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Another Approach to Corporate Stock Basis

By Alan L. Feld

Gordon Warnke's article[1] makes a significant contribution. It helps to map a largely unexplored continent of tax law, the use and determination of adjusted basis in corporate shares in connection with certain nonrecognition transactions, recently elaborated in Reg. §1.358-2.[2] The regulation provides guidance of particular relevance to the allocation of basis when the shareholder owns two or more batches of stock with differing adjusted bases. As Gordon's article makes clear, apparently simple tax law directives concerning the treatment of adjusted basis raise difficult questions and choices, often in common situations. In this article, I propose to make explicit some of the polarities that underlie the choices in this area and to state some places where I differ from Gordon as to their resolution.

Ownership of shares of corporate stock performs two different investment functions and the ambiguities that arise in the measurement of a shareholder's adjusted basis in corporate stock reflect them. Investors may hold shares as representing a fractional interest in the activities of the corporation itself, looking directly to the enterprise for primary returns on investment. In the extreme case, a sole shareholder depends entirely on the corporation's activities for its rewards. Other investors may hold shares as a financial instrument that produces income, gain or loss with some independence from the activities of the corporation. Thus, the risks and returns to an investor in a publicly traded company depend at least as much on the operation of financial market forces as on the corporation's successes or failures. A long history reflects this duality.[3] Each of these functions points to a different kind of income measurement, either based on consideration of the entire investment or based on a relevant portion of it. The differences emerge starkly in determining how to treat a partial disposition of shares in a taxable transaction. When a shareholder sells to a third party less than all the shares owned, tax law determines gain or loss on a share by share basis, reflecting the status of each share as a separate financial investment.[4] When a shareholder sells some shares directly to the issuing corporation, however, the Code determines whether to characterize the transaction as a sale or a corporate distribution by reference to the change in the shareholder's relative stake in the corporation and not by reference to each share.[5] Application of an aggregate approach occasionally produces a different measure of gain than the separate unit approach.

Basis determinations reflect these differences. Adjusted basis of stock in an exchange operates as a stacking or ordering rule to determine the extent to which proceeds received in the exchange reflect a return of investment. When an investor sells all the shares owned to another investor, the ordering generally recovers the full amount of the adjusted basis first, with any overage or shortfall producing gain or loss.[6] When the shareholder disposes of less than all the interest in the corporation, the ordering question becomes more complicated and may turn on whether to apply a unified or per unit approach to adjusted basis. Gordon's article analyzes the results for a deceptively simple case, ownership of

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10 shares, each with a basis of five and another 10 shares, each with a basis of 10, for a total investment of 150, in the context of many different transactions and points out the difficulties encountered and the decision points along the way. Much of his analysis tracks the unit-by-unit approach adopted in Reg. §1.358-2 in 2006. I want to suggest an alternative approach to a subset of the transactions that may avoid some of the less attractive results of current law and may provide a better guide in the areas currently lacking authority.

Basis considerations in exchanges of stock arise at two different points, *ex ante* and *ex post*. Basis first determines the extent of recovery of the shareholder's prior investment in the corporation's shares to measure gain or loss on the exchange. After that determination, a second issue deals with allocation of basis to the assets acquired on the exchange, and any shares previously owned and retained, so as to create a base for the measurement of future gain or loss. The basis rule going forward also will have implications for the holding period of each asset. Further, application of the *ex ante* stacking rule requires a judgment as to which investments to count in the calculation. Should recovery of the investment and measurement of gain involve only the specific shares tendered in an exchange, all the shares owned within the same class or all classes of stock in the same corporation? Gordon's article pushes the question down further, to shares of the same class held in separate brokerage accounts, and asks whether, as a practical matter, the basis inquiry should look only to the shares in any single account in certain circumstances. Finally, the basis determination *ex post* raises the possibility of fragmentation, the embodiment within a single share of two different basis calculations, now required in some exchanges under the new Code Sec. 358 regulations.[7] Fragmentation already existed in some measure prior to adoption of the Code Sec. 358 regulations,[8] but as Gordon's article states, the unit-by-unit approach of the regulations makes fragmentation more common and brings complexity and unresolved questions to mainstream reorganizations.

Gordon's article carefully examines the decisions taken in the Code Sec. 358 regulations. The regulations start from a simple value judgment that combines two well-established tax rules. First, a shareholder ordinarily treats adjusted basis on a separate unit-by-unit approach under Reg. §1.1012-1(c). This allows a shareholder who disposes of less than all shares owned to choose between different batches of stock with different tax characteristics. Second, reorganization exchanges do not constitute recognition events to the extent of qualified consideration. It seems to follow that an exchange of stock for stock in a reorganization ordinarily should leave the allocation of adjusted basis unchanged. The shareholder therefore should retain separate-block adjusted bases in the new shares received and should not average stock bases. The regulations play out the implications of that conclusion by tracing basis in a variety of exchanges.

While this value judgment coherently addresses the treatment of adjusted basis *ex post*, it does not of itself suggest how to order or stack adjusted basis *ex ante* in dealings between the shareholder and the corporation, including reorganizations that may result in gain recognition. Preservation of the shareholder's ability to elect which shares to exchange in a later taxable transaction need not imply a similar election within the reorganization exchange itself. The regulations, however, seem to push the unit-by-unit analysis to its logical conclusion with occasionally unfortunate results. A competing vision emerges from the Code's treatment of distributions to shareholders from the corporation, one that takes a more unitary view of the shareholder's investment. I propose to modify the regulations' across-the-board unit-by-unit approach, with the application of a unified or aggregate approach in assessing dealings between the shareholder and the corporation, leaving the unit-by-unit determination for dealings between the shareholder and outside parties. Thus, in distributions from the corporation, the shareholder first would treat the stacking question on a unified basis. After determining the tax consequences of the transaction, adjusted basis going forward will affect third-party dealings, and allocation of basis on a unit by unit approach would apply.

Consider a corporate distribution to shareholders without surrender of shares. After exhaustion of earnings and profits, the distribution reduces adjusted basis of the stock and any excess gives rise to gain.[9] Suppose a shareholder who owns 10 shares with a basis of $5 per share and 10 shares of the same class of stock with a basis of $10 per share receives a distribution from the corporation of $140. The corporation had no earnings and profits. On a per unit approach, each share receives $7, so that 10 shares have gain of $2 each, leaving zero basis going forward, while the

other 10 shares have no gain and $3 of adjusted basis going forward. An aggregate basis approach instead marshals the basis in all the shares, $150, so that none of the distribution results in gain. This seems a more logical approach to the corporation's dealings with its shareholder: tax all distributions of earnings as dividends, then allow the recovery of shareholder investment, and only then treat the shareholder as recognizing gain. Gordon's article also prefers the latter result, which is contrary to the limited applicable authority,[10] but on somewhat different grounds. As for adjusted basis going forward, the *ex post* tracing could remain intact. No blending or averaging of basis need occur: 10 shares would have exhausted all their basis, while each of the remaining 10 shares would have a basis of $1.

The words of Code Sec. 301 permit this result. They create sufficient ambiguity to allow either an aggregate or unit-by-unit approach. Subsection (c)(2) requires that the distribution reduce the adjusted basis of "the stock." The antecedent in Code Sec. 301(a) refers to a distribution by a corporation with respect to "its stock." "The stock" could refer to a share by share determination or could refer back to the aggregate of "its stock" on which the corporation makes the distribution.

The result should not change if the shareholders ratably transfer shares to the corporation on receipt of the distribution. Suppose the same shareholder who owns 20 shares transferred 10 shares to the corporation on receipt of the $140 distribution. Assume further that Code Sec. 302(d) applies to treat the transaction as a Code Sec. 301 distribution. It seems inappropriate in this context to apply a tracing rule modeled on Reg. §1.1012-1(c). That provision provides rules for determining which shares acquired on different dates or at different prices the holder sold or transferred, but Code Sec. 302(d) by its terms characterizes the transaction as a distribution of property, not as a sale or exchange. Application of an aggregate approach rather than a unit-by-unit approach seems warranted. It follows that neither the first-in rule nor the shareholder identification rule of the regulation should apply. Rather, under an aggregate approach the shareholder once again should recognize no gain. The only remaining issue concerns the allocation of the unused $10 of basis. The logic of using the tracing approach *ex post* might treat five of each batch of stock as retained. Five shares would have a basis of $2 each and five a basis of zero.

Another area where application of an aggregate approach *ex ante* produces more logical results than a strict unit-by-unit analysis arises when a shareholder receives boot in a reorganization. Suppose the sole shareholder of X Corporation, who owns 10 shares with a basis of five and 10 shares with a basis of 10, exchanges them in a reorganization for 20 shares of Corporation Y stock worth 130 and cash of 70. Code Sec. 356 requires the shareholder to recognize gain on the exchange up to the amount of the nonqualifying consideration. On an aggregate view, the shareholder has engaged in a single exchange, giving rise to gain of 50, which the shareholder should recognize in full.

The regulations, however, apply a different result under its unit tracing theory. Reg. §1.358-2(a)(2)(ii) allocates a *pro rata* portion of the Y stock and a *pro rata* portion of the cash to each X share. The regulations thus deem the shareholder to have received 10 shares of Y stock and 35 of cash in exchange for the low-basis X shares, producing a realized gain of 50, of which the shareholder recognizes 35. On the exchange of the other block of X stock the shareholder realizes no gain or loss. The regulations allow the shareholder to alter this result when the terms of the exchange specify that shares of a particular class or money are received in exchange for specified shares of stock or for shares of a specific class and the terms are economically reasonable.[11] A dual exchange presumably satisfies economic reasonableness if the consideration for each part represents fair market value. As a consequence, if the exchange agreement allocated cash of 70 and Y stock worth 30 to the high-basis batch and the remainder of the Y stock to the low basis batch, the shareholder would recognize no gain.[12]

This result strains the language of Code Sec. 356(a)(1), which requires recognition of "the gain" when "the exchange" includes boot. The regulations in effect treat the transaction as two exchanges, each with its own calculation of gain. Further, the exchange of cash of 70 and Y stock worth 30 for the high basis stock, standing alone, probably would not even qualify for reorganization treatment on continuity of interest grounds. Treating the separate exchange in this example as a taxable transaction does not give rise to gain, since the basis of the X shares exactly equals the consideration received, but has other implications.[13] For example, the Y stock would take a new holding period.

An earlier authority, Rev. Rul. 74-515,[14] took a similar bifurcation approach. There, X, a publicly held corporation with both common and preferred stock

outstanding, merged into Y corporation. Holders of X corporation common stock received Y corporation common stock. Holders of X corporation preferred stock received cash. Some shareholders owned only one class of stock or the other, while other shareholders owned some of both. The ruling held the boot provision inapplicable to shareholders who owned solely one class or the other: Common shareholders received only qualified consideration and no boot; preferred stockholders received no qualified consideration, did not come within Code Sec. 356, and simply redeemed their stock. The Ruling did apply Code Sec. 356 to shareholders who owned both classes of stock. It allocated the mixed consideration by class, deeming the common exchanged for common stock and the preferred for cash. Shareholders who received cash greater than their basis in the preferred stock recognized gain. Shareholders whose basis in the preferred exceeded the cash received, however, could not recognize loss, by reason of Code Sec. 356(c).

When carried too far, however, application of the unit-tracing approach so as to treat the event as two separate exchanges undermines the stacking rule established by the Code for the treatment of boot in a reorganization. That rule recognizes the gain realized in a reorganization to the extent that the shareholder receives cash in the exchange. Rev. Rul. 74-515 carved out a limited exception when it distinguished what appears to be a class of traditional preferred stock from common stock, both widely held. The regulations, however, do not limit its two-exchanges result to such cases. Reg. §1.358-2(c), Examples 4 and 5, refer to a second class of stock, without further specification, so that two classes of common stock in a closely held corporation apparently would qualify. Moreover, although these examples deal with shares of different classes, Reg. §1.358-2-(a)(ii) allows an exchange agreement to specify the consideration "for a particular share" of stock. Thus, as noted, shareholders who own high basis and low basis stock of the same class may stack the high-basis batch against the cash in the exchange agreement and thereby defeat current gain recognition, subject only to the limitation that the terms of the exchange must be "economically reasonable."

As Gordon's article notes, this unit tracing approach may leave unused some portion of the old-share basis in the exchange for boot. Suppose the shareholder who holds 10 shares with basis of five each and 10 shares with basis of 10 each, exchanges them for total consideration of 190, allocating the low basis stock for shares in the acquiring company worth 95 and the high basis stock for 95 cash. Gordon's article proposes to recognize the five of unused basis in the latter exchange as a loss.[15] This result undercuts the statutory pattern. The reorganization provisions grant shareholders deferral of realized gain but they do not allow a shareholder to defer gain and also to recognize loss. When a shareholder receives both qualified property and boot in a reorganization, Code Sec. 356(c) bars recognition of loss "from the exchange." Moreover, a loss recognition rule would encourage shareholders in a closely held corporation who anticipate its eventual disposition to bifurcate their stock investment, loading capital contributions onto one batch only. The regulations should not encourage creation of losses in this way. Instead, they should allocate the unused basis to the qualified property received on the exchange.

Gordon's article makes a number of innovative policy recommendations, some of which would require legislative action, while the Treasury could implement still others under current law. The article directs a number of proposals at "ordinary shareholders," those who hold less then five percent of the stock of a publicly traded company. These shareholders almost always hold their shares as a financial interest and without any direct impact on the operations of the corporation itself. One proposal would treat all sales of stock back to the corporation as exchanges entitled to capital gain or loss treatment. Under this proposal, the usual tests under Code Sec. 302(b) for treating a redemption as a Code Sec. 301 distribution, generally with dividend consequences, would not apply. In some instances of corporate buybacks of shares, application of the Code Sec. 302(b) tests to a particular shareholder may depend on the actions of other shareholders in order to determine whether the fractional interest in the corporation represented by the shareholder's remaining shares has declined.[16] The Code Sec. 302(b) tests for distinguishing exchanges from dividend equivalent distributions have worked reasonably well for closely held corporations or when a shareholder has a dominant interest in a publicly traded corporation. When the shareholder has only a tiny fractional interest in the corporation to begin with, however, the Code Sec. 302(b) tests may produce arbitrary results. Gordon's proposal deserves consideration, with one caveat, whether

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to draw the line at five percent or some lower figure.

By carefully working through the implications of the unit-by-unit rule of Reg. §1.358-2, Gordon's article has disclosed many of the nuances and questions that lie in its application. I would modify the regulation further with incorporation of an aggregate basis rule to take account of corporate distributions in the form of cash or other recognition property. Gordon's article makes an excellent start on the work of clarifying the practical implications of the regulation. Now the Treasury needs to continue the process of refining its handiwork.

ENDNOTES

[1] Gordon E. Warnke, *Developments, Theories and Themes in Stock Basis*, TAXES, Mar. 2007, at 85.

[2] T.D. 9244, IRB 2006-8, 463 (2006).

[3] The duality reaches back to the venerable case of *Eisner v. Macomber*, SCt, 1 USTC ¶32, 252 US 189 (1920). The majority opinion of Justice Pitney reflects a focus on the shareholder's fractional interest in the corporation, with a closely held corporation as the model. Justice Brandeis' dissent treats shares as financial instruments traded in established markets.

[4] *See* Reg. §1.1012-1(c). I have elsewhere criticized the operation of this rule; *see* Feld, *When Fungible Portfolio Assets Meet: A Problem of Tax Recognition*, 44 TAX LAW. 409 (Winter 1992).

[5] *See* Code Sec. 302(b)(1)–(3).

[6] Code Sec. 1001(c). Even in this straightforward situation, the Code at times may require a unit by unit approach; *see* Code Sec. 267.

[7] Reg. §1.358-2(a)(vi).

[8] *See* Rev. Rul. 85-164, 1985-2 CB 117; Kahn and Lehman, *Exchanges of Multiple Stocks and Securities in Corporate Divisions or Acquisitive Reorganizations*, TAX NOTES 1417 (2004).

[9] Code Sec. 301(c)(2) and (3).

[10] *W.T. Johnson*, CA-4, 71-1 USTC ¶9148, 435 F2d 1257.

[11] Reg. §1.358-2(a)(ii).

[12] Reg. §1.358-2(c), Example 5, reaches this result in an exchange involving two classes of stock. *See also* Rev. Rul. 74-515, 1974-2 CB 118.

[13] The gain recognized in a taxable exchange of the high basis batch will equal the gain recognized under Code Sec. 356 if the consideration equals or exceeds the basis in the old shares and the basis exceeds the value of the new stock received. For example, if the total cash consideration on the exchange increased to 90, and the exchange specified a swap of the 100-basis batch for 90 of cash and 30 in Y stock, under the regulations the shareholder would recognize 20 of gain under Code Sec. 356, the same amount as the shareholder would recognize on a taxable exchange.

[14] Rev. Rul. 74-515, 1974-2 CB 118.

[15] The preamble to the regulations raised the question of whether to allow loss recognition, but did so in the context of a two-class example similar to Rev. Rul. 74-515. T.D. 9244, 2006-1 CB 463. As noted, Rev. Rul. 74-515 held that no loss would be recognized.

[16] *Compare* Rev. Rul. 76-385, 1976-2 CB 92, *with* Rev. Rul 81-289, 1981-2 CB 82.

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impractical. For example, in cases where there are multiple tiers of partnerships, it may be difficult or impossible for an upper-tier partnership to obtain adequate information in order to push the book-up down through all of the tiers. For this reason, the approach suggested should be permitted, but not required.

[144] However, if the partners of P do not choose to take such an approach, the Code Sec. 704(b) regulations clearly do not compel them to do so.

[145] In other words, the aggregate revaluation of S's assets should, if at all possible, be extrapolated from the value of A's LTP Interest in S (as agreed to by the partners of P upon its contribution by A). Assuming that there is no change in the economic interests of the S partners, such partners should be mostly neutral as to this revaluation since the reverse Code Sec. 704(c) impact at that level should itself be neutralized by the fact that the S partners will bear its burden proportionately.

[146] *See* Reg. §1.708-1(c)(3)(i).

[147] In circumstances such as those presented by the example, where other property is simultaneously transferred with the Code Sec. 704(c) property, it is unclear whether a bifurcation is permitted such that a portion of the substituted basis property is treated as received for the Code Sec. 704(c) property and a portion for the other property. The regulations specifically sanction a bifurcation/specific identification approach when Code Sec. 704(c) property and other property are simultaneously transferred to a corporation in a Code Sec. 351(a) transaction, but are silent as to Code Sec. 721(a) transactions. *See* Reg. §1.704-3(a)(8)(i) (last sentence). In general, a partner has a single basis and a single capital account in a partnership. *See* Reg. §1.704-1(b)(2)(iv)(b); Rev. Rul. 84-53, 1984-1 CB 59.

[148] Reg. §1.708-1(b)(2).

[149] *See* Rev. Rul. 87-50, 1987-1 CB 157. Even though the construct for a Code Sec. 708(b)(1)(B) termination has been changed, the position taken by the ruling is now confirmed by the Code Sec. 708 regulations. Reg. §1.708-1(b)(2).

[150] *See* Rev. Rul. 87-51, 1987-1 CB 158. Even though the construct for a Code Sec. 708(b)(1)(B) termination has been changed, the position taken by the ruling is now confirmed by the Code Sec. 708 regulations. Reg. §1.708-1(b)(2).

[151] Reg. §1.705-1(a).

[152] *Id.*

[153] Code Sec. 732(a), (b); Reg. §1.732-1(a), (b).

[154] Code Sec. 752(a).

[155] Code Sec. 752(b).

[156] Reg. §1.752-1(a).

[157] Code Sec. 752(c), for example, states that "a liability to which property is subject shall ... be considered a liability of the owner of the property."

[158] The regulations are consistent with the prior published position of the IRS. *See* Rev. Rul. 77-309, 1977-2 CB 216.

[159] Reg. §1.752-4(a).

[160] Reg. §1.704-2(e)(2) provides that allocations of nonrecourse deductions must be made "in a manner that is reasonably consistent with allocations that have substantial economic effect of some other significant partnership item attributable to the property securing the nonrecourse liabilities." Reg. §1.704-2(k) contains rules that address tiered partnerships in circumstances where a lower-tier partnership allocates nonrecourse deductions to an upper-tier partnership. Those regulations do not address the issue posed by the example in the text because none of the deductions of S would be nonrecourse deductions.

[161] Reg. §1.704-2(b)(3).

[162] P would be obligated to pay $100 to the creditor of S in the event that S was unable to make repayment. Thus, the creditor could reach the land held by P, and thus the liability could be viewed as encumbering the assets of P for purposes of Reg. §1.704-2(b)(2), which provides that an increase in partnership minimum gain is created by a decrease in the adjusted tax basis of property encumbered by a nonrecourse liability below the amount of that liability.

[163] *See* Wasserman, at 19-70 to 19-75; 1984 ALI Report, at 515–16.

[164] Reg. §1.751-1(a)(1). The statute provides that:

> The amount of money, or the fair market value of any property, received by a transferor partner in exchange for all or