treated as a gift to the remaining shareholders who were his brothers and sisters, thereby increasing the surviving shareholders' basis in their shares of the corporation's stock) and Hitchon v. Comm'r, 45 T.C. 96 (1965) (gift by a father of 1,508 of his 1,509 shares in a family owned corporation to the corporation, where his three sons each owned 1 share, treated as a gift by the father of his interest in the corporation to his sons, and each of the sons' basis in their 1 share of stock is increased by their father's basis in the stock acquired by gift)).

A provision and an example in Regulations Section 1.355-6 suggest that, for purposes of measuring the amount of a corporation's stock acquired by purchase under Section 355(d), capital contributions and stockless Section 351 transactions involve a deemed issuance of shares or create segmentation within shares. Under Section 355(d)(5)(B), shares received in certain Section 351 transactions are treated as purchased. An exception excludes from purchase treatment certain acquisitions of stock "(whether actual or constructive)" in Section 351 transactions between members of the same affiliated group. Reg. § 1.355-6(d)(3)(v)(A). An example concludes that cash contributions to a corporation from its sole shareholder do not result in purchases of "additional" stock under the affiliated group exception. Reg. § 1.355-6(d)(3)(v)(B) ex. 1. The example thereby implies that the capital contributions (which also appear to be stockless Section 351 transactions) might have resulted in the acquisition of additional (constructive) shares that would have been treated as purchased shares, but for the affiliated group exception. The foregoing suggests that a stockless Section 351 transaction or capital contribution that involves the types of property enumerated in Section 355(d)(5)(B) results in a deemed issuance of shares or segmentation within shares for purposes of Section 355(d). See also PLR 200808006 (Nov. 7, 2007) (in which a taxpayer assumed that a stockless Section 351 transaction gives rise to segmented basis for purposes of Section 355(d)). It appears that the regulations under Section 355(d) establish a deemed-issuance or segmentation rule for capital contributions or stockless Section 351 transactions solely for purposes of Section 355(d) (because absent such a rule, capital contributions and stockless Section 351 transactions would never be treated as purchases for purposes of Section 355(d)).

Two recent private letter rulings hold that the increase in basis resulting from a contribution of property to capital is allocated pro rata to all shares. See PLR 201411006 (Dec. 5, 2013) (in the case of property being contributed to capital, the basis in such contributed property will be added to the transferor's existing basis in transferee stock, such that each share of transferee stock shall have an identical increase in basis as a result of the contribution); PLR 201333007 (May 20, 2013) (transferor's issuance and recapitalization approach to stockless Section 351 transactions except to the same limited set of Section 351 transactions that were subject to the tracing regime.[51] They did not address capital contributions at all. Therefore, under current law, the allocation of basis in stockless Section 351 transactions and capital contributions is the subject of some uncertainty.

**e. Recognition of Losses/Scope of Exchange**

Under Sections 354 and 356, a shareholder exchanging stock or securities in a reorganization generally does not recognize any loss. As discussed above, current law provides for basis tracing and for non-pro rata allocations of consideration received in a reorganization. As a result, a shareholder may exchange a share of stock or security in a reorganization solely for boot. Such an exchange presents no special problem if the shareholder realizes a gain with respect to such share. If the shareholder realizes a loss with respect to the share, however, it is not clear how that loss or the taxpayer's basis in the share should be treated. Recognition appears to be contrary to the language of Section 356, but there is no nonrecognition property to which the basis may be traced under the principles of the current tracing regime. The preamble to the 2006 Final Regulations requested comments on whether the realized loss in such an exchange should be recognized.

## B. Proposed Regulations

The Proposed Regulations are intended to provide for consistent treatment of economically similar transactions, so that all dividend-equivalent transactions governed by Section 301 are treated in a consistent manner and all exchange transactions

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basis in its stock of the transferee will be increased by an amount equal to the basis of the transferred assets, and such increased basis will not be separately tracked within any share).

[51] Reg. § 1.358-2(a)(2)(viii).

to which Section 302(a) applies are treated in a consistent manner, without regard to the specific transaction or provision of the Code that caused Section 301 or Section 302(a) to apply. The principle that a single share is the basic unit of property in stock underlies many of the revisions and clarifications in the Proposed Regulations.

### 1. Dividend-Equivalent Transactions

#### a. Section 301 Distributions

The Proposed Regulations treat a pro-rata portion of any Section 301 distribution as being made with respect to each share in the relevant class. Thus, for distributions under Section 301 that give rise to basis recovery under Section 301(c)(2) (because they are not paid from earnings and profits), the Proposed Regulations adopt the per-share approach to basis recovery applied under current case law.[52] Therefore, even if a taxpayer attempts to make a contrary designation, a Section 301 distribution is treated as received ratably with respect to each share of the class of stock upon which the distribution is made, and a shareholder may only recover the basis in a given share under Section 301(c)(2) before recognizing gain with respect to such share under Section 301(c)(3). As a result, a shareholder may recognize gain with respect to particular shares of a corporation as a result of a Section 301 distribution while having unrecovered basis in other shares of the same class.

#### b. Dividend-Equivalent Redemptions

As discussed above in Part **III.A.1.b(ii)**, the Code does not specify which shares participate in a distribution deemed to occur under Section 302(d) or how the basis in the redeemed shares is recovered. The Proposed Regulations offer answers to both

[52] Prop. Reg. § 1.301-2(a).

questions by reference to a hypothetical transaction that accounts for both the surrender of the redeemed shares and the deemed distribution.

Because the Proposed Regulations seek to treat all dividend-equivalent transactions consistently, they treat a dividend-equivalent redemption as a pro rata distribution to all shares of the redeemed class of shares held by the redeemed shareholder immediately before the redemption, and they apply the same per-share approach to basis recovery with respect to those shares (the "Redeemed Class Approach"). A pro rata distribution will therefore be deemed made on all of the shares in such class, regardless of which shares the shareholder surrenders in form or purports to identify.[53] The preamble to the Proposed Regulations explains that the distribution is treated as being made only with respect to the shares of the redeemed class because "different classes of stock have distinct legal entitlements that are respected for federal income tax purposes."[54] Thus, while it has previously been unclear whether a shareholder may recover the redeemed shares' basis, the retained shares' basis, all basis or some basis from all shares of the redeemed class, the Proposed Regulations would apply the last approach. The basis of all shares of the redeemed class would be available to be recovered, but on a per-share basis rather than on an aggregate basis.

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[53] Prop. Reg. § 1.302-5(a)(1).

[54] The Proposed Regulations provide two definitions for what constitutes a class of stock. In the context of allocating basis among nonrecognition property in certain exchanges or distributions, the Proposed Regulations provide that shares of stock which differ either because they are in different corporations or because the rights attributable to them differ (although they are in the same corporation) are considered different classes of stock. Prop. Reg. § 1.358-2(a)(2). In the context of redemptions under Section 302(d), the Proposed Regulations provide that a class of stock is defined with respect to economic rights to distributions rather than the labels attached to shares or rights with respect to corporate governance. Prop. Reg. § 1.302-5(b)(2). For a discussion of issues regarding the definition of a class of stock, see Scott M. Levine, Class of Stock: A Definition in Need of Refinement, 124 TAX NOTES 341 (July 27, 2009).

If less than all of the shares of a class of stock held by the redeemed shareholder are redeemed, the Proposed Regulations provide for a deemed recapitalization to account for the in-form surrender of the redeemed shares. In such deemed recapitalization, the redeemed shareholder is treated as surrendering all of its shares of the redeemed class, including the redeemed shares, in exchange for the actual number of shares it holds after the redemption transaction.[55] Thus, the basis of each share in the redeemed class, after any reduction for the distribution occasioned by the redemption, will be traced to some portion of the retained shares in the redeemed class under the tracing regime applicable to recapitalizations.

If all shares of the redeemed class held by the taxpayer are redeemed, the Proposed Regulations do not permit the shifting of basis to other classes of shares or to shares attributed to the redeemed shareholder. Instead, they adopt a deferral regime similar to that of the withdrawn 2002 Proposed Regulations discussed above. Under the Proposed Regulations, the basis in the redeemed shares is treated as a deferred loss to be taken into account on the "inclusion date."[56] The inclusion date is generally the earliest date on which (i) the conditions of Section 302(b)(1), (2) or (3) are satisfied or (ii) all classes of stock of the issuing corporation become worthless.[57] If the redeemed shareholder is a corporation, the inclusion date also includes the date of certain transactions in which the corporation ceases to exist for tax purposes.[58]

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[55] Prop. Reg. § 1.302-5(a)(2)

[56] Prop. Reg. § 1.302-5(a)(3)(i).

[57] Prop. Reg. § 1.302-5(b)(4)(i). The definition of "inclusion date" in the Proposed Regulations is not identical to the definition of "final inclusion date" in the 2002 Proposed Regulations, but there is extensive overlap.

[58] Prop. Reg. § 1.302-5(b)(4)(ii).

Thus, where less than all shares of a class of stock are redeemed, the hypothetical transaction described in the Proposed Regulations effectively retains the "proper adjustment" allowed under current law, but makes the adjustment more specific and limits it to any shares of the redeemed class actually owned by the redeemed shareholder following the redemption. Where there are no other shares of the redeemed class held by the shareholder following the redemption, the deemed transaction would not provide an answer. In those circumstances, the Proposed Regulations treat the loss as recognized and deferred until the occurrence of an inclusion date. This treatment differs from the deferral regime of the withdrawn 2002 Proposed Regulations, which treated the remaining basis of each share surrendered in a dividend-equivalent redemption as a deferred loss without regard to the other shares held by the shareholder.

**c. Dividend-Equivalent Reorganization Exchanges**

If a shareholder receives boot in addition to nonrecognition property in a reorganization, it must be determined whether the exchange is dividend-equivalent. As the preamble to the Proposed Regulations notes, under Clark, whether an exchange is dividend-equivalent under Section 356(a)(2) depends upon the effect of the shareholder's "overall exchange," but neither the Code nor Clark defines the scope of the exchange to be analyzed where multiple types of property are surrendered in exchange for multiple types of consideration. Under Zenz v. Quinlivan,[59] an exchanging shareholder in a Section 302 redemption determines dividend-equivalency based on all the facts and circumstances. Again in the interest of treating all dividend-equivalent transactions consistently, the Proposed Regulations provide that the determination of whether a reorganization is dividend-equivalent must take into account the "overall reorganization

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[59] 213 F.2d 914 (6th Cir. 1954).

exchange." In other words, the determination does not look at a single surrendered share or class of shares, but looks at all exchanges by the shareholder in question.

To be consistent with the treatment of dividends and dividend-equivalent redemptions, the Proposed Regulations do not permit a shareholder in a dividend-equivalent reorganization to allocate particular consideration to specific shares within a class of stock surrendered. Economically reasonable designations among classes are still respected.[60] A shareholder's receipt solely of boot with respect to a class of stock in a reorganization is treated as received pro rata with respect to each share in the class.

If an exchange in a reorganization is dividend-equivalent, however, the Proposed Regulations treat the exchange of any class of stock solely for boot as outside the scope of Section 356(a)(2) (which only applies to exchanges in which nonrecognition property is received) and as governed by Section 302(d).

#### d. Dividend-Equivalent Section 304 Transactions

The Proposed Regulations under Section 304 are designed to treat dividend-equivalent Section 304 transactions in the same manner as other transactions governed by Section 301. The Proposed Regulations provide that the property received by the transferor from the acquiring corporation in a Section 304(a)(1) transaction is to be treated as received in redemption of "common stock" of the acquiring corporation.[61] Dividend-equivalence is determined under the same Section 302 tests that apply to redemptions, but by reference to the ownership of the stock of the issuing corporation.[62] If none of those tests are met and Section 301 applies to the property received in the

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[60] The Proposed Regulations provide equivalent rules that apply to dividend-equivalent split-offs. Prop. Reg. § 1.355-1(e)(1).

[61] Prop. Reg. § 1.304-2(a)(1).

[62] § 304(b)(1); Prop. Reg. § 1.304-2(a)(2).

deemed redemption, the transaction is treated as if the transferor had transferred the issuing corporation stock to the acquiring corporation in exchange for acquiring corporation common stock in a Section 351(a) transaction, and the acquiring corporation had then redeemed its deemed-issued common stock for property.[63] To the extent that Section 301(c)(2) applies to the deemed redemption of the common stock of the acquiring corporation, the amount distributed in such redemption is applied to reduce the adjusted basis of each share of common stock directly held or deemed held by the transferor on a pro rata, share-by-share basis.[64] Finally, after any basis reduction under Section 301(c)(2), the pre-redemption shares, including the deemed-issued shares, are deemed recapitalized into the actual number of acquiring corporation common shares outstanding.

**2. Non-Dividend-Equivalent Transactions**

**a. Redemptions**

Under current law, a shareholder that sells shares of a given class may choose which shares within that class to sell.[65] The same rule applies in the case of a redemption treated as a sale or exchange under Section 302(a). To be consistent with sale treatment, the Proposed Regulations would preserve this flexibility in redemptions that are not dividend-equivalent.

**b. Reorganizations**

If a reorganization exchange is not dividend-equivalent (taking into account the entire exchange, as described above), the Proposed Regulations treat shares

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[63] Prop. Reg. § 1.304-2(a)(3).

[64] Prop. Reg. § 1.304-2(a)(4).

[65] See Reg. § 1.1012-1(c). But note that proposals currently exist to curtail or eliminate such shareholder choice. See supra note 6.

that are exchanged solely for boot as being outside of the scope of Section 356 and governed instead by Section 302(a).[66] A shareholder participating in a non-dividend-equivalent reorganization exchange can designate which consideration is received in exchange for each share, provided that the designation is economically reasonable.[67] If, taking into account such designated allocations, solely boot is treated as received for a share, the shareholder will recognize gain or loss with respect to that share pursuant to Section 302(a).

### 3. Tracing, Averaging and Segmenting Principles

#### a. Reorganizations

The Proposed Regulations largely follow the tracing rules in the 2006 Final Regulations for reorganization transactions, with a few clarifications regarding shareholder elections.

#### b. Section 351 Exchanges and Capital Contributions

For purposes of determining the amount of gain recognized in a Section 351 transaction, the Proposed Regulations expressly adopt the rule established in Revenue Ruling 68-55 that each type of consideration a transferor receives in a Section 351 exchange is allocated among the assets such transferor transferred, based on their fair market values.[68]

As discussed above, the tracing approach that currently applies to reorganizations does not apply to most Section 351 transactions. It applies to an exchange by a shareholder under Section 351 only if the exchange is also a

[66] Prop. Reg. § 1.354-1(d)(2).

[67] Prop. Reg. § 1.354-1(d)(1).

[68] Prop. Reg. § 1.351-2(b).

reorganization, the shareholder receives no stock or securities in an exchange to which neither Section 354 nor 356 applies, no liabilities of the taxpayer are assumed and the transaction is not a "loss duplication" transaction with respect to which an election under Section 362(e)(2)(C) is made. The Proposed Regulations extend the tracing rules to all Section 351 exchanges in which no liabilities are assumed, without regard to whether the exchange is also a reorganization or whether property other than stock or securities was transferred.[69] The tracing approach does not apply to each transferred asset separately, however. Instead, it appears that the tracing regime applies to trace the basis in each block of stock surrendered separately, but the bases of all transferred assets other than stock are carried over to all of the stock of the transferee not treated as received in exchange for the transferred stock and then allocated equally among them.[70] The Proposed Regulations do not expressly address whether this equal allocation with respect to non-stock assets results in identical averaged or identical segmented bases in such shares.

The Proposed Regulations also extend the deemed issuance and recapitalization approach that currently applies to stockless reorganizations to Section 351 exchanges in which assets are surrendered for no consideration, or consideration with a smaller value, and to capital contributions under Section 118.[71]

[69] Prop. Reg. § 1.358-2(g)(2). Note that because the rule providing for basis averaging in Section 351 transactions that also qualify as reorganizations and for which an election under Section 362(e)(2)(C) is made was finalized in 2013, after the date of issuance of the Proposed Regulations, the Proposed Regulations currently do not provide a carve-out from basis tracing for such transactions. However, if the Proposed Regulations were adopted as final, such regulations would presumably include a carve-out from basis tracing for Section 351/reorganization overlap transactions for which an election under Section 362(e)(2)(C) is made.

[70] Prop. Reg. § 1.358-2(i) ex. 16.

[71] Prop. Reg. §§ 1.358-2(g)(3), 1.1016-2(e).

### 4. Miscellaneous Matters

The Proposed Regulations provide some technical rules to coordinate with other provisions of the Code.[72] They also raise a number of issues that the IRS and Treasury are still considering, some of which are the subject of specific requests for comments.[73] These rules and requests for comments, while important, generally do not impact the fundamental choices made in the Proposed Regulations that are the subject of this Report. Accordingly, they are not addressed herein.

## IV. Comments and Recommendations

This Part IV considers changes that might be made to the Proposed Regulations and, in some cases, to current law to treat similar transactions more consistently. It also considers changes that might be made in the interest of administrability. Before considering these changes, however, it is important that any changes to current law be considered in the context of goals to be achieved. One of the most difficult aspects of trying to develop a holistic approach to the areas addressed by the Proposed Regulations is defining what the unifying principles underlying that approach should be, a task made even more difficult by the disparate treatment and lack of guidance under current law with respect to many of the items discussed in this Report.

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72 Among other things, the Proposed Regulations contain provisions to (i) clarify that designated allocations that are given effect for purposes of determining gain and basis are also given effect for purposes of determining whether a transaction is a nonrecognition transaction or a taxable exchange, (ii) address the apportionment of interest and other expenses under Section 864(e) and (iii) reconcile the all-shares-within-class approach that applies in dividend-equivalent redemptions generally with the redeemed-shares approach that applies to redemptions treated as extraordinary dividends under Section 1059(e)(1)(A)(iii).

73 The preamble to the Proposed Regulations explains that the Treasury and IRS request comments on or are reserving on issues including (i) the treatment of redemptions of stock held by partnerships, trusts and S corporations; (ii) the treatment of redeemed shareholders with deferred losses that file consolidated returns; (iii) the treatment of redemptions of Section 306 stock; (iv) the determination of inclusion dates after a Section 355 pro rata split-up and (v) the characterization of the exchange in which an exchanging shareholder is deemed to receive a share in an all-cash Section 368(a)(1)(D) reorganization.

On the one hand, one could use as unifying principles the concepts that a single share is the basic unit of property in corporate tax and that all economically similar transactions should be treated similarly. The Proposed Regulations largely take this approach, although as discussed later in this Part IV, we believe that in certain circumstances the Proposed Regulations deviate from this approach by using what at least some on the Executive Committee believe is an inapposite analogy of an economically similar transaction (see the discussion of boot allocations in dividend-equivalent reorganizations in Part IV.D.1, below). As also discussed in this Part IV, in some other cases the Proposed Regulations adopt approaches (such as the Redeemed Class Approach to dividend-equivalent redemptions) that may lead to uneconomic results. In addition, there are cases for which the Proposed Regulations are unclear as to which approach is to be applied.

Rather than a single share as the basic unit of property, a unifying principle could instead be the relationship between the shareholder and the corporation. Indeed, many of the recommendations in this Report are prompted by an implicit or explicit questioning of whether, at least in the large shareholder context, a single share rather than the relationship between the shareholder and the corporation should be the primary focus in determining appropriate gain and basis consequences. Accordingly, throughout various sections of this Part IV we examine the Proposed Regulations in light of another possible paradigm, one in which distinctions are made among (i) small shareholders in publicly traded corporations ("Small Public Shareholders"), where a share is like any other item of property and the shareholder is not involved with the corporation in any meaningful way, (ii) large shareholders, where the shareholder is more symbiotically involved with the corporation, either through a meaningful economic stake in or management of the corporation (or both) ("Large Shareholders"), and (iii) shareholders, be they private or public shareholders, that are neither Small Public Shareholders nor Large Shareholders ("Other Shareholders"). Much of the administrative complexity under the approaches adopted in the Proposed Regulations arises largely in the context of Large Shareholders, such as with respect to capital contributions, stockless transactions, dividend-equivalent redemptions, dividend-equivalent reorganizations, and dividend-equivalent Section 304 transactions. For such shareholders (as well as for Other Shareholders in certain circumstances discussed further in this Part IV), we believe that deviations from pure tracing and per-share basis recovery are warranted in some cases for reasons of both theory and administrability. But we are also conscious of concerns regarding taxpayer electivity and, accordingly, our proposals are designed to try to minimize electivity while maximizing administrability where possible.

Administrability with respect to broker reporting also could have been an organizing principle behind the Proposed Regulations. We note that the 2006 Final Regulations seem to adopt as one of their principles the facilitating of broker reporting.[74] Assuming that facilitating broker reporting continues to be a priority of the government, we believe that certain of the proposals in the Proposed Regulations might be reconsidered with this principle in mind, and that in certain circumstances consideration might be given to sacrificing similar treatment of economically similar transactions in aid of facilitating broker reporting. This issue is also discussed in various places in this Part IV.

[74] See supra note 35.

Lastly, the Proposed Regulations do not discuss the issue of earnings and profits. Taking the issue of earning and profits into account can have an impact on how one thinks about a number of the items addressed in the Proposed Regulations. Although the topic of earnings and profits is broader than just the items addressed in the Proposed Regulations, and is largely beyond the scope of this Report, the topic of earnings and profits is discussed in certain sections of this Part IV where we believe it has the most relevance to the topic at hand (such as selection among various approaches to dividend-equivalent redemptions and issues arising in dividend-equivalent reorganizations).

We start this Part IV with a discussion of issues arising under Section 351 and capital contributions since some of the proposals provided with respect to those issues, such as certain de minimis exceptions we propose, provide building blocks for the issues regarding dividend-equivalent redemptions, dividend-equivalent reorganizations and dividend-equivalent Section 304 transactions discussed later in this Part IV.

### A. Section 351 Transactions and Capital Contributions

In general, if tracing is to be applied to reorganization transactions, we agree with the extension in the Proposed Regulations of the tracing approach to stock received in exchange for stock surrendered in all Section 351 transfers in which no liabilities are assumed (and no election under Section 362(e)(2)(C) is made).[75] The Proposed Regulations are intended to treat economically equivalent transactions equivalently and to treat the share as the fundamental unit of property. To meet those goals, Section 351 transfers should not result in the averaging or segmenting of basis with respect to surrendered stock. Rather, like reorganizations, Section 351 transfers should

[75] As discussed above in note 69, if the Proposed Regulations were ever to be adopted as final, such regulations would presumably include a carve-out from basis tracing for Section 351/reorganization overlap transactions for which an election under Section 362(e)(2)(C) is made.

result in traced basis. As the preamble notes, however, basis tracing may not be practicable in Section 351 transfers in which liabilities are assumed because Section 357 applies an aggregate approach to the determination of gain where liabilities are assumed.[76] Therefore, we think that the extension of tracing principles for stock surrendered to all transactions in which no liabilities are assumed (and no Section 362(e)(2)(C) election is made) represents an improvement because it leads to increased tracing of basis and more consistency.[77] For the same reasons, we agree with the extension in the Proposed Regulations of the deemed issuance and recapitalization approach to stockless Section 351 transactions, subject to the modifications described below. In addition, we believe rules should be adopted that expressly address whether averaging or segmenting applies with respect to stock received in a Section 351 transaction that does not have a traced basis. Lastly, we believe greater guidance should be provided regarding the allocation of consideration received in Section 351 transactions in which one of the assets transferred is stock of another corporation. Averaging versus segmenting is addressed below, followed by a discussion of stockless Section 351 transactions and capital contributions, and then a discussion of allocation of consideration.

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76 For a discussion of the difficulties of adopting tracing presented by the existence of Section 357(c), see the First Section 358 Report, supra note 4 at 35-45.

77 Although making the choice of regime depend upon whether any liabilities are assumed may lead to some shareholder electivity, the difficulty of reconciling a tracing regime with Section 357(c) may make such electivity unavoidable. In certain cases, such as where a liability is assumed to avoid a tracing result, existing judicial doctrines or Code provisions might be applied to require tracing (perhaps, for example, by treating the liability assumption as boot under Section 357(b)). Additionally, as discussed above in note 41, it is not clear to us why it was felt necessary to preserve averaging in a Section 351/reorganization overlap transaction with respect to which a Section 362(e)(2)(C) election is made. As such, at least with respect to Section 351 exchanges where assets with a net built-in loss are transferred, a shareholder can avoid basis tracing even where no liabilities are assumed by making a Section 362(e)(2)(C) election, albeit at the cost of reducing the shareholder's basis in the transferee stock by the amount of the net built-in loss in the transferred assets.

### 1. Averaging Versus Segmenting when Tracing Does Not Apply

#### a. In General

As described in Part III.A.2.a above, the position of the IRS is that a pro rata allocation of consideration is required in a Section 351 exchange of multiple assets for mixed consideration.[78] As a result of this pro rata allocation, in many Section 351 transactions, every share received will have a basis determined by reference to multiple assets. This makes the question of whether basis is averaged or segmented more important than it would be in a reorganization, where the tracing and allocation rules are designed to minimize the number of shares that reflect diverse bases. The Proposed Regulations extend the tracing rules, including those designed to minimize the number of shares reflecting diverse bases, to many more Section 351 transactions. However, exchanges of mixed, non-stock assets, exchanges involving the assumption of liabilities and exchanges in which a Section 362(e)(2)(C) election is made still present the issue.

We recommend that Regulations make clear that the bases of shares received in Section 351 exchanges where basis is not traced to specific surrendered assets generally should be averaged. First, this approach is most consistent with the principle underlying the Proposed Regulations that a single share is the basic unit of property in corporate stock. Segmenting, on the other hand, is consistent with treating stock as having no basic unit or an infinitely small basic unit.

Second, we believe that the better interpretation of current guidance is that segmenting is required in a Section 351 transaction only for purposes of differentiating, where relevant, long-term and short-term capital gain or loss. This view is informed by the fact that the authority in favor of segmenting, Revenue Ruling 85-164, requires that

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[78] See Rev. Rul. 85-164, 1985-2 C.B. 117; Rev. Rul. 68-55, 1968-1 C.B. 140.

shares that are disposed of be treated as segmented only when the differing holding periods would affect the transferor's tax liability (and only separates the transferor's shares in the transferee into the number of segments necessary to take separate holding periods into account, not the number of segments necessary to track each transferred asset).[79]

Third, segmenting can create unmanageable administrative burdens. While the holding-period-based segmenting described in Revenue Ruling 85-164 requires some additional calculations, the requirement is temporary. A transferor that transfers assets all having a long-term holding period or that retains the transferee stock long enough that differences in holding periods are no longer relevant never needs to complete the calculations. Segmenting for general purposes, however, will require taxpayers to track every segment of every share as a matter of course because differences in basis are potentially relevant no matter how far in the future the transferor disposes of the transferee stock. Section 351 transactions are common, and a generally-applied, permanent segmenting regime will require shareholders that regularly transfer property in transactions treated as Section 351 exchanges to permanently track an ever-increasing number of segments of each share – an administrative burden that appears to be out of proportion to any apparent rationale for this rule. Any subsequent exchange of segmented shares in a reorganization will give rise to even more burdensome computations, as each segmented share's basis must be traced to some number of new shares. The proliferation of segmented-basis shares under the tracing regime as it exists under current law or under the Proposed Regulations appears inconsistent with provisions

[79] See also PLR 201150021 (Sept. 20, 2011) and PLR 201043021 (June 29, 2010), discussed supra note 44.

designed to minimize the number of segmented-basis shares received in a reorganization. Because the tracing regime reflects a share-by-share approach to basis determinations, it seeks to avoid the creation of segmented-basis shares by requiring that received shares reflect surrendered shares. When applied to an exchange of shares having identical but segmented bases, the operation of this rule is not entirely clear, but it appears to trace the segmented bases in the target shares into segmented-basis acquiror shares, an operation that will be made more complex by any mismatches in the number of shares. Example 1 below under Part IV.A.2.c illustrates the complexity that segmenting can cause in a routine capital contribution.[80]

A segmenting regime will also require taxpayers to know the precise value of each asset in order to determine what portion of a share will take its basis from such asset. Under an averaging regime, a transferor will often be able to determine its recognized gain and stock basis and the transferee's asset basis without needing to know the exact value of each asset at the time of the transaction.

For the foregoing reasons, we also recommend that the bases of individual shares be averaged rather than segmented in reorganizations, Section 355 transactions and any other transactions addressed by the Proposed Regulations.

**b. Exceptions**

While we believe that averaging should be the general rule when tracing to individual shares does not apply, limited circumstances or purposes may justify segmenting.

Holding periods. As discussed above, in the view of the IRS, shares of stock received in a Section 351 exchange are treated as having distinct segments to the

[80] See also Reg. § 1.367(b)-13 and the examples therein, which illustrate the complexity that arises from a requirement to track segments of shares in certain foreign corporations.

extent necessary to take into account relevant different holding periods in the stock received in the exchange.[81] Segmenting shares for the limited purpose of tracking disparate holding periods that would affect the transferor's tax consequences does not give rise to the same degree of administrative burden associated with segmenting generally because such differences are temporary. Moreover, if the approach of segmenting to track separate holding periods were not retained, then an alternative approach to holding periods would need to be devised. Among the approaches that might be considered are the "single-category" method that a taxpayer used to be permitted to elect with respect to certain shares of regulated investment companies[82] and the divided holding period approach applicable to partnership interests.[83] Because every alternative to segmented holding periods has its own shortcomings,[84] in general we recommend that segmenting to track relevant differing holding periods be retained.[85]

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81 Rev. Rul. 85-164, 1985-2 C.B. 117.

82 See former Reg. § 1.1012-1(e)(4) prior to amendment by T.D. 9504, 2010-2 C.B. 670.

83 See Reg. § 1.1223-3(b). See also Warnke Article, supra note 6 at 88-89. The Obama Proposal, supra note 6, addresses the holding period issue by requiring the use of basis averaging only for all identical shares of portfolio stock held by a taxpayer that have a long-term holding period, whether held in different accounts with the same broker or with different brokers.

84 For a discussion of the shortcomings of the "single-category" method and the divided holding period approach, see Warnke Article, supra note 6 at 88-92.

85 Another approach that might be applied is the "double-category" method that a taxpayer used to be permitted to elect with respect to certain shares of regulated investment companies. The double-category method was eliminated when the broker basis reporting regulations were finalized. See T.D. 9504, 2010-2 C.B. 670. See former Reg. § 1.1012-1(e)(3) (before amendment in 2010). Under the double-category approach, shares are divided into blocks according to short-term and long-term holding periods and the bases within each block are then averaged; as time passes and holding periods change, shares shift from one block to the other block. Applying the double-category approach to Section 351 transactions, upon a transfer of assets in a Section 351 exchange, two blocks of stock would be created, each block having an averaged basis reflecting the basis of short-term and long-term assets transferred in the Section 351 exchange. As the shares "age," shares would shift from one block to the other block, resulting in changing averaged basis of the shares in each block. This approach creates its own complexity and would not appear to produce a result that is substantially simpler than segmenting basis within a share to track holding periods. Moreover, as previously discussed, tracing basis even to separate blocks of stock may not be practicable in Section 351 transactions in which liabilities are assumed. Accordingly, we do not recommend adopting a double averaging approach with respect to Section 351 transactions.

Overriding policy considerations. We are aware that there may be other circumstances in which the IRS and Treasury might wish to prevent the offsetting of gains and losses that might be traced to a single share of stock in a Section 351 transaction. We think that consideration should be given to whether it is more administrable to create separate rules that require segmenting where it is most important (such as possibly, for example, targeted rules under Section 267 and Section 1248) than to require permanent segmentation for all shares issued in Section 351 transactions.[86]

**2. Stockless Section 351 Transactions and Capital Contributions**

As discussed in Part **III.B.3.b** above, the 2006 Final Regulations established a deemed issuance and recapitalization approach to certain reorganizations and the Proposed Regulations extend this approach to certain Section 351 transactions and capital contributions under Section 118. Also as discussed above, it is not clear under current law how basis in a stockless Section 351 transaction or a capital contribution is allocated, but we believe it is likely that the basis in the transferred assets is merely added to the transferor's basis in its existing shares in the transferee. As with stockless Section 351 transactions, we generally agree with the extension of tracing principles to capital contributions because this increases consistency, thereby reducing electivity. However, we also note that the deemed recapitalization and issuance approach has at least one drawback, in that it requires determination of the values of the property

[86] We note, however, that recent private letter rulings seem to indicate a view that there may be only limited, if any, circumstances in which segmenting is necessary to achieve policy goals other than tracking relevant holding periods. See PLR 201150021 (Sept. 20, 2011) and PLR 201043021 (June 29, 2010), discussed supra note 44, where a transferor contributed stock of foreign corporations to a foreign subsidiary in exchange for common and preferred equity in the foreign subsidiary, and the Service ruled that the transferor's aggregate basis in the transferee foreign corporation's shares received was the same as the aggregate basis of the contributed property, with each share within each class of stock received having an identical, averaged basis. But cf. Regulations Section 1.367(b)-13 and the examples therein, requiring segmenting in connection with certain foreign-to-foreign reorganizations to preserve certain Section 1248 attributes.

transferred and of the transferee corporation. Given the frequency with which some shareholders make or are treated as making capital contributions to corporations, this drawback is significant. Therefore, we would propose exceptions to the deemed issuance and recapitalization regime of the Proposed Regulations to free certain routine transactions from valuation requirements.

#### a. De Minimis Contributions

Contributions to a corporation that are small in relation to the value of the corporation present less of an opportunity to achieve inappropriate tax results. Therefore, we would suggest that the deemed issuance and recapitalization approach not apply to contributions of assets having a value of less than five percent (or some other specified percentage)[87] of the pre-contribution value of the stock of the transferee corporation held by the transferor (the "de minimis contribution exception"). To claim the benefit of the de minimis contribution exception, the transferor must know something about the value of the contributed property and the corporation. For contributions of property that are near the limit of eligibility, the exception may not be of much use. The rule will be valuable, however, in the case of contributions that are clearly de minimis. Moreover, deemed contributions such as one that might arise from an inadvertent and insignificant value mismatch in dealings between a corporation and shareholder could qualify for the exception.

#### b. De Minimis Disparity Between Value and Basis

Similarly, contributions of assets whose bases are not significantly different from their values are unlikely to result in abuse, because there is no significant

[87] As discussed throughout this Report, tracing can lead to significant administrative complexity in certain circumstances. Accordingly, in the interest of reducing that complexity, a threshold higher than five percent may be appropriate.

gain or loss inherent in such assets, and the contribution of such assets to a corporation will not significantly affect the amount of gain or loss inherent in the transferor's stock of the transferee. Therefore, we suggest that the deemed issuance and recapitalization approach not apply to a contribution of an asset the basis of which differs from its value by an amount that is less than five percent (or some other specified percentage)[88] of such value (the "de minimis disparity exception"). Like the de minimis contribution exception, the de minimis disparity exception would require some knowledge of the value of the transferred assets but would benefit those transactions in which the variation between value and basis is clearly de minimis. Moreover, it would eliminate any deemed issuance and recapitalization in the very common situation of a contribution of cash to a corporation.[89]

#### c. Treatment of Contributions Meeting Exceptions

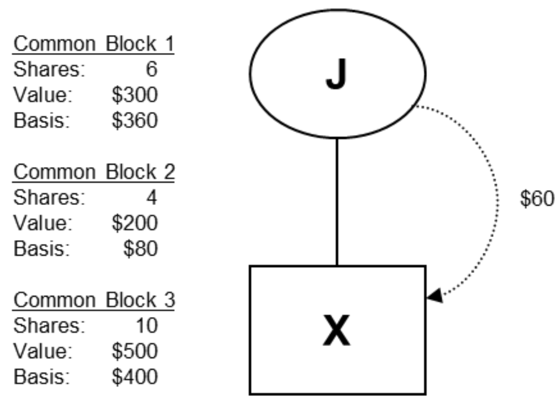
The basis of the property contributed in a transaction meeting the requirements of either the de minimis contribution exception or the de minimis disparity exception would be added to the contributor's basis in existing shares in the recipient

[88] See supra note 87.

[89] In the interests of further aiding administrability, consideration might be given to excepting all capital contributions from tracing and applying averaging as the general rule instead, subject to adoption of anti-avoidance rules to prevent results that may be felt to be inappropriate, such as the stuffing of assets with significant built-in gain into a subsidiary in whose stock there is significant built-in loss shortly prior to a disposition. Under this approach, absent application of any applicable anti-abuse rule, a proportional part of the basis of any contributed asset would be added to and blended with the existing basis of each share, thereby augmenting each share's basis but preserving pre-existing basis blocks. Although some members of the Executive Committee would favor this approach, a substantial majority of the Executive Committee believes that adoption of the de minimis exceptions for capital contributions discussed in this Report, together with adoption of aggregate basis recovery as recommended in Part IV.B below, is a sufficient, and better, approach to balancing tracing and administrability tensions.

corporation and be averaged, not segmented, subject to any exceptions for segmenting in particular circumstances as discussed in Part IV.A.1.b above.[90]

<u>Example 1</u>




Facts: J holds 20 shares of the common stock of corporation X, constituting all of X's outstanding shares, 6 shares with a basis of $60 per share, 4 shares with a basis of $20 per share and 10 shares with a basis of $40 per share. The value of each X share is $50. J contributes $60 in cash to the capital of X and receives no consideration therefor.

Result: Under the Proposed Regulations, the deemed issuance and recapitalization approach applies. J would be treated as receiving 1.2 shares for the $60 contribution ($60/$50 per share value of the existing stock) and then as surrendering all of its 21.2 real and hypothetical shares for its 20 actual shares in a recapitalization. The block of 6 shares would be exchanged for 5.660 shares (6 shares × 20 shares/21.2 shares), the block of 4 shares would be exchanged for 3.774 shares (4 × 20/21.2), the block of 10 shares would be exchanged for 9.434 shares (10 × 20/21.2), and the new block of 1.2 shares would be exchanged for 1.132 shares (1.2 × 20/21.2). Under the tracing rules, the bases of like shares must be grouped to the extent possible, but the decimals in the foregoing sentence show that 2 of the 20 post-recapitalization shares will have bases attributable to shares from

90 Where the contributor owns shares of only one class in the recipient corporation, a proportional amount of the basis of the property contributed would be added to each existing share. Where the contributor owns shares of more than one class, however, the situation becomes more complex. One possibility would be to allocate basis among classes held by the contributor in proportion to the relative values of such classes and then further allocate basis proportionately among shares within each class. That approach may lead to questionable results, however. For example, if the contributor owns both common shares and market-rate, nonparticipating preferred shares of a non-distressed recipient corporation, it would seem inappropriate to allocate a portion of the basis in the contributed assets to the preferred shares. A more rational approach may be to allocate the contribution among classes of shares in proportion to the increase in value of each class occasioned by the contribution. Under this approach none of the contribution would be allocated to the preferred shares in the preceding example.

different blocks. J would ultimately hold 5 shares with a basis of $63.60 per share ($360 basis/5.660 shares), 3 shares with a basis of $21.20 per share ($80 basis/3.774 shares), 9 shares with a basis of $42.40 per share ($400 basis/9.434 shares), 1 share with a basis of $53.10 ($60 basis/1.13 shares) and 2 shares with segmented bases. If J's blocks were acquired in the order in which they were described in the facts, the segments would be traced so that J held one share that was divided into a 66.0 percent segment (5.660 shares − 5 shares) with a $41.98 basis (0.660 shares × $63.60 basis per share) and a 34.0 percent segment (the amount of the 0.774 share remainder from the second basis block that can fit in the first segmented share) with a $7.21 basis (0.340 shares × $21.20 basis per share) and a second share that was divided into a 43.4 percent segment (the amount of the 0.774 share remainder from the second basis block that could not fit in the first segmented share) with a $9.20 basis (0.434 × $21.20 basis per share), a 43.4 percent segment (9.434 shares − 9 shares) with an $18.40 basis (0.434 × $42.40 basis per share) and a 13.2 percent segment (1.132 shares − 1 share) with a $7.01 basis (0.132 × $53.10 basis per share).

If the recommendations described above were adopted, the result would be much simpler. Because the contribution is of cash, the de minimis disparity exception would apply. Thus, no new stock would be treated as issued and J would continue to hold the same three blocks of X stock. Because each share has an equal value, the basis in each share would be increased by an equal portion of the $60 contribution, or $3 per share. J would therefore hold 6 shares with a basis of $63 per share, 4 shares with a basis of $23 per share and 10 shares with a basis of $43 per share. Subject to any applicable exceptions for segmenting, the basis of each individual share would be averaged rather than segmented.[91]

#### d. Related Transactions

The benefit of the de minimis exceptions could be eliminated in abusive situations. Because the exceptions are premised on their not leading to inappropriate tax results, a taxpayer generally should be permitted to intentionally contribute assets meeting the de minimis disparity exception or to limit a capital contribution to an amount meeting the de minimis contribution exception. In the event that a transaction meets the requirements of an exception in form but not in substance, however, as where a series of

[91] Even if the de minimis disparity exception were not adopted and the deemed-issuance and recapitalization rules were applied, the 2 shares with the segmented basis in the example above would instead simply have bases of $49.19 ($41.98 + $7.21) and $34.61 ($9.20 + $18.40 + $7.01) if our proposal on segmenting were adopted and no exception for segmenting applied.

related transfers are within the de minimis contribution exception when taken separately but not when taken together, a rule could be adopted to exclude such transaction from the benefit of the exception.

#### e. Extension to Other Stockless Transactions

We believe that the deemed issuance and recapitalization approach creates undue burdens and requires unnecessary valuations in all stockless transactions. Therefore, we recommend that the de minimis contribution exception and de minimis disparity exception be extended to certain other stockless transactions. More specifically, a stockless Section 351 transaction or a stockless reorganization should be exempt from the deemed issuance and recapitalization approach if the transferred assets or property surrendered therein meets the requirements of either of the de minimis exceptions described above. In the context of a stockless reorganization the determination of whether the de minimis contribution exception applies would be made by reference to the value of the property surrendered by the shareholder and the value of the stock of the acquiring corporation held by such shareholder before the reorganization.

#### f. Extension of De Minimis Exceptions to Transactions where Stock is Received

If the de minimis exceptions described above are adopted for capital contributions, stockless Section 351 transactions and other stockless transactions, consideration might be given to extending these de minimis exceptions to certain transactions in which stock is received. Specifically, if the exceptions were adopted for stockless transactions, then to maximize consistency and minimize electivity, they might also be extended to transactions that could have been consummated as stockless transactions without changing the economics of the transaction. That criterion should be satisfied only in transactions that do not result in a shift in ownership from one shareholder to another shareholder in the transferee or acquiring corporation, as the case may be.[92] The de minimis exceptions could be applied to a transaction in which stock is actually issued in the same manner as described above for stockless transactions.

For example, assume J owns 100 voting common shares of the stock of corporation X having a value of $100 and a basis of $50 and constituting all of the shares of X. J transfers all of the stock of corporation Y, having a value and basis of $100, to X in exchange for an additional 100 voting common shares of X stock. In this circumstance, to be consistent with the de minimis disparity exception for stockless transactions discussed above, consideration might be given to treating the foregoing transaction for basis determination purposes as a $100 capital contribution of the stock of Y to X followed by a recapitalization of J's pre-existing 100 X shares into 200 X shares.

While the foregoing methodology would promote consistency between stockless and stock transactions, it would do so at the cost of promoting averaged basis over traced basis. Nevertheless, consistency of basis results in this case may be more compelling than the preservation of tracing principles.[93]

### 3. Allocation of Consideration

The Regulations do not expressly address allocations of consideration in Section 351 transactions. As indicated in Revenue Ruling 68-55,[94] however, it is the

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[92] The IRS and Treasury have considered such limitations in other contexts. Regulations Section 1.368-2(*l*) addresses transactions that qualify as a reorganization under Section 368(a)(1)(D) despite the absence of any in-form stock consideration that might meet the distribution requirement of Sections 368(a)(1)(D) and 354(b)(1)(B). Such absence is generally disregarded if there is identical ownership of the stock of the transferor and transferee, taking into account certain constructive ownership rules of Section 318 and certain de minimis variations in ownership.

[93] In Part IV.F below, the possibility of adopting an averaging regime in certain circumstances is discussed. If it were adopted, there would be no need for the de minimis exceptions to tracing discussed herein for taxpayers to which the averaging regime applies.

[94] 1968-1 C.B. 140.

government's position that under current law consideration received by a transferor in a Section 351 exchange must be allocated proportionally among all assets transferred.

The Proposed Regulations apparently continue this proportional allocation approach. However, certain portions of the Proposed Regulations might be read to suggest that designated allocations between stock and other assets (and, with respect to the consideration allocated to stock, among shares) might be possible where both stock and other assets are surrendered in a Section 351 exchange.[95]

On the one hand, it might be argued that requiring proportional allocation of consideration with respect to stock transferred by a shareholder to the transferee corporation in a Section 351 exchange creates an inconsistency between Section 351 exchanges and reorganization exchanges, since designated allocations among classes of stock (and, in some cases, among shares of stock) are permitted in reorganizations. If the

[95] Proposed Regulations Section 1.351-2(b) expressly adopts the proportional allocation of consideration rule for Section 351 transactions set forth in Revenue Ruling 68-55 and does not indicate any exception for stock versus nonstock assets transferred. However, the example provided in Proposed Regulations Section 1.351-2(b) only involves the transfer of nonstock assets. But Proposed Regulations Section 1.358-2(i) Example 17 includes stock as a transferred asset in a Section 351 transaction. The example allocates the consideration received pro rata among all assets transferred, including the stock, and cites Proposed Regulations Section 1.351-2, leading to the conclusion that, under the Proposed Regulations, designated allocations are not permitted even where stock is one of the transferred assets. (See also the preamble to the Proposed Regulations, which provides in relevant part: "[C]onsistent with Rev. Rul. 68-55, these regulations provide that, for purposes of determining gain under section 351(b), the fair market value of each category of consideration received in a section 351 exchange is allocated between the transferred assets in [sic] based on relative fair market values." 74 Fed. Reg. 3509, 3513 (Jan. 21, 2009)). On the other hand, Proposed Regulations Section 1.358-2(g)(2) provides: "If in an exchange to which section 351 applies stock or stock and property is transferred to a corporation and no liability is assumed by the transferee in the exchange, then the basis of the stock transferred … shall be allocated pursuant to paragraphs (b)(1) through (b)(3) of this section. Such rules [i.e., presumably the rules of paragraphs (b)(1) to (b)(3)] also apply to other property, money or more than one class of stock or securities received." But paragraphs (b)(1) through (b)(3) of Proposed Regulations Section 1.358-2 address tracing basis in stock or securities surrendered to shares received where all that is received is one class of stock. It is paragraph (b)(4) of Proposed Regulations Section 1.358-2 that, through a cross reference to Proposed Regulations Section 1.354-1(d)(1), addresses allocation (including designated allocations) where what is received by the shareholder is multiple classes of stock and/or boot. Proposed Regulations Section 1.354-1 generally permits designated allocations, except within a class of stock in a dividend-equivalent transaction. Accordingly, it is unclear whether the last sentence of Proposed Regulations Section 1.358-2(g)(2) perhaps indicates that designated allocations might have been contemplated by the drafters of the Proposed Regulations in at least some Section 351 exchanges.

goal of the Proposed Regulations is to promote consistency regarding the treatment of stock, then arguably either designated allocations with respect to stock transferred in Section 351 exchanges should be permitted or proportional allocations of consideration with respect to stock should be required in reorganization transactions.[96]

On the other hand, if designated allocations with respect to stock transferred in a Section 351 exchange were permitted, then inconsistencies would be created between transfers of stock and transfers of other assets in the same exchange. Said another way, absent permitting designated allocations among all assets (whether stock or nonstock) in a Section 351 transaction, or requiring proportional allocations among all shares in any exchange (including in any reorganization exchange), either an inconsistency will exist between stock transferred in a Section 351 exchange and stock transferred in a reorganization exchange or an inconsistency will exist between stock transferred in a Section 351 exchange and other assets transferred in the same exchange.[97] Moreover, if designated allocations were permitted with respect to stock but not other assets transferred in a Section 351 exchange, the issue of how consideration should be allocated between stock and other assets transferred to the transferee corporation would need to be addressed.[98] In addition, if designated allocations were permitted with respect

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[96] The preamble to the Proposed Regulations provides that the Proposed Regulations are "intended to be a comprehensive approach to stock basis recovery and stock basis identification to produce consistent results *among economically similar transactions*. . . ." 74 Fed. Reg. at 3510 (emphasis added). Of course, that begs the question of whether a Section 351 exchange is an economically similar transaction to a reorganization exchange for purposes of designated allocations of consideration.

[97] For a more extensive discussion of inconsistencies under the Proposed Regulations between the allocation of consideration in Section 351 transactions and reorganizations (assuming proportional allocation of consideration continues to be required among both stock and nonstock assets in a Section 351 transaction) and of "cherry picking" issues raised by designated allocations, see the American Bar Association Section of Taxation, Comments on Proposed Regulations Regarding Allocation of Consideration and Allocation and Recovery of Basis in Transactions Involving Corporate Stock or Securities (Apr. 28, 2010) (the "ABA Report").

[98] Assume J owns Class A and Class B shares in corporation X, with each class of shares owned by J having a value of $25. In addition, J owns a truck having a value of $25 and a piece of equipment

to stock in a Section 351 exchange, to the extent different designated allocation rules apply in dividend-equivalent and non-dividend-equivalent reorganizations, decisions would need to be made as to what corollary of such rules should apply in the Section 351 context.[99] If liabilities were assumed in connection with the Section 351 exchange, additional complications may also arise.

The topic of designated allocations between stock and nonstock assets (and among nonstock assets), has wider ranging implications than just the allocation of consideration among stock in reorganization exchanges and other stock transactions and, other than as regards allocations within a class of shares in non-dividend-equivalent reorganizations, is not addressed further in this Report. Nevertheless, we believe that the

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having a value of $25. J transfers the X stock, the truck and the equipment to corporation Y in a Section 351 transaction in exchange for $50 in cash and Y stock having a value of $50. Should J and Y be able to designate all the cash as going to the X stock and all the Y stock as going to the truck and equipment, vice versa or any other allocation J and Y agree on that is "economically reasonable", with the consideration as so divided then (i) being required to be allocated proportionally to the truck and the equipment, but (ii) being subject to further designated allocations between the classes (or even among shares within classes) of the X stock? For example, should J and Y be able to agree that $20 of cash and $30 of Y stock will be allocated to the X stock and $30 of cash and $20 of Y stock will be allocated to the truck and equipment, with the $30 of cash and $20 of Y stock then being required to be allocated pro rata between the truck and the equipment and J and Y being able to agree to further designated allocations of the $20 of cash and $30 of Y stock among the two classes of X stock (or even among shares of X stock in the same class)? Or should all consideration be allocated pro rata in the first instance among the X stock, the truck and the equipment (resulting in $25 of cash and $25 of Y stock being allocated to the X stock, $12.50 of cash and $12.50 of Y stock being allocated to the truck and $12.50 of cash and $12.50 of Y stock being allocated to the equipment), with J and Y then being able to agree to designated allocations of the $25 of cash and $25 of Y stock among the two classes of X stock (or even among shares of X stock in the same class)?

99 For example, should Section 304 be used as the corollary for a "dividend-equivalent" Section 351 transaction? If so, then to be consistent with the rules under the Proposed Regulations applicable to reorganization exchanges, designated allocations should not be permitted among shares within a class (but should be permitted among classes if permitted in dividend-equivalent reorganizations) if any boot in the Section 351 transaction would be subject to Section 301 treatment under Section 304. Or, should the corollary be broader, such as some sort of comparison to whether the transaction would have been treated as dividend equivalent if it were subject to the reorganization dividend equivalency rules. For example, if J owns only 3% of the Class A stock and 3% of the Class B stock of corporation X and transfers that stock to corporation Y for 100% of Y's stock plus cash, even though Section 304 would not apply to the transaction (because J is not in control of X), should the transaction be treated as a "dividend-equivalent" Section 351 transaction because it would be dividend equivalent if the hypothetical deemed issuance and redemption of Y stock used to determine dividend equivalence in reorganizations were applied? Or should yet some other test be applied to determine whether a Section 351 exchange is "dividend equivalent"?

intent of the Proposed Regulations regarding designated allocations in Section 351 exchanges should be clarified and, in deciding what rules should apply in making allocations in Section 351 exchanges involving stock, the considerations discussed above should be taken into account.

## B. Section 301 Distributions

### 1. Per-Share Versus Aggregate Basis Recovery

As discussed above, to the extent a distribution by a corporation to its shareholder is in excess of the distributing corporation's earnings and profits, basis is recovered on a share by share basis under the Proposed Regulations, and to the extent the distribution is in excess of the basis of a share, gain is recognized even if there is unrecovered basis in other shares (a per-share basis recovery approach). An alternative approach would be to recover all basis in all shares before any gain is recognized (an aggregate basis recovery approach). As also discussed above, although it is not clear from the language of Section 301(c)(2) whether a shareholder's basis in its stock can be recovered in the aggregate prior to gain recognition under Section 301(c)(3), existing case law has applied a per-share approach. Good arguments exist, however, in favor of adopting an aggregate approach to basis recovery. Aggregate basis recovery is a paradigm followed in other areas of the law with respect to distributions, including under the partnership[100] and subchapter S[101] regimes. A variant of aggregate basis recovery is also followed under the consolidated return regime.[102] Although it might be argued that

[100] See Rev. Rul. 84-53, 1984-1 C.B. 159.

[101] See Reg. § 1.1367-1(c)(3) ("If the amount [of passthrough items and distributions] attributable to a share [in an S corporation] exceeds its basis, the excess is applied to reduce (but not below zero) the remaining basis of all other shares of stock in the corporation owned by the shareholder in proportion to the remaining basis of each of such shares.").

such regimes are distinguishable because, unlike subchapter C, they all apply some pass-through principles, the aggregate approach to basis recovery under such regimes is not limited to basis created by pass-through items.

Furthermore, when a shareholder contributes stock of a corporation to such corporation's capital, the shareholder generally is not permitted to take a deduction with respect to its basis in the contributed shares if the shareholder holds other stock in the corporation.[103] Allowing the shareholder not to recognize gain with respect to distributions from a corporation so long as the shareholder has unrecovered basis in other shares of the corporation might be viewed as an appropriate corollary to the contribution result.

Moreover, Section 301(c)(1) (by its reference to Section 316) adopts an aggregate approach in determining what portion of a distribution is paid from earnings and profits and, accordingly, is treated as a dividend. All of the distributing corporation's earnings and profits are available, rather than merely the ratable portion corresponding to the shares with respect to which the distribution is made. Especially in the context of a closely held corporation, if a distribution from the corporation to its shareholder is taxed as a dividend based on all available earnings and profits, then a corollary might be that

[102] Simplifying somewhat, the consolidated return rules permit the creation of "negative basis" or "excess loss accounts" ("ELAs") in shares and contain certain mechanisms designed to minimize the creation of ELAs when there is positive basis remaining in other shares held by the taxpayer, although the rules minimizing the creation of ELAs generally do not apply to ELAs created as a result of distributions.

[103] See Comm'r v. Fink, 483 U.S. 89 (1987). Fink involved a non-pro rata contribution by a shareholder that owned a majority of the corporation's shares both before and after the contribution. The Court observed it was not deciding the case of a shareholder that contributed enough shares to lose control, but, as a dissenting opinion in the case noted, it is difficult to discern anything in the Court's reasoning that would suggest a different result in the loss of control case. Moreover, a distribution with respect to which there is no surrender of shares is normally made to all shareholders. Accordingly, the better analog to such a distribution is a pro rata contribution of stock by all shareholders, which is clearly a transaction with respect to which shareholders are not permitted to take a loss.

the shareholder also should be permitted to recover its entire investment in the corporation before recognizing gain.[104]

Permitting aggregate basis recovery has the added benefit, at least in the context of closely-held corporations, of being easily administrable. It also makes economic sense when a shareholder is viewed as making a unitary investment in the corporation. As regards administrability, consider, for example, a sole shareholder that routinely makes contributions to a corporation or engages in reorganization transactions, sometimes receiving stock in the transaction and sometimes receiving no consideration. If aggregate basis recovery were permitted under Section 301, the shareholder would not need to determine how its aggregate basis in the stock of the corporation was allocated to each share in order to determine the tax consequences of a distribution, but would only need to know the aggregate basis in the stock of the corporation.[105] Under the Proposed Regulations, the shareholder would need to track the separate basis of each share, which can entail significant complexity.

The primary drawback of permitting aggregate basis recovery is that taxpayers might be viewed as being permitted too much electivity if, on the one hand, the taxpayer is treated as making a unitary investment in the corporation, but where the taxpayer disposes of some but not all of its shares in a sale or exchange transaction, the

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104 See Warnke Article, supra note 6 at 104-106; Letter from Philip J. Levine et al., McDermott, Will & Emery to Eric Solomon, Assistant Secretary (Tax Policy), Department of the Treasury, et al. (Nov. 28, 2008); Letter from Mark Boyer et al., PricewaterhouseCoopers LLP, to Karen Gilbreath Sowell, Deputy Assistant Secretary (Tax Policy), Department of the Treasury, et al. (July 7, 2008), reprinted in 2008 TAX NOTES TODAY 135-64 (July 7, 2008).

105 Even if aggregate basis recovery were adopted, a shareholder would still need to track the separate basis of each share in order to determine gain or loss if the shareholder were to dispose of less than all of its shares. While such situations may arise, in our experience, shareholders who engage in capital contributions, stockless reorganizations and other transactions with respect to which tracing basis can be extremely complex are also much more likely to receive distributions in excess of earnings and profits than engage in taxable dispositions of only a portion of their shares.

taxpayer is then permitted to pick and choose which shares are sold.[106] We believe, however, that it is appropriate to draw distinctions between circumstances in which (i) a shareholder is receiving a return of capital from a corporation and (ii) a shareholder is transferring a portion of its investment in the corporation to a third party.

In addition, although viewing the shareholder as making a unitary investment in the corporation may make sense in the context of closely-held corporations or large shareholders in publicly traded corporations, in the context of a small shareholder in a publicly traded corporation where a share is held as a financial interest rather than as a true investment in the underlying corporation, arguably the better theoretical approach would be to treat each share of stock as a distinct unit of property with a unique basis.[107] Moreover, as a practical matter, to the extent facilitating broker reporting is thought to be an important goal, this view of a share of stock as a distinct unit of property facilitates broker reporting as each broker can then determine gain on a share by share basis, without the need to know whether the shareholder owns other shares in the same corporation with a different broker and what basis the shareholder has in those other shares (which would be required if aggregate basis recovery were applicable to shareholders of publicly traded corporations).

For the foregoing reasons, on balance, we believe that aggregate basis recovery should be adopted for all shareholders. However, we would support the

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[106] This electivity would not necessarily be limited to sales to third parties. Electivity might be achieved in upstream sales to a related party to which Section 304 is not applicable. In addition, a modified form of electivity might also apply in certain cross-chain reorganizations or Section 351 transactions with boot and in Section 304 transactions. But in the related party context such electivity is more likely to be with respect to the recognition of gain on gain shares than loss on loss shares. See §§ 267, 351(a) and 354.

[107] Cf. Alan L. Feld, Another Approach to Corporate Stock Basis, 86 TAXES 131 (Mar. 2008) (discussing significant shareholders viewing their stock interests as representing an interest in the underlying corporation, whereas ordinary investors view their stock interests as merely financial instruments).

adoption of the per-share approach as regards Small Public Shareholders if it were felt important to facilitate broker reporting. We note, moreover, that such holders could be viewed as raising somewhat different policy considerations.

If aggregate basis recovery is adopted and electivity is viewed as a concern, consideration might be given to adoption of appropriate anti-electivity measures to prevent any perceived abuses that might arise from selective disposition of shares. Finally, even if aggregate basis recovery is not adopted for all shareholders, we recommend that it be adopted at least for shareholders with substantial connections to the corporation in question (i.e., Large Shareholders). In other areas of the tax law, ownership thresholds such as 20 percent,[108] 50 percent[109] and 80 percent[110] have been used as relevant dividing lines.[111]

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108 See, e.g., § 197(f)(9) (defining a "related person" for purposes of the anti-churning rules as one bearing a relationship specified in Section 267(b) or Section 707(b)(1), substituting "20 percent" for "50 percent"); § 243(c) (providing an 80 percent dividends received deduction for dividends received from a corporation the stock of which is owned 20 percent or more by vote and value by the taxpayer); § 246A(c)(2)(B) (providing one definition of "portfolio stock" as stock of any corporation other than stock possessing at least 20 percent of the total vote and value of such corporation, and such stock is owned by 5 or fewer corporate shareholders).

109 See, e.g., § 246A(c)(2)(A) (providing one definition of "portfolio stock" as stock of any corporation other than stock possessing at least 50 percent of the total vote and value of such corporation); § 267(b) (testing relatedness using a 50 percent by value ownership threshold); § 269(a) (defining "control" for purposes of Section 269(a) as the ownership of stock possessing at least 50 percent of the total vote or value of the corporation); § 304(c) (defining "control" for purposes of Section 304 as ownership of stock possessing at least 50 percent of the total vote or value of the corporation); § 318(a)(2)(C) and (3)(C) (attribution to or from a corporation applies if 50 percent or more of the total value of the stock in a corporation is owned, directly or indirectly, by or for any person); § 368(a)(2)(F)(iii) (in determining whether a corporation is an investment company for reorganization purposes, a parent corporation is deemed to own its ratable share of a subsidiary's assets provided that the parent owns 50 percent or more of the total vote or value of the stock of such subsidiary); § 897(c)(5) (in determining whether a corporation is a United States real property holding corporation, such corporation is treated as owning its ratable share of a subsidiary's assets provided that the corporation owns 50 percent or more of the fair market value of all classes of stock of the subsidiary).

110 See, e.g., § 243(b) (providing a 100 percent dividends received deduction for dividends received by a corporation from another corporation that, among other requirements, is a member of the same affiliated group as defined in Section 1504(a)); § 332 (for purposes of subsidiary liquidations under Section 332, the parent corporation must, on the date of adoption of the plan of liquidation until the receipt of the property of the subsidiary corporation, own stock in the subsidiary corporation meeting the requirements of Section 1504(a)(2)); § 351 (refers to "control" as defined in Section 368(c)); § 368(c) (defining "control" for various purposes as the ownership of stock possessing at least 80 percent

### 2. Implementation of Aggregate Basis Recovery

If aggregate basis recovery is adopted, a further issue arises as to whether gain should be recognized only after basis in all shares in all classes held by a shareholder has been recovered (an all classes approach) or once basis in the shares within the class with respect to which the distribution is made has been recovered (a within class approach). We believe that if aggregate basis recovery is adopted, a within class approach generally should be followed and all examples in this Report that apply aggregate basis recovery follow that approach.

But even if a within class approach to aggregate basis recovery is adopted, a question still arises as to how basis recovery should be sequenced among different basis blocks within a class. There are at least three possible sequencing approaches: the "proportional," "recursive" and "spillover" approaches. Under a proportional approach, basis is recovered from all shares in a manner that preserves the ratio of the basis in any share to the basis in any other share in the class from which basis is recovered. For example, if four shares had basis of \$10, \$20, \$30 and \$40, respectively, and \$75 of aggregate basis were to be recovered, then the basis in the four shares would be reduced to \$2.50, \$5, \$7.50 and \$10, respectively, preserving the 1:2:3:4 ratio of the basis in the shares.

Under a recursive approach, the same absolute amount of basis would be recovered from each share in the class, up to but not exceeding the basis in any share, and

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of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation); § 1504(a)(2) (affiliation is determined by stock ownership in a corporation that possesses at least 80 percent of the total vote and value of such corporation).

[111] Other dividing lines are also possible and are also used elsewhere in the Code, such as 5 percent, 10 percent, or 25 percent. We do not mean to foreclose consideration of such other thresholds. We also do not explore in this Report whether vote, value or vote and value is the appropriate measure of whatever threshold percentage is chosen.

then any further basis recovery would be achieved by recovering the same absolute amount of basis from the remaining shares, up to but not exceeding the remaining basis in any remaining share, and so on until the basis in every share reaches zero, at which point gain would be recognized. Using the example in the paragraph above, the basis in all four shares first would be reduced by $10 apiece at which point the basis in the first share would reach zero. The basis in the remaining three shares then would be reduced by a further $10 apiece at which point the basis in the second share would also reach zero. The remaining $5 in basis recovery would come equally from the two remaining non-zero basis shares, leaving the four shares with basis of $0, $0, $7.50 and $17.50, respectively.

The spillover approach combines the absolute and proportional elements of the other two approaches. This is the approach applied to shares in subchapter S corporations by Regulations Section 1.1367-1(c)(3). Under this approach, basis in each share is tentatively reduced by the same absolute amount. Then, to the extent any shares would have a negative amount of basis, the aggregate negative amount is allocated to shares with remaining positive basis in proportion to that remaining positive basis. Using the same example as in the previous two paragraphs, each share's basis would tentatively be reduced by $18.75, leaving tentative basis of -$8.75, $1.25, $11.25 and $21.25, respectively. To offset the $8.75 of negative basis and restore the first share to zero basis, the basis in the remaining three shares is reduced by a total of $8.75 in proportion to their share of the $33.75 of tentative remaining basis. The result is shares with basis of $0, $0.93, $8.33 and $15.74, respectively.

We believe the recursive basis approach is the most consistent with <u>Johnson</u> and the idea that a distribution is paid pro rata on each share. It also preserves absolute differences in basis among shares with basis remaining. On the other hand, the spillover approach is an approach already applied under current law in the subchapter S context. Accordingly, consistency might favor adoption of the spillover approach.[112]

### C. Section 302 Redemptions

We agree with the decision of the IRS and Treasury to make the treatment of the distribution that is deemed to occur upon a dividend-equivalent redemption consistent with that of an actual in-form distribution with no surrender of shares. As noted above, the Code requires that a dividend-equivalent redemption be treated like a Section 301 distribution but does not further describe such distribution. The broad statutory language is sufficient to prevent basis recovery or capital gain treatment if the issuing corporation has sufficient earnings and profits to support dividend treatment of all redemption proceeds. As discussed above, however, it does not establish which shares participate in the distribution deemed to occur under Section 302(d) or how the unrecovered basis in the redeemed shares is preserved. The Redeemed Class Approach of the Proposed Regulations addresses both of these issues by reference to the same hypothetical distribution and recapitalization transaction. The adoption of such a consistent economically-equivalent transaction from which all tax consequences flow is essential to reconciling a very general statutory provision with an increasingly specific share-by-share approach to stockless transactions. However, based on the view of the economic substance of a dividend-equivalent redemption held by at least some portion of the Executive Committee of the Tax Section, we propose that consideration be given to two alternative paradigms – the dividend controlling shares approach (the "DCS Approach"), and the bifurcated distribution approach (the "Bifurcated Distribution

[112] Unless otherwise noted, in the remainder of this Report and Appendix A hereto, it is assumed that if aggregate basis recovery is adopted, a recursive approach is applied.

Approach") – either of which could serve as that single model. Appendix A hereto contains a number of examples, referenced below, that contrast and compare the results in various scenarios under the Redeemed Class Approach, the DCS Approach and the Bifurcated Distribution Approach.[113]

### 1. Redeemed Class Approach

As explained above in Part III.B.1.b, the Redeemed Class Approach treats a dividend-equivalent redemption as a pro rata distribution to all shares of the redeemed class of shares held by the redeemed shareholder immediately before the redemption. If less than all of the shares of a class of stock held by the redeemed shareholder are redeemed, the aggregate basis of all shares in the redeemed class held by the shareholder, after any reduction for the distribution occasioned by the redemption, is concentrated in the retained shares.

Unfortunately, this treatment of the distribution as always being only on shares in the redeemed class and the resulting concentration of unrecovered basis in any retained shares in the redeemed class can lead to some very uneconomic results. For example, where the redeeming corporation has earnings and profits in excess of the amount paid in the redemption and substantially all of the shares in the redeemed class are redeemed, the redeemed shareholder can end up with a significant uneconomic built-in loss in the remaining shares in the redeemed class.[114] That uneconomic built-in loss may then later be recognized by disposing of the remaining shares in the redeemed class.

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[113] The examples in Appendix A also compare and contrast the results in each of the scenarios depending on whether the de minimis exceptions recommended herein, aggregate basis recovery, also recommended herein, basis averaging (discussed in greater detail in Part IV.F below) or a combination thereof are applied.

[114] See, e.g., the basis results under the Redeemed Class Approach in Scenario 2A of Appendix A, wherein $1000 of basis is concentrated in a share of preferred stock with a value of $10.

Moreover, the Redeemed Class Approach adopts a paradigm that seems to be at odds with corporate reality, at least in cases in which the redeeming corporation has earnings and profits that equal or exceed a substantial portion of the redemption proceeds. In that case, for federal tax purposes, all or a substantial portion of the redemption proceeds are treated as dividends. Yet the Redeemed Class Approach treats the redemption proceeds as being a distribution with respect to shares in the redeemed class without regard to whether a distribution of that magnitude in fact could be paid on such shares as a corporate matter.[115]

### 2. Dividend Controlling Shares Approach

Under the DCS Approach, a dividend-equivalent redemption would be treated as (i) the surrender of the redeemed shares as a contribution to capital with respect to the shares that caused the redemption to be dividend equivalent, followed by (ii) a distribution of the redemption proceeds as a distribution with respect to such post-capital contribution shares. More specifically, under the DCS Approach the deemed distribution would be with respect to all of the shares (the "dividend controlling shares") owned by the taxpayer in each class of shares with respect to which, had the taxpayer not actually or constructively owned shares in that class, Section 302(d) would not have applied to the redemption in question. The deemed distribution would be treated as made to all dividend controlling shares owned by the taxpayer in proportion to their relative fair market values.

[115] Note that another possible drawback of the Redeemed Class Approach is that, at least in the case of a Small Public Shareholder, this approach would create additional burdens on broker reporting because it shifts basis among shares. However, the DCS Approach and the Bifurcated Distribution Approach discussed below also shift basis among shares and therefore will create the same, if not more, administrative burden on brokers. This issue is discussed in greater detail below in Part IV.C.7 of this Report.

More specifically, to apply the DCS approach, the steps described below would be followed:

1. First, identify the shares that caused the redemption to be dividend equivalent (i.e., the dividend controlling shares).

2. Second, treat the redeemed shares as being contributed to the capital of the dividend controlling shares owned by the shareholder.[116] If the shareholder does not own any dividend controlling shares (i.e., the redemption distribution is dividend-equivalent solely by reason of attribution), then treat the redeemed shares as being recapitalized into dividend controlling shares.

3. Third, treat the deemed distribution as being made proportionally on all the post-capital contribution/recapitalization dividend controlling shares held by the shareholder. Any portion of the distribution in excess of earnings and profits would reduce basis proportionally in the shareholder's dividend controlling shares, and any amount in excess of basis in each dividend controlling share would be recognized as gain (unless aggregate basis recovery is adopted).

4. Fourth, if all the shareholder's dividend controlling shares are redeemed (i.e., the shareholder does not own any dividend controlling shares following the redemption because they were all redeemed or the shareholder was only deemed to own dividend controlling shares by reason of the Step 2 recapitalization above), treat any unrecovered basis in the redeemed shares as a deferred loss.

[116] Note that under the Proposed Regulations, the deemed issuance and recapitalization approach applies to capital contributions. However, if the de minimis contribution and de minimis disparity exceptions recommended above are adopted and are applicable, then the basis of the redeemed shares would simply be added to the shareholder's basis in the dividend controlling shares, and each dividend controlling share will have an averaged, not segmented, basis, subject to any applicable segmenting exceptions.

The DCS Approach appears to be more consistent than the Redeemed Class Approach with the principle underlying Section 302. It also appears to be more consistent than the Redeemed Class Approach with the treatment of economically equivalent transactions in which the shareholder and corporation could actually engage, and with the operation of underlying corporate law. Dividend controlling shares typically are common stock and other voting stock. If a holder of shares of nonvoting, nonparticipating preferred stock and voting common stock surrenders some shares of the preferred stock in a dividend-equivalent redemption, such a shareholder should not be treated as having received an additional distribution with respect to those preferred shares or other shares of the same class because the receipt of an additional distribution is inconsistent with the terms of nonvoting, nonparticipating stock. It is more consistent to treat such a holder as receiving an additional distribution with respect to its common shares and as surrendering the nonparticipating shares prior to the distribution for no consideration (as a contribution to capital) or for additional common shares.

The DCS Approach has the benefit of being more conceptually pure than the Redeemed Class Approach as well as minimizing the basis concentration that can result under the Redeemed Class Approach.[117] However, a substantial drawback of the DCS Approach is that it is significantly more complex than the Redeemed Class Approach. As discussed above in Part III.B.1.b, the Redeemed Class Approach treats the redemption distribution as being made solely with respect to all shares in the redeemed class and treats any redeemed shares, along with any retained shares in the same class, as

[117] For example, in situations where a shareholder owns both preferred and common stock in a corporation, if all but one share of the shareholder's preferred stock are redeemed in a dividend-equivalent redemption, the basis in the redeemed shares will not be concentrated on the single remaining share of preferred stock, but is rather added to the basis of the common (i.e., the dividend controlling shares). Compare the basis results with respect to the retained preferred shares under the DCS Approach versus the Redeemed Class Approach in Scenarios 2A and 4A in Appendix A.

being recapitalized into the number of retained shares. Accordingly, all that needs to be known to calculate any redemption distribution gain and post-recapitalization basis blocks under the Redeemed Class Approach is the block-by-block basis in the pre-redemption shares in the redeemed class and the number of remaining shares in the class held by the redeemed shareholder after the redemption. By contrast, under the DCS Approach, the redeemed shares, along with the dividend controlling shares,[118] are treated as being recapitalized into the number of dividend controlling shares[119] and the redemption distribution is then treated as being made proportionally with respect to each of those post-recapitalization shares. Accordingly, under the DCS Approach, in order to calculate any redemption distribution gain and post-recapitalization basis blocks, the relative values of the redeemed shares and dividend controlling shares need to be determined, as well as the pre-recapitalization block-by-block basis of both the redeemed shares and the dividend controlling shares. This often will require complex valuations, as well as basis numbers that the shareholder may not have.[120]

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118 For ease of discussion, in this Report it is assumed that the redeemed shares and the dividend controlling shares are always in different classes. If they are not, such as for example when there is only one class of stock outstanding, then there is little, if any, difference in results among the three approaches to dividend-equivalent redemptions discussed in this Report.

119 Although the DCS Approach treats the redeemed shares as being contributed to the capital of the dividend controlling shares, under the Proposed Regulations capital contributions are treated as if new shares of the class with respect to which the contribution is made are issued and then those new shares along with the actual shares in the class held by the shareholder are recapitalized into the number of actual shares. Accordingly, the impact of treating redeemed shares as being contributed to capital is the recapitalization result described in the text. This Report recommends exceptions to these recapitalization rules for certain capital contributions, which are discussed in Part IV.A. But unless otherwise noted, for purposes of the discussion in this Part IV.C, it generally is assumed that these exceptions do not apply and a contribution to capital always results in a deemed recapitalization. It is also generally assumed for purposes of the discussion in this Part IV.C, unless otherwise noted, that neither aggregate basis recovery nor basis averaging (discussed in greater detail in Part IV.F below) are applied.

120 For example, in Scenario 2A in Appendix A, J owns 100 X common shares (the dividend controlling shares) and 100 X preferred shares. Each preferred share has a pre-redemption basis and value of $10 and X redeems 99 of A’s 100 preferred shares for $990. Under the DCS Approach, the 99 redeemed preferred shares and 100 common shares are first deemed recapitalized into 100 common shares and then $990 is deemed distributed proportionally on each of the 100 post-recapitalization common

In addition, where the redeeming corporation has no earnings and profits, the DCS Approach can result in greater gain recognition (and correspondingly greater unrecovered basis) than the Redeemed Class Approach.[121] This greater gain/greater unrecovered basis result may be viewed as a failing of the DCS Approach. Alternatively, it may be viewed largely as a by-product of choosing per share rather than aggregate basis recovery in Section 301(c)(2) distributions. But, if one assumes that per share basis recovery is the right paradigm, then there is no denying the DCS Approach takes away the selectivity inherent in the Redeemed Class Approach, which lets one recover basis in shares in particular classes by merely selecting the class from which shares are redeemed.[122]

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shares. To determine the basis blocks that result from the deemed recapitalization (and, hence any redemption distribution gain from the $990 distribution on the common stock and the post-transaction basis blocks) it is necessary to know both the value of the preferred stock (which may not be overly difficult, since presumably it is necessary to know the value in order to know the redemption price) and the value of the common stock (which may be much harder to determine). (In the simplified example in Scenario 2A the value of the common is stated to be $1000, as if known with certainty. This certainty will rarely exist in practice.) It is also necessary to know the block-by-block basis of the 100 pre-recapitalization common shares, as well as of the 99 redeemed preferred shares. By contrast, under the Redeemed Class Approach, the first step is that the $990 distribution is deemed made solely on the full 100 preferred shares. Then, the 100 preferred shares are deemed recapitalized into the 1 remaining preferred share. Because the redemption distribution under the Redeemed Class Approach is deemed to occur only on shares in the redeemed class and the recapitalization is deemed to be into the same class of shares as the remaining share, all that needs to be known to determine any redemption distribution gain and post-transaction basis blocks in the recapitalized share(s) is the block-by-block basis in the pre-redemption preferred shares and the number of shares into which the preferred shares are deemed recapitalized. No valuations are required. In addition, no knowledge of the basis, or basis blocks, in the 100 common shares is necessary because no distribution is deemed made with respect to those shares. See Scenario 6A in Appendix A for a more complex fact pattern involving two blocks of pre-recapitalization common stock rather than the one block involved in Scenario 2A.

[121] Compare the aggregate gain and remaining basis results under the DCS Approach versus the Redeemed Class Approach in Scenarios 1A and 5A in Appendix A. Note, however, that the DCS Approach can result in less aggregate gain recognition and more aggregate basis recovery than the Redeemed Class Approach in certain cases where the value of the redeemed shares exceeds such shares' basis. For example, compare the aggregate gain and remaining basis results under the DCS Approach versus the Redeemed Class Approach in Scenario 6A in Appendix A.

[122] Said another way, the DCS Approach fully embraces Section 302(d)'s disregard for the form of the transaction in a dividend-equivalent redemption whereas the Redeemed Class Approach respects the class designation selected through the form of the transaction.

### 3. Bifurcated Distribution Approach

As discussed above, the DCS Approach attempts to determine what group of shares the holder holds that caused the redemption to be treated as a distribution and treats the redemption distribution as being made only on those shares. It rationalizes the elimination of the redeemed shares by treating them as being recapitalized into dividend controlling shares prior to the redemption distribution.

Instead of viewing the entire distribution as being made with respect to only one group of shares (as both the Redeemed Class and DCS Approaches do), one could consider how else the distribution could have been made. That is, how else might the distribution have been made from a corporate law perspective in a manner that is consistent with the transaction being treated as a distribution on shares (as mandated by Section 302(d)), rather than a sale of shares. One possible approach, referred to in this Report as the Bifurcated Distribution Approach, might be as follows:

1. First, to the extent the distribution is not in excess of the distributing (redeeming) corporation's earnings and profits, treat the distribution as being made on the shares that could receive such distribution under the governing corporate documents if a "dividend" were paid for corporate purposes. In the paradigm case of one class of common and one class of fixed rate preferred, that means the redeemed preferred would get any accrued dividends as of the redemption date, and anything in excess of that dividend would go to the common.[123]

[123] Because any accrued dividends on unredeemed shares of preferred would be unaffected by the redemption, no dividends would be treated as paid on such shares upon redemption of other preferred shares.

2. Second, as regards "non-dividends," the governing corporate documents would presumably allow such distribution to be paid to any class of shares, so, consistent with form (at least as regards which class receives the distribution), treat any distribution in excess of earnings and profits as being paid proportionally on all shares in the redeemed class. Any amount of the non-dividend distribution in excess of basis would be recognized as gain.

3. Third, if less than all of the shareholder's shares are redeemed, then any unrecovered basis in the redeemed shares would be accounted for by treating the redeemed shares as being contributed to the capital of all remaining shares (whether in the redeemed class or other classes) in proportion to the distributions treated as made on such shares under the foregoing distribution rules.[124] Because a capital contribution is treated under the Proposed Regulations as a deemed issuance of stock followed by a recapitalization,[125] for purposes of determining basis blocks resulting from such capital contribution, the pre-capitalization value of shares would be treated as equal to their pre-

[124] Conceptually, the redeemed shares should be treated as contributed to the capital of the shares whose value is increased by the contribution. But, if the hypothetical distribution construct under the Bifurcated Distribution Approach were followed and the value of shares were treated as being reduced by any distributions received on such shares (as should be the case), capitalizing the redeemed shares into the remaining shares in accordance with the distributions on such remaining shares is the same as capitalizing the redeemed shares into shares whose value is increased by such capitalization. That is, the redemption distributions, in the aggregate, will always equal the pre-redemption value of the redeemed shares (otherwise too much or too little is being paid for the redeemed shares). To the extent the amount distributed in the redemption distribution is not allocated to the remaining shares under the Bifurcated Distribution Approach, it is allocated to the redeemed shares. Hence, the value of the redeemed shares, after being reduced to take into account the portion of the distribution allocated to the redeemed shares, will be equal to the portion of the distribution allocated to the remaining shares. Accordingly, capitalizing the redeemed shares into the remaining shares in proportion to the distribution treated as made on such remaining shares is the same as capitalizing the redeemed shares into the remaining shares in proportion to the increase in value of such remaining shares occasioned by the capitalization.

[125] Note however that if the de minimis contribution and de minimis disparity exceptions recommended above are adopted and are applicable, then the basis of the redeemed shares would simply be added to the basis of the shares upon which the capital contribution is deemed made.

redemption distribution value less the amount of the redemption distribution treated as made on such shares under the foregoing distribution rules.

4. Fourth, if all the shareholder's shares (in all classes) are redeemed, treat any unrecovered basis in the redeemed shares as a deferred loss.[126]

Unlike the DCS Approach, but like the Redeemed Class Approach, the Bifurcated Distribution Approach ensures basis recovery in the redemption distribution is

[126] To illustrate the operation of the Bifurcated Distribution Approach, consider the fact pattern in Scenario 4A in Appendix A. In that scenario, J owns 100 shares of X common stock having a value of $1000 and a basis of $300 and 100 shares of X preferred stock having a value and basis of $1000 (or $10 per share). X has $600 of earnings and profits and redeems 99 of A's preferred shares for $990. Assume there are no dividends accrued on the preferred shares at the time of the redemption. Since X has $600 of earnings and profits, the first $600 of the $990 distribution resulting from the redemption is a dividend under Section 301(c)(1). Because there are no dividends accrued on the preferred shares, the full $600 dividend is deemed paid on the common shares. The remaining $390 distribution that is in excess of earnings and profits is not a dividend. Accordingly, it is deemed paid solely on the preferred shares (i.e., the redeemed class), as a $3.90 distribution on each of the 100 preferred shares, reducing the basis of each preferred share from $10 to $6.10. The 99 redeemed preferred shares, each having a basis of $6.10 (for a total basis in the redeemed shares of $603.90), are then deemed contributed to the capital of the remaining shares in proportion to distributions deemed received on such shares. The 100 common shares were deemed to have received a distribution of $600 and the 1 retained preferred share was deemed to have received a distribution of $3.90. Accordingly, 99.35 percent ($600/$603.90) of the redeemed shares, along with all of the common shares, are deemed recapitalized into the 100 common shares outstanding after the transaction, and 0.65 percent ($3.90/$603.90) of the redeemed shares, along with the 1 retained preferred share, are deemed recapitalized into the 1 preferred share outstanding after the transaction. For purposes of determining basis blocks, the preferred shares are treated as having a value of $610 ($1000 pre-transaction value less $390 redemption distribution) and the common shares are treated as having a value of $400 ($1000 pre-transaction value less $600 redemption distribution). The value of the preferred stock deemed contributed to the common stock is 99.35 percent of the value of the 99 redeemed preferred shares, as calculated above, or $600 (99.35 percent × 99/100 × $610). Because the value of the preferred stock deemed recapitalized into common is $600 and the value of the common stock prior to the recapitalization is $400, post-recapitalization there are two blocks of common stock, one of 40 shares having a basis of $300 and one of 60 shares having a basis of $600 (99.35 percent of the $6.10 per share basis in the 99 deemed recapitalized preferred shares). The one remaining preferred share has a basis of $10 resulting from the deemed recapitalization of the one retained share having a basis of $6.10 and the portion of the redeemed preferred shares that are deemed recapitalized into the one preferred share having a basis of $3.90 (0.65 percent of the $6.10 per share basis in the 99 deemed recapitalized preferred shares). See also Scenario 5A for application of the Bifurcated Distribution Approach in a case where there are two blocks of pre-redemption common stock, and Scenario 6A for application of the Bifurcated Distribution Approach in a case where the pre-redemption basis and value of the preferred shares are not equal. While those two cases involve different fact patterns than above, the mechanics for determining redemption distribution gain and post-recapitalization basis blocks under the Bifurcated Distribution Approach are the same.

targeted only to shares in the redeemed class.[127] Unlike the Redeemed Class Approach, but like the DCS Approach, the Bifurcated Distribution Approach generally prevents concentration of unrecovered basis in the retained shares.[128]

Where the redeeming corporation has earnings and profits, the Bifurcated Distribution Approach, like the DCS Approach, suffers from complexity compared to the Redeemed Class Approach. In such circumstances, as is generally the case with the DCS Approach, valuation of both shares in the redeemed class and shares in the dividend controlling shares class is required in order to determine post-recapitalization basis blocks. Moreover, like in the case of the DCS Approach, but unlike the case of the Redeemed Class Approach, in order to determine post-recapitalization basis blocks under the Bifurcated Distribution Approach, pre-redemption basis blocks in both the redeemed preferred shares and the common shares need to be known. On the other hand, the Bifurcated Distribution Approach requires valuations only to determine post-redemption basis blocks, not the amount of any redemption distribution gain, since such gain is determined under the Bifurcated Distribution Approach solely by reference to the basis of shares in the redeemed class. By contrast, under the DCS Approach the first step is to treat the redeemed shares as recapitalized into dividend controlling shares. Accordingly, under the DCS Approach, valuations are required to determine both the redemption distribution gain and the post-redemption basis blocks.[129]

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[127] Compare the aggregate gain and basis recovery results under the Bifurcated Distribution Approach versus the DCS Approach (and the Redeemed Class Approach) in Scenarios 1A, 3A, 4A, 5A and 6A in Appendix A.

[128] Compare the basis recovery results under the Bifurcated Distribution Approach versus the Redeemed Class Approach (and DCS Approach) in Scenarios 2A and 4A in Appendix A.

[129] Although valuations may not be necessary to determine redemption distribution gain under the Bifurcated Distribution Approach, absent performing valuations at the time of the redemption transaction to determine basis blocks, it may be difficult to reconstruct the valuations necessary to

The complexity of the DCS Approach and the Bifurcated Distribution Approach, however, can be significantly ameliorated by adopting some or all of the de minimis consideration exception, the de minimis disparity exception, aggregate basis recovery or basis averaging discussed in Parts IV.A.2, IV.A.1, IV.B and IV.F of this Report (collectively, "basis tracing relief").[130]

### 4. Other Possible Approaches

The DCS Approach and the Bifurcated Distribution Approach are designed to be reasonably administrable approaches (at least where one or more of the basis tracing relief suggestions discussed in this Report are adopted) to dividend-equivalent redemptions that are more consistent with the underlying economics of the transaction than the Redeemed Class Approach. It may be possible to formulate approaches that are even more consistent with the underlying economics, but, in general, such approaches are even more complex.

None of Redeemed Class Approach, the DCS Approach or the Bifurcated Distribution Approach consistently allocates unrecovered basis among all of the shares that cause a redemption to be dividend equivalent. The Redeemed Class Approach does not seek to approximate that result, and the DCS Approach and the Bifurcated Distribution Approach only approximate it because they allocate basis only to shares directly held by the redeemed shareholder. It would be possible to allocate unrecovered

determine such basis blocks if there is a subsequent disposition, Section 301(c)(2) distribution or other transaction for which knowing basis blocks is relevant to determine gain or loss.

[130] Simplification generally occurs by elimination of the need to create an additional block of common stock, elimination of the need to know anything other than aggregate basis within a class, or both, and by the concomitant reduction in computations and information requirements. See, e.g., Appendix A (application of the de minimis disparity rule or basis averaging to the DCS Approach in Scenarios 1B, 2B, 3B, and 4B and to the Bifurcated Distribution Approach in Scenarios 2B, 3B and 4B, application of the de minimis disparity rule to the DCS Approach in Scenario 5B, application of aggregate basis recovery to the DCS Approach in Scenarios 1C, 5C and 6B, and application of basis averaging to both the DCS Approach and the Bifurcated Distribution Approach in Scenario 6C).

basis in a manner that does not discriminate between shares held directly by the taxpayer and those attributed to the taxpayer. For example, under an expanded DCS Approach, a redeemed shareholder in a dividend-equivalent redemption could be treated first as receiving the redemption proceeds as a Section 301 distribution with respect to its redeemed shares and all of its dividend controlling shares in proportion to their relative fair market values. After the deemed distribution, the unrecovered basis of the redeemed shares could then be apportioned between the dividend controlling shares held by the taxpayer and those attributed to the taxpayer in proportion to their relative values. The unrecovered basis apportioned to attributed shares would then be treated as a deferred loss. The basis of the redeemed shares apportioned to the dividend controlling shares held by the taxpayer would be allocated among such dividend controlling shares in the same manner as if such shares and the taxpayer’s dividend controlling shares were exchanged for solely the dividend controlling shares in a recapitalization.

While adding significant complexity, even this expanded approach would not achieve true parity with the underlying economics. Once shares are treated as owned by a shareholder, economic purity arguably is achieved only by treating any deemed distribution as also occurring with respect to the attributed shares. Taken to this extreme, this approach would involve recovering basis in Section 301(c) distributions from shares attributed to, but not actually owned by, the shareholder. Further, it may require that any portion of a distribution treated as a dividend under Section 301(c)(1) be treated as made with respect to attributed shares and therefore as dividend income to the related party. The Executive Committee believes that such an approach, even if permissible under current law, should not be pursued.

### 5. Recovery of Deferred Losses

The Redeemed Class Approach, DCS Approach and Bifurcated Distribution Approach each prescribe a method for recovering basis in a dividend-equivalent redemption and preserving unrecovered basis. A related but separate issue is how and when the preserved basis is taken into account. Each of the three approaches calls for loss deferral, albeit to different extents and in different circumstances. The recommendations below are independent of which approach is adopted or whether some variation on one or more of them is adopted.

#### a. Ratable Recovery

As described above, the Proposed Regulations provide an inclusion date for deferred losses that generally is the first date on which (i) circumstances have changed such that one of the tests of Section 302(b)(1), (2) or (3) would be satisfied or (ii) all classes of stock of the issuer have become worthless. We recommend that the IRS and Treasury consider instead a ratable recovery approach, under which losses would be taken into account as the shares that gave rise to the deferred loss cease to be held by or attributed to the shareholder ("ratable recovery"), regardless of whether such reduction in ownership would satisfy one of the Section 302(b) tests. For example, if a redeemed shareholder's loss is deferred because of shares attributed to such shareholder from her husband, under a ratable recovery approach, a disposition by the husband of a portion of such shares would entitle the redeemed shareholder to take into account a corresponding portion of her deferred loss.[131] The attribution of shares to a redeemed shareholder from a

[131] To apply ratable recovery, a determination must be made as to which shares gave rise to the deferred loss in order to determine which shares' disposition give rise to ratable recovery. This is the same question as which shares are dividend controlling shares. (Of course, under the Proposed Regulations, the same determination needs to be made in order to know when an inclusion date occurs.) Where more than one class of shares are dividend controlling shares, deferred loss would be allocated between such classes based on relative fair market values and proportionally to shares within a class.

related person effectively treats the two persons as the same taxpayer for purposes of testing dividend equivalence. They are not treated as the same shareholder for purposes of determining basis recovery, however. Under current law, basis generally shifts to the related party only if the redeemed shareholder has no other shares of the same issuer. Under the Proposed Regulations, the two persons are treated even less like a single taxpayer, since basis does not shift between them at all. We understand this limitation to be based on the potential abuse that arises from basis shifting among related parties. The inclusion date approach in the Proposed Regulations, however, causes a redeemed shareholder to recover its basis on a different schedule depending on whether the shares that caused the redemption to be dividend equivalent are held by a related person or by the redeemed shareholder. In the example above, if the redeemed shareholder directly held the shares described as held by her husband, the basis in the redeemed shares would be traced to a block of those shares. The wife would then recover such basis upon the disposition of such shares. Ratable recovery would attempt to make the recovery of a deferred loss approximate the basis recovery to which the taxpayer would be entitled if the taxpayer and the holder of the attributed shares were a single taxpayer.

Ratable recovery can also be combined with the inclusion date approach, so that a redeemed shareholder would take its deferred loss into account ratably as dividend controlling shares owned by or attributed to the redeemed shareholder cease to be owned by or attributed to the redeemed shareholder, but the redeemed shareholder would be permitted to recover all of its remaining basis upon a sufficient reduction in its direct and attributed interest to meet one of the relevant Section 302(b) tests or any other event that would be an inclusion date taking into account all owned and attributed shares. Eliminating the inclusion date feature appears to be more consistent with treating a shareholder as actually holding the attributed shares. The argument for retaining the inclusion date feature might be administrability. It is burdensome to base the tax consequences to one taxpayer on the actions of another. In the context of redemptions, it is necessary under current law, the Redeemed Class Approach, the DCS Approach and the Bifurcated Distribution Approach to monitor the holdings of related parties for the purposes of determining dividend equivalence, so ratable recovery with no inclusion date would not introduce a novel requirement, although it clearly has the potential to require monitoring of the actions of related taxpayers for a longer period of time. On balance, however, we believe that if ratable recovery is applied, it should be applied in lieu of, rather than in addition to, the inclusion date approach.

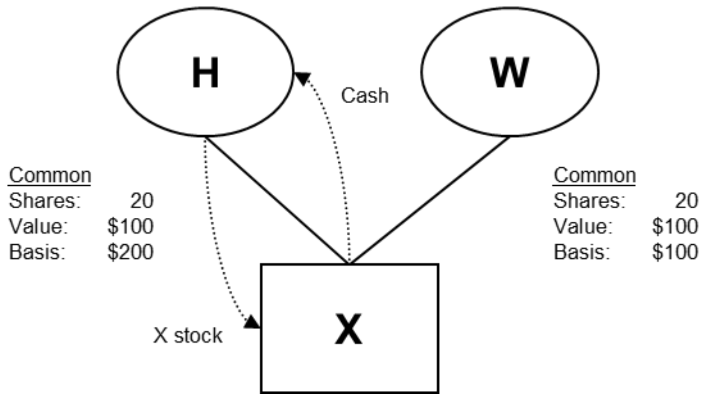
**b. Redemptions followed by Planned Dispositions**

Under the Redeemed Class Approach in the Proposed Regulations, a shareholder may be able to circumvent the deferred loss regime by excluding a nominal number of shares from a dividend-equivalent redemption and then selling them. The Proposed Regulations provide a consistent rule for recovery of basis in the deemed distribution; basis is recovered from all shares in the redeemed class. The Proposed Regulations, however, provide two different rules for preservation of the unrecovered basis of the redeemed shares. Where the shareholder holds no additional shares of the redeemed class, the basis becomes a deferred loss. As demonstrated in Scenario 2 in Appendix A, however, where the shareholder retains shares of the redeemed class, a deemed recapitalization concentrates the pre-redemption basis of the redeemed class in separate blocks in the retained shares (or separate segments of a share where there is only one retained share and segmenting is applied). The recapitalization approach may not be problematic in arm’s-length transactions in which a shareholder has a small portion of its shares redeemed. The discontinuity between the recapitalization approach and the deferred loss approach, however, introduces electivity into transactions in which a shareholder is terminating its investment. A shareholder that is terminating its direct investment in one class of stock of the issuing corporation may be able to accelerate its basis recovery by structuring the transaction as part redemption and part sale.

As illustrated in Scenario 1 in Appendix A, if J owns common shares and preferred shares in corporation X and all of J's preferred shares in X are redeemed in a dividend-equivalent redemption where X has sufficient earnings and profits such that the full amount of the distribution is treated as a dividend, J's unrecovered basis in the redeemed shares (here, $300) would become a deferred loss. When that deferred loss is taken into account would then depend on J's disposition of its X common stock. If, on the other hand, all but one of J's preferred shares were redeemed, then as illustrated in Scenario 2, all of J's basis in its preferred shares will be preserved in J's single retained preferred share and can be recovered as a recognized loss upon J's disposition of that single share.

As demonstrated in Scenarios 1 and 2 in Appendix A, neither the DCS Approach nor the Bifurcated Distribution Approach would create such a cliff effect in the above circumstance because the retention of preferred shares is irrelevant under those approaches. In either case, the basis of the redeemed shares would shift to the common shares. Both the DCS Approach and the Bifurcated Distribution Approach can produce a cliff effect, however, where the dividend controlling shares are shares attributed to the taxpayer, as illustrated in the following example.

Example 2




Facts: Corporation X has outstanding common stock with a value of $5 per share. A husband and wife each hold 20 common shares. The husband's basis is $10 per share and the wife's basis is $5 per share. As before, X has sufficient earnings and profits to support full dividend treatment of any distribution or deemed distribution under Section 301. The husband wishes to dispose of his direct investment in X, and X is willing to redeem his common shares. The husband determines that a redemption of his common stock by the corporation will be dividend equivalent because of his wife's continuing interest.

Result: Under the Proposed Regulations, if the husband's 20 common shares are redeemed, he will be treated as receiving a pro rata distribution with respect to such shares, resulting in a $100 dividend, and then the $200 basis in such shares would be treated as a deferred loss. If only 19 shares are redeemed, the husband will still receive a pro rata distribution, but the unrecovered basis in his redeemed common shares will be traced to his remaining share, which could be sold for a $195 loss. This result will also occur under the DCS Approach and the Bifurcated Shares Approach.

The DCS and Bifurcated Shares Approaches are open to the same manipulation as the Redeemed Class Approach in the above instance because, where the redeemed class is also the sole class of dividend controlling shares, there is no difference between the distribution within class methodology employed by the Redeemed Shares Approach and the methodology employed by the DCS and Bifurcated Shares Approaches. To prevent such a manipulation, we recommend that final Regulations adopt a rule that if shares are redeemed and, as part of a plan including such redemption, shares to which the basis of the redeemed shares would otherwise shift are sold, no basis in the redeemed shares will shift to the sold shares.[132] Under such a rule, only the pre-redemption basis in the sold share or shares would be recovered immediately, and the basis that otherwise would be treated as shifting to the sold shares would instead shift to retained shares or, if there are none, become a deferred loss.

Under the above proposal, if the husband in the example above had nineteen of his shares redeemed and then sold the remaining share, no basis in the redeemed shares would have shifted to the sold share. Rather under any of the Redeemed Class, DCS or Bifurcated Distribution Approaches, he would recognize a loss of only five dollars, the amount of the loss attributable to the sold share before the redemption. Then, under any of those approaches, the husband's $190 basis in his other nineteen shares would become a deferred loss, because the husband would hold no shares to which the basis in such shares could be carried.

Alternatively, as discussed in Part IV.C.4 above, where a redeemed shareholder is attributed shares owned by another person, unrecovered basis of the redeemed shareholder might be apportioned among both post-redemption shares actually owned by the redeemed shareholder and shares attributed to the redeemed shareholder. Under this approach, unrecovered basis apportioned to attributed shares would be treated as a deferred loss and recovered under whichever recovery method (whether a ratable recovery method or an inclusion date method) was adopted. If the above approach were applied to the facts in Example 2 above and nineteen of the husband's twenty shares were redeemed then the husband's $190 of unrecovered basis in the redeemed shares would be

[132] If such a rule were adopted, it might be coupled with a rebuttable presumption that sales made within a certain period of the redemption were part of a plan. Cf. § 355(e)(2)(B); Reg. § 1.355-7.

apportioned \$9.05 (1/21 x \$190) to the husband's one remaining share and \$180.95 dollars (20/21 x \$190) to the wife's twenty shares. The \$9.05 apportioned to the husband's one remaining share would either be averaged with the existing basis in that share, resulting in a basis of \$19.05 in that share, or segmented with a 47.51 percent segment of the husband's one share having a basis of \$9.05 and the remaining 52.49 percent segment having a basis of \$10. In either event, the husband's basis in the retained share would be recovered upon a subsequent disposition of that share by the husband. The \$180.95 of unrecovered basis apportioned to the wife's twenty shares would be treated as a deferred loss and would be taken into account by the husband either ratably as the wife disposed of her shares or in its entirety upon the occurrence of an inclusion event.

Although the unrecovered basis apportionment approach described above reaches greater precision and obviates the need for adopting the planned disposition rule discussed above, it does so at the cost of significant complexity. While it may be felt that such complexity is an acceptable trade-off where a transaction is structured to circumvent the deferred loss regime, its application in all cases would seem inadvisable. For example, if in the above example only one of the husband's twenty shares were redeemed and apportionment were applied, \$4.87 of the \$10 of unrecovered basis in the redeemed share would be apportioned to the nineteen retained shares and \$5.13 would be apportioned to the twenty shares held by the wife even if the husband had no plan to dispose of any of his retained shares. Presumably the choice made in the Proposed Regulations of adopting a deferred loss approach only where the redeemed shareholder has no remaining shares in the redeemed class reflects the judgment of the drafters of the

Proposed Regulations that the complexities created with respect to deferred losses, such as those discussed above, generally should be avoided.

Another potential approach to the basis concentration issue would be to return to the approach of the withdrawn 2002 Proposed Regulations. As discussed previously, under those Regulations, any unrecovered basis in a share was treated as a deferred loss even if the redeemed shareholder owned other shares of the same class. That deferred loss was then recovered upon the occurrence of an accelerated loss or final inclusion date. The withdrawn 2002 Proposed Regulations were the subject of significant controversy[133] and would have still permitted significant loss recognition in certain cases based on only minor changes in economic position. For example, a widely-held corporation might redeem a pro rata portion of each shareholder's shares rather than paying a dividend. Under the withdrawn 2002 Proposed Regulations, that redemption would have created a deferred loss for each redeemed share equal to the shareholder's pre-redemption basis in that share. Later, the shareholder could sell a small portion of its remaining shares in an unrelated transaction,[134] creating a final inclusion date,[135] and would take into account the deferred loss with respect to the shares previously redeemed.

This result might be ameliorated by adopting a ratable recovery approach in addition to the per share approach of the withdrawn 2002 Proposed Regulations,[136] but,

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133 See, e.g., American Bar Association Section of Taxation, Comments Concerning Proposed Regulations Providing Guidance Regarding the Treatment of Unutilized Basis of Stock Redeemed in Certain Transactions (Sept. 9, 2003); Alan L. Feld, Preserving Basis After Redemption, 98 TAX NOTES 1143 (Feb. 17, 2003).

134 If the redemption and the sale were related transactions, then, under Zenz, the redemption might give rise to exchange treatment under Section 302(a) rather than dividend treatment under Section 302(d).

135 See Rev. Rul. 76-385, 1976-2 C.B. 92 (small reduction in holdings of a small shareholder results in application of Section 302(b)(1)).

136 For a similar suggestion of possibly combining a ratable recovery approach with the per share approach of the withdrawn 2002 Proposed Regulations, see Feld, supra note 133.

on balance, we believe that an appropriately crafted rule preventing shifting of basis in redeemed shares to shares that are sold as part of a plan, coupled with a DCS or Bifurcated Distribution Approach, should serve to address most of the situations that are likely to arise.

### 6. Summary of Approaches

The Redeemed Class Approach is the least complex of the three approaches to apply as it generally does not require any valuations in order to function. However, it is not a very satisfying model conceptually because it can result in treating distributions as being made on shares which have little (if any) connection to the reason why the Code treated the redemption as being a distribution in the first place. This in turn can produce uneconomic consequences by concentrating basis in retained shares that is far in excess of the value of those shares.

The DCS Approach is more conceptually satisfying than the Redeemed Class Approach and greatly ameliorates the basis concentration that can occur under that approach. The DCS Approach, however, is significantly more complex than the Redeemed Class Approach. Absent application of aggregate basis recovery, basis averaging or some other form of basis tracing relief, the DCS Approach requires valuations and other information about basis blocks in both the redeemed shares and the dividend controlling shares in order to calculate both redemption distribution gain and post-redemption basis blocks. Moreover, absent some form of basis tracing relief, where the redeeming corporation has no earnings and profits, the DCS Approach can result in greater gain recognition while there is still unrecovered basis in the redeemed shares than would occur under the Redeemed Class Approach.

The Bifurcated Distribution Approach seems more conceptually satisfying than the Redeemed Class Approach though less satisfying than the DCS Approach. It has the benefit of both ameliorating the basis concentration issues inherent in the Redeemed Class Approach and the gain recognition prior to full basis recovery in the redeemed shares that can occur in the DCS Approach. Moreover, while the Bifurcated Distribution Approach, like the DCS Approach, requires valuations to determine post-redemption basis blocks, it does not require valuations to determine redemption distribution gains.

The Executive Committee does not have a consensus view on which of the above three approaches, if any, should be adopted. One's view on this topic may shift depending on what type of basis tracing relief is adopted. For example, if the de minimis exceptions and aggregate basis recovery recommended in this Report are adopted, many of the perceived shortcomings of the DCS Approach would be greatly ameliorated. Although the Executive Committee does not have a recommendation as regards a particular approach, it believes that the government should consider approaches to dividend-equivalent redemptions that minimize the basis concentration issues inherent in the Redeemed Class Approach, as well as address basis concentration issues that can arise under all three approaches in the case of attributed ownership.

### 7. Special Considerations for Small Public Shareholders

Each of the approaches to dividend-equivalent redemptions discussed in this Report involve the shifting of basis from redeemed shares to other shares in at least some circumstances. This shifting of basis complicates broker reporting where a Small Public Shareholder holds shares in the same company through multiple brokers. In such circumstance, each broker may need to know what shares are held by each other broker in order to perform the basis computations required by the particular dividend-equivalent redemption approach chosen.

If facilitating broker reporting is an important objective, then the problem described above is not easily solved. One possible solution, however, would be to adopt a "redeemed shares only" approach with respect to dividend-equivalent redemptions of shares held by Small Public Shareholders. Under this approach, the deemed dividend distribution is treated as made pro rata on each redeemed share, and the amount of dividend, basis recovery, and gain is determined on a per share basis. Any unrecovered basis in each redeemed share is treated as a deferred loss that, as discussed above, could then be recovered ratably or on an inclusion date basis as other shares are sold.

We believe, however, that fundamentally altering for Small Public Shareholders what we believe is the conceptually correct treatment of dividend-equivalent redemptions to facilitate broker reporting would be ill-advised. Moreover, we believe that the number of cases in which Small Public Shareholders are involved in dividend-equivalent redemptions is not sufficiently large to justify creating a separate regime to address such circumstances.

**D. <u>Reorganizations</u>**

In determining the tax consequences under the Proposed Regulations to a shareholder surrendering stock in a reorganization, the effect of designated allocations of consideration depends on whether the reorganization is dividend equivalent. In a non-dividend-equivalent reorganization, the Proposed Regulations permit designated allocations of consideration among classes and among shares within each class if the terms of the exchange are economically reasonable. By contrast, in a dividend-equivalent reorganization, the Proposed Regulations permit only designations of consideration among classes of stock, and all consideration received with respect to a class of stock is allocated proportionately to each share in the class.

If, under the foregoing rules for allocating consideration, a share of stock is treated as exchanged solely for boot, then, under the Proposed Regulations, the exchange of such share is outside the scope of Section 356 and is governed instead by Section 302. If, taking into account the overall reorganization exchange, the exchange is dividend equivalent, the receipt of solely boot for a share is governed by Section 302(d). Otherwise, it is governed by Section 302(a).

We agree that in a dividend-equivalent reorganization the consideration received with respect to a class of shares should be allocated proportionately to each share within a class; contrary to the Proposed Regulations, on balance, we believe that such proportional allocation also should apply in a non-dividend-equivalent reorganization. If, however, contrary to our recommendation, designated allocations within a class in non-dividend-equivalent reorganizations are permitted for all transactions, or for at least some public transactions, the rules regarding contingent designations should be clarified.

As in the Second Section 358 Report, we continue to be divided as to whether shares for which only boot is received in accordance with the relevant allocation methodology should be treated as outside the scope of Section 356. If, however, shares exchanged solely for boot in a reorganization are treated as outside the scope of Section 356 and Section 302 is to be applied, we believe that a clearer construct than that contained in the Proposed Regulations is required in the case of dividend-equivalent reorganizations. Each of these points is discussed in turn below.

### 1. Allocation of Boot

#### a. Designations in General

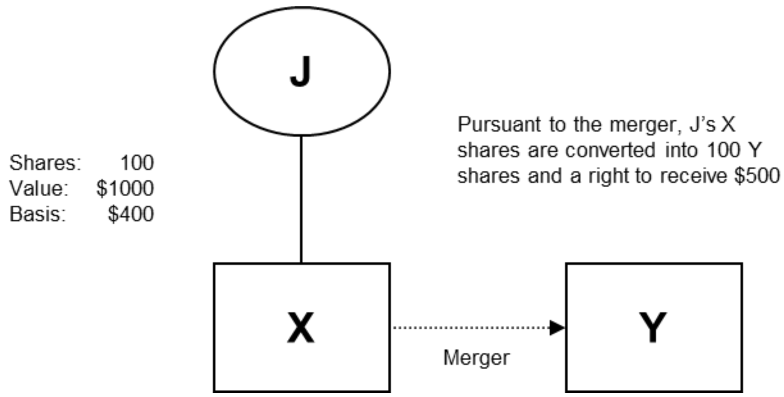
As discussed above, in the case of dividend-equivalent reorganizations, the Proposed Regulations require all consideration received with respect to a class of surrendered shares to be treated as received pro rata with respect to each share within the class. According to the preamble to the Proposed Regulations, this choice was made to ensure similar tax treatment of dividend-equivalent reorganization exchanges and dividend-equivalent redemptions.

As also discussed above, the Proposed Regulations do not extend this pro-rata-within-class allocation rule to non-dividend-equivalent reorganization exchanges. The preamble to the Proposed Regulations justifies this dichotomy between dividend- and non-dividend-equivalent reorganization exchanges by analogizing a non-dividend-equivalent reorganization exchange to a non-dividend-equivalent redemption. Because in a non-dividend-equivalent redemption a shareholder can elect to surrender high basis shares, low basis shares or any combination thereof, the preamble reasons that a shareholder engaging in a non-dividend-equivalent reorganization exchange should be able to specify the receipt solely of boot for a particular share, if the terms of the exchange are economically reasonable.

Unlike a redemption in which a shareholder retains shares, a reorganization typically involves the surrender by each shareholder of all of its shares in the target corporation in exchange for reorganization consideration. Accordingly, we believe the better analogy for a non-dividend-equivalent reorganization is not to a non-dividend-equivalent redemption with retained shares but to a non-dividend-equivalent redemption in which all of the shareholder's shares are redeemed. In such circumstances, there do not appear to be any authorities compelling respecting a designated allocation of different types of consideration to particular shares within the same class.[137] Moreover, permitting designated allocations within a class of stock in a non-dividend equivalent reorganization results in significant shareholder electivity.[138]

To illustrate what is at stake, consider the following example.

Example 3




Facts: J owns 100 shares of stock of corporation X. J has a basis of $4 in each share and each share has a value of $10. J surrenders all 100 shares in X in a reorganization in exchange for $500 in cash plus 100 shares of stock of publicly traded corporation Y, each such share having a value of $5 per share.

Result: J realizes $600 of gain ($1000 value less $400 basis). If the parties are able to designate, for example, each of 50 X shares as surrendered for 2 Y shares and each of 50 X shares as surrendered for $10 in cash, then J will recognize only $300 of the gain realized. On the other hand, if proportional allocation is applied, with the result that each X share is

[137] We do not address in this Report whether and, if so, in what circumstances designated allocations of consideration among (rather than within) classes of shares are appropriate based on analogies to other areas of the law. Under both the 2006 Final Regulations and the Proposed Regulations such designated allocations are permitted in both dividend- and non-dividend-equivalent reorganizations so long as economically reasonable. For a discussion of some of the policy issues regarding permitting designated allocations among classes of shares, see ABA Report, supra note 97, at 12-17.

[138] In addition, some commentators have suggested that permitting designated allocations within a class is arguably contrary to the literal language of the Code. For a discussion of why the language of Section 356 seems to contemplate only a single exchange, see Second Schler Article, supra note 23, at 388-89.

treated as surrendered for 1 Y share and $5 in cash, J will recognize $500 of gain.[139]

Osrow v. Commissioner[140] considered the somewhat analogous situation of a single exchange of multiple assets for stock. In that case, the taxpayers were the two original shareholders of a corporation that they formed with equal cash contributions in exchange for stock. Over time, each taxpayer also made loans to the corporation. The taxpayers reached an agreement with an underwriter under which the underwriter would offer the corporation's stock to the public and the shareholders would accept additional shares of the corporation in payment of the corporation's debt to them. Each shareholder received a certificate representing new shares in exchange for its original shares, and each received on the same day a certificate representing additional new shares as payment of the corporation's debt. Each taxpayer sold a portion of its new shares in the public offering, and each instructed the underwriter to sell all shares received as repayment of the corporation's debt before selling any shares acquired in exchange for the original shares. The IRS argued that all of the shares held by each taxpayer had an equal basis because the taxpayers, in substance, contributed the debt owed to them by the corporation and then received all of their new shares in exchange for their old shares. The court,

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[139] Under the 2006 Final Regulations, the parties can designate certain X shares as surrendered solely for Y shares and certain X shares, even within the same class, as surrendered solely for boot so long as the terms of the exchange are economically reasonable. Note that if in Example 3 above J had a basis of, for example, $4 per share in 50 shares (Block 1) and $16 per share in 50 shares (Block 2) rather than $4 in each of the X shares, J would realize no overall gain in the transaction ($1000 value and $1000 basis). Yet, if proportional allocation were applied, J would recognize $300 of gain, whereas if J were able to designate all the cash as being in exchange for the Block 2 shares, J would not recognize any gain. Cf. Rev. Rul. 68-23, 1968-1 C.B. 144. This gain recognition without overall gain realization has been questioned by some commentators. See, e.g., Second Schler Article, supra note 23, at 380-81; Warnke Article, supra note 6, at 94-95. Nevertheless, it continues to reflect the view of the government and is not addressed further in this Report. While designated allocations within a class may be a way of addressing this seemingly anomalous anti-taxpayer result in certain situations, it seems an odd choice of solution and leads to other seemingly anomalous pro-taxpayer results in other cases, as illustrated in Example 3 above.

[140] 49 T.C. 333 (1968).

however, agreed with the taxpayers' contention that they received certain shares in repayment of their loans and other shares in exchange for their low-basis original shares. Thus, the receipt of fungible consideration for mixed property resulted not in a pro rata allocation, but essentially in two separate exchanges. We think Osrow is best read as a case about tracing basis versus averaging or segmenting, however. Under the taxpayers' chosen form, there was no designation for them to make regarding the exchange; each taxpayer received the appropriate number of shares for each pre-transaction interest. Perhaps because the court respected the separateness of the exchanges, the exchanges were not held to result in averaged or segmented basis in each share, but in distinct blocks.

In at least one context, the IRS has respected a specific allocation of particular consideration to specific assets exchanged in a single transaction. Revenue Ruling 68-13 discusses the allocation of down payments to inventory (not eligible for installment sale treatment) and non-inventory property (potentially eligible for installment sale treatment) for purposes of determining whether the amount of the down payment received with respect to the non-inventory property is consistent with installment sale treatment under Section 453. It is clear from example 3 of the ruling that, in a sale of inventory and other property for a down payment and deferred payments, a disproportionate amount of the down payment may be treated as received in exchange for the inventory if certain conditions are met. Thus, a taxpayer may be able to get a tax benefit, the deferral associated with installment sale treatment of the eligible non-inventory property, as a result of a non-pro rata allocation of the different components of the consideration. No example in the ruling, however, involves a non-pro rata allocation of different components of consideration to assets having the same non-tax characteristics, such as shares of stock of a single class. Accordingly, it is not clear that such an allocation would be respected under Revenue Ruling 68-13.[141]

As discussed above, Revenue Ruling 85-164 holds that an allocation of specific consideration to specific transferred assets (even where the transferred assets do not have the same tax characteristics) is not controlling for purposes of determining the transferor's basis or holding period in the transferee stock in Section 351 transactions. While restricted in its application to Section 351 transactions, Revenue Ruling 85-164 demonstrates at least one circumstance in which designated allocations have not been respected in the realm of Subchapter C of the Code.[142]

Also, in the context of liquidating distributions, another exchange in which a shareholder typically surrenders its entire interest in the issuer for mixed property, designated allocations generally are not permitted. If a shareholder holds a single block of stock and receives a series of distributions in complete liquidation of the corporation, the distributions first will be applied against the total adjusted basis of his stock and gain will be recognized only after an amount equal to the shareholder's adjusted basis has been fully recovered.[143] An example in the Regulations illustrates that a holder of multiple blocks of stock who receives a liquidating distribution must allocate the

[141] Cf. Collins v. Comm'r, 48 T.C. 45 (1967) (respecting for purposes of installment sale treatment the designation of a mortgage note secured by approximately 33 out of 53 acres of real estate sold simultaneously to the same purchaser as being allocable to the mortgaged property and cash as being allocable to both the mortgaged and non-mortgaged property).

[142] While not respected by the IRS, designated allocations have been respected in Section 351 transactions in certain circumstances by the courts. See, e.g., Brown v. Comm'r, discussed supra note 30.

[143] See Rev. Rul. 68-348, 1968-2 C.B. 141 (citing Quinn v. Comm'r, 35 B.T.A. 412 (1937); Letts v. Comm'r, 30 B.T.A. 800 (1934)), amplified by Rev. Rul. 85-48, 1985-1 C.B. 126.

distribution ratably to such blocks and compute gain or loss separately with respect to each such block.[144]

Revenue Ruling 68-348 established or clarified that a holder of multiple blocks that receives a series of liquidating distributions must allocate the distributed property to the blocks ratably among the blocks, without regard to whether or not there is a surrender of any stock prior to the final distribution. Thus, in the context of a complete liquidation, a taxpayer is not permitted to elect a particular allocation, even by structuring the transaction in such a way that certain shares are in form surrendered for specific properties on different dates.

None of the above authorities, however, definitively answers the question of whether designated allocations should be permitted among shares of the same class surrendered for mixed consideration in a non-dividend-equivalent reorganization, and we are not aware of any authority that does. Some on the Executive Committee believe that permitting designated allocations among shares within a class in a non-dividend-equivalent reorganization is consistent with the treatment of each share as a separate unit of property, and for Small Public Shareholders has the added benefit of facilitating broker reporting (discussed below). A substantial majority of the Executive Committee believes, however, that permitting designated allocations within classes in non-dividend-equivalent reorganizations is not required in order to treat each share as a separate unit of property and permitting such allocations provides an unwarranted grant to taxpayers to elect tax consequences with no corresponding economic substance. Indeed, even in circumstances where a shareholder holds only one block of shares and has an identical

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[144] See Reg. § 1.331-1(e); Rev. Rul. 68-348, 1968-2 C.B. 141 (citing Cooledge v. Comm'r, 40 B.T.A. 110 (1939)).

basis in each share, as in Example 3, the Proposed Regulations would continue to allow the shareholder to designate certain of such shares as surrendered for acquiror stock and certain of such shares as surrendered for boot in non-dividend-equivalent reorganizations, thereby maximizing loss recognition or minimizing gain recognition. Moreover, in circumstances where a shareholder has both gain and loss shares of the same class, the Proposed Regulations would permit the shareholder through designated allocations of consideration to recognize loss on the loss shares while avoiding recognition of gain on the gain shares in a non-dividend-equivalent reorganization. Those on the Executive Committee that believe designated allocations within a class should not be permitted in a non-dividend-equivalent reorganization see no overriding principle, and no overriding policy reason, why either of the above results should be permitted and recommend that, if designated allocations within a class are not permitted in dividend-equivalent reorganizations, they similarly should not be permitted in non-dividend-equivalent reorganizations.

**b. Special Considerations for Small Public Shareholders**

If facilitating broker reporting is an important policy objective, then consideration might be given to permitting designated allocations within a class for Small Public Shareholders in non-dividend equivalent reorganizations. If designated allocations within classes are not permitted in such circumstances, the consideration received in the reorganization by an individual broker as a matter of form may be different from the consideration treated as having been received for tax purposes, in which case the broker will not be able to determine what was received for tax purposes based solely on the information available to such broker. Moreover, the electivity concern is less of an issue for Small Public Shareholders because a Small Public Shareholder may already have the option to choose which shares are receiving solely cash simply by selling such shares in the market prior to the reorganization.[145]

Nevertheless, for the reasons stated above, a substantial majority of the Executive Committee believes that designated allocations should not be permitted even for Small Public Shareholders.

**2. Contingent Designations**

If, contrary to our recommendations, designated allocations within a class are permitted by the final regulations with respect to a non-dividend-equivalent reorganization, then we believe the rules regarding designations in the public context should be clarified. As discussed above, the 2006 Regulations currently provide that if the terms of the exchange specify the consideration as being received in exchange for a particular share of target stock or security or a particular class of target stock or securities, then for purposes of determining gain recognition under Section 356 and basis under Section 358, such terms of the exchange will control provided that they are economically reasonable.[146] The Proposed Regulations provide for similar rules relating to the terms of the exchange, but permit designations to shares of stock both within a class and between classes of shares for non-dividend-equivalent reorganizations, and only

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[145] A similar "self-help" argument can be made in favor of also permitting designated allocations within classes for Small Public Shareholders in the context of dividend-equivalent reorganizations. However, as in the case of dividend-equivalent redemptions discussed above in Part IV.C, the number of cases in which Small Public Shareholders are involved in dividend-equivalent reorganizations would not seem to be sufficiently large to justify having special rules permitting designated allocations within classes. Moreover, if, as under the Proposed Regulations, the dividend-equivalent redemption rules are applied to any shares in a dividend-equivalent reorganization with respect to which solely cash is received, permitting designated allocations of consideration by Small Public Shareholders in a dividend-equivalent reorganization would not solve broker reporting issues absent also adopting broker reporting solutions in the dividend-equivalent redemption arena.

[146] Reg. §§ 1.356-1(b) and 1.358-2(a)(2).

between classes of shares for dividend-equivalent reorganizations.[147] It is unclear under current law how the phrase "terms of the exchange" should be interpreted in the context of public transactions and, accordingly, when designated allocations are permitted in such transactions. For example, if the reorganization documents provide that a shareholder is permitted to specify in its letter of transmittal what consideration it would like allocated to which shares, is that sufficient to support upholding of the allocation? Or is something more required and, if so, what?[148]

The Proposed Regulations contain two examples illustrating the application of the designated allocation rules in the context of public company reorganizations. In both examples, the terms of the reorganization permit target shareholders to elect to receive either cash or stock for each of their target shares. If the cash is oversubscribed, however, the terms of the exchange provide that a pro rata mix of stock and cash will be received for the shares for which only cash was elected. In both examples, a target shareholder, J, elects to receive cash for its high basis target shares and stock for its low basis target shares. The reorganization exchange is not dividend equivalent as regards J.

In the first example, J receives all the cash and stock J elected to receive and the example respects the designated allocation. In the second example, the cash is oversubscribed and J receives a mix of cash and stock for the shares for which J elected only cash and stock for the shares for which J elected only stock. The example respects the designation of solely stock for the shares for which only stock was elected and the

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[147] Prop. Reg. §§ 1.354-1(d)(1) and 1.358-2(b)(4).

[148] For a further discussion of the uncertainty under current law regarding designated allocations in public transactions, see New York State Bar Association Tax Section, Report on Final Regulations Regarding Allocation of Basis Under Section 358 and Related Matters 15-20 (Report No. 1137, Dec. 13, 2007).

designation of the pro rata mix of stock and cash for shares for which only cash was elected.

However, much more typically, if cash were oversubscribed, the terms of the reorganization would provide that J would receive all cash for some of J's cash election shares and all stock for the remainder of J's cash election shares. The Proposed Regulations do not address what the result would be in this case if J could designate in advance the order in which particular shares would be surrendered for cash in the event of oversubscription. For example, suppose J owns 100 shares in a single class, elects cash for all of them, and the proration factor is 50 percent. Assume under the terms of the reorganization, J could designate in advance that in this case, 50 particular shares would be exchanged solely for cash, and the other 50 would be exchanged for stock. The Executive Committee believes that if designated allocations of cash and acquiror stock to target shares are to be respected in the absence of proration, then "contingent designations" of cash and acquiror stock to target shares in the presence of proration should also be permitted. We do not see any substantive difference between these situations. At a minimum, we believe that if the shareholder is assured of receiving cash for a minimum percentage of the shareholder's target shares (e.g., if cash elections for 40 percent of all target stock will be accepted, so that any one shareholder is assured of receiving cash for at least 40 percent of all of the shareholder's shares tendered for cash), then the minimum cash received is indistinguishable from the case where no proration occurs. Moreover, in light of current uncertainty regarding designated allocations involving proration in the public company context and the importance of this issue, we believe that, whether or not our contingent designations recommendation is adopted, the final regulations should clarify whether contingent designations will be respected in the event of proration.[149] If, however, designated allocations between shares within the same class are not permitted in either dividend-equivalent or non-dividend-equivalent reorganizations, as we propose, the issue of contingent designations will largely be mooted.[150]

### 3. Non-Application of Section 356 to an Exchange of Shares Solely for Boot

A fundamental question is, if Section 356 is not applied to shares for which only boot is received in a reorganization, what provision of the Code should apply? In the preamble to the 2006 Final Regulations, the IRS and Treasury requested comments on the treatment of an exchange of loss shares solely for boot in a reorganization. In the Second Section 358 Report, a substantial majority of the Executive Committee recommended that Section 356 should apply to such an exchange and that a deferral regime be adopted with respect to any losses.[151] That is, in the majority's view, the intent and better interpretation of Section 356 was that it should be applied with respect to an exchange of shares solely for boot, so long as the surrendering shareholder received some nonrecognition property in the overall transaction.[152]

A minority of the Executive Committee believed that, in light of the particularized tracing regime adopted by the 2006 Final Regulations, Section 356 should not apply with respect to an exchange of shares solely for boot, regardless of whether the

[149] For a more comprehensive discussion of designated allocations in the public company context, see Second Schler Article, supra note 23, at 386-88.

[150] However, as long as designated allocations are permitted as between different classes of stock, contingent designation issues may still arise where there are multiple classes of stock, although it is likely to be a rare scenario where elections of cash and stock consideration are permitted among classes in a public corporation reorganization.

[151] Second Section 358 Report, supra note 4, at 34.

[152] Id. at 35.

surrendering shareholders received nonrecognition property.[153] The Second Section 358 Report noted, however, that if the minority view were adopted, the issue of what provisions of the Code applied to such an exchange (including possibly Section 302, 304 or 1001, depending on the circumstances) was unresolved.[154]

The Proposed Regulations essentially adopt the minority view but effectively sidestep the issue of what provisions should apply to an exchange of shares solely for cash by simply providing that Section 302 applies. The Service does not explain the rationale behind the application of Section 302 to such an exchange, but the decision to do so presumably stems from Revenue Ruling 74-515,[155] which is the only authority of which we are aware that treats an exchange of shares solely for boot in connection with a reorganization as subject to Section 302 outside of the consolidated return context.[156] In that ruling, corporation X, which had common and preferred stock outstanding, merged into corporation Y in a transaction qualifying as a reorganization under Section 368(a)(1)(A) (an "A reorganization"). In the merger, the common stock of X was exchanged solely for common stock of Y and the preferred stock of X was exchanged solely for cash. The ruling holds, among other things, that the tax consequences to the X shareholders that held solely X preferred stock and, accordingly, received solely cash were determined under Section 302. The ruling states that "[u]nder

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153 Id. at 38.

154 Id. at 41.

155 1974-2 C.B. 118.

156 In the consolidated return context, boot received by a member shareholder in an intercompany reorganization generally is treated as received in a separate transaction. More specifically, the member shareholder generally is treated as receiving solely stock in the intercompany transaction and then having a portion of that stock redeemed in a transaction to which Section 302 applies if Section 354 would have applied to the transaction but for the fact that boot is received. See Reg. § 1.1502-13(f)(3); -13(f)(7) exs. 3 and 4. The foregoing consolidated return rules apply whether the shares in question are exchanged solely for boot or partially for boot and partially for stock.

the facts of this case, the cash received by those X shareholders who owned only X preferred stock was not essentially equivalent to a dividend." Accordingly, the ruling holds that the receipt of cash by those X shareholders was a distribution in exchange for stock pursuant to Section 302(a).

Revenue Ruling 74-515 provides no explanation as to why Section 302 governs the treatment of X shareholders that own solely X preferred stock, but it was released at a time when the IRS was of the view that dividend equivalency in the context of a reorganization was determined using an "immediately before" construct. Under this construct, dividend equivalency was determined by examining what the result would be if X had redeemed the shares for which boot was received immediately before, and independent of, the reorganization.[157] Perhaps this view explains why the ruling concluded that Section 302 governed the treatment of X shareholders that owned solely X preferred stock.

Nevertheless, even if the foregoing accurately reflects the unstated rationale of Revenue Ruling 74-515, it is not obvious why Section 302 is the appropriate provision to govern the treatment of shareholders receiving solely boot in an A reorganization if Section 356 does not apply to such boot.[158] The construct of an A reorganization is that the target corporation transfers its assets to the acquiring

[157] The IRS argued for a target corporation to be treated as redeeming its shares immediately before the reorganization in Wright v. United States, 482 F.2d 600 (8th Cir. 1973). Although the IRS lost the argument in Wright, it reaffirmed its position in Revenue Ruling 75-83, 1975-1 C.B. 112, revoked by Rev. Rul. 93-61, 1993-2 C.B. 118. In so doing, it cited Revenue Ruling 74-515 for the proposition that it is appropriate to look to the principles developed under Section 302 for determining dividend equivalency. Combined with the argument of the IRS in Wright, it seems clear that the IRS was advocating for the test of dividend equivalency to be made by treating the target corporation as redeeming its shares immediately before, and independent of, the reorganization at the time Revenue Ruling 74-515 was released.

[158] Merely because dividend equivalency under Section 356 was determined, in the view of the IRS, by reference to a hypothetical Section 302 redemption of target shares in a transaction occurring before, and independent of, the reorganization, it does not necessarily follow that Section 302 actually applies to shareholders to which Section 356 does not apply.

corporation in exchange for the merger consideration and then liquidates, distributing the merger consideration to its shareholders in exchange for the shareholders' target shares.[159] Under that construct, because the target shareholder would be treated as receiving consideration in exchange for its target shares in a complete liquidation of target, Section 331, and not Section 302, would seem to govern the treatment of such exchange.[160] On the other hand, it seems counter-intuitive to apply Section 331 to a dividend-equivalent reorganization when Section 331(b) specifically provides that Section 301 does not apply to any distribution of property to which Section 331 applies.

While applying Section 302 to shares for which solely boot is received (assuming the decision is made not to apply Section 356 to such shares) has intuitive appeal, it nonetheless raises significant issues in the context of dividend-equivalent reorganizations, and the lack of a specific construct in the Proposed Regulations explaining how Section 302 is applied in that context leaves a number of very important, unanswered questions. Those unanswered questions, which are explored below, include (i) are shares of the target corporation or the acquiring corporation treated as redeemed, (ii) if shares of the acquiring corporation are treated as redeemed, which shares are so treated, and (iii) which corporation's earnings and profits are relevant.[161]

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159 Cf. Rev. Rul. 69-6, 1969-1 C.B. 104.

160 If the reorganization was determined to be non-dividend equivalent, then whether the deemed redemption distribution should be governed by Section 331 or Section 302(a) does not make any practical difference, as both provisions would treat the redemption as an exchange under section 1001.

161 Which corporation's earnings and profits are relevant needs to be known to determine what portion of the Section 302(d) distribution, if any, results in dividend income under Section 301(c)(1) and what portion results in recovery of basis or gain from the disposition of stock under Section 301(c)(2) and (c)(3).

The issues discussed in this section of the Report only arise in dividend-equivalent reorganizations. In non-dividend-equivalent reorganizations, treating shares with respect to which solely boot is received as being subject to Section 302 results in such shares being governed by Section 302(a). Under Section 302(a), the share is merely treated as exchanged for the boot, and gain or loss is recognized based solely on the shareholder's basis in the relevant share and the amount of boot received with

#### 4. The Reorganization Construct

Absent a construct as to what is deemed to happen in a reorganization, it is difficult to know how to determine the correlative effects under Section 302 of a reorganization exchange. In a normal redemption distribution, the application of Section 302 looks to the relationship between the corporation and the shareholder whose shares are being redeemed. However, where Section 302 is applied to a dividend-equivalent reorganization where a shareholder receives solely boot in exchange for a class of target stock, application of Section 302 is much less clear because there are two corporations (target and acquiring) that could potentially be treated as making the redemption distribution. The threshold question is, therefore, should the target corporation be treated as redeeming its shares prior to the reorganization (the "Target Redemption Construct") or should the acquiring corporation be treated as redeeming its shares following the reorganization (the "Acquiror Redemption Construct").

Revenue Ruling 74-515, discussed above, would seemingly support the use of a Target Redemption Construct in applying Section 302 to an exchange of shares solely for boot in a reorganization. However, Revenue Ruling 74-515 involved an A reorganization, pursuant to which the target corporation went out of existence, and the Service simply stated that the exchange by the minority shareholders of their preferred shares for cash was not essentially equivalent to a dividend. Presumably, the application of the Section 302(b) tests to determine dividend equivalency in a direct asset

respect to that share. Thus, the difficult issues that arise under the Proposed Regulations with respect to dividend-equivalent reorganizations in which shares are exchanged solely for boot – such as what happens to any unrecovered basis in such shares – simply do not arise under the Proposed Regulations with respect to non-dividend-equivalent reorganizations.

reorganization[162] under the Target Redemption Construct cannot simply be made solely by reference to the ceasing-to-exist target corporation, because that would lead to the untenable result that a direct asset reorganization would never be treated as dividend equivalent under a Target Redemption Construct. Perhaps the drafters of Revenue Ruling 74-515 would treat the acquiring corporation as a "successor" to the target corporation and this successor notion would apply to determine dividend equivalency under Section 302.[163]

However, the Proposed Regulations apply Section 302 not just to exchanges of stock solely for boot in direct asset reorganizations, such as A reorganizations, but to all reorganizations, including indirect asset reorganizations and stock reorganizations. While, in a direct asset reorganization, a successor rationale may at least help explain how dividend equivalency can be achieved when applying Section 302 under a Target Redemption Construct, such rationale would not adequately explain how dividend equivalency is achieved in an indirect asset reorganization or stock reorganization under a Target Redemption Construct.

In an indirect asset reorganization, the construct appears to be that the subsidiary of the issuing corporation receives the merger consideration from the issuing corporation and transfers this merger consideration to the target corporation in exchange

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[162] In this Report, (i) the term "direct asset reorganization" means an A reorganization or a reorganization described in Section 368(a)(1)(C) (other than the parenthetical therein), Section 368(a)(1)(D) (if such reorganization satisfies the requirements of Section 354(b)(1)), Section 368(a)(1)(F) (if such reorganization involves two juridical entities) or Section 368(a)(1)(G); (ii) the term "indirect asset reorganization" means a reorganization described in the parenthetical in Section 368(a)(1)(C) or Sections 368(a)(1)(A) and (a)(2)(D) and (iii) the term "stock reorganization" means a reorganization described in Section 368(a)(1)(B) (a "B reorganization") or in Sections 368(a)(1)(A) and (a)(2)(E) (an "A2E reorganization").

[163] This successor notion, however, seems more consistent with an Acquiror Redemption Construct (discussed later in this Report) than with a Target Redemption Construct, since the Target Redemption Construct tests for dividend equivalency by treating the target as redeeming the shares for which boot was received immediately before the reorganization.

for the target corporation's assets; these steps are followed by a liquidation of the target corporation in which the target corporation transfers the merger consideration to its shareholders in exchange for such shareholders' target stock.[164] Under this construct, it would appear that the subsidiary of the issuing corporation, rather than the issuing corporation, would be the successor to the target under a successor theory. But, in that case, the test for dividend equivalency under Section 302 would seem to depend on the target shareholders' continuing interest in the subsidiary. That is, if the subsidiary is the successor to the target corporation, the determination of whether Section 302(a) or (d) applies would seem to depend on the shareholder's continuing ownership of the subsidiary, taking into account the attribution rules of Section 318. But, under those attribution rules, the target shareholder would not be treated as having any ownership in the subsidiary unless the target shareholder owned, directly or indirectly, fifty percent or more of the value of the issuing corporation's stock.[165] Again, this would seemingly limit the circumstances under which a reorganization exchange would be treated as dividend equivalent, contrary to the notion in the Proposed Regulations that dividend equivalency is determined by looking at the overall reorganization transaction taking the principles of Clark and Zenz into account.

Similar issues resulting from application of a Target Redemption Construct in the indirect asset reorganization context could also arise when the Target Redemption Construct is applied to stock reorganizations where a shareholder exchanges

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[164] Cf. Rev. Rul. 84-44, 1984-1 C.B. 105. But see Reg. § 1.358-6 (applying an "over the top" methodology in determining the issuing corporation's basis consequences with respect to the subsidiary corporation in a triangular reorganization) and Reg. § 1.1032-2 (treating the issuing corporation as issuing its stock directly for the target assets acquired by the subsidiary for purposes of applying Section 1032).

[165] See § 318(a)(2)(C). However, it would be unusual to have a dividend-equivalent indirect asset reorganization in which target shareholders end up with less than 50 percent of the issuing corporation's stock.

target shares solely for boot.[166] Although unusual, a situation could arise where applying the Section 302(b) tests to an exchange by a shareholder of its target stock solely for boot under a Target Redemption Construct could result in a situation where such target shareholder would not be treated as having any ownership in the target corporation after the reorganization under the attribution rules of Section 318, even though the reorganization is treated as dividend equivalent under Clark and Zenz.[167] Again, the Proposed Regulations simply do not seem to envision treating the receipt of shares solely for boot as a redemption by the target corporation or to require strict adherence to Section 302 concepts such as rigid application of the Section 318 attribution rules.[168]

Given the issues associated with a Target Redemption Construct discussed above, perhaps the Acquiror Redemption Construct provides a better explanation for the choice of Section 302 as the provision applicable to shares for which only cash is received in a dividend-equivalent reorganization. The Acquiror Redemption Construct

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[166] This will only occur in the context of an A2E reorganization, which permits target shareholders to receive up to twenty percent boot. A shareholder can never receive solely boot for a class of shares in a B reorganization, since no boot is permitted to be received in a B reorganization.

[167] For example, assume that J owns all of the stock of corporation X, comprised of two classes, each voting, with the first class having 81 percent of the voting power and 90 percent of the value of all shares and the second class having the remaining 19 percent of the voting power and 10 percent of the value. Further, assume (i) J transfers all the stock of X to corporation Y, receiving solely Y voting stock for the first class of X stock and solely cash for the second class of X stock, (ii) J ends up with less than 50 percent of the stock of Y, and (iii) the reorganization would be treated as dividend equivalent under Clark and Zenz. In that case, the transaction would be an A2E reorganization in which J receives solely boot for a class of stock and that would not be dividend equivalent if the rules under Section 302 and Section 318 were applied in a Target Redemption Construct. In our experience, such transactions, while they may be possible, are rare.

Moreover, the construct of a stock reorganization is that the target shareholder transfers target stock to the acquiring corporation in exchange for the merger consideration. To the extent that the target shareholder receives solely boot for certain shares, so that the transaction is outside the scope of Section 356 under the Proposed Regulations, the transaction arguably should be governed by Section 304 (to the extent that the requirements of Section 304 are met) or Section 1001, rather than by Section 302.

[168] But Treasury and the IRS may have authority to promulgate a "look-through" rule in the context of redemption distributions in connection with reorganizations that differs from the Section 318 attribution rules. See New York State Bar Association Tax Section, Report on Distributions in Connection with Reorganizations, 45 (Report No. 1158, June 18, 2008).

would seemingly be supported by the Supreme Court's decision in Clark, which held that dividend equivalence in reorganizations should be determined "immediately after" the steps of the reorganization have been completed.[169] Under Clark, in determining whether boot paid in a reorganization has the effect of the distribution of a dividend, the tests under Section 302 are applied by comparing the interest in the acquiror that the shareholder receives in the reorganization with the interest that the shareholder would have received if no boot were paid. Thus, a shareholder is treated as receiving only acquiror stock, a portion of which is then redeemed in exchange for boot, and the deemed redemption is tested under Section 302.

Under the Acquiror Redemption Construct, a shareholder surrendering all of its shares of a class of target stock in a dividend-equivalent reorganization solely for boot would be treated as receiving only acquiror stock for such shares in the reorganization and then, solely in exchange for the boot, surrendering such acquiror stock to the acquiror in a redemption to which Section 302(d) applies.[170] Compared to the Target Redemption Construct, the Acquiror Redemption Construct is easier to reconcile conceptually with the choice of Section 302 as the paradigm to be applied with respect to shares for which solely cash is received.[171] On the other hand, if the Acquiror

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169 489 U.S. at 739-40.

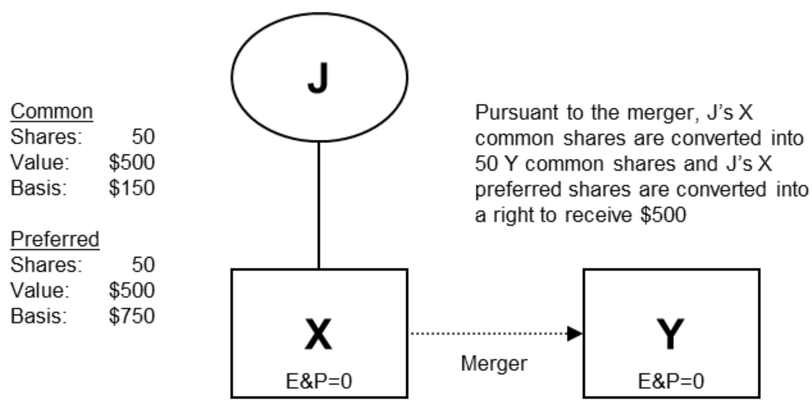
170 Under the Proposed Regulations, as well as under the recommendations in this Report, if a shareholder receives any acquiror stock with respect to a class of target stock in a dividend-equivalent reorganization, all consideration received by the target shareholder with respect to shares of that class is deemed to be received pro rata with respect to each share. Accordingly, Section 356, including its "dividend within gain" rule, will apply to such shares. As a result, basis in the acquiror shares received will be determined under Section 358 (which determines basis in the acquiror shares received based solely on the pre-reorganization basis in the target shares surrendered, the amount of boot received with respect to the shares and the amount of gain or dividend income recognized) and will not depend on any Section 302(d) construct. Therefore, only classes of shares for which solely boot is received in dividend-equivalent reorganizations raise the difficult basis issues addressed in this section of the Report.

171 Although this approach is easier to reconcile conceptually, it seems at odds with the construct of an asset reorganization as a transaction in which the target corporation transfers its assets to the acquiring

Redemption Construct is to be applied, a decision must be made as to which class of acquiror stock is deemed received and then redeemed. Under either the Redeemed Class Approach, the DCS Approach or the Bifurcated Distribution Approach discussed in this Report, post-reorganization basis and loss deferral consequences can differ depending on the class of shares deemed received and redeemed.

An example most easily demonstrates the above issues as well as the consequences of the selection of one construct versus the other in a dividend-equivalent reorganization. As these consequences depend on a number of variables, including whether the acquiror or target corporation has earnings and profits and, if so, which corporation's earnings and profits are relevant, we start with an example in which neither the acquiror nor target has any earnings and profits. For ease of comparison, the results under the various constructs discussed in the example below are summarized in a table at the end of the example.

Example 4




Facts: J owns 50 shares of common stock of corporation X and 50 shares of X preferred stock, which is non-voting and nonparticipating. The value of a single share of each class is $10. J has a $3 basis in each share of X

corporation for the merger consideration and then liquidates, giving the merger consideration to the target shareholders in exchange for their target shares. This approach, however, is consistent with the approach adopted by the consolidated return regulations. See supra note 156.

common stock and a $15 basis in each share of X preferred stock. X merges into corporation Y, a corporation that has only common stock outstanding, in an A reorganization. J does not own any stock of Y prior to the merger. Under the terms of the reorganization exchange, each share of X common stock held by the shareholders of X is converted into a share of Y common stock with a value of $10, and each share of X preferred stock is converted into a right to receive $10 in cash. Assume that, taking the overall reorganization into account, J's receipt of cash in exchange for the X preferred stock has the effect of a distribution of a dividend. Neither X nor Y has any available earnings and profits.

Result: Target Redemption Construct – Redeemed Class or Bifurcated Distribution Approach Followed[172]

Under the Target Redemption Construct, X would be treated as redeeming all of the X preferred stock held by J for $500, or $10 per share, in a transaction to which Section 302(d) applies. As a result, if the Redeemed Class Approach is followed, J would be treated as receiving a distribution of $10 per preferred share to which Section 301(c)(2) applies. This would reduce J's basis in each preferred share from $15 to $5. Because J no longer owns any X preferred shares after the deemed redemption, J's remaining basis in the X preferred shares (an aggregate of $250) would become a deferred loss that would be taken into account upon the occurrence of an "inclusion event."[173] Under the normal reorganization

[172] Because there are no earnings and profits, the results under the Bifurcated Distribution Approach are the same as under the Redeemed Class Approach. If there were earnings and profits in excess of the redemption proceeds, the results under the Bifurcated Distribution Approach would be the same as under the DCS Approach (although such results would be different than in this Example 4 where there are no earnings and profits). In circumstances where there are earnings and profits but in an amount less than the redemption proceeds, application of the Bifurcated Distribution Approach will produce some results similar to that of the Redeemed Class Approach (basis recovery only in shares in the class with respect to which the redemption occurs) and some results similar to that of the DCS Approach (shifting of any unrecovered basis in the redeemed shares to dividend controlling shares, but only in proportion to the distributions treated as being made under the Bifurcated Distribution Approach with respect to those shares). For an example of the operation of the Bifurcated Distribution Approach in the context of a dividend-equivalent Section 304 transaction in which there are earnings and profits but in an amount less than the distribution, see infra note 192.

[173] The Proposed Regulations do not specify how to determine whether an inclusion event occurs in the context of a reorganization. Under a literal application of the Target Redemption Construct, the inclusion event in the above example might be treated as occurring upon the consummation of the reorganization because, upon such reorganization, J ceases to own any X stock, literally satisfying the complete termination rule of Section 302(b)(3). It seems doubtful, however, that this is an appropriate time for J to recognize the deferred loss, as J's continuing interest in Y is sufficient to result in the reorganization being dividend-equivalent with respect to J. It seems more appropriate that J's loss continues to be deferred until J disposes of some of the Y stock received in the reorganization (at which point, if the ratable loss allowance approach discussed in this Report is followed, J would recover a ratable portion of the loss) or until J disposes of an amount of Y stock such that, had J received only the remaining Y stock at the time of the reorganization, the reorganization would not have been dividend equivalent with respect to J. Cf. PLR 201330004 (Jan. 30, 2013) (cross chain sale of issuing corporation treated as a dividend-equivalent section 304 sale even though the taxpayer "expected" that a formal plan of liquidation of the issuing corporation would be adopted shortly after

rules, J would be treated as surrendering J's 50 shares of X common stock for 50 shares of Y common stock in the merger and taking a basis in each Y common share of $3 per share (Block 1).

Result: Target Redemption Construct – DCS Approach Followed

If the Target Redemption Construct is followed, but the DCS Approach discussed in this Report is applied, then J would be treated as contributing the 50 X preferred shares owned by J to the capital of X. After the deemed issuance and recapitalization, J would hold 25 shares of X common stock with a $6 basis per share and 25 shares with a $30 basis per share.[174] J would then be treated as receiving a $10 distribution with respect to each of the 50 shares of X common stock. Because there are no available earnings and profits, none of the distribution is treated as a dividend. The $250 distributed with respect to the high-basis shares results in $250 of basis recovery. The $250 distributed with respect to the low-basis shares results in a recovery of J's $150 basis and $100 of gain. J would therefore hold 25 shares with a $0 basis and 25 shares with a $20 basis per share. Under the normal reorganization rules, J would be treated as surrendering J's 50 shares of X common stock for 50 shares of Y common stock in the merger and taking a basis in 25 of those shares of $0 per share (Block 1) and the other 25 of those shares of $20 per share (Block 2).[175]

Result: Acquiror Redemption Construct – Redeemed Class or Bifurcated Distribution Approach Followed

Under the Acquiror Redemption Construct, J would be treated as exchanging its 50 shares of X common stock for 50 shares of Y common stock in the merger and taking a basis in each such Y common share of $3 per share, and J would also be treated as exchanging its X preferred stock solely for stock of Y. Because no actual stock of Y is received in exchange for the X preferred stock, two alternative possibilities would

the sale); PLR 201252008 (Sept. 18, 2012) (cross-chain section 304 sale of stock treated as dividend-equivalent under section 302(d) even though the selling corporation subsequently liquidates for U.S. federal tax purposes as part of the same plan).

174 Since the X preferred shares constitute 50 percent of the pre-contribution value of J's shares in X and have a basis 50 percent higher than the value of the preferred shares, it is assumed that neither the de minimis contribution nor the de minimis disparity exception, even if adopted, would apply. (These exceptions, if applicable, would have caused J's basis in the X preferred shares merely to be added to J's basis in its existing shares of X common stock.)

175 In this example, although applying the DCS Approach has an impact on J's treatment in the distribution that is deemed to precede the reorganization, it has no impact on J's treatment in the reorganization other than affecting J's basis in the Y shares received. If, however, in the merger J received boot and Y common stock for J's X common stock, rather than solely Y common stock, applying the Target Redemption Construct combined with the DCS Approach would affect the amount of gain J recognizes in the reorganization.

seem to be possible: the class of Y stock that J is treated as receiving for its X preferred stock is (i) a hypothetical class having the same terms as the X preferred stock or (ii) Y common stock.[176] If approach (i) is followed, then J is deemed to momentarily hold preferred stock in Y having a value of $500 and a basis of $750. (The number of shares of hypothetical preferred stock is indeterminate because the class does not exist and irrelevant because of the immediate deemed redemption of the entire class.) This preferred stock is treated as immediately redeemed by Y in exchange for the $500 in cash that J actually received. After the deemed redemption, J has unrecovered basis in the Y preferred stock of $250 that would become a deferred loss that would be allowed under the normal loss recovery rules for dividend-equivalent redemptions of Y stock. If approach (ii) is followed, then J is treated as receiving 50 Y common shares for the 50 X preferred shares and as having those shares redeemed for $500. Under the Proposed Regulations, the $500 would be treated as a distribution with respect to all Y common shares actually (or, in this case, deemed) held by J. Thus, J would be treated as receiving a $5 per share distribution with respect to (x) each of the 50 Y common shares J is deemed to receive with respect to the X preferred shares J surrendered and (y) each of the 50 Y common shares J actually received for J's X common shares.[177] As a result, J would recognize $100 of gain and have a post-distribution basis of $0 in the 50 Y common shares J actually received and $10 of basis in each of the 50 Y common shares J is deemed to receive for J's preferred shares in X. The 100 Y common shares would then be deemed recapitalized into the 50 Y common shares that J actually owns, so J ends up with 25 Y common shares with a $0 basis (Block 1) and 25 Y common shares with a basis of $20 per share (Block 2).[178]

Result: <u>Acquiror Redemption Construct – DCS Approach Followed</u>

Although the mechanics differ, the DCS Approach produces the same ultimate result under the Acquiror Redemption Construct as under the Target Redemption Construct, regardless of whether the Y shares deemed

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[176] As discussed in Part IV.E below, an "exchange for Y common stock" approach is consistent with the approach adopted by the Proposed Regulations for Section 304 transactions.

[177] The examples demonstrating the approaches in this section of the Report assume that J has no pre-existing ownership of Y stock, which is unlikely to be the case in a dividend-equivalent reorganization. This assumption is made solely to simplify the examples. If J owned pre-existing shares in Y, the numbers and mechanics in the examples would change, but the same concept would apply.

[178] If, rather than J receiving solely Y common shares with respect to J's X common shares, J had received Y common shares and boot, J should have been treated as exchanging its X common shares for Y common shares and boot and as then exchanging the X preferred shares for Y common shares that are next redeemed in a dividend-equivalent redemption. Thus, J's basis in the Y common stock received for the X common stock, as adjusted for gain recognized in the reorganization and the boot received, would be further adjusted to reflect the portion of the distribution deemed to be made with respect to those shares as a result of the deemed issuance of the Y common shares for J's preferred shares in X followed by the redemption of the Y common shares.

issued for the X preferred shares are Y common shares or a new class of Y preferred shares. In either case, J will recognize a gain of $100 and end up with 25 Y shares with a $0 basis (Block 1) and 25 Y shares with a $20 basis (Block 2).[179]

[179] On these facts, the Acquiror Redemption Construct and the Target Redemption Construct would also each produce the same result under the DCS Approach (albeit not the result produced in Example 4) if J's basis in the X preferred shares met the de minimis disparity exception, regardless of whether the Y shares deemed issued for the X preferred shares are Y common shares or a new class of Y preferred shares. In either case, a block of Y shares reflecting the basis J had in the X preferred shares would be deemed issued and redeemed, with the result that J's basis in the X preferred shares would be added to and averaged with J's basis in the Y common shares actually received. If, however, contrary to the assumption in the above example, J owned Y common shares prior to the reorganization, under the Acquiror Redemption Construct J's basis in the X preferred stock would be added to and averaged with both the Y common shares J actually received in the reorganization and the Y common shares J owned before the reorganization. Under the Target Redemption Construct, J's basis in the X preferred stock would be added to and averaged with J's basis in its X common shares and that averaged basis would then be reflected only in the Y common shares J receives in the reorganization. As a result, if J's basis in the X preferred shares met the de minimis disparity exception, different basis and other consequences can result depending on whether the Acquiror Redemption Construct or Target Redemption Construct is applied.

Summary Table

| | **Target Redemption Construct** | **Acquiror Redemption Construct** (where Y preferred shares are deemed issued and redeemed) | **Acquiror Redemption Construct** (where Y common shares are deemed issued and redeemed) |
|---|---|---|---|
| **Redeemed Class or Bifurcated Distribution Approach** | Gain: $0<br>Deferred Loss: $250<br>Block 1 Basis: $150<br>Block 2 Basis: N/A | Gain: $0<br>Deferred Loss: $250<br>Block 1 Basis: $150<br>Block 2 Basis: N/A | Gain: $100<br>Deferred Loss: $0<br>Block 1 Basis: $0<br>Block 2 Basis: $500 |
| **DCS Approach** | Gain: $100<br>Deferred Loss: $0<br>Block 1 Basis: $0<br>Block 2 Basis: $500 | Gain: $100<br>Deferred Loss: $0<br>Block 1 Basis: $0<br>Block 2 Basis: $500 | Gain: $100<br>Deferred Loss: $0<br>Block 1 Basis: $0<br>Block 2 Basis: $500 |

On balance, we believe that the Acquiror Redemption Construct is preferable to the Target Redemption Construct. The Acquiror Redemption Construct is more consistent with the precepts of Clark and is easier to reconcile conceptually with the choice of Section 302 as the section governing shares for which solely boot is received in a dividend-equivalent reorganization.[180] On balance, we also believe that if the Acquiror Redemption Construct is adopted, the acquiring corporation should be viewed as issuing a hypothetical class of acquiror stock having the same characteristics as the target stock for which solely boot is received. We believe that this will help provide greater consistency between classes of shares held by a shareholder that are redeemed in their entirety in a dividend-equivalent redemption and classes of shares held by a shareholder for which solely boot is received in a dividend-equivalent reorganization, regardless of

[180] In the wake of Clark, the IRS applied an Acquiror Redemption Construct for determining dividend equivalency for transactions to which Section 354 would apply but for the receipt of boot but continues to apply a Target Redemption Construct for transactions to which Section 355 would apply but for the receipt of boot. See Rev. Rul. 93-62, 1993-2 C.B. 118 and Rev. Rul. 93-61, 1993-2 C.B. 118; cf. Reg. § 1.1502-13(f)(3). We do not address in this Report what is the appropriate approach for transactions to which Section 355 would apply but for the receipt of boot.

whether a Redeemed Class, DCS or Bifurcated Distribution Approach is employed with respect to such redemptions or reorganizations.

Regardless of which construct is adopted, the already highly-complex analysis outlined above becomes even more complex if the target or acquiring corporation has relevant available earnings and profits.[181] Because relevant available earnings and profits will impact the portion, if any, of a dividend-equivalent redemption distribution that reduces basis under Section 301(c)(2), it is not possible to apply a dividend-equivalent redemption construct to determine basis in a dividend-equivalent reorganization without determining which corporation's earnings and profits are relevant. As noted above in Part III.A.1.c, a similar issue exists under current law in determining which portion of the recognized gain in a dividend-equivalent reorganization is a dividend under Section 356(a)(2). That issue remains unresolved.[182]

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[181] For these purposes, "relevant" means that the earnings and profits of the corporation in question are taken into account for purposes of determining the characteristics of a distribution; "available" means that the corporation has earnings and profits that meet applicable criteria for determining whether a distribution is treated as coming out of earnings and profits.

[182] Compare Davant v. Comm'r, 366 F.2d 874, 889-90 (5th Cir. 1966) (both target's and acquiror's earnings and profits taken into account in a reorganization under Section 368(a)(1)(D) with a complete overlap of shareholders), and Rev. Rul. 70-240, 1970-1 C.B. 81 (same) with Atlas Tool Co. v. Comm'r., 70 T.C. 86, 121 (1978), aff'd, 614 F.2d 860 (3d Cir. 1980) (only target's earnings and profits looked to in a reorganization under Section 368(a)(1)(D) with a complete shareholder overlap), Am. Mfg. Co. v. Comm'r, 55 T.C. 204, 231 (1970) (same), and Estate of John Bell v. Comm'r. 30 T.C.M. (CCH) 1221, 1225 (1971) (same). Compare PLR 9041086 (July 19, 1990) (relevant earnings and profits were those of the acquiror in an A2E reorganization), and PLR 9039029 (June 29, 1990) (same, in an A reorganization), with PLR 9439006 (June 28, 1994) (relevant earnings and profits were those of target in a reorganization under Section 368(a)(1)(C)), and PLR 9118025 (Feb. 5, 1991) (same, in a reorganization under Section 368(a)(2)(D)). In Field Service Advice 001651 (July 21, 1995), the IRS admitted that, in the wake of the Clark decision, its position is unclear regarding the source (target's or acquiror's earnings and profits) of "dividend-equivalent boot" in cases other than those in which there is identical ownership in the target and the acquiror. In identical ownership cases, the IRS continues to look to the combined earnings and profits of the target and the acquiror. Id.; see Rev. Rul. 70-240, 1970-1 C.B. 81. See also International Tax Competitiveness Act of 2013, H.R. 1555, 113th Cong. § 4 (2013) and the House Bill, supra note 21, which propose to look to the earnings and profits of the target and acquiror in a dividend-equivalent acquisitive reorganization under Section 368(a)(1)(D) (and any other reorganization specified by the Secretary of the Treasury).

If a Target Redemption Construct is chosen, the initial intuitive response might be that the target's, and only the target's, earnings and profits should be relevant. Conversely, if an Acquiror Redemption Construct is selected, the initial intuitive response might be that the acquiror's, or perhaps the acquiror's and target's, earnings and profits should be the relevant earnings and profits.[183] Such intuition seems suspect, however, where pre-existing ownership of stock of the other corporation results in the reorganization being dividend equivalent, which will often be the case. For example, if the Target Redemption Construct is selected but the reorganization would not be dividend equivalent but for the pre-existing ownership of acquiror stock by the target shareholder, it would seem to make sense to take the acquiror's earnings and profits into account.

We have no recommendation as to how to resolve the earnings and profits issue, as we believe it is best resolved in the larger context of which corporation's earnings and profits are taken into account in determining the extent to which gain is treated as a dividend under Section 356 under current law – a topic that is beyond the scope of this Report. We note, however, that the complexity of this issue and the complexity of the various approaches discussed in this section may argue in favor of reconsidering the approach in the Proposed Regulations of treating shares for which solely boot is received in a reorganization as subject to Section 302 rather than Section 356.[184]

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[183] In a direct asset reorganization, the acquiring corporation generally will inherit the earnings and profits of the target corporation. See Reg. § 1.381(a)-1(a). Accordingly, in such reorganizations, an Acquiror Redemption Construct generally will result in both the target's and the acquiror's earnings and profits automatically being taken into account. In an indirect asset reorganization or a stock reorganization, the target's earnings and profits generally will not be combined with the acquiring corporation's earnings and profits. Accordingly, in such reorganizations, absent a different rule being applied, an Acquiror Redemption Construct generally will result in only the acquiror's earnings and profits being taken into account.

[184] If a shareholder receives boot for all its target shares in a reorganization that is dividend equivalent to the shareholder (i.e., because the shareholder actually or by attribution owned sufficient pre-

### E. <u>Section 304 Transactions</u>

Unlike dividend-equivalent redemptions governed by Section 302(d) or the construct for dividend-equivalent reorganizations in the Proposed Regulations, the construct for dividend-equivalent "brother-sister" Section 304 transactions is reasonably well defined under current law.[185] As discussed in Part III.A.1.d, under Section 304(a)(1), the target shareholders in a dividend-equivalent brother-sister Section 304 transaction transferring target stock to the acquiring corporation are treated as doing so in a Section 351(a) transaction in exchange for acquiror stock, and the acquiror is then treated as redeeming that stock for the property actually received by the target shareholders. This construct is essentially the Acquiror Redemption Construct discussed in Part IV.D.4 above.

In addition to providing a deemed issuance and redemption construct, Section 304 addresses which corporation's earnings and profits are relevant. Under Section 304(b)(2), the deemed redemption in a dividend-equivalent Section 304 transaction generally is treated as a dividend from the acquiring corporation to the extent

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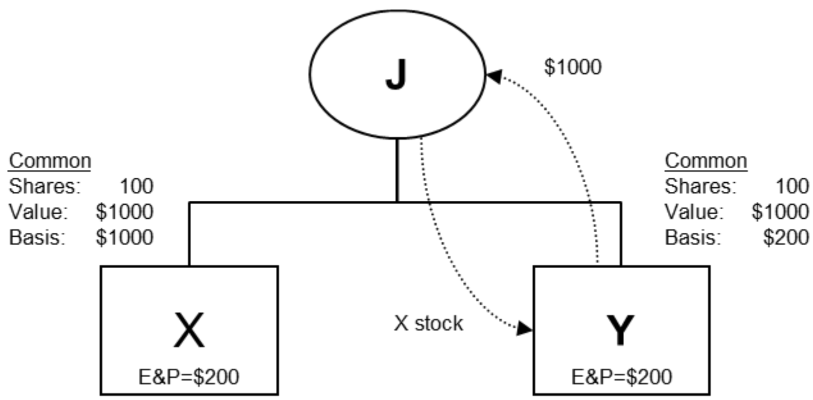
reorganization shares of the acquiring corporation to make the transaction dividend equivalent), then, as in Revenue Ruling 74-515, Section 356 by its terms would not apply to the shareholder. Accordingly, a construct might still have to be developed to address such cases even if Section 356 applied to all shareholders that received at least some acquiring corporation stock in the reorganization. Given the nominal share approach for "all cash D reorganizations" adopted in Regulations Section 1.368-2(*l*), however, it would seem to be a rare case in which a target shareholder could receive no actual or deemed shares in the reorganization and that reorganization could still be dividend equivalent to the shareholder.

185 "<u>Brother-sister</u>" Section 304 transactions are transactions governed by Section 304(a)(1) in which two corporations are under common control and one (the acquiring corporation) acquires stock in the other (the issuing corporation) from the person or persons that control the corporations (the transferor) in return for property. "<u>Parent-subsidiary</u>" Section 304 transactions are governed by Section 304(a)(2) and are transactions in which the issuing corporation controls the acquiring corporation. Under Section 304(a)(2), the disposition by a parent shareholder of parent stock to a subsidiary is treated as a redemption of such stock by the parent from the parent shareholder. As such, the transaction should be subject to the rules in the Proposed Regulations with respect to redemptions discussed in Part III.B.1.b and is not separately discussed here. Although Section 304 refers to the acquiring corporation and the issuing corporation, to be consistent with the terminology used in the rest of this Report, in this section of the Report the issuing corporation is referred to as the target corporation and the shareholders of the issuing corporation are referred to as target shareholders.

of the acquiring corporation's earnings and profits and then as a dividend from the target corporation to the extent of the target corporation's earnings and profits.

The Code does not, however, specify what type of acquiror shares are deemed issued and redeemed. The Proposed Regulations, without discussion of the choice in either the preamble or the text, treat the acquiring corporation as issuing and redeeming acquiror common shares.

Example 5[186]




Facts: J owns all of the stock of corporation X and corporation Y. J's interest in X is represented by 100 common shares with a value and basis of $10 per share. J's interest in Y is represented by 100 common shares with a value of $10 per share and a basis of $2 per share. J sells all of the stock of X to Y for $1000 in cash. Each of X and Y has $200 of earnings and profits.

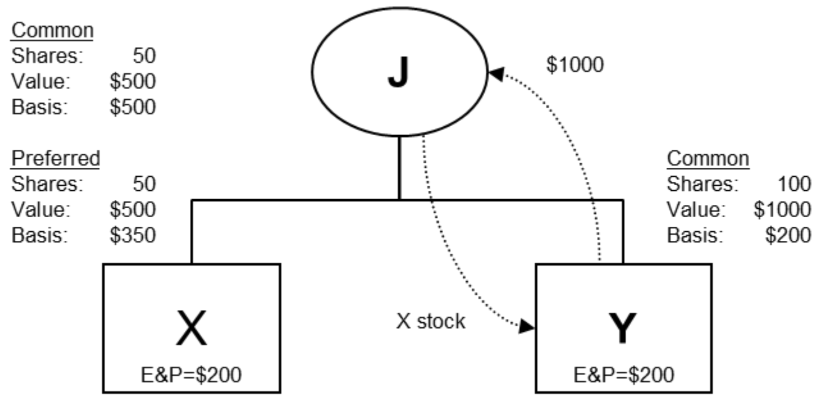
Result: Under Section 304(a)(1), J is treated as if it received the $1000 from Y as a distribution in redemption of the stock of Y. Because the transaction is dividend equivalent, the parties are treated as if J transferred the X common stock to Y for stock of Y in a Section 351(a) transaction and Y then redeemed such deemed-issued stock. Under the Proposed Regulations, the deemed-issued Y stock is Y common stock. Therefore, J is first treated as transferring 100 shares of X common stock to Y for 100 additional shares of Y common stock. J consequently would be treated as holding 200 shares of Y common stock, 100 with a basis of $10 per share and 100 with a basis of $2 per share. J would then be treated as surrendering the 100 additional shares of Y common stock in a redemption. Under the approach applicable under the Proposed Regulations to dividend-equivalent redemptions generally, J would be

186 See also Prop. Reg. § 1.304-2(c) ex. 2.

> treated as receiving the redemption proceeds ratably with respect to each Y share. Accordingly, J would be treated as receiving a $5 distribution per share. J would be treated as receiving an aggregate dividend of $400 (the amount of available earnings and profits of both Y and X), or $2 per share – $200 from Y and $200 from X. The remaining $600 distributed would be treated as a non-dividend distribution of $3 per share with respect to each of the 200 Y shares. As a result, J would recover (i) $3 of J's $10 basis per share with respect to the high-basis shares and (ii) J's entire basis with respect to each of the low-basis shares, and J would recognize a gain of $1 per share with respect to each such low-basis share ($100 of aggregate gain). Immediately after the deemed distribution, J would hold one block of 100 shares with a basis of $0 per share and one block of 100 shares with a basis of $7 per share. Finally, those 200 shares would be treated as recapitalized into 100 shares, so that J would hold 50 shares with a $0 basis per share and 50 shares with a $14 basis per share.

The Redeemed Class Approach causes the transferor's basis recovery to be proportional to the fair market values of (i) the transferred stock of the target corporation, regardless of its class, and (ii) all of the common stock of the acquiring corporation held by the transferor. In the foregoing example, because the value of the transferred X stock was equal to the value of all outstanding Y common stock, the deemed-issued shares and the actual Y shares were equal-sized blocks and participated equally in the pro rata distribution that the Proposed Regulations deem to occur upon a dividend-equivalent redemption. On the facts of the above example, the result under the Proposed Regulations appears sensible. Where the target corporation has more than one class of stock outstanding, however, treating the deemed-issued shares as acquiror common stock can lead to seemingly anomalous results.

Example 6




Facts: The facts are the same as in the preceding example, except that rather than owning 100 common shares in X each having a value and basis of $10, J owns 50 X common shares each having a value and basis of $10 and 50 X preferred shares each having a value of $10 and a basis of $7. J sells all of the X common and preferred stock to Y for $1000.

Result: Under the Proposed Regulations, Y is treated as issuing 100 Y common shares to J, 50 in exchange for the 50 X common shares and 50 in exchange for the 50 X preferred shares, resulting in J having a basis of $10 per share in 50 Y common shares and $7 per share in the other 50 Y common shares. Y is then treated as redeeming those 100 Y shares for their value of $1000. As discussed in the preceding example, the $1000 will be treated first as a $200 dividend from Y, then as a $200 dividend from X. The remaining $600 will be treated as a non-dividend distribution made ratably with respect to each of the 200 Y common shares (100 deemed and 100 actual) owned by J, or a distribution of $3 per share. Because J has three blocks of Y common shares, 50 having a basis of $10 per share (Block 1), 50 having a basis of $7 per share (Block 2) and 100 having a basis of $2 per share (Block 3), the $3 per share non-dividend distribution will result in J having remaining basis of $7 per share with respect to Block 1, $4 per share with respect to Block 2 and $0 per share with respect to Block 3. In addition, because the distribution per share with respect to Block 3 is $1 per share greater than J's basis in such shares, J will recognize a gain of $1 per share with respect to those shares (an aggregate gain of $100). The 200 Y common shares will then be treated as recapitalized into the 100 Y common shares that J actually owns, resulting in J having basis of $14 per share in 25 Y common shares, $8 per share in 25 Y common shares and $0 per share in 50 Y common shares.

The above result generally is consistent with the application of the combined Acquiror Redemption Construct/DCS Approach to dividend-equivalent reorganizations, discussed in Part IV.D above (which combined approach generally results in the deemed issuance of acquiror common shares for any target shares for which solely boot is received, regardless of the class of target shares for which solely boot is received). This result also generally is consistent with the DCS Approach to dividend-equivalent redemptions, discussed in Part IV.C.1, but seems inconsistent with the Redeemed Class Approach.[187] A more consistent approach would seem to be to treat the acquiror as issuing shares of acquiror stock having the same characteristics as the target shares acquired and then redeeming those shares. In the above example, this would result in Y being treated as issuing 50 Y preferred shares for the 50 X preferred shares and then redeeming those Y preferred shares for $10 per share. Assuming that half of the available earnings and profits are allocated to the $500 distribution on the preferred,[188] under the Redeemed Class Approach, J would be treated as receiving a $4 per share dividend with respect to the Y preferred shares and a non-dividend distribution of $6 per share. J's basis in the 50 Y preferred shares deemed issued would be reduced from $7 to $1 per share and, under the Proposed Regulations, the $1 of remaining basis per share would be treated as a deferred loss.[189]

[187] Consider, for example, a reverse subsidiary merger. If a transaction qualifies as an A2E reorganization, then under the Proposed Regulations a preferred share transferred solely for cash will be governed by Section 302. If the shareholder's overall exchange is dividend equivalent, then the preferred share transfer is governed by Section 302(d), and the Redeemed Class Approach is applied (the application of which is unclear under the Proposed Regulations in a reorganization). If, however, the transaction fails to qualify as a reorganization (as a result of the mix of consideration not meeting the 80 percent stock requirement of Section 368(a)(2)(E)) and the transaction is instead a Section 304 exchange, a preferred share surrendered for cash will be treated as surrendered for common stock. If the target corporation had merely redeemed the preferred share (rather than undertaking a reorganization or a Section 304 transaction), the distribution (and hence basis recovery) would be treated under the Proposed Regulations as being solely with respect to shares of preferred stock.

[188] This assumes that the $400 of available earnings and profits are allocated for federal income tax purposes proportionally to the distributions on the common and preferred. A different allocation of earnings and profits may be possible and would affect the gain and basis results in this example.

[189] Under this construct, in addition to issuing 50 Y preferred shares for the 50 X preferred shares and redeeming them for $500, Y would also be treated as issuing 50 Y common shares for the 50 X

Things get even more complex if the acquiror has more than one class of stock outstanding. If the approach in the Proposed Regulations (wherein acquiror common stock is issued for target stock) is followed, regardless of what class/classes of target stock is/are surrendered or how many classes of stock the acquiror has outstanding, the result is the same as in Example 5/6 above. In this regard, simplicity recommends the approach in the Proposed Regulations. If a deemed issuance of like-characteristic stock approach were adopted, however, then application of the Redeemed Class Approach would require determining whether the deemed-issued shares of acquiror stock are a separate class or are of the same class as one of the classes of acquiror stock outstanding. The most logical approach appears to be to make that determination based on the characteristics of the shares involved. Thus, for example, "plain" common stock of the target and the acquiror would be treated as having the same characteristics and acquiror common stock would be treated as issued for target common stock. However, where there are economic differences (other than a different issuer), between a class of target stock and all classes of acquiror stock, a new class of acquiror stock would be treated as issued for the target stock and then redeemed.

A further complication to this multiple class conundrum arises if the DCS Approach discussed in this Report is followed. In that case, it is necessary to decide

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common shares and redeeming those shares for $500. As discussed above, assuming the other half of available earnings and profits were allocated to the distribution on the common shares, $200 of the $500 distribution would constitute a dividend. Under the Redeemed Class Approach of the Proposed Regulations, the remaining $300 non-dividend distribution with respect to each of the 150 Y shares J is treated as owning (50 deemed and 100 actual) would result in basis recovery of $2 per share ($300/150). J's basis in each of its 50 Y common shares would be reduced from $10 per share to $8 per share, and J's basis in each of its 100 Y common shares would be reduced from $2 per share to zero. The 150 Y common shares would then be treated as being recapitalized into 100 Y common shares, with the result that J would have three blocks of Y common shares, one block of 33 shares having a basis of $12 per share, one block of 66 shares having a basis of zero per share and one block of one share having a basis of $4 (which share, if segmenting were applied, would have a 1/3 segment with a basis of $4 and a 2/3 segment with a basis of zero).

which class or classes of shares of the acquiror are dividend controlling shares. This task is not an easy one. Under Section 304, dividend equivalency is determined by comparing the transferring target shareholders' ownership of target stock immediately before and immediately after the transfer, attributing to the target shareholder a portion of the target stock owned by the acquiror under a modified version of the constructive ownership rules of Section 318.[190] Because the amount attributed is based on value, rather than vote,[191] and all shares of the acquiror constitute part of the value of the acquiror shares on which attribution of the target shares is based, all classes of acquiror stock owned by the target shareholder, even non-voting, nonparticipating preferred stock, potentially will be partially responsible for dividend equivalency.[192]

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190 § 304(b)(1).

191 § 318(a)(2)(C).

192 As with reorganizations discussed in Part IV.D of this Report, the results under the Bifurcated Distribution Approach are the same as the results, whatever they may be, under the DCS Approach in dividend-equivalent Section 304 transactions where there are earnings and profits in excess of the boot distributed, and are the same as the results, whatever they may be, under the Redeemed Class Approach where there are no earnings and profits. And where there are earnings and profits but in an amount less than the boot distributed, application of the Bifurcated Distribution Approach results in an amalgamation of the consequences under the Redeemed Class Approach and the DCS Approach. To illustrate this latter case, consider the facts of Example 6 and a regime under which there is a deemed issuance of like-characteristic stock. Pursuant to the dividend-equivalent Section 304 transaction, Y is treated as issuing 50 shares of Y preferred stock for J's 50 shares of X preferred stock, and 50 shares of Y common stock for J's 50 shares of X common stock. Y is then treated as distributing $500 in redemption of the deemed issued Y preferred stock and $500 in redemption of the deemed issued Y common stock. Assume again that for federal income tax purposes, $200 of the distribution on the preferred and $200 of the distribution on the common will be treated as paid from earnings and profits. As under the Redeemed Class Approach, the remaining $300 non-dividend distribution on the Y preferred shares would reduce the basis in the Y preferred shares from $350 to $50, and the remaining $300 non-dividend distribution on the Y common shares would reduce the basis in the actual and deemed Y common shares proportionally, $100 from the 50-share block and $200 from the 100-share block. Unlike under the Redeemed Class Approach, the remaining basis in the redeemed common and preferred stock would be accounted for by treating the redeemed shares as being contributed to the capital of all remaining unredeemed shares in proportion to the distributions treated as made under the Bifurcated Distribution Approach on such shares. Because the only remaining unredeemed shares with respect to which distributions were treated as being made under the Bifurcated Distribution Approach are the 100 shares of actual Y common stock, the 50 deemed-issued shares of Y preferred stock with a remaining basis of $50 and the 50 deemed-issued shares of Y common stock with a remaining basis of $400 are treated as contributed to the capital of the 100 shares of Y common stock. Under the Proposed Regulations, such capital contribution is treated as a deemed issuance and recapitalization. Therefore, J will end up with one block of 25 shares with $50 basis, one block of 25 shares with $400 basis, and one block of 50 shares with $0 basis.

Given the complexity of devising a unifying approach to Section 304 transactions that is consistent across all fact patterns and also administrable, the decision of the Proposed Regulations to treat the deemed-issued shares as common stock in all instances may be the most practical approach. This approach, however, would seem to argue for a similar approach to dividend-equivalent reorganizations and dividend-equivalent redemptions. While hardly perfect, applying the DCS Approach in those cases would appear to be more consistent with the approach adopted in the Proposed Regulations with respect to dividend-equivalent Section 304 transactions than the Redeemed Class Approach.[193]

### F. <u>Basis Averaging Within Classes</u>

Another approach through which many of the complexities addressed in this Report could be ameliorated would be through adoption of an averaging regime under which a taxpayer's basis in any share within a particular class is averaged such that each share has an identical basis to every other share. If basis were averaged within classes, then whether aggregate or per share basis recovery were applied and whether the de minimis exceptions recommended in this report were adopted would be largely irrelevant. Moreover, averaging within classes would be similar to the rule that exists today for interests in a partnership.

A substantial majority of the Executive Committee, however, believes that averaging within classes should not be pursued. Taxpayers have had separate basis in

[193] Whatever approach is ultimately adopted with respect to dividend-equivalent brother-sister Section 304 transactions, we recommend that if the "capitalization prior to distribution" approach discussed in this Report with respect to redemptions and reorganizations is adopted, it also be adopted for Section 304 transactions. This will have the effect of importing into Section 304 the de minimis exceptions to separate basis tracing and provide for averaging of the basis in surrendered shares in the target corporation that meet a de minimis exception with the basis in acquiring corporation shares (including any such shares deemed issued for target shares that don't meet a de minimis exception).

separate shares for purposes of calculating gain and loss on sales since the beginning of the income tax. Any deviation from such a system needs to be carefully considered. Furthermore, absent adoption of significant and complex anti-abuse rules, adoption of an averaging regime is likely to lead to more taxpayer electivity with little if any reduction in administrative complexity. For example, absent rules dealing with ownership of shares through related entities, any averaging system would be largely elective. If a taxpayer wanted to average basis in shares within a class, the taxpayer would hold the shares directly; if the taxpayer wanted to trace basis, the taxpayer would hold different blocks of shares through different entities (including through pass-through entities). A taxpayer could also initially keep its options open by using different entities to have a traced basis, then switch to average basis by merging the entities together. Any rules to address this electivity are likely to be complex and difficult to administer.

We presume that if averaging were adopted it would apply on a class by class basis, as averaging basis across classes could lead to significant distortion (for example, importing inherent gain in common into preferred shares held by the same taxpayer). Yet if only applied on a class by class basis, the system may be susceptible to manipulation through having different classes of stock with only modest differences in terms. Although an anti-abuse rule may be able to be crafted to address these modest difference situations, again, additional complexity would be created.

Given the foregoing considerations, a substantial majority of the Executive Committee believes that averaging within classes should not be adopted, especially since they believe the vast majority of the most difficult issues inherent in tracing can be addressed by adoption of the de minimis rules and aggregate basis recovery proposals set forth in this Report.

While a substantial majority of the Executive Committee is not in favor of an averaging regime, at least some members believe that averaging may be worth considering for Large Shareholders if aggregate basis recovery is not adopted. Thus, for example, averaging within classes might be considered for a shareholder that owns 50 percent or more of the shares in a corporation. At this level of ownership the relationship between the shareholder and the entity is more closely aligned than at lower levels of ownership.[194] These higher levels of ownership are also more likely to give rise to the complexities of tracing occasioned by capital contributions, stockless reorganizations and other similar transactions.

The consideration of averaging within classes, contrary to our recommendations, would raise the additional issue of whether averaging should be mandatory or elective. Although some would favor mandatory averaging, if averaging were adopted and if the IRS and Treasury believe they have the authority to mandate averaging, others believe that averaging should only be adopted on a one-time, all shares, all related parties elective basis, as described below.

The purpose of permitting an averaging election would not be to maximize taxpayer-favorable electivity, but to simplify basis determinations and to tax corporate transactions without regard to the division of an interest in a corporation into shares. As an elective alternative regime to tracing, it would plainly introduce an element of electivity into the tax treatment of Large Shareholders. To minimize unfair "cherry-picking" that could otherwise result, we recommend that certain limitations be imposed on elective averaging by Large Shareholders if elective averaging is permitted. First, the

[194] Fifty percent need not be the threshold adopted for determining who is a Large Shareholder and is only used here for purposes of illustration. As discussed elsewhere in this Report, other levels of ownership, such as 20 percent or 80 percent, may also be appropriate dividing lines. See supra notes 108 to 111 and the accompanying text.

election should be a one-time election not revocable without consent of the IRS. Second, it should be a taxpayer-by-taxpayer election, effective for all shares of any issuer held by the electing taxpayer on or after the date of the election. To prevent an electing taxpayer from circumventing such consistency requirement by holding certain shares through another non-electing entity, all taxpayers that are part of the same controlled group might be required to make the same election.

However, as noted above, even if the foregoing constraints are adopted, if elective averaging were permitted (or mandatory averaging were required) for Large Shareholders, it might still be possible for such shareholders to cherry-pick through the use of different classes of stock or holdings through related parties. But it may be easier to craft appropriate anti-abuse rules for such shareholders, or at least the complexity entailed in any such rules may be a more acceptable tradeoff in the Large Shareholder context given the other complexities inherent in tracing in capital contributions, stockless reorganizations and other stockless transactions in which these shareholders more frequently engage. Nevertheless, if averaging within classes were pursued for Large Shareholders, these issues would need to be considered further.

## V. <u>Other Matters</u>

As noted elsewhere in this Report, there may be aspects of the Proposed Regulations or the recommendations in this Report for which modifications may be appropriate in certain circumstances based on differing policy considerations. Those circumstances may include international transactions and transactions within a consolidated group. Although international and consolidated group issues generally are not covered in this Report, we do not believe that the policy considerations relevant to those areas should prevent progress from being made in the non-international, non-consolidated context and we encourage the IRS and Treasury to continue to work on, and provide further guidance with respect to, the important and difficult issues addressed in the Proposed Regulations.

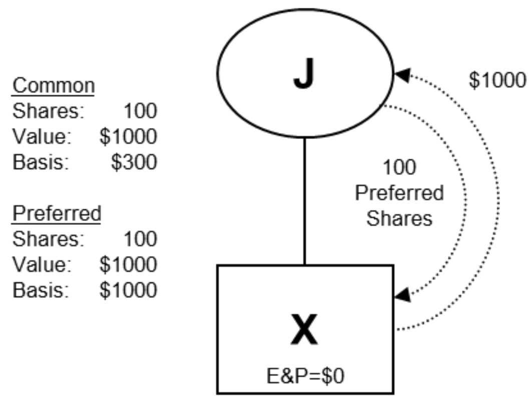
We realize, however, that even in the domestic, non-consolidated context the complexity of the issues discussed in this Report may make addressing all of the aspects of the Proposed Regulations a daunting proposition in the near term. We believe, however, that further guidance could be provided on certain matters addressed in the Proposed Regulations without finalizing the entire package. Such matters might include clarification that dividend-equivalent redemptions of shares of a corporation having only one class of shares outstanding results in a pro rata distribution with respect to each pre-redemption share held by the redeemed shareholder (and to the extent the distribution is in excess of available earnings and profits, basis recovery in each such share, whether on a per share or aggregate basis). It might also include clarification that in a dividend-equivalent brother-sister Section 304 transaction where both the issuing and acquiring corporation have only a single class of shares outstanding, the acquiring corporation is treated as issuing to the target shareholder additional common shares of the acquiring corporation's stock and then redeeming such shares.

Lastly, we note that the principle that the basic unit of property in corporate stock is a single share, which underlies many of the choices made in the Proposed Regulations, is difficult to apply in the context of entities that for federal income tax purposes are corporations but under local law are partnerships or limited liability companies or other entities the interests in which are not represented by individual shares. The existence of corporations that are subject to the rules of subchapter C of the Code that do not issue individual shares might be taken as another argument in favor of an aggregate basis recovery regime for at least Large Shareholders as discussed in Part IV.B. Publicly traded stock will presumably continue to be divided into many equal-sized shares, while interests in closely-held corporations, including those that are not corporations under state law, may not be. It might also be taken as evidence that a share may not be sufficiently significant economically to serve as the primary organizing principle for determining tax consequences in subchapter C of the Code.

# APPENDIX A: REDEMPTION EXAMPLES

Unless otherwise noted, in all of the examples in this Appendix A, (i) segmenting is assumed not to apply, (ii) where aggregate basis recovery is applied, charts display the results under the recursive approach, and (iii) dollar amounts are rounded to the nearest dollar. Some scenarios show the effects of determining basis blocks under the proportional, recursive and spillover approaches to aggregate basis recovery, but, as noted in the Report, it is not necessary to know the basis in each block, just aggregate per class basis, to determine gain in Section 301(c)(2) distributions if aggregate basis recovery is employed. Although it may be necessary to know the basis in each block if less than all shares in the class are subsequently disposed of, we believe such a partial disposition is unlikely to be a normal occurrence.

## Scenario 1: No E&P and all preferred shares are redeemed




### Scenario 1A

None of de minimis rules, aggregate basis recovery or averaging applied.

***Redeemed Class Approach*** – Pro rata distribution of $1000 on preferred stock, full recovery of basis in preferred shares.

***DCS Approach*** – Capital contribution of 100 preferred shares to common shares treated as deemed issuance and recapitalization, resulting in two blocks of common, one block of 50 shares with $300 basis (Common Block 1) and one block of 50 shares with $1000 basis (Common Block 2). Pro rata distribution of $1000 on common stock, resulting in basis recovery of $300 in Common Block 1 and $200 of gain, and basis recovery of $500 in Common Block 2 ($500 basis remaining).

***Bifurcated Distribution Approach*** – Same as Redeemed Class Approach on these facts. Pro rata distribution of $1000 on preferred stock, full recovery of basis in preferred shares.

| **Redeemed Class Approach** | | | **Common Block 1** | **Common Block 2** | **Preferred** |
|---|---|---|---|---|---|
| Dividend Amount | $0 | Shares | 100 | N/A | 0 |
| Gain Recognized | $0 | Value | $1000 | N/A | $0 |
| Deferred Loss | $0 | Basis | $300 | N/A | $0 |
| **DCS Approach** | | | | | |
| Dividend Amount | $0 | Shares | 50 | 50 | 0 |
| Gain Recognized | $200 | Value | $500 | $500 | $0 |
| Deferred Loss | $0 | Basis | $0 | $500 | $0 |
| **Bifurcated Distribution Approach** | | | | | |
| Dividend Amount | $0 | Shares | 100 | N/A | 0 |
| Gain Recognized | $0 | Value | $1000 | N/A | $0 |
| Deferred Loss | $0 | Basis | $300 | N/A | $0 |

### Scenario 1B

De minimis rules/averaging applied. Because there are no blocks within classes, the de minimis rules and averaging produce the same result.

***Redeemed Class Approach*** – Same as Scenario 1A.

***DCS Approach*** – De minimis disparity rule/averaging applies to capital contribution of preferred shares to common shares, resulting in increased basis in the common stock to $1300, with each share having an identical, averaged basis. Pro rata distribution of $1000 on common stock results in $1000 of basis recovery ($300 basis remaining).

***Bifurcated Distribution Approach*** – Same as Scenario 1A.

| **DCS Approach w/ de minimis rules** | | | **Common Block 1** | **Common Block 2** | **Preferred** |
|---|---|---|---|---|---|
| Dividend Amount | $0 | Shares | 100 | N/A | 0 |
| Gain Recognized | $0 | Value | $1000 | N/A | $0 |
| Deferred Loss | $0 | Basis | $300 | N/A | $0 |

### Scenario 1C

Neither the de minimis rules nor averaging applied; aggregate basis recovery applied.

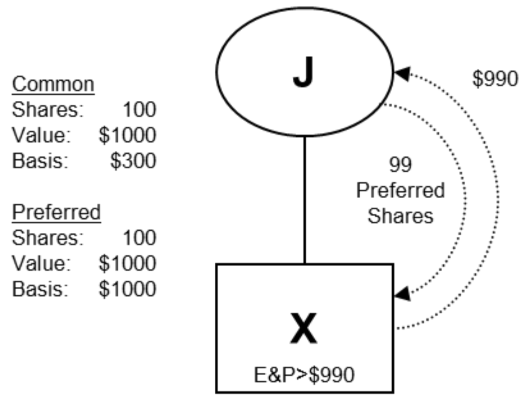
***Redeemed Class Approach*** – Same as Scenario 1A.

***DCS Approach*** – Same as Scenario 1A, except that with aggregate basis recovery, no gain is recognized on Common Block 1. Under the recursive approach, basis is reduced $6 per share in all 100 common shares, then $8 more per share in Common Block 2, leaving total basis of $0 in Common Block 1 and $300 in Common Block 2. Under the spillover approach, the result is the same, because after a $10 per share tentative basis reduction, the $200 recovered in excess of the basis in Common Block 1 is recovered from Common Block 2. Under the proportional approach, basis is reduced to $69 in Common Block 1 and $231 in Common Block 2, preserving the 300:1000 ratio.

***Bifurcated Distribution Approach*** – Same as Scenario 1A.

| **DCS Approach w/ aggregate basis recovery** | | | **Common Block 1** | **Common Block 2** | **Preferred** |
|---|---|---|---|---|---|
| Dividend Amount | $0 | Shares | 50 | 50 | 0 |
| Gain Recognized | $0 | Value | $500 | $500 | $0 |
| Deferred Loss | $0 | Basis | $0 | $300 | $0 |

## Scenario 2: Full E&P and all but one of the preferred shares are redeemed[1]




### Scenario 2A

Neither the de minimis rules nor averaging applied.

***Redeemed Class Approach*** – Pro rata distribution of $990 on preferred stock treated entirely as a dividend, deemed recapitalization of 100 shares of preferred stock into one preferred share with $1000 basis.

***DCS Approach*** – Capital contribution of 99 preferred shares to common shares treated as deemed issuance and recapitalization, resulting in two blocks of common,[2] one block of 50.25 shares with $300 basis (Common Block 1) and one block of 49.75 shares with $990 basis (Common Block 2). Pro rata distribution of $990 on common stock treated entirely as a dividend.

***Bifurcated Distribution Approach*** – Same as DCS Approach on these facts. Assuming no accrued dividends on the preferred shares as of the redemption date, $990 distribution treated entirely as a dividend on common stock. Capital contribution of 99 preferred shares to common shares treated as deemed issuance and recapitalization, resulting in two blocks of common,[2] one block of 50.25 shares with $300 basis (Common Block 1) and one block of 49.75 shares with $990 basis (Common Block 2).

| **Redeemed Class Approach** | | | **Common Block 1** | **Common Block 2** | **Preferred** |
|---|---|---|---|---|---|
| Dividend Amount | $990 | Shares | 100 | N/A | 1 |
| Gain Recognized | $0 | Value | $1000 | N/A | $10 |
| Deferred Loss | $0 | Basis | $300 | N/A | $1000 |
| **DCS Approach[2]** | | | | | |
| Dividend Amount | $990 | Shares | 50.25 | 49.75 | 1 |
| Gain Recognized | $0 | Value | $502.50 | $497.50 | $10 |
| Deferred Loss | $0 | Basis | $300 | $990 | $10 |
| **Bifurcated Distribution Approach[2]** | | | | | |
| Dividend Amount | $990 | Shares | 50.25 | 49.75 | 1 |
| Gain Recognized | $0 | Value | $502.50 | $497.50 | $10 |
| Deferred Loss | $0 | Basis | $300 | $990 | $10 |

### Scenario 2B

De minimis rules/averaging applied. Because there are no blocks within classes, the de minimis rules and averaging produce the same result.

***Redeemed Class Approach*** – Same as Scenario 2A.

***DCS Approach*** – De minimis disparity rule/averaging applies to capital contribution of 99 preferred shares to common shares, resulting in increased basis in the common stock to $1290, with each share having an identical, averaged basis. Pro rata distribution of $990 on common stock treated entirely as a dividend.

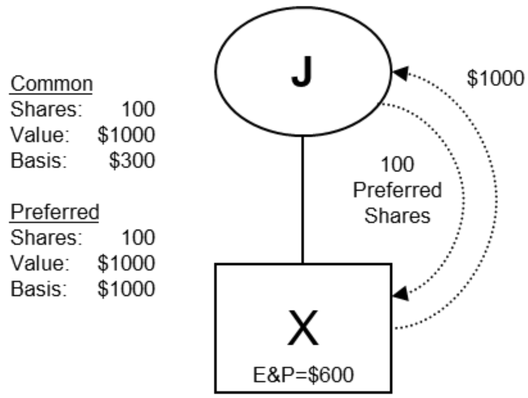
***Bifurcated Distribution Approach*** – Same as Scenario 2A, except de minimis disparity rule/averaging applies to capital contribution of 99 preferred shares to common shares, resulting in increased basis in the common stock to $1290, with each share having an identical, averaged basis.

| **DCS Approach w/ de minimis rules** | | | **Common Block 1** | **Common Block 2** | **Preferred** |
|---|---|---|---|---|---|
| Dividend Amount | $990 | Shares | 100 | N/A | 1 |
| Gain Recognized | $0 | Value | $1000 | N/A | $10 |
| Deferred Loss | $0 | Basis | $1290 | N/A | $10 |
| **Bifurcated Distribution Approach w/ de minimis rules** | | | | | |
| Dividend Amount | $990 | Shares | 100 | N/A | 1 |
| Gain Recognized | $0 | Value | $1000 | N/A | $10 |
| Deferred Loss | $0 | Basis | $1290 | N/A | $10 |

1 Because there are no cases in Scenario 2 in which basis is recovered or gain is recognized on any shares, aggregate basis recovery would not change any of the gain results or basis allocations and, accordingly, is not shown.

2 Technically, there would be three basis blocks, one consisting of 50 shares, one consisting of 49 shares, and one consisting of one share with a segmented basis, For ease of presentation, two blocks are shown, each with a fractional share.

## Scenario 3: Partial E&P and all preferred shares are redeemed[3]




### Scenario 3A

Neither the de minimis rules nor averaging applied.

***Redeemed Class Approach*** – Pro rata distribution of $1000 on preferred stock results in a $600 dividend and $400 of basis recovery. Unrecovered basis of $600 in the redeemed preferred shares is treated as a deferred loss.

***DCS Approach*** – Capital contribution of 100 preferred shares to common shares treated as deemed issuance and recapitalization, resulting in two blocks of common, one block of 50 shares with $300 basis (Common Block 1) and one block of 50 shares with $1000 basis (Common Block 2). Pro rata distribution of $1000 on common stock results in a $600 dividend and $400 of basis recovery allocated proportionally to each share in the class. Accordingly, Common Block 1 has $200 of basis recovery ($100 basis remaining) and Common Block 2 has $200 of basis recovery ($800 basis remaining).

***Bifurcated Distribution Approach*** – Assuming no accrued dividends on the preferred shares as of the redemption date, $600 of the distribution is treated as a dividend on common stock, with the remaining $400 treated as paid proportionally on the preferred. Capital contribution of 100 preferred shares (now with $600 basis) to common shares[4] treated as deemed issuance and recapitalization, resulting in two blocks of common, one block of 40 shares with $300 basis (Common Block 1) and one block of 60 shares with $600 basis (Common Block 2).

| **Redeemed Class Approach** | | | **Common Block 1** | **Common Block 2** | **Preferred** |
|---|---|---|---|---|---|
| Dividend Amount | $600 | Shares | 100 | N/A | 0 |
| Gain Recognized | $0 | Value | $1000 | N/A | $0 |
| Deferred Loss | $600 | Basis | $300 | N/A | $0 |
| **DCS Approach** | | | | | |
| Dividend Amount | $600 | Shares | 50 | 50 | 0 |
| Gain Recognized | $0 | Value | $500 | $500 | $0 |
| Deferred Loss | $0 | Basis | $100 | $800 | $0 |
| **Bifurcated Distribution Approach** | | | | | |
| Dividend Amount | $600 | Shares | 40 | 60 | 0 |
| Gain Recognized | $0 | Value | $400 | $600 | $0 |
| Deferred Loss | $0 | Basis | $300 | $600 | $0 |

### Scenario 3B

De minimis rules/averaging applied. Because there are no blocks within classes, the de minimis rules and averaging produce the same result.

***Redeemed Class Approach*** – Same as Scenario 3A.

***DCS Approach*** – De minimis disparity rule/averaging applies to capital contribution of 100 preferred shares to common shares, resulting in increased basis in the common stock to $1300, with each share having an identical, averaged basis. Pro rata distribution of $1000 on common stock results in a $600 dividend and $400 of basis recovery in the common stock ($900 basis remaining).

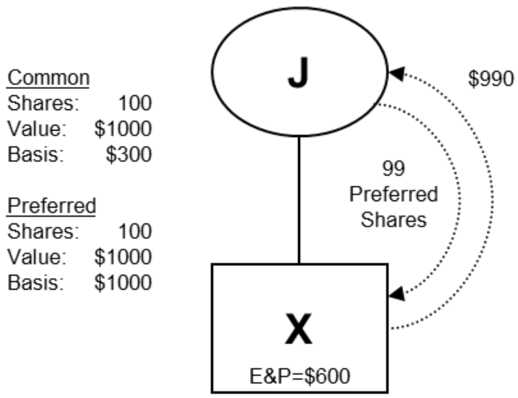
***Bifurcated Distribution Approach*** – Same as Scenario 3A, except de minimis disparity rule/averaging applies to capital contribution of 100 preferred shares (now with $600 basis) to common shares, resulting in increased basis in the common stock to $900, with each share having an identical, averaged basis.

| **DCS Approach w/ de minimis rules** | | | **Common Block 1** | **Common Block 2** | **Preferred** |
|---|---|---|---|---|---|
| Dividend Amount | $600 | Shares | 100 | N/A | 0 |
| Gain Recognized | $0 | Value | $1000 | N/A | $0 |
| Deferred Loss | $0 | Basis | $900 | N/A | $0 |
| **Bifurcated Distribution Approach w/ de minimis rules** | | | | | |
| Dividend Amount | $600 | Shares | 100 | N/A | 0 |
| Gain Recognized | $0 | Value | $1000 | N/A | $0 |
| Deferred Loss | $0 | Basis | $900 | N/A | $0 |

[3] Because there are no cases in Scenario 3 in which gain is recognized on any shares, aggregate basis recovery would not change any of the gain results and, accordingly, is not shown (although application of the proportional approach to aggregate basis recovery would change the basis remaining under the DCS Approach in Scenario 3A to $208 in Common Block 1 and $692 in Common Block 2).

[4] Because all of the preferred shares have been redeemed, there are no preferred shares remaining with respect to which a distribution is treated as being made. Accordingly, the remaining basis in the redeemed preferred shares is capitalized solely into the common shares.

## Scenario 4: Partial E&P and all but one of the preferred shares are redeemed[5]




### Scenario 4A

Neither the de minimis rules nor averaging applied.

***Redeemed Class Approach*** – Pro rata distribution of $990 on preferred stock results in a $600 dividend and $390 of basis recovery ($600 of unrecovered basis remaining from the redeemed shares). Deemed recapitalization of 100 shares of preferred stock into 1 share with $610 basis.

***DCS Approach*** – Capital contribution of 99 preferred shares to common shares treated as deemed issuance and recapitalization, resulting in two blocks of common,[6] one block of 50.25 shares with $300 basis (Common Block 1) and one block of 49.75 shares with $990 basis (Common Block 2). Pro rata distribution of $990 on common stock results in a $600 dividend and $390 of basis recovery allocated proportionally to each share in the class. Common Block 1 has $196 of basis recovery ($104 basis remaining) and Common Block 2 has $194 basis recovery ($796 basis remaining).

***Bifurcated Distribution Approach*** – (See note 126 for a detailed explanation of mechanics.)

| **Redeemed Class Approach** | | | **Common Block 1** | **Common Block 2** | **Preferred** |
|---|---|---|---|---|---|
| Dividend Amount | $600 | Shares | 100 | N/A | 1 |
| Gain Recognized | $0 | Value | $1000 | N/A | $10 |
| Deferred Loss | $0 | Basis | $300 | N/A | $610 |
| **DCS Approach[6]** | | | | | |
| Dividend Amount | $600 | Shares | 50.25 | 49.75 | 1 |
| Gain Recognized | $0 | Value | $502.50 | $497.50 | $10 |
| Deferred Loss | $0 | Basis | $104 | $796 | $10 |
| **Bifurcated Distribution Approach** | | | | | |
| Dividend Amount | $600 | Shares | 40 | 60 | 1 |
| Gain Recognized | $0 | Value | $400 | $600 | $10 |
| Deferred Loss | $0 | Basis | $300 | $600 | $10 |

### Scenario 4B

De minimis rules/averaging applied. Because there are no blocks within classes, the de minimis rules and averaging produce the same result.

***Redeemed Class Approach*** – Same as Scenario 4A.

***DCS Approach*** – De minimis disparity rule/averaging applies to capital contribution of 99 preferred shares to common shares, resulting in increased basis in the common stock to $1290, with each share having an identical, averaged basis. Pro rata distribution of $990 on common stock results in a $600 dividend and $390 of basis recovery in the common stock ($900 basis remaining).

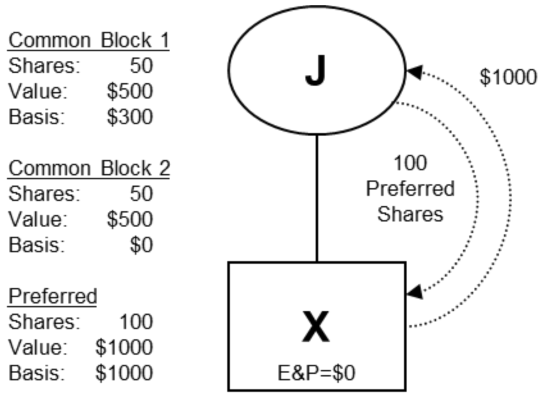
***Bifurcated Distribution Approach*** – Same as Scenario 4A, except de minimis disparity rule/averaging applies to capital contribution of 99 preferred shares (now with $603.90 basis), in part to the one remaining preferred share and in part to the common shares (no new block of common stock created), resulting in increased basis in the one preferred share to $10 and increased basis in the common stock to $900, with each common share having an identical, averaged basis.

| **DCS Approach w/ de minimis rules** | | | **Common Block 1** | **Common Block 2** | **Preferred** |
|---|---|---|---|---|---|
| Dividend Amount | $600 | Shares | 50 | N/A | 1 |
| Gain Recognized | $0 | Value | $1000 | N/A | $10 |
| Deferred Loss | $0 | Basis | $900 | N/A | $10 |
| **Bifurcated Distribution Approach w/ de minimis rules** | | | | | |
| Dividend Amount | $600 | Shares | 100 | N/A | 1 |
| Gain Recognized | $0 | Value | $1000 | N/A | $10 |
| Deferred Loss | $0 | Basis | $900 | N/A | $10 |

5 Because there are no cases in Scenario 4 in which gain is recognized on any shares, aggregate basis recovery would not change any of the gain results and, accordingly, is not shown (although application of the proportional approach to aggregate basis recovery would change the basis remaining under the DCS Approach in Common Block 1 and Common Block 2 in Scenario 4A, to $209 in Common Block 1 and $691 in Common Block 2).

6 Technically, there would be three basis blocks, one consisting of 50 shares, one consisting of 49 shares, and one consisting of 1 share with a segmented basis, For ease of presentation, two blocks are shown, each with a fractional share.

## Scenario 5: No E&P, more than one block of common stock, and all preferred shares are redeemed




### Scenario 5A

None of de minimis rules, averaging or aggregate basis recovery applied.

***Redeemed Class Approach*** – Pro rata distribution of $1000 on preferred stock, full recovery of basis in preferred shares.

***DCS Approach*** – Capital contribution of preferred shares to common shares treated as deemed issuance and recapitalization, resulting in three blocks of common, one of 25 shares with $300 basis (Common Block 1), one of 25 shares with $0 basis (Common Block 2), and one of 50 shares with $1000 basis (Common Block 3). Pro rata distribution of $1000 on common stock, resulting in basis recovery of $250 in Common Block 1 ($50 basis remaining), $250 of gain on Common Block 2, and $500 of basis recovery in Common Block 3 ($500 of basis remaining).

***Bifurcated Distribution Approach*** – Same as Redeemed Class Approach on these facts. Pro rata distribution of $1000 on preferred stock, full recovery of basis in preferred shares.

| **Redeemed Class Approach** | | | **Common Block 1** | **Common Block 2** | **Common Block 3** | **Preferred** |
|---|---|---|---|---|---|---|
| Dividend Amount | $0 | Shares | 50 | 50 | N/A | 0 |
| Gain Recognized | $0 | Value | $500 | $500 | N/A | $0 |
| Deferred Loss | $0 | Basis | $300 | $0 | N/A | $0 |
| **DCS Approach** | | | | | | |
| Dividend Amount | $0 | Shares | 25 | 25 | 50 | 0 |
| Gain Recognized | $250 | Value | $250 | $250 | $500 | $0 |
| Deferred Loss | $0 | Basis | $50 | $0 | $500 | $0 |
| **Bifurcated Distribution Approach** | | | | | | |
| Dividend Amount | $0 | Shares | 50 | 50 | N/A | 0 |
| Gain Recognized | $0 | Value | $500 | $500 | N/A | $0 |
| Deferred Loss | $0 | Basis | $300 | $0 | N/A | $0 |

### Scenario 5B

De minimis rules (but not averaging) applied.

***Redeemed Class Approach*** – Same as Scenario 5A.

***DCS Approach*** – De minimis disparity rule applies to capital contribution of preferred shares to common shares, resulting in increased basis in Common Block 1 to $800 and increased basis in Common Block 2 to $500, with each share within a block having an identical, averaged basis. Pro rata distribution of $1000 on common stock results in $500 of basis recovery in Common Block 1 ($300 basis remaining) and $500 of basis recovery in Common Block 2 ($0 basis remaining).[7]

***Bifurcated Distribution Approach*** – Same as Scenario 5A.

| **DCS Approach w/ de minims rules** | | | **Common Block 1** | **Common Block 2** | **Common Block 3** | **Preferred** |
|---|---|---|---|---|---|---|
| Dividend Amount | $0 | Shares | 50 | 50 | N/A | 0 |
| Gain Recognized | $0 | Value | $500 | $500 | N/A | $0 |
| Deferred Loss | $0 | Basis | $300 | $0 | N/A | $0 |

### Scenario 5C

Neither de minimis rule nor averaging applied; aggregate basis recovery applied.

***Redeemed Class Approach*** – Same as Scenario 5A.

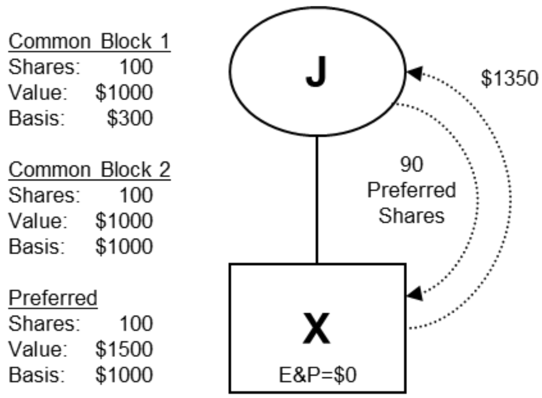
***DCS Approach*** – Same as Scenario 5A, except that with aggregate basis recovery, no gain is recognized on Common Block 2. If basis is recovered using the recursive approach, basis in Common Block 1 is reduced to $0 and basis in Common Block 3 is reduced to $300. If the spillover approach is applied, each share's basis is tentatively reduced by $10, leaving Common Block 1 with $50 of basis, Common Block 2 with -$250 and Common Block 3 with $500. The -$250 in Common Block 2 is reallocated between Common Blocks 1 and 3 in the 1:10 proportion of their remaining basis, which results in reductions of $23, to $27, in Common Block 1 and $227, to $273, in Common Block 3. If the proportional approach is applied, basis in Common Block 1 is reduced to $69 and basis in Common Block 3 is reduced to $231, preserving the 300:1000 ratio of the basis in Common Block 1 and Common Block 3.

***Bifurcated Distribution Approach*** – Same as Scenario 5A.

| **DCS Approach w/ aggregate basis recovery** | | | **Common Block 1** | **Common Block 2** | **Common Block 3** | **Preferred** |
|---|---|---|---|---|---|---|
| Dividend Amount | $0 | Shares | 25 | 25 | 50 | 0 |
| Gain Recognized | $0 | Value | $250 | $250 | $500 | $0 |
| Deferred Loss | $0 | Basis | $0 | $0 | $300 | $0 |

7 If averaging were applied, the result would be the same except there would only be one block of 100 common shares, each having an identical, averaged basis of $3.

## Scenario 6: No E&P, more than one block of common stock, appreciated preferred,[8] and 90 preferred shares are redeemed




### Scenario 6A

Neither averaging nor aggregate basis recovery applied.

***Redeemed Class Approach*** – Pro rata distribution of $1350 on preferred stock, resulting in $1000 of basis recovery and $350 of gain. Deemed recapitalization of 100 preferred shares into 10 preferred shares (with $0 basis).

***DCS Approach*** – Capital contribution of 90 preferred shares to common shares treated as deemed issuance and recapitalization, resulting in three blocks of common,[9] one block of 59.7 shares with $300 basis (Common Block 1), one block of 59.7 shares with $1000 basis (Common Block 2), and one block of 80.60 shares with $900 basis (Common Block 3). Pro rata distribution of $1350 on common stock, resulting in $300 of basis recovery on Common Block 1 and $103 of gain ($0 basis remaining), $403 of basis recovery on Common Block 2 ($597 basis remaining), and $544 of basis recovery on Common Block 3 ($356 of basis remaining).

***Bifurcated Distribution Approach*** – Same as Redeemed Class Approach on these facts. Pro rata distribution of $1350 on preferred stock, resulting in $1000 of basis recovery and $350 of gain. Deemed recapitalization of 100 preferred shares into 10 preferred shares (with $0 basis).

| **Redeemed Class Approach** | | | **Common Block 1** | **Common Block 2** | **Common Block 3** | **Preferred** |
|---|---|---|---|---|---|---|
| Dividend Amount | $0 | Shares | 100 | 100 | N/A | 10 |
| Gain Recognized | $350 | Value | $1000 | $1000 | N/A | $150 |
| Deferred Loss | $0 | Basis | $300 | $1000 | N/A | $0 |
| **DCS Approach[9]** | | | | | | |
| Dividend Amount | $0 | Shares | 59.70 | 59.70 | 80.60 | 10 |
| Gain Recognized | $103 | Value | $597 | $597 | $806 | $150 |
| Deferred Loss | $0 | Basis | $0 | $597 | $356 | $100 |
| **Bifurcated Distribution Approach** | | | | | | |
| Dividend Amount | $0 | Shares | 100 | 100 | N/A | 10 |
| Gain Recognized | $350 | Value | $1000 | $1000 | N/A | $150 |
| Deferred Loss | $0 | Basis | $300 | $1000 | N/A | $0 |

### Scenario 6B

No averaging; aggregate basis recovery applied.

***Redeemed Class Approach*** – Same as Scenario 6A (because of application of the within class approach to aggregate basis recovery).

***DCS Approach*** – Same result as Scenario 6A, except that with aggregate basis recovery, no gain is recognized on Common Block 1. If basis is recovered using the recursive approach, $5.025 of basis is recovered from each of the 200 shares of common, reducing the basis in Common Block 1 to $0, the basis in Common Block 2 to $700 and the basis in Common Block 3 to $495, and then the remaining $345 of basis is recovered pro rata from the shares in Common Block 2 and Common Block 3, leaving $553 basis in Common Block 1 and $297 in Common Block 2. If the spillover approach is used, $6.75 of basis per share is recovered, and the $103 recovered in excess of the basis in Common Block 1 is allocated between Common Block 2 and Common Block 3 in proportion to their remaining basis of $597 and $356, respectively, leaving $532 basis in Common Block 2 and $318 basis in Common Block 3. If basis is recovered using the proportional approach, the 300:1000:900 ratio of basis is preserved, leaving $116 basis in Common Block 1, $386 basis in Common Block 2, and $348 basis in Common Block 3.

***Bifurcated Distribution Approach*** – Same as Scenario 6A (because of application of the within class approach to aggregate basis recovery).

| **DCS Approach[9]** | | | **Common Block 1** | **Common Block 2** | **Common Block 3** | **Preferred** |
|---|---|---|---|---|---|---|
| Dividend Amount | $0 | Shares | 59.70 | 59.70 | 80.60 | 10 |
| Gain Recognized | $0 | Value | $597 | $597 | $806 | $150 |
| Deferred Loss | $0 | Basis | $0 | $553 | $297 | $100 |

[8] De minimis rules are assumed not to apply in this scenario. The de minimis disparity rule is unlikely to apply because the preferred stock's value is 50 percent greater than its basis. The de minimis contribution rule is unlikely to apply in this scenario because the preferred stock's value is approximately 43 percent of the value of X.

[9] Technically, there would be four basis blocks, with the last one consisting of two shares comprised of the fractional shares shown. For ease of presentation, three blocks are shown, each with a fractional share.

### Scenario 6C

Averaging applied (treated as though J owns one block of common stock held with $1300 of basis, and each common share has identical, averaged basis); aggregate basis recovery is not relevant so long as it is applied within class rather than across all classes.

***Redeemed Class Approach*** – Same gain recognition as Scenario 6A. Averaging has no effect because there are no basis blocks in the preferred stock and all distributions under the Redeemed Class Approach are treated as being made solely with respect to the preferred shares.

***DCS Approach*** – Capital contribution of 90 preferred shares to common shares treated as deemed issuance and recapitalization, but because averaging applies, the basis of the common stock simply increases to $2200. Pro rata distribution of $1350 on common stock treated entirely as basis recovery ($850 basis remaining).

***Bifurcated Distribution Approach*** – As in Scenario 6A, same as Redeemed Class Approach on these facts.

| **Redeemed Class Approach** | | | **Common Block 1** | **Common Block 2** | **Common Block 3** | **Preferred** |
|---|---|---|---|---|---|---|
| Dividend Amount | $0 | Shares | 200 | N/A | N/A | 10 |
| Gain Recognized | $350 | Value | $2000 | N/A | N/A | $150 |
| Deferred Loss | $0 | Basis | $1300 | N/A | N/A | $0 |
| **DCS Approach** | | | | | | |
| Dividend Amount | $0 | Shares | 200 | N/A | N/A | 10 |
| Gain Recognized | $0 | Value | $2000 | N/A | N/A | $150 |
| Deferred Loss | $0 | Basis | $850 | N/A | N/A | $100 |
| **Bifurcated Distribution Approach** | | | | | | |
| Dividend Amount | $0 | Shares | 200 | N/A | N/A | 10 |
| Gain Recognized | $350 | Value | $2000 | N/A | N/A | $150 |
| Deferred Loss | $0 | Basis | $1300 | N/A | N/A | $0 |