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# Federal Tax Advisory

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*Insights Into Recent Regulatory, Judicial and Legislative Developments*

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## All-Cash D Regulation Amended

### *Reg. Section 1.358-2T(a)(2)(iii)*

On November 18, 2011, the Treasury filed an amendment to the final regulations published in 2009 that address what is known as the all-cash D reorganization. The amendment clarifies a question about stock basis involving the so-called nominal share, which some had claimed was not clear in the 2009 regulation. The clarification will be viewed as unfavorable to taxpayers, but is not surprising. However, it created yet another ambiguity in the regulation.

***Example:*** P owns X and Y. X owns T, and Y owns Acq. T sells all of its assets to Acq. for cash equal to the assets' value, and T liquidates into X. Under the 2009 regulations, the sale is treated as a D reorganization of T into Acq. and Acq. is deemed to issue to T a nominal share of Acq. stock. T is deemed to distribute the nominal share of Acq. stock to X in the deemed liquidation of T. X is deemed to distribute the nominal share of Acq. stock to P, which is deemed to contribute the nominal share of Acq. to Y, which owns the rest of the Acq. stock. Of course, the nominal share has zero value, because all of the value of T's assets was "paid for" with the cash from Y. The issue addressed in the amendment is the basis of the nominal share and what can be done with it.

### *The Designation Rule*

The 2009 regulation said that the shareholder of T could designate the real share of stock of the acquiring corporation to which the basis of the nominal share would be assigned. It was fairly clear that this designation rule applied only if T's shareholder actually owned Y stock. (*See* Cummings, "The Stockless D Reorganization Regulations," *Journal of Taxation*, Feb 2010.)

However, according to the preamble to the amendment, T.D. 9558, "some maintain these rules… could be interpreted to allow an inappropriate allocation of basis by persons that do not own actual shares of stock in the issuing corporation," which would mean on the facts of the example above that X might designate the basis of the nominal Acq. share to jump over to certain actual shares of Acq. stock owned by Y.

The advantage of this ploy would be that the nominal share could avoid being deemed to travel up the chain from X to P before it is deemed to travel down the other chain from P to Y. Outside of a consolidated group (for example, among foreign corporations), the deemed distribution of the nominal share from X to P would trigger gain or loss under Section 311 and P would receive the nominal share with a basis equal to its value—zero. Therefore, even if P or Y could designate that basis to an actual share of Acq. stock, there would be no basis to designate.

### *The Clarification*

The 2009 regulations fairly clearly limited the ability to designate basis to the actual shareholder of T; what the Treasury was concerned about was to whose shares of Acq. that shareholder of T assigned the basis of the nominal share. The new temporary regulation, Section 1.358-2T(a)(2)(iii), flips the ambiguity and apparently does not limit to the actual shareholder of T the ability to designate the share to which the nominal share basis will be assigned, but does limit that ability to an actual shareholder of T; that shareholder "must" make the designation. Therefore, on the facts of the example above, X cannot, on or after November 21, 2011, designate a share of Acq. owned by Y to receive the basis of the nominal share, but apparently Y could do so, if there were any basis to designate, once the nominal share made its way around to Y by deemed distributions and contributions.

Although there would be no basis in the nominal share if it were pushed up by T to X to P in deemed distributions in the example, if P directly owned T, then P could receive basis in the nominal share that P could push down the other chain to Y. Therefore, the change that permits any deemed owner of the nominal share to make the designation if it actually owns Acq. shares would enable Y to make such a designation.

## *Status of 2009 Regulation*

The preamble states that the Treasury "did not intend" the interpretation of the original regulation that some have asserted and "does not believe" it supports the result claimed. Thus, the Treasury believes that in a case where there is basis left in the nominal share after the exchanged basis of the T stock is reduced by the cash distributed, X should be deemed to distributed the loss share (basis in excess of zero value) and not be allowed to recognize the loss under Section 311(a) (outside consolidation), giving P a zero basis in the nominal share. It disagrees with a taxpayer that would claim it has transferred that basis in some of the Acq. shares actually owned by Y, which Y could then sell and recognize the loss.

However, the temporary regulation that clearly heads off that argument is not effective retroactively. This is curious because the Treasury might have asserted its authority under Section 7805(b)(3) to make a regulation retroactive to prevent abuse.

## *Planning*

The all-cash D reorganization frequently is stumbled into when corporations sell assets of one subsidiary for book value to another subsidiary. While the sale usually will be treated as a D reorganization, when someone starts looking into the tax consequences, gain can be recognized if the cash exceeds the target stock basis; and if the target stock basis exceeds the cash, then the loss of basis described above can occur if the target is not immediately below the parent corporation and the nominal share is deemed to be distributed up a chain. Any taxpayers who encountered this situation, and took the chance of designating an actual share of Acq. owned by some brother or sister corporation to receive the basis, can take some comfort from the way the effective date of the temporary regulation was handled.

Alternately, in these situations, it is usually preferable from a planning standpoint not to have a nominal share, which avoids falling into the deemed distribution-contribution, scenario. With an actual share of Acq. being issued in the transaction, the taxpayer can choose where it will be transferred or not.

Finally, the temporary regulation opens up two new possibilities and one ambiguity. First, if X owns one share of Acq., then it appears to this author that X can—indeed, must—designate the basis of the nominal share to that share; X is the first actual shareholder to "receive" the nominal share and there is no reason to require the nominal share to travel all the way to the major shareholder of Acq. before allowing an intervening shareholder to make the designation. This interpretation would prevent a loss of basis as described above. Perhaps some will argue that the designation must be apportioned between X and Y, but that is hard to see.

A second and unrelated point, and a new ambiguity: the temporary regulation makes clear something that appeared not to be authorized by the original regulation, in that it authorizes the actual owner of Acq. stock, who is deemed to own the nominal share, to designate where that basis will go among the Acq. stock shares it owns, even if the actual owner of the Acq. stock did not participate in the Section 354/356 exchange in the D reorganization (which the original regulation required). This is good for taxpayers. The curious thing about this change, however, is that it is not explained as such in the preamble to the temporary regulation, and will seem like a new ambiguity that was introduced in a regulation intended to clear up ambiguities.

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