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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

TD 9122

RIN 1545-BC28

Guidance under Section 1502; Stock Basis after a Group Structure Change

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulation.

SUMMARY:

DATES: These regulations are effective April 26, 2004.

FOR FURTHER INFORMATION CONTACT: Ross Poulsen, (202) 622-7770 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) under section 1502 of the Internal Revenue Code of 1986 (Code), specifically §1.1502-31, relating to the determination of the basis of stock in the former common parent after a group structure change. Section 1.1502-31 applies if one corporation (P) succeeds another corporation (T) under the principles of §1.1502-75(d)(2) or (3) as the common parent of a consolidated group in a group structure change. Section 1.1502-31 provides that if a corporation acquires stock of the former common parent in a group structure change, the basis of the members in the former common parent's stock immediately after the group structure change is generally redetermined to reflect the former common parent's net asset basis.

Because of a concern that the application of the net asset basis rule may produce inappropriate results on the disposition of stock acquired in a transaction in which, under generally applicable rules, the basis of the acquired stock would otherwise be determined by reference to the acquirer’s cost, the IRS and Treasury Department issued regulations proposing to except from the application of the net asset basis rule stock acquired in a transaction in which gain or loss was recognized in whole. Those regulations were included in a notice of proposed rulemaking (REG-130262-03) published in the **Federal Register** (68 FR 40579 [technical correction published in 68 FR 52545]) on July 8, 2003.

No public hearing was requested or held regarding the proposed regulations. One written comment, however, was received. That comment urged the expeditious promulgation of the proposed regulations as final regulations.

This Treasury decision adopts the proposed regulations without substantive changes as final regulations. The final regulations apply to group structure changes that occur after April 26, 2004. With respect to group structure changes that occur on or before April 26, 2004 and in a consolidated return year beginning on or after January 1, 1995, these regulations apply at the election of the group.

Special Analyses

It has been determined that these regulations are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations do not have a significant impact on a substantial number of small entities. This certification is based on the fact that these regulations primarily will affect affiliated groups of corporations, which tend to be larger businesses. Moreover, the number of taxpayers affected is minimal and the regulations will simplify basis determinations. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, the proposed regulations preceding these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact.

Drafting Information

The principal author of this regulation is Ross Poulsen, Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.1502-31 is amended by revising paragraphs (b)(2), (d)(2)(ii), (g), and (h) to read as follows:

'1.1502-31 Stock basis after a group structure change.

* * * * *

(b) * * *

(2) Stock acquisitions. If a corporation acquires stock of the former common parent in a group structure change, the basis of the members in the former common parent's stock immediately after the group structure change (including any stock of the former common parent owned before the group structure change) that is, or would otherwise be, transferred basis property is redetermined in accordance with the results for an asset acquisition described in paragraph (b)(1) of this section. For example, if all of T's stock is contributed to P in a group structure change to which section 351 applies, P's basis in T's stock is T's net asset basis, rather than the amount determined under section 362. Similarly, if S merges into T in a group structure change described in section 368(a)(2)(E) and P acquires all of the T stock, P's basis in T's stock is the basis that P would have in S's stock under paragraph (b)(1) of this section if T had merged into S in a group structure change described in section 368(a)(2)(D).

* * * * *

(d) * * *

(2) * * *

(ii) Stock acquisitions. If less than all of the former common parent's stock is subject to the redetermination described in paragraph (b)(2) of this section, the percentage of the former common parent's net asset basis taken into account in the redetermination equals the percentage (by fair market value) of the former common parent's stock subject to the redetermination. For example, if P owns less than all of the former common parent's stock immediately after the group structure change and such stock would otherwise be transferred basis property, only an allocable part of the basis determined under this section is reflected in the shares owned by P (and the amount allocable to shares owned by nonmembers has no effect on the basis of their shares). Alternatively, if P acquired 10 percent of the former common parent=s stock in a transaction in which the stock basis was determined by P=s cost, and P later acquires the remaining 90 percent of the former common parent=s stock in a separate transaction that is described in paragraph (b)(2) of this section, P retains its cost basis in its original stock and the basis of P=s newly acquired shares reflects only an allocable part of the former common parent=s net asset basis.

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(g) <u>Examples</u>. For purposes of the examples in this section, unless otherwise stated, all corporations have only one class of stock outstanding, the tax year of all persons is the calendar year, all persons use the accrual method of accounting, the facts set forth the only corporate activity, all transactions are between unrelated persons, and tax liabilities are disregarded. The principles of this section are illustrated by the following examples:

<u>Example 1</u>. <u>Forward triangular merger</u>. (i) <u>Facts</u>. P is the common parent of one group and T is the common parent of another. T has assets with an aggregate basis of $60 and fair market value of $100 and no liabilities. T's shareholders have an aggregate basis of $50 in T's stock. In Year 1, pursuant to a plan, P forms S and T merges into S with the T shareholders receiving $100 of P stock in exchange for their T stock. The transaction is a reorganization described in section 368(a)(2)(D). The transaction is also a reverse acquisition under '1.1502-75(d)(3) because the T shareholders, as a result of owning T's

stock, own more than 50% of the value of P's stock immediately after the transaction. Thus, the transaction is a group structure change under '1.1502-33(f)(1), and P's earnings and profits are adjusted to reflect T's earnings and profits immediately before T ceases to be the common parent of the T group.

(ii) Analysis. Under paragraph (b)(1) of this section, P's basis in S's stock is adjusted to reflect T's net asset basis. Under paragraph (c) of this section, T's net asset basis is $60, the basis T would have in the stock of a subsidiary under section 358 if T had transferred all of its assets and liabilities to the subsidiary in a transaction to which section 351 applies. Thus, P has a $60 basis in S's stock.

(iii) Pre-existing S. The facts are the same as in paragraph (i) of this Example 1, except that P has owned the stock of S for several years and P has a $50 basis in the S stock before the merger with T. Under paragraph (b)(1) of this section, P's $50 basis in S's stock is adjusted to reflect T's net asset basis. Thus, P's basis in S's stock is $110 ($50 plus $60).

(iv) Excess loss account included in former common parent's net asset basis. The facts are the same as in paragraph (i) of this Example 1, except that T has two assets, an operating asset with an $80 basis and $90 fair market value, and stock of a subsidiary with a $20 excess loss account and $10 fair market value. Under paragraph (c) of this section, T's net asset basis is $60 ($80 minus $20). See sections 351 and 358, and '1.1502-19. Consequently, P has a $60 basis in S's stock. Under section 362 and '1.1502-19, S has an $80 basis in the operating asset and a $20 excess loss account in the stock of the subsidiary.

(v) Liabilities in excess of basis. The facts are the same as in paragraph (i) of this Example 1, except that T's assets have a fair market value of $170 (and $60 basis) and are subject to $70 of liabilities. Under paragraph (c) of this section, T's net asset basis is negative $10 ($60 minus $70). See sections 351 and 358, and ''1.1502-19 and 1.1502-80(d). Thus, P has a $10 excess loss account in S's stock. Under section 362, S has a $60 basis in its assets (which are subject to $70 of liabilities). (Under paragraph (a)(2) of this section, because the liabilities are taken into account in determining net asset basis under paragraph (c) of this section, the liabilities are not also taken into account as consideration not provided by P under paragraph (d)(1) of this section.)

(vi) Consideration provided by S. The facts are the same as in paragraph (i) of this Example 1, except that P forms S with a $100 contribution at the beginning of Year 1, and during Year 6, pursuant to a plan, S purchases $100 of P stock and T merges into S with the T shareholders receiving P stock in exchange for their T stock. Under paragraph (b)(1) of this section, P's $100 basis in S's stock is increased by $60 to reflect T's net asset basis. Under paragraph (d)(1) of this section, P's basis in S's stock is decreased by $100 (the fair market value of the P stock) because the P stock purchased by S and used in the transaction is consideration not provided by P.

(vii) Appreciated asset provided by S. The facts are the same as in paragraph (i) of this Example 1, except that P has owned the stock of S for several years, and the shareholders of T receive $60 of P stock and an asset of S with a $30 adjusted basis and $40 fair market value. S recognizes a $10 gain from the asset under section 1001. Under paragraph (b)(1) of this section, P's basis in S's stock is increased by $60 to reflect T's net asset basis. Under paragraph (d)(1) of this section, P's basis in S's stock is decreased by $40 (the fair market value of the asset provided by S). In addition, P's basis in S's stock is increased under '1.1502-32(b) by S's $10 gain.

(viii) Depreciated asset provided by S. The facts are the same as in paragraph (i) of this Example 1, except that P has owned the stock of S for several years, and the shareholders of T receive $60 of P stock and an asset of S with a $50 adjusted basis and $40 fair market value. S recognizes a $10 loss from the asset under section 1001. Under paragraph (b)(1) of this section, P's basis in S's stock is increased by $60 to reflect T's net asset basis. Under paragraph (d)(1) of this section, P's basis in S's stock is decreased by $40 (the fair market value of the asset provided by S). In addition, S's $10 loss is taken into account under '1.1502-32(b) in determining P's basis adjustments under that section.

Example 2. Stock acquisition. (i) Facts. P is the common parent of one group and T is the common parent of another. T has assets with an aggregate basis of $60 and fair market value of $100 and no liabilities. T's shareholders have an aggregate basis of $50 in T's stock. Pursuant to a plan, P forms S and S acquires all of T's stock in exchange for P stock in a transaction described in section 368(a)(1)(B). The transaction is also a reverse acquisition under '1.1502-75(d)(3). Thus, the transaction is a group structure change under '1.1502-33(f)(1), and the earnings and profits of P and S are adjusted to reflect T's earnings and profits immediately before T ceases to be the common parent of the T group.

(ii) Analysis. Under paragraph (d)(4) of this section, although S is not the new common parent of the T group, adjustments must be made to S's basis in T's stock in accordance with the principles of this section. Although S's basis in T's stock would ordinarily be determined under section 362 by reference to the basis of T's shareholders in T's stock immediately before the group structure change, under the principles of paragraph (b)(2) of this section, S's basis in T's stock is determined by reference to T's net asset basis. Thus, S's basis in T's stock is $60.

(iii) Higher-tier adjustments. Under paragraph (d)(4) of this section, P's basis in S's stock is increased by $60 (to be consistent with the adjustment to S's basis in T's stock).

(iv) Cross ownership. The facts are the same as in paragraph (i) of this Example 2, except S purchased 10% of T's stock from an unrelated person for cash. In an unrelated transaction, S acquires the remaining 90% of T's stock in exchange for P stock. S's basis in the initial 10% of T's stock is not redetermined under this section. However, S's basis in the additional 90% of T's stock is redetermined under this section. S's basis in that stock is adjusted to $54 (90% of T's net asset basis).

(v) Allocable share. The facts are the same as in paragraph (i) of this Example 2, except that P owns only 90% of S's stock immediately after the group structure change. S's basis in T's stock is the same as in paragraph (ii) of this Example 2. Under paragraph (d)(2) of this section, P's basis in its S stock is increased by $54 (90% of S's $60 adjustment).

Example 3. Taxable stock acquisition. (i) Facts. P is the common parent of one group and T is the common parent of another. T has assets with an aggregate basis of $60 and fair market value of $100 and no liabilities. T's shareholders have an aggregate basis of $50 in T's stock. Pursuant to a plan, P acquires all of T's stock in exchange for $70 of P's stock and $30 in a transaction that is a group structure change under '1.1502-33(f)(1). P's acquired T stock is not transferred basis property. (Because of P's use of cash, the acquisition is not a transaction described in section 368(a)(1)(B).)

(ii) Analysis. The rules of this section do not apply to determine P's basis in T's stock. Therefore, P's basis in T's stock is $100.

(h) Effective dates -- (1) General rule. This section applies to group structure changes that occur after April 26, 2004. However, a group may apply this section to group structure changes that occurred on or before April 26, 2004 and in consolidated return years beginning on or after January 1, 1995.

(2) Prior law. For group structure changes that occur on or before April 26, 2004 and in consolidated return years beginning on or after January 1, 1995, with respect to which the group does not elect to apply the provisions of this section, see '1.1502-31 as contained in the 26 CFR part 1 edition revised as of April 1, 2003. For group structure changes that occur in consolidated return years beginning before January 1, 1995, see

'1.1502-31T as contained in the 26 CFR part 1 edition revised as of April 1, 1994.

Mark E. Matthews
Deputy Commissioner for Services and Enforcement.

Approved: April 14, 2004

Gregory F. Jenner
Acting Assistant Secretary of the Treasury.