TAX MANAGEMENT

MEMORANDUM

Proposed Basis Recovery Regulations

by Joshua T. Brady
Ivins, Phillips & Barker
Washington, D.C.

INTRODUCTION

On January 21, 2009, the Internal Revenue Service (the ''Service'') proposed regulations (the ''Proposed Regulations'') that would provide rules relating to the recovery of stock basis in §301 distributions and transactions that are treated as §301 distributions under §§302(d) and 304.[1] As discussed in more detail below, the Proposed Regulations would answer fundamental questions relating to basis recovery under §§301, 302(d), and 304, that have been largely unanswered since their enactment in 1954.

The remainder of this article is divided into two parts. The first discusses those aspects of the Proposed Regulations that would affect the recovery of basis in §301 distributions. The second discusses those aspects of the Proposed Regulations that would affect the recovery of basis in §302(d) redemptions and §304(a)(1) transactions.

SECTION 301 DISTRIBUTIONS

Background

Distributions of money or property by a corporation to its shareholders are generally governed by §301, which provides:

> *Section 301. Distributions of property.*
>
> (a) In general. Except as otherwise provided in this chapter, a distribution of property (as defined in §317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).
>
> * * * *
>
> (c) Amount taxable. In the case of a distribution to which subsection (a) applies —

---

[1] REG-143686-07, 74 Fed. Reg. 3509 (1/21/09), *as corrected by* 74 Fed. Reg. 9575 (3/5/09). The Proposed Regulations also would provide rules under §§356 and 358 relating to the determination of gain and the basis of stock or securities received in §368 reorganizations. Those aspects of the Proposed Regulations are beyond the scope of this article.

(1) Amount constituting dividend. That portion of the distribution which is a dividend (as defined in §316) shall be included in gross income.

(2) Amount applied against basis. That portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock.

(3) Amount in excess of basis.

(A) In general. Except as provided in subparagraph (B), that portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, shall be treated as gain from the sale or exchange of property.

* * * *

Thus, under §301(c), a three-tier hierarchy determines the taxation of distributions to shareholders: First, under §301(c)(1), the distribution is treated as a dividend to the extent of the distributing corporation's current or accumulated earnings and profits (''E&P''). Second, under §301(c)(2), the amount of the distribution in excess of the corporation's E&P is ''applied against and reduce[s] the adjusted basis of the stock.'' Third, under §301(c)(3), the amount of the distribution in excess of the basis recovered under §301(c)(2) is treated as capital gain.

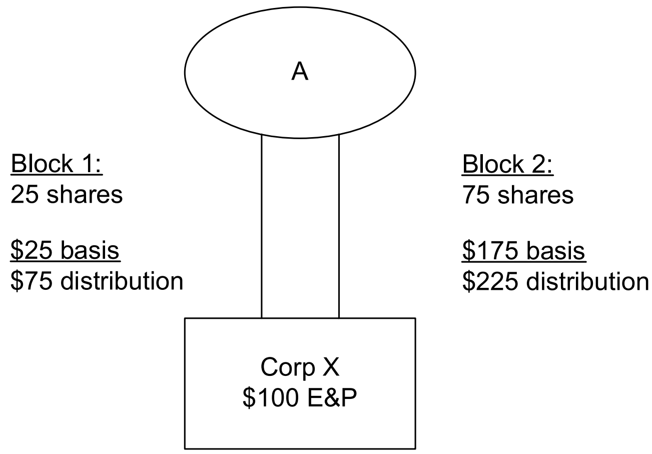
One of the primary issues addressed by the Proposed Regulations is whether the term ''the adjusted basis of the stock'' in §302(c)(2) refers to the aggregate basis of the distributee's stock or the basis of each share individually. There is very little authority relating to how a shareholder recovers basis under §301(c)(2). In the preamble to the Proposed Regulations, the Service acknowledged:

> [T]he tax law does not provide rules concerning whether a shareholder recovers its stock basis in the aggregate, or alternatively, whether a shareholder is required to recover stock basis share-by-share.[2]

The Proposed Regulations would provide that a shareholder must recover basis under §301(c)(2) on a share-by-share approach (sometimes referred to as the pro-rata basis recovery approach).[3] This approach is demonstrated by the following example in the Proposed Regulations:

Example 1: Share-by-Share Basis Recovery

Facts. Corporation X, a calendar year taxpayer, has only common stock outstanding. *A*, an individual, owns all 100 shares; 25 were acquired on Date 1 for $25 (Block 1) and 75 were acquired on Date 2 for $175 (Block 2). On December 31, when Corporation X had E&P of $100, it made a $3 distribution on each share of common stock.



Analysis. A is treated as receiving $75 of the distribution on Block 1 and $225 on Block 2. On Block 1, *A* will have a $25 dividend under §301(c)(1), a $25 return of basis under §301(c)(2) and a $25 gain under §301(c)(3). On Block 2, *A* will have a $75 dividend under §301(c)(1), a $150 return of basis under §301(c)(2) and will have a remaining basis of $25 in the shares of Block 2.[4]

In contrast, under the aggregate-basis recovery approach, after taking into account $100 of dividend income under §301(c)(1), *A* would apply his *aggregate* $200 basis against the remaining portion of the distribution. Thus, under the aggregate-basis recovery approach, *A* would not recognize any gain under §301(c)(3) and would be left with $0 of basis in both blocks of stock.[5]

In support of its adoption of the share-by-share basis recovery approach, the preamble to the Proposed

[2] 74 Fed. Reg. at 3510.

[3] Prop. Regs. §1.301-2(a). The rules would apply to transactions that occur after the date final regulations in the Federal Register. Prop. Regs. §1.301-2(b).

[4] Prop. Regs. §1.301-2(a), *Ex.*

[5] There would be no difference between the share-by-share approach and the aggregate approach if *A* had a uniform basis in the Corporation X shares. For instance, if *A* had a $2 basis in each of the shares (i.e., $50 basis in Block 1 and $150 basis in Block 2), both the share-by-share approach and the aggregate approach

ISSN 0148-8295

Regulations states that it is ''[c]onsistent with the fundamental notion that a share of stock is the basic unit of property.'' [6] As discussed below, the results under the aggregate-basis recovery approach seem more consistent with the purposes of §301.

Origin of the Share-by-Share Approach: *Johnson v. U.S.*

The origin of the share-by-share basis recovery approach is generally viewed as *Johnson v. U.S.*[7] Indeed, the preamble to the Proposed Regulations cites only *Johnson* in support of adopting the share-by-share approach.

In *Johnson*, the taxpayer purchased 52% of the stock of Mayflower Corporation (''Mayflower'') in 1949 for $1,040; the taxpayer purchased the remaining 48% in 1954 for $144,500. Thus, the taxpayer had an aggregate $145,540 basis in the stock. In 1963, the taxpayer received a $169,000 distribution from Mayflower. The taxpayer reported $13,565 as a dividend under §301(c)(1), the amount of Mayflower's E&P at that time. Of the remaining $155,435, the taxpayer applied $145,540 against his entire basis in the Mayflower stock under §301(c)(2), and reported $9,895 as capital gain under §301(c)(3)(A).

The government asserted that 52% of the distribution in excess of the corporation's E&P (52% × $155,435 = $80,826) should be allocated to the stock acquired in 1949 with a basis of $1,040, resulting in gain of $79,786 of gain under §301(c)(3) ($80,826 − $1,040 = $79,786); and 48% of the excess distribution (48% × $155,435 = $80,826) should be allocated to the stock acquired in 1954 with a basis of $144,500, leaving $69,891 of remaining basis in those shares under §301(c)(2).

The district court rejected the government's argument, reasoning as follows:

> We believe that the statute does not prohibit a tax-free recovery of basis, and that a distribution of corporate funds in a reasonably businesslike manner is justifiable without other crucial business motives or objectives. It simply allows the stockholder to withdraw his original investment out of funds which are not earnings and profits, and to reduce the basis of his stock to zero. No income has been realized and, when the stock is sold or otherwise disposed of, the income realized will be fully taxed. In the absence of cases directly in point, we reason by analogy to *Burnet v. Logan*, 283 U.S. 404, 51 S. Ct. 550, 75 L. Ed. 1143 (1931); *Inaja Land Co., Ltd.*, 9 T.C. 727 (1947).[8]

The government appealed, arguing that the taxpayer must recover his basis under the share-by-share approach. In support of its position, the government cited *Skinner v. Eaton*,[9] in which the court held that the bases of separately acquired blocks of stock could not be aggregated in computing gain or loss on the stock upon its taxable sale to an unrelated purchaser.

Without citing any authority other than the text of §§301(c) and 1012, the court of appeals held in favor of the government, reasoning as follows:

> These provisions, in our judgment, preclude the aggregation of the cost of the two lots of stock here to reach an adjusted basis for tax purposes. The tax laws are peremptory and inexorably command assessment on the transaction as a pro rata distribution.[10]

The opinion of the court of appeals seems conclusory when compared to the more reasoned analysis of the district court. The district court's analogy to *Burnet v. Logan* and *Inaja Land* (generally viewed as ''open transaction'' cases) seems more persuasive than the court of appeals' unsupported assertion.

In *Burnet v. Logan*, the taxpayer sold stock of a corporation, the assets of which included stock of a subsidiary that owned a mine lease. The taxpayer sold her stock for cash and a stream of annual royalty payments based on the amount of iron ore extracted from the mine. The government argued that, at the time of the sale, the value of the future royalties could be estimated based upon the amount of reserves in the mine, and that the transaction should be taxed based upon that estimated value. The Supreme Court disagreed, holding that the value of the royalties ''had no ascertainable fair market value,'' and that the petitioner ''properly demanded the return of her capital investment before assessment of any taxable profit based on conjecture.'' [11]

In *Inaja Land*, the taxpayer owned riverfront property that it had purchased for $61,000. The land was used for fishing and for grazing. In 1934, the City of Los Angeles altered the flow of the water in the river

---

would result in *A* taking into account a $100 dividend under §301(c)(1), $200 of basis recovery under §301(c)(2), and no gain under §301(c)(3).

[6] 75 Fed. Reg. at 3510.

[7] 435 F.2d 1257 (4th Cir. 1971), *rev'g* 301 F. Supp. 1 (E.D. Va. 1969).

[8] 303 F. Supp. at 5 (citation to secondary authority omitted).

[9] 45 F.2d 568 (2d Cir. 1930), *cert. denied* 283 U.S. 837 (1931).

[10] 435 F.2d at 1259.

[11] 283 U.S. at 413.

ISSN 0148-8295

over the taxpayer's property. Ultimately, the city paid the taxpayer $50,000 for a perpetual easement to allow water to flow over the land. The Commissioner contended that the payment was compensation for loss of present and future income and consideration for release of causes of action against the city, constituting ordinary income. The taxpayer argued that the consideration was paid for the easement granted to the city, but that the character of the easement rendered it impracticable to attempt to apportion a basis to the portion of property affected. The taxpayer argued that because the payment received was less than the basis of the entire property, no gain should be recognized until the entire property was sold. Citing *Burnet v. Logan*, the Tax Court reasoned that ''[a]pportionment with reasonable accuracy of the amount received not being possible, and this amount being less than petitioner's cost basis for the property, it cannot be determined that petitioner has, in fact, realized gain in any amount.'' [12] It concluded that ''[a]pplying the rule . . ., no portion of the payment in question should be considered as income, but the full amount must be treated as a return of capital and applied in reduction of petitioner's cost basis.'' [13]

Burnet v. Logan and *Inaja Land* represent different aspects of the open transaction doctrine. Under *Burnet v. Logan*, the doctrine applies if the value of the consideration received cannot be determined — a situation described in the regulations as ''rare and extraordinary.'' [14] Under *Inaja Land*, the doctrine applies if the allocable portion of the basis of the property disposed cannot be determined because the portion of the property disposed cannot be determined. In this respect, the *Johnson* district court's citation of *Inaja Land* is more appropriate. At least as much as in cases like *Inaja Land*, a shareholder receiving a corporate distribution should not recognize gain until its entire basis in the stock of the distributing corporation is recovered, because *no portion* of the stock is disposed.[15]

As discussed below, although *Johnson* squarely addressed the question whether a shareholder recovers basis under §301(c)(2) under the aggregate or share-by-share approach, the case was seldom cited by courts or the Service.

[12] 9 T.C. at 736.

[13] *Id.*

[14] Regs. §1.1001-1(a).

[15] As recently as last year, in *Fisher v. U.S.*, 82 Ct. Fed. Cl. 780 (2008), the Court of Federal Claims applied the open transaction doctrine to a demutualization of a life insurance company and allowed a policyholder who retained his policy and received cash in lieu of stock for his equity interest to recover his full cost basis in his policy before recognizing gain. The court held that, under open transaction principles, the policyholder's basis could not be allocated between the policy itself and the equity interest, because there was no reasonable basis for such allocation.

The Intermittent Life of *Johnson v. U.S.*

Only one case has ever cited *Johnson*. In *Anderson v. Comr.*,[16] the Tax Court held that *Comr. v. Court Holding Co.*[17] did not apply to a corporation's distribution of portfolio stock to the taxpayer and the taxpayer's subsequent sale of the stock. In its recitation of the facts of the case, the Tax Court noted that the taxpayer treated the distribution of the portfolio stock as a §301 distribution and, because he had multiple blocks of stock in the distributing corporation with a non-uniform basis, he followed his accountant's advice to recover his basis on a share-by-share approach under *Johnson*.[18] Thus, appropriateness of the court of appeals' reasoning in *Johnson* was never at issue in *Anderson*.

Prior to the publication of the Proposed Regulations, the Service cited *Johnson* in only two instances, both of which are written determinations.[19] In PLR 8928066 (7/14/89), the Service ruled that the value of ''hot stock'' of a controlled corporation distributed to distributing shareholders (and thus taxable as a §301 distribution under §355(a)(3)(B)) would be applied against each shareholder's basis of the distributing corporation stock on a share-by-share approach. In TAM 7950023 (9/11/79), in which the National Office concluded that a taxpayer was not entitled to use installment sale reporting on the sale of land, the National Office noted that the taxpayer's reliance on the district court's opinion in *Johnson* for the general proposition that the taxpayer could assert substance over form was misplaced because the taxpayer failed to realize the district court was overturned by the court of appeals.[20]

Until recently, *Johnson* was seldom discussed in secondary authorities. Apart from a citation in Bittker & Eustice,[21] the case was rarely the subject of analysis. But *Johnson's* days of ''flying under the radar'' [22] ended abruptly in 2002, when the Service originally

[16] 92 T.C. 138 (1989).

[17] 324 U.S. 331 (1945).

[18] 92 T.C. at 145 n. 5.

[19] Section 6610(k)(3) provides that written determinations may not be used or cited as precedent.

[20] Shortly after the Proposed Regulations were released, the Chief Counsel's Office cited *Johnson* approvingly in CCA 200924041 (2/13/09), relating to basis reduction under §1059. The memorandum is discussed in more detail below.

[21] *See* Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶8.02[5] n. 55 (7th ed. 2000). The authors did not seem convinced of the correctness of the decision, stating that ''it is not clear whether the shareholder is entitled to recover his aggregate basis before reporting any gain.'' *Id.*

[22] One wonders how the issue raised in *Johnson* was subject to only one published case. Surely the fact pattern in *Johnson* must be repeated numerous times each year. Why is it that those cases

ISSN 0148-8295

proposed regulations relating to dividend-equivalent redemptions under §§302(d) and 304(a)(1), which raised questions about (but did not answer) the propriety of the share-by-share basis recovery approach.[23] Before turning to dividend-equivalent redemptions, however, it is worth reviewing those instances of the tax law that support the aggregate-basis recovery approach, as opposed to the share-by-share basis recovery approach.

Authorities Supporting Aggregate-Basis Recovery Approach

Shareholder Contributions to Capital

Comr. v. Fink,[24] the leading case dealing with shareholder's non–pro rata contribution of stock to the capital of a corporation, stands in contrast to the *Johnson* court's share-by-share approach to basis recovery approach. In *Fink*, the taxpayers (husband and wife) owned 72.5% of the stock of a corporation (''Travco''). Travco needed new capital as a result of financial difficulties. The taxpayers voluntarily surrendered some of their shares to Travco in an effort to ''increase the attractiveness of the corporation to outside investors.'' [25] As a result, the taxpayers' ownership of Travco was reduced to 68.5%. The taxpayers received no consideration for the surrendered shares, and no other shareholder surrendered any stock.

The taxpayers claimed ordinary loss deductions for the full amount of their basis in the surrendered shares. The Commissioner denied the deductions, arguing that surrender of the stock was a contribution to the corporation's capital and did not give rise to a loss or deduction, and that the taxpayers' basis in the surrendered shares should be added to their basis in their remaining Travco stock. The Tax Court agreed.[26]

A divided court of appeals reversed,[27] concluding that the proper treatment of the stock surrender turned on the choice between ''unitary'' and ''fragmented'' views of stock ownership:

> Under the ''fragmented view'' of stock ownership each share of stock is considered a separate investment. A shareholder who surrenders shares to the issuing corporation is considered to have finally disposed of the particular shares surrendered. The surrender of the shares closes the transaction, and the shareholder is entitled to an immediate ordinary loss. Under the ''unitary view'' of stock ownership the stockholder's entire investment is viewed as a single indivisible property unit. The surrendering shareholder is recognized as having surrendered stock for the benefit of stock retained. The transaction remains open, and the surrendering shareholder must add the basis of the surrendered shares to the basis of the stock retained.[28]

The court of appeals held that fragmented view was appropriate and concluded that the taxpayers were entitled to an ordinary loss deduction for the basis of their surrendered shares.

The Supreme Court reversed, adopting the unitary view of stock ownership and concluding that ''a controlling shareholder's voluntary surrender of shares, like contributions of other forms of property to the corporation, is not an appropriate occasion for recognition of gain or loss.'' [29]

Commentators have noted that the Supreme Court's adoption of the unitary view of stock ownership supports the aggregate-basis recovery approach:

> If there is a ''unitary'' view of stock investment with respect to contributions to the capital of a corporation, a similar approach should be taken with respect to a return of a shareholder's investment from the corporation. If in the context of a contribution, a shareholder does not recognize loss until such time as the shareholder disposes of his entire investment in the corporation (e.g., the stock becomes worthless), then in the context of a distribution it seems equally appropriate that the shareholder not recognize any gain upon the receipt of a corporate distribution until such time as the shareholder has received distributions representing his entire investment in that class of stock.[30]

In addition to *Fink*, there are other authorities supporting the aggregate-basis recovery approach, as described below.

---

were never litigated?

[23] REG-150313-01, 67 Fed. Reg. 64331 (10/18/02), *as corrected by* 67 Fed. Reg. 78761 (12/26/02) (the ''2002 Proposed Regulations''). The 2002 Proposed Regulations are discussed below.

[24] 483 U.S. 89 (1987).

[25] *Id.* at 91.

[26] *Fink v. Comr.*, T.C. Memo 1984-418.

[27] *Comr. v. Fink*, 789 F.2d 427 (6th Cir. 1986).

[28] 483 U.S. at 100.

[29] *Id.* at 429 (citations and internal quotations omitted).

[30] Boyer et al., Letter to Karen Gibreath Sowell, Deputy Assistant Secretary (Tax Policy) (7/7/08), *reprinted in* 2008 *TNT* 135-64 (7/14/08). *See also* Warnke, ''Developments, Theories and Themes in Stock Basis,'' 86 *TAXES* 97, at 117 (March 2008) (''A shareholder not having to recognize gain with respect to distributions from a corporation so long as the shareholder still has unrecovered basis in other shares of the corporation might be viewed as an appropriate corollary to the contribution result.''); Bittker & Eustice, above fn. 21 (discussing *Fink*).

ISSN 0148-8295

Partner's Basis in Partnership Interest

A partner in a partnership has a single unified basis in its partnership interest or interests regardless of whether the partner owns both limited and general partnership interests, and regardless of whether the interests in the partnership are represented by certificates indicating ownership interests.[31] Thus, upon receiving a distribution from a partnership, a partner generally recovers its entire basis before recognizing any gain.

S Corporation "Spillover" Rule

In general, if an S corporation without E&P makes a distribution to a shareholder, the recipient's basis in each share is reduced (but not to below zero) by the amount of the distribution allocated to each share. However, Regs. §1.1367-1(c)(3) provides a "spillover" rule under which, if the amount of a distribution attributable to a share exceeds its basis, the excess is applied to reduce (but not to below zero) the remaining bases of all other shares of stock in the corporation owned by the shareholder in proportion to the remaining basis of each of those shares. The shareholder recognizes gain only after its aggregate basis has been recovered.[32]

Allocations of Consolidated Return Investment Adjustments

Under Regs. §1.1502-19(d), if a shareholder-member owns shares of the same class of stock in a subsidiary, some of which shares have an excess loss account ("ELA") (i.e., negative basis) and the others a positive basis, any positive investment adjustments under Regs. §1.1502-32 and contributions to capital are first allocated to reduce or eliminate the ELA. Conversely, under Regs. §1.1502-32(c)(2)(i), any negative investment adjustments are applied to reduce the basis of the shares with the positive basis.[33]

Consolidated Return Unified Loss Rule

Recently, a "unified loss rule" was adopted to restrict losses on sales of consolidated group subsidiary stock. One component of that rule provides that if one or more consolidated group members dispose of part but not all of their stock in another group member at a loss, and if the stock of that member consists of two or more blocks with different bases, stock basis is redetermined to eliminate the loss to the extent of the basis disparity.[34]

Conclusion

As discussed above, the preamble to the Proposed Regulations concedes that the current law does not provide any guidance on whether shareholders recover basis under the share-by-share approach or the aggregate approach. The court of appeals' conclusory opinion in *Johnson* does not offer reasoned support for share-by-share approach. Further, in light those authorities such as *Fink* that support aggregate-basis recovery principles — and in light of *Johnson's* largely dormant existence for four decades — it may be open to debate whether the share-by-share approach is more appropriate than the aggregate approach.

Can Taxpayers Recap Out of Share-by-Share Basis Recovery Gain?

Even if the Proposed Regulations are finalized, an interesting question arises whether a taxpayer with high- and low-basis blocks of stock (such as *A* in Example 1), can recapitalize his blocks of stock into two separate classes and pay separate dividends on each class. For instance, assume *A* exchanges his Block 2 shares of common stock for a new class of preferred stock ("Block 2 Preferred Stock") in a recapitalization intended to qualify as a §368(a)(1)(E) reorganization. Under §358, *A's* basis in the Block 2 Preferred Stock will be $175, which is equal to his basis in the Block 2 common stock exchanged therefor.

Assume that Corporation X then distributes $275 with respect to the Block 2 Preferred Stock and $25 with respect to the Block 1 common stock. If the bifurcated form of the transaction is respected, then with respect to the $275 distribution on the Block 2 Preferred Stock, *A* should have $100 of dividend under §301(c)(1) and $175 of basis recovery under §301(c)(2). With respect to the $25 distribution on the Block 1 common stock, *A* should have $25 of basis recovery under §301(c)(2). Thus, the recapitalization would allow *A* to avoid the gain that would be recognized under the share-by-share basis recovery approach. Of course, whether the form of the transaction would be respected would depend on a number of variables, such as business purpose, step transaction, and whether or not the two classes of stock are really separate.[35]

DIVIDEND-EQUIVALENT REDEMPTIONS

Introduction

Section 302(a) provides that if a corporation redeems its stock for money or other property, the re-

[31] Warnke, above fn. 30, at 99–100.

[32] *See* Bittker & Eustice, above fn. 21; Boyer et al., above fn. 30.

[33] Boyer et al., above fn. 28.

[34] Regs. §1.1502-36(b).

[35] *See* Levine, "Class of Stock: A Definition in Need of Refinement," 124 *Tax Notes* 341 (7/27/09).

ISSN 0148-8295

demption will be treated as an exchange if §302(b) applies. For a redemption to be treated as an exchange under §302(b), the transaction must satisfy one of the following provisions: (1) the redemption is not substantially similar to a dividend; (2) the redemption is substantially disproportionate; (3) the redemption completely terminates a shareholder's interest in the corporation; or (4) the redemption is in connection with a qualifying partial liquidation.

Section 302(d) provides that if a corporation redeems its stock, and §302(a) does not apply, the redemption will be treated as a distribution of property to which §301 applies (a ''dividend-equivalent redemption'').

There is relatively little authority relating to how a shareholder recovers its stock basis under §301(c)(2) in a dividend-equivalent redemption. Such transactions pose three issues:

(1) Is the basis recovered under §301(c)(2) limited to the basis of the shares redeemed (the ''specific-basis recovery approach'');

(2) If the specific-basis recovery approach is not appropriate, is the basis of the shares owned by the redeemed shareholder recovered under the share-by-share approach or the aggregate approach; and

(3) If the amount of the redemption does not exceed the corporation's E&P and the redeemed shareholder's basis, what happens to the shareholder's unrecovered basis?[36]

As discussed below, with respect to question (1), the Proposed Regulations would correctly reject the specific-basis recovery approach. With respect to question (2), the Proposed Regulations would adopt the share-by-share approach (the same approach that would apply in the context of ''regular'' §301 distributions, as discussed above). With respect to question (3), the Proposed Regulations sensibly would retain the rule that allows a shareholder to shift unrecovered basis to its non-redeemed shares of the same class; however, the Proposed Regulations would prohibit a shareholder from shifting unrecovered basis to non-redeemed shares of a different class or to shares held by a related shareholder. As discussed below, the prohibition against ''basis shifting'' is appropriate in many circumstances, but may be unnecessarily restrictive in others.

Rejection of the Specific-Basis Recovery Approach

The Proposed Regulations reject the specific-basis recovery approach. This rejection comports with the substance-over-form principles underlying §302(d). It also comports with the legislative history of §302. Regs. §1.302-2(a), which was originally promulgated in 1955 and is taken nearly verbatim from the Senate Report accompanying the enactment of §302,[37] provides:

> The determination of whether or not a distribution is within the phrase ''essentially equivalent to a dividend'' (that is, having the same effect as a distribution without any redemption of stock) shall be made without regard to the earnings and profits of the corporation at the time of the distribution. For example, if *A* owns all the stock of a corporation and the corporation redeems part of his stock at a time when it has no earnings and profits, the distribution shall be treated as a distribution under §301 pursuant to §302(d).[38]

If the specific-basis recovery approach applied to a dividend-equivalent redemption, the second sentence of the regulation would be meaningless, i.e., there

[36] The same issues are raised in §304(a)(1) transactions. Section 304(a)(1) provides that if one or more persons are in control of each of two corporations and, in return for property, one of the corporations (the ''acquiring corporation'') acquires stock in the other corporation (the ''target corporation'') from the person(s) so in control, then such property is treated as a distribution in redemption of the stock of the acquiring corporation. The deemed redemption is then tested under §302(b) (by reference to the ownership of stock of the target corporation). If the deemed redemption fails to qualify under §§302(b)(1)–(4) and is thus treated as dividend-equivalent redemption, the transaction is treated as if (1) the transferor contributed the stock of the target corporation to the acquiring corporation in exchange for stock of the acquiring corporation in a transaction to which §351(a) applies, and (2) the acquiring corporation then redeemed the stock it is deemed to have issued. Under §304(b)(2), the distribution is a dividend first to the extent of the E&P of the acquiring corporation and then to the extent of the E&P of the target corporation.

Thus, if the amount received in the deemed redemption of the acquiring corporation stock exceeds the combined E&P of the target and acquiring corporations, the question presented is whether the shareholder may recover basis only in the hypothetically issued and redeemed shares of the acquiring corporation (i.e., specific-basis recovery), or whether the shareholder may also recover basis of its existing acquiring corporation shares (and if so, whether the basis of those shares is recovered under the share-by-share or aggregate-basis recovery approach).

[37] S. Rep. No. 83-1666, at 234 (1954).

[38] After the promulgation of the regulation, an advisory committee appointed by the Subcommittee on Internal Revenue Taxation of the House Committee on Ways and Means recommended that the prohibition against specific-basis recovery in Regs. §1.302-2(a) be codified. *See* Advisory Group on Subchapter C of the Internal Revenue Code of 1954, *Revised Report on Corporate Distributions and Adjustments* at 3 (1958). *See also* Bittker, ''Stock Redemptions and Partial Liquidations Under the Internal Revenue Code of 1954,'' 9 *Stan. L. Rev.* 13, at 41 n. 103 (providing example allowing for aggregate-basis recovery in §302(d) redemption).

ISSN 0148-8295

would be no difference in tax treatment as between a redemption taxed as a sale and one taxed as a §301 distribution because in both cases the shareholder would be limited to recovering the basis of only the redeemed shares.

Historically, the Service has rejected the specific-basis recovery approach in the context of dividend-equivalent redemptions under both §302(d)[39] and §304(a)(1).[40] In the 2002 Proposed Regulations, however, the Service seemed to adopt the specific-basis recovery approach in dividend-equivalent redemptions.[41] Even when those proposed regulations were withdrawn after heavy criticism,[42] the Service reiterated that it thought specific-basis recovery was the "better view" of how basis is recovered in dividend-equivalent §302(d) redemptions.[43]

Thankfully, the Service appears to have abandoned the specific-basis recovery approach once and for all. In this respect, the Proposed Regulations would bring welcome clarity to a recently confused area of the law.[44]

Application of Share-by-Share Basis Recovery Approach

As in the context of §301 distributions, the Proposed Regulations would adopt the share-by-share basis recovery approach in dividend-equivalent redemptions under §§302(d) and 304(a)(1).[45] Thus, as in an actual §301 distribution, the Proposed Regulations could produce gain with respect to some shares while other shares have unrecovered basis.

While such an approach may be inconsistent with those authorities applying aggregate-basis recovery principles (as discussed above), if the Service adopts the share-by-share approach in the context of §301 distributions, it would be logical to adopt such an approach to dividend-equivalent redemptions. What remains open to debate however, is the Proposed Regu-

---

[39] *See, e.g.*, FSA 1956 (12/3/96) (specific-basis recovery does not apply to §302(d) redemption).

[40] *See, e.g.,* PLR 8826033 (4/14/88) (specific-basis recovery does not apply to pre-1997 §304(a)(1) transaction); TAM 9748003 (8/8/97) (same); PLR 200611004 (11/30/05) (same under current §304(a)(1)).

The Service also conceded that the specific-basis recovery approach was not appropriate in *Cox v. Comr.*, 78 T.C. 1021 (1982). In that case, the taxpayer owned 100% of the stock of two corporations, RCI and New Roanoke. The taxpayer had a $1,000 basis in the stock of each of the two corporations. RCI had no earnings and profits. The taxpayer sold all of the stock of New Roanoke to RCI in exchange for notes with an aggregate principal amount of $100,000. Under §304(a)(1), as then in effect, the stock sale was treated as if (i) the taxpayer contributed the stock of New Roanoke to RCI as a capital contribution (thus increasing his basis in the RCI stock to $2,000 under Regs. §1.304-2(a)) and (ii) RCI redeemed an unspecified portion of its stock. Because the taxpayer owned all of the stock of RCI before and after the deemed redemption, the redemption was subject to §302(d). The Tax Court explained that the Service had conceded on brief that the taxpayer was entitled to recover his entire $2,000 basis in the stock of RCI before recognizing gain under §301(c)(3). *See* 78 T.C. at 1023 n. 3.

[41] While the 2002 Proposed Regulations did not provide a clear statement that the specific-basis recovery approach applied to §302(d) redemptions, former Prop. Regs. §1.304-3 *Example (3)* would have provided for specific-basis recovery in a dividend-equivalent §304(a)(1) transaction.

In that example, Corporation X and Corporation Y each have outstanding 200 shares of common stock, all of which are owned by *H*, an individual. *H* has a basis in his Corporation X stock of $60 and in his Corporation *Y* stock of $30. Corporation X has $5 of E&P and Corporation Y has $25 of E&P. *H* sells his 200 shares of Corporation X stock to Corporation Y for $150. Under §304(a)(1), the transaction is treated as if (1) *H* contributed his Corporation X shares to Corporation Y for new Corporation Y shares in a §351(a) exchange (thus, under §358, *H* takes a $60 basis in the hypothetically issued Corporation Y shares); and (2) Corporation Y redeemed the hypothetically issued shares for $150 in a §302(d) redemption. In the redemption, *H* is first treated as receiving a dividend of $30 under §301(c)(2) (equal to the combined E&P of Corporations X and Y). The example then applies the specific-basis recovery approach, allowing *H* to recover only his $60 basis in the hypothetically issued and redeemed Corporation Y shares under §301(c)(2). *H* then recognizes $60 of §301(c)(3) gain with respect to remaining portion of the deemed distribution.

[42] *See* American Bar Association, *Comments Concerning Proposed Regulations Providing Guidance Regarding the Treatment of Unutilized Basis of Stock Redeemed in Certain Transactions* (9/9/03), *reprinted in* 2003 *TNT* 178-47 (9/15/03).

[43] Announcement 2006-30, 2006-1 C.B. 879. Shortly before withdrawing the 2002 Proposed Regulations, the Service had issued regulations providing that §§367(a) and (b) would not apply to a deemed §351 transfer of stock of a foreign or domestic target corporation to a foreign acquiring corporation in a §304(a)(1) transaction. *See* T.D. 9250, 2006-11 I.R.B. 588. The §367 regulations were based, in part, on the belief that the specific-basis recovery approach was appropriate, in which case, the income recognized by the transferor in the transaction (whether dividend or capital gain or both) would equal or exceed the built-in gain in the stock of the target corporation. (Conversely, if the specific-basis recovery approach does not apply, the transferor shareholder may recover basis in its existing shares of the foreign acquiring corporation; thus, the transferor may not recognize all of the built-in gain on the target stock.)

Shortly after the Proposed Regulations were released, the Service amended the §367 regulations to take into account the Proposed Regulations' rejection of the specific-basis recovery approach. *See* T.D. 9444, 2009-9 I.R.B. 603. The amended §367 regulations generally retain the "turn off" of §367(a)–(b), but provide an exception if the distribution is applied against and reduces the transferor's existing basis in the foreign acquiring corporation's stock.

[44] Shortly after the Proposed Regulations were released, the Service issued CCA 200924041, above fn. 20, which also rejected the specific-basis recovery approach in the context of a redemption under §1059(e)(1)(A)(ii).

[45] Prop. Regs. §§1.302-5(a)(1) and 1.304-2(a)(4). Significantly, the deemed distribution is limited to the shares of the redeemed class. See below text accompanying fns. 61–62.

ISSN 0148-8295

lations' treatment of the redeemed shareholder's unrecovered basis. This aspect of the Proposed Regulations is discussed in the following section.

Anti-Basis Shifting Provisions

Background

The current regulations under §302 provide limited guidance with respect to the tax treatment of a shareholder's unrecovered basis in a dividend-equivalent redemption, stating only that ''[i]n any case in which an amount received in redemption of stock is treated as a distribution of a dividend, proper adjustment of the basis of the remaining stock will be made with respect to the stock redeemed.'' [46]

The current regulations contain three examples illustrating what constitutes a ''proper adjustment.'' In two of the examples, the redeemed shareholder continues to own stock of the redeeming corporation after a dividend-equivalent redemption. In those cases, the unrecovered basis in the redeemed shares is added to the basis of the shares of the redeeming corporation that the shareholder owns after the redemption.[47]

In the third example, all of the shareholder's stock in the redeeming corporation is redeemed in a dividend-equivalent redemption, but the shareholder constructively owns stock of the redeeming corporation by reason of his wife's continuing ownership of stock of the redeeming corporation. The example concludes that the redeemed shareholder's basis in the redeemed shares shifts to his wife's basis in her shares of stock of the redeeming corporation.[48]

In the recent heyday of tax shelters, taxpayers cited the example of the basis-shifting husband and wife to support shifting basis from a person that is not subject to U.S. tax (such a foreign corporation) to a person that is subject to U.S. tax (usually through option attribution under §318(a)(4)). In Notice 2001-45,[49] the Service originally announced that it would attack such transactions on the grounds that the basis shift was not ''proper'' within the meaning of the current regulations. In the 2002 Proposed Regulations, however, the Service went far beyond what taxpayers may have expected and prohibited a taxpayer who has less than all of its shares of the redeeming corporation redeemed in a dividend-equivalent redemption from shifting unrecovered basis even to unredeemed shares that the taxpayer continues to own after the redemption. As discussed below, the Proposed Regulations would apply less restrictive anti-basis shifting rules.

Anti-Basis Shifting Provisions of the Proposed Regulations

The Proposed Regulations would provide different rules relating to treatment of a redeemed shareholder's unrecovered basis in a dividend-equivalent redemption depending on whether (1) less than all of the shares of a single class held by the taxpayer are redeemed (a ''dividend-equivalent partial redemption'') or (2) all of the shares of a single class of shares are redeemed (a ''dividend-equivalent complete redemption'').

In the case of a dividend-equivalent partial redemption, the Proposed Regulations would provide that in a hypothetical §368(a)(1)(E) recapitalization, the redeemed shareholder is deemed to exchange all its shares in the class, including the redeemed shares, for the actual number of shares held after the redemption.[50] The tracing rules of the §358 regulations [51] then would apply to preserve the basis of the shares exchanged in the recapitalization in the remaining shares of the redeemed class held by the shareholder.

In the case of a dividend-equivalent complete redemption, the Proposed Regulations would treat the amount of the unrecovered basis as a deferred loss of the redeemed shareholder that can be accessed on the ''inclusion date,'' which is defined as the earlier of (1) the first date on which the redeemed shareholder would satisfy the requirements of §302(b)(1), (2), or (3), if the facts and circumstances that exist at the end of such day had existed immediately after the redemption; or (2) the first date on which all classes of stock of the redeeming corporation become worthless within the meaning of §165(g).[52]

These rules are demonstrated by the following examples.

> *Example 2: Dividend-Equivalent Partial Redemption*
>
> *Facts. A* and *B*, husband and wife, each own 100 shares (50%) of the common stock of Corporation X, which they hold as a capital asset. On Date 1, *A* acquired 50 shares for \$100 (Block 1). On Date 2, *A* acquired 50 shares for \$200 (Block 2). On December 31,

[46] Regs. §1.302-2(c).

[47] *Id., Exs. (1)* and *(3)*.

[48] *Id., Ex. (2)*.

[49] 2001-2 C.B. 129. The notice also classified such basis-shifting transactions as listed transactions within the meaning of §6011, thereby imposing reporting and record-keeping requirements relating to such transactions. In Announcement 2002-97, 2002-2 C.B. 757, the Service offered taxpayers a voluntary settlement program if the taxpayer conceded 80% of claimed basis shift.

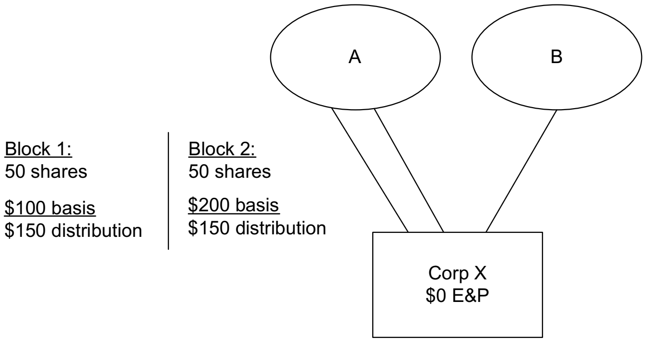
[50] Prop. Regs. §1.302-5(a)(2).

[51] Regs. §1.358-2.

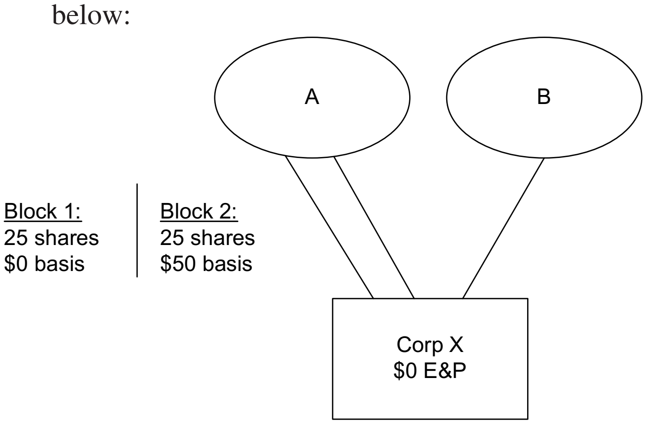
[52] Prop. Regs. §1.302-5(a)(3). The attributes of the loss (such as character and source) are preserved as of the date of redemption that gave rise to such loss.

ISSN 0148-8295

Corporation X, which has no current or accumulated E&P, redeems all of *A's* Block 2 shares for $300. Under §302(d), the redemption proceeds are treated under §301 as a recovery of basis.



Analysis. Immediately before the redemption, the distribution of property is applied on a pro rata, share-by-share basis with respect to each of the shares in the redeemed class held directly by *A*, the redeemed shareholder. Accordingly, *A* will have a $50 capital gain on Block 1 ($150 distribution – $100 basis) under §301(c)(3) and $50 of basis remaining on Block 2 ($150 distribution – $200 basis). To reflect the actual number of shares held by *A* after the redemption, *A's* shares in the redeemed class, including the shares actually surrendered, will be treated as exchanged in a recapitalization under §368(a)(1)(E). The basis in *A's* recapitalized shares will be determined under Regs. §1.358-2. Accordingly, *A* will have 25 shares with a zero basis (attributable to Block 1) and 25 shares with a basis of $50 (attributable to Block 2),[53] as depicted below:



As in the case of a §301 distribution (see Example 1 above), the share-by-share basis recovery approach causes *A* to recognize gain on his low-basis Block 1 shares that would otherwise be offset by his basis in the high-basis Block 2 shares if the aggregate-basis recovery approach applied. In that case, *A* would be entitled to recover his entire $300 basis in his Corporation X shares and would not recognize any gain on the redemption. Following the redemption and deemed §368(a)(1)(E) recapitalization, *A* would have 50 shares of Corporation X stock with a $0 basis.

Even while the results of the Proposed Regulations are inconsistent with those authorities supporting aggregate-basis recovery principles, they are a marked improvement over the 2002 Proposed Regulations' use of the specific-basis recovery approach. For instance, assume the same facts as Example 2 except that (1) *A* has a $150 basis in each of Block 1 and 2 and (2) Corporation X has $250 of E&P. In that case, when Corporation X redeems the Block 2 shares for $300 in a dividend-equivalent redemption, *A* would have a $250 dividend under §301(c)(1) under both the Proposed Regulations and the 2002 Proposed Regulations. Under the Proposed Regulations' share-by-share basis recovery approach, the remaining $50 of the deemed distribution would be allocated equally between Blocks 1 and 2 as follows: (1) $25 would be offset against *A's* basis of Block 1, thereby reducing its basis to $125; and (2) $25 would be offset against *A's* basis of Block 2, also reducing its basis to $125. After the deemed §368(a)(1)(E) recapitalization, *A* would hold two blocks of 25 shares, each with a $125 basis. Thus, *A* would have a uniform $250 aggregate basis in his 50 remaining Corporation X shares.

Continuing with the revised example, under the 2002 Proposed Regulations' specific-basis recovery approach, after taking into account the $250 dividend, the remaining $50 of the deemed distribution would be offset only against *A's* basis in Block 2, thereby reducing its basis to $100. *A* would retain his $150 basis in Block 1. But unlike the Proposed Regulations (which would allow *A* to retain his unrecovered basis in the Block 2 shares he continues to own after the redemption), the 2002 Proposed Regulations would have treated *A's* $100 of unrecovered basis in his Block 2 shares as a deferred loss. Like the Proposed Regulations, under the 2002 Proposed Regulations, *A* could recognize the $100 deferred loss on the first date on which *A* would satisfy the requirements of §302(b)(1), (2), or (3), if the facts and circumstances that exist at the end of such day had existed immediately after the redemption (referred to in the 2002 Proposed Regulations as the ''final inclusion date''). However, the 2002 Proposed Regulations would have allowed *A* to utilize a dollar-for-dollar amount of the deferred loss if he subsequently recognized any gain on the sale Corporation X shares. This represented a flaw in the 2002 Proposed Regulations.

For instance, continuing with the revised example, under the 2002 Proposed Regulations, if *A* subsequently sold 25 of his remaining 50 shares for $150,

[53] Prop. Regs. §1.302-5(e), *Ex. 1*.

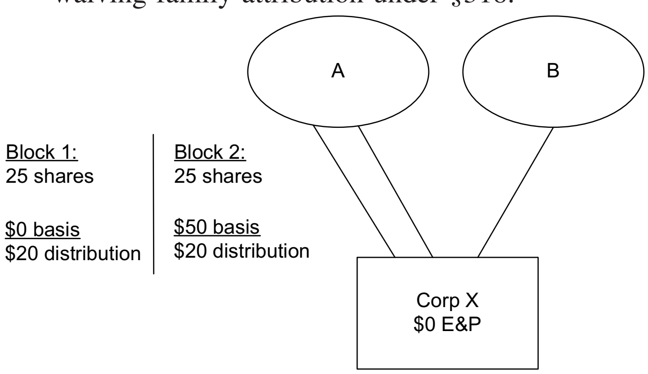
ISSN 0148-8295

he would allocate $75 of his remaining $150 aggregate basis to the sold shares and recognize $75 of gain. But *A* could offset that gain with $75 of the deferred loss, thus recognizing no gain or loss on the sale.[54] In contrast, under the Proposed Regulations, if *A* subsequently sold 25 of his remaining 50 shares for $150, he would allocate $125 of his remaining $250 aggregate basis to the sold shares and recognize $25 gain. Thus, the 2002 Proposed Regulations offered *A* an opportunity to utilize a disproportionate amount of the deferred loss.[55]

As demonstrated in the following example, the Service retained the concept of a deferred loss in the Proposed Regulations, but unlike in the 2002 Proposed Regulations, the deferred loss rule applies only to dividend-equivalent complete redemptions (i.e., when all of the shareholder's shares of a single class are redeemed).

Example 3: Dividend-Equivalent Complete Redemption

Facts. The facts are the same as in Example 2, except that Corporation X, on the following December 31, when it has no current or accumulated E&P, redeems all of *A's* remaining 50 shares for $40. *A* does not file an agreement described in §302(c)(2)(A)(iii) waiving family attribution under §318.



Analysis. Because *A* is treated under §318(a)(1) as owning *B's* shares, the redemption is described in §302(d) and is treated as a distribution to which §301 applies. As in Example 2, immediately before the redemption, the distribution is applied on a pro rata, share-by-share basis with respect to each of the shares in the redeemed class held by *A*. Accordingly, *A* will have a $20 capital gain on Block 1 ($20 distribution − $0 basis) and a $30 capital loss on Block 2 ($20 distribution − $50 basis). *A's* $30 loss is deferred and may be taken into account by *A* only on the inclusion date.[56]

The results in Example 3 highlight the differences between the current regulations, which shift *A's* $30 unrecovered basis in his Block 2 shares to *B*, and the Proposed Regulations, which prevent any basis shift in dividend-equivalent complete redemptions.

While the prohibition against basis shifting makes sense in circumstances (such as in Notice 2001-45 [57]) where the economic relationship between the shareholders was clearly attenuated compared to the relationship imposed by §318,[58] the prohibition against basis shifting appears unnecessarily restrictive in those instances where the redeemed and unredeemed shareholders are part of a single economic unit. For instance, what if *A* and *B*, instead of being husband and wife,[59] are both corporations wholly owned by a single shareholder? What if *A* and *B* are members of the same consolidated group? Previously, the Service ruled that where two members of a consolidated group own stock of the redeeming corporation, and the redeemed member has unrecovered basis from a dividend equivalent-complete redemption, the redeemed member's unrecovered basis in the stock of the redeeming corporation shifts to unredeemed member's basis on the stock of the redeeming corporation.[60]

Even apart from whether the Proposed Regulations should be modified to allow a shareholder to shift unrecovered basis to another shareholder in certain circumstances, another potential hurdle to basis shifting remains: specifically, the Proposed Regulations would prohibit a shareholder from shifting unrecovered basis from a dividend-equivalent complete redemption of

---

[54] *See* former Prop. Regs. §1.302-5(f), *Ex. 2*.

[55] *See* Feld, *Preserving Basis After Redemption* (1/15/03), *reprinted in* 2003 *TNT* 40–45 (2/28/03).

[56] Prop. Regs. §1.302-5(e), *Ex. 2*.

[57] Above fn. 49.

[58] The Service has recognized that the §318 attribution rules are overbroad in other circumstances. *See, e.g.,* Rev. Rul. 74-605, 1974-2 C.B. 97 (§304 does not apply to upstream stock sale notwithstanding literal application under §318); PLR 200637022 (6/6/06) (§304 does not apply to sale of third-tier subsidiary of seller-parent to second-tier subsidiary of buyer-parent where seller-parent and buyer-parent were partners in partnership, notwithstanding literal application under §318).

[59] Of course, the determination of whether a husband and wife constitute an economic unit depends on factors beyond tax, like love. *See, e.g., Haft Trust, et al. v. Comr.*, 510 F.2d 43 (1st Cir. 1975), *rev'g and rem'g* 61 T.C. 398 (1973), *supplemented by*, 62 T.C. 145 (1974) (family hostility could negate §318 attribution in determining qualification under §302(b)(1)); Rev. Rul. 80-26, 1980-1 C.B. 66 (Service will not follow *Haft Trust*).

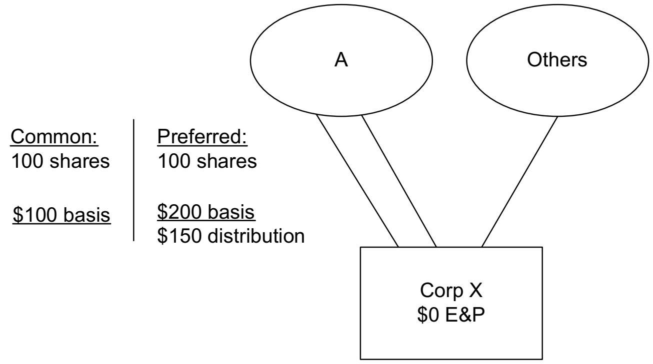
[60] *See* PLR 200810015 (12/4/07); *see also* PLR 9815050 (1/9/98) (shift of ELA). In the preamble to the Proposed Regulations, the Service stated that it "continue[s] to study the issues raised when a redeemed shareholder with a deferred loss files a consolidated return." 74 Fed. Reg. at 3512.

ISSN 0148-8295

one class of stock to unredeemed shares of another class held by the same shareholder. This prohibition on inter-class basis shifting is demonstrated in the following example:

Example 4: No Inter-Class Basis Shifting

Facts. Corporation X has both common and preferred stock outstanding. *A*, an individual, has 100 shares of common stock with a basis of $100 and 100 shares of nonvoting preferred stock with a basis of $200. The 100 shares of common stock represent 50% of voting control of Corporation X. Corporation X, when it has no current or accumulated E&P, redeems all of *A's* preferred stock for $150. Section 302(d) applies to the redemption, and therefore the distribution is treated as a distribution of property to which §301 applies.



Analysis. If Corporation X had declared a distribution under §301 with respect to the redeemed preferred stock, the distribution would have been limited to the shares of common stock. Therefore, the only basis recovered under §301(c)(2) is the basis of *A's* preferred stock.[61] *A* has $50 in excess basis after the redemption of all its preferred stock,

[61] *See Kinch v. Comr.*, 1 T.C.M. 147 (1942) (corporation distributed (1) $42,000 on preferred stock (in which taxpayer had a

ISSN 0148-8295

which will not shift to the common stock held by *A*. Under Regs. §1.302-5(a)(3), the $50 unrecovered basis is treated as a deferred loss until the inclusion date.[62]

The results in Example 4 are in contrast to those that allow a shareholder to shift unrecovered basis from the redeemed class to an unredeemed class.[63] This disparate treatment can impact *A's* recognition of gain or loss on subsequent sales of redemptions of his Corporation X common stock.

For example, following the application of the Proposed Regulations, assume Corporation X subsequently redeems 50 of *A's* shares of common stock (having a basis of $50) for $1. The redemption would satisfy the requirements of §302(b)(2); as a result, *A* would recognize a $49 capital loss on the redemption of the common stock. The sale would also constitute an inclusion date,[64] and *A* would take into account all of the $50 deferred loss. Thus, *A* would have a total loss of $99.

In contrast, under current law, *A's* $50 of unrecovered basis from his preferred stock shifts to his common stock; thus *A's* basis in his common stock would be $150. Upon the redemption of 50 of *A's* shares of common stock (having a basis of $75) for $1, *A* would recognize a $74 capital loss. Thus, in comparison to current law, the Proposed Regulations would allow *A* to accelerate the recognition of a greater amount of his loss on his shares of common stock. While this aspect of the Proposed Regulations may seem reminiscent of the problems in the 2002 Proposed Regulations,[65] it is actually consistent with the treatment that would occur if, in Example 4, instead of redeeming *A's* preferred stock, Corporation X had distributed the $150 as a dividend on the preferred stock. In that case, *A* would have $50 of basis remaining in his preferred stock. If Corporation X subsequently redeemed the preferred stock (having a basis of $50) and 50 shares of *A's* common stock (having a basis of $50) for $1, the redemptions would each satisfy the requirements of §302(b)(2)[66] and *A* would recognize $99 of loss.

Conclusion

The Proposed Regulations' provisions regarding basis recovery in dividend-equivalent redemptions represent a significant improvement over the 2002 Proposed Regulations. Nevertheless, the Proposed Regulations leave open many questions, particularly whether a shareholder's unrecovered basis in a dividend-equivalent complete redemption should be permitted to shift to another taxpayer with whom the redeemed shares an economic relationship (such as members of the same controlled group or consolidated group).

$300,000 basis) and (2) $150,000 on its common stock (in which taxpayer had $0 basis); distribution exceeded corporation's E&P; taxpayer not permitted to use any of his basis in preferred stock to offset gain on common stock).

[62] Prop. Regs. §1.302-5(e), *Ex. 3*.

[63] *See U.S. v. Davis*, 397 U.S. 301 (1970) (interpreting Regs. §1.302-2(c) to shift shareholder's unrecovered basis in redeemed stock to other shares held by the redeemed shareholder, even where those other shares are of a different class of stock than those redeemed); Rev. Rul. 66-37, 1966-1 C.B. 209 (same).

[64] *See* Regs. §1.302-2(a) (redemption of nonvoting preferred stock can satisfy §302(b)(2) if simultaneous redemption of voting common stock also satisfies requirements).

[65] See above text accompanying fn. 55.

[66] See above fn. 64.

ISSN 0148-8295