

The Tax Consequences of Stock Splits, Mergers and Spin-Offs

by Claude Y. Paquin, J.D.

Article Highlights

- Taxpayers must keep track of cost basis, including the prices for shares acquired on different dates.
- In a spin-off, the allocation of cost basis is done in proportion to the fair value of the stocks.
- When a merger occurs, the recognizable gain to shareholders of the acquired company will not exceed the cash received.

Common stockholders of General Electric Co. (GE) learned in March 2014 that the board of directors had decided to divest itself of the part of the company that provides credit card services.



If all continues to go according to plan, General Electric shareholders on the appropriate record date will find themselves owning shares of the new company Synchrony Financial (SYF) in addition to their GE shares.

Corporate decisions like this happen infrequently in the life of any one company. They are, however, fairly common in a diversified stock portfolio and have tax consequences for the investors who own their stock.

To help you get a better grasp of the impact of events like the Synchrony Financial spin-off, it is useful to look at the recent past history of Merck & Co. Inc. (MRK). Merck is a large U.S. pharmaceutical company. The company's story includes stock splits, a spin-off, and later a merger providing stock in the acquirer with money to boot. "Boot" is now the term witty financial experts use to describe the extra cash that sometimes comes with a stock distribution.

Tax Basis: A Refresher

The U.S. Internal Revenue Code (IRC) does not just simply require U.S. citizens and residents to pay taxes, it also requires them to keep records. Keeping records has

two meanings: It can mean holding on to information others send you, or it can mean creating the information you are expected to need later for a proper computation of your taxes.

With capital assets such as shares of a corporation's common stock, it is important to compute the basis of that

stock and to determine its acquisition date.

Basis, in tax law, is a technical term that defines the amount from which a profit or loss will be computed. If an asset has a basis of \$1,000, selling it for \$2,500 will cause a profit of \$1,500, while selling it for \$600 will cause a loss of \$400. A basis usually starts out being the cost of the asset, but adjustments may later need to be made.

The acquisition date is the starting point for measuring a holding period. Currently, capital gains from the sale of assets with a holding period of over one year are generally taxed at a lower rate than gains from assets held for a shorter period. But there is a possibility of tacking two periods together. For instance, that new Synchrony Financial stock that a General Electric stockholder may receive will be considered to have the same acquisition date as the GE stock that spawned it.

Obviously, then, U.S. taxpayers must keep track of the basis of their capital assets, and of each asset's acquisition date. They must be able to show, in case of audit, the records that will substantiate what they claim to be their basis and acquisition date.

The next little wrinkle in this picture is the concept of "lot." When stock in a given company is bought on two or

more separate occasions, each purchase represents a lot (with a separate acquisition date and a separate cost basis). Each lot has to be accounted for separately because it has its own basis and acquisition date.

Finally, we should acknowledge the word “recognition” as signaling whether something that looks like a profit or a loss will be considered as such in computing an investor’s tax. A profit that is said not to be recognized is a profit that’s not currently taxed and thus lives on to see another, later tax day.

The Merck Story

Stock Splits

The simplest way to understand the tax consequences for stock investors of what corporations can do is to take a look at the experience of an investor we’ll call Angela.

On September 2, 1986, Angela purchased 100 shares of Merck for \$11,594. Under IRC Section 1012(a) this \$11,594 cost was the initial basis in this stock. Merck split 3-for-1 in June 1988, and 3-for-1 again in May 1992, giving Angela 900 shares with the same \$11,594 basis. Each of these splits (and subsequent ones) was essentially an exchange of new shares for old shares, and IRC Section 354(a)(1) provides for no gain or loss to be recognized each time.

Angela sold 400 shares of Merck in August 1993. The basis of her remaining shares was calculated as: 500 remaining shares ÷ 900 total shares × \$11,594, or \$6,441.11.

In February 1999, Merck split 2-for-1. This raised her number of shares from 500 to 1,000 shares. The total basis did not change, nor did the acquisition date or the holding period.

Spin-Off

In early 2003, Merck decided to spin off its Medco Health Solutions subsidiary, a pharmacy benefit management company, by distributing 0.1206 share of Medco Health Solutions per Merck share to its shareholders. This entitled Angela to 120.6 Medco shares (0.1206 shares of Medco times 1,000 shares of

Spin-Off: Formulas for Allocating Basis

Specific formulas are used to calculate the allocation of basis between mother and daughter companies in the event of a spin-off.

If there is more than one lot, a separate calculation is needed for each lot. To do this, start with these known items:

- N_m is the number of shares in the mother company (M) after the spin-off;
- P_m is the price per M share chosen for the allocation;
- N_d is the number of shares (including any fractional share) in the daughter company (D) after the spin-off;
- P_d is the price per D share chosen for the allocation; and
- B_t is the total basis to be allocated.

Then compute the two items we need as follows:

- B_m , the basis of the M shares after the spin-off = $B_t \times N_m \times P_m \div [(N_m \times P_m) + (N_d \times P_d)]$
- B_d , the basis of the D shares (including any fractional share) after the spin-off = $B_t - B_m$

We can verify the result for B_d by making sure it also equals

$$B_t \times N_d \times P_d \div [(N_m \times P_m) + (N_d \times P_d)].$$

If a fractional D share was received in cash, it should be considered to have been sold, and the newly calculated basis of the remaining whole D shares should be adjusted appropriately. One way to do this is to consider (a) the whole number of D shares actually received, which is the integer of N_d ; (b) the number (N_d) of D shares (including the fraction) to which one was entitled; and (c) the newly calculated basis (B_d) for all the D shares to which the investor was entitled.

To find the correct final basis of the whole D shares actually received, one can simply take the ratio of (a) to (b) and multiply it by (c). The difference between that and the original B_d will be the basis of the fractional share that was sold as part of the process.

Merck), but with the understanding that, as is the usual practice, the fractional share would be converted into cash and paid out to her in cash.

On the evening of August 19, 2003, Angela received 120 shares of Medco and \$15.95 for her 0.6 fractional share allocation.

IRC Section 355(a)(1), on the distribution of stock and securities of a controlled corporation, provides that no gain is to be recognized to, and no income is includable in the income of, the stockholder who receives such a distribution. The \$15.95 in cash is, however, recognized.

At this point, Angela was required to allocate her \$6,441.11 basis between her Merck stock and her Medco stock. Under Treasury Regulations Section 1.358-2(a)(2)(iv), the allocation of cost basis is done in proportion to the fair

market values of the two blocks of stocks. The fair market value for each block is equal to the number of shares times a price per share.

In determining the price per share, Angela had four choices. She could use (1) the closing trading price of each stock on August 19 (a possibility only when the distributed stock was already trading as a public company—as was true here—and the parent company is distributing its remaining stake), (2) the opening trading price of each stock on the morning of August 20, (3) the average trading price of each stock on August 20, or (4) the closing trading price on August 20. The average trading price is generally understood to be the average of the high and low prices on that day; historical statistical stock records commonly show the open, close, low and high prices for each day a stock

was traded.

Angela decided to use the opening trading prices (\$51.70 for Merck and \$23.10 for Medco) on August 20, 2003, to allocate her \$6,441.11 basis among the two stocks, resulting in a cost basis of \$6,111.78 for her 1,000 shares in Merck shares and \$329.33 for her 120.6 shares of Medco. [The box on page 6 displays the formulas for the needed computations.]

Since the Medco basis resulting from Angela's choice was \$329.33 for 120.6 shares, the basis for the \$15.95 cash payment corresponding to 0.6 share was \$1.64. She dutifully reported the cash payment on her 2003 income tax return as a sale of a 0.6 share of Medco, with acquisition date of September 2, 1986, and a long-term capital gain of \$14.31.

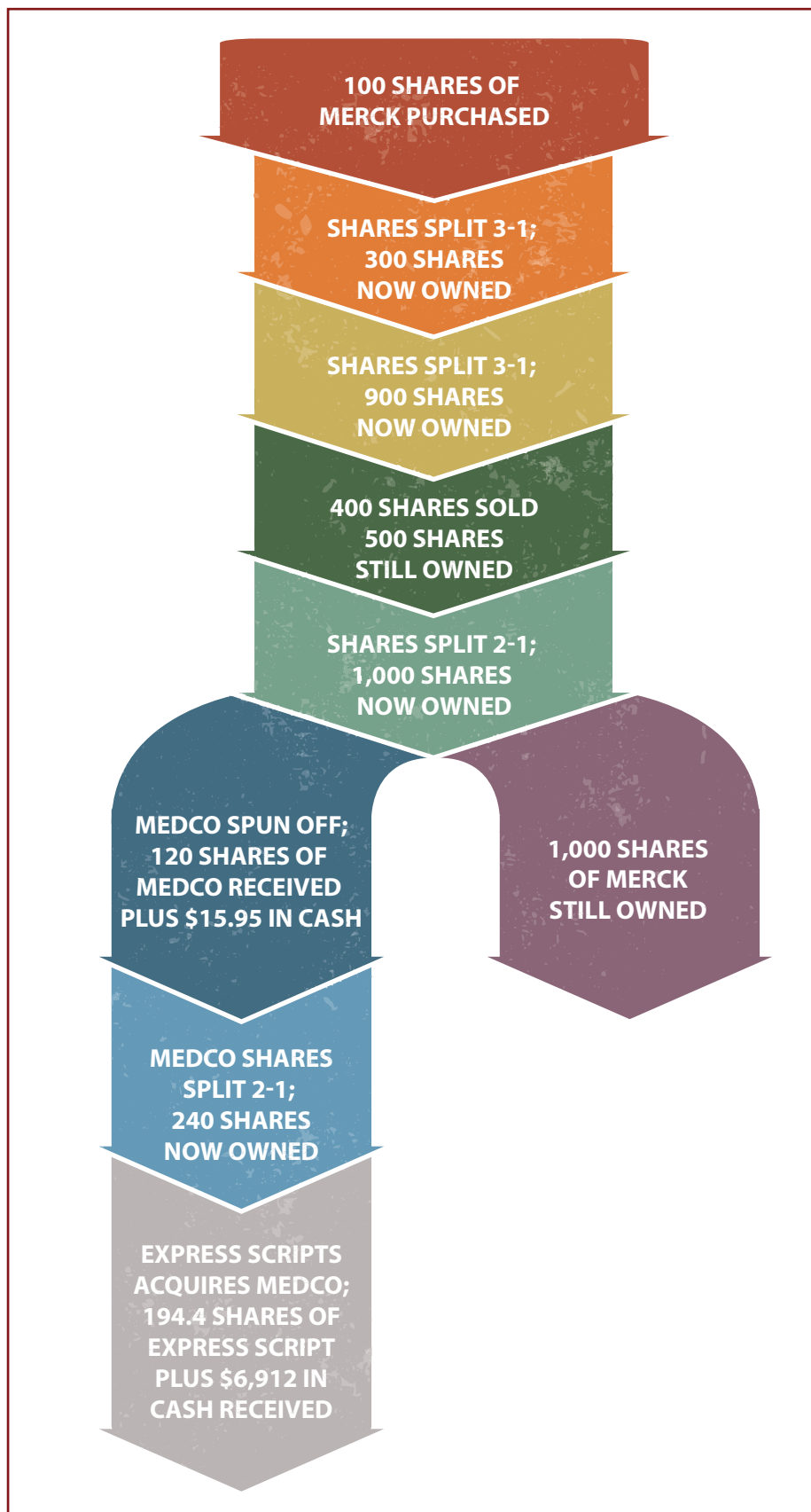
At this point, Angela's records showed her to be the proud owner of 1,000 Merck shares with a \$6,111.78 basis and a September 2, 1986, acquisition date (for the purpose of determining her holding period). Her records also showed her as the proud owner of 120 Medco shares with a \$327.69 basis (\$329.33 minus \$1.64 for the 0.6 shares) and also a September 2, 1986, acquisition date.

In January 2008, Medco declared a 2-for-1 split, thus causing Angela to have 240 Medco shares with a still-unchanged cost basis of \$327.69 and an acquisition date of September 2, 1986. Observe that the basis per share now comes to \$1.3653 (\$327.69 cost basis ÷ 240 shares). The per share cost basis is correct even though the stock never sold for a per share price that low. Stock splits can produce per share cost basis numbers such as that and create the impression of a stock being much cheaper than it ever actually was.

After the Spin-Off Comes a Merger

On April 2, 2012, Medco completed a merger with Express Scripts Holding Co. (ESRX), another pharmacy benefit management company. The terms of this merger were to exchange one share of Medco for 0.81 share of Express Scripts plus \$28.80 in cash (boot). This transaction gave Angela 194.4 shares

Figure 1. Changes in Merck and Medco Stock



Bonds Converted to Stock

Corporations that go through bankruptcy proceedings sometimes end up converting their bondholders into stockholders (regardless of whether bondholders like it or not, and they normally do not). IRC Section 368(a) generally considers the conversion as a form of reorganization, and thus the tax principles that apply to other reorganizations would apply here too, with no recognition of gain or loss.

Bonds and preferred stocks said

to be convertible were created through a legal instrument that sets forth their features, and each one can be different. The issuing corporation's legal counsel would normally be expected to have provided a legal opinion on whether or not the conversion of a particular security created a taxable event, perhaps after having sought and obtained an advance ruling from the Internal Revenue Service.

Conversions of these securities may be viewed as taxable exchanges

of property, and the fair market value of the newly acquired stock on the date of the exchange—which will serve as a sale date and an acquisition date—will generally serve as both the sale price of the old security and the basis of the newly acquired stock. The Internal Revenue Code lists and defines common nontaxable exchanges at Sections 1031 to 1045, and 1031(a)(2) specifically excludes stocks and bonds exchanges, which means they're taxable.

of Express Scripts plus \$6,912 in cash. (This time, the fractional share did not have to be sold and thus exchanged for cash because Angela had an additional 60 Medco shares from another lot dated August 19, 2010, which were converted into 48.6 Express Scripts shares, making the total for her a round figure.)

The value received as of the early morning of Monday, April 2, 2012, for each Medco share was \$72.69. This was calculated based on the Friday, March 30, 2012, Express Scripts closing price (and thus its value) of \$54.18 per share. Receiving 0.81 Express Script shares plus \$28.80 cash resulted in a value received per Medco share of $\$28.80 + (0.81 \times \$54.18)$, or \$72.69.

Angela's value received for the 240 Medco shares was thus $240 \text{ shares} \times \72.69 , or \$17,445.60. The basis remained \$327.69 and the acquisition date remained September 2, 1986. The cash received was $240 \text{ shares} \times \28.80 , or \$6,912.00.

IRC Section 356(a)(1) covers this situation by stating that the gain to a recipient shall be recognized in an amount not in excess of the cash received. Thus, only \$6,912.00 is recognized as a gain. (It was a long-term capital gain because the original Merck acquisition date of September 2, 1986, still held).

IRC Section 358 provides the method for determining the basis for the new stock when money (boot) is received in the exchange. The basis of the 194.4

shares of Express Scripts is computed as the original basis *minus* the cash received *plus* the reportable gain. The math is or $\$327.69 \text{ (cost basis)} - \$6,912.00 \text{ (cash from merger)} + \$6,912.00 \text{ (reportable gain)}$, which leaves the basis as \$327.69.

Angela's federal income tax return for 2012 thus showed a long-term capital gain of \$6,912 on Form 8949, which found its way into Schedule D and on line 13 of Form 1040.

The current basis of Angela's 1,000 Merck shares continued to be \$6,111.78, with an acquisition date of September 2, 1986. The basis of the 194.4 shares of Express Scripts was still \$327.69, with a September 2, 1986, acquisition date for the purpose of determining the holding period under IRC Section 1223.

Observe that Angela's gain upon the Medco-Express Scripts merger was the \$17,445.60 value of what she received (\$6,912.00 in cash and Express Scripts shares worth \$10,533.60) minus her \$327.69 basis in the Medco stock she surrendered in the exchange, or \$17,116.89. Had Angela sold the stock, her taxable capital gain would have been \$17,116.89. By keeping the Express Scripts stock, her taxable capital gain was only the cash she received, or \$6,912.00.

When the Boot Exceeds One's Profit

But let us imagine a situation where Angela's basis in Medco might have been

\$12,000. Then her gain would have been calculated as the \$17,445.60 value of what she received (\$6,912.00 in cash and Express Scripts stock worth \$10,533.60) minus her \$12,000 basis in the Medco stock she surrendered in the exchange, or a gain of \$5,445.60.

Even though Angela received \$6,912 in cash, her taxable capital gain would have been limited, under IRC Section 356(a)(1), to the amount of her gain, or \$5,445.60. Her basis in her new 194.4 shares of Express Scripts stock would then have been recalculated as her original basis (\$12,000) *minus* the cash received *plus* the reportable gain, or $\$12,000 - \$6,912.00 + \$5,445.60$, which would have brought the basis down to \$10,533.60.

Mergers That Come With Boot

The system here is relatively simple: (1) determine the basis of the old stock; (2) calculate the value of what is being received; (3) calculate the gain by subtracting the basis (step 1) from the value of what is being received (step 2); (4) write down the cash amount received; (5) pick the lower amount between the gain and the cash as the reportable capital gain; and (6) calculate the basis for the new stock by subtracting the amount in step 4 from the basis in step 1 and adding the gain in step 5. The two figures you really want are (a) the

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with the needs of the family and/or heirs, thus maximizing the family wealth for future generations.

For example, it may be in the best interests of the family for a surviving spouse to disclaim IRA assets, pushing them down to the named contingent beneficiaries. By bypassing the primary beneficiary, these assets do not add to an otherwise potentially taxable estate for the surviving spouse. Another example would be a case where one or more of the adult children is named as primary beneficiary of a parent's IRA and is already financially secure. By choosing not to accept the IRA assets, through the process of disclaiming, these funds could transfer to another beneficiary and provide a means of liquidity for that individual.

While there are a number of steps that must be taken in order to utilize the disclaiming process, it may be well worth your time to explore the benefits that this final planning opportunity presents. This strategy should be coordinated with your financial adviser and estate planning attorney.

Conclusion

There are a multitude of methods and options for effectively using an IRA as part of a holistic estate plan and no specific combination of strategies will suit each investor. In order to adequately address your and your family's needs, it is best to consult a professional to review your personal situation and guide you through the process to build and implement your customized strategy. These professionals may include, but are not limited to, your personal financial adviser, a tax professional or your estate planning attorney. These advisers will have the unique skills and knowledge about these various strategies to help effectively coordinate them with you and necessary legal counsel. ▲

—By Daniel D. Sudit, market manager, and Kevin G. McCandlish, CFEA, wealth adviser, at BMO Private Bank.
Learn more about the authors at www.aaii.com/authors/daniel-sudit and www.aaii.com/authors/kevin-mccandlish.

Feature: Tax Strategies

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reportable gain for the current year's income tax return, and (b) the basis for the new stock in anticipation of the day you will need that figure.

The reasoning behind the formula to determine the basis is this. Suppose that when Angela makes a stock investment, she sets down two buckets. One bucket is labeled basis and the other is labeled capital gain. Angela thinks a bit about money as if it were water. She puts \$12,000 in her basis bucket and accumulates an extra \$5,445.60 in her capital gain bucket. Then she receives \$6,912 in cash, which represents a withdrawal from her two buckets: the capital gain bucket gets emptied completely (and taxed in the process) to the tune of

\$5,445.60, and the basis bucket suffers a withdrawal of \$1,466.40, with only \$10,533.60 left in it.

Mergers with boot do not happen terribly often. But here Angela knew what to do. A commercial tax preparer or tax software might have been able to determine the capital gain amount to be reported in her 2012 income tax return, if she had had all the right figures to provide them to start with, but would either one have calculated her new basis and given her the benefit of the information in anticipation of future tax returns? That is doubtful. (The 2012 year-end statement her brokerage firm provided her showed erroneous figures, which of course she did not use.)

Conclusion

Corporate events sometimes happen that call for investor action, even if it's just a recalculation of one's basis and the updating of records that may prove crucial one day. Tax return preparers often have to rely upon the diligence of the taxpayers they assist, and it can pay to know what to expect, and what to do, when corporate events take place with one of your stocks.

While it is impossible to present an encyclopedic review of all that's involved with corporate mutations, this article may help bolster the confidence of stock investors who have been told change is coming in a company. ▲

An AAI member since 1989, Claude Y. Paquin, J.D., (cypaquin@gmail.com) is a retired actuary and tax lawyer from Georgia who recently released his latest book, "Tax Guide for the Stock Investor: Help on Keeping More of What You Make." This article is an adaptation of materials in the book. Find out more about the author at www.aaii.com/authors/claude-paquin.