(C) Tax Analysts 2012. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Right Basis? Basis in Distributed Subscription Rights

By Afshin Beyzaee

Afshin Beyzaee

Afshin Beyzaee is a tax partner in the Los Angeles office of Liner Grode Stein Yankelevitz Sunshine Regenstreif & Taylor LLP.

The author would like to thank Hatef Behnia for his valuable comments and suggestions.

In this report, Beyzaee describes the basic rules regarding a shareholder's basis in subscription rights distributed by a corporation with respect to its shares. He discusses how those rules fail to specify the proper allocation of a shareholder's basis when the shareholder disposes of his preexisting shares while retaining those distributed rights and how that gap in the rules allows for potential abuses. He also explains why some seemingly relevant general tax rules do not provide a satisfactory solution. Finally, he proposes two alternative regulatory revisions to resolve the problem.

The information herein is of a general nature and based on authorities that are subject to change. Its applicability to specific situations should be determined through consultation with your tax adviser. This report represents the views of the author only and does not necessarily represent the views or professional advice of Liner Grode Stein.

Copyright 2012 Afshin Beyzaee.
All rights reserved.

Table of Contents

I.	**Basic Rights Basis Rules**	915
	A. General Rule	916
	B. Problems	917
II.	**Unsatisfactory Solutions**	919
	A. Open Transaction	919
	B. Corrective Provisions	919
III.	**Proposed Rules**	920
	A. Reallocation of Basis	921
	B. Treating Rights the Same as Shares	921
IV.	**Conclusion**	922

A corporation occasionally will distribute to its shareholders rights to acquire its stock (sometimes referred to as subscription rights). Typically, the rights are distributed as part of a reorganization, to raise additional capital from existing shareholders, or under "poison pill" or "net operating loss preservation" shareholder rights plans. Treasury regulations governing a shareholder's basis in those distributed rights have been in effect for over half a century without change. However, there is a gap in the rules that seems ripe for abuse: There is no provision specifying the proper allocation of a shareholder's basis when the shareholder disposes of his preexisting shares while retaining the distributed rights.

I. Basic Rights Basis Rules

Section 305 provides that gross income does not include the value of stock of a corporation distributed to its shareholders.[1] Section 305(d) further provides that the term "stock" includes rights to acquire stock of the distributing corporation.[2] Thus, the distribution of rights is generally not a taxable event for the recipient.[3]

Under section 307(a), the secretary is directed to prescribe regulations describing how basis is to be allocated between the shares distributed and the shares for which that distribution was made. The secretary has provided rules for the allocation of basis for those situations in reg. section 1.307-1 and -2. The rules generally function well for allocating

---

[1]This report will deal only with stock that is not section 306 stock as defined in section 306(c). Section 306 provides special rules for stock other than common stock that is distributed for common stock.

[2]For some time, there was uncertainty about whether the distribution of rights to acquire property of the distributing corporation at a price below the property's fair market value was an immediate distribution of property to the recipients. The question appears to have been settled in favor of treating that as a distribution of property to the shareholders subject to section 301. *See* Rev. Rul. 70-521, 1970-2 C.B. 72; *Redding v. Commissioner*, 630 F.2d 1169 (7th Cir. 1980); and the cases cited by those authorities. Given the specific treatment of rights as stock under section 305(d), those authorities are not applicable to a distribution of rights to acquire stock of the distributing corporation. Accordingly, while an analysis of those authorities may be useful, they are better addressed at another time.

[3]Section 305; *Miles v. Safe Deposit & Trust Co.*, 259 U.S. 247 (1922); reg. section 1.307-1(b), example.

basis to distributed shares of stock, but some significant problems arise when applying the rules to allocate basis to distributed rights.

A. General Rule

Reg. section 1.307-1(a) provides the general rule for when a shareholder receives a tax-free distribution of stock from his common stock. The shareholder's basis in his existing shares is to be allocated between the existing shares and the distributed shares in proportion to their fair market values on the date of the distribution.

Example 1: Shareholder A owns two shares of C Corp. stock. Each share has a basis of $15 (for a total basis of $30) and an FMV of $60. C distributes one share of common stock to each shareholder for every two shares of common stock the shareholder owns. Immediately after the distribution, the value of each share is $40. A's total basis of $30 is allocated equally among the three shares, giving him a basis of $10 in each share.

The rule for distributed rights is slightly different. After setting out the rule described above for distributions of stock, reg. section 1.307-1(a) goes on to provide that ''the general rule will apply with respect to stock rights only if such rights are exercised or sold.''[4] Although the language in the regulations leaves some ambiguity, Rev. Rul. 74-501 makes clear that the general rule to which that sentence refers is the one described earlier in the regulations for allocating basis in the case of distributions of stock.[5] Then, when the rights are exercised, the exercise price is added to the basis allocated to the rights to yield the basis of the shares received on exercise.[6]

The following examples illustrate the rule:

Example 2: Shareholder A owns two shares of Corporation C stock. Each share has a basis of $15 (for a total basis of $30) and an FMV of $60. C distributes one right to acquire a single share for every two shares of common stock held. The exercise price of the right is $30. The FMV of the right after the distribution is $20, and the FMV of each share after the distribution is $50.[7] A exercises the right. On the exercise of the right, the basis of the preexisting shares is allocated between the preexisting shares and the right based on their relative FMVs immediately after the distribution. Thus, $12.50 of the basis in the preexisting shares goes to each preexisting share,[8] and $5 of the basis in the preexisting shares goes to the right.[9] The $5 basis allocated to the right plus the $30 exercise price yields a basis in the new share of $35.

Example 3: The facts are the same as in Example 2, except that instead of exercising the right, A immediately sells the right for $20. Again, $12.50 of

---

[4]Section 307(b) also provides that if the value of the distributed rights is less than 15 percent of the FMV of the shares with respect to which they were distributed at the time of the distribution, the shareholder's basis in the rights will be zero, unless the shareholder irrevocably elects to determine the basis of the rights and the shares under the rules otherwise provided. That de minimis rule was added in the 1954 code as a simple rule to ''eliminate, unless the recipient elects otherwise, the problems of allocation.'' H.R. Rep. 1337, A89; *see also* S. Rep. 1622, 43-44 (''Your committee has provided a rule to eliminate the necessity under present law of making negligible basis allocations between stock and stock rights issued on such stock''). The problems described in this report arise only when the rights are at least 15 percent of the value of the shares at the time of the distribution or when the shareholder makes the election described in section 307(b)(2). Thus, for the sake of simplicity, all references to rights in this report refer to rights that fall into one of those two categories.

[5]1974-2 C.B. 98 (''Section 1.307-1(a) of the regulations provides that the general rule of section 307(a) will apply with respect to stock rights only if such rights are exercised or sold'').

[6]Reg. section 1.307-1(b). The formulas for allocating basis as illustrated in the regulations are as follows:

(Footnote continued in next column.)

$$SB = \left(\frac{S}{S+R}\right) \text{ x } OB \quad \text{and} \quad RB = \left(\frac{R}{S+R}\right) \text{ x } OB$$

where SB is the basis allocated to the shares with respect to which the right was distributed, RB is the basis allocated to the right, S is the FMV of the shares immediately after the distribution, R is the FMV of the right immediately after the distribution, and OB is the basis in the shares immediately before the distribution. It is useful to note that the formulas described in reg. section 1.307-1(b) are different from the formulas described in *Miles*. In *Miles*, the court used the following formulas (assuming one right distributed in respect of each preexisting share):

$$SB = \frac{OB + EP}{2} \quad \text{and} \quad RB = \left(\frac{OB + EP}{2}\right) - EP$$

where EP is the exercise price of the right. That method was adopted for a time by the IRS in reg. 65, Article 39 (T.D. 3940, Revenue Act of 1924) before being revised to the existing formulation.

[7]For the purposes of this report, the value of a share is being determined to be its share of the corporate assets on a liquidation basis, and the value of a right is being determined to be the difference between the value of the share that will be received on exercise and the exercise price of the right. I acknowledge that there may be a variety of considerations, such as prevailing market conditions, tax rates, and minority discounts, that may yield different results. However, for the sake of simplicity, those considerations are being ignored here. An expert in valuation should be consulted regarding any valuation issues. The values in this example are determined as follows:

$$\textit{Value of Right} = \frac{\textit{Value of Preexisting Shares + Exercise Price}}{\textit{\# of Shares After Exercise}} - \textit{Exercise Price} = \frac{(2 \text{ x } \$60) + \$30}{3} - \$30 = \$20$$

$$\textit{Value of Share} = \frac{\textit{Value of Preexisting Shares + Exercise Price}}{\textit{\# of Shares After Exercise}} = \frac{(2 \text{ x } \$60) + \$30}{3} = \$50$$

[8]$$\textit{Basis of Each Preexisting Share} = \left(\frac{\$50}{\$50 + \$50 + \$20}\right) \text{ x } \$30 = \$12.50$$

[9]$$\textit{Basis of Right} = \left(\frac{\$20}{\$50 + \$50 + \$20}\right) \text{ x } \$30 = \$5$$

(C) Tax Analysts 2012. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

(C) Tax Analysts 2012. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

basis is allocated to each preexisting share, and $5 of basis is allocated to the right. A has $15 of gain on the sale of the right.

In Example 2, if A immediately sells the new share received on the exercise of the right at its FMV of $50, he effectively recovers $20 of the pre-distribution value of his investment and recovers $5 of his pre-distribution basis.[10] Thus, he recovers one-sixth of the value and one-sixth of the basis. That is the same as the outcome in Example 3. Those results are clearly correct: As with any other sale or exchange of a partial interest, the taxpayer recovers basis in the same proportion as the proportionate value of the interest sold.[11] Moreover, just as A's final economic situation is exactly the same regardless of whether he exercises the right and immediately sells the new share he receives or just directly sells the right, so too is his tax result the same. The end point is the same, so it is correct that a different path does not change the result.

B. Problems

So far, so good. When the shareholder immediately exercises the right or sells the right while retaining the old shares, the results make sense. But that sensibility fades as new fact patterns emerge.

Example 4: The facts are the same as in Example 2, except that instead of exercising the right, A lets the right expire unexercised but continues to hold the preexisting shares.

What is the answer here? Reg. section 1.307-1(a) provides that "the general rule will apply with respect to stock rights *only if* such rights are exercised or sold" (emphasis added). But what is the rule when the rights are neither exercised nor sold? The current regulations, which were adopted in 1955 under the 1954 code, were the first to use the "only if" language.[12] However, the preceding regulations, promulgated under the corresponding provision of the 1939 code — section 113(a)(19) — were similar in that they provided rules for when the right was sold and when the right was exercised before the preexisting shares were sold, but not when the preexisting shares were sold before either of those events.[13] Moreover, there is no legislative history or any preambles to any regulations that shed any light on that question.[14]

What appears to be the most straightforward reading of the regulations is that no basis is allocated to the right *until* it is exercised or sold. So, if the right expires unexercised, no basis is ever allocated to it. On its face, that seems reasonable because it prevents a shareholder from recognizing a loss by allowing the right to expire while continuing to hold the existing investment. For Example 4, that yields what could be considered the correct result.[15] But, consider the following example:

Example 5: The facts are the same as in Example 2, except that A continues to hold the right without exercising it and immediately sells the old shares at their FMV of $50 each.

Does the proposal for resolving Example 4 still work? When A sells the preexisting shares, it is impossible to know whether the right will be exercised, sold, or allowed to expire. The plain language of the regulations stipulates that the allocation rule cannot apply if the right is not exercised or sold, which suggests that the entire basis remains with the preexisting shares and is fully recovered by A on the sale of the preexisting shares. So even though A has an ongoing investment in C, he will have fully recovered his tax basis, which is very unusual under the tax framework for investments in corporations. The following example underscores the issue:

Example 6: Shareholder B owns two shares of Corporation C stock. Each share has a basis of $60 (for a total basis of $120) and an FMV of $60 (for a total FMV of $120). C distributes one right to acquire a single share for every two shares of common stock held. The exercise price of the right is $30. The FMV of the right after the distribution is $20, and the FMV of each share after the distribution is $50.[16] B continues to hold the right without exercising it and immediately sells the preexisting shares at their FMV of $50 each.

Those facts are identical to those in Example 5, except that B has basis equal to the FMV of the shares immediately before the distribution rather than the lower basis that A has. Economically, B continues to have $120 of value: $100 of cash and a right worth $20. If no basis is allocated to the right,

---

[10] The value A has in shares will be reduced from $120 to $100, and the net value he has in cash is increased from $0 to $20 ($50 of proceeds, less $30 of exercise price). The basis remaining in the shares is $25, down from the original $30.

[11] Reg. section 1.61-6(a); Rev. Rul. 77-413, 1977-2 C.B. 298.

[12] T.D. 6152 (Dec. 2, 1955).

[13] *See*, *e.g.*, 26 CFR section 19.113(a)(19)-1 (1940 Supp.), 26 CFR section 39.113(a)(19)-1 (1954). The formulation used for the 1939 code was used as far back as the Revenue Act of 1926 in reg. 69, Art. 69 (T.D. 3922). Before that, the formulation described in *Miles* was used beginning with the regulations for the Revenue Act of 1924 in reg. 65, Art. 39 (T.D. 3940). Before the Revenue Act of 1924, all amounts realized on the sale of rights was income, so

(Footnote continued in next column.)

there was no allocation issue. *See*, *e.g.*, reg. 45, Art. 39 (T.D. 2831) (Rev. Act of 1918); reg. 62, Art. 39 (T.D. 3295) (Rev. Act of 1921).

[14] *Id.*, T.D. 6152, H.R. Rep. 1337, A89, S. Rep. 1622, 43-44.

[15] As discussed in Section III.B, there is a good argument that some basis should have been allocated to the right, allowing the taxpayer a loss in this situation.

[16]
$$\textit{Value of Right} = \frac{\textit{Value of Shares + Exercise Price}}{\textit{\# of Shares After Exercise}} - \textit{Exercise Price} = \frac{(2 \times \$60) + \$30}{3} - \$30 = \$20$$

$$\textit{Value of Share} = \frac{\textit{Value of Shares + Exercise Price}}{\textit{\# of Shares After Exercise}} = \frac{(2 \times \$60) + \$30}{3} = \$50$$

the result is that B actually recognizes a *loss* for tax purposes without any corresponding economic loss.[17]

Here, it seems that a portion of the basis should have been allocated to the right after all. As noted above, however, the regulations would seem to prohibit that, as the right had not been exercised or sold at the time. The following variations help illustrate why the problem arises:

Example 7(a): The facts are the same as in Example 6, except that B sells the right for its FMV of $20, then sells one preexisting share for its FMV of $50 and retains the other preexisting share.

Example 7(b): The facts are the same as in Example 6, except that B later exercises the right and receives a new share worth $50.

Example 7(c): The facts are the same as in Example 6, except that B allows the right to expire unexercised.

The economic results in the first two variations are identical: B will have $70 of cash and one share of stock of C worth $50. In Example 7(a), the rule provides that the basis is allocated in accordance with the general rule, resulting in $50 of basis in the retained preexisting share and no gain or loss on the sale of the other preexisting share and the right. Because the end result in Example 7(b) is economically identical to that in Example 7(a), the tax result should be the same. Can we get there under the regulations?

The correct answer seems to be to allocate a portion of the basis in the preexisting shares to the right when either the right or the preexisting shares are sold. That results in no gain or loss on the preexisting shares and the right sold and a $50 basis in the share retained. Because the right has been exercised or sold, that would be consistent with the regulations. Unfortunately, after considering Example 7(c), the result is not so clear.

In Example 7(c), it seems sensible for a portion of the basis to have been allocated to the right, resulting in a $20 loss when the right expires rather than when the preexisting shares were sold. But recall that the regulations very clearly state that basis is allocated to the right *only if* it is exercised or sold. Because the right is never exercised or sold in Example 7(c), that allocation of basis to the right would be in direct contravention of the text of the regulations.

That conundrum arises because when the preexisting shares are sold, B may not know whether it will end up with the facts in Example 7(b) or the facts in Example 7(c). What is B to do on his return for the year the preexisting shares are sold? If he allocates the basis in contravention of the regulations, he forgoes a loss in the year of the sale with the expectation of recovering the basis allocated to the right in the subsequent year. If the right expires, B is left in a precarious position. The IRS could easily claim that he is not entitled to any loss in the subsequent year because the allocation to the right was forbidden by the regulations. And by that time, the statute of limitations could have run on the prior year that includes the sale of the preexisting shares. That means that if the IRS successfully denies the loss, B is left in the difficult position of having to look to the mitigation provisions to try to recoup that basis in the prior year.

Alternatively, if B follows the prescription in the regulations and keeps the entire basis allocated to the preexisting shares, he will claim a loss on the sale of those preexisting shares even though he has suffered no economic loss.[18] Certainly the IRS would be suspicious of that. If B had intentionally exploited the gap in the rules, it would be hard to imagine the IRS not challenging him on it, and perhaps rightfully so. But, it hardly seems fair to give a taxpayer who unwittingly finds himself in those circumstances the difficult choice between taking a position that is contrary to the Treasury regulations and taking a position that appears so aggressive.

Where does this leave us? So far, the situations fall into three broad categories:

- If the taxpayer still owns the preexisting shares when the right is sold or exercised, as in examples 2, 3, and 7(a), it is clear under the regulations that the basis in the preexisting shares is partially allocated to the right. That result seems correct.
- If the taxpayer retains the preexisting shares and allows the right to expire, as in Example 4, it appears under the regulations that the basis remains allocated to the preexisting shares. Although there may be good arguments for allocating some of the basis to the right even in this situation, the result hardly seems objectionable.
- If the taxpayer disposes of the preexisting shares but retains the right unexercised, as in examples 5, 6, 7(b) (before exercising the right),

[17]B would have received $100 for shares in which he had a basis of $120, yielding a loss of $20. Note that if B were to later sell the right for $20, he would recognize a $20 gain that would offset the $20 loss that he recognized on the sale of the shares. That would allow B to improperly accelerate the loss.

[18]Indeed, in some cases, such as if he were to sell the preexisting shares at $55 per share, B would have an economic gain and yet still be claiming a loss for tax purposes.

(C) Tax Analysts 2012. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

and 7(c) (before allowing the right to expire), the tax treatment is unclear, although the regulations seem to require that all the basis remain with the preexisting shares and be recovered on their sale. If correct, this result is inappropriate and susceptible to significant abuse. If there is another result that is more appropriate, however, it is equally problematic in that a taxpayer would be hard-pressed to discern it from the existing law, particularly given the language of the regulations.

II. Unsatisfactory Solutions

A. Open Transaction

One suggestion could be to adopt an approach similar to an open transaction. Under that rule, if a shareholder with preexisting shares and rights disposes of the preexisting shares but retains the rights, the tax consequences to the shareholder of the disposition of the preexisting shares will not be determined until the rights are sold, exercised, or allowed to expire. While that rule would be consistent with the regulations and would yield the proper tax consequences, it would be inconsistent with the general tax rule that each tax year stand on its own, and it would be difficult to administer.

The federal income tax system is based on the general principle that tax is assessed ''on the basis of annual returns showing the net result of all the taxpayer's transactions during a fixed accounting period.''[19] Just as there are other exceptions to that general rule, the allocation of basis on the distribution of rights could be a time when that rule could be changed.[20] But this approach is not without its own difficulties. Unlike other cases when the annual accounting period rule is contravened, this is a situation in which the consequences associated with one asset would be determined by reference to a completely separate asset.

As a prime example, assume the shareholder gifts the preexisting shares to a third party but retains the rights. Under section 1015(a), the donee's basis in the preexisting share would be based on the shareholder's basis in the shares at the time of the gift. Under that rule, at the time of the gift, the donor's basis still would not be fixed, so the donee would not be able to determine his basis.[21] That would put the donee in the unusual position of having shares in which his basis would depend on a third party's actions — that is, if the donor were to exercise or sell the right, the donee's basis would be lower than if the donor were to allow the right to expire. Further, if the donee were to sell the preexisting shares before the right was sold, exercised, or allowed to expire, the actual tax liability of the donor would appear to be determined based on the actions of a third party. That is hardly a satisfying result.

Similar problems could arise in the distribution of preexisting shares by a partnership to its partners. Under section 732, a partner generally takes property distributed by a partnership with the same basis as the partnership had in the property. One could easily imagine a situation when a partnership distributes the preexisting shares to its partners but retains the right.[22] That would create the same complications as in the gift of the preexisting shares. Moreover, it seems to open up the possibility of abuse by allowing a partnership to shift basis between itself and its partners.

That solution may work well in some situations, but it seems to create more complications in others. Ultimately, it seems to be an unnecessarily complicated approach to adopt intentionally.

B. Corrective Provisions

There are several statutory and common law rules that are intended to alleviate the harsh results that sometimes arise by reason of the principle that each tax year stands on its own. Among those are the mitigation provisions described in sections 1311 through 1314, the tax benefit doctrine, and the duty of consistency. Those rules appear to provide a solution to the allocation problem for rights. As discussed above, the main problem is that the regulations appear to provide a rule that depends on facts that may not be determined until a future year. The problem with all the corrective rules is that while they are designed to avoid inequities that result from errors or inconsistencies, they do not provide the actual rule of law that applies in the first instance.

---

[19]*Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 363 (1931).

[20]Exceptions include the open transaction doctrine (*Burnet v. Logan*, 283 U.S. 404 (1931)), the treatment of option premiums (*Virginia Iron Coal & Coke Co. v. Commissioner*, 99 F.2d 919 (4th Cir. 1938)), and claim of right (section 1341).

[21]Consider the applicability of the rule in section 1015(a) that provides that when ''the facts necessary to determine the basis in the hands of the donor . . . [are] impossible to obtain,'' for that purpose, the basis in the hands of the donor is its FMV at the time the donor acquired the asset. *See also* reg. section 1.1015-1(a)(3). If that were applicable (a question that is beyond the scope of this article), the donee would appear to obtain the higher original basis even if the donor ultimately sold or exercised the right.

(Footnote continued in next column.)

[22]Note even that if the partnership distributed the right, it would appear that the plain language of the regulations would not allow an allocation of basis, because the right would not have been ''exercised or sold.'' It would not be surprising, however, if a court were to read the word ''sold'' to include any disposition.

(C) Tax Analysts 2012. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

1. Mitigation provisions. The mitigation provisions provide relief when either the taxpayer or the IRS takes an erroneous position in one year and later takes an inconsistent position after the initial tax year is closed. In that situation, the mitigation provisions allow either the taxpayer or the Service to recover the tax or the benefit that was erroneously realized in the past. They provide an equitable remedy that is designed to keep taxpayers and the IRS from taking unfair advantage of the statute of limitations rules to enjoy a double benefit.[23]

Those provisions might apply if a taxpayer that was damaged by a fire erroneously thought that the fire was in 2000 and claimed a deduction in that year. Later, the taxpayer realizes that the fire was actually in 2001 and files a claim for a refund for the 2001 tax year after the statute of limitations for the 2000 tax year has expired. If the IRS allows the refund for the 2001 tax year, the mitigation provisions would allow it to assess additional tax attributable to the deduction taken in the 2000, despite the statute of limitations.[24]

But the mitigation provisions will not operate to rectify the situation unless one of the parties took an erroneous position in a prior year. Thus, there must be a correct position that is to be taken at the time. The mitigation provisions do not provide that answer.

2. Tax benefit doctrine. The tax benefit doctrine is a rule that allows the taxpayer or the IRS to ''cancel out'' a prior deduction with a current income inclusion when there is a later event that is ''fundamentally inconsistent with the premise on which the deduction was initially based. That is, if that event had occurred within the same taxable year, it would have foreclosed the deduction.''[25] That doctrine is commonly applied when a taxpayer takes a bad debt deduction but collects the debt in a later year. The key to the application of the tax benefit doctrine is that there must be an event that is fundamentally inconsistent with the tax treatment of the prior event in that the tax treatment of the prior event would have been different if both events had occurred in the same tax year. The underlying premise is that the rule that determined the tax consequence for the prior year would have yielded different tax consequences for that event if the taxpayer or the IRS knew at the time that the later event would occur. The rule is designed to deal with the fact that in the year of the first event, neither the taxpayer nor the Service has perfect information about the future.

Whether the tax benefit doctrine applies depends on what the rule is regarding the tax consequences when the shareholder disposes of the preexisting shares but retains the rights. If the rule is such that the tax consequences on the disposition of the preexisting shares depend on what the shareholder does with the rights (along the lines of the open transaction approach discussed above), then the tax benefit rule would apply. If the rule is such that the tax consequences on the disposition of the preexisting shares are determined without regard to what the shareholder does with the rights, then the tax benefit rule would not apply. However, the tax benefit doctrine does not determine which of the two is the case.

3. Duty of consistency doctrine. The duty of consistency, or quasi-estoppel, doctrine would not work to rectify the problem, either. According to the courts, a taxpayer who benefits from a misrepresentation in an earlier year on which the statute of limitations has run, is precluded by a duty of consistency from taking the position that his tax in a later year should be reduced because the earlier misrepresentation was incorrect and he should have paid more tax in that earlier, closed year instead.[26] For the duty to apply, the taxpayer must have made a misrepresentation of fact, not of law, and the IRS must have reasonably relied on that misrepresentation.

When basis allocation problems arise, the taxpayer does not make any misrepresentations, so that doctrine would not apply. Again, the problem does not arise because of a mistake, misrepresentation, or misunderstanding of facts, but rather because the rules for determining the tax consequences are unclear. The duty of consistency does not correct for problems that arise when the law is not clear; it only applies to correct for problems that arise when there is a misrepresentation of fact. So, that doctrine is not helpful, either.

III. Proposed Rules

What follows are two possible solutions to the problems described in this report. The first accepts the premise that if the right is allowed to expire unexercised, the holder should not be allowed a loss. The second challenges that premise and provides what appears to be the more economically correct rule.

[23]*See* Michael I. Saltzman, *IRS Practice and Procedure*, para. 5.05 (Feb. 2012).

[24]Example adapted from Boris Bittker and Lawrence Lokken, *Federal Taxation of Income, Estates, and Gifts*, para. 113.9 (Feb. 2012).

[25]*Hillsboro Nat'l Bank v. Commissioner*, 460 U.S. 370, 383-384 (1983).

[26]*See Southern Pac. Trans. Co. v. Commissioner*, 75 T.C. 497, 559-561 (1980).

(C) Tax Analysts 2012. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

(C) Tax Analysts 2012. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

A. Reallocation of Basis

The reason it is difficult to determine the tax consequences when the preexisting shares are sold but the rights are retained is that at the time of the sale of the preexisting shares, it is still not known whether the taxpayer will exercise, sell, or allow the rights to expire. While no statement from Treasury was found explaining its reasoning for adopting the special rule for rights in reg. section 1.307-1(a), it appears to have been concerned about shareholders who would recognize a loss by allowing the rights to expire but retaining an ongoing investment in shares of the corporation. The solution Treasury adopted, however, produces the problems described above.

There is an alternative rule that appears to address the Service's concern while avoiding the issues described above. The rule would operate as follows:

1. At the time of the distribution, the basis in the preexisting shares is allocated between the preexisting shares and the right based on their respective FMVs at the time of the distribution.

2. If the shareholder allows the right to expire before disposing of the preexisting shares, the basis in the rights will be allocated back to the preexisting shares, and the shareholder shall recognize no loss as a result of the expiration of the rights.

That rule resolves the problems described above and still addresses the concern about shareholders improperly recognizing a loss without terminating their investments by merely allowing the rights to expire.

That rule could be adopted by making minor revisions to reg. section 1.307-1. First, the last sentence of reg. section 1.307-1(a) should be removed and replaced with the following:

> In the case of stock rights, if the stockholder retains such rights and allows them to expire prior to disposing of the stock previously held, the basis allocated to such rights under the rule described in this paragraph will be reallocated back to the stock previously held.

Second, the example in reg. section 1.307-1(b) would have to be updated to reflect the new rule.

B. Treating Rights the Same as Shares

Another alternative would be to simply eliminate the special rule for rights and treat them the same as shares that are distributed for shares. As discussed above, there is a good argument for that result. Economically, the rights are no different from shares, so there is no reason why they should be treated differently.

Recall Example 4. There, A allows the right to expire while retaining the preexisting shares. Some might argue that A should not be allowed a loss when the right expires because that is a phantom loss, as A has the same preexisting shares he had before the distribution. But that ignores the economic reality of the situation. Because it was assumed that the right had a positive value, A's failure to exercise it means that A has lost economic value ($20 in that example). By allowing the right to expire, A either was allowing himself to be diluted by the other holders who did exercise their rights or was giving up a right to dilute other holders who did not exercise their rights. Either way, A would have a smaller percentage ownership of C than if he exercised the rights.

Compare that with the following example:

Example 8: The facts are the same as in Example 2, except that instead of distributing a right, C distributes two-fifths of a share of common stock for every two shares of common stock held. After the distribution, each whole share is worth $50 (meaning the fractional share is worth $20).[27] According to the Treasury regulations, the existing basis is allocated pro rata among all the shares. Thus, $12.50 of the basis in the preexisting shares goes to each whole share (meaning the fractional share is allocated a basis of $5).[28] A abandons the two-fifths share he received as a distribution.

In Example 8, it is clear that under section 165, A would be allowed a loss of $5.[29] Because allowing the right to expire in Example 4 is economically equivalent to abandoning the fractional share, why should A's tax position be any different? Indeed, if A exercised the right in Example 4 for $30 and then sold it for $30, thereby effectively ''abandoning'' the $20 of value attributable to the right, it is clear he would be allowed the loss of $5 of basis allocated to the right (see Example 2). In light of that, the better result seems to be to completely dispense with the special rule for rights.

To accomplish that, all that is needed is to eliminate the last sentence of reg. section 1.307-1(a) and revise the example in reg. section 1.307-1(b) to conform to the revised rule.

---

[27] $$\textit{Value of Each Share After Distribution} = \frac{\textit{Aggregate Value of Shares Before Distribution}}{\textit{\# of Shares After Distribution}} = \frac{\$120}{2.4} = \$50$$

[28] $$\textit{Basis of Each Share After Distribution} = \frac{\textit{Aggregate Basis of Shares Before Distribution}}{\textit{\# of Shares After Distribution}} = \frac{\$30}{2.4} = \$12.50$$

[29] Reg. section 1.165-5(i).

IV. Conclusion

The Treasury regulations governing the allocation of basis between shares and rights distributed with respect to those shares leave a gap when the shares are sold and the rights are retained. That gap appears to be susceptible to abuse by unscrupulous taxpayers and a source of frustration or anxiety for scrupulous taxpayers. The first proposed solution appears to fill that gap in an appropriate way. The second proposed solution resolves the problem by eliminating the special rule. Regardless of whether either proposal or an alternative is adopted, Treasury should solve the problem.

It takes a lot of hard work to become an expert.

Fortunately, it's much easier to remain one.

To update their expertise each day, tax professionals simply look to *Worldwide Tax Daily*.
It's the only daily service for timely international tax news and developments from more than 180 countries – with news stories and analyses by more than 200 correspondents and practitioners.
To learn more, visit us at taxanalysts.com.

worldwide tax daily®
taxanalysts® *The experts' experts.*℠

(C) Tax Analysts 2012. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.