# NEW YORK STATE BAR ASSOCIATION

# TAX SECTION

# REPORT ON FINAL REGULATIONS

# REGARDING ALLOCATION OF BASIS UNDER SECTION 358

# AND RELATED MATTERS

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**Report No. 1137**

**NEW YORK STATE BAR ASSOCIATION TAX SECTION**

**REPORT ON FINAL REGULATIONS REGARDING ALLOCATION OF BASIS UNDER SECTION 358 AND RELATED MATTERS**[1]

## I. INTRODUCTION

This report ("Report") of the New York State Bar Association Tax Section (the "Tax Section") comments on final regulations regarding the allocation of basis under Section 358[2] and related matters issued by the Internal Revenue Service (the "IRS") and Treasury Department ("Treasury") that were published on January 26, 2006 (the "Final Regulations").[3] The Final Regulations replaced proposed regulations (Reg-116564-03) issued on May 3, 2004 (the "Proposed Regulations"), which were the subject of a prior Tax Section Report.[4]

The Final Regulations primarily address the determination of the basis of stock or securities received in reorganizations described in Section 368 and distributions to which Section 355 applies. They adopt the same basic tracing approach as the Proposed Regulations to determine the basis of stock or securities received by a

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[1] The principal drafter of this Report was Gordon Warnke, with substantial assistance from Steven Harrison. Helpful comments were received from Kimberly Blanchard, Monica Coakley, Stuart Finkelstein, Patrick Gallagher, Martin Huck, Stephen Land, Charles Morgan, Deborah Paul and Michael Schler.

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

[3] T.D. 9244, 2006-1 C.B. 463, 71 F.R. 4264. The Final Regulations have been subject to some corrections not relevant to the substance of this Report. *See* 71 F.R. 13767 (March 17, 2006), 71 F.R. 19117-19118 (April 13, 2006); Announcement 2006-31, 2006-20 I.R.B. 912 (May 15, 2006).

[4] NYSBA Tax Section, Report on Proposed Regulations Regarding Allocation of Basis Under Section 358 (May 27, 2005) (Report No. 1088)(the "2005 Report").

shareholder or security holder in such a transaction. In light of the uncertainty surrounding basis determinations under prior law, the greater clarity offered first by the Proposed Regulations and now by the Final Regulations is welcome. This Report suggests some further clarifications and other changes to give further certainty regarding the application and scope of the Final Regulations.

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

Part II of this Report summarizes our recommendations. Part III provides a brief overview of prior law, the Proposed Regulations and the Final Regulations. Part IV discusses our comments and recommendations with respect to the Final Regulations in greater detail.

## II. SUMMARY OF RECOMMENDATIONS

A. Illustrate Rule for Allocating Basis from Multiple Classes of Surrendered Shares or Securities to a Lesser Number of Shares or Securities. The Final Regulations require that, when shares or securities are surrendered for a smaller number

of shares or securities, the basis in a share or security received must reflect the basis of shares or securities surrendered that have the same basis and holding period to the extent possible, regardless of the terms of the exchange. We suggest that the regulations illustrate whether that rule may vary where the shares or securities surrendered are of differing classes and the terms of the exchange specify another allocation.

B. Clarify Rules on Designated Allocations in Public Exchanges. Under the Final Regulations, the allocation of consideration specified in the terms of the exchange will, in certain circumstances, control the determination of basis. The Preamble to the Final Regulations suggests that the terms of the exchange are susceptible to control by a taxpayer only in transactions in which the target is closely held, but the text of the Final Regulations has no such limiting language. We recommend that the IRS and Treasury clarify what is necessary for an allocation to be respected where the target is publicly traded.

C. Clarify Scope of New Rules Governing Stockless Reorganizations. The Final Regulations provide a method, based on a deemed stock issuance, for determining the basis of certain shares of stock in a reorganization in which shares of stock or securities are surrendered and no property, or property of lesser value, is received in exchange. We recommend that there be a clarification of whether the character of the stock deemed issued in a "stockless reorganization" as determined for purposes of Section 358 is controlling for other purposes, such as qualification of a transaction as a reorganization.

D. Clarify Basis Determinations in Triangular Reorganizations. Regulations Section 1.358-6, which addresses the basis of a parent's stock in its

subsidiary in certain triangular reorganizations, was not updated in connection with the issuance of the Proposed Regulations or Final Regulations. Regulations Section 1.358-6 describes a deemed contribution by a parent corporation to its subsidiary in which basis is determined under Section 358. Now that there may be divergent regimes under Section 358 depending on whether the downstream transfer is treated as a reorganization or solely as a Section 351 transaction, we recommend clarifying the allocation of basis among the parent's shares of stock of its subsidiary in a triangular reorganization.

E. Clarify Scope of the Final Regulations' Method for Allocating Consideration. The Final Regulations contain rules for allocating the different types of consideration received to the shares of stock and securities surrendered for purposes of determining gain under Section 356 and determining basis in nonrecognition property[5] under Section 358. We recommend that the IRS and Treasury clarify whether those rules are intended to govern the allocation of consideration for other purposes, including the determination of whether an exchange qualifies as a reorganization.

F. Clarify the Determination of Basis in a Sole-Shareholder Distribution. In a distribution under Section 355 by a distributing corporation of the stock of a controlled corporation to the distributing corporation's shareholders, the tax basis consequences to the shareholders may differ under the Final Regulations depending on whether the distribution is effected as a split-off or a spin-off[6] and whether the

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[5] As used in this Report, the term "nonrecognition property" means stock or securities permitted to be received without the recognition of gain or loss under Sections 351, 354, 356 or 361, and the term "boot" means cash and any other property other than nonrecognition property. Throughout this Report, as in Reg. § 1.358-2(a)(1) and Withdrawn Prop. Reg. § 1.358-2(a)(1), the terms "stock" and "securities" are used to indicate stock and securities received that are nonrecognition property, rather than boot under the relevant provisions of Sections 351, 356 and 361.

[6] In this Report, a "spin-off" is a distribution governed by Section 355 in which no shares of the distributing corporation are surrendered, and a "split-off" is a distribution governed by Section 355 in

shareholders have more than one block[7] of stock in the distributing corporation. We suggest that the IRS and Treasury clarify whether such differing treatment applies where the distributing corporation has only one shareholder.

G. Address Treatment of Losses on Stock or Securities Exchanged Solely for Boot. The Final Regulations allocate consideration for purposes of determining gain recognition under Section 356 in the same manner as for determining basis under Section 358. Therefore, certain shares of stock or securities may be treated as exchanged solely for boot in connection with a reorganization. A substantial majority of the Tax Section's Executive Committee believes that in such circumstances loss recognition should be deferred and the excess of basis over boot with respect to the loss stock or securities should be added to the basis of other nonrecognition property received by the exchanging holder. A minority of our Executive Committee believes that such losses should be recognized immediately, unless a different treatment is mandated under other provisions of the Code (for example, dividend treatment under Section 302 or 304).

H. Provide a Rule for Determining Which Shares or Securities Are Surrendered When Less Than All Shares or Securities Are Surrendered. The Final Regulations provide rules for allocating the property received in a reorganization or split-off to the stock and securities surrendered for that property (or with respect to which the property was distributed), and for identifying shares received in such a transaction upon a later disposition. We suggest that there be additional guidance on determining what

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which holders of shares of the distributing corporation surrender some or all of their distributing corporation shares in exchange for shares of the controlled corporation.

[7] In this Report, a "block" of stock or securities refers to all of the stock or securities of a given class that are purchased on the same date and at the same price.

shares of stock or securities are surrendered in an exchange under Section 354, 355 or 356 when less than all of a shareholder's shares or securities are surrendered.

I. Address Consolidated Group Issues. This Report provides two suggestions for clarifying the determination of basis (and excess loss accounts) in certain transactions within a consolidated group.

## III. BACKGROUND

### A. Prior Law.

If a taxpayer with multiple blocks of shares of stock or securities sells a portion of such shares or securities, the taxpayer may be able to determine which shares or securities are sold under the rules in Regulations Section 1.1012-1(c).[8] Prior to the issuance of the Proposed Regulations, it was unclear whether a taxpayer's separate basis in multiple blocks of shares of stock or securities surrendered in a reorganization was preserved in the shares of stock or securities received in the reorganization.

Under Section 358(a)(1), a taxpayer's aggregate basis in stock or securities received is, in general, the same as the taxpayer's basis in the property exchanged therefor, decreased by the amount of any boot, and decreased by any loss or increased by any gain or dividend income recognized by the taxpayer in the exchange. The method for allocating that aggregate basis among the stock and securities received in a reorganization (or those received and retained in a distribution under Section 355) was uncertain. For example, it was unclear whether a shareholder exchanging multiple blocks of stock of the same class for new stock in a reorganization would receive a single block

[8] The regulations require "adequate identification" to make such a designation, absent which, the earliest shares acquired are treated as the first to be sold for purposes of determining the basis and holding period of the shares sold. Reg. § 1.1012-1(c)(1).

of new stock with an averaged or split basis, or separate blocks each reflecting the basis of a block held before the reorganization. Also, in an exchange of multiple classes or blocks of stock and securities for multiple classes of stock or securities, or for stock or securities and boot, it was unclear how to determine which consideration was received for which surrendered shares or securities.

**B. Proposed Regulations.**

The Proposed Regulations sought to change and clarify the determination of basis in reorganizations and Section 355 transactions in several ways, most of which were intended to preserve the differing bases of shares or securities after certain exchanges and distributions. They proposed a tracing regime, in which the basis of each share of stock or security surrendered in a reorganization or split-off would be traced to the specific shares or securities, or portions of shares or securities, received therefor. Withdrawn Prop. Reg. § 1.358-2(a)(i). A similar rule allocated the basis of each share or security of the distributing corporation in a spin-off between that share or security and the specific share or security received with respect thereto. Withdrawn Prop. Reg. § 1.358-2(a)(ii). Special rules provided for the allocation of basis from a number of surrendered shares or securities to a larger or smaller number of shares or securities received in exchange therefor or with respect thereto. Withdrawn Prop. Reg. § 1.358-2(a)(i) and (ii).

In an exchange of multiple shares of stock or securities for a single share or security, the Proposed Regulations required that, to the extent possible, each share or security received reflect the bases of surrendered shares or securities acquired on the same date for the same price. Withdrawn Prop. Reg. § 1.358-2(a)(i). That rule tended to result in separate blocks of shares or securities each having a basis that reflects the basis

of a pre-exchange block of shares or securities, rather than a single block of shares or securities in which each share or security has a split or averaged basis reflecting the bases of all pre-exchange blocks. A similar rule governed the tracing of basis to the shares or securities received in distributions under Section 355 in which no shares or securities were surrendered. Withdrawn Prop. Reg. § 1.358-2(a)(ii).

The Proposed Regulations also clarified that a taxpayer holding shares or securities with bases determined under the rules outlined above could, upon or prior to a disposition of such shares or securities, designate which shares or securities were received in exchange for which surrendered shares or securities in order to identify shares or securities having a particular basis as being disposed under Section 1012. Withdrawn Prop. Reg. § 1.358-2(a)(2)(iii).

The tracing rules in the Proposed Regulations applied to an exchange by a shareholder under Section 351 only if (i) the exchange was also described in Section 354 or 356, (ii) the shareholder received no stock or securities in an exchange to which neither Section 354 nor 356 applied in connection with the exchange, and (iii) no liabilities of the taxpayer were assumed in the exchange. Withdrawn Prop. Reg. § 1.358-2(a)(2)(iv).

A more detailed discussion of the Proposed Regulations can be found in our 2005 Report.

### C. Final Regulations.

The Final Regulations adopt the tracing approach introduced in the Proposed Regulations and further adhere to the concept of a reorganization or spin-off as a set of related but distinct exchanges or distributions. As described below, the Final

Regulations differ from the Proposed Regulations in that they provide even more specific guidance on allocation of consideration and tracing of basis in certain circumstances.

To trace the basis from a share of stock or security surrendered to the stock or securities received therefor, a shareholder or security holder must determine how much property of each type, including boot, is received with respect to the share or security surrendered. The Proposed Regulations did not provide specific rules for the allocation of boot or multiple classes of nonrecognition property received in a reorganization or Section 355 transaction. The Final Regulations provide that, if economically reasonable terms of an exchange specify that boot or a particular class of stock or security is received in exchange for (or with respect to) a particular share of stock or security or a particular class of stock or securities, then such terms shall control for purposes of Section 358. Reg. § 1.358-2(a)(2)(ii) and (v). Where the transaction terms do not specify an allocation, each element of the consideration received is allocated pro-rata to the shares of stock and securities surrendered according to their fair market values. *Id.* The Final Regulations provide for an identical allocation of consideration for purposes of determining the amount of gain recognition under Section 356. Reg. § 1.356-1(b).

In another change from the Proposed Regulations, the Final Regulations provide a rule for determining the basis of shares in the issuing corporation after a reorganization in which no property is received, or in which the property received is of lesser value than the shares and/or securities surrendered in the exchange. Reg. § 1.358-2(a)(2)(iii). A simple example of such a "stockless" reorganization is a merger of one corporation into another corporation where each corporation is wholly-owned by a

common direct parent and no stock in the acquiring corporation is taken back in the merger: *i.e.*, P owns S1 and S2, and S1 merges into S2 with no S2 stock being received by P in the merger. Although no additional stock of S2 is issued to P in the merger, P's basis in its S2 stock must be adjusted to reflect P's basis in its S1 stock. The Proposed Regulations did not provide a method for allocating the adjustment among P's stock in S2, with the possible result that a stockless reorganization would result in S2 shares having an averaged or split basis. The Final Regulations adopt the construct of a deemed stock issuance and recapitalization, such that a shareholder in a stockless reorganization, like P in the above example, generally is treated as having received shares equal in value to the shares or securities surrendered (reduced by the value of any property actually received in the exchange) and then as having surrendered the shares already owned, any shares actually issued in the exchange, and the shares deemed issued, in exchange for the number of shares actually held immediately after the transaction, in a recapitalization. Reg. § 1.358-2(a)(2)(iii). This has the effect of preserving the shareholder's separate bases in its retained shares (P's S2 shares in the example above) and in the shares and/or securities surrendered for no property (P's S1 shares), in blocks of stock corresponding in size to the relative pre-transaction values of the pre-existing shares and the property transferred in the transaction. As discussed in more detail in Part IV.C. below, the Final Regulations also provide a rule for determining the class of the stock deemed issued. *Id.*

The Final Regulations also clarify that, to the extent a share of stock or security is received for (or with respect to) more than one share of stock or security with differing bases and/or holding periods, the new share or security will have a split (rather than averaged) basis and/or holding period, so that a portion of the share or security

received will reflect the basis and holding period of each share or security exchanged therefor. Reg. § 1.358-2(a)(2)(vi).

The Final Regulations contain two rules governing the overlap of Regulations Section 1.358-2(a) with provisions governing the determination of basis in other types of exchanges. In the case of an exchange described in Section 351, the Final Regulations apply to the same extent as the Proposed Regulations described above. Reg. § 1.358-2(a)(2)(viii)[9]. The Final Regulations also apply to exchanges that are described both in Section 1036 and in Section 354 or 356. Reg. § 1.358-2(a)(2)(ix).

In connection with the Final Regulations, the IRS and Treasury also issued temporary and proposed regulations under Section 1502 to provide for the adjustment of excess loss accounts ("ELAs") in shares of member corporations in certain transactions without regard to whether shares in which there is an ELA are those of the target or the acquiror in the transaction. Temp. Reg. § 1.1502-19T(d)[10]. An example demonstrating

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[9] On October 23, 2006, proposed regulations were issued under Section 362(e)(2) (the "Proposed 362(e)(2) Regulations"). REG-110405-05, 71 F.R. 62067. The Proposed 362(e)(2) Regulations, if finalized in their present form, would expand Regulations Section 1.358-2(a)(2)(viii) to provide that, in addition to the current limitations on the application of the basis tracing provisions of the Final Regulations to Section 351 exchanges, such provisions would not apply to Section 351 exchanges with respect to which the taxpayer elects to apply Section 362(e)(2)(C). For example, assume corporation P transfers stock in corporation S2 to corporation S1 solely in exchange for S1 voting stock in a transaction qualifying under Section 351 and described in Section 368(a)(1)(B). Also assume the stock transferred consists of two blocks of stock -- a gain block and a loss block -- and that the aggregate loss in the loss block exceeds the aggregate gain in the gain block (i.e., the shares have an overall built-in loss). If P and S1 elect to apply Section 362(e)(2)(C) to reduce P's basis in the S1 shares received in the exchange (rather than having S1 reduce its basis in the shares of S2 it receives), then under the Proposed 362(e)(2) Regulations the basis tracing provisions of the Final Regulations would not apply to determine P's basis in the S1 stock received. On the other hand, if P and S1 did not elect to apply Section 362(e)(2)(C), the basis tracing rules of the Final Regulations would apply. *Cf.* Prop. Reg. § 1.362-4(d), Example 2. The Proposed 362(e)(2) Regulations are beyond the scope of this Report.

[10] T.D. 9244, 2006-1 C.B. 463, 71 F.R. 4264 (January 26, 2006); REG–138879-05, 71 F.R. 4319 (January 26, 2006). The temporary and proposed regulations were recently finalized without material change as Regulations Section 1.1502-19(d). T.D. 9341, 2007-35 I.R.B. 449, 72 F.R. 39313 (July 18, 2007). For ease of reference, Regulations Section 1.1502-19(d), and the examples in paragraph (g) of that section illustrating the operation of paragraph (d), as they existed prior to promulgation of Regulations Section 1.1502-19T(d) are referred to in this Report as "Former Regulations Section 1.1502-19(d)," and Temporary Regulations Section 1.1502-19T(d) and current Regulations Section

the investment adjustment rule of the regulations under Section 1502 was also modified to reflect the methodology of the Final Regulations in the context of a stockless reorganization with boot inside a consolidated group. Reg. § 1.1502-32(b)(5)(ii), Example 6.

## IV. COMMENTS AND RECOMMENDATIONS

Our 2005 Report agreed with the tracing approach contained in the Proposed Regulations because it brought greater clarity to an area that had been governed by conflicting authorities. The Final Regulations offer even greater clarity and specificity. Some of the recommendations below relate to areas where still more clarification would be useful. As the tracing regime becomes more clearly delineated, however, so do certain inconsistencies and discontinuities; other comments below relate to areas where the Final Regulations may need to be reconciled with other provisions of the tax law.

Many of the issues in this Report arise from or are exacerbated by the provisions in the Final Regulations that permit designated allocations of boot and multiple classes of nonrecognition property for purposes of Sections 356 and 358. This Report assumes that those provisions will be retained and attempts to reconcile and harmonize them with other provisions that require allocations, including Sections 368 and 351. We express no view in this Report as to whether permitting such designated allocations is preferable to proportional allocations or other possible allocation methodologies.

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1.1502-19(d), together with the examples in paragraph (g) of those sections illustrating the operation of such paragraphs (d), are referred to as "Current Regulations Section 1.1502-19(d)."

### A. Illustrate Rule for Allocating Basis from Multiple Classes of Surrendered Shares or Securities to a Lesser Number of Shares or Securities.

Where shares or securities are surrendered in a reorganization or split-off for a smaller number of shares or securities, the basis allocated to each share or security received must be traced from surrendered shares or securities having the same basis and holding period to the extent possible. Reg. § 1.358-2(a)(2)(i). A similar rule governs the tracing of basis in a spin-off from shares or securities of the distributing corporation to the shares and securities of the controlled corporation received with respect thereto. Reg. § 1.358-2(a)(2)(v). Those rules further the aim of preserving in separate blocks of new stock or securities the differing bases that a shareholder or security holder had in different blocks of its original shares or securities. That approach prevents Section 358 from being an elective tracing or split-basis regime. For example, if a shareholder exchanged two blocks of 10 target shares (20 shares in total) for a total of 10 acquiror shares, a rule respecting the shareholder's allocation would allow the shareholder to preserve the blocks by surrendering two shares from the same block for each acquiror share or create a single block by surrendering a combination of one share from each block in exchange for each acquirer share. The latter may not lead to as much concern under the split-basis approach now required by Regulations Section 1.358-2(a)(2)(vi) as it would under an averaging regime. The rules in the Final Regulations do, however, minimize the number of shares with split bases and holding periods.

Consider a simple example of a recapitalization in which shareholder X holds 100 shares of common stock of corporation T, 50 with a $10 basis acquired on date 1 and 50 with a $1 basis acquired on date 2. X exchanges its 100 shares of T common

stock in a recapitalization under Section 368(a)(1)(E) for 50 newly-issued shares of T common stock. An exchange of stock or securities pursuant to a recapitalization under 368(a)(1)(E) generally is subject to the tracing regime under the Final Regulations. Therefore, each new T share is treated as received in exchange for two old T shares, and, regardless of the terms of the exchange, each new T share is treated as received in exchange for two old T shares from the same block. Accordingly, X receives two blocks of new T shares, 25 having a basis of $20 each and 25 having a basis of $2 each. The recapitalization replicates the aggregate bases of the blocks of old stock in proportionately sized blocks of the new T stock. The same result will occur in any similar recapitalization (except that, where bases of shares of a given block of pre-recapitalization shares must be traced to a fractional number of new shares, one or more new shares with split bases will result). *Cf.* Reg. § 1.358-2(c), Example 14.

The Final Regulations draw no distinction between designated allocations in exchanges in which the shareholder or security holder surrenders multiple blocks of the same class of stock or securities and those in which the shareholder or security holder surrenders multiple classes of stock or securities. In either case, the basis of a share or security received must reflect the bases of surrendered shares or securities with like bases and holding periods. Accordingly, if the terms of an exchange specify that an acquiring corporation will issue shares of its sole class of stock in exchange for one share of each of the two classes of the target corporation, the terms of that exchange would not control for purposes of Section 356 or 358.

For example, assume corporation T has outstanding an equal number of shares of common and preferred stock, which are held by the same persons in equal

proportions. At the time in question, each share of common stock has the same value as each share of preferred stock. A, a corporation with only one class of stock outstanding, offers to acquire all of the stock of T by issuing one A share in exchange for one share of T common stock plus one share of T preferred stock. Individual X, who owns 10 shares of T common stock with a basis of $10 per share plus 10 shares of T preferred stock with a basis of $1 per share, exchanges such shares for 10 shares of A stock. If basis were allocated according to the terms of the exchange, X would receive one block of 10 A shares, and half of each A share would have a basis of $10 and the other half of each share would have a basis of $1. Under the Final Regulations, however, apparently X will receive 5 A shares with a $20 basis per share and 5 A shares with a $2 basis per share.

While we do not object to the result in the Final Regulations, we could also support a regime in which the terms of the exchange control where multiple classes of stock are involved. To remove any confusion that may exist with respect to this matter, we recommend that an example illustrate whether the terms of the exchange can be respected for purposes of basis allocation under Section 358 when the shareholder or security holder surrenders not just different blocks (as illustrated in example 14 under Regulations Section 1.358-2(c)), but different classes of stock or securities.

**B. <u>Clarify Rules on Designated Allocations in Public Exchanges</u>.**

If a shareholder or security holder surrenders a share of stock or a security for shares of stock or securities of more than one class, or stock or securities plus boot, and the terms of the exchange specify what type of consideration is received for a particular share or security, or class of shares or securities, surrendered, then those terms (if "economically reasonable") are respected in determining gain recognition under

Section 356 and basis under Section 358. Reg. § 1.356-1(b); § 1.358-2(a)(2)(ii).[11] To the extent the terms of the exchange do not specify the allocation (or, presumably, if the specified terms are not "economically reasonable"), each type of consideration will be allocated pro rata to the shares or securities surrendered based on their fair market values. *Id.* A similar rule applies to distributions under Section 355. Reg. § 1.358-2(a)(2)(v).

It is not clear precisely what must be in the terms of the exchange in order for them to govern the allocation. The Preamble to the Final Regulations explains that taxpayers are not expected to be able to control the terms of the exchange except where the target in the reorganization is closely held. It is apparent that a shareholder is more likely to be able to control the terms of an exchange if that shareholder owns a substantial part of a closely held corporation rather than a miniscule fraction of a publicly traded corporation. It is less clear, however, that a reorganization involving a publicly-traded corporation is not conducive to designated allocations if those with control over the terms of the exchange are inclined to create one, or if individual shareholders are permitted to supply certain terms of the exchange that pertain solely to them. Nor is it readily apparent why shareholders in a public transaction should be afforded less flexibility than their private transaction counterparts regarding allocations of boot or shares of stock or securities of more than one class received, so long as such allocations are economically reasonable.

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[11] Presumably, "economically reasonable" means that property must be surrendered in exchange for property with a like value, so that there may be many economically reasonable ways to articulate the terms that all result in the same aggregate exchange. Another reading of the phrase might require that there be some reasonable purpose for the chosen allocation. We believe that the former is the appropriate standard; if the latter (or something else altogether) is intended, then clarification would be useful.

One interpretation is that the IRS and Treasury intend the phrase "terms of the exchange" to include only the terms of the acquisition agreement. The terms of the exchange would in that case be more likely to be controlled by the target shareholders where the target is closely held, because in such circumstances the target shareholders are more likely to have a meaningful say in the terms of the acquisition agreement. In the acquisition of either a publicly-held or closely-held target, however, the acquisition agreement could provide that the allocation can be decided at a point in the future (for example, in the case of a public transaction, in the letter of transmittal). If the phrase "terms of the exchange" is interpreted to include only the terms of the original agreement and not some subsequent designation, then an allocation decided at some point in the future apparently would not be respected in either a public or private exchange.

Consider a reorganization where all one million shares of publicly traded target, T, with a value of $2 each, are to be surrendered by T shareholders, who will receive, in the aggregate, $1 million in cash and one million shares of stock in A, each of which is worth $1. There are several ways that the documents governing the exchange could describe the exchange, with consequences that may or may not differ from the default rule (and may or may not be respected) under the Final Regulations.

If the terms of the document specify that each T share will be exchanged for one share of A and $1 in cash, it is safe to conclude that each T share will be considered exchanged for one share of A and $1 in cash, because that is both the default (pro-rata) allocation and the designated allocation. *See* Reg. § 1.358-2(a)(2)(ii).

If the terms of the exchange instead specify that, for every two shares of T stock surrendered, one is exchanged for two A shares and one is exchanged for $2 in

cash, then the allocation is less clear. If the terms also provided that a shareholder holding a single share receives $1 and one A share, one might conclude that the exchange is identical in substance to the pro-rata allocation described in the paragraph above. Even if there is nothing to undercut the substance of the terms, it is not clear whether a shareholder with two shares of unequal bases may designate which share is exchanged for cash and which for stock. Such an allocation would be consistent with the terms of the exchange, but the terms of the exchange may not be of a type entitled to deference under Regulations Section 1.358-2(a)(2)(ii) because they do not specify that any type of consideration is received in exchange for a particular share. Furthermore, no other authority appears to permit the shareholder to select what consideration is received for which shares. Accordingly, the consideration is presumably allocated pro-rata to the two shares, even though such allocation is inconsistent with the terms of the exchange.

The terms of the exchange could specify that each T shareholder will receive in the aggregate a number of A shares equal to the number of T shares surrendered and a number of dollars in cash equal to the number of T shares surrendered. The terms could also invite shareholders to indicate on a letter of transmittal or similar communication at or prior to the closing of the exchange which shares the stockholder wishes to surrender for cash and which for stock. It is not clear whether such designations, made unilaterally by the shareholders, would be considered "terms of the exchange" that would control the allocation of consideration for purposes of Sections 356 and 358. Because the designation has no effect on the proportion of A stock and cash to be received by a shareholder, the designation has little or no economic substance apart from any tax effect. The exchange is economically identical to one in which each T share

is exchanged for equal parts A stock and cash. Arguably, however, any such designation should be respected despite the absence of economic consequences, because in a private transaction, the documents could specify that particular shares are exchanged for particular consideration despite the absence of any non-tax economic consequences of such specification.

The exchange could provide instead for a cash election in which each shareholder could elect to receive cash or stock with respect to each of its shares, without any constraint on the overall mix of consideration paid to each shareholder, but subject to adjustment to the extent necessary to make the mix of consideration 50 percent stock and 50 percent cash across all T shareholders. If a T shareholder elected to receive only cash in exchange for one block of T shares and only A shares for another block of T shares, and the T shareholder received that mix of consideration (*i.e.*, no adjustment was necessary), then the shareholder's allocation should warrant more respect, because it has the potential for real non-tax consequences. For example, if the cash election had been oversubscribed, the shareholder would have received less than 100 percent cash for its shares it elected to exchange for cash, and would still have received 100 percent stock for the shares it elected to exchange for shares.

Of course, a taxpayer having to rely on other shareholders subscribing in the aggregate for precisely 50 percent stock and 50 percent cash is hardly a satisfactory approach. An alternative, if necessary to achieve the desired tax result, might be to structure the cash election so that any reduction in cash consideration due to oversubscription is based on the extent to which the cash the shareholder elected exceeds 50 percent of the shareholder's total consideration. Under such a structure, any

shareholder electing exactly 50 percent cash would be assured of receiving cash, and only cash, with respect to the shares the shareholder designated.

Other structures are also possible but, in our view, it is questionable to require taxpayers to go through various machinations in public transactions to reach the same tax result they could achieve in a private transaction with the same economics. Moreover, we believe that it is important that taxpayers have certainty regarding whether and when designations will be respected in public transactions.

Accordingly, we recommend that the IRS and Treasury provide examples to illustrate precisely what is required for an allocation specified by the terms of a public exchange to be respected for purposes of Sections 356 and 358. In our view, if there is a clear and contemporaneous indication of what stock or securities the parties intend to be surrendered for what property, and the exchange so defined is economically reasonable, that indication should be sufficient to create a designated allocation. For instance, a shareholder should be able to indicate on a letter of transmittal which shares or securities are to be exchanged for each type of consideration. Such a rule would effectively give parties in a public transaction the same freedom to structure their affairs as those in a transaction with a closely held target.

### C. Clarify Scope of New Rules Governing Stockless Reorganizations.

The Final Regulations provide needed guidance on the treatment of stockless reorganizations. As outlined above, a shareholder that surrenders stock or securities in a stockless reorganization redetermines its basis in its stock in the acquiring corporation as if it received stock or securities equal in value to the stock or securities surrendered, less the value of any property (including nonrecognition property and boot)

actually received in the reorganization, and then surrendered the shares retained, any shares received, and the shares deemed received, in exchange for the number of shares actually held after the transaction in a recapitalization under Section 368(a)(1)(E). Reg. § 1.358-2(a)(2)(iii). The deemed recapitalization is a reorganization that is subject to the allocation and tracing rules of the Final Regulations, which preserve the separate bases of the owner's retained shares and the shares or securities surrendered for no property. Reg. § 1.358-2(a)(2)(ii) and (iii).

The Final Regulations also provide that the class of stock that is deemed to be issued in the hypothetical transaction described above is based on the acquiring corporation stock held by the shareholder or security holder:

> If the shareholder owns only one class of stock of the issuing corporation the receipt of which would be consistent with the economic rights associated with each class of stock of the issuing corporation, the stock deemed received by the shareholder pursuant to the previous sentence shall be stock of such class. If the shareholder owns multiple classes of stock of the issuing corporation the receipt of which would be consistent with the economic rights associated with each class of stock of the issuing corporation, the stock deemed received by the shareholder shall be stock of each such class owned by the shareholder immediately prior to the transaction, in proportion to the value of the stock of each such class owned by the shareholder immediately prior to the transaction.

Reg. § 1.358-2(a)(2)(iii). *See* Reg. § 1.358-2(c), Examples 10 and 11.

We recommend that the IRS and Treasury clarify whether the class of stock deemed issued in such an exchange, as determined under the Final Regulations, is controlling for purposes of determining whether the exchange qualifies as a reorganization. Reorganizations described in Section 368(a)(1)(B) or Section 368(a)(1)(C) must involve the receipt of voting stock in exchange for stock or properties (respectively) of the target. In instances where no stock is actually issued in the

transaction, the qualification of the transaction as a reorganization will depend on (among other things) whether stock is deemed to be issued, and whether any such deemed-issued stock is deemed to be voting stock, for purposes of Section 368. By its terms, Regulations Section 1.358-2(a)(2)(iii) applies only to exchanges that qualify as reorganizations, so a taxpayer presumably may not rely on that provision to determine, as an initial matter, whether an exchange qualifies as a reorganization. Therefore, we recommend that guidance (not necessarily under Section 358) clarify whether the construct described in Regulations Section 1.358-2(a)(2)(iii) applies for other purposes, including qualification of a transaction under Section 368.[12] We also recommend that guidance confirm what is implied in Example 11 of the Final Regulations. Example 11 concludes that, where a shareholder owns both shares of preferred stock and common stock of an acquiring corporation ("X"), and the pre-transaction value of X is such that the liquidation preference of the X preferred stock could be satisfied even absent the transaction, any shares deemed issued to the shareholder by X in any stockless transaction are shares of X common stock.

### D. Clarify Basis Determinations in Triangular Reorganizations.

Certain basis determinations in triangular reorganizations are determined under Regulations Section 1.358-6, which was not amended in connection with the issuance of the Proposed Regulations or Final Regulations. Regulations Section 1.358-6 describes reorganizations involving three corporations: "P," the issuer of stock issued as consideration in the reorganization, "S," a party to the reorganization controlled by P, and

[12] At least one IRS private letter ruling held that stock deemed issued by an acquiring corporation with only voting common stock outstanding was voting stock for purposes of determining reorganization qualification. *See* PLR 9551011 (Sep. 19, 1995).

"T," another party to the reorganization. Reg. § 1.358-6(b)(1). In a triangular reorganization, P's basis in the stock of S (or in T, in the case of a reverse-triangular reorganization of S into T) is generally determined as if P first acquired the stock or assets (depending on the type of triangular reorganization) of T and, second, contributed such stock or assets to S (with P's basis in T stock in the case of a reverse-triangular reorganization being what P's basis in its S stock would have been had the transaction been a forward-triangular reorganization of T into S). For each type of triangular reorganization, the regulations specify that the deemed contribution in the second step is a transaction in which P's basis in the stock of S or T is "determined under section 358." Reg. § 1.358-6(c). Regulations Section 1.358-6 does not specify whether the transfer of assets or stock that P is deemed to make occurs in a deemed reorganization under Section 368 or a deemed exchange under Section 351 and different rules now apply to exchanges under Sections 354 and 356, on the one hand, and Section 351 on the other. Reg. § 1.358-2(a), -2(b). Prior to the issuance of the Proposed Regulations and Final Regulations, the distinction may have had less relevance, especially if one were of the view that an averaged or split-basis regime applied regardless of the type of nonrecognition transaction involved. Under the Final Regulations, however, the results will differ depending on the characterization of the transaction in which P is deemed to transfer stock or assets.

For some types of triangular reorganizations, the deemed transfer could only qualify as an exchange under Section 351. In a triangular C reorganization, a forward triangular reorganization, or a reverse triangular merger (other than a reverse triangular merger that also qualifies as a B reorganization or a Section 351 transaction),

the deemed transfer by P is of assets of T. Reg. § 1.358-6(c)(1) and (2). Unless such assets happen to consist solely of stock and securities and no liabilities are deemed assumed in connection with the deemed transfer, the deemed transfer would not be one to which the tracing regime — including the stockless reorganization provisions — of the Final Regulations would apply. Reg. § 1.358-2(a)(2)(viii). If the deemed transfer is outside the scope of the Final Regulations, it is unclear how P determines its basis in its S or T shares. Consistent with the stockless reorganization provisions of the Final Regulations, P might be treated as having transferred T assets for additional shares of S, which would give P multiple blocks of shares in S, and then as having recapitalized those blocks of shares into the number of shares P actually owns under the principles of Regulations Section 1.358-2(a)(2)(iii). While consistent with the stockless reorganization provisions of the Final Regulations, in that it preserves the differing bases in various blocks of stock, there is currently no guidance of which we are aware providing for deemed-issuance-and-recapitalization treatment of a stockless Section 351 exchange. *See* Reg. § 1.358-2(a)(2)(iii), -2(a)(2)(viii), -2(b). Further complicating the determination, any stock deemed issued in an exchange under Section 351 apparently may have an averaged basis, reflecting the average of the separate bases of all of the T assets (or such stock may have a split basis, at least as regards T assets having relevant, different holding periods). *See* Rev. Rul. 85-164, 1985-2 C.B. 117.

Where P is deemed to transfer T stock to S, as is the case in a triangular B reorganization, or P is deemed to transfer stock held by T to S, the analysis becomes both more and less complicated. In such cases, the first question that must be answered is whether the deemed transfer of stock can qualify as a reorganization, a question whose

answer will depend in part on the scope of the rules governing stockless reorganizations discussed in Part IV.C. above. If it cannot, then the transaction should be governed solely by the basis rules applicable to Section 351 transactions, leading to the same basis issues discussed above. If the deemed transfer can qualify as a reorganization, then the second question that must be answered is whether the deemed transfer includes assets other than stock or securities or involves the assumption of liabilities. If it does, then, once again, under the Final Regulations only the Section 351 regime applies. If it does not, then the deemed stock transfer should be subject to the stockless reorganization provisions of the Final Regulations. Under those rules, P generally would be deemed to receive stock of S (or T) equal in value to the stock that P transfers to S and then recapitalize its actual shares and deemed-issued shares into the number of shares of S (or T) that P actually holds immediately after the transaction, with the result that P will have blocks of stock of S (or T) after the transaction corresponding to the S shares it held before the transaction and the property transferred to S (or T). Reg. § 1.358-2(a)(2)(iii).[13]

In light of the uncertainties surrounding the determination of basis under Regulations Section 1.358-6, we recommend that the IRS and Treasury clarify whether the deemed transfer of stock or assets in a triangular reorganization is intended to be a transaction governed by (i) the stockless reorganization regime in the Final Regulations,

[13] An argument might be made that, since a triangular reorganization is a "reorganization," the stockless reorganization rules of the Final Regulations should automatically apply (assuming the triangular reorganization is not also itself a Section 351 transaction involving the assumption of liabilities or the transfer of assets in addition to stock or securities). It seems highly unlikely, however, that the stockless reorganization provisions of the Final Regulations were intended to encompass the transfer from P to S that is deemed to occur under Regulations Section 1.358-6 in a triangular reorganization since, as described above, in a number of circumstances there is no way the transfer from P to S could itself qualify as a reorganization.

(ii) similar rules or (iii) different rules, and illustrate by way of examples the application of the applicable regime to triangular reorganizations.[14]

### E. Clarify Scope of the Final Regulations' Method for Allocating Consideration.

As described above, the Final Regulations provide that the terms of an exchange or distribution can govern the allocation of multiple types of consideration received to multiple shares of stock or securities or multiple classes of stock or securities surrendered for purposes of Sections 356 and 358. Reg. § 1.356-1(b); Reg. § 1.358-2(a)(2)(ii) and (v). The Final Regulations do not directly address the allocation of consideration for any other purposes, including the determination of whether the transaction qualifies as an exchange or distribution under Section 368 or 355.

Section 356, by its terms, applies only to exchanges described in Section 355 or Section 368. Section 356(a)(1)(A). Section 358 applies to certain other transactions, such as exchanges under Section 351, but the Final Regulations apply only to reorganizations under Section 368 and exchanges and distributions under Section 355. Therefore, in order to apply the rules of Regulations Sections 1.356-1(b) and 1.358-2(a)(2)(ii) in a transaction, one first must establish that the transaction is a reorganization. Accordingly, if qualification of the transaction as a reorganization depends on the allocation of multiple types of consideration received to multiple classes of stock and/or securities surrendered, one presumably cannot rely on the allocation method established by the Final Regulations to make that allocation.

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[14] We note that different rules apply in the context of certain triangular reorganizations where the surviving corporation is a foreign corporation. *See* Reg. §§ 1.358-6(e), 1.367(b)-13. The proposed regulations that were the predecessor of Regulations Section 1.367(b)-13 (REG-125628-01) were the subject of NYSBA Tax Section, Report on Proposed Regulations Regarding Cross-Border Mergers (July 26, 2005) (Report No. 1094).

Conversely, if a taxpayer wants an acquisition to be a qualified stock purchase described in Section 338 (a "QSP"), rather than a reorganization, it is not clear whether the taxpayer can invoke an allocation methodology which by its terms applies only to reorganizations to allocate consideration in a way that prevents the acquisition from qualifying as a reorganization.

Consider a reverse triangular merger pursuant to which corporation P acquires closely-held corporation T by merging P's subsidiary S into T. Before the transaction, T's shareholder, X, holds 100 shares of T voting common stock with a value of $100 and an aggregate basis of $10, and 100 shares of T non-voting preferred stock with a value of $100 and an aggregate basis of $100. The parties negotiated that X will receive, in the aggregate, 170 shares of P voting common stock, worth $1 per share, and $30 in cash in exchange for its common and preferred T shares.

The terms of the exchange, if economically reasonable, will control the allocation of consideration for purposes of Sections 356 and 358. Reg. § 1.358-2(a)(2)(ii). If the terms are silent, then each class of shares (because they are of equal value) will be exchanged for 85 P shares and $15 in cash. *Id.* Provided consideration is allocated in the same manner for purposes of determining reorganization qualification and all other requirements are met, the transaction will qualify as a reorganization under Section 368(a)(1)(A) and (a)(2)(E). X will realize no gain or loss with respect to its high-basis preferred stock and will recognize $15 of the $90 gain it realizes with respect to its low-basis common stock. X will have an aggregate basis of $10 in the 85 shares deemed received for its common stock and an aggregate basis of $85 in the 85 shares deemed received for its preferred stock.

Assume instead that X wishes to allocate all of the cash consideration to its high-basis non-voting preferred stock in order to avoid any gain recognition in the exchange, so the exchange documents specify that X shall receive 100 P shares for its voting common T shares and receive 70 P shares and $30 for its non-voting preferred shares. If the transaction qualifies as a reorganization, X will recognize no gain with respect to its common shares (because it receives no boot in exchange for them) or its preferred shares (because it realizes no gain with respect to them), and X will have a block of 100 P shares with an aggregate basis of $10 and 70 P shares with an aggregate basis of $70. If the terms of the exchange are also respected in determining how consideration is allocated for purposes of Section 368, however, then this exchange is not a reorganization, because X did not exchange at least 80 percent of its T non-voting preferred stock for P voting stock. Sections 368(a)(2)(E)(ii), 368(c).

We recommend that the IRS and Treasury clarify how consideration is allocated for purposes of qualification under Section 368. The allocation method provided in the Final Regulations for Sections 356 and 358 is based on the actual terms of the exchange, so absent a specific requirement to the contrary, taxpayers will likely feel compelled to allocate in the same manner for qualification under Section 368 where non-recognition treatment is important, because to do otherwise would be to disavow their chosen form. On the other hand, taxpayers may not feel totally comfortable with relying on the allocation method provided in the Final Regulations to determine whether they have a QSP where purchase treatment is important. Therefore, we recommend that the IRS and Treasury consider a rule that, for purposes of qualification of a transaction as a reorganization under Section 368 or a QSP under Section 338, respects the allocation of

consideration specified in the terms of an exchange where such allocation is economically reasonable, with a default rule allocating consideration pro rata absent an economically reasonable allocation specified in the terms of the exchange.

We also recommend a clarification of what rules govern the recognition of gain in transactions described both in Section 368 and Section 351 that are subject to the Final Regulations. The provisions of the Final Regulations under Section 356 appear to conflict with Section 351 for those exchanges that are subject to both. Section 356, as interpreted by Regulations Section 1.356-1(b), permits a shareholder, in certain circumstances, to realize gain and receive boot, yet avoid recognition of any gain by allocating nonrecognition property to surrendered stock and securities in which there is gain and allocating boot to surrendered stock and securities in which there is a loss (or at least no gain). There is no equivalent provision applicable to exchanges under Section 351; under existing guidance, boot received in a Section 351 transaction is allocated among the assets exchanged in accordance with the relative fair market values of such assets. *See* Rev. Rul. 68-55, 1968-1 C.B. 140. Accordingly, a different amount of gain can be required to be recognized under Section 351 than under Section 356. We suggest that, unless the allocation regime applicable to Section 356 is extended to Section 351, the IRS and Treasury provide an overlap rule eliminating this apparent conflict and expressly deferring to the Section 356 result.[15]

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[15] There is precedent in other circumstances for giving deference to the gain recognition rules of the reorganization provisions over the gain recognition rules of Section 351 in cases of potential conflict. For example, in transactions in which a transferring corporation transfers assets to an acquiring corporation for nonrecognition property and boot, but the transferring corporation is protected from gain recognition under Section 361(b)(1)(A), the IRS has ruled that no gain is recognized by the transferring corporation even though the transaction evidently is also one to which Section 351(b) applies. *See, e.g.*, PLR 9544004 (Nov. 22, 1944); PLR 9750044 (Sep. 12, 1997).

## F. Clarify the Determination of Basis in a Sole-Shareholder Distribution.

Under the Final Regulations, a Section 355 distribution[16] may have different basis consequences depending on whether it is structured as a spin-off or a split-off. In a spin-off, the shareholder's bases in shares of stock of the distributing corporation, D, will be allocated between those D shares and the shares in the controlled corporation, C, received with respect thereto. In a split-off, the bases of the D shares surrendered will be traced to the shares of C received. It appears that the foregoing difference may result even where D has only one shareholder and the economic consequences of a spin-off and a split-off therefore are identical.

Consider, for example, the distribution by D of the stock of C to D's publicly-traded corporate parent, P, which owns 100 percent of the shares of D. P has two blocks of D shares. Block 1 has a value of $100 and a basis of $100, in the aggregate. Block 2 has a value of $100 and a basis of $0, in the aggregate. The stock of C accounts for half of the pre-distribution value of D. Upon completion of the distribution of the stock of C to P, P plans to distribute the stock of C to its shareholders.

If the distribution is structured as a pro-rata spin-off, P will retain all of its D shares, and P will be deemed to receive half of the C shares with respect to its high-basis D shares and half with respect to its zero-basis D shares. Reg. § 1.358-2(a)(2)(v).

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We also note that, under Regulations Section 1.358-2(a)(2)(viii), the basis tracing regime of the Final Regulations does not apply where an exchange is described in both Section 351 and Section 354 or 356, if, in connection with the exchange, property is surrendered for stock or securities in an exchange to which neither Section 354 nor Section 356 applies or liabilities are assumed. However, there is no corollary statement in the Final Regulations that if, in connection with the exchange, no property is surrendered in an exchange to which neither Section 354 nor Section 356 applies and no liabilities are assumed, the tracing regime applies notwithstanding that the exchange is also described in Section 351. While this is the obvious import of the Final Regulations and the Preamble thereto, it may be worth making this point explicit.

[16] In this Part IV.F., all distributions are governed by Section 355 unless otherwise indicated.

As a result, half of P's original $100 basis in its high-basis D shares will be allocated to those D shares and the other half to the half of the C shares received with respect thereto. Reg. § 1.358-2(a)(2)(iv); *Cf.* Reg. § 1.358-2(c), Example 12.

If the distribution is structured as a split-off, P will surrender half of its D shares in exchange for all of the C shares. If the form of the transaction is respected and P causes the terms of the exchange to reflect that P surrenders its zero-basis D shares in exchange for C shares, then that allocation should be respected. Reg. § 1.358-2(a)(2)(ii). P will therefore retain its $100 basis in its D shares and will have a basis of $0 in the stock of C. Reg. § 1.358-2(a)(2)(i). *Cf.* Reg. § 1.358-2(c), Example 13. This split-off result is likely to be preferable for P, because, while P's basis in D may or may not be relevant in the foreseeable future, P's basis in C is almost certainly irrelevant if the external distribution of C to P's shareholders is governed by Section 355. In the external distribution, P will dispose of its C stock without gain recognition (so it incurs no detriment from having a low basis in the C stock), and P's shareholders will determine their basis in the C shares received by reference to their basis in their P shares, not by reference to P's basis in the C shares distributed.

Under the spin-off/split-off dichotomy in the Final Regulations, unless the parent of a distributing corporation has the same basis in all of its shares of the distributing corporation, it typically will benefit from effecting any internal distribution precedent to an external distribution (or another internal distribution) as split-off in which it surrenders its lowest basis shares of the distributing corporation in exchange for the stock of the controlled corporation.[17]

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[17] Sole shareholders that are not corporations may also benefit from a distribution being effected as a split-off rather than a spin-off, but unlike in the case of a corporate shareholder, the gain inherent in the

Of course, similar discontinuities may exist in analogous taxable transactions. The question of how surrendering shares in a sole-shareholder split-off should be treated is similar in certain respects to the question of how surrendering shares in a taxable redemption by a corporation of stock held by a sole shareholder should be treated.[18] The resolution of the question need not be the same in each instance, however, because the policy considerations may differ. We recommend that the IRS and Treasury consider the issues described above, and clarify the treatment of split-offs to sole shareholders under the Final Regulations.[19]

### G. Address Treatment of Losses on Stock or Securities Exchanged Solely for Boot.

Because the Final Regulations permit consideration to be allocated according to the terms of the exchange in certain circumstances, it is possible that some shares of stock or securities surrendered in connection with a reorganization or a split-off may be exchanged solely for boot. Determination of gain recognition in such instances is straightforward if Section 356 applies to the exchange.[20] But, as the Preamble to the Final Regulations notes, where there is a loss inherent in shares of stock or securities

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low-basis block of C stock received typically cannot be eliminated in a subsequent transaction. On the other hand, assuming Example 13 in Regulations Section 1.358-2(c) correctly illustrates the rule, the shareholder may simply surrender shares and decide later, after all the facts are known (such as whether the shareholder is going to dispose of the C shares received or the D shares retained), whether the shareholder prefers to have surrendered its high-basis or low-basis D shares for the C shares. Example 13 is discussed further under Part IV.H., below.

[18] For a discussion of some of the issues involved in determining the treatment of a taxable redemption of shares from a shareholder, see NYSBA Tax Section, Report on Basis Recovery in a Dividend Equivalent Redemption (June 13, 2006) (Report No. 1112).

[19] Similar issues to those discussed in this Part IV.F. may also arise where, although D does not have a sole shareholder, all the shareholders of D surrender shares proportionately in a split-off.

[20] But see the discussion below under Part IV.G.3. regarding the possibility of treating shares of stock or securities exchanged solely for boot in a reorganization or a split-off as being outside of the scope of Section 356.

exchanged solely for boot, it is not clear what should happen to the basis in such shares or securities if Section 356 applies, at least to the extent the basis exceeds the boot received.

In an example posed in the Preamble to illustrate this issue, A holds 100 shares of common stock and 100 shares of preferred stock of T. The common shares and the preferred shares each have an aggregate value of $100. A has a $10 aggregate basis in its common shares and a $150 aggregate basis in its preferred shares. T merges into corporation X in a reorganization, and, as the terms of the exchange specify, A receives 100 shares of X common stock worth $100 for its T common stock and $100 in cash for its T preferred stock. A recognizes none of the $90 gain it realizes with respect to its T common stock, and has a $10 aggregate basis in its 100 shares of X stock. A recognizes none of the $50 loss it realizes with respect to its T preferred stock. Usually, a loss realized in a reorganization is deferred rather than disallowed, because the basis in the loss shares will be reflected in the basis in the nonrecognition property received therefor. As the Preamble notes, however, no nonrecognition property is received for the preferred stock in this example.

In the Preamble to the Final Regulations, the IRS and Treasury requested comments on the treatment of loss shares or securities exchanged solely for boot. There are at least three possible approaches to losses realized in an exchange of stock or securities solely for boot in connection with a reorganization or Section 355 transaction: permanent disallowance, deferral or immediate recognition. As further discussed below, a substantial majority of our Executive Committee supports a deferral regime for such losses, while a minority supports immediate loss recognition. Other than administrative

ease, there would appear to be no reasonable arguments for permanent disallowance of loss.

### 1. Permanent Disallowance of Losses.

Permanent disallowance of loss is the least equitable approach and the least consistent with the purpose of the reorganization provisions, which is deferral of gain and loss where stock and securities are received. Moreover, the tax law generally has been interpreted in a manner that prevents the disallowance of an economic loss or the permanent elimination of basis.[21] Given that a loss disallowance rule would forever deny a loss to the taxpayer, we question whether such a rule would be valid if adopted.

### 2. Deferral of Losses.

A substantial majority of our Executive Committee recommends that a deferral regime apply to loss shares exchanged solely for boot in the context of a transaction to which Section 356 applies. One possible approach for deferring the loss is discussed below, but regardless of the method, the majority believes that deferral is preferable to permanent disallowance or immediate recognition.

Deferral of the loss is consistent with the historical treatment of losses in reorganizations. Losses generally are preserved in the form of a higher basis in the nonrecognition property received in a reorganization. Where no such nonrecognition property is received for loss shares, regulations could provide that the basis in the loss shares, to the extent it exceeds the value of the property received therefor, be added to the

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[21] *See, e.g., Coyle v. U.S.*, 415 F.2d. 488 (4th Cir. 1968) (stating that, whatever happens to basis in a Section 304 transaction where the taxpayer does not actually own any stock after the transaction, "it is clear that the taxpayer's basis will not disappear"); *Rite Aid Corp. v. U.S.*, 255 F.3d 1357, 1359 (Fed. Cir. 2001) (holding that, at least as applied to the facts of the case, the disallowance of loss under the consolidated return regulation's loss disallowance rule was invalid); *but see* Rev. Rul. 70-496, 1970-2 C.B. 74 (disappearing basis in Section 304 context), obsoleted by Rev. Rul. 2003-99, 2003-2 C.B. 388.

basis of the nonrecognition property received by the taxpayer for the other shares or securities. On the facts from the example in the Preamble, A's basis in its X common stock could be increased by $50, the amount of the disallowed loss with respect to A's preferred stock.

A rule that achieves deferral through basis-shifting (and any disallowance rule) is arguably inconsistent with the approach of the Final Regulations of treating the exchange of each surrendered share or security in a reorganization or split-off as separate and distinct from the exchange of each other share or security for purposes of applying Sections 356 and 358. Section 354 governs transactions in which nonrecognition property is received, and Section 356 applies only where Section 354 (or Section 355) would apply but for the receipt of boot in addition to nonrecognition property. If treated as a separate and distinct exchange, the surrender of a share or security solely for boot is not an exchange described in Section 356, because, as no nonrecognition property is received in that separate exchange, it would not have been governed by Section 354 but for the receipt of boot. If Section 356 does not apply to the exchange, then the loss rules of Section 356(c) would not be applicable and, as discussed further below, subject to other potential limitations under the Code, the loss would immediately be recognized.

Our majority view, however, is that consistency with the share-by-share approach of the Final Regulations is a lesser concern than following what most of us believe is the intent, and the better interpretation, of the language of Section 356. That is, so long as the surrendering shareholder receives some nonrecognition property in the overall transaction, Section 356 should be interpreted as requiring deferral of losses realized on the surrender of target shares in connection with a reorganization.

A rule that defers loss by reallocating basis to other shares of stock might raise the complex issue of how such basis should be reallocated when there are multiple other blocks or classes of stock still held by the tendering shareholder. Reallocation issues have troubled practitioners and the government alike in other areas of the tax law, including the basis-shifting approach to certain dividend-equivalent redemptions under Section 302.[22] Under Section 302, a shareholder surrendering all of its shares solely in exchange for cash may be treated as receiving a dividend, because the shareholder may be deemed to own shares under Section 318, including shares held by certain related persons. In such a case, to avoid extinguishing the basis in the surrendered shares, the basis would be added to the basis in the shares of the related person. This potential for shifting basis from one taxpayer to another accounts for at least part of the concern with a basis-shifting approach.[23]

It seems that a basis-shifting approach under Section 356 should be able to avoid that concern. The applicability of Section 356 is determined on a shareholder-by-shareholder basis. An exchange of shares or securities solely for boot would never be governed by Section 356 unless the exchanging shareholder actually received nonrecognition property in the same transaction. Such shareholder's basis in the surrendered shares or securities, to the extent it exceeded the value of the boot, could be added to the basis in such nonrecognition property. If a basis-shifting regime were adopted, however, it would be necessary to provide rules specifying how the excess basis

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[22] *See, e.g.,* Sections 302, 304; Reg. §§ 1.302-2(c), 1.304-1; REG-150313-01, 2002-2 C.B. 777, 67 F.R. 64331 (Oct. 18, 2002), *withdrawn* 71 F.R. 20044 (April 19, 2006); Announcement 2006-30, 2006-19 I.R.B. 879 (May 8, 2006); *See generally* NYSBA Tax Section Report No. 1112 (*supra* note 18).

[23] *See* Notice 2001-45, 2002-1 C.B. 129.

should be allocated to the nonrecognition property received, where such property is composed of shares or securities of different classes and/or having different bases.

We also note that in many cases the effect of a rule that disallows or defers losses could be minimized through simple planning. Consider the facts of the example from the Preamble to the Final Regulations discussed at the beginning of this Part IV.B., but assume that, instead of allocating all 100 X shares to A's T common stock, the terms of the exchange allocate 99 X shares and $1 of cash to A's T common stock and one X share and $99 of cash to A's T preferred stock. A would then recognize $1 of the $90 gain realized with respect to its common stock, and have a $10 aggregate basis in the 99 X shares received for its common stock. A still would recognize none of the $50 loss realized with respect to its preferred stock, but would have a single X share with a basis of $51. A may then be able to sell that X share and, without significantly diminishing its interest in X, recognize the entire $50 loss that would have been deferred or disallowed by Section 356 if only cash had been allocated to A's preferred. Of course, in certain circumstances, a target shareholder may not have control over the terms of an exchange of target stock and securities, and may therefore receive solely boot in exchange for certain shares or securities with little or no opportunity to plan around the tax consequences.[24]

While reconciling a loss-deferral rule with the share-by-share approach of the Final Regulations may by complex, some members of our Executive Committee

[24] *See, e.g.,* Rev. Rul. 74-515, 1974-2 C.B. 118 (involving an A reorganization where, pursuant to the terms of the merger agreement, target common stock was exchanged solely for acquiror common stock, and target preferred stock was exchanged solely for cash).

believe that it is the only one of the three possibilities for which there is authority under the Code.

### 3. Immediate Recognition of Losses.

A minority of our Executive Committee thinks that the reorganization and split-off rules should be interpreted to permit the immediate recognition of loss where loss shares or securities are exchanged solely for boot.

A rule providing for immediate recognition of the loss is inconsistent with past interpretations of Section 356, under which a shareholder that receives some stock in the acquiring corporation in a reorganization recognizes no loss on an exchange in connection with such reorganization, even if the shareholder receives solely boot with respect to some shares or securities.[25] As noted above, however, the Final Regulations adopt the approach of treating a reorganization or split-off as multiple exchanges of particular stock and securities for particular property, rather than as a single exchange. Permitting the recognition of loss where loss shares or securities are exchanged solely for boot is the most consistent with the tracing regime now adopted by the Final Regulations.

On the other hand, permitting the recognition of losses in connection with a reorganization would create an additional conflict between the treatment afforded in the context of a Section 351 transaction and the treatment afforded in the context of a Section 368 reorganization where such provisions overlap. Accordingly, an overlap rule would be required to reconcile any rule permitting the recognition of losses in Section 368 reorganizations with the rule in Section 351(b)(2) preventing the recognition of loss in

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[25] *Cf.* Rev. Rul. 74-515.

Section 351 transactions. See Part IV.E. above for a similar discussion of overlap issues raised by the allocation of boot methodology of the Final Regulations.

Treating stock or securities exchanged solely for boot as being outside the scope of Section 356 would achieve equal tax treatment of all taxpayers receiving such boot, regardless of whether they also exchange other shares or securities for nonrecognition property in the transaction. *Contrast* Rev. Rul. 74-515 (target preferred stock exchanged solely for cash by shareholders owning only preferred stock was governed by Section 302(a), but target preferred stock exchanged solely for cash by shareholders that also exchanged target common stock for acquiror common stock was governed by Section 356).[26]

As discussed above, if loss is permitted to be recognized in connection with a reorganization or split-off where loss shares or securities are exchanged solely for boot, the most compelling rationale for permitting such loss would be that Section 356 should be applied on a share-by-share basis. The corollary to this rule should be that

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[26] Another possible approach to addressing the recognition of losses in reorganizations or split-offs where loss shares are surrendered solely for boot is to require the recognition of a corresponding amount of the exchanging shareholder's gain that would otherwise be deferred under Section 356, or, if less, the amount of gain that would otherwise be deferred in the exchange. That approach is effectively a hybrid of the basis-shifting approach and the immediate recognition approach. Consider the facts of the example from the Preamble to the Final Regulations again. A could be permitted to recognize its $50 loss, but also be required to recognize $50 of its $90 gain. The hybrid approach would have the same effect as the basis-shifting approach on these facts, because the recognition of gain would offset the recognition of loss and increase A's basis in its X common stock from $10 to $50. If A's deferred gain were only $20 rather than $90, A would recognize under the hybrid approach that $20 gain and the $50 loss, thereby effectively accelerating a net loss of only $30 rather than $50. A would increase its basis in X stock by only $20, to $30. Finally, if A had no deferred gain, the hybrid approach would result in recognition of the entire loss without any offsetting gain recognition, thereby matching the results under the loss recognition approach. It should be noted that the hybrid approach essentially has the effect of causing boot, which may be allocated to loss shares and securities under the Final Regulations, to be reallocated to gain shares or securities (to the extent necessary to offset recognized loss, or to the extent of the gain that would otherwise be deferred, whichever amount is smaller), and therefore seems inconsistent with the spirit of the Final Regulations. Moreover, the hybrid approach is susceptible to the same taxpayer planning as the regimes discussed above. For the reasons discussed, we believe the immediate recognition approach is more consistent than the hybrid approach with the general approach adopted by the Final Regulations.

Section 356 also would be inapplicable where gain shares or securities are exchanged solely for boot.[27]

If exchanges of stock or securities solely for boot in the context of a reorganization or split-off are treated as being outside the scope of Section 356, those exchanges could have materially different results beyond the recognition of loss. For example, exchanges of stock solely for boot would have to run the gauntlet of Section 302 (in the case of split-offs, recapitalizations and, presumably, acquisitive asset reorganizations) or of Section 304 (in the case of acquisitive stock reorganizations, if there was sufficient shareholder overlap for Section 304 to apply).[28] Under Section 302 or 304 the boot might be treated as a dividend in the full amount of the boot received, as the "dividend within gain" limitation of Section 356 would not apply.[29]

The application of Section 356 to exchanges of stock or securities for nonrecognition property and boot, but not to exchanges for only boot, may lead to some seemingly inconsistent results. For example, a shareholder may receive nonrecognition property and boot with respect to certain shares or securities in an acquisitive

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[27] The Final Regulations apply Section 356 to gain shares or securities surrendered solely for boot in a reorganization. *See* Reg. § 1.356-1(d), Example 4.

[28] If an exchange of stock solely for boot in an acquisitive stock reorganization were treated as being outside the scope of Section 356 and there was insufficient shareholder overlap for Section 304 to apply, then the exchange would be subject to the normal Section 1001 rules.

[29] In an acquisitive asset reorganization, the target goes out of existence. Thus, unless the acquiring corporation is treated as a successor to the target corporation for purposes of applying Section 302, the target shareholder will have a complete termination of its interest in the target, and the immediate recognition approach always will result in exchange treatment, rather than dividend treatment, for the target shareholder under Section 302. Accordingly, turning off Section 356 in the context of gain shares or securities surrendered solely for cash in connection with a reorganization could have the unintended result of bestowing exchange treatment on the shareholder even when the shareholder would have received dividend treatment under Section 356. If immediate recognition is permitted, this issue would need to be addressed. *Cf.* Rev. Rul. 74-515 (treating shareholders that received solely cash in an acquisitive asset reorganization as having had their stock redeemed in a transaction to which Section 302(a) applied).

reorganization while simultaneously receiving only boot with respect to other shares or securities in the same transaction. In such circumstances the tax consequences of the receipt of boot with respect to shares or securities exchanged for boot and nonrecognition property would be governed by Section 356, while the tax consequences of the receipt of boot with respect to the shares or securities exchanged solely for boot would be governed by Section 302, 304 or 1001.

Moreover, similar to the case of a deferral or disallowance regime, a taxpayer effectively may be able to elect to have its boot governed by Section 356, on the one hand, or Section 302, 304 or 1001 on the other, based on the taxpayer's desired tax consequence. Consider again the facts of the example from the Preamble to the Final Regulations, discussed in Part IV.G.2. above. Under the immediate loss recognition regime discussed above, A would recognize a $50 loss with respect to the T preferred stock (assuming Section 302 did not somehow apply to give A dividend treatment). If A wanted to defer its loss recognition, however, the terms of the exchange might be modified to allocate 99 X shares and $1 of cash to A's T common stock and 1 X share and $99 of cash to A's T preferred stock. As discussed above in the context of the deferral regime, that allocation would cause A to recognize $1 of gain with respect to its common stock and to have a $10 aggregate basis in the 99 X shares received for its common stock. A would recognize no loss with respect to the preferred shares, because they are exchanged for nonrecognition property in addition to boot. Therefore, as under the deferral regime, A would have a $51 basis in the single X share received for its preferred stock, which A might retain until it wishes to recognize its loss.

Although the above differences in treatment may appear anomalous, they are largely an outgrowth of the significant degree of electivity permitted with respect to the allocation of boot under the Final Regulations and the differing treatment of boot under Sections 302, 304, 356 and 1001.

### H. Provide a Rule for Determining Which Shares or Securities Are Surrendered When Less Than All Shares or Securities Are Surrendered.

Generally, under the Final Regulations, the basis consequences to a shareholder of the target in a reorganization, or of the distributing corporation in a Section 355 transaction, are determined as of the date of the transaction.[30] That is, on the date of a reorganization or Section 355 transaction, a shareholder of target or distributing knows the number of shares it holds in each corporate party to the transaction, and with what basis, although the shareholder may not know (or have decided) which specific share has which basis. Regulations Section 1.358-2(a)(2)(vii) allows the shareholder to designate which share has which basis at the time of a later disposition, or, if no designation is made, the shares received with respect to those first acquired are deemed disposed.

The Final Regulations do not appear to contain a rule, however, that specifically determines what shares are surrendered in an exchange under Section 354, 355 or 356, where less than all of a shareholder's shares are surrendered. Regulations Section 1.358-2(a)(2) does not appear to contemplate the surrender of less than all target shares in a reorganization under Section 354 or 356. For example, target shareholders may exchange control, but not 100 percent of their shares of the target, in a

[30] For ease of discussion, only shares of stock are discussed in this Part IV.H. but similar rules and issues generally also apply to securities.

reorganization under Section 368(a)(1)(B). Moreover, in a split-off some shares of distributing may be retained, and the regulations do not appear to provide a rule for determining which ones.

There are several possible approaches to making the determination. One possibility would be to follow the approach of the designated exchange provision under Regulations Section 1.358-2(a)(2)(ii). Under that rule, a shareholder would be deemed to surrender whatever shares of target are specified under the terms of the exchange. Where no shares were specified, the determination could follow the approach taken by the Regulations under Section 1012, where absent an identification, the shares acquired first are deemed to be surrendered.

Example 13 under Regulations Section 1.358-2(c) appears to adopt another approach, however. In the example, individual J owns 40 of the 80 outstanding shares of corporation X, 20 with a $2 basis and 20 with a $4 basis. X owns all 40 shares of the stock of corporation Y. The stock of X is worth $80 prior to the distribution of Y and the stock of Y is worth $40. In a split-off under Section 355, J surrenders 20 shares of X stock for 20 shares of Y stock. The example states "J is not able to identify which shares of X stock are surrendered. In addition, J is not able to identify which shares of Y stock are received in exchange for each surrendered share of X stock." The analysis explains that, under Regulations Section 1.358-2(a)(2)(i), each of J's 20 shares of Y stock is treated as received in exchange for one share of X stock, and the basis of the X stock retained by J will remain unchanged. The analysis goes on to say:

> Under [Regulations Section 1.358-2(a)(2)(vii)], on or before the date on which the basis of a share of Corporation X or Corporation Y stock becomes relevant, J may designate which shares of Corporation X stock J surrendered in the exchange and which share of the Corporation Y stock

> received is received for each share of Corporation X stock surrendered. Therefore, it is possible that a share of Corporation Y stock would have a basis of $2 and be treated as having been acquired on Date 1, or would have a basis of $4 and be treated as having been acquired on Date 2.

Reg. § 1.358-2(c), Example 13.

Although this rule might be viewed as generous to the taxpayer, by allowing a wait-and-see approach to deciding what shares were surrendered, it does not appear to contradict any provision in the Final Regulations or to be problematic on the facts of this example. J will determine his or her basis at the first time it is relevant, which by definition will prevent taking inconsistent positions. Moreover, J's selection of which X shares it surrenders to X does not affect X's basis in its own stock (since X has no basis in that stock).

In the context of a B reorganization, however, a rule permitting a target shareholder to decide in the future which of its target shares it surrendered may be problematic. The basis of target stock in the hands of the acquiror in a B reorganization is determined by reference to the basis of such stock in the hands of the target shareholder. Section 362(b). It may therefore be relevant to the acquiror before it is relevant to the target shareholder which shares were exchanged, but the Final Regulations appear to only permit a designation by the target shareholder as to which shares were exchanged and do not appear to require any such designation until the basis of a share of the stock of the acquirer received by the target shareholder becomes relevant to the target shareholder.

It would be helpful for the IRS and Treasury to clarify the rules relating to the designation of which shares are surrendered in an exchange where less than all of a shareholder's shares are so surrendered.

## I. Address Consolidated Group Issues.

### 1. Clarify Basis Reallocation under Temporary Regulations Section 1.1502-19(d).

Former Regulations Section 1.1502-19(d) provided that if a member, P, had an ELA in shares of a class of stock of another member, S, at the time there was a basis adjustment with respect to other shares of the same class of S's stock owned by the member (for example, as a result of a reorganization involving S), the adjustment was allocated first to equalize and eliminate P's ELA in the S stock. As explained in the Preamble to the Final Regulations, Former Regulations Section 1.1502-19(d) was largely elective because its applicability depended on the direction of a transaction (*i.e.*, it would affect the ELA in shares of stock of S, where S was an acquiring corporation, but an ELA in shares of a target corporation would be carried over into the shares of S). Current Regulations Section 1.1502-19(d) imposes a broader rule that causes positive basis to be reallocated to eliminate an ELA regardless of the direction of the transaction (*i.e.*, the rule applies whether the ELA exists in shares of stock of the target or the acquiror).

We agree with this broader rule but think it would be useful to illustrate with an example how the reallocation of basis is done where P has more then one block of S stock with positive basis.[31] For instance, to the greatest extent possible, an equal amount of basis could be re-allocated from each share with positive basis. Alternatively, for example, basis could be reallocated in a manner that equalizes post-reallocation basis

[31] All of the examples in Current Regulations Section 1.1502-19(d) involve members with a single block of positive-basis stock outstanding, as did all the examples in Former Regulations Section 1.1502-19(d). The issue of how to reallocate basis where a member has more than one block of positive-basis stock outstanding also existed under Former Regulations Section 1.1502-19(d).

in all shares to the greatest extent possible.[32] A third approach might be to reallocate basis from each share in proportion to the positive basis in such share.[33] Whatever approach is adopted, consistent with the current theme of the consolidated return regulations, we believe no ELA should be created with respect to any share from which positive basis is reallocated.

### 2. Consider Clarifying the Result in the Modified Example in Regulations Section 1.1502-32.

The Final Regulations modified Example 6 of Regulations Section 1.1502-32(b)(5)(ii) to illustrate the interaction of the investment adjustment rules of the consolidated return regulations with the Final Regulations under Section 358 in the context of a stockless reorganization with boot inside a consolidated group. In the example, corporation P owns subsidiaries S and T. T merges into S with P receiving no additional S stock but receiving a cash payment that is treated as a dividend. The example explains the deemed issuance and recapitalization now required by Regulations Section 1.358-2(a)(2)(iii) and how that deemed issuance and recapitalization results in P having two blocks of S stock. The example goes on to say that the cash is "treated as a

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[32] We believe that the first approach is more consistent than the second approach with the approach of the Final Regulations of preserving pre-existing basis in blocks of stock to the greatest extent possible. Allocating an equal amount of basis from each share having a positive basis is also more consistent with the approach taken by the investment adjustment rules of Regulations Section 1.1502-32(c) to prevent or eliminate ELAs, which rules are referenced in Current Regulations Section 1.1502-19(d). *See* Current Reg. § 1.1502-19(d)(1)(last sentence); Reg. § 1.1502-32(c)(2)(i). On the other hand, allocating basis in a manner that tends to equalize post-reallocation basis is more consistent with the reallocation rules of Regulations Section 1.1502-35 that apply in the case of certain transfers of member stock and deconsolidations of members. *See* Reg. §§ 1.1502-35(b)(1), -35(b)(2); *see also* Prop. Reg. 1.1502-36(b), REG-157711-02, 72 F.R. 2964 (January 23, 2007). It is also consistent with the equalization of ELAs in blocks when two corporations that are members of a consolidated group are combined and the common parent of the two corporations has an ELA in the stock of each corporation prior to the combination. *See* the Preamble to T.D. 9341, 72 F.R. 39313 July 18, 2007.

[33] Such a proportional reallocation regime is also consistent with the aims of the Final Regulations in preserving separate blocks with differing bases, and it provides a more straightforward calculation than allocating an equal amount of basis from each share, which may require adjustment as the basis of each positive-basis block is depleted.

dividend distribution under Section 301 and, under [Regulations Section 1.1502-32(b)(3)(v)], the [cash] is a distribution to which [Regulations Section 1.1502-32(b)(2)(iv)] applies. Accordingly, P's total basis in the S stock is decreased by the [cash] distribution."

The example does not illustrate how P's basis in the S stock is decreased, however. Under Regulations Section 1.1502-32(c)(1), the basis reduction arising from a dividend generally is allocated to the shares to which the distribution relates. While it is not clear from the language of Example 6, Regulations Section 1.1502-13(f)(3) suggests that the "dividend" in Example 6 is in fact a dividend-equivalent redemption described in Section 302(d). *Cf.* Reg. § 1.1502-13(f)(7), Example 3. It would be helpful if the example made clear how to trace basis through the deemed issuance, deemed recapitalization and deemed redemption, including the selection of the shares that are deemed to be redeemed.

Given the focus of the Final Regulations on share-by-share basis determinations, further modifying the example to illustrate the determination of how P's basis in each of S shares is decreased would be useful. It would also be useful to have an example comparing that determination to the basis that would result if a non-boot distribution were made by T to P prior to the reorganization in which T is merged into S.