Limitation on Loss Duplication and Importation of Built-in Losses

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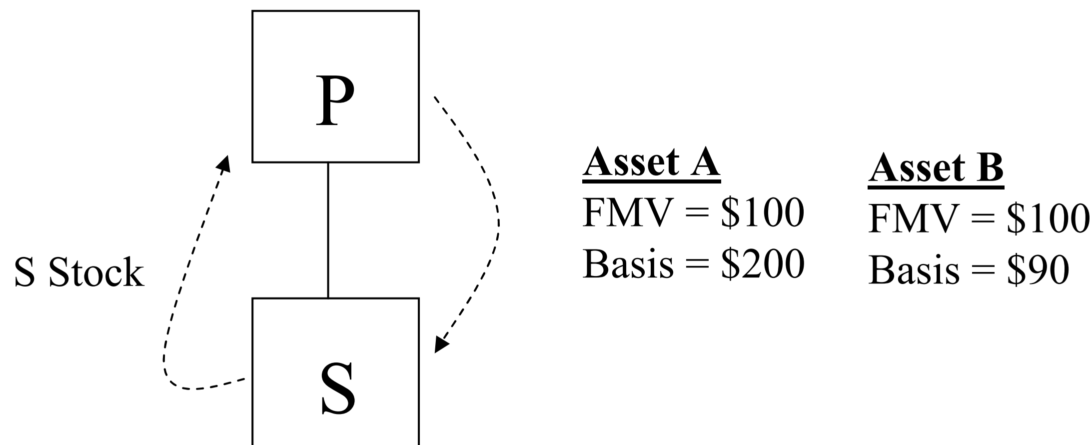
Section 362(e)(2) Limitation on Transfer of Built-in Losses— Overview

- **Section 362 Prior to AJCA: Section 351 Transactions (Other than Loss Importation Transactions Discussed Below)**
  - Under section 358, the transferor's basis in the stock of the controlled corporation was the same as the basis of the property contributed to the controlled corporation, increased by the amount of any gain (or dividend) recognized by the transferor on the exchange, and reduced by the amount of any money or property received, and by the amount of any loss recognized by the transferor
  - Under section 362, the corporation's basis in the transferred property was the same as it would have been in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer

- **Section 362 as Amended by AJCA: Section 362(e)(2)—Transfer of losses in a Section 351 Transaction**
  - If the aggregate adjusted basis of property contributed by a transferor (or by a control group of which the transferor is a member) to a corporation exceeds the aggregate fair market value of the property transferred:
    - The transferee's aggregate basis in the properties is limited to the aggregate fair market value of the transferred property
    - Any required basis reduction is allocated among the transferred properties in proportion to their built-in-loss immediately before the transaction
    - Transferor and transferee may elect to limit the basis in the stock received by the transferor to the aggregate fair market value of the transferred property, in lieu of limiting the basis in the assets transferred
      - Such election shall be included with the tax returns of the transferor and transferee for the taxable year in which the transaction occurs and, once made, shall be irrevocable

Section 362(e)(2) Limitation on Transfer of Built-in Losses—Example



Facts: P contributes: (i) Asset A with a fair market value of $100 and an adjusted basis of $200 and (ii) Asset B with a fair market value of $100 and a basis of $90 to S in exchange for S stock in a section 351 exchange.

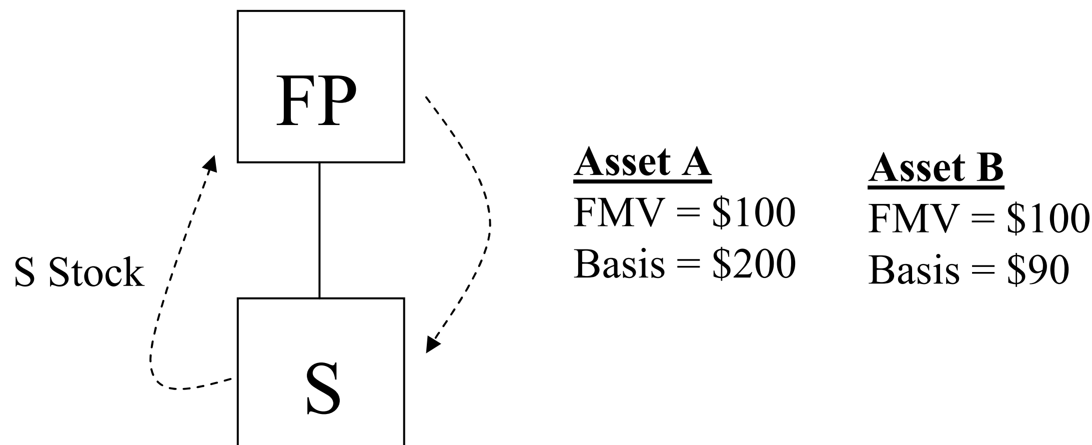
Analysis: Unless P and S elect otherwise, P's basis in its S shares is $290. There is an aggregate built-in loss of $90 in Assets A and B. Thus, S's aggregate basis in Assets A and B equals $200 (i.e., the aggregate fair market value of Assets A and B). S's basis in Asset A is reduced to $110 [$200 – ($90 x $100/$100)] (i.e., the proportionate share of built-in loss allocable to Asset A). S's basis in Asset B remains $90 [$90 – ($90 x $0/$100]. See section 362(e)(2).

Section 362(e)(1) Limitation on Importation of Built-in Losses—Overview

- **Section 362 Prior to AJCA: Incorporations, Reorganizations and Liquidations**
  - The basis of property received by a corporation, whether from domestic or foreign transferors, in a tax-free incorporation, reorganization, or liquidation of a subsidiary corporation was the same as the adjusted basis in the hands of the transferor, adjusted for gain or loss recognized by the transferor

- **Section 362 as Amended by AJCA: Section 362(e)(1)—Importation of Losses (Incorporations, Reorganizations and Liquidations)**
  - If a "net built-in loss" is imported into the U.S in a tax-free incorporation or reorganization from persons not subject to U.S. tax, the basis of each property so transferred is its fair market value
    - A "net built-in loss" is treated as imported into the U.S. if the aggregate adjusted bases of property received by a transferee corporation exceed the fair market value of the properties transferred
  - Similar rules apply in the case of the tax-free liquidation by a domestic corporation of its foreign subsidiary

Section 362(e)(1) Limitation on Importation of Built-in Losses—Example



Facts: FP, a non-U.S. corporation not subject to U.S. taxation, incorporates S, a U.S. corporation. FP contributes to S: (i) Asset A with a fair market value of $100 and an adjusted basis of $200 and (ii) Asset B with a fair market value of $100 and a basis of $90 in exchange for S stock in a section 351 exchange. Immediately before the contribution, FP's gain or loss with respect to Assets A and B is not subject to U.S. taxation.

Analysis: FP's basis in its S shares is $290. Although this transaction is subject to the rules of sections 362(e)(1) and (e)(2), the loss importation rules of section 362(e)(1) have priority. See section 362(e)(2)(A)(i). Thus, S's basis in Asset A is reduced to $100 and S's basis in Asset B is increased to $100. See section 362(e)(1).

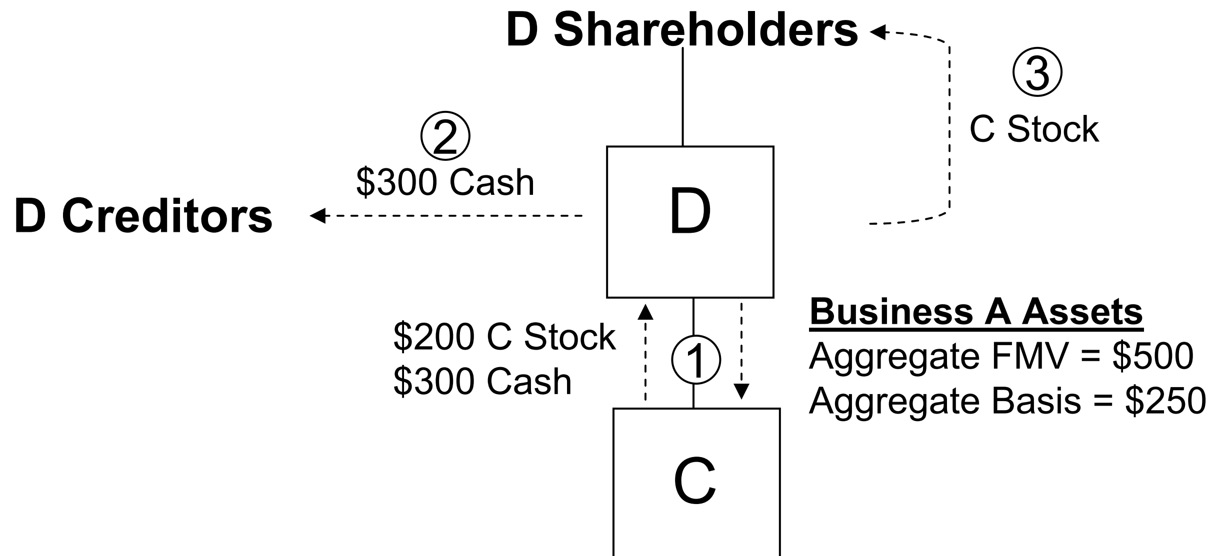
Boot in Divisive Reorganizations

Treatment of Transfers to Creditors in Divisive Reorganizations—Overview

- Section 361(b)(3) Prior to AJCA: Transfers to Creditors
  - A transferor corporation did not recognize gain if it received money or other property in a section 368(a)(1)(D) reorganization and distributed that money or other property to its shareholders or creditors
  - The amount of property that could be distributed to creditors without gain recognition was unlimited

- Section 361(b)(3) as Amended by AJCA
  - The amount of money plus the fair market value of other property that a distributing corporation can distribute to its creditors without gain recognition under section 361(b) is limited to the amount of the basis of the assets contributed to a controlled corporation in a divisive reorganization

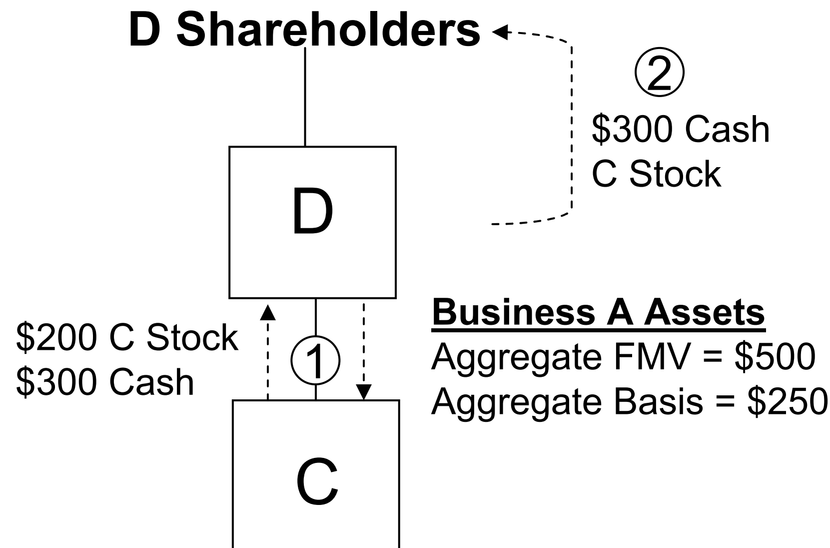
Treatment of Transfers to Creditors in Divisive Reorganizations—Example



Facts: D owns all of the stock of C in which it has a basis of $100. D conducts business A and B, and C conducts business A. For valid business purposes, D wants to spin-off business A to its shareholders. D contributes its business A assets, which have an aggregate fair market value of $500 and an adjusted basis of $250, to C in exchange for $200 worth of C stock and $300 cash. D uses the cash to repay currently outstanding debt. D then distributes all of its C stock pro rata to its shareholders. Assume that the spin-off qualifies under section 355.

Analysis: The amount of money and the fair market value of other properties the D can receive tax-free under section 361(b) and then distribute to D creditors without gain recognition is limited to the total adjusted basis of the properties transferred by D to C. Therefore, D has $50 of gain ($300 cash distributed to its creditors - $250 aggregate basis in property contributed to C). See section 361(b)(3).

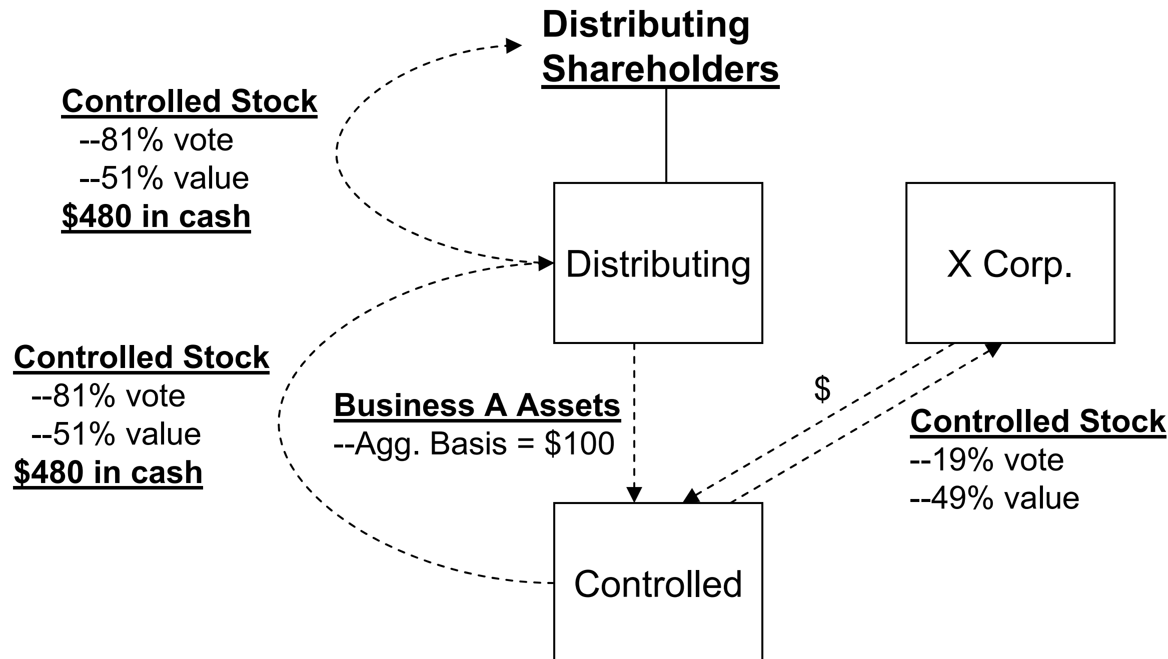
Treatment of Transfers to Shareholders in Divisive Reorganizations—Example



Facts: D owns all of the stock of C in which it has a basis of $100. D conducts business A and B, and C conducts business A. For valid business purposes, D wants to spin-off business A to its shareholders. D contributes its business A assets, which have an aggregate fair market value of $500 and an adjusted basis of $250, to C in exchange for $200 worth of C stock and $300 cash. D distributes the cash to its shareholders as a dividend. D also distributes all of its C stock pro rata to D's shareholders. Assume that the transaction qualifies under section 355.

Analysis: The amount of money and the fair market value of other properties that D can receive tax-free under section 361(b) and then distribute to D shareholders without gain recognition is not limited to the total adjusted basis of the properties transferred by D to C. See section 361(b)(1)(A).

Treatment of Transfers to Shareholders in Divisive Reorganizations—Alternative Transaction



Facts: Distributing contributes its Business A assets (aggregate basis of $100) to Controlled and X Corp. contributes cash to Controlled. In exchange, Distributing receives Controlled stock having 51% of the value and 81% of the vote, and X Corp. receives Controlled stock having 49% of the value and 19% of the vote. Distributing distributes the cash to its shareholders as a dividend; Distributing also distributes all of its Controlled stock pro rata to Distributing's shareholders. Assume the transaction qualifies under Sections 355 and 368(a)(1)(D).

Analysis: See "Treatment of Transfers to Shareholders in Divisive Reorganizations–Example."

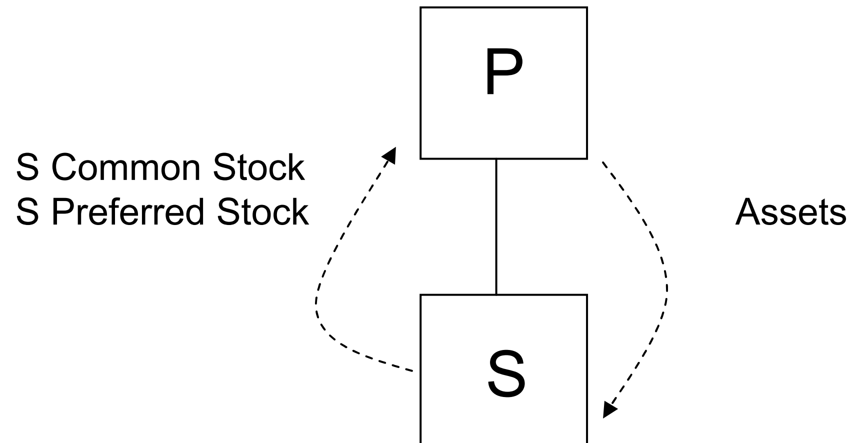
Nonqualified Preferred Stock

Clarification of the Definition of Nonqualified Preferred Stock—Overview

- Section 351(g) Prior to AJCA
  - In general, the receipt of nonqualified preferred stock by an exchanging shareholder in a reorganization, section 351 transaction, or corporate division is taxable
  - Nonqualified preferred stock is defined as any "preferred stock" if
    - The holder has the right to require the issuer or a related person to redeem or purchase the stock
    - The issuer or a related person is required to redeem or purchase the stock
    - The issuer or a related person has the right to redeem or repurchase, and, as of the issue date, it is more likely than not that such right will be exercised or
    - The dividend rate of the stock varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or similar indices, regardless of whether such varying rate is provided as an express term of the stock (as in the case of an adjustable rate stock) or as a practical result of other aspects of the stock (as in the case of auction stock)
  - "Preferred stock" is defined as stock that is "limited and preferred as to dividends and does not participate in corporate growth to any significant extent"

- Section 351(g)(3)(A) as Amended by AJCA
  - The definition of "preferred stock" is clarified to ensure that stock for which there is not a real and meaningful likelihood of actually participating in the earnings and profits of the corporation is not considered to be outside the definition of stock that is limited and preferred as to dividends and does not participate in corporate growth to any significant extent
  - Effective date: May 14, 2003

Clarification of the Definition of Nonqualified Preferred Stock—Example

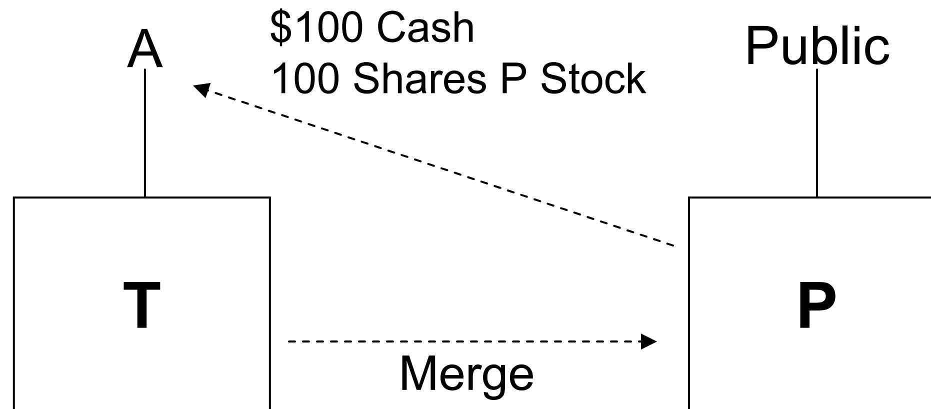


Facts: P contributes assets to S in exchange for S common stock and S preferred stock. The S preferred stock entitles a holder to a dividend that is the greater of seven percent or the dividends S common shareholders receive.

Analysis: The S preferred stock does not avoid being preferred stock for purposes of section 351(g) if the S common shareholders are not expected to receive dividends greater than seven percent. See section 351(g)(3)(A).

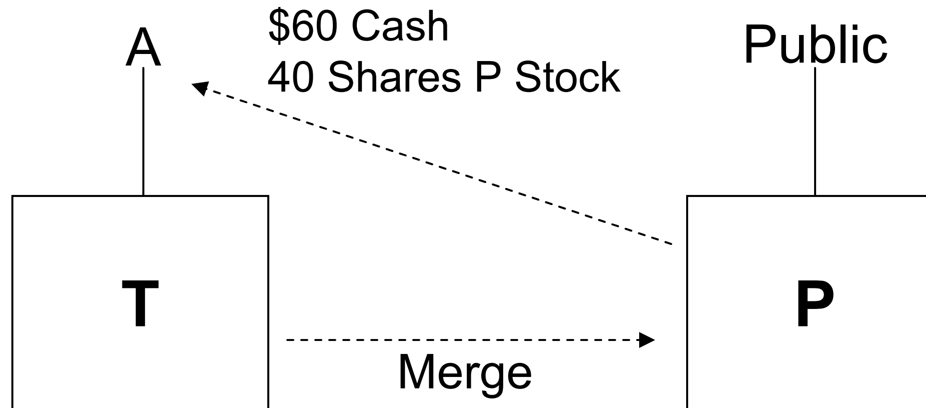
Continuity of Interest

Quantitative Continuity



Facts: T, a corporation wholly-owned by individual A, enters into an agreement to merge into P, a publicly traded corporation, in exchange for $100 and 100 shares of P stock at a time when P stock is trading at $1 a share.

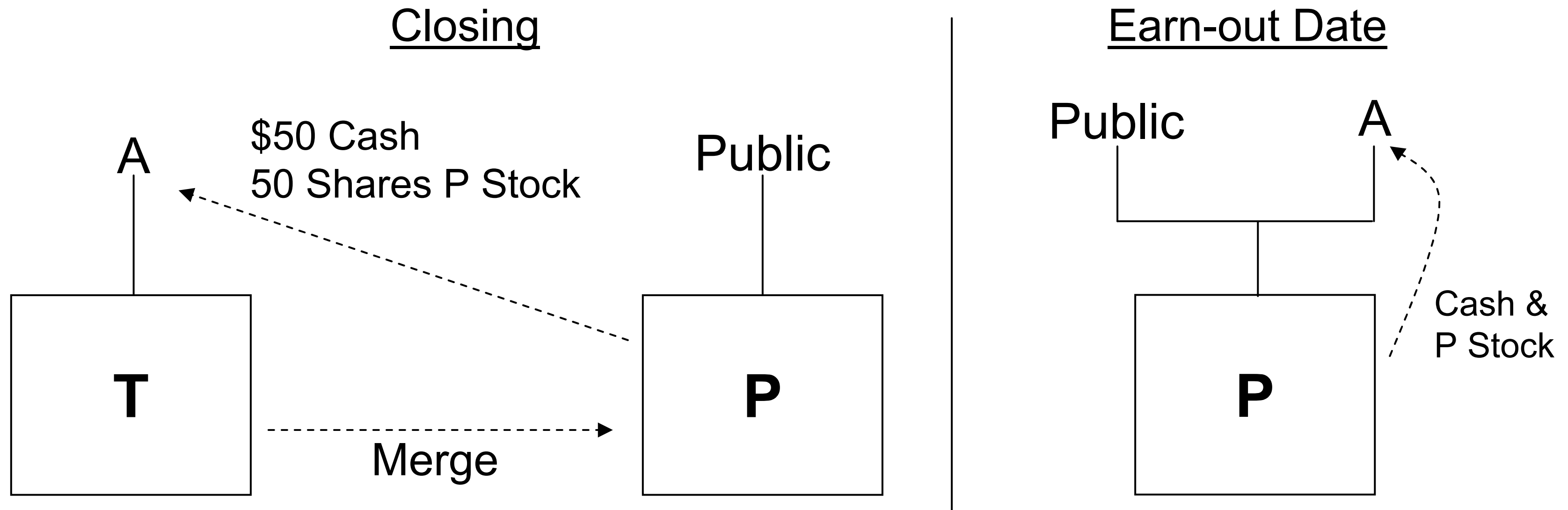
Continuity of Interest — Changes in Share Price



Facts: On January 3 of Year 1, P and T sign a binding contract pursuant to which T will be merged with and into P on June 1 of Year 1. Pursuant to the contract, A will receive 40 P shares and $60 cash in exchange for all of the outstanding stock of T. At the end of the day on January 2 of Year 1, the P stock trades for $1 per share. On June 1 of Year 2, the P stock trades for $.25 per share.

Analysis: Under proposed regulations issued August 10, 2004, the merger satisfies the continuity of interest ("COI") requirements. Under the proposed regulations, whether the transaction satisfies the COI requirement is determined by reference to the value of the P stock as of the end of the day on January 2 of Year 1. For continuity of interest purposes, the T stock is exchanged for $40 of P stock and $60 cash. The transaction preserves a substantial part of the value of the proprietary interest in T (40%). Therefore, the transaction satisfies the continuity of interest requirement. See Prop. Treas. Reg. § § 1.368-1(e)(2), (e)(7)(i).

Continuity of Interest — Contingent Earn-out



Facts: On January 3 of Year 1, P and T sign a binding contract pursuant to which T will be merged with and into P. At the end of the day on January 2 of Year 1, the P stock trades for $1 per share. Pursuant to the contract at closing A will receive $50 in P shares and $50 cash. In addition, if the future earnings of P meet certain targets, P must pay A an additional $100 on the third anniversary of the closing date (in the same 50/50 proportion). On June 1 of Year 4, the P stock trades for $5 per share.

Issue: Does this transaction satisfy the COI requirements? See Prop. Treas. Reg. § § 1.368-1(e)(2), (e)(7)(i).

Continuity of Interest — Contingent Earn-out, cont.

- Assume that, at the end of the day on January 2 of Year 1, the P stock trades for $1 per share; at closing, the P stock trades for $1 per share; and on June 1 of Year 4, the P stock trades for $5 per share.

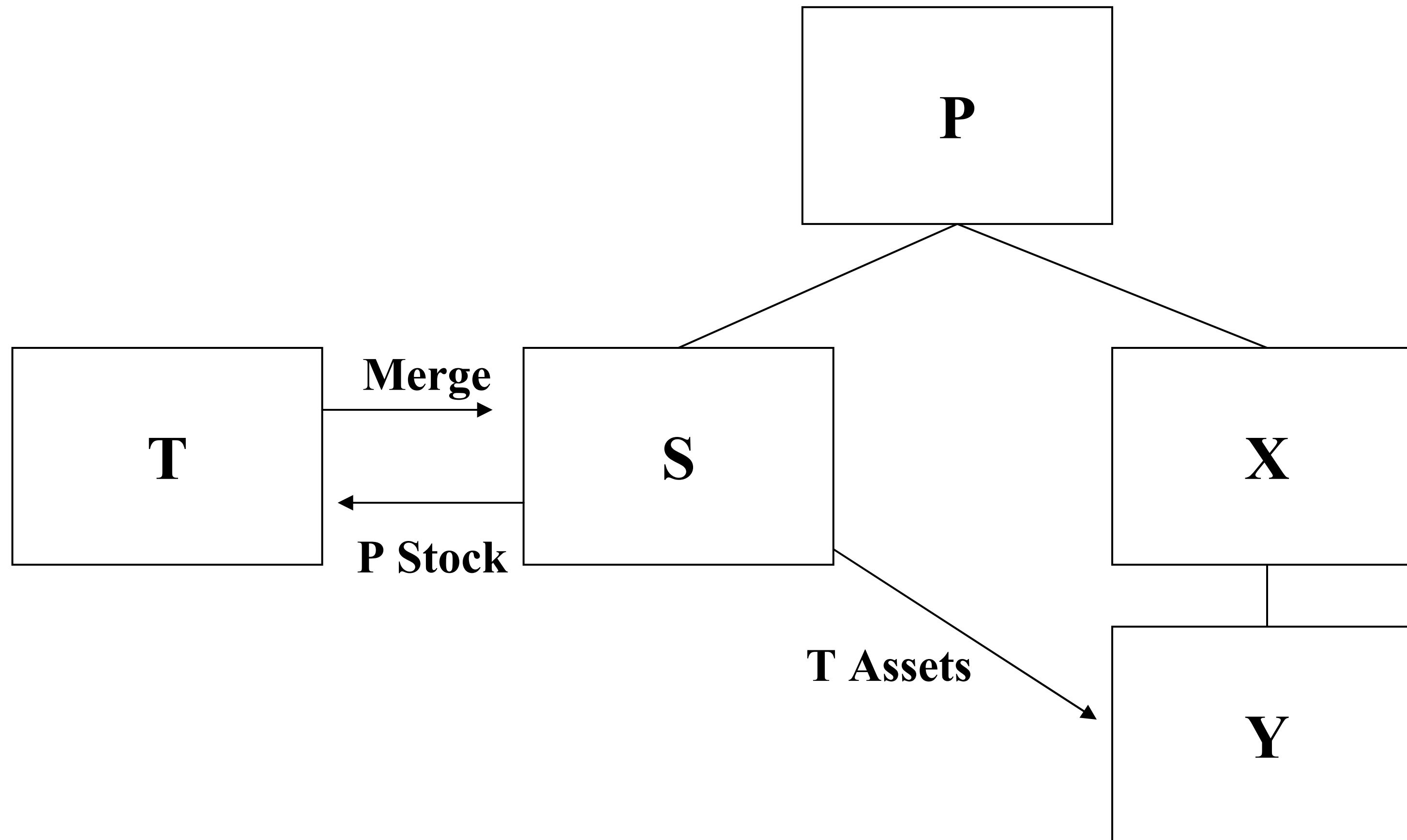
Closing	Earn-Out	Total
$50 Cash	$50 Cash	$100 Cash
50 shares x $1=$50	10 shares x $5=$50	60 shares=$100 FMV

Value of Stock:	Closing	Earn-Out
	50 shares x $1=$50	50 shares x $1=$50
	10 shares x $1=$10	10 shares x $5=$50
	$60	$100

Continuity: If shares are valued on the earn-out date: $100/$200=50%
If shares are valued at contract/closing: $60/$160=37.5%

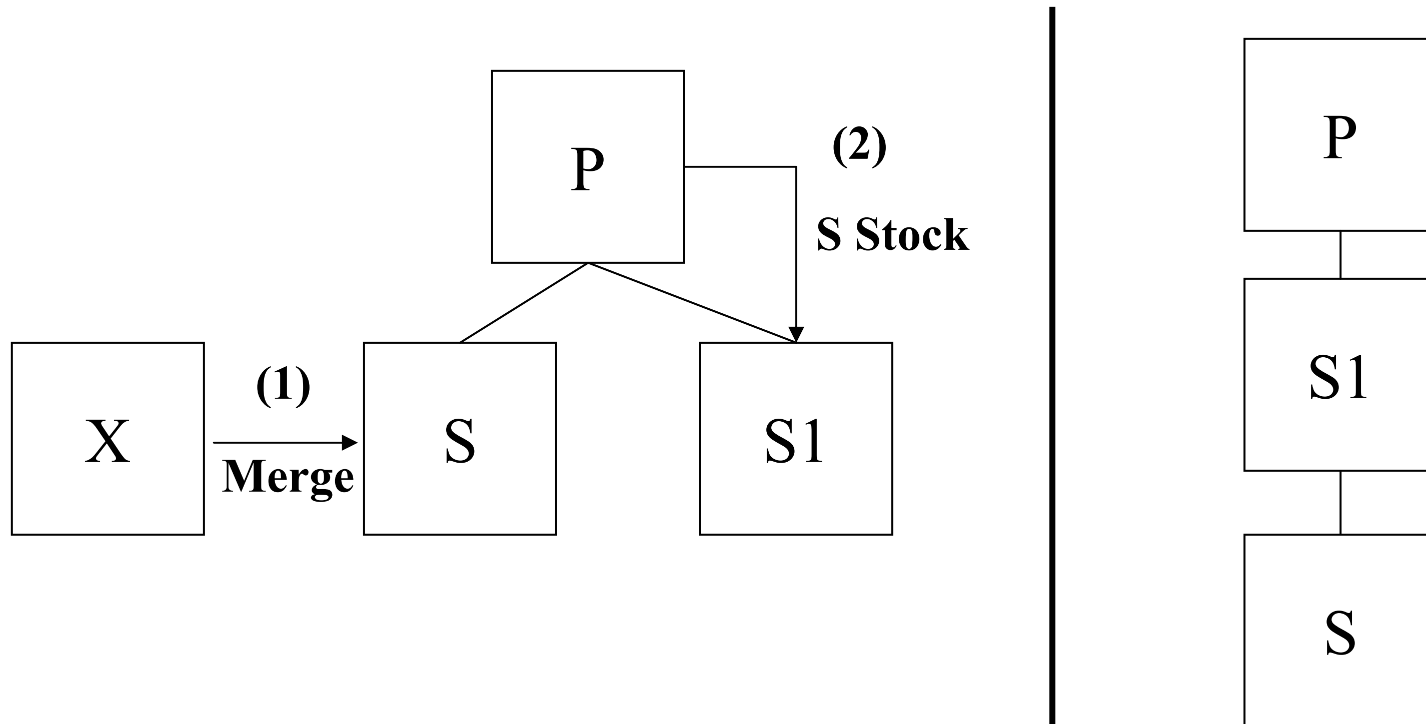
Step Transaction and COBE

Cross-Chain Transfers: COBE vs. Step Transaction



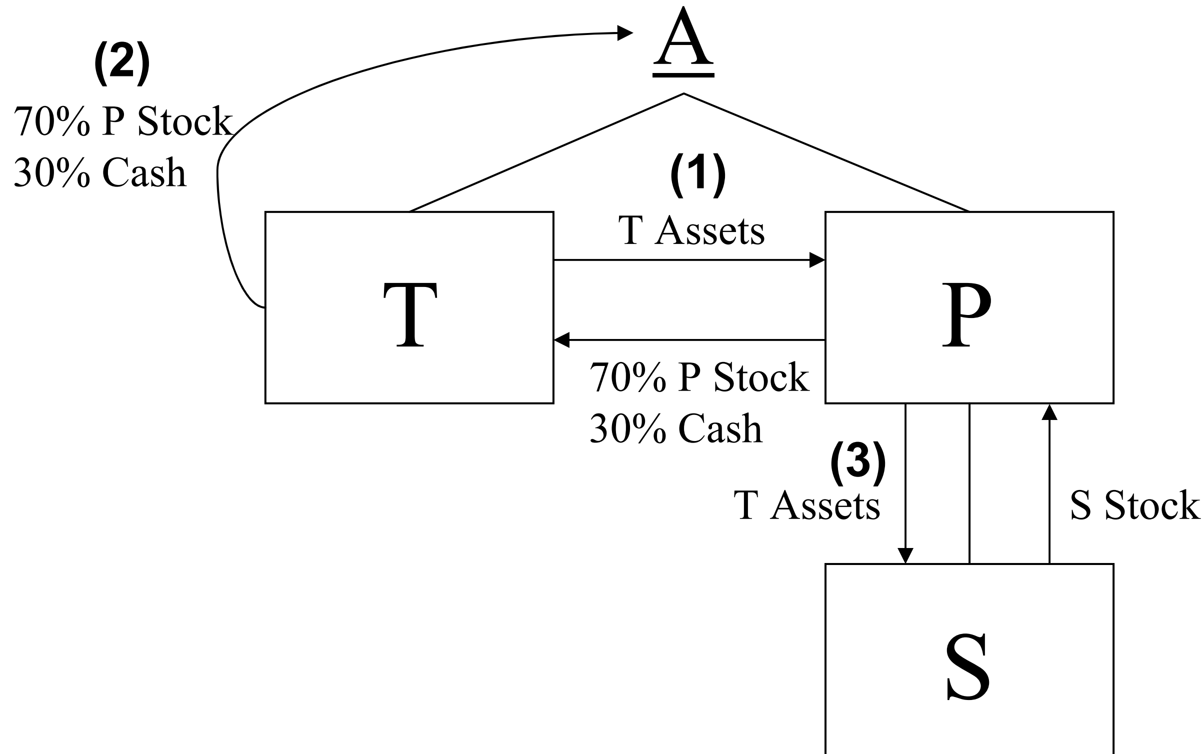
Facts: P owns 100% of the stock of S and X. X owns 100% of the stock of Y. T, an unrelated corporation, merges into S, with the T shareholders receiving P stock for their T stock. Immediately thereafter, S transfers the T assets to Y.

Rev. Rul. 2001-24



Facts: Pursuant to a plan of reorganization, X merges into S, P's newly formed wholly owned subsidiary, in a transaction that is intended to qualify as a reorganization under Sections 368(a)(1)(A) and 368(a)(2)(D). S continues the historic business of X. As part of the reorganization plan, P then transfers the S stock to S1, P's pre-existing wholly owned subsidiary. Without regard to P's transfer of the S stock to S1, X's merger into S qualifies as a reorganization under Sections 368(a)(1)(A) and 368(a)(2)(D).

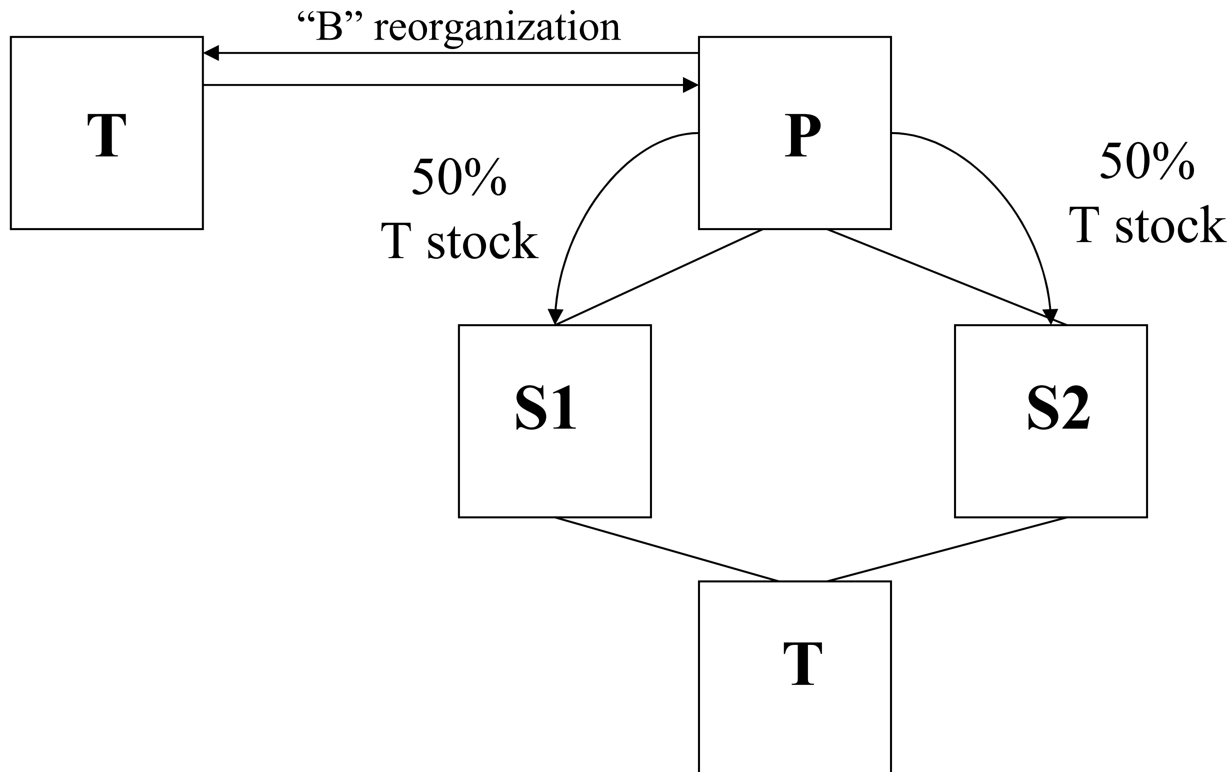
Rev. Rul. 2002-85



Facts: A, an individual, owns 100 percent of T, a state X corporation. A also owns 100 percent of P, a state Y corporation. First, pursuant to plan of reorganization, T transfers all of its assets to P in exchange for consideration consisting of 70 percent P voting stock and 30 percent cash. Second, T liquidates, distributing the P voting stock and cash to A. Third, P transfers all of the T assets to S, a preexisting, wholly owned subsidiary of P, in exchange for S stock.

Result: The transaction qualifies as a "D" reorganization even though P does not retain the assets of T. See also Prop. Treas. Reg. §§ 1.368-1(d)(4)(i)(B), -2(k).

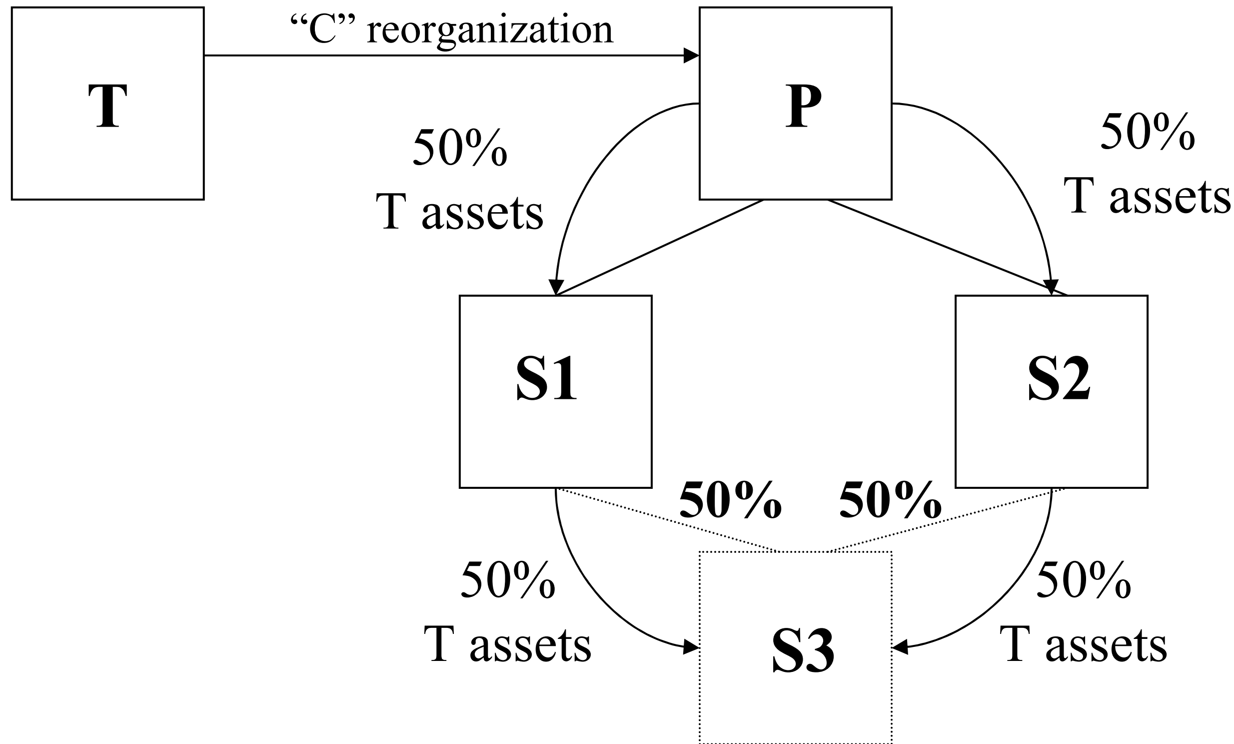
COBE and Drop-Down of Assets Following Tax-Free Reorganization; Example 1



Facts: P owns more than 80 percent of the stock of S1 and S2. P acquires T in tax-free reorganization qualifying under section 368(a)(1)(B) ("B" reorganization). Immediately after the reorganization, P contributes 50 percent of the T stock to S1 and 50 percent of the T stock to S2.

Does the transaction satisfy COBE? See Prop. Treas. Reg. §§ 1.368-1(d)(4)(i)(B), -2(k)

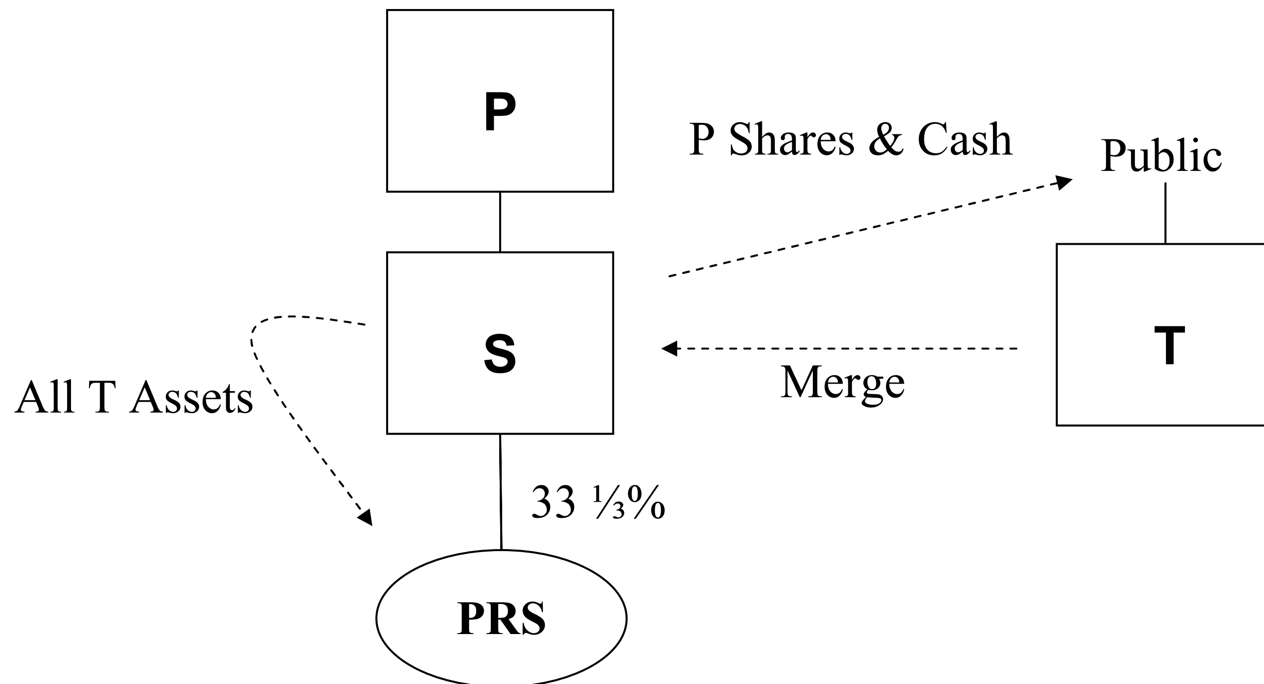
COBE and Drop-Down of Assets Following Tax-Free Reorganization; Example 2



Facts: P owns more than 80 percent of the stock of S1 and S2. T merges into P in tax-free reorganization qualifying under section 368(a)(1)(C) ("C" reorganization). Immediately after the reorganization, P contributes 50 percent of the T assets to S1 and 50 percent of the T assets to S2. S1 and S2 form S3, and S1 and S2 each contribute to S3 their respective 50 percent of T assets in exchange for 50 percent of the S3 stock.

Does the transaction satisfy COBE? See Current Treas. Reg. §§ 1.368-1(d)(4), -2(k); Prop. Treas. Reg. §§ 1.368-1(d)(4)(i)(B), -2(k)

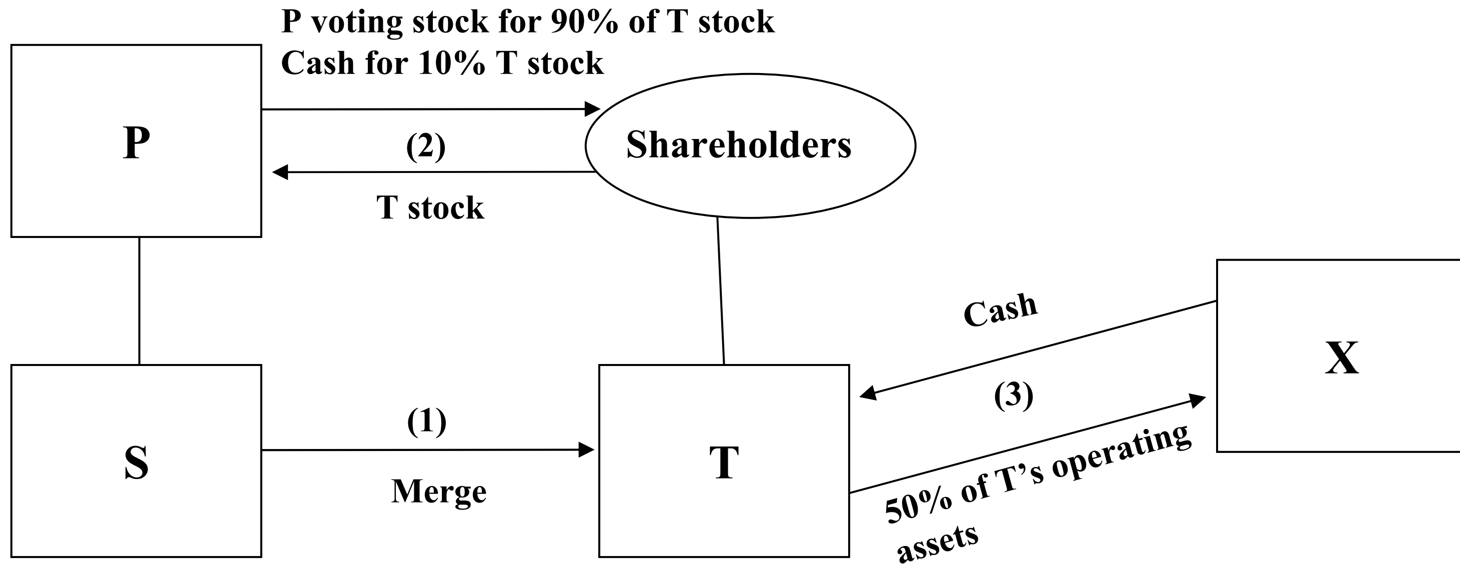
COBE and Drop-Down of Asset to Partnership Following Tax-Free Reorganization; Example 3



Facts: S acquires all of the T assets in the merger of T into S. In the merger, T shareholders receive P stock and cash. Pursuant to the plan of reorganization, S transfers all of the T assets to PRS, a partnership in which S owns a 33 1/3 percent interest. S does not perform active and substantial management functions as a partner with respect to PRS's business.

Analysis: Under Prop. Treas. Reg. § 1.368-2(k), the transaction, which otherwise qualifies as an "A" reorganization by reason of section 368(a)(2)(D), is not disqualified by the transfer of T assets from S to PRS because S has an ownership interest in PRS immediately after the transfer, S is a member of the qualified group and is treated as conducting the business of PRS under Treas. Reg. § 1.368-1(d)(4)(iii), and the transaction satisfies the COBE requirements of Treas. Reg. § 1.368-1(d). See Prop. Treas. Reg. § 1.368-2(k)(3), ex. 5.

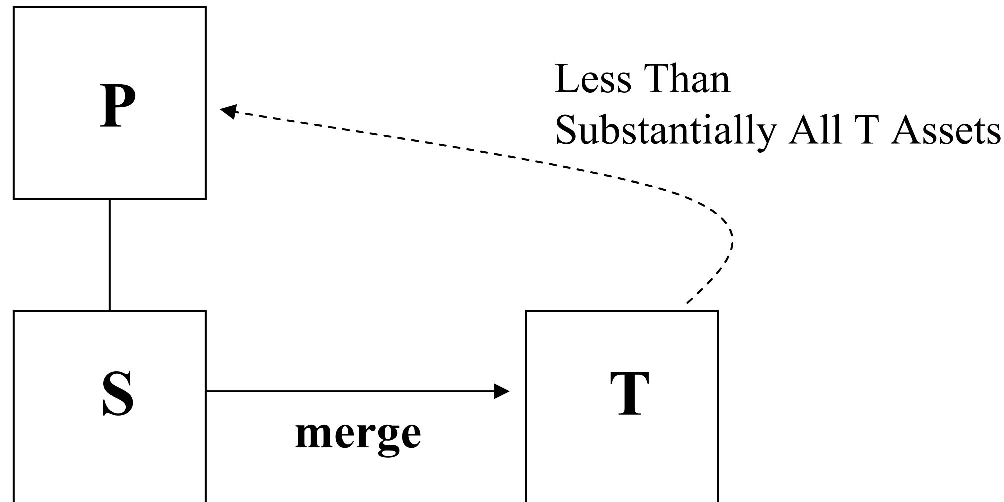
Rev. Rul. 2001-25



Facts: P and T are manufacturing corporations organized under the laws of state A. S, P's newly formed wholly owned subsidiary, merges into T in a statutory merger under the laws of state A. In the merger, P exchanges its voting stock for 90% of the T stock, and tenders cash for the remaining 10% of T stock. As part of the merger plan, T sells 50% of its operating assets to X, an unrelated corporation, for cash. T retains the sales proceeds. Without regard to the requirement that T hold substantially all of the assets of T and S, the merger satisfies all the other requirements applicable to reorganizations under Sections 368(a)(1)(A) and 368(a)(2)(E).

Variation: What if T uses the cash it received for 50% of its assets to pay down its own debt?

Push-up of Assets To a Corporation Following Tax-Free Reorganization



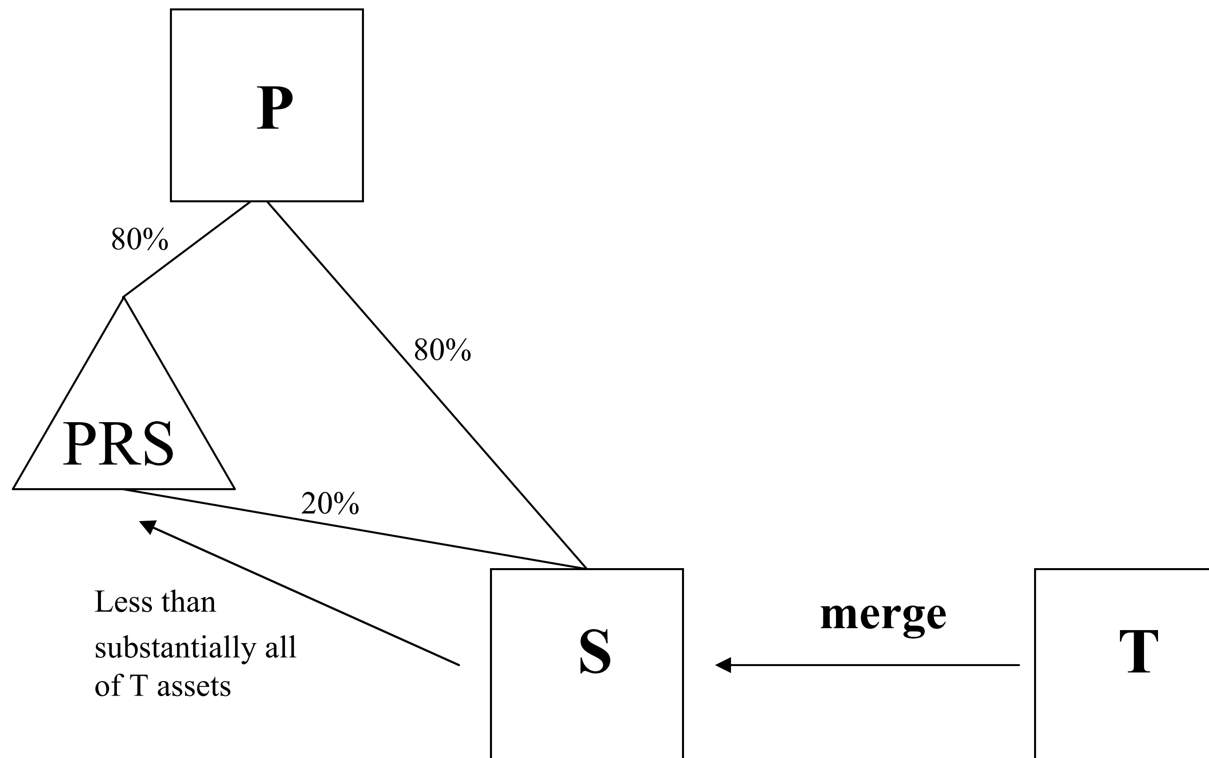
Facts: P owns 100 percent of S. S merges into T in a reverse triangular merger qualifying under section 368. Immediately after the merger of S into T, T distributes to P less than substantially all of its assets.

Alternative 1: Same facts as above, except T merges into S in a forward triangular merger and S distributes substantially all of the T assets to P.

Alternative 2: Same facts as alternative 1, except S liquidates into P.

See Prop. Treas. Reg. §§ 1.368-1(d)(4)(B)(i), -2(k).

Push-up of Assets to Partnership Following Tax-Free Reorganization

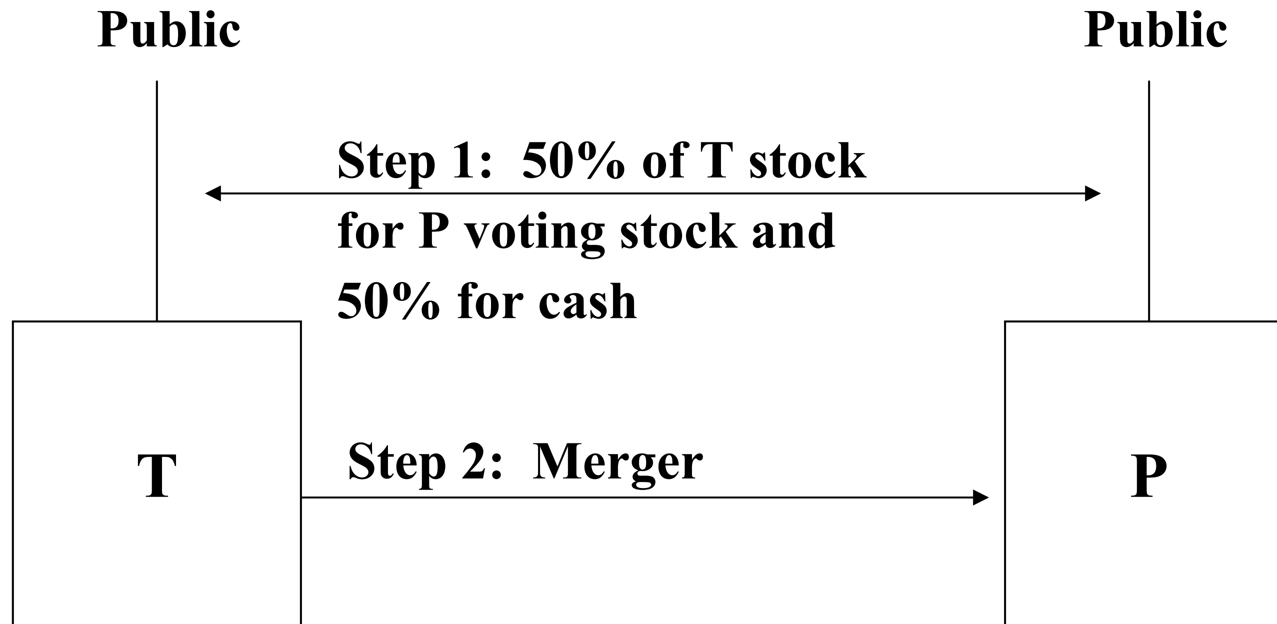


Facts: P owns 80 percent of S and PRS. PRS owns the remaining 20 percent of S. T merges into S in a merger qualifying under section 368(a)(1)(A) by reason of section 368(a)(2)(D). Immediately after the merger of T into S, S distributes to PRS less than substantially all of T's assets in redemption of 5 percent of the stock of S owned by PRS.

Results: Under Prop. Treas. Reg. § 1.368-2(k), the reorganization is not disqualified by the transfer of T assets from S to PRS.

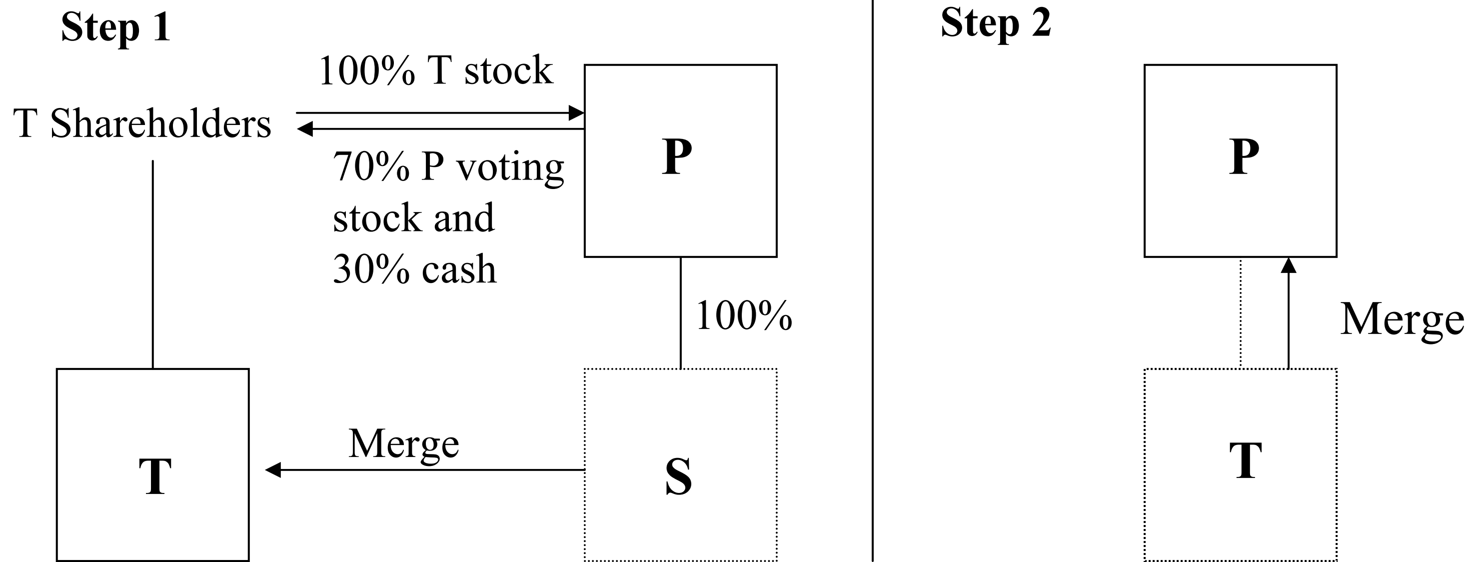
King Enterprises Transaction and Rev. Rul. 2001-46

King Enterprises Transaction



Facts: The shareholders of T exchange all of their T stock for consideration consisting of 50% P voting stock and 50% cash. Immediately following the exchange, and as part of the overall plan, P causes T to merge upstream into P. The transaction should qualify as an "A" reorganization. See King Enterprises, Inc. v. United States, 418 F.2d 511 (Ct. Cl. 1969); Rev. Rul. 2001-26, 2001-1 C.B. 1297.

Rev. Rul. 2001-46 - Situation 1



Facts: P owns all of the stock of S, a newly formed wholly owned subsidiary. Pursuant to an integrated plan, P acquires all of the stock of T, an unrelated corporation, in a statutory merger of S into T, with T surviving. In the merger, the T shareholders exchange their stock for consideration of 70% P voting stock and 30% cash. Immediately thereafter, T merges upstream into P.

Result: If the acquisition were viewed independently from the upstream merger of T into P, the result should be a QSP of T stock followed by a section 332 liquidation. See Rev. Rul. 90-95, 1990-2 C.B. 67. However, because step transaction principles apply, see King Enterprises, Inc. v. United States, 418 F.2d 511 (Ct. Cl. 1969), the transaction is treated as a single statutory merger of T into P under section 368(a)(1)(A). P acquires the T assets with a carry-over basis under section 362, and P may not make a section 338 election for T.

Note: On July 8, 2003, the Service issued new final and temporary regulations that permit taxpayers to turn off the step transaction doctrine and to make a section 338(h)(10) election in the transaction described above. See Treas. Reg. § 1.338-3(c)(1)(i), (2) and Temp. Treas. Reg. § 1.338(h)(10)-1T.

New Temp. Treas. Reg. § 1.338(h)(10)-1T(c)(2), (e)

• The new temporary regulations provide that "a section 338(h)(10) election may be made for T where P's acquisition of T stock, viewed independently, constitutes a qualified stock purchase and, after the stock acquisition, T merges or liquidates into P (or another member of the affiliated group that includes P) . . . " Temp. Treas. Reg. § 1.338(h)(10)-1T(c)(2).

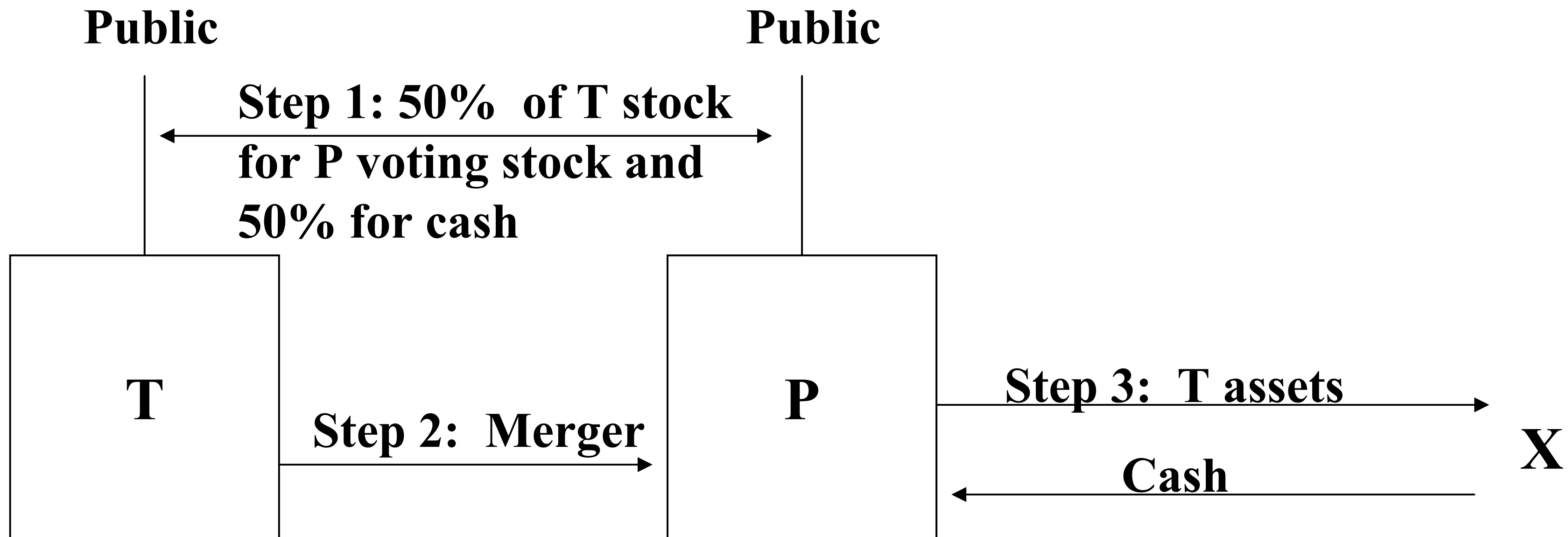
• This rule applies regardless of whether, under the step transaction doctrine, the acquisition of T stock and subsequent merger or liquidation of T into P (or P affiliate) qualifies as a reorganization under section 368(a). Id.

• If a section 338(h)(10) election is made under these facts, P's acquisition of T stock will be treated as a QSP for all Federal tax purposes and will not be treated as a reorganization under section 368(a). See Temp. Treas. Reg. § 1.338(h)(10)-1T(e), Ex. 12 & 13.

• However, if taxpayers do not make a section 338(h)(10) election, Rev. Rul. 2001-46 will continue to apply so as to recharacterize the transaction as a reorganization under section 368(a). See id. at Ex. 11.

• The regulations are effective for stock acquisitions occurring on or after July 8, 2003.

King Enterprises Transaction - Variation

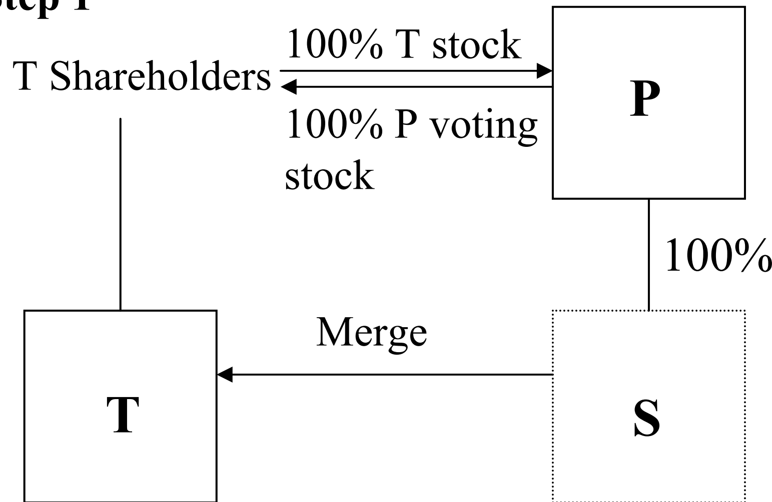


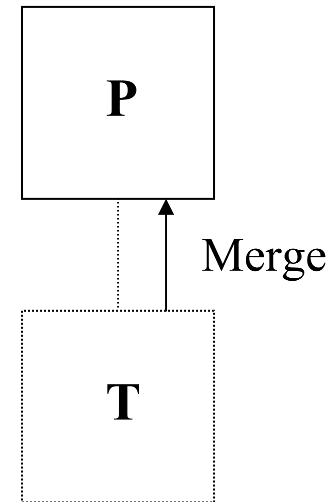
Facts: Same facts as in Variation 1, except P sells T's assets to X a third party immediately after the merger of T into P.

Questions: (1) Does the Step-Transaction Doctrine apply?

(2) What is the result of this transaction for Federal income tax purposes?

Rev. Rul. 2001-46 - Situation 2





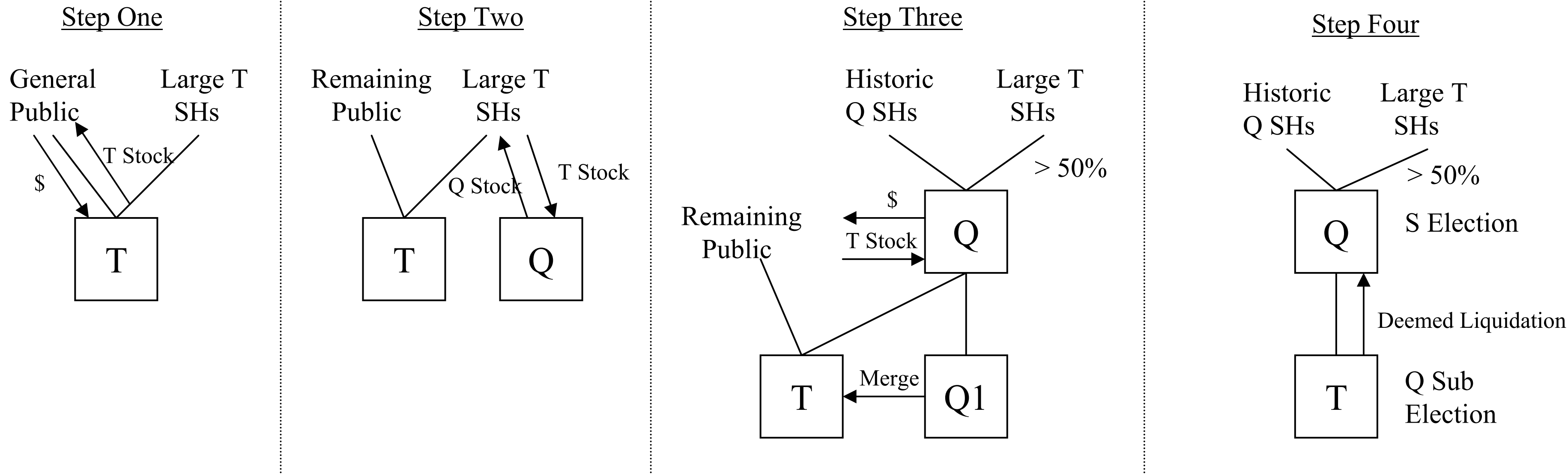
Facts: Same facts as in Situation 1, except that the T shareholders receive solely P stock in exchange for their T stock, so that the merger of S into T, if viewed independently of the upstream merger of T into P, would qualify as a reorganization under section 368(a)(1)(A) by reason of section 368(a)(2)(E).

Result: Step transaction principles apply to treat the transaction as a merger of T directly into P.

Note: The taxpayers cannot not change this result under the new section 338 regulations because, standing alone, P's acquisition of T does not constitute a qualified stock purchase.

PLR 200141040

King Enterprises Variation--D Reorganization

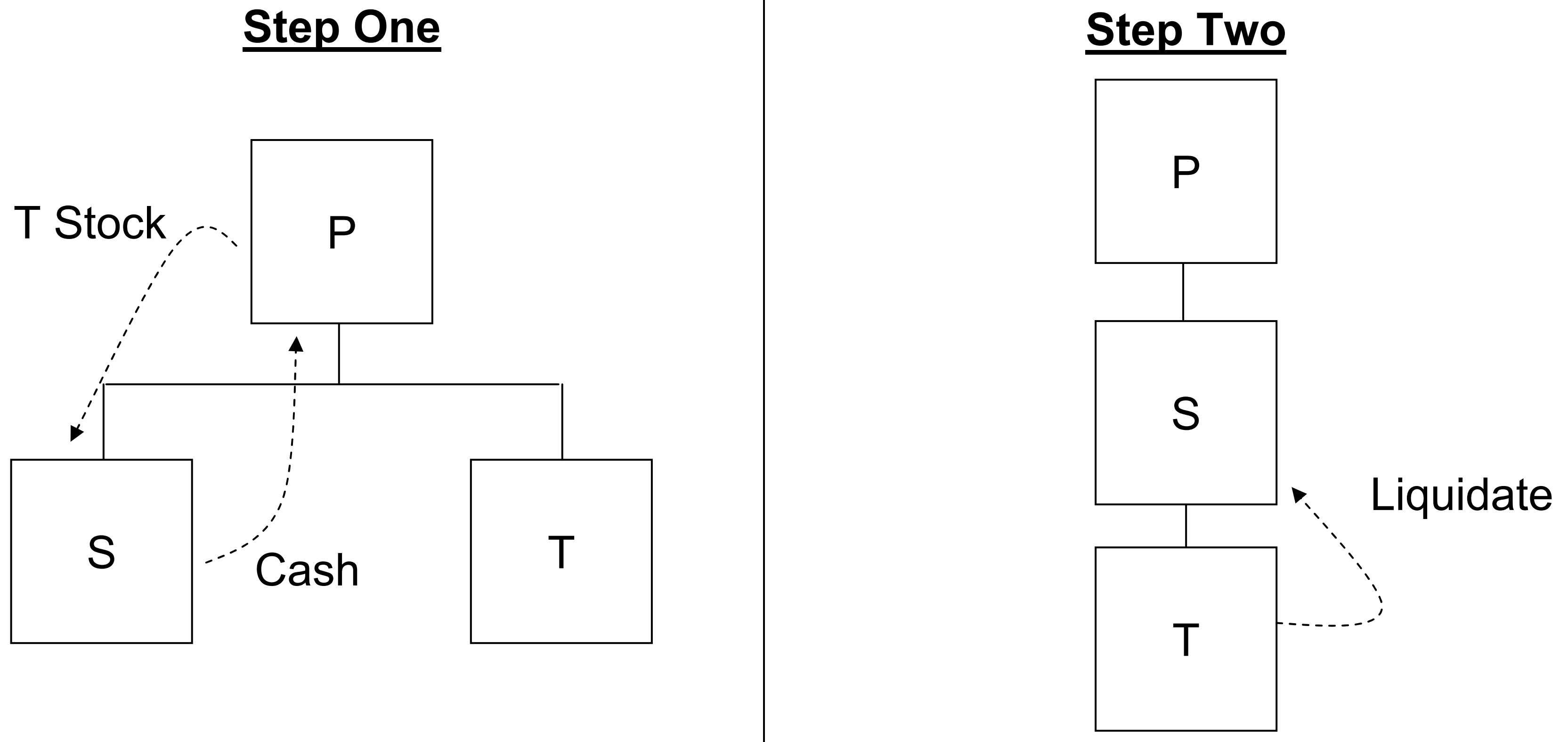


Facts: (1) T makes a tender offer to all of its shareholders to acquire T stock to increase the percentage ownership of T's largest shareholders
(2) T's largest shareholders contribute T stock to Q solely in exchange for Q stock
(3) Q forms wholly-owned subsidiary Q1 that merges into T, with T surviving the merger. All of T's remaining shareholders except Q will receive cash for T stock as part of the merger.
(4) Q will make a Subchapter S election and a QSub election for T, resulting in a deemed liquidation of T.

Result: Four steps of transaction will be collapsed and treated as the transfer by T of "substantially all" of its assets to Q in exchange for Q stock and the assumption by Q of T's liabilities, followed by the liquidation of T. The transaction will qualify as a "D" Reorganization.

Intragroup Transactions

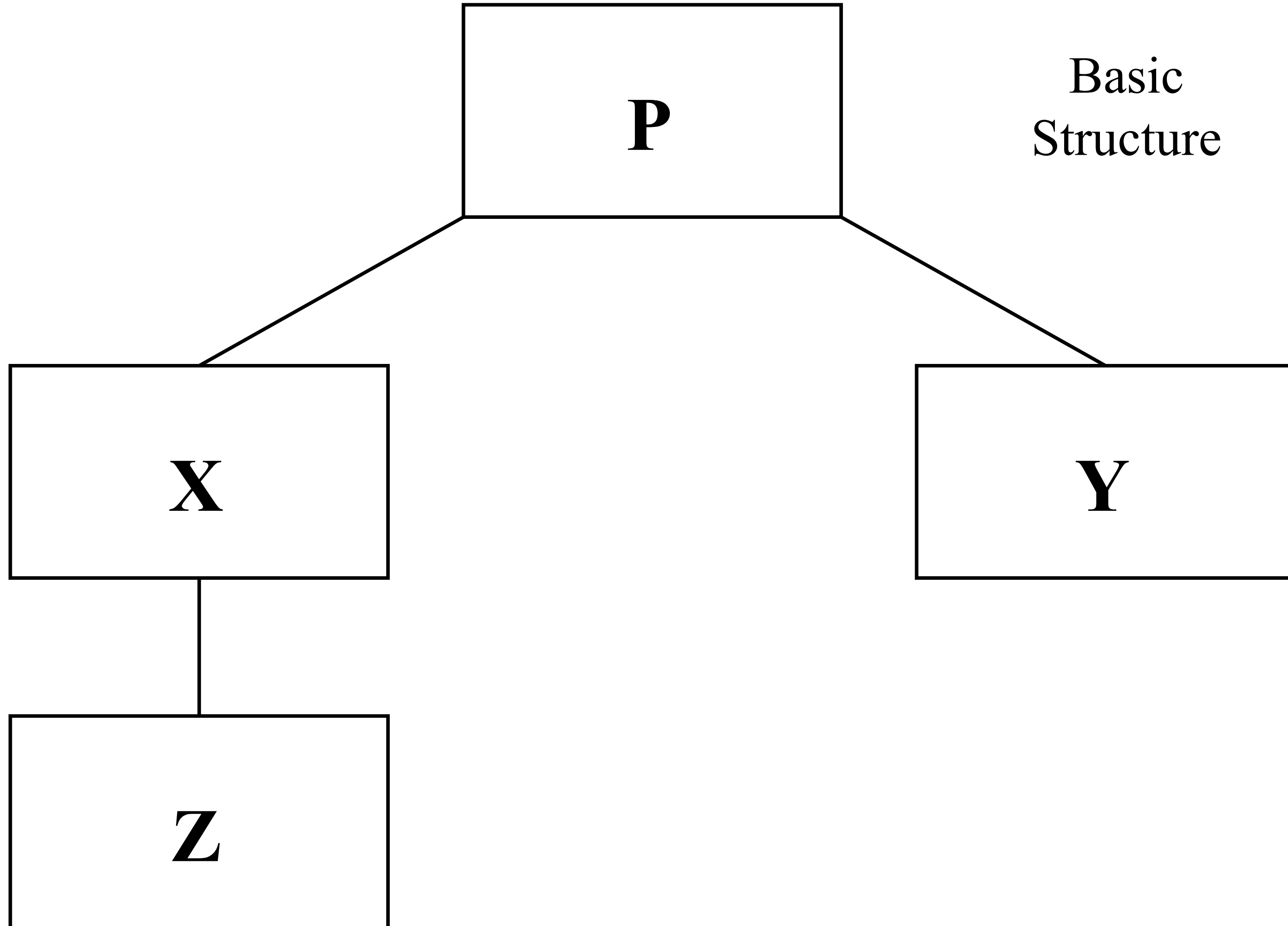
Rev. Rul. 2004-83



Facts: Corporation P owns all the stock of Corporation S and Corporation T. P, S, and T are members of a consolidated group. As part of an integrated plan, S purchases all the stock of T from P for cash and T completely liquidates into S. Assume that if T had sold its assets directly to S and T had completely liquidated into P, the transaction would have qualified as a reorganization under § 368(a)(1)(D) of the Internal Revenue Code.

Issues: In Rev. Rul. 2004-83, the Service ruled that step transaction principles apply to treat this transaction as a merger of T into S under section 368(a)(1)(D). In addition, Rev. Rul. 2004-83 provides that the result would be no different if P, S, and T were not members of a consolidated group. In the Service's view, no policy exists that would require section 304 to apply where section 368(a)(1)(D) would otherwise apply.

Intragroup Asset and Stock Transactions



Intragroup Asset and Stock Transactions Continued

This example examines the tax consequences of asset and stock transfers within a consolidated group.

Alternative 1: Asset Sale

1. Z sells its assets to Y.

2. Y takes a cost basis in the assets.

Alternative 2: Stock Sale

1. X sells Z stock to Y.

2. Y takes a cost basis in Z stock. Z retains historic basis in its assets.

Alternative 3: Asset Sale and Liquidation

1. Z sells its assets to Y and Z liquidates into X.

2. The transaction appears to constitute a D reorganization. Under Treas. Reg. § 1.1502-13(f)(3)(ii), the boot is treated as received in a separate transaction under Section 302 rather than Section 356.

Intragroup Asset and Stock Transactions Continued

Alternative 4: Stock Sale and Liquidation

1. X sells the Z stock to Y and Z liquidates into Y.

2. The treatment of the transaction is the same as described above in Alternative 3.

Alternative 5: Asset or Stock Transfer

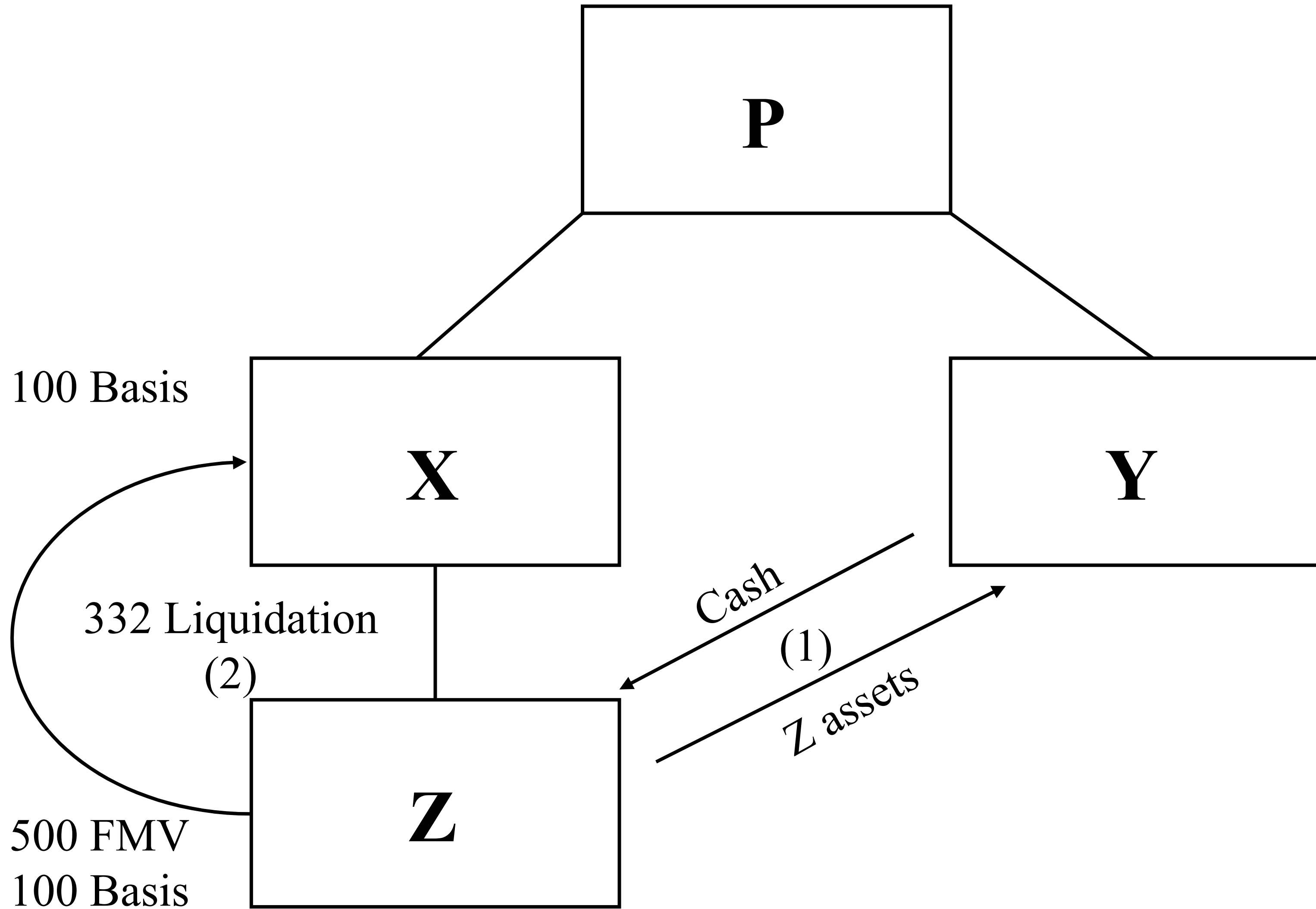
1. Z transfers its assets to Y for no consideration (or X transfers the Z stock to Y for no consideration).

2. Z is deemed to transfer its assets to Y in a Section 351 transaction, followed by a distribution of the Y stock to X and then to P.

3. Alternatively, Z is deemed to distribute its assets to X and then to P followed by a contribution of the assets by P to Y.

4. In the first case, there is deferred gain (loss) on the Y stock. In the second case, there is deferred gain (loss) on the Z assets.

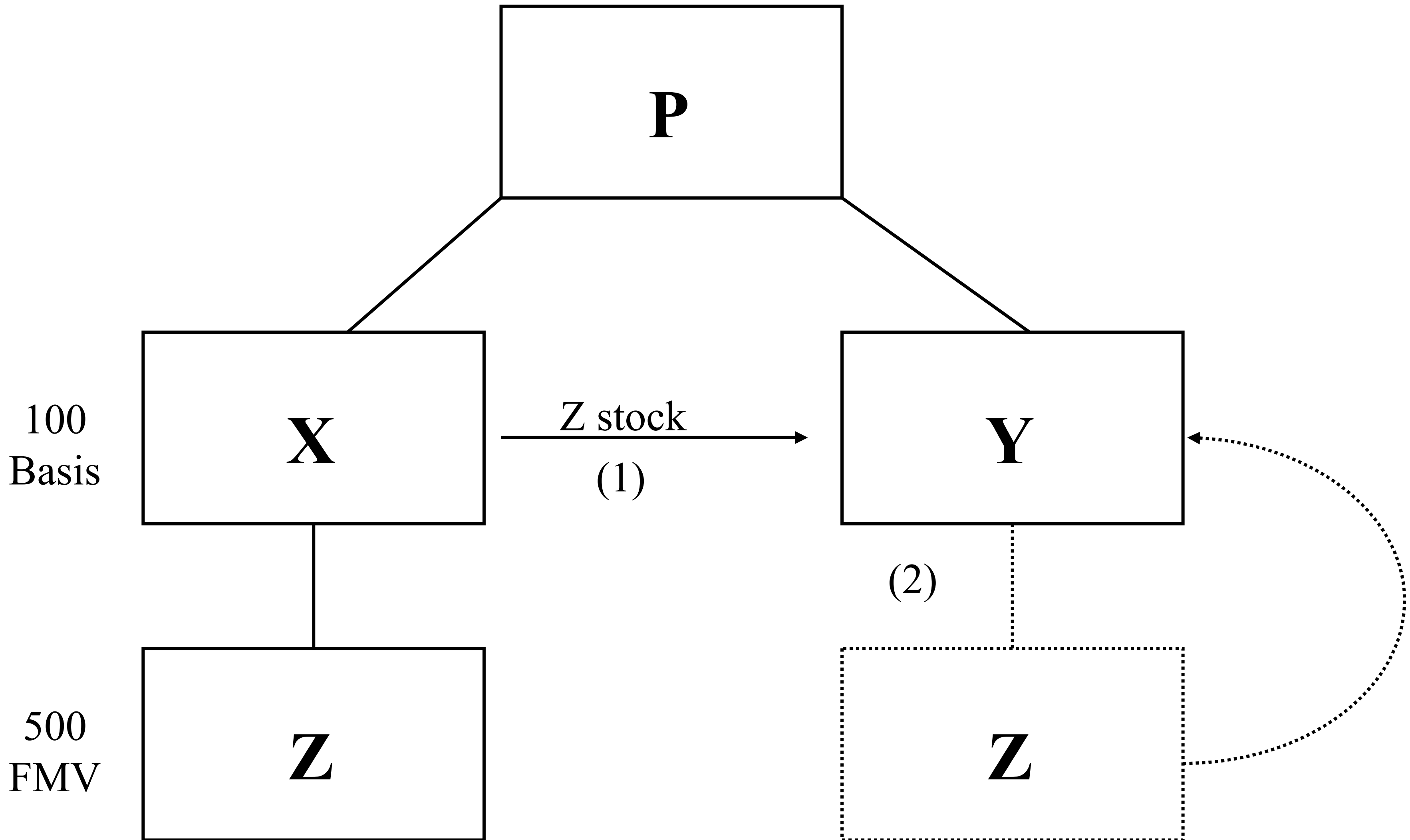
Boot in D Reorganization



Alternative 1: Asset Sale and Liquidation

Z sells its assets to Y and Z liquidates into X.

Boot in D Reorganization Continued



Alternative 2: Stock Sale and Liquidation

X sells the Z stock to Y and Z liquidates into Y.

Boot in D Reorganization Continued

Results

The transactions both appear to constitute D reorganizations. Under Treas. Reg. § 1.1502-13(f)(3)(ii), the boot is treated as received in a separate transaction under Section 302 rather than Section 356.

Issues

1. Is the redemption taxed as a distribution?

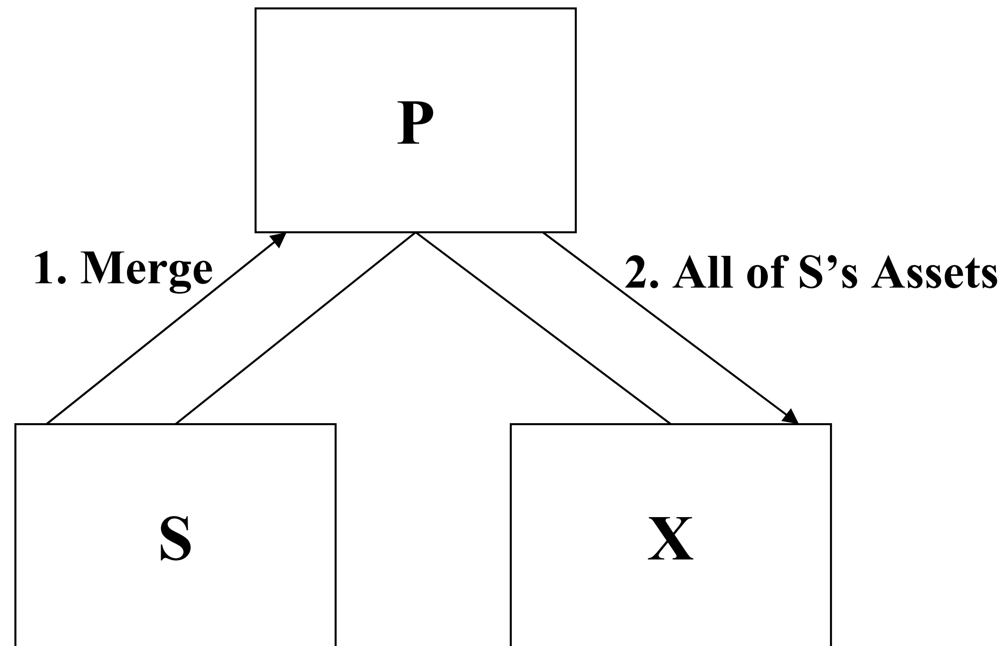
2. If so, do we look to the E&P of Z, Y or both Z and Y in measuring the amount of the dividend?

3. Is the dividend eliminated?

4. Does the distribution of the dividend impact stock basis?

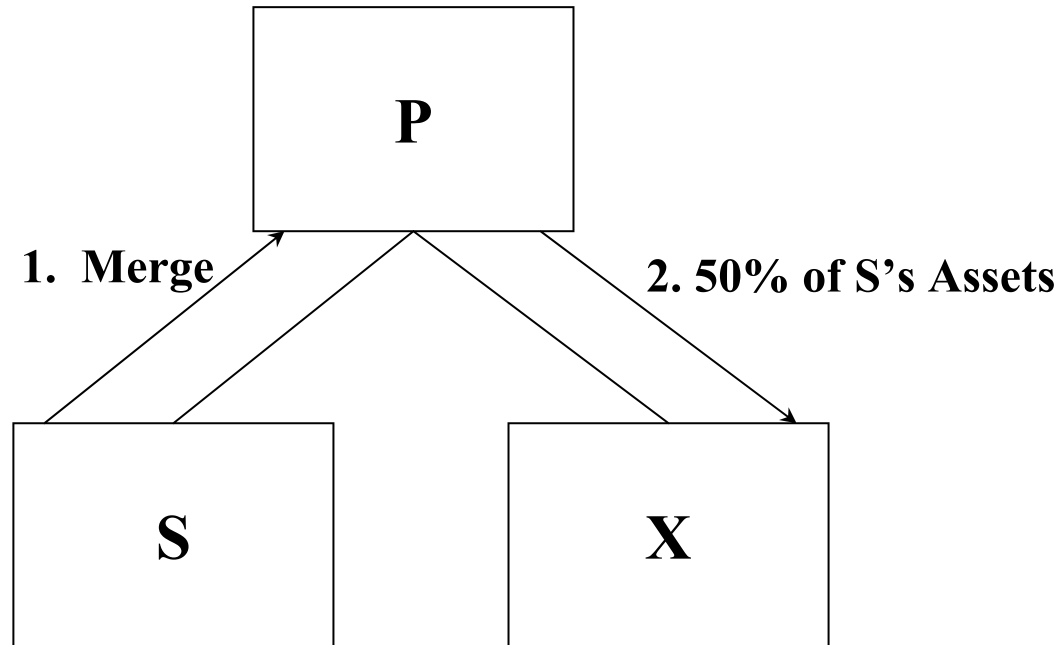
5. If E&P is not available, how is the transaction taxed?

Rev. Rul. 69-617



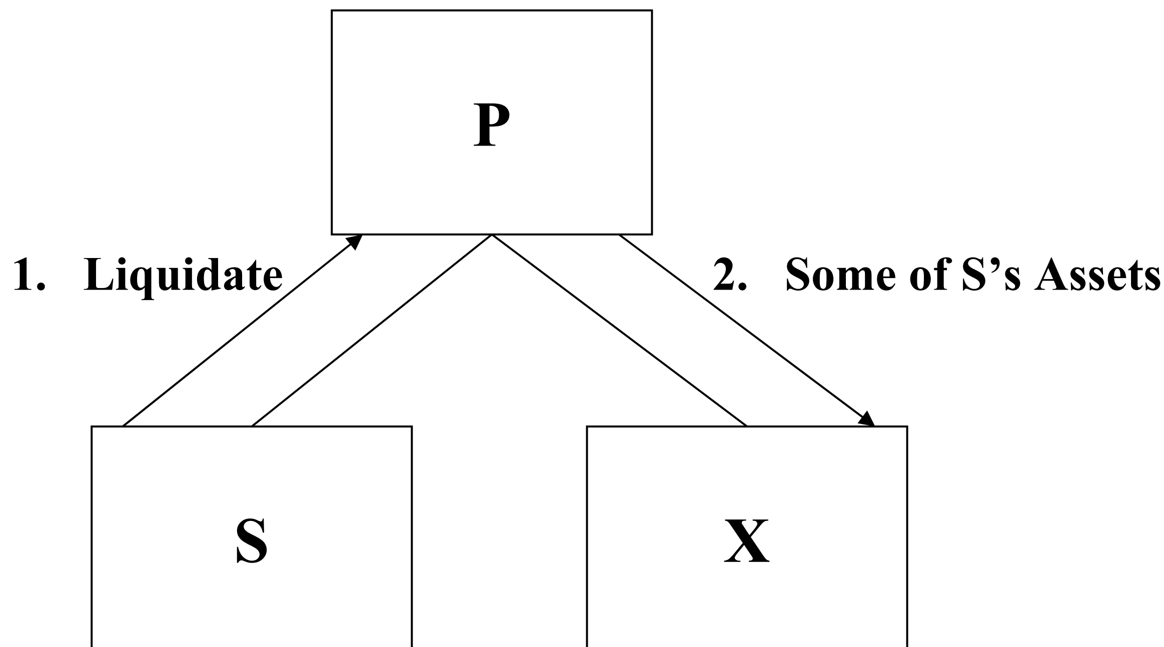
Facts: P owns all of the stock of S and X. S merges into P pursuant to state law. P then transfers all of the assets received from S to X.

Rev. Rul. 69-617 (Variation)



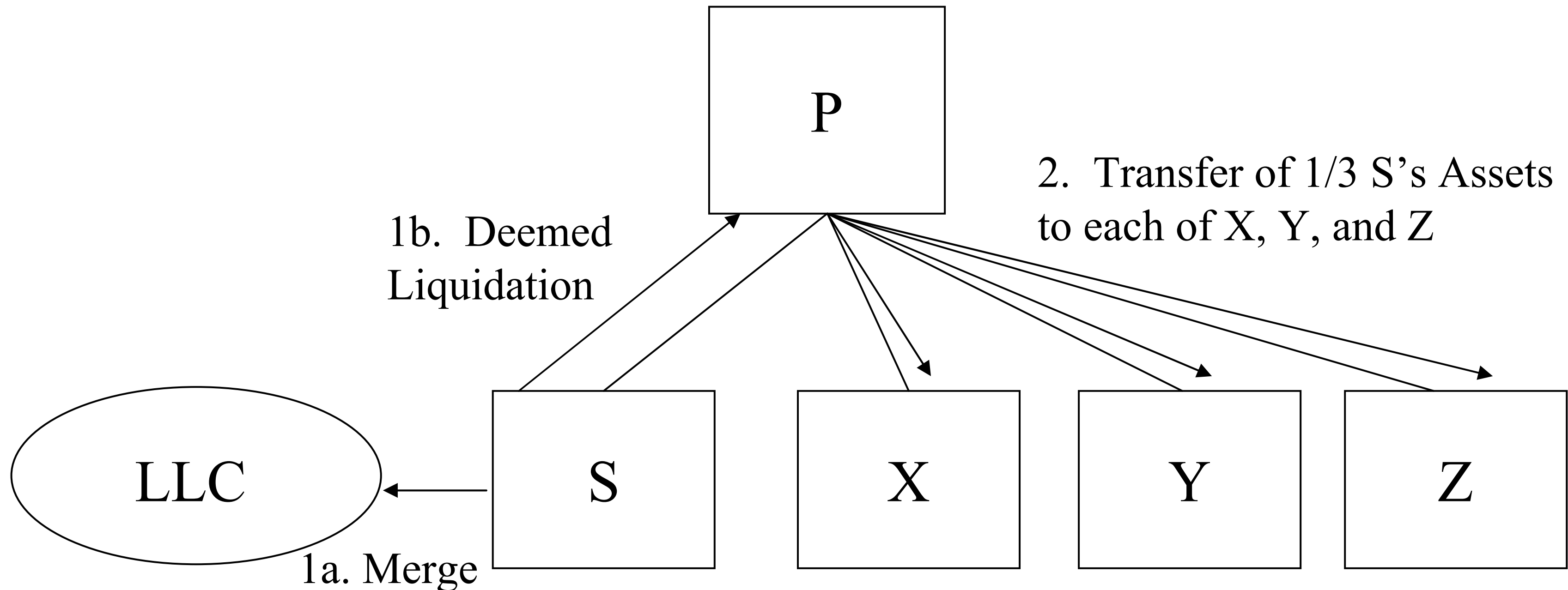
Facts: P owns all of the stock of S and X. S merges into P pursuant to state law. P then transfers 50% of the assets received from S to X. Although this transaction appears to raise "liquidation/reincorporation" issues, private letter rulings allow the partial drop of S's assets to X following the Section 368(a)(1)(A) reorganization. See, e.g., PLR 9222059 (Jun. 13, 1991); PLR 9422057 (Mar. 11, 1994); PLR 8710067 (Dec. 10, 1986). These rulings rely on Rev. Rul. 69-617 and treat the transaction as a merger followed by a Section 368(a)(2)(C) drop of assets. At least one ruling would allow a double-drop of S's assets following the reorganization. See PLR 9222059 (Jun. 13, 1991).

<u>Rev. Rul. 69-617 &</u>
<u>The New Bausch & Lomb Regulations</u>



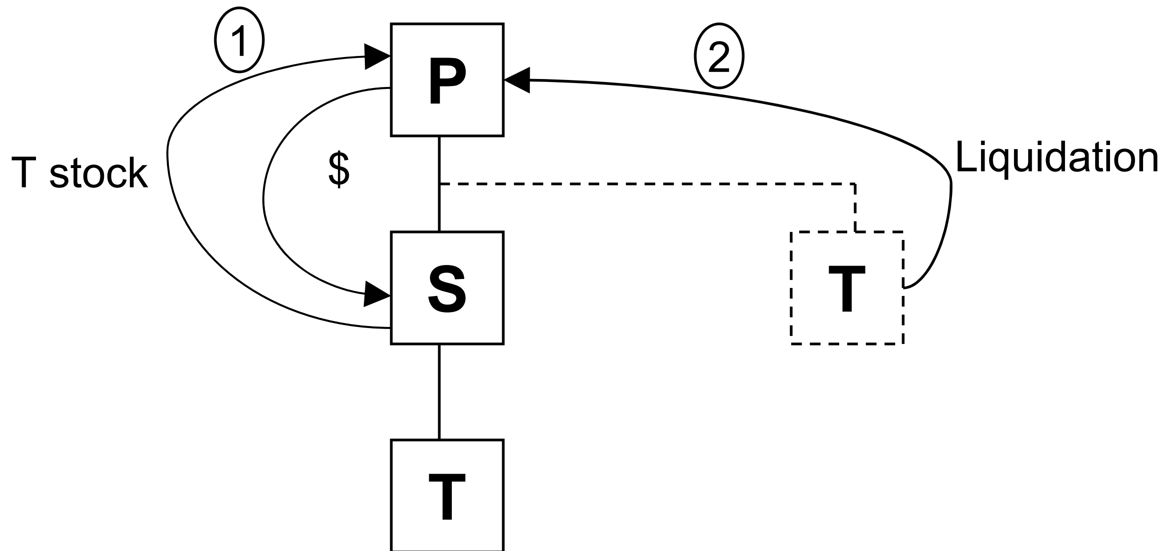
<u>Facts</u>: P owns all of the stock of S and X. S liquidates, distributing all of its assets to P. P then transfers some of the assets received from S to X. Can this transaction be treated under the analysis of Rev. Rul. 69-617 as a C reorganization followed by a drop of assets under Section 368(a)(2)(C), given the new <u>Bausch & Lomb</u> regulations? <u>See</u> Treas. Reg. Section 1.368-2(d)(4). What if X were a newly formed corporation?

Rev. Rul. 69-617 (Variation) & The New Bausch & Lomb Regulations



Facts: P owns all of the stock of S, X, Y, and Z. S merges into an LLC created by P, causing a deemed liquidation of S for tax purposes. LLC then transfers 1/3 of S's historic assets to X, Y, and Z respectively. (P will be treated as transferring such assets to X, Y, and Z for tax purposes).

Upstream Stock Sale and Liquidation

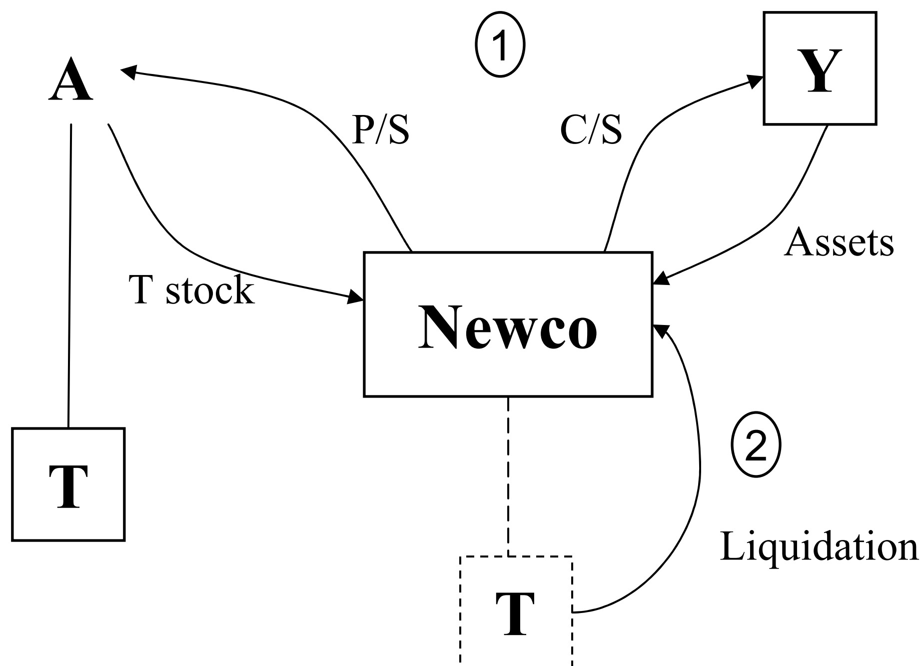


Facts: P owns all the stock of S, and S owns all the stock of T. P, S and T file separate returns. As part of a plan, (1) S sells the T stock to P for cash, and (2) T is liquidated into P. S retains the cash purchase price for the T stock.

Issue: Is the form respected? Or, is T treated as selling its assets to P and then liquidating into S (or is T treated as liquidating into S, and S treated as selling the T assets to P)? See Rev. Ruls. 70-106, 1970-1 C.B. 70; 74-605, 1974-2. C.B. 97; 75-521, 1975-2 C.B. 210; 77-427, 1977-2 C.B. 100.

What if, instead of liquidating into P, T is merged into P? Or, T is converted into a LLC classified as a disregarded entity? What if P, S and T file consolidated returns? What if P is an individual?

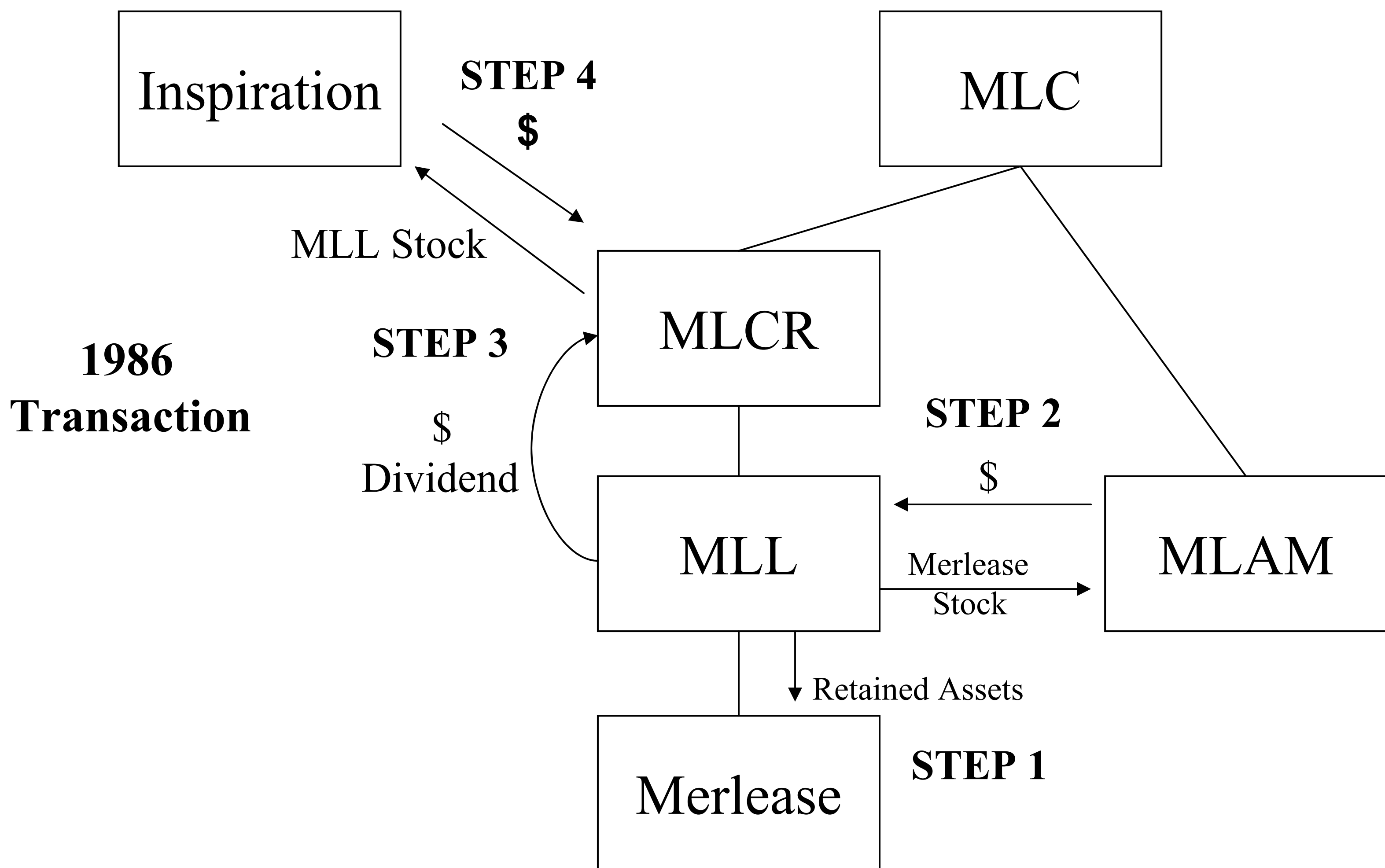
Section 351 Contribution and Liquidation



Facts: A, an individual, owns all of the stock of T. A and Y form Newco by contributing T stock and assets, respectively. In return, A receives preferred stock and Y receives common stock. T liquidates into Newco after the contribution of T stock.

Issue: The form of the transaction is a section 351 contribution followed by a section 332 liquidation. Can the transaction be recharacterized as a liquidation of T and a contribution of T's assets by A? A failed 'C' reorganization? A section 351 contribution by T and a liquidation of T?

Merrill Lynch v. Commissioner



Step One: MLL contributes certain retained assets to Merlease that MLC does not want to sell to Inspiration.
Step Two: MLL sells Merlease cross-chain to a sister subsidiary, MLAM, in a section 304 transaction.
Step Three: MLL distributes the gross sale proceeds to MLCR as a dividend.
Step Four: MLCR sells MLL to Inspiration, an unrelated third party.

Merrill Lynch v. Commissioner

Position of Merrill Lynch: Under the consolidated return regulations in effect during 1986, Merrill Lynch took the position that the cross-chain sale of Merlease and the dividend to MLCR should be treated as a deemed redemption under section 304 subject to dividend treatment under section 301. Merrill Lynch argued that the transaction did not qualify for sale or exchange treatment under section 302 due to the fact that MLL's interest in Merlease was not terminated at the time of the cross-chain sale. Therefore, Merrill Lynch claimed that MLCR was entitled to a step-up in its basis in its MLL stock to the extent of the dividend and recognized a loss on its sale of MLL stock to Inspiration.

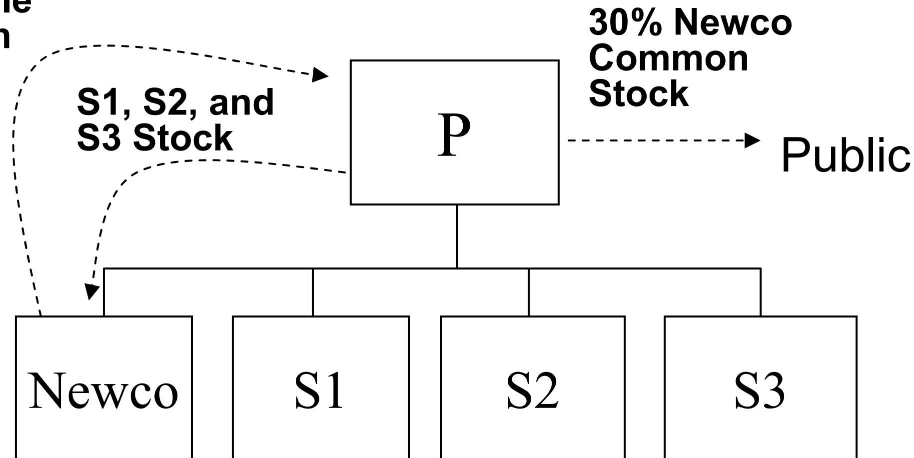
Decision of Tax Court: The Tax Court ruled that the cross-chain sale, dividend, and sale of MLL to Inspiration were steps in a plan to terminate MLL's ownership of Merlease and the section 304 redemption was therefore subject to sale or exchange treatment because it represented a complete termination of MLL's interest in Merlease under section 302(b)(3). The Court concluded that the cross-chain sale and sale of MLL to Inspiration represented a "firm and fixed" plan to terminate MLL's interest in Merlease for purposes of determining whether the section 304 redemption should be treated as a sale or exchange or a dividend. See Zenz v. Quinlivan, 213 F.2d 914 (6th Cir. 1954); Niedermeyer v. Commissioner, 62 T.C. 280 (1974). In reaching its decision, the Court focused on the fact that the complete plan to sell MLL was presented to Merrill Lynch's board of directors only four days after the cross-chain sale and while the sale was not finalized, it was sufficiently mature at that time that a tax reserve for the transaction was established.

Merrill Lynch v. Commissioner

Decision of Second Circuit: The Second Circuit affirmed the Tax Court decision finding that there was a "firm and fixed" plan to sell MLL at the time of the cross-chain sale and, thus, the cross-chain sale qualified for sale or exchange treatment.

Additional Merrill Position: On appeal, Merrill Lynch took the position that for section 302 purposes, the stock ownership of the parent company, MLC, was to be considered rather than the stock ownership of MLL. Because the issue of law was first raised on appeal, the Second Circuit remanded the issue back to the Tax Court.

P.L.R. 200427011

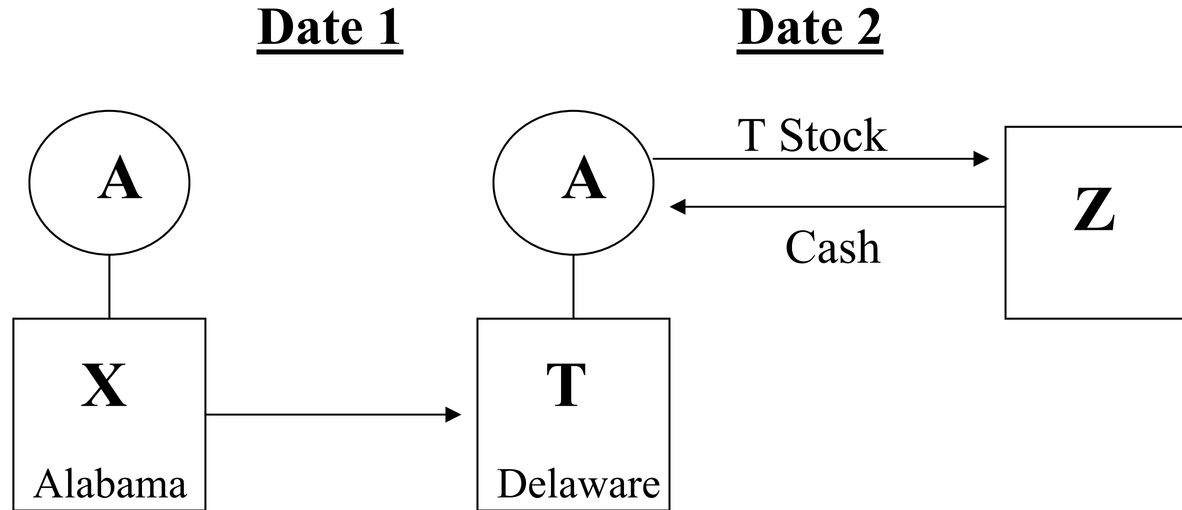


Facts: P forms Newco with a minimal amount of capital. P executes a "firm commitment" underwriting agreement to sell Newco stock and convertible instruments in an IPO. P then contributes the shares of subsidiaries S1, S2, and S3 to Newco in exchange for all of the outstanding Newco common stock, Newco convertible instruments, and other non-stock consideration (e.g., short-term promissory notes or cash). Pursuant to the underwriting agreement, P sells 30% of the common stock to the public. P also represents that, although not legally obligated to do so, it fully intends to reduce its interest in Newco below 50% within two years of completing the sale of the 30% of the common stock to the public.

Issue: Can P and Newco make a section 338(h)(10) election with respect to the contributed subsidiaries? See P.L.R. 200427011 (October 6, 2003); Merril Lynch & Co., Inc. v. Commissioner.

“E” and “F” Reorganizations

"F" Reorganization, Step Transaction, COI, and COBE



Facts: A is the sole shareholder of Corporation X, an Alabama corporation. On Date 1, X changes its state of incorporation to Delaware and its name to T Corporation in a reorganization intended to qualify under section 368(a)(1)(F). Immediately after the reorganization (on Date 2), A sells 100 percent of the T stock to Z for cash.

Issue: Is COI satisfied? On August 12, 2004, the IRS and Treasury issued proposed regulations stating that the application of the COI and COBE requirements to an "F" reorganization is not required to protect the policies underlying the reorganization provisions. See Prop. Treas. Reg. § 1.368-2(m)(2). In addition, the proposed regulations provide that related events that precede or follow a transaction or series of transactions that constitutes a "mere change in corporate form" will not cause that transaction or series of transactions to fail to qualify as an "F" reorganization. Prop. Treas. Reg. § 1.368-2(m)(3)(ii).

“Mere Change” Requirements

- Proposed regulations issued by Treasury and the IRS on August 12, 2004, provide that, to qualify as an “F” reorganization, a transaction must result in a “mere change in identity, form, or place of organization of one corporation.” Prop. Treas. Reg. § 1.368-2(m).

- A transaction constitutes a “mere change” only if the following four requirements are satisfied. See Prop. Treas. Reg. § 1.368-2(m)(1)(i)(A)-(D).

  – All of the stock of the resulting corporation, including stock issued before the transfer, must be issued in respect of stock of the transferring corporation.
  – There must be no change in the ownership of the corporation in the transaction, except a change that has no effect other than that of a redemption of less than all the shares of the corporation.
  – The transferring corporation must completely liquidate in the transaction.
  – The resulting corporation must not hold any property or have any tax attributes (including those specified in section 381(c)) immediately before the transfer.

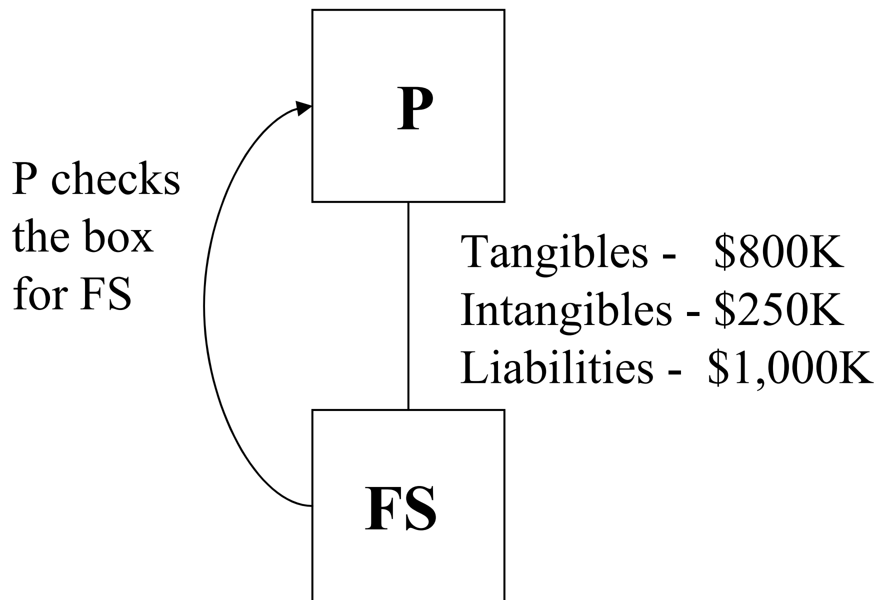
“E” Reorganization, COI, and COBE

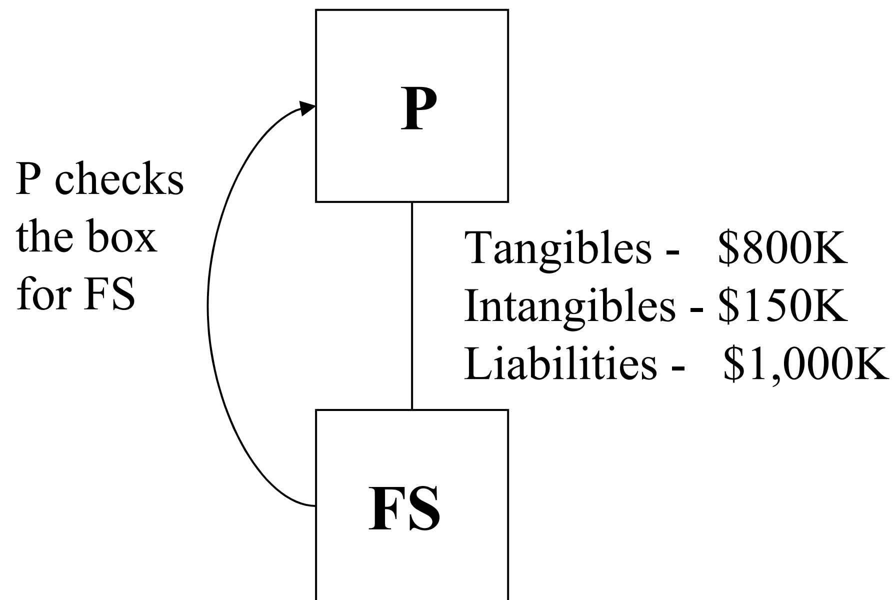
- On August 12, 2004, the IRS and Treasury issued proposed regulations stating that the application of the COI and COBE requirements to an “E” reorganization is not required to protect the policies underlying the reorganization provisions. See Prop. Treas. Reg. § 1.368-1(b).

TROUBLED COMPANIES AND NO NET VALUE REGULATIONS

TROUBLED COMPANIES: INSOLVENCY AND LIABILITY ISSUES

Rev. Rul. 2003-125





Situation 1: Corporation P owns 100 percent of the stock of Subsidiary FS, an entity organized under the laws of Country X that operates a manufacturing business. FS is an "eligible entity" under Treas. Reg. § 301.7701-3(a) and, prior to July 1, 2003, FS is treated as a corporation for federal tax purposes (under section 7701(a)(3)). On December 31, 2002, the stock of FS was not worthless. On July 1, 2003, P files a check-the-box election for FS, changing the classification of FS from a corporation to a disregarded entity for federal tax purposes effective as of that date. At the close of the day immediately before the effective date of the election, the fair market value of FS's assets, including intangible assets such as goodwill and going concern value, exceeds the sum of its liabilities. However, at that time, the fair market value of FS's assets, excluding intangible assets such as goodwill and going concern value, does not exceed the sum of its liabilities. After the change in entity classification election is effective, FS continues its manufacturing operations.

Situation 2: Same facts as in Situation, except that at the close of the day immediately before the effective date of the election, the fair market value of FS's assets, including intangible assets such as goodwill and going concern value, does not exceed the sum of its liabilities.

Rev. Rul. 2003-125 (Cont.)

Holding: When an election is made to change the classification of an entity from a corporation to a disregarded entity, the shareholder of such entity is allowed a worthless security deduction under section 165(g) if the fair market value of the assets of the entity, including intangible assets such as goodwill and going concern value, does not exceed the entity's liabilities such that on the deemed liquidation of the entity the shareholder receives no payment on its stock.

Situation 1: Because the aggregate value of FS's tangible and intangible assets ($1,050,000) exceeds FS's liabilities ($1,000,000) immediately before the effective date of the P's check-the-box election for FS, the stock of FS is not worthless on that date. Accordingly, because P receives at least partial payment on its FS stock in the deemed liquidation of FS. As a result, section 332 applies to the deemed liquidation and no loss is allowable to P.

Situation 2: Because the aggregate value of FS's tangible and intangible assets ($950,000) does not exceed FS's liabilities ($1,000,000) immediately before the effective date of the P's check-the-box election for FS, the stock of FS is worthless. Accordingly, section 332 does not apply because P does not receive any payment on its FS stock in the deemed liquidation of FS. The deemed liquidation is an identifiable event that fixes P's loss with respect to the FS stock and, therefore, P is allowed a worthless security deduction under section 165(g) for its 2003 tax year. Also, depending on the facts, FS's creditors, including P, may be entitled to a deduction for a partially or wholly worthless debt under sections 165 or 166.

Rev. Rul. 2003-125 (Cont.)

Rev. Rul. 2003-125 clarifies that:

- Where a worthless stock deduction is claimed upon the liquidation of a corporation and the stock did not become worthless in a prior tax year, the standard for determining worthlessness is whether the shareholders receive payment for their stock. See H.K. Porter Co. v. Commissioner, 87 T.C. 689 (1986).

- A shareholder receives no payment for its stock in a liquidation if, at the time of the liquidation, the fair market value of the corporation's assets is less than the corporation's liabilities.

- The value of intangible assets, including goodwill and going concern, is included in determining the fair market value of the entity's assets immediately before the deemed liquidation.

- Certain facts, such as (i) the continuation of the corporation's business after a liquidation without a substantial infusion of capital, and (ii) the revenues of that business following the liquidation exceed the amount required to service debt that existed immediately prior to the liquidation, may suggest that at the time of liquidation the fair market value of the liquidating entity's assets, including goodwill and going concern value, exceeded the sum of its liabilities.

Rev. Rul. 2003-125 (Cont.)

Rev. Rul. 2003-125 clarifies that (cont.):

- Nevertheless, depending on the facts, the parent could claim a bad debt deduction and a worthless stock deduction where its wholly owned subsidiary owes a bona fide indebtedness to its parent corporation that exceeds the fair market value of its assets and the subsidiary transfers all of its assets to the parent in partial satisfaction of its indebtedness. This may be true even where the parent continues the business formerly conducted by the subsidiary. See Rev. Rul. 70-489, 1970-2 C.B. 53, *amplifying* Rev. Rul. 59-296, 1959-2 C.B. 87.

- If a shareholder receives no payment for its stock in a liquidation of the corporation, neither section 331 nor section 332 applies to the liquidation.

- The fact that a shareholder receives no payment for its stock in a liquidation of the corporation demonstrates that such shareholder's stock is worthless.

- The liquidation is an identifiable event that fixes the loss with respect to the stock for purposes of a worthless stock deduction under section 165(g).

TROUBLED COMPANIES: LIQUIDATIONS AND UPSTREAM MERGERS

In General

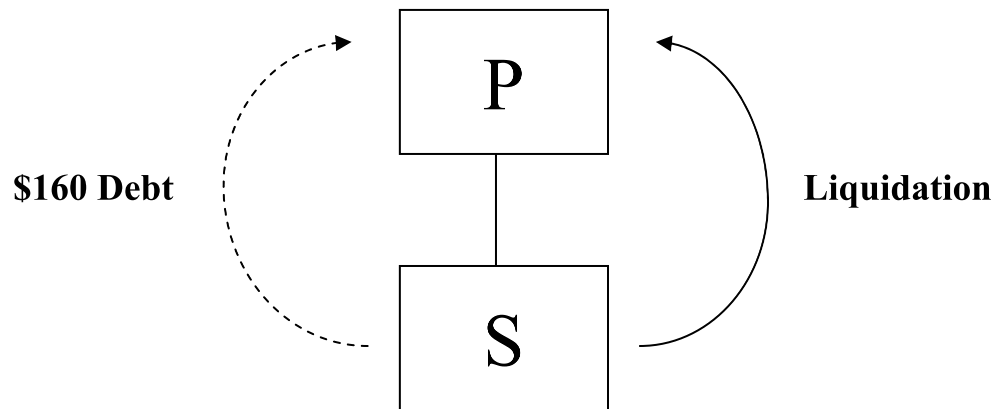
- Section 332 - A liquidation is not taxable to a corporate shareholder if the corporate shareholder owns at least 80 percent (by vote and value) of the stock of the liquidating subsidiary. Section 337 shields the liquidating company from tax.
  - If the requirements of section 332 are not satisfied, a liquidation is taxable to the liquidating corporation and its shareholders under sections 331 and 336.
- Treas. Reg. §1.332-2(b) – Section 332 applies only where the parent receives at least partial payment for its stock.
  - This requirement has been held to apply to section 331 liquidations as well. See Braddock Land Co. v. Commissioner, 75 T.C. 324 (1980); Jordan v. Commissioner, 11 T.C. 914 (1948).
  - Section 332 requires a distribution in cancellation or redemption of *all* of the stock of the liquidating company. Thus, a distribution that is sufficient to redeem only the company's preferred stock is not a liquidation. See Commissioner v. Spaulding Bakeries, Inc., 252 F.2d 693 (2d Cir. 1958); H.K. Porter Co. v. Commissioner, 87 T.C. 689 (1986).
- Therefore, section 332 does not apply when a parent liquidates an insolvent subsidiary, and the parent can recognize loss on its sub stock under section 165(g). Iron Fireman Mfg. Co. v. Commissioner, 5 T.C. 452 (1945); H.G. Hill Stores, Inc. v. Commissioner, 44 B.T.A. 1182 (1941); Rev. Rul. 70-489, 1970-2 C.B. 53, amplifying, Rev. Rul. 59-296, 1959-2 C.B. 87.

In General

- Proposed No Net Value Regulations – The proposed regulations retain the partial payment rule of the current regulations and provide new rules with respect to liquidations involving multiple classes of stock. Prop. Treas. Reg. §1.332-2(b).
  - If partial payment is not received for *every* class of stock but is received for at least one class, the proposed regulations look separately to each class of stock to determine the tax consequences.
  - With respect to those classes of stock for which no payment is received, the proposed regulations refer to section 165(g) worthless stock deductions.
  - With respect to those classes of stock for which payment is received, the proposed regulations refer to section 368(a)(1) regarding a potential reorganization or to section 331 if the distribution does not qualify as a reorganization.

- The Service also takes the position that an upstream merger cannot qualify as a tax-free A reorganization. Rev. Rul. 70-489. But see Norman Scott, Inc., 48 T.C. 598 (noting that unlike the requirement for a liquidation that there be a payment in cancellation or redemption of stock, there is no such requirement for a statutory merger to qualify under section 368(a)(1)(A)).

Liquidation vs. Upstream Merger

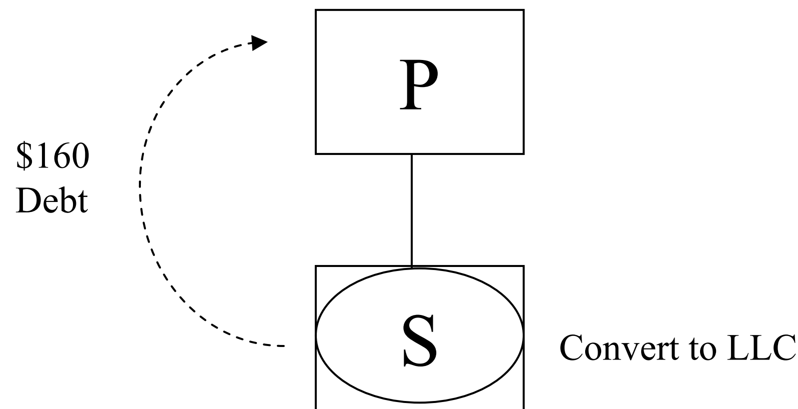


Facts: P owns all of the stock of S. S has assets worth $100 and is indebted to P in the amount of $160. S adopts a plan of liquidation, and distributes all of its assets to P.

Result: The transaction does not qualify as a section 332 liquidation under either current law or the proposed regulations. Instead, S should be treated as transferring its $100 of assets in satisfaction of its $150 debt to P, and P should be entitled to a worthless stock deduction of $100 and a bad debt deduction of $50.

What if S merged upstream into P? See Norman Scott, Inc., 48 T.C. 598. But see Rev. Rul. 70-489, 1970-2 C.B. 53, amplifying, Rev. Rul. 59-296, 1959-2 C.B. 87. Could the liquidation be treated as an upstream C reorganization?

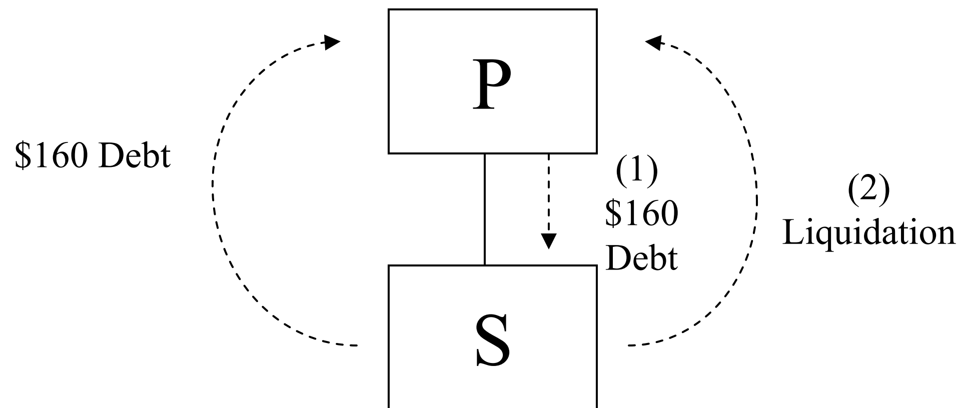
Deemed Liquidation



Facts: P owns all of the stock of S. S has assets worth $100 and is indebted to P in the amount of $160. S converts into a single-member LLC pursuant to state law.

Result: The conversion into a single-member LLC results in a deemed liquidation under Treas. Reg. §301.7701-3(g)(1)(iii). However, because S is insolvent, the deemed liquidation does not qualify as a section 332 liquidation under either current law or the proposed regulations. The deemed liquidation is considered an identifiable event that fixes the loss with respect to the stock for purposes of a worthless stock deduction under section 165(g). Rev. Rul. 2003-125, 2003-52 I.R.B. 1 (reversing the result in F.S.A. 200226004 (Mar. 7, 2002)). Thus, P should be entitled to worthless stock and bad debt deductions, even though P continues the business formerly conducted by S. Id.*;* see also Rev. Rul. 70-489, 1970-2 C.B. 53, amplifying Rev. Rul. 59-296, 1959-2 C.B. 87.

Revenue Ruling 68-602



Facts: P owns all of the stock of S. S has assets worth $100 and is indebted to P in the amount of $160. P cancels the $160 debt by contributing it to S's capital. S then adopts a plan of liquidation, and distributes all of its assets to P.

Result: In Rev. Rul. 68-602, 1968-2 C.B. 135, the Service ruled that the debt cancellation was an integral part of the liquidation and had no independent significance other than to secure the tax benefits of S's net operating loss carryover. Therefore, the Service regarded the cancellation as transitory and disregarded it. Cf. Rev. Rul. 78-330, 1978-2 C.B. 147 (respecting debt cancellation immediately before a sideways merger because such cancellation had independent economic significance). As a result, the liquidation in this example does not qualify as a section 332 liquidation, and the result is the same as in the prior two examples. The proposed regulations do not change this result.

TROUBLED COMPANIES:
SECTION 351 INCORPORATIONS

In General

- Section 351 – No gain or loss is recognized if property is transferred to a corporation solely in exchange for stock of such corporation.

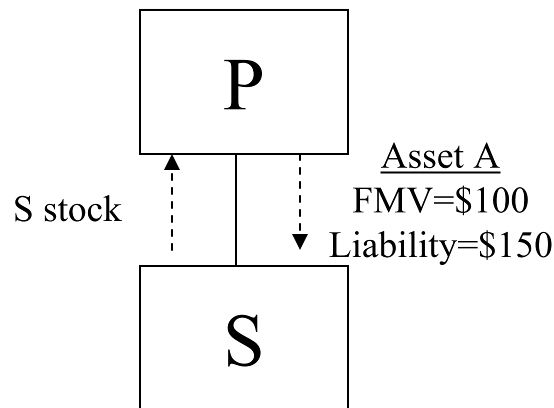
- Where the transferor of property is the sole shareholder of the transferee corporation, issuance of new stock is not necessary, because it would be a meaningless gesture. See Lessinger v. Commissioner, 85 T.C. 824 (1985), aff'd, 872 F.2d 519 (2d Cir. 1989); Rev. Rul. 64-155, 1964-1 CB 138.

- In Rosen v. Commissioner, 62 T.C. 11 (1974), the taxpayer transferred the assets and liabilities of a sole proprietorship to a newly formed corporation. At the time of the transfer, the liabilities exceeded the value of the assets, and the corporation was insolvent. The court held that the taxpayer realized gain under section 357(c) to the extent the liabilities assumed exceeded the adjusted basis of the assets transferred. See also Focht v. Commissioner, 68 T.C. 223 (1977); G.C.M. 33,915 (Aug. 26, 1968). But see DeFelice v. Commissioner, 386 F.2d 704 (10th Cir. 1967) (rejecting the taxpayer's argument that section 357(c) did not apply, because he was insolvent; the court found that the taxpayer failed to prove he was insolvent).

In General

- Proposed No Net Value Regulations - The proposed regulations provide that stock will not be treated as issued for property if either (i) the fair market value of the transferred property does not exceed the sum of the amount of liabilities of the transferor that are assumed by the transferee in connection with the transfer and the amount of money and fair market value of any other property received by the transferor in connection with the transfer (i.e., the transferor does not transfer net value), or (ii) the fair market value of the assets of the transferee does not exceed the amount of its liabilities immediately after the transfer (i.e., the transferee is insolvent). Prop. Treas. Reg. §1.351-1(a)(1)(iii).
  - For purposes of (i), any liability of the transferor to the transferee that is extinguished in connection with the transfer is treated as a liability assumed by the transferee.

Underwater Property

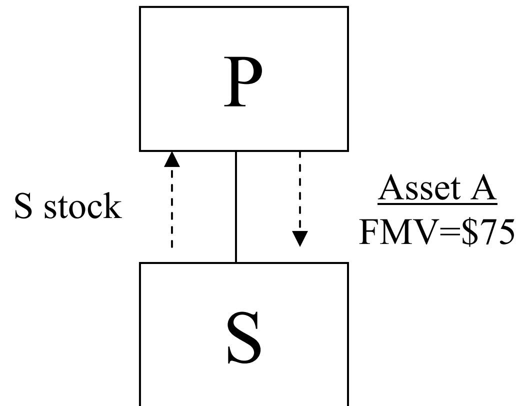


Facts: P owns all of the stock of S. S has assets worth $500 and liabilities of $200. P contributes Asset A to S, which is worth $100, but is subject to a nonrecourse liability of $150.

Result: The transaction arguably qualifies under section 351 under current law. See Rosen, 62 T.C. 11, Focht, 68 T.C. 223; G.C.M. 33,915 (Aug. 26, 1968); *cf*. section 301(b)(2) (amount of distribution reduced, but not below zero, for liabilities assumed or to which property is subject); section 311(b)(2) (fair market value of property received in distribution not less than amount of liability assumed or to which the property is subject); section 336(b) (same). But see DeFelice, 386 F.2d 704. However, under the proposed regulations, the transaction would not qualify, because P does not transfer net value. Prop. Treas. Reg. §1.351-1(a)(1)(iii).

What if, in addition to Asset A, P transfers Asset B, which is unencumbered and has a value of $75?

Transfer to Make S Solvent



Facts: P owns all of the stock of S. S has assets worth $100 and liabilities of $150. P contributes Asset A to S, which is worth $75.

Result: The transaction should qualify under section 351 under either current law or the proposed regulations.

TROUBLED COMPANIES:
TAX-FREE REORGANIZATIONS

Proposed No Net Value Regulations

- **Asset Reorganizations**
  - There is a surrender of net value if the FMV of the property transferred by the target <u>exceeds</u> the sum of (i) the target liabilities assumed by the acquiror in connection with the exchange and (ii) the amount of money and the FMV of any other property received by the target in connection with the exchange. Prop. Treas. Reg. §1.368-1(f)(2)(i).
    - Any liability that the target owes the acquiror that is extinguished in the exchange is treated as assumed in connection with the exchange.
  - There is a receipt of net value if the FMV of the assets of the issuing corporation exceeds the amount of its liabilities immediately after the exchange. Prop. Treas. Reg. §1.368-1(f)(2)(ii).

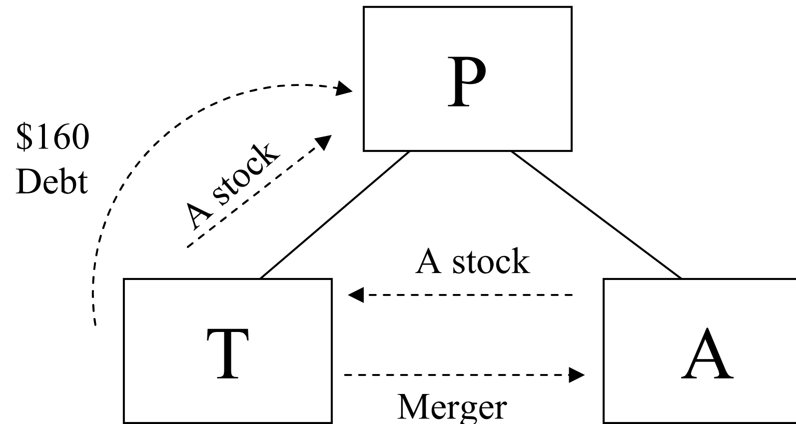
Proposed No Net Value Regulations

- **Stock Reorganizations**
  - There is a surrender of net value if the FMV of the assets of the target *exceeds* the sum of (1) the amount of the target liabilities immediately prior to the exchange and (ii) the amount of money and the FMV of any other property received by the target shareholders in connection with the exchange. Prop. Treas. Reg. §1.368-1(f)(3)(i).
    - Assets of the target that are not held immediately after the exchange and liabilities of the target that are extinguished in the exchange are disregarded.
  - There is a receipt of net value if the FMV of the assets of the issuing corporation exceeds the amount of its liabilities immediately after the exchange. Prop. Treas. Reg. §1.368-1(f)(3)(ii).

Proposed No Net Value Regulations

- **Exceptions**
  - The net value requirement does not apply to E and F reorganizations. Prop. Treas. Reg. §1.368-1(b)(1).
  - The net value requirement does not apply to acquisitive D reorganizations, provided the FMV of the property transferred to the acquiror by the target exceeds the amount of target liabilities immediately before the exchange (including any liabilities cancelled, extinguished, or assumed in connection with the exchange), and the FMV of the assets of the acquiror equals or exceeds the amount of its liabilities immediately after the exchange. Prop. Treas. Reg. §1.368-1(f)(4); see also Rev. Rul. 70-240.

Sideways Asset Reorganization
Parent Debt

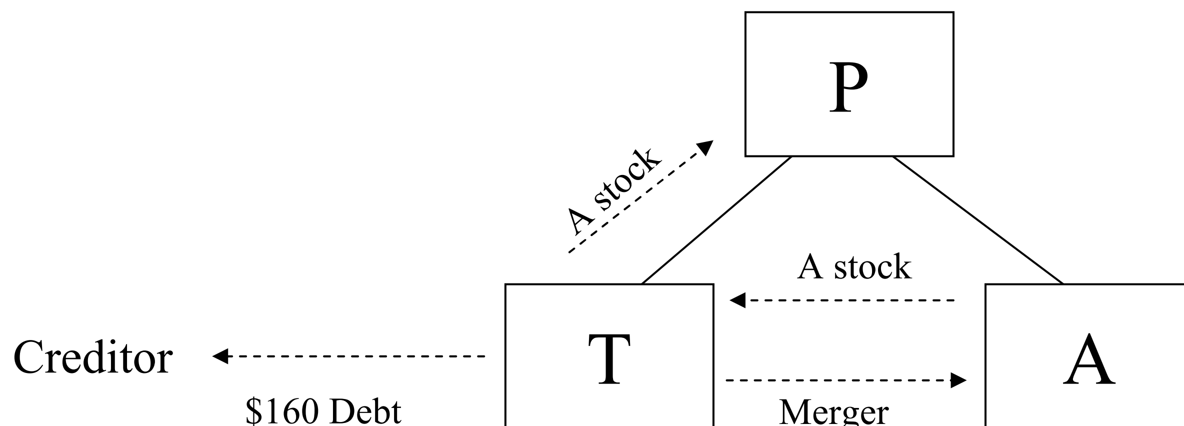


Facts: P owns all of the stock of T and A. T has assets with a fair market value of $100 and liabilities of $160, all of which are owed to P. T merges into A, with P receiving $100 worth of additional A stock in exchange for its T debt. A is solvent both before and after the merger.

Result: The transaction should qualify as a tax-free A reorganization under current law. See Norman Scott, Inc., 48 T.C. 598; Rev. Rul. 54-610, 1954-2 C.B. 152; see also G.C.M. 33,859 (June 25, 1968). The result is the same under the proposed no net value regulations, because (i) T surrendered net value in that the FMV of the property transferred by T ($100) exceeds the sum of the liabilities assumed by A ($0) and the amount of money and fair market value of other property received by T in connection with the exchange ($0), and (ii) T received net value in that the FMV of A's assets exceeds its liabilities immediately after the exchange. Prop. Treas. Reg. §1.368-1(f)(2), (f)(5), Ex. 2.

What if A issues no stock to B in the reorganization? Compare Laure v. Commissioner, 653 F.2d 253 (6th Cir. 1981) and Rev. Rul. 64-155, 1964-1 C.B. 138 with Warsaw Photographic Associates, Inc. v. Commissioner, 84 T.C. 21 (1985); see also Prop. Treas. Reg. §1.368-1(f)(5), Exs. 2 & 3.

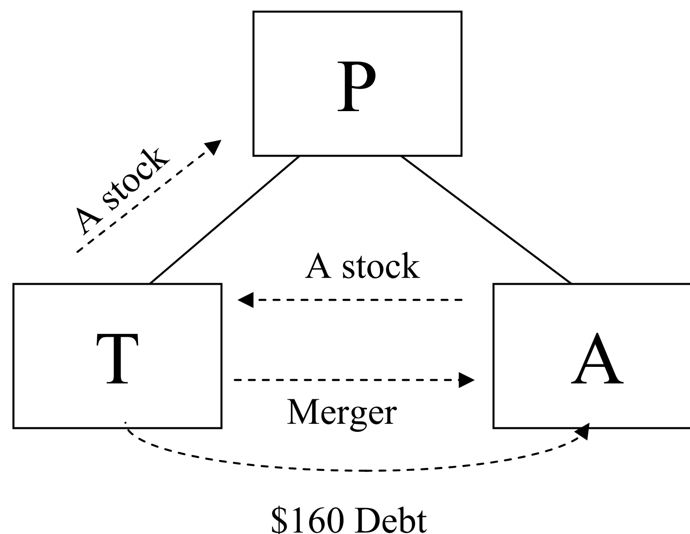
Sideways Asset Reorganization
Third-Party Debt



Facts: P owns all of the stock of T and A. T has assets with a fair market value of $100 and liabilities of $160, all of which are owed to Creditor. T merges into A, with P receiving $100 worth of additional A stock. A is solvent both before and after the merger.

Result: The transaction is distinguishable from Norman Scott, Inc., but it should qualify as a tax-free A reorganization under the IRS's reasoning in G.C.M. 33,859 (June 25, 1968) that because Creditor had not taken affirmative steps to assert its proprietary interest, P remains the holder of the proprietary interest. However, the merger does not satisfy the net value requirement of the proposed regulations, because T does not surrender net value—the FMV of the property transferred by T ($100) does not exceed the sum of the liabilities assumed by A ($160) and the amount of money and fair market value of other property received by T in connection with the exchange ($0). Prop. Treas. Reg. §1.368-1(f)(2)(1).

Sideways Asset Reorganization Brother-Sister Debt



Facts: P owns all of the stock of T and A. T has assets with a fair market value of $100 and liabilities of $160, all of which are owed to A. T merges into A, with P receiving $100 worth of additional A stock. Assume further that the T debt is worth $100, and A has other assets worth $400, so A is solvent both before and after the merger.

Result: The transaction should qualify as a tax-free A reorganization under current law. See Norman Scott, Inc., 48 T.C. 598; G.C.M. 33,859 (June 25, 1968). However, the merger does not satisfy the net value requirement of the proposed regulations, because T does not surrender net value. The proposed regulations treat debt owed by the target to the acquiring corporation that is extinguished in an exchange as if it were assumed by the acquiring corporation. Prop. Treas. Reg. §1.368-1(f)(2)(i). Thus, the FMV of the property transferred by T ($100) does not exceed the sum of the liabilities assumed by A ($160) and the amount of money and fair market value of other property received by T in connection with the exchange ($0). Prop. Treas. Reg. §1.368-1(f)(2)(1).

What if the direction of the merger were reversed, so that A merged into T? See Prop. Treas. Reg. §1.368-1(f)(5), Ex. 6

Cross-Border Merger Regulations

Proposed Section 368 Regulations
Overview

- On January 5, 2005, Treasury and IRS issued Prop. Treas. Reg. § 1.368-2(b).
- The proposed regulations would amend the definition of a "statutory merger or consolidation" (i.e., an "A" reorganization) to include certain mergers or consolidations effected pursuant to non-U.S. law.
  - Historically, an "A" reorganization was defined as a transaction effected pursuant to the laws of the United States or a State or the District of Columbia.
  - The proposed regulations would eliminate the jurisdictional requirement and define a statutory merger or consolidation as a "transaction effected pursuant to the statute or statute necessary to effect the merger or consolidation," subject to certain requirements.
  - This definition could allow a transaction effected pursuant to non-U.S. law to qualify as an "A" reorganization provided that the transaction would otherwise qualify as a reorganization.

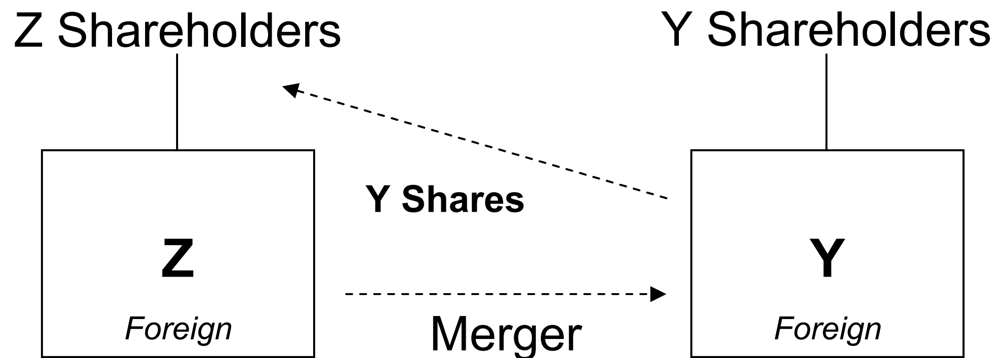
Proposed Section 368 Regulations
Overview

- In addition, the proposed regulations would allow mergers involving disregarded entities to qualify as "A" reorganizations even if the combining entity, the combining entity of the transferee unit, or a disregarded entity involved in the transaction is a foreign entity (by deleting Temp. Reg. section 1.368-2T(b)(1)(iii)).

- The proposed regulations are prospective based on the date they are issued as final regulations.
  - Until that time, the rules under Temp. Reg. § 1.368-2T(b)(1) control.
  - Thus, until the new proposed regulations are finalized, the two changes summarized above do not apply.

Proposed Section 368 Regulations

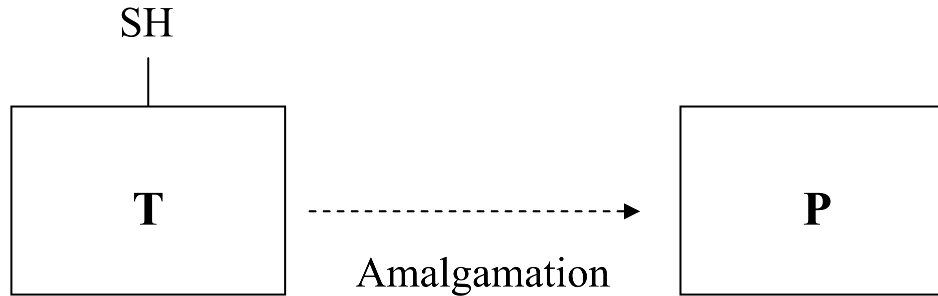
Example 1: Definition of Statutory Merger or Consolidation



Facts: Z and Y are entities organized under the laws of Country Q and classified as corporations for Federal tax purposes. Z merges into Y under Country Q law. Pursuant to statutes of Country Q the following events occur simultaneously: (i) all of the assets and liabilities of Z become the assets and liabilities of Y, (ii) Z's separate legal existence ceases for all purposes, and (iii) Z shareholders receive Y voting stock.

Analysis: This transaction would not qualify as an "A" reorganization under Temp. Treas. Reg. § 1.368-2T(b)(1)(ii), because the merger was not effected pursuant to the laws of the United States or a State or the District of Columbia. Under recently proposed regulations, however, this transaction should qualify as an "A" reorganization. See Prop. Treas. Reg. § § 1.368-2(b)(1)(ii), -2(b)(1)(iii) Ex. 9.

Proposed Section 368 Regulations
Example 2: Amalgamation

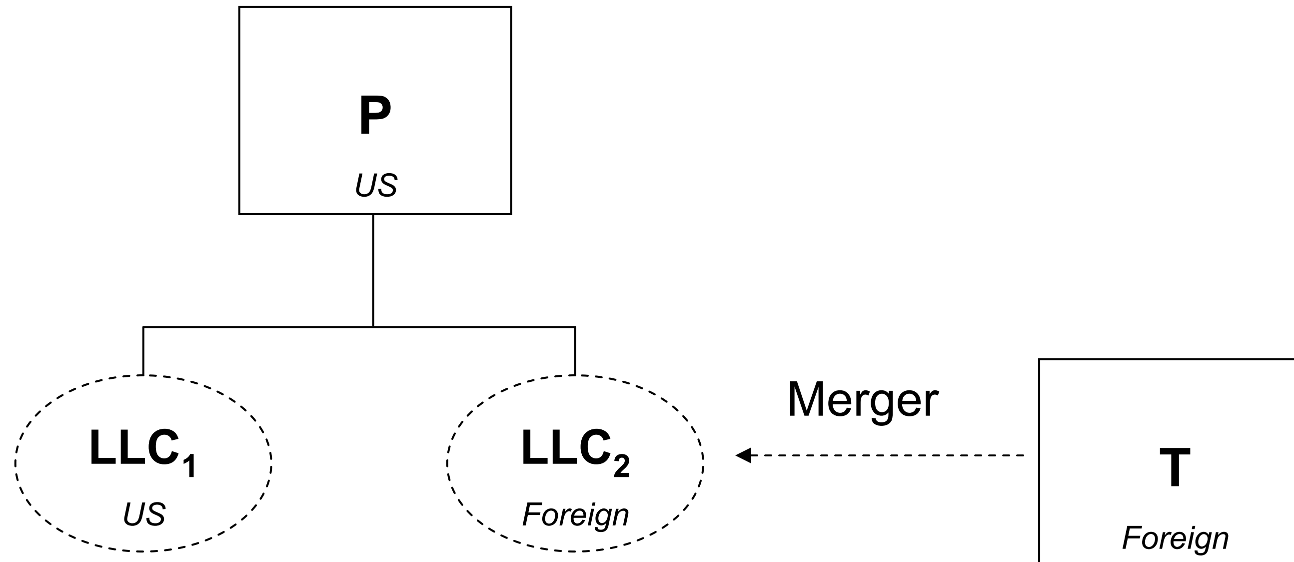


Facts: T, a Province Q Limited Company with a single US shareholder (SH), amalgamates with P, also a Province Q Limited Company, pursuant to the law of Province Q. By operation of law, the assets of T and P become assets of a new entity ("Amalco"), P and T cease their separate existence, and SH and the P shareholders receive shares of Amalco stock as consideration. SH receives 30% of Amalco's outstanding shares.

Issues: Assuming that all other requirements applicable to reorganizations are satisfied, if this transaction were effected under Delaware corporate law it would qualify as a statutory merger or consolidation and, therefore, as an "A" reorganization. However, because the transaction is carried out under Province Q law and not US law, it cannot qualify as an "A" reorganization under current law. Under recently proposed regulations, the amalgamation should qualify as an "A" reorganization, because it is a transaction effected pursuant to the statute or statutes necessary to effect the merger or consolidation (i.e., Province Q amalgamation law), all of the assets (other than those distributed in the transaction) and liabilities (except to the extent satisfied or discharged in the transaction) of each member of one or more combining units (i.e., P and T) become the assets and liabilities of one or more members of another combining unit (i.e., Amalco), and P and T cease to exist. See Prop. Treas. Reg. § 1.368-2(b).

Proposed Section 368 Regulations

Example 3: Mergers Involving Foreign Disregarded Entities

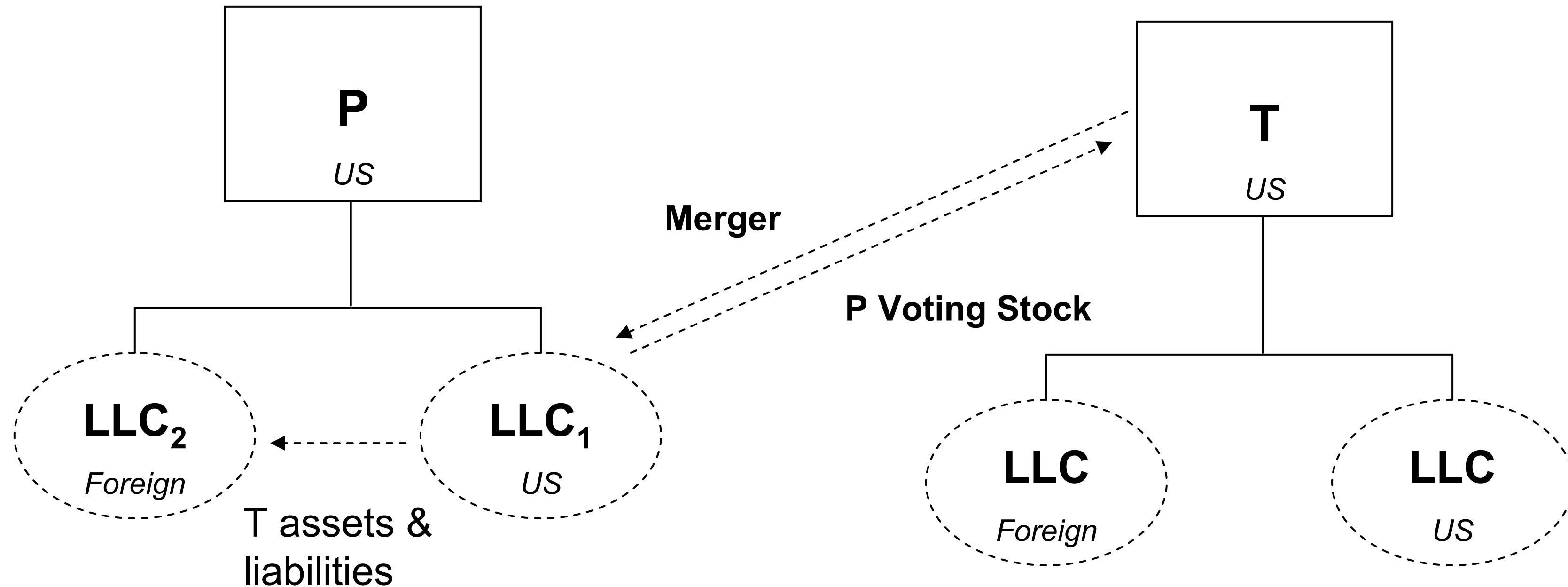


Facts: P owns 100% of the outstanding units of LLC_1 and LLC_2. Both LLCs are treated as disregarded entities for Federal tax purposes. LLC_2 and T are entities organized under the laws of Country Q. P and its LLCs are a combining unit. T is a combining unit. Pursuant to Country Q law, T merges with and into LLC_2.

Analysis: This transaction would not qualify as an "A" reorganization under Temp. Treas. Reg. § 1.368-2T(b)(1)(iii). Under recently proposed regulations, which would eliminate Temp. Treas. Reg. § 1.368-2T(b)(1)(iii), this transaction should qualify as an "A" reorganization. See Preamble to Prop. Treas. Reg. § 1.368-2(b)(1).

Proposed Section 368 Regulations

Example 4: Merger of Target Into U.S. LLC Followed by Transfer of Assets to Foreign LLC

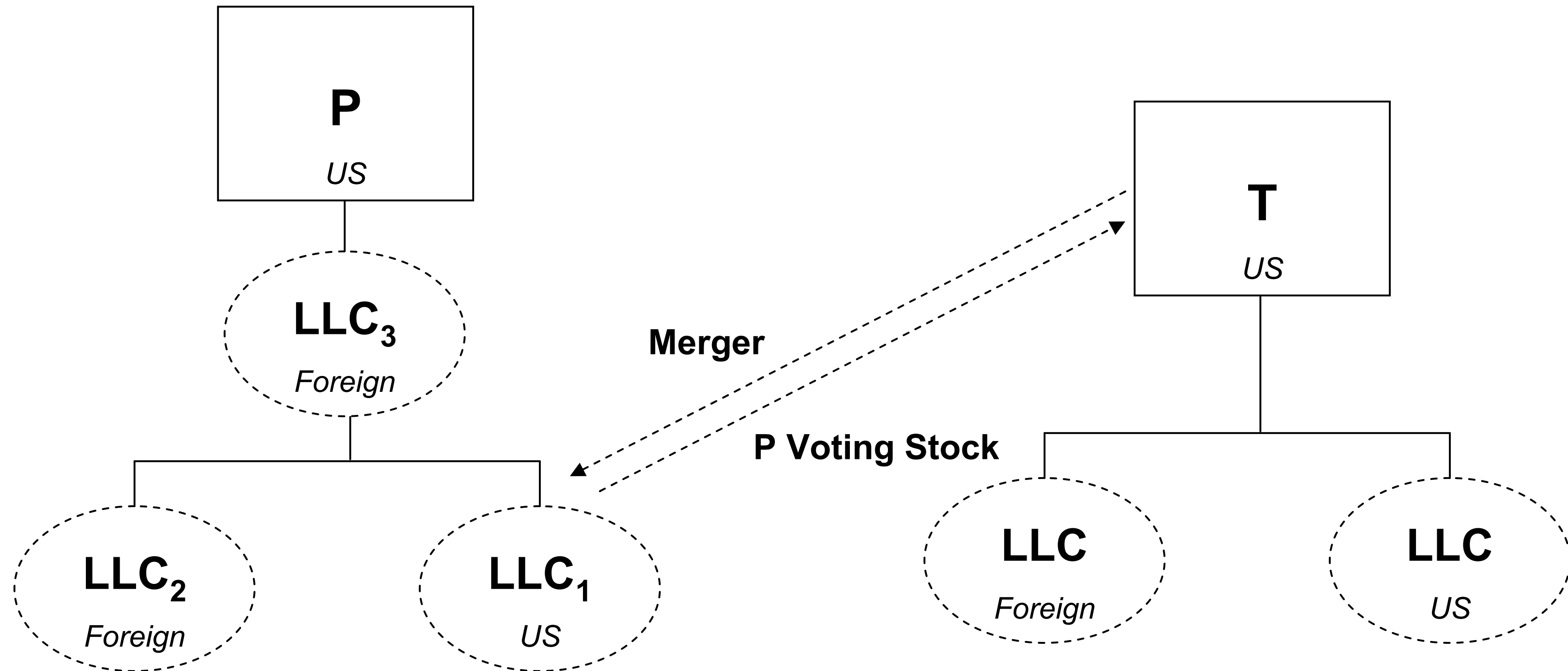


Facts: Same facts as Example 3, except that T is a Delaware corporation and owns two LLCs that are treated as disregarded entities for Federal tax purposes. P and its LLCs are a combining unit. T and its LLCs are a combining unit. T merges into LLC_1, with the T shareholders receiving P voting stock. In a separate transaction following the merger, LLC1 transfers T assets and liabilities to LLC_2.

Analysis: Does this transaction qualify as a tax-free statutory merger? Under recently proposed regulations, which would eliminate Temp. Treas. Reg. § 1.368-2T(b)(1)(iii), the subsequent transfer of assets to LLC_2 should not affect whether this transaction qualifies as an "A" reorganization. See Preamble to Prop. Treas. Reg. § 1.368-2(b)(1).

Proposed Section 368 Regulations

Example 5: Merger of Target Into U.S. LLC Wholly-Owned by Foreign LLC

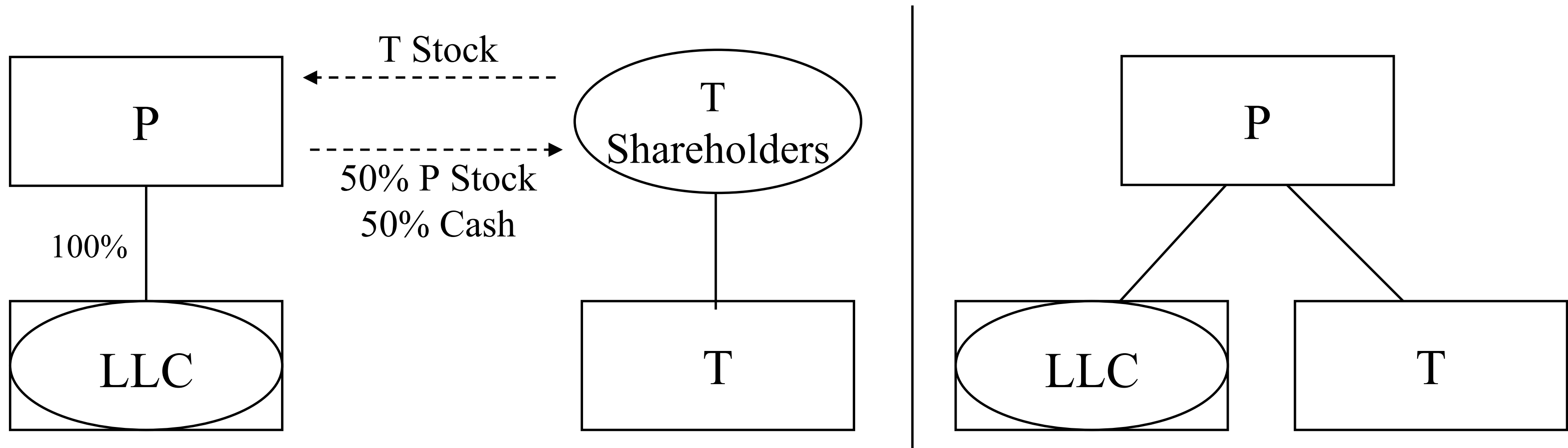


Facts: Same facts as Example 4, except that P holds its interests in LLC_1 and LLC_2 through LLC_3, a wholly owned foreign entity that P has elected to treat as a disregarded entity for Federal tax purposes, and LLC_1 does not subsequently transfer T's assets and liabilities to LLC_2.

Analysis: Does this transaction qualify as a tax-free statutory merger? Under recently proposed regulations, which would eliminate Temp. Treas. Reg. § 1.368-2T(b)(1)(iii), this transaction should qualify as an "A" reorganization. See Preamble to Prop. Treas. Reg. § 1.368-2(b)(1).

Proposed Section 368 Regulations

Example 6: Step Transaction Issues



Facts: P and T are domestic corporations. P owns all of the interests in LLC, a domestic limited liability company that is disregarded for federal tax purposes. T's shareholders transfer their T stock to P in exchange for 50% P stock and 50% cash. Immediately after the acquisition, T engages in one of the following alternative transactions.

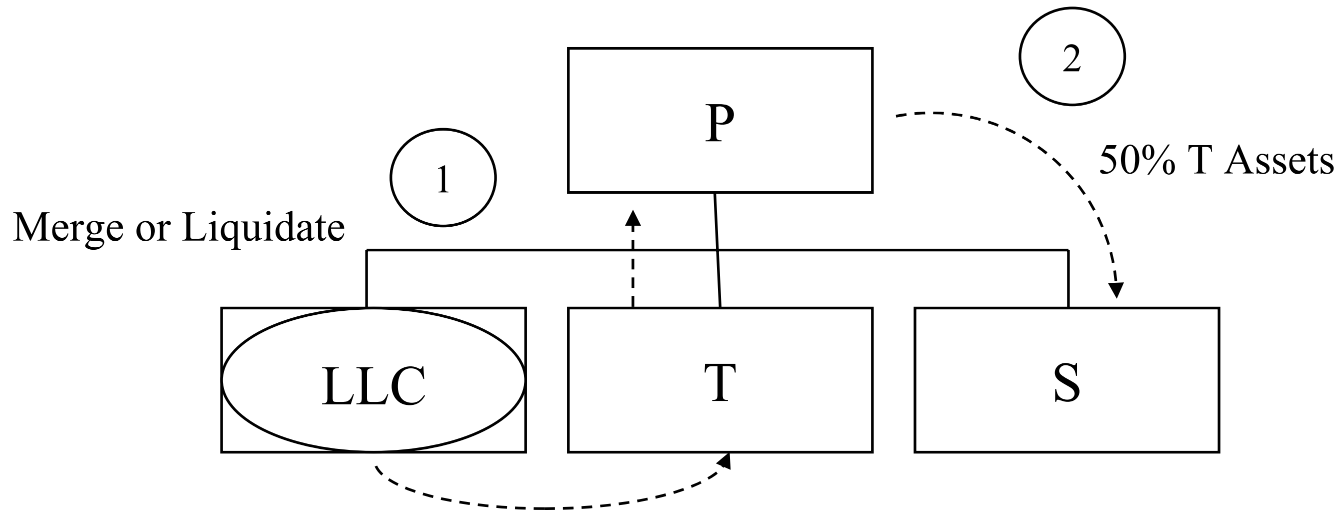
Alternatives:

1. T merges into P.
2. T merges into LLC.
3. T files a form in Delaware to become an LLC.
4. T liquidates into P.

Result: Under the temporary and proposed regulations, alternatives 1 and 2 should be treated as if T merged into P in a tax-free A reorganization. *See King Enterprises, Inc. v. United States*, 418 F. 2d 511 (Ct. Cl. 1969); Rev. Rul. 2001-46, 2001-42 I.R.B. 321; P.L.R. 9539018 (June 30, 1995). Alternative 4 should be treated as a qualified stock purchase followed by a section 332 liquidation. *See* Rev. Rul. 95-95, 1990-2 CB 67. If Alternative 3 satisfies the definition of statutory merger or consolidation in the regulations, it should be treated the same as Alternatives 1 and 2; if not, it should be treated the same as Alternative 4.

Proposed Section 368 Regulations

Example 7: Revenue Ruling 69-617 Variation



Facts: P, T, and S are domestic corporations. P owns all of the stock of T and S and all of the interests in LLC, a domestic limited liability company that is disregarded for federal tax purposes. T engages in one of the following alternative transactions and immediately thereafter, P contributes half of T's assets to S.

Alternatives:

1. T merges into P.
2. T merges into LLC.
3. T files a form in Delaware to become an LLC.
4. T liquidates into P.

Result: Under the temporary and proposed regulations, alternatives 1 and 2 should be treated as if T merged into P in a tax-free A reorganization, followed by a drop of assets under section 368(a)(2)(C). *See* Rev. Rul. 69-617, 1969-2 CB 57; P.L.R. 9422057 (Mar. 11, 1994); P.L.R. 9222059 (Jun. 13, 1991); P.L.R. 8710067 (Dec. 10, 1986). Alternative 4 should be viewed as an upstream C reorganization, followed by a section 368(a)(2)(C) drop. *See* Treas. Reg. Section 1.368-2(d)(4). If Alternative 3 satisfies the definition of statutory merger or consolidation in the regulations, it should be treated the same as Alternatives 1 and 2; if not, it should be treated the same as Alternative 4.

Section 355(e) and Predecessor/Successor Proposed Regulations

Section 355(e)

Section 355(e)

In General

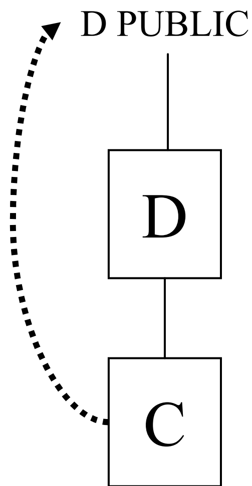
- Section 355(e) imposes a corporate-level tax on any distribution (i) to which section 355 (or so much of section 356 as relates to section 355) applies, and (ii) that is part of a "plan (or series of related transactions)" pursuant to which 1 or more persons acquire directly or indirectly stock representing a 50-percent or greater interest in the distributing corporation or any controlled corporation.

- A plan is presumed to exist with respect to an acquisition that occurs during the four-year period beginning two years before and ending two years after the distribution.

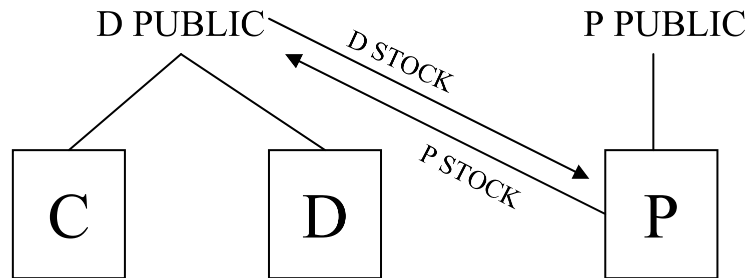
Section 355(e)

Basic Morris Trust Structure

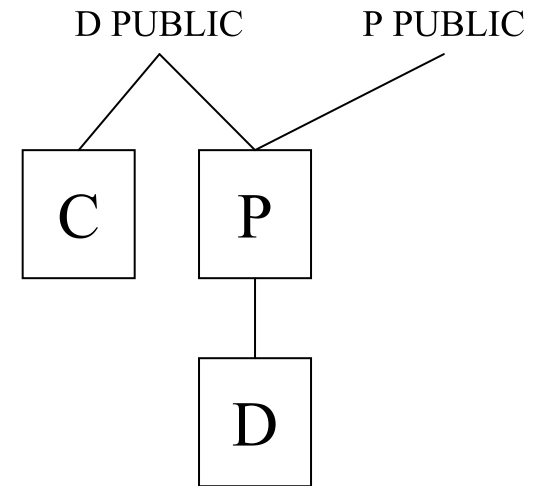
1.



2.



3.

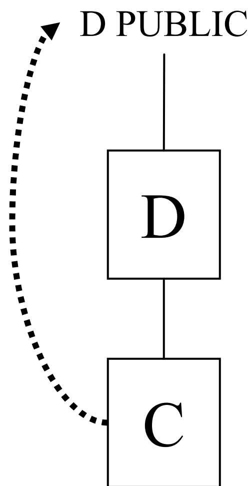


Facts: A publicly traded corporation ("D") owns all the stock of a controlled corporation ("C"). D has an adjusted basis in its C stock of $100, and the fair market value of its C stock is $150. In order to facilitate an acquisition of D by a third corporation ("P"), D distributes its C stock to its shareholders. Within two years, P acquires all the stock of D in a section 368(a)(1)(B) reorganization.

Section 355(e)

Section 355(e) Applies

1.



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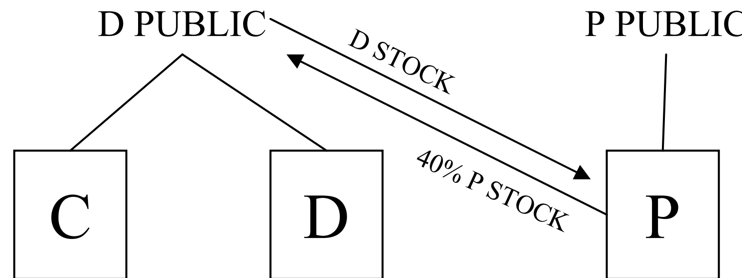

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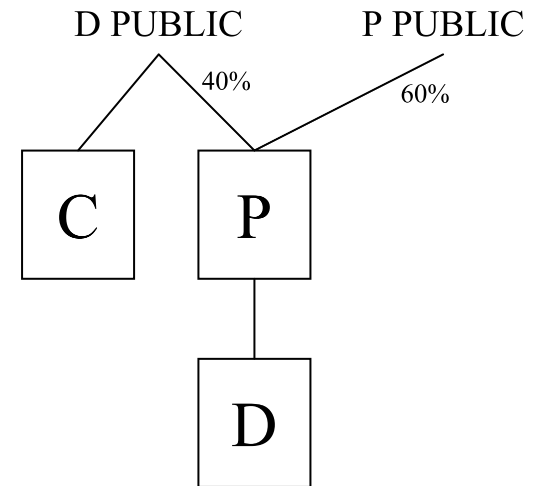
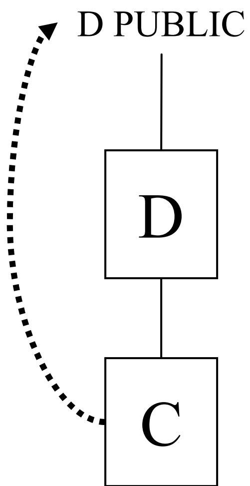


Facts: Same facts as in the previous example, but assume further that in the B reorganization the shareholders of D receive 40 percent of the stock of P in exchange for their D stock.

Section 355(e)

Section 355(e) Inapplicable

1.



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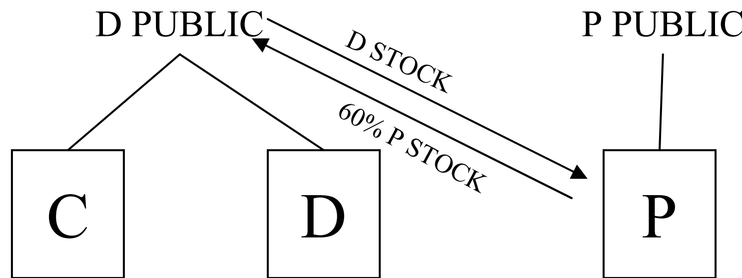
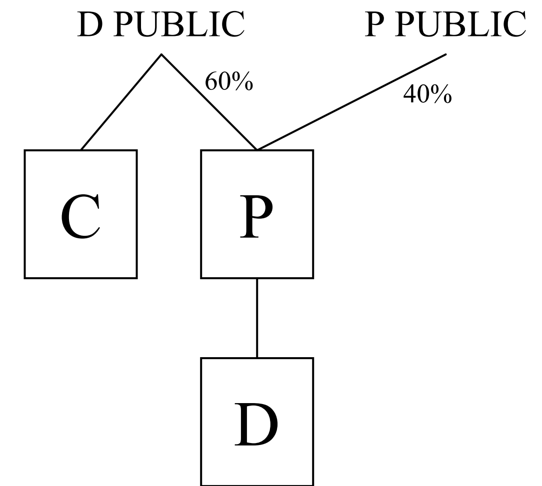


3.



Facts: Same facts as the previous example, except that in the B reorganization, the shareholders of D receive 60 percent of the stock of P in exchange for their D shares.

Final Section 355(e) Regulations
In General

- On April 19, 2005, the IRS issued final regulations under section 355(e), which provide guidance on the definition of "plan (or series of related transactions)."

- Brief History of Plan Regulations:

  - First proposed regulations issued August 24, 1999 – withdrawn January 2, 2001.

  - Second set of proposed regulations issued January 2, 2001.

  - First temporary regulations issued August 3, 2001 ("2001 Temporary Regulations).

  - Proposed and temporary regulations withdrawn April 26, 2002.

  - New proposed and temporary issued April 26, 2002 ("2002 Temporary Regulations").

  - Final regulations issued April 19, 2005 ("Final Regulations").

Final Regulations
Effective Date

- The Final Regulations apply to distributions occurring after April 19, 2005.

- Distributions on or prior to April 19, 2005

  - If the distribution occurs after April 26, 2002 but on or before April 19, 2005, the taxpayer can elect to apply the Final Regulations in whole, but not it part, in lieu of applying the 2002 Temporary Regulations.
  - If the distribution occurs after August 3, 2001 but on or before April 26, 2002, the taxpayer can elect to apply the Final Regulations or the 2002 Temporary Regulations in whole, but not in part, in lieu of applying the 2001 Temporary Regulations.
  - If the distribution occurs after April 1, 2002 but on or before August 3, 2001, the taxpayer can elect to apply the Final Regulations or the 2002 Temporary Regulations.

Final Section 355(e) Regulations
Super Safe Harbor

Treas. Reg. § 1.355-7(b)(2) provides that:

> In the case of an acquisition (other than a public offering) after the distribution, the distribution and the acquisition can be part of a plan *ONLY IF* there was an agreement, understanding, arrangement, or substantial negotiations regarding the acquisition or a similar acquisition at some time during the 2-year period ending on the date of the distribution.

Final Section 355(e) Regulations

Safe Harbors

- **Safe Harbor I (Non-acquisition Business Purpose) -** Acquisition occurring after a distribution is not part of a plan if (a) the distribution was motivated (in whole or in substantial part) by a corporate business purpose other than to facilitate an acquisition *of the acquired corporation*, and (b) the acquisition occurs more than 6 months after the distribution and there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition *or a similar acquisition* during a period *beginning 1 year before the distribution* and ending 6 months after the distribution.
- **Safe Harbor II (Acquisition Business Purpose) -** Acquisition occurring after a distribution is not part of a plan if (a) the distribution was not motivated by business purpose to facilitate the acquisition *or a similar acquisition*, (b) the acquisition occurs more than 6 months after the distribution and there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition *or a similar acquisition* during a period *beginning 1 year before the distribution* and ending 6 months after the distribution, and (c) no more than *25 percent* of acquired corporation stock was either acquired or subject to an agreement* for 1 year prior to and 6 months after distribution. Acquisitions excluded from a plan under Safe Harbors VII, VIII, or IX are disregarded.
- **Safe Harbor III (Acquisitions More Than One Year After) -** Acquisition occurring after a distribution is not part of a plan if there was no agreement, understanding, or arrangement concerning the acquisition at the time of the distribution and there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition within 1 year after the distribution.

Final Section 355(e) Regulations
Safe Harbors (Continued)

- **Safe Harbor IV (Acquisitions More Than Two Years After) –** Acquisition (other than involving a public offering) occurring prior to a distribution is not part of plan if the acquisition occurs before the date of the first disclosure event regarding the distribution.
  - Safe Harbor IV does not apply if the acquirer (or a coordinating group in which acquirer is a member) is a controlling shareholder or a ten-percent shareholder of the acquired corporation (Distributing or Controlled) at any time during the period beginning immediately after the acquisition and ending on the date of distribution.
  - Safe Harbor IV does not apply if the acquisition occurs in connection with a transaction in which the aggregate acquisitions are of stock possessing 20 percent or more of the vote or value of the stock of the acquired corporation (Distributing or Controlled).
- **Safe Harbor V (Pro Rata Distribution)** – Acquisition (other than involving a public offering) of Distributing stock occurring prior to a pro rata distribution if (a) the acquisition occurs after the date of a public announcement regarding the distribution AND (b) there were no discussions by Distributing or Controlled with the acquirer regarding a distribution on or before a public announcement regarding the distribution. Safe Harbor V is subject to the same conditions as Safe Harbor IV.

Final Section 355(e) Regulations
Safe Harbors (Continued)

- **Safe Harbor VI (Certain Public Offerings) -** Acquisition involving a public offering occurring prior to a distribution is not part of a plan if the acquisition occurs before the date of the first disclosure event regarding the distribution if the stock acquired is not listed on an established securities market (a) immediately after the acquisition or, if so, (b) before the date of the first public announcement regarding the distribution.
- **Safe Harbor VII (Public Trading)** - Acquisition of target stock listed on established market is not part of a plan if immediately before or after the transfer neither the transferor, the transferee, nor any coordinating group of which the transferor or transferee is a member is (a) the acquired corporation (Distributing or Controlled), (b) a corporation that is controlled (under section 368(c)) by the acquired corporation, (c) a member of a controlled group of corporations (under section 1563) of which the acquired corporation is a member, or (e) a controlling shareholder of the acquired corporation, or (f) a 10-percent shareholder of the acquired corporation.
  - Safe Harbor VII does not apply if the acquired corporation knows, or has reason to know, that the transferor or transferee intends to become a controlling shareholder or a 10-percent shareholder at anytime after the acquisition and before the date that is 2 years after the distribution.
  - Safe Harbor VII also does not apply to an indirect acquisition of voting power by a person other than the transferee that occurs by reason of the transfer.

Final Section 355(e) Regulations
Safe Harbors (Continued)

- **Safe Harbor VIII (Compensatory Stock Arrangements)** - Acquisition (to which section 83 or sections 421(a) or (b) applies) of stock by employees, directors, or independent contractors in connection with such person's performance of services for (a) Distributing, (b) Controlled, (c) a related person, (d) a corporation the assets of which Distributing, Controlled, or a related person are acquired in a tax-free reorganization, or (e) a corporation that acquires the assets of Distributing or Controlled in a tax-free asset reorganization. A related person is defined under section 355(d)(7)(A).
  - Safe Harbor VIII does not apply if the acquirer (or a coordinated group of which the acquirer is a member) is either a controlling shareholder or a 10-percent shareholder of the acquired corporation immediately after the acquisition.
- **Safe Harbor IX (Acquisition By Qualified Plans) -** Acquisition by a retirement plan of Distributing or Controlled (or any other person that is treated as the same employer as Distributing or Controlled under section 414(b), (c), (m) or (o)) that qualifies under section 401(a) or 403(a) will not be considered part of a plan.
  - Safe Harbor IX does not apply to the extent that the stock acquired during the four year period beginning 2 years before the distribution, in the aggregate, represents 10% or more of the vote or value of the acquired corporation.

Final Section 355(e) Regulations
Factors (Plan v. Non-Plan)

Factors Evidencing Plan:

Factors 1 and 2 involve Post-Distribution Acquisitions -

- Non-public offering - Agreement* during 2-year period before the distribution between D or C and the acquirer regarding the acquisition or a similar acquisition.
- Public offering - Discussions during 2-year period before the distribution between D or C and an investment banker regarding the acquisition or a similar acquisition.

Factors 3 and 4 involve Pre-Distribution Acquisitions -

- Non-public offering - Discussions during 2-year period before the acquisition regarding a distribution between D or C and the acquirer, *or* a person who intends to cause a distribution can meaningfully participate in the distribution decision as a result of the acquisition.
- Public offering - Discussions during 2-year period before the acquisition between D or C and an investment banker regarding a distribution.

Factor 5 involves Pre- and Post-Distribution Acquisitions -

- The distribution was motivated by a business purpose to facilitate the acquisition or a similar acquisition.

* The term "agreement" as used here includes an understanding, arrangement, or substantial negotiations.

Factors Evidencing Non-Plan:

Factors 1 and 2 involve Post-Distribution Acquisitions -

- Public offering – No discussions between D or C and an investment banker during 2-year period before the distribution regarding the acquisition or a similar acquisition.
- There was an identifiable, unexpected change in market or business conditions occurring after the distribution resulting in unexpected acquisition.

Factors 3 and 4 involve Pre-Distribution Acquisitions -

- Non-public offering - No discussions during 2-year period before the acquisition between D or C and the acquirer regarding a distribution (*unless* acquisition occurs after pubic announcement of distribution, or a person other than D or C who intends to cause a distribution can meaningfully participate in the distribution decision as a result of the acquisition).
- There was an identifiable, unexpected change in market or business conditions occurring after the acquisition resulting in unexpected distribution.

Factors 5 and 6 involve Pre- and Post-Distribution Acquisitions -

- The distribution was substantially motivated by a business purpose (within the meaning of § 1.355-2(b)) other than to facilitate the acquisition or a similar acquisition of D or C.
- The distribution would have occurred at about the same time and in similar form regardless of acquisition or a similar acquisition.

Final Section 355(e) Regulations
Operating Rules

- **Internal and Outside Advisor Discussions Rule** – Internal discussions and discussions with outside advisors by or on behalf of the officers or directors of Distributing or Controlled may be indicative of one or more business purposes for the distribution and the relative importance of such purposes.

- **Hostile Takeover Rule** – Distributions intending (in whole or substantial part) to decrease the likelihood of the takeover of either Distributing or Controlled ("the save me take him" purpose), will be treated as a business purpose to facilitate the acquisition, if Distributing engages in discussions with a potential acquirer regarding an acquisition of Distributing or Controlled.

- **Public Trading Rule** – Fact that distribution makes Controlled stock available for trading, or makes Distributing or Controlled stock trade more actively, is not taken into account on determining whether an acquisition is part of a plan.

- **Disregard of Section 355(e) Gain Rule** – Consequences of 355(e) and existence of indemnifications from section 355(e) gain are disregarded when determining intentions of parties.

- **Multiple Acquisitions Rule** – All acquisitions of Distributing or Controlled stock that are considered to be part of a plan are aggregated for purposes of the 50% test.

Final Section 355(e) Regulations
Definitions

- **Agreement, Understanding, or Arrangement**
  - Requires an agreement, understanding, or arrangement between either (a) one or more officers, directors, or controlling shareholders of Distributing or Controlled (or someone with the permission of such persons) and the acquirer (or someone with the permission of the acquirer) or (b) an agreement, understanding, or arrangement between an acquirer (or someone with permission of acquirer) that is a controlling shareholder of Distributing or Controlled immediately after the acquisition that is the subject of the agreement and the transferor (or someone with permission of transferor).
  - Neither binding contract, nor agreement on all significant terms is necessary, but binding contract is *per se* showing of agreement, understanding, or arrangement.
  - In the case of a public offering, an agreement, understanding, or arrangement is based upon an discussions with an investment banker.
  - In the case of an acquisition a corporation, an agreement, understanding, or arrangement is based upon an agreement, understanding, or arrangement with one or more officers, directors, or controlling shareholders of acquiring corporation (or someone with permission of such persons).
- **Substantial Negotiations**
  - Requires discussion of *significant economic terms* between either (a) one or more officers, directors, or controlling shareholders of Distributing or Controlled (or someone with the permission of such persons) and the acquirer (or someone with the permission of the acquirer) or (b) an agreement between an acquirer (or someone with permission of acquirer) that is a controlling shareholder of Distributing or Controlled immediately after the acquisition that is the subject of the agreement and the transferor (or someone with permission of transferor).
  - In the case of a public offering, substantial negotiations are based upon discussions with an investment banker.
  - In the case of an acquisition a corporation, substantial negotiations are based upon discussions with one or more officers, directors, or controlling shareholders of acquiring corporation (or someone with permission of such persons).

Final Section 355(e) Regulations
Definitions (Continued)

- **Discussions** – Must involve one or more officers, directors, or controlling shareholders of the entity engaging in the discussions (or someone with the permission of such persons).

- **Similar Acquisition** –
  - In the case of a non-public offering acquisition, an actual acquisition is "similar" to another potential acquisition if both effect a direct or indirect combination of all or a significant portion of the same business operations, and the ultimate owners of the business operations are substantially the same. In the case of a public offering acquisition, differences in the terms of stock, class of stock issued, size of the offering, timing of the offering, price, or participants, have no bearing on whether the acquisition and a potential acquisition are "similar."
  - In the case of a single public offering, an actual acquisition is "similar" to a potential acquisition even though there are changes in the terms of the stock, the class of stock being offered, the size of the offering, the timing of the offering, the price of the stock, or the participants in the offering.
  - In the case of more than one actual public offering, an actual acquisition is "similar" to a potential acquisition if the initial and second actual acquisition involving a public offering is the same as or similar to a potential acquisition and the purposes of the second actual acquisition involving a public offering are similar to the potential acquisition and the second acquisition occurs close in time to the first public offering.

Final Section 355(e) Regulations
Definitions (Continued)

- **Public Offering** – An acquisition of stock for cash where the terms of the acquisition are established by the acquired corporation (Distributing or Controlled) or the seller with the involvement of one or more investment bankers and the potential acquirers have no opportunity to negotiate the terms of the acquisition.

- **Disclosure Event** – Any communication regarding the distribution between an officer, director, shareholder, controlling shareholder, related corporations, or employee of Distributing or Controlled (or an outside advisor of any of those persons) and the acquirer or any other person not described above).

Final Section 355(e) Regulations

2001 Temp. Regs. v. 2002 Temp. Regs. v. 2005 Final Regs.

2001 Temporary Regulations	**2002 Temporary Regulations**	**2005 Final Regulations**
➢ No similar rule	➢ Super Safe Harbor - No plan if no agreement* 2 years before the distribution	➢ Super Safe Harbor – No substantive change
Safe Harbors	Safe Harbors	Safe Harbors
➢ Safe Harbor I required business purpose other than to facilitate an acquisition "of Distributing or Controlled"	➢ Safe Harbor I requires business purpose other than to facilitate an acquisition "of the acquired corporation"	➢ No substantive change
➢ Safe Harbors I and II required no agreement* concerning the acquisition before a date that is 6 months after the distribution	➢ Safe Harbors I and II require no agreement* concerning the acquisition ***or a similar acquisition 1 year before*** and 6 months after the distribution	➢ No substantive change
➢ Safe Harbor II available only if stock subject to acquisition business purpose was not more than 33% and amount actually acquired or subject to an agreement* within 6 months was not more than 20%	➢ Safe Harbor II available only if no more than ***25%*** of the stock of the acquired corporation is acquired or subject to an agreement* ***between 1 year before*** and 6 months after the distribution	➢ No substantive change
➢ Safe Harbor III available only if acquisition more than 2 years out and no agreement* at time of distribution or within 6 months thereafter	➢ Safe Harbor III available only if no agreement, understanding, or arrangement at time of distribution and no agreement* ***within 1 year thereafter***	➢ No substantive change
➢ Safe Harbor IV protected acquisitions more than 2 years before distribution if no agreement* at time of acquisition or 6 months after	➢ No substantive change	➢ Safe Harbor IV available if acquisition (not a public offering) occurs ***prior to first disclosure event***

* The term "agreement" as used here includes an understanding, arrangement, or substantial negotiations.

Final Section 355(e) Regulations
2001 Temp. Regs. v. 2002 Temp. Regs. v. 2005 Final Regs.

2001 Temporary Regulations	2002 Temporary Regulations	2005 Final Regulations
Safe Harbors:	Safe Harbors:	Safe Harbors:
➢ Safe Harbor V protected trading between less than 5% shareholders	➢ Safe Harbor V protects trading between less than 10% shareholders	➢ No substantive change to Safe Harbor V (now Safe Harbor VII)
➢ Safe Harbor V silent as to vote-shifting transactions	➢ Safe Harbor V provides a special rule with respect to vote-shifting transactions	➢ No substantive change
➢ Safe Harbor VI protected stock acquired by employee or director in section 83 transaction with Distributing or Controlled	➢ Safe Harbor VI protects stock acquired by employee, director, ***or independent contractor*** in section 83 ***or section 421(a)*** transaction with Distributing or Controlled	➢ Safe Harbor VI (now Safe Harbor VIII) protects stock acquired by employee, director, or independent contractor in section 83, or section 421(a) ***or (b)*** with Distributing, Controlled, or **a *corporation the assets of which are acquired by Distributing or Controlled in a reorganization***
➢ No similar safe harbor	➢ Safe Harbor VII protects certain acquisition of stock by a retirement plan	➢ No substantive change to Safe Harbor VII (now Safe Harbor IX)
➢ No similar safe harbor	➢ No similar safe harbor	➢ Safe Harbor V protects certain acquisitions of stock before pro rata distributions when public announcement of distribution prior to acquisition or discussions
➢ No similar safe harbor	➢ No similar safe harbor	➢ Safe Harbor VI protects public offering acquisitions before distributions if the acquisition occurs prior to first disclosure event (or public announcement)

Final Section 355(e) Regulations
2001 Temp. Regs. v. 2002 Temp. Regs. v. 2005 Final Regs.

2001 Temporary Regulations

Plan Factors:

- 9 plan factors
- Post-distribution acquisitions (not involving public offerings or auctions) – discussions between D or C and the acquirer or a potential acquirer regarding the acquisition or a similar acquisition
- Pre-distribution acquisitions – discussions between D or C and the acquirer ***or a potential acquirer*** regarding the distribution
- Public offering ***or auction*** – discussions between D or C and investment banker ***or other outside advisor*** regarding acquisition (or, in the case of a pre-distribution offering or auction, discussions regarding the distribution)
- Distribution was motivated by an acquisition business purpose
- Acquisition and distribution occurred within 6 months of each other or there was an agreement* within 6 months
- Debt allocation between D and C made an acquisition likely

2002 Temporary Regulations & 2005 Final Regulations

Plan Factors:

- 5 plan factors
- Post-distribution acquisitions (not involving public offerings) – ***agreement**** regarding the acquisition or a similar acquisition ***during 2-year period before the distribution***
- Pre-distribution acquisitions – discussions between D or C and the acquirer, ***or person who intends to cause a distribution can meaningfully participate in decision to distribute as a result of the acquisition***
- Public offering – discussions between D or C and investment banker regarding acquisition ***or similar acquisition*** (or, in the case of a pre-distribution offering, discussions regarding the distribution)
- No change
- Deleted
- Deleted

* The term "agreement" as used here includes an understanding, arrangement, or substantial negotiations.

Final Section 355(e) Regulations
2001 Temp. Regs. v. 2002 Temp. Regs. v. 2005 Final Regs.

2001 Temporary Regulations

Non-Plan Factors:

- 7 non-plan factors
- Post-distribution acquisition (not involving public offerings or auctions) – no discussions between D or C and acquirer or a potential acquirer regarding the acquisition or similar acquisition
- Pre-distribution acquisition (not involving public offerings or auctions) – no discussions between D or C and acquirer regarding the distribution (N/A where acquisition is after the public announcement)
- Post-distribution public offering ***or auction*** – no discussions between D or C and investment banker ***or other outside advisor*** regarding acquisition
- Distribution was motivated in whole or substantial part by a non-acquisition business purpose
- Identifiable, unexpected change in market or business conditions occurring after the distribution (acquisition) that resulted in the acquisition (distribution)
- Distribution would have occurred at the same time and in similar form regardless of the acquisition or a similar acquisition

2002 Temporary Regulations & 2005 Final Regulations

Non-Plan Factors:

- 6 non-plan factors
- Deleted
- Pre-distribution acquisition (not involving public offerings) – no discussions between D or C and acquirer ***during 2-year period before the acquisition*** (N/A ***where person who intends to cause a distribution can meaningfully participate in decision to distribute as a result of the acquisition)*** *(N/A in 2002 Temp. Regs. where acquisition is after the public announcement).*
- Post-distribution public offerings – no discussions between D or C and investment banker regarding acquisition *or similar acquisition*
- Same, except sentence deleted stating that the presence of an acquisition business purpose is relevant in determining extent motivated by non-acquisition business purpose
- No change
- No change (except to delete the parenthetical including a previously proposed similar acquisition that did not occur)

Final Section 355(e) Regulations

2001 Temp. Regs. v. 2002 Temp. Regs. v. 2005 Final Regs.

2001 Temp. Regulations	2002 Temp. Regulations	2005 Final Regulations
Operating Rules:	Operating Rules:	Operating Rules:
➢ Reasonable certainty is evidence of an acquisition business purpose	➢ Deleted	➢ Same
➢ Reserved on substantial diminution of risk operating rule	➢ Deleted substantial diminution of risk operating rule	➢ Same
Other Rules:	Other Rules:	Other Rules:
➢ Discussions not defined	➢ Discussions defined to require discussions between officers, directors, or controlling shareholders	➢ Same
➢ Substantial negotiations not defined	➢ Substantial negotiations defined to require discussions of significant economic terms	➢ Same
➢ Similar acquisition defined broadly to include different acquirers	➢ Similar acquisition defined more narrowly to include combination of all or a significant portion of the same business operations, and ultimate owners substantially the same	➢ Similar acquisition defined more broadly to include multiple acquisitions involving public offerings that are similar to a public offering
➢ Public offering not defined	➢ Public offering not defined	➢ Public Offering defined to include stock issuances for cash

Final Section 355(e) Regulations

2001 Temp. Regs. v. 2002 Temp. Regs. v. 2005 Final Regs.

2001 Temp. Regulations

Other Rules

- Reserved on Example 7 of proposed regulations (relating to multiple acquisitions)
- Option treated as an agreement on the date of grant, unless taxpayer established that not more likely than not to be exercised as of later of date of grant or date of distribution

2002 Temp. Regulations

Other Rules

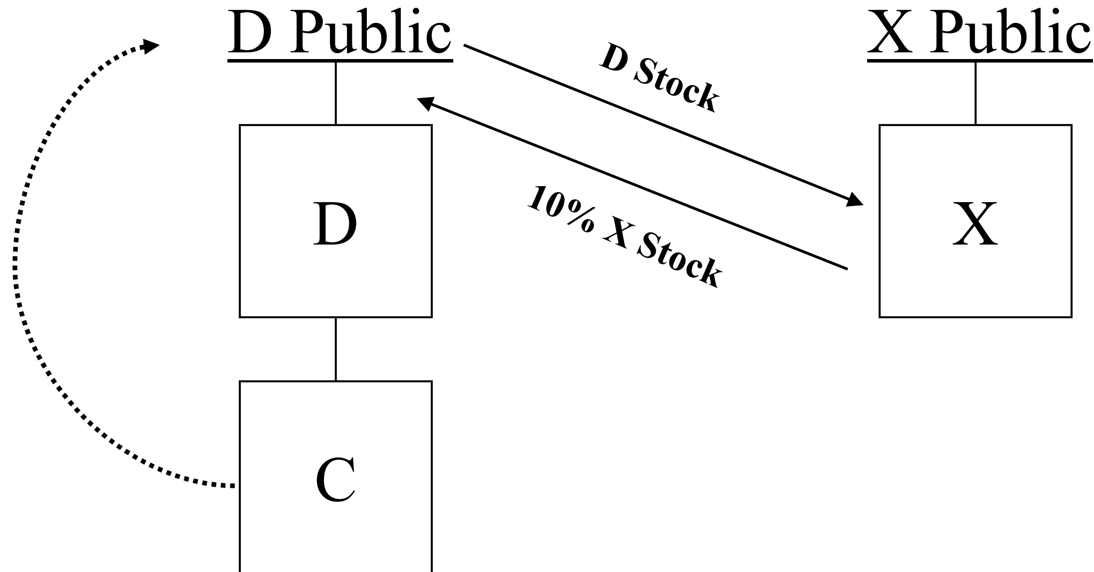
- Deleted Example 7
- Option treated as an agreement, understanding, or arrangement on the earliest of (i) writing, (ii) transfer, or (iii) modification, if it was more likely than not to be exercised on such date

2005 Final Regulations

Other Rules

- Deleted Example 7
- Option treated as an agreement, understanding, or arrangement on the earliest of (i) writing, (ii) transfer, or (iii) modification, if it was more likely than not to be exercised on such date

Final Section 355(e) Regulations
Super Safe Harbor & Safe Harbors I, III

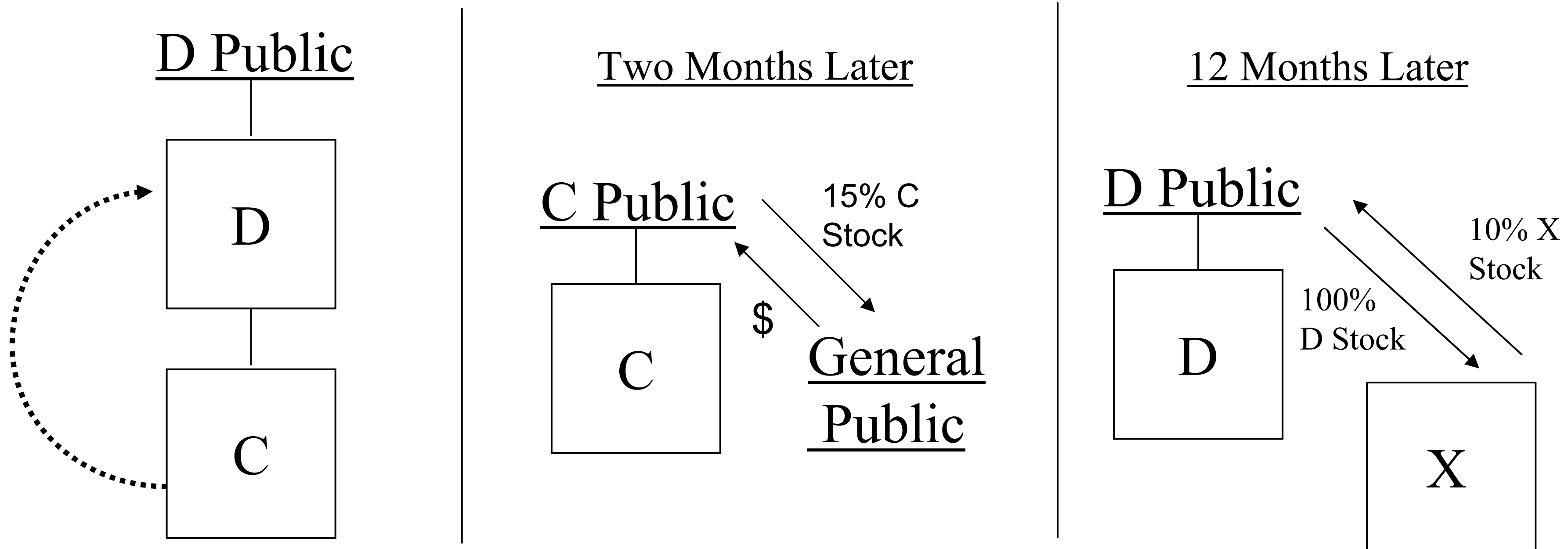


Facts: D and C's purpose for a spin-off of C is that, if D and C are separated, their combined interest costs can be reduced. D spins off C. Negotiations between D and X begin 8 months after the spin-off, and 12 months after the spin-off X acquires all the stock of D for 10% of the stock of X.

Does the Super Safe Harbor apply? Is Safe Harbor I available? Is Safe Harbor III available? Does the result change if D has as an additional purpose the idea of facilitating a possible acquisition of D or C by X? By Y? Does the result change if substantial negotiations between D and X occurred 6 months before the spin-off, broke down 2 weeks prior to the distribution, then resumed 8 months after the spin-off? Thirteen months after the spin-off?

Final Section 355(e) Regulations

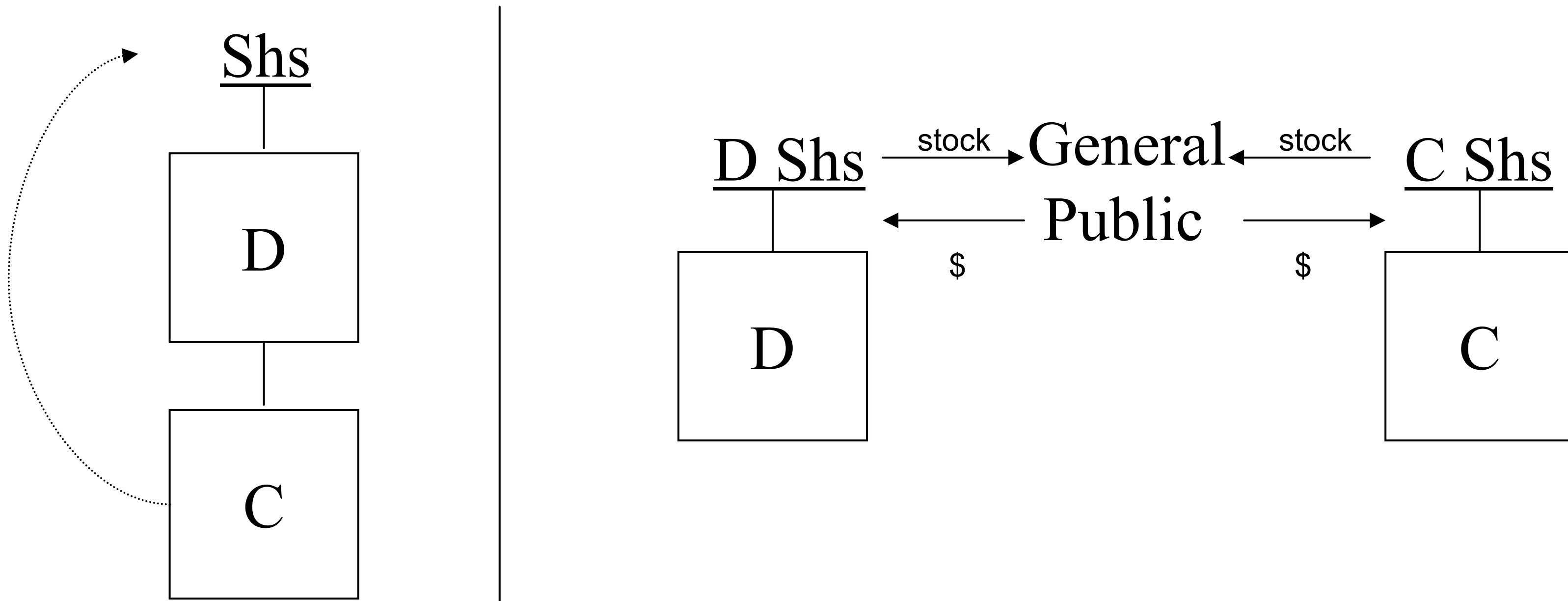
Safe Harbor II



Facts: D and C's purpose for a spin-off of C is to allow C to finance expansion of its distribution network by issuing 15% new stock in an IPO. D spins off C. As planned, 2 months after the spin-off C issues 15% of its stock in an IPO. Negotiations between D and X begin 8 months after the spin-off, and 12 months after the spin-off X acquires all the stock of D for 10% of the stock of X.

Does Safe Harbor II apply to the IPO by C? Does Safe Harbor II apply to the acquisition of D by X? Does Treas. Reg. § 1.355-7(b)(2) or Safe Harbor I or III apply? Does the result change if C issues 30% of its stock in the IPO?

Final Section 355(e) Regulations
Safe Harbor VII – Public Trading

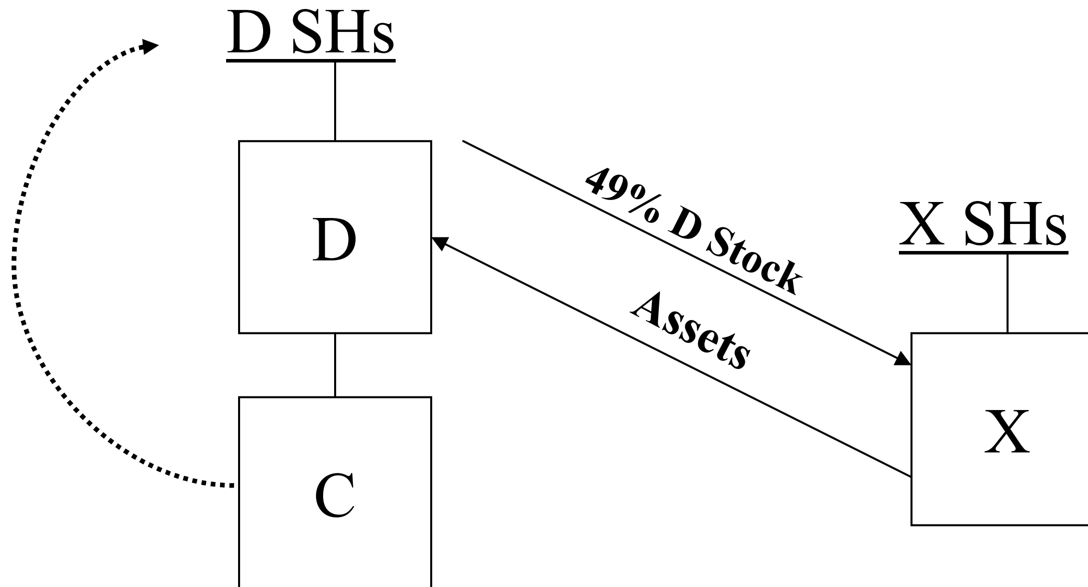


General Rule: Acquisition of target stock listed on an established market is not part of a plan if immediately before or after the transfer neither the transferor, the transferee, nor any coordinated group of which the transferor or transferee is a member is:

(1) the acquired corporation (Distributing or Controlled);
(2) a corporation that is controlled (under section 368(c)) by the acquired corporation;
(3) a member of a controlled group of corporations (under section 1563) of which the acquired corporation is a member;
(4) an underwriter for the acquisition;
(5) a controlling shareholder of the acquired corporation; or
(6) a 10-percent shareholder of the acquired corporation.

Final Section 355(e) Regulations

Safe Harbor VIII - Options

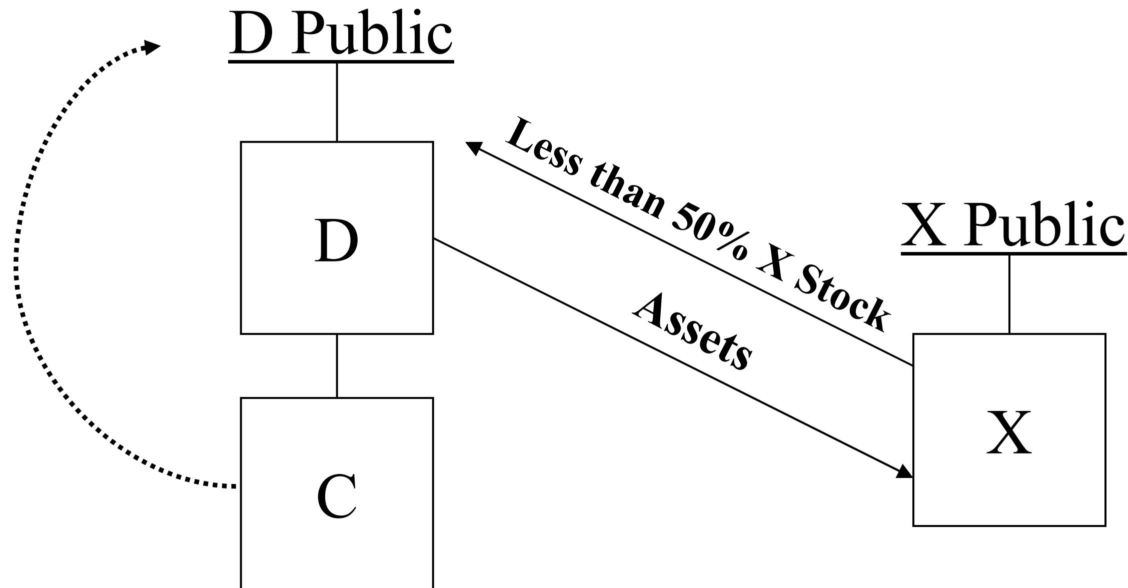


Facts: D spins-off C stock and, on the same day, X merges into D pursuant to an agreement entered into within 1 year of the distribution. The X shareholders receive 49% of the D stock after the merger. Prior to the distribution, both D and X had outstanding options issued to employees and directors in connection with their performance of services. In connection with the merger, X options are converted into D options, and within 6 months after the distribution former employees of X exercise their options and receive D stock. If such options had been exercised prior to the merger, X shareholders would have received 50% of the D stock.

Does Safe Harbor VIII apply to the acquisition of D stock by the former X employees? Does it make a difference if the X employees exercised their options for X stock prior to the merger?

Final Section 355(e) Regulations

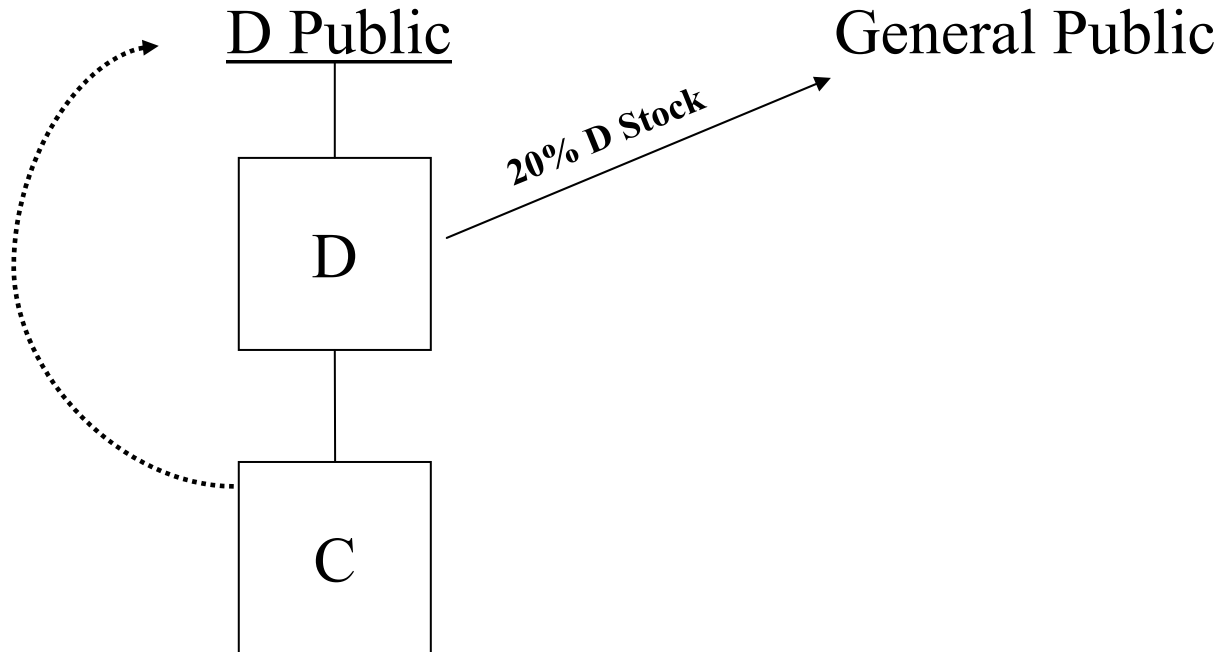
Morris Trust Transaction



Facts: D wishes to combine with X, but X does not want to acquire C. D and X enter into and agreement for D to merge into X, subject to D's spin-off of C and other conditions. One month after the agreement, D spins off C and, on the same day, D merges into X. The D shareholders own less than 50% of the X stock after the merger.

Are the spin-off and the acquisition of D by X parts of a "plan (or series of related transactions)" within the meaning of section 355(e)? See Treas. Reg. § 1.355-7(j), Ex. 1.

Final Section 355(e) Regulations
Public Offering

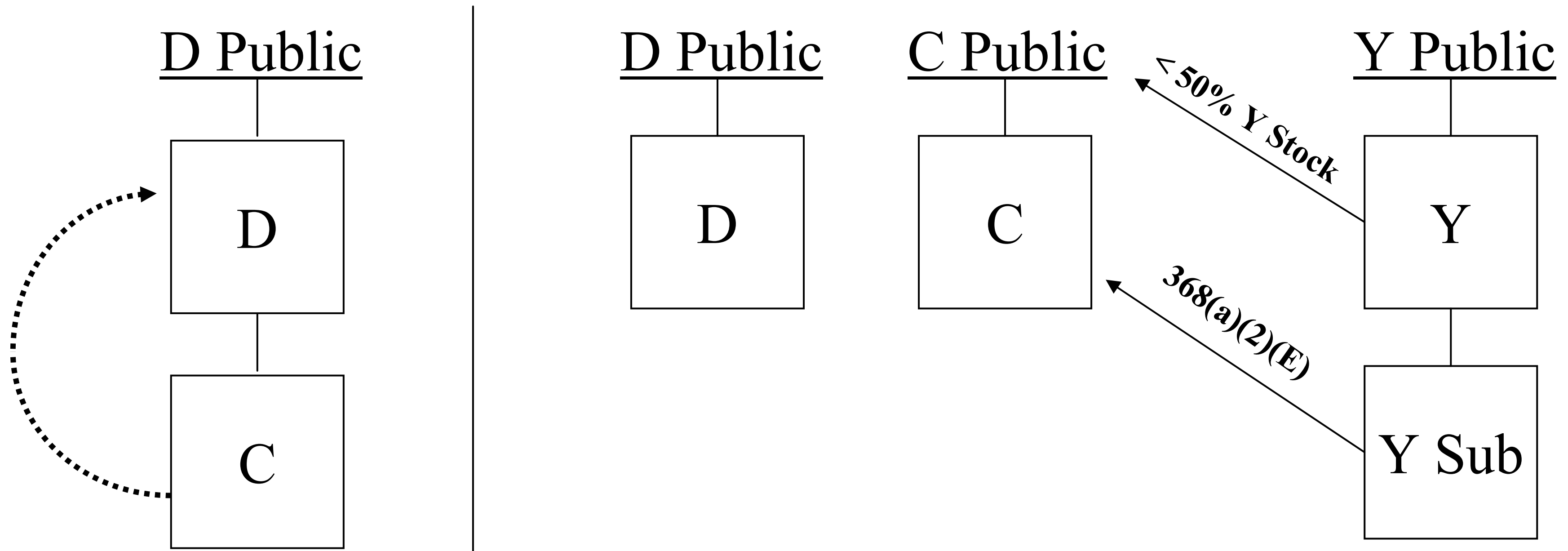


Facts: D discusses the possibility of a public offering of 20% of the D stock with an investment banker. It is decided that D should be a stand alone company when the public offering occurs. One month later, D spins off C pro rata to the D shareholders in order to facilitate the stock offering of 20% of the D stock. The public offering of D stock occurs 7 months after the spin-off of C.

Are the spin-off and the public offering parts of a "plan (or series of related transactions)" within the meaning of section 355(e)? See Treas. Reg. § 1.355-7(j), Ex. 2.

Final Section 355(e) Regulations

Hot Market

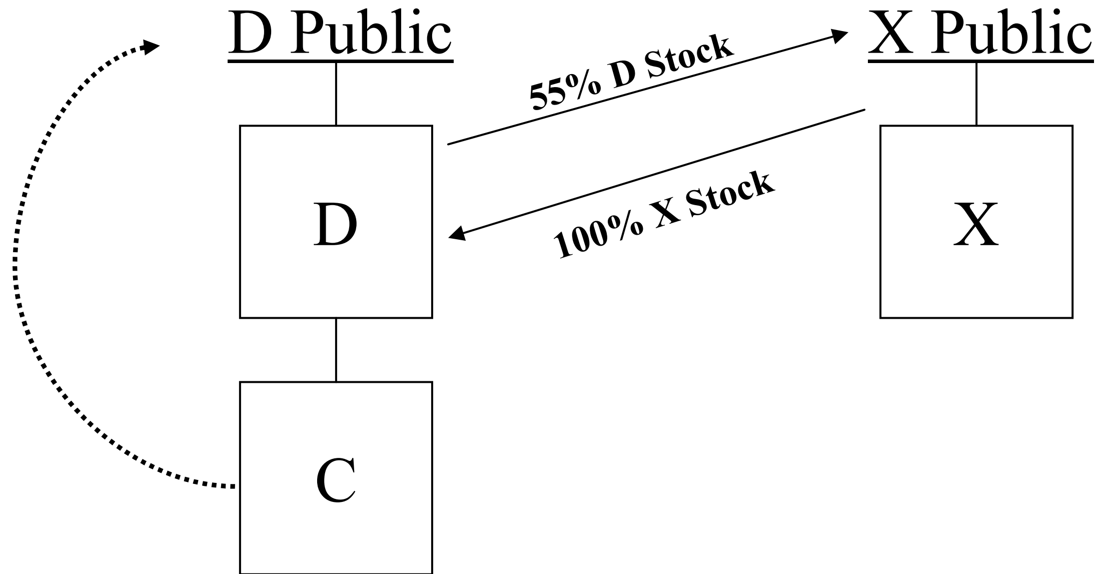


Facts: D, whose stock is widely held and listed on an established market, announces that it will spin off C pro rata to its shareholders. The spin-off is motivated by D's desire to improve its financing options. Although neither D nor C has been approached about an acquisition of C, at the time of the spin-off, it is reasonably certain that C will be acquired. Less than 6 months after the spin-off, Y acquires C in a merger qualifying under section 368(a)(2)(E). The C shareholders receive less than 50% of the Y stock as a result of the merger.

Are the distribution of C and the acquisition of C by Y parts of a "plan (or series of related transactions)" within the meaning of section 355(e)? See Treas. Reg. § 1.355-7(j), Ex. 3. Does the result change if either D or C had negotiated with Y regarding the acquisition of C prior to the spin-off?

Final Section 355(e) Regulations

Unexpected Opportunity

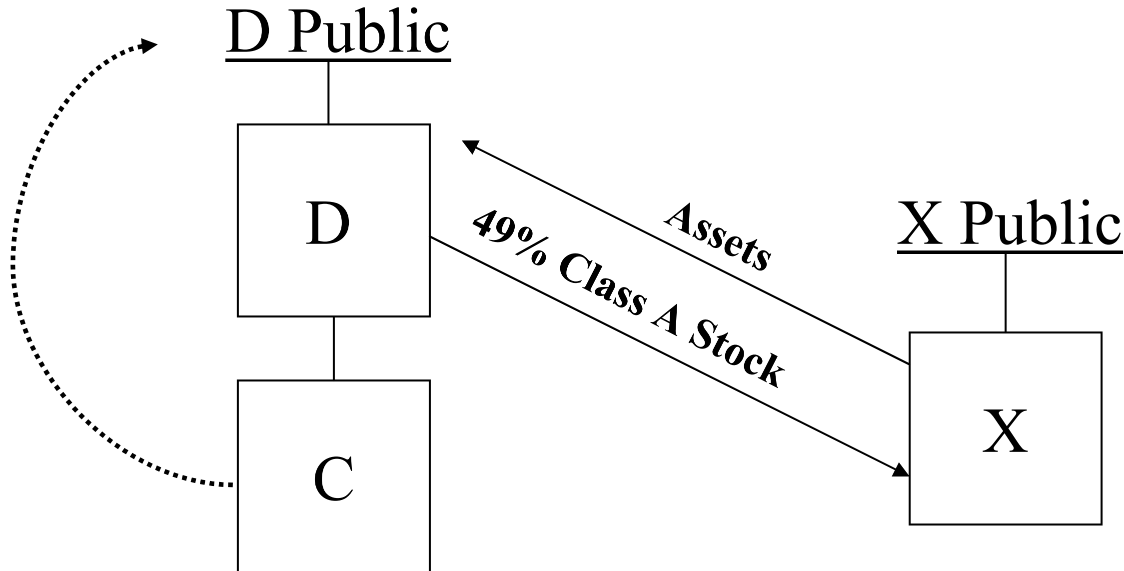


Facts: D, whose stock is widely held and listed on an established market, announces that it will spin off C pro rata to its shareholders. The spin-off is motivated by a bona fide business purpose other than to facilitate an acquisition. After the announcement, but before the spin-off, widely-held X becomes available as an acquisition target. There were no discussions between D or C and X prior to the announcement. D acquires X prior to the spin-off of C. After the acquisition, the X shareholders own 55% of D.

Are the acquisition of X by D and the spin-off of C parts of a "plan (or series of related transactions)" within the meaning of section 355(e)? See Treas. Reg. § 1.355-7(j), Ex. 4. Does the result change if C is spun-off prior to the acquisition of X? Does the result change if X is acquired before the announcement?

Final Section 355(e) Regulations

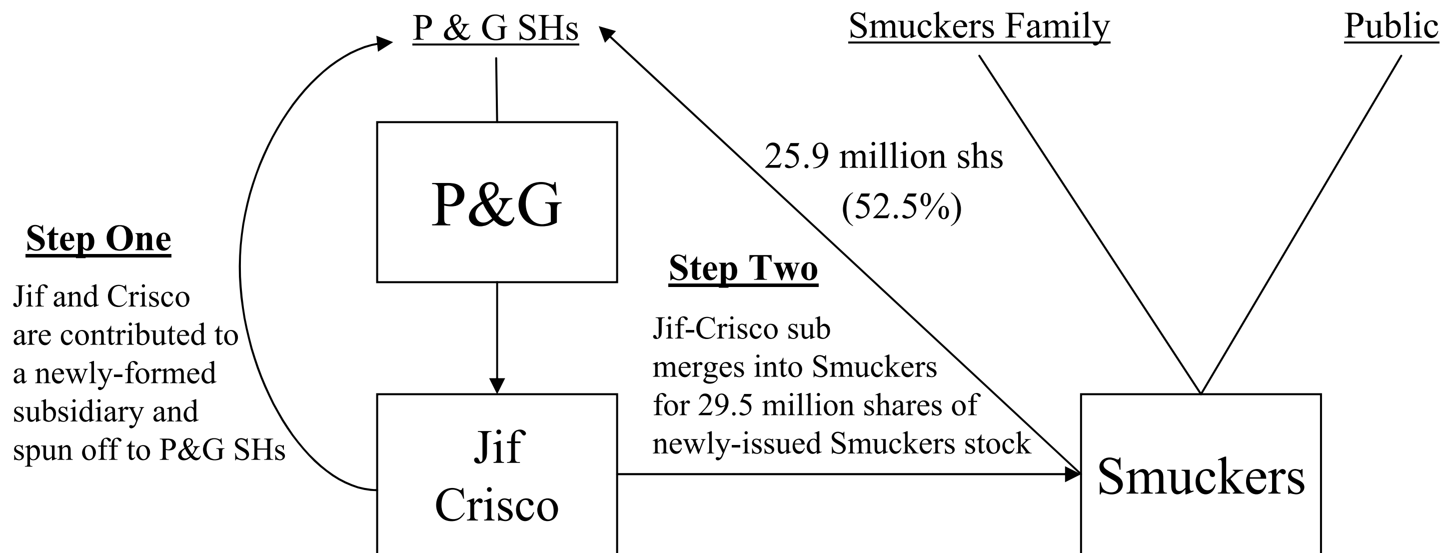
Vote Shifting Transaction



Facts: D wishes to acquire X, but X's shareholders do not want to acquire an indirect interest in C, so D agrees to spin off C to facilitate the acquisition of X. The merger agreement between D and X provides that D will amend its corporate charter to provide for two classes of stock - Class A and Class B, both with 10 votes in the election of D directors. A disposition of Class B shares by an original shareholder will result in such shares having only 1 vote. One day before the merger, D spins off C. In the merger, D shareholders exchange their D stock for Class B stock, which constitutes 51% of the voting power of D, and X shareholders exchange their X stock for Class A stock. Within 30 days of the merger, some D shareholders sell their class B stock, but no former X shareholders sell their Class A stock. As a result, within 30 days of the merger, former X shareholders hold 52% of the voting power of D.

Are the spin-off of C and the merger of X into D parts of a "plan (or series of related transactions)" within the meaning of section 355(e)? Is the public trading of the Class B shares part of a plan? See Treas. Reg. § 1.355-7(j), Ex. 5. What if the public trading was primarily by a family of mutual funds that owned 10% of the D stock?

Final Section 355(e) Regulations
Smuckers Acquisition of Jif/Crisco

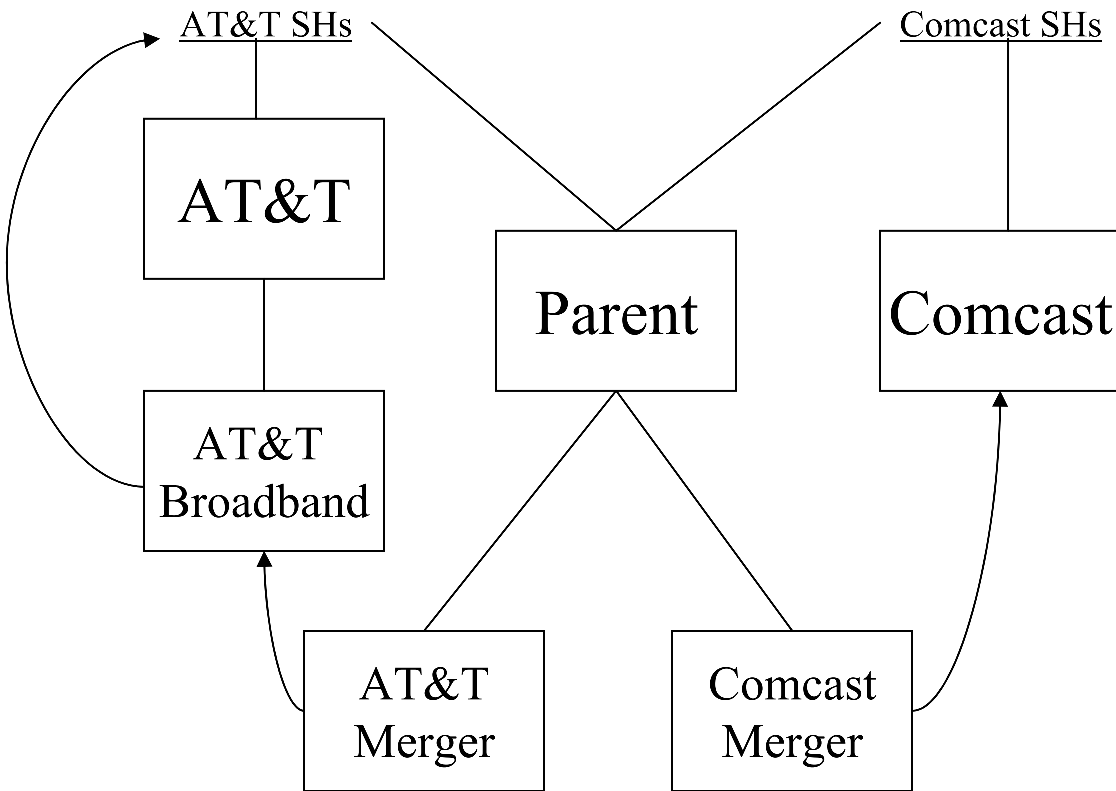


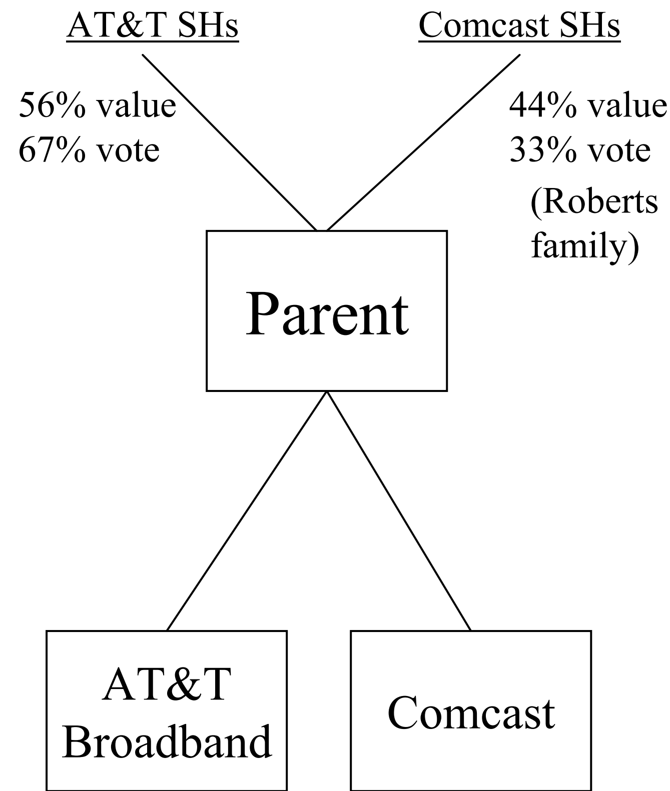
Facts: Pursuant to an agreement between P&G and Smuckers, P&G contributed its Jif and Crisco brands to a newly-formed subsidiary, Jif-Crisco, and Jif-Crisco was spun off to P&G SHs. Jif-Crisco merged into Smuckers in exchange for 29.5 million newly-issued shares of Smuckers stock, which were distributed to P&G SHs. The terms of the Smuckers shares issued in the merger provide for 10 votes per share, except that if they are sold, each share will have one vote with respect to extraordinary events, such as selling the company, unless the stock is held for more than four years, in which case it will increase to 10 votes.

Result: The distribution of Jif-Crisco and the merger of Jif-Crisco into Smuckers should be considered part of a plan. See Treas. Reg. § 1.355-7(b)(3)(i) (agreement within 2 years of distribution), (b)(3)(v) (business purpose to facilitate the acquisition). However, section 355(e) does not apply immediately after the merger because P&G SHs obtained 52.5% voting control of Smuckers. Does the result change if, as expected, P&G SHs sell their shares after the merger? See Treas. Reg. § 1.355-7(d)(7)(i), (ii)(B); P.L.R. 200234044.

Final Section 355(e) Regulations

Comcast Merger with AT&T Broadband





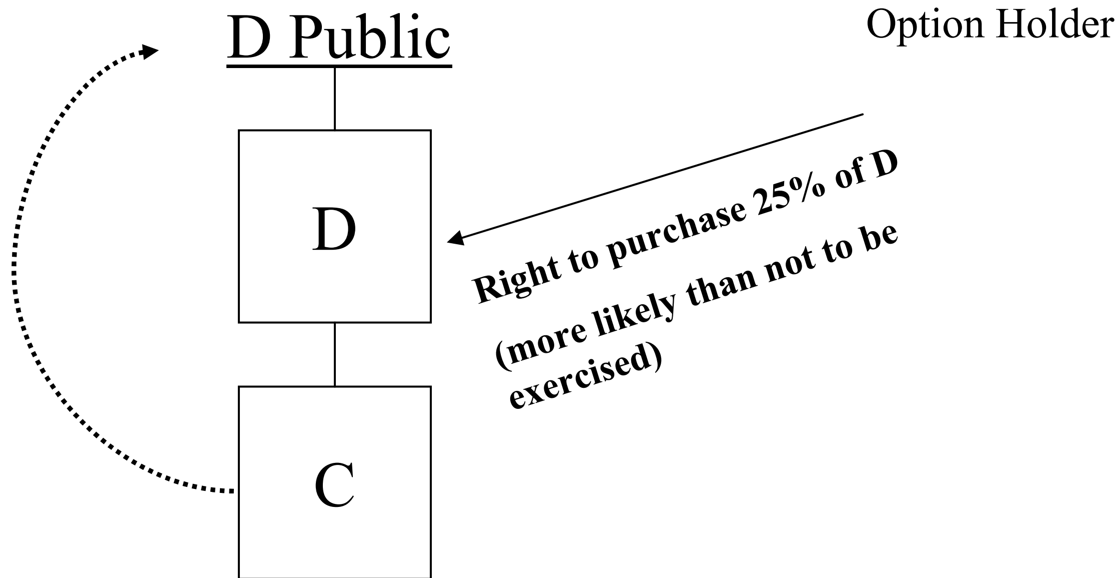
Facts

1. AT&T spins off AT&T Broadband and AT&T's 25.5% interest in Time Warner to AT&T shareholders
2. Parent corporation is formed with two merger subsidiaries
3. AT&T Merger merges into AT&T Broadband with AT&T Broadband surviving
4. Comcast Merger merges into Comcast with Comcast surviving
5. Steps 2-4 treated as section 351 nontaxable exchanges

Result

1. The spin-off of AT&T Broadband followed by the acquisition AT&T should be considered part of a plan.
2. Section 355(e) should not apply because AT&T shareholders receive more than 50% of Parent. Does the result change if this is a vote shifting transaction?

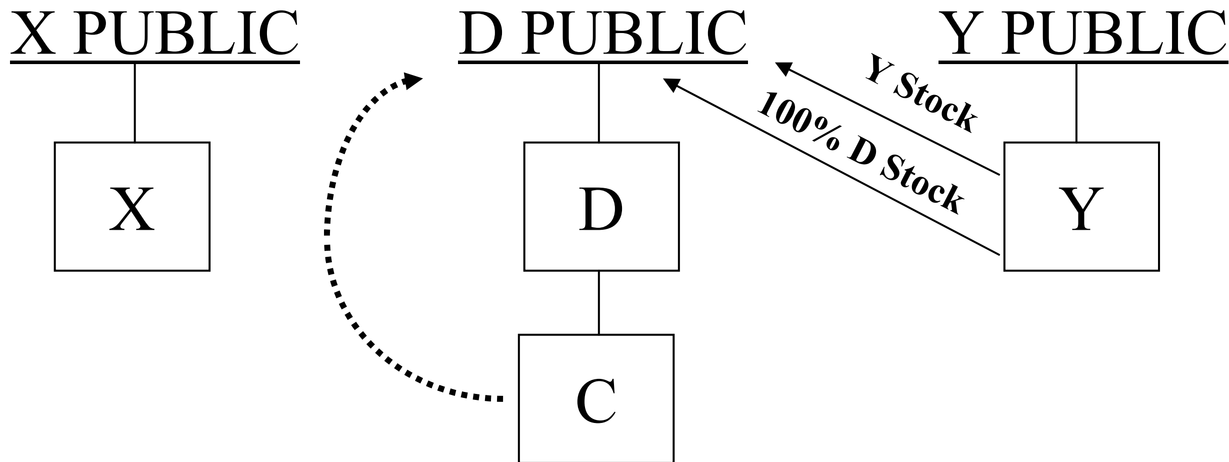
Final Section 355(e) Regulations
Option Rules



Facts: Distributing and Option Holder substantially negotiate for Option Holder to acquire an option to acquire 25% of Distributing. 5 months later, Distributing distributes Controlled for a non-acquisition business purpose. 5 months after the distribution, Distributing and Option Holder enter into an option to allow Option Holder to purchase 25% of Distributing. 3 years after the distribution, Option Holder exercises the option and acquires 25% of Distributing.

Distributing and the Option Holder will be treated as if they substantially negotiated for the acquisition of the Distributing stock within six months before the distribution, thus, Safe Harbors 1 and 2 are unavailable. In addition, because the substantial negotiations occurred before the distribution, Super Safe Harbor is not present. See Temp. Treas. Reg. § 1.355-7(e)(1), (d)(1) and (2), and (b)(2).

Final Section 355(e) Regulations
Similar Acquisition

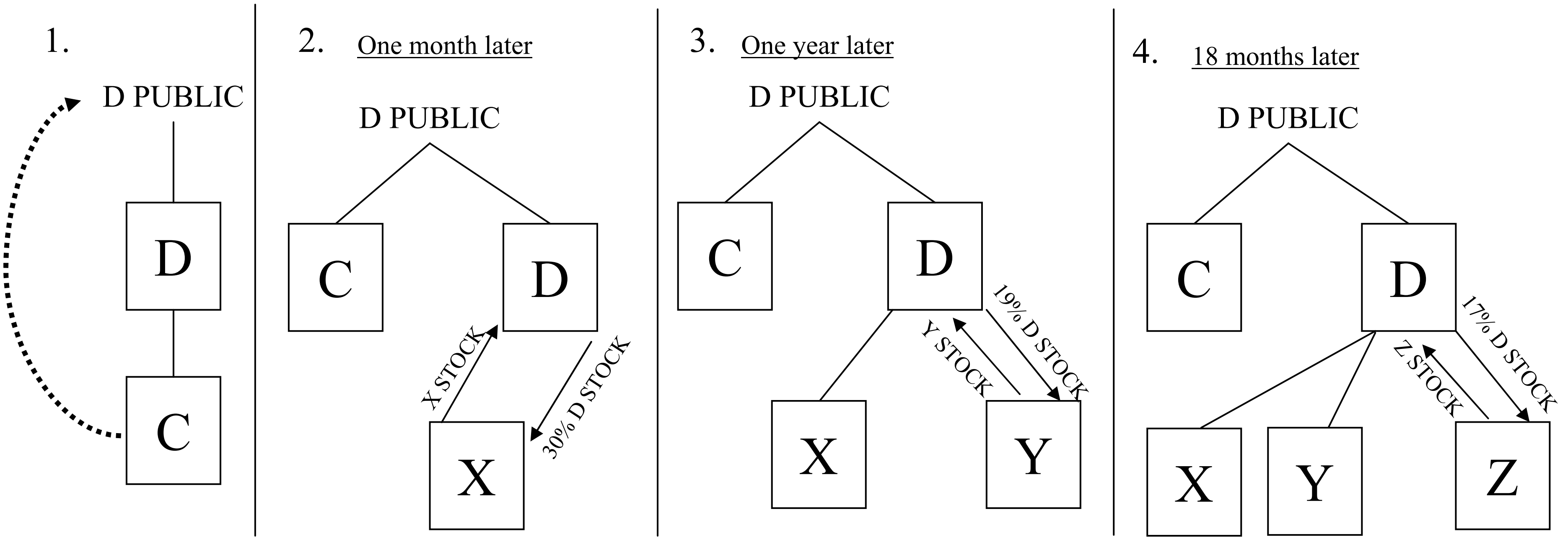


Facts: D, X, and Y are each publicly traded corporations engaged in the manufacturing and sale of trucks. C is engaged in the manufacture and sale of buses. D and X engage in substantial negotiations regarding X's acquisition of D stock from the D shareholders in exchange for X stock. D and X do not reach an agreement regarding the acquisition. 3 months after D and X begin negotiations, D spins off C. 3 months after the spin-off, Y acquires all of the D stock from the D shareholders in exchange for Y stock.

Are the spin-off of C and the acquisition of D stock by Y parts of a "plan (or series of related transactions)" within the meaning of section 355(e)? See Treas. Reg. § 1.355-7(j), Ex. 6. Does the result change if, instead of Y acquiring D, a wholly owned subsidiary of X acquires D?

Assume instead that C was not a pre-existing corporation so that D engaged in the sale and manufacture of trucks and buses, and that the truck business was significant relative to the bus business. 3 months after X and D begin negotiations for the acquisition of D, D contributes its truck business to C and spins off C. After the distribution, X begins negotiations with C and acquires C 3 months later. See Treas. Reg. § 1.355-7(j), Ex. 7.

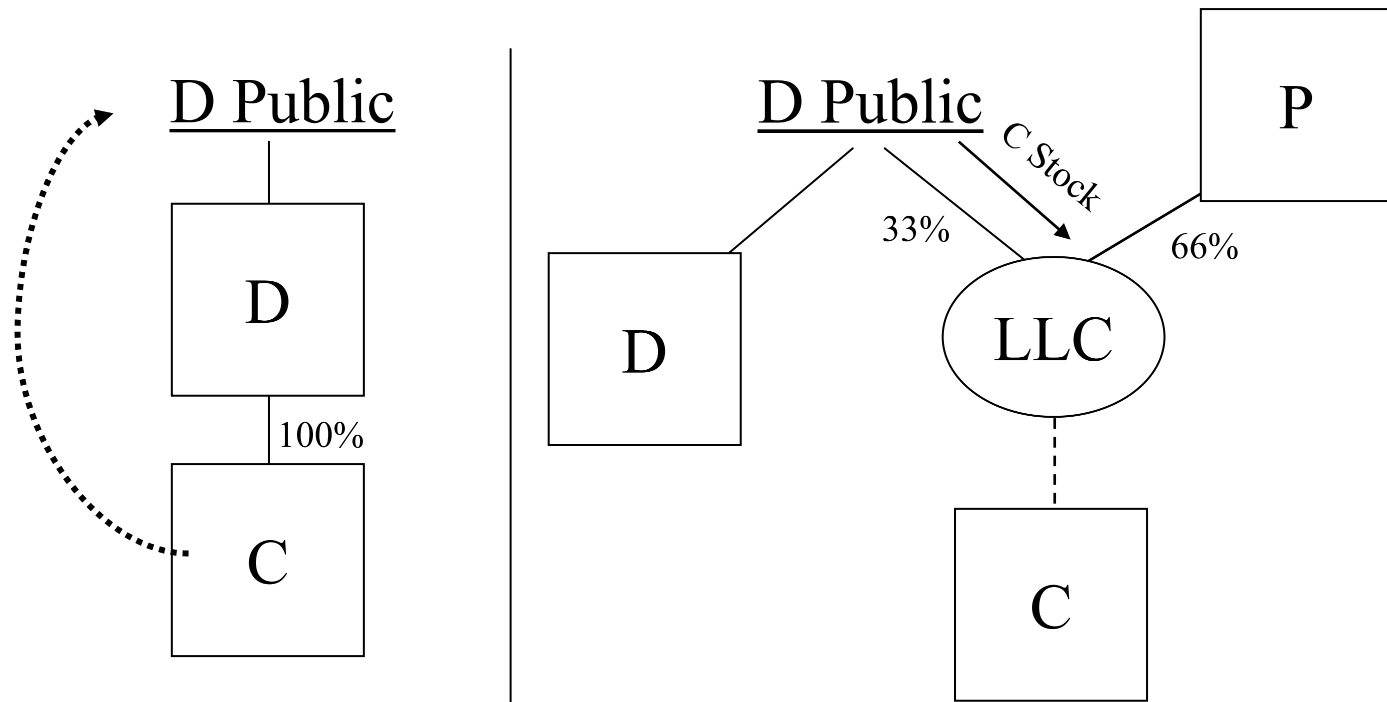
Final Section 355(e) Regulations
Similar Acquisition – Ex. 7 of Old Prop. Regs.



Facts: A publicly traded corporation ("D") owns all the stock of a controlled corporation ("C"). C, which engages in a separate line of business from D, has been an impediment to D's strategy to grow its business through acquisitions. Prior to distributing C, D has identified two potential targets, X and Y. D negotiates with X, but has no contact with Y prior to distribution. 1 month after the distribution of C, D acquires X for 30% of D's stock. 7 months after the distribution of C, D begins negotiating with Y, and, 5 months later, acquires Y for 19% of D's stock. 18 months after the distribution, D acquires Z for 17% of D's stock. D had not identified Z as a target until after the distribution. What is the result under the Final Regulations?

Final Section 355(e) Regulations

Similar Acquisition – Section 355(e) Transaction



Facts: P substantially negotiates with D to acquire the stock of C in exchange for P stock. D distributes all of the stock of its wholly owned subsidiary, C, in a tax-free spin-off pursuant to section 355. Within six months, P offers to acquire the C stock in a tax-free reorganization. Instead of a direct acquisition, C agrees to a transaction wherein C's shareholders drop their stock into a newly formed LLC in exchange for a one-third interest in the LLC, and P drops some of its assets into the LLC in exchange for two-thirds of the interests.

Is the acquisition of C stock by LLC a similar acquisition? Does the result change if C and P contribute assets to LLC in exchange for LLC interests? Assume instead that P is wholly owned by individual A. Prior to the distribution P and D terminate negotiations and A sells all of the P stock to individual B. B and D then begin substantial negotiations, and D distributes C. Is the acquisition of C stock by LLC a similar acquisition?

Predecessor/Successor Proposed Regulations

Prop. Treas. Reg. § 1.355-8

- Section 355(e)(4)(D) provides that, for purposes of section 355(e), any reference to Distributing or Controlled includes a reference to any "predecessor" or "successor" of Distributing or Controlled

- On November 22, 2004, Treasury and IRS issued Prop. Treas. Reg. § 1.355-8 providing:
  - Definitions of "predecessor" and "successor"
  - Rules for determining whether there has been an acquisition of a "predecessor" or "successor"
  - Rules limiting the amount of gain recognized under section 355(e) in certain circumstances

Prop. Treas. Reg. § 1.355-8
Definitions of "Predecessor" and Related Rules

- **Distributing:** Under the proposed regulations, a corporation is a predecessor of Distributing if it satisfies one of the following tests:
  - A corporation that before the distribution transfers property to Distributing in a transaction to which section 381 applies (a "combining transfer") if:
    - Distributing subsequently transfers some (but not all) of the acquired property to Controlled (or a predecessor of Controlled) ("a separating transfer"), and
    - The basis of such property immediately after the transfer to Controlled (or a predecessor of Controlled) is determined in whole or in part by reference to the basis of the property in the hands of Distributing immediately before the transfer.

  - A corporation that, before the distribution, transfers property to Distributing in a combining transfer if:
    - Some but not all of the property transferred to Distributing includes Controlled stock, and
    - After the combining transfer, Distributing transfers less than all the property acquired (other than the Controlled stock) to Controlled.

Prop. Treas. Reg. § 1.355-8
Definitions of "Predecessor" and Related Rules (cont.)

- **Controlled**
  - The preamble to the proposed regulations states that the policy underlying the definitions of a predecessor of Distributing does not appear to necessitate a definition of a predecessor of Controlled, because Controlled generally will not be able to transfer property that it receives in such a transaction to Distributing tax-free.
  - Nonetheless, the proposed regulations provide a definition for the purposes of determining whether a corporation is a predecessor of Distributing, calculating the limitations on gain recognition, and the special affiliated group rule (described below).
  - A predecessor of Controlled is defined as a corporation that, before the distribution, transfers property to Controlled in a transaction to which section 381 applies.

Prop. Treas. Reg. § 1.355-8

Definitions of "Predecessor" and Related Rules (cont.)

- **Deemed acquisitions:**
  - If there is a predecessor of Distributing, then each person that owned an interest in Distributing immediately before the combining transfer is treated as acquiring stock representing an interest in the predecessor of Distributing in the combining transfer.
  - If an acquisition of Distributing occurs after Distributing's combination with a predecessor, the acquisition will count not only as an acquisition of Distributing, but also as an acquisition of the predecessor.

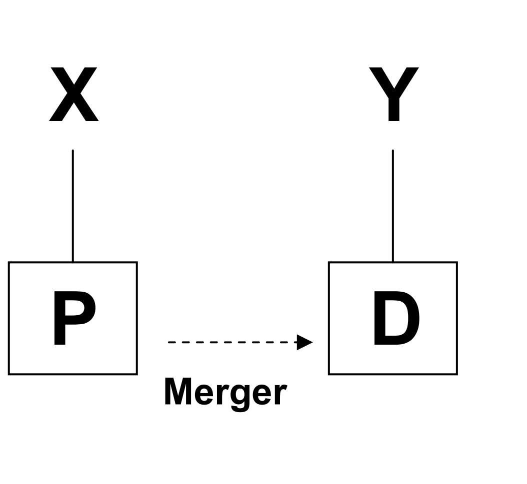
- **Separate counting for Distributing and its predecessors:** The measurement of whether one or more persons have acquired stock that in the aggregate represents a 50% or greater interest in either a predecessor of Distributing or Distributing that is part of a plan that includes the distribution shall be made separately.

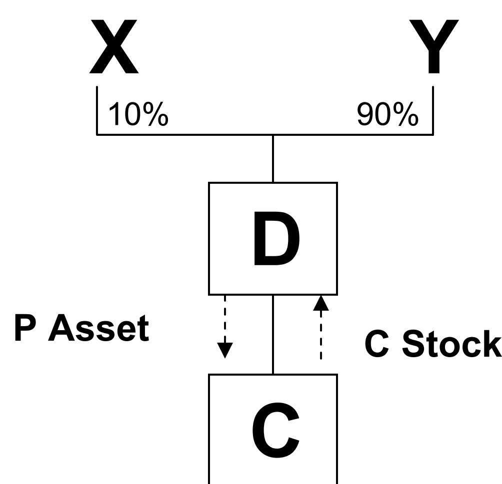
- **Predecessor of a predecessor is excluded:** The proposed regulations specifically exclude from the definition of predecessor a corporation that transfers property to a predecessor of Distributing or Controlled in a transaction to which § 381 applies.
  - This rule does not apply to corporations that have engaged in an "F" reorganization. Under the proposed regulations, the resulting corporation in an "F" reorganization is treated as the same corporation that engaged in the reorganization.

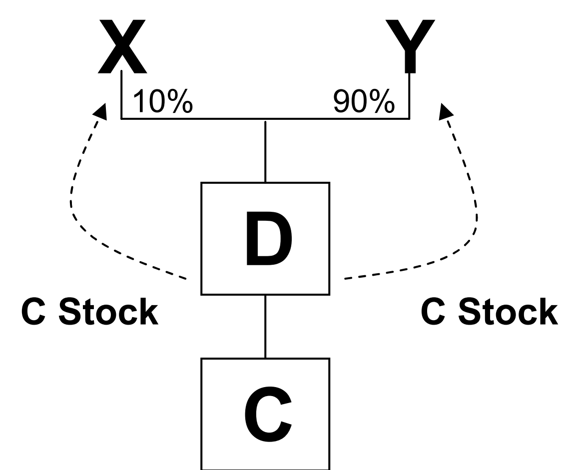
- **Multiple predecessors permitted**: More than one corporation may be a predecessor of Distributing or Controlled.

- **Substitute assets:** If Distributing transfers any property it received in the combining transfer in a transaction in which gain or loss is not recognized in whole, the property received by Distributing is treated as transferred to Distributing in the combining transfer.

Prop. Treas. Reg. § 1.355-8
Predecessor of Distributing: Example





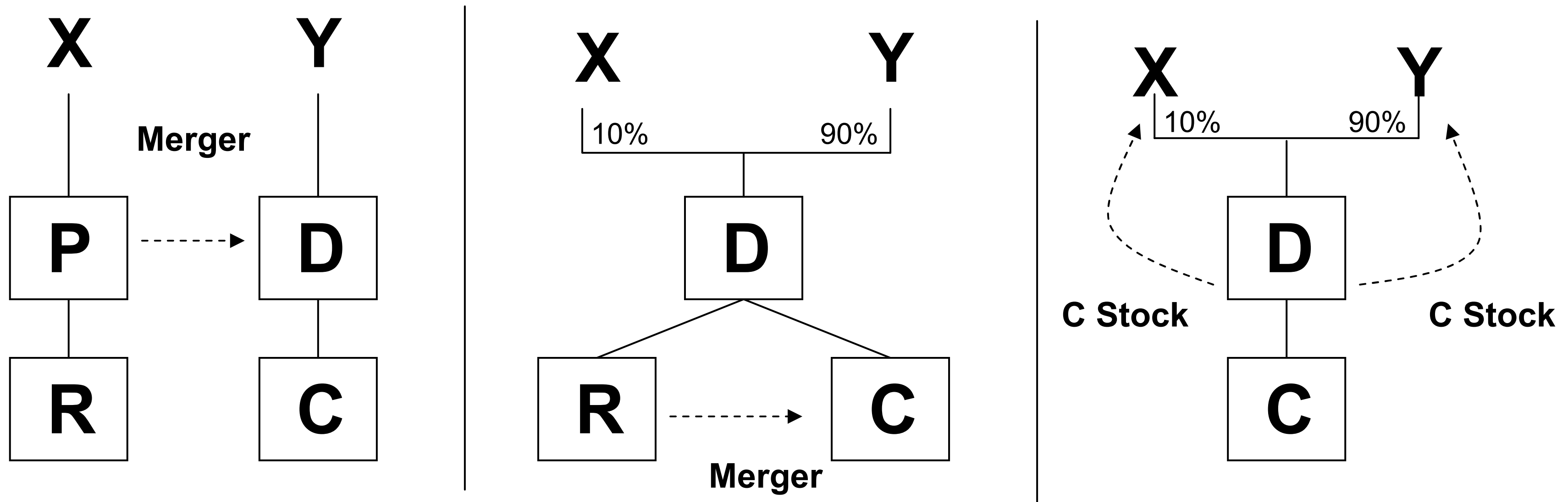


- **Facts:** X owns 100% of the stock of P and Y owns 100% of the stock of D. P merges into D in an "A" reorganization. Immediately after the merger, X and Y own 10% and 90%, respectively, of the stock of D. D then contributes to C one of the assets acquired from P in the merger. D receives additional C stock in exchange. D distributes the stock of C to X and Y pro rata.

- **Analysis:** Under the proposed regulations, P is a predecessor of D because: (i) before the distribution P transferred property to D in a transaction to which section 381 applies, (ii) D transferred some but not all of the acquired property to C, and (iii) immediately after the transfer to C, the property has a basis determined in whole or in part by reference to the basis of the property in the hands of D immediately before the transfer to C. Y is treated as acquiring stock representing 90% of the voting power and value of P. See Prop. Treas. Reg. § 1.355-8(g), Ex. 1.

Prop. Treas. Reg. § 1.355-8

Predecessor of Controlled: Example



- **Facts:** X owns 100% of the stock of P and P owns various assets including 100% of the stock of R. Y owns 100% of the stock of D and D owns 100% of the stock of C. P merges into D in an "A" reorganization. Immediately after the merger, X and Y own 10% and 90%, respectively, of the stock of D. D then causes R to merge into C in a "D" reorganization. D distributes the stock of C to X and Y pro rata.

- **Analysis:** R is a predecessor of C because before the distribution R transferred property to C in a transaction to which section 381 applies. P is a predecessor of D because some but not all of the property transferred to D includes stock of R, a predecessor of C, and after the merger, D does not transfer all of the property acquired from P to C. Y is treated as acquiring stock representing 90% of the voting power and value of P. See Prop. Treas. Reg. § 1.355-8(g), Ex. 3.

Prop. Treas. Reg. § 1.355-8
Definition of "Successor" and Related Rules

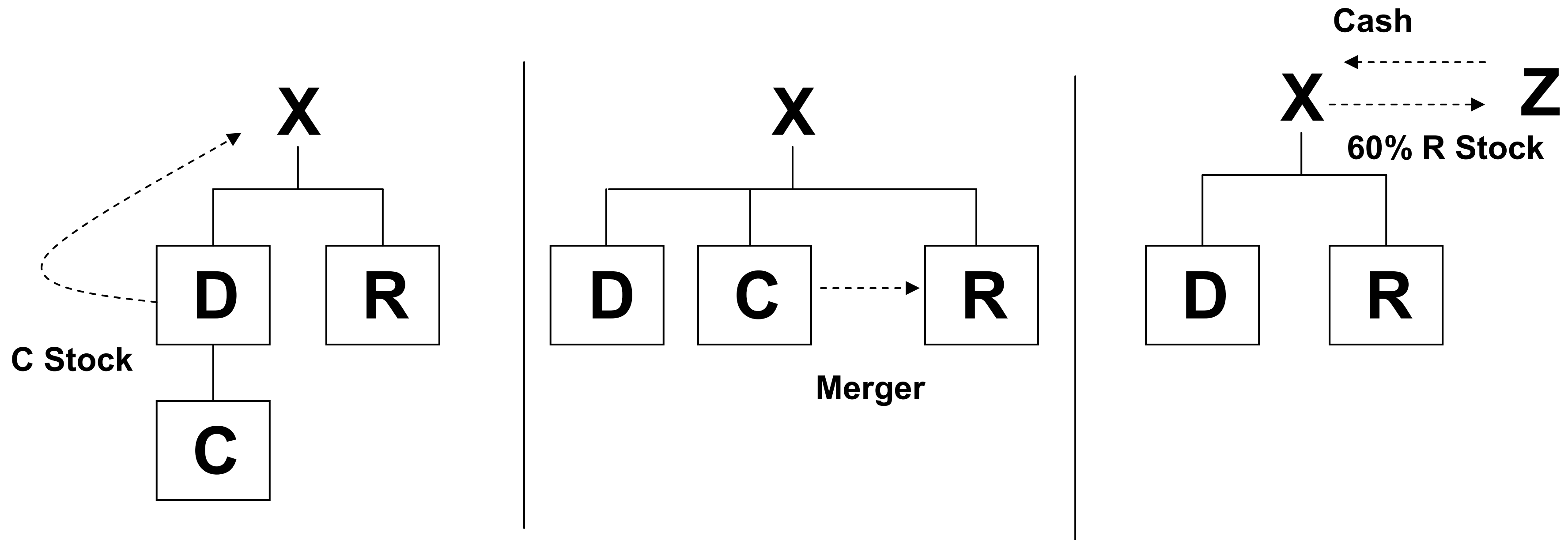
- **Successor:** Under the proposed regulations, a successor is any corporation to which Distributing or Controlled transfers property after the distribution in a transaction to which section 381 applies (a "successor transaction").

- **Deemed Acquisitions:**
  - If there is a successor of Distributing, then each person that owned an interest in the successor of Distributing immediately before the successor transaction is treated as acquiring Distributing stock in the successor transaction.
  - If there is a successor of Controlled, then each person that owned an interest in the successor of Controlled immediately before the successor transaction is treated as acquiring Controlled stock in the successor transaction.
  - If stock of the successor of Distributing is acquired after the successor transaction, the stock of the successor is treated as the stock of Distributing.
  - If stock of successor of Controlled is acquired after the successor transaction, the stock of the successor is treated as the stock of Controlled.

- **Successor of successor permitted:** The proposed regulations permit more than one successor.
  - Example: Distributing transfers property to Corporation X after the distribution in a transaction to which section 381 applies, and X transfers property to Corporation Y in a transaction to which section 381 applies. Each of X and Y may be a successor of Distributing. See Prop. Treas. Reg. § 1.355-8(c)(2).

Prop. Treas. Reg. § 1.355-8

Successor: Example



- **Facts:** X owns 100% of the stock of each of D and R. D owns 100% of the C stock. D distributes all of its C stock to X. Immediately after the distribution, C merges into R in a "D" reorganization. Immediately after the merger, X owns all of the R stock. Subsequently, Z purchases 60% of the stock of R from X.

- **Analysis:** R is a successor of C because after the distribution C transfers property to R in a transaction to which section 381 applies. Accordingly, Z acquired an interest in a successor of C. The stock of R is treated as stock of C. Therefore, Z is treated as acquiring a 60% interest in C. See Prop. Treas. Reg. § 1.355-8(g), Ex. 5.

Prop. Treas. Reg. § 1.355-8
Affiliated Group Rule

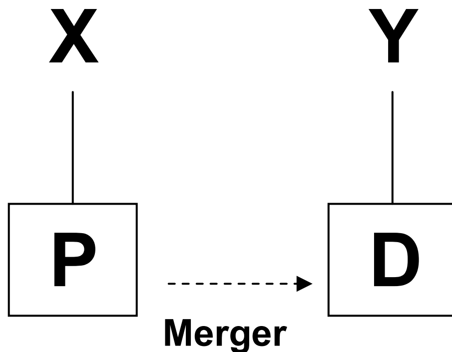
- In general, a plan (or series of related transactions) will not result in the application of section 355(e) if, immediately after the completion of such plan or transactions, Distributing and all controlled corporations are members of a single affiliated group. See section 355(e)(2)(C).

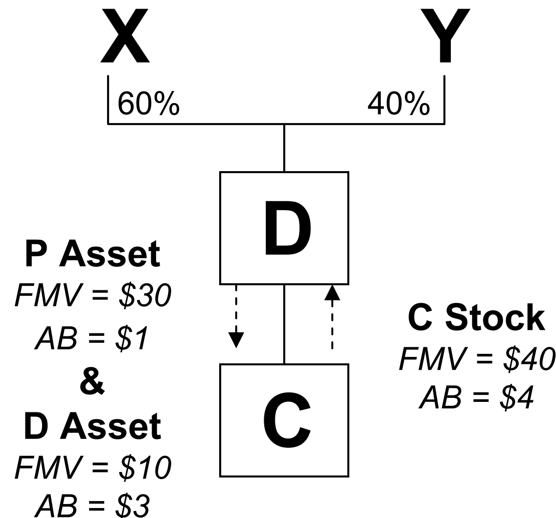
- The proposed regulations provide that, for purposes of section 355(e)(2)(C):
  - A predecessor of Distributing or Controlled is treated as continuing in existence following its transfer of property to Distributing or Controlled, and
  - Distributing or Controlled is treated as continuing in existence following a transfer of property to a successor.

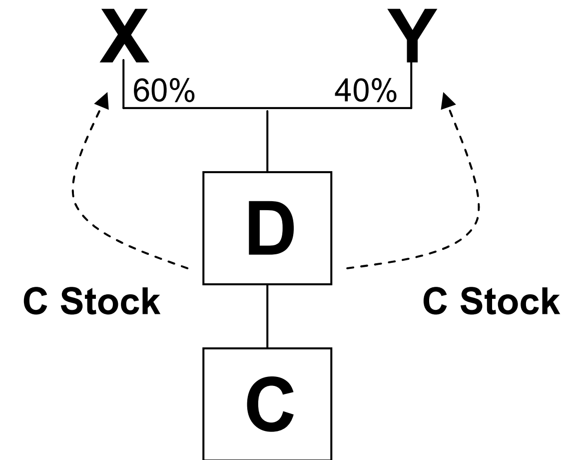
Prop. Treas. Reg. § 1.355-8
Limits On Gain Recognition

- The proposed regulations provide two rules limiting the amount of gain that Distributing must recognize under section 355(e) in certain circumstances.
  - **Acquisition of a Predecessor of Distributing:** If a distribution and acquisition of stock that in the aggregate represent a 50% or greater interest in a predecessor of Distributing are part of a plan, then the amount of gain that Distributing recognizes by reason of such acquisition will not exceed the amount of gain, if any, that the predecessor of Distributing would have recognized if immediately before the distribution, the predecessor had
    - Transferred the property that was transferred to Controlled and the stock of Controlled that it transferred to Distributing in the combining transfer to a newly formed, wholly owned corporation solely for stock of such corporation in an exchange to which section 351 applied (even if section 351 would not have actually applied), and
    - Sold the stock to an unrelated person for cash equal to its fair market value.
  - **Acquisition of Distributing:** If a distribution and acquisition of stock that in the aggregate represent a 50% or greater interest in Distributing are part of a plan and the acquisitions occur in the combining transfer, then the amount of gain that Distributing recognizes will not exceed the amount of gain that Distributing would have recognized had it not transferred assets of the predecessor to Controlled and had it not acquired any Controlled stock from the predecessor.
    - The proposed regulations calculate the gain limitation as the excess, if any, of the amount described in section 355(c)(2) or section 361(c)(2), as applicable, over the amount of gain, if any, that Distributing would have been required to recognize if there had been acquisitions of stock that in the aggregate represent a 50% or greater interest in the predecessor of Distributing that was part of the plan involving the distribution.

Prop. Treas. Reg. § 1.355-8
Limits on Gain Recognition: Example





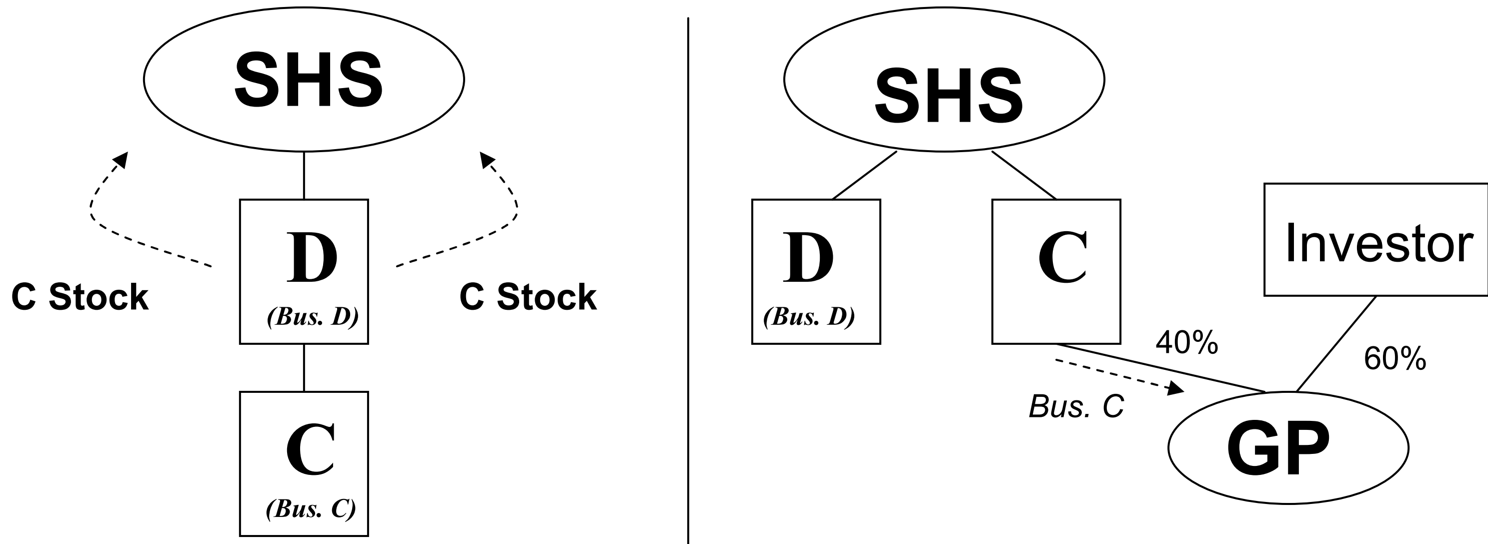


- **Facts:**
  - X owns 100% of the stock of P and Y owns 100% of the stock of D. P merges into D in an "A" reorganization. In the merger, X acquires 60% of the D stock. After the merger, therefore, X and Y own 60% and 40%, respectively, of the stock of D. D then contributes to C, a newly formed corporation, some of the assets acquired from P in the merger and one asset that it owned prior to the merger, in exchange for C stock in a transfer that qualifies as a "D" reorganization. After the contribution, D distributes the C stock to its shareholders pro rata.
  - Immediately before the distribution, the contributed asset that D had owned prior to the merger had a basis of $3 and a fair market value of $10 and the contributed assets acquired from P have an aggregate basis of $1 and an aggregate value of $30. In addition, immediately before the distribution, D's C stock has a basis of $4 and a fair market value of $40.

Prop. Treas. Reg. § 1.355-8
Limits on Gain Recognition: Example (cont.)

- **Analysis:**
  - **Predecessor:** P is a predecessor of D because before the distribution P transferred property to D in a transaction to which section 381 applies, D transferred some but not all of the acquired property to C, and immediately after the transfer to C, the property has a basis determined in whole or in part by reference to the basis of the property in the hands of D immediately before the transfer to C.
  - **Gain Recognition:**
    - Y is treated as acquiring stock representing 40% of the voting power and value of P. There are not acquisitions that in the aggregate represent a 50% or greater interest in P in the merger that are pursuant to a plan that includes a distribution. However, there is an acquisition by X of a 60% interest in D in the merger. If that acquisition were pursuant to a plan that includes the distribution, D would be required to recognize gain in the amount described in section 361(c)(2) ($36 of gain).
    - D would recognize $7 of gain. Since the acquisition occurred in the combining transfer, the amount of gain recognized by D would not exceed $7, the built in gain on D's assets transferred to C. The proposed regulations provide that this gain limitation is determined by a different equation: the excess of the gain described in section 361(c)(2) ($36) over the gain that D would have been required to recognize if there had been an acquisition of stock representing a 50% or greater interest in P (but not D) that was part of a plan involving the distribution ($30 - $1, or $29). See Prop. Treas. Reg. 1.355-8(g), Ex. 4.

Prop. Treas. Reg. § 1.355-8
Post-Spin Contribution of Assets to a Partnership



- **Facts:** D distributes the stock of C pro rata to its shareholders. Immediately thereafter, C forms partnership GP with an unrelated third party corporation, Investor. C contributes all of its assets to GP in return for a 40% interest and Investor contributes cash for a 60% interest.

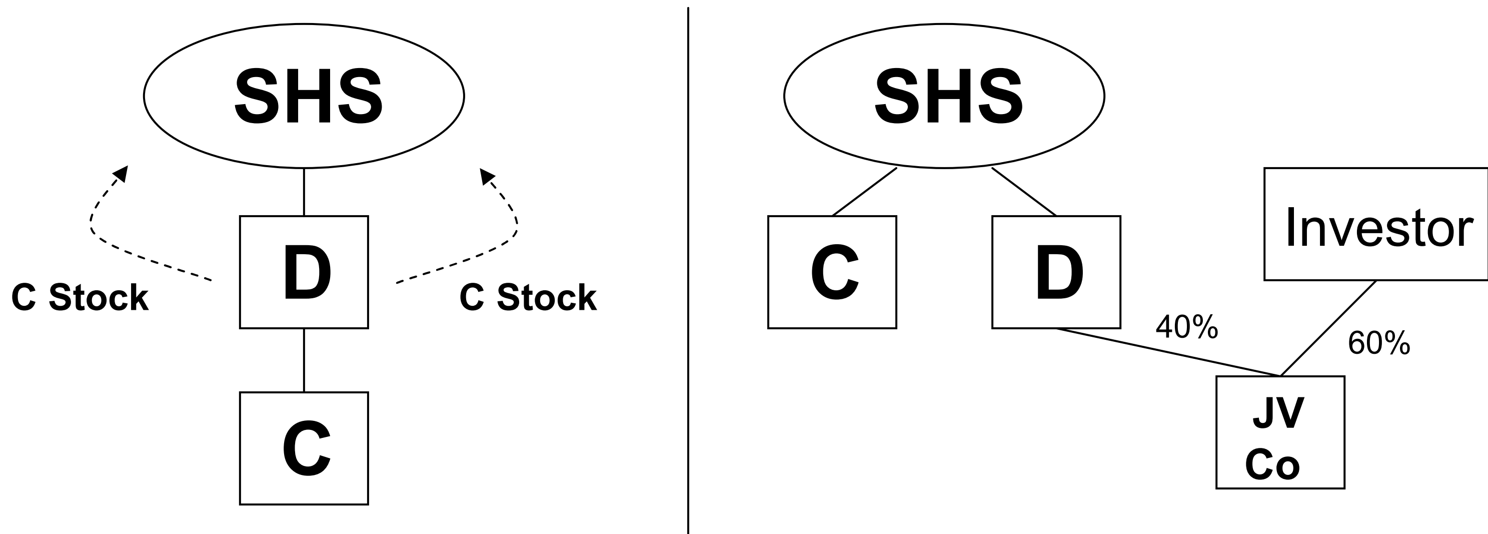
- **Alternative 1:** Same facts as above except C receives a 60% interest and Investor receives a 40% interest in GP. One year later, there is a profits interest flip such that C has a 40% interest and Investor has a 60% interest in GP.

- **Alternative 2:** Same facts as above except Investor contributes a business to GP (instead of cash). The GP interests are structured so that C has a 60% interest in the business it contributes to GP and a 40% interest in the business contributed by Investor; Investor has a 40% interest in the business contributed by C and a 60% interest in the business contributed by Investor.

- **Alternative 3:** Same as initial facts except C contributes a portion of the assets to GP in return for a 20% interest. SHS sell 30% of the C stock to an unrelated third party.

- **Issues:**
  - Does section 355(e) apply to this transaction?
  - Is GP a successor of C? See sections 355(e)(4)(C) and 355(e)(4)(D).

Prop. Treas. Reg. § 1.355-8
Post-Spin Contribution of Assets to a Corporation



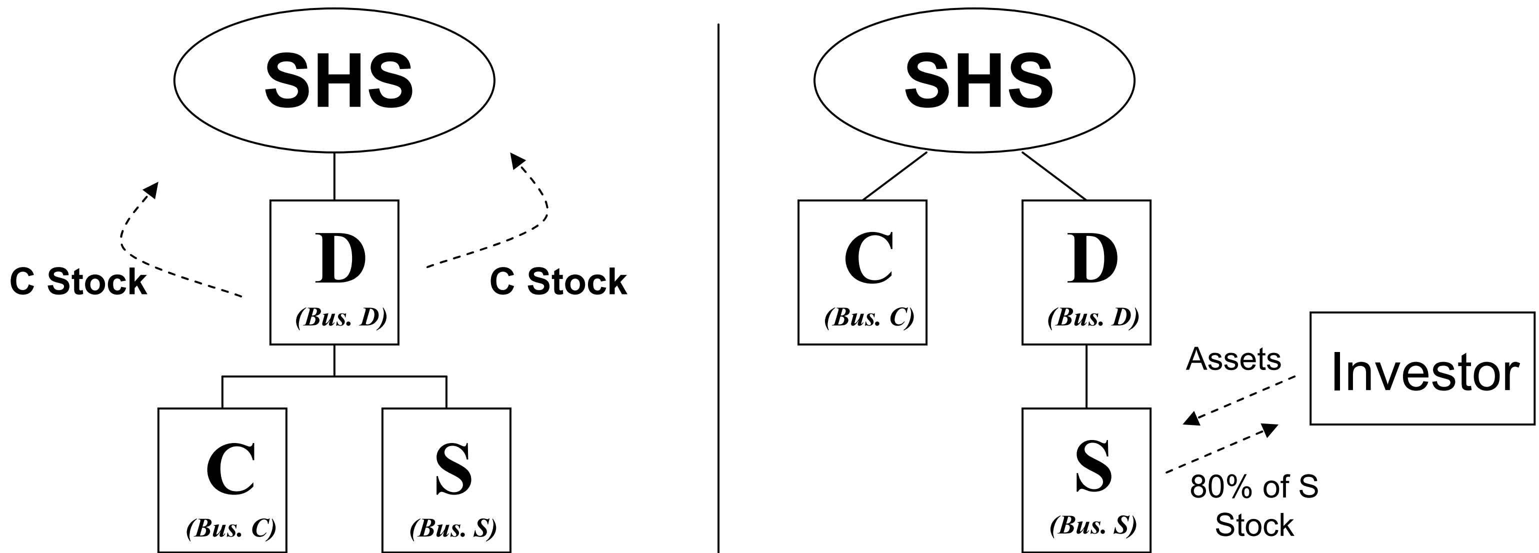
➢ **Facts:** D distributes the stock of C pro rata to its shareholders. Immediately thereafter, D forms a Joint Venture, JV Co, with an unrelated third party corporation, Investor. D contributes assets to JV Co in return for a 40% interest and Investor contributes cash for a 60% interest.

➢**Issues:**

- Can this transaction give rise to a taxable distribution?
- Does it matter **(i)** what percentage of D's assets are contributed to JV Co or **(ii)** whether D contributes its active trade or business to JV Co?

Prop. Treas. Reg. § 1.355-8

Post-Spin Sale of a Subsidiary



➢ **Facts:** D distributes the stock of C pro rata to its shareholders. As part of the same plan, Investor, an unrelated corporation, transfers Assets to S in exchange for 80% of the S stock under section 351.

➢**Issues:**

- Does section 355(a) apply to the initial transaction?
- Does section 355(e) apply to the issuance of more than 50% of the S stock to Investor? If so, is all or only part of the gain on the distribution of the C stock recognized to D?
- Would the answer be different if Investor had purchased 80% of the S stock from D for cash?

Selected Section 338 Issues

Tier Effect – Different Recovery Classes

T		Value	Basis
	Marketable securities --	4,000	2,500
	Accounts receivable --	4,000	4,000

Facts

Corporation T has two groups of assets, marketable securities with a value of $4,000X and a basis of $2,500X and accounts receivable with a value and basis of $4,000X. P purchases the T stock for $6,000X, and P and S join in a Section 338(h)(10) election for T.

Case 1. All assets are held in T.

Case 2(a). The securities are held in a wholly owned subsidiary of T (T1) and the receivables are held in a second wholly owned subsidiary (T2). Section 338(h)(10) elections are made for T, T1, and T2.

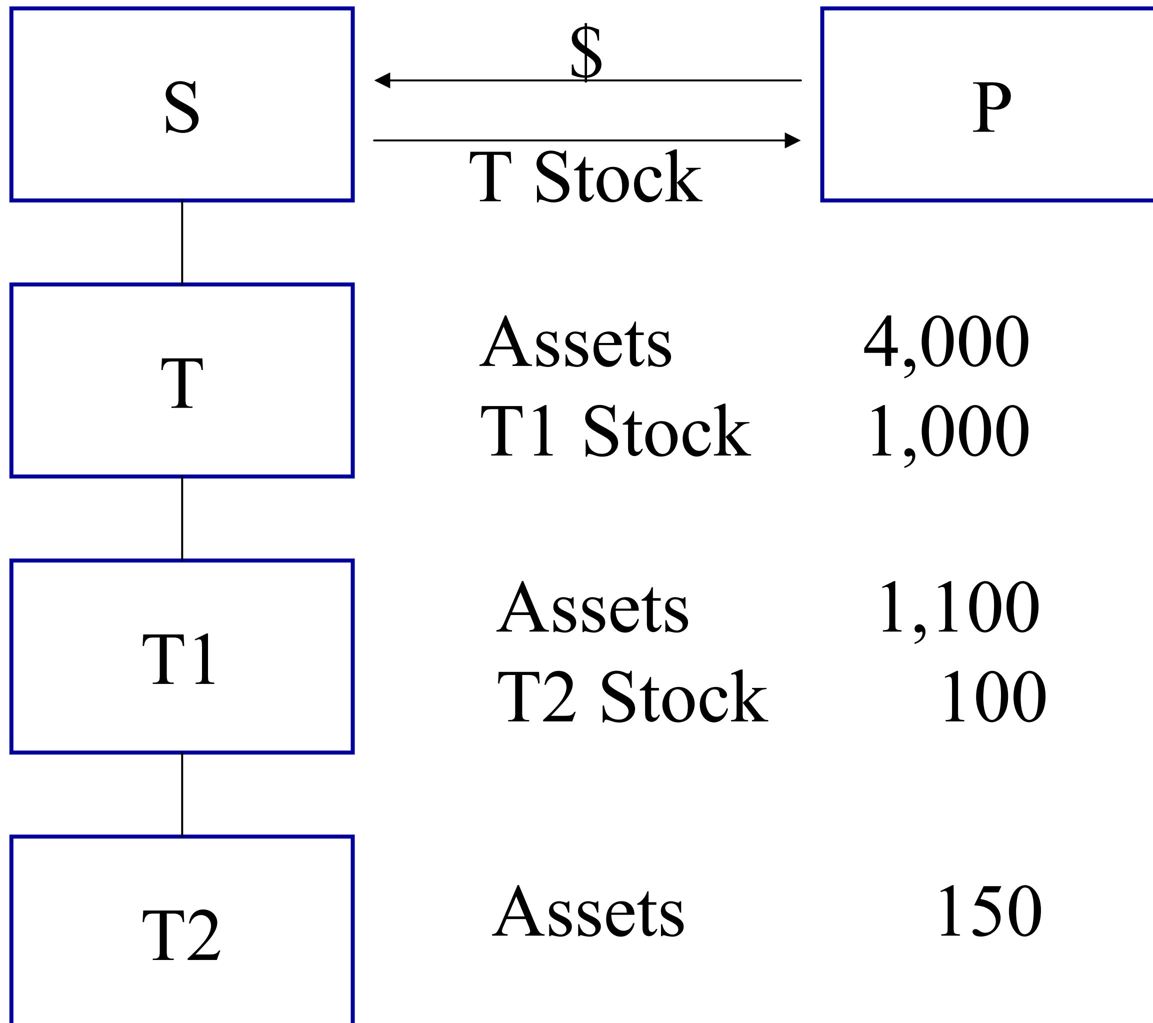
Case 2(b). A Section 338(h)(10) election is made for T1 (securities), but not T2 (receivables).

Tier Effect – Different Recovery Classes Continued

Case 3(a). The receivables are held directly by T. The securities are held by T1. A Section 338(h)(10) election is made for T1.

Case 3(b). No Section 338(h)(10) election is made for T1.

Section 338(h)(10) Vs. Section 1060



Section 338(h)(10) Vs. Section 1060 Continued

Facts

Corporation T owns and operates a business with a value of 4,000X, and also owns all of the stock of Corporation T1. The value of the T1 stock is 1,000X. T1 owns and operates a business with a value of 1,100X, and also owns all of the stock of T2. The value of the T2 stock is 100X. T2 owns and operates a business with a value of 150X.

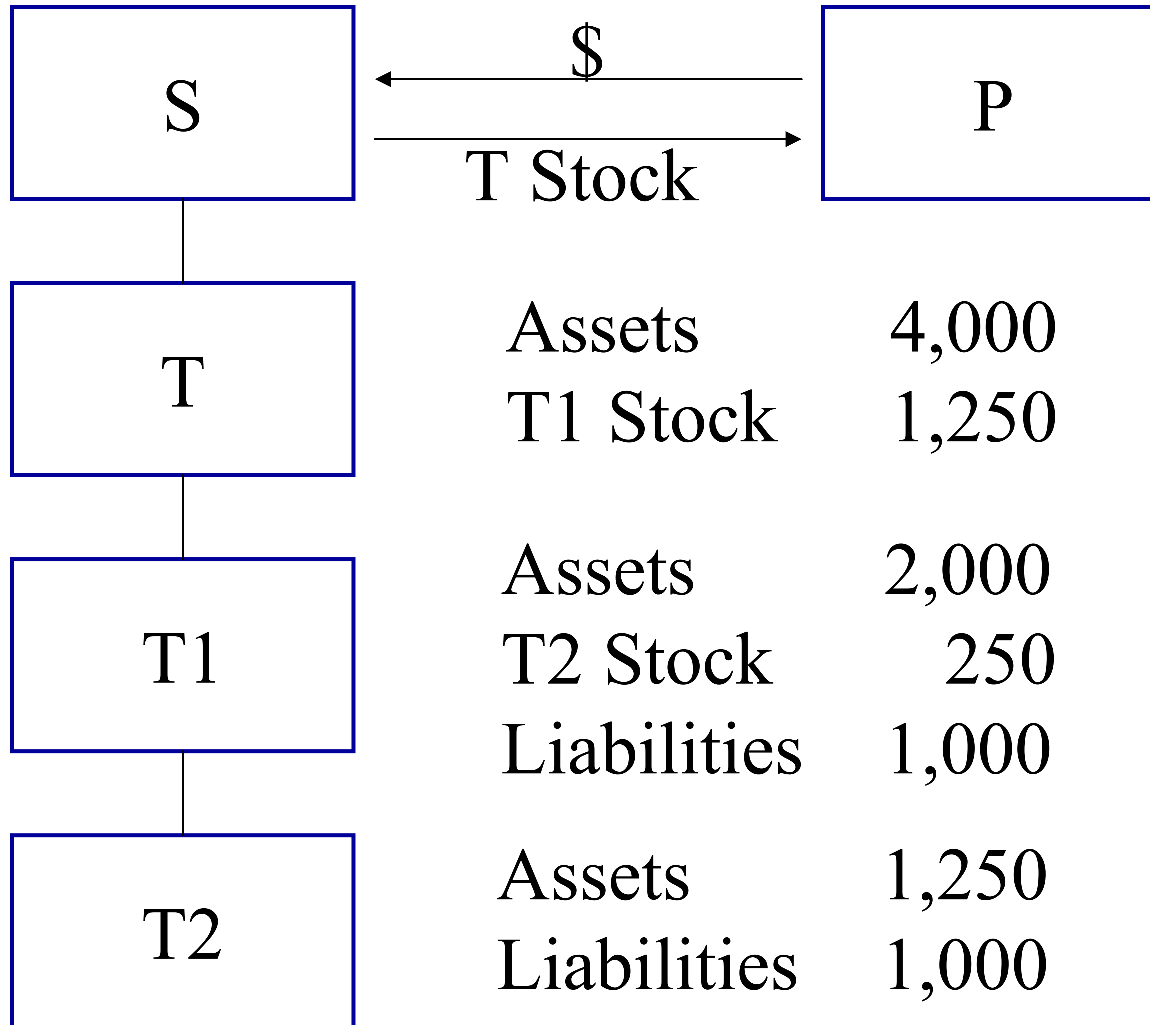
P purchases all of the T stock from S for 4,500X and P and S (the common parent of the T group) join in a Section 338(h)(10) election with respect to T, T1, and T2.

Questions

1. What are the basis and selling price consequences to P and to S?

2. What would the results be if the businesses of T1 and T2 were separately conducted as divisions of T, and P purchased all of the T assets for 4,500X in a transaction to which Section 1060 applied?

Section 338(h)(10) Vs. Section 1060



Section 338(h)(10) Vs. Section 1060 Continued

Facts

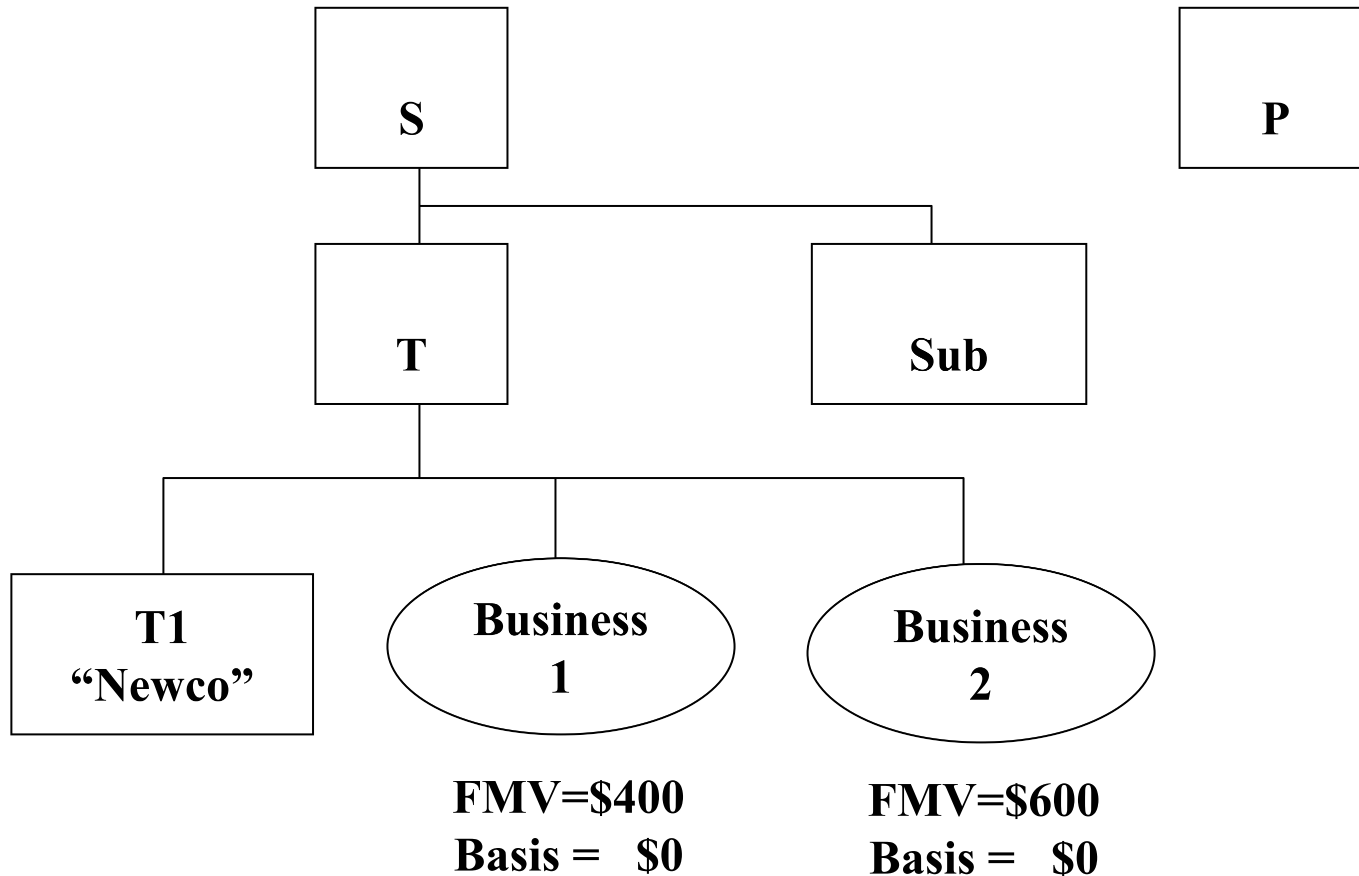
Corporation T owns and operates a business with a value of 4,000X, and also owns all of the stock of T1. The value of the T1 stock is 1,250X. T1 owns and operates a business with a value of 2,000X, and also owns all of the stock of T2 with a value of 250X. T1 also has liabilities of 1,000X. T2 owns and operates a business with a gross value of 1,250X and has liabilities of 1,000X.

P purchases all of the T stock from S for 4,500X and P and S (the common parent of the T group) join in a Section 338(h)(10) election with respect to T, T1 and T2.

Questions

1. What are the basis and selling price consequences to P and S?
2. What would the results be if the businesses of T1 and T2 were separately conducted as divisions of T, and P purchased all of the T assets for 4,500X (plus the assumption of liabilities) in a transaction to which Section 1060 applied?

Section 338(h)(10) and Unwanted Assets



Facts

The S group files consolidated returns. S owns all the stock of T. T owns Business 1 and Business 2. S also owns all the stock of Sub.

Section 338(h)(10) and Unwanted Assets Continued

P wants to buy Business 1 but not Business 2. The parties want to structure the transaction as a sale of the T stock with a Section 338(h)(10) election.

Questions

- May the parties make a Section 338(h)(10) election?
- If so, is P entitled to a cost basis in the assets it is deemed to acquire from T?
- Will the S group be taxed on the deemed sale of the assets wanted by P and/or on the transfer of the assets not wanted by P?

Transactions

Basic Transaction

- T distributes Business 2 to S, and S retains Business 2.
- S sells the T stock to P for $400 cash.

Section 338(h)(10) and Unwanted Assets Continued

Variation 1
- T sells Business 2 to Sub for $600 cash.
- S sells the T stock to P for $1,000 cash.

Variation 2
- T distributes Business 2 to S.
- S transfers Business 2 to Sub.
- S sells the T stock to P for $400 cash.

Variation 3
- T distributes Business 2 to S.
- S transfers Business 2 and $300 cash to Sub.
- S sells the T stock to P for $400 cash.

Variation 4
- T transfers Business 2 to a new subsidiary, T1, for all the T1 stock.
- T distributes the T1 stock to S, and S retains the T1 stock.
- S sells the T stock to P for $400 cash.

Section 338(h)(10) and Unwanted Assets Continued

Authorities

Code Sections 338(h)(10), 354(b)(1), 368(a)(1)(D) and 368(a)(2)(H)

Old Reg. §§ 1.338(h)(10)-1(e)(1) and (e)(2)

Reg. §§ 1.338(h)(10)-1(b)(6), (d)(4)(i), (d)(5), (d)(9) and (e) Examples 2 and 3, 1.1502-6 and 1.1502-13(f)(3)

Telephone Answering Service Co. v. Commissioner, 63 T.C. 423 (1974), *aff'd* 546 F.2d 423 (4th Cir. 1976) *cert. denied* 431 U.S. 914 (1977)

PLR 8821047 (February 26, 1988)

PLR 8938036 (June 27, 1989)

PLR 9044063 (August 7, 1990)

PLR 9210041 (December 12, 1991), *supplementing* PLR 9137040 (June 17, 1991)

PLR 9253027 (October 2, 1992)

PLR 9303005 (October 19, 1992)

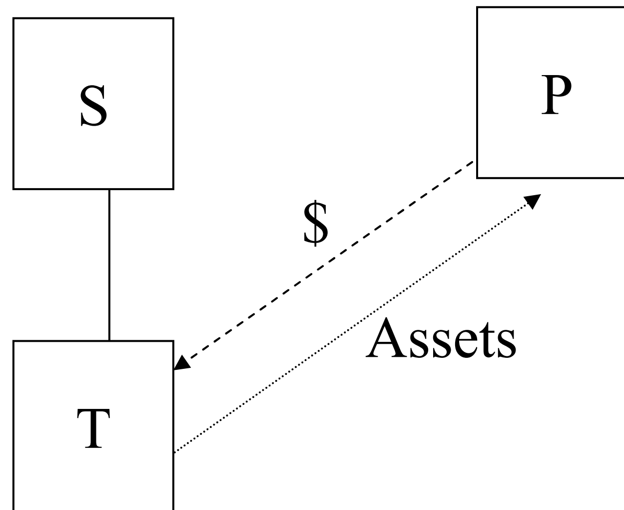
PLR 9434009 (May 18, 1994)

PLR 9735038 (June 2, 1997)

PLR 9738031 (June 24, 1997)

PLR 9847027 (August 25, 1998)

Contingent Items



Facts

S owns all the stock of T, which operates a business. T's basis in its assets is $2,000. T has no debts, but a patent infringement lawsuit is pending against T. The plaintiff in the lawsuit claims $1,500 damages, but T's counsel has advised that the claim is weak, and that its settlement value is $100. T sells all its assets to P for –

- $3,000 cash at closing.
- An earn-out payment after three years of up to $800 plus interest, with a discounted present value estimated at $400.

Contingent Items Continued

- T's assumption of the patent infringement liability.

Three years after closing, P pays T the earn-out of $400 plus interest.
Ten years after closing, the patent infringement case is tried. X wins a $1,500 judgment against P as successor to T, and P pays the judgment plus $1,000 interest.

Questions

a. What are the amounts realized and the taxable gain or loss to T?

b. How is P's basis in the T assets determined?

c. How would the results change if the actual earn-out payment is $600 plus interest? $0?

d. How would the results change if T's basis in its assets totaled $3,200?

e. How would the results change if S and T had agreed to indemnify P for the patent infringement liability above $100? Suppose a $1,000 escrow fund had been set aside out of the purchase price to fund the indemnity.

Contingent Items Continued

f. How would the results change if, instead of T selling its assets to P, S sold the T stock to P with a Section 338(h)(10) election?

Authorities

Reg. §§ 1.1001-1(a), (g)(2), 1.1001-1(a), 1.1012-1(g), 1.1274-2(g), 1.274-5(a), 1.1275-4(c), 1.338-4(b)(1)(ii), (d)(2), 1.338-5(b)(2)(ii), (b)(2)(iii) *Example 2*, 1.338-7, 15a.453-1(d)(2)(iii), 1.461-1(a)(2), (a)(5), (g)(1)(ii)(c)

TAM 9125001 (December 24, 1990), *modifying* TAM 8741001 (June 16, 1987)

TAM 9721002 (January 24, 1997)

Illinois Tool Works, Inc. v. Commissioner, 117 T.C. 139 (2001)

New Proposed Basis Determination Regulations

Stock Basis Determinations Prop. Treas. Reg. § 1.358-1&2

- On April 29, 2004, the Service issued proposed regulations under section 358, which provide guidance for determining the basis of stock or securities received in certain tax-free transactions.
- The proposed regulations adopt a tracing method (rather than an averaging method) for determining basis in tax-free reorganizations.
- Accordingly, the proposed regulations require taxpayers to determine the basis of stock or securities received in the transaction by reference to the basis of the specific stock or securities surrendered in exchange therefor or to which a disposition of stock relates (i.e., in a transaction to which section 355 applies).
- Such a rule ensures the continued application of Treas. Reg. § 1.1012-1(c), which allows taxpayers owning more than one lot or block of stock to identify the particular lot or block of stock that the taxpayer is selling or otherwise transferring.

Stock Basis Determinations
Prop. Treas. Reg. § 1.358-1&2 Continued

- The proposed regulations make minor amendments to current Treas. Reg. § 1.358-1 by deleting from paragraph (a) references to former sections 371 and 374 and adding paragraph (c) (regarding effective dates).

- The proposed regulations substantially amend current Treas. Reg. § 1.358-2 by revising paragraphs (a)(1) & (2), removing paragraphs (a)(3)-(5), revising paragraphs (b)(1) & (c), and adding paragraph (d).

- The proposed regulations are not effective until the date they are published as final regulations in the Federal Register.

Stock Basis Determination Continued; Allocation of Basis -- Prop. Treas. Reg. § 1.358-2

Acquisitive Transactions – Prop. Treas. Reg. § 1.358-2(a)(2)(i)

- If a shareholder or security holder surrenders a share of stock or a security in an exchange to which section 354, 355, or 356 applies, the basis of each share of stock or security received in the exchange is determined by reference to the particular stock or security exchanged therefor (as adjusted under Treas. Reg. §1.358-1).

- If more than one share of stock or security is received in exchange for one share of stock or one security, the basis of the surrendered stock or security is allocated to the stock or securities received in exchange therefor in proportion to the fair market value of such stock or securities.

- If one share of stock or security is received in exchange for more than one share of stock or security (or a fraction thereof), the basis of surrendered stock or securities is allocated to the stock or security received in a manner that reflects, to the greatest extent possible, that a share of stock or security received is received in respect of shares of stock or securities acquired on the same date and at the same price.

Stock Basis Determination Continued; Allocation of Basis -- Prop. Treas. Reg. § 1.358-2

Divisive Transactions – Prop. Treas. Reg. § 1.358-2(a)(2)(ii)

- If a shareholder or security holder receives stock or securities in a distribution to which section 355 applies (or so much of section 356 as relates to section 355), but does not surrender any stock or security in exchange therefor, the basis of each share of stock or security of the distributing corporation, as adjusted under Prop. Treas. Reg. § 1.358-1, is allocated between the share of stock or security of the distributing corporation with respect to which the distribution is made and the share or shares of stock or securities (or allocable portions thereof) received with respect to the share of stock or security of the distributing corporation in proportion to their fair market values.

- If one share of stock or security is received in respect of more than one share of stock or security or a fraction of a share of stock or security is received, the basis of each share of stock or security of the distributing corporation must be allocated to the shares of stock or securities received in a manner that reflects that, to the greatest extent possible, a share of stock or security received is received in respect of shares of stock or securities acquired on the same date and at the same price.

Stock Basis Determination Continued; Allocation of Basis -- Prop. Treas. Reg. § 1.358-2

Designation of Stock or Securities - Prop. Treas. Reg. § 1.358-2(a)(2)(iii)

- If a shareholder or security holder is not able to identify the stock or security received in exchange for (or distributed with respect to) a particular stock or security, the shareholder or security holder may designate the historic stock or security to which the new stock or security relates, provided that:
  - The designation is consistent with the terms of the exchange or distribution, and
  - The designation is made on or before the first date on which the basis of a share of stock or security received is relevant (i.e., when such shares or securities are sold or otherwise transferred).
- Such designation is binding for purposes of determining the Federal tax consequences of any sale or transfer of, or distribution with respect to, the shares or securities received.
- If the shareholder or security holder fails to make a designation, upon the sale or other transfer of the stock or security received, such shareholder or security holder will be treated as selling or transferring the share received in respect of the earliest share purchased or acquired.

Stock Basis Determination Continued; Allocation of Basis -- Prop. Treas. Reg. § 1.358-2

Other Rules

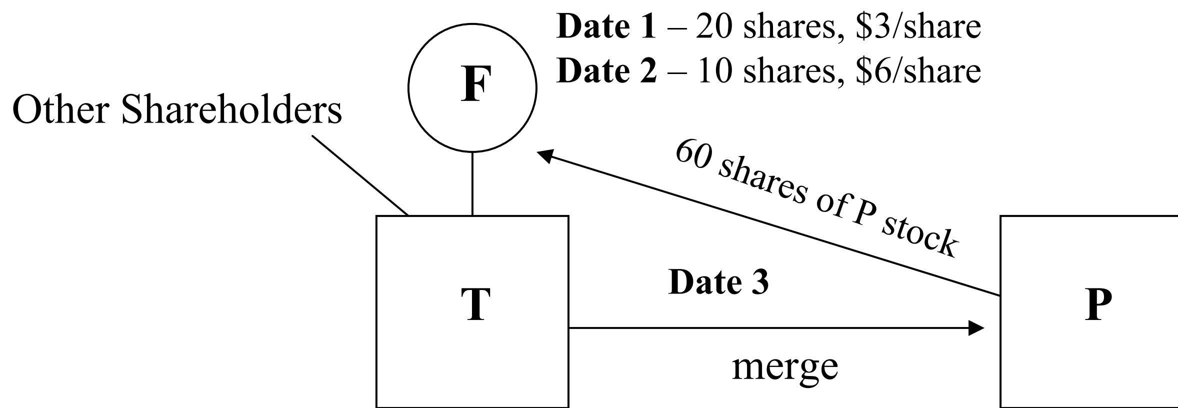
- The aforementioned rules do not apply to determine the basis of a share of stock or security received by a shareholder or security holder in an exchange described in both section 351 and section 354 or section 356, if, in connection with the exchange, the shareholder or security holder exchanges property for stock or securities in an exchange to which neither section 354 nor 356 applies or liabilities of the shareholder or security holder are assumed. Prop. Treas. Reg. § 1.358-2(a)(2)(iv).

- The term "stock" means stock that is not "other property" under section 356. Prop. Treas. Reg. § 1.358-2(a)(1).

- The term "securities" means securities (including, where appropriate, fractional parts of securities) that are not "other property" under section 356. Id.

- Current Treas. Reg. § 1.358-2(b), which applies to transactions governed by section 351 or section 361, is amended to provide that the term "stock" refers only to stock that is not "other property" for purposes of those sections, and the term "securities" refers only to securities that are not "other property" for purposes of those sections.

Stock Basis Determination
Example 1

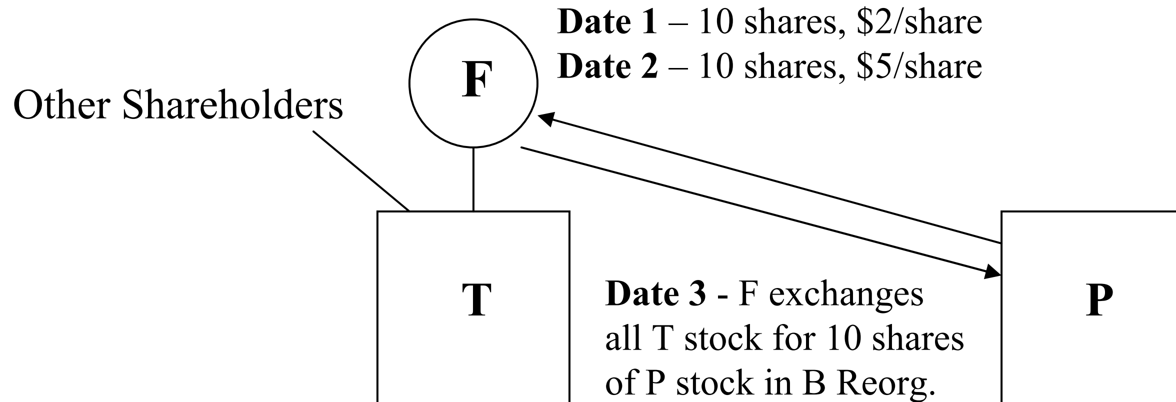


Facts: F, an individual, acquired 20 shares of T stock on Date 1 for $3 each and 10 shares of T stock on Date 2 for $6 each. On Date 3, P acquires the assets of T in a reorganization under section 368(a)(1)(A). Pursuant to the terms of the plan of reorganization, F receives 2 shares of P stock for each share of T stock. Therefore, F receives 60 shares of P stock. Pursuant to section 354, F recognizes no gain or loss on the exchange. F is not able to identify which shares of P stock are received in exchange for each share of T stock.

Analysis: Under Prop. Treas. Reg. § 1.358-2(a)(2), F has 40 shares of P stock, each of which has a basis of $1.50 and are treated as having been acquired on Date 1. F has 20 shares of P, each of which has a basis of $3 and is treated as having been acquired on Date 2. On or before the date on which the basis of a share of P stock received becomes relevant, F may designate which of the shares of P have a basis of $1.50 and which have a basis of $3.

See Prop. Treas. Reg. § 1.358-2(c) Ex. 1.

Stock Basis Determination
Example 2

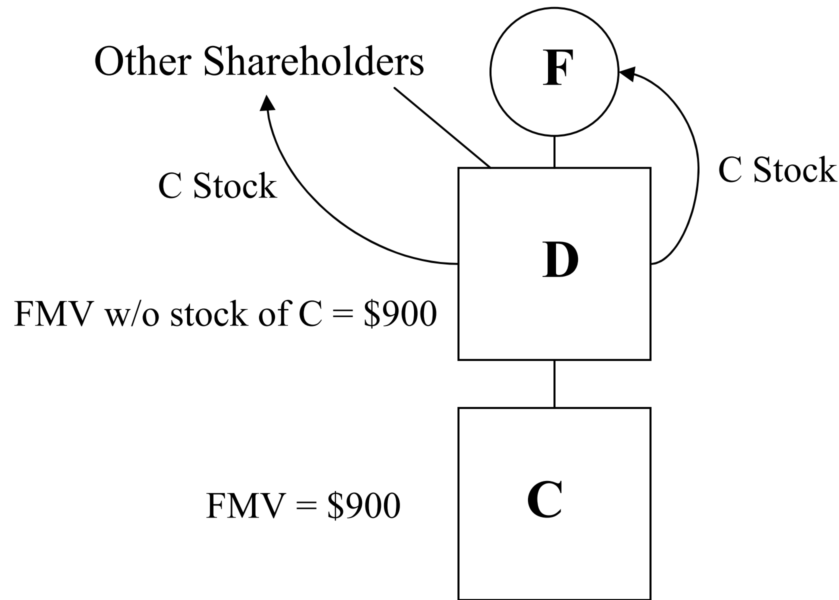


Facts: F, an individual, purchased 10 shares of T stock on Date 1 for $2 per share and 10 shares of T stock on Date 2 for $5 per share. On Date 3, P acquires the stock of T in a reorganization under section 368(a)(1)(B). Pursuant to the terms of the reorganization, F receives one share of P stock for every 2 shares of T stock. Pursuant to section 354, F recognizes no gain or loss on the exchange. F is not able to identify which portion of each share of P stock is received in exchange for each share of T stock.

Analysis: Under Prop. Treas. Reg. § 1.358-2(a)(2), F has 5 shares of P stock each of which has a basis of $4 and is treated as having been acquired on Date 1 and 5 shares of P stock each of which has a basis of $10 and is treated as having been acquired on Date 2. On or before the date on which the basis of a share of P stock received becomes relevant, F may designate which of the shares of P have a basis of $4 and which have a basis of $10.

See Prop. Treas. Reg. § 1.358-2(c) Ex. 4.

Stock Basis Determination
Example 3



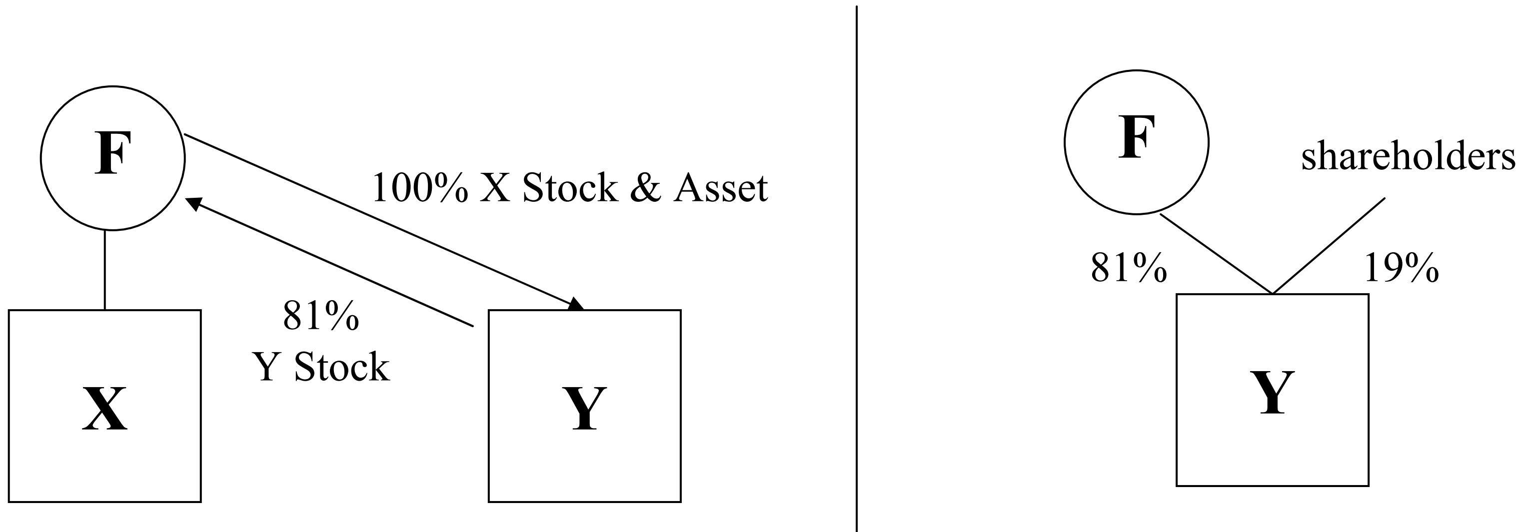
Date 1 – 5 shares, $4/share
Date 2 – 5 shares, $8/share
Date 3 – D distributes all C stock pro rata to D shareholders, 2 C shares for every D share owned

Facts: F, an individual, purchased 5 shares of D stock for $4 per share on Date 1 and 5 shares of D stock for $8 per share on Date 2. D owns all of the outstanding stock of C. The fair market value of the stock of D, excluding the stock of C, is $900. The fair market value of the stock of C is $900. In a distribution to which section 355 applies, D distributes all of the stock of C pro rata to its shareholders. No stock of D is surrendered in connection with the distribution. In the distribution, F receives 2 shares of C stock with respect to each share of D stock. Pursuant to section 355, F recognizes no gain or loss on the receipt of the shares of C stock. F is not able to identify which share of C stock is received in respect of each share of D stock.

Analysis: Under Prop. Treas. Reg. § 1.358-2(a)(2), because F receives 2 shares of C stock with respect to each share of D stock, the basis of each share of D stock is allocated between such share of D stock and two shares of C stock in proportion to the fair market value of those shares. Therefore, each of the 5 shares of D stock acquired on Date 1 will have a basis of $2 and each of the 10 shares of C stock received with respect to those shares will have a basis of $1. In addition, each of the 5 shares of D stock acquired on Date 2 will have a basis of $4 and each of the 10 shares of C stock received with respect to those shares will have a basis of $2. On or before the date on which the basis of a share of C stock received becomes relevant, F may designate which of the shares of C have a basis of $1 and which have a basis of $2.

See Prop. Treas. Reg. § 1.358-2(c) Ex. 7.

Stock Basis Determination
Example 4

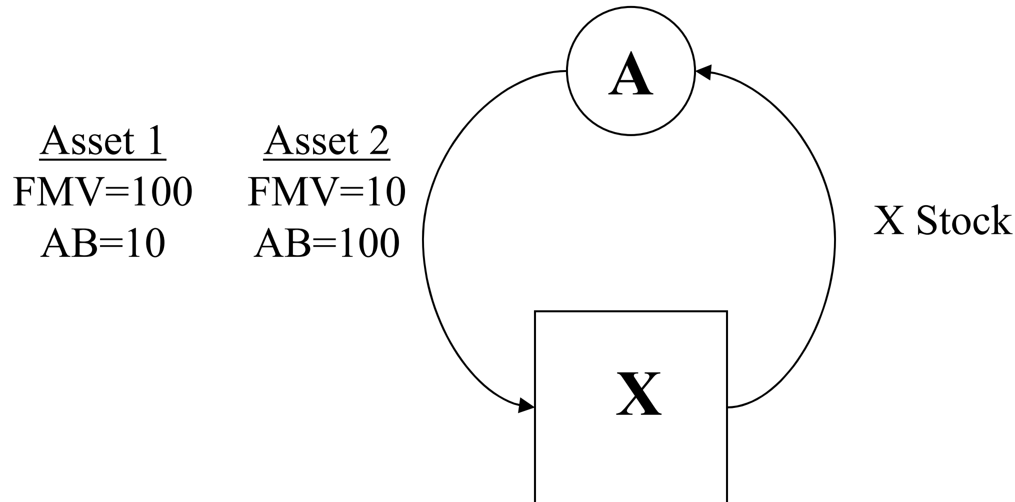


Facts: F owns 100 percent of Corporation X. On Date 1, X transfers 100 percent of the X stock and Asset to Y solely in exchange for Y stock. After the transaction, F owns 81 percent of Y. The transaction qualifies under both section 351 and section 354.

Analysis: Because F received stock in Y in a transaction that qualifies under both section 351 and section 354, the new proposed regulations do not apply to determine F's basis in its Y stock.

See Prop. Treas. Reg. § 1.358-2(a)(2)(iv); Prop. Treas. Reg. § 1.358-2(c) Ex. 5.

Stock Basis Determination
Example 5



Facts: In a transaction qualifying under section 351, A forms Corporation X and contributes to X Asset 1, with a value of $100 and a basis of $10, and Asset 2, with a value of $10 and a basis of $100, solely in exchange for 100 percent of the stock of X.

- Is A's basis in its X stock blended?

- The new proposed regulations do not apply to this transaction?