

## Basis Disappearance in All-Cash D Reorganizations

By Jonathan Zhu

Jonathan Zhu is a tax partner at Wilson Sonsini Goodrich & Rosati, Palo Alto, Calif. The views expressed in this article are solely those of the author and should not be attributed to his firm or any other person. Zhu thanks Jasper L. Cummings, Jr. and Michael R. Faber for helpful comments.

This article urges the IRS to clarify its position regarding basis disappearance in some all-cash type D reorganizations under the newly finalized regulations dealing with those transactions.

Copyright 2010 Jonathan Zhu.  
All rights reserved.

This article urges the IRS<sup>1</sup> 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 stockless D reorganizations.<sup>2</sup> 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 acquirer 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.<sup>3</sup>

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.<sup>4</sup>

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.<sup>5</sup> 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.<sup>6</sup>

Further, however, under the regulations and as illustrated in the example,<sup>7</sup> 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,<sup>8</sup> and yet S1's basis in the nominal share is its FMV,<sup>9</sup> which is zero. Subsequent transfers would have no further effect because they relate to transfers of an asset with zero basis and zero value.<sup>10</sup> In

<sup>5</sup>Section 358(a)(1)(A).

<sup>6</sup>Section 356(a) requires recognition of gain when there is boot, but section 356(c) prohibits recognition of any loss realized.

<sup>7</sup>Reg. section 1.368-2(l)(2)(i) ("where appropriate, the nominal share will be further transferred through chains of ownership to the extent necessary to reflect the actual ownership of the transferor and transferee corporations"); reg. section 1.368-2(l)(3), Example 3.

<sup>8</sup>Section 311(a). Different rules apply in the consolidated return context. In that case, "the principles of section 311(b) apply to [S3's] loss, as well as gain, from an intercompany distribution of property." Reg. section 1.1502-13(f)(2)(iii). As a result, S3's loss is not categorically denied but only deferred until recognized or otherwise determined under the matching rule. *Id.* See also reg. section 1.1502-13(f)(7)(i), Example (1)(d) ("loss property"). It is unclear, however, how the matching rule applies when the loss property is the nominal share, which will have a zero basis in the hands of S1 and the subsequent transferees. Under the regulations, "if a shareholder or security holder surrenders a share of stock or a security in a [stockless D reorganization] in which that shareholder or security holder is deemed to receive a nominal share . . . such shareholder may . . . designate the share of stock of the issuing corporation to which the basis, if any, of the nominal share will attach." Reg. section 1.358-2(a)(2)(iii) (as amended by T.D. 9475) (emphasis added). Although S3 holds the nominal share with a \$30x basis, it holds no share of stock of S, the issuing corporation, to which the basis could be attached. On reaching the hands of S4, the nominal share has a basis equal to its FMV, which is zero. The "if any" language above in reg. section 1.358-2(a)(2)(iii) is not entirely instructive about how or when S4 would recognize the "corresponding item" triggering S3's deferred loss. Although it seems reasonable for S4 to be able to attach the zero basis to a designated share the sale of which to an unrelated party would trigger S3's deferred loss recognition, it would be helpful for the IRS to confirm this approach. Cf. reg. section 1.1502-13(f)(7)(i), Example (4) (amended by T.D. 9475, *supra* note 2) (gain example).

<sup>9</sup>Section 301(d).

<sup>10</sup>If the nominal share did have any basis, section 362(e)(2) may apply to limit the inside basis of the nominal share to its

(Footnote continued on next page.)

<sup>1</sup>In this article, references to the IRS include those to the Treasury Department, as appropriate.

<sup>2</sup>T.D. 9475 (Dec. 18, 2009), *Doc 2009-27671, 2009 TNT 241-7*.

<sup>3</sup>Reg. section 1.368-2(l)(3), Example 3.

<sup>4</sup>Reg. section 1.368-2(l)(2)(i).

short, the \$30x basis in the nominal share has disappeared, and the taxpayer appears to have no way of recouping that basis.<sup>11</sup>

### 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)."<sup>12</sup> By rejecting the alternative approach of "simply deem[ing] the statutory requirement satisfied" 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.<sup>13</sup> 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.<sup>14</sup> 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."<sup>15</sup> 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*."<sup>16</sup> 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."<sup>17</sup> 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.<sup>18</sup> 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.<sup>19</sup>

---

FMV in a section 351 transfer, unless an election under section 362(e)(2)(C) is made to reduce the outside basis instead.

<sup>11</sup>There is no disappearing basis in the case of realized gain. Assume, in our example, that S3's adjusted basis in its T stock is \$40x instead of \$100x. The realized gain is \$30x, which must be less than the amount of boot (\$70x) and which therefore must all be recognized. Section 356(a)(1). The gain may be treated as dividend in whole or in part. Section 356(a)(2). In recognizing the \$30x gain, S3's basis in its T stock has been entirely recovered. As in the case of a tax-free reorganization, S3 recognizes this gain without any basis adjustments to T's assets transferred to S. See *infra* note 13 (similar issue in consolidated return setting).

<sup>12</sup>T.D. 9475 (under "Issuance of Nominal Share"), *supra* note 2.

<sup>13</sup>*Id.* Under the same fact pattern, but with gain rather than loss and in the consolidated return context, the subsequent deemed transfers of the nominal share may duplicate gain in the sense described below. The deemed transfer of the nominal share from S3 to S1 generates deferred intercompany gain arising from the excess loss account created in S3's deemed redemption of S's stock deemed issued (which stock has an FMV of \$100x and is in addition to the nominal share to which the excess loss account attaches). See reg. section 1.1502-13(f)(7)(i), Example 4 (amended by T.D. 9475, *supra* note 2). This gain is "to be subsequently taken into account under the matching and acceleration rules," *id.*, without any adjustment to the basis of the target's assets in the hands of the acquirer. See American Bar Association Section of Taxation, "Comments on Proposed and Temporary Regulations Under Code Section 368(a)(1)(D)," Pt. II.C (Apr. 16, 2008), *Doc 2008-8517*, 2008 TNT 75-22; New York State Bar Association (NYSBA) Tax Section, "Report on Proposed and Temporary Regulations Regarding All-Cash Acquisitive D Reorganizations," Pt. III.B (Sept. 25, 2009), *Doc 2009-21411*, 2009 TNT 185-74. The gain duplication in this sense is intended. T.D. 9475 (under "Application of Final Regulations to Consolidated Groups"), *supra* note 2. See also *supra* note 11 (similar issue in separate return setting).

<sup>14</sup>For a general discussion, see NYSBA, *supra* note 13.

---

<sup>15</sup>Reg. section 1.358-2(a)(2)(iii) (amended by T.D. 9475). This rule addresses the "inaccessible basis" issue discussed by commentators. See NYSBA, *supra* note 13, at Pt. III.A.

<sup>16</sup>T.D. 9475 (under "Basis Allocation") (emphasis added), *supra* note 2.

<sup>17</sup>*Id.* (under "Issuance of Nominal Share").

<sup>18</sup>For a general discussion on the issues arising in tax deeming rules, see Jonathan Zhu, "Tax Deeming Rules: A Method to the Madness," *Tax Notes*, Dec. 6, 2004, p. 1425, *Doc 2004-21168*, or 2004 TNT 235-41. The deeming rule here is the deeming of T's asset sale and liquidation as a stockless D reorganization through the issuance and distribution of a nominal share, and the ancillary imaginary transactions are those steps — the subsequent transfers of the nominal share — that did not in fact occur but are needed to implement the deeming rule. The article proposes generally to give no tax effect to the ancillary steps. See *id.* at 1431-1432 (explaining reasons for proposal).

<sup>19</sup>At a cost, of course, of a split ownership for S. The deemed distribution by S3 is also responsible for generating the deferred intercompany gain, when there is gain, in the consolidated return context. See *supra* note 13.