

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

REG-116564-03

RIN 1545-BC05

Determination of Basis of Stock or Securities Received In Exchange For, or With Respect to, Stock or Securities in Certain Transactions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations under section 358 that provide guidance regarding the determination of the basis of stock or securities received in exchange for, or with respect to, stock or securities in certain transactions. These proposed regulations affect shareholders of corporations.

DATES: Written or electronic comments must be received by July 2, 2004.

ADDRESSES: Send submissions to CC:PA:LPD:PR (REG-116564-03), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 am and 4 pm to: CC:PA:LPD:PR (REG-116564-03), Courier's desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20044, or sent electronically, via the IRS Internet site at www.irs.gov/regs or via the Federal eRulemaking Portal at www.regulations.gov (indicate IRS and REG-116564-03).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Theresa Kolish, Emidio J. Forlini, Jr. or Reginald Mombrun, (202) 622-7930, concerning submissions of comments, Treena Garrett, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

Section 1012 of the Internal Revenue Code (Code) provides that the basis of property is generally the cost of such property. Section 1.1012-1(c) provides that, if shares of stock are sold or transferred by a taxpayer who purchased or acquired lots of stock on different dates or at different prices, and the lot from which the stock was sold or transferred cannot be adequately identified, the stock sold or transferred is charged against the earliest of such lots purchased or acquired in order to determine the basis of such stock.

Under this rule, a shareholder has greater flexibility in planning the tax consequences of the sale by specifically identifying the shares sold. The rules for adequate identification operate differently depending on the manner in which the shares are held and actions taken by the shareholder. For example, when shares are held through a broker, an adequate identification is effected by giving the proper instructions to the broker. This rule allows identification without regard to the particular shares physically transferred by the broker. The rule also allows identification when several lots are represented by a single share certificate. However, if a shareholder holds a different share certificate for each lot, the identity of the shares is determined by the specific certificate sold.

Section 358(a)(1) generally provides that the basis of property received pursuant to an exchange to which section 351, 354, 355, 356, or 361 applies is the same as that of the property exchanged, decreased by the fair market value of any other property (except money) received by the taxpayer, the amount of any money received by the taxpayer, and the amount of loss to the taxpayer which was recognized on such exchange, and increased by the amount which was treated as a dividend, and the

amount of gain to the taxpayer which was recognized on such exchange (not including any portion of such gain which was treated as a dividend). Section 358(b)(1) provides that, under regulations prescribed by the Secretary, the basis determined under section 358(a)(1) must be allocated among the properties received in the exchange or distribution.

Section 1.358-2(a)(2) provides that, if as the result of an exchange or distribution under section 354, 355, 356, or former 371(b) a shareholder who owned stock of only one class before the transaction owns stock of two or more classes after the transaction, then the basis of all the stock held before the transaction (as adjusted under §1.358-1) must be allocated among the stock of all classes (whether or not received in the transaction) held immediately after the transaction in proportion to the fair market values of the stock of each class. In addition, §1.358-2(a)(3) provides that, if as the result of an exchange under section 354, 355, 356, or former 371(b) a security holder who owned only securities, all of one class, before the transaction, owns securities or stock of more than one class, or owns both stock and securities, then the basis of all the securities held before the transaction (as adjusted under §1.358-1) must be allocated among all the stock and securities (whether or not received in the transaction) held immediately after the transaction in proportion to the fair market values of the stock of each class and the securities of each class.

Section 1.358-2(a)(4) provides that, in every case in which, before the transactions, a person owned stock of more than one class or securities of more than one class or owned both stock and securities, a determination must be made, upon the basis of all the facts, of the stock or securities received with respect to stock and securities of each class held (whether or not surrendered). The allocation described in §1.358-2(a)(2) is separately made as to the stock of each class with respect to which

there is an exchange or distribution and the allocation described in §1.358-2(a)(3) is separately made with respect to the securities of each class, part or all of which are surrendered in the exchange.

Section 1.358-2(a)(5) provides a special rule that applies in cases in which a shareholder retains stock or securities pursuant to a plan of recapitalization under section 368(a)(1)(E). In those cases, the basis of the stock retained remains unchanged.

When all of the taxpayer's stock in a target corporation is transferred in a reorganization in exchange for stock of the acquiring corporation or the issuing corporation, it may be difficult to identify physically which share of stock of the target corporation was surrendered for which share of stock of the acquiring or issuing corporation. Questions have arisen regarding whether, for purposes of section 1012 and the regulations thereunder, a shareholder that sells or transfers shares of stock received in an exchange or distribution to which section 354, 355, or 356 applies can identify that share as being traceable to a particular lot of exchanged shares and, if so, how such an identification can be effected.

A number of authorities have addressed this issue but have reached inconsistent results. For example, in Arrott v. Commissioner, 136 F.2d 449 (3d Cir. 1943), the court reasoned that the shares surrendered in an acquisitive reorganization lost their identity when traded for new shares in the reorganization and held that the basis of the shares acquired was determined by averaging the basis of the shares exchanged. Accord Commissioner v. Bolender, 82 F.2d 591 (7th Cir. 1936); Helvering v. Stifel, 75 F.2d 583 (4th Cir. 1935); Commissioner v. Von Gunten, 76 F.2d 670 (6th Cir. 1935); see also Revenue Ruling 55-355 (1955-1 C.B. 418).

On the other hand, other courts have rejected the average basis method for determining the basis of stock received in a reorganization. For example, in Bloch v. Commissioner, 148 F.2d 452 (9th Cir. 1945), the court permitted the basis of blocks of stock received in an acquisitive reorganization to be traced to the basis of the surrendered stock. The court reasoned that where the shareholder can trace the “transmigrations” of shares of stock, there is no reason the shareholder should not be entitled to identify which shares are sold. In Kraus v. Commissioner, 88 F.2d 616 (2d Cir. 1937), the court held that if a taxpayer acquires a corporation's stock at different times and at different prices and exchanges that stock in a recapitalization, the bases of that stock are not blended or averaged in computing the basis of the acquired stock. See also Osrow v. Commissioner, 49 T.C. 333 (1968).

The IRS and Treasury Department have considered whether tracing or averaging is the more appropriate method for determining the basis of stock received in a reorganization described in section 368 or a distribution to which section 355 applies. In view of the carryover basis rule of section 358, the IRS and Treasury are not convinced that a reorganization is an event that justifies averaging the bases of the exchanged blocks of stock. Moreover, the IRS and Treasury Department are concerned that averaging the bases of the exchanged blocks of stock may inappropriately limit the ability of taxpayers to arrange their affairs or may afford opportunities for the avoidance of certain provisions of the Code.

The authorities holding that the basis of shares received in a reorganization is determined by the average basis method have reached that conclusion on the basis that it is not possible to match shares received with shares surrendered. The IRS and Treasury Department do not believe that this inability requires the use of the average basis method. When stock of one corporation is surrendered in exchange for stock of

another corporation in a reorganization, the documents governing the reorganization will typically identify how many, and what class of, shares of the target corporation are being exchanged for how many, and what class of, shares of the acquiring or issuing corporation. That is, the exchanging shareholder will know that one or more shares of the acquiring or issuing corporation are being received in exchange for one or more shares of the target corporation. However, when the shareholder sells or transfers stock of the acquiring or issuing corporation, it may not know which share of stock of the target corporation corresponds to a particular share of the acquiring or issuing corporation. Although, in some cases, the exchange may present obstacles to physical tracing, these obstacles are not materially different from those that exist in the absence of a reorganization where shares are held through a broker or consolidated in a single certificate. Thus, the IRS and Treasury Department believe that it is appropriate to permit shareholders to identify the shares of the acquiring corporation sold or transferred by reference to the shares surrendered in exchange therefor.

These proposed regulations remove §1.358-2(a)(2) through (5) and (c) and replace these provisions with a more complete set of rules for determining the basis of each share or security received in a reorganization described in section 368 and a distribution to which section 355 applies. These proposed regulations generally provide that the basis of each share of stock or security received in an exchange to which section 354, 355, or 356 applies will be the same as the basis of the share or shares of stock or security or securities exchanged therefor. The determination of which share of stock or security is received in exchange for, or with respect to, a particular share of stock or security will be made in accordance with the terms of the exchange or distribution.

If more than one share of stock or security (or a combination of shares of stock and securities) is received in exchange for one share of stock or security, the basis of the share of stock or security surrendered will be allocated to the shares and/or securities received based on the fair market value of the shares and/or securities received. In addition, if one share of stock or security is received in respect of more than one share of stock or security or a fraction of a share of stock or security is received, the basis of the shares of stock or securities surrendered must be allocated to the shares of stock or securities received in a manner that, to the greatest extent possible, reflects that a share of stock or security received is received in respect of shares of stock or securities acquired on the same date and at the same price. Therefore, if a shareholder that acquired 2 shares of stock of a target corporation on Date 1 for \$2 each and 2 shares of stock of the target corporation on Date 2 for \$3 each and the shareholder exchanges such shares for 2 shares of the acquiring corporation, one share of the acquiring corporation will be treated as acquired for the shares of the target corporation acquired on Date 1 and the other share will be treated as acquired for the shares of the target corporation on Date 2. Accordingly, one share will have a basis of \$4 and the other share will have a basis of \$6. This rule avoids, to the greatest extent possible, creating shares or securities with split holding periods.

In the case of an exchange to which both section 351 and section 354 or section 356 applies, however, these rules do not apply if, in connection with the exchange, the shareholder or security holder also exchanges property for stock or securities in an exchange to which neither section 354 nor 356 applies or liabilities of the shareholder or security holder are assumed. This limitation on the application of these rules is intended to prevent a conflict between, on the one hand, those rules that apply to determine the basis of stock received in an exchange to which section 351 applies

(including the effect of the application of section 357(c)) and, on the other hand, these proposed rules.

In the case of a distribution to which section 355 applies in connection with which there is no exchange of shares of stock or securities but only the receipt of additional shares of stock or securities, these proposed regulations provide that the basis of each share of stock or security of the distributing corporation is allocated between the share of stock or security of the distributing corporation and the share of stock or security received with respect to such share of stock or security of the distributing corporation in proportion to their fair market values. If one share of stock or security is received in respect of more than one share of stock or security or a fraction of a share of stock or security is received, the basis of each share of stock or security of the distributing corporation must be allocated to the shares of stock or securities received in a manner that reflects that, to the greatest extent possible, a share of stock or security received is received in respect of shares of stock or securities acquired on the same date and at the same price.

The IRS and Treasury Department recognize that, in certain cases, the shareholder will not be able to identify which particular share (or portion of a share) of stock or security was exchanged for, or received with respect to, a particular share (or portion of a share) of stock or security. In these cases, the proposed regulations permit the shareholder or security holder to designate which share or security was received in exchange for, or in respect of, which share or security. Such designation, however, must be consistent with the terms of the exchange or distribution.

The designation must be made on or before the first date on which the basis of a share or security received is relevant, for example, the date on which a share or security received is sold or is transferred in an exchange described in section 351 or section 721

or a reorganization described in section 368. The designation is binding for purposes of determining the Federal tax consequences of subsequent transactions involving any share or security received or property received with respect to such share or security. If the shareholder fails to make a designation, then the shareholder will not be able to identify which shares are sold or transferred for purposes of determining the basis of property sold or transferred under section 1012 and §1.1012-1(c) and, instead, will be treated as selling or transferring the share received in respect of the earliest share purchased or acquired.

The current regulations under section 358 include references to transactions described in former sections 371(b) and 374, which were repealed by section 11801(a)(19) of Public Law 101-508 (104 Stat. 1388) effective November 5, 1990. To reflect the repeal of these sections, these proposed regulations remove the references to sections 371(b) and 374 as they currently appear in the regulations under section 358.

Effective Date

These regulations are proposed to apply to exchanges and distributions of stock or securities occurring after the date these regulations are published as final regulations in the **Federal Register**.

Effect on Other Documents

These proposed regulations would obsolete Revenue Ruling 55-355 (1955-1 C.B. 418) for transactions occurring after the date these regulations are published as final regulations in the **Federal Register**.

Special Analysis

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory

assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C chapter 5) does not apply to these regulations, and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight copies) that are submitted timely to the IRS. Alternatively, taxpayers may submit comments electronically via the IRS Internet site at www.irs.gov/regs or via the Federal eRulemaking Portal at www.regulations.gov. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying. A public hearing may be scheduled if requested in writing by any person who timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place of the hearing will be published in the **Federal Register**.

Drafting Information

The principal authors of these regulations are Reginald Mombrun, Theresa Kolish, and Emidio J. Forlini, Jr. of the Office of the Associate Chief Counsel (Corporate), IRS. However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1-- INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read, in part, as follows:

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

Section 1.358-2 also issued under 26 U.S.C. 358. * * *

Par. 2. Section 1.358-1 is amended by:

1. Revising paragraph (a).
2. Adding paragraph (c).

The revision and addition read as follows:

§1.358-1 Basis to distributees.

(a) In the case of an exchange or distribution to which section 354 or 355 applies in which, under the law applicable to the year in which the exchange is made, only nonrecognition property is received, the sum of the basis of all of the stock and securities in the corporation whose stock and securities are exchanged or with respect to which the distribution is made, held immediately after the transaction, plus the basis of all stock and securities received in the transaction shall be the same as the basis of all the stock and securities in such corporation held immediately before the transaction allocated in the manner described in §1.358-2. In the case of an exchange to which section 351 or 361 applies in which, under the law applicable to the year in which the exchange was made, only nonrecognition property is received, the basis of all the stock and securities received in the exchange shall be the same as the basis of all property exchanged therefor. If in an exchange or distribution to which section 351, 356, or 361 applies both nonrecognition property and “other property” are received, the basis of all

the property except “other property” held after the transaction shall be determined as described in the preceding two sentences decreased by the sum of the money and the fair market value of the “other property” (as of the date of the transaction) and increased by the sum of the amount treated as a dividend (if any) and the amount of the gain recognized on the exchange, but the term gain as here used does not include any portion of the recognized gain that was treated as a dividend. In any case in which a taxpayer transfers property with respect to which loss is recognized, such loss shall be reflected in determining the basis of the property received in the exchange. The basis of the “other property” is its fair market value as of the date of the transaction. See §1.460-4(k)(3)(iv)(A) for rules relating to stock basis adjustments required where a contract accounted for using a long-term contract method of accounting is transferred in a transaction described in section 351 or a reorganization described in section 368(a)(1)(D) with respect to which the requirements of section 355 (or so much of section 356 as relates to section 355) are met.

* * * * *

(c) Effective date. Paragraph (a) of this section applies to exchanges or distributions of stock and securities after the date these regulations are published as final regulations in the **Federal Register**. Paragraph (b) of this section applies to exchanges or distributions of stock and securities after December 31, 1953.

Par. 3. Section 1.358-2 is amended by:

1. Revising paragraphs (a)(1) and (a)(2).
2. Removing paragraphs (a)(3), (a)(4), and (a)(5).
3. Revising paragraphs (b)(1) and (c).
4. Adding paragraph (d).

The revisions and addition read as follows:

§1.358-2 Allocation of basis among nonrecognition property.

(a) Allocation of basis in exchanges or distributions to which section 354, 355, or 356 applies. (1) As used in this paragraph the term stock means stock which is not “other property” under section 356. The term securities means securities (including, where appropriate, fractional parts of securities) which are not “other property” under section 356.

(2)(i) If a shareholder or security holder surrenders a share of stock or a security in an exchange under the terms of section 354, 355, or 356, the basis of each share of stock or security received in the exchange shall be the same as the basis of the allocable portion of the share or shares of stock or security or securities exchanged therefor (as adjusted under §1.358-1). If more than one share of stock or security is received in exchange for one share of stock or one security, the basis of the share of stock or security surrendered shall be allocated to the shares of stock or securities received in the exchange in proportion to the fair market value of the shares of stock or securities received. If one share of stock or security is received in respect of more than one share of stock or security or a fraction of a share of stock or security is received, the basis of the shares of stock or securities surrendered must be allocated to the shares of stock or securities received in a manner that reflects, to the greatest extent possible, that a share of stock or security received is received in respect of shares of stock or securities acquired on the same date and at the same price.

(ii) If a shareholder or security holder receives one or more shares of stock or one or more securities in a distribution under the terms of section 355 (or so much of section 356 as relates to section 355) and does not surrender any shares of stock or securities in connection with the distribution, the basis of each share of stock or security of the distributing corporation (as defined in §1.355-1(b)), as adjusted under §1.358-1,

shall be allocated between the share of stock or security of the distributing corporation with respect to which the distribution is made and the share or shares of stock or security or securities (or allocable portions thereof) received with respect to the share of stock or security of the distributing corporation in proportion to their fair market values. If one share of stock or security is received in respect of more than one share of stock or security or a fraction of a share of stock or security is received, the basis of each share of stock or security of the distributing corporation must be allocated to the shares of stock or securities received in a manner that reflects that, to the greatest extent possible, a share of stock or security received is received in respect of shares of stock or securities acquired on the same date and at the same price.

(iii) If a shareholder or security holder that purchased or acquired shares of stock or securities in a corporation on different dates or at different prices exchanges such shares of stock or securities under the terms of section 354, 355, or 356, or receives a distribution of shares of stock or securities under the terms of section 355, and the shareholder or security holder is not able to identify which particular share of stock or security (or portion of a share of stock or security) is received in exchange for, or with respect to, a particular share of stock or security, the shareholder or security holder may designate which share of stock or security is received in exchange for, or with respect to, a particular share of stock or security, provided that such designation is consistent with the terms of the exchange or distribution. The designation must be made on or before the first date on which the basis of a share of stock or security received is relevant. The basis of the shares or securities received, for example, is relevant when such shares or securities are sold or otherwise transferred. The designation will be binding for purposes of determining the Federal tax consequences of any sale or transfer of, or distribution with respect to, the shares or securities received. If the

shareholder fails to make a designation, then the shareholder will not be able to identify which shares are sold or transferred for purposes of determining the basis of property sold or transferred under section 1012 and §1.1012-1(c) and, instead, will be treated as selling or transferring the share received in respect of the earliest share purchased or acquired.

(iv) Paragraphs (a)(2)(i) through (iii) of this section shall not apply to determine the basis of a share of stock or security received by a shareholder or security holder in an exchange described in both section 351 and section 354 or section 356, if, in connection with the exchange, the shareholder or security holder exchanges property for stock or securities in an exchange to which neither section 354 nor 356 applies or liabilities of the shareholder or security holder are assumed.

(b) Allocation of basis in exchanges to which section 351 or 361 applies. (1) As used in this paragraph (b), the term stock refers only to stock which is not “other property” under section 351 or 361 and the term securities refers only to securities which are not “other property” under section 351 or 361.

* * * * *

(c) Examples. The application of paragraphs (a) and (b) of this section is illustrated by the following examples:

Example 1. (i) Facts. F, an individual, acquired 20 shares of Corporation N stock on Date 1 for \$3 each and 10 shares of Corporation N stock on Date 2 for \$6 each. On Date 3, Corporation O acquires the assets of Corporation N in a reorganization under section 368(a)(1)(A). Pursuant to the terms of the plan of reorganization, F receives 2 shares of Corporation O stock for each share of Corporation N stock. Therefore, F receives 60 shares of Corporation O stock. Pursuant to section 354, F recognizes no gain or loss on the exchange. F is not able to identify which shares of Corporation O stock are received in exchange for each share of Corporation N stock.

(ii) Analysis. Under paragraph (a)(2) of this section, F has 40 shares of Corporation O each of which has a basis of \$1.50 and is treated as having been acquired on Date 1 and 20 shares of Corporation O each of which has a basis of \$3 and is treated as having been acquired on Date 2. On or before the date on which the basis

of a share of Corporation O stock received becomes relevant, F may designate which of the shares of Corporation O have a basis of \$1.50 and which have a basis of \$3.

Example 2. (i) Facts. The facts are the same as in Example 1, except that instead of receiving 2 shares of Corporation O stock for each share of Corporation N stock, F receives 1½ shares of Corporation O stock for each share of Corporation N stock. Therefore, F receives 45 shares of Corporation O stock. Again, F is not able to identify which shares (or portions of shares) of Corporation O stock are received in exchange for each share of Corporation N stock.

(ii) Analysis. Under paragraph (a)(2) of this section, F has 30 shares of Corporation O each of which has a basis of \$2 and is treated as having been acquired on Date 1 and 15 shares of Corporation O each of which has a basis of \$4 and is treated as having been acquired on Date 2. On or before the date on which the basis of a share of Corporation O stock received becomes relevant, F may designate which of the shares of Corporation O have a basis of \$2 and which have a basis of \$4.

Example 3. (i) Facts. E, an individual, purchased 20 shares of Class A stock of Corporation P on Date 1 for \$3 per share and 10 shares of Class B stock of Corporation P on Date 2 for \$3 per share. On Date 3, E exchanges each share of Class A stock for one share of new Class C stock and one share of new Class D stock in a reorganization under section 368(a)(1)(E). Pursuant to section 354, E recognizes no gain or loss on the exchange. On the date of the exchange, the fair market value of each share of Class A stock is \$6, the fair market value of each share of Class C stock is \$2, and the fair market value of each share of Class D stock is \$4. E is not able to identify which shares of Class C and Class D stock of Corporation P are received in exchange for each share of Class A stock of Corporation P.

(ii) Analysis. Under paragraph (a)(2) of this section, because E receives one share of Class C stock and one share of Class D stock for each share of Class A stock, the basis of each share of Class A stock surrendered is allocated to one share of Class C stock and one share of Class D stock in proportion to their fair market values. Therefore, \$1 of the basis of each share of Class A stock is allocated to each share of Class C stock and \$2 of the basis of each share of Class A stock is allocated to each share of Class D stock. E's basis in each share of Class B stock remains \$3.

Example 4. (i) Facts. G, an individual, purchased 10 shares of Corporation Q stock on Date 1 for \$2 per share and 10 shares of Corporation Q stock on Date 2 for \$5 per share. On Date 3, Corporation R acquires the stock of Corporation Q in a reorganization under section 368(a)(1)(B). Pursuant to the terms of the reorganization, G receives one share of Corporation R stock for every 2 shares of Corporation Q stock. Pursuant to section 354, G recognizes no gain or loss on the exchange. G is not able to identify which portion of each share of Corporation R stock is received in exchange for each share of Corporation Q stock.

(ii) Analysis. Under paragraph (a)(2) of this section, G has 5 shares of Corporation R each of which has a basis of \$4 and is treated as having been acquired on Date 1 and 5 shares of Corporation R each of which has a basis of \$10 and is treated as having been acquired on Date 2. On or before the date on which the basis of

a share of Corporation R stock received becomes relevant, G may designate which of the shares of Corporation R have a basis of \$4 and which have a basis of \$10.

Example 5. (i) Facts. The facts are the same as in Example 4, except that, in addition to transferring the stock of Corporation Q to Corporation R, G transfers land to Corporation R. In addition, after the transaction, G owns stock of Corporation R satisfying the requirements of section 368(c). G's transfer of the Corporation Q stock to Corporation R is an exchange described in sections 351 and 354. G's transfer of land to Corporation R is an exchange described in section 351.

(ii) Analysis. Pursuant to paragraph (a)(2)(iv) of this section, because neither section 354 nor section 356 applies to the transfer of land to Corporation R, the rules of paragraphs (a)(2)(i) through (iii) of this section do not apply to determine G's basis in the Corporation R stock received in the transaction.

Example 6. (i) Facts. H, an individual, purchased 10 shares of Corporation T stock on Date 1 for \$3 per share and 10 shares of Corporation T stock on Date 2 for \$6 per share. On Date 3, Corporation V, a newly formed, wholly owned subsidiary of Corporation U, merges with and into Corporation T with Corporation T surviving. As part of the plan of merger, H receives one share of Corporation U stock for each share of Corporation T stock. In connection with the transaction, Corporation U assumes a liability of H. In addition, after the transaction, H owns stock of Corporation U satisfying the requirements of section 368(c). H's transfer of the Corporation T stock to Corporation U is an exchange described in sections 351 and 354.

(ii) Analysis. Pursuant to paragraph (a)(2)(iv) of this section, because, in connection with the transfer of the Corporation T stock to Corporation U, Corporation U assumed a liability of H, the rules of paragraphs (a)(2)(i) through (iii) of this section do not apply to determine H's basis in the Corporation U stock received in the transaction.

Example 7. (i) Facts. J, an individual, purchased 5 shares of Corporation X stock for \$4 per share on Date 1 and 5 shares of Corporation X stock for \$8 per share on Date 2. Corporation X owns all of the outstanding stock of Corporation Y. The fair market value of the stock of Corporation X, excluding the stock of Corporation Y, is \$900. The fair market value of the stock of Corporation Y is \$900. In a distribution to which section 355 applies, Corporation X distributes all of the stock of Corporation Y pro rata to its shareholders. No stock of Corporation X is surrendered in connection with the distribution. In the distribution, J receives 2 shares of Corporation Y stock with respect to each share of Corporation X stock. Pursuant to section 355, J recognizes no gain or loss on the receipt of the shares of Corporation Y stock. J is not able to identify which share of Corporation Y stock is received in respect of each share of Corporation X stock.

(ii) Analysis. Under paragraph (a)(2) of this section, because J receives 2 shares of Corporation Y stock with respect to each share of Corporation X stock, the basis of each share of Corporation X stock is allocated between such share of Corporation X stock and two shares of Corporation Y stock in proportion to the fair market value of those shares. Therefore, each of the 5 shares of Corporation X stock acquired on Date 1 will have a basis of \$2 and each of the 10 shares of Corporation Y stock received with

respect to those shares will have a basis of \$1. In addition, each of the 5 shares of Corporation X stock acquired on Date 2 will have a basis of \$4 and each of the 10 shares of Corporation Y stock received with respect to those shares will have a basis of \$2. On or before the date on which the basis of a share of Corporation Y stock received becomes relevant, H may designate which of the shares of Corporation Y have a basis of \$1 and which have a basis of \$2.

(d) Effective date. This section applies to exchanges or distributions of stock and securities after the date these regulations are published as final regulations in the **Federal Register**.

Deputy Commissioner for Services and Enforcement.