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Code Sec. 356 and 358 Regulations Are Taxpayer Friendly—But Only if Target Shareholders Use Them

By Donald P. Board • Wood LLP

Most of us have never met a "taxpayer-friendly" rule we didn't like. But tax rules can be friendly in rather different ways. To the public, a friendly rule is one that is substantively more favorable than the alternative. If Congress suddenly cut the accuracy-related penalty from 20 percent to five percent, millions of taxpayers would conclude that they have a friend in Washington.

Readers of THE M&A TAX REPORT, however, likely take a broader view. When tax professionals are trying to structure a transaction to meet an array of tax and non-tax objectives, what they often need most are rules that give them *options*. The mere fact that a rule increases the number of possible paths from point A to point B is usually enough to earn it the Tax Planner's Seal of Approval.

The friendliest rules of all are those that let taxpayers or their advisors *elect* some desired result without even touching the underlying transaction. File a form or put some magic language into the merger agreement, and *voilà!* That was the general perception back in 2006, when the Treasury Department issued new regulations to govern the calculation of gain and the allocation of basis in what we loosely term "tax-free" reorganizations. [*See* T.D. 9044 (Jan. 23, 2006) (the "2006 Regulations").]

Despite their complexity, the 2006 Regulations were warmly received. Who, after all, *wouldn't* welcome rules allowing tax planners to control the amount of "boot gain" target shareholders must recognize under Code Sec. 356(a)(1)? And planners were certainly not going to object to rules letting them fine-tune the allocation of basis to newly acquired stock pursuant to Code Sec. 358(b)(1).

This all sounds great, doesn't it? But how have the 2006 Regulations actually fared in practice? If the unhappy anecdote recounted in *M. Tseytin* [110 TCM 617, Dec. 60,478(M), TC Memo. 2015-247, *aff'd*, CA-3 120 AFTR 2d 2017-5539 (2017)] counts as evidence, it could be harder for taxpayers to take advantage of these planning opportunities than the framers of the 2006 Regulations may have assumed.

Tseytin is a cautionary tale that M&A tax advisors will want to bear in mind. The case also invites us to consider how the taxpayerfriendliness of the 2006 Regulations may depend on the transactional setting. We begin, however, by examining the rules for allocating basis and boot on their own terms.

Break It Down: The Tracing Principle

U.S. tax law generally analyzes a taxable *sale* of a collection of assets by breaking the transaction into its components. The tax consequences to the seller (gain or loss) and the buyer (basis) are determined as if each asset were being sold separately. This approach applies even when (1) the buyer pays a lump sum for the whole collection, and (2) the assets constitute a single trade or business. [*See Williams v. McGowan*, CA-2, 152 F2d 570 (1945).]

A corporate reorganization can raise analogous issues. Because target shareholders do not recognize all the gain they realize in the exchange, they take a *substituted basis* in the shares they receive. The drafters of the 2006 Regulations considered allocating this substituted basis to the new shares using an "averaging" method. However, they concluded that a reorganization should not wipe out existing differences in stock basis.

So, instead, the 2006 Regulations opted for a "tracing" rule. The basis of each share of stock *received* in a reorganization must derive from the basis of one or more shares *surrendered* in the exchange. This basis can be adjusted up or down by other rules, but the process begins with share-by-share tracing.

"Designating" Shares: Like, Whenever

For *non*-tax purposes, shares of a single class of stock are generally fungible. A conventional acquisition agreement simply states an exchange ratio for each class. In a two-for-one exchange, 100 shares of target common stock are replaced, *en masse*, by 200 common shares of the acquirer. There is no objective basis to decide whether any given pair of acquirer shares was received in exchange for a target share with a $10 basis or for another target share with a $100 basis.

That is a problem for the tracing principle. The 2006 Regulations respond by requiring each shareholder to "designate" *which* of his new acquirer shares were received in exchange for *which* shares of the target. This ensures that the basis profile of the new shares will be just as craggy as that of the target shares surrendered in the exchange.

Knowing the IRS, one might have expected the 2006 Regulations to include a rule requiring the shareholder to do something to nail this down. Perhaps the shareholder could file some kind of "designation schedule" along with his tax return for the year of the exchange. But the actual rule is a model of flexibility.

The target shareholder does not have to designate the provenance of a new share until his basis in that share becomes *relevant* for tax purposes. [Reg. §1.358-2(a)(2)(vii).] Suppose, in the example above, that a target shareholder waits until eight years after the merger to sell two of his acquirer shares for a total of $60. Under the 2006 Regulations, *this* is the time when he must trace the two shares back to one of the target shares he gave up. If he selects a share with a $10 basis, he will have a $50 *gain*. If he picks one with a $100 basis, he can harvest a $40 *loss*.

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That's convenient for the shareholder, of course. However, the 2006 Regulations are hardly giving away the store. Imagine that the shareholder *had* been required to file some kind of a basis designation back at the time of the closing.

The shareholder would still have been free, eight years later, to select *which shares* to sell. Hence, he could have engineered the desired gain or loss *regardless* of the prior designation. One is tempted to conclude that there is nothing particularly "friendly" about allowing the shareholder to postpone designating his share basis until it becomes relevant.

What if the shareholder simply fails to designate by the date of the subsequent sale? The 2006 Regulations fill the gap by treating the shareholder as having received the two acquirer shares for his *earliest-acquired* target share. [Reg. §1.358-2(a)(2)(vii).] This first-in, first-out ("FIFO") rule seems arbitrary, but at least it provides a straightforward, objective way to allocate basis to the shares being sold.

Had the Treasury been so inclined, it could have imposed an *across-the-board* FIFO rule to determine a shareholder's basis when he sells shares received in a reorganization. But the 2006 Regulations require FIFO only if the shareholder fails to make his *own* selection. If we view it as an alternative to mandatory FIFO, the designation rule deserves the "taxpayer friendly" accolade after all.

Class Complications

As initially proposed, the 2006 Regulations did not venture beyond this simple designation rule. During the comment period, however, somebody asked what happens if the shareholder receives *more than one* class of stock in exchange for *more than one* class or block of target shares. Is a just-in-time basis designation permitted in those cases, too?

That got the drafters' attention. If the shares received in an exchange are not fungible from a non-tax perspective, designating their basis at the time of the exchange can have consequences that shareholders cannot avoid by simply selecting which shares to transfer in a subsequent transaction. A rule permitting shareholders to postpose the designation of stock basis until it matters would therefore open the door to the kind of "wait-and-see" tax planning that the IRS can't stand.

The 2006 Regulations prevent this by requiring that the designation in a multi-class exchange be set forth *in the acquisition agreement*. [Reg. §1.358-2(a)(2)(ii).] This does not make basis planning impossible. But it does mean that target shareholders must do their planning without the benefit of hindsight.

Example. Alice owns two 100-share blocks of Corporation X common stock. Each block is worth $100. Alice has a basis of $50 in one block and $250 in the other. Corporation Y wants to acquire all of Alice's shares in a reorganization in exchange for 100 shares of Corporation Y *common* stock (worth $100), and 100 shares of Corporation Y *preferred* stock (also worth $100).

Begin with what Alice *cannot* do in this multi-class exchange. Suppose that, two years after the closing, Alice wants to sell the Corporation Y common stock, which is then worth only $70. Alice is *not* permitted to set up a $180 tax loss by using this as an occasion to designate the Corporation Y common stock as the shares she received when she surrendered the Corporation X shares with the $250 basis.

Suppose, however, that Alice had known (or suspected), *before* the deal closed, that she would want to sell the Corporation Y common stock in a year or two. In that case, she could have pushed to get language into the acquisition agreement specifying that she was receiving the 100 shares of Corporation Y common stock in exchange for her high-basis block of Corporation X shares. The 2006 Regulations would respect the allocation in a subsequent sale.

What if Alice's desired designation does not make it into the acquisition agreement? The default rule is that a *pro rata* portion of each class of stock received will be treated as received in exchange for each share of target stock, based on the fair market value of the shares surrendered. [Reg. §1.358-2(a)(2)(ii).]

Here, Alice is surrendering two blocks of Corporation X common stock with equal fair market values. Under the default rule, Alice will be treated as having received the Corporation Y *common* stock in exchange for

(1) $50 of Corporation X common stock with a basis of $25, and (2) $50 of Corporation X common stock with a basis of $125. Alice's basis in her Corporation Y *preferred* shares will be determined the same way.

If Alice subsequently sells all of her Corporation Y common stock for $70, she will realize an $80 loss (*i.e.*, $70 minus her total basis of $150). If she sells less than all her new common shares, she can use the permissive designation rule to allocate her $150 basis to the shares at the time of the sale. Most likely, she will want to minimize her gain by preferentially tracing the shares being sold back to shares of Corporation X in the block with the $125 basis.

Allocating Boot

The second major focus of the 2006 Regulations is the allocation of boot. If the property received in a reorganization includes money or property not permitted to be received under Code Sec. 354, "the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property." [Code Sec. 356(a)(1).]

A literal-minded reader might take this to mean that the target shareholder is supposed to (1) figure out his *total* gain realized in the reorganization by adding up, asset by asset, all the individual gains he has realized in the exchange, and then (2) recognize this total gain to the extent of the total boot received. Under this aggregate approach, there would be no reason to allocate boot. If a shareholder realized a total gain of $1,091, while receiving a total of $712 in boot, he would recognize $712 in gain. Done.

But, once again, U.S. tax law breaks the transaction into its components. Gain is not only *realized*, but also *recognized*, one asset at a time. Hence, to determine the amount of taxable boot gain under Code Sec. 356(a)(1), we need rules allocating boot to specific shares.

Minimizing Gain Recognition

The 2006 Regulations respect a shareholder's allocation of boot to target shares so long as (1) it is economically reasonable, and (2) it is set forth in the acquisition agreement. [Reg. §1.356-1(b).] This creates planning opportunities.

Suppose that a shareholder is going to exchange *two* shares of target common stock, each worth $100. Shareholder has a $30 basis in one share, but a $110 basis in the other. According to the term sheet, shareholder will exchange his two shares of the target for $200 in merger consideration consisting of (1) six shares of the acquirer's common stock, worth $20 apiece, and (2) $80 in cash.

If the shareholder wants to defer recognizing gain, he should make sure that the acquisition agreement allocates the entire $80 in cash, plus one of the acquirer shares, to his target share with the $110 basis. The remaining five acquirer shares should be allocated to the target share with the $30 basis.

The exchange of the share with the $110 basis for cash and stock worth $100 will result in a $10 loss, which will not be recognized [Code Sec. 356(c)]. But what matters is the fact that the exchange will not produce any *gain*. Allocating the cash to the high-basis stock lets the shareholder pocket the $80 without triggering Code Sec. 356(a)(1).

What about the share with the $30 basis? It will be exchanged for five shares of the acquirer worth $100. None of the $70 gain realized will be recognized because this exchange does not include any boot. Mission accomplished.

In the absence of an allocation, the 2006 Regulations will allocate the boot *pro rata* to the shares surrendered in proportion to their fair market values. In this example, each of the $100 target shares would be treated as having been exchanged for (1) three shares of acquirer stock worth $60, and (2) $40 in cash.

The shareholder would therefore recognize $40 of the $70 gain realized from the exchange of the target share with the $30 basis. His $10 loss on the exchange of the share with the $110 basis would still go unrecognized. But now the losing exchange would have neutralized only $40 in boot.

Background to the *Tseytin* Case

Michael Tseytin, a Soviet émigré, is a cross-border entrepreneur. In 1990, even before the dissolution of the U.S.S.R., Mr. Tseytin opened the first store in Moscow selling Western computers. He subsequently came to own 75 percent of U.S. Strategies, Inc. ("USSI"), a U.S. corporation that owned and operated

Pizza Hut and KFC franchises throughout the Russian Federation.

In 2007, Mr. Tseytin met with AmRest Holdings, NV ("AmRest"), a Dutch company, whose shares were traded on the Warsaw Stock Exchange. AmRest owned and operated its own Pizza Hut, KFC, Burger King and Starbucks franchises through Central and Eastern Europe. Naturally, AmRest was interested in acquiring USSI.

On May 20, 2007, AmRest, USSI and Mr. Tseytin entered into a merger agreement calling for USSI to be acquired by a newly organized subsidiary of AmRest. The transaction was expected to qualify as a forward subsidiary merger described in Code Sec. 368(a)(2)(D). The merger consideration would be AmRest stock and cash worth about $54 million.

But there was one matter that had to be dealt with first. AmRest insisted on acquiring 100 percent of the shares directly from Mr. Tseytin. So, the transaction would not close until Mr. Tseytin acquired the remaining 25 percent of the USSI stock.

Archer Consulting Corp. ("Archer"), a corporation organized in the British Virgin Islands, owned the missing 25 percent (the "Archer Shares"). Archer was willing to sell its stake for $14 million in cash. That was about $500,000 more than the Archer Shares would fetch in the merger, but apparently Mr. Tseytin did not mind paying a premium to get the deal done.

Mr. Tseytin entered into a purchase and sale agreement with Archer on May 25, 2007. The sale closed on June 14. However, Mr. Tseytin was not required to pay Archer its $14 million until AmRest completed its acquisition of USSI.

Archer did not have to wait long. The merger became effective on July 2. AmRest issued Mr. Tseytin a block of new shares with a market value of about $30.8 million. It also wired him $23.1 million in cash. Mr. Tseytin then paid Archer the promised $14 million.

As a result of the transaction with Archer, Mr. Tseytin went into the merger with two distinct blocks of USSI stock. One was the 25-percent block (the Archer Shares), in which he had a $14 million cost basis. The other was his original 75-percent block (the "Original Shares"). His basis in the Original Shares was *zero*.

Original Tax Return

Mr. Tseytin filed his 2007 personal tax return on October 15, 2008. On Schedule D ("Capital Gains and Losses"), he presented the USSI shares exchanged in the merger as a *single* block. He treated his receipt of the $23.1 million in cash as taxable, but only to the extent it exceeded $6 million. That was the portion of his $14 million basis Mr. Tseytin thought should be set off against the cash he received.

He therefore reported a $17.1 million gain. On audit, however, the IRS analyzed the exchange of each of his two blocks of USSI shares separately, in accordance with the 2006 Regulations. Gain or loss realized with respect to each block had to be determined using the basis of the shares making up *that* block.

The IRS allocated 75 percent of the total consideration (*i.e.*, $40.4 million) to the Original Shares. Mr. Tseytin had a zero basis in those shares, so he realized a $40.4 million gain.

The IRS allocated the remaining 25 percent of the consideration to the Archer Shares. This came to about $13.5 million. That was less than Mr. Tseytin's $14 million basis, so he realized a $500,000 *loss* on this second exchange.

The next step was application of Code Sec. 356(a)(1). The merger agreement had made no effort to allocate the $23.1 million in boot between the two blocks of stock. So, the IRS allocated 75 percent of the cash ($17.3 million) to the Original Shares, and 25 percent ($5.8 million) to the Archer Shares.

Mr. Tseytin was therefore required to recognize $17.3 million of this $40.4 million gain from the exchange of the Original Shares. This was about $200,000 more than the $17.1 million he had reported on his original return. The IRS assessed a $30,000 deficiency (the $200,000 was long-term capital gain taxable at 15 percent) and tacked on a $6,000 penalty for disregarding the 2006 Regulations.

Amended Return

About a year later, Mr. Tseytin filed an amended return. This time, he reported only $9.1 million in gain—$8 million less than he had reported on his original return. This is what actually triggered the audit.

The reasoning underlying Mr. Tseytin's amended position was opaque. The Tax Court thought that he had gone completely off the rails. The court took him to task for a number of errors, including computing his gain in a way that "ignored" his receipt of $30.8 million in AmRest stock.

The taxpayer's possible motivation, if not his reasoning, becomes clearer when we consider what he failed to do back in May 2007. Mr. Tseytin was negotiating the exchange of two blocks of target stock with different bases for AmRest stock and $23.1 million in boot. This would have been a perfect opportunity to save taxes by allocating boot to the high-basis shares.

Mr. Tseytin held the Archer Shares with a $14 million basis. The Archer shares were entitled to 25 percent of the total consideration—about $13.5 million. Consequently, it would have made sense to put language into the merger agreement allocating $13.5 million of the $23.1 million in cash to the Archer Shares.

With that allocation in place, the exchange would still have produced a $500,000 loss, but it would have neutralized $13.5 million of boot in the process. This would have been a big improvement over the IRS's *pro rata* allocation, which attributed only $5.8 million of cash to the Archer Shares.

The tax payoff would have come from the reduction in the amount of boot available for allocation to the Original Shares. Mr. Tseytin would have realized a $40.4 million gain from that exchange. But now there would have been only $9.6 million in cash (*i.e.*, $23.1 million *minus* $13.5 million) to trigger recognition under Code Sec. 356(a)(1).

Retroactive Allocation of Boot?

With only $9.6 million of boot allocated to the Original Shares, Mr. Tseytin would have reported just $9.6 million in gain. That is in the same range as the $9.1 million that he reported on his amended return. Is this a coincidence?

Apparently not. If we use actual figures, we see that Mr. Tseytin reported $9,099,320 in gain on his amended return. This is just $100 different from the result we obtain if we simply subtract Mr. Tseytin's $14 million basis in the Archer Shares from the $23,099,420 of cash he received.

Compare this to what would have happened if Mr. Tseytin had managed to allocate $14 million of boot to the Archer Shares in the merger agreement. Mr. Tseytin's $14-million basis would have absorbed the $14 million in cash without triggering any boot gain—a tax planner's delight.

This would have only left $9,099,420 in boot to allocate to the Original Shares. Hence, Mr. Tseytin would have reported $9,099,420 in gain on his exchange of the Original Shares. That is exactly how much Mr. Tseytin reported on his amended return, give or take 100 bucks.

It would not be surprising if Mr. Tseytin or his advisors had realized, after the closing, that his failure to allocate boot to the Archer Shares in the merger agreement had been a serious mistake. The oversight forced Mr. Tseytin to recognize an additional $7.7 million in gain (*i.e.*, $17.3 million minus $9.6 million) for no good reason. The amended return almost seems like a substitute for the boot allocation that was omitted from the merger agreement.

The amended return began by allocating the $23.1 million in cash *pro rata* to the two blocks of shares he had surrendered. Hence, $5.8 million was allocated to the Archer Shares and $17.3 million to the Original Shares. The next step should have been to recognize the gain, if any, realized on the exchange of each block to the extent to the boot allocated to that block.

Instead, Mr. Tseytin calculated brand new figures for his gain and loss. But he did it as if he had received *nothing but cash* for his shares. This is what the Tax Court was referring to when it said that Mr. Tseytin had "ignored" the $30.8 million in stock he had received in the merger.

Mr. Tseytin concluded that he had realized a $17.3 million long-term capital gain when he exchanged his zero-basis Original Shares for $17.3 million in cash. But he claimed that he had suffered an $8.2 million short-term capital *loss* when he swapped his high-basis Archer Shares for a mere $5.8 million in cash. Netting the alleged gain and loss figures, Mr. Tseytin reported a long-term capital gain of $9,099,320.

This calculation may seem like madness, yet there is method in it. By calculating gain and loss solely with respect to the cash received, then netting the results, the amended return let Mr. Tseytin apply 100 percent of his basis to avoiding recognition of boot gain under Code Sec. 356(a)(1). The goal, apparently, was to produce the same result as allocating $14 million of cash to the Archer Shares in the merger agreement.

If the merger agreement had in fact allocated $14 million to the Archer Shares, the allocation would not have been "economically reasonable" for purposes of Reg. §1.356-1(b). The Archer Shares *should* have been allocated $13.5 million of the total merger consideration (*i.e.*, 25 percent of $53.9 million). Hence, the maximum cash allocation to the Archer Shares would have been limited to $13.5 million.

But this was all moot. The Tax Court rejected Mr. Tseytin's unorthodox calculation. It also agreed with the IRS that it warranted a penalty for disregarding rules and regulations. The Third Circuit affirmed *per curiam*.

Taxpayer Friendly?

There is little chance that an acquisition agreement would attempt to allocate basis or boot when the target is a publicly traded company. In theory, a public target might try to draft allocations to benefit some influential insiders. But it is hard to imagine any securities lawyer signing off on that plan.

The drafters of the 2006 Regulations assumed that only closely held targets would press to include allocations into acquisition agreements. But even here there is variation.

> **Example.** Gizmo, Inc., has been Widget Corporation's biggest customer for almost 40 years. The president of Gizmo, knowing that the founder of Widget is retiring next year, proposes a merger of the two closely held companies. Widget's founder and his family are satisfied with the offer of $6 million in cash and $8 million in Gizmo common and preferred stock. Gizmo and Widget plan to wrap up the deal within the next eight months.

In this kind of transaction, it is reasonable to expect the merger agreement to include allocations drafted to take advantage of the 2006 Regulations. The two closely held corporations are on friendly terms, they know they want to do the deal, and everybody's happy with the price.

Best of all, there is no big rush. At some point, the Widget family accountant will generate some spreadsheets and suggest an allocation. The family will be able to think through the accountant's assumptions and propose alternatives. If some family member feels the allocation is not quite fair, it can be adjusted—or the founder may simply lay down the law.

This sedate example has a distinctly old-timey feel about it. These days, the M&A scenario is often quite a bit different.

> **Example.** Memogenics was founded only four years ago, but it is on a roll. Over the past three quarters, revenues have increased by 1,700 percent. True, the corporation is still running at a loss, but the upside *could* be unlimited.
>
> Two weeks ago, Gorgon Corp., the industry leader, unexpectedly proposed to acquire Memogenics for $24 million in cash and stock. There is a substantial earn-out, and the letter of intent includes a dozen pages of conditions. The deal is sign and close. Gorgon has made it clear that the transaction must happen within the next 60 days.

Memogenics is probably going to spend the next two months in a sprint, trying to satisfy Gorgon's conditions and diligence requests. Gorgon will also offer up an 80-page acquisition agreement, which will try to shift as much risk as possible onto Memogenics' stockholders. Negotiating the final agreement will be time-consuming, expensive, and probably contentious. It may not be clear until the very end that the deal will actually happen.

The frantic pace and uncertainty may prevent the target and its shareholders from focusing on something like allocations under the 2006 Regulations. Even if the topic is raised, there could be disagreements about who should get what. The last thing the shareholders will want is to launch into a second negotiation among themselves.

These days, most private-company deals are sign and close. This is a problem if the target and its shareholders cannot deal with allocations until after the deal is signed. Once the deal closes, it's too late.

Conclusion

It is not clear what went wrong in the acquisition of USSI. It was not a sign-and-close transaction. Mr. Tseytin signed the merger agreement on May 20, 2007, but the deal was not consummated until July 2.

In the intervening weeks, Mr. Tseytin was able to negotiate and complete the purchase of the Archer Shares. Presumably, he or his advisors *could* have drafted an amendment to the merger agreement. At that point, he was the only shareholder, so there was nobody to disagree with how he chose to allocate the $23.1 million in boot.

Was this planning opportunity simply overlooked? Yes, that kind of thing does happen. Readers who have made it this far, however, have probably been immunized against making that mistake.

In a hectic, high-pressure M&A transaction, the target and its shareholders may not have the time or inclination to pursue potential allocations. But it would probably be a good idea for the tax advisor to raise the issue—and to document that he or she has done so.

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