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September 18, 1995

The Honorable Leslie B. Samuels
Assistant Secretary (Tax Policy)
Department of the Treasury
Room 3120 MT
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

The Honorable Margaret M. Richardson
Commissioner
Internal Revenue Service
Room 3000
1111 Constitution Avenue, NW
Washington, D.C. 20224

Re: **Stock Basis Adjustments in Triangular Reorganizations**

Dear Secretary Samuels and Commissioner Richardson:

I am pleased to enclose a report on the regulations proposed last year under sections 358, 1032 and 1502, relating to stock basis adjustments to be made in connection with triangular reorganizations. The principal authors of the report are Patrick C. Gallagher and Mary Kate Wold, Co-Chairs of our Committee on Reorganizations.

In determining basis the Proposed Regulations generally impose an "over-the-top" model, under which the basis of a controlling corporation in the stock of its target or of its acquisition subsidiary following a tax-free triangular reorganization is determined as if the controlling corporation had acquired the target's assets or stock itself, and then contributed them to its subsidiary. The report strongly supports the adoption of this model, including its application to reverse triangular mergers. We believe that for most

triangular reorganizations the use of this model will produce reasonable, consistent and readily understood results.

The report does, however, comment on certain technical aspects of the Proposed Regulations, as well as on several related issues for which further guidance is needed. The report suggests, for example, that the requirements that corporations control or be controlled by one another "immediately before the reorganization" imposes a timing requirement that is more strict than prior guidance seemed to impose, and could, perhaps unintentionally, exclude certain reorganizations from the scope of the Proposed Regulations. The report also comments on the procedures involved in electing whether the basis of a controlling corporation following a reverse triangular merger that is also a "B" reorganization is based on the target's asset basis or its shareholders' stock basis; on the need for a clearer factual premise for Example 2 of Proposed Regulation section 1.358-6(c)(4); and on the need for guidance clarifying that a subsidiary transferring controlling corporation stock in a reverse triangular merger does not recognize gain or loss.

The report also discusses the disparate treatment of consolidated groups, as compared to affiliates which are not consolidated, in cases where liabilities exceed asset basis. While the disparity in treatment may present some distortions, on balance the report concludes that it is better to adopt the theoretically sound result for consolidated groups, even if the law does not permit the extension of a similar negative basis concept to unconsolidated corporations.

Certain aspects of the Proposed Regulations and the accompanying Preamble raise questions relating to the treatment of inversions, cross-ownership, and other related-party situations. These are complex and very difficult areas, which will require a great deal of careful thought to define and resolve. Rather than endeavoring to address these questions in the context of the Proposed Regulations, the report instead recommends that the Proposed Regulations be finalized, and that the Treasury reserve these more difficult topics for later consideration. The basis consequences attending these kinds of situations need to be considered in the context of a comprehensive analysis of the issues raised by cross-ownership and the like; it would not be appropriate to treat these questions piecemeal by including them in the Proposed

Regulations, nor would it be appropriate to defer finalization of these very useful and important Proposed Regulations while considering the overall treatment of a more narrow and rather arcane set of problems.

Finally, the report comments on two collateral questions that should be addressed in finalizing the Proposed Regulations. The first is the holding period a controlling corporation will have in its target or subsidiary stock following the reorganization. The report recommends that the method used to compute basis should also be applied in determining holding period. This is consistent with general tax law principles, and will avoid unnecessary confusion.

Second, the report recommends that certain "zero-basis" issues presented by triangular reorganizations be addressed, specifically the treatment of warrants and options (which should be included in Proposed Regulation §1.1032-2), and the treatment of debt. The problem of zero basis arises in a number of different contexts, all of which should be addressed at some point, but we believe that the warrants issue, and perhaps the debt issue as well, should be dealt with in finalizing the Proposed Regulations.

Please call me if you or your staffs would like to discuss the report in greater detail. We commend you for the practical and clear approach taken in the Proposed Regulations, and thank you for this opportunity to comment.

Very truly yours,

Carolyn Joy Lee

Carolyn Joy Lee
Chair

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NEW YORK STATE BAR ASSOCIATION TAX SECTION

COMMITTEE ON REORGANIZATIONS

REPORT ON REGULATIONS UNDER SECTIONS 358, 1032 AND 1502 CONCERNING STOCK BASIS ADJUSTMENTS IN TRIANGULAR REORGANIZATIONS

September 18, 1995

NEW YORK STATE BAR ASSOCIATION
TAX SECTION
COMMITTEE ON REORGANIZATIONS

Report on Proposed Regulations Under Sections 358, 1032 and 1502 Concerning Stock Basis Adjustments in Triangular Reorganizations (CO-993-71)[1]

September 18, 1995

This report comments on proposed Treasury regulations §1.358-6, §1.1032-2 and §1.1502-30, issued on December 22, 1994 and entitled "Controlling Corporation's Basis Adjustment in its Controlled Corporation's Stock Following a Triangular Reorganization" [CO-993-71] (the "Proposed Regulations").

On January 2, 1981, the Internal Revenue Service (the "Service") published proposed regulations under sections 358 and 1032[2] (1981 proposed regulations §1.358-6 and §1.1032-2), which provided for nonrecognition of gain in certain triangular reorganizations and for calculating the basis of the controlling corporation ("P") in the stock of its acquisition subsidiary ("S") or the target corporation ("T") after a tax-free triangular reorganization.[3] The 1981 proposed regulations used mechanical rules which generally determined P's basis after a tax-free triangular reorganization as though P had acquired the T assets or stock and then contributed them to S. This model is commonly referred to as the "over-the-top" model.

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1 This report was prepared by Pamela J. Campbell, Patrick C. Gallagher, Bertram E. Kessler, Dale L. Ponikvar, Charles H. Simmons, Dwight L. Wassong and Mary Kate Wold. Helpful comments were given by Peter C. Canellos, Judy Kramer, Carolyn Joy Lee, Richard O. Loengard, Michael L. Schler and Steven C. Todrys.

2 Unless otherwise specified, all "section" references are to the Internal Revenue Code of 1986, as amended.

3 46 Fed. Reg. 113-114 (January 2, 1981). The references to P, S and T herein have the meaning given in the 1994 Proposed Regulations unless otherwise indicated.

On December 22, 1994, the Service withdrew the 1981 proposed regulations and issued the Proposed Regulations. Like the 1981 proposed regulations, the 1994 Proposed Regulations apply the over-the-top model to determine P's basis in its S or T stock after a tax-free triangular reorganization. However, the Proposed Regulations provide general rules for adjusting P's basis in the S or T stock rather than the mechanical rules contained in the 1981 proposed regulations.

Subject to the comments below, we strongly support the adoption of the over-the-top model as a general rule, and believe the Proposed Regulations are admirable in setting out the rule concisely and in a manner that produces clear and reasonable results in most circumstances. We have the following comments.

1. The "Control Immediately Before" Requirement (Proposed Regulation §1.358-6(b)).

Proposed Regulation §1.358-6(b)(i) defines P as a corporation which, among other things, "is in control (within the meaning of section 368(c)) immediately before the reorganization of another party to the reorganization." Similarly, Proposed Regulation §1.358-6(b)(ii) defines S as a corporation which is a party to the reorganization and is "controlled by P before the reorganization."

The first parentheticals in sections 368(a)(1)(B) and (C), which permit triangular reorganizations, as well as section 368(a)(2)(D), only require that P be "in control of the acquiring corporation" and do not address the point in time when the control requirement must be satisfied. Only section 368(a)(2)(E) provides that P must be in control of T "before the merger."

This point has, however, been implicitly addressed in a revenue ruling. Rev. Rul. 73-16, 1973-1 C.B. 186, involves a triangular "B" reorganization where P did not control S

before the reorganization. The ruling concludes, without directly discussing the control requirement, that P's acquisition qualifies as a tax-free "B" reorganization, even though P, rather than controlling S immediately before the reorganization, acquired control of S as part of the larger transaction. In the ruling, S acquired all of the stock of T in exchange for S voting stock. Immediately thereafter, P acquired all of the stock of S in exchange for P voting stock. The ruling states that because the two exchanges were part of a prearranged, integrated plan, they may not be considered independently. Accordingly, the exchanges were recast as the acquisition by P of all of the stock of S for P stock, and the simultaneous acquisition by S of the stock of T in exchange for P stock. The ruling concludes that both exchanges qualify as "B" reorganizations.

We believe the requirement in Proposed Regulation §1.358-6(c) that P must control S before the reorganization may unintentionally exclude from the application of the Proposed Regulations certain section 368 reorganizations in which P obtains control of S in connection with the acquisition. Accordingly, we recommend that the final regulations eliminate the requirement that P control S immediately before the reorganization. This might be accomplished by changing Proposed Regulation §1.358-6(b)(1) to define P as "a corporation ... (B) that is 'in control' of S within the meaning of section 368(a)(1)(B), (a)(1)(C), (a)(2)(D) or (a)(2)(E), as applicable," and to define S as "a corporation ... (B) that is the 'acquiring corporation' within the meaning of section 368(a)(1)(B), (a)(1)(C) or (a)(2)(D) or the 'merged corporation' within the meaning of section 368(a)(2)(E), as applicable."

2. Reverse Triangular Mergers (Proposed Regulation §1.358-6)

Proposed Regulation §1.358-6(c)(2) applies to determine P's basis in its T stock after a reverse triangular merger. The general rule in a reverse triangular merger is that P's basis in the T stock is calculated in the same manner as P's basis in S stock would be in the case of a

forward triangular merger. That is, P's basis is calculated as though P first acquired T's assets directly from T in a transaction in which section 362(b) applies and then transferred the assets (to T or S as the case may be) in a transaction in which section 358 applies.

a. Reverse Triangular Merger Also Qualifying As a "B" Reorganization. Where the reverse triangular merger also qualifies as a "B" reorganization, Proposed Regulation §1.358-6(c)(2)(iii) provides P with a choice of methods to determine its basis in the T stock. P may apply the general rule for reverse triangular mergers discussed above or P may determine its basis as if it acquired T's stock from the former T shareholders (other than P) in a transaction in which P's basis was determined under section 362(b). Generally then, these alternatives allow P to calculate its basis in the T stock by reference to the basis T had in its assets or the basis T shareholders had in their T stock prior to the reorganization.

We support the approach of permitting P to choose between methods for computing its basis in T's stock for acquisitions qualifying as both a reverse triangular merger and a "B" reorganization, which is consistent with the dual classification of the transaction under section 368.[4]

However, the Proposed Regulations do not discuss the mechanics for P's choice of method in calculating its basis in the T stock where the transaction qualifies as both a reverse triangular merger and a "B" reorganization. In the absence of an express rule, presumably the choice would be made the first time P files a return on which its basis in its T stock is used, as it would be, for example, upon the subsequent sale of T stock. This is a sensible approach, since it

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4 For a discussion of this issue in connection with the 1981 proposed regulations (which did not permit this choice), see New York State Bar Association Tax Section, Committee on Reorganizations, "Report on Reverse Triangular Mergers and Basis-Nonrecognition Rules in Triangular Reorganizations," 36 Tax Law Review 395, 406-409 (1981). See also comment 3 below.

does not burden P with an artificial deadline for making the election, nor is an unnecessarily formal election procedure (with a default rule if P fails to comply with the procedure) imposed upon P. Moreover, presumably P, having chosen a method, must use the same method to calculate its basis in all its T shares acquired in the tax-free reorganization.

We recommend that the final regulations clarify the procedures for P's choice of method for computing its basis in T's stock consistent with the above presumptions. Specifically, we suggest that the final regulations indicate that (i) the choice of which method to use is made the first time P (or its successor or transferee) files a return which relies on the calculation of its basis in the T stock,[5] and (ii) once chosen, the method is binding on the electing taxpayer and its affiliates with respect to all T shares held by them (and also binding on any successor or transferee whose basis in the T shares is computed in whole or in part by reference to the basis of the electing taxpayer or its affiliates).[6]

Also see comment 7 below regarding P's holding period in its T or S stock.

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5 Subject to the consistency requirement of clause (ii), P should be able to amend such a return if it chooses to change the method used to calculate its T stock basis, to the same extent P could amend its return with regard to other positions. Moreover, if P calculates its T stock basis for a purpose other than filing a return, P should not be bound to the method selected.. In particular, if P and T are members of a consolidated group, P should not be bound to a method merely because that method is reflected in P's workpapers under Treasury Regulation §1.1502-32(g) (which requires P to reflect investment adjustments in its T shares annually on P's permanent records).

6 If T shares are divided among unrelated taxpayers after the reorganization but before an event requiring a determination of P's basis in the T shares (e.g., in a subsequent tax-free reorganization involving T), the unrelated transferees of the T shares might make different elections for computing their T stock basis. It is hard to see how any abuse could result from this disparity. Moreover, attempting to requiring conformity among the unrelated holders in such a case would be unduly complex. Therefore, we suggest that any rule of the type described in the text should require conformity among affiliates but not among unrelated T shareholders (except to the extent the shareholder received the T shares from a transferor that previously made the basis computation election).

b. Reverse Triangular Merger Where S Is a Preexisting Operating Company with Substantial Assets. Proposed Regulation §1.358-6(c)(4), Example 2, illustrates a reverse triangular merger of S into T (with T surviving) in exchange for P stock. S is a preexisting operating company "with substantial assets" which is wholly-owned by P. The example concludes that the transaction is a reorganization to which sections 368(a)(1)(A) and 368(a)(2)(E) apply. The example further concludes that because S is a previously existing operating company with substantial assets, the transaction does not qualify as a "B" reorganization. As a result, P may determine its T stock basis only by reference to T's asset basis using the over-the-top method, and the option for P to determine its T stock basis by reference to the former T shareholders' stock basis under section 362(b) is eliminated.

We recommend that the facts of Example 2 of Proposed Regulation §1.358-6(c)(4) be changed to provide a clearer basis for concluding that the transaction is not a "B" reorganization, such as by including some cash consideration from S. Any changes to Example 2 should also be made to Example 3 of Proposed Regulations §1.1502-30(b)(5). While we are aware of no direct authority, a reverse triangular merger of a pre-existing S with operating or other assets of its own into T may theoretically qualify as a "B" reorganization in part. Specifically, because there is a transfer of assets by S to T as well as a transfer of T stock by T shareholders to P, it is conceivable to bifurcate the transaction into two parts and analyze them separately under section 368:

- S's transfer of its own assets to T in the merger might be viewed as (i) S's transfer of those assets to T in exchange for some T stock followed by (ii) a liquidation of S in which it distributes the T stock to P.[7] This transaction generally could

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7 See Rev. Rul. 69-6, 1969-1 C.B. 104; West-Shore Fuel, Inc. v. U.S., 598 F.2d 1236 (2d (continued...)

qualify as an "A" or a "D" reorganization. Under this analysis, T would acquire S's historic basis in S's assets pursuant to section 362(b) and, for purposes of determining P's basis in the T stock, P's basis in its S stock would transfer to the T stock deemed received in exchange for S's assets under section 358(a)(1). The Proposed Regulations already accomplish this result by including in P's T stock basis P's historic basis in its S stock.

- The acquisition of the remainder of T's stock for P stock, whether issued directly by P or transferred to S as part of the plan of reorganization, might be tested separately to determine if a "B" reorganization has occurred. If it has, P arguably could determine its basis in those T shares by reference to the T shareholders' historic basis under section 362(b) in lieu of treating P as having acquired and then dropped down T's assets pursuant to the over-the-top method.[8]

c. Propriety of Over-the-Top Model for Reverse Triangular Mergers. The Proposed Regulations could have taken the position that, in lieu of the over-the-top model, P

7(...continued)
Cir. 1979).

8 The Service has separately analyzed other simultaneous transactions undertaken pursuant to one plan. In Rev. Rul. 72-522, 1972-2 C.B. 215, for example, P made a cash payment to T in exchange for unissued stock of T at the same time that P acquired all of the outstanding stock of T from T's shareholders in exchange for voting stock of P. The ruling concludes that there was a valid "B" reorganization, stating that, since P's cash payment to T was not part of the exchange between P and the former T shareholders and since such shareholders received none of the cash payment, "such payment is considered to be separate from the acquisition of their outstanding stock." See also Rev. Rul. 73-427, 1973-2 C.B. 301 (cash purchase of T stock and a subsequent merger of S into T viewed as separate steps, distinguishing Rev. Rul. 67-448) and PLR 8918094 (February 9, 1989) (treating the merger of a pre-existing operating S into T in exchange for cash with P owning all T's stock as two separate transactions: (i) a qualified stock purchase under section 338(d)(3) followed by (ii) a tax-free transfer of assets qualifying under section 368(a)(1)(D)).

should determine its T stock basis under section 362(b) by reference to the selling T shareholders' bases in their T stock in any reverse triangular merger, whether or not the transaction also qualifies as a "B" reorganization. This is because arguably a reverse triangular merger more closely resembles a direct exchange of T stock for P stock than it does a deemed transfer of T's assets to P followed by a dropdown of the assets to S. This is particularly so given that, in contrast to a forward triangular merger, there is in fact no transfer of T assets in a reverse triangular merger. This position is also supported (at least where S is transitory) by the Service's long-standing ruling policy which ignores a transitory S in a reverse triangular merger and treats the merger instead as a direct exchange between P and T's shareholders of P stock for T stock.[9] Indeed, as discussed in comment 3 below, the omission of reverse triangular mergers from Proposed Regulation §1.1032-2(c) may stem in part from an analysis that disregards the existence of a transitory S and assumes a direct exchange of P stock for T stock between P and the T shareholders.

Nevertheless, we believe the application of the over-the-top model to reverse triangular mergers, which was also a feature of the 1981 proposed regulations, is a reasonable approach, because it is consistent with the origination of reverse triangular mergers as a form of "A" reorganization. By allowing a choice between basis computation methods in those transactions that qualify as both a reverse triangular merger and a "B" reorganization, the Proposed Regulation is also within the statutory constraints of section 358.

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9 See, e.g., Rev. Rul. 67-448, 1967-2 C.B. 144; Rev. Rul. 73-427, 1973-2 C.B. 301; Rev. Rul. 78-250, 1978-1 C.B. 83.

3. Nonrecognition Treatment to S on the Exchange of P Stock in a Reverse Triangular Merger (Proposed Regulation §1.1032-2(b))

Like the 1981 proposed regulations, Proposed Regulation §1.1032-2(b) both (i) provides for nonrecognition treatment to S on its actual or deemed exchange of P stock for T stock in certain triangular reorganizations and (ii) excludes reverse triangular mergers from the enumerated transactions in which nonrecognition treatment applies to S with respect to the P stock issued in the transaction. The Preamble does not, nor did the Preamble to the 1981 proposed regulations, explain that omission.

In a reverse triangular merger where S is a newly-formed, transitory subsidiary, S's existence is ignored.[10] There should be no need for statutory protection of S against gain recognition in respect of the P stock, since P is deemed to have issued its stock directly to T's shareholders.

In a reverse triangular merger where S is a preexisting subsidiary whose existence is not ignored, however, S does need protection against gain recognition. Such a transaction can be viewed in either of two ways, each of which should result in nonrecognition treatment to S. Under one approach, any P stock delivered by pre-existing S in a reverse triangular merger would be deemed instead to have been delivered by P directly to T's shareholders. In that case, no gain would be recognized by S (because S did not deliver the P shares) or by P (under section 1032). Under the second approach, S would be deemed to have delivered the P shares in connection with its merger into T. In that case, section 361(a) should prevent S from recognizing gain or loss.[11] This is because pre-existing S is a "party" to the reorganization (its

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10 Id.

11 Section 361(a) provides that:

(continued...)

existence is not ignored) and exchanges "property" (P stock) in the merger for "stock" of T (another party).[12] The analysis under the second approach should be the same whether the P stock is acquired by S in connection with the merger or is "old and cold" in S's hands. That is, S should not recognize gain with respect to the P stock any more than S would recognize gain on other (tangible or intangible) S assets that it transfers to T in connection with the merger. (T also does not recognize gain or loss under section 361(c) on T's distribution of P stock received from S and distributed to T shareholders in the merger.)

Because of the importance of the issue, we recommend that the final regulations clarify that S will not recognize gain or loss in connection with the delivery of P stock (including "old and cold" P stock) in a reverse triangular merger. This could be accomplished by either (i) confirming that S is protected in all events under section 361(a) or (ii) adding reverse triangular mergers to the list of transactions covered by Proposed Regulation §1.1032-2(b) (but excluding reverse triangular mergers from the application of Proposed Regulation §1.1032-2(c)).

4. Recognition of Gain by S on the Exchange of "Old and Cold" P Stock (Proposed Regulation §1.1032-2(c))

Proposed Regulation §1.1032-2(c) requires S to recognize gain or loss on its delivery of P stock in a forward triangular merger, a triangular C reorganization or a triangular B

11(...continued)

> "No gain or loss shall be recognized to a corporation if such corporation is a party to a reorganization and exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization."

12 This analysis of the merger of S into T follows the Service's ruling in Rev. Rul. 69-6, 1969-1 C.B. 104, and the court's holding in West-Shore Fuel, Inc. v. U.S., 598 F.2d 1236 (2d Cir. 1979), in which a merger of T into S is treated as a sale by T of all of its assets to S in exchange for S stock, followed by a distribution by T of the S stock in complete liquidation of T to T shareholders in exchange for all their T stock.

reorganization "if S did not receive the P stock from P pursuant to the plan of reorganization." This is a change from the 1981 proposed regulations, which simply stated that S would not recognize gain or loss upon the receipt of money or property from T in exchange for P stock.

Proposed Regulation §1.1032-2(b) achieves nonrecognition treatment for S by treating P as having transferred its shares directly to T or to T's shareholders in exchange for T's assets or stock. Such nonrecognition for S follows the long-standing position of the Service expressed in Rev. Rul. 57-278, 1957-1 C.B. 124, in which S did not recognize gain or loss on P stock that S received from P as a contribution to capital and transferred to T in a triangular "C" reorganization.[13] This approach also conforms to the general characterization of triangular reorganizations under the over-the-top model for purposes of calculating P's basis in its T or S stock under Proposed Regulation §1.358-6, since S would not be required to recognize gain or loss if P acquired T's assets or stock and subsequently contributed them to S.

To the extent S did not acquire the P stock from P in connection with the reorganization, Proposed Regulation §1.1032-2(c) requires S (except in a reverse triangular merger) to recognize gain or loss on the exchange of the P stock for T's assets or stock.

In the case of a forward triangular merger or a triangular "C" reorganization, taxing S with respect to the old and cold P stock may be a correct application of current law. S is not holding the P stock merely as a conduit for P, and there may be no other justification for extending nonrecognition treatment to S. For example, if the transaction were viewed as a distribution of the old and cold P stock from S to P followed by P's transfer of the stock to T or

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13 Rev. Rul. 57-278 bases S's nonrecognition treatment on the resemblance of the transaction to one in which P first acquired the T stock in a "B" reorganization and then reincorporated T in another state. GCM 37493 (April 10, 1978), in discussing Rev. Rul. 57-278, draws the analogy of an acquisition by P of the T assets followed by P's dropdown of the assets to S.

T's shareholders in the reorganization, S would recognize gain on the P stock under section 311(b). Moreover, the protection afforded S under section 361 in a reverse triangular merger (discussed in comment 3 above) does not extend to a forward triangular merger or a triangular "C" reorganization. In both cases, S transfers (or is deemed to transfer) P stock to T in exchange for T's assets (rather than T stock), so that the exchange is not covered by section 361(a). Thus, providing nonrecognition treatment for S in connection with the delivery of old and cold P stock in a reverse triangular merger does not appear inconsistent with taxing S in connection with the delivery of old and cold P stock in a forward triangular merger or a triangular "C" reorganization.

On the other hand, in a triangular "B" reorganization, S's exchange of old and cold P stock for T stock appears to qualify as an exchange described in section 361(a). That is, S and P are both "parties" to the triangular "B" reorganization[14] and, pursuant to the plan of reorganization, S exchanges "property" (the P stock) solely for stock of T (also a party). Hence section 361(a) would appear to protect S from gain recognition with respect to old and cold P stock in a triangular "B" reorganization, which is inconsistent with the position taken in the Proposed Regulations.

Simply excluding triangular "B" reorganizations from the scope of Proposed Regulation §1.1032-2(c) would appear to conform to section 361(a). However, this approach would create the somewhat peculiar result of taxing S's delivery of old and cold P stock in connection with a forward triangular merger or a triangular "C" reorganization, but not in connection with a triangular "B" reorganization or (as discussed in comment 3 above) a reverse triangular merger. Such a distinction raises the broader question of whether S's delivery of old

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14 See section 368(b), first two sentences.

and cold P stock should be nontaxable in all triangular reorganizations. We believe this question should be considered in connection with the larger issues of cross ownership and related persons generally. As discussed in comment 6 below, we recommend that those difficult issues be reserved for further consideration, and we therefore suggest that the treatment of old and cold P stock under section 1032 be reserved for future guidance.

As an additional minor comment, it would be helpful if the final regulations provided further guidance as to when P stock will qualify as acquired by S "pursuant to the plan of reorganization" for purposes of Proposed Regulation §1.1032-2(c). Currently the only guidance is Proposed Regulation §1.1032-2(d) (Example 2(b)) and Proposed Regulation §1.358-6(d)(3)(e), each of which states that S will recognize gain on stock acquired in "an unrelated transaction several years before the reorganization." The phrase "plan of reorganization" of course is used extensively in Subchapter C itself, so that the broader implications of any such definition would need to be considered.

5. Treatment of Triangular Reorganizations where P and S are Members of a Consolidated Group (Proposed Regulation §1.1502-30)

Proposed Regulation §1.358-6(c)(1)(ii) provides that if the amount of T liabilities assumed by S or to which T assets are subject exceeds T's aggregate adjusted basis in its assets, P will not adjust its basis in its S stock[15] upon the deemed section 351 transfer of T's assets and liabilities to S. This floor upon the adjustment to P's basis in its S stock not only allows P to retain a basis in the stock of no less than zero, but allows P to fully preserve any historic basis in

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15 Although this discussion is limited to a forward triangular merger or a triangular "C" reorganization, a similar analysis would apply to a reverse triangular merger in which P's basis in its T stock is determined under Proposed Regulation §1.358-6(c)(2)(i).

its S stock.[16] In addition, Proposed Regulation §1.358-6(d)(2) provides that P will not adjust its basis in S stock below zero for consideration not provided by P.

In contrast, if P and S are members of a consolidated group, Proposed Regulation §1.1502-30 provides that the restrictions on negative adjustments to basis do not apply. The Preamble justifies this disparity by noting that in a nonconsolidated context "negative basis generally is not used under the Code," whereas the consolidated return regulations provide in effect for negative basis through the mechanism of an excess loss account.

We generally support the application of negative basis adjustments under Proposed Regulation §1.1502-30. These seem appropriate to conform T's or S's inside basis in the T assets with P's basis in the T or S stock. At the same time, the rule against negative adjustments in the nonconsolidated context under Proposed Regulation §1.358-6 is in effect forced by the generally acknowledged absence of a "negative basis" concept in the tax law.[17] Moreover, the collateral issues associated with introducing a "negative basis" concept would be complex.

We have some concern about the disparate treatment of consolidated and nonconsolidated taxpayers, which creates potential for distortions in taxpayer behavior designed to take advantage of the more favorable treatment of a nonconsolidated P and S under Proposed

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16 The Preamble states that the reason for preserving P's historic basis in S is to preserve neutrality between the use of an existing S and a newly-created S in the reorganization.

17 See, e.g., Rev. Rul. 75-451, 1975-2 C.B. 330 (no depletion in excess of basis for purposes of computing gain or loss on sale); Rev. Rul. 68-434, 1968-2 C.B. 137 ("interim" negative basis allowed in calculation of property basis in a section 333 liquidation; ruling noted that "it is generally recognized that basis cannot be reduced below zero"); GCM 37528 (May 3, 1978) (negative basis not a "recognized principle of tax law"). In Easson v. Commissioner, 33 T.C. 963 (1960), nonacq., 1964-2 C.B. 8, the Tax Court stated that "property cannot have a negative basis." 33 T.C. at 970. In contrast, the Ninth Circuit reversed stating that the tax law did not preclude a negative basis in property. Easson v. Commissioner, 294 F.2d 653 (9th Cir. 1961).

Regulation §1.358-6. Presumably taxpayers that have the flexibility to avoid the negative basis adjustment under Proposed Regulation §1.1502-30 would do so. For example, if S and/or P are newly formed in connection with a triangular reorganization and have not previously filed consolidated returns, they might simply postpone filing consolidated returns until the year following the acquisition of T to avoid a negative basis adjustment. Even if P is a member of a pre-existing consolidated group, it might capitalize S so that the control requirement of section 368 is satisfied but the affiliation requirement of section 1504 is not.[18] Devices of this type could undermine the effectiveness of the proposed negative adjustment rule for consolidated taxpayers, perhaps reducing the rule in some instances to a mere trap for the unwary. Nevertheless, we believe these concerns are outweighed by the importance of creating a theoretically sound rule for consolidated taxpayers, which should cover the vast majority of triangular reorganizations.

6. Cross-Ownership

The Preamble requests comments concerning the tax consequences of restructurings involving related parties and cross ownership (e.g., preexisting ownership of T stock by P or S). Cross ownership raises fundamental issues that transcend the questions of how P's basis in S or T stock should be determined under section 358 and how S should be treated under section 1032. Moreover, these issues are difficult to resolve because of their complexity and because of competing policy considerations they often raise.[19] Ultimately the basis and other implications of reorganizations involving cross ownership should be addressed in regulations or

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18 This could be accomplished, for example, by having an unrelated party hold a second class of S voting stock that possesses 20% or less of S's stock voting power (to comply with the control requirement of section 368(c)) but more than 20% of S's stock value (to fail the affiliation requirement of section 1504).

19 See, e.g., Cummings & Eustice, "IRS Revises Prop. Regs. on Stock Basis Adjustments in Triangular Reorganizations," J. Tax'n (June 1995) 324, 329-332.

other guidance. However, because of the difficulty of this subject, on one hand, and the importance of finalizing promptly the Proposed Regulations, on the other, we recommend that the final regulations reserve cross ownership issues for future guidance rather than attempt to address those issues. This will enable all concerned to review the labyrinthine cross ownership considerations carefully and thoughtfully without obstructing finalization of the Proposed Regulations, which are relatively self-sufficient and address most triangular reorganization cases of interest to taxpayers.

7. P's Holding Period in Its T or S Stock

The final regulations should clarify how P's holding period in its T or S stock is determined after a triangular reorganization. The Preamble to the Proposed Regulations states that "[t]he over-the-top model is not intended to construct a transfer of T assets or stock from P to S for any purpose of the Code except the determination of P's basis in its S or T stock." Therefore, the fiction created by the over-the-top model raises a question as to the holding period P will have in the T stock after the reorganization. Specifically, section 1223(l) provides that where the property received in an exchange has the same basis (in whole or in part) as the property exchanged, the holding period of the exchanged property is included in the holding period of the property received. Section 1223(2) provides that the transferee in an exchange may include the holding period of the transferor if the transferee has the same basis (in whole or in part) as the transferor had in the exchanged property.

Given the integral relationship between holding period and basis, we believe that P's holding period in its T or S stock should be determined consistent with the method used to compute P's basis under the Proposed Regulations. For example, where P's basis derives from the basis T shareholders had in the T stock, P's holding period in its T or S stock similarly should be determined by reference to the holding period of the T shareholders; to mandate use of T's

holding period in its assets would not make sense as that result simply is not consistent with the substance of the transaction for basis purposes. Moreover, requiring consistency between basis and holding period determinations would avoid potential administrative hardship to taxpayers in the case of a reverse triangular merger that also qualifies as a "B" reorganization. In such a case, P may choose to determine its basis by reference to T's basis in its assets in order to avoid the administration associated with substantiating the basis T shareholders have in their T stock, particularly when the T stock is widely held.[20] In such a case, it would be unreasonable to require P to determine its holding period in T's stock by reference to the holding period of the T shareholders, which would involve a similar substantiation burden.

We therefore recommend that the final regulations clarify, perhaps by adding a regulation under section 1223, that P's holding period in its T or S stock is to be determined consistent with the method for determining P's basis in the T or S stock. That is, if P's basis in its T or S stock is calculated by reference to T's basis in its assets under Proposed Regulation §1.358-6(c)(i) or §1.358-6(c)(2)(iii)(A), then the holding period of T in its assets should be included in P's holding period to the extent provided by section 1223(1);[21] and if P's basis in its T or S stock is calculated by reference to the basis T shareholders had in their T stock under Proposed Regulation §1.358-6(c)(2)(iii)(B) or §1.358-6(c)(3), then the holding period of the T shareholders in their stock should be included in P's holding period.

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20 This is true notwithstanding the availability of sampling as provided in Rev. Proc. 81-70, 1981-2 C.B. 729. For example, if P believes that the basis the T shareholders had in their T stock is roughly the same as the basis T has in its assets, P would likely calculate its basis in the T stock using T's basis in its assets and forego the expense of conducting a sampling.

21 Section 1223(1) provides for holding period tacking only to the extent the property exchanged was a capital asset or section 1231 property. Hence under this approach P would have a split holding period in the T or S shares to the extent the T assets included inventory property, for example.

8. Scope of Zero Basis Comfort in Triangular Reorganizations

a. P Warrants or Options. We recommend that the final regulations expand Proposed Regulation §1.1032-2 to provide that warrants or options to acquire P stock that are exchanged in a triangular reorganization are treated consistently with the exchange of P stock in such reorganization. We see no policy reason to create a zero basis issue by distinguishing for section 1032 purposes between P stock and P warrants or options. This conclusion is supported by section 1032 itself, which applies to the issuance by a corporation both of its stock and of options to purchase its stock.

It appears that this recommendation could be adopted without the need for any conforming change to Proposed Regulation §1.358-6. This is because the delivery of P warrants to T or to T's shareholders (however it is accomplished) should not affect P's basis in its T or S stock under section 358. That is, under the over-the-top model and section 362(b), P takes a carryover basis in the T assets it is deemed to receive, increased by any gain recognized by T.[22] However, T recognizes no gain on the receipt of P warrants (under section 361(b)(1)(A)) or on their distribution to T's shareholders (under section 361(c)(1)), and any gain recognized by T's shareholders on receipt of the P warrants is not taken into account under section 362(b), because T's shareholders are not the "transferor."

b. P Debt. Although outside the scope of section 1032, consideration also should be given to providing that the issuance of P debt in a triangular reorganization does not result in taxation to S under a zero basis theory, but rather is covered by the over-the-top model.

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22 The over-the-top model of Proposed Regulation §1.358-6(c)(1)(i) would always apply for this purpose, since P warrants may not be issued in a triangular "B" reorganization.