# Proposed 2009 Regulations Dealing with § 356 Nonrecognition Rules Should Be Given the Boot

TERRI GUINN*

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* J.D. Candidate, University of San Diego School of Law, December 2011; B.A., History and Law & Society, University of California Santa Barbara, December 2008. I would first like to thank Professor George Mundstock for his guidance and feedback throughout the development of this Comment. I am also grateful to Professor Karen Burke, Joseph Machi, and the entire *San Diego Law Review* editorial board for their hard work and for giving me this opportunity. And special thanks to my father, Stanley Guinn, for inspiring me to seek a deeper understanding of tax law. Lastly, this Comment is dedicated to my family and my best friend and companion, Matt Onorato, for their love and support in all that I do.

## I. INTRODUCTION

"Fire, Aim, Ready!" Could this be the approach taken by the Internal Revenue Service (the Service) in its attempt to finalize regulations, proposed more than two years ago, that would specify a new method for determining a shareholder's taxable gains and losses in certain reorganization transactions?[1] Has the Service decided to elevate theory over practicality without thinking through all of the ramifications of these regulations?[2] Finalizing these proposed regulations in their current form may have serious unintended consequences.[3] As drafted, they miss their intended mark by inadvertently creating a loophole whereby some shareholders could take immediate losses on some of their shares when, in reality, they have an overall gain.[4]

Corporate acquisitions take many forms.[5] Frequently, as in a § 368(a)(1)(B) reorganization, known as a "B" reorganization, the shareholders of the acquired corporation exchange their stock solely for stock of the acquiring corporation.[6] Congress has long recognized that such a swap of stock for stock should not trigger a tax because it results in a mere change in form of a continuing investment.[7] In many corporate acquisitions, however, the shareholders of the acquired corporation receive some cash in addition to stock of the acquiring

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1. *See* Michael Bologna, *IRS Remains Committed to Proposal on Basis Recovery and Identification*, 30 Tax Mgmt. Wkly. Rep. (BNA) No. 22, at 667 (May 30, 2011).
2. *See id.*
3. *See* Michael L. Schler, *Rebooting Section 356: Part 2—The Regulations*, TAX NOTES TODAY, July 27, 2010, pt. X(E), *available at* LEXIS, 2010 TNT 143-5.
4. *See id.*
5. *See* Note, *Three-Party Mergers: The Fourth Form of Corporate Acquisition*, 57 VA. L. REV. 1242, 1242 (1971). Corporate acquisitions generally take the form of statutory mergers, stock purchases, asset purchases, or three-party mergers. *Id.*
6. *See* John P. Steines, *Policy Considerations in the Taxation of B Reorganizations*, 31 HASTINGS L.J. 993, 993 (1980). In order for a transaction to qualify as a "B" reorganization, the exchange must involve solely stock, and after the exchange, the acquiring corporation must be in control of the acquired corporation. *Id.*; I.R.C. § 368(a)(1)(B) (2006). Section 368(c) defines the term *control* as "the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation." I.R.C. § 368(c) (2006).
7. *See* Steines, *supra* note 6, at 993. Section 354(a)(1) provides that "[n]o gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization." I.R.C. § 354(a)(1) (2006).

corporation.[8] In this case, as to an exchanging shareholder who has a gain on stock, Congress taxes the cash up to the gain present.[9] Conversely, for a shareholder whose stock has lost value, the receipt of cash in addition to stock of the acquiring corporation does not trigger a tax loss because the cash in no way reflects a loss on a continuing stock investment.[10] For example, in a related context, a shareholder with a built-in loss on his stock is still taxed on a dividend without an offset for the loss because the investment continues.[11] The loss nonrecognition rule for corporate acquisitions appears straightforward. The rule is particularly important in the current economic environment because many investors presently own stock that has lost value since it was purchased.[12] Surprisingly, in 2009, the Service issued proposed regulations interpreting the loss nonrecognition rule in a way that, in practice, would permit shareholders to recognize substantial losses, even in some cases where shareholders have no overall loss on their shares of the acquired corporation.[13] This Comment will explain why these proposed 2009 regulations set poor policy and are inconsistent with congressional intent.[14] But before turning to the abstract, it is helpful to consider the following recent real world example.

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8. The property or other money received in a corporate reorganization in addition to the stock is commonly referred to as "boot," which has been defined in *Webster's New Collegiate Dictionary* as "something to equalize a trade." *See* WILLIAM A. KLEIN ET AL., FEDERAL INCOME TAXATION 252 (15th ed. 2009); MERRIAM-WEBSTER'S COLLEGIATE DICTIONARY 132 (10th ed. 1997). The types of reorganizations where boot is permitted include (1) a statutory merger under § 368(a)(1)(A), (2) a subsidiary merger involving the stock of the parent of the acquiring corporation under § 368(a)(2)(D), (3) a reverse subsidiary merger involving the stock of the parent of the acquired corporation under § 368(a)(2)(E), (4) a practical merger—a "C" reorganization—involving the acquisition by one corporation of substantially all of the assets of the acquired corporation in exchange for the acquiring corporation's voting stock, and (5) a transfer of assets by one corporation to a corporation controlled by the transferor corporation or its shareholders under § 368(a)(1)(D). *See* I.R.C. § 368 (2006); D. Bret Carlson, *Boot at the Corporate Level in Tax-Free Reorganizations*, 27 TAX L. REV. 499, 503 (1972).

9. *See* Schler, *supra* note 3, pt. X(E); I.R.C. § 356(a)(1) (2006).

10. *See* Steines, *supra* note 6, at 993; I.R.C. § 356(c) (2006).

11. *See* Nickolas J. Kyser, *The Long and Winding Road: Characterization of Boot Under Section 356(a)(2)*, 39 TAX L. REV. 297, 297–98 (1984); I.R.C. § 356(a)(2) (2006).

12. *See infra* note 200 and accompanying text.

13. *See* Schler, *supra* note 3, pt. X(E).

14. *See infra* Parts IV–V.

## II. THE PROPOSED 2009 REGULATIONS IN ACTION: THE DIVX-SONIC MERGER

On Friday, October 8, 2010, Sonic Solutions (SNIC) acquired DivX (DIVX), a San Diego digital media and video developer, with the hopes of expanding the web-based infrastructure for Internet users to stream movies and television shows online.[15] Each share of DIVX common stock outstanding was valued at approximately $9.62 and was converted into the right to receive 0.514 of a share of SNIC common stock plus $3.75 cash.[16] Many DIVX shareholders who purchased their shares after 2008 realized a gain on their shares in the merger.[17] DIVX shareholders who purchased their shares before 2008, however, were not so fortunate and were forced to realize a loss on their shares.[18] In the merger, each shareholder should have recognized any realized gain[19] on his DIVX shares to the extent of the cash received and deferred any losses under Internal Revenue Code § 356 because each DIVX share was exchanged for some cash and a portion of a SNIC share.[20]

Suppose, however, that instead of recognizing this gain, a shareholder who held stock with aggregate unrealized gain in DIVX was able to avoid recognition of any gain and yet still recognize a loss for the current year. Although such a windfall for the shareholder would be unwarranted, it may nevertheless be achievable under the recent proposed 2009 regulations dealing with § 356.[21] For example, consider a DIVX

15. *See* Press Release, Sonic Solutions, Sonic Completes DivX Acquisition (Oct. 8, 2010), *available at* http://www.sec.gov/Archives/edgar/data/916235/000114420410053625/v198920_ex99-1.htm.

16. Sonic Solutions, Current Report (Form 8-K), at 2 (Oct. 7, 2010), *available at* http://www.sec.gov/Archives/edgar/data/916235/000114420410053625/v1989208k.htm; *DivX, Inc. Historical Prices*, DAILY FIN., http://www.dailyfinance.com/quote/unknown/divx-inc/divx/historical-prices?source=esadlftna10001 (last visited Nov. 11, 2011).

17. *See DivX, Inc. Historical Prices*, *supra* note 16. For instance, on March 9, 2009, the DIVX share price closed at $4.15 per share. *Id.* Those who purchased shares at this price realized a gain of approximately $5.47 per share in the merger—$9.62 - $4.15 = $5.47. *See id.*

18. *See id.* For instance, on November 6, 2007, the DIVX share price closed at $15.89 per share. *Id.* Those who purchased shares at this price would have suffered a loss of approximately $6.27 per share in the merger—$9.72 - $15.89 = -$6.27. *See id.* Some shareholders may have experienced even greater losses. *See id.* For instance, on November 28, 2006, the DIVX share price closed at $31.36 per share. *Id.* Those who purchased shares at this price would have suffered a substantial loss of approximately $21.74 per share in the merger—$9.62 - $31.36 = -$21.74. *See id.*

19. *See* KLEIN ET AL., *supra* note 8, at 37. A taxpayer realizes a gain or loss when the taxpayer experiences some change in circumstance such that he or she *might* have to take the gain or loss into account. *Id.* A taxpayer recognizes a gain or loss when the taxpayer is *required* to take the realized gain or loss into account. *Id.* The taxpayer may realize a gain or loss without recognizing it but may not recognize a gain or loss without realizing it. *Id.*

20. *See* Press Release, Sonic Solutions, *supra* note 15; I.R.C. § 356 (2006).

21. *See* Schler, *supra* note 3, pt. X(F).

shareholder who, prior to the DIVX-SNIC merger, held 750 shares of DIVX common stock purchased on November 6, 2007, at $15 per share with a total value of $7215 and total cost basis or purchase price of $11,250.[22] The DIVX shareholder also held another 1174 shares of the same DIVX common stock purchased on March 9, 2009, at $4.10 per share with a total value of $11,293.88, but with a total cost basis of only $4813.40.[23] Pursuant to the terms of the reorganization, the DIVX shareholder received approximately 988.94 shares of SNIC voting common stock valued at approximately $11.42 per share and $7215 in cash in exchange for the shareholder's 1924 shares of DIVX common stock.[24]

Rather than allocate the $3.75 to each of the DIVX shares as was done in the actual DIVX-SNIC merger, assume that in the exchange, the DIVX shareholder was permitted to allocate all consideration received in the form of SNIC stock to his low-basis ($4.10-per-share) DIVX stock and all of the cash consideration to his high-basis ($15-per-share) DIVX stock.[25] Assume further that the concurrent exchanges of the DIVX shareholder's low-basis and high-basis DIVX shares were treated as two separate and distinct transactions. Because the exchange of the shareholder's high-basis ($11,250) DIVX stock for cash ($7215) would take the form of an ordinary stock sale, assuming the cash did not have the effect of a dividend, the shareholder would recognize a $4035 loss on these shares, which the shareholder could then use to directly reduce current taxable income.[26] On the other hand, the exchange of the shareholder's low-

22. *See DivX, Inc. Historical Prices*, *supra* note 16. The cost basis of stocks or bonds is typically the purchase price plus any costs of purchase, such as commissions and recording or transfer fees. *See* I.R.C. § 1012 (2006); INTERNAL REVENUE SERV., PUBLICATION 551: BASIS OF ASSETS 2 (2011), *available at* http://www.irs.gov/pub/irs-pdf/p551.pdf.

23. *See* INTERNAL REVENUE SERV., *supra* note 22, at 2.

24. 0.514 x 1924 DIVX shares surrendered = approximately 988.94 SNIC shares received; $3.75 x 1924 DIVX shares surrendered = $7215 cash received. *See* Sonic Solutions, *supra* note 16, at 2.

25. *See id.*; *DivX, Inc. Historical Prices*, *supra* note 16.

26. $7215 amount realized - $11,250 basis = $4035 loss. Code § 302(a) states that "[i]f a corporation redeems its stock (within the meaning of section 317(b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock." I.R.C. § 302(a) (2006). Section 302(b)(1) then goes on to specify that "[s]ubsection (a) shall apply if the redemption is not essentially equivalent to a dividend." *Id.* § 302(b)(1). A taxpayer experiences a capital loss when the taxpayer sells an investment at less than the purchase price or adjusted basis. *See* KLEIN ET AL., *supra* note 8, at 704–05. Although losing money on an investment is never desirable, a taxpayer can recoup a percentage of his true losses by deducting these capital losses from his taxable income, thereby reducing his tax liability. *See id.* These capital losses may be used with no limits to reduce capital

basis ($4813.40) DIVX stock for SNIC stock ($11,293.88) would be treated as an exchange to which nonrecognition of gain would apply because, in form, it would appear to be a § 354 stock-for-stock exchange pursuant to a reorganization.[27] The shareholder would defer the realized but unrecognized $6480.48 gain[28] on these shares until subsequently selling the 1174 SNIC shares received in the exchange.[29] Thus, even though *in substance* the exchange *as a whole* resulted in the shareholder's realizing a gain of $2445.48,[30] by transaction-splitting the shareholder was able to structure *the form* of the exchange so as to recognize an immediate $4035 loss and defer a $6480.48 gain until some undetermined subsequent sale date.[31] When taking into account the time

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gains, but the amount by which ordinary income may be reduced by capital losses is limited to $3000. *Id.*

27. *See* I.R.C. § 354(a)(1) (2006) ("No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.").

28. $11,293.88 amount realized - $4813.40 basis = $6480.48 gain.

29. *See* I.R.C. § 358(a) (2006). The shareholder takes an exchanged basis, and his new basis in these SNIC shares becomes $4813.40—$4813.40 old basis in DIVX shares surrendered less $0 cash received plus $0 gain recognized. *See id.* Section 358(a) preserves the unrealized gain by providing that in an exchange to which §§ 351, 354, 355, 356, or 361 applies:

> *Nonrecognition property* (1) The basis of the property permitted to be received under such section without the recognition of gain or loss shall be the same as that of the property exchanged—
>
> (A) decreased by—
>
> (i) the fair market value of any other property (except money) received by the taxpayer,
>
> (ii) the amount of any money received by the taxpayer, and
>
> (iii) the amount of loss to the taxpayer which was recognized on such exchange, and
>
> (B) increased by—
>
> (i) the amount which was treated as a dividend, and
>
> (ii) the amount of gain to the taxpayer which was recognized on such exchange (not including any portion of such gain which was treated as a dividend).
>
> *Other property* (2) The basis of any other property (except money) received by the taxpayer shall be its fair market value.

*Id.* Note that on the Sonic Solutions side of the transaction, Sonic Solutions takes a transferred basis under § 362(b). *See id.* § 362(b) ("If property was acquired by a corporation in connection with a reorganization to which this part applies, then the basis shall be the same as it would be in the hands of the transferor. This subsection shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the exchange of stock or securities of the transferee (or of a corporation which is in control of the transferee) as the consideration in whole or in part for the transfer."); *see also* McDonald's Rests. of Ill., Inc. v. Comm'r, 688 F.2d 520, 523 (7th Cir. 1982) (stating the Commissioner ruled that a transfer of assets at issue was a statutory merger or consolidation, not a taxable acquisition).

30. ($11,293.88 SNIC stock + $7215 cash = $18,508.88 received) - ($11,250 basis DIVX stock + $4813.40 basis DIVX stock = $16,063.40 surrendered) = $2445.48 gain.

31. *See supra* text accompanying notes 25–30.

value of money, the shareholder could reap a significant benefit from this transaction because the shareholder could use the amount otherwise presently taxable to invest currently in other interest-earning projects.[32]

The DIVX-SNIC merger example exposes a loophole in the manner by which the new proposed 2009 regulations address the issue of loss recognition when corporate reorganizations involve the exchange of shares with their tax basis exceeding their fair market value (loss shares) solely for cash.[33] If they become final regulations, they will permit immediate recognition of losses, rather than deferral, realized upon the surrender of such shares.[34] Ordinarily, § 356 provides that if a shareholder surrenders his stock in exchange for other stock, and the exchange would go unrecognized under § 354 were it not for the fact that the shareholder also receives other property or money (boot) in addition to the stock, then the shareholder recognizes gain, *but not loss*, to the extent of the fair market value of the boot received.[35] However, the loss nonrecognition rule of § 356 is circumvented if a shareholder can arbitrarily allocate solely cash to his loss shares in a reorganization and treat this exchange

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32. *See* IVO WELCH, CORPORATE FINANCE 18 (2010). The concept of the time value of money is that "a dollar today is worth more than a dollar tomorrow." *Id.* This is because a taxpayer can always invest money and earn interest, thereby receiving more money in the future as a return on the investment. *See id.*; *see also* KLEIN ET AL., *supra* note 8, at 40 (noting that the simple advantage of tax deferral is "use in the interim of the amount that would otherwise have been presently paid in taxes").

33. *See* Schler, *supra* note 3, pt. X(F).

34. *See* The Allocation of Consideration and Allocation and Recovery of Basis in Transactions Involving Corporate Stock or Securities, 74 Fed. Reg. 3509, 3512 (proposed Jan. 21, 2009) (to be codified at 26 C.F.R. pt. 1) [hereinafter Proposed 2009 Regulations].

35. Section 356(a)(1) provides:

> (1) If—
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> (A) section 354 or 355 would apply to an exchange but for the fact that
>
> (B) the property received in the exchange consists not only of property permitted by section 354 or 355 to be received without recognition of gain but also of other property or money,
>
> then 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.

I.R.C. § 356(a)(1) (2006). Section 356(c) then addresses losses, specifying:

> (c) If—
>
> (1) section 354 would apply to an exchange or section 355 would apply to an exchange or distribution, but for the fact that
>
> (2) the property received in the exchange or distribution consists not only of property permitted by section 354 or 355 to be received without the recognition of gain or loss, but also of other property or money,
>
> then no loss from the exchange or distribution shall be recognized.

*Id.* § 356(c).

as a separate transaction, as is permitted under the proposed 2009 regulations.[36]

After Part I's introduction, Part II of this Comment illustrates the type of impact the proposed 2009 regulations will have on transactions where a shareholder who is a party to a corporate reorganization exchanges his target company's (target) shares for an acquiring company's (acquiring) shares and boot, and the shareholder decides to allocate solely boot to some of the target loss shares.[37]

Part III compares how the final 2006 regulations currently treat a shareholder's loss with how the proposed 2009 regulations will treat the same loss.[38]

Part IV asserts that Congress intended § 356 to apply in all cases in which a shareholder exchanges target stock for both stock and cash in a reorganization in order to ensure mandatory deferral of losses that lack economic reality.[39]

Part V discusses the present policy reasons for rejecting the proposed 2009 regulations.[40] The proposed 2009 regulations would open up a loophole that could significantly increase the current federal budget deficit and operate in a manner inconsistent with the Obama administration's recent endeavor to close tax loopholes by codifying the "economic substance" doctrine in § 7701(o).[41]

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36. *See* Schler, *supra* note 3, pt. X(E).
37. *See supra* text accompanying notes 15–36.
38. *See infra* Part III.
39. *See infra* Part IV.
40. *See infra* Part V.
41. *See infra* Part V. In addition to opening up a loophole in the tax code, the proposed 2009 regulations provide an interpretation of § 356 that the Treasury Department may not even be authorized to assert. *See* Mayo Found. for Med. Educ. & Research v. United States, 131 S. Ct. 704, 713–14 (2011). In the recent Supreme Court case *Mayo Foundation for Medical Education & Research v. United States*, the Court found that the Treasury Department has the authority to interpret ambiguities in the Code if the interpretation is reasonable as per the requirements of the two-part *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc*. test. *See id.*; Chevron U.S.A. Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 842–43 (1984). In *Mayo*, the Treasury Department did not consider medical school residents who worked full time to fall within the student exception under I.R.C. § 3121(b)(10), which exempts students from taxation on wages earned while in the employ of the school. *Mayo*, 131 S. Ct. at 715–16; I.R.C. § 3121(b)(10) (2006). The Court held that the Treasury Department's rule excluding students who worked more than forty hours per week from the student exception was a reasonable construction of congressional intent. *See Mayo*, 131 S. Ct. at 715–16.

Section 356, unlike the student exception under § 3121(b)(10) addressed in *Mayo*, is not ambiguous in requiring that losses go unrecognized. *See* I.R.C. § 356(c) (2006). Additionally, legislative authority and case law suggest that Congress did not intend § 356 to be an optional Code section. *See infra* Part IV. Thus, the Treasury Department's interpretation of § 356 that enables immediate loss recognition under the proposed 2009 regulations may not be authorized under the step-one ambiguity requirement of *Chevron* and may not be a reasonable interpretation of congressional intent under the step-two

Part VI proposes to modify the proposed 2009 regulations so as to require pro rata allocation of boot or basis-shifting that would effectively close the loophole created by the regulations.[42] A modification requiring pro rata allocation would conform more closely to congressional intent requiring mandatory § 356 application and loss deferral and would more consistently comport with the Obama administration's recent codification of the economic substance doctrine.[43]

Finally, Part VII concludes that the Treasury Department should modify the proposed 2009 regulations to require pro rata allocation of boot when a shareholder exchanges target stock for both acquiring stock and boot in a reorganization so as to more closely align the regulations with public policy and congressional intent to defer losses.[44]

## III. THE FINAL 2006 REGULATIONS AND THE PROPOSED 2009 REGULATIONS

Currently under the final 2006 regulations, a shareholder may dictate the terms of his exchange in a reorganization.[45] A shareholder may allocate the consideration received from the acquiring company to his target company shares in the manner of his choosing as long as the terms are economically reasonable.[46] Therefore, consistent with the proposed 2009 regulations, the shareholder can surrender some shares of target stock in the reorganization for acquiring stock while surrendering other shares solely for cash or other boot.[47] If the reorganization involves the exchange of the shareholder's target shares for both stock and boot, § 356 ordinarily applies.[48] In the case of a loss, however, the tax

reasonability requirement of *Chevron*. *See Chevron*, 467 U.S. at 842–43. Nevertheless, the Court in *Mayo* supports the position that the Treasury Department's interpretation of the Code should be given broad deference when the interpretation clarifies important individual rights and duties and ensures the efficiency of statutory implementation. *See Mayo*, 131 S. Ct. at 713–15.

42. *See infra* Part VI.

43. *See infra* Part VI.

44. *See infra* Part VII.

45. *See* Determination of Basis of Stock or Securities Received in Exchange for, or with Respect to, Stock or Securities in Certain Transactions; Treatment of Excess Loss Accounts, 71 Fed. Reg. 4264, 4265 (Jan. 26, 2006) (to be codified at 26 C.F.R. pt. 1) [hereinafter Final 2006 Regulations].

46. *Id.*; *see infra* note 56.

47. *See* KLEIN ET AL., *supra* note 8, at 252; Proposed 2009 Regulations, *supra* note 34, at 3512.

48. *See* I.R.C. § 356 (2006). Section 356 provides that losses go unrecognized while gains are recognized only to the extent of the lesser of boot received or gain

treatment is unclear.[49] Section 356 requires nonrecognition of losses, but when all of the loss shares are surrendered solely for cash, the shareholder winds up with no acquiring shares with which to preserve the loss.[50] Three available alternative tax treatments are (1) permanent disallowance,[51] (2) immediate recognition,[52] and (3) deferral.[53] The final 2006 regulations

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realized. *Id.* Applying § 356 to a stock-for-stock exchange in which a gain is realized, no gain would be recognized because no boot is received. *See id.* The gain is deferred by designating the basis of the surrendered shares to be the basis of the shares acquired. *See id.* § 358(a). Applying § 356 to an exchange of stock solely for cash in which a gain is realized, the amount of gain recognized is simply equal to the gain realized. *See id.* § 356. Because no gain is deferred, the basis of the acquired shares is equal to its fair market value on the date of the exchange. *See id.*

49. *See* Schler, *supra* note 3; Final 2006 Regulations, *supra* note 45, at 4265.

50. *See* Patrick C. Gallagher, *Report on Final Regulations Regarding Allocation of Basis Under Section 358 and Related Matters*, TAX NOTES TODAY, Dec. 14, 2007, pt. III(C), *available at* LEXIS, 2007 TNT 241-18; *see also* I.R.C. § 358(a) (codifying the general rule for the nonrecognition of property regarding basis to distributes). Ordinarily, loss deferral is accomplished in a reorganization to which § 356 applies by assigning the excess basis of the loss shares over the boot received to the shares received in the reorganization, such that the deferred loss is recognized upon a later sale of the stock received. *See id.* When a loss is realized upon exchanging stock solely for cash, however, this is impossible because the basis of cash is fixed at its face value and no shares are received to assign excess basis to. *See* Gallagher, *supra*, pt. IV(G). In such a case, without some mechanism to address this problem, the shareholder's loss will end up permanently disallowed. *See id.*

51. *See* Gallagher, *supra* note 50, pt. IV(G). Permanent disallowance would render an inequitable result to shareholders who would be deprived of a tax loss benefit due to a change in corporate form that was outside of their control. *See id.* In *Coyle v. United States*, a case in which the shareholder transferred shares of a corporation he controlled to a corporation that his sons owned, the court rejected such a draconian result. 415 F.2d 488, 493 (4th Cir. 1968). Due to family attribution rules, the shareholder had control of the corporation not only before the transaction through his own shares but after the transaction through his sons. *Id.* at 490. Therefore, the redemption was deemed essentially equivalent to a dividend. *See id.* at 493. As a result, the shareholder could not treat the redemption as a recovery of basis on his shares even though he no longer held the shares and thus could not recover his basis at a later date. *See id.* The court, however, took the position that the taxpayer should not permanently lose his tax basis, holding that it was "clear that taxpayer's basis w[ould] not disappear." *Id.* At a minimum, a taxpayer should be able to preserve his basis even if it means adding it to different property. *See id.* Thus, the basis could either be added to the sons' shares or added to the shareholder's remaining shares in the corporation. *Id.*

52. *See* Gallagher, *supra* note 50, pt. IV(G)(3). Section 356 disallows immediate loss recognition. I.R.C. § 356(c). Therefore, immediate loss recognition would be permissible only if § 356 could be avoided. *See id.* The proposed 2009 regulations allow shareholders to do just this by allowing them to split transactions otherwise falling under the purview of § 356 into separate § 354 stock-for-stock and § 302 stock-for-boot exchanges. *See* Schler, *supra* note 3, pt. F; Proposed 2009 Regulations, *supra* note 34, at 3512; *infra* text accompanying notes 71–81.

53. *See* Gallagher, *supra* note 50, pt. IV(G)(2). Loss deferral is typically accomplished by adding basis equal to the amount of the loss realized but not recognized to the shares received so as to be recognized later upon subsequent sale of the shares. *See id.* A problem surfaces when only boot is received because the shareholder does not receive any acquiring shares in the exchange to which basis could be added. *See id.* Nevertheless, in an *overall* transaction in which target stock is exchanged for both

unfortunately do not adopt any of the three alternative tax treatments, rendering guidance unclear.[54] The Service's clarification on this issue is of significance to shareholders who may want to exploit the ambiguity as a tax loophole or who simply desire certainty as to the tax consequences of their reorganization exchanges.[55]

According to these final 2006 regulations, a shareholder has discretion in setting the share allocation terms in a corporate reorganization as long as they are economically reasonable.[56] A shareholder could, for example, allocate both acquiring stock and cash—or other boot—to each of his target shares.[57] Alternatively, a shareholder could allocate all of the acquiring stock received to some of his target shares and all of the boot received to his remaining target shares.[58] However, even if the shareholder artificially separates the stock and boot received from the acquiring corporation when allocating this consideration among his target shares, the final 2006 regulations still view the shareholder's surrender of all of his target shares in exchange for acquiring stock and boot as part of a single transaction.[59] Therefore, § 356 applies because the transaction, as a whole, involves the exchange of target shares for both acquiring shares and boot.[60] But according to the final 2006

acquiring stock and cash, regardless of how the shareholder may choose to allocate his target shares, the shareholder still winds up with *some* shares in the acquiring corporation to which basis could be added for loss preservation and deferral purposes. *See id.* Under these circumstances, a taxpayer could preserve the loss by allocating the boot pro rata to each target share surrendered regardless of its basis or by basis-shifting. *See id.*; *infra* Part VI.

54. *See* Schler, *supra* note 3, pt. X(E).

55. *See* Final 2006 Regulations, *supra* note 45, at 4265; Schler, *supra* note 3, pt. X(E), (I). Although the uncertainty may leave open loopholes in the law for taxpayers, it is better for taxpayers to trade potential loopholes for certainty in the tax code so as to avoid postfiling challenges. *See* Dennis J. Ventry, Jr., *Cooperative Tax Regulation*, 41 CONN. L. REV. 431, 436 (2008).

56. *See* Final 2006 Regulations, *supra* note 45, at 4265. The final 2006 regulations do not define what is "economically reasonable." *See id.* However, an example is added to the Income Tax Regulations, Treas. Reg. § 1.356-1(d), Example 4, in which a shareholder exchanged one class of target shares with a fair market value of $100 for acquiring stock worth $100 and another class of target stock worth $100 for $100 in cash. *Id.* at 4269. The example states that this allocation is economically reasonable, indicating that an allocation is economically reasonable if the value of the target stock is the same as the value of the acquiring stock or cash, or both, for which the target stock is exchanged. *See* Final 2006 Regulations, *supra* note 45, at 4269; Treas. Reg. § 1.356-1(d), Ex. (4) (2006); Schler, *supra* note 3, pt. X(E).

57. *See* Final 2006 Regulations, *supra* note 45, at 4265.

58. *See id.*

59. *See id.* at 4265–66.

60. *See id.*; I.R.C. § 356 (2006).

regulations, § 356 applies to each portion of the transaction separately.[61] No gain is recognized on the share-for-share exchange because no cash boot is received.[62] There is, however, recognized gain to the full extent of any realized gain in a share-for-cash exchange because the realized gain will always be less than the boot received on these shares.[63] No loss is ever recognized as per the requirements of § 356.[64]

By analyzing the exchange as a whole to determine § 356 applicability, the final 2006 regulations ensure that shareholders are unable to avoid § 356 treatment by simply splitting their transactions into stock-for-stock and stock-for-cash exchanges.[65] Nevertheless, the preamble to these regulations acknowledges that when the stock-for-cash portion of an exchange results in an unrecognized loss under § 356, problems may arise because the shareholder will be left with no shares from this portion of the exchange on which to defer the loss.[66] The preamble's response to this problem offers little comfort to shareholders.[67] It states only that the Service *may* permit shareholders to recognize a loss when a

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61. *See* Final 2006 Regulations, *supra* note 45, at 4265–66. In other words, the treatment of the gain or loss on the stock-for-stock exchange under § 356 is determined separately from the treatment of the gain or loss on the stock-for-cash exchange under § 356. *See id.*

62. *See* I.R.C. § 356. Under § 356, gain is recognized only to the extent of the boot received. *Id.* Thus, when the shareholder receives only stock and no boot on this portion of the transaction, the shareholder does not recognize any gain. *See id.*

63. *See id.* This is because if only cash is received in exchange for the target shares, and receipt of cash, unlike acquiring stock, *is* taxable to the extent of the gain under § 356, all of the gain should be currently taxable. *See id.*

64. *See id.* For example, assume that a shareholder owns five shares of target stock with a basis of $10 per share and five shares of target stock with a basis of $30 per share. Each target share has a fair market value of $20. In a reorganization, the shareholder surrenders his stock in target for twenty shares of acquiring stock worth $5 and $100 in cash. The shareholder allocates the twenty acquiring shares to his low-basis target shares and allocates the $100 to his high-basis target shares. Under the final 2006 regulations, because the shareholder receives both stock and cash in exchange for the shareholder's target stock, § 356 applies to both the low-basis and high-basis stock exchanges, even though the low-basis shares are exchanged solely for shares and the high-basis shares are exchanged solely for cash. *See* Final 2006 Regulations, *supra* note 45, at 4265–66; I.R.C. § 356. Once § 356 is triggered, the low-basis target stock for acquiring stock exchange is analyzed separately from the high-basis target stock for cash exchange to determine the tax treatment of these exchanges under § 356. *See* Final 2006 Regulations, *supra* note 45, at 4265–66. Despite the realization of a gain of $50 on his low-basis target shares, the shareholder will not recognize any gain on these shares because he received only acquiring stock ($0 boot) in exchange for these shares. *See* I.R.C. § 356. Moreover, despite the realization of a loss of $50 on his high-basis shares, the shareholder will not recognize any of the loss because loss is not recognized under § 356. *See* Final 2006 Regulations, *supra* note 45, at 4265–66; I.R.C. § 356.

65. *See* Final 2006 Regulations, *supra* note 45, at 4265–66; Schler, *supra* note 3, pt. X(E).

66. *See* Final 2006 Regulations, *supra* note 45, at 4265; Gallagher, *supra* note 50, pt. IV(G).

67. *See* Schler, *supra* note 3, pt. X(E).

class of stock is exchanged solely for cash.[68] Use of the word *may* rather than *shall* suggests that recognition of the realized loss is far from certain.[69] These regulations therefore leave shareholders without a clear sense of the taxability of realized losses incurred when their shares are exchanged solely for cash in a corporate reorganization.[70]

The proposed 2009 regulations do not clarify the tax treatment of the loss when a shareholder exchanges loss shares solely for cash under § 356.[71] Instead, they provide a conspicuous loophole for shareholders to avoid § 356 application.[72] Similar to the final 2006 regulations, the proposed 2009 regulations enable a shareholder to allocate consideration received from an acquiring corporation to his target shares on a share-by-share basis.[73] Unlike the final 2006 regulations, however, each share of target stock is viewed as a separate unit of exchange rather than a piece of the broader overall exchange.[74] Therefore, if the shareholder of a target company chooses to allocate solely acquiring shares to some of his surrendered target shares, solely cash to other target shares, and both acquiring shares and cash to yet other target shares, then the target shares exchanged solely for acquiring shares will be governed by § 354, the target shares exchanged solely for cash by § 302, and the target shares exchanged for both by § 356.[75] If a shareholder exchanges his target stock for both stock and cash in the acquiring corporation and the cash received does not have the effect of a dividend,[76] then the

68. *See* Final 2006 Regulations, *supra* note 45, at 4265.

69. *See id.*; Schler, *supra* note 3, pt. X(E).

70. *See supra* note 55 and accompanying text.

71. *See* Schler, *supra* note 3, pt. X(E).

72. *See id.* A "loophole" is a way for taxpayers to decrease their tax liability "in contravention of the intention of the legislator . . . without breaching specific statutory duties." *See* Tracy A. Kaye, *The Regulation of Corporate Tax Shelters in the United States*, 58 AM. J. COMP. L. 585, 593 (Supp. 2010) (quoting Assaf Likhovski, *The Duke and the Lady:* Helvering v. Gregory *and the History of Tax Avoidance Adjudication*, 25 CARDOZO L. REV. 953, 954 n.1 (2004)); Mik Shin-Li, Note, *Strictly Wrong as a Tax Policy: The Strict Liability Penalty Standard in Noneconomic Substance Transactions*, 78 FORDHAM L. REV. 2009, 2012 (2009).

73. *See* Proposed 2009 Regulations, *supra* note 34, at 3512.

74. *See id.*

75. *See id.*; I.R.C. §§ 302(a)–(b), 354(a), 356 (2006).

76. *See* I.R.C. § 356(a)(2). Another problem with the immediate loss recognition allowed under the proposed 2009 regulations is that although some taxpayers may be able to take advantage of the regulations, others may not. *See* Schler, *supra* note 3, pt. X(F). If a shareholder exchanges target stock for both cash and acquiring stock, and the cash has the effect of a dividend, then § 302(d) applies when the shareholder allocates solely stock to some of his target shares and solely cash to his other target shares in order to avoid § 356 treatment. *See* I.R.C. § 302(d) (2006) ("[I]f a corporation redeems its

shareholder simply needs to allocate solely stock to some of his target shares surrendered and solely cash to his other shares in order to avoid § 356 treatment and recognize an immediate loss on some of his shares.[77]

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stock (within the meaning of section 317 (b)), and if subsection (a) of this section does not apply, such redemption shall be treated as a distribution of property to which section 301 applies."); *id.* § 301(c)(1) ("That portion of the distribution which is a dividend (as defined by section 316) shall be included in gross income."). This would result in dividend treatment for the *entire* amount of cash received, regardless of whether or not the target shares are loss shares. *See id.*

For example, assume a shareholder has ten shares of target stock, each with a basis of $100 and a fair market value of $50. Assume further that target has considerable earnings and profits. The shareholder exchanges his ten target shares for $200 in cash and five shares of acquiring stock, each worth $60. The shareholder then allocates the $200 received to four of his target shares surrendered and the five acquiring shares received to his other six target shares surrendered in order to avoid § 356 treatment. Under § 302(d), the full $200 received on the shares exchanged solely for cash would receive dividend treatment even though the shareholder actually suffered a $200 loss on those shares upon their surrender. *See id.* § 302(d).

Unlike § 356, which taxes only the lesser of gain realized or cash received, § 302(d) leads to a tax on the dividend to the extent of the earnings and profits under § 301. *See* § 301(c)(1). Under § 354, the shareholder would still maintain a deferred $300 loss on the other six target shares exchanged solely for stock, as inherent in a higher exchange basis attaching to the acquiring shares received. *See id.* §§ 354(a), 358(a). Overall, this result would be undesirable for the shareholder. *See* Schler, *supra* note 3, pt. X(F). It would be more beneficial for the shareholder to allocate both cash and stock to his target shares on a pro rata basis. *See id.* If done, the tax on the cash received would at least be limited under § 356 only to the amount of any gain recognized, if any, even when its receipt has the effect of a dividend. *See id.*; I.R.C. § 356(a)(2) ("If an exchange is described in paragraph (1) but has the effect of the distribution of a dividend (determined with the application of section 318(a)), then there shall be treated as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be treated as gain from the exchange of property.").

77. *See* Schler, *supra* note 3, pt. X(F). For example, assume a shareholder has ten target shares, each with a basis of $100 and a fair market value of $50. The shareholder exchanges his target stock for $200 in cash and five shares of acquiring stock, each worth $60. The shareholder then allocates the $200 received to four of his target shares surrendered and the five acquiring shares received to his other six target shares surrendered. If the $200 in cash did not have the effect of a dividend, under § 302(b)(1) the shareholder would be able to treat the stock-for-cash exchange like a sale and recognize a $200 loss on the four target shares exchanged solely for cash. *See* I.R.C. § 302(a)–(b). Under § 354, the shareholder would also be able to defer his $300 loss on the other six target shares exchanged solely for stock by taking an exchanged basis in the new acquiring shares. *See id.* § 354(a). The shareholder's five new acquiring shares would have a total basis of $600—the same as the total basis in his six target shares surrendered in exchange for them—while their fair market value would be $300. *See id.* § 358(a). The shareholder could then recognize a $300 loss upon subsequent sale of these five acquiring shares. *See* Gallagher, *supra* note 50, pt. IV(G). Although the shareholder would be unable to currently recognize his entire $500 loss, by splitting up the transaction as permitted under the new proposed 2009 regulations the shareholder would still be able to recognize $200 of the loss that could not have been recognized had § 356 applied. *See* I.R.C. § 356; Proposed 2009 Regulations, *supra* note 34, at 3512. Moreover, the shareholder would also preserve deferral of the other $300 loss through the receipt of an exchange basis in his new acquiring shares rather than risk the

Although this approach to loss treatment may have some superficial appeal, § 356 avoidance permitted under the proposed 2009 regulations can lead to unintended tax consequences if the shareholder holds some target stock with a fair market value exceeding its tax basis and some with fair market value below basis.[78] In such a circumstance, the shareholder can structure the exchange such that the shareholder recognizes loss on his built-in loss shares and defers gain on his built-in gain shares.[79] This would clearly provide a "best of both worlds" result for the shareholder.[80] In effect, the shareholder would be able not only to shelter his gains but also to currently recognize losses the shareholder should not yet be entitled to.[81] Although this result may initially appear favorable from the shareholder's perspective, it would also defer tax revenues collected by the Service.[82] Deferral of tax revenues would hinder federal government efforts to reduce tax rates and pay down the federal budget deficit, thereby triggering a long-run detriment to the shareholders and the American public that may outweigh the short-run benefits created by the loophole.[83]

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uncertainty as to loss treatment that would result if § 356 were to apply. *See* I.R.C. § 358(a); Final 2006 Regulations, *supra* note 45, at 4265.

78. *See* Schler, *supra* note 3, pt. X(F).

79. *See id.*

80. *See id.* For example, assume a shareholder holds seven target shares, each with a basis of $30 and fair market value of $60—his built-in gain shares—and four target shares, each with a basis of $50 and fair market value of $20—his built-in loss shares. The shareholder exchanges all of his target shares for acquiring shares worth $420 plus $80 in cash. The shareholder then allocates all of the acquiring shares received to his target gain shares surrendered and allocates all of the cash received to his target loss shares surrendered, as permitted under the proposed 2009 regulations. *See* Proposed 2009 Regulations, *supra* note 34, at 3512. The target gain shares exchanged solely for acquiring shares will be analyzed under § 354, and no gain will be currently recognized. *See* I.R.C. § 354(a). A gain of $210 will be deferred as a basis adjustment to the acquiring shares received. *See id.* § 358(a). The target loss shares exchanged solely for cash will be analyzed under § 302, which allows for current recognition of loss assuming that the cash received does not have the effect of a dividend. *See id.* § 302(a)–(b). Thus, a loss of $120 will be immediately recognized upon the exchange. *See id.* Even though the overall transaction results in a realized gain of $90, the shareholder is able to structure the transaction so as to facilitate an immediate $120 loss recognition but no corresponding gain recognition. *See id.* §§ 302(a)–(b), 354(a).

81. *See* Schler, *supra* note 3, pt. X(F).

82. *See* Kaye, *supra* note 72, at 587 (citing JAMES M. BICKLEY, CONG. RESEARCH SERV., R40219, TAX GAP, TAX ENFORCEMENT, AND TAX COMPLIANCE PROPOSALS IN THE 111TH CONGRESS 5 (2009); JANE G. GRAVELLE, CONG. RESEARCH SERV., R40004, MAJOR TAX ISSUES IN THE 111TH CONGRESS 10 (2008)).

83. *See id.*; Rachelle Y. Holmes, *Deconstructing the Rules of Corporate Tax*, 25 AKRON TAX J. 1, 51 (2010).

## IV. CONGRESSIONAL INTENT

### *A. Legislative History Supports Loss Deferral*

The proposed 2009 regulations run contrary to congressional intent, which is to apply § 356 in all corporate reorganizations where a shareholder receives both stock and boot in order to defer losses.[84] A straightforward interpretation of § 356 would require a shareholder to determine the section's applicability to a transaction *as a whole*.[85] Under this interpretation, the shareholder would not recognize any loss any time target stock was exchanged for acquiring stock in a reorganization even if boot was involved in the exchange.[86] Nowhere does the language of the section suggest that a shareholder may simply avoid § 356 by strategically allocating specific consideration received to specific shares of stock surrendered and then determining § 356 applicability on a share-by-share basis, as permitted by the proposed 2009 regulations.[87]

This straightforward interpretation is also consistent with legislative history.[88] In early federal income tax cases dealing with corporate reorganizations, the Supreme Court held that even minor changes in the form of a corporation resulted in realized gain to the shareholders.[89] Unless the rules were changed such that shareholders would not have to recognize certain gains, shareholders could face substantial taxation on gains in every reorganization that occurred, and corporations would therefore be less likely to engage in such reorganizations even if they were beneficial to business and commerce.[90] Realizing the need for reorganizations to encourage and promote successful businesses, Congress acted quickly to eliminate this deterrent by enacting one of the earliest nonrecognition Code sections: § 202.[91] It provided that a shareholder

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84. *See* Gallagher, *supra* note 50, pt. G(2) (stating that the intent of § 356 was that "so long as the surrendering shareholder receives some nonrecognition property in the overall transaction, Section 356 should be interpreted as requiring deferral of losses realized on the surrender of target shares in connection with a reorganization").

85. *See* Schler, *supra* note 3, pt. X(C); I.R.C. § 356 (2006).

86. *See* Schler, *supra* note 3, pt. X(G); I.R.C. § 356.

87. *See* Schler, *supra* note 3, pt. X(G); I.R.C. § 356.

88. *See* Schler, *supra* note 3, pt. X(G).

89. *See* STEPHEN A. LIND ET AL., FUNDAMENTALS OF CORPORATE TAXATION 413 (7th ed. 2008). In *Marr v. United States*, for example, the Court held that even changing the state of incorporation from New Jersey to Delaware triggered realized gain. 268 U.S. 536, 541–42 (1925).

90. *See* LIND ET AL., *supra* note 89, at 413.

91. *See id.* Section 202(b) of the Revenue Act of 1918 stated:

> When in connection with [a] reorganization, merger, or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value, no gain or loss shall be deemed to occur from the exchange, and the new stock or securities

could recognize neither gain nor loss upon the exchange of stock for stock in a reorganization.[92] In enacting this nonrecognition section, Congress reasoned that taxes should not hinder transactions that were mere readjustments of a continuing interest[93] in property, although represented in a different corporate form.[94] Similar to the rationale behind nonrecognition in like-kind exchanges under § 1031—that a taxpayer should not be taxed on an unliquidated gain—Congress felt that gain on property surrendered in a corporate reorganization should not be taxed because it was "substantially a continuation of the old investment still unliquidated."[95]

If the shareholder terminated a portion of his or her investment in a corporation, however, recognition of gain on that portion would be proper.[96] Thus, the Revenue Act of 1921 required shareholders to recognize realized gain, if any, to the extent of the boot received under § 202(e).[97]

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> received shall be treated as taking the place of the stock, securities, or property exchanged.

Revenue Act of 1918, ch. 18, § 202(b), 40 Stat. 1057, 1060 (1919).

92. Revenue Act of 1918 § 202(b).

93. *See* Kenneth A. Jewell, *Acquisitive Reorganizations and Continuity of Interest: The Case Against Preferred Stock*, 9 B.U. J. TAX L. 189, 194 (1991). For type "B" and "C" reorganizations, § 368 ensures continuity of interest by requiring that voting stock of the acquiring corporation comprise a certain percentage of the total consideration. *Id.* However, in type "A" reorganizations, § 368 does not address the composition of the consideration. *Id.* However, according to Revenue Procedure 77-37, the "continuity of interest" requirement is satisfied if

> there is a continuing interest through stock ownership in the acquiring or transferee corporation (or a corporation in "control" thereof within the meaning of section 368(c) of the Code) on the part of the former shareholders of the acquired or transferor corporation which is equal in value, as of the effective date of the reorganization, to at least 50 percent of the value of all of the formerly outstanding stock of the acquired or transferor corporation as of the same date. . . . Sales, redemptions, and other dispositions of stock occurring prior or subsequent to the exchange which are part of the plan of reorganization will be considered in determining whether there is a 50 percent continuing interest through stock ownership as of the effective date of the reorganization.

Rev. Proc. 77-37, 1977-2 C.B. 568; *see also* McDonald's Rests. of Ill., Inc. v. Comm'r, 688 F.2d 520, 527–28 (7th Cir. 1982).

94. *See* Treas. Reg. § 1.368-1(b) (as amended in 2008).

95. *See* Treas. Reg. § 1.1002-1(c) (1957); I.R.C. § 1031(a)(1) (2006) ("No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.").

96. *See* Revenue Act of 1918 § 202(b).

97. *See* Revenue Act of 1921, ch. 136, § 202(e), 42 Stat. 227, 230–31 (providing that when, in a reorganization, property is exchanged for property and boot, the fair market value of the boot "shall be applied against and reduce the basis, provided in this

Yet, this Act did not mention what would happen to a loss in such an exchange where boot was involved.[98] Finally, the Revenue Act of 1928 directly addressed treatment of the shareholder's loss under § 112(e).[99] It stated that a shareholder would not recognize a loss in the exchange.[100] The Revenue Act of 1928 also clarified what Congress had been trying to accomplish since its earlier 1918 version of § 202—that the nonrecognition of gain or loss rule in corporate formation changes meant deferral rather than permanent exclusion of the gain or loss.[101] Congress expressed its intent by providing carryover and substituted basis rules in its effort to preserve unrecognized gain or loss.[102] In this way, shareholders would still recognize gain or loss, but not until they liquidated their investment in the corporation.[103] This Act suggests that Congress not only intended § 356 to be mandatory rather than optional but also intended shareholders to defer their losses through a carryover or substituted-basis mechanism rather than permanently exclude or currently recognize their losses as the proposed 2009 regulations would permit.[104]

If Congress intended loss nonrecognition to be optional, it could have expressly provided elective language in the Code.[105] Instead, Congress reaffirmed its intent in the 1923 legislative history by providing an example in which the boot was looked at together *with* the stock in a reorganization in order to trigger nonrecognition treatment.[106] The

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section, of the property exchanged, and if in excess of such basis, . . . shall be taxable to the extent of the excess").

98. *See id.*

99. *See* Revenue Act of 1928, ch. 852, § 112(e), 45 Stat. 791, 817.

100. *See id.* (stating that when boot is involved in an otherwise tax-free reorganization, "no loss from the exchange shall be recognized").

101. *See* LIND ET AL., *supra* note 89, at 414.

102. *See* Revenue Act of 1928 § 113(a)(6)–(9).

103. *See* LIND ET AL., *supra* note 89, at 413–14.

104. *See* Schler, *supra* note 3, pt. X(G).

105. *Id.* Section 338(h)(10) provides an example of a Code section where Congress clearly expressed its intent that recognition of gain or loss be elective. I.R.C. § 338(h)(10) (2006). This section states that when a corporation purchases a stock interest in a target corporation "an *election* may be made" under which, if certain elements are met, no gain or loss will be recognized on stock sold or exchanged in the transaction by members of the selling consolidated group. *Id.* (emphasis added).

106. *See* H.R. REP. NO. 67-1432, at 3 (1923). The example Congress gave provided that

> the taxable gain shall not exceed the amount of "boot" received in exchange. Thus, if a taxpayer exchanges stock which cost him $100 for stock in a new corporation, together with $100 in "boot," the stock of the new corporation received in exchange would be valued, and if it is found that it is worth $100 the total amount received by the taxpayer has been $200, which is $100 in excess of the cost of the old, and he would therefore, under the proposed law, pay a tax on a gain of $100. If, however, the amount of the "boot" received is only $95 and the stock in the new corporation is worth $105, he has made the same gain of $100, but he would be taxed only on $95, namely, the amount of the "boot" received in exchange. *The reason for this is that the profit, so far as*

manner in which Congress examined the boot together with the stock in this example shows that Congress intended the transaction to be looked at as a whole rather than as a set of separate share-by-share transactions.[107] The rationale behind Congress's treatment of boot in the example was that it did not intend for shareholders to be forced to recognize any unrealized gain.[108] Logistically, Congress must have similarly intended nonrecognition treatment for unrealized losses as the counterpart to nonrecognition for unrealized gains.[109] Congress's intended result, however, would be meaningless if shareholders could simply avoid it altogether by splitting their transaction up into several share-by-share subtransactions and applying the tax treatment of a more favorable Code provision to each of these subtransactions.[110] Strategic use of § 302 and § 354 could enable shareholders to receive basis recovery on gain shares and loss recognition on loss shares even though they continue to hold an investment in the acquiring corporation.[111]

### *B. Congress Intended Similar Nonrecognition Sections To Prevent Taxpayers from Recognizing Gains or Losses that Lack Economic Reality*

Case law interpreting congressional intent behind similar Code sections can also be helpful in understanding the congressional intent underpinning § 356.[112] Similar to § 356, § 1031 prevents a taxpayer from recognizing gain or loss when property held for productive use in a business or

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> *it is contained in the new stock received, has not yet been realized*, and therefore should not be taxed until the new stock is sold or in some way disposed of so that the profit will be actually realized.

*Id.* (emphasis added).

107. *See* Schler, *supra* note 3, pt. X(G).

108. *See* Treas. Reg. § 1.1002-1(c) (1957).

109. *See* Schler, *supra* note 3, pt. X(C). Subsections (a) and (c) of § 356 use exactly the same language and work together to provide the rules for both gains and losses on a § 356 exchange, further suggesting that unrealized gains and losses under § 356 should be treated in similar manners. *See id.*

110. *See id.* pt. X(G).

111. *See id.*

112. *See* YULE KIM, CONG. RESEARCH SERV., 97-589, STATUTORY INTERPRETATION: GENERAL PRINCIPLES AND RECENT TRENDS 2 (2008). The Court recognizes that Congress can "legislate away" the Court's interpretation of a statute if Congress disagrees with the Court's interpretation. *See id.* To avoid this result, the Court frequently refers to legislative history and congressional intent in interpreting statutes. *See* Wirtz v. Bottle Blowers Ass'n, 389 U.S. 463, 468 (1968) ("[P]roper construction frequently requires consideration of [a statute's] wording against the background of its legislative history and in the light of the general objectives Congress sought to achieve.").

investment is exchanged solely for property of like kind that is also held for investment or productive use in a trade or business.[113] If the taxpayer receives boot, gain but not loss will be recognized to the extent of the boot because boot is not considered like-kind property.[114] In *Starker v. United States*, the plaintiff and his family agreed to convey land to a corporation in exchange for a deed to suitable real property within five years or payment of any outstanding cash balance.[115] The plaintiff and his family did not report any gain in the transaction, claiming the transaction was entitled to nonrecognition treatment under § 1031.[116] The court found that under § 1031, the exchange constituted a like-kind nonrecognition exchange because the contractual right to assume ownership of property should not be treated any differently from ownership of the property itself.[117] The court emphasized that the taxpayer still had an interest in property after the exchange and that the purpose of § 1031 was to prevent the inequity that would result if a taxpayer were required to pay taxes on such an exchange even when the taxpayer "[did] not 'cash in' or 'close out' his or her investment."[118]

Another nonrecognition Code provision, § 351, is also similar to § 356 in that it prevents taxpayers from recognizing gain or loss when they give property to a corporation in exchange for stock in the corporation and they are in control of the corporation immediately after the exchange.[119] If boot is received, gain but not loss will be recognized to the extent of the boot received because boot is not considered stock.[120] In *E. I. Du Pont de Nemours & Co. v. United States*, the plaintiff granted its subsidiary a nonexclusive license in connection with its foreign

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113. I.R.C. § 1031(a)(1) (2006).

114. *Id.* § 1031(b) (providing that if boot is received, "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"); *id.* § 1031(c) (providing that if boot is received "no loss from the exchange shall be recognized").

115. Starker v. United States, 602 F.2d 1341, 1342–43 (9th Cir. 1979).

116. *Id.* at 1343.

117. *Id.* at 1355.

118. *Id.*

119. I.R.C. § 351(a) (2006). Section 351(a) states the general rule that "[n]o gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation." *Id.*; *see also id.* § 368(c) (defining the term *control* to mean "the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation").

120. *See id.* § 351(b) (providing that if property other than stock is received, then "(1) gain (if any) to such recipient shall be recognized, but not in excess of—(A) the amount of money received, plus (B) the fair market value of such other property received; and (2) no loss to such recipient shall be recognized").

patents on herbicides in exchange for stock in the subsidiary.[121] The court found that the plaintiff had a continuous interest in, as well as continuous control over, the subsidiary, and that the transfer of the license, over which the plaintiff also had control, to the controlled subsidiary was not a taxable event pursuant to § 351.[122] By allowing the plaintiff to defer tax on the transaction, the court noted that in enacting § 351, Congress aimed to "disregard dispositions which are merely formal and do not have economic or commercial reality."[123]

Yet another provision of the Code, § 354, the foundation upon which § 356 was built, consistently prevents a taxpayer from recognizing gain or loss when the taxpayer exchanges stock or securities in a corporation solely for stock or securities in another corporation that is a party to the reorganization.[124] In *Commissioner v. Gilmore's Estate*, respondent shareholders in a New Jersey holding company were involved in a merger.[125] Pursuant to the terms of the merger, the respondents surrendered their holding company stock to the surviving corporation and received its shares in return, after which the holding company stock was cancelled.[126] On appeal, the court held that the transaction was a statutory merger[127] and therefore that the respondents' gain on the exchange of their stock in the holding company for stock in the surviving company was a nontaxable

121. E. I. Du Pont de Nemours & Co. v. United States, 471 F.2d 1211, 1212 (Ct. Cl. 1973).

122. *Id.* at 1217–19.

123. *Id.* at 1217. Similarly, in *Portland Oil Co. v. Commissioner*, an oil company transferred an installment contract to the petitioner corporation in exchange for capital stocks and bonds that the oil company distributed to its shareholders before dissolving. 109 F.2d 479, 483–84 (1st Cir. 1940). The court found that under § 112(b)(5) of the Revenue Act of 1928—now § 351—the exchange constituted a nonrecognition transaction because the oil company had not received any cash benefit on the exchange of the installment contract but merely received stock that the oil company could choose to hold onto for investment. *Id.* at 490. In finding that nonrecognition of the gain was appropriate in this circumstance, the court noted that Congress's intent behind § 112(b)(5) was to save taxpayers from recognizing gains or losses that resulted from mere changes in the form of ownership and lacked economic reality. *Id.* at 488.

124. I.R.C. § 354(a)(1) (2006).

125. Comm'r v. Gilmore's Estate, 130 F.2d 791, 792 (3d Cir. 1942).

126. *Id.*

127. *Id.* at 794. The court found that the transaction constituted a reorganization under section 112(g)(1)(A) of the Revenue Act of 1934. *See id.* at 794, 797. A reorganization under section 112(g)(1)(A) of the Revenue Act of 1934 was defined as a "statutory merger or consolidation." Revenue Act of 1934, ch. 277, § 112(g)(1)(A), 48 Stat. 680, 705. This is the same language now used to define an "A" reorganization under § 368(a)(1)(A) of the current Code. I.R.C. § 368(a)(1)(A) (2006).

reorganization.[128] The court noted that the purpose of nonrecognition of gain or loss in a reorganization transaction was to free shareholders from the burden of an income tax on "purely 'paper profits or losses' wherein there [was] no realization of gain or loss in the business sense but merely the recasting of the same interests in a different form, the tax being postponed to a future date when a more tangible gain or loss is realized."[129]

Another decision, *United Gas Improvement Co. v. Commissioner*, further supports the view that Congress intended § 354 to require not only deferral of gains but also deferral of *losses* not presently suffered rather than recognition of them immediately.[130] In *United Gas Improvement Co.*, the petitioner owned most of the stock of a company, which filed for a bankruptcy reorganization plan.[131] As part of the plan, the petitioner paid off the debts of the company in exchange for receipt of all of the capital stock of the reorganized company.[132] The petitioner deducted losses on its investment in the old company's stock and on the cancellation of the company's indebtedness.[133] The court determined that reorganization of the old company was part of one integrated transaction in which the petitioner did not cash out its equity interest in the old company but instead preserved its interest in the stock of the reorganized company.[134] Therefore, the transaction was considered a nontaxable reorganization, and the petitioner could not deduct the losses.[135] In rejecting the deduction, the court noted that "'the purpose of the statutory nonrecognition of gain or loss from reorganization transactions' . . . was in part 'to prevent losses [from] being established by bondholders, as well as stockholders, who ha[d] received the new securities without substantially changing their original investment.'"[136]

The court's understanding of Congress's intent behind nonrecognition of gain or loss in § 1031 and § 351 is the same rationale underlying nonrecognition pursuant to § 354—that shareholders should be free from

128. *Gilmore's Estate*, 130 F.2d at 795–97.

129. *Id.* at 794 (citing J.S. SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS: 1938–1861, at 332–40, 795–96 (1938)).

130. *See* United Gas Improvement Co. v. Comm'r, 142 F.2d 216, 218–19 (3d Cir. 1944).

131. *See id.* at 216–17.

132. *Id.* at 217.

133. *Id.*

134. *See id.* at 217–18.

135. *See id.* at 218–19. The court found that the transaction constituted a reorganization under section 112(g)(1)(D) of the Revenue Act of 1936. *Id.* at 218. A reorganization under section 112(g)(1)(D) of the Revenue Act of 1936 was defined as a "recapitalization." Revenue Act of 1936, ch. 690, § 112(g)(1)(D), 49 Stat. 1648, 1681. This is the same term now used to define an "E" reorganization under § 368(a)(1)(E) of the current Code. I.R.C. § 368(a)(1)(E) (2006).

136. *United Gas Improvement Co*., 142 F.2d at 218–19 (quoting Comm'r v. Neustadt's Trust, 131 F.2d 528, 530 (2d Cir. 1942)).

current taxation of purely paper profits or losses stemming from the mere recasting of their same interests in a different form.[137] Because §§ 1031, 351, and 354 are similar to § 356, both in terms of context of application and the manner in which they operate, the court's interpretation of congressional intent regarding these sections complements the legislative history of § 356 in strongly suggesting that Congress intended to employ § 356 as yet another tool to ensure that taxpayers would not recognize gain or loss that lacked economic reality.[138]

### *C. Similar Nonrecognition Sections Reject Transaction-Splitting as a Means To Achieve Immediate Recognition*

Sections 1031 and 351 both contain provisions that deal with boot.[139] Section 354 applies only to exchanges of stock solely for stock and thus leaves a gap concerning transactions involving boot.[140] Consequently, when a § 354 transaction involves boot, it triggers § 356.[141] It follows then that because § 356 fills the boot gap for § 354 and § 354 treats exchanges identically to §§ 1031 and 351, § 356 should treat boot in a manner consistent with §§ 1031's and 351's treatment of boot.[142]

In *Century Electric Co. v. Commissioner*, the taxpayer transferred a building it owned and used in its manufacturing business to a third party in exchange for a ninety-five-year lease on the same property and $150,000.[143] The court found that the transaction was a like-kind exchange under § 112(b) and § 112(e)—now § 1031—because the petitioner still ended up with an interest in the same property after the exchange.[144]

137. *See supra* notes 118, 123, 129, 136 and accompanying text.
138. *See supra* Part IV.A.
139. *See* I.R.C. §§ 1031(b), 351(b) (2006).
140. *See id.* § 354(a)(1).
141. *See id.* § 356.
142. *See supra* Part IV.B.
143. Century Elec. Co v. Comm'r, 192 F.2d 155, 158 (8th Cir. 1951). The petitioner claimed a deductible loss on the property exchanged for the lease and the $150,000, arguing that the transaction was a sale rather than an exchange of like property. *Id.*
144. *Id.* at 159–60. The only change in the exchange was that the petitioner's interest in the property was transformed from a fee to a lease. *Id.* Section 112(b)(1) of the Revenue Act of 1928 provided:

> No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment.

Consequently, the petitioner could not take an immediate loss in the transaction.[145] The court refused to let the $150,000 involved in the transaction turn the like-kind exchange into a sale that would permit the immediate recognition of a loss because the transaction could "not be separated into its component parts for tax purposes."[146] Instead, the court found that in determining whether to treat the transaction as a sale or a like-kind exchange, the "[t]ax consequences must depend on what actually was intended and accomplished rather than on the separate steps taken to reach the desired end."[147] In determining the intent, the court analyzed the exchange as a whole so that the taxpayer could not avoid nonrecognition treatment simply by including boot.[148]

*Labrot v. Burnet* similarly demonstrates that a § 351 transaction involving the exchange of property for both stock and cash should be analyzed as a whole so as to require nonrecognition treatment for a loss.[149] In *Labrot*, a partnership, in which the petitioners were partners, transferred cash and two properties to a newly formed corporation in exchange for virtually all of the stock in the corporation as well as $80,000.[150] The petitioners believed that the properties were transferred to the corporation solely in exchange for the $80,000, while the cash was transferred to the corporation separately in exchange for the corporation's stock.[151] In treating the transfer of the property as a sale, the petitioners deducted the difference between the cost of the two properties and the $80,000 as a loss on their tax returns.[152] The court, however, found the transaction as a whole was really a § 202(c)—a predecessor to § 351—nonrecognition transaction, stating that "the transaction [was] essentially one of the kind in which Congress did not intend for the purposes of taxation to recognize either gain or loss, and that we should be governed by its substance and not its

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Revenue Act of 1928, § 112(b)(1), 45 Stat. 791, 816. Section 112(e) provided:

> If an exchange would be within the provisions of subsection (b)(1) to (5), inclusive, of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange shall be recognized.

*Id.* § 112(e).

145. *Century Elec. Co.*, 192 F.2d at 159.

146. *Id.*

147. *Id.* The court found that the "end" of the transaction between the petitioner and the college was "that intended by the petitioner at its beginning, namely, the transfer of the fee in the foundry property for the 95-year lease on the same property and $150,000." *Id.*

148. *Id.*

149. *See* Labrot v. Burnet, 57 F.2d 413, 414 (D.C. Cir. 1932).

150. *Id.* at 413.

151. *Id.*

152. *Id.* at 414–15.

form."[153] The court's main concern in allowing the petitioners to split their transaction into two separate exchanges was that if the petitioners were permitted to deduct a portion of their investment losses as a result of the split, then future taxpayers could exploit this type of arrangement by selling their investments to themselves for merely nominal consideration so as to deduct even greater losses.[154] In refusing to recognize the transaction as two separate exchanges, the court held that the petitioner could not recognize a loss on the property surrendered to the corporation.[155]

In both *Century Electric* and *Labrot*, the court refused to split otherwise nonrecognition transactions into separate taxable and nontaxable transactions where boot was involved.[156] If this were not the case, application of either § 1031 or § 351 would be merely optional, encouraging shareholders to structure their transactions so as to recognize losses on property exchanged solely for boot while deferring gain on property exchanged solely for like-kind property or stock.[157] Following the court's interpretation of § 1031 and § 351, a shareholder's exchange of target stock for both acquiring stock and cash in a reorganization

153. *Id.* (internal quotation marks omitted). Section 202(c)(3) of the Revenue Act of 1921 stated:

> (c) For the purposes of this title, on an exchange of property, real, personal, or mixed, for any other such property, no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value; but even if the property received in exchange has a readily realizable market value, no gain or loss shall be recognized—
>
> . . . .
>
> (3) When (A) a person transfers any property, real, personal or mixed, to a corporation, and immediately after the transfer is in control of such corporation, or (B) two or more persons transfer any such property to a corporation, and immediately after the transfer are in control of such corporation, and the amounts of stock, securities, or both, received by such persons are in substantially the same proportion as their interests in the property before such transfer. For the purposes of this paragraph, a person is, or two or more persons are, "in control" of a corporation when owning at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the corporation.

Revenue Act of 1921, ch. 136, § 202(c)(3), 42 Stat. 227, 230.

154. *Labrot*, 57 F.2d at 414.

155. *See id.* The court also noted that treating the petitioners' transfer of the property as a separate sale was unreasonable because then the sale would have been virtually a sale of the property by the petitioners to themselves for about half the price. *Id.* Were the petitioners to sell the property to someone else, it would not have been at such a low price. *Id.*

156. *See supra* Part IV.C and notes 143–55.

157. *See supra* Part IV.C and notes 143–55.

transaction should be viewed as a single integrated transaction for the purpose of determining the applicability of § 356 as well.[158] Viewed as such, even if a shareholder chooses to allocate solely cash to some of the shareholder's target stock, § 356 will still apply to that portion of the transaction because, in its entirety, the transaction consists of target stock exchanged for both acquiring stock and cash.[159]

### *D.* Commissioner v. Clark *Supports Analyzing Transactions as a Whole*

Case law interpreting §§ 1031 and 351 supports the conclusion that Congress intended that whenever a shareholder exchanges stock for both stock and cash in a reorganization, § 356 should apply to the transaction as a whole and losses should therefore be deferred.[160] Case law interpreting § 356 also supports this conclusion.[161] In *Commissioner v. Clark*, the taxpayer was the sole owner of a target company.[162] The taxpayer exchanged his target shares for 300,000 acquiring shares and cash boot

158. *See supra* Part IV.C.
159. *See* I.R.C. § 356 (2006).
160. *See supra* Part IV.C.
161. *See* Comm'r v. Clark, 489 U.S. 726, 737 (1989). The Service also analyzed reorganization transactions as a whole to determine the effect of § 356 in Revenue Ruling 74-515. *See* Rev. Rul. 74-515, 1974-2 C.B. 118. In Revenue Ruling 74-515, a target company merged into an acquiring company. *See id.* The target shareholders exchanged target common stock for acquiring common stock and exchanged target preferred stock for cash. *See id.* The common-for-common exchanges and preferred-for-cash exchanges were "separate exchanges that were separately bargained for." *Id.* Thus, under § 354, shareholders who held only target common stock did not recognize gain or loss on its surrender for acquiring stock. *Id.*; I.R.C. § 354(a)(1) (2006). Under § 302(a), shareholders who held only target preferred stock recognized gain or loss on the surrender of target stock for cash that did not have the effect of a dividend. Rev. Rul. 74-515, 1974-2 C.B. 118; I.R.C. § 302(a)–(b) (2006). Yet, a shareholder who held both common and preferred stock in target was considered to have made one exchange under § 356 as opposed to two separate exchanges—an exchange of common-for-common stock under § 354 and an exchange of preferred-for-cash under § 302. Rev. Rul. 74-515, 1974-2 C.B. 118. The exchange was treated as an exchange under § 356 because, overall, the shareholder received both stock and cash from acquiring in exchange for his stock in target. *Id.*; I.R.C. § 356 (2006). As a result, the shareholder could not recognize any gain or loss on the common-for-common stock exchange, but on the preferred-for-cash exchange, the shareholder would recognize the full gain, but no loss. Rev. Rul. 74-515, 1974-2 C.B. 118; I.R.C. § 356.

Revenue Ruling 74-515's interpretation of the common-for-common and preferred-for-cash transactions as part of one larger transaction for shareholders who surrendered both common and preferred stock, even if arguably two separate transactions could have taken place, appears to be a somewhat strained attempt to invoke § 356. *See* Schler, *supra* note 3, pt. X(A). By viewing two conceivably separate exchanges as only one overarching transaction in order to apply § 356, the Service demonstrated its firm belief that a proper implementation of congressional intent was to apply § 356 in such a manner that ensured that a shareholder could not avoid § 356 by transaction-splitting. *See id.*

162. *See Clark*, 489 U.S. at 731.

of $3.25 million.[163] Section 356 applied to the exchange because the target shareholder received both stock and cash in exchange for his target shares.[164] The issue was not whether the boot was taxable under § 356 but rather whether the boot had the effect of a dividend distribution and would therefore be taxed as a dividend rather than as a capital gain.[165] The Court found that the language and history of § 356, as well as the economic substance of the transaction, revealed that the transaction should be analyzed as a whole in order to determine how to treat the boot.[166] The Court therefore took a postreorganization approach[167] to determine whether the taxpayer experienced a meaningful reduction in his potential ownership interest so as to receive capital gains treatment under § 302(a).[168] Under this postreorganization approach, the Court held that the taxpayer experienced a meaningful reduction in his potential ownership interest by accepting the cash payment and therefore this cash payment would not be taxed as a dividend.[169]

163. *Id.*
164. *Id.* at 732.
165. *See id.*; *see also* I.R.C. § 356(a)(2) (discussing gain on exchanges and treatment as dividends).
166. *Clark*, 489 U.S. at 737.
167. *Id.* at 736–37. In a postreorganization approach, a pure stock-for-stock exchange is imagined. *Id.* at 733. This is followed by an immediate postreorganization redemption of a portion of the taxpayer's new acquiring shares in exchange for cash equal to the amount of the boot. *Id.* The percent interest the taxpayer holds in the acquiring corporation immediately after the imaginary pure stock-for-stock exchange is then compared with the percent interest the taxpayer holds in the acquiring corporation after the postreorganization redemption. *See id.* If there is a substantial reduction in the taxpayer's interest in the acquiring corporation under § 302(b), then the boot qualifies for capital gains treatment under § 302(a). *Id.*; Rev. Rul. 93-61, 1993-2 C.B. 118. This is in contrast to a prereorganization approach, which was the approach used in *Shimberg v. United States*, 577 F.2d 283, 288–89 (5th Cir. 1978). Under the *Shimberg* prereorganization approach, the boot is treated as if it were payment in a prereorganization redemption by the target corporation for the taxpayer's target stock. *Id.* The percent interest the taxpayer held in the target corporation prior to the hypothetical redemption is then compared with the taxpayer's interest in the target corporation after the hypothetical redemption. *Id.* If there is a substantial reduction in the taxpayer's interest in the target corporation under § 302(b), then the boot qualifies for capital gains treatment. *Clark*, 489 U.S. at 733; Rev. Rul. 75-83, 1975-1 C.B. 112.
168. *Clark*, 489 U.S. at 737.
169. *Id.* at 740. The Court found that the shareholder experienced a substantial reduction of interest pursuant to § 302(b)(2) and therefore was entitled to capital gains treatment under § 302(a). *Id.* The Court also noted that the taxpayer might have been able to obtain capital gains treatment under § 302(b)(1), which allows for capital gains treatment if the boot is "not essentially equivalent to a dividend." *Id.* at 740 n.8 (quoting I.R.C. § 302(b)(1) (2006)). This possibility was not explored further, however, because the taxpayer already met the requirements of § 302(b)(2). *Id.*

In relation to the proposed 2009 regulations, *Clark* is important not because the boot qualified for capital gains rather than dividend treatment but because the Court found that § 356 transactions should be analyzed as a whole.[170] The Court noted that in determining dividend equivalency, "[s]ection 356(a)(2) asks whether '*an exchange* is described in paragraph (1)' that 'has the effect of the distribution of a dividend.'"[171] Thus, the question was not whether the boot itself had the effect of a dividend but rather whether the entire "exchange" had the effect of a dividend.[172] Paragraph (1) also refers to "the exchange," stating that § 356 applies if § 354 or § 355 would apply but for the fact that "the property received in *the exchange* consists not only of property permitted by section 354 or 355 to be received without the recognition of gain but also of other property or money."[173] This wording of the statute further supports the position that an exchange of target stock for both acquiring stock and boot should be analyzed as one integrated transaction.[174] Moreover, under § 356, boot is only taxable up to the gain realized in the overall reorganization transaction.[175] This restriction indicates, as the Court noted, that boot should, in fact, be considered an integral part of the whole reorganization and that Congress did not want taxpayers to be able to separate the boot from the other consideration.[176] Finally, the Court found that reading § 356 to require that boot and stock be considered part of one overall transaction was reinforced by the "step transaction" doctrine.[177] This doctrine provides that "interrelated yet formally distinct steps in an integrated transaction may not be considered independently of the overall transaction."[178]

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170. *Clark*, 489 U.S. at 737.
171. *Id.* (emphasis added) (quoting I.R.C. § 356(a)(2) (2006)).
172. *See id.*
173. *Id.* (emphasis added) (quoting I.R.C. § 356 (2006)).
174. *See Clark*, 489 U.S. at 737.
175. *See id.*; I.R.C. § 356.
176. *See Clark*, 489 U.S. at 737–38. If the boot in the reorganization has the effect of a dividend, then under § 356(a)(2), the boot is taxed as a dividend to the lesser of the taxpayer's ratable share of the undistributed earnings and profits of "the corporation" or the gain realized. *See* Jack Levin, Melvin S. Adess & Jere D. McGaffey, *Boot Distributions in Corporate Reorganizations—Determination of Dividend Equivalency*, 30 TAX LAW. 287, 303 (1976). Whether the phrase *the corporation* refers to the acquired or the acquiring corporation is unclear, but to remain consistent with viewing the transaction as a whole it would appear that the best interpretation of *the corporation* would be to look to both corporations. *See id.*
177. *See Clark*, 489 U.S. at 738.
178. *See id.* The step transaction doctrine's purpose is to ensure that transactions are taxed according to their substance and not their form. *See id.* If a court finds that applying the step transaction doctrine is appropriate it can either (1) disregard transactions or steps in a transaction that it believes are unnecessary, or (2) change the order of such transactions or steps. *See* True v. United States, 190 F.3d 1165, 1174–76 (10th Cir. 1999). In most cases, the former action is taken, and several transactions or

Overall, in determining whether boot under § 356 had the effect of a dividend, the Court came to the conclusion that a postreorganization approach was preferable to a prereorganization because a postreorganization approach at least acknowledged that a reorganization had taken place.[179] This was more in keeping with analyzing the transaction as a whole.[180] Whereas the Court analyzed the reorganization transaction as a whole for the purpose of determining whether the boot should be treated as a dividend, consistency would dictate that reorganization transactions should also be analyzed as a whole for the purpose of determining how losses should be treated when boot is involved.[181]

## V. THE PROPOSED 2009 REGULATIONS ARE INCONSISTENT WITH PUBLIC POLICY

If the proposed 2009 regulations become final regulations, many taxpayers will be able to obtain immediate recognition, rather than deferral, of their losses upon the surrender of their loss shares in a reorganization.[182] For many taxpayers, the ability to strategically structure a reorganization transaction so as to recognize current losses but defer gains on their target shares presents a favorable opportunity that taxpayers

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steps are integrated into a single transaction. *See id.* at 1175. Courts have developed three tests for determining when the step transaction doctrine should operate to collapse the individual steps of a complex transaction into a single integrated transaction for tax purposes: (1) binding transaction, (2) end result, and (3) mutual interdependence. *See id.* at 1174–75. Under the binding commitment test, separate steps will be collapsed into a single transaction only if, at the time the first step takes place, the taxpayer was under a commitment to complete the remaining steps. *See* Comm'r v. Gordon, 391 U.S. 83, 96 (1968). Under the end result test, if a court finds that a series of closely related steps or events is merely the means to achieve a particular end result, it treats the steps as a single transaction. *See* Kornfeld v. Comm'r, 137 F.3d 1231, 1235 (10th Cir. 1998). Finally, under the mutual interdependence test, separate steps will be collapsed if, under a reasonable interpretation of the objectively stated facts, the steps are interdependent of one another. *See* Redding v. Comm'r, 630 F.2d 1169, 1177 (7th Cir. 1980).

179. *See Clark*, 489 U.S. at 741. The prereorganization approach, on the other hand, ignores the reorganization by comparing only the taxpayer's interest in the target corporation at two points in time prior to the reorganization to determine if the taxpayer experiences a substantial reduction of interest in the corporation to qualify for capital gains treatment. *See supra* note 167 and accompanying text.

180. *See Clark*, 489 U.S. at 741; *supra* note 161 and accompanying text.

181. *See* Levin et al., *supra* note 176, at 303 (considering the importance of harmonizing the analysis of "*how much* boot is taxable as a dividend with the test of *whether* boot is taxable as a dividend" under an analysis of the reorganization as a whole).

182. *See* Schler, *supra* note 3, pt. X(F).

would enthusiastically embrace and exploit.[183] In light of the current federal budget deficit, however, this apparent windfall for taxpayers in the short run will do more harm than good in the long run.[184] Currently, high United States corporate tax rates motivate corporate taxpayers to take aggressive self-help measures, including the use of loopholes, to reduce their corporate tax liabilities.[185] In fiscal year 2001, for example, the Service estimated "that abusive corporate tax shelters contributed $10 to $15 billion of the $30 billion in unreported . . . corporate income taxes."[186] Similarly, individual shareholders also seek to take advantage of any opportunity they may have to reduce their tax liability.[187] In fiscal year 2001, the Service estimated that overall it failed to collect $345 billion in taxes owed for that year.[188] The annual failure to collect such substantial tax revenue sums owed by corporations and individuals has made a significant impact upon the current federal budget deficit and will continue to influence the projected federal budget deficit if something does not change.[189]

In reaction to the problem, the Obama administration proposed to close loopholes that enable taxpayers to avoid current taxation by

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183. *See supra* note 26 and accompanying text; Holmes, *supra* note 83, at 14 (noting that sophisticated taxpayers often create "convoluted structures" in an attempt to "achieve tax-favorable results").

184. *See* Kaye, *supra* note 72, at 587 (citing BICKLEY, *supra* note 82, at 5; GRAVELLE, *supra* note 82, at 10).

185. *See* Holmes, *supra* note 83, at 19. United States corporate tax rates are the second highest among the nations of the Organization for Economic Cooperation and Development (OECD). *See id.* at 15.

186. Kaye, *supra* note 72, at 587 (quoting BICKLEY, *supra* note 82, at 5) (internal quotation marks omitted). Even though the United States had the second highest statutory rate among the OECD countries, the United States only generated about 2% of its gross domestic product (GDP) from corporate tax revenues while the average OECD country received about 3% of its GDP from corporate tax revenues. *See* Holmes, *supra* note 83, at 19–20.

187. *See* Ventry, Jr., *supra* note 55, at 435.

188. *See* TREASURY INSPECTOR GEN. FOR TAX ADMIN., ADDITIONAL ACTIONS ARE NEEDED TO EFFECTIVELY ADDRESS THE TAX GAP 1 (2008) [hereinafter U.S. DEP'T OF TREASURY]. The $345 billion in uncollected taxes is considered a "tax gap." *See id.* A tax gap is the difference between the taxes that taxpayers should have paid on a timely basis and the taxes that taxpayers actually paid. *See* Ventry, Jr., *supra* note 55, at 432.

189. *See* Ventry, Jr., *supra* note 55, at 432. Senator Max Baucus stated that tax avoidance was unpatriotic and actually created the federal deficit, noting that "[w]hen people and companies . . . don't pay their taxes, the burden for paying this country's expenses falls even more heavily on Americans who do their duty every April 15." *Id.* (quoting Press Release, Sen. Max Baucus, Sen. Baucus Calls New Tax Gap Numbers "Unacceptable," Calls for Bolder IRS Action To Collect Taxes Owed (Feb. 14, 2006), *available at* 2006 WLNR 2612436) (internal quotation marks omitted). In fact, the Treasury Inspector General for Tax Administration estimated in 2008 that each percentage point of noncompliance by the public costs the federal government approximately $21 billion in lost revenue. *See* U.S. DEP'T OF TREASURY, *supra* note 188, at 1.

codifying the economic substance doctrine in its fiscal year 2010 revenue proposals.[190] Although closing loopholes certainly diminishes a taxpayer's ability to lower tax liability via aggressive tax planning, this lost benefit to the taxpayer will be outweighed by other benefits in the long run.[191] Increases in tax revenue to the Treasury Department resulting from closed loopholes would enable the government to lower its corporate and individual income tax rates, which are currently as high as they are, in part, to offset noncompliance and failure to collect.[192] Moreover, closing loopholes would enable the Treasury Department and the Service to reduce their administrative and enforcement costs, thereby making more funds available to other domestic programs.[193] Fewer loopholes and lower tax rates would also relieve pressure on taxpayers to spend large sums on developing complicated tax planning strategies specifically designed to lower their tax liabilities.[194] Strategic tax planning designed to exploit loopholes is often expensive and inefficient, and it discriminates against taxpayers who lack the resources to afford it.[195] Such inequity is reduced when loopholes are closed.[196]

Rather than close a loophole, the proposed 2009 regulations open up a new loophole because they enable shareholders to obtain immediate loss recognition in corporate reorganization transactions.[197] In so doing, the proposed 2009 regulations blatantly ignore the congressional intent that shareholders defer their losses in such transactions pursuant to § 356.[198]

190. *See* Kaye, *supra* note 72, at 601. The economic substance doctrine is codified in § 7701(o) and states:

> (1) In the case of any transaction to which the economic substance doctrine is relevant, such transaction shall be treated as having economic substance only if—
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> > (A) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and
> >
> > (B) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.

I.R.C. § 7701(o) (Supp. IV 2010). Under the recently codified economic substance doctrine, the penalties and expected deterrent effect of penalties if their transactions do not meet the requirements of the economic substance doctrine are estimated to raise $3.6 billion of federal revenue over a ten-year period between 2010 and 2019. *See* Shin-Li, *supra* note 72, at 2033.

191. *See* Holmes, *supra* note 83, at 51.
192. *See id.*
193. *See id.* at 52.
194. *See id.* at 13.
195. *See id.* at 14–15.
196. *See id.*
197. *See supra* note 72 and accompanying text.
198. *See supra* Part IV; I.R.C. § 356 (2006).

Even though the proposed 2009 regulations would open up only one loophole, any loophole has the potential to significantly reduce annual tax revenues.[199] As the example concerning the DIVX-SNIC merger demonstrates, in light of the current economic downturn, more and more shareholders who bought their stock prior to 2008 are likely to have substantial losses when entering into corporate reorganizations.[200] Such shareholders will be eager to use this new loophole to obtain an immediate tax benefit from their losses that they otherwise would not receive.[201] Treasury Department efforts should aim to close such loopholes, not open them, in order to raise revenue to reduce the federal deficit and work toward the eventual reduction in overall tax rates for corporations and individuals.[202]

## VI. LOSS DEFERRAL IS A MORE APPROPRIATE ALTERNATIVE

### A. *Loss Deferral and Pro Rata Allocation*

Legislative history, other nonrecognition provisions, and *Clark* all show that Congress intended § 356 to apply to all reorganization transactions where a shareholder exchanges target shares for both acquiring shares and boot.[203] By requiring § 356 application, Congress ensures that shareholders holding a continuing equity interest in the acquiring corporation do not obtain the unintended benefit of recognizing an immediate loss when, in substance, it has not yet been realized.[204] Preventing current recognition leaves but two possible ways

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199. *See* Kaye, *supra* note 72, at 587.

200. *See supra* note 18 and accompanying text; Allen Ferrell & Atanu Saha, *Securities Litigation and the Housing Market Downturn*, 35 J. CORP. L. 97, 100–01 & figs.1 & 2 (2009). In fact, many have suggested that the current economic downturn is worse than the Great Depression. *See Foreword: The Subprime Meltdown: Causes, Consequences, and Solutions*, 4 J. BUS. & TECH. L. 257, 257 (2009); Jon Hilsenrath et al., *Worst Crisis Since '30s, with No End Yet in Sight*, WALL ST. J., Sept. 18, 2008, at A1 ("This has been the worst financial crisis since the Great Depression. There is no question about it.").

201. *See* Schler, *supra* note 3, pt. X(F).

202. *See* Kaye, *supra* note 72, at 603–04 (noting that the Obama administration codified the economic substance doctrine as a "weapon in the arsenal against corporate tax shelters").

203. *See supra* Part IV.

204. *See supra* Part IV. To ensure that all losses are deferred, the Service does not even allow shareholders to net losses against gains under § 356. *See* Rev. Rul. 68-23, 1968-1 C.B. 144. Because Revenue Ruling 74-515 viewed reorganization transactions as a whole in order to invoke § 356, it initially seems appropriate to also analyze these transactions as a whole for the purpose of determining the overall tax consequences of the exchange. *See supra* note 161; Schler, *supra* note 3, pt. X(C). Such a position, however, would be inconsistent with congressional intent to defer losses because it would allow shareholders to recognize some of their losses by using them to offset their gains. *See* Rev. Rul. 68-23, 1968-1 C.B. 144.

to handle the loss—permanent disallowance or deferral.[205] Permanent disallowance would create an inequitable result to shareholders because it would deprive them of the ability to obtain a tax benefit from their loss due to a change in corporate form that was outside of their control.[206] Thus, of these two possibilities, loss deferral is the fairest alternative that upholds congressional intent to deny immediate recognition.[207]

Given deferral as the appropriate treatment for unrecognized losses, it remains to be determined whether a shareholder's ability to allocate specific consideration to specific shares surrendered should be allowed

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Revenue Ruling 68-23 sought to prevent the netting effect that would result if reorganization transactions were viewed as a whole for the purpose of determining the amount of gain recognized when a shareholder exchanges some target shares solely for cash and other target shares solely for acquiring stock. *See id.* In Revenue Ruling 68-23, the shareholder had 1000 shares in target stock valued at $505 each. *Id.* Six hundred shares of the shareholder's target stock had a basis of $495 per share (bloc 1), and 400 shares of the shareholder's target stock had a basis of $525 per share (bloc 2). *Id.* Pursuant to a plan of reorganization, the shareholder traded each of his target shares for acquiring shares valued at $500 each and $5 in cash. *Id.* In total, bloc 1 stock was worth $303,000 and had a basis of $297,000 while bloc 2 stock was worth $202,000 and had a basis of $210,000. *Id.* In exchange for bloc 1, the shareholder received acquiring stock worth a total of $300,000 and $3000 in cash, realizing a gain of $6000. *Id.* In exchange for bloc 2, the shareholder received acquiring stock worth a total of $200,000 and $2000 in cash, realizing a loss of $8000. *Id.*

Revenue Ruling 68-23 considered the transaction as a whole and therefore, because both stock and boot were received, applied § 356. *Id.* Because Revenue Ruling 68-23 viewed the exchanges together as a single transaction in order to invoke § 356, it reasonably follows that a single determination of realized gain or loss on the transaction would result. *See* Schler, *supra* note 3, pt. X(G)(3)(a). Thus, any realized gains on one bloc of stock would be netted against any losses on the other. *See id.* Under the facts of the ruling, if this approach were taken, the realized gain of $6000 on bloc 1 would be netted against the realized loss of $8000 on bloc 2 resulting in an overall net loss of $2000. *Id.* pt. X(B). According to § 356, this loss of $2000 would not be recognized. *Id.*

Revenue Ruling 68-23 did not adopt this approach, however. *See* Rev. Rul. 68-23, 1968-1 C.B. 144. The ruling required that the exchange of one bloc of shares be evaluated under § 356 separate and apart from the exchange of the other bloc of shares. *Id.* As a result, the gain of $6000 on bloc 1 was taxable to the extent of the $3000 cash received, and the loss of $8000 on bloc 2 went unrecognized. *Id.* The ruling used this approach to deny shareholders the ability to offset gains with losses, which would facilitate an immediate recognition of some of their losses. *See id.* In effect, this ruling saw one integrated transaction for the purpose of determining § 356 applicability, but it saw separate transactions for the purpose of implementing the mechanics of § 356. *See* Schler, *supra* note 3, pt. X(B). Construing § 356 in this somewhat strained and arguably inconsistent way strongly suggests that congressional intent behind the enactment of § 356 was to ensure that all losses in these reorganization transactions were deferred rather than currently recognized. *See id.* pt. X(G), § 3(a).

205. *See* Gallagher, *supra* note 50, pt. IV(G).
206. *See supra* note 51 and accompanying text.
207. *See* Gallagher, *supra* note 50, pt. IV(G)(2).

or disregarded in favor of pro rata allocation.[208] Pro rata allocation of the boot is more practical because it enables shareholders to preserve their loss in the basis of the shares directly exchanged for their loss shares.[209] It is also consistent with the treatment of boot in other loss nonrecognition Code sections, and it is safe from scrutiny under the economic substance doctrine.[210]

Allocation of boot on a pro rata basis would be consistent with the treatment of boot in § 351 nonrecognition exchanges pursuant to Revenue Ruling 68-55.[211] According to this ruling, the shareholder must allocate the fair market value of each category of consideration received from the corporation, including boot, separately to each asset transferred in proportion to the relative fair market values of the transferred assets.[212] If the shareholder realizes a loss with respect to any asset, the loss goes unrecognized.[213] However, because the shareholder exchanges each loss asset for at least some stock or other nonrecognition property in a § 351 transaction, the shareholder can nevertheless preserve the unrecognized loss by adding basis in excess of the cash received to the stock or other nonrecognition property for which the loss shares were exchanged.[214]

If a shareholder allocated boot on a pro rata basis in § 356 exchanges, in addition to Revenue Ruling 68-55 consistency, a shareholder could defer losses with relative conceptual ease.[215] The shareholder would

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208. *See* Schler, *supra* note 3, pt. X(G), § 1.
209. *See id.*
210. *See id.* pt. X(G), § 2.
211. *See* Rev. Rul. 68-55, 1968-1 C.B. 140.
212. *See id.*
213. *See id.* According to Revenue Ruling 68-55, in determining the amount of gain recognized under § 351(b) when several assets are transferred to a corporation, each asset must be considered as separately transferred in exchange for a portion of each category of consideration received. *See id.* The reason that each transferred asset is considered to be separately exchanged is to avoid the possibility of netting gains and losses. *See id.* If the combined tax basis of all of the various assets transferred is simply subtracted from the total fair market value of the total consideration received, in effect shareholders could recognize specific asset losses in a § 351 transaction by offsetting them against specific asset gains. *See id.* Such a result would clearly contravene § 351(b)(2)'s prohibition on loss recognition in § 351 transactions. *See id.*
214. *See id.*; I.R.C. § 358(a) (2006).
215. *See* Gallagher, *supra* note 50, pt. IV(G)(2). For example, suppose a shareholder has forty target shares of stock, each with a fair market value of $30. Twenty shares have a basis of $20 (gain shares), and twenty have a basis of $40 (loss shares). In a reorganization transaction, the shareholder surrenders his target stock in exchange for $400 and forty shares of acquiring stock, each worth $20. If the cash boot and the acquiring stock were allocated to the target shares on a pro rata basis, each target share would be exchanged for $10 and one acquiring share. Under § 356, the shareholder must recognize a $200 gain on the gain shares because the shareholder received $200 in boot on those shares while also having an overall realized gain of $200 on their surrender. *See* I.R.C. § 356 (2006). The shareholder would also take a $400 basis in the acquiring shares. *See id.* § 358. With regard to the loss shares, the shareholder is unable to recognize the $200 realized loss. *See id.* § 356. The shareholder

exchange each target share for some acquiring shares and some boot, and the shareholder would simply preserve any loss incurred on target loss shares by taking the same basis in the new acquiring shares as the basis in the loss shares exchanged, subject to certain adjustments to account for the boot.[216] This direct relationship between the basis of surrendered target loss shares and the acquiring shares is much simpler to grasp than the relationship where the basis of the target loss shares is preserved indirectly in acquiring shares exchanged for *other* target shares as would be the case under a basis-shifting method.[217]

A pro rata allocation of boot also shields § 356 transactions from attack under the economic substance doctrine.[218] Permitting shareholders to arbitrarily choose their own method of allocation not only defeats the purpose of § 356 in most circumstances but also lacks any foundation in economic substance and has no business purpose other than tax avoidance.[219] According to the economic substance doctrine provided in § 7701(o)(1), a shareholder's transaction will only have economic substance if there is a substantial business purpose[220] for the transaction and the shareholder's economic position changes in a meaningful way as a result of the transaction.[221] In a corporate reorganization where the shareholder receives both stock and boot from the acquiring corporation in exchange for his target shares, the shareholder typically does not give

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is able to preserve the loss by taking a basis in the acquiring shares received equal to the excess basis in the loss shares over the boot received. *See id.* § 358. Thus, the shareholder takes a $600 basis in the new acquiring shares received for the loss shares surrendered even though they are only worth $400 at the time of the exchange. *See id.* In this way, the shareholder recognizes his $200 deferred loss upon subsequent sale of these acquiring shares, thereby divesting his interest in this portion of the investment. *See* Gallagher, *supra* note 50, pt. IV(G)(2).

216. *See* I.R.C. § 358. To account for boot, the shareholder must decrease the exchanged basis by the amount of boot received and then increase the basis by the amount of gain recognized on the exchange. *See id.*

217. *See* Gallagher, *supra* note 50, pt. IV(G)(2).

218. *See* Schler, *supra* note 3, pt. X(G); I.R.C. § 7701(o) (Supp. IV 2010).

219. *See* Schler, *supra* note 3, pt. X(E).

220. *See* I.R.C. § 7701(o). In *Gregory v. Helvering*, for example, a corporation wholly owned by a taxpayer transferred 1000 shares of stock of another corporation to a new corporation. 293 U.S. 465, 467 (1935). The new corporation then transferred all of these shares to the taxpayer in complete liquidation. *Id.* The taxpayer then sold the shares and reported the gain as capital gain. *Id.* The Court found that although in form the transaction met the requirements to qualify as a reorganization, in substance the transaction was merely an elaborate scheme to diminish taxes by avoiding dividend treatment. *See id.* at 269–70. Because the transaction lacked a legitimate business purpose, it could not be upheld as a proper reorganization. *Id.*

221. I.R.C. § 7701(o).

separate consideration for each target share surrendered.[222] Therefore, other than tax avoidance, no reason justifies a shareholder's artificial allocation of consideration to separate shares.[223]

It is important to note that the economic substance doctrine does not apply where Congress actually intended for taxpayers to recognize a tax benefit by structuring a transaction in a certain way.[224] Congress did not intend § 356, however, to provide a tax benefit to shareholders.[225] On the contrary, Congress intended § 356 to be an anti-abuse provision to ensure that a shareholder could not arbitrarily split up a whole transaction and reconstitute it as several separate transactions in order to immediately recognize a loss that lacked economic reality, and also to ensure that a shareholder's boot was taxed to the extent of any gain and as a dividend if the boot had the effect of a dividend.[226] Therefore, because Congress created § 356 not with the intent to provide a tax benefit but rather with the intent to prevent abuse, applying the economic substance doctrine to shareholder allocations of stock in reorganization exchange transactions is appropriate.[227] This doctrine provides further support for the view that Congress never intended shareholders to have the discretion to arbitrarily allocate shares to avoid § 356 treatment.[228]

Finally, pro rata distributions of boot are already common practice in corporate reorganizations.[229] *Shimberg v. United States* highlighted this in adopting a prereorganization approach to determine when boot in a reorganization should be treated as a dividend.[230] The court noted that as a consequence of this approach, boot would be treated as a dividend any time the distribution was pro rata.[231] Nevertheless, the court assumed that

222. Schler, *supra* note 3, pt. X(G).

223. *Id.*

224. *Id.*

225. *See* Errol G. Golub, *"Boot" in Reorganizations—The Dividend Equivalency Test of Section 356(a)(2)*, 58 TAXES 904, 905 (1980). One of Congress's concerns was that without § 356, corporations might be able to "siphon off" accumulated earnings and profits at capital gains rates as opposed to ordinary income rates through a reorganization. *Id.*; *see also* Trenholme J. Griffin, *Treatment of Cash Distributions to Shareholders Pursuant to a Corporate Reorganization:* Shimburg v. United States, 20 B.C. L. REV. 601, 613–14 (1979) ("Section 356 was intended to prevent a corporation from bailing out retained earnings when there is no meaningful reduction in the shareholders' equity interest in the corporation."); Comm'r v. Clark, 489 U.S. 726, 742 (1989).

226. *See supra* note 225 and accompanying text.

227. *See* Schler, *supra* note 3, pt. X(G).

228. *See id.*

229. *See Clark*, 489 U.S. at 738–39 (quoting Clark v. Comm'r, 828 F.2d 221, 227 (4th Cir. 1987), *aff'd*, 489 U.S. 726).

230. *See* Shimberg v. United States, 577 F.2d 283, 288–89 (5th Cir. 1978); Golub, *supra* note 225, at 911.

231. *See Shimberg*, 577 F.2d at 289; Golub, *supra* note 225, at 911. The prereorganization approach results in automatic dividend treatment because if target

Congress intended this, stating that "it follows that a pro rata distribution of 'boot' to shareholders of one of the participating corporations must certainly have the 'effect of the distribution of a dividend' within the meaning of § 356(a)(2)."[232] Even though the court stated that its prereorganization approach did not establish an "automatic dividend" rule in all cases, the emphasis the court placed on the effect that its prereorganization approach would have on pro rata distributions suggests that pro rata distributions were prevalent in corporate reorganizations.[233] The Court in *Clark* also recognized this, noting that "corporate boot is usually distributed pro rata to the shareholders of the target corporation."[234] Although *Shimberg* and *Clark* recognize the possibility that boot may not always be distributed on a pro rata basis, the frequency with which boot is distributed in this way supports the position that mandatory pro rata distribution should be adopted because it will assist taxpayers in determining how to treat their losses under § 356 in reorganization transactions and will not be difficult to enforce.[235]

### *B. Loss Deferral and Basis-Shifting*

Another alternative to accomplish loss deferral, albeit a more complicated and less desirable alternative to pro rata allocation, is basis-shifting.[236]

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shareholders receive their boot on a pro rata basis from the target corporation before the merger, their percentage ownership in the target corporation will remain the same. *See Clark*, 489 U.S. at 739–40. Therefore, the shareholders would not experience a meaningful reduction in their interest in the corporation to qualify the boot for capital gains treatment under § 302(b)(2). *See id.*

232. *Shimberg*, 577 F.2d at 288 (quoting King Enters., Inc. v. United States, 418 F.2d 511, 521 (Ct. Cl. 1969)); Golub, *supra* note 225, at 911.

233. *See Shimberg*, 577 F.2d at 290; Golub, *supra* note 225, at 911.

234. *See Clark*, 489 U.S. at 738–39 (quoting *Clark*, 828 F.2d at 227).

235. *See supra* notes 229–34 and accompanying text.

236. *See* Gallagher, *supra* note 50, pt. IV(G)(2). Under a basis-shifting approach, the basis for the loss shares will be shifted to the basis of acquiring shares for which the loss shares *were not* directly exchanged. *See id.* One reason that the Treasury Department may be hesitant to enforce the basis-shifting approach is that when a shareholder surrenders all of his shares solely for cash and basis-shifting, rather than applying immediate recognition, the basis may shift to shares that the shareholder does not control. *See id.* For example, consider a shareholder who surrenders all of his target stock in a corporate reorganization and receives a redemption that has the effect of a dividend under family attribution rules. This shareholder would be unable to use the redemption to recover his basis in the target stock surrendered and moreover unable to preserve the basis by shifting it to any remaining target stock that may have been retained because, in this case, the shareholder has surrendered *all* of his target stock. *See id.*

This is very similar to the issue faced by the shareholder in *Coyle v. United States*, 415 F.2d 488, 493 (4th Cir. 1968). In *Coyle*, the court suggested that the shareholder could

The proposed 2009 regulations insist on allowing shareholders freedom to arbitrarily choose how to allocate the consideration they receive from the acquiring corporation to each target share.[237] Thus, despite the pro rata method's ease of application and its harmony with the economic substance doctrine, basis-shifting should also be explored as an alternative method to achieving loss deferral that is nevertheless compatible with non-pro rata allocations of consideration.[238] Under this method, if a shareholder allocates solely acquiring stock to his low-basis target shares and allocates solely cash to his high-basis target shares, the shareholder's loss can be preserved by shifting the loss incurred on the high-basis target shares to the basis in the acquiring shares the shareholder received in exchange for his low-basis target shares, even though the shareholder technically exchanged his high-basis target shares solely for cash.[239]

If the Treasury Department were to adopt basis-shifting as a sanctioned method for addressing losses, congressional intent to defer losses could

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preserve his basis by adding it to the basis in the shares of related persons. *See id.* However, taxpayers who want to benefit from their basis themselves rather than relinquish it to a relative may find this result undesirable. *See* Gallagher, *supra* note 50, pt. IV(G)(2).

Fortunately, this concern is inapplicable to a transaction in which the shareholder receives *both* acquiring stock and cash in exchange for his target shares. *See id.* In such a transaction, a shareholder will never end up without any acquiring stock to shift excess basis to. *See id.* Even if a shareholder chooses to allocate solely cash to some of this target stock and solely acquiring stock to his other target stock, the shareholder will still be able to transfer the basis in excess of the cash received on the stock-for-cash exchange to the basis in the acquiring stock received in the stock-for-stock exchange. *See id.*

237. Proposed 2009 Regulations, *supra* note 34, at 3512.

238. *See* Schler, *supra* note 3, pt. X(G)(3)(b).

239. *See* Gallagher, *supra* note 50, pt. IV(G)(2). For example, assume a shareholder owns five shares of stock with a basis of $10 per share and five shares of stock with a basis of $30 per share. Each share is worth $20. Pursuant to a reorganization, the shareholder surrenders his stock in target for twenty shares of acquiring stock, each worth $5 and $100 in cash. The shareholder allocates the twenty shares of acquiring to his low-basis target shares and allocates the $100 to his high-basis target shares. Under § 356, the shareholder will not recognize the $50 gain on the low-basis shares, nor will the shareholder recognize the $50 loss on the high-basis shares. *See* I.R.C. § 356 (2006). Because the shareholder only allocated acquiring shares to the low-basis shares, the shareholder recognizes no gain on this exchange, and the acquiring shares take the exchange basis of the shareholder's low-basis target shares, thus taking a total basis of $50. *See id.* §§ 356, 358(a). Because the shareholder allocated only cash to the high-basis shares yet will not recognize any loss on these shares under § 356, it follows that the consideration received for the high-basis shares would take the same exchanged basis of these target shares, taking a total basis of $150. *See id.* The $100 given in cash, however, cannot take a basis of $150 in order to defer the loss. *See* Gallagher, *supra* note 50, pt. IV(G). The loss could still nonetheless be deferred by adding the basis in excess of the cash received for the high-basis target shares surrendered to the new basis in the acquiring shares received in exchange for the low-basis target shares. *See id.* In this example, the basis in the loss shares exceeds the $100 cash received by $50. This excess basis could be added to the acquiring shares, giving these shares a total basis of $100 in order to preserve the $50 loss by reducing future gain on the shares. *See id.*

be satisfied in form.[240] In substance, however, shareholders could still minimize gain recognition and currently recognize losses through strategic allocations without substantially diminishing their investment interest.[241] A shareholder could, for instance, allocate substantially all of the boot plus only a small amount of acquiring shares to his high-basis target loss shares.[242] The shareholder would then preserve the loss in this small amount of acquiring shares and could subsequently sell the shares to recognize an immediate loss.[243]

This result would be inconsistent with the spirit of congressional intent to defer losses through § 356.[244] In such a scenario, basis-shifting only creates a more complex path for shareholders to follow in order to secure immediate loss recognition than if basis recovery and identification were determined using a simple share-by-share approach.[245] Pro rata allocation, on the other hand, more closely adheres to the congressional intent to defer losses underpinning § 356 without leaving room for shareholders determined to recognize immediate losses to maneuver their way around its effects.[246] Thus, of the two approaches to loss deferral where a shareholder exchanges target shares for both acquiring shares and boot, the pro rata allocation method is not only the most practical method but also the most effective method in achieving the intended loss deferral objective.[247]

240. *See* Gallagher, *supra* note 50, pt. IV(G)(2).
241. *See id.*
242. *See id.*
243. *See id.* Building upon the example in note 239, assume that instead of allocating all twenty acquiring shares to the shareholder's low-basis target shares and the entire $100 to his high-basis target shares, the shareholder allocates nineteen acquiring shares and $5 to his low-basis target shares surrendered and allocates one acquiring share and $95 to his high-basis target shares surrendered. Under this allocation scheme, the shareholder only recognizes $5 of the $50 gain on his low-basis target shares surrendered. *See* I.R.C. § 356. The shareholder still will not recognize any of the $50 loss on his high-basis target shares, but all of the loss can be preserved in the one acquired share received for his high-basis target shares. *See id.* § 358(a). Before their surrender, the shareholder's total basis in his five high-basis target shares was $150, and after calculating the excess of this basis over the $95 cash included in exchange for his high-basis target shares, the one new acquiring share would take on a $55 basis even though it only has a fair market value of $5. *See id.* The shareholder could then sell this acquiring share without substantially diminishing his interest in the acquiring corporation and recognize the $50 loss that § 356 disallowed. *See* Gallagher, *supra* note 50, pt. IV(G).
244. *See supra* Part IV.
245. Gallagher, *supra* note 50, pt. IV(G)(2).
246. *See supra* Part VI.A.
247. *See* Schler, *supra* note 3, pt. X(G).

## VII. CONCLUSION

The proposed 2009 regulations allow shareholders to split transactions and treat stock-for-stock exchanges separately from stock-for-cash exchanges so as to avoid the requirements of § 356 altogether and recognize an immediate loss on the loss shares they exchange.[248] This proposed solution, however, undermines congressional intent to defer losses and is too generous to some shareholders because it enables them to take immediate losses on some of their shares where, in totality, they have an overall gain.[249] A statement made by the court in *Jordan Marsh Co. v. Commissioner* accurately sums up the congressional intent underlying § 356 and similar nonrecognition provisions.[250] In that case, quoting *Portland Oil Co. v. Commissioner,* the court stated that the purpose of nonrecognition was to prevent the taxpayer from immediately recognizing gain or claiming a loss in certain transactions "where gain or loss may have accrued in a constitutional sense, but where in a popular and economic sense there has been a mere change in the form of ownership and the taxpayer has not really 'cashed in' on the theoretical gain, or closed out a losing venture."[251] In finding that nonrecognition, where applicable, was mandatory rather than optional, the court went on to say that nonrecognition was intended so that "as to both gains and losses the taxpayer should not have it within his power to avoid the operation of the section by stipulating for the addition of cash, or boot, to property received in exchange."[252]

The proposed 2009 regulations' loophole to loss nonrecognition goes against congressional intent and will substantially widen the tax gap, as the DIVX-SNIC example illustrates.[253] Many shareholders who purchased shares prior to 2008 will possess significant built-in losses when entering into reorganizations and will attempt to immediately recognize

248. *See* Proposed 2009 Regulations, *supra* note 34, at 3512.

249. *See supra* Part IV; *supra* notes 78–81 and accompanying text.

250. Jordan Marsh Co. v. Comm'r, 269 F.2d 453, 456 (2d Cir. 1958) (quoting Portland Oil Co. v. Comm'r, 109 F.2d 479, 488 (1st Cir. 1940)).

251. *See id.* (quoting *Portland Oil Co.*, 109 F.2d at 488) (internal quotation marks omitted). In *Jordan Marsh Co.*, the petitioner conveyed two parcels of property to a vendee in exchange for $2,300,000 and leases on the same property for terms of about thirty years. *Id.* at 453–54. The petitioner claimed that the transaction was a sale and took a deduction on its tax return in the amount of the difference between the adjusted basis on the property and the cash received. *Id.* at 454. The Commissioner disallowed the deduction, claiming that the transaction constituted a nonrecognition like-kind exchange. *Id.* The court agreed with the petitioner in finding that the transaction qualified as a sale rather than a like-kind exchange because the petitioner received cash reflecting the full value of the property and took on a new liability to make annual rental payments on the property. *Id.* at 456–58. Therefore, the petitioner closed out on a losing venture and its economic position was changed as a result of the transaction. *Id.* at 456.

252. *See id.* at 456.

253. *See supra* notes 15–36, 188 and accompanying text.

these losses while deferring gains because of this loophole.[254] This will prevent the Service from collecting a substantial amount of tax revenue that could otherwise help reduce the federal budget deficit.[255] Deferral of loss, on the other hand, both protects against contrived transaction structuring by shareholders for tax avoidance purposes and preserves congressional intent to defer losses in corporate reorganizations.[256] Requiring shareholders to allocate boot in § 356 transactions on a pro rata basis is the fairest and most practical way to accomplish deferral because shareholders can preserve any unrecognized target share losses in the tax basis of the newly acquired shares for which their surrendered target shares were directly exchanged.[257] Pro rata allocation of boot is also consistent with the treatment of boot in § 351 transactions, and it is safe from scrutiny under the economic substance doctrine.[258] Although a shareholder could also defer loss recognition through basis-shifting, this method would result in a practical circumvention of § 356 if transaction-splitting, as permitted under the proposed 2009 regulations, is allowed.[259] Thus, the Treasury Department should close this loophole by modifying the proposed 2009 regulations to conform more closely to congressional intent requiring mandatory § 356 application and loss deferral when shareholders exchange target stock for both acquiring stock and cash in a reorganization.[260]

254. *See supra* notes 200–02 and accompanying text.
255. *See supra* notes 200–02 and accompanying text.
256. *See supra* Part VI.
257. *See supra* Part VI.A.
258. *See supra* Part VI.A.
259. *See supra* Part VI.B.
260. *See supra* Part VI.A.