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PLANNING FOR THE PURCHASE OR SALE OF A CORPORATE BUSINESS FEDERAL TAX ASPECTS*

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I. Introduction.

A. Cast of characters.

"P" the acquiring entity; usually a corporation engaged in business (directly, through divisions, or through wholly-owned subsidiaries) at the time of the acquisition. P may be a public or a closely-held corporation.

"S" a wholly-owned subsidiary of P; usually a corporation newly organized for the purpose of acquiring T.

"T" the target entity; usually a corporation that is, and for several years has been, engaged in businesses (directly, through divisions, or through wholly-owned subsidiaries). T itself may be a wholly-owned subsidiary of another corporation.

B. The setting.

T owns substantial assets consisting of (1) cash and accounts receivable, (2) property, plant and equipment, and (3) real estate.

P is interested in acquiring all (or substantially all) of T's business but may not be interested in the real estate. P is prepared to consider either an asset or a stock acquisition for (1) cash and notes, (2) stock, or (3) a combination of cash and notes and stock, and an assumption of T's liabilities (either expressly or by operation of law).

C. The tax stakes.

The tax stakes will vary from situation to situation. While the permutations are numerous, one of two common fact patterns is likely to emerge. In the first of these patterns, T has been conducting a profitable business whose assets either have appreciated in value or have been depreciated for tax purposes at a rate that has exceeded the rate of economic decline in value (measured in current dollars). In the second pattern, T has incurred significant operating losses that have generated net operating loss and investment tax credit carryforwards.

1. P's objectives.

a. To recover its investment on an after-tax basis as soon as possible.

b. Considerations.

(1) "Write-up" basis of T's assets.

(2) Allocation of purchase price to short-term depreciable assets.

(3) Use T's net operating loss carryovers.

2. T's objectives.

a. Keep tax impact low.

b. Defer tax impact (or at least match it with cash flow).

3. Transaction patterns.

a. For tax analysis purposes, the possible transaction patterns fall into two categories: (a) tax-free reorganizations, and (b) taxable acquisitions. The principal nontax difference between the two patterns lies in the mix of the consideration offered by P.

b. In general, in a tax-free reorganization P will offer consideration consisting primarily of P stock. P will inherit all of T's tax attributes (basis, earnings and profits, net operating losses (if any), etc.) and will not be able to step up asset bases readily. §§ 362(b), 381. Neither T, nor T's shareholders, will recognize gain or loss in a tax-free reorganization. §§ 361(a), 354(a)(1). In effect, gain or loss recognition is deferred to a later time when T's shareholders dispose of the consideration received from P (usually, P stock). § 358(a)(1).

c. In a taxable acquisition, the consideration is likely to be cash, or notes and cash. Before the Tax Reform Act of 1986, the corporate-level tax could usually be avoided except for "recapture" items, and T's shareholders (absent collapsible corporation status) were entitled to capital gain treatment. Old §§ 337, 331. In these circumstances, P generally could step up asset bases or preserve net operating loss carryforwards but could not accomplish both of these objectives simultaneously. §§ 338, 381. Under the 1986 Act provisions, asset basis cannot be stepped up without paying a corporate-level tax on the full appreciation in the corporation's assets in addition to the tax paid by the shareholders on their gain. This may be an unacceptable price.

4. Taxable sale v. tax-free reorganization.

a. Advantages of tax-free reorganization.

(1) For the seller.

(a) No immediate tax. Tax is deferred until stock received is sold and may be completely avoided if T shareholder holds the stock until death. § 1014.

(b) Where P is publicly-held, investment in closely-held business is converted into marketable interest in a larger and probably more diversified corporation.

(2) For P.

(a) No need to use cash. P's own stock is cheap. Especially important in a time of high interest rates.

(b) P can get T's tax attributes, including net operating loss carryovers. § 381. But see §§ 269 and 382.

(c) Pooling of interests accounting treatment avoids need to write off cost of good will against earnings for non-tax purposes.

b. Advantages of taxable sale.

(1) For the seller.

(a) The seller can recognize a loss.

(b) The seller gets cash and is not locked into holding P's stock.

(c) No need to worry about qualification as a reorganization. Parties have much more flexibility in structuring the transaction.

(2) For P.

(a) T shareholders do not become P shareholders (particularly important when buyer is closely held).

(b) P may get stepped-up basis in T's assets.

(c) No need to worry about qualification as a reorganization. Easy to dispose of unwanted assets.

II. Tax free reorganizations.

Tax-free reorganizations can be divided into two broad categories based upon the type of permissible consideration payable by P to T or T's shareholders. In the first category are tax-free reorganizations in which the permissible consideration is "solely voting stock" of P, such as "B" and "C" reorganizations. In the second category are tax-free reorganizations in which the permissible consideration need not be "solely voting stock" of P, such as "A" reorganizations, subsidiary mergers and reverse subsidiary mergers.

A. Continuity issues.

Acquisitive tax-free reorganizations are subject to two continuity requirements: (1) continuity of interest, and (2) continuity of business enterprise.

1. Continuity of interest.

a. There is no precise formula in applying the continuity of interest test. There must be a showing (a) that T or its shareholders have retained a substantial proprietary stake in the enterprise represented by a material interest in the affairs of the transferee corporation, and (b) that such retained interest represents a substantial part of the value of the property transferred. Southwest Natural Gas Co. v. Commissioner, 189 F.2d 332, 51-1 USTC ¶ 9340, 40 AFTR 686 (5th Cir. 1951).

b. Cash and short-term securities paid by P are not sufficient to provide continuity of interest. Cortland Specialty Co. v. Commissioner, 60 F.2d 937, 3 USTC ¶ 980, 11 AFTR 857 (2d Cir. 1932); see also Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462, 3 USTC ¶ 1023, 11 AFTR 1112

(1933); Helvering v. Minnesota Tea Co., 296 U.S. 378, 35-2 USTC ¶ 9676, 16 AFTR 1258 (1935). In LeTulle v. Scofield, 308 U.S. 415, 40-1 USTC ¶ 9150, 23 AFTR 789 (1940), continuity was absent even though the consideration consisted of cash ($50,000) and long-term bonds ($750,000). The Supreme Court did find sufficient continuity, however, where 41 percent of the consideration was preferred stock and 59 percent was cash. John A. Nelson Co. v. Helvering, 296 U.S. 374, 36-1 USTC ¶ 9019, 16 AFTR 1262 (1935).

c. For ruling purposes, the Service requires that at least 50 percent of the consideration received by T shareholders consist of P stock. Rev. Proc. 77-37, § 3.02, 1977-2 C.B. 568.

d. The scope of the transaction must be defined in applying the continuity of interest test.

(1) Post-acquisition sales of P stock by T shareholders.

(a) A post-acquisition sale pursuant to a pre-acquisition intent counts against continuity. McDonald's Restaurants of Illinois, Inc. v. Commissioner, 688 F.2d 520, 82-2 USTC ¶ 9581, 50 AFTR2d 82-5750 (7th Cir. 1982), rev'g 76 T.C. 972 (1981). Many commentators disagree and the I.R.S. is known to be reconsidering the issue.

(b) Minority T shareholders should get representations from other T shareholders that they have no present intention to sell their P stock after the transaction.

(2) Post-acquisition mergers.

(a) The Service now agrees that a merger of T into a first-tier subsidiary of P after P acquires the T stock in a qualified stock purchase when a § 338 election is not made meets the continuity of interest test as to P and its affiliates, but the merger is taxable as to minority T shareholders. Reg. § 1.338-2(c)(3). For pre-§ 338 cases holding that the cash purchase of T stock must be

viewed as part of the merger transaction and can defeat continuity of interest, see Superior Coach of Florida v. Commissioner, 80 T.C. 895 (1983); Yoc Heating Corp. v. Commissioner, 61 T.C. 168 (1973).

(b) An argument by a corporation that acquired a large bloc of T stock in an unsuccessful attempt to take over T and that then transferred its stock to P, the successful bidder, in connection with a merger that its purchases should count against continuity was rejected by the Tax Court, which viewed it as an historic T shareholder for this purpose. J.E. Seagram Corp. v. Commissioner, 104 T.C. 75 (1995) (merger was a reorganization and taxpayer could not deduct a loss).

(3) See generally Faber, "Continuity of Interest and Business Enterprise: Is it Time to Bury Some Sacred Cows?," 34 Tax Lawyer 239 (1981); Faber, "Postreorganization Sales and Continuity of Interest," 68 Tax Notes 863 (1996).

e. The Service has ruled that T stock that P has owned for 8 years counts for continuity. Ltr. Rul. 9321025.

2. Continuity of business enterprise.

a. The regulations require a "continuity of business enterprise under modified corporate forms." Reg. § 1.368-1(b). See, e.g., Laure v. Commissioner, 70 T.C. 1087 (1978), rev'd, 653 F.2d 253, 81-2 USTC ¶ 9517, 48 AFTR2d 81-5354 (6th Cir. 1981).

b. In late 1979, the Service published proposed regulations that required the transferee corporation (P or S) to either (a) continue T's "historic business," or (b) continue to use a "significant portion" of T's "historic business assets" in a business. Prop. Reg. § 1.368-1(d). Curiously, the proposed regulations did not appear to apply to "B" reorganizations. In their final version, however, the regulations do apply to "B" reorganizations. See Reg. § 1.368-1(d) and, in particular, 1.368-1(d)(5) (examples); see also Rev. Rul. 81-92, 1981-1

C.B. 133; Faber, "Continuity of Interest and Business Enterprise: Is It Time to Bury Some Sacred Cows?," 34 Tax Lawyer 239 (1981). Thus, a sale of T's historic business by T before the transaction or by T or P after it may defeat reorganization treatment.

B. Reorganizations requiring consideration to be voting stock of P.

1. Stock-for-stock exchanges ("B" reorganizations).

a. There are essentially three types of "B" reorganizations. The first may be referred to as a "straight B" or a "simple B". In this transaction, P acquires T's stock from T's shareholders solely for P voting stock and after the transaction is in "control" of T. For this purpose, "control" is defined as the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock of T entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of T. §§ 368(a)(1)(B), 368(c)(1).

b. The second type of "B" reorganization is a transaction in which S (a subsidiary of P) acquires T's stock solely for P voting stock and after the transaction S is in control of T. S must be a first-tier subsidiary of P.

c. The third type of "B" reorganization is referred to as a "forced B". In this transaction, S is a newly organized transitory corporation that merges (under state merger laws) into T. As a result of the merger, T's shareholders receive solely voting stock of P and P ends up after the transaction in control of T. Since after the transaction is completed P controls T and T was acquired solely for voting stock of P, the transaction is treated as a "B" reorganization. Rev. Rul. 67-448, 1967-2 C.B. 144; Rev. Rul. 74-564, 1974-2 C.B. 124; Rev. Rul. 74-565, 1974-2 C.B. 125. This transaction is often used as the second step to squeeze out minority shareholders after an initial tender offer by P for T stock in exchange solely for P stock.

d. The stringent "B" reorganization requirements (solely for voting stock and control) raise a number of issues that must be analyzed carefully when the facts are not so simple as to permit a straightforward transaction. For example, what if some of T's shareholders want cash and are not interested in a stock-for-

stock transaction? What if shareholders dissent (in a squeeze-out merger) and are entitled to cash? If T has outstanding debentures, can P purchase the debentures for cash without affecting the status of the transaction as a "B" reorganization? Finally, what if P had acquired shares of T before the current negotiations?

(1) Redemptions.

T may, before the transaction with P, redeem the T shares held by some of its shareholders. To preserve "B" reorganization treatment, however, it is essential that (i) the funds spent by T be traceable to T (and not directly or indirectly to P), and (ii) no more than 50 percent of T's stock be redeemed before the transaction with P. See Rev. Rul. 55-540, 1955-2 C.B. 226; McDonald v. Commissioner, 52 T.C. 82 (1969); but see Rev. Rul. 75-360, 1975-2 C.B. 110. See also Rev. Rul. 68-562, 1968-2 C.B. 157, Rev. Rul. 79-100, 1979-1 C.B. 152.

(2) Dissenters and fractional shares.

"B" reorganization status can be preserved in a squeeze-out merger (forced "B") if the cash consideration paid to dissenters is provided by T. The transaction with the dissenters is treated as a redemption by T of their shares. Rev. Rul. 68-285, 1968-1 C.B. 147; Rev. Rul. 68-562, 1968-2 C.B. 157. Where fractional shares arise because of the exchange ratio and P does not wish to issue fractional shares, an arrangement can be made (such as with a bank) for the purchase of an additional fraction to make up a full share or for the sale of the fractional interest. Rev. Rul. 66-365, 1966-2 C.B. 116.

(3) T's debentures.

In the typical "B" reorganization, T's debentures continue to be outstanding because the only change occurring is at the T shareholder level. If P were to purchase T's debentures for cash or in exchange for its own debentures, the transaction should be viewed as a separate transaction that does not affect the status of the

"B" reorganization with the shareholders. Rev. Rul. 69-142, 1969-1 C.B. 107; Rev. Rul. 69-91, 1969-1 C.B. 106; Rev. Rul. 70-41, 1970-1 C.B. 77. Particular attention must be given, however, to situations where T's debts are guaranteed by a T shareholder. The Service can take the position that the payment of the debt by P is additional consideration to T's shareholders and thus violates the "solely for voting stock" requirement of a "B" reorganization. The Service will prevail if the payment is a condition of the exchange. Note also the risk that the Service could assert that T's debt is in reality the debt of its shareholder-guarantor if the corporation is thinly capitalized. See Rev. Rul. 79-4, 1979-1 C.B. 150; Rev. Rul. 79-89, 1979-1 C.B. 152. The thrust of the authorities is to support "B" reorganization treatment, provided that the stock-for-stock exchange values are equal.

(4) Creeping "B" reorganization.

(a) The issue arises in "two-step" acquisitions where P initially acquires shares of T and in a second step acquires additional shares of T in a purported "B" reorganization. If (i) P acquires the remaining T shares solely in exchange for voting stock of P, (ii) after the exchange P is in "control" (as previously defined) of T, and (iii) the initial acquisition of T shares was also in the form of an exchange solely for voting stock of P, "B" reorganization treatment will be available for the second transaction but not necessarily for the first transaction unless that transaction is not "old and cold". If, however, the initial acquisition of T shares was not solely for voting stock of P, "B" reorganization treatment for the second transaction can be assured if, and only if, the initial acquisition is "old and cold." Reg. § 1.368-2(c). Obviously, if the initial transaction was not solely for voting stock of P, it will be treated as a taxable transaction regardless of its age and temperature.

(b) The regulations provide that a series of stock-for-stock transactions are aggregated if they occur "over a relatively short period of time such as 12 months." Conversely, prior cash purchases of T shares by P may be disregarded if the cash purchases were independent of the stock-for-stock exchange. A holding period of 12 months may not be sufficient to achieve "old and cold" status absent a change of intent by P. Reg. § 1.368-2(c). See King Enterprises v. United States, 418 F.2d 511, 69-2 USTC ¶ 9720, 24 AFTR2d 69-5866 (Ct. Cl. 1969); Reeves v. Commissioner, 71 T.C. 727 (1979), rev'd sub nom. Chapman v. Commissioner, 618 F.2d 856, 80-1 USTC ¶ 9330, 45 AFTR2d 80-1290 (1st Cir. 1980); Pierson v. United States, 472 F. Supp. 957, 79-2 USTC ¶ 9432, 43 AFTR2d 1228 (D. Del. 1979), rev'd sub nom. Heverly v. Commissioner, 621 F.2d 1227, 80-1 USTC ¶ 9322, 45 AFTR2d 80-1122 (3d Cir. 1980); see also Faber, "The Use and Misuse of the Plan of Reorganization Concept," 38 Tax L. Rev. 515 (1983); McMahon, "Defining the "Acquisition" in B Reorganizations Through the Step Transaction Doctrine," 67 Iowa L. Rev. 31 (1981).

(c) P may "purge" the effect of the initial acquisition of T shares for cash by disposing of the T shares in an unconditional sale to an unrelated purchaser before making the offer to acquire the balance of the T shares solely for voting stock of P. Rev. Rul. 72-354, 1972-2 C.B. 216.

(5) A representation by P as to the value of its stock may disqualify a transaction, as may the payment of an indemnity in cash for the breach of a representation relating to P's financial situation.

(6) The use of a P subsidiary to provide cash to some T shareholders will violate the solely for voting stock requirement. Rev. Rul. 85-139, 1985-2 C.B. 123 ("B" reorganization); Rev. Rul. 85-138, 1985-2 C.B. 122 ("C" reorganization).

2. Stock-for-asset exchanges ("C" reorganizations).

a. As is the case in "B" reorganizations, there are also three types of "C" reorganizations.

(1) The first type of "C" reorganization is a "simple C", a transaction in which P acquires "substantially all" of T's assets solely in exchange for P voting stock.

(2) The second type of "C" reorganization is a transaction in which S, an existing or newly organized wholly-owned subsidiary of P, acquires substantially all of T's assets solely in exchange for P voting stock. §§ 368(a)(1)(C), 368(a)(2)(C). As in the case of "B" reorganizations, S must be a first-tier subsidiary of P.

(3) In the third type of "C" reorganization, T merges into S, T's shareholders receive solely voting stock of P, and S ends up with substantially all of T's assets. Rev. Rul. 67-236, 1967-2 C.B. 143; cf. § 368(a)(2)(D).

(4) "C" reorganizations are unusual because of the need to transfer each T asset.

b. The "substantially all" the properties requirement.

(1) The Service's ruling position is that the "substantially all of the properties" requirement of § 368(a)(1)(C) is satisfied if at least (i) 90 percent of the fair market value of T's net assets, and (ii) 70 percent of the fair market value of T's gross assets are transferred solely in exchange for P voting stock. Rev. Proc. 77-37, § 3.01, 1977-2 C.B. 568. Yet, in other rulings, the Service's focus has been on T's "business assets", as opposed to all assets; similarly, the courts have been somewhat more liberal than the Service's ruling policy, focusing on T's "operating assets" as the benchmark for the "substantially all" test. See Rev. Rul. 78-47, 1978-1 C.B. 114; Smothers v. United States, 642 F.2d 894, 81-1 USTC ¶ 9368, 47 AFTR2d 1372 (5th Cir. 1981).

(2) The principal purpose of the "substantially all" test is to insure that a "C" reorganization serves essentially as an acquisitive transaction rather than as a divisive transaction which, to achieve tax-free status, must meet the stringent requirements of § 368(a)(1)(D) or § 355. Thus, redemptions or spinoffs by T in conjunction with P's acquisition of T's remaining assets will be taken into account in measuring "substantially all" of T's assets and are likely to jeopardize the status of the P-T transaction as a valid "C" reorganization. See, e.g., Helvering v. Elkhorn Coal Co., 95 F.2d 732, 38-1 USTC ¶ 9238, 20 AFTR1301 (4th Cir. 1938), cert. denied, 305 U.S. 605 (1938). On the other hand, T may retain sufficient assets to cover liabilities that are not otherwise assumed by P in the reorganization. Rev. Rul. 57-518, 1957-2 C.B. 253.

(3) At one time, T could also have retained liquid and other assets (beyond amounts required to cover liabilities not assumed by P), provided that the "substantially all" test had been satisfied, even if the retention of these assets was to enter into an active business. Rev. Rul. 68-358, 1968-2 C.B. 156. Under the Tax Reform Act of 1984, a purported "C" reorganization will fail to achieve that status unless T distributes the stock, securities and other property it receives, as well as its other properties, in complete liquidation pursuant to the plan of reorganization. § 368(a)(2)(G)(i). Much discretion as to the interpretation of this change is left to the regulations. See Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 at 190-91 (1984).

c. Permissible cash.

Up to 20% of the consideration can be property other than P voting stock. § 368(a)(2)(B). Assumed liabilities reduce the 20% leeway and in most transactions eliminate it.

d. Liabilities of T.

The assumption of (or taking subject to) T's liabilities in a "C" reorganization does not violate the "solely for voting stock" requirement of § 368(a)(1)(C). Moreover, these liabilities are

not treated as "boot", i.e., that portion of the consideration in a tax-free reorganization that normally is taxable to the recipient.

e. Prior ownership of T stock by P.

Unlike the situation where "B" reorganization status is achieved despite prior ownership of T stock by P if T's stock was acquired for voting stock of P or if the prior transaction is "old and cold", ownership of an amount of T's stock that is less than 80 percent, no matter how or when acquired, will preclude "C" reorganization status. Bausch & Lomb Optical Co. v. Commissioner, 267 F.2d 75, 59-1 USTC ¶ 9468, 3 AFTR2d 1497 (2d Cir. 1959). In effect, P would be acquiring the percentage of the assets represented by its prior ownership in a taxable liquidation under § 331.

f. Overlap with "B" reorganization.

A "B" reorganization followed by a liquidation of T into P or S as part of the overall plan of reorganization is tested under the "C" reorganization rules to determine its tax-free status. Rev. Rul. 67-274, 1967-2 C.B. 141; Resorts International, Inc. v. Commissioner, 511 F.2d 107, 75-1 USTC ¶ 9405, 35 AFTR2d 75-1337 (5th Cir. 1975). Thus, the caveats as to redemptions, spinoffs, and the problems presented by a Bausch & Lomb fact pattern must be analyzed and resolved as if the transaction is intended to qualify as a "C" reorganization.

g. Alternative minimum tax.

The gain realized by T but not recognized may have to be taken into account under the corporate alternative minimum tax provisions.

C. Merger transactions.

1. "Straight merger" of T into P.

This is the first and most straightforward of the tax-free reorganizations that do not require that the consideration consist solely of voting stock of P. Under § 368(a)(1)(A), a merger or consolidation under state (or D.C. or territory) laws qualifies as an "A" reorganization. To qualify, however, it is essential to satisfy both the "continuity of interest" and

"continuity of business enterprise" tests (see Part II.A.). In general, to satisfy continuity of interest for ruling purposes, at least 50 percent of the consideration paid by P must be P stock (not necessarily P voting stock). Rev. Proc. 77-37, § 3.02, 1977-2 C.B. 568. To satisfy the continuity of business enterprise test, P must continue to conduct T's "historic" business or use a significant portion of T's "historic" business assets in the conduct of a business. Reg. § 1.368-1(d).

2. Triangular mergers.

a. Forward subsidiary merger.

(1) In a forward subsidiary merger, T merges into S and the T shareholders receive P stock (which need not be voting stock) and possibly other consideration. Both "continuity" tests apply.

(2) S may not use a combination of S and P stock in the merger; only P stock may be used.

(3) S must acquire "substantially all" of T's assets (as is the case in a "C" reorganization and unlike an "A" reorganization). The "substantially all" test is interpreted the same (i.e., for ruling purposes, 90 percent of net assets and 70 percent of gross assets) in a subsidiary merger as in a "C" reorganization, and, therefore, attention must be paid to redemptions and spinoffs before the reorganization.

(4) For purposes of the subsidiary merger rules, S is not a transitory corporation; if it is liquidated shortly after the merger of T into it, the transaction must be analyzed as a "C" reorganization to determine whether tax-free status has been achieved. Thus, for example, if nonvoting P stock was part of the consideration, the transaction will fail as a "C" reorganization (since not "solely for voting stock"). Similarly, if P had acquired more than 20 percent of T's shares before the transaction, the Bausch & Lomb case would not permit qualification as a "C" reorganization.

b. Reverse subsidiary merger.

(1) In a reverse subsidiary merger, S is merged into T, T's shareholders receive P stock, and P ends up with a wholly owned subsidiary, T.

(2) Under § 368(a)(2)(E), a reverse subsidiary merger will qualify as a tax-free reorganization if (i) T's shareholders receive P voting stock in exchange for an amount of T stock constituting "control" (as defined in § 368(c)(1) -- see Part II.B.1.a.) "in the transaction", and (ii) T ends up owning (X) substantially all of its assets and (Y) substantially all of S's assets. See Reg. § 1.368-2(j). For this purpose, "substantially all" is tested by the same standards as apply to "C" reorganizations and to subsidiary mergers.

(3) A reverse subsidiary merger is similar in many ways to the third type of "B" reorganization (the "forced B"), but there are differences: (i) in a "forced B", S is a transitory corporation; in a reverse subsidiary merger, S may be transitory or pre-existing; (ii) in a "forced B", the solely for voting stock rule applies; in a reverse subsidiary merger, P voting stock is required, too, but only to the extent necessary to acquire "control" of T; (iii) pre-transaction redemptions and spinoffs that may cause T to hold less than "substantially all" its assets at the time of the transaction will not necessarily affect the tax-free status of a "forced B" but will have an adverse impact on a reverse subsidiary merger; and (iv) "creeping control" is permitted in a "forced B" but not in a reverse subsidiary merger.

c. Other differences.

A forward subsidiary merger is basically an asset acquisition while a reverse subsidiary merger is a stock acquisition. This may be important with respect to liens, loan covenants, and sales taxes.

D. Shareholder treatment ("boot" issues).

1. A T shareholder in a reorganization who receives only P stock will have no recognized gain or loss. His or her basis and holding period in the T shares are carried over to the P shares. A shareholder who receives no shares of P stock but only cash or notes is treated as if there was a sale of his or her T shares. Under the Service's analysis, the transaction as to that shareholder is treated as a redemption of T shares by T rather than as a sale of T shares to P. The difference is significant in that to qualify for capital gain treatment the T shareholders must satisfy the requirements of § 302 after taking into account the attribution rules of § 318. Cf. Wright v. United States, 482 F.2d 600, 73-2 USTC ¶ 9583, 32 AFTR2d 73-5490 (8th Cir. 1973), § 356(a)(2) as amended by the Tax Equity and Fiscal Responsibility Act of 1982.

2. If the T shareholder receives both P stock and cash and notes, the shareholder is taxed on that portion of the consideration that is not P stock as does not exceed the gain that he or she would otherwise realize in the transaction if it were treated as a taxable transaction. The character of the gain (long-term capital gain or dividend income to the extent of the shareholder's pro rata share of earnings and profits) is determined by assuming that the cash was received in a redemption by P after the transaction with T. Commissioner v. Clark, 489 U.S. 726, 89-1 USTC ¶ 9230, 63 AFTR 2d 89-860 (1989); Rev. Rul. 93-61, I.R.B. 1993-30, 10.

3. If the non-P stock consideration qualifies for capital gain treatment, the installment method of reporting gain may be available if the consideration is in the form of installment obligations.

4. Generally, the portion of the consideration in a tax-free reorganization that is "boot" is readily identifiable. In many instances, however, the Service may assert that certain rights, actions, or elements of value that purport to be given for other items are in fact consideration for T stock and are boot. For example, amounts payable under employment contracts, to the extent that the compensation payable under the agreement is additional consideration for T's stock or assets, are treated as boot. Rev. Rul. 77-271, 1977-2 C.B. 116. On the other hand, registration rights as to P stock are not boot. Rev. Rul. 67-275, 1967-2 C.B. 142. See also Rev. Rul. 68-345, 1968-2 C.B. 155 (payment of dividend by T before "B" reorganization acceptable); Rev. Rul. 75-360, 1975-2 C.B. 110 (payment of dividend by T with borrowed funds and

repayment of loan by P can be boot); Rev. Rul. 70-108, 1970-1 C.B. 78 (option to purchase additional P shares by former T shareholders affects adversely status of transaction as a "B" reorganization), § 280G (provisions dealing with "golden parachutes").

III. Special problems in tax-free reorganizations.

A. Getting cash to the T shareholders.

1. Problem: Some T shareholders may want to receive cash instead of, or in addition to, P stock. The amount of cash or other property permitted is not the same for all types of reorganizations.

2. Different types of reorganizations permit varying amounts of cash to be paid to T shareholders as consideration for their T stock.

3. Other ways of getting cash and other property to the T shareholders besides as direct consideration for their T stock in the reorganization.

a. General comments.

(1) There are various ways of getting cash to the T shareholders in the context of a reorganization.

(2) Dangers.

(a) The other property may be considered as consideration for T stock. Greatest risk in a "B" or "C" reorganization where the presence of other property can disqualify the entire transaction.

(b) The distribution of other property may cause a failure to meet the "substantially all of the properties" test of the "C" reorganization or the triangular mergers.

b. Payment of dividends from T to T shareholders before the reorganization.

(1) The payment of a dividend by T before the reorganization will ordinarily not be treated as non-qualifying consideration from P. Rev. Rul. 68-435, 1968-2 C.B. 155; Rev. Rul. 56-184, 1956-1 C.B. 190.

(2) If T pays a dividend before the reorganization with borrowed funds and P later repays the loan, P will be treated as the source of the funds and the dividend will be treated as part of the reorganization. Rev. Rul. 75-360, 1975-2 C.B. 110.

(3) A substantial dividend can cause a failure to meet the "substantially all the properties" test of the "C" reorganization and triangular mergers.

c. Redemption of stock by T before the reorganization.

(1) If the redemption is not in proportion to shareholdings, gain may be capital ygain for the selling shareholder. § 302(b).

(2) The effect on qualification of the reorganization is the same as the effect of a dividend.

d. Payment of reorganization expenses by P.

(1) The I.R.S. has ruled that the acquiring corporation can assume or pay expenses of T and its shareholders that are "solely and directly related to the reorganization." Rev. Rul. 73-54, 1973-1 C.B. 187. Permissible expenses are only those directly related to the transfer of T's property or the T shareholders' equity interests. They include:

(a) Legal and accounting fees.

(b) Appraisal fees.

(c) Administrative expenses.

(2) The payment of personal expenses of the shareholders not directly related to the transfer of their stock will not be protected by Rev. Rul. 73-54 and may disqualify the reorganization. These include:

(a) Investment advice.

(b) Estate planning advice.

(c) Advice to a shareholder or group of shareholders relating to their individual participation in the transaction. The application of this exception in a "B" reorganization in which the T shareholders are the transferors is unclear.

(3) The payment of cash by P to T or its shareholders for the purposes of enabling them to pay their own reorganization expenses is treated as the payment of non-qualifying consideration. Rev. Rul. 73-54, supra.

(4) The allocation of legal fees to T that should have been charged to the T shareholders for personal services can disqualify a reorganization if the fees are paid by P.

(5) In a § 351 incorporation, the assumption of the transferors' expenses by the holding company does not disqualify the transaction and, in fact, can be entirely tax-free. Rev. Rul. 74-477, 1974-2 C.B. 116.

e. Reversing the transaction. T acquires P and the stock of T shareholders desiring cash is redeemed.

(1) The continuity of interest rules apparently only apply to the shareholders of the acquired corporation, not those of the acquiring corporation. Reversing the transaction will preserve tax-free treatment for one T shareholder when another T shareholder who owns more than 50% of T's stock wants only cash.

(2) Business considerations may prevent a reverse acquisition.

f. Employment or consulting agreements for T shareholders.

(1) Amounts paid to T shareholders after the reorganization under employment or consulting arrangements are not considered to be additional payments for T stock if they are reasonable in relation to the services performed.

(2) If payments for services are in proportion to T shareholdings despite varying abilities of the T shareholders to perform services, the I.R.S. may attack the arrangement.

B. Disposition of unwanted T assets.

1. Problem: T may operate many businesses or have assets that the acquiring corporation doesn't want.. P or S may be unwilling to incur the market risk and inconvenience of acquiring the unwanted assets and later selling them.

2. The easiest way to deal with unwanted assets is not to acquire them.

a. In a "C" reorganization, S/P can simply leave the unwanted assets in T as part of the basic transaction as long as this does not violate the "substantially all" requirement. Now that T must be liquidated, the T shareholders will have to pay tax on those assets in the liquidation.

b. In all other reorganizations, all the T assets pass to or under the control of S/P. If S/P doesn't want some of them, they must be disposed of outside the framework of the reorganization.

3. Disposing of unwanted assets can result in a failure to meet the continuity of business enterprise test, whether before or after the reorganization.

a. This will be a problem in all reorganizations.

b. This will not be a problem in a § 351 incorporation.

4. Effect of disposition of unwanted assets on the qualification requirements of different types of reorganizations.

a. "A" reorganization.

(1) Disposition of unwanted assets will not affect qualification as a reorganization.

(2) Techniques of disposition.

(a) Sale by T.

(b) Distribution by T as a dividend. T shareholders get stepped-up basis. Capital gain to T. § 311(b).

(c) Distribution by T to its shareholders in redemption of stock.

(d) Spin-off in tax-free reorganization. Commissioner v. Morris Trust, 367 F.2d 794, 66-2 USTC
¶ 9718, 18 AFTR2d 5843 (4th Cir. 1966); Rev. Rul. 68-603, 1968-2 C.B. 148.

b. "B" reorganization.

(1) Most forms of disposition will not affect qualification as a reorganization.

(2) Spin-off to a new corporation owned by the T shareholders could be viewed as amounting to a failure by S/P to acquire 80% control of T.

c. "C" reorganization.

(1) Disposition of unwanted T assets could result in a failure to meet the requirement that S/P acquire substantially all of T's properties.

(2) Attempting to dispose of unwanted T assets before the reorganization so that substantially all of the properties owned by T on the date of the reorganization are transferred to S/P may not work.

(a) Ordinary business transfers by T will not disqualify the reorganization.

(i) Sales of inventory in the ordinary course of business. Rev. Proc. 77-37, 1977-2 C.B. 568.

(ii) Regular quarterly dividends. Rev. Rul. 74-457, 1974-2 C.B. 122.

(b) Unusual dispositions will count against qualification.

(i) A non-taxable spin-off may prevent qualification. Helvering v. Elkhorn Coal Co., 95 F.2d 732, 38-1 USTC ¶ 9238, 20 AFTR 1301 (4th Cir. 1938), cert. denied, 305 U.S. 605 (1938). (Note that a spin-off does not jeopardize the qualification of an "A" reorganization.)

(ii) The I.R.S. considers stock redemptions and unusual distributions to count against the substantially all test for advance ruling purposes. Rev. Proc. 77-37, 1977-2 C.B. 568.

(c) A taxable sale of T assets for a fair price does not prevent qualification. It does not undermine the purpose of the substantially all test, which is to prevent the use of a "C" reorganization to avoid the normal requirements of divisive reorganizations. Rev. Rul. 88-48, 1988-1 C.B. 117.

d. Forward subsidiary mergers.

(1) In a forward subsidiary merger, S must acquire substantially all of T's assets.

(2) The effect of dispositions of unwanted assets on qualification are the same as in the case of the "C" reorganization. The "substantially all" standard is the same. Reg. § 1.368-2(b)(2).

(3) Although the forward subsidiary merger was designed as a variant of the "A" reorganization, the problem does not arise in the "A" transaction since it is not subject to the substantially all test.

e. Reverse subsidiary mergers.

(1) In a reverse subsidiary merger, T must "hold" substantially all of its properties and those of S after the transaction.

(2) The meaning of "substantially all" is the same as in the case of the "C" reorganization. The test must be applied separately to S and to T. Reg. § 1.368-2(j)(3)(iii).

(3) It is not clear whether the word "holds" in § 368(a)(2)(E) implies a longer period of retention after the transaction than in "C" reorganizations and forward subsidiary mergers where the statutory language speaks in terms of an "acquisition" of substantially all of T's properties. It is unlikely that a different standard was intended.

(4) Cash contributed by P to S and paid to T's shareholders as consideration for their stock, to pay dissenters, to pay T creditors, or to pay reorganization expenses is not taken into account. Reg. § 1.368-2(j)(3)(iii); Rev. Rul. 77-307, 1977-2 C.B. 117.

(5) Since "B" reorganizations are not subject to the substantially all test, an intended reverse subsidiary merger might be structured so as to qualify as a "B" reorganization where the disposition of unwanted assets was contemplated. But see Rev. Proc. 82-50, 1982-2 C.B. 839, in which the I.R.S. indicated that it would not rule on whether a failed reverse subsidiary merger also qualifies as a "B." It is understood that the no-ruling policy applies only where there is a clear overlap.

IV. Asset purchase taxable transactions.

A. Asset purchase rules.

1. In an asset purchase transaction, P will use cash and debt to purchase the assets of T. If T itself is not part of a larger company, it will normally be liquidated.

2. An asset purchase is sometimes accomplished by a cash merger of T into S or P.

3. Tax consequences to P.

The aggregate tax basis of the assets acquired will equal the total purchase price of the assets (both cash paid and deferred purchase price) plus any liabilities assumed or taken subject to. The allocation of the aggregate tax basis among the various assets is a crucial consideration and is discussed separately below.

4. Tax consequences to T.

a. T's full gain or loss on the sale will be recognized, subject to the rules of I.R.C. § 267 in cases of sales to related parties.

b. T's gain or loss on distributions of property to its shareholders in liquidation will be recognized, except as indicated below. I.R.C. §§ 336(a) and (d).

(1) Loss will not be recognized, however, if the property is distributed to a related person (within the meaning of I.R.C. § 267) and:

(a) the distribution is not in proportion to shareholdings, or

(b) the property was acquired by T during the 5 years preceding the distribution as a capital contribution or in an I.R.C. § 351 transfer (a rule designed to prevent "stuffing" T with loss property to offset corporate gains).

(2) The amount of loss will be reduced by any unrealized depreciation in property at the time T acquired it if:

(a) T acquired it in an I.R.C. § 351 transfer or as a capital contribution, and

(b) the property was acquired by T as part of a plan a principal purpose of which was to generate a deductible loss in the liquidation (presumed if acquired during the preceding 2 years except as provided in regulations).

(3) If the liquidation is subject to I.R.C. § 332, special rules apply.

(a) No loss is recognized. I.R.C. § 336(d)(3).

(b) Gain is not recognized on distributions to the controlling parent. I.R.C. § 337(a).

(c) Gain is recognized on distributions to other shareholders. I.R.C. § 336(a).

c. Net effect of new rules.

(1) Sales of assets followed by a liquidation will be subject to a double tax when T is not a subsidiary of another corporation.

(2) Since sales of T's stock need not be subject to a double tax if P is willing to forego stepping up the basis of T's assets under I.R.C. § 338, sales of stock may be preferred in many cases over sales of assets.

5. Tax consequences to T's shareholders.

a. If T is liquidated.

(1) Each shareholder of T will generally recognize capital gain or loss (assuming that the stock is a capital asset and that the corporation is not collapsible under § 341) equal to the difference between the fair market value of the property received upon the liquidation and the shareholder's basis in the T stock. §§ 331(a)(1) and 1001.

(2) A leveraged acquisition will involve a financing of the purchase price which, in some instances, will be provided by T itself. Where the transaction is structured as an asset purchase and T is liquidated, the question to be addressed is whether the distribution of the purchaser's notes to the shareholders of T upon its liquidation will trigger immediate recognition of the gain at the shareholder level. At one time, when T sold its assets on the installment method and distributed the

installment purchaser's obligations to its shareholders in complete liquidation, the shareholders were required to take into income (as amount realized) the full fair market value of the installment obligation (usually the face amount) even though the actual cash distributed may have been nominal. Well advised shareholders did manage through the use of trusts to defer recognition of income. See, e.g., Rushing v. Commissioner, 52 T.C. 888 (1968), aff'd, 441 F.2d 593, 71-1 USTC ¶ 9339, 27 AFTR2d 71-1139 (5th Cir. 1971).

(3) Under the Installment Sales Revision Act of 1980, Congress addressed the problem and provided that installment obligations acquired in the process of liquidating a corporation under § 337 as then in effect could generally be passed through to the shareholders without immediately triggering gain at the shareholder level. Shareholders could report their gain on the installment method by including payments in income as they were received. § 453(h); see also § 453B(d)(2).

(4) Installment obligations attributable to a sale of inventory qualified for continued deferral in the hands of shareholders (upon a distribution in liquidation pursuant to a plan of liquidation under then § 337) only if the sale of inventory was a qualified bulk sale. § 453(h)(1)(B).

(5) The shareholder's deferral privilege was not available if the obligor and the shareholder were related parties within the meaning of § 1239(b) to the extent that the installment obligation was attributable to the disposition by the target company of depreciable property. § 453(h)(1)(C). "Related parties" for purposes of § 1239(b) include a taxpayer and an 80-percent owned entity and two 80-percent owned entities.

(6) These rules were continued under the Tax Reform Act of 1986, with technical changes to reflect the new role of § 337. Deferral of the corporate-level gain is not available, however, if the installment obligation is distributed to the shareholders.

b. If T is not liquidated.

(1) If T does not liquidate, there will generally be no tax consequences to T's shareholders.

(2) Generally, T will not distribute to shareholders an installment obligation without first adopting a plan of complete liquidation, since such distribution will trigger a gain at the corporate level. If an installment obligation is distributed and the corporation has not yet adopted a plan of liquidation, not only will T recognize gain, but the shareholders will also be required to recognize gain on their exchange, based upon the fair market value of the obligation. Cf. § 453B(d). (If T is a subsidiary, a deferral of recognition of income on account of the sale of assets by T in exchange for installment obligations followed by its liquidation into its parent is available if the parent's basis for the assets received is determined under § 334(b) (i.e., a carryover basis from the subsidiary into the parent without regard to the parent's basis in its stock of the target (subsidiary) company).)

B. Determination of aggregate basis to P.

In an acquisition, the consideration to T will generally consist of cash, the assumption of liabilities, and debt representing the deferred purchase price. The aggregate amount of these items will represent the basis to be allocated among the assets acquired.

1. Cash.

To the extent that cash consideration is paid to T, the amount of basis to be allocated will be the exact amount of the cash paid.

2. Assumption of liabilities.

P's cost includes both liabilities assumed and liabilities to which the acquired assets are subject, regardless of whether the buyer has personal liability. Crane v. Commissioner, 331 U.S. 1, 47-1 USTC ¶ 9217, 35 AFTR 776 (1947).

a. The assumption of liabilities not appearing on books (e.g., contractual obligations, leases) may be treated as additional purchase price.

An unfavorable contractual obligation, such as a lease where the rent is higher than the fair rental value, may give rise to additional basis available for allocation. The amount of the liability should be the discounted excess of the rent called for under the lease over the rent that would be payable under a similar newly negotiated lease for comparable property. Commissioner v. Oxford Paper Co., 194 F.2d 190, 52-1 USTC ¶ 9128, 41 AFTR 683 (2d Cir. 1952). But see Rev. Rul. 55-675, 1955-2 C.B. 567 (indefinite liability not susceptible to valuation). If, on the other hand, the contractual obligation or lease is beneficial, it should be an asset to which a portion of the aggregate basis is allocable.

b. Contingent payments and assumptions of contingent liabilities.

(1) If contingent payments are used, the general rule appears to be that the basis of assets acquired for a contingent purchase price, whether the purchase price is contingent or the assumed liability is contingent, does not include any part of the contingent price until the contingency is satisfied or fixed, absolute, and capable of determination with reasonable accuracy. Albany Car Wheel Co. v. Commissioner, 40 T.C. 831 (1963), aff'd per curiam, 333 F.2d 653, 64-2 USTC ¶ 9578, 14 AFTR2d 5024 (2d Cir. 1964); Rev. Rul. 55-675, supra. See also Redford v. Commissioner, 28 T.C. 773 (1957); Hoblizell v. Commissioner, T.C. Memo. 1960-215, 19 CCH T.C.M. 1197, 29 P-H T.C.M. 60-1330 (1960); Associated Patentees, Inc. v. Commissioner, 4 T.C. 979 (1945).

(2) The degree of the contingency is important. If the contingency is reasonably certain to occur, the amount of the contingency should probably be currently capitalized and allocated to basis. See Mayerson v. Commissioner, 47 T.C. 349 (1966), acq. 1969-1 C.B. 21; Blackstone Theater Co. v. Commissioner, 12 T.C. 801 (1949), acq. 1949-2 C.B. 1.

3. Deferred purchase price.

P's cost includes the entire amount of deferred purchase price. If the obligations are not traded on an established market, compliance with the rules of §§ 1271-74 will be required. Note also the potential applicability of the imputed interest provisions of § 483 if the debt given by the acquiring corporation does not bear adequate interest.

V. Stock purchase taxable transactions.

A. Generally.

1. A purchase of T stock in a taxable transaction results in capital gains for the T shareholders (subject to the collapsible corporation rules).

2. The T assets keep their old basis unless a § 338 election is made.

B. Section 338.

1. General treatment of stock purchase as asset purchase.

a. P (or S) within 8 1/2 months after the month in which a qualified stock purchase occurs may elect to treat T as a corporation that sold all its assets pursuant to a plan of complete liquidation at the close of the stock's acquisition date at fair market value ("Old T"). T is also treated as a new corporation that purchased the assets on the day following such date for the price paid for its stock ("New T"). §§ 338(a), (g).

b. Under § 338 as initially enacted, gain or loss was not recognized to the target corporation, except for gain or loss attributable to stock held by minority shareholders as described below, to the same extent that gain or loss was not recognized under old § 337 when a corporation sold all its assets in the course of a complete liquidation. This provision was intended to provide nonrecognition of gain or loss to the same extent that gain or loss would not be recognized under § 336 if there were an actual liquidation of the target corporation on the acquisition date to which prior law § 334(b)(2) applied. Under the Tax Reform Act of 1986, gain or loss is recognized in full.

c. A qualified stock purchase occurs if 80 percent or more of the voting power and 80 percent of the value of all classes of stock (except nonvoting, preferred stock) is acquired by purchase during a 12-month period (the acquisition period). The acquisition date is the date within such acquisition period on which the 80-percent purchase requirement (the qualified stock purchase) is first satisfied. Generally, the 80-percent purchase requirement may be satisfied through a combination of stock purchases and redemptions.

d. In a leveraged buyout in which acquisition debt is transferred to T, an amount of T stock equal in value to the debt will be treated as if it had been redeemed. Only the other stock will be treated as if it had been purchased. If T management contributes more than 20% of the remaining stock to the acquisition corporation in a § 351 transfer, the 80% requirement will not be met.

e. If T is a subsidiary of another corporation, all parties can elect under § 338(h)(10) to have the transaction treated as if T had sold its assets to P while a member of the selling consolidated group and then liquidated into the selling parent tax-free under § 332. This avoids the double tax applicable to ordinary § 338 transactions. Comparable treatment is available if T is an S corporation.

2. Treatment of target corporation as a new corporation.

a. The assets of New T are treated as purchased for an amount equal to the grossed-up basis of P in T's stock on the acquisition date. The amount is adjusted under regulations for liabilities of the target corporation and other relevant items. Tax liabilities of the target corporation attributable to the deemed sale of its assets may result in an adjustment under the regulations. See Reg. § 1.338(b)-1(h).

b. Under the gross-up formula, if P owns less than 100 percent by value of T's stock on the acquisition date, the deemed purchase price is grossed up to equal 100-percent ownership by P. The Tax Reform Act of 1984 draws a distinction between "recently purchased stock" and "nonrecently purchased stock" for purposes of applying the gross-up formula. §§ 338(b)(1), (4) and (6). The effect of the distinction is to eliminate a step-up in

the basis of the assets for the appreciation in stock of T acquired by P before the 12-month acquisition period ending on the acquisition date. If P elects to recognize gain on that appreciation, however, a step-up can be achieved. § 338(b)(3)(A).

c. The deemed sale (and purchase) of all T's assets is deemed to occur at the close of the acquisition date in a single transaction. § 338(a). Under these rules, the provisions of subtitle F of the Code, relating to assessment, collection, refunds, statutes of limitations, and other procedural matters, apply without regard to the status of T as a new corporation. T thus remains liable for any tax liabilities incurred by it for any period before the election and must file an income tax return for its taxable year ending as of the close of the acquisition date.

3. Definition of purchase.

a. The term "purchase" is defined as it was under prior law to exclude acquisitions of stock with a carryover basis or from a decedent, acquisitions in an exchange to which §§ 351, 354, 355 or 356 apply, and acquisitions from a person whose ownership is attributed to the acquiring person under § 318(a). § 338(h)(3). Attribution under § 318(a)(4), relating to options, is disregarded for this purpose.

b. The purchaser must be a corporation. A transitory corporation that merges into T will be ignored. Rev. Rul. 90-95, 1990-2 C.B. 67.

4. Consistency requirement.

a. The statute requires consistency where the purchasing corporation makes qualified stock purchases of two or more corporations that are members of the same affiliated group. For this purpose, purchases by a member of the purchasing corporation's affiliated group, except as regulations provide otherwise, are treated as purchases by the purchasing corporation. § 338(f). The consistency requirement applies as well to a combination of a direct asset acquisition and qualified stock purchase. § 338(e). Under old temporary regulations, P could avoid an inadvertent § 338 election resulting from an asset purchase under § 338(e) by making a protective carryover basis

election. Prior Temp. Reg. § 1.338-4T(f)(6). The consistency rules do not apply to tax-free reorganizations. See generally Faber, "The Search for Consistency in Corporate Acquisitions," The Journal of Corporate Taxation, Autumn 1986.

b. The consistency requirement applies with respect to purchases over a defined "consistency period" determined by reference to the acquisition date applicable to the target corporation. The "consistency period" is the one-year period preceding the target corporation acquisition period plus the portion of the acquisition period up to and including the acquisition date, and the one-year period following the acquisition date. § 338(h)(4). Thus, if all of T's stock is purchased on the same day by P, the one-year period immediately preceding and the one-year period immediately following such day are included in the consistency period. If, within such period, there is a direct purchase of assets from T or a T affiliate by P, the statutory rules require that the acquisition of T be treated as an asset purchase as if a § 338 election had been made.

c. The consistency period may be expanded in appropriate cases by the I.R.S. where there is a plan to make several qualified stock purchases or any such purchase and an asset acquisition with respect to a target corporation and its affiliates. § 338(h)(4)(B).

d. The consistency requirement is applied to an affiliated group with reference to a target corporation and any "target affiliate." A corporation is defined as a "target affiliate" of the target corporation if each was, at any time during that portion of the consistency period ending on the acquisition date of the target corporation, a member of an affiliated group that had the same common parent. An affiliated group has the same meaning given to such term by § 1504(a) (without regard to the exceptions in § 1504(b)). This definition also applies in determining whether a purchase is made by a member of the same affiliated group as the purchasing corporation. §§ 338(e), (f) and (h)(6)(A). Corporations with common noncorporate shareholders are not treated as affiliated under these provisions.

e. In applying these rules, acquisitions of assets pursuant to sales by the target corporation or a target affiliate in the ordinary course of its trade or business and acquisitions in which the basis of assets is carried over will not cause the consistency

requirement to apply. § 338(e)(2). A sale by a target corporation will be considered as a sale in the ordinary course of business for this purpose even though it is not customary in the course of the selling corporation's business if it is a transaction that is a normal incident to the conduct of a trade or business, such as a sale of used machinery that was used in the seller's trade or business.

f. The consistency rules may be avoided by dividing the acquisition into several acquisitions: (1) one of which is a taxable purchase and one of which is a tax-free reorganization; (2) one of which is by P and one of which is by non-corporate shareholders of P; or (3) one of which is by P and one of which is by a corporation that P controls but of which P owns less than 80% of the stock.

g. Final regulations were adopted on January 12, 1994 that significantly limit the application of the consistency rules.

(1) The general approach of the regulations is to apply the consistency rules only when necessary to prevent abuses.

(2) If T is a subsidiary in a consolidated return group and P buys an asset from T (or a lower-tier T subsidiary) during the T consistency period so that gain from the sale of the asset is reflected in the basis of T's stock under the investment adjustment rules of the consolidated return regulations (so as to reduce gain on the sale of the T stock) and a section 338 election is not made with respect to T, P must take a carryover basis in the asset.

(a) The rule is mandatory. The District Director does not have discretion to apply carryover or cost basis treatment.

(b) Protective carryover basis elections and other elections under the old regulations are not required.

(c) Exceptions are made for sales in the ordinary course of business.

(3) Carryover basis treatment also applies if T sells an asset to P at a gain and distributes a presale dividend to its nonconsolidated parent during the consistency period that qualifies for the 100% dividends received deduction.

(4) the stock consistency rules are substantially repealed.

5. Section 338 after the Tax Reform Act of 1986.

Because T is now taxed on its full gain and not just on recapture items, § 338 has been used less frequently than it was in the past. It may be used when T has net operating loss carryovers or when T is a subsidiary of another corporation and the parties elect under § 338(h)(10) to have the sale of T's stock be tax-free to T's parent. In fact, § 338 may function primarily as a trap. In a taxable asset purchase, P may be required by the I.R.S. under the consistency rules to take a carryover basis for T's assets if the assets include all of the stock of a T subsidiary of nominal value. See Rev. Proc. 89-40, 1989-2 C.B. 453, for procedures for requesting the I.R.S. to waive carryover basis treatment where acquisition is primarily an asset acquisition.

6. Section 338(h)(10). Buying a subsidiary from an affiliated group filing consolidated returns.

a. P can step up the basis of T's assets to their fair market values if it buys 80% or more of T's stock and P and the selling affiliated group so elect. I.R.C. § 338(h)(10).

(1) Consequences of the Section 338(h)(10) election.

(a) T is treated as if it ("Old T") sold all of its assets in a taxable sale to itself ("New T").

(i) The price of the deemed sale is determined under a formula that is based on P's purchase price for the stock. Reg. § 1.338(h)(10)-1(f).

(ii) The sale is deemed to have been made by Old T as a member of the selling group. Thus, the selling group pays the tax on any realized gain.

(b) Old T is treated as having been liquidated immediately after the sale. Reg. § 1.338(h)(10)-1(e)(2).

(i) The liquidation will qualify under I.R.C. § 332 if the requirements of that provision are met (e.g., if T is solvent).

(ii) The I.R.S. apparently believes that the insolvency of T does not prevent § 338(h)(10) from applying, although it does mean that the liquidation is taxed under I.R.C. § 331 (with no transfer of tax attributes under § 381) and not under § 332. Highlights & Documents, October 13, 1994, p. 457.

(c) The sale of T's stock by the selling group is ignored.

(i) Gain or loss on the sale is not reflected in the taxable income or earnings and profits of the selling group. Reg. § 1.338(h)(10)-1(e)(2).

(ii) An excess loss account with respect to T will not be triggered. The transaction is treated conceptually as an asset sale and liquidation and an ELA would not be triggered if those transactions in fact happened. Rev. Rul. 89-98, 1989-2 C.B. 219.

(d) Prior deferred intercompany transactions.

(i) If T had previously purchased property from another member of the group in a deferred intercompany transaction, the deemed sale under § 338 will trigger a tax on the deferred gain. Reg. § 1.1502-13(f)(1); Ltr. Rul. 9434009.

(ii) If T had previously sold property to another member of the group in a deferred intercompany transaction, the deemed sale of assets and liquidation of T under § 332 will not trigger a tax on the deferred gain in accordance with the normal consolidated return rules.

(e) It is not clear whether New T remains liable for the consolidated return tax liabilities of the selling group for periods during which it was a member of the group. This is the I.R.S. position. Reg. § 1.338-2(d)(4). This is inconsistent with the tax result if T had sold its assets and liquidated under § 332. See also Ltr. Rul. 8714019 (no opinion regarding transferee liability).

(f) If T makes an actual distribution of assets to its parent in the selling group as part of the transaction (e.g., assets that P does not want), the distribution should be treated as part of the deemed § 332 liquidation with the normal tax consequences that would flow from this characterization. Ltr. Ruls. 9434009, 9044063

(2) Advantages of making a § 338(h)(10) election.

(a) The basis of T's assets is stepped up at the cost of only a single tax. (The ultimate shareholder-level tax is imposed only when the common parent of the selling group is liquidated or its stock is sold.)

(b) If T's gain on its assets is less than the selling group's gain on the T stock, the taxable gain on the transaction is lower.

(c) The tax attributes, including net operating loss and other carryovers, remain with the selling group. (In a straight § 338 election, they disappear.)

(d) The net operating losses of the selling group can be used to offset Old T's gain on the deemed sale.

(3) Disadvantages of making a § 338(h)(10) election.

(a) If T's gain on its assets is more than the selling group's gain on the T stock, the taxable gain on the transaction is higher.

(b) If T has liabilities, they are part of the deemed sale price in a § 338(h)(10) transaction and increase the selling group's gain (they also increase New T's basis for its assets). In a straight sale of T's stock with no § 338 election, they are ignored in determining the seller's gain.

(c) Installment sale treatment is apparently not available because T is deemed to have sold its assets to New T, which is not the issuer of the installment note (P is).

(d) The complexities of the § 338 consistency rules apply.

(e) The election may not be recognized for state purposes and may be treated as a regular § 338 election. Even if it is recognized, T (in the hands of P) may be taxed on the § 338 (h)(10) gain if T and the selling parent do not file combined state returns.

C. Disallowance of losses on sale of subsidiaries.

1. The loss disallowance rules were developed to prevent corporations from generating basis in subsidiary stock in excess of its value by using the investment adjustment rules of the consolidated return regulations and deducting the resulting loss when the stock is sold. The I.R.S. was concerned that this could undermine the repeal of the General Utilities principle. See Regs. §§ 1.1502-32 and 1.1502-33(c), Notice 87-14, 1987-1 C.B. 445.

2. General rules. Regulations § 1.1502-20.

a. Loss on the sale of a consolidated subsidiary is allowed only to the extent that it exceeds the sum of:

(1) The subsidiary's earnings and profits (less related expenses) from "extraordinary dispositions" after November 18, 1990 (generally defined as sales of capital and Section 1231 assets, bulk sales of inventory of a business, and sales of the assets of a business that are subject to Section 1060).

(2) Positive adjustments to the basis of the subsidiary's stock under the investment adjustment rules of Regulations §§ 1.1502-32(b)(1)(i) and (c)(1). Negative adjustments can be offset against positive adjustments in the same year but not in other years (with an exception permitting inter-year netting for years before September 13, 1991).

(3) Duplicated losses (generally built-in losses that the subsidiary can be expected to realize in the future.

b. Allowed losses will generally be actual economic losses not resulting from basis adjustments under the consolidated return regulations. The regulations are considerably more generous in this respect than Temporary Regulations § 1.1502-20T, that were adopted in March 1990 and withdrawn in November 1990.

c. Corporations may not "stuff" subsidiaries with asset transfers in order to avoid the loss disallowance rules.

d. If a subsidiary leaves the consolidated group, the basis in the subsidiary's stock that is retained by members of the group is reduced to its fair market value. This prevents corporations from avoiding the loss disallowance rules by deconsolidating a subsidiary.

e. If a loss on the disposition of stock of a subsidiary is disallowed, the common parent of the group may elect to transfer the subsidiary's net operating loss and capital loss carryovers to the common parent (up to the amount of the disallowed loss).

VI. Special problems in taxable transactions.

A. Allocation of purchase price.

1. Significance of allocation of purchase price.

a. The allocation of purchase price among different assets can have different tax consequences and, hence, can affect the economics of an acquisition.

b. The significance of allocations was reduced beginning in 1988 when capital gains and ordinary income became taxed at the same rates. References to depreciation recapture in the following discussion will be important again because of the restoration of the rate differential in OBRA 1990.

c. Allocations of price to the assets listed below will have the indicated tax consequences.

(1) Tangible personal property.

(a) Buyer: no current deduction, but can depreciate cost over asset's recovery period.

(b) Seller: gain will probably be ordinary income because of depreciation recapture. § 1245.

(2) Buildings.

(a) Buyer: no current deduction, but can depreciate cost over asset's recovery period (which is longer than the recovery period of tangible personal property).

(b) Seller: gain may be capital gain or, to the extent required by depreciation recapture, ordinary income. § 1250.

(3) Land.

(a) Buyer: no current deduction and not depreciable. Cost recovered when property is sold.

(b) Seller: gain is capital gain.

(4) Inventory.

(a) Buyer: no current deduction, but reduces ordinary income when assets are sold, which will probably occur soon.

(b) Seller: gain is ordinary income.

(5) Good will and other intangible property.

(a) Buyer: no current deduction. Under the 1993 tax legislation, good will and most other purchased intangibles can be amortized over 15 years.

(b) Seller: gain is capital gain.

(6) Covenant not to compete.

(a) Buyer: amortizable over 15 years.

(b) Seller: ordinary income when received.

(7) Consulting agreement.

(a) Buyer: deductible when paid or accrued.

(b) Seller: ordinary income when received.

2. Allocation of purchase price in stock acquisitions under § 338.

a. The basis regulations: adjusted grossed-up basis.

(1) The regulations provide rules by which New T determines the "adjusted grossed-up basis" of its assets, and allocates it among the assets. The regulations also provide how later adjustments to the purchase price of

Old T or changes in its assumed liabilities affect the basis of New T's assets.

(2) The regulations define New T's "adjusted grossed-up basis" ("AGUB") in its assets as the sum of: (i) P's "grossed-up basis" in "recently purchased stock" of T; (ii) P's basis in nonrecently purchased stock of T; (iii) the liabilities of T; and (iv) "other relevant items." Reg. § 1.338(b)-1(c)(1).

(3) T and each T subsidiary in the chain computes its grossed-up basis in stock held by it. For example, if T owns 80% of the stock of T1, its grossed-up basis of T1's stock would be equal to the amount of its adjusted grossed-up basis in its assets allocated to the T1 stock multiplied by a fraction, the numerator of which is 100% and the denominator of which is 80%.

b. Effect of liabilities.

(1) AGUB includes liabilities of Old T that New T is considered to assume as part of the purchase of Old T's assets.

(2) Liabilities assumed include liabilities to which the acquired assets are subject, including specific liens and nonrecourse debt secured by acquired assets.

(3) Liabilities do not include income tax liabilities of Old T resulting from the deemed sale of its assets when an election has been made under § 338(h)(10), since the income tax liability from the deemed sale is borne by the selling corporation and, therefore, is not assumed by New T.

(4) In order to be included as a liability, an obligation of Old T must be bona fide and properly includible in New T's basis under general rules of tax law.

(5) Nonrecourse debt of Old T in excess of the value of the asset to which it is attached would probably be disregarded. See Estate of Franklin v. Commissioner,

544 F.2d 1045, 76-2 USTC ¶ 9773, 38 AFTR2d 76-6164 (9th Cir. 1976).

(6) Contingent liabilities are not initially included in AGUB, although they may be included when they become unconditional.

c. Other relevant items.

(1) AGUB may be increased (or decreased) for "other relevant items." Such items may only arise from "adjustment events" occurring after the close of New T's first taxable year and I.R.S. adjustments. Reg. § 1.338(b)-1(g).

(2) "Adjustment events" include increases or decreases in the purchase price of T's stock, reductions in includible liabilities, and the maturing of T's contingent liabilities. Reg. § 1.338(b)-1(b).

(3) AGUB is initially determined at the beginning of the day after the acquisition date. However, adjustment events occurring during New T's first taxable year are treated as occurring as of the beginning of the day after the acquisition date. Reg. § 1.338(b)-1(c)(2). Only adjustment events occurring after the first taxable year are treated as "other relevant items."

d. Allocation of AGUB among target assets.

(1) The regulations mandate the use of a "residual" method for allocating AGUB. The method requires that T's assets be valued and classified into one of four classes. AGUB is then allocated, in turn, to each class, to the extent of the fair market value of the assets in the class. Any residual AGUB remaining after allocation to the first three classes must be allocated to the fourth class: "intangible assets in the nature of goodwill and going concern value." Reg. § 1.338(b)-2(b).

(2) Class I assets consist of cash, demand deposits and similar accounts in banks, savings and loan or similar depository institutions, as well as other items designated by the I.R.S.

(3) Class II assets are certificates of deposit, U.S. government securities, marketable stock and securities, foreign currency and other I.R.S.-designated items.

(4) Class III assets are all other tangible and intangible assets of T (other than Class I, II or IV), whether or not depreciable, depletable or amortizable.

(5) Class IV assets, as described above, consist of goodwill and going concern value.

(6) Within each class of assets (other than Class IV), the amount allocated to any one asset cannot exceed its fair market value.

(7) Fair market value is determined without regard to mortgages, liens, pledges or other liabilities. This is contrary to the "specific lien" rule of the regulations under old § 334(b)(2). See Reg. § 1.334-1(c)(4)(viii). It is unclear whether transaction costs can be included in fair market value. They should be. They can apparently be included in total basis. Reg. § 1.338(b)-1(g)(1).

(8) The adjusted grossed-up basis of an asset is also subject to any specific limitations imposed by the Internal Revenue Code. See, e.g., § 1056(a) (limiting basis allocated to player contracts transferred in connection with the sale of a franchise).

(9) Where T owns stock in subsidiaries, the stock is a Class III asset. The amount allocated to the stock is then treated as the price of the subsidiary's "recently purchased stock" for purposes of determining the AGUB of the subsidiary in its assets. This process is repeated down the chain.

(10) The determination of whether a T asset is a Class I, Class II or Class III asset will be relevant only in the case of a bargain purchase of the T stock.

(a) The "fair market value" limit on allocating purchase price makes classification irrelevant where a premium is paid.

(b) Where the purchase is a bargain purchase, the classifications could lead to anomalous results.

Example: Purchase price to be allocated to Class III assets is $100. The only Class III assets are accounts receivable of $100 and land with a value of $100. Under proportionate allocation, the accounts receivable will have a basis of only $50, generating an immediate taxable gain on collection.

e. Later adjustments to adjusted grossed-up basis.

(1) Definitions.

(a) A "contingent liability" is a T liability at the beginning of the day after the acquisition date that is not fixed and determinable by the close of New T's first taxable year. Temp. Reg. § 1.338(b)-3T(b)(1).

(b) A "contingent amount" is the amount of consideration to be paid for T stock that is not fixed and determinable at the close of New T's first taxable year plus T's contingent liabilities. Temp. Reg. § 1.338(b)-3T(b)(2).

(c) A "reduction amount" means a reduction in the consideration paid for T stock or in a liability included in AGUB after the close of New T's first taxable year. Temp. Reg. § 1.338(b)-3T(b)(3).

(d) An "acquisition date asset" means any asset (other than a Class I asset) held by New T at the beginning of the day after the acquisition date. Temp. Reg. § 1.338-3T(b)(4).

(2) General rule.

(a) A contingent amount that is taken into account in determining AGUB and the bases of T assets is taken into account at the time the amount becomes fixed and determinable. Temp. Reg. § 1.338(b)-3T(c)(1).

(b) A reduction amount is taken into account when the reduction in the consideration paid or the reduction of the liability occurs. Temp. Reg. § 1.338(b)-3T(c)(2).

(c) The amount of the increase or decrease in AGUB is the difference between AGUB immediately before the increase or decrease and AGUB recomputed by taking into account the contingent amount or reduction amount.

(3) Allocation of increases and decreases in AGUB.

(a) An increase in AGUB is allocated among T's acquisition date assets, subject to the fair market value limitation. Temp. Reg. § 1.338(b)-3T(d)(1).

(b) If an acquisition date asset has been disposed of, depreciated, amortized or depleted by New T before a contingent amount is taken into account, the regulations provide that the contingent amount otherwise allocable to the asset is treated under general principles of tax law. Temp. Reg. § 1.338(b)-3T(d)(2). For example, if an acquisition date capital asset is disposed of before a contingent amount is realized, the portion of the contingent amount allocable to the asset would be deducted as a capital loss. See Arrowsmith v. Commissioner, 344 U.S. 6, 52-2 USTC ¶ 9527, 42 AFTR 649 (1952).

(c) Decreases in AGUB arising from a reduction amount are allocated first against Class IV assets, then against Class III assets in proportion to their

fair market value, and then against Class II assets in the same manner. Temp. Reg. § 1.338(b)-3T(e).

(d) Where an acquisition date asset had been disposed of, depreciated, etc. before the reduction event occurs, the allocable reduction amount is treated in the same manner as described above for the allocation of a contingent amount. In the case of § 38 property, reduction may result in ITC recapture. Temp. Reg. § 1.338(b)-3T(e)(3).

(4) Special rule for allocation to particular assets.

(a) Special rules apply for allocating contingent amounts or reduction amounts to the extent that the contingency relates to income produced by a particular intangible asset (a "contingent income asset") such as a patent, secret process or copyright, and the increase or decrease relates to no other assets.

(b) Subject to the fair market value limitation, the increase or decrease is allocated first to the contingent income asset to the extent of its fair market value and then to the other assets. Temp. Reg. § 1.338(b)-3T(g)(ii). Solely for purposes of the fair market value limitation, the fair market value of the contingent income asset may be redetermined as of the time the contingent amount (or reduction amount) is taken into account.

3. Allocation of purchase price in asset acquisitions.

a. The 1986 Act added a new § 1060 to the Code, establishing special allocation rules for certain acquisitions. The Section is applicable to transactions completed after May 6, 1986, unless pursuant to a binding contract in effect on that date and at all times thereafter.

b. On July 18, 1988, the I.R.S. published proposed and temporary regulations under § 1060. The temporary regulations are generally retroactive to the effective date of the statute.

However, the reporting requirements included in the regulations (and discussed, infra) are applicable to asset acquisitions (and to certain adjustments in consideration) occurring in a taxable year for which the due date (including extension of time) of the income tax return or return of income is after September 12, 1988. 53 Fed. Reg. 27035 (July 18, 1988). The I.R.S. also published new I.R.S. Form 8594, "Asset Acquisition Statement Under Section 1060."

c. Section 1060 was intended to serve two principal purposes: (a) to mandate use of the "residual" method for allocating purchase price in all asset acquisitions; and (b) to permit the I.R.S. to identify appropriate returns for audit that are likely to involve an attempt to amortize "goodwill" or "going concern value", which were not amortizable under the law as then in effect.

d. Where § 1060 applies, the statute requires that consideration be allocated among the assets "in the same manner as amounts are allocated to assets under section 338(b)(5)." Although the legislative history of § 1060 suggests that Congress intended by this reference to mandate the use of the residual method, as described above, the regulations under § 338(b)(5) are considerably broader in scope.

e. Section 1060 applies to any "applicable asset acquisition," which is defined to include any direct or indirect transfer of assets which constitute a trade or business with respect to which the transferee's basis is determined wholly by reference to the consideration paid for the assets.

f. Although this outline focuses on the application of § 1060 to corporate transactions, the application of the statute is not limited to corporate transactions. Sales by sole proprietorships are covered. Moreover, since both "direct and indirect" transfers are covered, partnership transactions, including sales of partnership interests, are subject to the Section. The Section could apply to the simultaneous sale by T of its assets and by T shareholders of assets that are leased to T and used in its business.

g. Since § 1060 generally applies only where the transferee's basis is determined wholly by reference to the consideration paid for

the assets, corporate transactions involving the nonrecognition provisions of Subchapter C are excluded. A special provision causes § 1031 transactions to be subject to the statute.

h. Definition of "trade or business."

(1) In keeping with the broad definition of "trade or business" in the legislative history of § 1060, the regulations provide that a group of assets will constitute a "trade or business" if their use would constitute an "active trade or business" for purposes of § 355 or, even if the assets would not constitute a § 355 active business, if the assets are of a character "such that goodwill or going concern value could under any circumstances attach to such group." Temp. Reg. § 1.1060-1T(b)(2).

(2) Factors to be considered in determining whether a group of assets are of a character such that goodwill will attach include:

(a) The existence of an excess of total consideration over the aggregate book value of the assets purchased; and

(b) Related transactions, including lease agreements, licenses, covenants not to compete, or employment contracts between the purchaser and the seller.

(3) It is unclear from the regulations whether an asset purchase may be considered to involve more than one "trade or business," and, if so, whether § 1060 may (must) be applied separately to each.

(4) It is unclear how the rules apply to different sellers of the same business (e.g., when T sells its assets and T's shareholders sell real estate that they lease to T for use in T's business).

(5) It is also unclear whether purchased assets that are unrelated to the trade or business must be excluded from the calculation.

i. Allocation of purchase price.

(1) The § 1060 regulations follow the § 338 basis allocation regulations described above in allocating purchase price among asset classes, limiting the amount allocated to any asset (other than Class IV assets) to its fair market value, and prorating purchase price within an asset class in the case of a bargain purchase. Unlike the § 338 regulations, the § 1060 regulations include covenants not to compete in Class III. If read literally, this would subject an allocation to a covenant to a scale-down in case of a bargain purchase. The scope of this inclusion is unclear. It could be limited to the rights of T under covenants given by or to it with respect to third parties, or it could also apply to amounts paid by P for covenants given by T. Cf., Bay Cities Spay-Neuter Clinic, Inc., CCH California Tax Reporter ¶ 401-849 (SBE September 12, 1990) (payments for covenant are for services, not property, and cannot be reported by the recipient on the installment sale method).

(2) Where a liability is secured by a lien on a specific asset, the regulations treat the liability as part of the purchase price to be allocated generally among the assets. However, on the sale of an asset secured by a lien, the entire amount of the liability will be considered in determining the purchaser's basis in the asset for purposes of determining gain or loss under Reg. § 1.1001-2(a). Temp. Reg. § 1.1060-1T(e)(3). The temporary regulations override Reg. § 1.1001-2(a)(3), which generally limits the amount of a liability taken into account on a sale of an asset to the amount taken into consideration in determining the seller's basis in the property.

(3) The § 1060 regulations also follow the § 338 regulations with respect to the allocation of purchase price to contingent income assets such as a patent or trademark, and as to the allocation of purchase price for events occurring after the purchase transaction (e.g., earnouts or indemnification payments). The Notice of Proposed Rulemaking includes an amendment to the § 338 basis

regulations with respect to allocating an increase or decrease in AGUB that directly relates to the income produced by a "contingent income asset" to clarify that the redetermination is of the asset's fair market value on the purchase date. Temp. Reg. § 1.338(b)-3T(g). The change is elective for qualified stock purchases for which the acquisition date is before September 16, 1988.

(4) The Notice of Proposed Rulemaking also includes an amendment to the regulations under § 167 to provide that the basis for depreciation for assets acquired in a transaction to which § 1060 applies cannot exceed the amount of consideration allocated to the assets under § 1060. Temp. Reg. § 1.167(a)-5T.

j. Reporting requirements.

(1) Both the seller and the purchaser in an applicable asset acquisition must report information concerning the amount of consideration in the transaction and its allocation among the assets transferred. The I.R.S. has published Form 8594 for this purpose, which is to be used to make the initial report and to report any later adjustments to the consideration.

(2) Although the reporting requirements generally apply only to asset acquisitions for which the due date of a tax return (after extensions) is after September 12, 1988, they also apply to asset acquisitions after May 6, 1986, where there is an adjustment in the consideration which is reportable in a tax return to be filed on or after the September 12. Temp. Reg. § 1.1060-1T(h)(2)(ii).

(3) The statute does not require that the buyer and seller agree on the purchase price allocation or that the parties disclose to each other how they allocate the purchase price but OBRA 1990 requires the parties to follow any contractual allocation on their tax returns unless a party can show that the allocation would have been unenforceable under local law because of fraud, duress, or mistake. I.R.C. § 1060(a). See Commissioner v. Danielson, 378 F.2d 771, 67-1 USTC ¶ 9423, 19

AFTR2d 1356 (3d Cir. 1967), cert. denied, 389 U.S. 858 (1967).

(4) A separate Form 8594 is to be filed by buyer and seller with their tax returns for the year in which the acquisition occurs. The Form requires reporting of the fair market value of the purchased assets by class as well as the amount of the sales price allocated to each class.

(5) Although the Form does not generally require a breakdown of the valuation or allocation within each class, it does require a separate listing of each amortizable intangible asset included in Class III, including a description of the asset, its fair market value, useful life, and allocated sales price. This part of the Form may be particularly difficult for the seller to complete, since it may not know what intangible assets will be identified by the buyer and, in all likelihood, it will not have attempted to analyze the value of the intangible or its useful life.

(6) Form 8594 also asks several questions that will be useful to the I.R.S. in selecting returns for audit and in auditing returns. The Form asks whether the asset purchase agreement provides for allocation of the purchase price and, if so, whether the numbers contained on the Form are consistent with the contract. In addition, the buyer, but not the seller, is asked whether any ancillary assets were purchased from the sellers, such as licenses or covenants not to compete. If the question is answered in the affirmative, the buyer is required to list the type of agreement and the maximum amount payable under the agreement.

(7) Under § 6721, a failure to file the information return will subject a taxpayer to a penalty of $50 for each failure, subject to an annual limit of $100,000. In the case of intentional disregard of the filing requirement, however, the penalty imposed is the greater of $100 or 10% of the "aggregate amount of items required to be reported," without a $100,000 cap. See § 6721(b).

4. Amortization of purchased intangibles. § 197.

   a. Before the Omnibus Budget Reconciliation Act of 1993, purchased intangibles could be amortized only if the taxpayer could establish that they had a determinable useful life. The cost of good will and going concern value could not be amortized.

   b. Under the new law, most purchased intangibles can be amortized over a period of 15 years, without regard to their actual useful life.

      (1) Certain assets that were not amortizable under prior law are amortizable under § 197, such as good will and going concern value.

      (2) Certain assets that were theoretically amortizable under prior law but with respect to which taxpayers often had difficulty establishing a useful life, such as customer lists, are clearly amortizable under the new law but are subject to the 15-year recovery period, which may be longer than their actual useful life.

      (3) Covenants not to compete are subject to 15-year amortization. Covenants rarely last more than 3 or 4 years because of enforcement problems under applicable law. Thus, covenants not to compete have become something of a negative tax shelter because payments are recoverable only over a period that substantially exceeds their economic usefulness.

   c. Intangibles that are not subject to 15-year amortization include, <u>inter alia</u>, the following.

      (1) Publicly-available computer software (which is amortizable over 36 months).

      (2) Interests as a lessor or a lessee of leased tangible property.

      (3) Professional sports franchises.

(4) Contingent amounts that are paid for a trademark, trade name, or franchise and that are currently deductible under § 1253 (i.e., amounts that are contingent on use, paid ratably over the property's term, and are paid in substantially equal amounts or under a fixed formula).

5. Supporting allocations among assets.

a. Advance planning.

(1) Independent appraisals should be obtained before the transaction.

(2) The purchase contract in an assets acquisition should contain a detailed allocation.

(3) The purchase contract should require each party to follow the allocation on its income tax returns.

b. Handling controversies with the I.R.S.

(1) Independent appraisals should be obtained if none were obtained when the transaction was being put together.

(2) Asset values can be established from discounted catalog prices, comparable sales, and other sources.

B. Asset sale: should target be liquidated?

1. If T adopts a plan of liquidation, sells its assets, and liquidates.

a. T is taxed on its gain.

b. Shareholders pay capital gains tax on liquidation.

2. If T does not liquidate but stays in existence as a holding company, investing the sales proceeds.

a. T's gain on the sale of assets is taxed.

b. T's shareholders are not taxed since there is no liquidation. If a shareholder dies holding his or her stock, it gets a stepped-up basis equal to its value at death. § 1014.

c. Operation of the holding company.

(1) Earnings must be currently distributed to avoid personal holding company penalty tax of 39.6%.

(2) Corporation pays tax on its income, but dividends from U.S. corporations are 70% deductible. § 243

(3) Income protected from corporate-level tax by the dividends received deduction and interest from tax-exempt bonds may be subject to the alternative minimum tax.

d. Danger of accumulated earnings penalty tax in year of sale.

C. Installment sales. I.R.C. § 453.

1. Should installment sale be used?

a. Advantages.

(1) Buyer may be able to negotiate a better rate of interest from the seller than it can from a bank.

(2) Buyer may use holdback of price to protect itself against breaches of representations and warranties.

(3) Seller may reduce its tax liability by stretching gain over a period of years.

(4) Seller may reduce its alternative minimum tax liability.

b. Disadvantages.

(1) Buyer normally must encumber its assets to secure payment of the purchase price.

(2) Seller incurs credit risk.

2. The Installment Sales Revision Act of 1980.

a. 30% limit on payments in year of sale repealed. No problem with bootstrap purchases.

b. Requirement that there must be at least two payments repealed.

c. Installment sale can be used in an asset sale and related liquidation.

d. Installment sale treatment is automatic unless the seller elects not to use it.

e. Third-party guarantee, including standby letter of credit, is not equivalent of payment and can be used to secure the buyer's obligation.

f. Sale price can be uncertain.

(1) If maximum selling price is fixed, basis is allocated to portions of the maximum price and is recomputed if the maximum price is not paid. Temp. Reg. § 15A.453-1(c)(2).

(2) If there is no maximum sale price but the payment period is fixed, basis is spread evenly over the period, but basis less than a year's payment is carried over to the next year. Temp. Reg. § 15A.453-1(c)(3).

(3) If neither maximum price nor payment period is fixed, basis is recovered evenly over 15 years. Excess of basis over payment in any year is spread over the balance of the 15-year term. Temp. Reg. § 15A.453-1(c)(4).

3. Installment sale treatment not available if:

a. Obligation is payable on demand.

b. Obligation is by a corporation and is readily tradable.

c. The property sold is marketable stock.

4. Interest must be paid on deferred tax liability if the sale price exceeds $150,000 and if the seller owns installment notes exceeding $5,000,000. § 453A. This has substantially reduced the attractiveness of installment sales.

VII. Acquisitions of and by S corporations.

A. Introduction.

1. The provisions of the Internal Revenue Code that apply to sales and purchases of C corporations generally apply to sales and purchases of S corporations. I.R.C. § 1371(a)(1).

2. S corporations and their shareholders are not subject to the double tax on sales of corporate assets imposed on C corporations by the 1986 Tax Return Act.

3. S corporations present some unique problems involving preservation of the S election and application of the subchapter S provisions.

B. Taxable sales.

1. Sales of stock.

a. Sale of stock of an S corporation.

(1) The basis of the selling shareholders in their stock will have to be calculated in order to compute their gain or loss.

(a) Basis fluctuates and is affected by the corporation's profits and losses. Unlike a C corporation, a shareholder's basis is unlikely to equal his original cost. I.R.C. § 1367.

(b) A selling shareholder's basis for his stock is affected by events during the year of sale. If the shareholder and the corporation have different taxable years, the corporation's year may not have closed when the shareholder's individual income tax returns are due and he may be unable to compute his basis.

(2) Allocation of income during the year of the sale.

(a) Ordinarily, an S corporation's income and losses are allocated among all persons owning

stock during the year on a per-day per-share basis. I.R.C. §§ 1366, 1377(a)(1).

(b) Election to close the corporation's books on the termination of a shareholder's interest.

(i) For taxable years beginning before 1997, if all persons who owned stock during the year elect, the corporation's year can be closed on the day on which any shareholder terminates his interest during the year for purposes of allocating income and losses among the shareholders, in which case income and losses actually earned or sustained before the close are taxed only to those persons owning stock before the close. I.R.C. § 1377(a)(2).

(ii) For taxable years beginning after 1996, under regulations, the closing of the books method affects only the shareholder whose interest is terminated and those persons who acquire his or her shares (or all shareholders if he or she has transferred shares to the corporation) (together referred to as "affected shareholders") and the election is made only by the corporation and the affected shareholders (i.e., it need not be made by the other continuing shareholders).

- Note: The 1996 Act repealed old I.R.C. § 1377(a)(2) and replaced it with the new version, which is operative only when the I.R.S implements it in regulations. Thus, the closing of the books election has been repealed as of January 1, 1997, except to the extent that

regulations are adopted that are effective as of that date.

(c) Regulations § 1.1368-1(g)(2) allow a similar election under the following circumstances.

(i) A shareholder disposes of 20% or more of the corporation's stock during any 30-day period during the corporation's taxable year, even if the shareholder retains some stock.

(ii) A redemption of 20% or more of the corporation's stock from a shareholder during any 30-day period during the corporation's taxable year that is treated as a sale or exchange under I.R.C. §§ 302(a) or 303(a).

(iii) An issuance of an amount of stock equal to or greater than 25% of the previously outstanding stock to one or more new shareholders during any 30-day period during the corporation's taxable year.

(d) Strategy for the buyer if the S corporation's stock is bought during the middle of its taxable year.

(i) Don't volunteer to make an I.R.C. § 1377(a)(2) election.

(ii) After the purchase closes and the buyer owns the S corporation's stock, and if an I.R.C. § 1377(a)(2) election has not been made, try to accelerate income into the year of purchase and defer deductions into the next year, thus increasing the amount of the corporation's income part of which will be taxed to the sellers under the pro rata method. (As the actual owner

of the stock at the end of the year, the buyer will benefit economically from the receipt of the income.)

(A) Time income and expenses to accelerate taxable income.

(B) Elect accounting methods that defer deductions.

(e) Strategy for the seller if the S corporation's stock is bought during the middle of the taxable year.

(i) Get the buyer to elect under I.R.C. § 1377(a)(2) to close the corporation's taxable year on the date of the sale so as to prevent post-sale manipulation by the buyer.

(ii) If the buyer will not make an I.R.C. § 1377(a)(2) election, get representations from the buyer that he will not artificially accelerate income into the year of sale.

(iii) Even if the I.R.C. § 1377(a)(2) election is made, the buyer will still prepare the corporation's income tax return for the entire year in which the sale occurs. The corporation's taxable year does not actually end on the date of sale; it is treated as ending then solely for allocation purposes. Prop. Regs. § 1.1377-1(b)(2)(ii). The sellers should therefore get the buyers to agree to use accounting methods on the return that keep the corporation's taxable income to a minimum.

(iv) During 1987-1990, when long-term capital gains and ordinary income were taxed at the same rates, the

seller often did not care about this because the additional income increased his or her stock basis and reduced the gain on the sale. Beginning in 1991, capital gains are taxed at a lower rate than ordinary income and the increased stock basis will not fully compensate the seller for the additional ordinary income.

(3) Basis of the S corporation's assets.

(a) I.R.C. § 338 is theoretically available to transactions involving S corporations. Ordinarily, the basis of a corporation's assets does not change when its stock is bought by new shareholders.

(b) If a corporation wishes to buy the stock of an S corporation and make an I.R.C. § 338 election, the S election will terminate because the corporation will have a corporate shareholder.

(i) The tax liabilities resulting from the I.R.C. § 338 election will not be taxed to the selling shareholders for the period covered by the S election. The deemed sale will be reported on a single day return as if the corporation were a C corporation. Regs. § 1.338-1(e)(3). The buyer bears the economic burden of the tax.

(ii) The purchasing corporation could liquidate the S corporation, elect under I.R.C. § 338, and then make a new S election. If the buyer were owned by different shareholders than the S corporation, it should not be treated as a "successor corporation" to the S corporation and it should be eligible to make an S election within five years

under I.R.C. § 1362(g). See Rev. Rul. 77-155, 1977-1 C.B. 264.

(c) The use of an I.R.C. § 338(h)(10) election.

(i) Section 338(h)(10) elections are generally available when the stock of a subsidiary of another corporation is purchased and both the buyer and seller elect to have the transaction treated as a sale by the target of its assets followed by a liquidation of the target into its parent. The sale of the target's stock by the parent is ignored. The liquidation is tax-free under § 332 and, hence, the double tax that normally is imposed when a § 338 election is made is avoided.

(ii) On January 12, 1994, the I.R.S. adopted final regulations that allow a § 338(h)(10) election to be made with respect to the sale of an S corporation's stock, even though, because of the prohibition against corporate shareholders, an S corporation obviously cannot be a subsidiary of another corporation. The statutory authority for the regulations is the general authorization under I.R.C. § 338(i). Regs. § 1.338(h)(10)-1(a).

(iii) The S corporation shareholders must join in the election. Regs. § 1.338(h)(10)-1(d)(2).

(iv) The S corporation shareholders can increase their basis in the corporation's stock by the gain on the deemed sale that is passed through to them under § 1366. This reduces their gain on the liquidation, which is

taxed to them under the normal rules of § 331. Regs. § 1.338(h)(10)-1(e)(2)(ii).

(v) The shareholders' gain or loss on the sale of their stock is not recognized. Regs. § 1.338(h)(10)-1(e)(2)(iv).

(vi) Considerations in deciding whether to make a § 338(h)(10) election.

(A) The selling shareholders may be disadvantaged if part of the gain on the deemed asset sale would be ordinary income and not capital gain.

(B) If the S corporation had been a C corporation, the deemed asset sale may result in a corporate tax under I.R.C. § 1374. The § 1374 tax applies to any "transaction treated as a sale or exchange for federal income tax purposes." Regs. § 1.1374-4(a).

(C) The § 1374 tax is a liability of the S corporation and the economic burden of the tax will be borne by the buyer. Regs. § 1.338(h)(10)-1(e)(5).

(D) Converting the taxable event from a stock sale to an asset sale can have state and local income tax consequences, especially if the asset sale would produce business income that is subject to formulary apportionment.

(4) Bootstrap purchase of an S corporation's stock.

(a) One technique that is often used to get rid of unwanted target assets where the target is a C corporation is to have the buyer buy only part of the target's stock and to have the target redeem the rest, distributing in exchange the unwanted assets. Under prior law, if an exception to the general rule of I.R.C. § 311(d) was available, the target recognized no gain on the distribution. These exceptions were repealed by the 1986 Act.

(b) Under I.R.C. § 311(b), an S corporation will recognize gain, but not loss, on the distribution of property in a bootstrap purchase.

(5) A sale of an S corporation's stock will result in investment tax credit recapture if the seller's interest in the corporation is reduced to less than two-thirds of what it was when the property was placed in service.

b. Purchase of stock by an S corporation.

(1) The principal problem for taxable years beginning before 1997 involves preserving the S election in view of the requirement that an S corporation not be a member of an affiliated group of corporations (i.e. generally, bound by 80% stock ownership) within the meaning of I.R.C. § 1504(a). I.R.C. § 1361(b)(2)(A). The prohibition has been repealed, effective for taxable years beginning after 1996.

(2) If an S corporation buys 80% or more of a target's stock and liquidates the target within 30 days pursuant to a pre-arranged plan, the transitory formation of an affiliated group will be ignored and the S election will not terminate. Rev. Rul. 73-496, 1973-2 C.B. 312. The Tax Court has expressed the view that transitory ownership should not be ignored. Haley Brothers Construction Corp. v. Commissioner, 87 T.C. 498 (1986). The I.R.S. has ignored this dictum in later rulings. Ltr. Ruls. 8849015, 8830025, 8822091. The

S corporation and its temporary subsidiary cannot file consolidated returns. See T.A.M. 8837003 (C corporation not allowed to consolidate with subsidiary that it purchased with intent to liquidate).

(3) For taxable years beginning before 1997, an S corporation in its capacity as a shareholder of another corporation is treated as an individual for purposes of subchapter C. I.R.C. § 1371(a)(2).

(a) The I.R.S. has held in technical advice that this provision does not prevent the liquidation of a controlled subsidiary into an S corporation from qualifying under I.R.C. § 332 so that the liquidating corporation does not recognize gain on the distribution of appreciated assets and tax attributes pass under I.R.C. § 381. I.R.C. §§ 336, 337. Ltr. Rul. 9245004. Previously, the I.R.S. had ruled that § 1371(a)(2) prevented an S corporation that purchased another corporation's stock from making a § 338 election and it had been feared that the same reasoning would preclude the use of § 332. Ltr. Rul. 8818049 (revoked in Ltr. Rul. 9323024; in Ltr. Rul. 9325006, the I.R.S. denied the corporation's request that Ltr. Rul. 9245004 not be applied retroactively).

(b) For taxable years beginning after 1996, the committee reports to the 1996 Act make it clear that an S corporation can liquidate a subsidiary tax-free to both the parent and the subsidiary under §§ 332 and 337. Section 1371(a) has been amended to provide that the provisions of subchapter C of the Code shall apply to S corporations except as otherwise provided.

(c) If the S corporation merged downstream into the target, the problem might be avoided. Rev. Rul. 70-223, 1970-1 C.B. 79. The target could make an S election after the merger.

(d) One technique that should work before 1997 is for the S corporation's shareholders to buy target stock representing more than 20% of the voting power. See Ltr. Rul. 9011042. This will break affiliation even if it represents less than 20% of the value of the target's stock. I.R.C. § 1504(a)(2). The value of the target's voting stock can be reduced so as to lower its purchase price by recapitalizing the target to shift most of its value to nonvoting common stock. Such a recapitalization would be tax-free under I.R.C. § 1036. See Ltr. Rul 9523013, approving a § 1036 exchange and reciting the presence of a business purpose.

(4) The I.R.S. has ruled that an S corporation that bought 80% or more of the target's stock could elect to step up the basis of the target's assets under § 338. Ltr. Ruls. 9630005 and 9245004. It was not clear whether the one-day tax return on which the § 338 gain was reported was a C corporation return or an S corporation return. Previously, the I.R.S. had ruled that this could not be done because of § 1371(a)(2). Ltr. Rul. 8818049 (revoked in Ltr. Rul. 9323024; in Ltr. Rul. 9325006, the I.R.S. denied the corporation's request that Ltr. Rul. 9245004 not be applied retroactively). Under the 1996 Act, the committee reports make clear that an S corporation can be the purchaser in a § 338 transaction for taxable years beginning after 1996.

2. Sales of assets.

a. No particular problems are presented when an S corporation purchases the assets of another corporation as long as (for taxable years beginning before 1997) those assets do not include an 80% interest in the stock of another corporation (in which case an affiliated group would be formed and the buyer's S election would be terminated).

b. Sale of an S corporation's assets.

(1) Corporate-level tax under I.R.C. § 1374.

(a) A C corporation that elects S status will be taxed on any recognition during the first 10 years of the election ("recognition period") of gain that represents unrealized appreciation in the value of its assets when the election became effective.

Purpose: to prevent the use of an S election to avoid the double tax on C corporations and their shareholders resulting from General Utilities repeal.

(b) The total amount of gains taxed to the corporation cannot exceed the aggregate net unrealized gain when the election became effective.

(i) Losses are netted against gains. I.R.C. § 1374(d)(2)(A).

(ii) The I.R.S. will ignore contributions of loss assets done for the purpose of offsetting gains. Ann. 86-128, I.R.B. 1986-51, 22; Regs. § 1.1374-9.

(c) Effect of carryovers from C corporation years.

(i) Net operating and capital loss carryovers reduce recognized built-in gains. I.R.C. § 1374(b)(2).

(ii) Business credit carryovers reduce the tax.

(d) The gain taxed to the corporation under this provision cannot exceed the corporation's taxable income for the year determined as if it was not an S corporation. I.R.C. § 1374(d)(2)(A). Operating losses and losses from the sale of other assets can reduce the gain that is taxed to the corporation. Under

the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), net recognized gains that are not taxed because of the taxable income limit are carried forward to the next year. I.R.C. § 1374(d)(2)(B).

(e) The corporation is taxed whenever an asset owned on the election's effective date is sold and gain is recognized during the next 10 years.

(i) The taxpayer will have the burden of proving that a sold asset was not owned on the election's effective date.

(ii) Assets acquired by the corporation in a carryover basis transaction in exchange for an asset owned on the election's effective date will be subject to the tax. Ann. 86-128, I.R.B. 1986-51, 22. TAMRA makes clear that this applies to assets received in a tax-free reorganization, extending for 10 years after receipt. I.R.C. § 1374(d)(8).

(iii) Although the statute provides that the tax applies only if gain is "recognized" within the first 10 years of the S election, the I.R.S. has exercised its regulatory authority under I.R.C. § 1374(e) to hold that gain recognized after the end of the 10-year period pursuant to an installment sale made during the 10-year period will be subject to the tax. Notice 90-27, 1990-1 C.B. 336; Regs. § 1.1374-4(h).

(iv) The tax is not limited to sales of businesses, capital gains, or to sales of assets in the conventional sense. It applies to, among other items:

(A) Occasional sales of individual assets.

(B) Sales of inventory in the ordinary course of business (although LIFO inventory could, as a practical matter, escape the tax before the Revenue Act of 1987 required the corporation to pay a tax on LIFO inventory reserves; see III.B.7. above).

(I) The value of inventory on the effective date of the S election is determined as if all of the inventory had been sold in a bulk sale. Regs. § 1.1374-7(a). The Tax Court has held that the value, applying the traditional willing buyer/willing seller analysis, should be somewhere between the full retail price and cost because in an actual sale each party would want to make a profit. Reliable Steel Fabricators, Inc. v. Commissioner, T.C. Memo. 1995-293.

(II) The corporation's normal inventory method is used to determine which inventory is sold. Regs. § 1.1374-7(b).

(C) The collection of receivables by a cash basis corporation. The tax is based on the fair market value of the receivables on the effective date of the S election,

not on their face amount. Regs. § 1.1374-4(b)(3), Example (1).

(D) Items of income or deduction taken into account under § 481 if because of a change of accounting method that was effective before the start of the recognition period. Regs. § 1.1374-4(d).

(E) Items of income under § 995(b)(2) resulting from a DISC termination or disqualification occurring before the start of the recognition period. Regs. § 1.1374-4(e).

(F) Cancellation of debt income attributable to a debt of the corporation that was in place at the start of the recognition period. Regs. § 1.1374-4(f).

(G) Items of income taken into account under the completed contract method of accounting if the corporation began performance under the contract before the start of the recognition period and the item would have been included in income before the start of the recognition period under the percentage of completion method. Regs. § 1.1374-4(g).

(H) Partnership items. Regs. § 1.1374-4(i).

(I) If the corporation owns a partnership interest, items of gain or loss realized by the partnership are passed through to the corporation.

(aa) The amount that is passed through is limited to the built-in gain with respect to the partnership interest.

(bb) The look-through rules do not apply if the partnership interest has a fair market value of less than $100,000 as of the start of the recognition period and represents less than 10% of the partnership's capital and profits at all times during the year of the disposition.

(II) Gain on the disposition of a partnership interest is adjusted to take into account gains attributable to partnership property.

(v) It is not clear whether the tax applies to the receipt of assets upon the termination of an overfunded defined benefit pension plan.

(f) The taxable gain with respect to each asset will be the excess of the asset's value over its basis on the election's effective date.

(i) The burden of proof will be on the taxpayer. Appraisals should be made when feasible and records should be established at the outset.

(ii) It is not clear whether grouping of assets will be permitted.

(2) Sale of assets followed by liquidation of S corporation.

(a) The target's full gain on the sale is included in its taxable income, not just recapture items.

(b) The target's gain is passed through and taxed to the shareholders under the normal subchapter S rules.

(c) The gain that is passed through to the shareholders increases their basis in their stock of the target, thus reducing their gain on the liquidation. This basis adjustment eliminates the double tax that applies to sales and liquidations of C corporations. When a C corporation sells its assets and liquidates, the corporation is taxed on its gain on the sale of assets and the shareholders are taxed on their gain (representing the same appreciation in value) on the liquidation.

(3) Sale of assets followed by continued existence of S corporation.

(a) This technique can be used to avoid shareholder level tax when shareholders are elderly and the corporation can be liquidated after their deaths with no capital gains tax because of the basis step-up of I.R.C. § 1014.

(b) Before the SSRA, this technique usually required a termination of the S election because the holding company would have too much passive investment income. This is now a problem only if the corporation has subchapter C earnings and profits.

(4) Installment sale of corporation's assets.

(a) If the corporation sells its assets for an installment note and liquidates, the distribution of the note does not result in recognition of the deferred gain. I.R.C. § 453B(h).

(b) A problem has been created by the relationship of §§ 453B(h) and 453(h). The shareholders' basis in the stock of the liquidating corporation must be apportioned among the installment note and other property received in the liquidation, thus increasing their immediate gain on the liquidation.

3. When an S corporation is being sold, the tax laws may favor a sale of assets rather than a sale of stock.

a. In a sale of assets, the buyer gets a stepped-up basis at the cost of only a single tax. In a sale of stock, the buyer can get a stepped-up basis only at the cost of a double corporate-shareholder tax.

b. The availability of a § 338(h)(10) election under the new regulations neutralizes this factor when the buyer is a corporation.

c. Nontax business considerations may affect the choice of form.

C. Tax-free reorganizations.

1. Statutory mergers. I.R.C. § 368(a)(1).

a. C corporation merges into S corporation.

(1) The S election survives. The transitory (and theoretical) ownership of the S corporation's stock by the C corporation is ignored. Rev. Rul. 69-566, 1969-2 C.B. 165; Ltr. Rul. 9350003. Cf., West Shore Fuel, Inc. v. U.S., 598 F.2d 1236, 43 AFTR2d 79-1092, 79-1 USTC ¶ 9357 (2d Cir. 1979). The C corporation disappears so an affiliated group is not formed. Rev. Rul. 69-566, 1969-2 C.B. 165. An affiliated group will be formed, however, if the C corporation's assets include the stock of a subsidiary.

(2) The C corporation's debt obligations that are assumed by the S corporation may be a second class of stock if not held to be debt. But see safe harbor for certain straight debt instruments. I.R.C. § 1361(c)(5).

(3) Assets received from the C corporation are subject to the tax on built-in gains for the next ten years. I.R.C. § 1374(d)(8).

(4) The I.R.S. maintains that LIFO inventory recapture results under I.R.C. § 1363(d). Regs. § 1.1363-2.

b. S corporation merges into C corporation.

(1) The S corporation's S election ends on the day of the merger, when it no longer exists.

(2) The termination of the election is not retroactive, and it was not retro- active under prior law. Rev. Rul. 64-94, 1964-1 (Part 1) C.B. 317. Ltr. Rul. 9350003.

(3) It is not clear whether the S corporation's AAA passes to the C corporation for purposes of permitting tax-free distributions during the post-termination transition period.

(4) Investment tax credits previously claimed by the S corporation shareholders are not recaptured, even if their proportionate interests in the assets are reduced. Giovanini v. U.S., 9 F.3d 783, 72 AFTR2d 93-6512, 93-2 USTC ¶ 50,600 (9th Cir. 1993).

c. S corporation merges into S corporation.

(1) All of the above considerations are relevant.

(2) Although the statute is unclear, the I.R.S. has ruled that the target's AAA account carries over to the surviving corporation. Regs. § 1.1368-2(d)(2); Ltr. Ruls. 9115029, 9008041, 9002051, 8751013.

(3) The target's § 1374 built-in gain attributes pass to the surviving corporation. Ann. 86-128, I.R.B. 1986-51, 22.

2. Acquisition of target's stock in exchange for stock of the buyer or its parent. I.R.C. § 368(a)(1)(B).

a. For taxable years beginning before 1997, an S corporation could be neither a buyer nor a target in a "B" reorganization without terminating the S election because an affiliated group was formed.

b. An immediate liquidation of a target corporation by an acquiring S corporation might be ignored if it was pre-arranged and if the transitory existence of an affiliated group would not terminate the S election. Rev. Rul. 73-496, 1973-2 C.B. 312; contra, Haley Brothers Construction Corp. v. Commissioner, 87 T.C. 498 (1986). The acquisition and liquidation would be stepped together and treated as a "C" reorganization for some purposes. Resorts International, Inc. v. Commissioner, 511 F.2d 107, 35 AFTR2d 1337, 75-1 USTC ¶9405 (5th Cir. 1975); Rev. Rul. 67-274, 1967-2 C.B. 141.

c. For taxable years beginning after 1996, an S corporation can acquire another corporation's stock in a "B" reorganization.

3. Acquisition of target's assets in exchange for stock of buyer or its parent. I.R.C. § 368(a)(1)(C)

a. S corporation acquires C corporation's assets.

(1) The S election may terminate because the target corporation becomes an owner of the S corporation's stock, even if for a short time and even if only constructively because the stock is issued directly to the C corporation shareholders.

(2) Possible but uncertain ways of avoiding the problem.

(a) Argue that the transitory presence of a corporate shareholder should be ignored. Ltr. Rul. 8739010 (taxable purchase of S corporation's stock by a C corporation followed by an immediate distribution to the buyer's shareholders); Ltr. Ruls. 9422055, 9421022, 8926016, 8934020 (momentary ownership of S corporation's stock by a partnership followed by distribution to the partners); Cf. Rev. Rul. 73-496, 1973-2 C.B. 312, and Rev. Rul. 72-320, 1972-1 C.B. 270 (both dealing with transitory affiliated groups), and G.C.M. 39768 (holding that an S corporation can be a transferor in a reorganization and stating that an S election is not terminated merely because the corporation "momentarily has a corporate shareholder in the course of a reorganization").

(b) Have S corporation acquire C corporation's stock and immediately liquidate target.

(c) Get a ruling from the I.R.S.

(3) For taxable years beginning before 1997, the S election terminated if the C corporation's assets included 80% or more of a subsidiary's stock and an affiliated group was formed.

(4) If the C corporation is controlled by the same shareholders who control the S corporation, the transaction will be a reorganization under § 368(a)(1)(D).

b. C corporation acquires S corporation's assets.

(1) An S corporation can be a transferor in a "C" reorganization. G.C.M. 39768.

(2) The S election will not terminate because of the sale, but the target corporation must liquidate under the Tax Reform Act of 1984.

(3) For taxable years beginning before 1997, the S election terminates if the target ends up owning 80% or more of the C corporation's stock.

4. General problems of an S corporation as the buyer in a tax-free reorganization.

a. The increased number of shareholders may violate the 75 shareholder limit.

b. Not all of the target shareholders may be eligible to own stock in an S corporation. See Rev. Rul. 95-69, 1995-2C.B.38 I.R.B. 4, holding that the distribution of acquiring corporation stock by a target corporation that was a partnership to its partners (to enable the acquiring corporation to make an S election) did not destroy continuity of interest.

c. If the target shareholders end up controlling the S corporation, they can revoke the S election.

VIII. Preserving net operating loss carryovers.

A. General.

1. Net operating losses may be carried back 3 and forward 15 years. There are some exceptions to these rules for certain types of businesses, such as REITS and regulated transportation corporations. § 172.

2. General pattern of net operating loss ("NOL") carryovers in acquisitions. (It is assumed that T has NOL carryovers.)

a. If P acquires T's stock, T's NOL carryovers remain in T and can be used to offset T's post-transaction income, subject to the restrictions described below.

b. If P acquires T's assets:

(1) If the transaction is a tax-free reorganization, T's losses pass to P and can be used to offset P's post-transaction income, subject to the restrictions described below. § 381.

(2) If the transaction is taxable, T keeps the NOL carryovers. They can be used to offset T's gain on the sale and T's post-transaction income. If T is liquidated (other than in a § 332 transaction), the carryovers are extinguished.

3. The primary limitation on NOL carryovers in acquisitions is set forth in § 382.

B. Operation of § 382.

1. Introduction.

a. The Tax Reform Act of 1986 changed the focus of § 382.

(1) Under prior law, the general approach was to eliminate or reduce the amount of T's NOL carryovers in certain acquisitions.

(2) Under the new law, the carryovers remain intact but the post-acquisition income against which they can be applied is limited. The theory of the new law is that P's use of the carryovers should be limited to the use that T could have made of them if the acquisition had not occurred. It is assumed that T could have earned income each year equal to a reasonable return on its value, and the post-acquisition income against which T's NOL carryovers can be applied is therefore limited each year to a percentage of T's value on the acquisition date deemed to represent a reasonable rate of return.

b. Unlike prior law, taxable and tax-free acquisitions are generally subject to the same rules.

2. Limitations on post-acquisition use of NOL carryovers.

a. The limits apply generally to NOL carryovers and to unrealized built-in losses (if the total built-in losses exceed the lesser of 15% of T's value on the acquisition date or $10,000,000) that are recognized during the 5 years following the acquisition date.

b. If an acquisition is subject to § 382:

(1) The taxable income in each later year against which the NOL carryovers can be applied is limited to T's value on the acquisition date multiplied by the long-term tax-exempt bond rate.

(a) Computation of value.

(i) Value means fair market value.

(ii) Value is reduced by capital contributions primarily intended to increase T's value in order to reduce the impact of § 382. Contributions made during the 2 years preceding the acquisition date will be subtracted except as provided by regulations.

(iii) If immediately after the acquisition at least 1/3 of the loss corporation's assets are non-business (i.e., investment assets), T's value will be reduced by the excess of those assets' value over the debt allocated to them.

(b) The long-term tax-exempt bond rate is the long-term federal rate determined under § 1274, reduced to reflect a tax-exempt differential.

(c) The limit as so calculated is in-creased by the amount of any built-in gains as of the acquisition date that are recognized during the year (if the

total built-in gains exceed the lesser of 15% of T's value on the acquisition date or $10,000,000) and by any gain recognized in a § 338 transaction.

(2) The NOL carryover is extinguished as of the acquisition date if T's "business enterprise" is not continued for at least 2 years after the acquisition date (except for increases resulting from built-in gains and § 338 liabilities).

c. Acquisitions subject to § 382.

(1) Either of (a) or (b) below must occur.

(a) Owner shift involving a 5% shareholder.

(i) A change in the ownership of T's stock ...

(ii) that affects the percentage of T's stock owned by any person who is a 5% shareholder before or after the change.

(b) Equity structure shift.

Generally defined as a reorganization other than a divisive "D" or "G" reorganization or an "F" reorganization.

(2) After the shift, the percentage of stock of the loss corporation owned by one or more 5% shareholders has increased by more than 50 percentage points over the lowest percentage of stock owned by such shareholders at any time during the "testing period."

(a) In general, all stock owned by less-than-5% shareholders is treated as being owned by one 5% shareholder.

(b) The testing period is the 3-year period ending on any owner shift involving a 5% shareholder or equity structure shift. If an ownership change occurs, the testing period for determining whether

a second change has occurred shall not begin before the day after the first change.

d. General operating principles.

(1) Constructive ownership rules of § 318 apply, with certain modifications.

(2) Acquisitions by death, gift, divorce, or separation are not counted as changes.

(3) Changes attributable to fluctuations in the value of different classes of stock are ignored.

e. Special rules applicable to Title 11 or similar cases.

(1) Section 382 does not apply to an ownership change if:

(a) T is subject to court jurisdiction in a Title 11 or similar case immediately before the ownership change, and . . .

(b) T's shareholders and creditors (immediately before the change) own immediately after the change stock of the loss corporation comprising 50% or more of its voting power and value.

Stock transferred to a creditor is counted only if (i) the creditor had held its claim at least 18 months before the filing of the case, or (ii) the claim arose in the ordinary course of T's business and the creditor has at all times held the beneficial interest in the debt.

(2) The NOL for any post-change year is determined as if no deduction was allowed for interest on debt that was converted into stock under the court proceeding during any taxable year ending during the 3-year period preceding the taxable year during which the ownership change occurs or during that part of the year preceding the change.

(3) The pre-change NOL is reduced by 50% of the cancellation of debt income resulting from a stock-for-debt exchange that was not included in income because of the exception for Title 11 or similar cases in § 108(e)(10)(B).

(4) If another ownership change occurs within 2 years after an ownership change that is subject to the Title 11 exception, the § 382 limit is reduced to 0 after the second change.

(5) Regulations indicate that § 269 may present major problems in bankruptcy reorganizations.

(a) The continuity of business requirement of § 382(c) does not apply to § 382(1)(5) transactions. Reg. § 1.382-9(m)(l).

(b) An acquisition of control or property in a § 382(1)(5) transaction will normally be considered to be made for the principal purpose of tax avoidance unless the corporation "carries on more than an insignificant amount of an active trade or business" during and after the Title 11 or similar case. Reg. § 1.269-3(d).

(c) An acquisition of control of the corporation will be deemed to occur for purposes of § 269 no earlier than the date on which the bankruptcy court confirms the reorganization. Reg. § 1.269-5(b).

(d) A finding by a bankruptcy court that the principal purpose of the plan was not the avoidance of taxes for purposes of § 1129(d) of the Bankruptcy Code is not controlling for purposes of § 269 (the burden of proof is on the government under § 1129(d) and on the taxpayer under § 269). Reg. § 1.269-3(e).

C. Other restrictions on use of net operating losses.

1. Section 269.

a. Section 269(a)(1) provides that, if any person or persons acquire, directly or in-directly, control of a corporation and the principal purpose of the acquisition was to evade or avoid federal income taxes by securing the benefit of a deduction, credit, or other allowance that such person would not otherwise enjoy, the I.R.S. may disallow the deduction, credit, or other allowance.

b. "Control" is the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation. Section 269(a)(1) generally covers taxable transactions; § 269(a)(2) is a companion provision generally covering tax-free transactions.

c. Reg. § 1.269-3(a) provides that, if the evasion or avoidance purpose "exceeds in importance any other purpose, it is the principal purpose." Thus, the presence of a business purpose is not sufficient to avoid § 269 if the proscribed purpose was paramount. See, e.g., Scroll, Inc. v. Commissioner, 447 F.2d 612, 71-2 USTC ¶ 9588, 28 AFTR2d 71-5434 (5th Cir. 1971); Canaveral International Corporation, 61 T.C. 520 (1974), acq. 1974-2 C.B. 1. The regulations further indicate that the method of acquisition is immaterial if the proscribed purpose is present. See generally Watts, "Acquisitions Made to Avoid Taxes: Section 269," 34 Tax L. Rev. 539 (1979).

2. Relationship of Sections 269 and 382.

a. Reg. § 1.269-6 indicates that § 269 may be applied without regard to § 382 to deny the benefit from the loss carryovers.

b. The Conference Committee Report to the Tax Reform Act of 1986 indicates that § 269 continues to apply to acquisitions involving corporations with NOL carryovers. The Treasury Department is invited to review so-called "loss partnerships."

3. The Libson Shops doctrine.

   a. In Libson Shops v. Koehler, 353 U.S. 382, 57-1 USTC ¶ 9691, 51 AFTR 43 (1957), a case arising under the 1939 Internal Revenue Code, the Supreme Court ruled that a NOL carryover could offset only income produced by substantially the same business that incurred the loss. The Court did not consider the application of § 382 since it was first enacted in the 1954 Code.

   b. The remaining vitality of Libson Shops and its relationship to § 382 is unsettled. The Conference Committee Report under the 1986 legislation indicates that Libson Shops does not apply to transactions to which the 1986 rules apply.

4. Consolidated return regulations.

   P may seek to preserve the NOL carryovers of T and to use them by filing consolidated income tax returns with T. Set forth below are the principal rules of the regulations that limit the use of T's net operating losses.

   a. Separate return limitation year (SRLY) limitations.

      (1) T's loss carryovers may offset only its future income, and not the past or future income of P, under the SRLY rules in Reg. § 1.1502-21(c). See Rev. Rul. 75-378, 1975-2 C.B. 355, for an illustration of the concurrent application of § 381 and Reg. § 1.1502-21(c).

      (2) The regulations prevent an acquiring corporation from circumventing the SRLY rules by having a substantially smaller T acquire P. Without such rules, the loss corporation could become the common parent (which is not subject to the SRLY rules) and thereby offset P's profits with T's loss carryforwards. The "reverse acquisition" rules provide that T is subject to the SRLY rules notwithstanding its apparent position as common parent. Reg. §§ 1.1502-1(f)(3) and 1.1502-75(d)(3).

b. Consolidated return change of ownership.

(1) Reg. § 1.1502-1(g) defines a consolidated return change of ownership ("CRCO") as a 50-percentage point change in the ownership of the stock of the common parent attributable to a purchase or a redemption.

(2) Under Reg. § 1.1502-21(d), if a CRCO occurs, loss carryovers attributable to an affiliated group for taxable years before the CRCO may be deducted in later years only against taxable income of members of the group before the CRCO.

c. Built-in deductions.

(1) "Built-in deductions" are deductions that economically accrue before an acquisition in a SRLY but that are not recognized until after the acquisition.

(2) Reg. § 1.1502-15(a)(2) limits the ability of the acquiring corporation to use the post-acquisition "built-in" deductions to offset its profits; such deductions may only offset T's post-acquisition income.

IX. Joint buyer strategies.

A. It is assumed for purposes of this part of the outline that the acquisition of T is to be made by two unrelated corporations, P1 and P2. The joint venture vehicle that they form to make the acquisition, if any, is referred to as JVC, if a corporation, or JVP, if a partnership or a limited liability company that is treated as a partnership for tax purposes.

B. Ordinarily, P1 and P2 will want to form an entity to make the acquisition.

1. T and its shareholders will want to deal with one buyer, not two.

2. P1 and P2 will want to formalize their relationship respecting the purchase and operation of the business.

3. If the business is to be conducted by a corporation, 80% of T's stock must be acquired by a single corporation (or group of related corporations) to step up the basis of T's assets under § 338. A purchase of 50% of T's stock by each of P1 and P2 will not qualify.

C. Choice of joint venture entity.

1. Factors favoring the use of a partnership or a limited liability company (LLC)*.

a. The earnings of a JVP are taxed directly to the partners and can be distributed to the partners without additional tax. There is no entity-level tax. This is available under a JVC only if one of the shareholders owns 80% or more of the JVC's stock and can file consolidated returns with the JVC (which will rarely be the case) and, even if this is done, the other shareholder will have to pay tax on distributions to it. The dividends received deduction of Section 243 is only 80% (if 20% or more of the JVC's stock is owned by the payee). Moreover, dividends to the extent that they are protected by Section 243 may be subject to the alternative minimum tax.

b. The losses of a JVP are immediately deductible by the partners. Losses of a JVC are deductible by shareholders only if they file consolidated returns. The JVC cannot use subchapter S because it will have corporate shareholders.

c. A sale of JVC's assets will be subject to a double tax imposed on the JVC and its shareholders. A tax-free liquidation of a JVC would be possible only if one of the shareholders owned 80% or more of its stock. I.R.C. § 332. A sale of a JVP's assets is taxed only once, to the partners. A partnership can generally be liquidated tax-free.

d. A partnership offers more flexibility than does a corporation in allocating tax attributes, subject to I.R.C. § 704(b).

e. A partnership offers more flexibility than does a corporation in allocating control. Virtually any arrangement can be worked out in a partnership agreement.

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* In the remainder of this discussion, references to "partners" should be deemed to include members of an LLC.

2. Factors favoring the use of a corporation.

a. A JVP owned by unrelated corporations could not buy T's stock and step up the basis of T's assets by making a § 338 election. A JVC could. (One way to deal with this problem would be to have P1 buy T's stock, make a § 338 election, and then sell 50% of the stock of T to P2. Section 338 does not require the buyer to continue to hold T's stock. The I.R.S. might apply step transaction principles to a prearranged transaction.)

b. If one of the partners contributes appreciated property to a JVP, I.R.C. § 704(c) reduces the parties' ability to share tax attributes equally and introduces accounting complexity.

(1) Any gain on the property's sale must be allocated to the contributing partners to the extent of the appreciation on the date of the contribution.

(2) Depreciation must be allocated as if the noncontributing partner had bought its interest in the property from the contributing partner.

c. If a JVP is used, each partner may be deemed to be doing business in each state in which the partnership does business and may be taxed by each state based on the application of the state's apportionment formula to its nationwide (and, in some states, worldwide) property, payroll, and sales.

d. A corporate business can be sold tax-free in a reorganization under I.R.C. § 368. A partnership business can be sold tax-free only in the unlikely event that an exchange of like-kind property under I.R.C. § 1031 can be arranged. On the other hand, if the partners are special purpose corporations, their stock or assets can be transferred in tax-free reorganizations.

e. The nontax law governing the rights and obligations of partners and partnerships is less developed in some states than the law governing the rights and obligations of shareholders and corporations.

f. In a JVC, the liabilities of the venture will be limited to the venture assets. In a JVP, each partner will be fully liable for the venture's debts.

(1) The risk of unlimited liability can be reduced if the partners are special purpose subsidiaries.

(2) The impact of unlimited liability may be reduced by using a limited partnership, but this may not be feasible if both P1 and P2 are to be active in the business' management.

(3) P1 and P2 might form a limited partnership in which they are limited partners and a jointly-owned subsidiary is the general partner.

(a) The subsidiary may be ignored for tax purposes, but this should not be a problem.

(b) Local law would have to be examined to see if this arrangement would shield P1 and P2 from liability.

(4) An LLC can be formed to conduct the joint venture with P1 and P2 as the members.

(a) If structured with care, an LLC will be treated as a partnership for income tax purposes. See Rev. Proc. 95-10, 1995-1 C.B. 501, for guidelines as to when the Service will rule that an LLC will be treated as a partnership. Under Prop. Regs. §§ 301.7701-1 through 301.7701-3, an unincorporated entity such as an LLC could elect partnership or corporate classification.

(b) LLCs are new and state law respecting their powers and governance and the rights and obligations of their members is undeveloped.

D. Planning if a corporation is used as the venture entity.

1. If the parties would like P1 to be able to file consolidated income tax returns with the JVC.

a. P1 will have to own at least 80% of the voting power and value of the JVC's stock. I.R.C. § 1504(a)(2).

(1) Voting power is generally defined in terms of ability to elect directors. Rev. Rul. 69-126, 1969-1 C.B. 218.

(2) A voting agreement that gives P2 50% of the effective control of the JVC may prevent consolidation. The law is not clear on this point.

(3) Certain "straight" preferred stock is not taken into account. I.R.C. § 1504(a)(4). If the parties are willing to give P2 a limited and preferred position with respect to part of its investment, P1 and the JVC can file consolidated returns even if P1's and P2's stock investments are equal. P2 can also make part of its investment for long-term debt.

(4) Options to buy out a shareholder may be deemed to have been exercised. See Reg. § 1.1504-4.

b. If P1 and the JVC file consolidated returns, the parties should sign a tax sharing agreement under which the JVC pays its fair share of the tax liability of the P1 affiliated group.

2. One way of giving P1 and P2 the benefit of tax losses under some circumstances would be to have them operate the loss generating component of the business as a partnership. For example, if T has substantial amounts of depreciable assets, P1 and P2 could organize a JVP which would buy the assets from the JVC (or T) and lease them to T.

a. The JVP would deduct depreciation and, if the purchase was financed, interest, producing a tax shelter for P1 and P2.

b. T would have to pay the JVP a reasonable rent or the I.R.S. could reallocate income among the parties under I.R.C. § 482. See Commissioner v. B. Forman Co., 453 F.2d 1144, 72-1 USTC ¶ 9182, 29 AFTR2d 72-403 (2d Cir.), cert. denied, 407 U.S. 934 (1972), rev'g on this point 54 T.C. 912 (1971) (a corporation and its two 50% corporate shareholders are controlled by the same interests for purposes of § 482 with respect to transactions in which they engage in concert).

c. P1 and P2 could be treated as doing business in the states in which the JVP owned properties and could be taxable in those states. See IX.C.2.c. above.

E. Planning if a partnership is used as the venture entity.

1. Ordinarily, the JVP will be funded with cash contributions and loans. Third party loans will normally be guaranteed by P1 and P2.

2. If either partner transfers appreciated property to the partnership, special problems are presented.

a. Ordinarily, the transfer of property to a partnership in exchange for a partnership interest is tax-free. I.R.C. § 721.

(1) To the extent that the partnership interest is deemed to be received in exchange for services, § 721 does not apply and the partner may be taxed. Diamond v. Commissioner, 56 T.C. 530 (1971), aff'd, 492 F.2d 286, 74-1 USTC ¶ 9306, 33 AFTR2d 74-852 (7th Cir. 1974); Campbell v. Commissioner, T.C. Memo. 1990-162, rev'd, 943 F.2d 815, 91-2 USTC ¶ 50,420, 68 AFTR2d 91-5425 (8th Cir. 1991). The transfer of property, which may be hard to value, raises the possibility that the I.R.S. may argue that partnership interests were not distributed in proportion to capital contributions and that any discrepancy was attributable to a distribution of a partnership interest in exchange for services.

(2) If a partner contributing property receives disproportionate amounts of cash from the partnership, the I.R.S. may argue that it sold the property to the other partner or to the partnership or that it contributed the property to the partnership and then sold a partnership interest to the other partner.

(a) I.R.C. § 707(a)(2)(B) provides that a capital contribution of property followed by a cash distribution to the contributing partner may be treated as a taxable sale of the property.

(b) The statute is unclear as to whether the sale will be deemed to be of the property or of the partner-

ship interest. Section 704(c) will apply if the latter approach is followed.

b. If a partner transfers appreciated property to the JVP in exchange for a partnership interest, I.R.C. § 704(c) requires this to be reflected in allocations of partnership tax attributes.

(1) Any gain on the property's sale must be allocated to the contributing partner to the extent of the appreciation on the date of the contribution.

(2) Depreciation must be allocated as if the noncontributing partner had bought its interest in the property from the contributing partner.

3. Special allocations of tax attributes are permitted among the partners, but only if they have "substantial economic effect." I.R.C. § 704(b).

a. The regulations under I.R.C. § 704(b) contain detailed rules for determining when an allocation has substantial economic effect. In general, an allocation will have to reflect the flow of economic benefits and burdens.

b. In general, attempts to affect tax burdens by varying the timing of the allocation of income and deduction items will not be upheld.

c. Tax-loss partnerships in which the venture's income is allocated to one partner that has net operating losses in exchange for a later preferential allocation of income are of doubtful validity under the Regulations.

d. If one partner has net operating losses, one possibility is to have it purchase T and delay the formation of the JVP until several years later, protecting the other partner with an option arrangement.

(1) I.R.C. § 384 may limit the ability of a loss corporation to apply built-in profits of an acquired corporation against its preacquisition losses.

(2) If the I.R.S. treats the initial purchase and the later formation of the JVP as part of an integrated plan, it

may require T's profits to be allocated to each partner from the outset.

4. If one partner performs services for the partnership, payments to it will be guaranteed payments if in exchange for services and will be treated for tax purposes as if they were paid to a nonpartner.

X. Drafting the acquisition agreement.

A. The buyer's principal concerns in drafting the acquisition agreement are to flush out potential tax liabilities of T and to allocate responsibility for these liabilities. These issues generally involve representations and warranties as to existing and potential liabilities, covenants as to future actions, and indemnification for breaches of the representations, warranties and covenants. The seller's principal concerns are to limit its post-closing obligations.

B. Representations and warranties.

1. The buyer will seek a broad representation covering all potential existing tax liabilities of T. The seller may want to exclude certain taxes.

a. The representations should cover direct liabilities of T and any liabilities for which it may be liable under joint and several liability concepts (e.g., consolidated returns) or as transferee.

b. "Taxes" should be defined broadly, to include federal, state, local and foreign taxes and to cover all types of taxes. The representation should encompass "trust fund" type taxes such as employee withholding and sales taxes.

c. "Taxes" should also be defined to include any potential penalties under the tax laws, such as penalties for failure to obtain taxpayer identification numbers or to impose backup withholding under I.R.C. § 3406.

2. The representations should also include the filing of all required returns in all taxing jurisdictions.

3. The audit history of T (including open extensions of statutes of limitations) should be included and, where possible, a representation obtained regarding carryover issues likely to affect future periods not under audit.

4. Disclosure should be obtained about outstanding tax elections or special tax transactions which could be affected by a change in the ownership of T or a transfer of T assets.

   a. A transfer of property subject to a tax benefit lease under former I.R.C. § 168(f)(8) may trigger tax absent timely consents. See Reg. § 5c.168(f)(8)-2(a)(5).

   b. T may be a "consenting corporation" under I.R.C. § 341(f), which would affect a subsequent sale of T assets.

   c. T may be a "target" or "target affiliate" in a prior transaction to which I.R.C. § 338 may apply. If so, P may inherit the tax liability if the election is made after P acquires T.

   d. T may have made state tax law elections which will bind P following the purchase. See, e.g., Cal. Rev. & Tax Code § 25110 ("water's edge" election).

5. If T owns substantial real property, P may have a withholding obligation under I.R.C. Section 1445 if T is a "United States real property holding corporation" within the meaning of I.R.C. § 897. Note that T's representation is not absolute protection against liability unless provided under penalties of perjury. See Reg. § 1.897-2(h)(1).

6. Other issues to be covered in the representations and warranties include potential "golden parachute" liabilities under I.R.C. § 280G and I.R.C. § 4999 and the existence of any tax sharing agreement including T.

C. Covenants.

1. T's covenants will include obligations to be undertaken by it and/or its shareholders before and after the acquisition.

2. In the case of a stock purchase, the covenants may include an obligation to make an election under I.R.C. § 338(h)(10) and similar state provisions if requested by P.

3. In the case of an asset purchase, the parties may provide for an allocation of the purchase price in the agreement, with a covenant to file tax returns consistent with the allocation. Generally, an allocation agreed to by the parties will be binding upon them for tax purposes, although not binding on the I.R.S. I.R.C. 1060(a).

4. In the case of a stock purchase, tax events after the purchase may impact T and its selling stockholders. The parties' obligations in this event should be delineated in the covenants. The parties may seek agreement on how audit adjustments which affect preacquisition and post-acquisition years will be treated.

5. The purchase of T stock may or may not close its year for federal and state tax purposes. Where T's year does not close, agreement must be reached regarding responsibility for filing tax returns for the year and provision of requisite tax information.

6. Other issues to be considered in the covenants include audit cooperation, contest rights and records retention. In addition, responsibility for taxes arising out of the transaction, including sales taxes, transfer taxes and real property gains taxes, must be allocated.

D. Indemnification.

1. In those transactions in which representations and warranties survive the closing, provision must be made for the length of the survival period. Since these periods are generally short, a special period is needed for tax indemnification claims to leave time for the tax audit process.

2. The indemnity provisions should be drafted to provide that an indemnifiable loss occurs when a claim for taxes reduces an otherwise available loss or credit carryforward. In the absence of an agreement on this point, the seller may claim that no loss occurs until T has income which could have been offset by the loss or credit carryforward.