One of the critical pieces of information needed to book a stock-for-stock exchange or a distribution of stock is the fair market value of the security received. This value is essential in computing capital gain or loss or determining basis allocation. Unfortunately, the Internal Revenue Code does not tell us how to correctly determine fair market value. It is basically a question of fact as to what is reasonable under the circumstances.

This article examines some of the considerations that enter into a fair market value determination. It is presented in two parts. Part one discusses general principles and how CCH applies them. Part two, which will appear in the next issue of CAP EXCHANGE, looks at some actual transactions that illustrate the difficulties in arriving at a reasonable fair market value.

Why is fair market value important?

Fair market value is defined as the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell. For stocks traded on the open market, this usually means the price paid. That price becomes our cost basis in the stock. If the stock is then exchanged for another stock, and the exchange is tax-free, the basis in the new stock equals the basis in the old stock, as adjusted over time. It carries forward because no taxable event has occurred. If the exchange is taxable, however, the new stock is treated as “consideration” paid for the old stock, and we have to determine whether a gain or loss was recognized in the exchange. In order to compute gain or loss, we compare the fair market value of the stock received with our basis in the stock surrendered.

If, instead of exchanging one stock for another, we receive stock as a distribution on stock already held, fair market value is important in several ways. On one hand, when receipt of the new stock is taxable, the amount realized is usually equal to the fair market value of the stock received. On the other hand, in a tax-free spin-off, we need to allocate a portion of the basis of the old stock to the new. This is done based on their relative fair market values.

The Regulations under Code Sec. 307 generally provide that if a shareholder receives a nontaxable distribution of stock, then the basis of the stock on which the distribution was made must be allocated between the old and the new stocks in proportion to their fair market values on the date the stock is distributed to the stockholder (not the record date). Date of distribution is an important subject that will be discussed more fully in part two of this article.

Why allocate basis?

To put it simply, the Code requires us to allocate basis in certain cases. But let’s look at the rationale. In a nontaxable distribution, where we receive new stock on our existing stock, our original holding grows, but it all remains in the same “basket,” if you will. Since the amount of our initial investment (our basis) remains the same, it must be allocated among all the items in the basket. This is not so if the distribution is taxable. In that case, the Code views the new security as the equivalent of cash. It is treated as income and taxed accordingly. Yet it is an asset that can be held and traded at a later date, so it goes into a new basket with its own basis equal to its fair market value at the time of receipt.

Not only are we required to allocate basis in nontaxable distributions, but the Code requires us to do so based on relative fair market values. If we

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Letter from Managing Editor

Dear Capital Changes Subscriber:

Welcome to the first issue of CAP EXCHANGE, created exclusively for subscribers to CCH Capital Changes. This newsletter is included as part of your subscription and is intended to bring you useful information and perspectives on:

◆ Important tax issues
◆ Effective use of Capital Changes products
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We also hope to bring you articles from outside authors as well as our readers on relevant topics. So if you would like to submit an article for publication or if you have any suggestions on subjects you would like us to cover, please let us know.

The editor of CAP EXCHANGE is Richard Ryndak. He is a senior writer/analyst and editor of our ADR/Global Capital Changes products. Before coming to CCH he practiced law for 15 years, first as a customs and international trade attorney, and later as in-house counsel for Abbott Laboratories, Sears World Trade and Case Corporation where he was responsible at different times for international corporate transactions in Europe, Latin America, Australia, and Africa.

If you have any questions or comments regarding this newsletter or the material covered, please give Richard a call at (847) 267-7118 or contact him by e-mail at ryndakr@cch.com. You can also fill out and return by fax the form enclosed with this newsletter. We would love to hear from you!

The enormous growth in equity holdings by the investing public, as well as the volume and complexity of corporate actions, has increased the challenge for all of our customers maintaining quality account data and accurate tax information. On behalf of the entire Capital Changes editorial staff, I thank you for allowing us to assist you with this very important aspect of your clients’ equity investments.

Sincerely,

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were allowed to allocate any way we wished, we could artificially affect the amount of gain or loss recognized in a subsequent sale or exchange. Let’s say you own stock in company A on which you receive additional stock in company B. If you decide to sell stock B immediately and hold stock A indefinitely, it would be to your advantage to have as much of your original basis as possible allocated to stock B (the higher the basis, the lower the gain on the sale). Even if you decide to sell stock A a few years later and you recognize more gain because of the lower basis, at least you succeeded in deferring the gain. The Code frowns on this sort of machination for the purpose of avoiding taxation.

OK, so give it to me!

Considering the importance of fair market value and the speed and volume of trading, it is no wonder that stockholders and portfolio managers are eager to get the figures as quickly as possible. There was a time when CCH tried to satisfy this eagerness by figuring and publishing fair market values and basis allocations within hours of a transaction closing. However, problems sometimes arose weeks later when companies published their own figures that conflicted (albeit by fractions of a percentage point) with ours. Since determining fair market value is a question of fact, it was not a case of one being right and the other wrong. A security can have many fair market values, depending on the method used and rounding. Nevertheless, most of our customers were reluctant to go against the company’s published figures and felt obliged to rebook the transaction.

After talking with a number of our subscribers, we learned that they preferred we wait to see if the company published their own figures before we published ours. We recognized that even discrepancies in a number six places to the right of a decimal can be critical to an account. Other services make speed their number one priority, but at CCH we feel that accuracy is paramount, and that it is better to avoid publishing conflicting numbers by checking with the company first. Moreover, after the company issues its numbers, we analyze and confirm those numbers before publishing. Companies have been known to make mistakes, then change their numbers after talking to us.

As a rule, CCH will defer to the company when it issues a statement on fair market value. Companies use various methods for calculating fair market value, such as closing prices, weighted averages, the price of a stock at the specific time of day the deal closed, or appraisals. In an effort to avoid publishing conflicting values we try to confirm whether the company will publish its own numbers. If the company does not provide values, and assuming the stock is publicly traded, CCH will publish the average of the high and the low prices quoted on an open market or recognized exchange on the valuation date, a method well accepted by the IRS for determining fair market value.

One more thing …

There are times when it appears that a fair market value or basis allocation is called for in a particular transaction. Even though most of the writers and editors at CCH Capital Changes are lawyers and have seen similar transactions in the past, we are not engaged in rendering legal, tax, accounting or professional advice, and we are not privy to the corporate information necessary to render a tax opinion. Therefore, we publish summaries of corporate actions based primarily on publicly available sources, such as SEC filings, press releases and material received directly from the company. We also rely on communications with high-level company officials when appropriate, as well as their agents and depositaries.

What this means is that if a company has not expressed an opinion about the taxability of a transaction, or about the need for a market value or basis allocation, we will not undertake the calculations on our own. Similarly, in tender offers involving the exchange of securities, we are reluctant to provide a fair market value for the security received unless the offer document specifies a date that can be used for all shareholders. Otherwise, it is impossible to know which date to use for valuation, especially when the offeror may have as much as two weeks from the expiration date to distribute the new securities. We would be interested, however, in receiving suggestions from our subscribers on this last point.
Year-End Return of Capital Reporting

At tax time, investors busy themselves, or rather, busy their (very) busy tax professionals, with tallying and characterizing their profits and losses for the tax year. The sight of a Form 1099-DIV usually brings to mind dividend distributions. But this is a good time to remember another kind of distribution that is also reported on the form. We are talking about “return of capital” distributions (ROC if you like acronyms). Generally, ROC distributions are found on the taxpayer’s Form 1099-DIV under Nontaxable Distributions.

Money and other property an investor receives from an investment can be characterized in several ways. Companies that generate profits on a regular basis often pay, and in the case of Real Estate Investment Trusts (REITs) must pay, dividends. When paid out of current and accumulated earnings and profits, those dividends are included in the gross income of the investor as ordinary income.

But a company could pay a dividend without adequate earnings and profits to cover the amount paid. In that case, the excess is not treated as ordinary income; rather, it is considered a nontaxable return of capital that is applied in reduction of the shareholder’s basis. In other words, “return of capital” means that the shareholder is getting back his or her original investment (basis) in the stock. Since that original investment was made with money that had already been taxed, it would not be fair to tax it again when it is returned to the investor. However, it is fair to reduce the investor’s basis in the stock, because part of the original investment (basis) in the stock has been paid back.

So what happens when the entire original investment is returned? After the basis has been reduced to zero, the amount of any dividend that exceeds earnings and profits is treated as capital gain. This is because the shareholder has received more than he or she paid for the stock. The shareholder still holds the stock, but the company paid back the investment (return of capital) and is now, providing a taxable gain.

The important thing to remember is that return of capital distributions require shareholders to adjust their basis. As intimated above, REITs are special entities that are required by law to make regular distributions to their holders. At the end of their taxable year they must determine whether their distributions exceed earnings and profits, and report the excess, if any, to their holders. CCH Capital Changes now reports these return of capital distributions by REITs in order to help investors track their basis reductions and properly report their capital gains.

ADDITIONS TO THE CAPITAL CHANGES PRODUCT LINE

Capital Changes Watch. We now offer a service providing personalized e-mail notice any time CCH publishes a corporate action affecting companies in your portfolio. The notice links directly to a summary listing that contains: company name, CUSIP® number, transaction date and headline. A simple click on the company name links you to the full transaction story on the Capital Changes Daily Internet product.

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ADR/Global Historical Capital Changes. In November 1999, CCH created a new Capital Changes group to begin complete coverage of ADRs and global securities. Launched as a Daily Internet and Lotus Notes® service in February 2000, this expanded coverage has met with enthusiastic customer acceptance. Because information on non-U.S. companies can be more difficult to obtain and understand, customers appreciate the ability to receive concise explanations, CCH Basis Factors™ and key tax information.

We have now compiled ADR/Global reporting (November 1999 to present) into a historical product that is available as a companion to our U.S. Capital Changes database found on the CCH Research Network, an Internet-based subscription service.

For more on these products, or to set up a free trial, contact your sales representative at 1-888-224-7377.

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