

# Current Developments in Corporate Taxation

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## American Bar Association May 2009 Meeting

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# Agenda

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1. Proposed Basis and Boot Regulations
2. Rev. Proc. 2009-25
3. Rescission Transactions
4. Merrill Lynch Case

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# 1. Proposed Basis and Boot Regulations

REG-143686-07 (January 21, 2009), amended  
REG-143686-07 (March 5, 2009)

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# Overview

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- The primary objective of the proposed regulations is to provide a single stock basis recovery model for actual or deemed distributions to which §301 applies (“dividend equivalent” transactions) and a single model for sale or exchange transactions to which §302(a) applies (“non-dividend equivalent” transactions), including certain elements of reorganization exchanges.
- In addition, the proposed regulations modify the basis determination regime of the current regulations under §358 and address certain other basis determination issues.
- The overarching theme of the proposed regulations is to produce consistent results among economically similar transactions involving corporate transactions.
- The effective date of the proposed regulations generally is the date the regulations are published as final regulations in the Federal Register.

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# Section 301 and 302 Transactions

# Existing Law under Section 301

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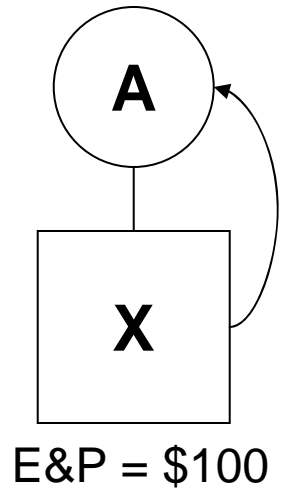
- Consequences of distribution under §301(c):
  - Dividend to the extent of current and accumulated E&P, then:
  - Basis recovery, then:
  - Gain from sale or exchange.
- Distribution consequences determined per share?  
Johnson v. U.S., 435 F.2d 1257 (4th Cir. 1971). Per class? Among all directly owned shares? Among all shares including attribution?
- Allocation of distributions per share/class respected?

# Proposed Regulations Regarding Section 301 Distributions

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- Principles of Proposed Regulations
  - Share of stock is the basic unit of property
  - Any distribution on stock of a single class treated as paid pro rata with respect to all shares of that class
  - Class of stock is determined with respect to rights to distributions; not voting or other rights
  - May have gain in some shares and unrecovered basis in other shares of the same class
  - Same rules for §301(a) distributions and redemptions treated as distributions under §301(d)

# Base Case



A owns 100 shares of X common stock, representing all of X's stock.

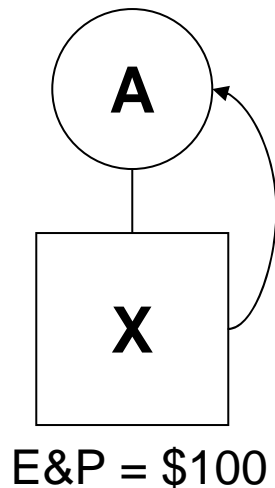
The stock was acquired in two blocks. Block 1 has 25 shares and a basis of \$25. Block 2 has 75 shares and a basis of \$175.

X makes a distribution of \$300 (\$3 per share).

Tax Consequences		
	Block 1	Block 2
Dividend	\$25	\$75
Basis	\$25	\$150
Gain	\$25	N/A
Unrecovered Basis	\$0	\$25

Authorities:  
Johnson v. U.S., 435 F.2d 1257 (4th Cir. 1971); Prop. Reg. §1.301-2(a); *but cf.* Treas. Reg. §1.1367-1(c)(3).

# Distributing Has Two Classes of Common; Distribution on Class B Common



A owns 25 shares of X Class A common stock and 75 shares of X Class B common stock, representing all of the X stock. A has a basis of \$25 in the Class A common stock and a basis of \$175 in the Class B common stock. X makes a distribution of \$300 on the Class B common stock.

Distribution to Class B common stock respected so long as it has different rights to distributions than the Class A common stock and the allocation is economically reasonable.

Tax Consequences		
	Class A Common	Class B Common
Dividend	N/A	\$100
Basis	N/A	\$175
Gain	N/A	\$25
Unrecovered Basis	\$25	\$0

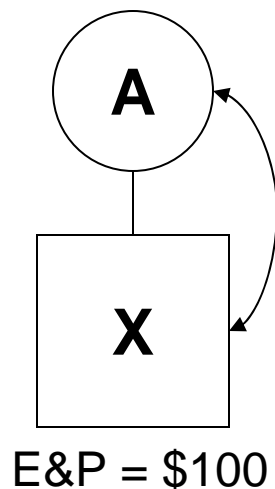
# Application of Proposed Regulations to Dividend Equivalent Redemptions

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- Rules under the proposed regulations apply to result in the same consequences as a §301 distribution
- Distribution deemed paid with respect to all shares of the redeemed class held by the shareholder immediately prior to the redemption
- Immediately after the distribution, the corporation is deemed to undertake a 'reverse split' recapitalization of the stock of the class resulting in the actual number of shares remaining. Existing rules under §358 apply to trace basis.
- Unlike existing law, if all shares are redeemed but the transaction is dividend equivalent by attribution, then the loss with respect to any unrecovered basis in the redeemed shares is suspended until the inclusion date, which is the earlier to occur of (i) an event that would permit recognition of the loss under §302(b)(1), (2) or (3), or (ii) worthlessness of all redeeming corporation stock.
- For corporate shareholders, loss may be included when all assets are disposed of in a transaction in which gain or loss is recognized in whole and the corporation ceases to exist for tax purposes.

# Base Case

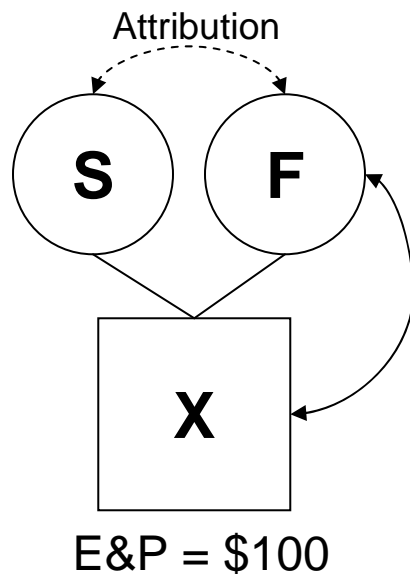
A owns 100 shares of X common stock representing all of X's stock. The stock was acquired in two blocks. Block 1 has 25 shares and a basis of \$25. Block 2 has 75 shares and a basis of \$175. X redeems all of Block 1 for \$300 (\$3 per share).



Dividend, basis recovery, and gain consequences are the same as the Base Case with a direct distribution. Immediately after, A is treated as surrendering 100 shares of common stock for 75 shares of common stock. A's aggregate basis in the common stock is \$25—18 shares have \$0 basis, 56 shares have a \$0.44 basis, and 1 share consists of a 75% segment having a \$0 basis and a 25% segment having a \$0.11 basis (numbers rounded).

Deemed Recapitalization Basis Consequences	
Number of Shares	Basis Per Share
18 shares	\$0
56 shares	\$0.44
1 share	75% = \$0 25% = \$0.11

# Complete Redemption; Dividend Equivalence by Attribution



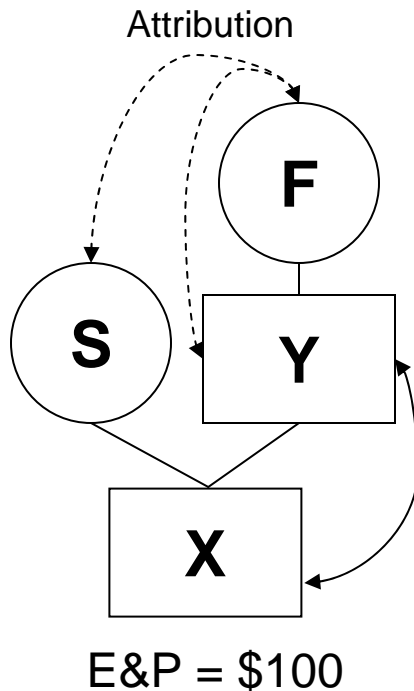
Son owns 25 shares of X common stock with a basis of \$25. Father owns 75 shares of X common stock with a basis of \$175. X redeems all of F's shares for \$100. F and S do not waive family attribution.

Transaction is treated as a distribution under §302(d). Under the proposed regulations, F's unrecovered basis of \$175 cannot be claimed as a loss until the occurrence of an event that satisfies §302(b)(1), (2) or (3) or when the shares become worthless under §165(g). Under existing law, the \$175 of unrecovered basis shifts to the stock held by S.

Tax Consequences		
	S	F
Dividend	N/A	\$100
Basis	N/A	\$0
Gain	N/A	N/A
Unrecovered Basis	\$25	\$175

# Complete Redemption; Dividend Equivalence by Attribution

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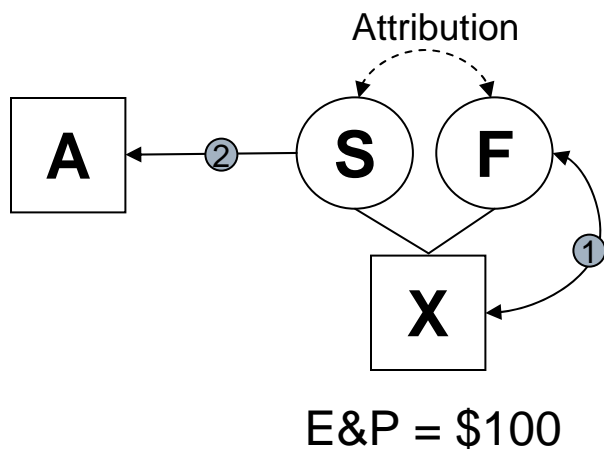
Son owns 25 shares of X common stock with a basis of \$25. Father owns all of the stock of Y corporation. Y owns 75 shares of X common stock with a basis of \$175. X redeems all of Y's stock for \$100. F and S do not waive family attribution.

Transaction is treated as a distribution under §302(d). Under the proposed regulations, Y's loss is deferred until the conditions under §302(b)(1), (2), or (3) are satisfied or all X shares become worthless or Y disposes of its assets in a fully taxable transaction and ceases to exist for all tax purposes. Under existing law, Y's basis shifts to S's stock in X? F's stock in Y?



# Loss Inclusion by Occurrence of Section 302(b) Event

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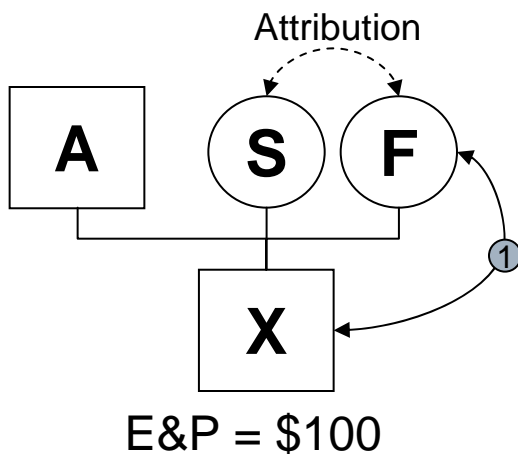


Son owns 25 shares of X common stock with a basis of \$25. Father owns 75 shares of X common stock with a basis of \$175. On Date 1, X redeems all of F's shares for \$100. F and S do not waive family attribution. On Date 2, S sells all of the X stock to A, an unrelated party, for cash.

The Date 1 transaction is treated as a distribution under §302(d). F's unrecovered basis cannot be claimed as a loss until the occurrence of an event that satisfies §302(b)(1), (2) or (3) or when the shares become worthless under §165(g).

On Date 2, F may claim the loss as F does not own any X stock by attribution.

# Worthlessness of Attributed Stock; No Loss Inclusion



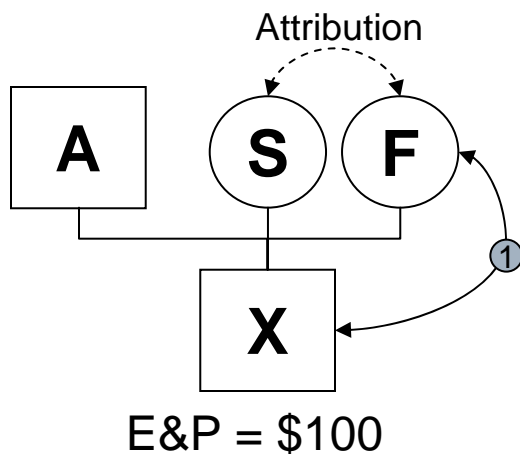
Son owns 25 shares of X common stock. Father owns 75 shares of X common stock with a basis of \$175. A, an unrelated party, owns nonvoting preferred stock of X. On Date 1, X redeems all of F's shares for \$100. F and S do not waive family attribution. On Date 2, the common stock held by S becomes worthless and an identifiable event makes the worthless stock deduction available. The preferred stock retains a positive value.

The Date 1 transaction is treated as a distribution under §302(d). F's unrecovered basis cannot be claimed as a loss as of that date.

On Date 2, if the worthlessness does not qualify as a disposition under §302(b), F may not claim the loss. Even though all stock that would be attributed to F is worthless, some stock (the preferred stock held by unrelated A) retains its value so F may not include the suspended loss.

# Abandonment of Attributed Stock; Loss is Included

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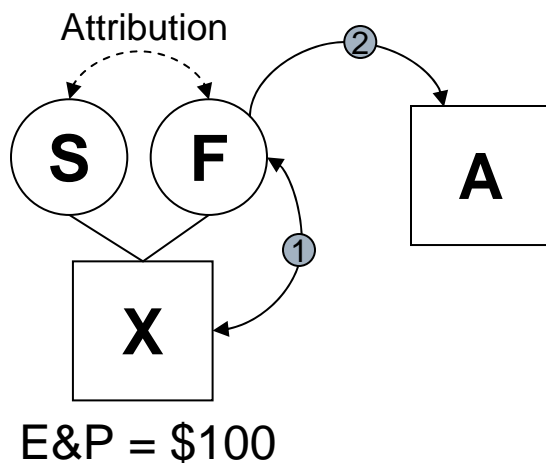


Son owns 25 shares of X common stock. Father owns 75 shares of X common stock with a basis of \$175. A, an unrelated party, owns nonvoting preferred stock of X. On Date 1, X redeems all of F's shares for \$100. F and S do not waive family attribution. On Date 2, the X stock is worthless and S abandons it. The preferred stock retains a positive value.

The Date 1 transaction is treated as a distribution under §302(d). F's unrecovered basis cannot be claimed as a loss until the occurrence of an event that satisfies §302(b)(1), (2) or (3) or when all of the X shares become worthless under §165(g).

On Date 2, F may claim the loss since F no longer holds any X stock by attribution.

# Redemption of Portion; Sale of Remaining to Unrelated



Son owns 25 shares of X common stock with a basis of \$25. Father owns 75 shares of X common stock with a basis of \$175. On Date 1, X redeems 74 of F's shares for \$98.67. F and S do not waive family attribution. On Date 2, F sells 1 share to unrelated A for \$1.33.

The Date 1 transaction is treated as a distribution under §302(d). F's unrecovered basis in the redeemed shares is deemed recapitalized into F's remaining X share and cannot be claimed as a loss.

The Date 2 transaction is a sale and F may claim a loss of \$173.67, based on the difference between the fair value of the shares (\$1.33) and their tax basis (\$175).

Do any step transaction or Zenz-like principles apply to prevent this result?

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# Reorganization Exchanges

# Current Law: Step 1— Allocate Boot

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**Rule 1** - If terms of exchange specify boot is received in exchange for particular shares, the terms control if economically reasonable

**Rule 2** - If no terms specified, or if specified terms are not economically reasonable, boot is allocated pro rata based on FMV

# Allocating Boot—Example

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T shareholder has 20 shares of T common stock, 10 acquired on each of two dates. Pursuant to the terms of the reorganization exchange that are economically reasonable, the shares are exchanged for specific consideration:

10 Block 1 T shares, \$600 basis	➡	100 Acq shares, FMV = \$1,000
10 Block 2 T shares, \$1,100 basis	➡	\$1,000

**Rule 1:** On these facts, the Block 1 T shares are treated as exchanged for the 100 Acq shares and the Block 2 T shares are treated as exchanged for the \$1,000.

**Rule 2:** If no terms specified or terms specified but not economically reasonable, then each of Block 1 and Block 2 would be treated as being exchanged for 50 Acq shares + \$500.

# Current Law: Step 2—Determine the Applicable Section

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If T shareholder exchanges:

- |                 |   |                  |           |
|-----------------|---|------------------|-----------|
| 1. All T Stock  | ⇒ | Solely Acq Stock | §354      |
| 2. All T Stock  | ⇒ | Solely \$        | §302      |
| 3. All T Stock  | ⇒ | Acq Stock + \$   | §§354/356 |
| 4. Some T Stock | ⇒ | Solely Acq Stock | §354      |
| Some T Stock    | ⇒ | Solely \$        | §356      |

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Authorities:

§§302, 354, 356; Rev. Rul. 74-515, 1974-2 C.B. 118.

## Current Law: Step 3—Determine the Amount of Section 356 Gain/Loss

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Gain realized = value received - basis in shares  
(determined on a share-by-share basis)

Gain recognized is limited to the amount of boot

No loss allowed

# Determining Section 356 Gain/Loss—Example

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T shareholder has 20 shares of T common stock, 10 acquired on each of two dates. In the reorganization exchange the T shares are exchanged for:

$$\left. \begin{array}{l} 10 \text{ Block 1 T shares, } \$600 \text{ basis} \\ 10 \text{ Block 2 T shares, } \$1,100 \text{ basis} \end{array} \right\} \rightleftarrows \left\{ \begin{array}{l} 100 \text{ Acq shares, FMV} = \$1,000 \\ \$1,000 \end{array} \right.$$

If the terms of the reorganization exchange are economically reasonable and specify that the Block 1 T shares are exchanged for the 100 Acq shares and the Block 2 T shares are exchanged for the \$1,000 in cash, then:

Block 1 T shares: \$400 gain realized, \$0 recognized

Block 2 T shares: \$100 loss realized, \$0 recognized

If no terms specified or terms specified but not economically reasonable, then each of Block 1 and Block 2 would be treated as being exchanged for 50 Acq shares + \$500.

Block 1 T shares: \$400 gain realized, \$400 recognized

Block 2 T shares: \$100 loss realized, \$0 recognized

Note the built-in loss in Block 2 does not reduce the gain realized and recognized on Block 1 in the exchange.

# Current Law: Step 4— If Section 356 Gain, Determine “Dividend Equivalence” of the Exchange

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- T shareholder treated as receiving all Acq stock and Acq redeems stock for boot
- Apply §302 principles
- Analyze based on “overall exchange”
  - Note Clark only had one class of stock
- If exchange is dividend equivalent, then §356 gain is a dividend to the extent of applicable E&P; otherwise §356 gain taxed as normal gain.

# Proposed Regulations: Step 1— Determine “Dividend Equivalence” of the Exchange

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Conceptual approach of the proposed regulations appears to be:

- Assume there is gain realized on the exchange
- T shareholder treated as receiving all Acq stock and Acq redeems stock for boot
  - Where there are multiple classes, what type of Acq stock?
- Apply §302 principles
- Analyze based on “overall exchange”, even if certain exchanges are governed by §302

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Authorities:

Preamble to Prop. Regs.; Clark v. Comm’r, 489 U.S. 726 (1989); Zenz v. Quinlivan, 213 F.2d 914 (6th Cir. 1954),<sup>26</sup>  
Prop. Reg. §1.354-1(d).

# Proposed Regulations: Step 2— Allocate Boot

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**Dividend Rule** - If exchange is dividend equivalent, boot is allocated pro rata across all shares in the class; specific allocations within a class are ignored (but specific allocations among classes are respected if economically reasonable)

**Non-Dividend Rule** - If exchange is not dividend equivalent, specific allocations, even within a class, control if economically reasonable

# Allocating Boot—Example

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T shareholder has 20 shares of T common stock, 10 acquired on each of two dates. Pursuant to the terms of the reorganization exchange that are economically reasonable, the shares are exchanged for specific consideration:

10 Block 1 T shares, \$600 basis	⇒	100 Acq shares, FMV = \$1,000
10 Block 2 T shares, \$1,100 basis	⇒	\$1,000

**Dividend Rule:** If the exchange is dividend equivalent, the specific allocation is ignored (even though economically reasonable) and each block of T shares is treated as exchanged for 50 Acq shares + \$500.

**Non-Dividend Rule:** If the exchange is not dividend equivalent, the terms of the exchange will be respected.

# Proposed Regulations: Step 3— Determine the Applicable Section

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If T Shareholder exchanges:			<u>Proposed Regulations</u>	<u>Current Law</u>
1.	All T Stock	⇒ Solely Acq Stock	§354	Same
2.	All T Stock	⇒ Solely \$	§302	Same
3.	All T Stock	⇒ Acq Stock + \$	§§354/356	Same
4.	Some T Stock	⇒ Solely Acq Stock	§354	Same
	Some T Stock	⇒ Solely \$	§302	§356

# Proposed Regulations: Step 4— Determine Amount of Gain/Loss

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## **If §356 applies:**

Gain realized = value received - basis in shares  
(share-by-share determination)

Gain recognized is limited to the amount of boot

No loss allowed - §356(c)

Dividend equivalence of exchange only affects character of gain recognized

## **If §302 applies:**

If dividend equivalent exchange, no boot within gain limitation—  
taxed on entire amount under §302(d)

If not dividend equivalent exchange, losses may be recognized  
under §302(a)

# Determining Section 356 Gain—Example

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T shareholder has 20 shares of common stock, 10 acquired on each of two dates. The exchange has the effect of a dividend distribution and therefore, consideration may not be specifically allocated:

$$\left. \begin{array}{l} 10 \text{ Block 1 T shares, } \$600 \text{ basis} \\ 10 \text{ Block 2 T shares, } \$1,100 \text{ basis} \end{array} \right\} \longrightarrow \left\{ \begin{array}{l} \$1,000 + \\ 100 \text{ Acq shares, FMV} = \$1,000 \end{array} \right.$$

Each block is treated as exchanged for 50 Acq shares + \$500.

Block 1 T shares: \$400 gain realized; \$400 recognized

Block 2 T shares: \$100 loss realized; \$0 loss recognized

Note the built-in loss in Block 2 does not reduce the gain realized and recognized in the Block 1 exchange.

# Determining Section 302 Gain—Example

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T shareholder has common and preferred stock. In a dividend equivalent exchange, the terms of the reorganization provide that the common and preferred stock are exchanged for specific consideration:

T preferred shares, \$600 basis	⇒	\$1,000
T common shares, \$1,100 basis	⇒	100 Acq shares, FMV = \$1,000

Section 302(d) governs the receipt of \$1,000 for the T preferred shares. Assuming E&P > \$1,000, T shareholder will have \$1,000 dividend.

Note all \$1,000 of boot received on the T preferred shares is taxed even though there is only \$400 gain realized. If, however, one share of Acq stock were received in respect of the T preferred shares, T shareholder would be taxed under §356 and the dividend income would be limited to \$400.

If exchange were not dividend equivalent and T shareholder's basis in the T preferred shares were \$1,100, T shareholder would recognize a \$100 loss under §302(a); the same result would obtain if the T preferred shares were instead T common shares with a basis of \$1,100.

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# Section 351 Transactions and Capital Contributions

# Actual Section 351 Transactions: Current Law

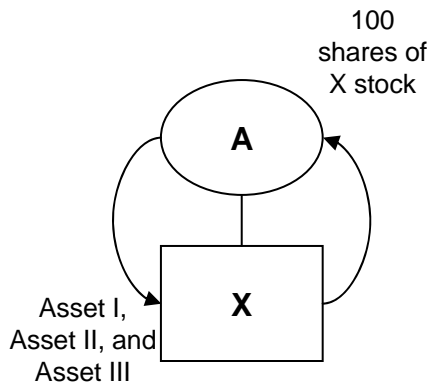
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The basis tracing rules apply in the case of a §351 transaction only where (i) the §351 transaction is also a reorganization, (ii) no assets other than stock or securities are transferred to the controlled corporation as part of the §351 transaction, and (iii) no liabilities are assumed.

If the basis tracing rules do not apply, then the basis and holding period of the shares received in the §351 transaction are split for purposes of determining long-term or short-term capital gain or loss where the transferred assets have different relevant holding periods. See Rev. Rul. 85-164, 1985-2 C.B. 117.

If boot is received in addition to stock in a §351 transaction, for purposes of determining the amount and character of the gain recognized in the exchange, the boot is allocated among the assets transferred in proportion to their relative fair market values. See Rev. Rul. 68-55, 1968-1 C.B. 140.

# Actual Section 351 Transactions: Example 1, Current Law



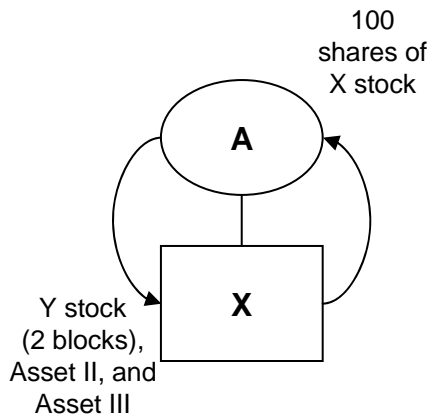
**Facts:** A contributes Asset I, Asset II, and Asset III, to X, a new corporation, in exchange for 100 shares of X in an exchange to which §351 applies.

**Result:** The initial basis of each share of X that A receives is \$1x. For purposes of determining long-term or short-term capital gain or loss on a disposition of X stock, each share has a split basis and holding period. In particular, 20% of each share has a basis of \$0.40x with a holding period of less than 1 year and 80% of each share has a basis of \$0.60x with a holding period of more than 1 year.

**Queries:** Is basis segmented for any other purpose? After the year holding period has passed, does basis continue to be segmented?

	Asset I	Asset II	Asset III
Character of Asset	Non-stock, capital asset held for less than 1 year	Non-stock, capital asset held for more than 1 year	Non-stock, capital asset held for more than 1 year
Basis	\$40x	\$20x	\$40x
FMV	\$20x	\$30x	\$50x
% of Total FMV	20%	30%	50%

# Actual Section 351 Transactions: Example 2, Current Law



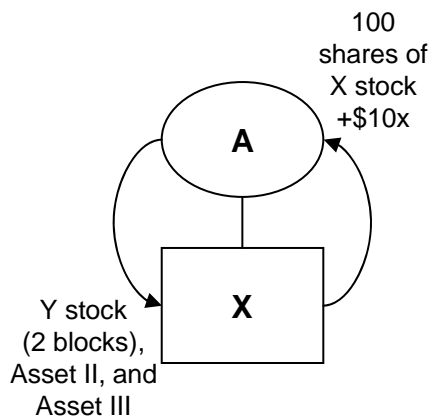
**Facts:** The facts are the same as in Example 1, except that Asset I is 100% of the stock of Y (in two separate blocks) and A's transfer of Y stock to X also qualifies as a reorganization under §368(a)(1)(B).

**Result:** The basis tracing rule does not apply because assets other than stock or securities are transferred to X. The results are the same as in Example 1.

**Query:** If Asset II and Asset III had de minimis value, would the basis tracing rule apply?

	Asset I	Asset II	Asset III
Character of Asset	100 shares of Y stock (100% of Y) held for less than 1 year	Non-stock, capital asset held for more than 1 year	Non-stock, capital asset held for more than 1 year
Basis	50 shares: \$10x 50 shares: \$30x	\$20x	\$40x
FMV	\$20x	\$30x	\$50x
% of Total FMV	20%	30%	50%

# Actual Section 351 Transactions: Example 3, Current Law



**Facts:** The facts are the same as in Example 2, except that 100 shares of Y constitute only 10% of Y and, in addition to receiving 100 shares of X, A also receives \$10x (A's transfer of Y stock to X does not qualify as a reorganization under §368(a)(1)(B)).

**Result:** The boot is allocated on an asset-by-asset basis based on the transferred assets' relative fair market values. Accordingly, \$1x is allocated to each block of Y shares, \$3x is allocated to Asset II, and \$5x is allocated to Asset III. While no gain is realized with respect to either block of Y shares, and hence no gain is recognized with respect to the Y shares, \$3x of gain is recognized with respect to Asset II and \$5x of gain is recognized with respect to Asset III. The basis tracing rule does not apply. A has an aggregate basis of \$0.98x in each share of X received. That basis is split for purposes of determining long-term or short-term capital gain or loss on a disposition of X stock.

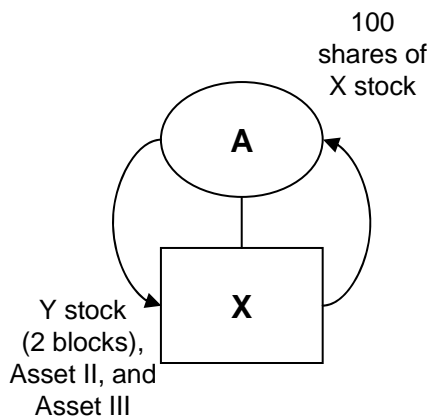
	Asset I	Asset II	Asset III
Character of Asset	100 shares of Y stock (10% of Y) held for less than 1 year	Non-stock, capital asset held for more than 1 year	Non-stock, capital asset held for more than 1 year
Basis	50 shares: \$10x 50 shares: \$30x	\$20x	\$40x
FMV	\$20x	\$30x	\$50x
% of Total FMV	20%	30%	50%

# Actual Section 351 Transactions: Proposed Regulations

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1. The basis tracing rules applicable to reorganizations also apply to stock or securities transferred to a controlled corporation in a §351 transaction provided that no liabilities of the transferring shareholder are assumed in the §351 transaction, even if the transfer of stock does not qualify as a reorganization.
2. If assets in addition to stock or securities are transferred, the other assets are segregated from the stock or securities and the normal §351 basis rules are applied separately to such other assets.
3. If boot is received in the §351 transaction, the proportional boot allocation rules of Rev. Rul. 68-55 are applied to the transferred assets and then the basis rules described above are applied.
4. If liabilities are assumed, then the basis tracing rules do not apply to any of the assets transferred, including any stock or securities. (Because §357(c) applies an aggregate basis approach to determining gain with respect to transferred assets, whereas a tracing regime applies an individual asset basis approach for tracing basis, the two regimes conflict where liabilities are assumed in a §351 transaction.)

# Actual Section 351 Transactions: Example 4, Proposed Law



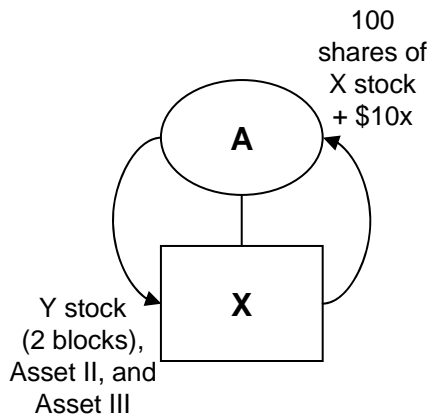
**Facts:** The facts are the same as in Example 2.

**Result:** The transfer is bifurcated; the basis tracing rules apply to the transfer of Asset I and current law continues to govern the transfers of Assets II and III. Therefore, (1) each of the 10 shares received in respect of 50 shares of Y that have an aggregate \$10x basis has a basis of \$1x; (2) each of the 10 shares received in respect of the 50 shares of Y that have an aggregate \$30x basis has a basis of \$3x; and (3) each of the remaining 80 shares received in respect of Asset II and Asset III has a basis of \$0.75x (\$20x basis of Asset II, plus \$40x basis of Asset III, divided by 80 shares received).

**Variation:** The same result would obtain if the Y shares transferred constituted only 1% of the stock of Y and the transfer of those shares did not qualify as a reorganization under §368(a)(1)(B).

	Asset I	Asset II	Asset III
Character of Asset	100 shares of Y stock (100% of Y)	Non-stock, capital asset	Non-stock, capital asset
Basis	50 shares: \$10x 50 shares: \$30x	\$20x	\$40x
FMV	\$20x	\$30x	\$50x
% of Total FMV	20%	30%	50%

# Actual Section 351 Transactions: Example 5, Proposed Law



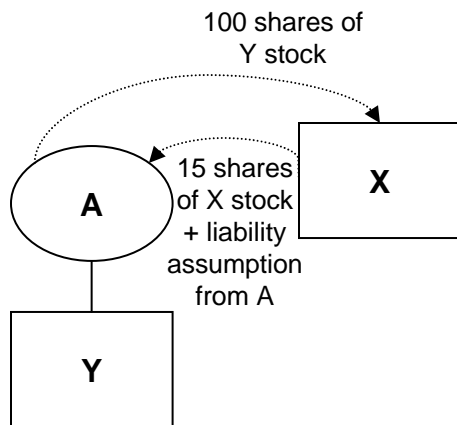
**Facts:** The facts are the same as in Example 3 (A's Y shares constitute 10% of the Y stock and, in addition to receiving 100 shares of X, A receives \$10x).

**Result:** The boot is first allocated among all of the transferred assets. Accordingly, an aggregate of \$2x is allocated to the Y shares, \$3x is allocated to Asset II, and \$5x is allocated to Asset III. As a result, while no gain is recognized with respect to the Y shares, \$3x of gain is recognized with respect to Asset II and \$5x of gain is recognized with respect to Asset III. The transfer is bifurcated; the basis tracing rules apply to the transfer of Asset I and current law continues to govern the transfers of Assets II and III.

**Query:** How is the \$2x of boot allocated to the Y shares allocated among those shares?

	Asset I	Asset II	Asset III
Character of Asset	100 shares of Y stock (10% of Y)	Non-stock, capital asset	Non-stock, capital asset
Basis	50 shares: \$10x 50 shares: \$30x	\$20x	\$40x
FMV	\$20x	\$30x	\$50x
% of Total FMV	20%	30%	50%

# Actual Section 351 Transactions: Example 6, Proposed Law



**Facts:** Initially, A owns no shares of X and 100 shares of Y, constituting 10% of Y. A transfers the Y shares to X in exchange for 15 shares of X (constituting control within the meaning of §368(c)) and X assumes a liability of A in the amount of \$10x.

**Result:** The basis tracing rule does not apply. The initial basis of each share that A receives is \$2x.

**Query:** If the amount of the liability assumed were de minimis, would the basis tracing rule apply?

	Asset I
Character of Asset	100 shares of Y stock (10% of Y)
Basis	50 shares: \$10x 50 shares: \$30x
FMV	\$20x

# Capital Contributions and “Stockless” Section 351 Transactions

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In certain circumstances (e.g., a transfer to a wholly owned corporation), a shareholder may transfer shares or property to a transferee corporation in a nonrecognition transaction without receiving the stock of the transferee.

How should the basis of the surrendered stock or other property be preserved in such a “stockless” transaction?

- Addition: the basis of any surrendered stock or property could be added to the basis of the shareholder’s existing shares, possibly pro-rata in proportion to value.
- Deemed issuance and recapitalization: the shareholder could be treated as receiving shares with a value equal to that of the transferred property, and then surrendering all of its shares (actual and deemed) in exchange for the actual number of shares it holds in a recapitalization.
- Segmenting: each transfer could increase the basis of each share, but with the basis of the transferred property preserved in a discrete segment of each share held.

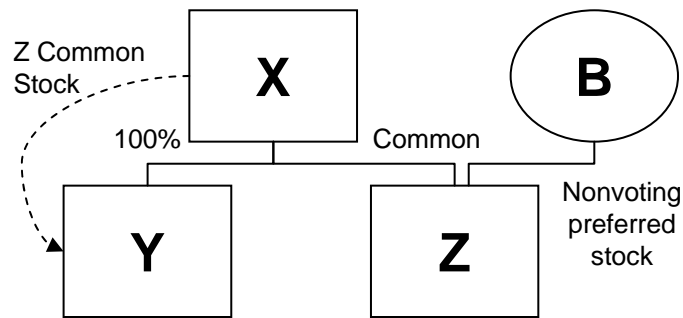
# Capital Contributions and “Stockless” Section 351 Transactions: Current Law

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- There has been little Treasury guidance governing the basis consequences of capital contributions and stockless §351 transactions, subject to one exception.
- Under Treas. Reg. §1.358-2(a)(2)(iii) and (viii), stock is deemed issued and recapitalized in stockless §351 exchanges that are also reorganizations provided that the shareholder or security holder does not also transfer property other than stock or securities and no liabilities of the shareholder or security holder are assumed in the transaction.

# Stockless Section 351/Capital Contribution: Example 7, Current Law

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**Facts:** X contributes the common stock of Z to Y but receives no additional Y stock in respect of the contribution. The transaction is one to which §§118 and 351 apply.

**Result:** Is X's basis in each of its Y shares increased by \$20 to \$42 on an unsegmented basis? On a segmented basis? Is X treated as contributing the Z stock to Y in exchange for 20 additional Y shares followed by a recapitalization of the 40 Y shares deemed to exist into 20 shares?

### X's Y Common Stock

<u>Shares</u>	<u>Basis</u>	<u>FMV</u>
20	\$440	\$500

### X's Z Common Stock

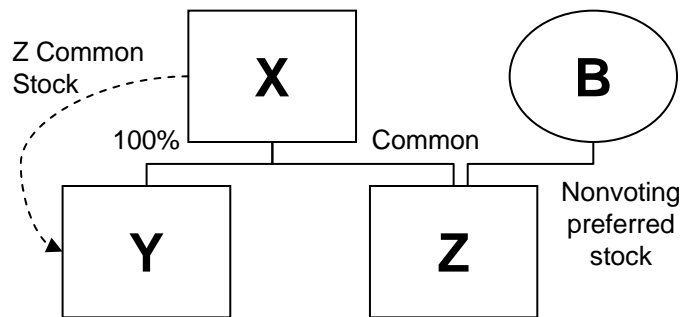
<u>Shares</u>	<u>Basis</u>	<u>FMV</u>
20	\$400	\$500

# Capital Contributions and “Stockless” Section 351 Transactions: 2009 Proposed Regulations

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The deemed issuance and recapitalization approach is expanded to apply to all stockless §351 exchanges and to all capital contributions. That approach applies even if liabilities are assumed.

# Stockless Section 351/Capital Contribution: Example 8, Proposed Law



**Facts:** X contributes the common stock of Z to Y but receives no additional Y stock in respect of the contribution. The transaction is one to which §§118 and 351 apply.

**Result:** X is treated as contributing the Z stock to Y in exchange for 20 additional Y shares followed by a recapitalization of the 40 Y shares deemed to exist into the 20 shares that actually exist. Accordingly, 10 of X's Y shares each have a basis of \$40 and 10 of X's Y shares each have a basis of \$44.

### X's Y Common Stock

<u>Shares</u>	<u>Basis</u>	<u>FMV</u>
20	\$440	\$500

### X's Z Common Stock

<u>Shares</u>	<u>Basis</u>	<u>FMV</u>
20	\$400	\$500

**Variation:** What is the result if Y assumes \$1 of X's liabilities in the transaction?

**Observation:** The new rules require a valuation of both the contributed asset and the stock of the controlled corporation each time a contribution to a controlled corporation is made.

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# Dividend Equivalent Section 304 “Brother-Sister” Transactions

# Dividend Equivalent Section 304 “Brother-Sister” Transactions: Current Law

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- Section 304(a)(1) applies to a transaction in which two corporations (“brother-sister” corporations) are under common control, and one (the acquiring corporation) acquires stock in the other (the issuing corporation) from the person or persons that control the corporations (the transferor), in return for property.
  - Section 304(a)(1) provides that the property is treated as received by the transferor as a distribution in redemption of acquiring corporation stock.
  - To the extent such distribution is governed by §301, the transaction is treated as if:
    - The transferor transferred issuing corporation stock to the acquiring corporation in exchange for acquiring corporation stock in a §351(a) exchange, and
    - The acquiring corporation redeemed those deemed-issued shares.

Note: §304(a)(1) does not indicate what type of acquiring corporation stock is deemed received in a §351 exchange and then deemed redeemed.

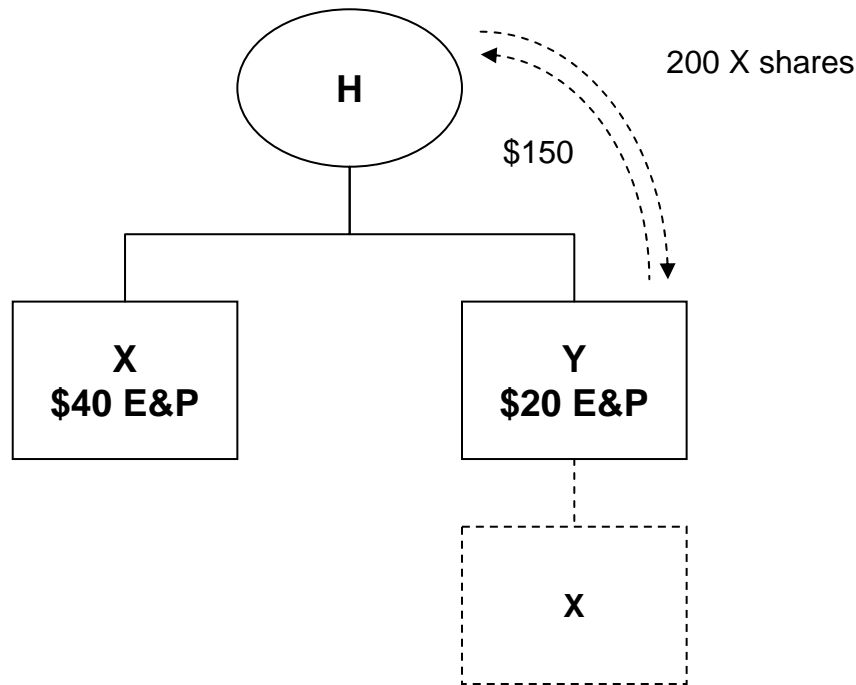
- The deemed-issuance approach does not apply to §304(a)(2) transactions (where the issuing corporation controls the acquiring corporation).

# Dividend Equivalent Section 304 “Brother-Sister” Transactions: Proposed Regulations

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- The proposed regulations specify that the property received by the transferor from the acquiring corporation is to be treated as received in redemption of acquiring corporation common stock.
- Testing for dividend-equivalence is under the same §302 tests that apply to actual redemptions, but by reference to the ownership of issuing corporation stock.
- If §301 applies to the property received in the deemed redemption, the transaction is treated as if the transferor had transferred the issuing corporation stock to the acquiring corporation in exchange for acquiring corporation common stock in a §351 exchange, and then the acquiring corporation redeemed its deemed-issued common stock for property.
  - The acquiring corporation’s basis in the issuing corporation stock is determined under §362.
  - The transferor's basis in the deemed-issued acquiring corporation common stock is equal to the transferor’s basis in the issuing corporation stock surrendered under §358.
- To the extent that §301(c)(2) applies to the deemed redemption of the common stock of the acquiring corporation, the amount distributed in such redemption is applied to reduce the adjusted basis of each share of common stock directly held or deemed held by the transferor on a pro rata, share-by-share basis.

# Prop. Reg. Section 1.304-2(c), Example 2



**Facts:**

<u>H's Common Stock</u>			
<u>Corporation</u>	<u>Shares</u>	<u>Basis</u>	<u>FMV</u>
X	200	\$100	\$150
Y	200	\$30	\$150

Individual H owns 100% of corporations X and Y, and transfers its 200 X shares to Y for \$150 in cash.

**Result:**

Under the proposed regulations, the transaction is treated as if H transferred its X stock to Y for 200 shares of Y common stock in a §351(a) exchange, and then Y redeemed the 200 deemed-issued common shares for \$150 in cash.

# Prop. Reg. Section 1.304-2(c), Example 2 (continued)

**Analysis:**

	After Deemed §351(a) Exchange			Distribution (on Deemed-Issued and Original Y Shares)					After Deemed Recapitalization		
	Shares	Shares	Basis	FMV	Total Distribution	301(c)(1) Dividend	301(c)(2) Recovery	301(c)(3) Gain	Remaining Basis	Shares	Basis
Y Original	200	200	\$30	\$150	\$75	\$30	\$30	\$15	\$0	100	\$0
Y Deemed issued		<u>200</u>	<u>\$100</u>	<u>\$150</u>	<u>\$75</u>	<u>\$30</u>	<u>\$45</u>	<u>\$0</u>	<u>\$55</u>	<u>100</u>	<u>\$55</u>
Y Total	400	400	\$130	\$300	\$150	\$60	\$75	\$15	\$55	200	\$55
X (Y's basis)		200	\$100	\$150			(No change)			(No change)	

**Queries:**

- What is the result if X had outstanding common and preferred shares, and H transferred only the preferred to Y? (Compare this result to the result where X merely redeems the X preferred from H.) What if Y has two classes of common stock outstanding?
- How would basis in the redemption be recovered under current law? See Preamble, T.D. 9250 (Mar. 13, 2006); Preamble, T.D. 9444 (Feb. 11, 2008); Treas. Reg. §1.367(a)-9T(b).
- Should Y get a basis step-up in the X stock for any gain recognized by H? What about for any dividend? Cf. Preambles, T.D. 9444 and REG-147636-08 (Feb. 11, 2008); Treas. Reg. §1.367(a)-9T(b).

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## 2. Rev. Proc. 2009-25: Single Issue Section 355 Rulings

# Background: IRS Letter Ruling Practice

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- Ordinarily, the Service will not issue a letter ruling on a part of an integrated transaction.
- If part of a transaction falls in a no-rule area, the Service may issue a ruling on other parts. Where it is impossible to determine the tax consequences of a larger transaction without knowing the resolution of a no-rule issue, the taxpayer must represent the tax consequences of the no-rule issue.
- The Service generally does not issue rulings on issues “clearly and adequately” addressed by statute, regulations, decisions of a court, or published authorities (e.g., no “comfort” rulings) or with respect to certain no-rule areas (e.g., §§332, 351, 1036, 368(a)(1)(A), (B), (C), (E), or (F), or as to the consequences of a corporate reorganization).
- If the Service determines that there is a significant issue, and to the extent the transaction is not described in another no-rule section, the Service will issue a letter ruling on the entire transaction, and not just the significant issue. Rev. Proc. 2009-3, 2009-1 I.R.B. 107, at §3.01(38).

# Rev. Proc. 2009-25: Single Issue Section 355 Rulings—General Requirements

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What's new?

- For a larger or integrated transaction, taxpayers may request rulings on:
  - part of a transaction; or
  - on a particular legal issue.
- Upon request, ruling requests will be handled on an expedited basis, with the goal of responding within ten weeks of receipt of request.
- This pilot program only applies to requests that:
  - (1) Are solely under the jurisdiction of the Associate Chief Counsel (Corporate),
  - (2) Are significant (as defined in Rev. Proc. 2009-3, §3.01(38)), and
  - (3) Involve the tax consequences or characterization of a transaction (or part of a transaction) that occurs in the context of a §355 distribution.

Example: The Service may rule on whether the acquisition of the assets of one corporation by another corporation meets the continuity of business enterprise requirement or is described in §355(b)(2)(C) even though the ruling does not address the overall qualification of the transaction under §368 or §355, respectively, as long as the acquisition occurs in the context of a §355 distribution.

# Rev. Proc. 2009-25: Single Issue Section 355 Rulings—Required Representations

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- Ruling requests must still comply with relevant requirements of any other applicable revenue procedures. See, e.g., Rev. Proc. 2009-1, 2009-1 I.R.B. 1, at Appendix E. For example, a request for a §351 ruling on a transaction that occurs in the context of a §355 distribution must provide all of the information required by Rev. Proc. 83-59. However, if the request is solely for a ruling on a significant issue under §351, the request must provide the information and representations required by Rev. Proc. 83-59 that pertain only to that significant issue.
- Where a taxpayer is requesting a ruling regarding a significant issue under a Code or Regulations section (e.g., §368(a)(2)(C)), the taxpayer must provide a representation regarding qualification or characterization of the transaction under such Code or Regulations section (e.g., §368(a)(1)(A)).

# Rev. Proc. 2009-25: Single Issue Section 355 Rulings—No Rule Policy/355(e) Rulings

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- Current no-rule policies also govern requests for rulings pursuant to Rev. Proc. 2009-25, (e.g., no rulings on device, business purpose, or plan within the meaning of §355(e)).
- However, the Service will rule on a significant non-plan issue or issues under §355(e) (e.g., whether a corporation constitutes a predecessor of the distributing corporation) if an adverse ruling on such non-plan issue or issues would result in a direct or indirect acquisition by one or more persons of stock representing a 50-percent or greater interest in the distributing corporation or the controlled corporation that is part of a plan under §355(e).
- Also, the Service may issue a ruling regarding the effect of redemptions under §355(e) pending the issuance of temporary or final regulations regarding redemptions under §355(e) if an adverse ruling on such question would result in there being a direct or indirect acquisition by one or more persons of stock representing a 50-percent or greater interest in the distributing corporation or the controlled corporation that is part of a plan under §355(e).

# Rev. Proc. 2009-25: Single Issue Section 355 Rulings—Specific Requirements for Requests

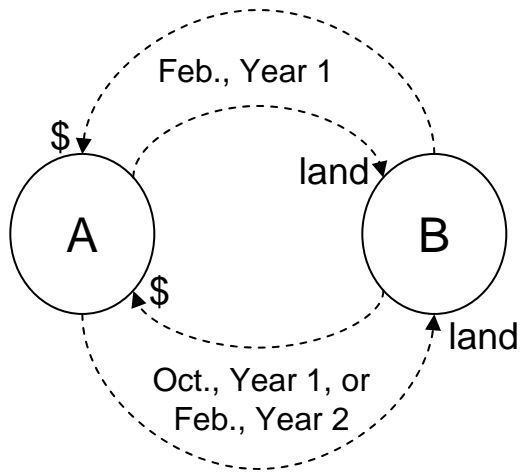
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- Taxpayers should call the Office of Associate Chief Counsel (Corporate) for a pre-submission conference before preparing a ruling request under Rev. Proc. 2009-25.
- All requests for rulings under Rev. Proc. 2009-25 must contain the following:
  - (1) A narrative description of the transaction that puts the issue in context;
  - (2) An explanation concerning why the issue is significant;
  - (3) Applicable information from other relevant revenue procedures with respect to the significant issue;
  - (4) The precise ruling being requested;
  - (5) Where the taxpayer is requesting a ruling on the tax treatment of **part of an integrated transaction**, a representation regarding the relevant tax consequences of the larger transaction (to the “best knowledge and belief” of the taxpayer);
  - (6) Where the taxpayer is requesting a ruling on a **particular legal issue** under a Code section or section of the Regulations (e.g., Treas. Reg. §1.368-2(k)), a representation (to the “best knowledge and belief” of the taxpayer) regarding qualification or characterization of the transaction under such Code or Regulations section (e.g., §368(a)(1)(A)); and
  - (7) A statement that no rulings outside the jurisdiction of the Associate Chief Counsel (Corporate) are requested.

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## 3. Rescission Transactions

# Rev. Rul. 80-58, 1980-1 C.B. 181



## Relevant Facts

- In February of Year 1, A sells to B a tract of land in exchange for cash.
- Under the terms of the contract, if B is unable to have the land rezoned within a specified period, A must accept reconveyance of the land from B and pay to B all amounts expended by B in connection with the sale.
- In October of Year 1, or, alternatively, February of Year 2, B reconveys the land to A.

## Holding

- A will not recognize gain from the sale if the reconveyance occurs in October of Year 1 but will recognize gain if the reconveyance doesn't occur until February of Year 2.

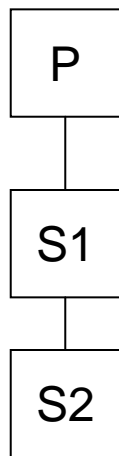
## Key Quotes from the Ruling)

“The legal concept of rescission refers to the abrogation, canceling, or voiding of a contract that has the effect of releasing the contracting parties from further obligations to each other and restoring the parties to the relative positions that they would have occupied had no contract been made. A rescission may be effected by mutual agreement of the parties, by one of the parties declaring a rescission of the contract without the consent of the other if sufficient grounds exist, or by applying to the court for a decree of rescission.” (Emphasis added.)

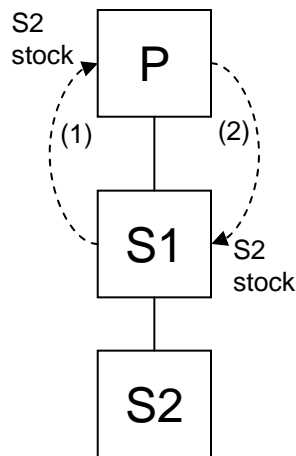
“The annual accounting concept requires that one must look at the transaction on an annual basis using the facts as they exist at the end of the year. That is, each taxable year is a separate unit for tax accounting purposes.” (Emphasis added, citations omitted.)

# Rescinding “Distributions”

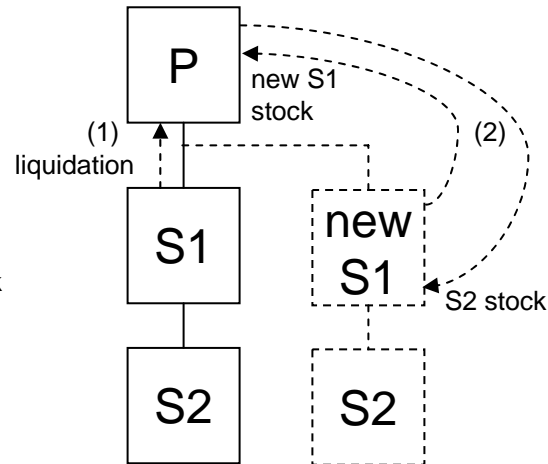
## Starting Point



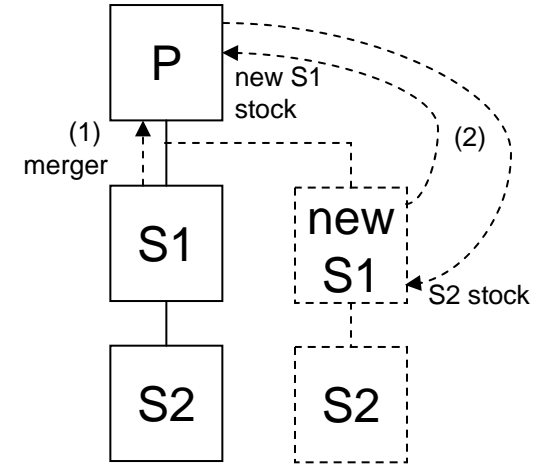
## Scenario 1



## Scenario 2



## Scenario 3

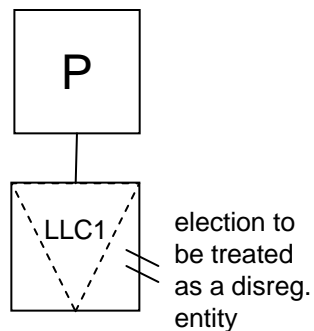


## Description of Scenarios

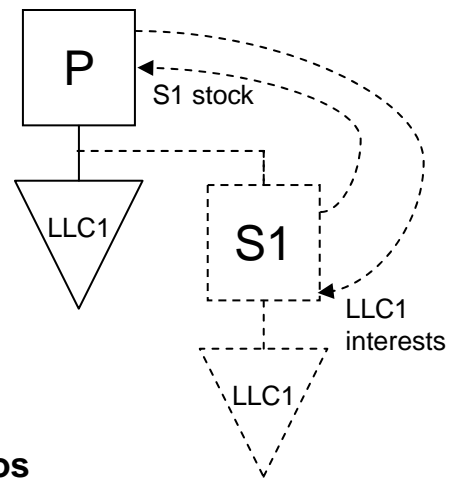
- Starting Point: In all 3 scenarios, P owns S1 and S1’s only asset is all of the stock of S2, an operating company.
- Scenario 1: S1 distributes S2 to P in a non-liquidating distribution (for corporate purposes) followed by a same year retransfer of S2 by P to S1. Cf. PLR 200915031.
- Scenario 2: S1 distributes S2 to P in a liquidating distribution followed by a same year creation of a new corporation (“new S1”) and transfer of former S1 assets (the S2 stock) to new S1.
- Scenario 3: S1 merges up into P followed by a same year creation of a new corporation (“new S1”) and transfer of former S1 assets (the S2 stock) to new S1. Cf. PLR 200701019.

# Rescinding “Disregarded Entity” Elections

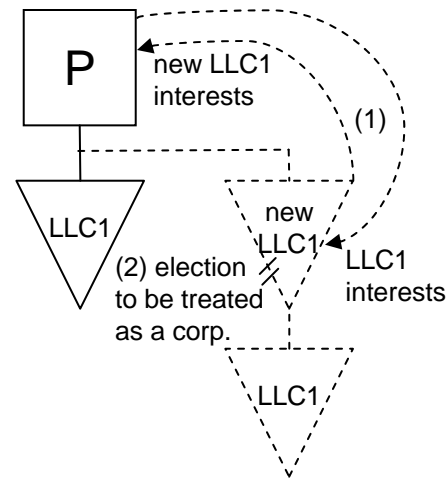
## Original Transaction



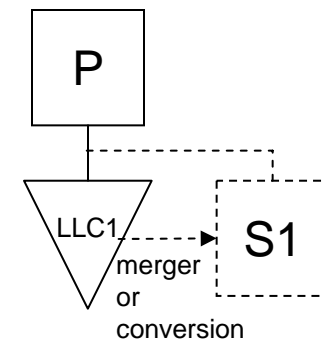
## Scenario 1



## Scenario 2



## Scenario 3



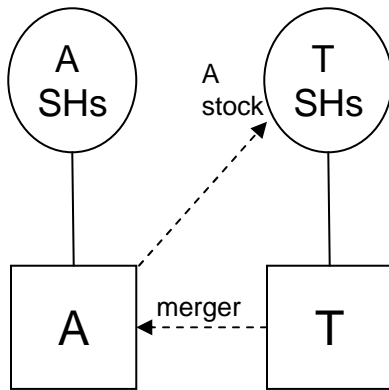
## Description of Scenarios

- Original Transaction: In all 3 scenarios, P elects to have an LLC (“LLC1”) that is treated as a corporation for U.S. federal income tax purposes be treated as a disregarded entity.
- Scenario 1: In the same year, P drops LLC1 into a new corporation (“S1”).
- Scenario 2: In the same year, (1) P drops LLC1 into a new LLC (“new LLC1”) and (2) elects to have new LLC1 treated as a corporation.
- Scenario 3: In the same year, LLC1 converts under state law into, or merges into, a new corporation (“S1”).

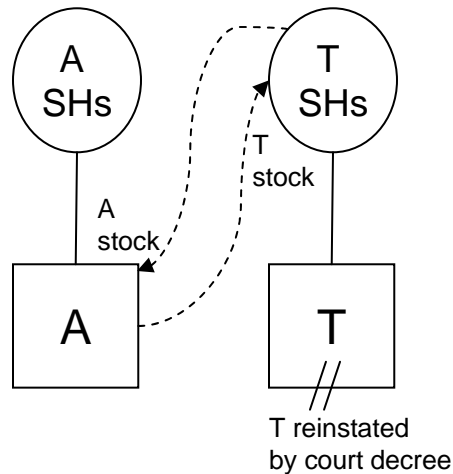
Query: What if in the Original Transaction, rather than P electing to have LLC1 treated as a disregarded entity, LLC1 had merged into LLC2, a newly-formed LLC treated as a disregarded entity? Cf. PLR 200613027.

# Rescinding “Sideways” Merger

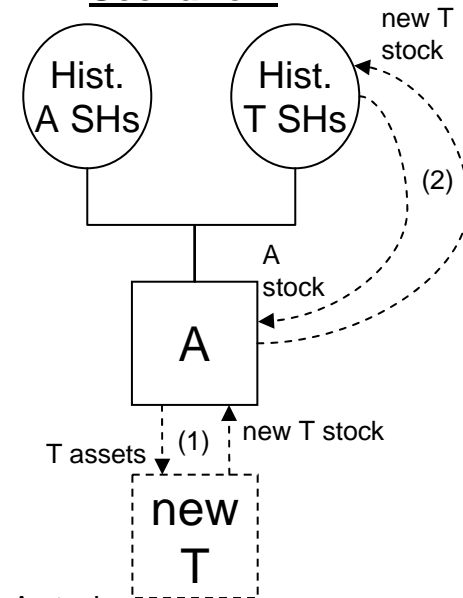
## Original Transaction



## Scenario 1



## Scenario 2



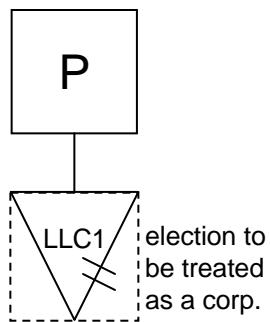
## Description of Scenarios

- Original Transaction: In both scenarios, T merges into A with T shareholders receiving A stock.
- Scenario 1: In the same year as the original transaction, a court rescinds the merger (such that T is reinstated as a corporation). Cf. PLR 200911004.
- Scenario 2: In the same year as the original transaction (1) A forms a new corporation (“new T”) and drops all the T assets into new T in exchange for new T stock and (2) the new T stock is split off to the historic T shareholders in exchange for all of the A stock they received in the merger. Cf. PLR 200908016.

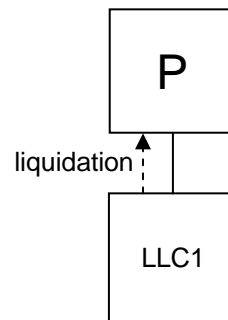
Query: What happens if, immediately after the transaction in Scenario 1 or Scenario 2, A acquires the T stock for A stock? Does it matter whether A and T had always intended that A acquire the T stock? Cf. PLR 200701019.

# Rescinding “Corporate Entity” Elections

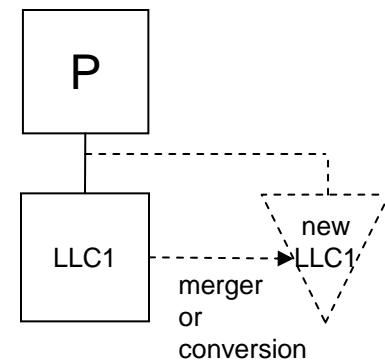
## Original Transaction



## Scenario 1



## Scenario 2



## Description of Scenarios

- Original Transaction: In both scenarios, P elects to have an LLC (“LLC1”) that is treated as a disregarded entity for U.S. federal income tax purposes be treated as a corporation.
- Scenario 1: In the same year, P liquidates LLC1.
- Scenario 2: In the same year, LLC1 converts under state law into, or merges into, a new LLC (“new LLC1”).

Query: What if in the Original Transaction, rather than P electing to have LLC1 treated as a corporation, LLC1 had converted into a corporation under state law? Cf. PLR 200613027.

# What is the Same Taxable Year?

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## Description of Scenarios

- Scenario 1: Transaction occurs on the last day of the year but under Treas. Reg. §1.1502-76(b)(2)(ii)(B) it is treated as occurring at the beginning of the following day.
- Scenario 2: Transaction occurs on the last day of the year but has no tax effect until the following year (e.g., under §382(b)(3) the §382 limitation does not apply to the portion of the taxable income allocable to the period ending on or before the change date).
- Scenario 3: “Check-the-box” election effective the first day of new year but under Treas. Reg. §301.7701-3(g)(3)(i) the transactions that are deemed to occur as a result of the election are treated as occurring immediately before the close of the preceding day.

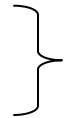
# Rescission, Reformation, and 9100 Relief

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## Doctrine

## Concept

**Rescission  
(Transaction)**



The taxpayer **did** something and now wants to be treated retroactively as if it **hadn't**.

**Reformation  
(Transaction)**



The taxpayer **didn't do** something and now wants to be treated retroactively as if it **had**.

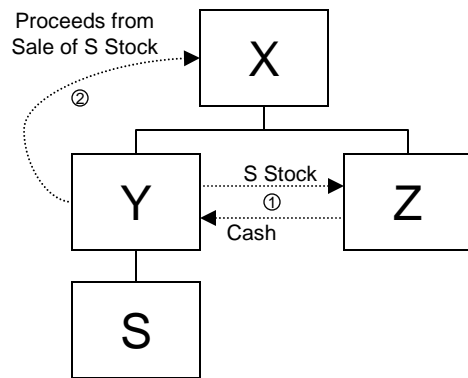
**9100 Relief  
(Tax Elections)**

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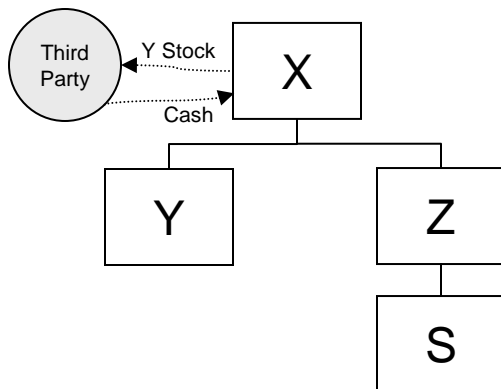
## 4. Merrill Lynch Case

# Merrill Lynch & Co. v. Commissioner, 131 T.C. No. 19 (Dec. 30, 2008)

## Step 1: Cross-Chain Sale



## Step 2: Sale to Third Party



## Facts:

Y sold the stock of S to Z for cash and distributed the proceeds from the sale to X. X then sold the stock of Y to a third party.

X took the position that the sale of S stock to Z was subject to §304(a)(1), and that the sale proceeds should be treated as dividend income under §301(c). X's basis in Y was increased by the amount of sales proceeds and then decreased by the amount of the distribution, resulting in X having the same basis in the Y stock as it had before the sale of S by Y.

## Issue:

Whether X's continuing constructive ownership of S after the cross-chain sale must be taken into account in analyzing the tax consequences of the cross-chain sale by Y under §§304(a)(1) and 302(b)(3).

## Holding:

Under §304, Y is the only relevant shareholder for purposes of determining whether Y's interest in S was completely terminated, and consequently, because Y's interest in S was completely terminated upon X's sale of the Y stock to the third party, the sales proceeds should be treated as a payment in exchange for stock under §302(a).