NEW YORK STATE BAR ASSOCIATION

TAX SECTION

REPORT ON "ZERO BASIS"

October 16, 2006

Report No. 1120

New York State Bar Association Tax Section
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This report[1] comments on Revenue Ruling 2006-2,[2] which revoked Revenue Ruling 74-503[3] and announced that the "zero basis" conclusions set forth in that ruling are under study. The reconsideration of this issue by the Internal Revenue Service is a welcome development, since the application of zero basis to stock and securities of a transferor in a tax-free transaction creates the potential for the taxation of fictitious gains as well as other unintended results. We believe that a fair market value basis is generally appropriate in these circumstances, although further rules are needed to limit the tax effects of post-transfer gains and losses from stock or securities of a parent held by its subsidiary.

I. Introduction

With Revenue Ruling 2006-2, effective December 20, 2005, the Internal Revenue Service revoked Revenue Ruling 74-503 and modified its longstanding position on the tax consequences of a corporation's transfer of its own stock in a tax-free transaction.

In Revenue Ruling 74-503, a parent corporation transferred shares of its treasury stock, which had been purchased from its shareholders for less than their fair market value at the time of the transfer, to its subsidiary in exchange for newly issued shares of the subsidiary, which constituted 80 percent of its only outstanding class of stock. The

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[1] This report was prepared by an *ad hoc* committee of the New York State Bar Association Tax Section, consisting of L. Howard Adams, Linda M. Beale, Kimberly S. Blanchard, Bryan Bloom, Peter Connors, Richard M. Corn, Luca Dell'Anese, Timothy J. Devetski, Patrick C. Gallagher, Barry Grandon, Elizabeth T. Kessenides, Michael Kliegman, Jonathan Kushner, Stephen B. Land, Michael Levin, Vadim Mahmoudov, Gary B. Mandel, David S. Miller, Charles Morgan, David J. Passey, Deborah L. Paul, Michael L. Schler, Jodi J. Schwartz, Jack Smith, Karen Gilbreath Sowell, Linda Z. Swartz, Gordon E. Warnke and Diana L. Wollman. Stephen Land was the principal drafter, with assistance from Luca Dell'Anese. Helpful comments were also received from Peter C. Canellos, Martin D. Ginsburg, Charles I. Kingson, Erika W. Nijenhuis and David R. Sicular.

[2] Rev. Rul. 2006-2, 2006-2 I.R.B. 261.

[3] Rev. Rul. 74-503, 1974-2 C.B. 117.

transfer of the parent stock, tax-free under Section 351,[4] was not for the purpose of enabling the subsidiary to acquire property by the use of that stock.

Revenue Ruling 74-503 stated that the basis of the parent's treasury stock received by the subsidiary and the basis of the newly issued subsidiary's stock received by the parent were both zero. To reach this conclusion, the Service reasoned that when the parent and the subsidiary transfer their own stock in exchange for the other entity's stock, the carryover basis rules of Section 362(a) apply to both corporations. As a consequence, the basis of the parent's treasury stock received by the subsidiary was the same as it was in the hands of the parent corporation immediately prior to the exchange. Similarly, the basis of the newly issued stock of the subsidiary received by the parent was the same as it was in the hands of the subsidiary immediately prior to the exchange.

With reference to the subsidiary's stock, the Service stated that the basis of previously unissued stock is zero in the hands of the subsidiary issuing it in a transaction in which Section 362 applies. As for parent's stock, the Service affirmed that the cost of purchasing the treasury shares did not create a basis in these shares in the hands of the corporation since the repurchase was, for tax purposes, equivalent to a redemption of the shares. Thus, the Service concluded, a corporation's treasury stock is no different than its previously unissued stock and the basis of the parent's treasury stock received by the subsidiary is also zero.

In Revenue Ruling 2006-2, however, the Service reversed its conclusion that Section 362(a) applied in determining the basis of the stock of a subsidiary received by the parent. In addition, the Ruling announced that the other conclusions in Revenue Ruling 74-503, including its "zero basis" conclusions, are under study.

The revocation of Revenue Ruling 74-503 provides an opportunity for a much needed reconsideration of the federal income tax treatment of the issuance of parent shares to a subsidiary in a tax-free transaction, and the sale or exchange by a subsidiary of its parent's stock.

[4] All section references are to the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise stated herein.

II. Summary of Recommendations

We believe that the principal problems faced by taxpayers under the zero basis rule can be addressed, without creating opportunities for abuse, by adopting the recommendations listed below:

1. Stock of a corporate shareholder contributed to a corporation should have a fair market value basis in the hands of the transferee, and the basis of the shares received in exchange should also have a fair market value basis.

2. A set of basis adjustment rules should be provided so that a sale of parent stock by a subsidiary does not give rise to a taxable gain or a deductible loss, and so that changes in the value of parent shares held by the subsidiary are not taken into account in determining gain or loss on a sale of subsidiary stock by the parent.

3. These basis adjustment rules should apply in full where the subsidiary is at least 80% owned by the parent, and otherwise should apply on a proportionate basis. Below some lower threshold (between 20% and 50%), the basis adjustment rules should not apply at all.

4. Stock of a corporate shareholder contributed to a partnership should have a fair market value basis in the hands of the transferee, and the basis of the partnership interest received in exchange should also have a fair market value basis.

5. Section 1032 should be extended so that changes in value of a partner's stock held by the partnership are not taken into account in determining gain or loss from a sale of the partner's partnership interest.

6. The rules proposed above for a fair market value basis, and for subsequent basis adjustments, should apply regardless of whether the entities involved are domestic or foreign.

7. Debt contributed by its obligor to a corporation or partnership should have a basis in the hands of the transferee equal to its issue price, and the basis of the shares or partnership interest received in exchange should also reflect that issue price.

8. Where debt is issued to a related party, no gain or loss should be recognized when that debt is resold to a third party, and instead the debt should be treated as newly issued at the resale price for purposes of determining the is-

suer's original issue discount or premium, and similar rules should apply where the related party holding debt ceases to be related to the issuer.

9. The recommendations listed above for a fair market value basis in shares, and an issue-price basis in debt, contributed to a corporation or partnership in a tax-free transaction can be implemented without legislation, but it may be prudent not to adopt those recommendations until legislation can be enacted addressing the recommendations that prevent fictitious gains and losses.

These recommendations are premised on a view that parent stock held by a subsidiary should be viewed as a sort of treasury stock, so that it would be inappropriate to include gains and losses attributable to changes in value of that stock in the corporate tax base. This view could be logically extended to treat this parent stock for all purposes as a non-asset, much like actual treasury stock. A consequence of that treatment would be to treat a subsidiary's purchase of parent shares from a third party as a distribution from the subsidiary to the parent in an amount equal to the purchase price, followed by a redemption of the shares by the parent. However, the legal fictions now embodied in Section 304 stop short of implying such a distribution.[5] This report briefly discusses in Part IV.B.4 below the implications of this broader view, which might justify an "interim" zero basis rule. It is not necessary, however, to go this far in order to solve the problem of fictitious gains and losses, and the report therefore focuses on that problem without addressing the ramifications of the broader view.

III. Background

The "zero basis" problem emerges in the broader context of the federal income tax treatment of a corporation's dealing in its own shares, either directly or through affiliates. Concern over the consequences of these dealings has motivated over the years a set of legislative and administrative rules, as well as judicial decisions, aimed at preventing unwarranted tax avoidance while permitting nonabusive commercial arrangements.

Before 1954, a corporation would recognize gain or loss on the disposition of treasury stock, having a basis in the stock equal to the amount paid for it.[6] This rule left wide scope for tax planning: a corporation that would realize a gain upon a sale of treasury stock could avoid it by issuing new shares instead, while a corporation with a declining

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[5] Rev. Rul. 80-189, 1980-2 C.B. 106; Broadview Lumber Co. v. United States, 561 F.2d 698 (7th Cir. 1977).

[6] T.D. 4430, XIII-1 C.B. 36 (1934).

stock value could generate a loss by reselling purchased treasury shares at a lower price. The potential for these tax avoidance techniques induced Congress in 1954 to enact Section 1032(a), providing that a corporation does not recognize gain or loss from buying and selling its own shares, regardless of whether those shares were previously unissued or held as treasury stock.[7]

The enactment of Section 1032(a), however, did not completely eliminate these planning possibilities, since it does not apply to sales by a subsidiary of its parent's stock. Parent company stock held by a subsidiary is not considered by the Service to be treasury stock, and therefore its sale or exchange can generate a taxable gain or loss.[8] As a result, the parent could contribute treasury stock with a high basis to its subsidiary in order to recognize a loss if the price of the parent stock went down, or could sell shares directly without a taxable gain if the price rose. This technique would work, however, only if the subsidiary could inherit the parent's cost basis in those treasury shares, or could obtain a fair market value basis in those shares when contributed to the subsidiary.

Revenue Ruling 74-503 blocked any opportunity to realize a loss on contributed parent shares, since it applied a zero basis regardless of whether those shares were unissued shares or treasury shares of the parent. Notwithstanding the Service's legitimate concern in this regard, the conclusions reached in the ruling have been subject to widespread criticism.[9]

A. Problems with Zero Basis

The principal difficulty with the zero basis rule is that it can result in tax on an artificial gain, on which the parent corporation would not have been taxed had it sold the

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[7] *See* H. Rep. No. 1337, 83rd Cong. 2d Sess. A268 (1954).

[8] Rev. Rul. 70-305, 1970-1 C.B. 169. The ruling concluded, "the stock of *P* held by *S* is not treasury stock and the sale of such stock is not to be treated as a sale of such stock by the corporation of its own capital stock pursuant to the provisions of section 1032."

[9] *See, e.g.*, Sheldon I. Banoff, *How IRS' New Zero-Basis Approach Will Affect Corporate Tax Planning,* 42 J. TAX'N 96 (1975); Elliott Manning, *The Issuer's Paper: Property or What? Zero Basis and Other Income Tax Mysteries,* 39 TAX L. REV. 159 (1984); Douglas H. Walter, *"The Issuer's Own Stock"—Section 1032, Section 304 and Beyond,* 68 TAXES 906 (1990); Jasper L. Cummings, Jr., *The Silent Policies of Conservation and Cloning of Tax Basis and Their Corporate Applications,* 48 TAX L. REV. 113 (1992); Stephen B. Land, *Strange Loops and Tangled Hierarchies,* 49 TAX L. REV. 54 (1993). *See also* New York State Bar Association Tax Section, *Sale or Exchange by a Subsidiary Corporation of Its Parent Corporation's Stock,* 47 TAXES 146 (1969); American Bar Association Tax Section, *Recommendation No. 1980-8, reprinted in* 33 TAX LAW. 1543 (1980); AMERICAN LAW INSTITUTE, FEDERAL INCOME TAX PROJECT SUBCHAPTER C 302-12 (1982).

stock itself.[10] Although few would argue with the ruling's conclusion that the cost of purchasing treasury shares does not create a basis in these shares in the hands of the parent, that "no basis" conclusion does not necessarily imply zero basis. The ruling's zero basis conclusion creates a taxable gain equal to the entire proceeds that the subsidiary realizes on a later disposition of the parent stock. By contrast, no gain would have been recognized if the parent had sold the shares itself and contributed the proceeds to the subsidiary.

The ruling determined the subsidiary's basis in the parent shares by applying the carryover basis rule of Section 362. After the Service concluded that the parent had a zero basis in its own stock, the application of Section 362 led to its conclusion that this zero basis carried over when the shares were acquired by the subsidiary. Yet, as pointed out by the American Bar Association in its 1980 recommendations on this topic,

> "The purpose of the carryover basis rule in section 362 (which the Service relies upon to arrive at a zero basis result) is to assure that any deferred gain or loss that has accrued to the transferor will be preserved and eventually recognized by the transferee ... Section 362 was not intended to create gain or loss which had not accrued to the transferor at the time of the tax-free exchange. Gain or loss does not accrue to a parent corporation merely by failing to issue its stock until the subsidiary is ready to use it. Carrying over a zero basis to the subsidiary under section 362 thus has the effect of ultimately creating gain to the subsidiary which never accrued to the parent, contrary to the purposes of section 362."[11]

The zero basis rule can lead to inconsistent tax treatment of economically equivalent transactions, distinguishing for example between the acquisition of treasury stock by a parent corporation followed by a transfer to the subsidiary, and the direct acquisition of the stock by the subsidiary with cash contributed by the parent.[12] The consequence of

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[10] AMERICAN LAW INSTITUTE, *supra* n. 9, at 303.

[11] American Bar Association Tax Section, *supra* note 9, at 1547-1548. *See also* New York State Bar Association Tax Section, *supra* note 9, at 152.

[12] Manning, *supra* note 9, at 191, notes a further oddity arising from the zero basis rule:

these artificial distinctions is to transform the zero basis problem into a trap for the unwary,[13] with its unfavorable tax consequences applying only to those taxpayers who fail to avoid the zero-basis problem through careful tax planning.

For instance, the parent can avoid the zero-basis problem by issuing its own shares directly to a third party in exchange for property, and then contributing the property to the subsidiary.[14] In this case, Section 1032 would provide nonrecognition treatment to the parent with respect to the issuance of its own shares, the parent would take a fair market value basis in the property,[15] and the subsidiary would have a carryover basis[16] equal to the parent's basis in the property.

Alternatively, the zero basis complications can be avoided if the subsidiary purchases parent shares for cash. In this case the parent would recognize no gain by reason of Section 1032 and the subsidiary would have a cost basis in the shares.[17] If the share value goes down, the subsidiary could realize a tax loss, precisely the result that Revenue Ruling 74-503 sought to avoid.

Furthermore, the parent could contribute its own shares to its subsidiary in a transaction that technically violates Section 351's control requirement. In that case, both the parent and the subsidiary would avoid taxation under Section 1032, and they both would have a fair market value basis in the exchanged shares. Such a non-Section 351 exchange could be achieved, for example, if an unrelated party held any number of shares of straight nonvoting preferred stock of the subsidiary, and the parent (including its consolidated subsidiaries) did not hold at least four times as many shares of that class. In this

> "Assume a corporation issues two shares of identical common stock, one share as a taxable dividend on preferred stock to a corporate stockholder and a second as a contribution to capital to a more than 80% owned subsidiary. The Service, for reason undisclosed, would hold (1) the amount of the distribution of the first share and the basis of the share to the distributee equals its fair market value, notwithstanding the statutory rule that the distributing corporation's basis for property distributed to a corporate shareholder is both the amount of the distribution and the basis to the distributee unless fair market value is less, but (2) the second share has a basis equal to zero in the transferee's hands because a corporation's basis for its own stock is zero. This is an unsolved mystery."

[13] American Bar Association Tax Section, *supra* note 9, at 1548; AMERICAN LAW INSTITUTE, *supra* note 9, at 304; Walter, *supra* note 9, at 910.

[14] Walter, *supra* note 9, at 911.

[15] Section 1012; Rev. Rul. 56-100, 1956-1 C.B. 624. *See generally* Calvin H. Johnson, *The Legitimacy of Basis from a Corporation's Own Stock,* 9 Am. J. Tax Pol. No. 2, at 155 (1991).

[16] Section 362(a).

[17] Walter, *supra* note 9, at 911.

case, the control requirement of Section 351 would not be met, even though the subsidiary could still consolidate with the parent.

B. Existing Zero Basis Relief

Limited relief to corporations confronted with the implications of the zero-basis problem has been provided over the years by the Treasury and the Service in a number of specifically tailored exceptions to the general rule.[18] The first such relief was provided by the Service, to prevent recognition of gain when a subsidiary uses the stock of its parent to compensate its employees for services performed.[19]

Relief from the zero basis problem has also been allowed in the context of a tax-free triangular reorganization.[20] Parent stock transferred to a subsidiary (or to a target company or its shareholders on behalf of a subsidiary) in a triangular B or C reorganization or a forward triangular merger could trigger a taxable gain in an amount equal to its fair market value if that stock were considered to have a zero basis. Regulations issued under Section 1032 avoid this result by treating the parent shares as if the parent had exchanged its stock for the target's stock or assets, followed by a contribution by the parent of target stock or assets to the subsidiary.[21] As a consequence, the parent corporation will have a deemed carryover basis in target's stock or assets,[22] while the subsidiary will avoid gain recognition.[23]

Until recently, the consolidated return regulations provided relief from the zero basis problem when a member of a consolidated group disposed of stock of the common parent in a "qualified disposition."[24] The subsidiary in this case was treated as having

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[18] BORIS I. BITTKER & JAMES E. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, Vol. 1, at 3.11[5].

[19] Rev. Rul. 80-76, 1980-1 C.B. 15. The ruling involved a parent controlling at least 80 percent of the voting power and value of the subsidiary's stock. Under the facts *A*, a shareholder of *P*, transferred *P* stock directly to *B*, an employee of *S*. The ruling held that "because Section 83 applies to the transfer of *P* stock to *B*, *S* does not recognize gain or loss on the transfer of the *P* stock." *See* Steven W. Rabiz, *Proposed Stock for Property Exchange Regs Help Some, Could Do More,* 81 TAX NOTES 503 (Oct. 26, 1998). The ruling was declared obsolete when the point was addressed in Regs. § 1.1032-3. T.D. 8883 (Feb. 12, 2000).

[20] Regs. § 1.1032-2; T.D. 8648, 60 F.R. 66077 (Dec. 21, 1995).

[21] Regs. § 1.1032-2(b).

[22] Section 362(b).

[23] The protection is incomplete, however, since the relief granted by Regs. § 1.1032-2 does not cover the transfer of parent debt or options in connection with tax-free reorganizations.

[24] Regs. § 1.1502-13(f)(6)(ii).

purchased the parent shares immediately before the disposition for their fair market value.[25]

Those regulations were superseded in 2000[26] by broader regulations under Section 1032, which extended nonrecognition protection beyond the consolidated return context in circumstances where the subsidiary is essentially a conduit using parent stock to acquire cash or property or to pay compensation.[27] The regulations apply to transactions in which the subsidiary acquires money or other property in exchange for stock of the parent, provided that:

1. the stock of the parent is transferred to the subsidiary as part of a plan pursuant to which the subsidiary "immediately" transfers the stock to acquire money or other property;

2. the subsidiary receives the stock directly or indirectly from the parent as a contribution to capital or in a Section 351 transaction; and

3. no party receiving the stock of the parent has either a transferred or exchanged basis in the stock.[28]

In such a case, the subsidiary does not recognize gain or loss on its disposition of the stock.[29] Instead, the transaction is treated as if immediately before the disposition the sub-

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[25] A disposition is a qualified disposition if: (i) the subsidiary acquires the parent stock directly from the parent through a contribution to capital or a transaction to which Section 351 applies; (ii) pursuant to a plan, the subsidiary transfers the stock immediately to a non-member; (iii) the non-member transferee is not related to any member of the consolidated group of the issuer; (iv) parent stock is not exchanged for parent stock; (v) the parent neither becomes nor ceases to be the common parent as part of the plan; and (vi) the subsidiary is not a non-member that becomes a member, or a member that becomes a non-member, as part of the plan. *Id.*

[26] Regs. § 1.1502-13(f)(6)(v).

[27] Regs. § 1.1032-3(b). *See* BITTKER & EUSTICE, *supra* n. 18, Vol. 1, at 3.11[5]. Similar rules apply to stock options issued by the parent in these circumstances. Regs. § 1.1032-3(d).

[28] Regs. § 1.1032-3(c).

[29] When the proposed regulations (now finalized) were introduced, the Service explained the rationale of the rule in the following terms:

sidiary purchased the stock from the parent for its fair market value with cash contributed to the subsidiary by the parent.[30]

A feature of all of these forms of regulatory relief is that they never allow a non-zero basis to generate a loss. In each case, to qualify for relief, the parent shares must be disposed of immediately after they are acquired by the subsidiary, so there is no opportunity for them to decline in value.

C. Revocation of the Zero Basis Ruling

Revenue Ruling 2006-2 expressly disavowed only one of the conclusions reached in Revenue Ruling 74-503: that the parent's basis in the stock of its subsidiary received in exchange for the issuance of parent stock was determined under Section 362(a). Indeed, the application of Section 362(a) in this context was puzzling, since the parent is the transferor, and the transferor's basis is normally determined under Section 358(a). Section 358(a) provides a "substitute" basis for property received by a transferor in a Section 351 transaction, equal to the basis in the property exchanged, increased by gain recognized and decreased by the amount of money and the fair market value of other property received. By contrast, Section 362(a) provides a "carryover" basis for property received by the transferee in a Section 351 transaction, equal to the transferor's basis in that property, increased by any gain recognized by the transferor.

In Revenue Ruling 74-503, the Service had applied Section 362(a) rather than Section 358(a) to determine the basis of the subsidiary stock because it determined that the application of Section 358(a) was precluded by Section 358(e), which provides:

> "[S]ome of the concerns that ultimately led to the enactment of section 1032 are present where a subsidiary corporation holds the stock of a parent corporation. For example, a parent corporation could place treasury stock in a subsidiary corporation in order to attempt to recognize losses if the price of the parent corporation stock goes down, or could sell shares directly if the price rises. See Rev. Rul. 74-503, 1974-2 C.B. 117. The zero basis result limits such planning opportunities. These tax avoidance possibilities are not present, however, in transactions where one corporation transfers its own stock to another corporation pursuant to a plan by which the second corporation immediately transfers the stock of the first corporation to acquire money or other property. The risk of selective loss recognition does not arise where the stock of the parent corporation is used immediately by the subsidiary corporation to acquire money or other property and therefore does not have sufficient time to depreciate in value."

63 Fed. Reg. 50816 (Sep. 23, 1998).

[30] Regs. § 1.1032-3(b).

> (e) EXCEPTION.—This section shall not apply to property acquired by a corporation by the exchange of its stock or securities (or the stock or securities of a corporation which is in control of the acquiring corporation) as consideration in whole or in part for the transfer of the property to it.

In the example given in the ruling, Section 358(e) literally applies to the parent's receipt of subsidiary stock as well as to the subsidiary's receipt of parent stock. Yet to apply Section 358(e) to these facts goes beyond the apparent purpose of Section 358(e), which was to ensure that Section 362(a) rather than Section 358(a) determines the basis to the transferee in a Section 351 transaction.[31]

Viewed in isolation under the facts of these rulings, one might wonder what the fuss was about. Regardless of whether Section 358(a) or Section 362(a) applies, the basis of the subsidiary stock received by the parent would still be zero since, given the premise in Revenue Ruling 74-503 that both corporations had a zero basis in their own stock, applying either a carryover basis or a substituted basis would give each corporation a zero basis in the stock of the other.

Which section determines basis can make a difference, however, if there is boot in the exchange:

> *Example (1)* Parent *P* contributes its own stock worth 100*x* for shares of its subsidiary *S* worth 5*x* plus 95*x* in cash.

If *P*'s basis in the *S* stock is determined under Section 362(a), then that basis would be equal to the subsidiary's basis in its own stock, which under the theory of the ruling would be zero. By contrast, if Section 358(a) were to apply, it could literally produce a negative basis, since *P*'s basis in the *S* stock would be equal to *P*'s basis in its own stock (zero), plus any gain recognized (also zero), minus the amount of money received (95*x*), for a net negative basis of -95*x*.[32] At the very least, this example shows that, wholly apart from the potential to tax fictitious gains, the zero basis approach does not coordinate well with the substituted basis rules.

Indeed, applying Section 362(a) rather than Section 358(a) could produce a possible advantage to US multinationals seeking to repatriate earnings from foreign subsidiaries without a US tax cost:

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[31] *See* Jasper L. Cummings, Jr., *IRS Revokes Zero Basis Ruling but Questions Regarding Motives Remain*, DAILY TAX REP. (Jan. 6, 2006).

[32] Absent Section 1032, the receipt of the 95*x* in cash would be taxable under Section 351(b), preventing any negative basis.

Example (2) Foreign subsidiary *F* transfers 95*x* of cash plus its own stock worth 5*x* in exchange for stock worth 100*x* of a domestic affiliate *D* which is not a direct parent of *F*. (*D* could be a grandparent of *F*, or a sister company.). At the same time, the domestic parent *P* of *D* contributes other property to *D* worth 100*x* in exchange for additional *D* stock.

Here *F* has made an investment in United States property (the *D* shares), which generates subpart F income to its United States shareholders in an amount equal to its adjusted basis in the *D* shares.[33] Under these facts, *F* is part of the "control group" along with *P* as transferors in a Section 351 exchange. If *F*'s basis in the *D* shares is determined under Section 362(a), then that basis will be equal to *D*'s basis in its own shares, which is zero under the theory of the 1974 ruling. By contrast, if *F*'s basis in the *D* shares is determined under Section 358(a), then that basis will be equal to the 95*x* of cash plus *F*'s (zero) basis in its own shares, in which case *F*'s United States shareholders will have 95*x* of subpart F income. This appears to be a more sensible result, since 95*x* in cash has in fact been repatriated. Indeed, preventing the avoidance of subpart F income through this technique appears to have been the motivation for the Service's revocation of Revenue Ruling 74-503,[34] and more particularly, its disavowal of the application of Section 362(a) to determine the basis of the stock received by the transferor.

D. Debt Obligations

A corporation's dealing with its own debt obligations presents many of the same potential problems and tax planning opportunities that arise when a corporation deals with its own shares. Again, as in the case of shares, the Service has argued that debt issued by the transferor in a tax-free transaction has a zero basis in the hands of the transferee. This approach has the undesirable effect of turning the proceeds of repayment or sale of the loan into taxable gains even if the loan is repaid or sold at par.[35]

The analogy with shares, however, is not exact, since corporations do suffer tax consequences from dealings in their own debt, and the issuance of an obligation has an identifiable cost to the issuer in that it creates an obligation to repay it. Moreover, if a parent issues debt to a subsidiary, and the subsidiary later resells it to a third party for less than par, the resulting loss is one the parent could have claimed had it sold the debt to a

[33] Code § 956(a).

[34] Alternatively, the transaction might be attacked on the ground that the *D* shares, to the extent acquired for cash, should not be treated as having been acquired as part of a Section 351 exchange and should simply take a cost basis under Section 1012.

[35] AMERICAN LAW INSTITUTE, *supra* n. 9, at 305.

third party itself, although this loss would have been reflected over time in the form of original issue discount deductions.[36] Thus, some questions regarding a subsidiary's dealings in its parent's debt relate to timing and character of the resulting gains and losses, rather than whether those gains and losses should be in the corporate tax base at all.

For debt obligations, the zero basis problem has emerged in connection with the interpretation of Section 357. Under Section 357(a), the transferee corporation's assumption of liability, or its acquisition of property subject to liability, in a Section 351 exchange is not treated as money or other property, and therefore is not taxed as boot. Such an assumed liability, however, is treated as boot for purposes of reducing the transferor's basis, preserving the potential to tax the "discharge of indebtedness" type gain resulting from the assumption of liability. In addition, in order to prevent negative basis, Section 357(c) requires the recognition of gain to the extent that the assumed liabilities exceed the adjusted basis of the transferred property.

Transferors holding property subject to liabilities in excess of basis can avoid recognizing income under Section 357(c) by paying off some or all of the liabilities before entering into a Section 351 exchange, or by contributing additional cash or other high-basis assets into the corporation in order to increase the total basis of the property transferred. An alternate approach would be for the transferor to issue a promissory note to the transferee in an amount equal to the excess of liabilities over the basis of the transferred assets, on the theory that the promissory note has a basis equal to its face amount.[37]

In Revenue Ruling 68-629,[38] however, the Service rejected the idea that a transferor could issue its note to avoid Section 357(c) gain. The ruling dealt with an individual taxpayer who transferred all of the assets of a sole proprietorship to a newly organized corporation in exchange for all the stock of the corporation and its assumption of the liabilities pertaining to the sole proprietorship. At the time of transfer the assumed liabilities exceeded the adjusted basis of the transferred assets, so the taxpayer issued a personal promissory note in an amount equal to the excess.

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[36] Section 1272(a).

[37] As observed by Bittker and Eustice: "From a financial point of view, the note—assuming it's bona fide —has about the same effect as a note given by the transferor to a bank or other third party before the § 351 exchange to raise cash to reduce the liabilities to which the transferred property will be subject. To be sure, if this analogy is accepted § 357(c) would lose its potency: but this would not compromise its function, because the note in fact eliminates the benefit that the transferor gets from transferring property subject to liabilities in excess of basis—the very same protective job assigned to § 357(c)." BITTKER & EUSTICE, *supra* n. 18, Vol. 1, at 3.06[4][b].

[38] 1968-2 C.B. 154.

The Service ruled that the transferor had zero basis in the promissory note because he incurred no cost in issuing it:

> "Section 1012 of the Code provides that the basis of property is its cost except as otherwise provided in the Code. Since the taxpayer occurred no cost in making the note, its basis to him was zero. Therefore, the transfer of the note to the corporation did not increase the basis of the assets transferred and the liabilities assumed by the corporation exceeded the taxpayer's basis in the assets transferred. Accordingly, section 357(c) of the Code applies to the transaction and gain is recognized to the taxpayer on the transfer of the assets of the sole proprietorship and the promissory notes in exchange solely for stock of the corporation plus the assumption of liabilities of the proprietorship in the amount by which the liabilities assumed exceeds the basis of the assets transferred."[39]

The Tax Court sustained Revenue Ruling 68-629 in *Alderman v. Commissioner*,[40] reasoning that reaching a conclusion different from the zero basis solution would "effectively eliminate Section 357(c) from the Internal Revenue Code. It would be relatively a simple matter to execute a note so that the adjusted basis would always exceed liabilities."[41] Yet perhaps the matter is not so simple, since to the extent of the note, the transferor has not been relieved of liability.

Just as in the case of shares, the zero basis approach adopted by the Service in this context, and accepted by the Tax Court, has been subject to widespread criticism.[42] Again, the problem with the zero basis rule is that it creates tax liabilities on fictitious gains, at both the shareholder and corporate levels. Although it is difficult to argue with the Service's conclusion that the issuer has no basis in the note because that note is a liability rather than an asset to its issuer, as in the case of shares it would be mistaken to infer that no basis means zero basis.

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[39] *Id.*

[40] 55 T.C. 662 (1971).

[41] *Id.*, at 665

[42] *See* Manning, *supra* n. 9, at 195-197; Kenneth P. Brewer, *The Zero Basis Hoax*, 63 TAX NOTES 457 (Apr. 25, 1994); Jasper L. Cummings Jr., *Zero Basis Hoax or Contingent Debt and Failure of Proof? Sorting Out the Issues in the* Lessinger *Case*, 2 FLA. TAX REV. 283 (1994); Steven Quiring, *Section 357(c) and the Elusive Basis of the Issuer's Note*, 58 TAX LAW. 97 (2003); Stuart Lazar, Lessinger, Peracchi, *and the Emperor's New Clothes: Covering a Section 357(c) Deficit With Invisible (or Nonexistent) Property*, 58 TAX LAW. 41 (2004); Jerred G. Blanchard Jr., *Zero Basis in the Taxpayer's Own Stock or Debt Obligations: Do Those Instruments Constitute Property?* 106 TAX NOTES 1431 (Mar. 21, 2005).

Indeed, the Service's position was rejected by the Second Circuit in *Lessinger v. Commissioner,*[43] where the Court held that a transferor did not recognize Section 357(c) gain in connection with the corporation's assumption of the shareholder's liability in excess of the aggregate adjusted basis of the property, apart from the transferor' own obligation, transferred in a Section 351 transaction. The Court based its decision on the grounds that, while the transferor's own obligation is not property in its own hands,[44] it does constitute property to the transferee, with a basis equal to its face amount.[45] To conclude otherwise, the Court stated, would cause the transferor to be subject to tax on a "truly phantom gain."[46] The opinion also stated that the adjusted basis referred to in Section 357(c) refers to the transferee corporation's basis in the obligation, equal to its face amount.[47]

The Ninth Circuit reached a similar result in *Peracchi v. Commissioner,*[48] but with different reasoning. There, the Court distanced itself from *Lessinger* by holding that the transferor had a cost basis in his promissory note given to his wholly owned transferee corporation. The transferor's cost in the notes, the Court concluded, depended on whether the risk of bankruptcy of the transferee corporation was significant enough to confer substantial economic effect on the contribution of the note to the corporation. Because the Court considered that risk to be non-trivial, the transferor's cost basis in its own obligation was the face amount of the obligation.

The *Lessinger* and *Peracchi* decisions have received mixed reviews, with commentators agreeing on the need to find a solution to Section 357(c) hardship but criticizing as

[43] 872 F. 2d 519 (2d Cir. 1989), *rev'g* 85 T. C. 824 (1985).

[44] "'Basis,' as used in tax law, refers to assets, not liabilities. Section 1012 provides that '[t]he basis of property shall be the cost of such property, except as otherwise provided.' Liabilities by definition have no 'basis' in tax law generally or in section 1012 terms specifically." *Id.,* at 525.

[45] "[T]he corporation should have a basis in its obligation from Lessinger, because it incurred a cost in the transaction involving the transfer of the obligation by taking on the liabilities of the proprietorship that exceeded its assets, and because it would have to recognize income upon Lessinger's payment of the debt if it had no basis in the obligation." *Id.,* at 525.

[46] *Id.,* at 527.

[47] *Id.,* at 526. This conclusion literally conflicts with Section 362's requirement that the transferee's basis in a Section 351 transaction be determined by reference to that of the transferring shareholder, a difficulty avoided by the reasoning in *Peracchi, infra* n. 48.

[48] 143 F.3d 487 (9th Cir. 1998).

inadequate the particular modes of analysis employed by the two courts.[49] Both cases, however, illustrate the difficulty of attempting to apply zero basis to contributed debt.

IV. Detailed Recommendations

A. Fair Market Value Basis

In rethinking the "zero basis" conclusions of Revenue Ruling 74-503, it is instructive to start with a case that does not implicate Section 351 at all:

> *Example (3)* *A* and *B* are both large corporations. In an exchange of shares, each acquires a block of stock worth 100*x* from the other. After this exchange of shares, each corporation owns less than 5 percent of the other.

Since neither corporation controls the other, Section 351 does not apply to the exchange of shares, and neither Section 358(a) nor Section 362(a) applies to determine the basis of the shares. Indeed, the only nonrecognition provision that applies to this exchange is Section 1032, and the regulations under that section indicate that in such a case the basis of the property acquired by each corporation in exchange for its stock is to be determined under Section 1012.[50] The basis of acquired property under Section 1012 is its "cost", hardly a helpful guide when considering property acquired for newly issued stock. Yet the same question arises when the property acquired in exchange for newly issued stock is stock of a third party (or anything else, such as Blackacre or a truck), and the Service long ago acknowledged that in such a case the basis of the property acquired is equal to the fair market value of the stock issued in exchange for it.[51]

Providing a fair market value basis for property received in exchange for the issuance of stock fulfills the purpose of Section 1032, which is to exclude the proceeds of stock issuances from the corporate tax base. The same considerations apply when the property acquired is newly issued stock of the other party to the exchange. When two corporations issue stock to each other and each takes a fair market value basis, they might appear to have created basis out of thin air, but this creation of basis is no more mysterious than the basis that is created when shares are issued for cash or other property. More worrisome would be the application of zero basis to an exchange of shares, which would have the result of creating *gain* out of thin air.

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[49] *See, e.g.*, Jack Bogdanski, *Shareholder Debt, Corporate Debt: Lessons from* Levitt *and* Lessinger, 16 J. CORP. TAX'N 348 (1989); Michael Megaard & Susan Megaard, *Can Shareholder's Note Avoid Gain on Transfer of Excess Liabilities?* 71 J. TAX'N 244 (1989).

[50] Regs. § 1.1032-1(d).

[51] Rev. Rul. 56-100, 1956-1 C.B. 624.

This discussion deliberately avoids consideration of the fact that the shares that each corporation acquires in the other represents in small part an indirect ownership interest in itself. To that degree, it could legitimately be said that the acquired shares are a form of quasi-treasury stock that should not be considered to be property with a defined basis. This is indeed a valid concern, and it is discussed in detail below. Yet where neither corporation has a significant percentage stake in the other, that consideration is not a sufficient reason to disturb the simplicity of the rule providing a fair market value basis, since the investment of each corporation in the other is overwhelmingly an investment in the other corporation's other assets, and only to a small degree an indirect investment in itself.

In cases where Section 351 does apply, it is also possible for the corporations involved to be only loosely affiliated:

> *Example (4)* Corporation *C* contributes shares worth 5*x* representing a small (less than 1 percent) interest in itself to existing corporation *D* (previously wholly owned by individual *I*) in exchange for 5 percent of *D*'s stock. At the same time, individual *J* contributes other property worth 75*x* in exchange for 75 percent of *D*'s stock.

Since *C* and *J* together control *D*, the transaction is described in Section 351. *J*'s basis in the *D* stock that she receives is determined under Section 358, and is equal to her basis in the property surrendered. As to *C*'s basis in the *D* stock received by it, there is merit to the conclusion of Revenue Ruling 2006-2, that Section 362(a) does not apply. The question remains, however, whether Section 358(a) applies, and if so, whether it requires a zero basis.

As a threshold matter, it is not obvious that Section 351 should apply to *C*'s transfer at all. Section 351(a) applies by its terms if "property is transferred" to a corporation. Yet *C*'s own stock is not property in *C*'s hands, and it is being issued, not transferred. One could imagine taking this example out of Section 351 entirely and determining basis under Section 1012, just as in Example (3). While this approach may produce a sensible basis result, it upsets a fairly settled view that Section 351 does apply in these circumstances, and taking this transaction out of Section 351 would have other consequences, including removing *C* from the relevant transferor group for purposes of determining whether *J*'s transfer satisfies the Section 351 control test. For this reason, we recommend that the transaction continue to be governed by Section 351, and that the appropriate basis result be determined within that framework.

The Section 351 framework points to Section 358(a) to determine *C*'s basis in the *D* shares, yet the literal terms of Section 358(a) do not provide an unambiguous answer, since they determine this basis by reference to *C*'s basis in its own shares issued in the exchange. Yet *C* had *no* basis in its own shares, since those shares were not property in its own hands, and this is quite a different thing from saying that it had a zero basis. Consequently, the language of Section 358(a) fails to resolve the issue, and the appropriate result must be determined by reference to the purposes of Sections 351 and 1032.

Those purposes are easily stated: Section 1032 excludes the proceeds of stock issuances from the corporate tax base, and Section 351 allows tax-free contributions of property to a controlled corporation. The basis rules of Sections 358 and 362 ensure that the gain deferred by Section 351 is preserved in the shares issued to the transferor group and the property received by the transferee.

Viewed in this light, the justification for a fair market value basis becomes clear. Here, Section 351 is not deferring any gain at all, since *C* has no inherent gain in its own shares to defer, and any proceeds of their issuance are protected by Section 1032 regardless of whether Section 351 applies. Consequently, the basis rules of Section 358 and 362 should not be applied in a manner that creates a built-in gain on the issuance of the *C* shares. This purposive analysis provides the clear answer that a purely textual analysis cannot provide, and avoids the hardships and anomalies that caused so much criticism of the 1974 ruling's zero basis approach.

Providing a fair market value basis, regardless of whether the shares were acquired in a Section 351 transaction or in some other exchange for property, means that the transferee can immediately resell the shares without realizing a gain or loss, rendering unnecessary the *ad hoc* rules of the Section 1032 regulations described in Part III.B above. Moreover, a fair market value basis mimics the result of a purchase of the shares with contributed cash, thereby avoiding creating meaningless distinctions between equivalent transactions. And a comparison of Example (3) with Example (4) highlights the absurdity of applying Section 351 in a manner that creates gain that would otherwise be eliminated under Section 1032.

Once again, the discussion has avoided the fact that, to a small degree, the exchange gives *C* an indirect ownership interest in itself. Example (4) was crafted to make this self-ownership interest small enough to plausibly ignore, and in any event the same issue arose in Example (3), which was outside the scope of Section 351. The next section offers recommendations on how to deal with this indirect self-ownership, but that prob-

lem is not limited to the Section 351 context, and therefore needs to be addressed more generally.

B. Avoidance of Fictitious Gains and Losses

1. Subsidiary Dealings in Parent Stock

The zero-basis problem is most frequently debated in the context of parent shares that are contributed to a subsidiary that is wholly owned, or nearly wholly owned, by the parent:

> *Example (5)* Parent *P* contributes its own shares worth 100*x* to its wholly owned subsidiary *S,* who promptly disposes of the *P* shares for property or services worth 100*x.*

This is the clearest case for allowing a fair market value basis in the context of a transfer to a wholly owned subsidiary, which is why existing regulatory relief[52] focuses on this situation. Since the *P* shares in *S*'s hands are a sort of quasi-treasury stock, it is understandable that the Service would be reluctant to allow *S* to claim a loss on those shares, but such a claim would not arise in the case of an immediate resale.

By contrast, if the sale occurs some time later, there is potential for the subsidiary to realize a gain or loss:

> *Example (6)* Parent *P* contributes its own shares worth 100*x* to its wholly owned subsidiary *S.* Some time later, *S* disposes of the *P* shares for 60*x* in cash.

If *S* were allowed to deduct its 40*x* loss, it would have obtained a benefit that *P* would not have obtained if it had sold the shares directly. Yet this concern is not dependent on the fact that *S* acquired the *P* shares in a tax-free exchange under Section 351:

> *Example (7)* Parent *P* contributes its own shares worth 100*x* to its subsidiary *S,* which is wholly owned by *P* except for a small block of nonvoting preferred shares that is owned by a third party. Some time later, *S* disposes of the *P* shares for 60*x* in cash.

Section 351 does not apply to the contribution of *P* shares, since *P* does not control *S* on account of the preferred stock owned by a third party. Yet it is equally troubling to allow the 40*x* loss to *S* in this circumstance. These examples suggest that Section 351 is not at the heart of the problem, and therefore the solution is unlikely to be found in an analysis of Sections 358 and 362.

[52] *See* Part III.B *supra.*

Indeed, the identical concern is present even if the *P* shares are not contributed at all:

> *Example (8)* Subsidiary *S*, which is wholly owned by Parent *P*, purchases *P* shares for 100x in cash from a third party. Some time later, *S* disposes of the *P* shares for 60*x* in cash.

To be sure, in this case *S* has suffered an actual loss in that its cash assets have been depleted by 40*x*. But *P* would not have been allowed to deduct such a loss if it had purchased and sold those shares directly. Nor would *S* have been entitled to deduct the loss if it was a limited liability company that had not elected to be taxed as a corporation under the check-the-box regulations.[53] Even if *S* were treated as a separate corporation, the loss would be disallowed under the consolidated return regulations if *P* were the common parent of an affiliated group filing consolidated returns.[54]

The concern that the loss is in some sense artificial arises because the *P* shares, in the hands of *S*, so closely resemble treasury stock. The cases described in the preceding Part, where neither company had a significant interest in the other, did not present the same concern, even if allowing a fair market value basis for contributed shares led to a subsequent tax loss.

While *P* shares in the hands of *S* are like treasury shares, they are not identical to treasury shares. The principal difference is that those shares are real assets of *S* from the point of view of *S*'s creditors, whereas true treasury shares of *P* are meaningless to creditors. But this difference does not justify a difference in tax treatment in this context. To be sure, the *P* shares in the hands of *S* represent a real asset to *S*'s creditors, and if the *P* shares are publicly traded, they may be easier to liquidate than *S*'s other assets. But ultimately those *P* shares simply represent a claim on *P*'s assets, and a junior claim at that. In this sense, *S*'s ownership of *P* shares punctures some small holes in *S*'s corporate veil in a way that allows *S*'s creditors to dilute the interests of *P*'s other shareholders. Yet this would be equally true if *S* were an LLC that was treated as a disregarded entity. Although in either case creditors of *S* may well care about *S*'s investment in the *P* shares, that investment affects *P* or its other shareholders only as a measure of how much the corporate veil protection of *S* has been eroded by the share cross-ownership.

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[53] Regs. § 301.7701-3.

[54] Regs. § 1502-13(f)(6)(i).

The same reasoning applies equally to gains:

> *Example (9)* Subsidiary *S,* which is wholly owned by Parent *P,* purchases *P* shares for 100*x* in cash from a third party. Some time later, *S* disposes of the *P* shares for 140*x* in cash.

In this case, there is 40*x* of gain rather than loss. But if the *P* shares are to be treated like treasury stock, then that 40*x* of gain does not belong in the corporate tax base, regardless of whether *S* acquired those shares by purchase or in a tax-free transaction.

2. *Proposed Basis Adjustments*

To avoid giving tax effect to fictitious gains and losses, we recommend that the Service develop rules, which would likely require legislation,[55] that would preclude a subsidiary from recognizing a taxable gain or loss upon a disposition of shares of its parent. There are two ways in which this could be accomplished mechanically:

1. *Exemption/disallowance.* An exemption could be provided for any gains, while any losses are disallowed; or
2. *Basis adjustments.* The basis of the *P* shares could be adjusted to equal their fair market value immediately before a disposition.

These approaches are substantively equivalent, and either would avoid recognition of fictitious gains and losses. The discussion here uses the basis adjustment approach, which may be easier to apply in cases of partial ownership, since the basis adjustment mechanism provides a means of tracking which gains and losses should or should not be subject to tax. Those cases are discussed more fully in Part IV.C below.

In either case, the same rules should be applied for purposes of computing earnings and profits: thus, under the exemption approach, gains and losses from a subsidiary's dealings in parent shares should not affect earnings and profits; and under the basis adjustment approach, those adjustments should apply for earnings and profits purposes as well.

The discussion of the examples in this Part has focused on the basis of the *P* shares held by *S,* but similar issues arise with regard to the *S* shares held by *P*. Consider the following variant of Example (6):

> *Example (10)* Parent *P* contributes its own shares worth 100*x* to its wholly owned subsidiary *S. S* owns 500*x* worth of other assets. Some time later, after the *P*

[55] *See* Part IV.G *infra.*

> shares have declined in value by 40*x* but the value of the other assets has remained unchanged, *P* sells the *S* shares for 560*x* in cash.

Here the 40*x* loss is entirely attributable to a decline in value of the *P* shares. Since such a loss would not have been deductible if the *P* shares had been held as treasury shares rather than contributed to *S,* a mechanism is needed that either disallows the loss on the sale of the *S* shares, or reduces the basis of those shares by 40*x* to reflect the decline in value attributable to the *P* shares.

Pursuant to the recommendations in Part IV.A, in Example (10) *S* would obtain a fair market value basis of 100*x* in the contributed shares of *P,* and *P* would be entitled to increase its basis in its shares of *S* by 100*x.* Thus, under the first method (exemption/disallowance), *P*'s overall basis in its *S* shares would be increased to 600*x,* and a tax loss of 40*x* would arise on the subsequent disposition, but that loss would be disallowed. Under the second method (basis adjustments), *P*'s basis in the *S* shares would also be increased to 600*x,* but there would be a downwards adjustment of 40*x* just before the sale, so *P* would realize no gain or loss.

In some circumstances, the effect of these adjustments could be to create a loss where there would otherwise be a gain, and *vice versa.* Thus, if in Example (10) the value of *S's* other assets had increased by 30*x,* then *P* would recognize 30*x* of gain on a sale of its *S* shares for 590*x,* even though the amount realized is 10*x* less than its basis of 600*x* before the adjustment for the decline in value of the *P* shares.

Basis adjustments are also needed when *P* acquires additional *S* shares, to ensure that built-in gains in *S*'s *P* shares affect only the basis of the shares already owned:

> *Example (11)* *S* intends to sell a block of *P* shares with a basis of 100*x* and a value of 150*x.* Just before that sale, *P* purchases from *S* a block of additional shares of *S,* paying cash equal to their fair market value.

Before the sale of *P* shares by *S,* there needs to be an upwards basis adjustment of 50*x* in the *P* shares held by *S,* so that *S* recognizes no gain or loss on the sale. Similarly, there needs be a similar 50*x* adjustment in the basis of the *S* shares held by *P.* If those adjustment were not made until the sale of the *P* shares by *S,* then a portion of the basis adjustment to the *S* shares held by *P* would be allocated to the newly purchased shares, causing them to have a basis in excess of their fair market value, which could enable *P* to trigger a fictitious loss on a sale of those shares. To avoid that result, basis adjustments should be made to both the *P* shares held by *S* and the *S* shares held by *P* at the time *P* acquires additional *S* shares, so that any subsequent basis adjustments to the newly purchased *S* shares reflect only changes in value of the *P* shares that occur after those *S*

shares are purchased. These basis adjustment rules make it fairly easy for *P* to trigger an adjustment at will by acquiring or disposing of a small amount of *S* stock, but we do not see this as a problem, since the rules are intended to allow basis adjustments whenever necessary to avoid recognition of fictitious gains and losses.

If *P* obtains a fair market value basis for *S* shares received in exchange for *P* stock, then it can immediately sell those shares without recognition of gain, even if there is built-in gain on its other *S* shares. This possibility arises because the regulations under Section 1012 generally allow sellers of shares to track the basis of separate lots of shares, and to specifically identify the lot out of which shares are being sold.[56] Although *P* in this circumstance has implicitly divested itself of a portion of its appreciated position in its pre-existing *S* shares without recognition of gain, the same potential would exist if *P* had acquired additional *S* shares for cash and sold those shares (or if the purchaser had bought shares directly from *S*), and *S* had used the cash to buy *P* shares. But these cases can cause difficulties with subsequent basis adjustments:

> *Example (12)* *P* owns all five outstanding shares of *S*, with a basis of zero and an aggregate value of 500*x*. *P* contributes its own stock for an additional share of *S* worth 100*x*, and immediately sells that share for 100*x*, recognizing no gain or loss. The *P* stock held by *S* declines in value to 60*x*, and *S* then sells that stock, triggering a downwards basis adjustment of 40*x*.

If *P* were to apply that downwards basis adjustment of 40*x* to its retained shares in *S*, its basis would be reduced from zero to negative 40*x*. To avoid negative basis in this circumstance, we recommend that basis not be reduced below zero, but that the excess adjustment trigger a taxable gain to *P*, which essentially represents a portion of *P*'s gain that was not realized on the previously sold *S* share because of the Section 1012 cost rules.

Where *S* has only one class of shares outstanding, any basis adjustments should be made ratably over all of the *S* shares held by *P*, since all *S* shares participate in any fluctuations in the value of the *P* shares held by *S*. If *P* holds more than one class of *S* shares, then any basis adjustments should be allocated among those classes in a manner that reasonably reflects the extent to which each such class would be affected by changes in value of the *P* shares held by *S*. Thus, if *P* holds both common and straight preferred *S* stock, any basis adjustments should be applied only to the common stock, if it is reasonable to expect that changes in value of the *P* shares held by *S* would not materially affect the value of *S*'s preferred stock.

[56] Regs. § 1.1012-1(c).

3. *Parent Shares Owned Before Affiliation*

A difficult question arises if a target already owns shares of its acquiror:

> *Example (13)* Corporation *S* buys shares of corporation *P* at a cost of $10x$ at a time when *S* and *P* are otherwise unrelated. Some time later, when those *P* shares are worth $100x$, *P* buys all of the shares of *S*.

Once *S* is wholly owned by *P*, the *P* shares owned by *S* become quasi-treasury stock, and under the recommendations so far, *S* would not recognize gain or loss on a subsequent disposition of the *P* shares. Yet $90x$ of gain in the *P* shares arose while they were held by *S* before *S* was acquired by *P*. There is no reason to exclude that $90x$ of gain from the corporate tax base, so long as corporations are generally subject to tax on dealings in shares of other corporations.

There are a number of possible ways to deal with a target's built-in gain in acquiror shares:

1. *Immediate recognition.* The built-in gain can be triggered when the target is acquired;
2. *Deferral.* The built-in gain can be deferred until the target sells the acquiror's shares, notwithstanding the general recommendation that no gain or loss be recognized when a subsidiary sells shares of its parent; or
3. *Permanent exemption.* The built-in gain can be exempted permanently.

Immediate recognition makes sense in Example (13) above if the *P* shares held by *S* are considered to have been effectively redeemed at the time *P* acquires the stock of *S*, although *S* itself realizes nothing on the acquisition. The *P* shares may have little practical value in the hands of *S*, since under many corporate laws a subsidiary cannot vote parent shares,[57] and securities law restrictions may apply to a sale of those shares. But upon the acquisition of *S* by *P*, the *P* shares held by *S* become in a sense a non-asset, and the point of immediate recognition would be to preserve in the corporate tax base any built-in gains or losses at that time. Even so, if *S* was a member of another consolidated group before its acquisition by *P*, there should be no actual tax cost to this immediate recognition, assuming that, as we believe would be appropriate, *S* recognizes its gain on the *P* shares immediately before the acquisition, while it is still a member of the selling group. In that case, the resulting basis adjustments under the consolidated return regula-

[57] *See, e.g.*, Del. Code Ann. tit. 8, § 160(c).

tions[58] would reduce the selling group's gain by the amount of gain recognized by *S* on the *P* shares.

Deferral postpones any gains and losses until a realization event, but would at least in principle preserve the built-in gains and losses in the corporate tax base. In practice, however, deferral would be tantamount to an exemption of gains, since rather than having *S* sell the *P* shares, *P* could sell other *P* shares itself and contribute the proceeds to *S*, or *S* could sell other *P* shares that benefit from the proposed recommendations for avoiding tax on fictitious gains and losses. The built-in losses, on the other hand, could be triggered by a sale of the previously owned *P* shares, creating a whipsaw situation in which gains but not losses are effectively excluded. An outright exemption would be a more straightforward way of excluding gains with less whipsaw potential, although *S* would still have the ability to sell *P* shares with a built-in loss before its acquisition by *P*, and to sell built-in gain shares afterwards.

Viewed in isolation, immediate recognition of any built-in gain (as well as any built-in loss) is most consistent with the spirit of the proposed rules for treating parent shares held by a subsidiary as a form of quasi-treasury stock. However, this case must be viewed in the light of existing rules that govern a merger of a target that already owns acquiror shares:

> *Example (14)* Corporation *S* buys shares of corporation *P* at a cost of 10*x* at a time when *S* and *P* are otherwise unrelated. Some time later, when those *P* shares are worth 100*x*, *S* merges into *P* in a tax-free "A" reorganization.

The *P* shares held by *S* disappear in the merger without recognition of gain, resulting in a permanent exemption of the 90*x* of gain that accrued before the merger.[59] Unless this result were to be changed, we see no reason to treat Example (13) differently. For this reason (but only for this reason) we believe that a permanent exemption is appropriate, but that result should be revisited if there were to be a change in the rules that apply to the tax-free merger in Example (14).

[58] Regs. § 1.1502-32(b)(2).

[59] *Cf.* Rev. Rul. 78-47, 1978-1 C.B. 113 ("C" reorganization). In 1994, the Service announced that it would no longer rule in these cases where the parent-target was not an 80-percent distributee for Section 332 purposes, Rev. Proc. 94-76, 1994-2 C.B. 825, but the issue was taken off the no-ruling list a few years later. Rev. Proc. 99-3, 1999-1 C.B. 103.

4. *Interim Zero Basis Rule*

The foregoing assumes that the fair market value basis recommendation in Part IV.A is also applied in the parent-subsidiary context, although the basis becomes largely irrelevant if rules are in place to prevent the subsidiary from recognizing fictitious gains or losses on the sale of parent shares. Yet if those shares are viewed as quasi-treasury stock, one could ask whether they should be assigned any basis at all. A fair market value basis could be applied immediately before sale, but in the meantime "no basis" would in fact mean "zero basis." This result has appeal, but not for the reasons stated in Revenue Ruling 74-503: it is not the application of Section 351 that would justify an interim zero basis, but rather the character of the parent shares as quasi-treasury stock.

While an interim zero basis rule in this context might be justified on theoretical grounds, some problems arise in its application. For example, for such a rule to work systematically there would have to be scope for allowing negative basis:

> *Example (15)* Parent *P* contributes its own shares worth 100*x* to its wholly owned subsidiary *S* in exchange for shares of *S* worth 50*x* and 50*x* of cash. *S* owns 500*x* worth of other assets, but *P*'s basis in its pre-existing shares of *S* is only 10*x*.

Unless *P* gets basis credit for the contributed *P* shares, its receipt of cash would result in a basis of negative 50*x* under Section 358(a), and its overall basis in *S* would be negative 40*x*. In the consolidated return context, this case could be handled by creating an excess loss account,[60] although any excess loss account created in this fashion would likely be eliminated by the upwards basis adjustment that would occur just before a sale of *S* stock.

The interim zero basis rule is based on a view that quasi-treasury stock, however acquired, should not have a "real" basis any more than actual treasury stock does. This implies that when *S* makes a 100*x* cash purchase of *P* shares, as in Example (8), *P*'s basis in *S* should be reduced by 100*x*, to reflect the fact that 100*x* of *S*'s cash has been replaced by what it, to *P*, a non-asset. Moreover, *P* has used *S*'s money to effectively reduce its own number of shares outstanding, which could be viewed as implying a distribution from *S* to *P*. Indeed, Section 304(a)(2) already treats the purchase in Example (8) as a redemption in *P* shares, although it stops short of imputing a distribution from *S* to *P*. But such an imputed distribution would be necessary where *P* is domestic and *S* is foreign;

[60] *See* Regs. § 1.1502-19.

otherwise, the interim zero basis rule would facilitate Section 956 avoidance,[61] contrary to the objectives of Revenue Ruling 2006-2.[62]

A fair market value basis for contributed parent shares would allow the parent to avoid recognizing gain under Section 357(c) by contributing shares with a value equal to the excess of assumed liabilities over the tax basis of other contributed assets, as was done with contributed debt in the *Lessinger* and *Peracchi* cases:[63]

> *Example (16)* *P* contributes to *S* assets with a basis of 10*x* and a value of 100*x*, subject to assumed liabilities of 50*x*. *P* avoids recognizing 40*x* of gain under Section 357(c) by also contributing *P* stock worth 40*x*.

The interim zero basis approach would presumably require recognition of the 40*x* of Section 357(c) gain, regardless of how much *P* stock was contributed. If that result were considered appropriate on the grounds that the *P* shares are quasi-treasury stock, then consideration would have to be given to the case where the *P* shares are acquired for contributed cash, or from cash acquired from another source.

The prevention of fictitious gains and losses can be achieved with the basis adjustments recommended here, without the further step of applying an interim zero basis rule. Such a rule could be worth considering as part of a broader project to treat subsidiary-owned parent shares like treasury stock, but such a project would raise issues, like the application of Section 357(c) and the collateral effects of a Section 304(a)(2) transaction, that are beyond the scope of this report.

5. *Anti-Abuse Rule*

While it appears that the basis adjustments that we propose properly eliminate the potential for fictitious gains and losses, tax basis is used throughout the Code in many contexts other than computing gain or loss on a sale, and any clarification of the tax basis of parent shares held by a subsidiary could potentially create potential for abuse when applied in the context of various rules that were developed without consideration of their

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[61] *See* Example (2), *supra*, and accompanying text.

[62] Even with a fair market value basis, Section 956 may not fully block repatriations of cash where foreign *S* purchases domestic *P* stock directly from *P*, and the stock is exchanged for shares of a foreign affiliate in a tax-free transaction before the end of the calendar quarter, when investment in US property is measured. This is the basis of the so-called "killer B" technique, where the subsequent transaction is a triangular "B" reorganization. The Service recently announced in Notice 2006-85 that it would issue regulations under Section 367(b) that would treat the transfer of cash from *S* to *P* as a taxable distribution in this circumstance.

[63] *See* Part III.D *supra*..

application to cases of cross-ownership of shares between a parent and a subsidiary. One such case is the attempt to use a zero basis rule to avoid Section 956. On the other hand, a fair market value basis might produce inappropriate results in contexts where parent shares held by a subsidiary should be disregarded.[64] Since it is not easy to foresee all of the circumstances in which such a potential for abuse might arise, we believe it would be appropriate to adopt an anti-abuse rule that would authorize the Service to disregard the basis of parent stock held by a subsidiary, as well as the portion of the parent's basis in the subsidiary's stock attributable to the subsidiary's ownership of parent stock, when appropriate to carry out the purpose of any provision of the Code or regulations where that basis is relevant, if a principal purpose of the subsidiary's dealings in the parent stock was tax avoidance.[65]

Such an anti-abuse rule should be broadly drafted to cover even situations where one corporation has only a relatively small ownership interest in a second corporation, if substantially all of the assets of that second corporation consist of stock of the first corporation, since in such a case stock of the second corporation in the hands of the first corporation is a surrogate for treasury stock. Also, since gains and losses of a subsidiary arising from changes in the value of parent stock do not belong in the corporate tax base, similar treatment is also justified for derivative transactions based on the value of parent stock.[66]

C. Minority Ownership

Where a partially owned subsidiary owns shares in its parent, the considerations described in the preceding Part also apply, but only to a proportionate degree. If a 70% owned subsidiary owns shares of its parent, then a corresponding fraction of that share interest can be seen as quasi-treasury stock, but the remaining 30% is attributable to the

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[64] For example, parent stock held by a subsidiary, and subsidiary stock held by a parent to the extent attributable to such parent stock, could distort interest allocations under Regs. § 1.861-9T, although treatment of an affiliated group as a single taxpayer under Section 864(e)(1) and Regs. § 1.861-11T minimizes the potential scope of this problem.

[65] Some of the difficult questions that arise in applying an anti-abuse rule relate to how thoroughly parent stock owned by a subsidiary should be disregarded. For example, should basis attributable to contributed parent shares be taken into account in determining gain under Section 357(c) for liabilities in excess of basis? Unless the parent stock were to be disregarded for all purposes (which would entail, among other things, treating a subsidiary's purchase of parent stock as a dividend to the parent), in applying an anti-abuse rule the Service will need to make clear when parent stock will *not* be disregarded.

[66] Similar considerations that arise when a corporation enters into derivatives on its own stock have motivated the extension of Section 1032 to transactions in options and futures on a corporation's own stock. The point here is that a subsidiary's derivatives on parent stock should not be treated any differently.

minority interest and represents a real investment. When a subsidiary is nearly wholly owned, we recommend that, for reasons of simplicity, the rules described in the preceding Part be applied without regard to the small minority interest. Defining the precise threshold for disregarding a minority interest is a line-drawing exercise to which there is no precise answer, but we suggest that an 80% threshold would be appropriate, since under the consolidated return rules minority ownership of up to 20% is treated as consistent with the single-entity theory that justifies consolidated filings.

Where the minority interest is too large to be disregarded, then we suggest that the rules described above for avoiding fictitious gains and losses be applied on a proportionate basis. Thus, a 70% owned subsidiary should recognize only 30% of any gains and losses that may arise on dealings in its parent shares. Such a proportionate approach can achieve the proper exclusion of fictitious gains and losses from the corporate tax base, although we expect that in many, if not most, cases the tax consequences of the partial exclusion will be affect both the parent and the minority shareholders. Thus, if a 70% owned subsidiary recognizes 30% of the gain on a sale of parent shares, and the subsidiary itself has only one class of shares, then 70% of the tax on that gain or loss will be economically borne by the parent, even though the gain is being triggered by reason of the presence of minority investors.

Since the owned percentage can vary over time during periods when the subsidiary itself may be dealing in parent shares, the determination of the appropriate amount of gain or loss to be recognized is best handled through a series of basis adjustments in the parent shares held by the subsidiary, and the subsidiary shares held by the parent. Those adjustments can be summarized as follows:

1. When a subsidiary sells shares of its parent, the parent buys or sells shares of the subsidiary, or the subsidiary redeems shares from or issues shares to a third party, the basis of any parent shares owned by the subsidiary should be increased or decreased by any built-in gain or loss immediately before the sale, effectively marking those shares to market. The parent's portion and the minority's portion of the increases and decreases in the basis of any parent shares held by the subsidiary under this rule should be tracked and cumulated separately.

2. At the time of the transaction, the basis of all of shares of the subsidiary owned by the parent should be increased or decreased by the parent's portion of any resulting increases or decreases in the basis of parent shares held by the subsidiary.

3. The parent's portion is the percentage of the subsidiary that is owned by the parent, which should be generally determined immediately before the transaction triggering the adjustment. If, however, the transaction is a purchase or redemption of subsidiary shares, in adjusting the basis of parent shares owned by the subsidiary, the parent's portion should be determined immediately after the transaction.[67]

4. When a subsidiary sells shares of its parent, the subsidiary should recognize gain or loss equal to the cumulative amount of the minority's portion of adjustments in basis, including adjustments that occur upon the sale itself.

Where the parent's portion is 100%, these rules coincide with the recommendations of the preceding Part for wholly owned subsidiaries.

These basis adjustment rules can be illustrated by the following extended example:

Example (17) *P* owns 100% of *S* with an aggregate value and basis of 400*x*. *P* contributes 100 shares of *P* worth 100*x*. Those shares appreciate in value to 200*x*.

(i) *P* sells 40% of *S* for 240*x*. Immediately before the sale, *P* increases its 500*x* basis in its shares of *S* by the 100*x* of built-in gain attributable to the *P* shares held by *S*. In addition, *S* increases its basis in its *P* shares by 100*x*, to 200*x*. *P* recognizes no gain or loss, since the basis of the 40% interest that is sold is 240*x*. This is the intended result, since the change in the value of *S* is solely attributable to its *P* shares.

(ii) The value of the 100 *P* shares held by *S* further appreciates to 250*x*. *S* sells 50 of those *P* shares for 125*x*. At this time, *S*'s basis in those 50 *P* shares is 100*x*. Immediately before the sale, *S* increases its basis in those *P* shares by 25*x*, the built-in gain in those shares, of which 15*x* is the parent's 60% portion of the increase and 10*x* is the minority's 40% portion. *S* recognizes gain of 10*x*, which represents the minority's portion of basis adjustments on the sold *P* shares. The basis of the 50 retained shares is also increased by 25*x*, of which 15*x* is the parent's portion and 10*x* is the minority's portion. *P* increases its 360*x* basis in its *S* shares by 30*x*, which is the parent's portion of the increases in basis of the *P* shares held by *S*, including both the sold and retained shares.

(iii) *P* repurchases 10% of *S* for 70*x* at a time when the remaining 50 shares of *P* still held by *S* have increased further in value, from 125*x* to 175*x*, but the value of *S*'s other assets, including the 125*x* proceeds of the sale of *P* shares in (ii) above, has

[67] This exception to the general rule that the parent's share should be determined immediately before the transaction has the effect of exempting the portion of the built-in gain or loss on the *P* shares that is attributable to the *S* shares purchased by *P*.

remained unchanged. P now owns 70% of S. The basis in the P shares held by S is increased by $50x$, of which $35x$ is the parent's 70% portion and $15x$ is the minority's 30% portion. P increases its $390x$ basis in its existing S shares by $30x$, which is the parent's 60% (just before the repurchase) portion of the $50x$ increase in S's P shares. P's total basis in its S shares, including the newly purchased shares, is $490x$.

(iv) S sells its remaining 50 P shares at a time when those shares are still worth $175x$. S recognizes $25x$ of gain, which includes the $10x$ increase in (ii) and the $15x$ increase in (iii) attributable to the minority interest.

(v) P sells its remaining 70% stake in S for $490x$. P recognizes no gain or loss, since under these facts all of the changes in the value of S have been attributable to its investment in P.

Below some threshold of ownership, it becomes appropriate to disregard the percentage of P stock owned by S that could be viewed as quasi-treasury stock, and to simply treat the two corporations as unrelated. This threshold could be as high as 50%, since below that level the fictitious gains and losses from S's dealings in P stock (and from P's dealings in S stock) are outweighed by the real gains and losses. We do not recommend any specific threshold here, but it should be at least 20%, to avoid having to apply these rules to what are essentially portfolio investments.

D. Partnerships

A partnership acquiring stock of a corporate partner raises questions that are analogous to those raised when corporations own stock in each other. The problems are less pressing, however, since in the partnership context Section 1032 has been applied in a manner that eliminates some of the fictitious gains resulting from an application of zero basis to contributed stock.

The following example is drawn from the facts of Revenue Ruling 99-57:[68]

Example (18) Corporation C and individual I become equal partners in a new partnership P, with C contributing 100 of its own shares worth $100x$, and I contributing property with a value and basis equal to $100x$. Some time later, P sells the 100 C shares for $120x$.

Citing Revenue Ruling 74-503, the Service ruled that C had a zero basis in its own shares, and that this zero basis carried over to P under Section 723. Consequently, the sale of the C shares produced $120x$ of gain, of which $100x$ was fictitious gain created by the application of a zero basis rule. Happily, all of the fictitious gain was allocable to C

[68] 1999-2 C.B. 678.

under Section 704(c), and since that gain preserved its character in *C*'s hands as gain from its own stock, the gain was excluded under Section 1032. Furthermore, of the $20x$ of gain that accrued post-contribution, the $10x$ that was allocable to *C* was also excluded under Section 1032.

While it is difficult to argue with the result under these facts, a zero basis theory can have the effect of denying a deduction for real losses, as illustrated by a variation on the preceding example:

> *Example (19)* Corporation *C* and individual *I* become equal partners in a new partnership *P*, with *C* contributing 100 of its own shares worth $100x$, and *I* contributing property with a value and basis equal to $100x$. Some time later, *P* sells the 100 *C* shares for $80x$.

Here, there is $20x$ of post-contribution loss rather than gain. If the *C* shares are given a zero basis in the hands of the partnership, then the partnership has $80x$ of gain, all of which is allocable to *C* under Section 704(c). Economically, however, half of that post-contribution loss was borne by the other partner, *I*. Unless the partnership has elected remedial allocations,[69] *I* will not obtain any current tax benefit from that loss, although *I*'s share of the loss will be preserved in the basis of her partnership interest.

The zero basis theory of Revenue Ruling 99-57 can also result in a tax on fictitious gains. Because the ruling views *C* as having a zero basis in the stock it contributes, its partnership interest takes a substituted basis of zero under Section 722. Under the facts of the ruling, *C* is allowed under Section 705 to increase the basis of its partnership interest by the $110x$ of gain allocated to it, thus preserving this gain from taxation when *C* disposes of its partnership interest. Yet this rule does not protect *C* if it disposes of its interest at a time when the partnership still owns the *C* shares:

> *Example (20)* Corporation *C* and individual *I* become equal partners in a new partnership *P*, with *C* contributing 100 of its own shares worth $100x$, and *I* contributing property with a value and basis equal to $100x$. Some time later, after the *C* shares have appreciated in value to $120x$ (but the value of the other property has stayed the same), *C* sells its partnership interest for $110x$.

Under the ruling, *C* has a zero basis in its partnership interest, and realizes $110x$ of gain on the sale. Section 1032 does not protect this gain from taxation, even though the gain is entirely attributable to the value of the *C* shares at the time of contribution plus *C*'s share

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[69] *See* Regs. § 1.704-3(d).

of the post-contribution gain, since there is no general rule that characterizes gain from a sale of a partnership interest by reference to the partnership's underlying assets.[70]

These anomalies can be avoided by giving a fair market value basis to both the contributed shares and the partnership interest received in exchange. The justification is analogous to that given in the Section 351 context: Section 721 and its associated basis rules are intended to preserve gain for later taxation; but if a partnership interest is acquired for the partner's own stock, then under Section 1032 there is no deferred gain to preserve. We therefore recommend that, as part of its planned reconsideration of the zero basis issue in the corporate context, the Service also apply in the partnership context the fair market value basis rule proposed in Part IV.A above.

Providing a fair market value basis for shares of a partner contributed to a partnership would replicate the results of Example (18) and Revenue Ruling 99-57, since the partnership would have an initial basis of 100*x* in the contributed shares, and the 20*x* of subsequent gain would be split equally between the two partners, with the 10*x* of gain allocable to *C* being excluded by Section 1032 and the 10*x* of gain allocable to *I* being taxable. Such a rule would also fix the problem with Example (19), since again the partnership would have an initial basis of 100*x*, and the subsequent loss would be split equally, with the 10*x* of loss allocable to *C* being disallowed by Section 1032 and the 10*x* of gain allocable to *I* being deductible. In neither case would there be a need for subsequent basis adjustments of the sort discussed in Part IV.B above.

Merely providing an initial fair market basis, however, is not sufficient to avoid the tax on fictitious gain that occurs in Example (20) upon a subsequent sale of the partnership interest, since Section 1032 does not cover gains and losses on such a sale, even though the gain or loss may be attributable to the partner's own stock. This problem could be addressed with a system of basis adjustments, but in the partnership context it would also be feasible to simply extend Section 1032 to cover these gains and losses. Rules would be needed for determining how much gain or loss is attributable to the partners' own stock, but there is precedent for this sort of calculation in the existing rules for determining gain under Section 751(a) that is taxable as ordinary income.[71] Thus, this

[70] There are some limited rules of this nature, such as Section 751(a), which taxes gains attributable to certain "hot assets" as ordinary income. In addition, the Service takes the view that a foreign partner's gain from a sale of an interest in a partnership that is engaged in a U.S. trade or business is effectively connected, as if the partner had sold the underlying assets itself. Rev. Rul. 91-32, 1991-1 C.B. 107. *But see* Kimberly S. Blanchard, *Rev. Rul. 91-32: Extrastatutory Attribution of Partnership Activities to Partners*, 76 TAX NOTES 1331 (Sept. 8, 1997).

[71] *See* Regs. § 1.751-1(a)(2).

gain or loss could be determined by looking to the amount of gain or loss from the partner's own stock that would have been allocated to that partner if the partnership had sold all of its assets for cash immediately before the sale of the partnership interest.

Such a rule would apply even if the Section 1032 gain or loss was different in polarity from, or exceeded, the overall gain or loss from the sale of the partnership interest:

> *Example (21)* Corporation *C* and individual *I* become equal partners in a new partnership *P*, with *C* contributing 100 of its own shares worth 100*x*, and *I* contributing property with a value and basis equal to 100*x*. Some time later, after the *C* shares have depreciated in value to 80*x*, but the value of the other property has increased to 130*x*, *C* sells its partnership interest for 105*x*.

Here, *C*'s overall gain is 5*x*, comprising its 10*x* share of the 20*x* loss on the *C* shares and its 15*x* share of the 30*x* gain on the other property. The 10*x* loss would be disallowed under Section 1032, and the 15*x* gain would be taxable.

E. Foreign Entities

The considerations supporting a fair market value basis, and preventing giving tax effect to fictitious gains and losses, apply equally regardless of whether the entities involved are domestic or foreign. We therefore recommend that these proposed rules not be restricted to domestic entities. In the case of subsidiaries that are controlled foreign corporations, this would require that the basis adjustments recommended in Part IV.B above also apply in determining their earnings and profits.

There can be no assurance or even an expectation that foreign countries will adopt similar rules. Consequently, a foreign subsidiary dealing in shares of its domestic parent may suffer foreign tax consequences even if the resulting gains and losses have no U.S. tax effect. If there is a foreign tax on fictitious gain, the resulting foreign tax credit could result in a loss of U.S. tax revenue from share dealings that the U.S. tax law would disregard. Of course, differences in tax base can generally arise with a creditable foreign income tax, and there is no general rule precluding credits for foreign taxes on items that are income for foreign tax purposes but not for U.S. tax purposes.

Creditable foreign taxes imposed on items that are not income for U.S. tax purposes are assigned to the general limitation basket.[72] If the parent has excess tax credit capacity in that basket, the parent could potentially use credits for those taxes to offset U.S. tax on other general limitation income. Notwithstanding this cross-crediting potential, we do not believe it is necessary to adopt special rules for treating these taxes in a

[72] Regs. § 1.904-6(a)(1)(iv).

manner that is any different from the treatment of foreign taxes imposed on other items that are not income for U.S. tax purposes. The tax credit limitation and basket rules are the means by which the United States protects its primary right to tax U.S. source income, and the potential erosion of its ability to reach items of foreign income that are sheltered through cross-crediting is a well-known effect of the basket system.

As noted in Part IV.B above, a purchase of parent shares by a subsidiary, by using the subsidiary's money to effectively retire parent stock, can be seen as an implicit distribution from the subsidiary to the parent. Thus, if the parent is domestic and the subsidiary is foreign, then the subsidiary's purchase of parent stock can give rise to subpart F income under Section 956(a). If the parent is foreign and the subsidiary is domestic, then the subsidiary's purchase of parent stock should arguably give rise to a dividend subject to withholding, although Section 304(a)(2) in its current form does not do so. However, the question whether any such distributions should be imputed for tax purposes is beyond the scope of this report.

F. Debt Obligations

As discussed in Part III.D above, the Service has attempted to apply a zero basis theory to debt obligations contributed by the obligor in a Section 351 transaction, but has been rebuffed by the courts. Although Section 1032 does not apply to the proceeds of debt, the basis of property acquired with debt is the issue price of the debt as determined under Section 1273 or 1274,[73] and the holder of the debt has a basis equal to that issue price. This basis rule supports the general rule that debt proceeds are not taxable, except to the extent the debt is discharged without repayment, in which case income may be recognized at that time under Section 108(a).

As with stock, when an issuer contributes its own debt in a transaction that is tax-free under Sections 351 or 721, there is no built-in gain to defer. Since the debt is newly issued, the carryover basis rules of Sections 362 and 723, as well as the substituted basis rules of Section 358 and 722, provide no well-defined answer. But since outside the context of these "tax-free" transactions the receipt of property in exchange for the issuer's own debt produces a basis in that property equal to the issue price, there is no reason to apply a zero basis rule in the tax-free context. Accordingly, we recommend that the usual issue-price rules for determining basis of property acquired with debt also apply to stock or a partnership interest acquired in exchange for the issuer's own debt, and that the transferee's basis in this debt be determined by reference to that issue price.

[73] Regs. § 1.1012-1(g)(1).

In the case of a subsidiary holding debt of its parent, that debt could be viewed in a manner similar to quasi-treasury stock, so that dealings by the subsidiary in the parent's debt do not give rise to immediate gains or losses. In general, the tax law does give effect to *bona fide* debt of a shareholder to a corporation, even where that corporation is wholly owned by the shareholder. Moreover, gain or loss recognized by a subsidiary on a disposition of parent debt does represent an economic gain or loss to the selling group, since the proceeds of the disposition determine the yield on the obligation to the purchaser, which is also the cost of capital to the selling group. Accordingly, we believe that the sale of parent debt by a subsidiary should be treated in the same manner as if the debt had been newly issued at that time for an amount equal to the proceeds realized by the subsidiary. This is the approach currently taken under the consolidated return regulations, but we believe it should apply regardless of whether the parent and subsidiary file consolidated returns.[74]

Under this approach, if the subsidiary sold parent debt below par, there would be no immediately deductible loss, but the original discount would be deductible by the parent over the term of the obligation.[75] Conversely, a sale of that debt at a premium would not generate an immediately taxable gain, but the parent would be required to offset its interest deductions with accrued bond premium.[76]

These recommendations can be illustrated by the following example:

> *Example (22) P* contributes its own debt with a face amount of 100*x* to its subsidiary *S* in exchange for shares of *S*. The debt bears interest at a rate at least equal to the applicable federal rate. Some time later, *S* sells the debt to a third party for 90*x*.

Since neither the debt nor the *S* shares is publicly offered or traded, the issue price is determined under Section 1274, which provides for an issue price equal to the face amount of the debt where, as is the case here, there is adequate stated interest. Accordingly, *S*'s

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[74] *See* Regs. § 1.1502-13(g). Those regulations apply generally to intercompany debt obligations, not just parent debt owned by a subsidiary. The regulations treat the intercompany debt as satisifed just before an event that causes the debt to cease to be intercompany debt, such as a sale of the debt to a nonmember. This deemed satisfaction of the debt can produce gains and losses to the creditor and debtor members, which are given the same character under the matching rule of Regs. § 1.1502-13(c). A similar rule could be applied under the proposed extension of these rules to parent debt held outside the consolidated return context; alternatively, any gain or loss to the parent and subsidiary on the deemed satisfaction of the pre-existing debt could be simply disregarded.

[75] *See* Regs. § 1.163-4(a)(1).

[76] *See* Regs. § 1.163-13(a).

basis in the debt is $100x$, and *P*'s basis in the *S* shares received in exchange is also $100x$. On the subsequent sale of the debt by *S* for $90x$, *S* would not be entitled to deduct its $10x$ loss, but *P* would be entitled to treat the debt as having been issued at that time at a discount of $10x$, and would be entitled to deduct that discount over the remaining term of the obligation. *P* would also be required to reduce its basis in its *S* shares by $10x$ in order to avoid the possibility of a double deduction.

Similar rules should apply if *P* sells its interest in *S* at a time when *S* holds *P* debt: *P* should not be allowed a loss on the sale of the *S* shares to the extent attributable to a decline in value of the *P* debt, but that debt should be treated as newly issued at a discount at that time.

These considerations also apply to a subsidiary's purchase of outstanding parent debt from a third party. Indeed, existing law already treats such a purchase as an occasion for the parent to recognize discharge of indebtedness income if the debt is acquired for less than its adjusted issue price.[77] Moreover, those rules go beyond the parent-subsidiary case to cover any situation where the purchaser of the debt has a relationship to the obligor specified in Sections 267(b) or 707(b)(1). Similar rules apply in some cases where the obligor acquires a holder of its outstanding debt.[78]

While there is no obviously correct place to draw the line, we believe it is appropriate to have parity between the rules governing discharge of indebtedness income for debt acquired by a related party, and rules for treated debt sold by a related party as newly issued for purposes of determining original issue discount and premium. Accordingly, we suggest that the rules described above for dispositions of parent debt by a subsidiary apply in any case where the debt is issued to a person having a relationship to the obligor specified in Sections 267(b) or 707(b)(1), where that debt is subsequently sold to a third party, or the relevant relationship is terminated.

G. Authority

We believe that the recommendations for applying a fair market value basis for stock, and an issue-price basis for debt, contributed to a corporation or partnership can be adopted by regulation as a proper interpretation of existing law in those contexts. For debt, such a conclusion is well supported by the *Lessinger* and *Peracchi* cases. For stock, the proper operation of Section 1032 itself provides the needed justification. To be sure, a fair market value basis rule cannot be located within the texts of Section 362 or 723, but

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[77] Section 108(e)(4).

[78] Regs. § 1.108-2(c).

those texts simply provide no answer where the property is being newly issued rather than transferred, and the proper answer must be divined by means other than a textual analysis of those sections. In these circumstances, the determination of a proper basis rule is well within the Treasury's general authority to issue interpretive regulations.

By contrast, legislation may be needed, outside the consolidated return context, to implement the recommendations for stock basis adjustments, sales of interests in partnerships holding stock of the selling partner, and sales of related-party debt. The Treasury and the Service could proceed with the guidance recommended in the preceding paragraph without waiting for legislation on these other items. It may be more prudent, however, to wait for this legislation, since allowing a fair market value basis for contributed shares without also adopting the stock basis adjustment rules will increase the circumstances in which a subsidiary can claim a loss on a sale of parent stock. This concern should not be overstated, however, since the potential to create fictitious losses already exists under current law, where a subsidiary can obtain a cost basis in parent stock acquired outside of a tax-free transaction. Possibly, in cases where the generation of a tax loss by these means is principally tax motivated, the transaction could be vulnerable to challenge on the basis that no loss has been "sustained" within the meaning of Section 165.[79] But the surest way to avoiding expanding the potential for these fictitious losses, as well as eliminating any such potential that exists under current law, would be to seek prompt enactment of authorizing legislation that would enable all of these proposals to be adopted together.

[79] A number of cases not then covered by Section 267 have nonetheless disallowed losses on sales between related parties where the sale was undertaken to trigger the tax loss. *See* Higgins v. Smith, 308 U.S. 473 (1940); Northern Pac. Ry. v. United States, 378 F 2d 686 (Ct. Cls. 1967); Crown Cork Int'l Corp. v. Commissioner, 4 T. C. 19 (1944). There is evidence, however, that in enacting Section 1032 Congress thought that tax motivated sales of treasury stock could otherwise give rise to a deductible loss. *See* n. 7 *supra.*