This article urges the IRS1 to clarify its position on a potential basis disappearance in acquisitive all-cash D reorganizations (each a stockless D reorganization) involving tiered entities that may occur under the newly finalized regulations dealing with those transactions.

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This article urges the IRS to clarify its position regarding basis disappearance in some stockless D reorganizations under the newly finalized regulations regarding basis disappearance in some all-cash type D reorganizations (each a stockless D reorganization) in which that shareholder or security holder surrenders a share of stock or a security in a stockless D reorganization.

Those regulations are effective December 18, 2009.

The Fact Pattern

An example in the final regulations presents the issue. Using the same terminology as the regulations, we assume the following fact pattern: P owns all the stock of S1 and S2; S1 owns all the stock of S3, which owns all the stock of T, the target corporation; S2 owns all the stock of S4, which owns all the stock of S, the acquiring corporation; and T sells all its assets to S for $70x in cash, which is the fair market value of those assets, and liquidates immediately thereafter.3

We further assume that S3 has an adjusted basis of $100x in its T stock before T’s asset sale and liquidation and that S3 therefore realizes a $30x loss from the transaction.

The Disappearing Basis

Under the regulations, T’s asset sale to S and its liquidation are treated as a stockless D reorganization. The distribution requirement of sections 368(a)(1)(D) and 354(b)(1)(B) is treated as having been satisfied even though no acquirer/transferee stock (S stock) is issued or distributed. Instead, S is deemed to issue a nominal share of S stock to T in addition to the $70x cash, and T is deemed to distribute both the nominal share and the $70x cash in its liquidation into S3.4

In the hands of S3, the nominal share would have a basis of $30x under section 358(a)(1)(A), which is the initial adjusted basis of S3’s T stock, reduced by $70x of cash received by S3.5 Because S3 in reality receives nothing other than the $70x cash, the $30x basis in the nominal share represents the loss realized by S3 that it could not recognize.6

Further, however, under the regulations and as illustrated in the example,7 S3 is deemed to distribute the nominal share to S1, which is in turn deemed to distribute the nominal share to P. P is then deemed to transfer the nominal share to S2, which is in turn deemed to transfer the nominal share to S4. At the end of the deemed issuance and transfers, S4 remains the sole shareholder of S.

The distribution of the nominal share by S3 is presumably governed by section 301. As a result, S3 cannot recognize the $30x loss,8 and yet S1’s basis in the nominal share is its FMV,9 which is zero. Subsequent transfers would have no further effect because they relate to transfers of an asset with zero basis and zero value.10
short, the $30x basis in the nominal share has disappeared, and the taxpayer appears to have no way of recouping that basis.\textsuperscript{11}

\textbf{The Need for Clarification}

The regulations’ intent regarding the basis disappearance in the fact pattern above is not entirely clear. On the one hand, the preamble says that commentators “have asked for clarification as to whether the deemed issuance of a nominal share has any tax significance beyond satisfying the distribution requirement of section 354(b)(1)(B).”\textsuperscript{12} By rejecting the alternative approach of “simply deeming” the statutory requirement satisfied \textsuperscript{13} without the nominal share issuance, the preamble appears to answer yes to the commentators’ question and may require giving separate tax effect to the subsequent transfers.\textsuperscript{15} The disappearing basis then follows.

On the other hand, the preamble takes pains, in many places, to address the potential disappearing basis problem in a stockless D reorganization.\textsuperscript{14} Reg. section 1.358-2(a)(2)(iii) is amended to allow taxpayers in those cases to “designate the share of stock of the issuing corporation to which the basis, if any, of the nominal share will attach.”\textsuperscript{16} In promulgating this taxpayer-friendly attachment rule, the preamble says the IRS “agree[s] that the basis in the shares of the stock surrendered should be preserved in the basis of the stock of the transferee in a transaction described in these final regulations.”\textsuperscript{17} The preamble states this in general terms, without any exception for transactions that are described “in these final regulations” but that involve tiered entities. Also, the preamble says that “beyond satisfying section 354(b)(1)(B), the IRS . . . believe[s] that the nominal share should be treated as nonrecognition property . . . and thus substituted basis property.”\textsuperscript{18} This seemingly suggests that the nominal share is designed to be a device for preserving basis and not eliminating it.

I believe that in a stockless D reorganization, the $30x remaining basis that S3 had in T stock should not be eliminated as a result of the deemed distribution by S3 to S1 (or any other deemed transfers). I also believe that, on balance, the newly issued regulations dealing with stockless D reorganizations are not intended to cause a taxpayer’s basis to evaporate as a result of an ancillary transfer called into existence by a deeming rule.\textsuperscript{19} A clarification from the IRS on this point, including on to which asset the basis would attach, would be appropriate and welcome. Meanwhile, in cases when basis preservation is too important to allow for any significant ambiguity, taxpayers should consider, for example, for S to issue an actual share to T, which share S3 can retain rather than distribute to S1. It is this distribution, either actual or deemed, that results in the basis disappearance.\textsuperscript{19}