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Identifying Basis

Reg. Section 1.356-1(b) contains a surprising and sometimes overlooked rule:

> For purposes of computing the gain, if any, recognized pursuant to section 356 and paragraph (a)(1) of this section, to the extent the terms of the exchange specify the other property or money that is received in exchange for a particular share of stock or security surrendered or a particular class of stock or securities surrendered, such terms shall control provided that such terms are economically reasonable.

Section 356 is the section that controls the taxation of boot received by shareholders in reorganizations. Its general rule is that the shareholder recognizes its realized gain to the extent of boot received. The regulations apply the rule on a share-by-share basis.

Often a shareholder holds several blocks of stock with different basis. Just as selling high-basis shares by directing the broker to transfer those shares can reduce income recognized on stock sales, this regulation allows the merger agreement to specify which shares are exchanged for which flavor of consideration: stock or boot.

The regulation does not distinguish between dividend-equivalent boot and gain. It does not distinguish between target corporations with many shareholders and few. However, the specification must be in the "terms of exchange." Also they must be "economically reasonable."

If the exchange is value for value, which it must be in any event, it should be economically reasonable. If the target is closely held, it should be possible to specify particular shares in the reorganization agreement. A common example is a cross-chain D reorganization.

If the target is widely held, then the corporate parties might attempt to comply with the regulation by writing into the agreement that the shareholders can make such a specification to the transfer agent, and the specification shall be deemed to be part of the agreement. There is no published guidance saying this will work—but there also is none saying it will not work. If this is attempted, the corporation should tell the shareholders to consult their tax advisers about reporting.

For more information, please contact Jack Cummings at 919.862.2302.

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