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April 28, 2010

Hon. Douglas Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Comments on Proposed Regulations Regarding Allocation of Consideration and Allocation and Recovery of Basis in Transactions Involving Corporate Stock or Securities

Dear Commissioner Shulman:

Enclosed are comments on proposed regulations regarding allocation of consideration and allocation and recovery of basis in transactions involving corporate stock or securities. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Stuart M. Lewis
Chair, Section of Taxation

Enclosure

cc: Michael F. Mundaca, Assistant Secretary (Tax Policy), Department of the Treasury
William Wilkins, Chief Counsel, Internal Revenue Service
Joshua Odintz, Acting Tax Legislative Counsel, Department of the Treasury
William Alexander, Associate Chief Counsel, Office of Associate Chief Counsel (Corporate), Internal Revenue Service

ABA SECTION OF TAXATION

COMMENTS ON PROPOSED REGULATIONS REGARDING ALLOCATION OF CONSIDERATION AND ALLOCATION AND RECOVERY OF BASIS IN TRANSACTIONS INVOLVING CORPORATE STOCK OR SECURITIES

These comments ("Comments") are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Neil Barr of the Corporate Tax Committee of the Section of Taxation, with assistance from Ryan LaRosa. Substantive contributions were made by Jasper Cummings, Philip Levine, Timothy Shuman, John Sweet, Dana Trier, Gary Vogel, Daniel White and Michael Wilder. These Comments were reviewed by Robert Woodward, Committee Chair. The Comments were further reviewed by Robert H. Wellen of the Section's Committee on Government Submissions and by Peter H. Blessing, Council Director for the Corporate Tax Committee.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal income tax principles addressed by these Comments, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: April 28, 2010

EXECUTIVE SUMMARY

These Comments respond to the request for comments regarding the Regulations proposed by the Department of the Treasury ("Treasury") and the Internal Revenue Service (the "Service") in the Federal Register on January 21, 2009, and as corrected on March 5, 2009 (the "Proposed Regulations"),[1] providing guidance regarding the recovery of stock basis in distributions under section 301,[2] transactions that are treated as dividends to which section 301 applies, and the determination of gain and the basis of stock or securities received with respect to, or in exchange for, stock or securities in certain transactions.[3]

The Proposed Regulations provide a single model for stock basis recovery for shareholders that receive constructive or actual distributions under section 301 (dividend equivalent transactions) and a single model for transactions treated as a sale or exchange of stock under section 302(a) (non-dividend equivalent transactions). The Preamble to the Proposed Regulations (the "Preamble") states that the "cornerstone" of the Proposed Regulations is that a "share of stock is [a] basic unit of property that can be disposed of and, accordingly, the results of a transaction should generally derive from the consideration received in respect of that share."[4] The Proposed Regulations adopt a single model for the recovery of stock basis in "economically similar" transactions.[5] The core principles of the Proposed Regulations are that:

(i) in connection with a dividend equivalent transaction, taxpayers generally may specify the class of stock upon which the distribution is paid, but they are required to treat the distribution as paid *pro rata* to all shares within the class held by the distributee, and

(ii) for non-dividend equivalent transactions, taxpayers may specify both the consideration paid in respect of a class of stock and the shares within the class that are transferred.[6]

The Preamble states that section 301 distributions should be treated as made on a *pro rata* basis with respect to all shares of stock within the class upon which the distribution is made,

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[1] Prop. Reg. §§ 1.301-2, 1.302-2, 1.302-5, 1.304-1, 1.304-2, 1.304-3, 1.304-5, 1.351-2, 1.354-1, 1.355-1, 1.356-1, 1.358-1, 1.358-2, 1.358-6, 1.368-1, 1.861-12, 1.1001-6, 1.1016-2, 1.1374-10, 74 Fed. Reg. 3509 (2009), *as corrected by* 74 Fed. Reg. 9575 (2009).

[2] References to a "section" are to a section of the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

[3] These Comments do not, as a general matter, address issues that are unique to corporations filing consolidated returns. Such issues may be addressed in subsequent comments.

[4] 74 Fed. Reg. at 3510.

[5] *Id.*

[6] *Id.*

notwithstanding any designations to the contrary, citing *Johnson v. United States*[7] for this proposition.[8] The Proposed Regulations would not permit shareholders to make distinctions on a share-by-share basis within a class for dividend equivalent transactions. These rules also apply to transactions that are subject to taxation under section 301 by reason of section 302(d), section 304 or section 356. However, if a transaction is not equivalent to a dividend, the Proposed Regulations would permit shareholders, in certain circumstances, to designate different shares of stock within the applicable class, including selecting the shares surrendered in the transaction. In these cases, section 1012 is used as a paradigm for transactions between the shareholder and the redeeming or issuing corporation, and shareholders generally are free to identify the shares transferred in an exchange and the consideration received therefor.

Many of the fundamental policy choices in the Proposed Regulations follow from decisions made in 2006.[9] The fundamental policy choices that inform the construct in the Proposed Regulations, and the potential alternatives, have been developed extensively in comments submitted by this Committee, as well as others.[10] These Comments identify certain issues presented by the Proposed Regulations and respond to requests for comments by Treasury and the Service in the Preamble.

Comments Relating to Selectivity. The Proposed Regulations would allow a taxpayer engaging in a multi-class stock reorganization that involves different forms of consideration to specify the consideration allocable to a particular class of stock—so long as the allocation is "economically reasonable." This approach allows a taxpayer to recognize loss in a reorganization if the class of shares transferred by the taxpayer in the exchange is allocated only non-stock consideration, even if the same shareholder transfers shares of another class in exchange for stock. This result is inconsistent with the Service's longstanding position set forth in Rev. Rul. 74-515.[11] In this respect, the Proposed Regulations raise important policy questions regarding taxpayers' ability to "cherry pick" consideration in a multi-class stock reorganization. Moreover, the Proposed Regulations would incorporate the principle of Rev. Rul. 68-55,[12] a long-standing anti-cherry picking ruling, with respect to non-reorganization exchanges. We are not aware of a compelling policy justification for permitting the flexibility to allocate specific consideration to stock in a reorganization while denying that same flexibility in other transactions. Accordingly, we

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[7] 435 F. 2d 1257 (4th Cir. 1971).

[8] 74 Fed. Reg. at 3510.

[9] *See* T.D. 9244, 2006-1 C.B. 463 (Jan. 23, 2006) (finalizing Regulations under sections 356 and 358).

[10] *See*, *e.g.*, Individual Comments submitted by the ABA Section of Taxation, "Comments Concerning Proposed Regulations Providing Guidance Regarding the Treatment of Unutilized Basis of Stock Redeemed in Certain Transactions" (Sept. 9, 2003), *available at* *http://www.abanet.org/tax/pubpolicy/2003/030909ct.pdf*; Gordon E. Warnke, *Developments, Theories and Themes in Stock Basis*, 86 Taxes 85 (Mar. 2008); Alan L. Feld, *Another Approach to Corporate Stock Basis*, 86 Taxes 131 (Mar. 2008).

[11] 1974-2 C.B. 118.

[12] 1968-1 C.B. 140.

recommend that Treasury and the Service undertake further study of these issues, with the objective of providing consistent rules in both transactional settings.

Comments Relating to Formalism. The Proposed Regulations would allow minor changes to an overall business transaction to cause meaningful changes to the tax consequences of the transaction. Such a form-driven regime raises the question of whether an anti-abuse rule should be incorporated in final Regulations and whether the economic substance doctrine is "relevant" (within the meaning of section 7701(o)) to transactions governed by the Proposed Regulations. We recommend that no anti-abuse rule be adopted, and that final Regulations clarify that the economic substance doctrine is not "relevant" to the form chosen by a taxpayer to achieve a result sanctioned by the Proposed Regulations. Moreover, given the highly formalistic nature of the Proposed Regulations, we recommend that transactions considered to be abusive be specifically identified as such in final Regulations. Finally, if Treasury and the Service are troubled by the electivity afforded by the Proposed Regulations, we suggest that consideration be given to broadening the definition of "class" to eliminate certain planning opportunities and traps for the unwary in the Proposed Regulations.

Comments Relating to Administrability with regard to Stockless Transactions. We believe that the stockless exchange rules contained in the Proposed Regulations would impose significant administrative costs in connection with intra-group restructurings. Accordingly, we recommend certain exclusions or simplifying conventions for common transactions. At a minimum, we recommend that transfers of cash and member debt be excluded from the application of the stockless exchange rule, or that a simplifying convention be adopted within affiliated groups that allows existing tax basis to be adjusted without a hypothetical recapitalization.

Comments Related to Flow-through Entities and the Deferred Loss Regime. We recommend a default rule under which the owners of a flow-through entity are treated as the "redeemed shareholders" of stock redeemed from the entity for purposes of determining whether a deferred loss may be allocated to the owners of the flow-through entity. We believe that, in general, it would be appropriate to reduce an owner's outside basis in the flow-through entity when the redemption occurs (*i.e.*, a "net operating loss" model). We also propose that a flow-through entity be permitted to elect to be treated as the "redeemed shareholder," which election would be binding on all owners of the flow-through entity. If the election is made, the reduction of the owners' outside basis would be deferred until the applicable inclusion date.

Comments Relating to the Redemption of Section 306 Stock. We recommend that a redemption of section 306 stock be subject to the rules generally applicable to redemptions governed by section 302(d), with modifications to preserve the remaining section 306 taint of any non-redeemed shares of section 306 stock. Accordingly, we do not recommend a regime whereby the basis of redeemed section 306 stock would shift back to the stock with respect to which the section 306 stock arose.

Comments Relating to the Treatment of Deferred Losses in Connection with Split-Up Transactions. We believe that a *pro rata* split-up is not the proper occasion for an inclusion date. We recommend a regime that, based on objective measures, treats the corporation that represents, to the greatest extent, the continuation of the distributing corporation as "continuing" for purposes of the deferred loss regime. The inclusion date after a *pro rata* split-up would be tested by reference to that corporation.

Comments Relating to the Tax Effect of a Hypothetical Recapitalization. Under certain circumstances under the Proposed Regulations, a taxpayer would be deemed to surrender all of its shares in a redeemed class in a hypothetical recapitalization. The hypothetical recapitalization seeks to preserve the tax attributes of the blocks of stock within the class held by the taxpayer. We do not believe that such a hypothetical recapitalization is intended to have federal income tax consequences beyond the basis tracing in the Proposed Regulations, but the Proposed Regulations contain no statement to this effect. Accordingly, we recommend that the final Regulations clarify that the hypothetical recapitalization has no federal income tax effect other than the basis tracing results stated in the Proposed Regulations.

Comments Relating to the Definition of a "Class" of Stock. The Proposed Regulations contain two somewhat inconsistent definitions of a "class" of stock. Assuming that the general contours of the definition of "class" are retained, we support the use of the definition in Proposed Regulation section 1.302-5(b)(2) uniformly throughout the Proposed Regulations.

DISCUSSION

I. <u>BACKGROUND: CURRENT LAW</u>

A. Distributions with Respect to Stock and Dividend Equivalent Redemptions

1. Distributions with Respect to Stock

Section 301 governs the tax treatment of distributions by a corporation of money or other property to its shareholders with respect to its stock. Under sections 301(c) and 316, a distribution is treated as a dividend to the extent of the distributing corporation's earnings and profits. The portion of any distribution that is in excess of the distributing corporation's earnings and profits is first applied to "reduce the adjusted basis of the stock," and, thereafter, is treated as giving rise to gain from the sale or exchange of property. Section 301 and the Regulations thereunder do not currently contain rules governing a shareholder's recovery of the basis in its stock when (i) the shareholder receives a distribution from a corporation in excess of the corporation's earnings and profits and (ii) the distribution is made with respect to shares of stock that were acquired by the shareholder on different dates or at different prices. The leading case in this area, *Johnson v. United States*,[13] held that, when a corporation made a distribution to a shareholder holding two blocks of common stock with different tax bases with the intention that the distribution be made on a non-*pro rata* basis with respect to the high-basis block, the distribution was nonetheless treated as having been made *pro rata* among all of the shares in the class. Sections 301 and 1012, in the view of the court, "preclude the aggregation of the cost of the two lots of stock . . . and inexorably command assessment of the transaction as a *pro rata* distribution."[14]

2. Dividend Equivalent Redemptions

a. Section 302

Section 302 governs the tax treatment of stock redemptions. Under section 302(a), a distribution by a corporation of money or other property in redemption of stock will be treated as a sale of the stock if the distribution (i) is not essentially equivalent to a dividend, (ii) is substantially disproportionate with respect to the shareholder, (iii) terminates the shareholder's interest in the corporation or (iv) is a redemption in partial liquidation of a non-corporate shareholder. If the distribution in redemption of stock is not treated as a sale under any of clauses (i) through (iv), the distribution is treated under section 302(d) as a distribution subject to taxation under section 301 (a "Dividend Equivalent Redemption").

The current Regulations under section 302 provide that, if a taxpayer surrenders shares in a Dividend Equivalent Redemption, "proper adjustment" is to be made to the taxpayer's

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[13] 435 F. 2d 1257 (4th Cir. 1971).

[14] *Id*. at 1259.

basis in its remaining shares.[15] If the taxpayer continues to hold shares following the Dividend Equivalent Redemption, the unrecovered basis in the redeemed shares is added to the basis of the unredeemed shares.[16] Moreover, if all shares of a taxpayer's stock are redeemed in the transaction, the taxpayer's unrecovered basis may be shifted to shares owned by related parties under certain circumstances.[17] The ability to shift basis under section 302 has led to transactions that the Service has viewed as abusive.[18] Regulations were proposed in 2002 to address these perceived basis-shifting abuses.[19] After receipt of a number of comments, in 2006, the Service withdrew the 2002 Proposed Regulations, at which time the Service announced further study of the issues presented by the 2002 Proposed Regulations.[20]

b. Section 304

Section 304 governs the tax treatment of sales of stock involving related corporations. Under section 304(a)(1), if one or more persons ("parent") is in control of two corporations and one of those corporations (the "acquirer") acquires stock of the other corporation (the "target") from parent in exchange for money or other property, the transaction is treated as a distribution of the property in redemption of stock of the acquirer. The redemption is subject to the section 302 rules for determining dividend equivalence. If the sale is treated as a Dividend Equivalent Redemption, the transaction is treated as if parent contributed the target stock to the acquirer in exchange for a newly issued stock of the acquirer in a hypothetical section 351 transaction and then the acquirer redeemed the newly issued stock. Under section 304(b)(2), the distribution would be treated as a dividend to the extent of the earnings and profits of the acquirer and then to the extent of the earnings and profits of the target. To the extent that the distribution exceeds the earnings and profits of both the target and the acquirer, the parent would recover its basis in the stock of the acquirer.[21]

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[15] Reg. § 1.302-2(c).

[16] *See* Reg. § 1.302-2(c), Ex. (1), (3).

[17] *See* Reg. § 1.302-2(c), Ex. (2).

[18] *See, e.g.*, Notice 2001-45, 2001-2 C.B. 129 (July 27, 2001); *H.J. Heinz Co. v. United States*, 76 Fed. Cl. 570 (2007).

[19] Notice of Proposed Rulemaking, 67 Fed. Reg. 64,331 (2002).

[20] Announcement 2006-30, 2006-19 I.R.B. 879.

[21] The Service has stated that the "better view" of current law is that only the basis in the shares deemed issued in the section 304 construct may be recovered. *See* Withdrawal of Proposed Regulations Relating to Redemptions Taxable as Dividends, 71 Fed. Reg. 20,044 (2006); *cf*. Reg. § 1.367(a)-9T(e), Ex. (stating that the taxpayer "takes the position" that the basis of pre-existing shares, in addition to that of the deemed issued shares, is recovered). However, the Proposed Regulations would change this result (after the application of section 1059) and would provide that, consistent with other dividend equivalent transactions, the deemed distribution would be made *pro rata* across all shares of the class of stock deemed issued. Prop. Reg. § 1.304-2(a)(4).

B. Non-Dividend Equivalent Redemptions

If a taxpayer owns stock in a corporation that is redeemed in a transaction taxed as a sale or exchange under section 302(a) (a "Non-Dividend Equivalent Redemption"), the taxpayer may select the shares that are treated as redeemed.[22]

C. Reorganization Exchanges

Section 356 governs the taxation of boot received in a reorganization. If, pursuant to a reorganization, a taxpayer exchanges its stock in the target corporation for qualifying property and boot, the consequences of the receipt of the boot depend on whether the exchange "has the effect of the distribution of a dividend."[23] Under the Supreme Court's holding in *Clark v. Commissioner*,[24] whether the receipt of boot has the effect of a dividend for purposes of section 356(a)(2) is determined by reference to the "exchange as a whole."[25]

Rev. Rul. 74-515[26] is an important ruling in the current overall framework for basis recovery in the context of a reorganization. The ruling addresses a statutory merger under section 368(a)(1)(A) in which target common stock is exchanged for acquirer common stock and target preferred stock is exchanged for cash. The ruling concludes that section 354 applies to a holder of common stock who transfers target common stock for acquirer common stock. On the other hand, section 302 applies to a shareholder who transfers only target preferred stock in exchange solely for cash. A shareholder who owns both target common stock and target preferred stock is treated under the ruling as having made a single exchange governed by section 356, with the result that the loss nonrecognition rule of section 356(c) applies to the preferred stock exchanged solely for cash.[27]

The Regulations provide that if the terms of a reorganization exchange specify that boot (or stock of a particular class) is received in exchange for a particular class of stock or particular securities surrendered, the terms generally will be respected if they are

[22] Reg. § 1.1012-1(c).

[23] I.R.C. § 356(a)(2).

[24] 489 U.S. 726 (1989).

[25] *Id*. at 727. A reorganization with boot is examined under *Clark* as if the target shareholders received only stock consideration in the reorganization and then, immediately after the reorganization, the acquirer stock deemed received in the reorganization is redeemed in exchange for the boot in a transaction governed by section 302.

[26] 1974-2 C.B. 118.

[27] *Id*. ("Those *X* shareholders who owned both common stock and preferred stock are treated as having made an exchange described in section 356(a)(1) of the Code because the property they received in the exchange for their former *X* stock interest consisted not only of *Y* stock which is permitted by section 354, but also of cash.").

"economically reasonable."[28] Under current law, this general rule applies for both a reorganization exchange that is treated as equivalent to a dividend under section 356(a)(2) (a "Dividend Equivalent Exchange") and a reorganization exchange that is not treated as equivalent to a dividend (a "Non-Dividend Equivalent Exchange").

II. <u>PROPOSED REGULATIONS</u>

A. Distributions with Respect to Stock and Dividend Equivalent Redemptions

Generally

The Proposed Regulations would adopt the *Johnson* model for dividend equivalent transactions. Under the Proposed Regulations, taxpayers that receive a distribution subject to taxation under section 301 (including a Dividend Equivalent Redemption under section 302(d) or section 304) would be required to recover the basis in their stock on a *pro rata*, share-by-share basis with respect to the class of stock on which the distribution is (or is deemed to be) made. A taxpayer that receives such a distribution (or surrenders shares in such a Dividend Equivalent Redemption) could recognize gain with respect to some shares while continuing to have unrecovered basis in other shares of the same class.

Hypothetical Recapitalization

If a taxpayer surrenders shares in a Dividend Equivalent Redemption and continues to hold shares in the redeemed class, the taxpayer's unrecovered basis in the redeemed shares is reflected in the taxpayer's remaining shares. The Proposed Regulations provide that such a taxpayer is deemed to have exchanged all of its shares (including the redeemed shares) in a hypothetical recapitalization under section 368(a)(1)(E) for the number of shares in the redeemed class that it directly holds after the Dividend Equivalent Redemption (the "Hypothetical Recapitalization"). The tracing rules under section 358 preserve the taxpayer's basis of the shares exchanged in the Hypothetical Recapitalization in the shares that it continues to hold after the redemption. The Proposed Regulations, however, do not specify whether the Hypothetical Recapitalization is a cognizable tax event for any other purpose.

Deferred Losses and Anti-Basis Shifting

If a taxpayer surrenders all of its shares of a class of stock in a Dividend Equivalent Redemption but does not recover all of its basis in the redeemed shares, the Proposed Regulations would not permit the taxpayer to shift its unrecovered basis to other classes of stock held by the taxpayer or to any stock held by related parties or to recognize a loss immediately. Adopting a model similar to the 2002 Proposed Regulations, the Preamble states:

> [u]nder current law, if all of the shares of a single class held by a shareholder are redeemed in a dividend equivalent redemption, any unrecovered basis in the redeemed shares is permitted to shift to other shares in certain circumstances. See § 1.302-2(c). The IRS and Treasury Department believe that the shifting of

[28] Reg. §§ 1.356-1(b), 1.358-2(a)(2)(ii).

> stock basis is inconsistent with the fundamental principle that each share is a separate unit of property, and can lead to inappropriate results.[29]

The Proposed Regulations therefore would preserve the tax basis of the redeemed shares for the redeemed shareholder in the form of a deferred loss. The character and amount of the deferred loss would be fixed at the time of the redemption. The deferred loss could be accessed upon the occurrence of an "inclusion date" with respect to the redeemed shareholder. The "inclusion date" is the earlier of the date that the conditions of any of section 302(b)(1), (2) or (3) are satisfied with respect to the redeemed shareholder, or the date all shares of the issuing corporation, including shares in classes other than the redeemed class, become worthless under section 165(g).

The Proposed Regulations include special inclusion date rules applicable only to corporate shareholders. First, if the redeemed shareholder is a corporation, an inclusion date includes the date on which the issuing corporation has recognized all gain and loss with respect to its assets and has ceased to exist for tax purposes. Additionally, a foreign corporation may have an inclusion date upon a tax-free domestication of its assets in a section 332 liquidation or in a reorganization that is a section 381 transaction. Finally, a foreign corporation that is not a controlled foreign corporation on the date of the redemption may have an inclusion date on the date it transfers its assets to a controlled foreign corporation in a section 332 liquidation or in a reorganization that is a section 381 transaction.

The Proposed Regulations reserve as to the inclusion date for deferred losses incurred with respect to stock held by flow-through entities. The Preamble requests comments as to whether it is appropriate to view the flow-through entity or its owner as the redeemed shareholder for purposes of the Proposed Regulations. Comments are also requested regarding the appropriate timing for the "outside" basis adjustment in the equity of the flow-through entity attributable to the deferred loss.

The Proposed Regulations define "class" for purposes of taxing Dividend Equivalent Redemptions by reference to "economic rights to distributions rather than labels attached to shares or rights with respect to corporate governance."[30]

B. Dividend Equivalent Exchanges

The Proposed Regulations apply rules similar to the rules governing section 301 distributions and Dividend Equivalent Redemptions for purposes of determining the character of boot received in reorganizations and spin-offs. The Preamble, citing *Zenz v. Quinlivan*,[31] states that the "overall reorganization exchange" is considered in determining whether a

[29] 74 Fed. Reg. at 3510.

[30] Prop. Reg. § 1.302-5(b)(2).

[31] 213 F. 2d 914 (6th Cir. 1954).

reorganization is equivalent to a dividend.[32] The determination of whether an exchange is dividend equivalent then drives the tax consequences associated with the classes and blocks of shares surrendered.

The Proposed Regulations would provide that in a Dividend Equivalent Exchange, allocation of consideration to specific shares within a single class is not respected. That is, in a Dividend Equivalent Exchange, each share within a class would be treated as exchanged for a *pro rata* portion of each type of consideration paid for that class. Nevertheless, economically reasonable allocations of consideration between different classes of stock would be respected in a Dividend Equivalent Exchange.

In addition, the Proposed Regulations provide that section 302(d), not section 356(a)(2), would apply when a class of stock is exchanged in a reorganization solely for boot. Therefore, the loss nonrecognition rule of section 356(c) would not apply. However, the exchange would be subject to taxation under section 356, not section 302, if one share of acquirer stock were added to the consideration received by the taxpayer in respect of stock of such class.

C. Non-Dividend Equivalent Exchanges

If a reorganization is a Non-Dividend Equivalent Exchange, the Proposed Regulations would respect "economically reasonable" designations both between and within classes of stock. If a share of stock is exchanged solely for boot pursuant to a Non-Dividend Equivalent Exchange, it is treated as a redemption subject to taxation under section 302(a). Accordingly, because section 302(a) rather than section 356 would apply in that case, a shareholder may recognize a loss on an exchange pursuant to a plan of reorganization under the Proposed Regulations.

III. THEMATIC ISSUES: SELECTIVITY AND THE IMPORTANCE OF FORM

The Section of Taxation and others have written extensively about the various alternatives for recovery of basis in Dividend Equivalent Redemptions and Dividend Equivalent Exchanges, as well as the infirmities of the deferred loss regime under Proposed Regulation section 1.302-5 as it was proposed in 2002.[33] As a general matter, we will not revisit those concerns in this report, although a number of those participating in the preparation of these Comments continue to have significant reservations with respect to the adoption of a deferred loss regime. However, the Proposed Regulations raise several other important policy questions, which are discussed below.

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[32] 74 Fed. Reg. at 3511.

[33] *See supra* note 10.

The regime of corporate taxation under Subchapter C is in many respects form-driven.[34] Small differences in an overall transaction structure may materially alter the tax consequences of a transaction. For example, the addition of any boot to a transaction otherwise qualifying as a B reorganization may cause the transaction to violate section 368(a)(1)(B)'s "solely for . . . voting stock" requirement, thus resulting in a taxable stock sale. Courts are aware of the electivity created by this strict interpretation of "solely."[35] Likewise, it is possible in certain contexts effectively to elect section 301 or section 302 treatment in connection with the extraction of corporate profits prior to a disposition transaction.[36] Against the backdrop of this overall framework, the importance of form and taxpayer electivity has, if anything, been strengthened in the Proposed Regulations.

In this regard, the Proposed Regulations elevate section 1012 and the "share of stock" as the cornerstone of the regime for taxing dividends, redemptions and related aspects of reorganizations. We question whether a share of stock, as a basic unit of property, should be the predominant focus of the taxation regime in this context. Rather, we believe that a case may be made that the regime for taxing dividends, redemptions, and related aspects of reorganizations should turn instead on the shareholder's relationship to the corporation or the overall terms of the transaction.[37]

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[34] *See, e.g.*, Reg. § 1.368-2(k) (providing that a transaction otherwise qualifying as a reorganization will not be "disqualified or recharacterized" as a result of one or more subsequent transfers of stock or assets described in the Regulation, thus allowing substantial electivity between "upstream" and "sideways" reorganizations in certain circumstances).

[35] *See Chapman v. Commissioner*, 618 F. 2d 856, 874 (1980) ("Transactions may have been structured on the basis [of this interpretation of "solely"], with cash intentionally introduced to prevent reorganization treatment.").

[36] For example, when a sole shareholder sold some shares to a third party and had the balance of her shares redeemed for cash by the corporation, the entire transaction was taxed under the predecessor to section 302 (rather than as, in part, a dividend). *Zenz v. Quinlivan*, 213 F. 2d 914, 917-18 (6th Cir. 1954), *acq.*, Rev. Rul. 54-458, 1954-2 C.B. 167. However, when a shareholder received a distribution from a corporation preceding a sale of the stock of the corporation, the distribution was treated as a section 301 distribution. *See Litton Indus. v. Commissioner*, 89 T.C. 1086 (1987); Rev. Rul. 75-493, 1975-2 C.B. 109.

[37] *See, e.g., Davis v. United States,* 397 U.S. 301 (1970) (reviewing a shareholder's relationship to the corporation before and after a redemption in determining whether the redemption was not essentially equivalent to a dividend). There is also a question as to whether the "component" approach is consistent with the scope of the "exchange" as expressed by the Supreme Court in *Clark*. In *Clark*, the Court noted

> The language of § 356(a) strongly supports our understanding that the transaction should be treated as an integrated whole. Section 356(a)(2) asks whether "*an exchange* is described in paragraph (1)" that "has the effect of the distribution of a dividend." The statute does not provide that boot shall be treated as a dividend if its payment has the effect of the distribution of a dividend. Rather, the inquiry turns on whether the "exchange" has that effect. Moreover, paragraph (1), in turn, looks to whether "the property received in the exchange consists not only of property permitted by section 354 or 355 to be received without the recognition of gain but also of other property or money." Again, the statute plainly refers to one integrated transaction and, again, makes clear that we are to look to the character of the exchange as a whole and not simply its component parts.

(…continued)

The premise that stock must be viewed as a fundamental unit of property seems especially debatable with respect to transactions involving stock of consolidated group members. Although shares are distinct units of property for certain consolidated return purposes, a number of provisions are designed to eliminate or mitigate basis disparities among shares of member stock.[38] Virtually all redemptions within a consolidated group are Dividend Equivalent Redemptions that reduce basis rather than result in gain or loss, and a group member that holds shares in a target subsidiary generally cannot recognize gain or loss at all from the receipt of boot in an intercompany reorganization.[39] Thus, there is little need to preserve gain and loss in specific shares, and we believe the case for applying the specific allocation policies in the final section 358 Regulations to reorganizations within a consolidated group is weak.

The paradigm of the Proposed Regulations, focusing on a single share of stock, allows for the Service's conclusion in the Proposed Regulations that it is appropriate for taxpayers to recognize a loss with respect to a component of a reorganization. This policy choice also allows for minor structural differences in an overall economic transaction to play an important role in the taxation of the transaction. This section of the Comments addresses these policy issues.

Cherry Picking. A fundamental issue presented by the Proposed Regulations concerns the ability of a taxpayer to "cherry pick" consideration in connection with a multi-asset exchange. Under the Proposed Regulations, a corporation with multiple classes of stock that engages in a reorganization involving different forms of consideration may specify (or allow shareholders to specify) the consideration allocable to a particular class of stock without challenge by the Service, as long as the allocation is "economically reasonable."[40] This electivity, however, raises an important question about the interaction of "cherry picking" principles and corporate transactions. The Service has often taken the position that cherry picking of assets in a multi-asset corporate exchange should not be permitted,[41] presumably

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(continued…)

This broad interpretation of the component approach appears to be somewhat inconsistent with the implicitly narrow interpretation under the Proposed Regulations.

[38] *See, e.g.*, Reg. § 1.1502-19(d) (reallocating basis in shares at the time of a basis adjustment or determination to equalize and eliminate excess loss accounts); Reg. § 1.1502-32(c)(4) (reallocating basis adjustments between common and preferred stock when necessary to determine tax liability of any person); Reg. § 1.1502-36(b) (reallocating basis adjustments to and from shares at the time of a transfer of a loss share).

[39] *See* Reg. § 1.1502-13(f)(3). *But cf.* Reg. § 1.1502-13(f)(7)(i), Ex. 4 (creating intercompany gain in the deemed distribution of a nominal share issued in a cash D reorganization, rather than blending the excess loss account in the nominal share with positive basis in other actual shares of the issuer).

[40] Prop. Reg. § 1.354-1(d). The phrase "economically reasonable" is not defined in the existing Regulations or the Proposed Regulations, but it appears to require only that there be a value-for-value exchange.

[41] *See* Rev. Rul. 85-164, 1985-2 C.B. 117 (disallowing taxpayer's attempt to determine bases of stock in new corporation by designating specific property to be exchanged for specific stock and holding that basis of property transferred must be allocated among all stock received in proportion to fair market values of stock of

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each class); Rev. Rul. 68-55, 1968-1 C.B. 140 (requiring separate allocation of fair market value of each category of consideration received to transferred assets in proportion to relative fair market values of transferred assets); PLR 82-21-054 (Feb. 24, 1982) ("The Internal Revenue Service generally takes the position that where multiple properties are transferred and multiple properties are received in exchange therefor by the transferor, then a pro rata portion of each property received must be considered as having been received in exchange for each property transferred. It is improper to arbitrarily allocate specific properties received to specific properties transferred."). *But cf. Collins v. Commissioner*, 48 T.C. 45, 49 (1967) (approving taxpayer's treatment of transfer of parcel as two sales, one for cash and one via installment sale, when indenture deed covered entire parcel but mortgage indenture excluded part sold for cash and treatment was consistent with business purpose of land development); Rev. Rul. 68-13, 1968-1 C.B. 195 (permitting specific allocation of down payment to inventory for installment sale purposes); *Monaghan v. Commissioner*, 40 T.C. 680 (1963) (same); *Brown v. Commissioner*, 27 T.C. 27, 33 (1956) (upholding separate treatment of partnership assets contributed to corporation controlled by partners and partnership assets sold to corporation via installment sales contract when partners had legitimate business reason for using different forms to transfer assets and each transfer was reasonable from business perspective); *Nassau Lens Co. v. Commissioner*, 308 F. 2d 39, 46 (2d Cir. 1962) (criticizing the Service's allocation approach when a sole proprietorship incorporated its assets in exchange for stock, notes, and the assumption of liabilities; the Second Circuit held that "the Tax Court applied an erroneous legal standard when it placed such emphasis on [the taxpayer's] lack of a business purpose," and remanded the case for further findings).

Taxpayers' ability to cherry pick generated some discussion in connection with the promulgation of the disguised sale Regulation under section 707. *See* T.D. 8439, 1992-2 C.B. 126 (Sept. 30, 1992). Based on an analysis of the evolution of the section 707 disguised sale Regulations, a few TAMs suggested that taxpayers could, under certain circumstances, "cherry pick" assets that would be treated as sold in a transaction governed by Situation 1 of Rev. Rul. 99-5. TAM 200540010 (Oct. 7, 2005) and TAM 200512020 (Mar. 25, 2005). However, those TAMs were subsequently revoked and reissued, and the language that originally suggested that "cherry picking" was permitted was described as "incorrect" and deleted. *See* TAM 200701032 (Jan. 1, 2007) and TAM 200650017 (Dec. 15, 2006). *See also* New York State Bar Association, *Report on Proposed Section 707 Regulations Concerning Disguised Sales of Property Through Partnerships* (Oct. 25, 1991), reprinted at 91 Tax Notes Today 226-40 (Nov. 4, 1991) ("Prop. Treas. Reg. section 1.707-3(e) provides that if a partner transfers multiple properties to a partnership pursuant to a plan, the total consideration that is treated as received by the partner from the partnership as part of a sale transaction is to be allocated among each item of property transferred pursuant to the plan, based on the properties' relative fair market values. Thus, under this rule, a partner will not be permitted to treat certain transfers of property to a partnership as contributions under section 721, while treating other property transfers as sales, if all such transfers take place pursuant to a plan. Presumably, this rule was inserted into the Proposed Regulations to preclude partners from utilizing in the tax planning technique of selling high-basis properties to a partnership while transferring low-basis assets in the form of a contribution subject to section 721. This provision raises several policy issues. First, there is nothing in the legislative history to the 1984 Act or in section 707(a)(2) to suggest that Congress intended to change whatever the existing treatment for multiple property transfers by sale and contribution may be. Second, although the Service has the authority to promulgate such a rule, that does not mean the rule is necessarily appropriate for all multiple property transfers to partnerships. That is particularly the case where there are sound nontax business reasons for the designated consideration transferred to the partner for each asset. For example, suppose that a partnership agrees to accept a contribution of business assets in exchange for a partnership interest on some future date, but because the transferor and partnership have separate credit lines to finance receivables and inventory, and the amounts of receivables and inventory fluctuate considerably, the partnership agrees to pay cash to buy any receivables and inventory it receives. It seems odd to have the amount of gain or loss recognized with respect to other assets depend on the levels of receivables and inventory at the time of the transfer. Third, the proposed rule differs from the rule that applies to contributions and sales of property to corporations by shareholders, where at least in some sales situations sales have been recognized. We believe the rules on multiple property transfers should be consistent for all taxpayers, whether they choose to do business as partners in a partnership or as shareholders in a corporation.").

on the theory that it is difficult to separately bargain for consideration among gain and loss assets that are part of an overall exchange. It is arguably consistent with the economics of an overall exchange, in which a cluster of assets (*e.g.*, a business) is exchanged for stock or other consideration, to prevent cherry picking.

However, the Proposed Regulations depart from this approach in connection with corporate reorganizations. Building on the section 1012 identification principles, the Proposed Regulations, following earlier amendments to the section 356 and section 358 Regulations, adopt a regime under which a taxpayer is permitted to specify the terms of the exchange, and, accordingly, the consideration to be received for different "classes" (or even "shares," in the context of Non-Dividend Equivalent Exchanges) of stock transferred in the exchange, as long as the specification is "economically reasonable."[42] An important question raised by the Proposed Regulations is whether a reorganization is the appropriate occasion to allow "cherry picking." Moreover, as described below, it is unclear why a share of stock should be considered more of a "basic unit of property" than other (tangible) assets that may be contributed to a corporation.

This flexibility is most problematic to the extent amplified by the decision to allow taxpayers to recognize a loss in a reorganization exchange when boot is the sole consideration received in respect of a class of stock, and the same taxpayer, as part of the same "overall" transaction, participates in a stock-for-stock exchange governed by section 356.[43] Section 356(c) denies a loss to the transfer of stock or securities in "an exchange" subject to section 356. By allowing a taxpayer to claim a loss with respect to a transfer of one class of stock in a reorganization while permitting reorganization treatment with respect to a transfer of another class, the Service has implicitly interpreted "an exchange" for purposes of section 356 to mean the transfer by a holder of a specific class of stock for economically reasonable consideration.

A number of those participating in the preparation of these Comments have concerns regarding the justification for a taxpayer benefitting from tax deferral in connection with a transfer of some stock while also being permitted to recognize a loss in connection with other shares that are transferred as part of the same overall transaction. As discussed above, in Rev. Rul. 74-515,[44] the Service ruled that when a taxpayer surrendered more than one class of stock in a reorganization and received stock for one class of stock and boot for the other,

[42] Prop. Reg. §§ 1.354-1(d)(1), 1.356-1(b) and 1.358-2(b)(4).

[43] *Contra* Rev. Rul. 74-515, 1974-2 C.B. 118; GCM 34592 (Aug. 30, 1971) ("In summary on this point, we believe that the proper method for determining the tax consequences to those shareholders in this case who exchange both common and preferred stock is to treat the exchanges as a single reorganization transaction governed by section 356, with gain or loss to be computed separately on each exchange and accorded nonrecognition to the extent of the qualifying consideration received therein. This position complies with the intent of Congress that the tax consequences to a shareholder who participates in a reorganization should be determined under the reorganization provisions and not the Code provisions dealing with current corporate distributions.").

[44] 1974-2 C.B. 118.

section 356 applied by treating the "exchange" as a single transaction encompassing everything given up and received by the taxpayer. Accordingly, the taxpayer was not permitted to recognize a loss with respect to either component of the transfer. Under the Proposed Regulations, this result would no longer obtain, and Rev. Rul. 74-515[45] would become irrelevant in this regard. The result under the Proposed Regulations seems inconsistent with the purpose of the reorganization provisions, as described in Regulation section 1.368-1(b):

> [t]he purpose of the reorganization provisions of the Code is to except from the general rule [of gain or loss recognition] certain specifically described exchanges incident to such readjustments of corporate structures made in one of the particular ways specified in the Code, as are required by business exigencies and which effect only a readjustment of continuing interest in property under modified corporate forms.

We suggest that Treasury and the Service reconsider this significant departure from well-settled law.

Moreover, the flexibility of the Proposed Regulations is limited to reorganizations. In contrast, the Proposed Regulations would apply historic anti-cherry picking principles with respect to assets other than stock by including the principle of Rev. Rul. 68-55[46] in the Regulations. Rev. Rul. 68-55 has long stood for the proposition that the "exchange" for purposes of section 351 includes the overall exchange (*i.e.*, all property transferred to the corporation in exchange for all consideration received). Thus, the Service appears to have taken two different approaches to the scope of the word "exchange" – a narrow approach for purposes of section 356(c) and a broad approach for purposes of section 351(b). The disparity in outcomes under the two approaches is highlighted by the following examples.

Example 1

A. Facts. Shareholder owns shares of Class A Stock and Class B Stock in Corporation X, which are different classes of stock. The Class A Stock has an adjusted tax basis of $110 and a fair market value of $100. The Class B Stock has an adjusted tax basis of $0 and a fair market value of $100. Corporation X enters into a reorganization governed by section 368(a) with Corporation Y. The reorganization documents specify that Corporation X pays $100 in cash for the Class A Stock and issues $100 of Corporation Y stock for the Class B Stock.

B. Analysis. Section 302 applies to the exchange of Class A Stock for cash. Under the Proposed Regulations, assuming section 302(d) does not apply to the exchange,

[45] *Id.*

[46] 1968-1 C.B. 140; *see* Prop. Reg. § 1.351-2(b) ("[t]o determine the amount of gain recognized under section 351(b), the fair market value of each category of consideration received by each transferor is allocated to the properties transferred *in proportion to each property's relative fair market value.*") (emphasis added).

Shareholder would recognize a $10 loss on the transfer of the Class A Stock. Section 354 applies to the exchange of Class B Stock for stock in Corporation Y. Thus, under the Proposed Regulations, no gain or loss would be recognized on the transfer of the Class B Stock in exchange for Corporation Y stock.

Example 2

A. Facts. Shareholder owns a building and a piece of land. The building has an adjusted tax basis of $110 and a fair market value of $100. The land has an adjusted tax basis of $0 and a fair market value of $100. Pursuant to an exchange governed by section 351, Shareholder transfers the building and the land to Corporation. The transaction documents specify that Corporation pays $100 in cash for the building and issues $100 of stock for the land.

B. Analysis. The Proposed Regulations (by including the principle of Rev. Rul. 68-55[47]) would require an allocation of consideration between the properties transferred in accordance with their relative fair market values. Accordingly, Shareholder would be deemed to exchange (i) the building for $50 of cash and $50 of Corporation stock and (ii) the land for $50 of cash and $50 of Corporation stock. Shareholder would realize a $10 loss with respect to the building and a $100 gain with respect to the land. Under section 351(b), Shareholder would recognize $50 of gain with respect to the land but is not permitted to recognize the $10 loss with respect to the building.

We question whether there are sound policy justifications for the differing outcomes in the above examples. We do not believe that stock is more of a "fundamental unit of property" than a building or a piece of land, or than many other types of assets, or that stock is more susceptible to identification and allocation than other properties.[48] Moreover, the agreed-upon allocation of the consideration described in Example 2 presumably would satisfy the "economically reasonable" standard applicable to corporate stock. We also are concerned about the effect on tax administration of interpreting the same word – "exchange" – differently for purposes of related statutory provisions, particularly in light of section 356(c).[49] It is the *same* provision—section 358—that determines the basis results to a

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[47] 1968-1 C.B. 140.

[48] Consider, for example, the result that would occur under the Proposed Regulations if Shareholder contributed two shares of stock in different corporations and two buildings, trucks, or other non-stock assets to Corporation in a section 351 exchange. Under the Proposed Regulations, Shareholder would have three blocks of stock in Corporation, one block attributable to each share of stock transferred and one combined block attributable to the non-stock assets. Prop. Reg. § 1.358-2(i), Ex. 16.

[49] The Service has, in certain circumstances. applied reorganization-type principles to section 351 exchanges. *See, e.g.*, Rev. Rul. 95-74, 1995-2 C.B. 36 (holding that a transferee corporation in a section 351 exchange essentially would "step into the shoes" of the transferor for purposes of determining whether the transferee could deduct certain liabilities; the "step into the shoes" concept applies in section 381 transactions but typically does not apply to section 351 exchanges); Rev. Rul. 94-45, 1994-2 C.B. 39 (applying a step-in-the-shoes approach to a section 351 exchange in which an accrual basis life insurance company transferred investment assets together with its right to future income and obligations under its insurance and annuity
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shareholder under section 351 exchanges and section 368 reorganizations. We recognize the policy considerations underlying anti-cherry picking rules and the fact that in section 351 exchanges the parties generally would have the ability to optimize tax results in making the allocation. However, these considerations appear to be equally relevant for reorganizations.

We believe the principles governing the allocation of consideration in a multi-asset exchange should be applied consistently across transactional settings. We considered two potential alternatives, in addition to the model adopted by the Proposed Regulations. A number of those participating in the preparation of these Comments advocated a regime in which the principles of Rev. Rul. 68-55[50] would apply across all transactional settings, including reorganizations.[51] Others participating in the preparation of these Comments favor an approach in which economically reasonable allocations of consideration would govern the tax consequences of a transaction, without regard to the qualification of the transaction as a reorganization.[52] We were unable to reach a consensus as to which approach is preferable, although we are of the view that whichever regime is adopted should be applied consistently. Accordingly, we recommend that Treasury and the Service reconsider the inclusion of the principle of Rev. Rul. 68-55 in the Proposed Regulations and consider further the application of anti-cherry picking policies in other transactional settings.

Form Driven Regime Generally. More broadly, the Proposed Regulations allow very minor changes to the overall business transaction to cause meaningful changes in the tax consequences of the transaction. For example, because the Proposed Regulations would create a deferred loss only when "all" of the shares of stock in the redeemed class are redeemed in connection with a Dividend Equivalent Redemption, a taxpayer apparently would be allowed to avoid creation of a deferred loss under Proposed Regulation section 1.302-5 by retaining (and then selling) only one share of stock in the redeemed class. Likewise, under the Proposed Regulations, if a taxpayer surrenders all of its target shares of a single class solely for boot in a reorganization transaction, section 302 would apply to that transaction, even though section 354 or section 356 may apply to other shares surrendered in the same overall reorganization transaction. However, if the same taxpayer were to receive only one new share of acquirer stock, together with boot, for its target stock of a particular class, section 356 would apply to that aspect of the transaction.

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contracts to its wholly owned subsidiary; the Service held that causing the transferor to have an income inclusion would be inconsistent with the purpose of section 351).

[50] 1968-1 C.B. 140.

[51] Such a regime would presumably require revisions to current Reg. §§ 1.356-1(b) and 1.358-2(a)(ii).

[52] Although beyond the scope of this report, a related issue is whether a different "cherry picking" regime should apply to wholly taxable transactions. *See supra* note 41.

The following example illustrates the importance of form under the Proposed Regulations:

Example 3

A. Facts. Shareholder owns all of the existing stock of Corporation, consisting of 100 shares of Class A stock and 100 shares of Class B stock. Shareholder's Class A stock has a basis of $1000 and a value of $200. Corporation redeems 99 shares of the Class A stock for $198. Shareholder subsequently sells its remaining 1 share of Class A stock to a third party for $2. Corporation does not have any current or accumulated earnings and profits.

B. Analysis. Because Shareholder owned all of the stock of Corporation both before and after the redemption, the redemption is a Dividend Equivalent Redemption. Shareholder is treated as receiving $1.98 with respect to each share of Class A stock, and Shareholder has $8.02 in remaining basis in each share of Class A stock. In a hypothetical recapitalization, Shareholder is treated as surrendering all 100 shares of Class A stock in exchange for 1 share of Class A stock, with the 1 share having a basis of $802. As a result of the sale to a third party, Shareholder recognizes a $800 loss. Had Corporation instead redeemed all 100 shares of Class A stock, Shareholder's $800 in unrecovered basis would not shift to Shareholder's Class B stock; rather, Shareholder would have an $800 deferred loss.

A number of those participating in the preparation of these Comments expressed concerns as to whether the Proposed Regulations are overly formalistic in this regard and whether meaningful tax distinctions should turn on small differences in the economic transaction. Such a form-driven regime raises the question of whether an anti-abuse rule should be incorporated in the Proposed Regulations. Final Regulations could include a rule intended to preclude taxpayers from "toggling" if the retained shares (in the case of a Dividend Equivalent Redemption) or the additional acquirer share (in the case of a Dividend Equivalent Exchange) are economically insignificant.[53] However, on balance, we believe it is important to have bright line rules for commercial transactions effected for valid business reasons. Accordingly, we do not recommend the adoption of an anti-abuse rule. We believe that the result in Example 3 is mandated by the formalistic approach of the Proposed Regulations and that no general anti-abuse rule should prevent Shareholder from obtaining a loss under the facts of the example.[54] If Treasury and the Service view this result as

[53] Such a rule might be styled as an objective anti-abuse rule or might take into account subjective standards. For example, an objective anti-abuse rule might measure the value of the "toggle" share relative to, in the case of a Dividend Equivalent Redemption, the value of the shares of the same class redeemed in the transaction and, in the case of a Dividend Equivalent Exchange, the value of the boot received in consideration for the shares of the same classes transferred.

[54] The example also illustrates the importance of the transaction sequence. Had the order of the transactions been reversed (*i.e.*, Shareholder first sells one share of Class A stock to a third party and then Corporation redeems the remaining Class A shares), Shareholder would recognize loss only with respect to one share and the loss with respect to the remaining 99 Class A shares would be deferred. An argument can be made
(…continued)

inappropriate, we recommend that specific rules be provided on which taxpayers may rely, or that a general, less formalistic approach be adopted.[55] Likewise, we recommend that the final Regulations clarify that the economic substance doctrine codified in new section 7701(o) is not "relevant" to variations in form designed to achieve a specific result under the Proposed Regulations.[56]

We recognize that cross-border reorganizations raise special policy concerns, and that these concerns may be motivating the emphasis in the Proposed Regulations on treating a share of stock as a unit of property. For example, we recognize that the preservation of section 1248 amounts, gain recognition agreements, and other attributes following a reorganization is important to the Regulations under sections 367 and 1248. Portions of those Regulations have adopted specific additional rules imposing a share-by-share regime with respect to certain reorganizations.[57] In the case of section 367 Regulations, specific additional rules were removed when the final section 358 Regulations adopted a share-by-share approach for most purposes.[58] Accordingly, some of these Regulations would need to be amended if the specific allocation regime under section 358 were scaled back or eliminated. It is, however, likely that other means could be adopted to preserve section 1248 amounts and other attributes in cross-border reorganizations.[59] On balance, we do not believe that the issues raised by cross-border reorganizations require such a significant change to the policies that have previously applied to the treatment of tax-free exchanges in the domestic context.

Finally, we note that the electivity under the Proposed Regulations arises, in part, because the Proposed Regulations create a different "class" of stock if shares differ *at all* with respect to economic rights.[60] If Treasury and the Service wish to reduce the electivity

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that the final Regulations should reach the same outcome for economically equivalent transactions, regardless of the order in which the steps of the transaction occur.

[55] Similar issues are presented by the recently finalized section 368(a)(1)(D) Regulations. *See* T.D. 9475, 2010-4 I.R.B. 304 (Dec. 18, 2009). Under these Regulations, a taxpayer may prevent the creation of a deferred intercompany transaction (and accordingly achieve excess loss account treatment) in the reorganization by issuing to the transferor corporation a single share of stock of the acquiring corporation.

[56] Section 7701(o) applies only if the economic substance doctrine is "relevant" to the transaction in question. *See* The Reconciliation Act of 2010, Pub. L. 111-152 § 1409, 124 Stat. 1029 (to be codified at I.R.C. § 7701(o)).

[57] *See, e.g.*, Reg. § 1.367(b)-13 (providing rules to supplement the provisions of Regulation section 1.358-6 for triangular reorganizations).

[58] *See, e.g.*, Reg. § 1.367(b)-4.

[59] *See, e.g.*, T.D. 9243, 2006-1 C.B. 475 (Jan. 25, 2006) (rejecting a commentator's recommendation that section 1248 shareholders be permitted to elect to include section 1248 amounts in income, in lieu of applying a basis tracing regime).

[60] For example, a corporation might recapitalize its outstanding Class A preferred (which is callable at year 10 at par) into two classes: Class A preferred having the same characteristics but half the value and Class B (which is callable at, say, year 9 at par). These two classes would differ economically, thus creating separate (…continued)

permitted by the Proposed Regulations, consideration might be given to broadening the definition of "class." For example, all shares that participate in corporate growth to a significant extent might be grouped in one class and all shares that do not might be grouped in another class.

Administrability in Stockless Transactions

If assets are transferred to a corporation in certain "stockless" exchanges, under the Proposed Regulations, shares would be deemed to have been issued by the corporation and then recapitalized to preserve the tax attributes of the blocks of stock associated with the transfer (the "Stockless Exchange Rule").[61] A number of those participating in the preparation of these Comments have expressed concern that these hypothetical share issuance and recapitalization rules would be difficult to administer. In particular, such a regime would impose significant administrative costs on common intra-group restructurings that are often effected without the issuance of additional shares.

Under the Stockless Exchange Rule, if a shareholder transfers assets to a corporation in a section 351 transaction, but receives no stock in exchange therefor, the corporation is deemed to have issued to the shareholder stock with a value equal to the value of the transferred assets. Then, the shareholder is treated as having surrendered all of its shares in the corporation, including the shares that were deemed issued, in a Hypothetical Recapitalization. In order to apply this rule, it is necessary to determine the value of the property transferred and the value of the transferee's stock at the time of each transfer. Even if the property transferred is cash, the overall value of the stock of the transferee (and thus the percentage of the transferee stock deemed issued for the cash) is in many cases not easily determined.

Transfers among members of an affiliated group, whether or not filing a consolidated return, occur routinely for a variety of business reasons. Such transfers frequently are made between parents and wholly owned subsidiaries and do not involve the issuance of additional shares. Examples include payments by parents or other upper-tier corporations of subsidiary expenses (*e.g.*, compensatory transfers of parent stock to subsidiary employees), transfers of cash to subsidiaries for capital expenditures or acquisitions, or contributions to capital by a parent corporation of a subsidiary's debt obligation.

Because the flow of cash typically goes in both directions, the net effect of the Stockless Exchange Rule may produce distortions. For example, assume that P transfers cash to S in week 1 to address a short-term financial need in S. In week 2, S distributes excess cash to P in a different amount. Under the Stockless Exchange Rule, the week 1 transfer would result in a hypothetical share issuance and Hypothetical Recapitalization. The week 2

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classes, with the result that in a reorganization the Class A preferred could be cashed out at a recognized loss and the Class B preferred exchanged for stock without recognition.

[61] *See* Prop. Reg. §§ 1.358-2(d), -2(g)(3).

distribution would be spread *pro rata* among P's various blocks of S stock, including the block created as a result of the week 1 transfer, thus resulting in basis shifts between shares that are created solely from offsetting cash amounts. Although some of this distortion could be ignored as circular, such treatment would not fully address the situation.

If the rule proposed were to be made final, it would be necessary to value each member of some affiliated groups on almost a daily basis. Such valuations typically would be made retrospectively when stock basis becomes relevant. Although the Stockless Exchange Rule is consistent with the general tracing rules of Regulation section 1.358-2, application in the context of stockless section 351 transfers between members of affiliated groups would be unadministrable for both taxpayers and the Service. Moreover, imposing this administrative burden appears inconsistent with recent fundamental policy decisions in consolidated return Regulations that were directed at avoiding the difficulty of requiring valuations for property transferred between members of a group.[62]

We believe that the Stockless Exchange Rule should exclude certain common transfers from its application. One approach would be to exclude contributions of cash (or deemed cash contributions as in Regulation section 1.1032-3) and member debt from the rule. Alternatively, a rule might be adopted for an affiliated group pursuant to which, if no stock is issued in consideration for the asset transfer, the basis of the contributed assets is added to the shareholder's existing basis in the stock of the transferee. Although such exclusions and simplifying conventions might sacrifice theoretical consistency, we believe such an approach is justified to address administrability and complexity concerns. Moreover, we are not aware of any abuses or policy reasons that would support the broad and burdensome rule in the Proposed Regulations. To the extent concerns exist relating to the section 1248 and section 367 issues discussed above, we recommend that the final Regulations apply, at least in the affiliated corporation context, a more narrowly tailored approach than the Hypothetical Recapitalization.

[62] *See, e.g.*, 72 Fed. Reg. 55,139 (2007) (stating, in the preamble to Proposed Regulations under Regulation section 1.1502-13(g), that "in recognition of the administrative burden involved in valuing intercompany obligations and in order to limit the effects of section 1.1502-13(g) on certain routine intragroup transactions . . . these proposed regulations provide a number of exceptions from the application of the deemed satisfaction and reissuance model"); 72 Fed. Reg. 3020 (2007) (stating, in the preamble to unified loss rules of Proposed Regulation section 1.1502-36, that a tracing approach to property with built in gain would be difficult to administer: "Valuation also imposes a significant financial and administrative burden on both taxpayers and the government. These problems are exacerbated because the corporation's assets are not themselves the subject of an arms-length transaction and, in most cases, the date on which the assets are actually valued is long after the stock transaction.").

IV. OTHER COMMENTS

Flow-through Entities and the Deferred Loss Regime

The Preamble requests comments regarding two issues relating to the application of the deferred loss regime to flow-through entities (*i.e.*, partnerships, S corporations and certain trusts).[63]

The first issue with respect to which comments are requested is the appropriate time for reflecting the deferred loss in the outside basis of the flow-through entity. Two alternatives are suggested: basis reduction at the time of the redemption of the shares giving rise to the deferred loss and basis reduction at the time of the inclusion date. The Preamble states that, as a general rule, a deferred loss is reflected in the outside basis of the flow-through entity only when it can be accessed by the flow-through entity. The Preamble recognizes that this general rule can result in disconformity between inside attributes and outside basis. Moreover, the Service and Treasury have expressed concern that this disconformity could present the opportunity for separation of the dividend income arising from the redemption and the later recognition of the deferred loss. Accordingly, the Preamble suggests as an alternative a net operating loss approach under which outside basis would be reduced at the time the deferred loss arises.

The second issue with respect to which comments are requested is whether it is appropriate to treat the flow-through entity or the owner of the flow-through entity as the redeemed shareholder for these purposes. The Preamble notes a relationship between this issue and the issue relating to the timing of the outside basis adjustment. The Preamble takes the position that treating the owner of the flow-through entity as the redeemed shareholder may be more appropriate if the deferred loss is treated as a net operating loss for purposes of the timing of the outside basis adjustment, whereas the deferral of the outside basis adjustment until the inclusion date would be more consistent with a view in which the flow-through entity is treated as the redeemed shareholder. Although not stated in the Preamble, presumably the Service and Treasury identify these alternatives to ensure that the deferred loss is taken into account once, but only once, either in the form of outside basis or the occurrence of the inclusion date.

The determination of whether a redemption is treated as a dividend may be based, by operation of the relevant attribution rules, on the flow-through entity owners' stock ownership outside of the flow-through entity. Accordingly, we believe the starting point for the treatment of a redemption of shares held by a flow-through entity is to allow for the owner of the flow-through entity to be treated as the redeemed shareholder for purposes of determining whether the flow-through entity may allocate a deferred loss to the owner.[64] We believe that

[63] 74 Fed. Reg. at 3512.

[64] *Cf.* Reg. § 1.871-14(g)(3) (if a debt obligation is held by a partnership, the test to determine whether the obligation is held by a person that is a ten-percent shareholder of the obligor for purposes of the portfolio interest exemption applies at the partner level, not at the partnership level).

this treatment will ensure that, upon a disposition of the interest in a flow-through entity, the relevant owner will have the greatest opportunity to recognize all of the tax consequences associated with the redemption of shares held through the entity (*i.e.*, assuming the inclusion date rules are satisfied with respect to that equity holder's non-flow-through entity shares) under a net operating loss model for outside basis adjustments. The deferred loss would be allocated among the owners in the same proportion that the flow-through entity allocated the dividend income giving rise to the deferred loss. [65] The deferred loss would be an attribute that is separately stated, specific to the owner to whom it was allocated and would be recognized by that owner upon the inclusion date with respect to that owner. As with Regulations proposed in 2002, section 704(c) principles would apply to the allocation of a deferred loss. If such a regime is adopted, we recommend that an owner be permitted to include a deferred loss once the owner experiences an inclusion date even if the inclusion date occurs after the owner disposes of its interest in the flow-through entity.

Example 4[66]

A. Facts. In Year 1, A and B, two unrelated individuals, each contribute $100 to form a 50-50 partnership, PS. A and B share in the income of PS equally. PS buys 100 shares of Corporation Z stock for $200. A owns the remaining 400 outstanding shares of Corporation Z stock directly. In Year 2, Corporation Z redeems all of PS's shares for $300. At that time, the basis of A's interest in PS is $100 and the basis of B's interest in PS is $100. At the end of Year 2, Corporation Z has current and accumulated earnings and profits of $130. Because A's ownership of the Z stock is attributed to PS under section 318(a)(3)(A), the redemption is treated as a distribution to which section 301 applies (*i.e.*, the redemption is a Dividend Equivalent Redemption). The redemption proceeds, therefore, are treated as a dividend to the extent of Corporation Z's earnings and profits, $130, and as a recovery of basis in the amount of $170. PS's only items of income, gain, loss, deduction and credit for Year 2 arise from the redemption of the Corporation Z stock. On January 1 of Year 4, A sells his entire interest in PS to C, an unrelated individual.

B. Analysis. Each of A and B would be allocated one-half of the dividend, or $65 each in Year 2. PS also recognizes a deferred loss of $30 in Year 2, which is allocated to each of A and B in the same proportions as the dividend income, or $15 each. (Because PS acquired the Z stock for cash, no amounts are allocated to the partners under section 704(c).) For purposes of determining whether an owner of PS may take

[65] *Cf.* Rev. Proc. 2009-37, 2009-36 I.R.B. 309 (Aug. 17, 2009) (partnership COD income that is deferred by reason of a section 108(i) election is allocated in proportion to the partners' distributive shares at the time of the debt discharge; S corporation COD income that is deferred under section 108(i) is shared *pro rata* among only those shareholders that are shareholders of the S corporation immediately before the reacquisition transaction; subsequent changes in ownership do not affect the proportion in which deferred COD income is included).

[66] The facts in this Example 4 are loosely based on Example 7 in Proposed Regulation section 1.302-5(f) in the basis shifting Regulations that were proposed in 2002 and later withdrawn. *See* Notice of Proposed Rulemaking, 67 Fed. Reg. 64,331 (2002).

his share of the loss into account currently, the relevant owner is, by default, treated as the redeemed shareholder. If A were the redeemed shareholder, A would not satisfy the inclusion date rules in Year 2, because A owns Z stock directly. A would have a deferred loss of $15, which would be reflected in A's outside basis in his PS interest. Accordingly, A's basis in his interest in PS would be increased by his share of the dividend ($65) and decreased by his share of the deferred loss ($15). The inclusion date rules would be satisfied with respect to B, because B does not actually or constructively own any Z stock. B would take his share of the loss into account currently and would not have a deferred loss. Accordingly, B's basis in his interest in PS would be increased by his share of the dividend ($65) and decreased by his share of any loss currently taken into account ($15). On January 1 of Year 4, A would still not satisfy the inclusion date rules because A would continue to own Z stock directly, thus A would continue to have a $15 deferred loss. All of the tax attributes associated with the redemption, including the dividend income, the deferred loss and the negative basis adjustment attributable to the deferred loss, would be taken into account by A and B. C, as A's transferee, would not receive any allocations attributable to the deferred loss. A's deferred loss would be taken into account when A satisfies the inclusion date rules (*e.g.*, on A's later disposition of a sufficient amount of his Z stock).

For a number of flow-through entities, a net operating loss model might lead to undesirable tax consequences, even in the absence of the abusive situation identified in the Preamble. For example, by accelerating the outside basis reduction in a flow-through entity, owners of a flow-through entity might experience taxable income earlier (or taxable loss later) than otherwise would be the case. This result seems somewhat inequitable when viewed from the perspective of a flow-through entity with owners that have no intention of reducing their direct or indirect interest in the non-redeemed shares. Accordingly, we recommend that final Regulations permit a flow-through entity to elect to be treated as the redeemed shareholder in lieu of its owners, which election would be set forth in the partnership agreement and would be binding on all owners. If an entity makes this election, the entity's outside basis adjustments with respect to the deferred loss would then occur upon the inclusion date with respect to the flow-through entity. Moreover, under this regime, if a member of a flow-through entity transfers an interest in the flow-through entity prior to the inclusion date with respect to the flow-through entity, under principles similar to the mandatory negative basis adjustments in section 743(b), the transferee would not benefit from any subsequent allocation of the deferred loss upon the flow-through entity's inclusion date.

Example 5

A. Facts and Analysis. The facts are the same as in Example 4, however, PS makes an election to be treated as the redeemed shareholder for purposes of determining whether an owner of PS may take his share of the loss into account currently. If PS makes the election, PS would not satisfy the inclusion date rules in Year 2, because A's ownership of the Z stock is attributed to PS under section 318(a)(3)(A). As a result, each of A and B would have a $15 deferred loss that would not be reflected in their outside bases in their interests in PS. Each of A's and B's basis in their interests in PS would be increased by their share of the dividend, $65 each. On January 1 of

Year 4, due to A's sale of his interest in PS to C, A's direct ownership of Z stock would no longer be attributed to PS under section 318(a)(3)(A). As a result, PS would experience an inclusion date. At such time, A and B would take into account the $15 deferred loss, and A's and B's basis in their interests in PS would be decreased by their share of the loss taken into account, $15 each. A's basis adjustment would be taken into account immediately prior to the sale of A's interest in PS.[67] If, on the other hand, B sold its interest to D, an unrelated third party, prior to A's sale to C, B's basis for purposes of determining gain or loss on the sale to D would not reflect a negative basis adjustment attributable to the deferred loss. By operation of section 743(b) principles, D would not participate in any tax consequences associated with the allocation by PS of a deferred loss upon a later inclusion date.[68]

The following example illustrates the application of section 704(c) principles to the foregoing regimes:

Example 6

A. Facts. In Year 1, A and B, two unrelated individuals, form a 50-50 partnership, PS. A and B share all of PS's items equally, except to the extent required by section 704(c). A contributes to PS 100 shares of Corporation Z stock (with a basis of $140 and a value of $100). B contributes $100 to PS. PS buys 100 shares of Corporation Z stock for $100. A owns the remaining 400 outstanding shares of Corporation Z stock directly. In Year 2, Corporation Z redeems all of PS's shares for $300. At that time, the basis of A's interest in PS is $140 and the basis of B's interest in PS is $100. At the end of Year 2, Corporation Z has current and accumulated earnings and profits of $130. Because A's ownership of the Z stock is attributed to PS under section 318(a)(3)(A), the redemption is treated as a distribution to which section 301 applies. The redemption proceeds, therefore, are treated as a dividend to the extent of Corporation Z's earnings and profits, $130, and as a recovery of basis in the amount of $170. PS's only items of income, gain, loss, deduction and credit for Year 2 arise from the redemption of the Corporation Z stock. On January 1 of Year 4, A sells his entire interest in PS to C, an unrelated individual.

B. Analysis. Each of A and B would be allocated one-half of the dividend, or $65 each, in Year 2. PS also realizes a loss of $70 in Year 2. Under either the default or elective regime described above, PS would allocate the first $40 of this loss to A under provisions of the PS partnership agreement that are in compliance with section 704(c).

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[67] If the Z stock directly held by A were redeemed by Z prior to A's sale of his interest to C, PS would experience an inclusion date under section 302(b)(3). The occurrence of this inclusion date also would trigger a negative basis adjustment for A and B. No subsequent basis adjustments would occur thereafter upon A's subsequent sale of his PS interest to C.

[68] Thus, for example, if the Z stock directly held by A were redeemed by Z after B's sale of his interest to D, the deferred loss allocated to D upon the inclusion date would be offset by the equivalent of a negative section 743(b) adjustment with respect to D.

The remaining $30 of the loss would be allocated to each of A and B in the same proportions as the dividend income (*i.e.*, $15 each). For purposes of determining whether an owner of PS may take his share of the loss into account currently, the relevant owner is, by default, treated as the redeemed shareholder. If A were the redeemed shareholder, A would not satisfy the inclusion date rules in Year 2, because A owns Z stock directly. A would have a deferred loss of $55, and A's outside basis in his PS interest would be reduced accordingly. B would satisfy the inclusion date rules in Year 2, because B does not actually or constructively own any Z stock. B would take his share of the loss into account currently and would not have a deferred loss. Accordingly, B's basis in his interest in PS would be increased by his share of the dividend ($65) and decreased by his share of any loss currently taken into account ($15). A's deferred loss would be taken into account when A satisfies the inclusion date rules (*e.g.*, on A's later disposition of a sufficient amount of his Z stock).
If, on the other hand, PS makes the entity-level election to be treated as the redeemed shareholder for purposes of determining whether an owner of PS may take his share of the loss into account currently, PS would not satisfy the inclusion date rules in Year 2, because A's ownership of the Z stock is attributed to PS under section 318(a)(3)(A). As a result, A would have a $55 deferred loss allocated under section 704(b) and section 704(c) principles and B would have a $15 deferred loss and allocated under section 704(b) principles only. Each of A and B's basis in their interests in PS would be increased by their share of the dividend, $65 each. On January 1 of Year 4, due to A's sale of his remaining interest in PS to C, A's direct ownership of Z stock would no longer be attributed to PS under section 318(a)(3)(A). As a result, PS would experience an inclusion date. At such time, A and B would take into account their deferred losses, and the basis in their interests in PS would be decreased by their share of the loss taken into account. [69]

Application of the Proposed Regulations to Redemption of Section 306 Stock

The Preamble requests comments on the appropriate regime to apply in connection with a redemption of section 306 stock. Under section 306(a)(2), a redemption of section 306 stock is treated as a distribution to which section 301 applies. Regulation section 1.306-1, Example 2 currently suggests that if all of the section 306 stock is redeemed, any remaining basis of the redeemed section 306 stock should be added back to the basis of the stock with respect to which the section 306 stock was distributed. The Preamble requests comments as to whether the model of Regulation section 1.306-1, Example 2 or an alternative regime should apply in connection with a redemption of section 306 stock.

We believe that the treatment of a redemption of section 306 stock should flow from the statutory requirement in section 306(a)(2) that the redemption of section 306 stock be treated as a distribution governed by section 301 and not from its status as section 306 stock. For this reason, we recommend that a redemption of section 306 stock be subject to the rules generally applicable to redemptions governed by section 302(d), with slight modification to

[69] A's basis adjustment would be taken into account immediately prior to the sale to C.

preserve the remaining section 306 taint of any non-redeemed shares of section 306 stock. We do not perceive any policy underlying section 306 that suggests a different result and, assuming the Proposed Regulations are finalized in their current form, do not believe the redemption of section 306 stock should result in basis shifting. For these reasons, assuming that the Proposed Regulations are finalized in their current form, we do not believe that the basis of the section 306 stock should shift back to the stock with respect to which the section 306 stock arose.

Following the model adopted in the Proposed Regulations, we believe that revised section 306 Regulations should first look to whether the redeemed shareholder owns any non-redeemed stock that is in the same class as the redeemed section 306 stock. If the redeemed shareholder owns non-redeemed stock in the same class as the section 306 stock, we believe the distribution under section 306(a)(2) should be treated as any other redemption subject to section 302(d). Accordingly, the amount realized from the redemption would be treated as distributed *pro rata* with respect to all shares in the class, basis would be reduced, and gain would be recognized, in each case, in accordance with Proposed Regulation section 1.302-5(a)(1) and (2). To the extent a block of section 306 stock remains after the Hypothetical Recapitalization, it would continue to carry the section 306 stock taint. If, on the other hand, the redeemed shareholder does not own stock that is in the same class as the redeemed section 306 stock, we believe any remaining basis in the redeemed section 306 stock should be treated as a deferred loss under Proposed Regulation section 1.302-5(a)(3).

There is a question whether the regime suggested above is inconsistent with section 306(a)(1)(C), which denies a loss in connection with a disposition of section 306 stock. We do not believe that section 306(a)(1)(C) should be read to preclude the recognition of a deferred loss with respect to section 306 stock. Section 306(a)(1)(C), by its terms, does not apply to dispositions in redemption of section 306 stock. Dispositions in redemption of section 306 stock are governed by section 306(a)(2), not by section 306(a)(1). As noted above, section 306(a)(2) requires that a redemption be treated as a distribution subject to section 301. Thus, the structure of section 306 itself recognizes different treatment between redemption and non-redemption transactions and, in light of this difference in treatment, we believe the regime suggested above is the correct policy outcome, notwithstanding the general loss nonrecognition posture of section 306. Specifically, we believe that having adopted the deferred loss regime for dividend equivalent redemptions, section 306(a)(2) must be read to permit the recognition of a deferred loss upon the redemption of section 306 stock. We believe that, in light of the approach in the Proposed Regulations, this result is consistent with the section 306(a)(2) treatment of the redemption as a dividend under section 301.

Treatment of Deferred Loss in Connection with Split-Up Transactions

The Preamble requests comments on whether, after a section 355 *pro rata* split-up, the controlled corporations are the same as or different from the distributing corporation for purposes of determining whether the date of distribution would be an inclusion date for a deferred loss attributable to unrecovered basis. We do not believe that a *pro rata* split-up is the proper occasion for an inclusion date and thus recommend adopting a regime that allows Distributing to “continue” for purposes of the Proposed Regulations after a *pro rata* split-up.

The preamble to Regulations proposed under section 355(a)(3)(B) as well as the preamble to the Regulations proposed under section 304 included a concept that looks to whether a new corporation serves as the true embodiment of another corporation for purposes of those Code sections.[70] We believe that a natural extension of these principles in the context of a *pro rata* split-up would be to look to which corporation represents, to the greatest extent, the continued embodiment of Distributing and treat that corporation as Distributing for purposes of the deferred loss rules. Unlike the hot stock and section 304 Proposed Regulations, any such rule adopted in final Regulations would not serve an anti-abuse function. Accordingly, subjective intent would not appear to be relevant to the analysis. Objective measures for identifying the continuing embodiment of Distributing for these purposes could be by reference to gross assets, net assets, revenue or any combination of comparable metrics. Once that corporation is identified, the inclusion date after a *pro rata* split-up would be tested by reference to that entity.[71]

Tax Effect of the Hypothetical Recapitalization

Under the Proposed Regulations, if a taxpayer engages in a Dividend Equivalent Redemption or Dividend Equivalent Exchange and continues to own shares in the redeemed class, a taxpayer is deemed to surrender all of its shares in the redeemed class in a Hypothetical Recapitalization. The Hypothetical Recapitalization is included in the Proposed Regulations to preserve the tax attributes of the blocks of stock within the class held by the taxpayer.

A recapitalization is an event with independent tax consequences. For example, a recapitalization may qualify as a segregation event under Regulation section 1.382-2T(j)(2)(iii)(B). Moreover, a recapitalization may be treated as a transfer for purposes of

[70] *See* T.D. 9435, 2009-4 I.R.B. 333 (Dec. 15, 2008) ("The IRS and Treasury Department are considering issuing guidance that would provide that a target whose stock is acquired by distributing in a taxable transaction may be treated as the 'real controlled' for purposes of section 355(a)(3)(B) if, at the time of the distribution, the [controlled separate affiliated group ("CSAG")] cannot satisfy the requirements of section 355(b) without taking into account an [active trade or business ("ATB")] conducted by the target at the time the [distributing separate affiliated group ("DSAG")] acquired the stock of the target in the taxable transaction. In other words, section 355(a)(3)(B) could be implicated as a result of an acquisition of target stock if the target is engaged in an ATB at the time the DSAG acquires the target stock in a taxable transaction, the target stock is then acquired by controlled (or, in some cases, a CSAG member) prior to the distribution, and at the time of the distribution of the controlled stock the CSAG is not able to satisfy the requirements of section 355(b) without taking into account an ATB that was being conducted by the target at the time the DSAG acquired the target stock in the taxable transaction."); T.D. 9477, 2010-6 I.R.B. 385 (Dec. 29, 2009) ("Accordingly, the regulations amend §1.304-4T to provide that for purposes of determining the amount of a property distribution that is a dividend (and the source thereof) under section 304(b)(2), the acquiring corporation shall be treated as acquiring for property the stock of a corporation (deemed issuing corporation) that is controlled by the issuing corporation, if, in connection with the acquisition for property of stock of the issuing corporation by the acquiring corporation, the issuing corporation acquired stock of the deemed issuing corporation with a principal purpose of avoiding the application of section 304 to the deemed issuing corporation.").

[71] Alternatively, the deferred loss might be allocated to the stock of each controlled corporation (*e.g.*, based on relative fair market values), in which case the inclusion date would be determined separately with respect to each controlled corporation.

section 83.[72] We trust that Treasury and the Service do not intend for the Hypothetical Recapitalization to have tax effect beyond the basis tracing results included in the Proposed Regulations. Accordingly, we recommend that final Regulations include a statement to this effect. Moreover, we recommend that the final Regulations clarify that the Hypothetical Recapitalization does not affect the determination of whether the basis in stock is "qualifying basis" for purposes of Section 4.02(2)(b) of Rev. Proc. 2004-66.[73] Finally we recommend that the final Regulations also clarify that the Hypothetical Recapitalization qualifies as a tax-free transaction without regard to other principles of law, including the recent codification of the economic substance doctrine.[74]

Definition of a "Class" of Stock

The Proposed Regulations contain two somewhat inconsistent definitions of a "class" of stock.[75] Proposed Regulation section 1.302-5(b)(2) defines a class of stock by reference to "economic rights to distributions rather than the labels attached to shares or rights with respect to corporate governance." Interestingly, this definition applies for purposes of section 354, section 355 and section 356, but does not expressly apply for purposes of section 301.[76] Proposed Regulation section 1.358-2(a)(2) provides a slightly different definition, stating that "[s]tock . . . which differ . . . because . . . the rights attributable to them differ . . . are considered different classes of stock . . . for purposes of this section." Thus, the section 358 definition appears to allow for consideration of governance rights in the identification of a class.

We recommend that the Final Regulations clarify that a class of stock is defined similarly for all purposes of the Proposed Regulations. Moreover, we do not believe the policies underlying the Proposed Regulations would be furthered by finding different classes on the basis of identical economic rights, but different governance rights. For this reason, and subject to the observations above regarding the relationship between the definition of "class" and taxpayer electivity, we support the use of the definition in Proposed Regulation section 1.302-5(b)(2) uniformly throughout the Proposed Regulations. In any case, because the definition of a "class" of stock is such an important requirement for implementing the Proposed Regulations, we believe that Treasury and the Service should provide additional discussion of the reasons for choosing one particular definition over another and the relationship between the definition of "class" adopted and the extent of taxpayer electivity intended.

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[72] Rev. Rul. 2007-49, 2007-31 I.R.B. 237.

[73] *See* Rev. Proc. 2004-66, 2004 C.B. 999 (Nov. 16, 2004).

[74] *See supra* note 56.

[75] *See generally* Scott M. Levine, *Class of Stock: A Definition in Need of Refinement*, 124 Tax Notes 341 (July 27, 2009).

[76] *Id*.