February 18, 2016

Receipt of 'Boot' in Reorganizations: 'Tseytin'

By: Elliot Pisem and David E. Kahen

In a corporate reorganization described in Internal Revenue Code (IRC) section 368, a shareholder may dispose of stock of the target corporation. If the sole consideration received by the shareholder is stock in the acquiring corporation, no gain is generally required to be recognized by the shareholder.

If a transferring shareholder receives, in addition to stock of the acquiror, cash or other property, the gain *realized* by the transferring shareholder—equal to the total stock and nonstock consideration received, minus the transferring shareholder's basis in the shares transferred—is required to be *recognized*, but only to the extent of the amount of "boot" (that is, consideration (including cash) other than stock in the acquiror). On the other hand, if a shareholder realizes a loss in connection with an exchange of stock in connection with a reorganization, and any part of the consideration received by that shareholder consists of acquiror stock, the shareholder may not recognize that loss, regardless of whether boot was received by the shareholder in addition to the acquiror stock.

These relatively simple rules become more complicated where, in a single transaction, a shareholder transfers multiple blocks of stock, acquired at different prices. Let's assume that the shareholder realizes a gain with respect to some shares and a loss with respect to other shares. If the transaction were a fully taxable sale, the shareholder would ordinarily recognize both the gain and the loss and would be permitted to offset one against the other. On the other hand, if no boot at all were received in a nontaxable reorganization, the shareholder would recognize no gain and would not need to be able to offset recognized gain with a recognized loss.

Where boot is received in an otherwise nontaxable reorganization, things become even more complicated. The applicable Treasury Regulations make clear that gain must be determined on a block-by-block basis.[1] A shareholder might expect that, nevertheless, the aggregate of his basis in all of his shares could be taken into account, by offset against the aggregate of the value of the consideration received, in determining the magnitude of the gain potentially subject to recognition; or, perhaps, that any gain recognized might be offset by the recognition of loss with respect to those shares being transferred at a loss. A recent decision of the Tax Court[2] indicates that neither of these expectations would be well-founded; the shareholder may be required to recognize and pay tax on a surprisingly large amount of gain, at least absent planning that might achieve a more favorable outcome.

Tseytin v. Commissioner

Michael Tseytin owed 75% of the stock of US Strategies, Inc. (USSI), and USSI in turn owned most of the equity interest in limited liability companies that operated Pizza Hut and Kentucky Fried Chicken franchises in Russia. The other 25% of the stock of USSI was owned by an apparently unrelated British Virgin Islands corporation, Archer Consulting Corp.

AmRest Holdings, NV (AmRest), a Netherlands corporation the stock of which was publicly traded in Poland, owned and operated fast food franchises in Europe. In a merger agreement executed on May 20, 2007, AmRest agreed to acquire the stock of USSI from Tseytin through a merger of USSI into AmRest or its subsidiary intended to qualify as a nontaxable reorganization under IRC section 368, with no gain being recognized except to the extent required by reason of Tseytin's receipt of cash in addition to shares of AmRest. Tseytin further agreed to acquire the shares of USSI he did not already own (the "Archer shares") from Archer for $14,000,000 before the merger, and then to transfer 100% of the stock of USSI to AmRest.

On May 25, 2007, Tseytin entered into an agreement with Archer to purchase the Archer stock for $14,000,000, and that purchase closed on June 14. The merger of USSI into AmRest closed on July 2, and Tseytin received $23,100,000 in cash (about 43% of the

***Elliot Pisem** and **David E. Kahen** are partners in the law firm of Roberts & Holland LLP.*

total consideration) and AmRest stock then worth $30,800,000. On July 5, Tseytin paid Archer the $14,000,000 million owed for the Archer shares.

The merger agreement provided that each share of USSI stock was being transferred for an equal portion of the total merger consideration. On that basis, 25% of the overall consideration, or approximately $13,500,000, would be allocable to the Archer shares, indicating that Tseytin realized a loss on those shares of $500,000. Because Tseytin claimed no cost basis in the other USSI shares previously owned by him, his gain realized with respect to those shares was equal to the consideration allocable to them, $40,400,000.

Tseytin's original income tax return for 2007 did not disclose the separate cost bases and holding periods of the Archer shares and the other shares in USSI. The return treated all of the cash (43% of the total consideration) as received in a taxable transfer, but then allocated to that transfer 43% of Tseytin's total $14,000,000 basis in the shares transferred. This resulted in a basis offset of about $6,000,000 against the cash received, and Tseytin reported a long-term capital gain of $17,100,000 (equal to $23,100,000 - $6,000,000).

Tseytin then filed an amended return which took into account the separate bases that he had in the two blocks of stock in USSI, but (to quote the Tax Court) "ignored" the value of the non-cash consideration received in the form of AmRest shares. The amended return thus computed a long-term capital gain with respect to 75% of the USSI shares (in which Tseytin had a zero basis) equal to 75% of the cash consideration, or about $17,300,000. The return also claimed a short-term capital loss with respect to the Archer shares equal to 25% of the cash consideration ($5,800,000) minus his basis of $14,000,000 in those shares, resulting in a short-term capital loss of $8,200,000.

Following an audit, the IRS determined that Tseytin recognized gain, computed by treating 75% of the cash and AmRest shares as received in exchange for the 75% of the shares of USSI in which Tseytin had a basis of zero, resulting in recognition of gain equal to the boot received for those shares ($17,300,000). With respect to the Archer shares, the IRS determined that a loss of $500,000 had been *realized*, but could not be *recognized* or taken into account for tax purposes in 2007, because IRC section 356(c) provides that no loss is recognized where shares are transferred in a reorganization for stock qualifying under the reorganization rules plus boot. The IRS determination resulted in a relatively small amount of additional tax (in relation to the $3,800,000 reported as due on Tseytin's initial return[3]) of $30,000. The IRS also asserted a penalty of 20% of the tax due, or $6,000.

In the Tax Court, Tseytin did not attempt to defend the positions taken on his initial return, but he made two other arguments in support of his position that he did not owe additional tax and was entitled to a refund. The first was that, in respect of the Archer shares, Tseytin was acting as an agent or nominee for Archer, such that $14,000,000 of the cash consideration paid by AmRest should be viewed as having been received not by Tseytin, but rather by Archer, from AmRest. In the event that the first argument was not accepted, Tseytin further asserted that he should be permitted to subtract the $500,000 loss he realized with respect to the Archer shares from the gain of $17,300,000 with respect to the other shares he transferred.

Neither argument prevailed. With respect to the argument that Tseytin was acting as Archer's agent or nominee, the Tax Court observed that, under the form of the merger as set forth in transactional documents signed by Tseytin, he was the sole owner of all of the shares of USSI immediately before the merger with AmRest; and that, under the rule of *Commissioner v. Danielson*,[4] applicable in the Court of Appeals to which any appeal of this decision would lie, a taxpayer could generally not disavow its form absent proof of mistake, fraud, undue influence, duress, or the like, none of which was established here.

The court also noted that, even apart from the Danielson rule, it found no persuasive evidence that Tseytin was not the owner of the Archer shares at the time of the merger; and that both the original and amended returns filed by Tseytin reported the transfer of the Archer shares to AmRest as a transfer of shares owned by Tseytin.

As to Tseytin's alternative argument regarding the offset of the loss realized on the Archer shares against the gain recognized on the other shares, the opinion noted an IRS revenue ruling[5] that concluded that a loss realized with respect to one block of stock transferred in a reorganization with boot could not offset a gain realized on another block of stock. Moreover, there are cases supporting this conclusion, and Regulations issued subsequent to the ruling, under IRC sections 356 and 358, are generally supportive of that same approach of computing gain or loss on a block-by-block basis, albeit without addressing directly the issue before the court in *Tseytin*. The court further concluded that Tseytin had failed to cite any authority supporting the allowance of an offset of loss against gain realized from the disposition of another block of stock in the same transaction.

With respect to the asserted accuracy-related penalty, the court found that the IRS had met its burden of producing evidence that Tseytin had acted negligently or in disregard of rules or regulations in taking the positions reflected on the original return. There was simply no reasonable basis in law for treating the separate blocks of stock in USSI owned by Tseytin immediately before the merger as a single block for purposes of determining the amount and character of gain recognized.

The penalty generally does not apply where the taxpayer can show that he acted in good faith and with reasonable cause—for example, in reasonably relying on the advice of a tax professional. Tseytin argued that there was authority in support of positions taken on his amended return. The court concluded, however, that Tseytin did not introduce evidence sufficient to establish good-faith reliance on the advice of a tax professional in the position taken in the original return. Whether or not there was reasonable basis for some of the positions taken in the amended return was irrelevant to the penalty issue.

Observations

It is not difficult to have some sympathy for Tseytin's position. He entered into a reorganization transaction, such that the recognition of gain would be limited to the cash received; he received and retained cash boot of less than $10 million; yet, he was taxed on more than $17 million of gain. If this result had been identified before the transactions were documented and implemented, alternative structures might have been feasible that could have resulted in a better tax outcome. For example, Archer could have sold its shares directly to AmRest. It is impossible to ascertain, however, from the circumstances described in the opinion, whether the likely result in terms of the magnitude of the gain to be recognized was in fact identified at a time that would have permitted such alternative transaction structures to be considered.

---

[1] *See, e.g.*, Treas. Reg. section 1.358-2(a)(2)(vi), and -2(c) Ex. 4.
[2] *Tseytin v. Commissioner*, TC Memo 2015-247.
[3] Tseytin apparently did not actually pay a substantial part of the tax attributable to the reported gain.
[4] 378 F.2d 771 (3d Cir. 1967).
[5] Rev. Rul. 68-23 (1968-1 C.B. 144).