

The Tax Authority for Accurate Basis Tracking



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TORONTO-DOMINION & BANKNORTH MERGER—THE “TAXES TWO-STEP”

On March 1st, 2005, Banknorth Group, Inc. [NYSE: BNK] merged into Toronto-Dominion Bank [NYSE: TD, TSE: TD], a Canadian company. *Banknorth Group, Inc. (2000)*, Capital Changes Rep. (3-2-2005). The merger was structured in two separate steps—a “migratory merger” followed by an “acquisition merger” and the resulting tax treatment to shareholders of Banknorth is unusual. Banknorth noted this by including Appendix G to the Proxy Registration Statement for the merger and we published the examples included therein. *Banknorth Group, Inc. (2000)*, Capital Changes Rep. (3-10-2005).

The first step was the migratory merger—the reincorporation of Banknorth from Maine to Delaware. This eliminated anti-takeover provisions that would have hindered the acquisition. Holders of Banknorth (old) common received an identical number of Banknorth Delaware (new) common shares in the reincorporation. The migratory merger was structured to qualify as a tax-free reorganization. Accordingly, holders did not recognize gain or loss on the exchange of Banknorth (old) common for Banknorth Delaware (new) common. Basis and holding period carried over and opinion notes that basis and holding period in new stock may be determined by reference to each block or lot of Banknorth (old) common exchanged.

The second step was the acquisition merger. This involved the exchange of 51% of the Banknorth Delaware (new) common shares for Toronto-Dominion Bank common shares (0.2351 shares for each Banknorth Delaware (new) share exchanged) and cash (\$12.24 for each Banknorth Delaware (new) share exchanged). This was structured as a taxable merger. Accordingly, gain or loss is computed by subtracting the holder’s basis in the Banknorth Delaware (new) common exchanged in the acquisition merger from the fair market value of the Toronto-Dominion Bank common and the amount of cash received. Basis in the Toronto-Dominion stock equals its fair market value on the date of exchange and the holding period for such stock begins the day after the date of exchange.

Put Your Good Foot Forward!

A U.S. federal income tax issue noted in the registration statement is that the amount of taxable gain recognized in the acquisition merger differs depending on which particular lot (or lots) of Banknorth Delaware (new) common is exchanged in the second step.

Here’s an extremely simple example. Assume a holder only owns two shares of Banknorth (old) common—one was bought ten years ago at a price of \$6.828 (Lot 1); the other was bought nine months ago at a price of \$32.83 (Lot 2). In the migratory merger, the two shares are exchanged for two shares of Banknorth Delaware (new) common. The holder carries over basis and holding period of the shares exchanged and traces the two old lots (each containing one share) to the new shares received. Thus, the basis and holding period of one of the shares received is \$6.828 and ten years (New Lot 1) and the other is \$32.83 and nine months (New Lot 2).

In the acquisition merger, assume that the holder must exchange one of the two shares (50%) for a 0.2351 fractional interest in a Toronto-Dominion Bank common share and cash of \$12.24.

The Toronto-Dominion Bank common share has a fair market value on the exchange date of \$40.94—23.51% of a share is \$9.625. Accordingly, the total amount realized on the second step exchange is \$21.865.

If the holder exchanges the New Lot 1 share of Banknorth Delaware (new) common in the acquisition merger, gain of \$15.037 is recognized (\$21.865 combined cash and fair market value of property received less \$6.828 basis in New Lot 1 share exchanged). Alternatively, if the New Lot 2 share is exchanged, loss of \$10.965 is recognized (\$21.865 combined cash and fair market value of property received less \$32.83 basis in New Lot 2 share exchanged).

This simple example illustrates the importance to holders in selecting the proper lot (or lots or portions of lots) of shares to exchange in the second step acquisition merger. Selecting the most advantageous lot from a tax standpoint is putting the “good foot” forward in the second step!

Identification of Shares Sold Permitted by IRS

Appendix G only includes two examples and is only slightly more complicated than the simple example set forth above. A key assumption relied on in the “different cost basis” example of Appendix G is that the shareholder “adequately identifies the shares of stock sold as explained in Treasury Regulation Section 1.1012-1(c) and chapter 4 of IRS Publication 550.”

This “adequate identification” rule is the key, permitting a holder to select which lot or “foot” to put forward in the taxable second step of the Banknorth/Toronto-Dominion merger. Under the general rules regarding basis in stock holdings, Treas. Reg. Sec. 1.1012-1(c)(1) requires that taxpayers must separately account for each lot purchased. The regulations further provide that for purposes of computing gain or loss, if a holder does not specifically identify which lot of stock or securities is sold, the applicable lot is determined under a “first-in, first-out” or “FIFO” method. The FIFO method is generally disadvantageous for holders because presumably the earliest lot of stock or securities has the lowest basis and therefore will result in the greatest taxable gain (or smallest loss). The IRS permits holders to avoid this treatment by specifying which lot has been sold under the adequate identification rule generally set forth in

Treas. Reg. Sec. 1.1012(c)(2). The IRS has issued guidance regarding the necessary instructions and methods to specifically identify particular lots and brokers are generally familiar with these rules (this rule is expanded under other provisions of the regulations and other IRS guidance to favorably address stock held by brokers, through book-entry, and other circumstances). As referenced in Appendix G, this topic is generally discussed on page 44, Chapter 4 of IRS Pub. 550 for 2004 returns (available under publications on the IRS website: www.irs.gov).

Conclusion

The Banknorth/Toronto-Dominion Bank merger is unusual. Unlike typical one step mergers that are either taxable or tax-free, this merger involves two separate steps—a tax free reincorporation followed by a taxable acquisition merger. Because only 51% of shares are exchanged in the second step taxable merger, a holder’s identification of specific lots of shares sold may have significant ramifications in determining the amount of gain or loss recognized.

Contact: Stevie D. Conlon
847 267-2428

CAPITAL CHANGES IN-DEPTH™

Managing Editor

Denise Davidson, J.D.
847 267 2931
denise_davidson@cch.com

Senior Tax and Articles Editor

Stevie D. Conlon, J.D., C.P.A.
847 267 2428
stevie_conlon@cch.com

Designer

Don Torres

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If you would like to receive a copy via email, please send a request to john_kareken@cch.com or stevie_conlon@cch.com.

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