NEW YORK STATE BAR ASSOCIATION

TAX SECTION

REPORT ON PROPOSED REGULATIONS REGARDING ALLOCATION OF BASIS UNDER SECTION 358

May 27, 2005

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New York State Bar Association

Tax Section

Report on Proposed Regulations

Regarding Allocation of Basis Under Section 358[1]

I. Introduction.

This report ("Report") of the New York State Bar Association Tax Section comments on Proposed Regulations under Section 358[2] issued by the Internal Revenue Service ("IRS") and Treasury Department ("Treasury") on May 3, 2004 (REG-116564-03) (the "Proposed Regulations"). The Proposed Regulations address the determination of the basis of stock or securities received in a reorganization described in Section 368 or a distribution to which Section 355 applies.[3] In particular, in a situation where a taxpayer exchanges, or receives a distribution with respect to, multiple blocks of stock or securities (that is, stock or securities acquired at different times or at different prices), the Proposed Regulations adopt a "tracing" rather than an "averaging" or "split-basis" regime for determining the basis of the stock or securities received by the taxpayer in the

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[1] The principal drafter of this Report was Gordon Warnke, with substantial assistance from Monica Coakley and Steven Harrison. Helpful comments were received from Kimberly Blanchard, Tim Devetski, Kathleen Ferrell, Patrick Gallagher, Larry Garrett, Karen Gilbreath, Deborah Paul, David Sicular, Michael Schler and Jodi Schwartz.

[2] Except as otherwise noted, Section references are to the Internal Revenue Code of 1986, as amended, and references to Regulations are to the Treasury Regulations promulgated thereunder.

[3] On January 5, 2005, proposed amendments to Treasury Regulations promulgated under Sections 358, 367, 884 and 6038B were issued (REG-125628-01). Among other things, the proposed amendments provide special rules for determining the basis of property received in certain reorganizations that involve one or more foreign corporations. This Report does not address those proposed amendments, which will be the subject of a separate report.

transaction.[4] In light of the inconsistent authorities addressing this question under current law and the ambiguity of the current Regulations, the Proposed Regulations are a welcome clarification. This Report offers recommendations to further clarify this area of the law, and to potentially conform the treatment of similar transactions governed by Section 358 as well as those governed by Section 1036.

Part II of this Report summarizes our recommendations. Part III provides an overview of the current law regarding the allocation of basis under Section 358 and Section 1036 and a description of the Proposed Regulations. Our comments and recommendations with respect to the Proposed Regulations are then set forth in Part IV of this Report.

II. Summary of Recommendations.

Maintain Basis Tracing Regime; Add Certain Clarifications. We agree with the basis tracing approach adopted by the Proposed Regulations for stock and securities received in transactions governed by Sections 354, 355 or 356. We generally also agree with the approach taken by the Proposed Regulations to permit shareholders to designate which stock or securities received in the transaction were received in exchange for, or with respect to, a particular share or security held before the transaction, and the provision of a first-in/first-out ("FIFO") convention upon a subsequent disposition of less

[4] In this Report, the term "tracing" is used to describe the tracing of the separate basis of shares of stock or securities surrendered to separate shares of stock or securities received, the term "averaging" is used to describe the combining of the separate basis in shares of stock or securities surrendered and then allocating that combined basis among shares of stock or securities received in proportion to their respective fair market values, and the term "split-basis" is used to describe treating a proportionate amount of the separate basis of shares of stock or securities surrendered as being transferred to a fraction of each share of stock or securities received with the proportionate amount of basis (and holding period) of the shares of stock or securities surrendered surviving as a distinct amount with respect to a portion of each share of stock or securities received.

than all of the stock or securities received in the transaction when a taxpayer fails to make a designation. Our Report recommends certain clarifications to the Proposed Regulations, including more explicit illustrations of how basis tracing applies when multiple classes of stock or securities are exchanged or received or when stock or securities are retained (including, but not limited to, in exchanges to which Section 355 applies).

Provide Methodology for Allocating Boot. We recommend that the IRS and Treasury clarify how "boot" received in an exchange is allocated among the stock, securities and other assets surrendered in the exchange. We also recommend that the IRS and Treasury clarify how to determine whether and to what extent "boot" is recognized where securities are both exchanged and received.[5]

Extend Basis Tracing Regime to Section 351 Transactions. We recommend that consideration be given to extending the basis tracing regime of the Proposed Regulations to all stock-for-stock exchanges governed by Section 351, including those in which property other than stock or securities is transferred or in which liabilities are assumed. This Report includes suggestions for how to apply a basis tracing regime to Section 351 transactions, if the basis tracing regime of the Proposed Regulations is so extended, including transactions where liabilities are assumed.

Provide Methodology for Basis Determinations in "Stockless" Reorganizations. Our Report recommends a methodology for determining basis in

[5] We realize, however, that the allocation of "boot" may affect issues other than the computation of basis (including, for example, the qualification of a transaction as a reorganization). Accordingly, we recommend that the IRS and Treasury not delay finalization of the Proposed Regulations pending resolution of this issue.

certain reorganizations and Section 351 transactions where the taxpayer does not receive any stock or securities in the transaction.

Provide Special Rules for Intercompany Transactions. We recommend that the IRS and Treasury provide special rules in this area as necessary to maintain the integrity of the consolidated return regulations.

Coordinate Basis Allocation Rules of Section 1036 with the Basis Allocation Rules for Reorganizations and Section 351 Transactions. We recommend that the IRS and Treasury provide rules conforming the basis allocation rules for Section 1036 transactions with those for reorganizations and Section 351 transactions, especially in overlap cases.

III. Background.

A. Current Law.

Regulations under Section 1012 provide that if a taxpayer holds multiple blocks of stock (i.e., stock acquired on different dates or at different prices) and sells a portion of such stock, the earliest shares acquired are treated as the first to be sold for purposes of determining the basis and holding period of the shares sold. Reg. § 1.1012-1(c)(1). This "FIFO" rule does not apply if the shareholder is able to "adequately identify" the particular shares sold. Id. The Regulations describe what constitutes "adequate identification," and generally provide shareholders a great deal of latitude in being able to identify specific shares, even if the shares are held by a broker or are represented by a single stock certificate. See Reg. § 1.1012-1(c)(2), (3) and (4).

Under Section 358, a taxpayer's basis in stock or securities[6] permitted to be received without the recognition of gain or loss under Sections 351, 354, 355, 356 or 361 ("nonrecognition property") 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 other property received by the taxpayer in the exchange ("boot"), and decreased by any loss or increased by any gain or dividend income recognized by the taxpayer in the exchange. I.R.C. § 358(a)(1). The basis determined in accordance with the foregoing rules is allocated among the nonrecognition property received in accordance with Regulations to be promulgated. I.R.C. § 358(b)(1). In the case of an exchange to which Section 355 (or so much of Section 356 as relates to Section 355) applies, the allocation is made by taking into account both the nonrecognition property received and the stock or securities (if any) of the distributing corporation retained, with the allocation of basis being made among all such properties. I.R.C. § 358(b)(2). For purposes of this basis determination, all Section 355 distributions are treated as exchanges, with any distributing corporation stock or securities held by the taxpayer after the distribution treated as surrendered and received back in the exchange. I.R.C. § 358(c). The basis of boot received by a taxpayer is its fair market value. I.R.C. § 358(a)(2).

The current Regulations under Section 358 provide a limited set of rules for the determination and allocation of basis. Regulations section 1.358-1 describes how a taxpayer calculates its aggregate basis in the properties it holds following a transaction to which Section 358 applies. In the case of a reorganization or distribution to which

[6] Throughout this Report, the terms "stock" and "securities" are used as in Reg. § 1.358-2(a)(1) and Prop. Reg. § 1.358-2(a)(1) to indicate stock and securities that are nonrecognition property, rather than boot under the relevant provisions of Sections 351, 356 and 361.

Section 354 or 355[7] applies in which only nonrecognition property is received, the taxpayer's basis in all of its stock and securities in the subject corporation (that is, the corporation whose stock or securities are surrendered in the transaction or with respect to which a distribution is made) is allocated among such stock and securities held after the transaction and the stock and securities received in the transaction. In the case of an exchange to which Section 351 or 361 applies in which only nonrecognition property is received, the taxpayer's basis in the stock and securities received in the transaction is the same as its basis in the property exchanged therefor. If boot is received in a transaction to which Sections 351, 354, 355 or 361 applies, then, as described in the statute, appropriate adjustments are made to determine the aggregate basis amount in order to reflect the receipt of boot and the recognition of income, gain or loss in the transaction. Reg. § 1.358-1(a).

Current Regulations section 1.358-2 describes, in very general terms, how the basis determined under Regulations section 1.358-1 is allocated among the properties held by the taxpayer after the transaction. If the taxpayer held only stock, all of one class, before the transaction, and holds stock of more than one class after the transaction, the taxpayer's basis is allocated among the stock held after transaction in accordance with relative fair market values. If the taxpayer held only securities, all of one class, before the transaction, and holds multiples classes of securities, or a combination of stock and securities, after the transaction, the taxpayer's basis is allocated among the stock and

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[7] All references in the current Regulations to exchanges under repealed Sections 371 ("Reorganization In Certain Receivership And Bankruptcy Proceedings") and 374 ("Gain or Loss Not Recognized in Certain Railroad Reorganizations") have been ignored for purposes of this Report. These references are eliminated in the Proposed Regulations.

securities held after the transaction in accordance with relative fair market values. A similar rule is provided for exchanges to which Section 351 or 361 applies, where property is exchanged for multiple classes of stock or a combination of stock and securities. In such cases, the taxpayer's basis is allocated among the stock and securities received in accordance with their relative fair market values. Reg. § 1.358-2(a)(2), (a)(3) and (b)(2).

If the taxpayer held multiple classes of stock or securities, or a combination of stock and securities, before the transaction, the current Regulations provide that "a determination must be made, upon the basis of all the facts, of the stock and securities received with respect to stock and securities of each class held (whether or not surrendered)." Basis is then allocated separately for each class of stock or securities with respect to which there is an exchange or distribution. Reg. § 1.358-2(a)(4). Lastly, in the case of a recapitalization under Section 368(a)(1)(E) that provides each holder of stock or securities of a particular class with the option to surrender some or none of such stock or securities in exchange for stock or securities and the holder surrenders an identifiable part of the holder's stock or securities, the basis of the part of the stock or securities retained remains unchanged and is not taken into account in determining the basis of the stock or securities received. Reg. § 1.358-2(a)(5).

The current Regulations do not address the allocation of basis where a taxpayer exchanges, or receives a distribution with respect to, multiple blocks of stock or securities that fall within a single class of stock or securities issued by a corporation but which have different bases or holding periods. The methodology described in the current

Regulations, which calls first for the determination of an aggregate basis amount,[8] might be interpreted as requiring an averaging of the taxpayer's basis in multiple blocks of stock or securities or a split-basis within shares, or as simply not addressing the issue. Under an averaging approach, if a taxpayer holds 10 shares of Corporation A common stock with a fair market value of $10 and a basis of $3 per share and 10 shares of Corporation A common stock with a fair market value of $10 and a basis of $1 per share, and exchanges those 20 shares for 20 shares of Corporation B common stock with a fair market value of $10 per share in a reorganization to which Section 354 applies, the taxpayer's basis in its Corporation B stock would be $2 per share. Older case law has, in some instances, adopted this approach. See, e.g., Arrott v. Commissioner, 136 F.2d 449 (3d Cir. 1943), Commissioner v. Bolender, 82 F.2d 591 (7th Cir. 1936), Helvering v. Stifel, 75 F.2d 583 (4th Cir. 1935), Commissioner v. Von Gunten, 76 F.2d 670 (6th Cir. 1935). Under a split-basis approach, one half of each share received would have a basis of $1.50 and one half of each share would have a basis of $0.50, and each half of the share would have a holding period that corresponds to the holding period of the share from which the half-share's basis was derived. See Rev. Rul. 85-164, 1985-2 C.B. 117 and other authorities cited below.

However, there is support for approaches other than averaging or basis splitting. The IRS states in Revenue Ruling 55-355, 1955-1 C.B. 418 (involving an exchange of various blocks of two classes of parent preferred stock for shares in three

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[8] See, e.g., Reg. §1.358-1(a) which provides that in the case of an exchange or distribution in which only nonrecognition property is received, "the sum of the basis of all of the stock and securities in the corporation whose stock and securities are exchanged or with respect to which the distribution is made, held immediately after the transaction, plus the basis of all stock and securities received in the transaction shall be the same as the basis of all the stock and securities in such corporation held immediately before the transaction allocated in the manner described in §1.358-2."

subsidiaries of parent), that "[i]t is fairly well settled that *where identification is lacking*, an average basis must be used..." (emphasis added), thus acknowledging that in some cases, a specific identification or basis tracing approach may be appropriate.[9] In the example described above, under a basis tracing approach the taxpayer's basis in 10 shares of Corporation B stock would be $3 per share, and its basis in the other 10 shares of Corporation B stock would be $1 per share. Some courts have adopted a basis tracing approach. See, e.g., Kraus v. Commissioner, 88 F.2d 616 (2d Cir. 1937), Bloch v. Commissioner, 148 F.2d 452 (9th Cir. 1945), Osrow v. Commissioner, 49 T.C. 333 (1968). Similarly, in certain circumstances the IRS has found basis tracing to be appropriate. See PLR 7946005; PLR 6604126640A. It is not clear whether the adequacy of an identification of specific shares or securities is, for these purposes, determined under the principles set forth in Regulations section 1.1012-1(c), or under different principles.

All of the case law in this area was decided prior to the promulgation of the current Regulations under Section 358 (except for Osrow, which did not discuss the current Regulations under Section 358).

The IRS has ruled that when a taxpayer transfers multiple properties to a corporation in a Section 351 exchange, the determination of the taxpayer's basis in the stock and securities received in exchange for such properties may not be determined by treating specific shares or securities as exchanged for particular assets; rather, the basis of each property transferred is allocated among the stock and securities received in the

[9] The Proposed Regulations would obsolete Revenue Ruling 55-355.

exchange based on the relative fair market values of such shares and securities. Rev. Rul. 85-164, 1985-2 C.B. 117. This allocation methodology results in individual shares of stock received in the Section 351 exchange having a split holding period and split basis, at least for purposes of determining long-term or short-term capital gain or loss. Id.; cf. Rev. Rul. 67-309, 1967-2 C.B. 263 (split holding period and basis in two undivided one-half interests in real property acquired by taxpayer at different times for different prices); Rev. Rul. 62-140, 1962-2 C.B. 181 (split holding period and basis in stock acquired in exchange for a debenture plus cash).

If, however, the taxpayer receives boot in a Section 351 exchange, the IRS has ruled that the taxpayer must separately allocate the consideration it receives in the exchange among the assets transferred to the corporation for purposes of determining gain or loss on an asset-by-asset basis in accordance with relative fair market values. Rev. Rul. 68-55, 1968-1 C.B. 140. As some commentators have noted, the mechanics of this asset-by-asset determination of gain, in a transaction where boot is received or where liabilities are assumed, is an area of significant uncertainty. See Rabinovitz, "Allocating Boot in Section 351 Exchanges," 24 Tax L. Rev. 337 (1969); Cohen & Whitney, "Revisiting the Allocation of Boot in Section 351 Exchanges," 48 Tax Law. 959 (1995) (hereinafter "Cohen & Whitney").

Sections 1036 and 1031(d) provide rules for determining gain or loss and basis in the property received in circumstances in which common stock is exchanged for common stock or preferred stock is exchanged for preferred stock in the same corporation. Such an exchange may be between shareholders or between a shareholder and the corporation. See third sentence of Reg. § 1.1036-1(a). In the case of an

exchange with the corporation, the exchange may also qualify as a recapitalization under Section 368(a)(1)(E) and/or as a distribution under Section 305. See fourth sentence of Reg. § 1.1036-1(a).

The basis of property received in a Section 1036 exchange is determined under Section 1031(d). I.R.C. § 1036(c)(2). Under Section 1031(d) and the Regulations promulgated thereunder, the basis of property received in a Section 1036 exchange is the same as that of the property exchanged, decreased by the amount of any money received by the taxpayer and increased by the amount of gain or decreased by the amount of loss to the taxpayer that was recognized in the exchange. See I.R.C. § 1031(d); Reg. § 1.1031(d)-1.

B. Proposed Regulations.

We commend the IRS and Treasury's decision to provide clearer guidance with respect to basis allocations under Section 358, particularly with respect to taxpayers that exchange, or receive distributions with respect to, multiple blocks of stock.

In the preamble to the Proposed Regulations, the IRS and Treasury discuss the averaging approach and the basis tracing approach (but not, or at least not explicitly, the split-basis approach), and conclude that the basis tracing approach is more appropriate, noting that a reorganization that results in carryover basis treatment is not an event that justifies the averaging of the bases of multiple blocks of stock, and that the averaging approach may inappropriately limit legitimate taxpayer planning or facilitate inappropriate results. The Proposed Regulations would therefore replace current Regulations section 1.358-2 with a new set of rules to implement a basis tracing regime.

Under the Proposed Regulations, if a taxpayer surrenders a share of stock or a security in an exchange to which Section 354, 355 or 356 applies, the basis of each share of stock or security received in the exchange is the same as the basis of the allocable portion of the share or shares of stock or security or securities surrendered therefor (as adjusted under Regulations section 1.358-1). If more than one share of stock or security is received in exchange for one share of stock or one security, the basis of the share of stock or security surrendered is allocated to the shares of stock or securities received in the exchange in proportion to the fair market values of the shares of stock or securities received. A similar rule for distributions under Section 355 provides that if a shareholder or security holder receives stock or securities in a distribution under Section 355 (or so much of Section 356 as relates to Section 355) and does not surrender any stock or securities in connection with the distribution, the basis of each share of stock or security of the distributing corporation (as adjusted under Regulations section 1.358-1) is allocated between the share of stock or security of the distributing corporation with respect to which the distribution is made and the share or shares of stock or security (or allocable portions thereof) received in proportion to their fair market values.

The Proposed Regulations require that basis allocations be done in a manner that, to the greatest extent possible, reflects that a share of stock or a security received is received in respect of shares of stock or securities acquired on the same date and at the same price. According to the preamble to the Proposed Regulations, this rule is intended to avoid, to the greatest extent possible, creating shares or securities with split holding periods. For example, suppose a taxpayer acquired two shares of stock of Corporation A on date 1 for $2 each and two shares of stock of Corporation A on date 2

for $3 each. If the taxpayer exchanges the four shares for two shares of stock of Corporation B in a transaction to which Section 354 applies, one share of the Corporation B stock will be treated as acquired for the shares of Corporation A acquired on date 1 and the other share will be treated as acquired for the shares of Corporation B acquired on date 2. Accordingly, one share will have a basis of $4 and the other share will have a basis of $6.

The Proposed Regulations provide that, in the case of a transaction to which Sections 354, 355 or 356 applies, if a taxpayer exchanges, or receives a distribution with respect to, multiple blocks of stock or securities with different bases or holding periods, and the taxpayer is not able to identify which share of stock or security is received in exchange for, or with respect to, a particular share of stock or security, the taxpayer may designate which share of stock or security is received in exchange for, or with respect to, a particular share of stock or security (a "Designation"). A Designation must be "consistent with the terms of the exchange or distribution," and must be made on or before the first date when the basis of a share of stock or a security received is relevant (i.e., when the share is sold or is transferred in a nonrecognition transaction). The Proposed Regulations further provide that, if the shareholder fails to make a Designation, then upon a disposition of a share, the shareholder will be deemed to have first disposed of the share with the longest holding period (the "FIFO Rule").[10]

Under the Proposed Regulations, the basis tracing regime outlined above would not apply to stock or securities received in an exchange to which both Section 351

[10] This default rule, as it is articulated in the Proposed Regulations, applies only to shares of stock but presumably is intended to apply to securities, as well.

and Section 354 or 356 applies if, as part of the transaction, the taxpayer exchanges property for stock or securities in an exchange to which neither Section 354 nor 356 applies or in which liabilities of the taxpayer are assumed. In these instances (as well as in any case where a transaction qualifies solely as an exchange under Section 351 and not as a reorganization), the split-basis approach described in Revenue Ruling 85-164 would presumably continue to apply. The preamble to the Proposed Regulations indicates that this limitation on the application of the basis tracing rules of the Proposed Regulations is intended "to prevent a conflict between, on the one hand, those rules that apply to determine the basis of stock received in an exchange to which section 351 applies (including the effect on the application of section 357(c)) and, on the other hand, these proposed rules."

The Proposed Regulations do not address the allocation of basis in a Section 1036 transaction, including the proper basis allocation rules to apply to a transaction to which both Section 1036 and Section 354 or 356 apply.

IV. Comments and Recommendations.

A. The Proposed Regulations and the Basis Tracing Regime, Generally.

We agree with the basis tracing approach adopted by the IRS and Treasury in the Proposed Regulations, including the provisions allowing taxpayers to designate which stock or securities received in the transaction were received in exchange for, or with respect to, a particular share or security held before the transaction, and the provision of a FIFO Rule upon a subsequent disposition of less than all of the stock or securities received in the transaction when a taxpayer fails to make a Designation.

1. Benefits of the Basis Tracing Regime.

We believe that consistency of treatment among similarly situated taxpayers is desirable from a tax policy perspective. A basis tracing approach helps achieve this goal by preserving, after a reorganization, those basis differentials that existed prior to the reorganization, to the greatest extent possible. Averaging or splitting of bases, on the other hand, can lead to inconsistent treatment as well as certain anomalies.[11] We think such inconsistencies and anomalies should be avoided when possible, whether they benefit or are detrimental to the taxpayer.

To minimize the occurrence of inconsistent outcomes, and to further support the general basis tracing approach of the Proposed Regulations, this Report contains some suggestions for potentially extending basis tracing to all stock-for-stock exchanges in the Section 351 context (see IV.C. below) and for coordinating overlaps between Section 1036 transactions and transactions to which Sections 354 or 356 apply (see IV.F. below).

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[11] President Clinton's fiscal 1997 and 1998 budget proposals contained provisions that, if passed, generally would have required averaging of bases even of shares that were acquired by purchase and disposed of in a sale, with no intervening reorganization or other exchange. The proposal required that upon disposition of a security (defined to include stock, evidences of indebtedness and most instruments included in the definition of security in Section 475(c)(2)), the holder must determine its gain or loss based on the average basis of all of the "substantially identical" securities it holds. The holder determines whether any resulting capital gain or loss is long-term or short-term by assuming that shares were sold on a first-in-first-out basis. The Treasury would have been authorized to provide exceptions for shares that must be subject to special treatment under other provisions of the Code (such as Section 704(c)). Several shortcomings inherent in this approach have been observed, including increased recordkeeping burdens, the need for related-person rules to prevent circumvention of the rule, and the difficulty in defining "substantially identical" securities. See, e.g., Joint Committee on Taxation, Description and Analysis of certain Revenue-Raising Provisions Contained in the President's Fiscal Year 1998 Budget Proposal (April 16, 1997). The Joint Committee observed that the inconsistency between the averaging rule for determining basis and the FIFO rule for determining character could lead to short-term characterization of gain or loss that should be treated as long-term gain or loss as an economic matter.

2. Suggested Clarifications to the Proposed Regulations.

a. *Clarify allocation across multiple classes of stock or securities received in exchange for different blocks of stock.* We think it is unclear in the Proposed Regulations how basis is determined where multiple blocks of stock of the same class but with different bases are exchanged for stock or securities of more than one class in a transaction to which Section 358 applies. Consider, as an example, two blocks of 100 shares of Corporation A common stock, each block having a value of $100. The taxpayer has a basis in block one of $50 and a basis in block two of $250. The taxpayer transfers both blocks in a reorganization in exchange for 100 shares of Corporation B common stock worth $100 and 100 shares of Corporation B preferred stock worth $100. In the absence of transaction terms indicating that Corporation A shares are exchanged for Corporation B shares in a contrary manner, two approaches appear to be consistent with the Proposed Regulations. Under one approach ("Proportionate Allocation"), each type of property received would be allocated to the shares exchanged in proportion to fair market value: $50 worth of Corporation B preferred stock would be treated as received for each block of Corporation A common stock and $50 worth of Corporation B common stock would be treated as received for each block of Corporation A common stock. Accordingly there would be two blocks of Corporation B common stock (50 shares each) with bases of $25 and $125, respectively, and two blocks of Corporation B preferred stock (50 shares each) with bases of $25 and $125 respectively. On a subsequent disposition, the taxpayer could identify shares disposed of, but the identification would have to be consistent with the deemed exchange. Under the other approach ("Designated Allocation"), the taxpayer could designate that its low basis Corporation A shares were

exchanged for Corporation B common stock and its high basis Corporation A shares were exchanged for Corporation B preferred stock, or vice versa, or could make any other designation the taxpayer desired, so long as the value of the designated shares exchanged equaled (on the date of the exchange) the value of designated shares received and the designation was consistent with the terms of the exchange.[12]

Proportionate Allocation is arguably consistent, by analogy, with the rules applicable to multiple property transfers in a Section 351 exchange (see Rev. Rul. 85-164) and with the general approach otherwise employed in the current regulations and the Proposed Regulations of making allocations in proportion to fair market value (see, e.g., Reg. § 1.358-2(a)(2) and (3); Prop. Reg. § 1.358-2(a)(2)(i) and (ii)). On the other hand, the Proposed Regulations appear to grant the taxpayer great latitude in making Designations with respect to each share received in the transaction (see Prop. Reg. § 1.358-2(a)(2)(iii)) and designated allocations have been permitted in certain other areas of the law. See, e.g., Rev. Rul. 68-13, 1968-1 C.B. 195 (permitting, in certain circumstances, an arm's length allocation in the sale of a business of cash to assets not eligible for the installment method and notes to assets eligible for the installment method).

Guidance should be issued that clarifies whether only Proportionate Allocations are allowed or whether any Designated Allocation (so long as it is consistent with the terms of the exchange or distribution) is permitted. If Designated Allocations

[12] The taxpayer could not, however, identify half of each high basis share as surrendered for half of a share of stock received in exchange, and half of a share of low-basis shares for the remaining half of a share of stock received in exchange and thereby achieve averaging or a split-basis.

are permitted, we recommend that the Designated Allocation be required to be made at the time of the exchange or distribution, and that if the taxpayer fails to make a contemporaneous Designation, Proportionate Allocation should apply.

Similar allocation issues arise with respect to non-stock consideration received in exchange for stock and other assets transferred. Those issues are addressed later in this Report.

b. *Clarify rules for aggregating shares where one share of stock or security is received for multiple shares of stock.* Where one security or share of stock is received in exchange for more than one share or security surrendered, the Proposed Regulations require that basis must be allocated in a manner that "reflects, to the greatest extent possible, that a share of stock or security received is received in respect of shares of stock or securities acquired on the same date and at the same price." This rule requires that, where several blocks of shares are surrendered, the shares of each block are grouped with like shares and exchanged for new shares, rather than grouping shares of different blocks, which could result in an averaged basis, or a split basis and a split holding period, in each share received. The above rule limits such basis averaging or splitting to the case where the number of shares received for any given block is not a whole number and, in such a case, to only the fractional amount.

It is not clear that the Proposed Regulations should attempt to police basis averaging or splitting that arises through a reduction in the number of shares outstanding. For example, assume a taxpayer owns 10,000 shares of Corporation X common stock, and has a basis of $6,000 in 5,000 of the shares and a basis of $1,500 in the remaining

5,000 shares. If the taxpayer transfers the Corporation X shares to Corporation Y in a reorganization solely in exchange for three Corporation Y shares, under the Proposed Regulations it would appear that the taxpayer has a $4,000 basis in one Corporation Y share, a $1,000 basis in another Corporation Y share and a $2,500 combined basis in the third share.

There does not appear to be a universally simple solution to this intractable issue that does not itself create other problems. Moreover, absent guidance as to whether averaging or splitting is the correct regime for a share with a combined basis, it is difficult to analyze what problems exist with respect to the combined basis share. For example, in the previous example, does the combined basis share have a single, indivisible basis of $2500 (an averaged basis) and, if so, what is the holding period of the share? A weighted average of the holding periods of its component pieces? Or is the share bifurcated (a split basis), with one-half of the share having a basis of $500 and one-half of the share having a $2000 basis (and each half having its own holding period)? If an averaged basis regime is applied, can, for example, Section 267 loss in effect be offset against gain by recapitalizing shares into one share, thereby averaging basis on gain and loss shares?

We recommend that the IRS and Treasury provide additional guidance as to the appropriate treatment of combined basis shares, including illustrations in additional examples in the Proposed Regulations. We also recommend that, to the extent averaging

or splitting basis could lead to abuse or a trap for the unwary, those situations be dealt with separately in the areas where those problems might otherwise arise.[13]

Even in cases where averaging or splitting is required and no potential abuse is presented, averaging or splitting leaves open the question of how blocks should be grouped if a taxpayer has several blocks of stock or securities having different bases and holding periods. If shares received must be matched with surrendered shares that were purchased at different times and for different prices, it is not clear how to determine which surrendered shares should be grouped together. Greater weight could be given to minimizing differences in holding periods, or alternatively to minimizing differences in the bases of the grouped shares. We propose that shares having the same basis purchased on the same date should first be grouped together, and thereafter the remaining shares should be grouped according to their acquisition dates. This rule would be easy to administer. Also, it would minimize split holding period issues and simplify the determination under the FIFO Rule of which shares have been sold if no identification is made upon a subsequent sale.

Assume, for example, that S owns Blocks 1 through 4 of T common stock, each block consisting of 10 shares. The Blocks are numbered in order of the dates of their acquisition by S. S has a basis in each share in Block 1 of $3, in Block 2 of $12, in Block 3 of $6 and in Block 4 of $9. Those shares are exchanged by S in a reorganization for 30 shares of A common stock. Because 40 shares are exchanged for 30 shares, the

[13] We note in this regard that recently issued proposed regulations (REG-125628-01) generally apply a split-basis approach for shares held by a foreign acquiring corporation in a foreign subsidiary following certain reorganizations. These proposed regulations will be the subject of a separate report.

basis of each share of T stock will be traced to .75 of a share of A stock. The Proposed Regulations require that the basis of a single share of A stock be traced from T shares in the same block to the greatest extent possible. Each block of T stock is equal in value to 7.5 shares of A stock. Therefore, 7 A shares will have a pure traced basis from 9.33 of the shares in each block of T common stock. That is the greatest extent to which shares received can be treated as received in respect of shares of stock acquired on the same date and at the same price. The basis in the remaining .67 of a share from each block of T stock must be allocated among the remaining two shares of A stock. The Proposed Regulations do not address how this allocation should be made. The bases in the remaining shares could be aggregated and allocated between the remaining two shares in proportion to their (equal) fair market values. That method is the simplest, but it results in more averaged or split bases than necessary. In the alternative, the fractional shares from two of the blocks could be allocated to one A share and the fractional shares from the other two blocks could be allocated to the other A share. If the latter approach is selected, then the bases of the fractional shares from Block 1 and Block 3 could be traced to one A share, and the bases of the fractional shares from Block 2 and Block 4 could be traced to the second A share. That grouping would minimize the disparity between bases of T shares traced to a single A share, which furthers the goal of tracing bases. One remaining share would have a combined bases of $6.00 ($6 is .67 * ($3 + $6)) and the other remaining share would have a combined basis of $14.00 ($14 is .67 * ($9 + $12)). Or, as we recommend above, the bases of the fractional shares from Block 1 and Block 2 could be traced to one A share, and the bases of the fractional shares from Block 3 and Block 4 could be traced to the second A share. That grouping would minimize the

disparity in holding periods of T shares traced to a single A share but, in this case, would maximize the disparity in basis. Each remaining share in that case would have a basis of $10.00 (in one case because $10.00 is .67 * ($3 + $12) and in the other because $10.00 is .67 * ($6 + $9)).

c. *Clarify the scope of the aggregate basis rule of Proposed Regulations Section 1.358-1(a).* The Proposed Regulations leave current Regulations section 1.358-1(a) unchanged, except for the removal of references to Sections 371(b) and 374, to reflect the repeal of those sections. The first sentence of Regulations section 1.358-1(a) provides that, in the case of a reorganization or distribution to which Section 354 or 355 applies in which only nonrecognition property is received, the taxpayer's aggregate basis in the stock and securities received and any stock and securities retained in the subject corporation is the same as the shareholder's aggregate basis immediately prior to the transaction in all of its stock or securities in the corporation. Under the basis tracing regime of the Proposed Regulations, however, the basis of retained shares and securities would appear to be relevant only in the case of distributions to which Section 355 applies.[14] Because, under the Proposed Regulations, the basis in blocks exchanged is traced directly to shares or securities received in the exchange, there should be no effect on the basis of the taxpayer's shares or securities not exchanged in the transaction, except in the case of distributions to which Section 355 applies.

[14] As discussed earlier in this Report, current Regulations section 1.358-2(b)(5) contains a special rule applicable to recapitalizations under Section 368(a)(1)(E) that provides that if a shareholder exchanges some of its stock or securities as part of a plan that permits the exchange of some or none of such stock or securities, the shares retained will retain their basis and will not affect the basis of the shares received. This special rule is eliminated by the Proposed Regulations, presumably because it is the result achieved under the basis tracing regime in any event and, accordingly, is not needed.

For example, if in a reorganization under Section 368(a)(1)(B) a shareholder transfers some shares in the target corporation but retains others, the Proposed Regulations appear to determine the shareholder's basis in the acquiring corporation stock received solely by reference to the transferred shares, with no consequence to the shareholder's basis in its retained target shares. Similarly, in the case of an exchange to which Section 355 applies (i.e., a split-off or split-up), the Proposed Regulations appear to trace the shareholder's basis in the shares of the distributing corporation exchanged to the shares of the controlled corporation received, without regard to, or any impact on, the basis of any shares of the distributing corporation retained by the shareholder.[15]

As regards exchanges to which Section 355 applies, the basis tracing regime might be viewed as inconsistent with the statutory language of Section 358(b)(2) which seems to envision that the basis in retained shares as well as the basis in surrendered shares will be taken into account in determining basis allocations. Moreover, basis tracing may permit a taxpayer to transfer a high basis in certain blocks of a distributing corporation's shares to shares of a controlled corporation, while retaining low basis blocks in the distributing corporation. Although any potential abuse created by basis-to-value disparities between shares held by a shareholder in the controlled

[15] Current Regulations section 1.358-2(a), Example 4 contains a split-off fact pattern in which the shareholder's pre-transaction basis in the distributing corporation's stock is allocated between controlled corporation stock received and the distributing corporation stock retained. This example does not appear in the Proposed Regulations and, under the Proposed Regulations, the result in the example would appear to be different -- the shareholder's basis in the controlled corporation stock received would appear to be determined entirely by reference to the distributing corporation stock exchanged. (Although the current Regulations as well as the statute would appear to require an allocation of basis between surrendered and retained shares, private letter rulings issued by the IRS seem to be contradictory on the point. For example, compare PLR 9533028 (basis in surrendered stock allocated to controlled corporation shares received) and PLR 9544004 (basis is both surrendered and retained shares allocated among controlled shares received and distributing shares retained).)

corporation and the distributing corporation immediately after the transaction may already be adequately policed by other principles (such as the device test of Section 355), we question whether direct basis tracing of shares surrendered without regard to the basis in retained shares is permitted in light of the specific statutory language in Section 358 relating to Section 355 transactions.[16]

We recommend modifying the language of Regulations section 1.358-1(a) to clarify the treatment of retained shares. We also recommend that an example be added to the Proposed Regulations demonstrating the application of the proposed rules to an exchange to which Section 355 applies.

d. *Other suggested clarifications.* As noted below under "Provide a Methodology for the Allocation of Consideration Received," where the taxpayer holds multiple classes of stock or securities, or a combination of stock and securities, before the transaction, current Regulations section 1.358-2(a)(4), calls for a factual determination on a class-by-class basis of which stock or securities received in the transaction is allocable to which stock and securities surrendered. We recommend that a similar rule be included in the Proposed Regulations when finalized.

We also recommend that the Proposed Regulations, when finalized, clarify that in a circumstance where stock or securities received in the transaction are clearly traceable to a particular block of shares or securities held before the transaction, such

[16] Similar basis-to-value disparities can result from basis tracing in other reorganization contexts (such as in a reorganization under Section 368(a)(1)(B) where a taxpayer retains shares in the target corporation). Retained shares in a reorganization are a far more infrequent occurrence, however, than in an exchange governed by Section 355. Moreover, there is no statutory language in Section 358 that would seem to constrain the Regulations' allocation of basis in retained-share reorganizations.

actual identification of shares controls over any Designation or the FIFO Rule. Under the Proposed Regulations, a taxpayer may make a Designation only if it "is not able to identify which particular share of stock or security (or portion of a share of stock or security) is received in exchange for, or with respect to, a particular share of stock or security." Prop. Reg. § 1.358-2(a)(2)(iii). The Proposed Regulations go on to provide that, "if a shareholder fails to make a designation, then the shareholder will not be able to identify which shares are sold or transferred for purposes of determining the basis of property sold or transferred under section 1012 and § 1.1012-1(c)" and instead the FIFO Rule will apply. Id. This leaves unclear whether the FIFO Rule would apply in the case where a taxpayer was not eligible to make a Designation because specific identification of what particular share was received for a particular share was in fact possible. Such specific identification might be possible, for example, in a case where different blocks of stock held by the taxpayer before and after the transaction are held in separate accounts or through different brokers.

B. Provide a Methodology for the Allocation of Consideration Received.

We recommend that the IRS and Treasury issue guidance -- whether in Regulations under Section 358 or elsewhere -- that clarifies how a taxpayer allocates the consideration received in an exchange among the stock, securities and other assets surrendered by the taxpayer in the exchange, for purposes of determining gain and calculating and allocating basis among the properties held after the exchange. Regardless of the form that such guidance may take, we believe that after such guidance is issued, examples should illustrate how the Proposed Regulations operate in cases where the consideration received includes boot.

The current Regulations under Section 358 provide that, in any case where a taxpayer owns more than one class of stock or securities, or a combination of stock and securities, prior to the exchange or distribution, "a determination must be made, upon the basis of all the facts, of the stock or securities received with respect to stock and securities of each class held (whether or not surrendered)." Reg. § 1.358-2(a)(4). This factual determination of what nonrecognition property received in the transaction is allocable to stock and securities held before the transaction on a class-by-class basis should be included in the Proposed Regulations when finalized, but this determination should be explicitly required with respect to all consideration received in the exchange, not just the nonrecognition property. We believe that a facts-and-circumstances determination for this allocation is the most administrable and sensible approach. If the facts do not lend themselves to any particular allocation of the consideration among the classes of stock and securities held prior to the exchange, we propose that each element of consideration generally be allocated proportionally among the classes of stock and securities exchanged.[17] The foregoing general rule notwithstanding, however, we recommend that, if the facts do not lend themselves to any particular allocation, the securities held prior to the exchange be matched to securities received in the exchange, to the greatest degree possible.[18]

In addition to adopting a facts and circumstances approach, guidance should be issued regarding which facts and circumstances are relevant for making an allocation determination. For example, will a contractual allocation control in every case

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[17] Cf. Rev. Rul. 68-55, 1968-1 C.B. 140 (in the Section 351 context, consideration received in exchange for multiple assets is allocated to particular assets in proportion to their relative fair market values.)

[18] Cf. Reg. § 1.358-2(c), Example 3 and 4 (matching securities surrendered with securities received).

where there is such an allocation, or will it control only in circumstances where the allocation has some non-tax economic result. For instance, will the terms of an agreement specifying the property to be received in respect of common and preferred be respected when there is only one shareholder, or when common and preferred are held proportionately by all shareholders? Can a contractual allocation control allocations of consideration among different blocks of stock of the same class as well as among different classes of stock?

As illustrated in the example below, an allocation of the consideration received may be necessary in order to calculate the taxpayer's gain, and therefore its aggregate basis in the properties held after the transaction. In fact, in a case where the taxpayer surrenders and receives securities, without such an allocation it might not be possible to determine the extent to which securities received constitute nonrecognition property or boot.[19] Thus, an allocation of the consideration received among the stock and securities held by the taxpayer prior to the transaction is a necessary prelude to the determination and allocation of basis resulting from the transaction under Section 358.

To illustrate, suppose a taxpayer holds 100 shares of Corporation A Class 1 common stock and 100 shares of Corporation A Class 2 common stock. The taxpayer's Class 1 shares have a basis of $10 and a fair market value of $100. The taxpayer's Class 2 shares have a basis of $150 and a fair market value of $100. The taxpayer exchanges its Class 1 and Class 2 shares for 150 shares of Corporation Z

[19] For an expanded discussion of this point, with examples, see Kahn and Lehman, "Exchanges of Multiple Stocks and Securities in Corporate Divisions or Acquisitive Reorganizations," 104 Tax Notes 1417 (September 20, 2004).

common stock with a fair market value of $150 plus $50 of cash, in a transaction to which Section 354 applies.

If the consideration received by the taxpayer is allocated proportionately based on relative values to its Class 1 and Class 2 shares (i.e., 75 shares of Z stock plus $25 allocable to Class 1, and 75 shares of Z stock plus $25 allocable to Class 2) ("Scenario 1"), the taxpayer would recognize gain of $25 on its Class 1 shares, and no gain on its Class 2 shares. If the cash consideration is all allocated to the Class 1 shares (i.e., 50 shares of Z stock plus $50 cash allocable to Class 1, and 100 shares of Z stock allocable to Class 2) ("Scenario 2"), the taxpayer would recognize $50 of gain on its Class 1 shares, and no gain on its Class 2 shares. If the cash consideration is all allocated to the Class 2 shares (i.e., 100 shares of Z stock allocable to Class 1, and 50 shares of Z stock plus $50 cash allocable to Class 2) ("Scenario 3"), the taxpayer would recognize no gain on either its Class 1 or Class 2 shares.[20]

These different gain results lead to different basis amounts for the blocks of Z stock received (75 shares having a $10 basis and 75 shares having a $125 basis in Scenario 1, 50 shares having a $10 basis and 100 shares having a $150 basis in Scenario 2, and 100 shares having a $10 basis and 50 shares having a $100 basis in

[20] An alternative methodology to those set forth in Scenarios 1 through 3 might be to require gain recognition in an amount equal to the lesser of (i) the aggregate amount of gain realized with respect to the surrendered shares and (ii) the amount of cash received (the "Maximum Gain Recognition Methodology"). While the Maximum Gain Recognition Methodology would lead to the same result as Scenario 2 on the facts in the text, in many circumstances the Maximum Gain Recognition Methodology would lead to differing results. The Maximum Gain Recognition Methodology is inconsistent with the long standing block-by-block methodology for determination of gain and loss set forth in Revenue Ruling 68-23, 1968-1 C.B. 144 (which, on the facts in the ruling, applied a proportional allocation of cash consideration similar to the methodology employed in Scenario 1 in the text). Moreover, it is inconsistent with the long standing asset-by-asset approach to determining gain recognition in Section 351 transactions set forth in Revenue Ruling 68-55, 1968-1 C.B. 140.

Scenario 3). The foregoing basis determinations assume that basis for each block of shares received is determined under the same methodology used to allocate consideration and determine gain. The Proposed Regulations, when finalized, should confirm that this is the case.

The determination of how non-stock consideration is allocated among classes of stock and other assets transferred has implications beyond basis determinations under Section 358, including, in some cases, the qualification of a transaction as a reorganization under Section 368.[21] Because the determination implicates broader policy questions, we understand there may be reluctance to address this issue solely in the context of the Proposed Regulations. Rather than delay finalizing the Proposed Regulations pending addressing the appropriate allocation of non-stock consideration, we recommend that the Proposed Regulations be finalized as soon as possible. Pending further guidance on allocation issues, either the final regulations or the preamble thereto might simply clarify that consideration is allocated for purposes of Section 358 in the same manner as it is for other purposes of the tax law, such as determining the amount of gain recognized by the taxpayer in the reorganization.

[21] In certain circumstances, how stock consideration received is allocated among classes of stock surrendered may also impact the qualification of a transaction as a reorganization. For example, assume that voting stock having a value of $80 and non-voting stock having a value of $20 is received, and both voting and non-voting stock in a target corporation having an aggregate value of $100 is surrendered, in a transaction in which a subsidiary of the acquiring corporation is merged into the target corporation. Unless the voting and non-voting stock received is allocated proportionately to each class of stock surrendered, the transaction will not qualify, for example, as a reorganization under Sections 368(a)(1)(A) and (a)(2)(E)

C. Consider Extending the Basis Tracing Regime to All Section 351 Transactions.

In the case of an exchange described in both Section 351 and Section 354 or Section 356, the basis tracing regime of the Proposed Regulations does not apply if, in connection with the exchange, the taxpayer exchanges property for stock or securities in an exchange to which neither Section 354 nor Section 356 applies or liabilities of the taxpayer are assumed. Prop. Reg. § 1.358-2(a)(2)(iv). Accordingly, if, for example, a taxpayer transferred solely stock of one corporation to another corporation in a transaction described in both Section 368(a)(1)(B) and Section 351, the basis tracing regime would apply, but if in addition to stock, the taxpayer transferred another asset to the acquiring corporation in connection with the transaction, the basis tracing regime would not apply. Cf. Prop. Reg. § 1.358-2(c), Example 4 and Example 5. Similarly, if a taxpayer transferred solely stock in an exchange described in both Section 368(a)(1)(B) and Section 351, the basis tracing regime would apply, but if the taxpayer transferred solely stock representing a minority interest in the subject corporation and the transaction only qualified under Section 351, the basis tracing regime would not apply.

The Proposed Regulations do not specify what regime does apply to a Section 351 exchange that does not qualify in its entirety as a reorganization, or in which liabilities are assumed; presumably the split basis and split holding period approach described in Revenue Ruling 85-164 would apply. If so, significantly different basis and holding period results can ensue from seemingly minor changes in the facts. The preamble to the Proposed Regulations states that the above-described limitation on the application of the basis tracing regime is meant "to prevent a conflict between . . . those

rules that apply to determine basis of stock received in a transaction to which section 351 applies (including the effect of section 357(c)),” and the basis tracing rules of the Proposed Regulations. We believe that, as a general matter, having substantially different regimes apply to the determination of the basis of stock received in a tax free exchange for stock -- depending on what may be minor differences in the form of the transaction -- is undesirable. We therefore recommend that the IRS and Treasury consider whether the basis tracing regime should be extended to apply more broadly to exchanges governed by Section 351.

We realize that, in certain cases, administrative or policy considerations may outweigh the desire for consistency with respect to Section 351 transactions. As the IRS explained in G.C.M. 39418 (October 14, 1985), one benefit of a basis averaging regime is that it avoids the need to determine relative fair market values of each of the assets transferred in a Section 351 transaction, which would be burdensome, would not necessarily be based on arm’s-length bargaining, and, as noted in to the G.C.M., may in some cases present potential for abuse.[22]

Another reason for preferring a basis averaging regime in the Section 351 context may be concern that basis tracing may enable a taxpayer to maintain a significant interest in the assets transferred to the transferee corporation while selectively reaping the benefits of its high basis in certain of the transferred assets. Consider, for example, a taxpayer that owns six assets, each with an equal value, one with a high basis and five

[22] We note, however, that under Revenue Ruling 68-55, 1968-1 C.B. 140, individual asset valuation is required whenever boot is received in a Section 351 transaction. Moreover, if a split holding period regime is to apply, valuations would be necessary for assets with different holding periods even where no boot is received.

with a low basis. The taxpayer transfers all of the assets to a new corporation in exchange for six shares of stock in a Section 351 transaction. If the taxpayer is permitted to trace its basis from specific assets to specific shares, the taxpayer would be able to dispose of its one high basis share in order to monetize a portion of its investment with minimal up-front tax cost, even though it retains a continuing economic interest in the high basis asset through its other five shares in the corporation. This might lead to arguably inappropriate results in certain cases. However, such results may also be achievable in the reorganization context. Moreover, the investment company rules of Section 351(e) limit the extent to which non-operating assets can be used to achieve such arguably inappropriate results. In any event, while basis averaging may eliminate potential inappropriate results, it seems a blunt tool for the job.

We believe that, notwithstanding the concerns described above, in some situations -- such as a pure stock-for-stock exchange under Section 351 -- the application of a basis tracing regime to Section 351 transactions merits consideration (even if it is not extended to all Section 351 transactions). If the government were to extend the basis tracing regime to Section 351 transactions other than pure stock-for-stock exchanges, it could maintain elements of a basis averaging approach by applying a basis averaging rule to the stock received in exchange for non-stock assets (the "Hybrid Approach"). This Hybrid Approach and related issues are discussed in greater detail below.

1. Combine Basis in Assets Other Than Stock or Securities Contributed in a Section 351 Transaction.

As discussed above, one argument against basis tracing in Section 351 transactions involving the contribution of assets other than stock and securities is the

administrative impracticability of tracing individual bases upon the transfer of a multitude of assets, as in the transfer of an entire operating business. To avoid this administrative burden, we recommend that consideration be given to treating all transferred assets other than stock and securities as a single asset solely for determining the bases of stock and securities received in the Section 351 exchange.[23] This Hybrid Approach eliminates the administrative difficulty in tracing the bases in many assets, while maintaining consistency between basis allocations for stock transfers in reorganizations and Section 351 transactions.

To illustrate the Hybrid Approach, consider a contribution by the taxpayer to new Corporation A of 100 shares of Corporation T common stock with a basis of $100 and a fair market value of $250 ("T CS 1"), 100 shares of Corporation T common stock with a basis of $300 and a fair market value of $250 ("T CS 2"), a truck with a basis of $20 and a fair market value of $100, inventory with a basis of $80 and a fair market value of $50 and a building with a basis of $100 and a fair market value of $350. In return, the taxpayer receives 1000 shares of Corporation A common stock with a fair market value of $1000 ("A CS"). The tables below summarize these facts.

Surrendered			
Property	Shares	Basis	FMV
T CS 1	100	$100	$250
T CS 2	100	$300	$250
Truck		$20	$100
Inventory		$80	$50
Building		$100	$350
Total	200	$600	$1000

Received		
Property	Shares	FMV
A CS	1000	$1000
Total	1000	$1000

[23] Our proposal, however, would not eliminate the transferor's burden of determining gain and loss on an asset-by-asset basis under current law, which can be quite onerous. See Rev. Rul. 68-55, 1968-2 C.B. 140.

Under Revenue Ruling 85-164, each share of common stock received in a Section 351 transaction by the transferor is treated as received in respect of all of the assets transferred in proportion to the relative fair market values of the transferred assets, and accordingly each individual share has a split basis and holding period. Under the Hybrid Approach, the basis tracing regime of the Proposed Regulations would apply to the transferred shares and basis/holding period splitting could be applied, if appropriate, to the transferred non-stock assets. Accordingly, 250 shares of the Corporation A common stock would be treated as received for the low-basis T shares, 250 shares of the Corporation A common stock would be treated as received for the high-basis T shares, and the remaining 500 shares of Corporation A common stock would be treated as having been received for, collectively, the truck, inventory and building. Because there is no boot and no gain recognition in this example, the basis of each exchanged asset carries over without any adjustment. This is illustrated in the tables below.

Surrendered			
Property	Shares	Basis	FMV
T CS 1	100	$100	$250
T CS 2	100	$300	$250
Truck		$20	$100
Inventory		$80	$50
Building		$100	$350
Total	200	$600	$1000

Received			
Property	Shares	FMV	Basis
A CS	250	$250	$100
A CS	250	$250	$300
A CS	500	$500	$200
Total	1000	$1,000	$600

Although the Hybrid Approach may require aggregate valuation of non-stock assets and individual valuation of stock in circumstances not required under present law, the basis allocation consistency achieved for stock exchanged may outweigh the incremental administrative burden.

2. Coordination with Section 357.

In reorganization transactions, the assumption of a taxpayer's indebtedness in connection with the transaction generally is treated as boot received by the taxpayer in the reorganization. As such, the liability assumption generally does not raise additional issues beyond those raised by other types of boot.

In the context of a Section 351 transaction, however, the assumption of the taxpayer's liabilities is governed by Section 357. Under Section 357, the taxpayer generally does not recognize gain as a result of a liability assumption unless the sum of the liabilities assumed exceeds "the total adjusted basis of the property transferred." I.R.C.§ 357(c)(1).[24] Regardless of whether the liability assumption gives rise to gain recognition, the liability assumption generally results in a reduction in the basis of shares received by the taxpayer in the exchange. I.R.C. § 358(a)(1)(A)(ii) and (d)(1).[25]

The aggregate nature of Section 357 presents challenges to applying a basis tracing regime to Section 351 transactions. In order to apply a basis tracing regime, the basis reduction occasioned by Section 357 liability assumptions would need to be allocated on a block-by-block basis. Treating non-stock assets as one mass asset and applying basis tracing to transferred stock and the mass non-stock asset helps mitigate, but does not eliminate, these challenges. Accordingly, if basis tracing is to be extended

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[24] Section 357(b) provides an exception to this "nonrecognition" treatment in the case of certain assumptions having a tax avoidance purpose or lacking a bona fide business purpose.

[25] Liabilities assumed that would give rise to a deduction and certain other liabilities are generally excluded for purposes of both gain recognition and basis reduction determinations. I.R.C. § 357(c)(3), 358(d)(2).

to all Section 351 transactions, some method must be devised for allocating liabilities assumed in the transaction.

As previously discussed, Section 357(c) applies only when aggregate liabilities assumed exceeds the aggregate basis of the transferred assets. Therefore, any method devised for determining the amount of liabilities assumed on an asset-by-asset (or block-by-block) basis must allocate liabilities in such a way that no Section 357(c) gain is determined with respect to any asset (or block) except in cases where there is aggregate Section 357(c) gain. For example, if for purposes of calculating individual bases, assumed liabilities were allocated to the exchanged assets in proportion to fair market values -- the method often used to allocate other types of consideration -- Section 357(c) gain often would be overstated. Such overstatement would occur, for example, whenever the liabilities ratably allocable to an asset exceed the basis of such asset but aggregate liabilities do not exceed the aggregate basis of the transferred assets.

The Section 357(c)-Based Approach. One approach to this dilemma posed by liability assumptions is described in Cohen & Whitney. Their approach, which is described in greater detail below, is essentially to allocate Section 357(c) gain, and the excess liabilities giving rise thereto, among the transferred assets in proportion to the value of such assets less allocated liabilities not in excess of aggregate basis (with liabilities not in excess of aggregate basis allocated among the transferred assets in proportion to the transferred assets' tax basis). Their multi-step allocation approach (the "Section 357(c)-based approach") breaks down what combination of each class of stock, boot and liability assumption is received for each asset transferred. The approach is designed to ensure that the Section 357(c) gain computed for individual assets will sum to

the aggregate amount of Section 357(c) gain required by the statute and that total consideration and liabilities assigned to an asset will not exceed that asset's fair market value.

Under the first step of the Section 357(c)-based approach, assumed liabilities are allocated to each transferred asset in proportion to such asset's basis, to the extent of such basis. This step ensures that the computation will not arrive at any Section 357(c) gain for any particular asset in instances where assumed liabilities in the aggregate do not exceed aggregate basis. If all of the liabilities are allocated pursuant to this first step, then aggregate liabilities do not exceed aggregate basis and Section 357(c) does not apply. Nevertheless, because liabilities have been allocated in accordance with tax basis on an asset-by-asset basis, and basis tracing traces basis in stock received to specific blocks of stock transferred, allocating liabilities in accordance with the tax bases of assets transferred permits the determination of basis in shares received even where liabilities assumed do not exceed the aggregate basis of transferred assets. Moreover, because under the Hybrid Approach described above for Section 351 transactions all non-stock assets are treated as one mass asset, there is no need to allocate assumed liabilities to individual non-stock assets. Assuming there is no other boot in the transaction, in circumstances where liabilities do not exceed aggregate asset basis, the shareholder's basis in each block of stock received will be equal to the basis in the transferred stock, or aggregate basis in the mass asset, exchanged for such block of received stock, less the amount of assumed liability allocated to the transferred stock or mass asset, as the case may be.

Where the aggregate liabilities assumed do exceed the aggregate basis of stock and other assets transferred, there will be excess liabilities that are not allocated in the first step of the Section 357(c)-based approach. The second step of the Section 357(c)-based approach allocates these excess liabilities in proportion to the positive fair market values of the transferred assets, as reduced by the liabilities allocated thereto in the first step. This step ensures that, to the extent the assumed liabilities exceed basis, the gain attributable to such excess is allocated to assets upon which a gain is realized. In the last step of the Section 357(c)-based approach, any other boot is allocated in proportion to the positive fair market values of the assets transferred, as reduced by the liabilities allocated thereto in the first two steps.

As described in Cohen & Whitney, there may be reasons to deviate from these basic steps in some instances, such as where liabilities assumed in the exchange are secured by particular transferred assets.

To illustrate the computations required in the Section 357(c)-based approach, consider the following example. In a contribution by the taxpayer to new Corporation A (in a transaction to which section 304 does not apply) of 100 shares of Corporation T common stock with a basis of $200 and a fair market value of $150 ("T CS 1") and another 100 shares of Corporation T common stock with a basis of $50 and a fair market value of $150 ("T CS 2"), the taxpayer receives 120 shares of Corporation A common stock with a fair market value of $120 ("A CS"), and Corporation A also assumes a $180 unsecured liability of the taxpayer. The tables below summarize these facts.

Surrendered			
Property	Shares	Basis	FMV
T CS 1	100	$200	$150
T CS 2	100	$50	$150
Total	200	$250	$300

Received		
Property	Shares	FMV
A CS	120	$120
Liabilities		$180
Total	120	$300

No gain or loss is recognized in the exchange, because only nonrecognition property is received and the aggregate basis in the surrendered assets exceeds the sum of the liabilities assumed. For purposes of determining basis under the Section 357(c)-based approach, the liabilities are allocated to the surrendered assets first in proportion to their bases, to the extent of their bases. This step is shown in the next table as Allocation Step 1. Next, the remaining liabilities (in this case, none) are allocated in proportion to the positive fair market values of the exchanged assets as reduced by the liabilities allocated in Allocation Step 1. This step is shown in the next table as Allocation Step 2. After the liabilities are so allocated to each asset, the figures may be compared to the assets' bases to calculate the Section 357(c) gain attributable to each asset, and may be compared to the assets' fair market values to determine the residual values for purposes of allocating the stock received to the blocks of stock exchanged. The table below shows these computations.

Allocation of Liabilities and Consideration							
Property	Allocation Step 1	Residual FMV	Allocation Step 2	All Liabilities	§ 357(c) Gain	Residual FMV	% of A Stock
T CS 1	$144	$ 6	$0	$144	$0	$6	5%
T CS 2	$36	$114	$0	$36	$0	$114	95%
Total	$180	$120	$0	$180	$0	$120	100%

Under this approach, 5% of the Corporation A stock will be treated as received in exchange for the T CS 1 block of Corporation T common stock and 95% for

the T CS 2 block. The taxpayer's total basis in the Corporation A stock received in the exchange will be $70, because that is the original basis ($250) decreased by the boot (which for this purpose includes the $180 assumed liabilities). The basis attributable to the T CS 1 block will be $56 (its original basis of $200 less $144 of allocated liabilities treated as boot) and the basis attributable to the T CS 2 block will be $14 (its original basis of $50 less $36 of allocated liabilities). The share of the basis attributable to each block of Corporation T common stock is traced to the blocks of Corporation A stock treated as received therefor, ("A CS 1" and "A CS 2"), as shown below.

Reg. § 1.358--1(a) Total Basis	
Basis in TCS	$250
Boot Received	-$180
Dividend	$0
Gain Recognized	$0
Basis in A stock	$70
(Basis in) Boot	$0

Tracing Basis					
Adjusted Basis	A Block	Shares	Value	Basis	Basis Per Share
T CS 1: $56	A CS 1	6	$6	$56	$9.33
T CS 2: $14	A CS 2	114	$114	$14	$0.12
	Total	120	$120	$70	$0.58

The approach suggested above, however, does add complexity to the determination of basis in a transaction to which Section 357 applies. As the last table above shows, it can also lead to very high basis shares with disproportionately low values. The Section 357(c)-based approach treats high-basis shares as being surrendered for a disproportionately large portion of the aggregate liability assumption and a disproportionately small portion of the received stock. This tends to concentrate built-in loss so that after the exchange, the taxpayer may be able to recognize all of the losses that were inherent in surrendered shares by selling a very small portion of the shares received. The example above shows that the $50 loss inherent in the first block of T common stock is carried over to the first block of A stock, and the $100 gain inherent in the second block of T common stock is preserved in the second block of A stock. The allocation,

however, allows the taxpayer to recognize its entire loss by selling 5% of its interest in Corporation A, whereas prior to the exchange it would have had to sell 50% of its interest in Corporation T to recognize such loss.[26]

A Modified Section 357(c)-based Approach. In order to reduce the possibility of such distortion, another alternative for determining basis in nonrecognition property may be a regime in which the Section 357(c)-based approach is followed for all liabilities assumed and boot received by the transferor in a Section 351 transaction, but stock received is allocated to the surrendered property in proportion to the actual fair market value of the surrendered property, and not in proportion to the fair market values as reduced by allocated liabilities and boot.

To illustrate, consider the facts presented in the previous example. The allocation of liabilities to the two blocks of Corporation T common stock is identical under this method and is shown in the table below. Under this method, however, the allocation of the Corporation A stock to each of the surrendered blocks of stock is not based on the residual fair market values (after reduction for allocated liabilities), but instead is based on the relative fair market values of the two equal-sized blocks of Corporation T common stock. Accordingly, the percentage of Corporation A stock allocated to each of the blocks of stocks surrendered is 50%, as shown in the table, instead of 5% and 95% as under the Section 357(c)-based approach.

[26] In certain circumstances, the liability assumption allocated to a built-in loss asset under the Section 357(c)-based approach may equal or exceed the fair market value of the built-in loss asset, resulting in no shares in the acquiring corporation being treated as issued in exchange for the built-in loss asset. For a discussion of this issue, see Cohen & Whitney at 1007-11.

Allocation of Liabilities and Consideration							
Property	Allocation Step 1	Residual FMV	Allocation Step 2	All Liabilities	§ 357(c) Gain	Original FMV	% of A Stock
T CS 1	$144	$6	$0	$144	$0	$150	50%
T CS 2	$36	$114	$0	$36	$0	$150	50%
Total	$180	$120	$0	$180	$0	$300	100%

As under the Section 357(c)-based approach, the basis to be traced from the T CS 1 block will be $56 and the basis to be traced from the T CS 2 block will be $14. Unlike the former approach, however, each of these will be traced to an equal-sized 60-share block of Corporation A stock, as shown in the tables below.

Reg. § 1.358--1(a) -- Total Basis	
Basis in TCS	$250
Boot Received	-$180
Dividend	$0
Gain Recognized	$0
Basis in A stock	$70
(Basis in) Boot	$0

Tracing Basis					
Adjusted Basis	A Block	Shares	Value	Basis	Basis Per Share
T CS 1: $56	A CS 1	60	$60	$56	$0.93
T CS 2: $14	A CS 2	60	$60	$14	$0.23
	Total	120	$120	$70	$0.58

This example produces an arguably less distortive basis result than in the prior example, because there is not a concentration of basis in a very small percentage of the shares received. The result is less satisfactory than in the Section 357(c)-based approach, however, in the sense that it does not replicate the combination of gain and loss shares that existed before the exchange. None of the received shares under this modified approach has a built-in loss.

One further modification to the foregoing method might be considered. The distortive results of allocating liabilities to specific surrendered assets stem from the uneconomic allocation of liabilities required by Section 357. In other contexts, the consideration received is generally allocated among surrendered assets in proportion to

their fair market values. As discussed above, that method of allocating assumed liabilities is undesirable for basis allocation purposes because it can yield blocks of stock with negative bases or improper Section 357(c) gain. However, to make the allocation more rational, liabilities could be allocated in proportion to fair market values to the extent possible, with a reallocation to other blocks when there is an allocation of liabilities to a particular block that exceeds the basis of that block.

Applying this modification to the foregoing example, the allocation of liabilities would be slightly different. Of the $180 of assumed liabilities, $90 would be tentatively allocated to each of the two blocks of Corporation T common stock. The $40 of excess liabilities so allocated to the T CS 2 block would be reallocated to the T CS 1 block. This results in an allocation of $130 and $50 to the two blocks, shown in the table below as Allocation Step 1. As in the prior example, the Corporation A stock is still allocated in proportion to the fair market values of the two equal-sized blocks of Corporation T common stock.

Allocation of Liabilities and Consideration							
Property	Allocation Step 1	Residual FMV	Allocation Step 2	All Liabilities	§ 357(c) Gain	Original FMV	% of A Stock
T CS 1	$130	$20	$0	$130	$0	$150	50%
T CS 2	$50	$100	$0	$50	$0	$150	50%
Total	$180	$120	$0	$180	$0	$300	100%

In this case, the basis to be traced from the T CS 1 block will be $70 (the original $200 basis less $130 of allocated liabilities) and the basis to be traced from the T CS 2 block will be $0 (the original $50 basis less $50 of allocated liabilities). The final tracing of basis to the received shares is shown in the tables below.

Reg. § 1.358-1(a)-- Total Basis	
Basis in TCS	$250
Boot Received	-$180
Dividend	$0
Gain Recognized	$0
Basis in A stock	$70
(Basis in) Boot	$0

Tracing Basis					
Adjusted Basis	A Block	Shares	Value	Basis	Basis Per Share
T CS 1: $70	A CS 1	60	$60	$70	$1.17
T CS 2: $0	A CS 2	60	$60	$0	$0.00
	Total	120	$120	$70	$0.58

This methodology comes slightly closer to replicating the mix of gain and loss shares that were held prior to the exchange.

All of the methods described here have advantages and disadvantages. The Section 357(c)-based approach is the most internally consistent in that it considers each asset surrendered to be exchanged for a mix of nonrecognition property, liability assumptions and boot. The modified Section 357(c)-based approaches, in contrast, ignore the allocation of liabilities and boot in determining the allocation of nonrecognition property. Forcing together aggregate and individual asset concepts may lead to certain discontinuities. The modified approaches, however, seem less susceptible to abuse than the unmodified Section 357(c)-based approach. All of these approaches may result in the recognition of more or less gain by the taxpayer than an allocation of boot and excess liabilities strictly in accordance with fair market values.[27]

A full exploration of the Section 357(c)-based and other approaches are beyond the scope of this Report. Our purpose in discussing these approaches is to suggest that the aggregate computation of Section 357(c) gain required by the statute is

[27] Amendments to the Regulations under Section 357 may be necessary to implement the Section 357(c)-based approach or the other approaches discussed in this Report.

not necessarily irreconcilable with an asset-by-by asset (or block-by-block) allocation of all consideration in a Section 351 exchange, including assumed liabilities.

If a Section 357(c)-based or other approach to reconciling Section 357 with basis tracing proves to be too cumbersome administratively or unacceptable as a policy matter, then we recommend that transactions to which Section 357 applies be made the exception to the general rule of basis tracing and that basis in both stock and non-stock assets in such cases be determined in accordance with Revenue Ruling 85-164 (or whatever other methodology is appropriate in such context). To the extent there is concern that liability assumptions may be used to selectively elect basis averaging or splitting, consideration could be given to promulgating regulations explicitly stating that in such cases the assumption of liabilities may be treated as having a tax avoidance purpose or lacking a bona fide business purpose within the meaning of Section 357(b), thereby potentially taking the assumption out of Section 357(a) and (c) and subjecting the transaction to the basis tracing rules.

3. FIFO Considerations.

One question left open by the adoption of the FIFO Rule as the universal default rule in Proposed Regulations section 1.358-2(a)(2)(iii) is, in the case of Section 351 transactions to which a Hybrid Approach is applied, when are shares received in exchange for mass non-share assets deemed to have been acquired. The FIFO Rule looks to the date of the acquisition of the original block of stock that was exchanged for the block of stock in question. Therefore, each block of stock received for stock will have an acquisition date for applying the FIFO regime that is some single date before the exchange (or, in the case of the few blended shares, a blended date with an apparent place

in the sequence). Under the Hybrid Approach, however, the block of stock received for the mass non-stock assets generally will not have a corresponding single acquisition date, because it will have been received for a pool of assets that were acquired on various dates. While the most conceptually consistent rule to fill this gap would be to create some weighted-average acquisition date, we note that the split basis/split holding period rule to be applied under Revenue Ruling 85-164 to the stock that is received for multiple assets was meant to avoid creating a rule that was difficult to administer. We also note that the FIFO Rule is merely a default rule that applies only when the taxpayer does not make a Designation. In light of these considerations, we recommend adopting a rule that is relatively simple to apply, such as a rule that, solely for purposes of applying the FIFO Rule, requires the block of shares received in exchange for the non-stock assets be treated as received in exchange for assets acquired immediately before the exchange. (We do not, however, propose that such a rule be applied to determine the actual holding period of the block of shares received in exchange for non-stock assets.)

D. Provide a Methodology for Basis Determinations in "Stockless" Reorganizations.

It is not clear under the Proposed Regulations how basis should be determined in the case of a reorganization in which no stock is issued, such as, for example, a reorganization under Section 368(a)(1)(D) in which no stock is taken back or an amendment to a corporation's articles of incorporation resulting in a constructive recapitalization.[28] To be consistent with the basis tracing regime in the Proposed

[28] See Reg. § 1.1502-19(g), Example 2(c) (acknowledging possibility of a reorganization under Section 368(a)(1)(D) even though no stock is issued in the reorganization); J.E. Davant v. Commissioner, 366 F.2d 874, *cert. denied*, 386 U.S. 1022 (where owners of two corporations transferred the stock of one corporation to a third party and as part of the plan that party dissolved that corporation and transferred

Regulations, we believe that the basis of stock after a reorganization in which no stock was issued should be treated as if (i) the appropriate amount of stock had been issued, with basis traced from exchanged shares to shares deemed received under the general rules applicable to reorganizations, and then (ii) the number of shares in each block was reduced ratably in a recapitalization.

To illustrate, consider Corporation P, which directly and wholly owns two subsidiaries, S1 and S2. P owns 100 shares of S1 with an aggregate basis of $100, and 100 shares of S2 with an aggregate basis of $200. The fair market value of the stock of each of S1 and S2 is $100. S1 is merged into S2 in a transaction described in Section 368(a)(1)(D) and in which P does not take back any additional stock in S2. In this example, there appear to be least two ways to allocate P's basis in its S1 and S2 stock. Under one method, P would have a $3 basis in each of its S2 shares. Under the other method, P would have a $2 basis in each of 50 of its S2 shares, and a $4 basis in each of its remaining 50 S2 shares. The latter approach is consistent with the result that would ensue under the basis tracing approach in the Proposed Regulations if, in the merger, P

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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); Rev. Rul. 75-383, 1975-2 CB 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 CB 81 (same); Rev. Rul. 56-654, 1956-2 CB 216 (amendment to articles of incorporation that increased the value of preferred and decreased the value of the common was a recapitalization even though no exchange of shares occurred). See also Regulations section 1.358-6 addressing basis determinations in certain triangular reorganizations. Under Regulations section 1.358-6, the taxpayer's basis in stock of its subsidiary is increased by either the target's basis in its assets (less liabilities) or the transferring shareholders' basis in the target stock, depending on the circumstances. Regulations section 1.358-6 and the examples thereunder merely state that the taxpayer's aggregate basis in the stock of its subsidiary is increased without providing guidance as to how, or whether, that increase is traced to particular shares or blocks of shares in the subsidiary. But see recently proposed regulations (REG-125628-01) addressing, among other things, basis determinations in the context of certain foreign triangular reorganizations. Under those proposed regulations, a foreign parent corporation is generally required to split its basis in shares of subsidiary stock. These proposed regulations, which appear to adopt the split basis approach over concern regarding avoidance of Section 1248 gain that is unique to transactions involving certain types of foreign corporations, will be the subject of a separate report.

had taken back an additional 100 shares of S2 stock and then S2 effected a recapitalization with each of the 200 shares (100 with a basis of $1 and 100 with a basis of $2) undergoing a reverse 1-for-2 stock split. We believe that the second approach is more appropriate, in part because half of the value of the S2 stock is attributable to the stock of S1 that S2 now owns, and in part because the alternative approach would result in taxpayers having averaged or split-basis shares, contrary to the basic basis tracing regime of the Proposed Regulations.[29]

If the basis tracing regime is extended to Section 351 transactions, we believe that "stockless" Section 351 transactions[30] should be treated in the same manner as stockless reorganizations described above.[31]

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[29] In the case of a certain "stockless" recapitalizations and reorganizations, the issue of which shares are deemed exchanged may arise. For example, assume a taxpayer holds two blocks of 150 shares each of common stock in Corporation Y, one block with a basis of $60 and one with a basis of $20, each having a fair market value of $50, and one block of 100 shares of preferred stock (that is not non-qualified preferred stock) with a basis of $80 and a value of $100. Corporation Y's certificate of incorporation is amended, resulting in a deemed recapitalization with, as a result of the amendments, the preferred shares being worth $125 and the common shares being worth $75 (cf. Rev. Rul. 56-654). In such circumstances, we believe it would be appropriate to employ Proportional Allocation (described in IV.A.2.a. above) with the result that after the recapitalization, the taxpayer would hold one block of common stock having a basis of $45 and a fair market value of $37.50, one block of common stock having a basis of $15 and a fair market value of $37.50 and three blocks of preferred stock -- one block of 10 shares, having a fair market value of $12.50 and a basis of $15, a second block of 10 shares with a fair market value of $12.50 and a basis of $15 and a third block of 80 shares, having a fair market value of $100 and a basis of $80. An alternate approach would be to permit Designated Allocations. Under this approach, in the preceding example the taxpayer could choose to treat solely high-basis common shares, solely low-basis common shares or any combination of the two having an aggregate value of $25 as being constructively exchanged for new preferred shares having an aggregate value of $25. If, for example, the taxpayer chose solely high-basis common shares, the result would be as follows. The taxpayer would be treated as having surrendered 75 shares of common stock having a basis of $30 and a fair market value of $25 for 25 shares of new preferred stock having a basis of $30 and a fair market value of $25. The taxpayer would then be treated as recapitalizing the 225 shares of remaining common stock, 150 of which have a basis of $20 and 75 of which have a basis of $30, into 300 shares of common stock, 200 of which have a basis of $20 and 100 of which have a basis of $30, and as recapitalizing the 125 shares of preferred stock, 25 of which have a basis of $30 and 100 of which have a basis of $80, into 100 shares of preferred stock, 20 of which have a basis of $30 and 80 of which have a basis of $80.

[30] For examples of "stockless" Section 351 transactions, see Reg. § 1.1502-19(g), Example 2(a) (acknowledging possibility of a Section 351 transaction in which no stock is issued); Lessinger v.

E. Special Consolidated Return Considerations.

The regulations governing consolidated returns contain rules that often deviate from those applicable outside of the consolidated return context. We believe that, in certain circumstances, it may be appropriate for the consolidated return regulations to modify the basis allocation rules in the Proposed Regulations and those recommended in this Report to reflect single entity principles and other policy considerations applicable to consolidated returns. For example, it may be appropriate to modify the application of the Proposed Regulations to Section 355 transactions and the stockless reorganization recommendation of this Report to reflect special considerations applicable to excess loss accounts. [32] Also, the blended stock basis approach of Regulations section 1.1502-35T, although inconsistent with a basis tracing regime, may be appropriate in the consolidated return context.

F. Coordination with Section 1036.

As discussed earlier in this Report, Section 1036, in conjunction with Section 1031 and the Regulations promulgated thereunder, provides rules for determining

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Commissioner, 85 T.C. 824 (1985), rev'd on other grounds, 872 F.2d 519 (2d Cir. 1989); Rev. Rul. 64-155, 1964-1 C.B. 138 (1964). But see Abegg v. Commissioner, 429 F.2d 1209 (2d Cir. 1970), aff'g 50 T.C. 145 (1968), cert. denied, 400 U.S. 1008 (1971).

[31] We realize that our recommended approach to stockless reorganizations and Section 351 transactions is not consistent with the treatment of excess loss accounts under Reg. § 1.1502-19(g) in stockless transactions. As discussed in the text below, different considerations may apply in the consolidated return area, which considerations are best addressed by the consolidated return Regulations.

[32] Cf. Treas. Reg. § 1.1502-19(g), Example 2; I.R.C. § 358(g). Section 358(g) can also apply in the affiliated, non-consolidated context and, to the extent regulations are issued in such context, deviations from the Proposed Regulations and our recommendations may also be warranted. Similarly, there may be other provisions of the Internal Revenue Code where deviations from the basic basis tracing rules of the Proposed Regulations and our recommendations are warranted. If such deviations are warranted, we recommend that appropriate deviations be provided for in regulations under the specific Internal Revenue Code Section in question.

basis in property received in circumstances in which common stock is exchanged for common stock, or preferred stock is exchanged for preferred stock, in the same corporation. These rules will not necessarily be interpreted consistently with a basis tracing regime in all cases, even if the Proposed Regulations under Section 358 are finalized. We recommend that the Proposed Regulations clarify that where a transaction is governed both by Section 1036 and Section 354 or 356 (for example, a recapitalization of common for common, or preferred for preferred), the basis tracing rules of the Proposed Regulations apply.

In addition, we recommend that consideration be given to explicitly applying the basis tracing rules of the Proposed Regulations to transactions governed by Section 1036 to which neither section 354 nor 356 applies (for example, an exchange of common shares for common shares or preferred shares for preferred shares between individual shareholders). Even in the case of such "non-overlap" situations, the arguments in favor of basis tracing seem as compelling as in situations to which Section 354 or 356 applies.