

NEW YORK STATE BAR ASSOCIATION
TAX SECTION
REPORT ON BASIS RECOVERY IN A DIVIDEND EQUIVALENT
REDEMPTION
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I. Introduction

This report of the New York State Bar Association Tax Section discusses the issue of basis recovery in the context of certain redemption transactions that are treated under the Internal Revenue Code as a distribution under Section 301 (the "Report").² Generally, the issue arises where a corporation redeems some of its outstanding stock and the redeemed shareholder continues to own enough stock, either actually or constructively, such that Section 302(d) treats the redemption as a Section 301 distribution.³ If the distribution exceeds the corporation's earnings and profits, it is applied against and reduces the adjusted basis of the shareholder's stock under Section 301(c)(2) before the redeemed shareholder must recognize gain. Thus, the issue of which basis is available for reduction can be critical. While this issue certainly is not a new one,⁴ it has become a source of heightened concern as a result of a statement made by the

¹ The drafter of the Report was Karen Gilbreath Sowell, with significant assistance from Brian A. Peabody. Helpful comments were received from Kim Blanchard, Peter Blessing, Larry Garrett, Andrew Oringer, Michael Schler, Jodi Schwartz, Linda Swartz, and Gordon Warnke.

² All "Section" or "\$" references are to the Internal Revenue Code of 1986, as amended (the "Code").

³ The analysis and recommendations in this Report are limited to the common fact pattern involving a redemption of less than all of the shares of a single class where there are multiple blocks of stock with different bases.

⁴ See, e.g., Boris I. Bitker, *Stock Redemptions and Partial Liquidations Under the Internal Revenue Code of 1954*, 9 Stan. L. Rev. 13, 41, n. 103 (1956) (providing an example under which a shareholder with a \$100,000 basis in Corporation X stock has half of his stock redeemed for \$110,000 at a time when X has no earnings and profits, and concluding that the shareholder's basis in his retained X stock is reduced to zero and a \$10,000 gain is recognized). One commentator has observed that Bitker's approach differs from that of another commentator. See Jasper L. Cummings, Jr., *Service's Withdrawal of Regulations Under Sections 302, 304 Highlights Confusion About Stock Redemptions, Distributions*, Daily Tax Report, April 28, 2006, at J-3 (citing John Nolan, *The Uncertain Tax Treatment of Stock Redemptions: A Legislative*

Internal Revenue Service (the “Service”) and the Department of Treasury (“Treasury”) in the preamble to a recently issued regulation concerning the application of Section 367 to outbound stock transfers under Section 304.⁵ It appears from that statement that the Service and Treasury are of the view that only the basis of the shares actually (or fictionally) redeemed may be recovered under Section 301(c)(2), at least in the context of Section 304 outbound stock transfers. Further, shortly after the making the preamble statement, the Service and Treasury revoked proposed regulations issued in 2002 that would have dramatically altered the current rule for dividend equivalent redemptions that provides that “proper adjustment of the basis of the remaining stock will be made with respect to the stock redeemed.”⁶ In the notice of withdrawal, the Service and Treasury state that they are continuing to study the appropriate role for basis shifting in the context of dividend equivalent redemptions, and, in addition, the proper approach to the recovery of basis under Section 301(c)(2). Again, the Service and Treasury stated that the “better view” of current law is to limit the basis recovery to the basis of the shares redeemed, with no elaboration as to the scope of, or basis for, the statement. It appears that the statement was not intended to be limited only to Section 304 outbound stock transfers.

In light of the confusion created by the recent government statements on the issue of basis recovery in a dividend equivalent redemption transaction, and the regularity with which the issue arises in fact patterns that do not seem to implicate the government’s

Proposal, 65 Harv. L. Rev. 255, 283 (1951), as supporting the proposition that dividend equivalent redemptions reduce the basis of the stock redeemed).

⁵ REG-165579-02 (March 1, 2004).

⁶Treas. Reg. § 1.302-2(c). See Announcement 2006-30, 2006-19 IRB 879 (revoking Prop. Treas. Reg. §1.302-5 and other provisions issued in REG-150313-1 (2001)). Cf. *ABA Seeks Withdrawal of Proposed Anti-Basis-Shifting Transaction Regs*, 2003 TNT 178-47 (September 15, 2003) (urging the withdrawal of Prop. Treas. Reg. §1.302-5 and other provisions issued in REG-150313-1).

concerns in this area, the Report recommends that the Service and Treasury provide limited expedited guidance.

As described in the notice of withdrawal of the proposed regulations, there are a variety of difficult issues that are raised in the context of certain redemption transactions where the shareholder continues to own stock of the corporation, actually or constructively. The Report focuses only on the application of Section 301(c)(2) in the context of a Section 302(d) dividend equivalent redemption in which a corporation redeems some shares of a single class of stock owned by the shareholder and the shareholder is taxed under Section 301 solely because of the stock it continues to own directly (a “Basic Dividend Equivalent Redemption”). The Report considers five approaches to basis recovery in the Basic Dividend Equivalent Redemption case, concluding that either the All Shares Approach (under which the amount distributed in redemption is deemed to be distributed with respect to both the redeemed and non-redeemed shares, and any basis not recovered on the shares is then allocated to the non-redeemed shares), or the Recapitalization Approach (pursuant to which the redeeming corporation would be deemed to recapitalize the shareholder’s stock into a smaller number of shares that preserves the blocks of stock and the distribution would be made across the remaining shares) should be adopted in guidance. We do not believe that the approach seemingly favored by the Service and Treasury in its recent pronouncements is appropriate in the context of a Basic Dividend Equivalent Redemption, for the reasons described below. Further, we believe that this limited guidance should be issued on an expedited basis and any guidance in this area should be issued on a prospective basis only.

In the interest of expressing our views quickly with respect to Basic Dividend Equivalent Redemptions, the Report does not address the additional issues raised by the notice of withdrawal or otherwise in the context of dividend equivalent redemptions. Specifically, the Report does not address (1) the application of Section 301(c)(2) in the context of Section 304 transactions, (2) redemptions afforded Section 301 treatment as a result of constructive ownership of shares owned by another person, or (3) cases in which there are multiple classes of stock outstanding. Further, the Report does not address basis shifting under Treas. Reg. Section 1.302-2(c), or holding period issues. Significantly, we do not believe that issuing the limited guidance recommended in the Report would compromise the analysis of, and possible future guidance on, any of these other issues.

Part II of the Report is a background section describing the issue, the contexts in which it arises, and the relevant law and indications from the government that are taken into account by taxpayers under current law. Part III explores the various models upon which basis recovery can be determined, details the Tax Section's recommendations, and illustrates the effects of our recommendations.

II. Background

Distributions - Section 301

Under Section 301(c)(1), a distribution is first treated as a dividend to the extent of certain earnings and profits of the corporation. If the amount of the distribution is in excess of the relevant earnings and profits, under Section 301(c)(2), the distribution is applied against and reduces the adjusted basis of "the stock." "The stock" referred to by

Congress is the stock with respect to which the distribution was made.⁷ Where there is insufficient basis to be recovered against the distribution, under Section 301(c)(3), the remainder of the distribution is treated as gain from the sale or exchange of property.

In the context of an actual distribution declared by a corporation on a single class of stock, it is clear that the distribution is made with respect to all the shares, and the application of Section 301(c)(2) is straightforward. Where a shareholder of a distributing corporation owns blocks of stock that were acquired at different times or different prices, special consideration must be given to the allocation of the distribution among such blocks. In *Johnson v. U.S.*,⁸ where a corporation made a distribution to its sole shareholder who held his stock in two different blocks of a single class, the Fourth Circuit held that the distribution was made pro rata across the shares, and that as such, the taxpayer was required to recover basis under Section 301(c)(2) share-by-share, instead of on an aggregate basis, before gain was recognized under Section 301(c)(3). Other authorities follow this approach.⁹

⁷ Section 301(a)(1).

⁸ *Johnson v. U.S.*, 435 F.2d 1257 (4th Cir. 1971).

⁹ See *Kinch v. Comm'r*, 1 T.C.M. 147 (1942) (where a corporation declared a \$42,000 distribution on its preferred stock (for which the taxpayer had a \$300,000 basis) and a \$150,000 distribution on its common stock (for which the taxpayer had \$0 basis), and the amount of such distribution exceeded available E&P, the court did not permit the taxpayer to use any of his preferred stock basis to prevent the recognition of capital gain with respect to the common stock). Cf. *Estate of Rosset v. Comm'r*, 13 T.C.M. 1193 (1954) (taxpayer conceded, and the Tax Court agreed (without explanation) to a Service argument for a result identical to that of *Johnson* under similar facts); *Robert O. Anderson v. Comm'r*, 92 T.C. 138 (T.C. 1989) (observing the applicability of *Johnson* to a similar fact pattern); Rev. Rul. 68-348, 1968-2 C.B. 141 (ruling that, in the context of Section 331 liquidation in which the shareholder held several blocks of stock, each distribution must be allocated ratably among the several blocks of stock); Rev. Rul. 85-48, 1985-1 C.B. 126 (similar); Priv. Ltr. Rul. 8928066 (April 19, 1989) (applying the principles of *Johnson* in the case of a Section 355 distribution where the Service determined that the distributing corporation's shareholders were treated as having received a Section 301 distribution under Section 355(a)(3)(B) and Section 356(b)).

Redemptions under Section 302

If a corporation redeems stock¹⁰ and if Section 302(b)(1), (2), (3), or (4) applies,¹¹ such redemption is treated as a distribution in part or full payment in exchange for the stock, with the effect being that Section 1001 governs the transaction.¹² These distributions are awarded capital gain treatment because they are made disproportionately among the various shareholders.

In contrast, certain transactions that in form involve the redemption of shares are economically identical to distributions to shareholders that do not involve any redemption of shares (“dividend equivalent redemptions”).¹³ For example, if a single shareholder owns all of the stock of the redeeming corporation, the redemption of some shares from that shareholder for cash is economically indistinguishable from the mere distribution of corporate cash to the shareholder.¹⁴ In recognition of this, Section 302(d) taxes transactions that do not satisfy any of the criteria in Section 302(b) as corporate distributions subject to Section 301, notwithstanding their form as redemptions. A

¹⁰ Stock is treated as “redeemed” by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock is then cancelled, retired or held as treasury stock. Section 317(b).

¹¹ Section 302(b)(1) applies where a redemption is not essentially equivalent to a dividend, which generally means that the shareholder’s proportionate stock interest has undergone a meaningful reduction. Section 302(b)(2) applies where a redemption is substantially disproportionate with respect to the shareholder, which generally means that the shareholder owns less than 50 percent of the stock voting power and less than 80 percent of his pre-redemption proportionate stock interest. Section 302(b)(3) applies where a redemption effects a complete termination of the shareholder’s stock interest. Section 302(b)(4) applies where the shareholder receives the property in partial liquidation of the distributing corporation.

¹² Section 302(a); *see* Treas. Reg. §1.302-1(a) (stating that a distribution in redemption of stock is considered a distribution in part or full payment in exchange for the stock under Section 302(a) provided Section 302(b)(1), (2), (3), or (4) applies); *see also* Rev. Rul. 77-427, 1977-2 C.B. 100 (ruling that a redemption described in Section 302(b)(2) is treated as a sale under Section 1001); Priv. Ltr. Rul. 2003-07-001 (August 15, 2002) (similar, but in a Section 302(b)(1) context); Priv. Ltr. Rul. 2001-23-053 (March 12, 2001) (same); Priv. Ltr. Rul. 98-29-008 (April 13, 1998) (same).

¹³ Preamble, REG-150313-01 (2002).

¹⁴ *Id.*

corporation may redeem shares in lieu of declaring a distribution for a variety of business reasons. For example, a redemption may be employed as a means of avoiding foreign withholding tax, or a taxpayer may want to simplify its corporate structure or reduce the ownership of a particular shareholder.

When Congress enacted Section 302(d) in 1954 to provide that a dividend equivalent redemption should be treated as a distribution under Section 301, it did not make clear how Section 301(c)(2) should be applied in this context. There is no clear statement of law regarding whether the basis in all, or some, of the corporation's shares is reduced under Section 301(c)(2), and if so, how such a reduction is made.

Congress gave some indication of its understanding of the law in this area when it added Section 1059¹⁵ to the Code in 1984, and in the Conference Report stated that the conferees "wish to make clear their intention that if a redemption distribution is treated as a distribution under section 301 rather than a sale or exchange of the redeemed shares under section 302(a), the distribution is treated as made, pro rata, with respect to stock of the shareholder which is not redeemed."¹⁶ This statement strongly suggests that the shares redeemed should be treated as if they had been contributed to capital with respect to the non-redeemed shares immediately prior to the redemption, and that the distribution is then treated as made with respect to the non-redeemed shares. This characterization

¹⁵ If any corporation receives any extraordinary dividend with respect to any share of stock, and such corporation has not held such stock for more than two years before the dividend announcement date, the basis of such corporation in such stock generally is reduced (but not below zero) by the nontaxed portion of such dividends (generally, the portion of the dividend sheltered by any dividends received deduction). If the nontaxed portion of such dividends exceeds such basis, such excess is treated as gain from the sale or exchange of such stock for the taxable year in which the extraordinary dividend is received. In the case of any redemption of stock which is not pro rata as to all shareholders, any amount treated as a dividend with respect to such redemption is treated as an "extraordinary dividend" to which Section 1059(a)(1) and Section 1059(a)(2) apply without regard to the period the taxpayer held such stock.

¹⁶ See JCS-41-84 (1984); H.R. Rep. No. 861, 98th Cong. 2d Sess. (1984).

would indicate a basis shift *prior to* the application of Sections 301(c)(2) and (3).¹⁷ On occasion, the Service has adopted this approach in dealing with non-Section 1059 dividend equivalent redemptions.¹⁸

Subsequent changes to Section 1059 provide further evidence of Congress' belief that a shareholder's basis recovery is not limited to the shares redeemed in a redemption treated as a Section 301 distribution. For certain redemptions, Section 1059(e)(1)(A)(iii) expressly limits basis recovery to the basis of the shares redeemed, suggesting that Congress believed that the general rule is that basis in non-redeemed shares held by the shareholder also can be recovered.¹⁹

Deemed Dividend Equivalent Redemptions – Section 304

The basis recovery issue affects not only actual redemptions of shares that do not satisfy any of the categories of Section 302(b), but also deemed redemptions that occur as part of the tax fiction employed by Congress under Section 304 to prohibit capital gain treatment in sales of commonly controlled companies. Section 304(a)(1) generally provides that, for purposes of Sections 302 or 303, if one or more persons are in control of each of two corporations and in return for property one of the corporations acquires stock in the other corporation from the person(s) in control, then such property is treated as a distribution in redemption of the acquiring corporation's stock.

¹⁷ See Non-Redeemed Shares Approach, discussed *supra*. Cf. *Cox v. Comm'r*, 78 T.C. 1021 (1982) (in the context of a transaction under a prior version of Section 304(a)(1), court determined that basis shifted prior to testing the dividend-equivalent redemption under Section 301(c)(2)); Tech. Adv. Mem. 9748003 (August 8, 1997) (similar, but under the current statutory provision); F.S.A. 200111004 (November 14, 2000) (supplementing F.S.A. 200041009 (June 30, 2000)) (allowing full basis recovery in the context of a Section 304(a)(1) transaction involving an S corporation).

¹⁸ See 1999 IRS CCA Lexis 315 (June 16, 1999); 1996 FSA Lexis 145 (December 3, 1996).

¹⁹ The redemptions addressed in Section 1059(e)(1)(A)(iii) are redemptions that are dividend-equivalent by virtue of attribution of stock to an option holder and deemed redemptions under Section 304.

To the extent the distribution is treated as a distribution to which Section 301 applies, the transferor and the acquiring corporation are treated as if (1) the transferor transferred the stock of the issuing corporation to the acquiring corporation in exchange for stock of the acquiring corporation in a transaction to which Section 351(a) applies, and (2) the acquiring corporation then redeemed the stock it is treated as having issued. The ordering rules of Section 301(c) apply to determine the tax consequences of the deemed redemption of the fictional shares. First, the distribution is treated as a dividend to the extent of the acquiring corporation's and the issuing corporation's earnings and profits. Any excess distribution reduces the basis in the shares with respect to which the distribution is made, and finally results in capital gain. Again, the question arises as to which shares' basis is available for reduction under Section 301(c)(2).

Section 304 transactions are undertaken commonly to restructure within a corporate group and align and integrate operations following acquisitions. If a U.S. transferor transfers stock of a foreign or domestic corporation to a foreign acquiring corporation in exchange for property (an "outbound Section 304 transaction"), the transaction may effect a tax efficient repatriation of the property to the U.S. to the extent of the basis recovered under Section 301(c)(2).

In the preamble to recently issued final regulations that provide that Section 367 will not apply in the context of an outbound Section 304 transaction, the Service and Treasury appear to have taken the position that the amount of basis that may be recovered under Section 301(c)(2) is limited to the basis of the shares redeemed as part of the fiction created by Congress, as follows:

P, a domestic corporation, owns all the stock of F1 and F2, both of which are foreign corporations. P has an adjusted basis of \$0 in its F1 stock and \$100x in its F2 stock. P's stock of F1 and F2 has a fair market value of \$100x. Neither F1 nor F2 has current or accumulated earnings & profits. P sells its F1 stock to F2 for its fair market value of \$100x in a transaction subject to section 304(a)(1). Under section 304(a)(1), the transaction is treated as if P had transferred its F1 stock to F2 in exchange for F2 stock in a transaction to which section 351 applies, and then F2 redeemed such deemed issued stock.

Current law does not provide for the recovery of basis of any shares other than the basis of the F2 stock deemed to be received by P in the section 351(a) exchange (which would take a basis equal to P's basis in the F1 stock). Thus, P would recognize \$100x of gain under section 301(c)(3) (the built-in gain on the F1 stock), and P would continue to have a \$100x basis in its F2 stock that it holds after the transaction.²⁰

²⁰ Preamble, T.D. 9250 (2006); *see also* Preamble, REG-127740-04 (2005) ("In a section 304(a)(1) transaction in which a U.S. person transfers the stock of an issuing corporation to a foreign acquiring corporation, without the application of section 367(a), the U.S. person will nevertheless recognize an amount of income that is at least equal to the inherent gain in the stock of the issuing corporation that is being transferred to the foreign acquiring corporation. This income recognition results from the construct of the transaction as a distribution in redemption of the acquiring corporation shares. The income recognized may be in the form of dividend income, gain on the disposition of stock, or both. Section 301(c)(1), (3)." By stating that the income amount will at least equal the gain in the stock being transferred, the preamble seems to suggest that the only stock basis available for recovery is that of the transferred stock.). Prop. Reg. §1.304-2(c), Example 3 (limiting basis recovery to shares actually redeemed).

No citations are provided by the Service and Treasury for this preamble statement.²¹ Their view appears to follow from an acceptance of the form of the transaction as a redemption and a continuation of a basis theory that provides that basis is unique and attaches to the actual shares.

As noted, the Report does not address the application of Section 301(c)(2) in the context of a Section 304 transaction.

Review of Withdrawn Section 302 Regulations

In 2002, the Service and Treasury proposed regulations under Section 302 addressing basis recovery and basis shifting in redemptions. Significantly, Prop. Treas. Reg. § 1.302-5 proposed to repeal Treas. Reg. § 1.302-2(c), a long-standing provision which states that, “[i]n any case in which an amount received in redemption of stock is treated as a distribution of a dividend, proper adjustment of the basis of the remaining stock will be made with respect to the stock redeemed.”²² Instead, Prop. Treas. Reg. § 1.302-5 would have provided that unrecovered basis of redeemed shares does not shift in a redemption treated as a distribution under Section 301, but rather would be treated as a loss that would be taken into account either when the facts and circumstances that caused the redemption to be treated as a Section 301 distribution no longer exist, or to the extent of any gain recognized on the stock of the redeeming corporation by the redeemed

²¹ Cf. *United National Corporation v. Comm’r*, 143 F.2d 580 (9th Cir. 1944) (In analyzing the earnings and profits of a corporation in the context of a dividend equivalent redemption under the provisions of the Internal Revenue Code of 1939, for which there were provisions analogous to Sections 302(d) and 301(c), the Court suggested that where the distributing corporation had insufficient earnings and profits, the transaction would be “a capital distribution to be deducted from the cost of the *redeemed shares* in determining the base for a gain or loss under §[301(c)]” (emphasis added). As the case addressed only the determination of the amount of the earnings and profits, this statement is not the subject of further elaboration).

²² The regulations contain three examples of a “proper adjustment.” In two of the examples the redeemed shareholder continues to own stock in the redeeming corporation, and the third examples illustrates a case in which the continuing shareholder ownership is constructive. In the direct ownership cases, the basis in the redeemed shares shifts to the other shares owned by the redeemed shareholder. In the constructive ownership cases, the basis in the husband’s redeemed shares shifts to the wife’s shares.

shareholder. In illustrating this new regime, one example in the proposed regulations provided that only the basis in shares actually redeemed can be recovered under Section 301(c)(2).²³ No citation was given to support this result, and it seemed to have been logically compelled by the proposed elimination of the “proper adjustment” regime of current Treas. Reg. §1.302-2(c), not by current law.

The proposed regulations were recently withdrawn,²⁴ citing various critical comments to the proposed regime and stating that the Service and Treasury are continuing to study the issue of basis shifting in the context of dividend equivalent redemptions, as well as whether, under Section 301(c)(2), basis reduction should be limited to the basis of the shares redeemed or whether it should include the basis of shares retained. In this withdrawal notice, the Service and Treasury described the approach of limiting the basis to the shares redeemed as the “better view” of current law, but invited comments on the approach as well as other approaches.

III. Alternative Approaches

The Tax Section has identified four approaches to dealing with basis recovery in the case of a Basic Dividend Equivalent Redemption, as alternatives to the approach apparently favored by the Service and Treasury. In the context of a Basic Dividend Equivalent Redemption, we believe the approach apparently favored by the Service and Treasury - that only the basis of the shares actually (or fictionally under Section 304) redeemed may be recovered under Section 301(c)(2) – is not appropriate and is without firm grounding in its rationale under current law. While we would support the adoption of any of the four alternative approaches in future guidance, we believe that the All

²³ Prop. Treas. Reg. §1.304-2(c), Example 3.

²⁴ See Announcement 2006-30.

Shares Approach or the Recapitalization Approach are the most appropriate as they would produce the same gain recognition as would occur if no shares were exchanged in the redemption. Further, these approaches may be viewed as consistent with other basis regimes in other areas of current law, and their adoption could be accomplished regardless of whether the Service and Treasury ultimately modify the basis shifting rules of Treas. Reg. § 1.302-2(c).

In describing each of the approaches, we analyze the following example: Assume Corporation S is owned 100 percent by Corporation P. S has no earnings and profits. S has 3 blocks of common stock outstanding valued at \$1 share, acquired by P in three different transactions. As a result, P has three blocks of stock with the following bases:

Block 1	100 shares	\$ 0 basis
Block 2	100 shares	\$100 basis
Block 3	100 shares	\$200 basis

If S declares a \$100 distribution with respect to its common stock, because S has no earnings and profits, no part of the distribution is taxed as a dividend under Section 301(c)(1). If P could aggregate all of its basis when applying Section 301(c)(2), the distribution would reduce P's basis to \$200 and there would be no capital gain under Section 301(c)(3). Under the *Johnson case*,²⁵ however, the distribution would be treated as made equally with respect to each share of stock,²⁶ resulting in \$33.33 gain on Block 1, \$0 gain and resulting \$66.66 basis in Block 2, and resulting \$166.66 basis in Block 3.

²⁵ *Johnson v. U.S.*, 435 F.2d 1257 (4th Cir. 1971).

²⁶ Because each share of stock in each block has the same value, for ease and simplicity in the illustrations in the Report, we describe the results of the application of *Johnson* in terms of the blocks of stock, instead of share by share.

Service/Treasury Approach: Redeemed Shares Approach

As articulated in the recent preamble language, this approach would limit the basis recovery under Section 301(c)(2) to the basis in the shares redeemed (actually or fictionally under Section 304). In effect, this approach would view the distribution under Section 301 as occurring with respect to only the redeemed shares.

To illustrate using the example set forth above, if S redeemed Block 1 for \$100, P would recognize a gain of \$100 under Section 301(c)(3) because P has no basis in the Block 1 shares. If S redeemed Block 2 for \$100, P would reduce its basis in Block 2 to \$0 under Section 302(c)(2) and no gain would be recognized under Section 301(c)(3). If S redeemed Block 3 for \$100, P would reduce its basis in S to \$100 under Section 301(c)(2) and no gain would be recognized under Section 301(c)(3).

This approach clearly puts a premium on form. The amount of basis recovery depends principally on the shareholder's decision as to which shares to surrender for redemption. As such, taxpayers would be afforded planning opportunities, while unwary taxpayers may be unpleasantly surprised. In effect, this approach reintroduces form as a determinative factor in taxing redemptions treated as Section 301 distributions even though Congress determined in Section 302(d) to tax such redemptions in accordance with their underlying economic substance.

The Service and Treasury appear to be developing a basis regime in other parts of Subchapter C that emphasizes the basis of a share as attaching solely to that share as a specific attribute. Arguably, we suspect, the government believes that the Redeemed Shares Approach is consistent with those other developing rules and should be so. The Service and Treasury recently issued final regulations under Section 358, generally

providing a tracing methodology pursuant to which the basis of stock or securities received in a Section 368 reorganization is traced to the basis of the surrendered stock or securities, with similar provisions applying in the context of Section 355 exchange transactions (the “Section 358 Regulations”).²⁷ In general, taxpayers are able to designate which shares or securities of the target corporation are exchanged for which shares, securities or other consideration of the acquiring corporation, providing taxpayers significant electivity for determining resulting basis in acquiring stock or securities as well as the amount of gain that must be recognized under Section 356. In adopting these rules, the government rejected a basis averaging approach for these types of tax-free transactions as inconsistent with the rules that apply to taxable exchanges under Sections 1001 and 1012, stating concerns about limiting taxpayers’ ability to arrange their affairs and affording tax avoidance opportunities.²⁸

We do not believe that the decisions made in the Section 358 Regulations in the context of Section 368 reorganization exchanges and Section 355 exchanges are necessarily relevant to the issue of basis recovery in Basic Dividend Equivalent Redemptions. Fundamentally, the Section 358 Regulations address transactions in which there is a true exchange, whereas in the context of a Section 302(d) transaction, the exchange in form is disregarded and the transaction is treated as a distribution. In a dividend equivalent redemption, the number of shares outstanding has no significance.

²⁷ See Treas. Reg. § 1.358-2(a)(2). Cf. *NYSBA Members Comment on Proposed Regs on Stock Basis Determinations*, 2005 TNT 103-52 (discussing the proposed version of these regulations).

²⁸ The withdrawn Prop. Treas. Reg. § 1.302-5 regulations took a similar approach to basis as a specific attribute of particular shares, generally providing that such basis could not be shifted to other shares owned actually or constructively by the redeeming shareholder and eliminating the “proper adjustment” regime of current Treas. Reg. § 1.302-2(c). In such a regime, the Service and Treasury could not logically permit basis shifting to occur when the redemption proceeds exceed the earnings and profits and basis of the redeemed shares, and thus the Redeemed Shares Approach may have made sense. The proposed regulations have been withdrawn

The only significance of the transaction is that the redeeming shareholder has extracted cash from the corporation. In other contexts in which the number of shares generally has no meaning, the law does not seek to give significance to transactions that affect the number of shares, but instead simply seeks to rationalize the results.²⁹ For example, under Section 305(a), there is no income event when a corporation makes a distribution of stock to its shareholders with respect to its stock, and the number of shares is rationalized by allocating basis under Section 307. We note that the Recapitalization Approach discussed below is consistent with the Section 358 Regulations.

If the Service and Treasury determine to adopt this Redeemed Shares Approach for Basic Dividend Equivalent Redemptions, we strongly recommend that it be made on a prospective basis only. Taxpayers have been relying upon the language and intent of Section 302(d), logic and the authorities discussed above related to Section 301 and Section 1059 to support the various alternative approaches described below. The government's recent articulations of the Redeemed Shares Approach as the better view of "current law", seemingly for all dividend equivalent redemptions, came as a surprise to taxpayers and advisors alike.

Alternative: Aggregate Basis Approach

Under current law, many taxpayers and advisers believe that the aggregate basis in the redeeming shareholder's shares, both those redeemed and those not redeemed, is available for reduction under Section 301(c)(2) prior to gain recognition under Section 301(c)(3) (the "Aggregate Basis Approach"). Generally, there does not seem to be a

²⁹ See, e.g., *Comm'r v. Morgan*, 288 F.2d 676 (3d Cir. 1961), *cert. denied*, 368 U.S. 836 (1961); *Davant v. Comm'r*, 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1018 (1967); *Atlas Tool Co. v. Comm'r*, 614 F.2d 860 (3d Cir. 1980), *cert. denied*, 449 U.S. 836 (1980); *Smothers v. U.S.*, 642 F.2d 894 (5th Cir. 1981).

policy reason to deny a taxpayer full recovery of basis prior to gain recognition in the context of a dividend equivalent redemption.³⁰ In the context of multiple blocks of stock, however, we note that under a pure aggregate approach, a redeeming shareholder could achieve a better result if shares are exchanged for the distribution versus the result reached in a pure distribution under the *Johnson* case.³¹

To illustrate using the example above, if S redeemed Block 2 for \$100, under a pure aggregate approach, the \$300 basis P has in its S shares would be available for reduction before Section 301(c)(3) would apply regardless of the Blocks, effectively allowing basis to be “borrowed” among Blocks before gain recognition would occur.³² Following the basis reduction, the remaining basis would be allocated among the remaining shares in Block 1 and Block 3.

If, instead of redeeming shares in form, S simply distributed \$100 to P, except where the consolidated return rules apply, there is no concept of basis “borrowing” under the *Johnson* analysis. Because the substance of a dividend equivalent redemption is the same as a Section 301 distribution and Congress has directed its treatment as such, we believe the two transactions should be accorded the same treatment under the law. Thus, if the *Johnson* principle applies to an actual Section 301 distribution, it should apply a Section 301 distribution resulting from a Section 302(d) transaction. If the law develops

³⁰ None of the approaches described and recommended in this Report involve accessing basis for Section 301(c)(2) purposes from other taxpayers.

³¹ Under *Johnson*, a distribution is treated as made pro rata among the outstanding shares of a particular class, and thus the stock basis recovered under Section 301(c)(2) would be made share-by-share (and thus, as under the facts of that case, one stock block could generate capital gain under Section 301(c)(3) even though another, higher basis block may still have recoverable basis.

³² This principle appears in the consolidated return context, albeit for different reasons, where a member owns multiple stock blocks in another member and an excess loss account (“ELA”) exists. Here, basis adjustments are made in such a manner as to equalize and eliminate that member’s ELA. See Treas. Reg. §1.1502-19T(d)(1). For example, if P owned two blocks of S stock, one of which has an ELA of \$10 and another of which has a positive basis of \$10, and a \$25 negative adjustment under Treas. Reg. §1.1502-32 is made with respect to P’s S stock, the negative adjustment would first take away the basis of the non-ELA block before increasing the ELA of the ELA block.

to allow aggregate basis recovery for Section 301 distributions, such law should also apply for dividend equivalent redemptions.

Alternative: Non-Redeemed Shares Approach

Under the Non-Redeemed Shares Approach, the basis attributable to the shares actually redeemed is first allocated to the non-redeemed shares, and the amount distributed in the redemption is then treated as a Section 301 distribution proportionately with respect to the non-redeemed shares.³³ This approach de-emphasizes the form of the redemption and the number of S shares by treating the distribution as being made with respect to the shares that are outstanding at the end of the transaction after the basis has been allocated. Because the non-redeemed shares are the permanent shares in S's capital structure, it is logical that the Section 301 distribution would be made with respect to those shares.

To illustrate using the example above, if S redeemed Block 2 for \$100, first, to explain the fact that S reduced its shares by 100 shares, there would be an allocation of the \$100 basis in Block 2 to the other shares on a pro-rata basis, resulting in Block 1 having a \$50 basis and Block 3 having a \$250 basis. Then, when the distribution is made pro rata on the non-redeemed shares, the basis in Block 1 would be reduced to \$0 and the basis in Block 3 would be reduced to \$200.

If instead of redeeming shares in form, S simply distributed \$100 to P at a time when it owned 300 shares, and the *Johnson* court's analysis were applied, P would recognize gain of \$33.33 in Block 1, reduce its basis in Block 2 to \$66.66, and reduce its basis in Block 3 to \$166.66. We note that this comparison, however, does not take into

³³ This model appears to have been contemplated by Congress in its explanation of Section 1059 in the 1984 legislative history to Section 1059.

account the fact that as a result of the transaction, there are only 200 shares outstanding. In contrast, if the \$100 distribution were treated as having been made on the remaining 200 shares only, the *Johnson* approach should have the same consequences as the Non-Redeemed Shares Approach.

Alternative: All Shares Approach

Under the All Shares Approach, the amount distributed in redemption is deemed to be distributed with respect to both the redeemed and non-redeemed shares, and any basis not recovered on the redeemed shares is then allocated to the non-redeemed shares (but only after application of Section 301(c)(2) and (3)).

To illustrate using the example above, if S redeemed Block 2 for \$100, the Section 301 distribution would be treated as made with respect to all of the shares. Thus, P would recognize gain of \$33.33 in Block 1 under Section 301(c)(3), P's basis in Block 2 would be reduced to \$66.66 under Section 301(c)(2), and P's basis in Block 3 would be reduced to \$166.66 under Section 301(c)(2). Thereafter, in order to explain the fact that only 200 shares remain outstanding, the remaining \$66.66 basis in Block 2 would be allocated to Blocks 1 and 3, with the result that Block 1 has a basis of \$33.33 and Block 3 would have a basis of \$200.

If instead of redeeming shares in form, S simply distributed \$100 to P at a time when P owned all three Blocks and the *Johnson* court's analysis was applied, P would recognize gain of \$33.33 in Block 1 under Section 301(c)(3), and reduce its basis in Block 2 to \$66.66, and in Block 3 to \$166.66 under Section 301(c)(2). The All Shares Approach results in the same amount of Section 301(c)(3) gain, but then rationalizes the fact that there are fewer shares outstanding after the transaction. Under the All Shares

Approach, because the basis allocation occurs after the distribution has been accounted for, whether the Service and Treasury maintain the current Treas. Reg. § 1.302-2(c) or create a new regime (even one like withdrawn Prop. Treas. Reg. § 1.302-2(c)) is not relevant. Thus the All Shares Approach could be adopted prior to the completion of the full study of Section 302 basis issues.

Alternative: Recapitalization Approach

Under the Recapitalization Approach, the reduced number of shares would be explained by treating S as if it had recapitalized its shares from 300 to 200 shares. Following the approach of the Section 358 Regulations, the three blocks of basis would be preserved but in a smaller number of shares.³⁴ Thus, Block 1 would have approximately 67 shares with a basis of \$0, Block 2 would have approximately 67 shares with a basis of \$100, and Block 3 would have approximately 67 shares with a basis of \$200. S would be treated as though it made a separate distribution with respect to the shares.³⁵ As a result of the application of this approach, P would recognize \$33.33 of Section 301(c)(3) gain on Block 1, reduce its basis in Block 2 to \$66.66 and reduce its basis in Block 3 to \$166.66. Note that the order of the two events should not be significant because there is no shifting of the redeemed shares' basis.

Like the All Shares Approach, the Recapitalization Approach would yield the same amount of Section 301(c)(3) gain for P as would be recognized under the All Shares Approach, or if S simply made a Section 301 distribution. Further, because the Recapitalization Approach does not involve basis allocation, but instead preserves the basis in the three blocks, the number of shares that S has outstanding is truly meaningless

³⁴ Treas. Reg. § 1.358-2.

³⁵ Treas. Reg. § 1.301-1(l).

for purposes of determining the tax consequences of the transaction. Each of the other approaches, including the Redeemed Shares Approach, involves the allocation of basis from the redeemed shares to the remaining shares.