



Federal Tax ADVISORY ■

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D Reorganization Basis Regulations Finalized

Reg. Section 1.358-2 (T.D. 9702)

In November the Treasury finalized a temporary and proposed regulation dealing with the basis of stock of the target corporation in a nondivisive D reorganization. There are no surprises in the final regulation.

The Cases Addressed

The regulation addresses D reorganizations that have nothing to do with spin-offs: these are so-called nondivisive D reorganizations. The target corporation transfers substantially all of its assets to the acquiring corporation for stock and sometimes boot and distributes the same to its shareholder or creditors. The most common use of this reorganization format involves two commonly controlled corporations, usually with identical shareholders.

In cases of identical shareholders, the case law and now the regulations have been willing to deem issuance of stock by the acquiring corporation even when none is issued. This used to occur when target corporations wanted to be treated as selling their assets to a related corporation for cash or notes, and then liquidated (which then was tax free to the target corporation, without a reorganization). Such sales still occur, but for different intended purposes and tax results.

The most common cases are the all cash, part cash, or no consideration D reorganizations. The target sells all of its property to the acquiring corporation for cash that is supposed to equal the net value of the property. Sometimes the parties miscalculate or intentionally underpay. That will produce a bargain sale. Alternately, nothing is paid at all. The regulations handle these cases this way:

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- All cash, full value: The acquiring corporation is deemed to issue a nominal share of its stock to the target, which distributes that share plus the cash to its shareholder.
- Bargain sale: The acquiring corporation is deemed to issue its stock having a value equal to the difference between the net value of the target's property transferred and the consideration the acquiring corporation actually paid (stock and/or boot).
- No consideration: The acquiring corporation is deemed to issue stock having a value equal to the net value of the target's property.

The Problem

The problem addressed by the new final and prior proposed and temporary regulations is what to do with the basis of the deemed stock received by the target's shareholder. When the acquiring corporation pays boot, we know that any gain in the target stock will be recognized by the target's shareholder to the extent of the boot. It is rare for such gain cases to occur. The more common cases involve target stock with a built-in loss, or no gain or loss. In those cases, the target is deemed to receive acquiring corporation stock and deemed to distribute it to its shareholder, which expects to retain a built-in loss or no gain in that stock.

If the shareholder is also the shareholder of the acquiring corporation, then it adds the basis of its deemed shares (nominal or otherwise in the case of the bargain or no consideration exchange) to the basis of its acquiring corporation stock. The regulation calls for a deemed recapitalization to prorate the basis increase, except in the case of the nominal share whose basis is designated to particular actual shares of acquiring corporation stock.

The regulation allows the shareholder to designate the basis of the nominal share to particular shares of the acquiring corporation. Confusion arises, however, when the target shareholder does not own stock of the acquiring corporation. For example, the D reorganization is a "cross chain" transfer where the target is down the chain several links from the parent corporation.

In these cases the deemed stock of the acquiring corporation, just like actual shares, must be pushed up to the parent and if need be dropped down to the corporation that actually owned stock of the acquiring corporation. That push up of deemed shares is a Section 311 distribution. If there is gain in the shares, it will be recognized. If there is loss in the shares, the more common case, it gets more interesting.

Outside of consolidation, and in foreign corporations, the loss is lost under Section 311(a). Inside consolidation, Section 311(a) is turned off and the loss is deferred until accelerated under the matching regulations, but still the basis is "stripped off" the deemed shares. That means that under no circumstances can a basis in excess of value be added to the basis of stock in the acquiring corporation when the deemed share has been pushed up to a higher shareholder.

Designation

A principal concern of the regulation was to clearly prevent a result that some thought could be obtained under the proposed regulation: avoiding the process of pushing up the deemed share by letting the

immediate shareholder of the target “designate” the basis of the deemed share to certain shares of stock of the acquiring corporation actually held by an affiliate. The final regulation makes clear that the designation can only be made by the actual shareholder of the acquiring corporation, and by the time the deemed share gets to that shareholder, it will have lost its built-in loss.

Planning and Traps

Planners long have understood that the nominal share rule could be avoided by having the acquiring corporation issue one share and holding it at the level of the shareholder of the target corporation in the all-cash D case. That way, the group can avoid having a loss stripped out of the basis of the stock of the acquiring corporation. Alternately, if the target shareholder had held just one share of the acquiring corporation’s stock in advance, then the nominal share rule would apply and that shareholder could designate the basis of the nominal share to its one share, and also preserve the loss.

The only taxpayer that will be hurt by this regulation is the nonconsolidated group that totally misses the issue, a nominal share is deemed issued and moved around the group, and the loss is stripped out of the nominal share basis. To that extent, the regulation is a trap for the unwary.

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