

University of Michigan Law School

University of Michigan Law School Scholarship Repository

Articles

Faculty Scholarship

2004

Exchanges of Multiple Stocks and Securities in Corporate Divisions or Acquisitive Reorganizations

Douglas A. Kahn

University of Michigan Law School, dougkahn@umich.edu

Jeffrey S. Lehman

Cornell University

Available at: <https://repository.law.umich.edu/articles/1494>

Follow this and additional works at: <https://repository.law.umich.edu/articles>



Part of the [Business Organizations Law Commons](#), [Securities Law Commons](#), and the [Taxation-Federal Commons](#)

Recommended Citation

Kahn, Douglas A. "Exchanges of Multiple Stocks and Securities in Corporate Divisions or Acquisitive Reorganizations." J. S. Lehman, co-author. *Tax Notes* 104, no. 13 (2004): 1417-27.

This Article is brought to you for free and open access by the Faculty Scholarship at University of Michigan Law School Scholarship Repository. It has been accepted for inclusion in Articles by an authorized administrator of University of Michigan Law School Scholarship Repository. For more information, please contact mlaw.repository@umich.edu.

EXCHANGES OF MULTIPLE STOCKS AND SECURITIES IN CORPORATE DIVISIONS OR ACQUISITIVE REORGANIZATIONS

By Douglas A. Kahn and Jeffrey S. Lehman

Douglas A. Kahn is the Paul G. Kauper Professor of Law at the University of Michigan. Jeffrey S. Lehman is president of Cornell University.

Kahn and Lehman argue that when a corporate division or acquisitive reorganization involves an exchange of multiple blocks of securities and stocks, there is an unresolved issue of how the exchanged properties are to be matched in determining the amount of gain recognized and the basis of the acquired properties. They ask whether the exchanged properties should be compared in the aggregate, or be divided into separate segments? If divided into segments, should each segment be subject to a further division into sub-segments? How should the segmentation be determined? This article examines the different approaches that are possible, the difference in tax consequences attending each approach, and the authors' view of the best solution.

This article is drawn from a Hornbook by the authors of this work. *Corporate Income Taxation* (5th ed. 2001, West Group). The adaptation of the material from the Hornbook was made by Prof. Kahn, who made a number of changes, and so any errors in this work are not the fault of President Lehman.

Table of Contents

I. Introduction	1417
A. Exchange of One Security for Another	1418
B. Exchange of One Security for Two	1418
II. Gain Recognition and Basis	1419
A. Allocation of Boot	1419
B. Segmented by the Parties' Agreement	1420
C. Parties Silent as to Segmentation	1427
III. Conclusions	1427

I. Introduction

If specified conditions are satisfied, the Internal Revenue Code provides nonrecognition for gain or loss realized when stocks and securities of one corporation are exchanged for stocks and securities of another corporation. When the exchange is made as part of a corporate division (a split-off or a split-up), the principal nonrecognition provision is section 355; and when the exchange

is made as part of an acquisitive reorganization, the principal nonrecognition provision is section 354.¹ Complete nonrecognition is provided only when stock is exchanged solely for stock and securities are exchanged solely for securities of no greater principal amount.² If, in addition to receiving property that is permitted to be received without recognizing gain or loss, a taxpayer also receives other property (property that does not qualify for nonrecognition), the other property is sometimes referred to as "boot." When a taxpayer receives both nonrecognition property and boot in either a qualified corporate division or an acquisitive reorganization, nonrecognition is not necessarily lost entirely. In those cases, except for a so-called "B" acquisitive reorganization,³ section 356 provides that no loss can be recognized, and that realized gain will be recognized only to the extent of the boot received.⁴ The determination of whether any recognized gain is to be characterized as capital gain or as ordinary income turns on the operation of section 356(a)(2) and is not discussed in this article.⁵

Boot can come in many different forms, including cash. There are specific provisions in the code characterizing as boot properties that otherwise would be treated as nonrecognition property. One example is that "non-qualified preferred stock," unless received in exchange for other nonqualified preferred stock, is treated as boot.⁶ In this article, the focus will be on the extent to which securities are treated as boot, the determination of the amount of the shareholder's gain when securities boot is received, and the basis that the shareholder obtains in the acquired stocks and securities.

¹Unless indicated otherwise, a reference herein to a "section" number is to the Internal Revenue Code of 1986.

²Sections 354(a)(1) and 355(a)(1). In some circumstances, the receipt of stock in a corporate division or reorganization can cause recognition of income. See sections 354(a)(2)(C), 355(a)(3)(D), and 356(e) (nonqualified preferred stock), and section 355(a)(3)(B) (stock boot).

³A "B" acquisitive reorganization is an exchange of stock of one corporation solely for voting stock of a different corporation in compliance with the provision of section 368(a)(1)(B), which provision does not allow any boot to be received (subject to one minor exception).

⁴Section 356(a)(1), (c).

⁵See Douglas Kahn and Jeffrey Lehman, *Corporate Income Taxation* at pp. 772-780, 955-961 (5th ed. 2001, West Group)

⁶Sections 354(a)(2)(C), 355(a)(3)(D), and 356(e).

If, as part of a corporate division or reorganization, a taxpayer receives securities having a greater principal amount than the securities transferred by the taxpayer, the fair market value of the difference is treated as boot.⁷ Let us refer to the difference in the principal amount of a security or securities received over the principal amount of a security or securities surrendered as the “excess principal amount”; and let us refer to the fair market value of the excess principal amount as the “excess securities boot.” Note that it is only the fair market value of the difference in principal amounts that is treated as excess securities boot and that can cause recognition of gain.

A. Exchange of One Security for Another

The determination of the amount of excess securities boot when only a single security is exchanged for a single security is straightforward.⁸ We will first briefly discuss that circumstance and then move on to the more complex situation, which is the focus of this article, when the taxpayer transfers both stocks and securities, or stocks or securities of more than one class, in exchange for both stocks and securities, or stocks or securities of more than one class. Consider the following example.

Example 1. *A* owned a bond of the *T* Corporation in the principal amount of \$4,000 and having a fair market value of \$3,500. *A* had a basis of \$2,000 in that *T* bond. The *T* Corporation was acquired by the *P* Corporation in a merger that qualified as a reorganization under section 368(a)(1)(A). Pursuant to that reorganization, *A* transferred his *T* bond to *P* in exchange for which *A* received from *P* a bond of *P* having a principal amount of \$5,000 and a fair market value of \$3,500. *A* realized a gain of \$1,500 on that exchange, but he will recognize a gain only to the extent that he received boot. There is a \$1,000 difference between the \$5,000 principal amount of the *P* bond that *A* received and the \$4,000 principal amount of the *T* bond that he transferred to *P*. We will refer to that \$1,000 difference as the “excess principal amount.” The fair market value of that \$1,000 of excess principal amount is \$700 (20 percent of the \$3,500 value of the *P* bond since the \$1,000 excess principal amount constitutes 20 percent of the \$5,000 principal amount of the *P* bond). The \$700 fair market value of that \$1,000 difference in principal amounts constitutes the excess securities boot. *A* recognized \$700 of the \$1,500 gain that *A* realized on the exchange.

The next step is to determine the basis that *A* acquired in the *P* bond that he received in Example (1). To the extent that the *P* bond constituted boot to *A*, *A*'s basis in

that portion of the bond will equal its fair market value when he acquired it.⁹ The basis of boot, other than cash, received in a transaction that otherwise constitutes a nonrecognition transaction will always equal the fair market value of the boot. The boot in this case is 20 percent of the *P* bond, which portion of the bond had a fair market value of \$700. So, *A*'s basis in 1/5 of the *P* bond is \$700. *A*'s holding period for 1/5 of the *P* bond begins with his acquisition of that bond. *A*'s basis in the remaining 4/5 of the *P* bond is \$2,000, determined under section 358(a)(1) as the basis that *A* had in the *T* bond that he exchanged (\$2,000) increased by the gain recognized (\$700) and reduced by the amount of boot received (\$700). So, *A* has a basis of \$700 in 1/5 of the *P* bond and a basis of \$2,000 in the remaining 4/5 of that bond. *A*'s holding period for 4/5 of the bond includes the period that *A* held the *T* bond, assuming that both bonds constituted capital assets in *A*'s hands.¹⁰

B. Exchange of One Security for Two

Example 2. Consider the facts of Example 1 with the change that *P* transferred two of its bonds to *A* instead of just one. *P* transferred to *A* bond *P*-1 having a principal amount of \$2,000 and a fair market value of \$1,500 and bond *P*-2 having a principal amount of \$3,000 and a fair market value of \$2,000. The aggregate principal amount of the two bonds is \$5,000, which is \$1,000 greater than the principal amount of the *T* bond that *A* transferred in exchange. So, there is a difference of \$1,000 in the principal amounts of the bonds that were exchanged, and that difference can be referred to as the excess principal amount.

While it could be possible to segment this transaction into several exchanges — *A* could be deemed to have transferred about 43 percent of the *T* bond for the *P*-1 bond, and about 57 percent of the *T* bond for the *P*-2 bond — we have rejected that idea. We believe that if a shareholder transfers only one property and if there is no express agreement by the parties to segment the exchange, the transaction should be treated as an integrated exchange. In that regard, it is noteworthy that the regulations to section 358 require a segmentation of a transaction only when the transferor either held more than one class of stocks or securities or held both stocks and securities before the exchange took place.¹¹ The fact that the focus of that regulation is on the holdings of the shareholder before the exchange suggests that the trigger for a segmented approach is the types of property transferred or retained by the shareholder rather than the types of property received by the shareholder.

The excess principal amount of \$1,000 must be allocated between bond *P*-1 and bond *P*-2. The most reasonable method of making that allocation is according to the relative principal amounts of the

⁷Sections 354(a)(2)(A), 355(a)(3)(A), 356(d).

⁸Even when only securities are involved, the determination of boot can be complex if multiple securities are exchanged. The problem is whether to measure the excess principal amount by comparing the aggregate principal amounts of securities on each side of the exchange or to segment the exchanges into separate bundles. That same issue arises when stocks and securities are exchanged.

⁹Section 358(a)(2).

¹⁰Section 1223(1).

¹¹Treas. reg. section 1.358-2(a)(4).

two bonds. Accordingly, 40 percent of the \$1,000 excess principal amount (\$400) is allocated to bond *P-1*, and that constitutes 20 percent of the principal amount of *P-1*. The fair market value of that portion of the *P-1* bond is \$300 (20 percent x \$1,500 fair market value). The remaining \$600 of the \$1,000 excess principal amount is allocated to bond *P-2*, and it constitutes 20 percent of the principal amount of that bond. The fair market value of that portion of the *P-2* bond is \$400 (20 percent x \$2,000). The total amount of excess securities boot received by *A* then is \$700 (\$300 + \$400). While *A* realized a gain of \$1,500, he recognized only \$700 of that gain.

A's basis in the two *P* bonds in Example (2) is determined in the same manner as in Example (1) except that his basis in the nonrecognition portion of the two bonds must be allocated between them according to their fair market values.¹² The boot portion of each bond will have a basis equal to the fair market value of that portion — \$300 basis for the boot portion of the *P-1* bond, and \$400 basis for the boot portion of the *P-2* bond. *A*'s basis in his *T* bond (\$2,000), increased by the \$700 recognized gain and reduced by the \$700 boot received, which equals \$2,000 and which amount we will refer to as the "nonrecognition basis," is allocated between the two *P* bonds. The most reasonable method of allocation appears to be according to the fair market values of the nonrecognition portion of each bond. The fair market value of the nonrecognition portion of the *P-1* bond is \$1,200, and the fair market value of the nonrecognition portion of the *P-2* bond is \$1,600. So about 43 percent of the \$2,000 nonrecognition basis, which equals \$860, is allocated to the nonrecognition portion of the *P-1* bond, and \$1,140 of the nonrecognition basis is allocated to the nonrecognition portion of the *P-2* bond. *A*'s total basis in the *P-1* bond is \$1,160 (\$300 for 1/5 of the bond and \$860 for the remaining 4/5 of the bond). *A*'s total basis in the *P-2* bond is \$1,540 (\$400 for 1/5 of the bond and \$1,140 for the remaining 4/5 of the bond).

A's holding period for the 1/5 portion of each of the *P* bonds that constituted boot begins with the date he acquired those bonds. *A*'s holding period for the 4/5 of each *P* bond that constituted nonrecognition property will include the period that *A* held the *T* bond if the *T* bond and both *P* bonds are capital assets in *A*'s hands.

Now consider the more complex consequences that occur when multiple properties are exchanged.

II. Gain Recognition and Basis

When "section 306 stock" is exchanged in a corporate division or reorganization, there are special rules that apply, but we do not discuss section 306 stock in this article.¹³ In the discussion and examples in this article, none of the stock mentioned will be section 306 stock.

¹²Treas. reg. section 1.358-2(a)(2).

¹³For a brief discussion of that consequence, and for an exploration of the overall treatment of section 306 stock, see Douglas Kahn and Jeffrey Lehman, *Corporate Income Taxation* at pp. 240-252, 760.

Also, none of the stock mentioned in the examples will be nonqualified preferred stock or stock boot (as described in section 355(a)(3)(B)).

The numbers used in the examples in this article were chosen to illustrate how the tax law operates, and are not necessarily financially realistic. The examples are designed to illustrate principles, and the figures used were chosen for ease of computation.

A. Allocation of Boot

The process of calculating gain and determining basis in a corporate division or acquisitive reorganization transaction in which boot is present can become complex when there are multiple properties involved in the exchange. Specifically, what happens when a shareholder gives up more than one "class" of stock or security or more than one "block" from the same class of stock or security?¹⁴ May gains and losses be netted against one another to determine the amount of gain realized on the exchange? If not, how does one assign boot to the different components of the exchange to determine how much gain must be recognized and what basis the shareholder has in the acquired properties?

Example 3. *X* Corporation had 40 shares of common stock outstanding, divided equally between *P* and *Q*. *Q* had a basis of \$1,000 per share in a block of 10 shares that she purchased 10 years ago, and a basis of \$10,000 per share in the remaining block of 10 shares, which she purchased 5 years ago. Today, all the stock is worth \$5,000 per share.

In a split-off¹⁵ that qualifies under section 356, *X* distributes to shareholder *Q* all the stock of subsidiary *S*, plus \$10,000 cash, in exchange for all 20 shares of *X* stock owned by *Q*. The *S* stock is worth \$90,000. Thus, in this split-off, *Q* realized a gain of \$4,000 per share on 10 of her shares of *X* stock and a loss of \$5,000 per share on her other 10 shares of *X* stock, for an overall loss of \$10,000. In the transaction, *Q* received \$10,000 worth of boot.

The IRS has taken the position that in a case such as Example 3 where a shareholder gives up several different blocks of stock, realizing a gain on some and a loss on others, each block must be considered separately, so that realized gains and realized losses are not netted against one another.¹⁶ In other words, the transaction is segmented into two separate exchanges. In Example 3, *Q* received half the boot (\$5,000) in connection with the

¹⁴In drawing a distinction between situations involving multiple "blocks" of stock or securities and situations involving multiple "classes," we are following a convention reflected in the regulations and rulings. The regulations state that when they refer to stocks of more than one "class," they mean stocks that have different rights. Treas. reg. section 1.358-2(a)(1). The principal ruling involving more than one "block" of stock concerns stocks having identical rights, but different bases. See Rev. Rul. 68-23, 1968-1 C.B. 144.

¹⁵A "split-off" is a type of corporate division in which a corporation distributes stock and securities of a controlled subsidiary in exchange for stocks and securities of the distributing corporation.

¹⁶Rev. Rul. 68-23, 1968-1 C.B. 144.

redemption of older shares on which she realized a \$40,000 gain; she received the other half of the boot (\$5,000) in connection with the redemption of newer shares on which she realized a loss. She must recognize a gain of \$5,000 for her exchange of the older shares.¹⁷ She cannot recognize any of the realized loss.¹⁸

But how does one know how much of the boot that a shareholder received was in exchange for each block or class of surrendered stock or securities when the transaction was treated by the parties as an integrated exchange? In Example 3, how does one know that Q received exactly half the S stock and half the cash boot in exchange for each block of 10 shares? One can reach that result by allocating each form of consideration received equally among each share of the same class of stock surrendered, or one could reach the same result equally well by allocating the boot pro rata by fair market value among all the shares surrendered. That latter approach comports with the treatment accorded by the IRS to boot received in connection with a transfer to a controlled corporation under section 351(b).¹⁹

B. Segmented by the Parties' Agreement

Now, consider the consequences when multiple securities are received and surrendered.

Example 4. A owned (a) 100 shares of common stock of X having a basis of \$100,000 and a fair market value of \$200,000, (b) X bond #1 having a basis of \$25,000, a fair market value of \$40,000, and a principal amount of only \$10,000, and (c) X bond #2 having a basis of \$20,000 and a fair market value and principal amount of \$80,000.

In an exchange meeting the requirements of section 356, A surrenders to X (a) 50 shares of X common stock (half his holdings worth \$100,000 and having a basis of \$50,000), (b) X bond #1, and (c) X bond #2. In exchange, X distributes to A the following: (i) 20 shares of Y stock having a fair market value of \$20,000, (ii) Y bond #1 having a principal amount of \$60,000 and a fair market value of \$80,000, and (iii) Y bond #2 having a principal amount and fair market value of \$120,000.

Before making the exchange, A and X agree explicitly that in the transaction, A is surrendering the X common stock (worth \$100,000) solely in exchange for the distribution of Y common stock and Y bond #1, and A is surrendering the two X bonds solely in exchange for Y bond #2.

In Example 4, it is clear that A realizes a total gain of \$125,000, as follows:

- a \$50,000 gain on the exchange of X common stock,
- a \$15,000 gain on the exchange of X bond #1, and
- a \$60,000 gain on the exchange of X bond #2.

What is not at all obvious is how much gain A should recognize, and what basis A will have in the properties A acquired from X.

A first step to resolving those issues is to determine the amount of differences in the principal amounts of securities A received over the principal amounts of the securities A transferred. While there is no authoritative resolution of that question, several approaches present themselves.

1. Aggregate approach. One approach would aggregate all the securities transferred in either direction in the transaction and treat the fair market value of the aggregate excess principal amount as excess securities boot. We will refer to this approach as the "aggregate approach." In the context of Example 4, that aggregate approach would rest on the observation that A has received bonds having an aggregate principal amount of \$180,000 in exchange for bonds having an aggregate principal amount of \$90,000. Thus, $(\$180,000 - \$90,000) / \$180,000 = 50$ percent of each Y bond that A received represents excess principal amount. The fair market value of the portion of each Y bond that represents excess principal amount is boot. Fifty percent of Y bond #1 has a fair market value of \$40,000. Fifty percent of Y bond #2 has a fair market value of \$60,000. Since there is no other boot in the transaction, the total amount of boot that A received (all of which is excess securities boot) is \$100,000. If one were to allocate that boot across the surrendered assets according to fair market values, \$45,454 would be allocated to A's exchange of the X stock (causing that amount of gain to be recognized), \$18,182 would be allocated to A's exchange of X bond #1 (causing all \$15,000 of realized gain on that bond to be recognized), and \$36,364 would be allocated to A's exchange of X bond #2 (causing that amount of gain to be recognized). The total gain recognized by A would then be \$96,818.

2. Segmented approach. A different approach would segment the transaction into two separate exchanges. Under that approach, which we will call the "segmented approach," one would observe that the parties' agreement establishes that A received Y bond #1 in exchange for no X bonds at all. Thus, the entire \$60,000 of the principal amount of Y bond #1 constitutes excess principal amount, and the \$80,000 fair market value of that excess principal amount would be excess securities boot. One would then observe that A received Y bond #2 in exchange for both X bonds. Since the principal amount of Y bond #2 (\$120,000) exceeds the aggregate principal amount of the two X bonds (\$90,000) by \$30,000, 1/4 of Y bond #2 would be excess principal amount, and the fair market value of that excess principal amount, which also is \$30,000, constitutes excess securities boot. A would have \$30,000 worth of boot on account of the receipt of Y bond #2. As we will discuss below, there is a question whether the exchange for Y bond #2 should be subdivided into two separate exchanges in which X bond #1 is exchanged for part of Y bond #2, and X bond #2 is exchanged for the remaining part of Y bond #2. We will defer discussing that question for the moment, and will not divide the exchange for Y bond #2 into two separate exchanges at this time. When we do reach that question, the reader will see we believe a subdivision into two separate exchanges is the better solution.

3. Contrasting complete and partial segmentation. Should the \$80,000 of boot that A received because of Y

¹⁷Section 356(a).

¹⁸Section 356(c).

¹⁹Rev. Rul. 68-55, 1968-1 C.B. 140.

bond #1 be allocated only to the X stock that was exchanged in that segment, or should that boot be allocated among all of the properties transferred by A according to their fair market values? Similarly, should the \$30,000 of boot that is attributable to Y bond #2 be allocated between the two X bonds that were transferred in exchange for Y bond #2, or should that boot be allocated among all of the properties that A transferred? In other words, after applying the segmented approach to determine the amount of boot, should we determine the amount of recognized gain by continuing to apply the segmented approach (the complete segmented approach), or should we switch to an aggregate approach once the amount of boot is determined (the partial segmented approach)? The results are significantly different depending on which method is chosen.

If the complete segmented approach is used, A will recognize \$50,000 of gain on the X stock since all \$80,000 of the excess securities boot attributable to the receipt of Y bond #1 is allocated to the X stock. Since, for the moment, we are not subdividing the second exchange into two smaller exchanges, the \$30,000 of excess securities boot attributable to Y bond #2 is allocated between the two X bonds according to their fair market values. So, 1/3 of the \$30,000 of boot is allocated to X bond #1, and A will recognize \$10,000 gain thereby. The remaining 2/3 of the \$30,000 of boot will be allocated to X bond #2, and A will recognize \$20,000 gain thereby. The total gain recognized by A then will be \$80,000 — \$50,000 on the transfer of the X stock, \$10,000 on the transfer of X bond #1, and \$20,000 on the transfer of X bond #2. That \$80,000 of recognized gain is in contrast to the \$96,818 that A would recognize if the aggregate approach were employed.

What would be the amount of A's recognized gain if the partial segmented approach were adopted so that the boot determined under the segmented approach were then allocated among all of the transferred assets? The aggregate amount of excess securities boot that A received from the two segmented exchanges is \$110,000 (\$80,000 plus \$30,000). If that \$110,000 of boot were then allocated among all of the properties transferred by A according to their fair market values: \$50,000 of the boot would be allocated to the X stock, and so A would recognize all \$50,000 of his realized gain from that stock; \$20,000 of the boot would be allocated to X bond #1, and so A would recognize all \$15,000 of his realized gain from that bond; and the remaining \$40,000 of the boot would be allocated to X bond #2, and A would recognize that amount of his realized gain. The total amount of gain recognized by A under this hybrid segmented and aggregate approach (the partial segmented approach) would be \$105,000 as contrasted to the \$96,818 of gain recognized under the aggregate approach, and the \$80,000 of gain recognized under the complete segmented approach.

4. Considerations favoring adoption of a complete segmented approach. In determining whether to adopt the complete segmented approach, in which boot is allocated on a segmented basis, one might note that in another area of the corporate tax law, segmentation is not used in allocating boot. When multiple properties are transferred to a controlled corporation in exchange for stock and

boot, which can cause recognition of realized gain under section 351(b) to the extent of the boot received, the boot is allocated among all of the transferred properties according to their fair market values.²⁰ Nevertheless, the authors believe that the segmented approach should be applied consistently to determine recognized gain in the context of a corporate division or reorganization. If the segmented approach is the one used to determine the amount of boot, there is no reason to depart from that approach when allocating the boot among the transferred properties. While the language of section 356(a)(1) refers to gain recognized in "an exchange," that language does not resolve whether the "exchange" refers to the entire transaction or to each segmented exchange. An example in the regulations under section 358 uses the segmented approach both to determine the amount of boot that was received in a corporate division and also in allocating that boot among the properties that the shareholder transferred.²¹ In that regulatory example, none of the boot that the shareholder received was allocated to the appreciated security he transferred in exchange for a security of equal principal amount. While the total amount of gain recognized by the shareholder in that example in the regulations would not have been different if any of the boot had been allocated to the appreciated security, it would have changed the basis that the transferee obtained in the acquired properties.

The strongest support for adopting the aggregate approach for determining the amount of boot is to be found in the language of sections 356(d)(2)(B) and 356(d)(2)(C). Section 356(d)(2)(C) provides that in a section 355 "exchange," boot consists of the fair market value of the amount by which "the principal amount of the securities [plural in original] in the controlled corporation which are received exceeds the principal amount of the securities [plural in original] in the distributing corporation which are surrendered."²² The language of section 356(d)(2)(B) is to the same effect, but applies to exchanges made as part of a reorganization. But that statutory language is not dispositive for one could frame the choice between the aggregate and segmented approaches as a choice about what level of aggregation constitutes the "exchange" to which section 356(d)(2)(B) and (C) apply. Moreover, as noted above, the regulations under section 358 adopt a segmented approach. Those regulations provide that when a person who owns stock of more than one class, or securities of more than one class, or both stock and securities, participates in a reorganization or corporate division transaction, each class of stock, and each class of securities, should be treated as if it participated in a separate exchange.²³ While most of those regulations, by their terms, refer only to the calculation of basis, it would be anomalous to use different rules for the calculation of gain and the subsequent calculation of basis. Moreover, in one of the

²⁰*Id.*

²¹Treas. reg. section 1.358-2(c), Ex. (4).

²²The same aggregate approach is adopted in sections 355(a)(3)(A) and 354(a)(2)(A).

²³Treas. reg. sections 1.358-2(a)(4), -2(c), Exs. (3) and (4).

examples in those regulations, gain is determined by using a segmented approach.²⁴

Accordingly, we believe the correct approach in Example 4 to determine the amount of boot *and* of recognized gain is to segment the transaction into two separate exchanges (each of which hereinafter is sometimes referred to as an “exchange group”). We will examine below whether one of the exchange groups should be divided into two smaller exchanges.

5. Identification of properties included in an exchange group. As to the question of which properties should be included in each exchange group, we believe that where the parties’ agreement has expressly matched the properties to be exchanged, those matched pairings should be respected when applying the tax rules as long as the matched properties are approximately of the same fair market value or of the same principal amount. In other words, if the segmentation in the parties’ agreement is reasonable, it should be respected for tax purposes. That approach appears to have been adopted in examples set forth in the regulations.²⁵ In Part II.C of this article we will examine the question of how the exchange groups are to be determined when the parties failed to make an allocation in their agreement.

6. Further segmentation of an exchange group. Applying the segmented approach to Example 4, on the exchange of X common for Y common and Y bond #1 (the first exchange group), A would realize a gain of \$50,000 and would recognize all \$50,000 (having received \$80,000 in boot as a consequence of receiving Y bond #1). It is our view that the first exchange group should not be further segmented into individual exchanges since only one item that was surrendered by A is included in that exchange group and the parties did not expressly agree to segment that exchange group into several individual exchanges.²⁶ If more than one item of A’s had been included in the first exchange group, it might then have been necessary to segment that group into individual exchanges.

The second exchange group consists of A’s transfer of X bonds #1 and #2 for Y bond #2. Because two of A’s securities were transferred in this second exchange group, it can be further segmented into a transfer by A of X bond #1 for part of Y bond #2 and a transfer by A of X bond #2 for the remaining part of Y bond #2. The question then is whether the amount of boot received by A in this second exchange group is determined by comparing the principal amount of Y bond #2 with the aggregate principal amount of X bonds #1 and #2 (that is, an aggregate treatment for the second exchange group); or whether the amount of boot is determined by a further segmentation in which the principal amount of the portion of Y bond #2 that was exchanged for X bond #1 is compared with the principal amount of X bond #1; and a similar comparison is made between the principal amount of the portion of Y bond #2 that was exchanged for X bond #2 and the principal amount of X bond #2. If an aggregate approach is applied to an exchange group

(thereby departing from segmentation), we sometimes refer to that method as the “partial aggregate approach.” If, instead, an exchange group is itself segmented into two or more separate exchanges, we sometimes refer to that method as the “consistent segmented approach.”

Those alternative approaches can reach different results. The latter of the two alternatives (the consistent segmented approach) has the virtue of consistency in that it applies the segmentation approach throughout the process to its ultimate conclusion. In contrast, the first alternative (the partial aggregate approach) departs from the segmentation approach and shifts to an aggregate approach for part of the calculation. Let us examine the results reached under those alternative approaches, and then let us consider a different method of applying the consistent segmented approach and examine the result reached under that method.

7. Comparison of consistent segmented approach with partial aggregate approach. First, let us apply the consistent segmented approach by matching exchanged items within each exchange group by fair market value. X bond #1 would then be deemed to have been exchanged for 1/3 of Y bond #2, which 1/3 portion has a principal amount and fair market value of \$40,000. A will realize a gain of \$15,000 on that exchange, all of which will be recognized since the excess principal amount on that exchange (and thus the boot since the principal amount and value of Y bond #2 are equal) will be \$30,000. On the exchange of X bond #2 for 2/3 of Y bond #2, having a principal amount and fair market value of \$80,000, A will realize a gain of \$60,000, but A will not recognize any of that gain because there will be no excess principal amount and so no excess security boot. So the final result will be that A will recognize \$50,000 gain on his X common stock, \$15,000 gain on his X bond #1, and no gain on his X bond #2, for a total gain of \$65,000.

Next, let us apply the approach of shifting to the aggregate treatment for part of the computation (the partial aggregate approach). We will compare the principal amount of Y bond #2 with the aggregate principal amount of X bonds #1 and #2. The difference is \$30,000, and the fair market value of that difference is also \$30,000. So, there is excess security boot of \$30,000 in that segmented exchange. The question then is how is that \$30,000 of boot to be allocated between the X #1 and #2 bonds? The best solution seems to be to allocate the boot among the two X bonds according to their relative values. Accordingly, \$10,000 of the excess security boot would be allocated to the exchange of X bond #1 for 1/3 of Y bond #2, and thus \$10,000 of the \$15,000 gain realized on the transfer of X bond #1 will be recognized. The remaining \$20,000 of boot will be allocated to the exchange of X bond #2 for part of the Y bond #2, and so \$20,000 of the \$60,000 gain that was realized on that exchange will be recognized. In sum, A will recognize \$50,000 on X stock, \$10,000 on X bond #1, and \$20,000 on X bond #2, for a total gain of \$80,000.

On these facts, the partial aggregate approach resulted in A’s recognizing \$15,000 more gain than A would recognize under the consistent segmented approach. But that will not always be the case. With different basis figures for A, the consistent segmented approach can result in the recognition of a greater amount of gain than

²⁴Treas. reg. section 1.358-2(c), Ex. (4).

²⁵Treas. reg. section 1.358-2(c), Exs. (3) and (4).

²⁶See the text at note 11 *supra*.

results from the partial aggregate system. Overall, neither choice would seem to favor either the government or taxpayers and so can be deemed neutral from a programmatic perspective.

If one were to adopt the segmented approach for general application, which we believe to be the correct choice, there seems little reason to depart from that approach at some point along the process. We believe, therefore, that the segmented approach should be applied consistently throughout the computational process.

8. Another method for applying the consistent segmented approach. If the consistent segmented approach is adopted, once the initial segmentation of the exchanged items into exchange groups has taken place, there remains a question as to how each exchange group is to be subdivided into further segmented exchanges. In other words, within each exchange group, what standard is to be employed in matching each of the surrendered items in that group with one of the items from that group that the shareholder received. To the extent that it is feasible, items of like nature should be matched — for example, stock for stock, and securities for securities.²⁷ But how much of each property should be matched with its counterpart? Should exchange items of like nature within an exchange group be matched exclusively by fair market value, as we did in Part II.B.7 above in applying the consistent segmented approach to the second exchange group of Example 4? We will sometimes refer to that method as the “fair market value matching method.” Or should securities be singled out and matched by principal amounts to the extent thereof, with any excess principal amount being allocated among surrendered nonsecurity items in the exchange group according to their values? If the shareholder surrendered no nonsecurity items in that exchange group, the excess principal amount will be allocated among the surrendered securities in that exchange group according to their values. We will sometimes refer to that method as the “principal amount matching method.” We will address the question of which of those methods is preferable in the discussion of Example 5 in Part II.B.9 below.

As mentioned, we applied the fair market value method to the second exchange group of Example 4 in Part II.B.7 above. To compare the operation of the two methods, let us now see what the result would be if the principal amount matching method were applied to the second exchange group in Example 4.

In the second exchange group, under a regime of matching securities by their principal amounts, \$80,000 of the principal amount of Y bond #2 would be allocated to X bond #2, and \$10,000 of the principal amount of Y bond #2 would be allocated to X bond #1. The remaining \$30,000 of the principal amount of Y bond #2 (the excess principal amount) would be allocated between the two X bonds according to their fair market values. If A had surrendered a nonsecurity item in this exchange group, the excess principal amount would be allocated to that nonsecurity item; but since there was no nonsecurity item

in this exchange group, the excess principal amount must be allocated between the two securities that A received. Thus, \$20,000 of the excess principal amount of Y bond #2 would be allocated to X bond #2, and \$10,000 of the excess principal amount of Y bond #2 would be allocated to X bond #1. Since the principal amount and fair market value of Y bond #2 are equal, the value of the excess principal amount that is allocated to each X bond is equal to the allocated excess principal amount. This results in A’s recognizing a \$20,000 gain on X bond #2 and a \$10,000 gain on X bond #1. On those facts, the result is the same as the result reached under the fair market value matching method, but that will not be the case when the shareholder surrenders a nonsecurity item in the exchange group, as shown in the discussion of Example 5 in Part II.B.11 below.

9. Preferable method for subdividing an exchange group. Which of the two methods for applying the consistent segmented approach is better — the fair market value matching method or the principal amount matching method? There is no authoritative decision dictating which approach and which method within an approach is to be used. As already noted, we believe the consistent segmented approach is the better choice. As to the best method for applying that choice, that is a close call. For reasons set forth in the discussion of Example 5 in Part II.B.11, we have a preference for the principal amount matching method.

10. Determination of basis. How is A’s basis in the Y stock and bonds that he received to be determined? A’s basis in any boot he received will equal its fair market value.²⁸ A’s basis in any nonrecognition property he received will equal his basis in the property he held before the exchange (increased by gain recognized and decreased by boot received) allocated among all of the nonrecognition property received and any stocks and securities that A retained.²⁹ As previously noted, the regulations under section 358 require that a segmented approach must be used to allocate basis among those properties.³⁰

In most of the examples in this article, a taxpayer will receive a security, part of which constitutes boot and part of which constitutes nonrecognition property. Basis will be determined for each portion of such a security. While we may sometimes calculate the taxpayer’s total basis in the security, the segmented basis must be maintained because the taxpayer will have a different holding period for each portion of the security.

The determination of basis depends partly on the amount of gain recognized by A on each of the properties he transferred in the transaction, and the amount of A’s gain depends on whether an aggregate or segmented approach was applied in determining gain. It is worth emphasizing the point we made previously that since the regulations require that basis be determined by using the segmented method, it is reasonable to conclude that the

²⁷See Treas. reg. section 1.358-2(c), Ex. (3).

²⁸Section 358(a)(2).

²⁹Treas. reg. section 1.358-2(a).

³⁰Treas. reg. section 1.358-2(a)(4), (c), Exs. (3) and (4).

segmented approach should also be employed in determining the amount of gain recognized on the transaction. Nevertheless, we will determine the properties' basis when recognized gain is measured by both approaches. Let us first consider what the basis will be when gain is determined by using the segmented approach.

a. Basis when gain is determined by the segmented approach. *A's* \$100,000 basis in his 100 shares of *X* stock (as adjusted for gain recognized and boot received) must be allocated between the 20 shares of *Y* stock he received and the 50 shares of *X* stock he retained. Using a segmented approach to determine gain, *A* recognized \$50,000 of gain on the exchange of his 50 shares of *X* common for 20 shares of *Y* common plus the *Y* bond #1 (the first exchange group). *A's* basis in *Y* bond #1 will equal its fair market value of \$80,000 since all of that bond was boot.³¹ *A's* \$100,000 basis in his 100 shares of *X* stock will be increased by the \$50,000 gain he recognized on the transfer of 50 shares of *X* stock and decreased by the \$80,000 fair market value of the boot he received in that exchange group.³² That leaves a net decrease of \$30,000, so *A* must allocate the remaining \$70,000 of his basis between his retained 50 shares of *X* stock (having a value of \$100,000) and the 20 shares of *Y* stock he received (having a value of \$20,000) according to their respective values.³³ So *A* will have a basis of \$11,667 in the 20 shares of *Y* stock he received and a basis of \$58,333 in his retained 50 shares of *X* stock.

In the second exchange group, there was excess securities boot because the principal amount of *Y* bond #2 is greater than the aggregate principal amount of the two *X* bonds. As previously discussed, there is a question whether the second exchange group should be treated as an aggregate or further segmented into two separate exchanges (that is, the choice is between the partial aggregate approach and the consistent segmented approach). As we shall see, in the instant situation, the basis of the properties will be the same regardless of which approach is chosen, but that will not always be the case. While the authors favor the consistent segmented approach, we will determine the basis for both of those approaches.

If the partial aggregate approach is applied to the second exchange group, the excess principal amount is \$30,000, and the excess securities boot also is \$30,000. The excess securities amount and the boot are allocated between *X* bonds #1 and #2 according to their values. So, \$10,000 of both the excess securities amount and of the boot is allocated to *X* bond #1, causing \$10,000 of gain recognition; \$20,000 of excess securities amount and of boot is allocated to *X* bond #2, causing \$20,000 of gain recognition.

Of the \$120,000 principal amount of *Y* bond #2 that *A* received, \$30,000 constituted boot (having a value of the same amount), and so *A* has a basis of \$30,000 in that 1/4 of *Y* bond #2.

The remaining 3/4 of *Y* bond #2 is nonrecognition property whose basis is determined by reference to the basis that *A* had in the two *X* bonds as adjusted for gain recognized and boot received. The aggregate basis that *A* had in the two *X* bonds (\$45,000) is increased by the \$30,000 of recognized gain and decreased by the \$30,000 of boot that *A* received in the second exchange group. The resulting \$45,000 figure is the basis that *A* has in 3/4 of *Y* bond #2.

If instead, the second exchange group is segmented into two separate exchanges (the consistent segmented approach), the question arises whether the securities should be matched by fair market value or by principal amounts. That question is examined in connection with the discussion of Example 5 in Part II.B.11, and we conclude there that we have a preference for matching by principal amounts. We will use the principal amount matching method in determining the basis here.

The principal amounts of the bonds are matched so that \$80,000 of the principal amount of *Y* bond #2 (2/3 of that bond) is matched with *X* bond #2, and \$10,000 of the principal amount of *Y* bond #2 (1/12 of that bond) is matched with *X* bond #1. *A's* basis in 2/3 of *Y* bond #2 is equal to the \$20,000 basis that *A* had in *X* bond #2 increased by the \$20,000 gain³⁴ *A* recognized on *X* bond #2 and decreased by the \$20,000 of boot he received on that bond. So, *A* has a basis of \$20,000 in 2/3 of *Y* bond #2. *A's* holding period for 2/3 of *X* bond #2 is tacked on to the holding period he has for *Y* bond #2, assuming both bonds constituted capital assets in *A's* hands. *A's* basis in 1/12 of *Y* bond #2 is equal to his \$25,000 basis in *X* bond #1 increased by the \$10,000 gain³⁵ he recognized on that bond and reduced by the \$10,000 of boot he received on that bond. So, *A* has a basis of \$25,000 in 1/12 of *Y* bond #2. *A's* holding period for *X* bond #1 is tacked on to his holding period for 1/12 of *Y* bond #2, assuming that both bonds constituted capital assets in *A's* hands. Combining *A's* 2/3 and 1/12 interest gives *A* a 3/4 interest in *Y* bond #2, and he has a \$45,000 basis in that 3/4 interest.

After the matching by principal amounts was completed, there remained unallocated \$30,000 of the principal amount of *Y* bond #2. That \$30,000 of principal amount has a value of \$30,000 as well, and all of it constitutes boot. The \$30,000 principal amount and boot is allocated between the two *X* bonds according to their fair market values. That \$30,000 of principal amount and boot constitutes 1/4 of the *Y* bond #2, and so *A* has a basis of \$30,000 in 1/4 of *Y* bond #2. *A's* total basis in *Y* bond #2 is \$75,000 (\$20,000 + \$25,000 + \$30,000).

b. Basis when gain is determined by the aggregate approach. Even if, contrary to the authors' preferred view, the aggregate approach were adopted for determining gain, the determination of *A's* basis in the acquired *Y*

³¹Section 358(a)(2).

³²Section 358(a)(1).

³³Treas. reg. section 1.358-2(a)(2), (c), Exs. (2) and (3).

³⁴As shown in the next paragraph of the text, \$20,000 of boot is allocated to *X* bond #2, and so *A* recognized a gain of \$20,000 on the transfer of that bond.

³⁵As shown in the next paragraph of the text, \$10,000 of boot is allocated to *X* bond #1, and so *A* recognized a gain of \$10,000 on the transfer of that bond.

stock and Y bonds will nevertheless be made by using the segmented approach since that is required by the regulations.³⁶ A's basis in the portion of any property he received in the exchange that is treated as boot will equal the fair market value of that portion of the property.³⁷ A's basis in the nonrecognition portion of any property he received in the exchange is determined by making an allocation of the basis of the properties that A held before the exchange took place, increased by any gain recognized on each such property and decreased by the boot allocated to each such property.³⁸ The manner in which that allocation of basis is to be made when gain is determined by a different approach (aggregate approach) than basis is determined (segmented approach) is not clear, and the complexity engendered by having to apply two different approaches to the same transaction is a forceful argument for adopting the segmented approach in determining gain.

Recall that when the aggregate approach is used, there is \$90,000 of excess principal amount, \$100,000 of excess securities boot, and A recognized a gain of \$96,818.³⁹ The most reasonable approach to allocating the excess principal amount of \$90,000 to determine how much of each Y bond consists of excess principal amount is to allocate it between the two Y bonds according to their principal amounts. Accordingly, one-third of the excess principal amount (\$30,000) would be allocated to Y bond #1, and the remaining \$60,000 of excess principal amount would be allocated to Y bond #2. Of the \$60,000 of principal amount of Y bond #1, \$30,000 or 50 percent constitutes excess principal amount, and the fair market value of that portion of Y bond #1 is \$40,000. So A's basis in 50 percent of Y bond #1 is \$40,000 (its fair market value). Of the \$120,000 principal amount of Y bond #2, \$60,000 or 50 percent constitutes excess principal amount, and the fair market value of that portion of Y bond #2 is also \$60,000. So A's basis in 50 percent of Y bond #2 is \$60,000.

To determine the basis of the nonrecognition portion of the properties that A holds after the exchange, it is necessary to first determine the adjusted basis that A had in the properties he held before the exchange took place and then make the adjustments for gain recognized and boot received for each item of property. As you may recall, the gains realized by A on the transfer were: \$50,000 on the 50 shares of X stock, \$15,000 on the X bond #1, and \$60,000 on X bond #2. The \$100,000 of excess securities boot is allocated by fair market value among the 50 shares of X stock and the two X bonds that A transferred in the exchange. So \$45,454 of boot is allocated to the 50 shares of X stock that A transferred; \$18,182 of boot is allocated to X bond #1; and \$36,364 of boot is allocated to X bond #2. That allocation results in gain recognition of \$45,454 on the 50 shares of X stock, \$15,000 on X bond #1, and \$36,364 on X bond #2.

The requirement that the transaction be segmented in determining basis requires that the transaction be divided into two exchange groups. We will examine each exchange group separately.

The first exchange group consists of the transfer of 50 shares of X stock for 20 shares of Y stock and Y bond #1. A's \$100,000 basis in the 100 shares of X stock that he held before the exchange is increased by the \$44,454 gain he recognized on the 50 shares of X stock that were transferred as part of the first exchange group. By how much should the basis be reduced because of the receipt of boot? As noted just above, using the aggregate approach, \$44,454 of boot was allocated to A's transfer of the 50 shares of X stock to determine the amount of gain; but the portion of the Y bond #1 that A received in the first exchange group that constitutes boot is only \$40,000. The authors believe that because a segmented approach is required for determining basis, the actual amount of the Y bond #1 that constitutes boot (\$40,000) is the correct figure to use. So A's basis of \$100,000 in the 100 shares of X stock is increased by the \$44,454 gain and reduced by the \$40,000 of boot received in that exchange group. It would seem then that the resulting basis of \$104,454 is then allocated according to fair market values among: the 20 shares of Y stock that A received, the 50 shares of X stock that he retained, and the 50 percent of the Y bond #1 that does not constitute boot and so is the nonrecognition portion of that bond.⁴⁰ So A's basis in the 20 shares of Y stock he received is \$13,057; A's basis in the 50 shares of X stock that he retained is \$65,284; and A's basis in the nonrecognition portion of the Y bond #1 is \$26,113.⁴¹ A's total basis in Y bond #1 is \$66,113 — \$40,000 basis in the boot portion of that bond, and \$26,113 basis in the nonrecognition portion of the bond. A's holding period for the boot portion of Y bond #1 will be different from his holding period for the nonrecognition portion of that bond.

To apply a segmented approach in determining basis for a transaction in which the amount of boot was determined on an aggregate basis makes for an ill fit. The method adopted by the authors seems the best way to do that, but other approaches could be adopted. The uncertainty and awkwardness engendered by using two different approaches for determining gain and basis suggest that segmentation is a much better approach for determining gain so the same approach will be used for both purposes.

The second exchange group consists of a transfer of the two X bonds for Y bond #2. A's aggregate basis of \$45,000 in the two X bonds is increased by the \$51,364 aggregate gain that A recognized on those two bonds⁴² and is reduced by the \$60,000 of boot that A received in

³⁶Treas. reg. section 1.358-2(a)(4), (c), Exs. (3) and (4).

³⁷Section 358(a)(2).

³⁸Section 358(a)(1).

³⁹See the discussion of Example 4 in Part II.B.1 above in the text.

⁴⁰Treas. reg. section 1.358-2(a)(2).

⁴¹The \$104,454 basis is divided among the three properties in the following percentages: 12.5 percent to the Y stock, 62.5 percent to the 50 shares of X stock that A retained, and the remaining 25 percent to the nonrecognition portion of Y bond #1.

⁴²As shown above in the text, A recognized a gain of \$15,000 on X bond #1 and a gain of \$36,364 on X bond #2.

the exchange, resulting in an adjusted basis of \$36,364. A's basis in the nonrecognition portion of Y bond #2 is \$36,364, and his basis in the boot portion of Y bond #2 is \$60,000. His total basis in Y bond #2 is \$96,364. A will have a different holding period for the boot and nonrecognition portions of Y bond #2.

11. Subsegmentation within an exchange group.

Example 5. The same facts as Example 4, except that instead of owning X bond #1 before the exchange, A owned 50 shares of X preferred stock, having a basis of \$5,000 and a fair market value of \$40,000. Moreover, the principal amount of X bond #2 was \$90,000 (instead of \$80,000). In the exchange, A surrendered 50 shares of X common stock in return for 20 shares of Y common stock and Y bond #1; and A surrendered the X preferred stock and X bond #2 in return for Y bond #2.

Having shown how the aggregate approach to determining gain operates, and having shown to our satisfaction that the segmented approach is a far better method to use, we will apply only the segmented method from this point on.

Example 5 presses the question of segmenting even further. The treatment of the first exchange group of X Common for Y Common and Y bond #1 is the same as in Example 4, that is, A will recognize a gain of \$50,000 on that exchange. But how should the second exchange group of the X Preferred and X bond #2 for Y bond #2 be treated? The only boot received will be excess securities boot, but how is the amount of that boot (and indirectly the amount of gain) to be determined? Once again, two approaches suggest themselves.

One approach (a partial aggregate approach) would compare the X bond surrendered with Y bond #2 distributed and conclude that there should be \$30,000 of excess-security boot on account of Y bond #2. One could then allocate that \$30,000 of boot between the X Preferred and X bond #2 in accordance with their respective fair market values, so that A would recognize \$10,000 worth of gain on the X Preferred and \$20,000 worth of gain on X bond #2. A's total gain would be \$30,000 plus \$50,000 = \$80,000. That method essentially abandons the segmented approach once the transaction has been segmented into two exchange groups and applies an aggregate method to each exchange group.

Contrary to that treatment, a continued application of segmentation to the second exchange group would be more consistent with the underlying logic of the segmented approach. As previously noted, we refer to that approach as the "consistent segmented approach." Under that approach, the exchange of the X Preferred and X bond #2 for Y bond #2 is subsegmented into two separate exchanges. Two different methods might be employed to make that separation: the fair market value matching method and the principal amount matching method. We will examine both methods, but first we will apply the fair market value matching method. Under that method, the properties in the second exchange group will be matched according to their values, but properties of the same nature will be matched together to the extent that their values are equal. In Example 5, X bond #2 will be treated as having been exchanged for 2/3 of Y bond #2

(the first subsegmented exchange), and the X Preferred shares will be treated as having been exchanged for 1/3 of Y bond #2 (the second subsegmented exchange). In the first subsegmented exchange, A received no excess-security boot since X bond #2 had a principal amount of \$90,000, while 2/3 of Y bond #2 had a principal amount of only \$80,000. In the second subsegmented exchange, A received \$40,000 of excess-security boot. As a result, A recognized \$35,000 of gain on the X Preferred, and no gain or loss on X bond #2. A's total gain will be \$35,000 plus \$50,000 = \$85,000.

Under the fair market value matching method, the amount of gain recognized by A (\$35,000) on the exchange of the X Preferred and X bond for Y bond #2 is greater than the fair market value of the difference in principal amounts of the Y bond #2 and the X bond. Even so, we believe the consistent segmented treatment more closely conforms to the regulations. There is, however, as explained in the discussion of Example 4 in Part II.B.8, a different method for applying the consistent segmented treatment, which we refer to as the "principal amount matching method." We believe the principal amount matching method has considerable merit and adheres more faithfully to the legislative goal than do other techniques.

Under the principal amount matching method, once an exchange group has been identified, securities within the same exchange group are matched by principal amounts rather than by values. In the context of Example 5, the second exchange group is subsegmented first into an exchange of X bond #2 (having a principal amount of \$90,000) for \$90,000 of the principal amount of Y bond #2 (3/4 of that bond) even though the value of 3/4 of Y bond #2 is \$10,000 greater than the value of the X bond. The other subsegmented exchange consists of the X Preferred stock's being surrendered in exchange for 1/4 of Y bond #2. The matching of the amount of Y bond #2 to the surrender of X bond #2 is made by reference to their principal amounts rather than to their fair market values. The remaining \$30,000 of principal amount of Y bond #2 (1/4 of the bond) is allocated to any surrendered nonsecurity items in the exchange group according to their values. If there had not been a nonsecurity item in this exchange group, the \$30,000 excess principal amount from Y bond #2 would be allocated among securities in that exchange group according to their values. However, since the second exchange group contains the X Preferred stock, which is a nonsecurity item, the \$30,000 of excess principal amount of the Y bond #2 is allocated entirely to the surrendered X Preferred stock. The fair market value of that \$30,000 of principal amount, which happens also to be \$30,000, constitutes boot received for the X Preferred. A would then recognize \$30,000 gain on the X Preferred stock and no gain on X bond #2 since no excess securities boot was allocated to that bond. A's total gain from both exchange groups will be \$80,000.

Although, on these facts, the total gain recognized by A under the principal amount matching method of the consistent securities approach is the same as the amount A recognized under the partial aggregate approach, that will not always be the case. For example, if A's basis in the X Preferred stock had been \$25,000 (instead of \$5,000), under the principal amount matching method, A

would have recognized a gain of only \$15,000 from that exchange group; but *A*'s gain from that exchange group under the partial aggregate approach would still be \$30,000.

What justification is there for the approach of matching securities by principal amounts within an exchange group rather than matching them by fair market value? One reason is that sections 356(d), 354(a)(2)(A), and 355(a)(3)(A) all match securities by their principal amounts. Moreover, the method of matching by values will require difficult valuations of stocks and securities to be made. While valuations sometimes must also be made under the principal amount matching method, in many cases (such as the one presented by the facts of Example 5), either no valuation need be made or far fewer valuations will be required than would be the case under a value allocation method. The principal amount matching method has the merit of simplicity. The greater precision attainable through value matching should be sacrificed to the goal of administrative convenience.

A's basis in the properties he received is determined in the same manner as was described earlier in Part II.B.10. The basis will rest on the approach and method that is adopted to determine the amount and allocation of excess security boot. We see no need to work through those mechanics again, having covered them previously. Accordingly, we will not compute the basis of acquired properties for Example 5.

C. Parties Silent as to Segmentation

Example 6. *B* owned (a) 100 shares of common stock of *W* having a basis of \$100,000 and a fair market value of \$200,000 and (b) a *W* bond having a basis of \$30,000, a fair market value of \$100,000, and a principal amount of \$100,000. In an exchange meeting the requirements of section 356, *B* surrendered to *W* the following: (a) 50 shares of *W* common stock (half his holdings, worth \$100,000 and having a basis of \$50,000) and (b) the *W* bond. In exchange, *W* distributed to *B*: (a) 20 shares of *Z* stock having a fair market value of \$100,000 and (b) a *Z* bond having a fair market value and a principal amount of \$100,000. *B* and *W* have no agreement about what is being exchanged for what.

How should one decide what assets were exchanged for what assets in this transaction? If one were to match stock for stock and bond for bond, there would be no excess security boot in the transaction. However, if one were to assume that *B* received half the stock and half the bond in exchange for the *W* stock, and the other halves in exchange for the *W* bond, *B* would have received \$50,000 worth of excess security boot in connection with the surrender of the *W* stock, and would have to recognize \$50,000 worth of gain.

The regulations say only that "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)."⁴³ A plausible approach is that in virtually all cases when securities are surrendered and other securities are received, securities surrendered will be matched against securities distributed to the extent of their fair market values (and where there is more than one way to do so, in such a manner as to offset as much as possible of the principal amount of the securities distributed). An alternative approach, for which the authors have a preference, is to match securities by their principal amounts regardless of their relative values. The argument for this approach is discussed in Part II.B.11 of this article in connection with the consideration of the proper solution to Example 5. Regardless of which of those two approaches is adopted, under the facts set out in Example 6, the result will be the same. *B* will be deemed to have exchanged the *W* bond for the *Z* bond. *B* will not recognize any gain on that exchange, and *B* will have a basis of \$30,000 in the *Z* bond. *B* will be deemed to have exchanged the *W* Common for the *Z* Common. *B* will not recognize any gain on that exchange, and *B* will have a basis of \$50,000 in the *Z* Common.

III. Conclusions

The question of how gain and basis are to be determined when multiple securities are exchanged in a corporate division or acquisitive reorganization in which some of the taxpayer's realized gain is not recognized is more difficult than might appear at first glance. Even though the issue must arise frequently, there is no authoritative statement as to how it is to be resolved, and there has been little mention of the issue by commentators on the tax law.

The authors' view is that a consistent application of a segmented approach should be employed. That is, the transaction should be analyzed by segmenting the exchange into a number of separate smaller exchanges. Insofar as the determination of basis is concerned, segmentation is required by the regulations.

The matching of properties within each subset of exchanges should be made according to the parties' express agreement if they have made a reasonable designation. In the absence of a designation by the parties, the exchanged properties should be matched by pairing properties of like nature (for example, stocks for stocks and securities for securities) to the extent that it is feasible to do so when fair market values and principal amounts of securities are taken into account. In matching securities, the authors favor doing so in accordance with their principal amounts without regard to their values; but matching by values is a reasonable alternative.

⁴³Treas. reg. section 1.358-2(a)(4).