



**Part II Organizational Action** (continued)

17 List the applicable Internal Revenue Code section(s) and subsection(s) upon which the tax treatment is based ▶ Please see attached.

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18 Can any resulting loss be recognized? ▶ Please see attached.

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19 Provide any other information necessary to implement the adjustment, such as the reportable tax year ▶ The Merger and resulting stock exchange was effective on May 12, 2017. For Merchants stockholders whose taxable year is the calendar year, the reportable tax year is 2017.

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Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than officer) is based on all information of which preparer has any knowledge.

**Sign Here**  
Signature ▶ *Scott Kingsley* Date ▶ June 9, 2017  
Print your name ▶ Scott Kingsley Title ▶ EVP & CFO

<b>Paid Preparer Use Only</b>	Print/Type preparer's name	Preparer's signature	Date	Check <input type="checkbox"/> if self-employed	PTIN
	Firm's name ▶			Firm's EIN ▶	
	Firm's address ▶			Phone no.	

Form 8937

Community Bank System, Inc. (NYSE: CBU)

Posted on Community Bank System, Inc.'s website on June 9, 2017

EIN: 16-1213679

The information contained herein is being provided pursuant to the requirements of Section 6045B of the Internal Revenue Code of 1986, as amended (the "Code"). It contains a general summary regarding the application of certain U.S. federal income tax laws and regulations relating to the effects of the Merger (as defined below) on the tax basis of the various forms of merger consideration received by former Merchants Bancshares, Inc. ("Merchants") stockholders in connection with the Merger.

Community Bank System, Inc. (NYSE: CBU; "Community Bank System") does not provide tax advice to its stockholders. The examples below are provided pursuant to Section 6045B of the Code and are illustrative in nature for the convenience of the former stockholders of Merchants and their tax advisors to use in connection with establishing their specific tax position. You should consult your own tax advisor regarding the particular consequences of the Merger to you, including the applicability and effect of all U.S. federal, state and local and foreign tax laws.

**THE INFORMATION CONTAINED HEREIN DOES NOT CONSTITUTE TAX ADVICE AND DOES NOT PURPORT TO BE COMPLETE OR TO DESCRIBE THE CONSEQUENCES THAT MAY APPLY TO PARTICULAR CATEGORIES OF STOCKHOLDERS, NOR IS IT INTENDED OR WRITTEN TO BE USED, AND CANNOT BE USED, FOR THE PURPOSES OF AVOIDING PENALTIES UNDER THE CODE OR PROMOTING, MARKETING OR RECOMMENDING ANY TRANSACTION OR MATTER ADDRESSED HEREIN.**

Part II

#### **Question 14**

On May 12, 2017, Community Bank System completed its acquisition of Merchants pursuant to the Agreement and Plan of Merger, dated as of October 22, 2016 (the "Merger Agreement"), by and between Community Bank System and Merchants. Under the terms of the Merger Agreement, Merchants merged with and into Community Bank System, with Community Bank System being the surviving corporation of the Merger.

Under the terms of the Merger Agreement, Merchants stockholders were entitled to elect the form of merger consideration to be received in the transaction. Each stockholder who submitted a completed Letter of Election and Transmittal prior to the election deadline of May 9, 2017 had the ability to elect to receive, for each share of Merchants common stock either (a) \$40.00 in

cash (the “Cash Consideration”), (b) 0.9630 shares of Community Bank System common stock, par value \$1.00 per share, and cash in lieu of fractional shares, if any (the “Stock Consideration”), or (c) a combination of \$12.00 in cash and 0.6741 shares of Community Bank System common stock, and cash in lieu of fractional shares, if any (the “Mixed Election Consideration,” and together with the Cash Consideration and the Stock Consideration, the “Merger Consideration”). However, both the Cash Consideration and the Stock Consideration were subject to proration and adjustment procedures to ensure that the total amount of cash paid, and the total number of shares of Community Bank System common stock issued, in the Merger to Merchants stockholders, as a whole, will equal as nearly as practicable the total amount of cash and number of shares that would have been paid and issued if all of the Merchants stockholders received the Mixed Election Consideration (equating to an overall proration to approximately 70% stock and 30% cash).

Most of the Merchants stockholders who submitted election forms by the election deadline made “all-stock” election to receive their Merger Consideration solely in the form of shares of Community Bank System common stock. As a result of the elections of Merchants stockholders, and in accordance with the allocation and proration mechanisms of the Merger Agreement, the Merger Consideration was allocated as follows:

- Those stockholders that elected to receive the Stock Consideration received \$11.71 in cash and 0.6811 shares of Community Bank System common stock for each share of Merchants common stock;
- Those stockholders that elected to receive the Cash Consideration received \$40.00 in cash for each share of Merchants common stock;
- Those stockholders that elected to receive the Mixed Election Consideration received \$12.00 in cash and 0.6741 shares of Community Bank System common stock for each share of Merchants common stock; and
- Those stockholders that did not select an election preference or submit a properly completed election form within the required timeframe received the Mixed Election Consideration of \$12.00 in cash and 0.6741 shares of Community Bank System common stock for each share of Merchants common stock.

No fractional shares of Community Bank System common stock were issued in the Merger and any fractional share of Community Bank System common stock was paid at the rate of \$55.91 per share.

### **Question 15**

The effect of the Merger on the tax basis of a Merchants stockholder depends on the form of consideration received and are summarized below:

1. **Stockholders who received the Cash Consideration** (i.e., Merchants stockholders who elected cash only consideration).

A transaction in which a stockholder exchanged his or her shares of Merchants common stock solely for cash generally will result in recognition of gain or loss by the holder in an amount equal to the difference between the amount of cash received in the Merger and the stockholder's tax basis in the Merchants shares surrendered. Because the stockholder did not receive any new stock, there will be no new basis to compute. The taxability of capital gains and/or deductibility of capital losses is subject to limitations. *You should consult your tax advisor for more information.*

2. **Stockholders who received mixed merger consideration consisting of both stock and cash** (i.e., Merchants stockholders who elected to receive (1) the Mixed Election Consideration, (2) those who made an invalid election or no election, or (3) all Stock Consideration and were subject to proration).

A transaction in which a stockholder exchanged his or her shares of Merchants common stock for a combination of Community Bank System common stock and cash affects such stockholder's tax basis. Generally, the aggregate tax basis of Community Bank System common stock received by the Merchants stockholder in the Merger will be equal to the aggregate adjusted tax basis of the shares of Merchants common stock exchanged, reduced by the amount of cash received pursuant to the Merger (excluding any cash received in lieu of a fractional share of Community Bank System common stock) and increased by the amount of gain (excluding gain or loss resulting from any fractional share deemed received and exchanged for cash), if any, recognized by the Merchants stockholder on the exchange. The amount of gain recognized is the lesser of (A) the amount of gain realized (i.e., the excess of the sum of the amount of cash and the fair market value of Community Bank System common stock received pursuant to the Merger over the stockholder's aggregate tax basis in the shares of Merchants common stock surrendered) and (B) the amount of cash received pursuant to the Merger (excluding any cash received in lieu of a fractional share of Community Bank System common stock).

Treatment of Cash in Lieu of Fractional Shares. The receipt of cash in lieu of a fractional share of Community Bank System common stock generally will be treated as if the fractional share had been distributed to the Merchants stockholder in connection with the Merger and then sold for cash in a taxable transaction. Gain or loss generally will be recognized based on the difference between the amount of cash received in lieu of the fractional share and the portion of the stockholder's aggregate adjusted tax basis in the shares of Community Bank System common stock received in the Merger that is allocable to the fractional share. The gain or loss generally will be long-term capital gain or loss if the holding period of the corresponding Merchants common stock surrendered is more than one year at the effective time of the Merger. The deductibility of capital losses is subject to limitations.

Fair Market Value of the Stock Received. U.S. federal income tax law does not specifically prescribe how you should determine the fair market value of Community Bank System common stock for purposes of allocating your tax basis in connection with the Merger. Generally, fair market value is defined as the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of the facts. One possible approach to the various methods for determining the fair market value of Community Bank System common stock is to use the closing price of Community Bank System's common stock on May 12, 2017, the day of Merger, which was \$55.99 per share as reported on the New York Stock Exchange. Other approaches to determine the fair market value may also be possible. *You should consult your tax advisor to determine what measure of fair market value is appropriate.*

### **Question 16**

The following example illustrates the method by which a former Merchants stockholder would determine his or her basis in the Community Bank System stock received in the Merger. The example assumes that the stockholder is an individual U.S. citizen or resident who acquired his or her Merchants stock in one block at the same price for cash and holds such shares as capital assets. The example does not address any special rules that may apply to a particular stockholder (including shares received as compensation), nor do they address the consequences of any state, local or foreign tax laws.

#### **1. Stockholders receiving the Cash Consideration**

The following is an illustrative example of how the basis determination would be applied to a hypothetical stockholder who received the Cash Consideration:

**Shares of Merchants common stock owned:** 100

**Assumed tax basis in each share of Merchants common stock:** \$10.00 per share

**Merchants stockholder's aggregate adjusted tax basis** (100 shares of Merchants common stock multiplied by \$10.00 per share): \$1,000.00

**Cash consideration received in the Merger** (100 shares of Merchants common stock multiplied by \$40.00 in cash per share): \$4,000.00

**Recognized gain** (\$4,000 in cash consideration received minus \$1,000.00 aggregate adjusted tax basis): \$3,000.00

## 2. Stockholders receiving the Mixed Election Consideration

The following is an illustrative example of the basis determination for a hypothetical stockholder who elected to receive Mixed Election Consideration:

**Shares of Merchants common stock owned:** 100

**Assumed tax basis in each share of Merchants common stock:** \$10.00 per share

**Fair market value of each share of Community Bank System common stock received in the Merger:** \$55.99 (closing price of Community Bank System's common stock on May 12, 2017, the day of the Merger)

No fractional shares of Community Bank System common stock were issued in the Merger and any fractional share of Community Bank System common stock was paid at the rate of \$55.91 per share.

1. **Cost basis in Merchants Common Stock:** \$1,000.00  
(100 shares of Merchants common stock multiplied by \$10.00 per share)

2. **Total Merger Consideration:**

**Common stock received in Merger** (67 shares of Community Bank System common stock multiplied by \$55.99) \$3,751.33

Number of shares determined as follows:

*Each share of Merchants common stock was exchanged for 0.6741 shares of Community Bank System common stock (0.6741 multiplied by 100 shares):  
67.41 shares*

*Whole shares of Community Bank System common stock received in the Merger: 67 (rounded down from 67.41)*

**Cash consideration received in the Merger** (100 shares of Merchants common stock multiplied by \$12.00 in cash per share) + 1,200.00

**Value of fractional share of Community Bank System share received** (0.41 shares of Community Bank System common stock multiplied by \$55.91 in cash per share) + 22.92

**Total Merger Consideration** 

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\$4,974.25

3. **Realized Gain**

Total Consideration \$4,974.25

Less: Cost basis in Merchants common stock 

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-1,000.00

**Realized Gain:** 

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\$3,974.25

4.	<b>Recognized Gain</b>	\$1,200.00
	Determined as lesser of Realized Gain or Cash Received (not including cash in lieu of the fractional shares)	
5.	<b>Tax Basis in Community Bank System shares received in the Merger</b>	
	Basis in Merchants Shares	\$1,000.00
	Less: Cash Amount Received	-1,200.00
	Plus: Recognized Gain	+1,200.00
	<b>Basis in Community Bank System shares</b>	\$1,000.00
6.	<b>Taxable Gain on Fractional Share</b>	
	Cash paid in lieu of fraction shares (0.41 multiplied by \$55.91)	\$22.92
	Less: Basis attributable to fractional shares (0.41 multiplied by \$14.83)	-6.08
	<u>Basis of fractional share determined as follows:</u>	
	<i>Total basis in Community Bank System stock divided by the amount of Community Bank System shares received, including fractional shares (\$1,000/67.41 ): \$14.83</i>	
	<b>Taxable Gain</b>	\$16.84
7.	<b>Final Adjusted Tax Basis in Community Bank System Shares</b>	
	Basis in shares received (including fractional shares)	\$1,000.00
	Less: Basis attributable to fractional share	- 6.08
	<b>Basis in Community Bank System shares</b>	\$993.92
	<b>Per Share Basis</b> (\$993.92 divided by 67)	\$14.83

**3. Stockholders receiving mixed stock and cash consideration who elected to receive all Stock Consideration but were subject to proration**

The following is an illustrative example of the basis determination for a hypothetical stockholder who elected to receive the Stock Consideration and was subject to proration.

**Shares of Merchants common stock owned:** 100

**Assumed tax basis in each share of Merchants common stock:** \$10.00 per share

**Fair market value of each share of Community Bank System common stock received in the Merger:** \$55.99 (closing price of Community Bank System's common stock on May 12, 2017, the day of the Merger)

No fractional shares of Community Bank System common stock were issued in the Merger and any fractional share of Community Bank System common stock was paid at the rate of \$55.91 per share.



1.	<b>Cost basis in Merchants Common Stock:</b>	\$1,000.00
	(100 shares of Merchants common stock multiplied by \$10.00 per share)	
2.	<b>Total Merger Consideration:</b>	
	<b>Common stock received in Merger</b> (68 Shares of Community Bank System common stock multiplied by \$55.99)	\$3,807.32
	<u>Number of shares determined as follows:</u> <i>Each share of Merchants common stock was exchanged for 0.6811 shares of Community Bank System common stock (0.6811 multiplied by 100 shares): 68.11 shares</i>	
	<i>Whole shares of Community Bank System common stock received in the Merger: 68 (rounded down from 68.11)</i>	
	<b>Cash consideration received in the Merger</b> (100 shares of Merchants common stock multiplied by \$11.71 in cash per share)	+1,171.00
	<b>Value of fractional share of Community Bank System shares received</b> (0.11 shares of Community Bank System common stock multiplied by \$55.91 in cash per share)	+ 6.15
	<b>Total Merger Consideration</b>	\$4,984.47
3.	<b>Realized Gain</b>	
	Total Consideration	\$4,984.47
	Less: Cost basis in Merchants common stock	-1,000.00
	<b>Realized Gain:</b>	\$3,984.47
4.	<b>Recognized Gain</b>	\$1,171.00
	Determined as lesser of Realized Gain or Cash Received (not including cash in lieu of the fractional shares)	
5.	<b>Tax Basis in Community Bank System shares received in the Merger</b>	
	Basis in Merchants Shares	\$1,000.00
	Less: Cash Amount Received	-1,171.00
	Plus: Recognized Gain	+1,171.00
	<b>Basis in Community Bank System shares</b>	\$1,000.00

<b>6. Taxable Gain on Fractional Share</b>	
Cash paid in lieu of fraction shares (0.11 multiplied by \$55.91)	\$6.15
Less: Basis attributable to fractional shares (0.11 multiplied by \$14.68)	-1.61
 <i>Basis of fractional share determined as follows:</i>	
<i>Total basis in Community Bank System stock divided by the amount of Community Bank System shares received, including fractional shares (\$1,000/68.11 ): \$14.68</i>	
<b>Taxable Gain</b>	\$4.54
 <b>7. Final Adjusted Tax Basis in Community Bank System Shares</b>	
Basis in shares received (including fractional shares)	\$1,000.00
Less: Basis attributable to fractional share	-1.61
<b>Basis in Community Bank System shares</b>	\$998.39
<b>Per Share Basis</b> (\$998.39 divided by 68)	\$14.68

### Questions 17 & 18

The Merger was intended to qualify as a “reorganization” within the meaning of Section 368(a) of the Code. In general, the federal income tax consequences to the former Merchants stockholders are determined under Sections 356, 358 and 1221 of the Code. Generally, Merchants stockholders must recognize gain (but not loss), pursuant to Section 356 of the Code, in an amount equal to the lesser of (1) the amount of gain realized (i.e., the excess of the sum of the amount of cash and fair market value of the Community Bank System common stock received in the Merger over the stockholder’s adjusted basis in its shares of Merchants common stock surrendered, as determined pursuant to Sections 1001 and 1011 of the Code) and (2) the amount of cash received pursuant to the Merger (excluding any cash received in lieu of a fractional share of Community Bank System common stock).