WNTS Insight

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Important guidance on estimating outside stock basis in transferred basis transactions

The IRS recently issued Rev. Proc. 2011-35, which establishes four safe-harbor methods for estimating an acquiring corporation's outside basis in stock acquired in certain transactions, including section 351 transactions, "B" reorganizations, and reverse triangular reorganizations covered by section 368(a)(2)(E). This guidance may be extremely helpful for corporations that are considering making or that have made such an acquisition and is especially important for transferred basis transactions involving publicly traded targets.

The new guidance provides updated and expanded safe-harbor estimation methodologies for establishing the acquirer's basis in the target corporation's shares by reference to basis of the target's shareholders. The guidance includes a new estimation method for older transactions not covered by previous guidance.

The most favorable estimation method allowed by the new guidance requires certain data collection steps to be taken as near as possible to the target's acquisition date. Delays in obtaining necessary data will erode the amount of basis established.

Rev. Proc. 2011-35 is effective for transactions completed on or after June 20, 2011. Taxpayers may choose to apply it to earlier transactions.

Background

When a corporation is acquired in a tax-free stock acquisition, under certain conditions the acquirer may inherit a carryover basis in the target’s stock. As a practical matter, the carryover basis of the target stock in the hands of target shareholders is almost impossible to determine if the target was widely held and publicly traded. To overcome these difficulties, practitioners often employ estimation procedures, but there has been considerable disagreement regarding which sampling and modeling methodologies are appropriate.

Rev. Proc. 81-70 provided guidelines for estimating stock basis acquired in a "B" reorganization if documentary proof is unavailable. Under the guidelines, the preferred way to make these basis determinations was a survey of the surrendering target shareholders using statistical sampling techniques. Since that guidance was issued, however, fewer shares have been held in “certificated” or “registered” form as more investors buy and sell shares through brokerage accounts. As a result, these "street name" shareholders no longer can be identified and surveyed. The benchmarks in Rev. Proc. 81-70 thus have become nearly impossible to satisfy, as confirmed by IRS Notice 2004-44, which requested comments on the earlier guidelines.

Late in 2008, the IRS released Notice 2009-4, which expanded Rev. Proc. 81-70 by creating safe harbors for estimating stock basis in transferred basis transactions. The Notice provided three safe harbor methods and specified when each one would be appropriate.

Notice 2009-4 forecast release of an expanded version of Rev. Proc. 81-70 that would become effective for transactions on or after the date issued. Rev. Proc. 2011-35, which declares both Rev. Proc. 81-70 and Notice 2009-4 to be obsolete for transactions completed on or after June 20, 2011, provides what the IRS considers to be final guidance on this subject. Rev. Proc. 2011-35 restates Notice 2009-4's safe harbors and Rev. Proc. 81-70's statistical methodology with both new limitations and important liberalizations.

Key aspects of Rev. Proc. 2011-35

Rev. Proc. 2011-35 establishes four safe-harbor methods:

- A "survey method" safe harbor for "reporting shareholders" and for all or a sample of nonreporting shareholders;
- A statistical sampling safe harbor for nonreporting shareholders;
- A "certificate method" safe harbor for nonreporting registered shareholders and reporting registered shareholders who failed to respond to the survey; and
- A "basis modeling" safe harbor for nonreporting nominees and reporting nominees who failed to respond to the survey.

Note: The term "reporting" shareholder means a person holding five percent or more of a public company or one percent or more of a private company, an officer or director, or an employee plan. "Registered" shareholders are those holding shares in certificate form. "Nominees" are those holding shares for themselves or on behalf of others in street name, or institutional investors required to file Form 13F with the SEC.

Actionable insights

The survey method includes a new timeliness requirement: All surveys must be conducted within two years of the transaction, or by June 20, 2013, for transactions completed before June 20, 2011. If reporting shareholders fail to respond to the survey request, other methods may be used for estimating basis.

The statistical sampling method incorporates the most recent, liberalized IRS sampling guidance and clarifies that sampled shareholders may include nominees holding shares on behalf of many shareholders.

The basis modeling method for nominees, who typically hold the great majority of shares, has undergone substantial changes, including:

- Weekly shareholder position reports (SPRs) must be collected from the later of the first day of the target's first tax year or the date that is seven years prior to the transaction date, through the transaction date. The seven-year period corresponds to the Depository Trust Company's data retention period.
- Any missing SPRs will cause basis to be proportionately reduced; for example, if only six years of data are obtained, basis will be reduced by 1/7th.
- The modeling methodology allows an average cost basis approach rather than requiring use of the lowest basis determined under LIFO, FIFO, and average cost basis methodologies, as was the case under Notice 2009-4.
- Opening basis is estimated using the volume-weighted average share price in the three-month period prior to the first observation date or the beginning date of the target's first tax year if later. Notice 2009-4 generally required use of the IPO price, as well as subsequent public offering prices, even if several decades earlier than the first SPR date.
- SEC Form 13F quarterly filings by institutional investors may be used in lieu of SPRs, which may be particularly beneficial for older transactions for which few or no SPRs are available. Form 13F filings must be obtained for up to 10 years, and estimated basis per share is automatically subject to a 25-percent reduction.

Other general considerations for taxpayers using Rev. Proc. 2011-35:

- The IRS will not undertake its own survey of shareholders, other than perhaps of reporting shareholders.
- Unless it has actual knowledge of a target shareholder's basis, the IRS will not assert any alternative basis or methodology.
- Taxpayers may use any combination of the safe harbors.
- Taxpayers may enter into a pre-filing agreement to demonstrate compliance.
- Reporting requirements of Reg. secs. 1.351-3 and 1.368-3 will be deemed satisfied if certain filing and time requirements are met.

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