

## Part III - Administrative, Procedural, and Miscellaneous

### DETERMINATION OF BASIS IN PROPERTY ACQUIRED IN TRANSFERRED BASIS TRANSACTION

#### **Notice 2009-4**

##### I. Purpose

The Internal Revenue Service (IRS) is studying various issues that have arisen in connection with the determination of basis in stock that is acquired in reorganizations described in section 368(a)(1)(B) of the Internal Revenue Code and other transferred basis transactions. The IRS intends to issue further guidance on the determination of such basis. This Notice sets forth the substance of the guidance that the IRS currently contemplates issuing and requests comments on the administrability, accuracy, and appropriateness of such guidance.

##### II. Background

Section 368(a)(1)(B) of the Code provides that the term reorganization includes the acquisition by one corporation (Acquiring) of stock of another corporation (Target) solely in exchange for part or all of the voting stock of either Acquiring or its parent, provided that Acquiring has control of Target immediately after the acquisition (a B reorganization). Under section 362(b), Acquiring's basis in each share of Target stock acquired in the reorganization is determined with reference to the basis of the share in the hands of the transferor shareholder immediately before the reorganization. Section 362(a) provides similar treatment for Target stock received in a section 351 exchange.

Section 1.368-3 of the Income Tax Regulations requires each significant holder and each corporate party to a reorganization to provide certain essential information regarding the reorganization, including the basis of the transferred property, in a statement on or with its return for the year of the reorganization. In general, a significant holder is any shareholder that owns five percent (by vote or value) of a publicly traded corporation or one percent (by vote or value) of a non-publicly traded corporation. Section 1.351-3 of the regulations imposes similar reporting requirements on significant transferors and transferee corporations in section 351 exchanges. In general, a significant transferor is any transferor that owns five percent (by vote or value) of a publicly traded corporation or one percent (by vote or value) of a non-publicly traded corporation immediately after the section 351 exchange.

By 1981, the IRS had identified two significant problems encountered by taxpayers in attempting to establish basis in Target stock acquired in a B reorganization. One was that the acquisition of basis information from shareholders surrendering stock

of widely held corporations was time consuming, burdensome, and costly. The other was that not all surrendering shareholders were responding to requests for basis information. To facilitate the determination of basis in these cases, the IRS published Rev. Proc. 81-70, 1981-2 C.B. 729, which set forth general guidelines for surveying surrendering shareholders to determine the basis of Target stock acquired in B reorganizations and provided sampling and estimation procedures to address administrative burdens and shareholder nonresponsiveness.

At the time that Rev. Proc. 81-70 was published, most stock was registered stock, that is, the name of the beneficial owner of the stock was recorded by the issuing corporation's stock transfer agent on its books. However, market practices have changed substantially since the publication of Rev. Proc. 81-70. Today, stock of public companies is primarily held in street name, that is, the stock is held by a nominee (typically a clearinghouse or other financial institution holding stock on behalf of their members or customers) and the transfer agent's books list the nominee as the owner of the stock. Often there are several tiers of nominee owners, each subject to confidentiality and other constraints that could bar the release of information. As a result, the identification of the beneficial owners of large portions of public companies, and thus their bases in those interests, is often difficult or impossible to discover. To address this problem, many taxpayers have developed complicated modeling techniques intended to establish Acquiring's allowable basis in shares acquired in a B reorganization.

There is an additional concern that the information necessary to identify the nominee holders dissipates fairly quickly. In particular, the securities positions reports of depositories and clearinghouses, the most reliable means for identifying such holdings, are generally only maintained by the depository or clearinghouse for five to seven years. Thus, unless such information is secured within that time, the identification of nominee holders will be difficult if not impossible if a basis study subsequently becomes necessary. Accordingly, any model adopted to determine basis in nominee held shares must take that concern into account.

The IRS has been studying the issues raised by nominee stock holdings. As part of that study, the IRS issued Notice 2004-44, 2004-2 C.B. 32, requesting comments on both the difficulties encountered in applying, and the need for modification of, the guidelines set forth in Rev. Proc. 81-70. Written and oral comments were received from a number of sources, including taxpayers, practitioners, and IRS examination teams. Based on these comments, the IRS has concluded that the guidelines of Rev. Proc. 81-70 must be expanded to address the issues presented by nominee stock holdings. In addition, the IRS has concluded that basis determinations should be facilitated for small stock holdings and intends to adopt rules that simplify basis determination in such cases.

The IRS recognizes that the difficulties in establishing basis in Target stock acquired in B reorganizations can be presented whenever a corporation acquires Target stock in a transaction in which the acquiring corporation's basis in the acquired stock is

determined with reference to the transferring shareholder's basis (transferred basis transaction). In addition to B reorganizations, transferred basis transactions include section 351 exchanges (see section 362(a), which provides that the transferee corporation's basis in property received is determined with reference to the transferor's basis in the property). Transferred basis transactions also include reverse triangular mergers that qualify as either a section 351 exchange or a B reorganization if Acquiring elects to determine basis in acquired property under the provisions of section 362(b) (as permitted by §1.368-6(c)(2)(ii)). Certain triangular reorganizations involving foreign corporations may also be transferred basis transactions. See §1.367(b)-13. Accordingly, the IRS has concluded that any further guidance in this area will apply not only to B reorganizations, but to all transferred basis transactions in which Target stock is acquired.

### III. The Proposed Guidance: an Expansion of Rev. Proc. 81-70

#### A. Overview

The IRS continues to believe that the theoretically correct method for determining Target stock basis following a B reorganization is a survey of surrendering Target shareholders. The IRS also continues to believe that Rev. Proc. 81-70 provides essential guidance for obtaining Target stock basis information by surveying surrendering Target shareholders and for using sampling and estimation techniques in appropriate cases. Accordingly, those provisions of Rev. Proc. 81-70 will be preserved without material modification in the guidance that the IRS intends to issue. In this Notice, the guidance that the IRS expects to issue is referred to as Expanded Rev. Proc. 81-70.

As noted above, the concerns expressed regarding the determination of basis following a B reorganization are present, at least to some extent, in any transferred basis transaction. Therefore, the provisions of Expanded Rev. Proc. 81-70 will apply to all transferred basis transactions.

To address those concerns, and to simplify the determination of basis for small stock holdings, Expanded Rev. Proc. 81-70 will include several "safe harbor" provisions. Each safe harbor will apply to a specified group of surrendering shareholders and will prescribe a methodology that can be used to determine those shareholders' bases in surrendered stock. An acquiring corporation may use one or more of the safe harbors; Expanded Rev. Proc. 81-70 will not require the use of all the safe harbors.

The principal provisions of Expanded Rev. Proc. 81-70 are described in more detail in the following sections, beginning with generally applicable provisions in Section III.B of this Notice.

The safe harbor provisions are described in Section III.C (describing a survey method applicable to shares acquired from "reporting shareholders"), Section III.D (describing a certificate method applicable to shares acquired from "registered, non-

reporting shareholders”), and Section III.E (describing a basis modeling method applicable to shares acquired from “nominee, non-reporting shareholders”).

Section III.F modifies the reporting requirements under §§1.351-3 and 1.368-3 to take into account the time needed to complete a basis determination following a transferred basis transaction subject to Expanded Rev. Proc. 81-70.

Section III.G provides a safe harbor for taxpayers using a methodology prescribed in Expanded Rev. Proc. 81-70 and states that the IRS will not assert a different basis determination methodology if a taxpayer complies with the provisions of Expanded Rev. Proc. 81-70.

Section III.H expands the issues that may be the subject of a pre-filing agreement to include basis studies completed in accordance with the terms of Expanded Rev. Proc. 81-70.

Finally, Section III.I provides that Rev. Proc. 81-70 will be obsolete, subject to a transition rule, when Expanded Rev. Proc. 81-70 is issued.

#### B. Generally Applicable Provisions of Expanded Rev. Proc. 81-70

A determination of basis must be done timely and diligently to satisfy the conditions of any safe harbor under Expanded Rev. Proc. 81-70.

For purposes of Expanded Rev. Proc. 81-70, a determination of basis will be considered timely if it is completed within two years of the later of the date of the transferred basis transaction and the date that Expanded Rev. Proc. 81-70 becomes effective. In addition, a previously completed basis determination will be considered timely if made compliant with the provisions of Expanded Rev. Proc. 81-70 within two years of the date that Expanded Rev. Proc. 81-70 becomes effective.

For purposes of Expanded Rev. Proc. 81-70, an estimate of basis will be considered to have been done diligently if Acquiring made every reasonable effort to obtain best evidence and, to the extent it was unable to obtain such evidence, can demonstrate that the evidence or basis information could not have been reasonably obtained. The fact that the IRS could, or does, obtain basis information using methods not available to Acquiring does not prevent a determination that Acquiring was diligent in its estimate of basis. Further, Acquiring must have made every reasonable effort to identify and adjust for surrendered shares with low bases (relative to Target’s average historical trading price) and for surrendered shares with bases lower than the bases of shares bought and sold under normal market conditions. Circumstances in which this can occur include those in which shares are (1) held by investors with a transferred basis, (2) exchanged for convertible stock or debt, or (3) exchanged for debt or other property, as in bankruptcy reorganizations.

The provisions of each safe harbor specify the evidence that should be used for

the safe harbor. However, all basis determinations are to be based on best evidence and the determination of the source that is the best evidence is made as of the date of the transferred basis transaction. If a basis determination is not made timely and basis information is lost, missing, or disposed of (e.g., pursuant to the Target's, clearinghouse's or financial institution's record retention policy), and such information could have been obtained if Acquiring had sought it on or shortly after the date of the transaction, Acquiring will not satisfy the best evidence requirement.

In any case in which best evidence is not used, the IRS, in its discretion, may nevertheless accept such evidence, subject to appropriate adjustments to reflect the diminished credibility of the evidence used.

Notwithstanding any safe harbor prescribed in Expanded Rev. Proc. 81-70, if Acquiring has or acquires actual knowledge of a surrendering shareholder's actual basis in a share of surrendered Target stock, Acquiring's allowable basis in the share is equal to that surrendering shareholder's basis. Further, if the examining team has or obtains knowledge of a surrendering shareholder's actual basis in surrendered Target stock, Acquiring's allowable basis in that share is the basis identified by the examining team, even if the basis determined by Acquiring differs from that identified by the examining team. Where the basis of a share is known, any estimated or modeled basis amount must be adjusted to eliminate any basis amount attributable to such share.

### C. Safe Harbor for Target Stock Surrendered by or on behalf of Reporting Shareholders

Under this safe harbor, the basis of stock surrendered by reporting shareholders must be determined by survey. For purposes of Expanded Rev. Proc. 81-70, a "reporting shareholder" is any surrendering Target shareholder that was a significant transferor, a significant holder, an officer or director of Target, or plan that acquired Target stock for or on behalf of Target employees, such as an employee stock option or pension, immediately before the date of the transferred basis transaction. The term significant transferor has the same meaning as in §1.351-3 and the term significant holder has the same meaning as in §1.368-3.

To identify reporting shareholders, Target's books and records, the Master Securityholder Files maintained by the stock transfer agent, and Securities Exchange Commission (SEC) filings, including Schedule 13 series data, may be used.

In general, a survey must be done in accordance with the guidelines set forth in Rev. Proc. 81-70. Thus:

1. The survey should begin with the mailing of an inquiry letter to each reporting shareholder, which states the purpose for requesting the basis information for the surrendered stock, explains how basis is determined, and sets forth the importance of responding timely and accurately. After 30 days, one follow-up letter should be sent to non-responding shareholders. Several attempts also

should be made to telephone the non-respondent. These telephone contacts should be attempted on different days of the week and times of the day. Acquiring should maintain a log recording each attempted contact.

2. Any survey sent to a reporting shareholder must request all information necessary for proper determination of basis. Such information may include, but is not limited to:
  - a. Number of shares surrendered in the transferred basis transaction;
  - b. Dates those shares were acquired;
  - c. Total cost of those shares, including commission;
  - d. How the shares were acquired, for example, by gift, stock option, or inheritance, or as consideration in a prior transferred basis transaction;
  - e. Tax basis and, if different, cost basis;
  - f. The nominees (as defined in section E) that held the shares on both the date the shares were acquired and the date of the transferred basis transaction; and
  - g. In a transaction involving foreign corporations where the rules of §1.367(b)-13 may apply, whether the shareholder is a section 1248 shareholder with respect to the Target corporation.
3. Survey questionnaires should be sent by certified or registered mail.
4. The procedures by which the survey is designed and implemented must be documented and such documentation must be made available to the IRS examination team on request.

Under this safe harbor, Acquiring's basis in shares acquired from the surveyed shareholders will be the basis reported by such shareholders. If Acquiring does not receive a response from a surveyed shareholder, Acquiring may use estimation techniques to determine the basis of Target shares surrendered by the nonresponding shareholder. The estimation guidelines in Sec. 3 of Rev. Proc. 81-70 will be incorporated in Expanded Rev. Proc. 81-70.

However, under this safe harbor, if Acquiring does not survey a reporting shareholder, estimation may not be used and the basis of the shares acquired from such shareholder will be deemed to be zero.

#### D. Safe Harbor for Target Stock Surrendered by or on behalf of Registered, Non-reporting Shareholders

Under this safe harbor, the basis of stock surrendered by registered, non-reporting shareholders must be determined by the certificate method. For purposes of Expanded Rev. Proc. 81-70, a "registered, non-reporting" shareholder is a shareholder that held Target stock in certificated form, but that is not a reporting or nominee shareholder.

To determine basis under this certificate method, Acquiring must obtain or access Target's books and records and, using those books and records, identify all outstanding certificated shares that were surrendered by or on behalf of non-reporting shareholders and the dates that all such shares were issued. Using both public and private stock exchange trading data, Acquiring must then determine the average trading price of the Target shares on the date each certificate was issued. Subject to the limitations described below, Acquiring may treat the basis of each such share as equal to the average trading price on its issuance date.

Notwithstanding the general rule of this safe harbor, if there has been an extraordinary issuance or event, appropriate adjustment must be made to the basis otherwise determined under this safe harbor. For this purpose, an extraordinary issuance or event is any issuance or event that could have caused the basis of a share to be materially different from the average trading price on its issuance date, including but not limited to the following –

1. On or about the date a stock certificate was issued to a surrendering Target shareholder, another certificate held by the same shareholder was cancelled. In such a case, to the extent that the number of shares issued is less than or equal to the number of shares cancelled, the shares will not be valued as of the date the new certificate was issued, but instead as of the date the earlier certificate was issued. If a cancelled certificate was originally issued concurrently with the cancellation of another certificate, the shares would be valued as of the date of the earlier (or earliest) issuance.
2. A share was acquired by a surrendering Target shareholder in a tax-free stock split. In such a case, the share will be assigned a split adjusted basis.
3. A share was acquired by a surrendering Target shareholder as a result of a stock dividend. In such a case, the share will be assigned a zero basis.
4. A share was acquired by a surrendering Target shareholder in a transaction the details of which are known to the corporation either directly or indirectly. In such a case, the basis must be assigned based on all the information obtainable. This may include, but is not limited to, stock issued due to options, convertible stock, employee plans, and convertible debt.
5. A share was acquired by a surrendering Target shareholder in a prior tax-free exchange. In such a case, the share will be assigned a basis of zero unless, using Target's books and records, Acquiring can otherwise establish such basis.

Further, the basis otherwise determined with respect to any share of stock under this safe harbor must be reduced by any distributions paid to the surrendering Target shareholder to the extent such distributions were treated as a return of capital under section 301(c)(2).

## E. Safe Harbor for Target Stock Surrendered by Nominees on Behalf of Non-reporting Shareholders

Under this safe harbor, the basis of all stock surrendered by nominees on behalf of non-reporting shareholders is determined under the basis modeling method. For purposes of Expanded Rev. Proc. 81-70, the term nominee means the title owner of equity securities settled through a clearing agency registered pursuant to Section 17A of the Securities Exchange Act of 1934, that holds the stock for or on behalf of the beneficial owner of the stock, typically one of the nominee's participating members.

Modeled basis is determined separately for each series of shares and is done in accordance with the following:

### 1. Establish measuring dates

Acquiring must identify the measuring dates that will be used in constructing the model. Measuring dates must include the date of the initial public offering (IPO), all subsequent public offering dates prior to the first date for which a depository's or clearinghouse's securities positions report (SPR) is available, the first date for which an SPR is available, and the date of the transferred basis transaction. In addition, there must be a number of measuring dates between the first SPR date and the date of the transferred basis transaction. It is not necessary that every business day be a measuring date. However, the dates selected should be representative of Target stock trading activity, including dates surrounding periods of significant volatility in share price or trading activity of Target stock. In addition, the number and the dates of all measuring dates should demonstrate good coverage over the entire relevant period. In general, this means at least one measuring date per quarter.

### 2. Establish nominee starting basis

Each nominee's starting bases in its shares is determined differently depending on whether an SPR is available for the IPO date.

#### a. If an SPR is available for the IPO Date

Each nominee holding a share of Target stock on the IPO date is treated as having purchased that share for the IPO price or for the fair market value of the share on the IPO date, whichever is less. That deemed purchase price is the nominee's estimated starting basis in the share.

#### a. If no SPR is available for the IPO Date

Each nominee holding a share of Target stock on the first SPR date is treated as having purchased that share for the share's allocable portion of Target's pre-SPR Public Offering aggregate basis. That deemed purchase price is the nominee's estimated



starting basis in the share.

For purposes of this rule, Target's pre-SPR Public Offering aggregate basis is the excess of Target's "public offering basis" over Target's "redeemed share basis." Target's "public offering basis" is equal to the number of shares offered in the IPO multiplied by the lesser of the offering price and the fair market value of shares issued in the offering, plus the amount so computed for each subsequent public offering before the first SPR date (specifically, the number of shares issued in an offering multiplied by the lesser of the offering price and the fair market value of the shares issued in the offering). Target's redeemed share basis is the sum of the bases of all shares redeemed by Target prior to the first SPR date, treating each redeemed share as having been issued in the public offering immediately preceding the redemption of the share.

A share's allocable portion of Target's pre-SPR Public Offering aggregate basis is determined by allocating Target's pre-SPR Public Offering aggregate basis equally among all shares outstanding as of the first SPR date, other than shares that were privately placed.

### 3. Adjust estimated starting basis

Nominee holdings on the first SPR date are compared to the nominee holdings on the second measuring date. Any nominees not identified on the Initial SPR Date are treated as having purchased their shares, and any increase or decrease in the holdings of a previously identified nominee is treated as a purchase or sale of that number of shares, on the second measuring date. Any deemed purchase is considered to have been made for an amount equal to the volume-weighted average of the trading prices for the period between the first and second measuring dates. As of the end of the second measuring date, each nominee's basis in its Target stock holdings is deemed to be equal to its aggregate estimated starting basis in shares held on the first SPR date, increased to reflect the deemed cost basis of any stock purchased, or decreased to reflect a deemed sale of any stock, as appropriate.

Nominee holdings are then compared to nominee holdings at each next successive measuring date to determine the extent to which there are previously unidentified nominee holdings and changes in previously identified nominee holdings. New and increased holdings are treated as purchases, and decreased holdings are treated as sales, of Target stock. Sales are treated as being made either on the first-in, first-out ("FIFO"), the last-in, first-out ("LIFO"), or the average cost ("ACO") method. Acquiring must identify and adopt the single method that best predicts estimated basis across all investors, which will generally be LIFO, FIFO or ACO basis whichever is lower. As of the end of each measuring date, each nominee's holdings are deemed to have a basis equal to its basis on the immediately preceding measuring date, increased to reflect the deemed cost basis of any purchased stock, or decreased to reflect a deemed sale of any stock, as appropriate.

### 4. Allowable nominee basis

At the end of the last measuring date (the day of the transferred basis transaction), the aggregate of all basis computed for nominee holdings in each class is allocated equally among the shares in the class that were held by nominees. Acquiring's basis in Target shares acquired from nominees on behalf of non-reporting shareholders is deemed to be the basis allocated to such shares under this safe harbor model. Acquiring's basis in Target shares acquired from nominees on behalf of reporting shareholders is the basis in such shares that is established under section C, notwithstanding the allocation made for computational purposes under this basis modeling safe harbor.

#### F. Reporting Requirements

Corporations acquiring Target stock in a transferred basis transaction shall be treated as satisfying their reporting requirements under §§1.351-3 and 1.368-3 with respect to the return for the tax year in which the transaction is completed if the corporation includes a statement on or with such return stating that a basis study is pending with respect to the acquired stock. However, in such cases, the acquiring corporation must include complete statements as required under those regulations, with basis amounts determined pursuant to the study, on or with a return for a tax year that is no later than the tax year that includes the date that is two years after the date of the transferred basis transaction. These rules apply without regard to whether basis is determined under any of the Expanded Rev. Proc. 81-70 safe harbors.

#### G. Reliance on Expanded Rev. Proc. 81-70 Safe Harbors

If an acquiring corporation complies with the terms of a safe harbor described in Expanded Rev. Proc. 81-70, including those provisions that apply to all safe harbors described in Expanded Rev. Proc. 81-70, the IRS will not assert an alternative method to determine that corporation's allowable basis in stock covered by that safe harbor.

#### H. Pre-filing Agreements

The determination of whether a basis study is done in compliance with one or more of the Expanded Rev. Proc. 81-70 safe harbors may be the subject of a pre-filing agreement.

#### I. Effective Date, Effect on Other Documents

Expanded Rev. Proc. 81-70 will be effective for transferred basis transactions on or after the date it is issued. Because Expanded Rev. Proc. 81-70 will incorporate the provisions of Rev. Proc. 81-70 that have continued application, Rev. Proc. 81-70 will be obsolete for transactions under Expanded Rev. Proc. 81-70.

#### IV. Interim Use of Safe Harbor Methodologies

Prior to the issuance of Expanded Rev. Proc. 81-70, whether in the form described in this Notice or otherwise, taxpayers may use the methodologies of any safe harbor described in this Notice (taking into account those provisions generally applicable to all of the safe harbors) to determine the basis of Target stock acquired in any transferred basis transaction that occurs prior to the publication of Expanded Rev. Proc. 81-70. In such cases, the timeliness requirement will be deemed satisfied if the study is completed within two years of the later of the date of the transferred basis transaction and January 12, 2009. The IRS will not assert an alternative methodology against a taxpayer that determines basis in accordance with these proposed guidelines.

#### V. Request for Comments

The IRS requests comments regarding whether the approaches described in this Notice should be adopted and to what extent, if any, the approaches should be further combined or modified to produce a set of rules that is both administrable and reflective of statutory intent. The IRS is particularly interested in comments regarding whether a simpler methodology, such as one that would determine the basis of all surrendered shares by using a weighted average trading price, would be helpful to taxpayers and appropriate for the tax system. The IRS also specifically requests comments regarding the determination of basis in atypical transferred basis transactions, such as acquisitions in bankruptcy reorganizations, acquisitions involving foreign transfer agents, and acquisitions involving foreign corporations that may be subject to the rules of §1.367(b)-13.

Comments should refer to **Notice 2009-4** and should be submitted to:

Internal Revenue Service  
P.O. Box 7604  
Ben Franklin Station  
Washington, D.C. 20044  
Attn: CC:PA:LPD:PR  
Room 5203

or electronically via the IRS internet site at:  
[Notice.Comments@irs.counsel.treas.gov](mailto:Notice.Comments@irs.counsel.treas.gov).

All comments will be available for public inspection and copying.

#### VIII. DRAFTING INFORMATION

The principal authors of this Notice are George Johnson of the Office of Associate Chief Counsel (Corporate) and Ed Cohen of LMSB. For further information regarding this Notice generally, contact Mr. Johnson at (202) 622-7930 (not a toll-free number). For further information about estimation techniques described in this Notice, contact Edward Cohen at (212) 719-6693 (not a toll-free number).