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News & Information about CCH Capital Changes

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IRS Issues Proposed Stock Basis Allocation Regs. for Reorganizations

Shareholders often track the dates and purchase prices of separate blocks of identical stock for purposes of computing gain or loss on sale. What happens in a merger, spin-off or split-up, when shares of a new company are received? Does the shareholder have separate blocks of new stock with separate tax basis and holding periods? Or may the taxpayer compute an average basis for the new shares? On May 3rd, 2004, the IRS published proposed regulations that address this issue. They would not be effective until they become final (the day after final regulations are published). It is uncertain when that would occur or whether final regulations would adopt different rules. This article discusses these new proposed rules.

Background

Customers often acquire shares of stock in the same company over a period of time—purchasing one "block" or "lot" on one date and at one price per share and other blocks or lots at different dates, at different prices. This common practice can result in complex stock ownership records for shareholders and their agents. However, almost everyone manages this burden because tracking basis can be advantageous for U.S. tax purposes when stock is sold. And, it's the law.

For example, assume that Wiley E. Coyote purchased two blocks of Acme common stock—a block of 100 shares on January 15th, 2003, at a price of $5 per share (the 2003 block) and another of 50 shares on February 10th, 2004, at a price of $8 per share (the 2004 block). Wiley decides to sell 40 shares on May 1st, 2004 at a price of $10 per share. The amount of gain recognized on the sale and the determination of whether the gain is long-term or short-term depends on whether the shares sold were from the 2003 block or the 2004 block.

Internal Revenue Code Sec. 1012 provides the basic rules regarding the basis of property for federal income tax purposes and generally provides that the basis of property equals its cost. This starting point does not take into account various adjustments or exceptions under the Code, including those related to distributions on stock or other corporate actions, on which the Capital Changes Reporter focuses.

The regulations under Code Sec. 1012 include specific guidance regarding the determination of basis for stock sold. In general, Treas. Reg. Sec. 1.1012-1(c)(1) provides that taxpayers must use the first-in, first-out (FIFO) method for determining which shares are sold (and the basis of the shares sold) unless the stock sold can be "adequately identified" under rules set forth in the regulations. One thing the IRS has specifically ruled is that shareholders cannot use an average basis computed by blending different blocks of stock for determining gain or loss on shares sold—Rev. Rul. 61-97, 1961-1 CB 394.

So, it's either FIFO or specific identification if the shareholder can adequately identify the shares sold. When stock was commonly held in physical form, a shareholder could easily specify which shares of stock were being sold. Today, shares are held in street name by intermediaries—so how do you identify shares sold? IRS guidance on "adequate identification" has evolved as forms of stock ownership have changed and, among other things, IRS rules favorably address nominee forms of stock ownership, provided timely written instruction regarding which shares are intended for sale is provided by the taxpayer to his or her

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agent—see Treas. Reg. Sec. 1.1012-1(c)(3). Shareholders routinely provide such instruction in order to manage capital gains recognized on sales of stock.

Determining Basis of New Shares Received in a Reorganization

The Internal Revenue Code provides special rules governing so-called "tax free" corporate reorganizations including qualifying mergers, restructurings, spin-offs, split-ups and split-offs ("reorganizations"). Code Sec. 358 addresses the determination of basis for a shareholder who receives a distribution of stock or other securities in a reorganization. In general, the basis of stock received is the same as the stock exchanged, decreased by the fair market value of any other property (except money) received, the amount of any money received and the amount of any loss recognized, and increased by the amount, if any, treated as a dividend for tax purposes and the amount of gain recognized by the taxpayer on the exchange (excluding any portion treated as a dividend). Section 358(b) grants the IRS authority to issue regulations setting forth rules for allocating basis.

Unfortunately, the existing regulations did not address the allocation of basis to new shares where the taxpayer held multiple blocks of old shares. Various old court cases reached inconsistent conclusions regarding the determination of basis of new shares in similar circumstances. In some of them, the courts concluded that the specific identification of basis to different blocks was lost when the old shares were exchanged and the basis in the new shares was determined by averaging the basis in the old shares (for example, *Arrott v. Commissioner*, 136 F.2d 449 (3rd Cir. 1943)). In other cases, the courts permitted tracing of basis from old blocks to new blocks (for example, *Bloch v. Commissioner*, 148 F.2d 452 (9th Cir. 1945)).

However, the averaging method adopted by some of the courts where stock was received in a reorganization was inconsistent with the basic IRS rule against averaging in determining gain or loss for stock. The IRS issued a private letter ruling (only binding for the taxpayer who requested it) in 1979 (PLR 7946005, dated July 26, 1979) in which they examined whether adequate identification had been made by a taxpayer with regard to exchanged shares to avoid averaging. The IRS ruled favorably, permitting allocation of basis to separate blocks of new shares.

The New Proposed Regulations

On May 3rd, 2004, the IRS published the proposed regulations—Prop. Treas. Reg. Secs. 1.358-1 and 1.358-2). In the preamble, the IRS discusses both the adequate identification rule of the general basis rules for stock and the difficulty in establishing identification when stock is acquired in a reorganization. The IRS also notes the differing opinions of the courts regarding the basis of stock received in a reorganization and then notes that it does not believe an averaging method is justified or appropriate.

In general, Proposed Regulation Sec. 1.358-2(a)(2)(i) requires that in a reorganization a shareholder must allocate his or her basis to new shares in a manner that reflects, to the greatest extent possible, that a new share is received in respect of old shares acquired on the same date and

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ADR's—Examining Depositary Agreements for Foreign Shares

For the second part in our series on depositary receipts we will examine a typical American Depositary Receipt or Share ("ADR" or "ADS") Depositary Agreement and point out some key provisions.

In general, the depositary agreement is among the company (Air France), the depositary bank (Citibank) and the ADS holders. The agreement is a financial contract that governs the terms of the depositary receipt program and specifies the depositary's obligations.

As is typical for custodial agreements, it provides that each ADS holder is liable for any taxes or governmental charges payable by the depositary or custodian with respect to the ADS. These taxes may be withheld or deducted from any distributions made to holders. The depositary will file any reports necessary to reduce or eliminate certain taxes payable by holders under tax treaties or other laws and make reasonable efforts for holders to receive refunds on excess withholding taxes paid in foreign country. It is important to note that the depositary is not, however, obligated to provide holders with any information regarding the tax status of the company, including whether the company is a Passive Foreign Investment Company (PFIC) or a Foreign Personal Holding Company.

The agreement imposes limitations on ownership of ADSs. Each ADS represents a direct interest in shares underlying such ADS and may result in ownership of a number of shares which exceeds limits under applicable law or the company's Articles of Incorporation. If so, a holder may be required to disclose certain information regarding ownership of ADSs as if holder was owner of the underlying shares.

Whenever the depositary receives notice of cash distributions on underlying shares, or receives proceeds from sales of shares, the agreement provides that the depositary will, subject to local laws of company, distribute, in U.S. dollars where practical, such amounts to holders, net of fees and charges and taxes withheld.

If any distribution consists of a dividend in, or distribution of shares, the company will deliver such shares to the custodian in the name of the depositary. In some cases, the depositary will distribute such shares to holders, net of fees and taxes. However, the agreement provides that the depositary may withhold a distribution to holders if it has not received assurance from counsel that the distribution does not require securities law registration. In this case, the depositary may sell shares intended for holders and distribute proceeds, net of fees and taxes, to holders. *See, e.g., Bidvest Group Ltd.*, CCH ADR/Global Capital Changes Reporter (3-3-2004).

In the case of a rights distribution, the agreement provides that the company must indicate to depositary whether it wants holders to receive rights, and if so, whether such distribution is legal under U.S. securities laws. If not, depositary will attempt to sell rights, in a "riskless principal capacity", and distribute proceeds to holders, net of fees and taxes. *See e.g., Brasil Telecom Participacoes S.A.*, CCH ADR/Global Capital Changes Reporter (5-11-2004). If depositary cannot distribute rights or sell them, depositary will allow rights to lapse.

If the company gives notice of intention to exercise a redemption right, holders will receive redemption price, net of fees and expenses, upon surrender of their certificates. If less than all underlying shares are redeemed, holders' shares to be retired will be selected on pro rata basis as determined by depositary.

Whenever the depositary receives foreign currency from dividends or other distributions, which can be converted to U.S. dollars on a practicable basis, the agreement requires that the depositary must convert currency and distribute U.S. dollars to holders. The depositary will make a reasonable effort to obtain necessary approval or license of any government in order to convert currency, but is not obligated to do so.

The depositary will make a reasonable effort to set the record date for holders in any circumstance, as close to that of the record date for holders of underlying shares. Only holders at close of business in New York on such date are considered of record for particular action.

The depositary will also act as representative to exercise voting rights of holder after holder provides depositary with voting instructions. This seems to be the standard; however, there are cases where the holder must surrender ADR certificates in exchange for

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ADR Key Terms

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underlying shares in order to participate in shareholder meetings.

When the company notifies the depositary that it wants to terminate the agreement, the depositary provides notice to holders that the program will be terminated. After date of termination, the depositary will discontinue distributions of dividends and other proceeds and stop all notices to holders. For 6 months (in case of Air France agreement) from date of termination, holders may surrender certificates in exchange for underlying shares and any dividends or proceeds held for their benefit after payment of all outstanding fees and taxes. After 6 months from termination date, the depositary may sell underlying shares representing any outstanding ADSs and hold proceeds for benefit of holders.

New York law generally governs the Air France Deposit agreement, although French law governs rights of holders of ADSs and obligations of company in respect of holders and underlying shares. The agreement provides that federal and state courts in New York City will have jurisdiction to hear any claim that arises in connection with Agreement.

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at the same price. If, in the reorganization, the shareholder continues to hold shares of old stock, this block by block allocation rule also applies (Prop. Treas. Reg. Sec. 1.358-2(a)(2)(ii)). In addition, the shareholder must allocate basis among the old shares retained and the new shares received in proportion to their fair market values.

And, if a shareholder is not able to make such allocations based on blocks of old shares because the shareholder is not able to identify which particular share is received in exchange for or with respect to a particular share held, the shareholder may designate which shares are received for, or with respect to, a particular share of stock held (Prop. Treas. Reg. Sec. 1.358-2(a)(2)(iii)). This designation, at the shareholder's discretion, must be made on or before the first date on which the basis in the new shares is relevant (as when such shares are sold, for example) and will be binding for tax purposes with respect to all shares received.

Alternatively, if a shareholder is not able to make such an identification or "tracing" to the new shares and fails to timely designate as just described, then the proposed regulations require that the FIFO rule will be used for basis purposes in determining gain or loss on a sale under Code Sec. 1012 (Prop. Treas. Reg. Sec. 1.358-2(a)(2)(iii)).

Finally, the proposed regulations provide that these new allocation rules do not apply if, in addition to a stock or security exchange qualifying under the reorganization rules, the shareholder also exchanges property for stock or securities in an exchange not subject to the reorganization rules (of Code Sec. 354 and 356) or liabilities of the shareholder are assumed (Prop. Treas. Reg. Sec. 1.358-2(a)(2)(iv)). Non-eligible transactions include an exchange where the taxpayer also transfers land to the corporation (a transaction governed by Section 351) or where the corporation assumes liabilities of the shareholder. The proposed regulations also include helpful examples.

Conclusion

The proposed regulations conform the reorganization basis rules to the basic existing basis rules for stock and effectively permit specific identification of old shares to flow to new shares acquired in a reorganization. In general, they are favorable to taxpayers since they permit allocation of basis to blocks of new stock even when there is insufficient information to permit tracing. In this regard, they are pro-taxpayer. However, the proposed regulations prohibit the use of averaging of stock basis in reorganizations even though existing case law supports it in certain cases. This is consistent with the existing IRS position prohibiting stock basis averaging under Section 1012 and seems clearly within their authority given the broad grant of IRS power in this regard under Section 358. Overall, the proposed regulations are favorable to taxpayers and resolve inconsistencies in the computation of stock basis.

> The IRS ... does not believe an averaging method is justified or appropriate.