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Section 338(h)(10)

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SECTION 338(b)(10)

by

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I. HISTORY
I. HISTORY

A. Legislation

1. Section 338(h)(10) (originally Section 338(h)(9)) was enacted in late 1982 by Section 306(a)(8)(B)(i) of the Technical Corrections Act of 1982.

2. Its enactment, after the enactment of the general provisions of Section 338 in the Tax Equity and Fiscal Responsibility Act of 1982, was an outgrowth of other amendments made to resolve certain questions that arose under the basic provisions of Section 338.

   a. Thus, under Section 338 as enacted, when stock of a consolidated subsidiary was sold, it was unclear whether the liability resulting from the election was to be borne by the selling group or by the buyer.

   b. Since, as enacted, the Section 338 election (now referred to as a “regular” Section 338 election, or a “Section 338(g)” election) was made unilaterally by the purchaser, Congress believed that, similarly, the buyer should bear the economic burden of the resulting tax liability.

      (1) Accordingly, Section 338(h)(9) (then Section 338(h)(8)) was enacted to ensure that the results of the Section 338 election would not be included in the seller’s consolidated return.

   c. The debate, however, surrounding this technical correction led to the consideration of whether, if the parties so desired, the seller and not the buyer could bear the tax liability and, if so, what the contours of the deemed transaction should be.

      (1) Accordingly, in the same legislation, current Section 338(h)(10) was enacted to permit, under regulations, a different deemed transaction.

3. Even as originally conceived, however, the Section 338(h)(10) transaction was strikingly different than the “regular” Section 338 transaction.

   a. Thus, in the “regular” Section 338 election, gain (or loss) was to be recognized on the deemed asset sale generally only to the extent required under then Section 337 of the Code and related provisions (generally limited to recapture and similar items). In contrast, in the Section 338(h)(10) transaction, full gain or loss was to be recognized on the deemed asset sale.

   b. Conversely, in the “regular” Section 338 election, no provision exempted the seller’s otherwise recognized gain or loss on the sale of the target stock. In the Section 338(h)(10) transaction, that stock gain or loss was not to be recognized by the selling consolidated group.

4. In light of the uncertainty of the effects of this new transaction, Section 338(h)(10) was not to be self executing. Rather, it was to become effective only upon the issuance of implementing regulations. See H.R. Rep. No. 97-986, 97th Cong. 2d. Sess. 23 (1982).

5. The repeal of the General Utilities doctrine by the Tax Reform Act of 1986 made the “regular” Section 338(g) election uneconomic in all but a limited set of circumstances (e.g. in the case of foreign targets and targets with the net operating or built-in losses). Since, however, the Section 338(h)(10) transaction was largely not directly affected by General Utilities repeal, its relative importance has become paramount under Section 338. As a result, in large measure, many of the general rules of Section 338 (literally applicable to
both “regular” and Section 338(h)(10) elections) have become relevant and important only with respect to their impact on Section 338(h)(10) transactions.

B. Regulations

1. The implementing regulations were issued as temporary regulations (TD 8068), published in the Federal Register for January 8, 1986 (51 FR 741, 1986-1 C.B.165).
   a. Those first regulations only applied where the target corporation was a member of an affiliated group filing a consolidated return.
   b. In addition, those first regulations established the basic framework of the seller’s side transaction as an asset sale followed by a liquidation into the selling corporate shareholder.
   c. While there was some question whether the regulations would permit elections only for future transactions, they applied retroactively for qualified stock purchases occurring after January 12, 1983 the effective date of Section 338(h)(10).

2. While many sets of regulation impacting Section 338(h)(10) have been thereafter issued, three specific regulation packages are worthy of special mention.
   a. The complete regulatory history is set out in the Preamble to the most recent set of proposed regulations (Reg. 107069-97), published in the Federal Register for August 10 1999, 64 FR 43462 described in Section I.B.5. below.

3. The first, TD 8072, temporary regulations published in the Federal Register for January 29, 1986 (51 FR 3583, 1986-1 C.B. 111) established the basic residual method for allocating purchase and sales price, as well as the treatment of subsequent adjustments thereto.

4. The second, first published as proposed regulations (CO-i 11-90) on January 14, 1992 (57 FR 1409, 1992-1 C.B. 1000), were part of a comprehensive general revision of the Section 338 regulations. Those regulations were made final by TD 8515, published in the Federal Register for January 20, 1994 (59 FR 2958, 1994-1 C.B. 89)
   a. Among other changes made by the 1992/1994 regulations was the addition of S corporations and affiliated but nonconsolidated domestic subsidiaries as eligible targets for a Section 338(h)(10) election.
   b. Those regulations were effective for qualified stock purchases occurring after January 20, 1994 (the date of the final regulations), but an election was available to apply them to transactions occurring after January 14, 1992 (the date of the proposed regulations).

5. Finally, on August 4, 1999, comprehensive proposed regulations were issued under Sections 338 and 1060. This last package proposes to –
   a. Reorganize the current regulations to make them more coherent and easier to follow;
   b. Conform the results of transactions under Section 338(h)(10) and 1060;
   c. Provide a model/framework for Section 338(h)(10) transactions so as to allow determination of tax consequences in situations not specifically covered; and
d. Make various changes to reflect administrative experience and resolve questions previously raised.

e. The regulations are proposed to be applicable to qualified stock purchases occurring after the date final regulations are published in the Federal Register. Prop. Reg. §1.338(i)-1.

II. GENERAL DISCUSSION - FACTORS

A. In General

1. From its humble origins, Section 338(h)(10) has become a valuable and commonplace transaction. In this section, the basic principles of the transaction are described (which principles are discussed in detail in ensuing sections) and the factors influencing the decision whether to make this election are analyzed.

B. General Principles

1. General description.

   a. A Section 338(h)(10) election is an election, made by the buyer (hereinafter “P”) and seller (hereinafter “S”), generally to treat a qualifying purchase and sale of stock of an eligible target, (hereinafter “T”), for Federal income (and, in some cases, state) tax purposes as instead, a purchase and sale of the assets of T (and, in some cases T’s subsidiaries).

2. Seller.

   a. From S’s perspective, the transaction may be viewed as if the target (“Old T”) sold all of its assets at the close of the date of the stock purchase in a taxable transaction for an amount generally equal to the consideration received for the stock plus liabilities assumed, and then distributed the sales proceeds to its shareholder(s). The principal consequences of this characterization are that, as in any other taxable sale, Old T will recognize gain or loss on the assets transferred and, usually, the shareholders will have the tax result attendant to a liquidation of the company.


   a. From P’s perspective, the transaction may be viewed as if it created a new (at least 80 percent owned) subsidiary (“New T”) on the day after the date of the stock purchase, which subsidiary purchased the assets of Old T in a taxable transaction for an amount generally equal to the consideration paid for the stock plus the assumption of T’s liabilities. The principal consequence of this characterization is that, as in any other taxable purchase, New T will take basis in its assets equal to the purchase price, and will generally not succeeded to the tax attributes of Old T.

   b. This revaluation of asset basis will often result in a step up to the buyer. As a result, P should be prepared to pay more for the stock of T than it would have paid had it succeeded to T’s historic tax basis. In theory, this enhanced value of the assets is equal to the present discounted value of the tax benefit resulting from the step up, taking into account anticipated retention periods, depreciation lives, depreciation rates, discount rates, tax rates, etc.
C. **Factors**

1. **Desire for a stock transaction.**

   a. Since the consequences deemed to occur through a Section 338(h)(10) election could generally be accomplished directly through an actual purchase and sale of assets, the impetus for the Section 338(h)(10) election generally lies outside of the tax laws. Thus, usually, the election is first considered in those transactions where, for businesses or legal reasons, one or both of the parties desires to effect the acquisition or disposition through the purchase or sale of stock.

   (1) These reasons could include the presence of assets whose transfer would require third party consent, the existence of licenses or other privileges that are not transferable to third parties, or the desire to shift liability exposure.

2. **The cost (benefit) of the election to S – T's net inside versus S's outside basis.**

   a. As noted, from S’s perspective, the transaction is treated as a sale of assets, rather than a sale of stock. Accordingly, the relative detriment or benefit of the election will depend upon whether S pays more or less tax than it would have paid upon straight stock sale. This difference (if any) will depend, in turn, on the relationship between T’s net tax basis (i.e. gross basis less liabilities) in its assets (“net inside basis”) and S’s tax basis in its T stock (“outside basis”).

   b. Where T is a consolidated subsidiary or an S corporation, and has been held by S for long time (perhaps since inception), the differences between net inside basis and outside basis are not likely to be dramatic. In this case, should P desire a step up, S would be relatively indifferent as to whether to join in the Section 338(h)(10) election. Since, as noted, P generally should be willing to pay more for the enhanced value resulting from the step up, the relative neutrality of the election to S allows considerable room for negotiation and, hence, promotes the likelihood that the election will be made.

   (1) The loss disallowance regulations (Reg. §1.1502-20) may also promote the making of the election where net inside basis is close to outside basis, but both are greater than fair market value. In this case, however, S is not indifferent, as the election would permit deduction of the loss recognized on Old T’s sale of assets, whereas, because of loss duplication (or other factors), the correlative loss recognized on the actual sale of stock may be denied.

   c. Conversely, when T has been acquired relatively recently by S, a Section 338(h)(10) election may not make sense since outside basis may be considerably higher than net inside basis.

   (1) It may be possible that T’s net inside basis exceeds S’s outside basis. This situation may arise where the T stock was acquired in a Type B reorganization, or an exchange to which Section 351 applied. Similarly, if T were owned by S for some period, but not included in a consolidated return with S (e.g. an insurance company not eligible for consolidation for five years) inside basis may exceed outside basis.
3. The value of the election to P.  

Assuming a basis step-up, the value of the election to P will depend on –

a. The amount of the step up, i.e. the difference between the purchase price and Old T’s historic tax basis.

b. The allocation of the step up, i.e. whether it goes to short lived, or assets to be soon disposed of or, instead, to 15-year Section 197 intangibles.

(1) Even if the step up is allocated to Section 197 intangibles, the election is now still comparatively more valuable than before the 1993 enactment of Section 197, as, at the least, some recovery will be permitted for goodwill and going concern value.

c. P’s ability to realize the benefit of the step up. This, if the acquisition is highly leveraged, or the buyer is not otherwise a full rate taxpayer, the recovery of the basis increase may be significantly less valuable.

(1) It should be noted, however, that if New T were to generate an NOL in the P Group, that NOL could be carried back to earlier years of the P group. See Ltr. Rul. 8742006; see also Ltr. Rul. 8802006.

d. It may be possible that, even where outside basis is higher than net inside basis, the confluence of the foregoing factors makes the election sufficiently valuable such that P would insist on the election and compensate S for the increased tax cost.

4. Existence of T NOL.

a. While not dispositive, the existence of an NOL attributable to T is a favorable factor in the election determination.

b. Thus, on the seller’s side, if no election were made, the anti-circulatory rule of Reg. §1.1502-11(b) would preclude S from using T’s NOL to offset the stock gain. No such prohibition exists with respect to the use of that NOL to affect Old T’s asset gain.

(1) Further, where Old T is not an S corporation, to the extent that the NOL exceeds that gain, in most cases, S will succeed to this excess under Section 381, by reason of the deemed distribution by Old T being treated as a liquidation qualifying under Section 332.

c. On the buyer’s side, if no election were made, P’s ability to use T’s NOL may be limited by Sections 382, 384 and, where applicable, the SRLY rules. No such limitations apply to the recovery of the basis increase derived from the election.

d. As set forth in I.C. 2.b.(1) above, the presence of built-in losses in T’s assets may also occasion the making of the election. In these instances, however, the buyer may be relatively disadvantaged by taking a step down in T’s assets. By the same token, however, even in the absence of the election, recovery of the built-in loss may be limited by Section 382(h)(1)(B) and (h)(2)(B).

e. The existence of seller side losses is not always a qualifying factor, however.

(1) This, if S has a SRLY loss, that loss would be available to offset S’s stock gain but not Old T’s gain on the deemed side of its assets.
Similarly, if S has net capital losses, these would be available to offset S's gain on the sale of the T stock, but not any ordinary income recognized by Old T on the deemed sale of its assets.

5. **Minority ownership/recap accounting.**
   a. If S owns or sells less than 100 percent of the T stock to P, the election becomes more expensive. See VIII.C. infra.
   b. It is also noted that Section 338(h)(10) elections are often seen in instances where recap accounting is desired with respect to the transfer of the T stock. While beyond the scope of this outline, in those transactions, P generally acquires less than 100 percent of T, thus bringing into play the minority ownership issues referred to above and discussed below.

III. **ELIGIBILITY**

A. **Eligible Targets**

In order to be eligible for a Section 338(h)(10) election, T must be——

1. A member of an affiliated group of corporations that files a consolidated return;
2. A member of an affiliated group that files separate returns; or
3. An S corporation.

Reg. §1.338(h)(10)-1(a), (c), (d); Prop Reg. §1.338(h)(10)-1(b), (c).

B. **Status as Subsidiary**

If T is not an S corporation, it must be a subsidiary, and not the parent, of the consolidated or affiliated group. Reg. §1.338-1(c)(12); §1.338(h)(10)-1(d)(1)(i), (d)(ii), (c)(3), (c)(4); Prop. Reg. §§1.338(h)(10)-1(c)(1), (b)(1), (b)(2), (b)(3).

1. Thus, both the current and the proposed regulations require that T be acquired from a selling consolidated group (Reg. §1.338(h)(10)-1(d)(1)(i)) or a selling affiliate (Reg. §1.338(h)(10)-1(d)(1)(ii)); (Prop. Reg. §1.338(h)(10)-1(c)(1)).

a. (1) Under the current regulations, a selling consolidated group is defined as a selling group that files a consolidated return for the period that includes T's acquisition date. Reg. §1.338(h)(10)-1(c)(3).
   (i) A selling group is defined as an affiliated group that is eligible to file a consolidated return including T for the period including the acquisition date, and does not have a target as common parent. Reg. §1.338-1(c)(12).

(2) Under the proposed regulations, a selling consolidated group is defined as the consolidated group (as defined in Reg. §1.1502-1(h)) of which the consolidated target is a member on the acquisition date. Prop. Reg. §1.338(h)(10)-1(b)(2).
   (i) A consolidated target is defined as a target that is a member of a consolidated group on the acquisition date and is not the
common parent of the group on that date. Prop. Reg. §1.338(h)(10)-1(b)(1).

b. (1) Under the current regulations, a selling affiliate is defined as a domestic corporation (not a member of a selling group) from which P purchases an amount of T stock satisfying the requirements of Section 1504(a)(2). Reg. §1.338(h)(10)-1(c)(4).

(i) A question had arisen whether a life insurance company T, which has not been owned for 5 years, could be the subject of a Section 338(h)(10) election since, arguably, under Section 1504(c)(2), such a company was not “affiliated” with its selling corporate shareholder. The Internal Revenue Service (the “Service”) promptly answered this question affirmatively. See Ltr. Ruls. 9723026, 9646016, 9623023, and 9543036.

(2) The proposed regulations contain a similar definition, but focus on the ownership, rather than the sale, of the amount of stock described in Section 1504(a)(2).

(i) Also, the proposed regulations make clear that, if the stock ownership standard is satisfied, the target is considered “affiliated” for Section 338(h)(10) purposes, thus removing any doubt as to eligibility of nonconsolidated life insurance companies.

2. Conceptually, a Section 338(h)(10) election cannot apply to a parent since, if it did, the inclusive deemed sale tax liability would be, economically, P’s responsibility.

3. The foregoing definitions (especially the definition of selling group in Reg. §1.338-(c)(12)) raised the issue under the current regulations of whether a Section 338(h)(10) election may be made if the stock of the parent of the group is also acquired in a qualified stock purchase. Apparently this issue was merely the result of a drafting error, which is rectified in the proposed regulations.

a. Thus, the proposed regulations do not tie the election to a “selling group”. Rather, they focus on a consolidated target, defined simply to mean a group member other than the common parent. See Prop. Reg §1.338(h)(10)-1(b)(1), (b)(2).

C. Status as Group Member

Similarly, T must be a member of the group on the acquisition date. Reg. 1.338(h)(10)-1(c)(3), (c)(4). Prop. Reg. §1.338(h)(10)-1(b)(2), (b)(3). Specifically, in the case of a nonconsolidated subsidiary, the current regulations require P to purchase from the selling corporation, on the acquisition date, an amount of T stock that satisfies the requirements of Section 1504(a)(2). Reg. §1.338(h)(10)-1(c)(4). The proposed regulations first focus on the existence of Section 1504(a)(2) ownership (or consolidated status) on the acquisition date (Prop. Reg. §1.338(h)(10)-1(b)(1), (b)(3)), and then on the purchase of this amount of stock (Prop. Reg. §1.338(h)(10)-1(c)(1)).

1. Accordingly, no Section 338(h)(10) election can be made in a two-step acquisition if more than 20 percent but less than 80 percent of T is purchased in step one.

a. Similarly, if T is an S corporation, to be eligible for a Section 338(h)(10) election, P must purchase T stock from those persons who are shareholders of the S corporation immediately before the acquisition date. Reg. §1.338(h)(10)-1(d)(1)(iii), (c)(2). Accordingly, P can purchase no T stock before that acquisition date, since to do so would disqualify T from being an S corporation immediately
before the date of the stock purchase. See Sections 1361(b)(1)(B), 1362(d)(2), Reg. §1.338(h)(10)-1(c)(2).

b. The proposed regulations make clear that T does not lose its S status on the acquisition date merely because of P's corporate ownership (See Prop. Reg. §1.338(h)(10)-1(d)(3)(i)), and that any qualified subchapter S subsidiaries of T similarly remain qualified through the close of the acquisition date. (id).

2. In addition, if T is a subsidiary and has outstanding on the acquisition date options, warrants, convertible debentures, etc. which may be treated as stock or as exercised under the regulations provided under Section 1504(a)(5)(A) and (B), a Section 338(h)(10) election would not be available if the effect of such regulations were to cause T not to be included in the selling group's consolidated return or not be affiliated with the selling parent. See generally Reg. §1.1504-4.

a. P is not, however, placed in the precarious position of making a Section 338 election for T and then having the Section 1504(a)(5) regulations take away the applicability of Section 338(h)(10) (through excluding T from the S group). Thus, the current and proposed regulations both expressly provide that if the Section 338(h)(10) election is not valid, neither is the Section 338 election. See Reg. §1.338(h)(10)-1(d)(4); Prop. Reg. §1.338(h)(10)-1(c)(4). Also, the regulations no longer require an express Section 338 election for T. Rather, if the Section 338(h)(10) election is made, a Section 338 election is deemed to be made. Reg. §1.338(h)(10)-1(d)(3), Prop. Reg. §1.338(h)(10)-1(c)(3).

D. **Qualified Stock Purchase**

A qualified stock purchase must be made for T. Reg. §1.338(h)(10)-1(d)(1); Prop. Reg. §1.338(h)(10)-(c)(1).

1. **Qualified stock purchase defined.**

A qualified stock purchase is any transaction, or series of transactions, in which P "purchases," within the "12-month acquisition period," stock constituting at least 80 percent of the vote and 80 percent of the value of T. Only a narrow class of nonvoting nonparticipating preferred stock is excluded from consideration. Section 338(d)(3). See Section 1504(a).

a. **Twelve-month acquisition period.**

The 12-month acquisition period is generally the 12-month period beginning with the date of the first purchase of the T stock counted in determining whether a qualified stock purchase has occurred. Section 338(h)(1).

b. **Acquisition date.**

The acquisition date is the date on which the qualified stock purchase occurs. In other words, it is the first day that P achieves the required 80 percent ownership of T by purchase within the 12-month period. Section 338(h)(2).

c. **Aggregation rule.**

All stock purchases made by members of the P group are aggregated in determining whether a qualified stock purchase has occurred. Section 338(h)(5),(8); Reg. §1.338-1(d)(7). Prop. Reg. §1.338-2(c)(11).
The P group is defined to include P and other members of its affiliated group within the meaning of Section 1504(a). In determining whether the requirements of Section 1504(a) are satisfied, the exceptions to affiliation provided in Section 1504(b) are not taken into account. Section 338(h)(5).

2. **Purchase defined.**
   
   a. **In General.**
      
      To count as part of a qualified stock purchase, T stock must be acquired by “purchase.” A “purchase” is any acquisition of stock with the following exceptions.

   b. **Carryover basis acquisitions.**
      
      An acquisition where the basis to P is determined, in whole or in part, by reference to its basis in the hands of the transferor (carryover basis) is not a purchase. Section 338(h)(3)(A)(i).

      (1) For example, T stock acquired by P in a transaction to which Section 304(a)(1) applies, and which is treated as a distribution to which Section 301 applies, is not acquired by “purchase.” In such a Section 304(a)(1) transaction, P is treated as having received the acquired stock in exchange for its own stock in a transaction which Section 351(a) applies. See also III.D.2.c infra. See Reg. § 1.338-2(b)(2)(ii), Example 1 (not appearing in the proposed regulations).

   c. **Nonrecognition transactions.**
      
      Also excluded from the definition of “purchase” is an exchange to which Sections 351, 354, 355, or 356 apply, or any other acquisition described in regulations in which the transferor does not recognize the full amount of realized gain or loss. Section 338(h)(3)(A)(ii).

      (1) Thus, T stock acquired by P in an exchange to which Section 351 applies, a Type B reorganization, or a reorganization qualifying as a Type A by reason of Section 368(a)(2)(E), will not be acquired by purchase. Similarly, T stock received in a distribution to which Section 355 applies (i.e., a spin-off, split-off or split-up) will not be acquired by purchase.

      (i) For a possibly unanticipated and adverse application of Section 351, see III.D.8, infra.

      (2) It is questionable whether an acquisition of T stock directly from T (and not a T shareholder) for cash is to be considered a purchase.

      (i) The arguments against purchase treatment include the facts that (a) P's acquisition of T stock may qualify as an exchange to which Section 351 applies, and is therefore statutorily excluded from the purchase definition, or (b) otherwise qualifies for nonrecognition to T (the transferor) under Section 1032, and is therefore excluded under the spirit of Section 338(h)(3)(A)(ii). Also, cf. Section 338(h)(7)(A) (prior to its repeal by the Tax Reform Act of 1986).
Example: Corporation T, all of whose stock is owned by shareholder S, has a value of $10 X. Corporation P transfers to T $90 X in exchange for 90 percent of T's outstanding stock. It is difficult to see why this should be a qualified stock purchase inasmuch as S did not participate at all in the transaction. Nor should the result arguably be different merely because S owns some nonvoting stock in T (thereby making P's acquisition not an exchange to which Section 351(a) applies). It is noted that this cash acquisition by P would not have abated the "surrogate" tax previously provided by Section 338(c)(1) (prior to its repeal by the Tax Reform Act of 1986). See Section 338(h)(7)(A) (to abate surrogate tax, additional stock must be acquired by "purchase"; stock acquired directly from T presumptively not acquired by purchase). See General Explanation of The Deficit Reduction Act of 1984, prepared by the Staff of the Joint Committee on Taxation 993-994 (1984).

(ii) The arguments in favor of purchase treatment focus on the fact that, in other contexts, a cash purchase directly from the corporation is viewed similarly to a taxable purchase from outsiders. See Section 355(d)(5)(B)(i). Further, in those cases to which Section 351 would not apply, the statute does not literally exclude the acquisition from purchase treatment since no exclusionary regulations have yet been issued. Moreover, at least where the cash does not remain in T, but rather is distributed to T shareholders in redemption of stock, the effect is no different than an actual purchase by P of the T stock.

Example: Corporation T, all of whose stock is owned by shareholder S, has a value of $10 X. Corporation P transfers to T $8 X, which uses those funds (plus perhaps borrowed amounts) to redeem some or all of S's shares. As a policy matter, it is difficult to see why P has not made a qualified stock purchase of T. In fact, the Service once so ruled. See Letter Ruling 8830079.

(3) Notwithstanding the supporting arguments, P would be well advised not to count on acquisitions from T to satisfy the qualified stock purchase requirement.

(4) At the same time, however, acquisitions from T should not cause an otherwise qualifying purchase to fail.

Example: Corporation T, all of whose stock is owned by shareholder S, has a value of $75 X. Corporation P purchases all of the stock of T from S. Thereafter, and as part of the same plan, P contributes $25 X to T. A qualified stock purchase has occurred. Compare Reg. §1.368-2(j)(6), Example (7).

d. Related party acquisitions—Going public.

A purchase also does not include an acquisition from a person whose stock ownership would be attributed to P under the attribution rules of Section 318(a) (other than the option attribution rule of Section 318(a)(4)). Section 338(h)(3)(A)(iii).
The proposed regulations make clear that, for this purpose, relationship is tested immediately after the transaction (or series of transactions). Prop. Reg. §1.338-3(b)(3)(ii).

As a result, the proposed regulations confirm prior ruling position that Section 338(h)(10) may be utilized in a going public transaction. See Ltr. Rul. 9747001 (Technical Advice Memorandum); Ltr. Rul. 9142013; Ltr. Rul. 9541039, as modified by Ltr. Rul. 9549031 (Sale to ESOP). In these transactions, generally, S transfers the T stock to a Newco (N), at which time it has a binding commitment to sell at least 51 percent of the N stock to an underwriter (which, in turn, will sell that stock to the public). The Service has ruled that the binding commitment causes Section 351 not to apply to N's acquisition of the T stock. It has further held that, since S owns less than 50 percent of N at the conclusion of the transaction, the stock owned by S will not be attributed to N under Section 318, and therefore the unrelated party requirement of Section 338(h)(3)(A)(iii) is not violated. As a result, N's acquisition of the T stock is a qualified stock purchase, entitling N and S to join in a Section 338(h)(10) election. See also Prop. Reg. §1.338-3(b)(3)(iv), Example (1).

One concern in these transactions (not reflected in the example in the proposed regulations) is that N's acquisition of the T stock may qualify as a Type B reorganization. Thus, with the recent changes to the continuity of interest regulations (See Reg. §1.368-1(e)(1), (e)(6), Example (1), N's acquisition of T stock solely for voting stock will qualify, notwithstanding the pre-arranged sale. Since N will have acquired the T stock in an exchange to which Section 354 applies, a qualified stock purchase will not have occurred. Accordingly, it may be prudent for N to issue to S some cash or other nonqualifying consideration.

If N also sells stock in the transaction in an initial public offering, it is possible that the transaction will (to the taxpayer's detriment) qualify under Section 351 on the basis that S sold N stock to a co-transferor. See Rev. Rul. 79-194, 1979-1 C.B. 145. Thus, pursuant to Reg. §1.351-1(a)(3) (applicable to transactions occurring after May 1, 1996), any person who acquires stock for cash from an underwriter in a “qualified underwriting transaction” is treated as transferring the cash directly to the corporation in exchange for the stock. A qualified underwriting transaction is the usual underwriting where the corporation issues stock for cash and the underwriter is either the agent of the corporation (a “best efforts” underwriting), or the underwriter’s ownership is transitory (the usual “firm commitment” underwriting). As a result, in the IPO, the public is a transferor, and arguably S’s sale to the public through the underwriter (a transaction which is not governed by §1.351-1(a)(3)) is to that same transferor. While it is believed that a taxpayer could structure a concurrent primary and secondary offering to qualify under Section 351, (e.g., by attempting, if possible, to sell to separate public groups), it is also possible that all such transactions do not automatically so qualify. In any event, one would be well advised to cause Section 351 not to apply for other reasons as well (e.g., by having N issue to S a class of nonvoting preferred common stock which is sold by S to an unrelated third party pursuant to a binding commitment, and/or by having N issue that stock to third parties for services rendered).
In Ltr. Rul. 9747001 supra (issued before the changes to the Section 351 regulations), the Service held that the concurrent offerings by S and N caused Section 351 to apply because S sold the N stock to a co-transferor (the underwriter), citing Rev. Rul. 79-194. Rather Section 351 was failed, and the Section 338(h)(10) election therefore could be made, because S also received from N nonvoting preferred stock, which it sold to an unrelated third party pursuant to a binding commitment in effect when the stock was received.

One issue raised in these transactions is whether the momentary relationship among S, T, and N is sufficient to invoke the Section 197 anti-churning rules with respect to the intangible property in the hands of New T. For a variety of reasons, it is believed that application of those rules is inappropriate, and that New T, like any other unrelated buyer, may amortize the Section 197 intangibles acquired without having to prove that these were otherwise amortizable under prior law. It is hoped that forthcoming final regulations under Section 197 will confirm this result.

While not expressly covered in the proposed regulations, if previously unrelated S becomes related to P as part of the transaction, a qualified stock purchase will not occur. See Ltr. Rul. 9742039.

Example. S sells all of the stock of T to P for a package of consideration that includes P stock. At the completion of the transaction, S owns at least 50 percent of the value of the P stock, so that any stock owned by S would be attributed to P under Section 318(a)(3)(C). P's acquisition is not a qualified stock purchase.

In addition, a purchase, otherwise qualifying, will not be disqualified by the related party rules if the acquisition is from a corporation at least 50 percent of whose stock was purchased by P. Section 338(h)(3)(C).

If an acquisition is made from a related corporation excepted under Section 338(h)(3)(C), the running of the 12-month acquisition period begins when P is first considered as owning stock owned by the transferor under the attribution rules of Section 318 (other than paragraph (4)). Section 338(h)(1). Thus, if P is considered as owning that stock more than 12 months before P's actual purchase, that stock will not be counted as part of the qualified stock purchase. See Reg. §1.338-2(b)(3), Prop. Reg. §1.338-3(b)(3)(iii), (b)(3)(iv), Example (3).

e. **Insolvency.**

The proposed regulations provide that a purchase occurs only so long as “more than a nominal amount” is paid for the T stock. As a result, in general, a Section 338(h)(10) election may not be made for a stand alone involvent company. This and other points relating to insolvency are discussed in more detail in Section VIII.F supra.
3. **Combination purchase and redemption.**

   a. **In general.**

      The requirements for a qualified stock purchase may be satisfied through a combination of stock purchases by P and redemptions by T from persons other than P or a person related to P. Reg. §1.338-2(b)(5). Prop. Reg. §1.338-3(b)(5).

   b. **Computation.**

      Thus, to determine whether a qualified stock purchase has occurred,

      (1) Look to the first day on which P has achieved the required 80 percent ownership in T; and

      (2) Determine whether that 80 percent was acquired by purchase within the prior 12 months.

   c. **Effect of redemptions where T stock not owned by P (or person related to P).**

      Accordingly, such redemptions reduce the pool of outstanding T stock that P must acquire by purchase. In other words, stock redemptions reduce the denominator of the 80 percent fraction, thus generally requiring fewer shares to be purchased (i.e., the numerator amount) to satisfy the qualified stock purchase requirement.

      (1) It is irrelevant whether the redemption occurs before or after P has purchased any T stock, or before or after the beginning of the 12-month acquisition period. So long as P's purchase, combined with redemptions, result in P's having achieved 80 percent ownership by purchase within 12 months, a qualified stock purchase has occurred. The acquisition date is the date that P has achieved the 80 percent ownership.

   d. **Effect of redemptions where T stock owned by P (or person related to P).**

      (1) Redemptions from P (or a person related to P) generally are not taken into account for this purpose. Thus, such redemptions do not reduce the pool of stock that P must acquire to achieve a qualified stock purchase. Prop. Reg. §1.338-3(b)(5)(iii)(A).

      Example. P has owned 30 percent of the T stock for several years. T redeems this stock and, within 12 months, P purchases the remaining T stock (then constituting 100 percent). A qualified stock purchase has not occurred. Prop. Reg. §1.338-3(b)(5)(iv), Example (3).

      (2) This exception does not apply, however, if the redeemed stock was considered purchased by P during the 12-month period pursuant to Section 338(b)(3)(C), supra. See Prop. Reg. §1.338-3(b)(5)(iii)(B), - (b)(5)(iv), Example (4). Would this rule cover redemptions from P itself, if P had purchased the redeemed stock during the 12-month period? It would seem that it should. Cf. Prop. Reg. §1.338-3(b)(5)(iv), Example (3), supra (redeemed stock held by P for several years).

4. **Combination purchase and recapitalization.**

   a. While not expressly covered by the regulations, it is believed that the requirements for a qualified stock purchase may be satisfied through a combination of stock purchases by P and a recapitalization by T in which stock of T held by S is
exchanged for T stock not taken into account under the definition of a qualified stock purchase (i.e. stock described in Section 1504(a)(4)).

b. **Example.** Corporation S owns all of the common stock of Corporation T (the only class of stock outstanding) with a value of $100x. In a recapitalization transaction, S exchanges T common stock with a value of $25x for T stock described in Section 1504(a)(4). Within 12 months, P purchases all of the T common stock from S. A qualified stock purchase has occurred.

5. **Reverse triangular cash merger.**

a. A purchase includes the acquisition of T stock through the use of a reverse triangular cash merger. In this transaction, P forms a Newco (N) which merges into T. Pursuant to the merger, T's shareholders receive cash and/or stock in a taxable transaction. The formation of N is disregarded and P is treated as having acquired the T stock directly from the T shareholders. Reg. §1.338-2(b)(2)(ii), Example 2, (not appearing in the proposed regulations); Rev. Rul. 73-427, 1973-2 C.B. 301; and Rev. Rul. 90-95, 1990-2 C.B. 67.

6. **Application of purchase rules to subsidiaries of T.**

a. **In general.**

(1) If a Section 338(h)(10) election is made for T, New T is treated as having purchased the assets (including the stock of subsidiaries) of Old T. That deemed purchase is considered a purchase of stock under Section 338(h)(10). Section 338(h)(3)(B). Since New T and P are members of the same affiliated group, P's acquisition of T and New T's acquisition of the stock of the T subsidiaries are treated as made by one corporation (Section 338(h)(8)). Thus, a Section 338(h)(10) election can be made for T's subsidiaries, and their subsidiaries, down the chain. See generally Section 1.338-2(b)(4); Prop. Reg. §1.338-3(b)(4). See generally Section VIII E., infra.

(2) With the elimination of the stock consistency rules, Section 338(h)(10) will apply to lower tier subsidiaries of T only if it is affirmatively elected.

b. **Example.**

T owns 80 percent of T1. On January 1, 2000, P purchases 80 percent of T and joins in a Section 338(h)(10) election. By reason of that election, New T is treated as having purchased the assets of Old T, including the stock of T1. That deemed purchase of T1 stock by New T is considered a purchase for Section 338 purposes by a member of the P group on January 1, 2000. Thus, a Section 338(h)(10) election may be made for T1. This result occurs even though, economically, P has purchased only 64 percent (80 percent x 80 percent) of T1. T1's deemed sale of its assets occurs on January 1, 2000, immediately after the deemed sale of T's assets.
7. **Effect of post-acquisition events.**

a. **Liquidation/merger of T.**

(1) T's liquidation into P does not bar a Section 338(h)(10) election. Since the deemed sale of Old T's assets is considered to occur at the close of the acquisition date, if the liquidation occurs on the acquisition date itself it will be considered to occur on the following day, immediately after New T's purchase of the assets. Reg. §1.338-2(c)(1). Prop Reg. §1.338-3(c)(1).

(2) Similarly, a Section 338(h)(10) election may be made for T even though T is merged into another corporation, provided that, under the facts and circumstances, P is considered for tax purposes to be the purchaser of the T stock. Id.

(i) By analogy to the liquidation rules, except as set forth in (3) below, it would seem that even a prompt merger of T into another corporation would not bar the election.

(ii) If a qualified stock purchase and no Section 338(h)(10) election is made, T's subsequent liquidation into P, or merger into another member of the P group, is generally not treated as a taxable transaction to T or P. See Rev. Rul. 90-95, 1990-2 C.B. 67 (liquidation into P treated as separate Section 332 liquidation); Reg. §1.338-2(c)(3), Prop. Reg. §1.338-3(c)(3) (merger of T after qualified stock purchase satisfies continuity of interest and D reorganization control requirements).

(3) What if the acquisition of the T stock is effected in part with stock of P, and T is later liquidated into P or merged into P or a member of the P group? Is there a risk that a qualified stock purchase has not occurred?

(i) **Example:** P acquires from S all of the T stock in exchange for a mixture of consideration, 50 percent of which consists of P stock. Thereafter, pursuant to a plan of P in place at the time of the acquisition, T is merged into P under applicable state law.

(ii) On these facts, is it possible that the result of King Enterprises, Inc. v. United States, 418 F. 2d 511 (Ct. Cl. 1969) could apply to transform the transaction from a qualified stock purchase to a tax-free Type A reorganization? In public forums, employees of the Service have indicated that it was their personal view that such a result is possible.

(iii) What if, for any reason, the acquisition followed by the liquidation/merger of T did not qualify as a tax-free reorganization? Is it possible that the transaction would be cast as a direct taxable acquisition of T's assets by P or a member of the P group? Provided the acquisition of the T stock otherwise qualified as a qualified stock purchase, it is believed that Rev. Rul. 90-95, and Reg. 1.338-2(c)(3) supra, would apply to treat the transaction as a stock purchase followed by a Section 332 liquidation of T into P, or tax free reorganization of T, respectively.
b. **Tax-free liquidation or merger of P.**

If P is merged into another corporation in a tax-free reorganization, or liquidated into its parent under Section 332, the acquiring corporation will succeed to P's ability to join in the Section 338(h)(10) election (provided that P is considered for tax purposes to be the purchaser of the T stock). Reg. §1.338-2(c)(2); Prop. Reg. §1.338-3(c)(2).

c. **Downstream merger of P into T.**

(1) In general, Section 338(h)(10) must be elected by a corporation, not individual purchasers of T. Frequently, however, individuals will form a corporation (P) to purchase the T stock. In addition, for business reasons (for example, the requirement of P's lender to attach the lien to assets of T), it may be necessary to combine P and T. As noted in III-D.7.a. supra, if T liquidates into P, a Section 338(h)(10) election may be made for T. However, that liquidation requires a transfer of T's assets, which Section 338 was enacted to avoid. What if P merges downstream into T?

(2) The regulations allow the election, provided that P is considered for tax purposes to have purchased the T stock. (Reg. §1.338-2(b)(1); Prop. Reg. §1.338-3(b)(1)). Accordingly, if the existence of P is ignored as transitory (see Rev. Rul. 73-427, supra), the implication is that the election will not be allowed since the acquisition will be treated as made by the individual shareholders of P. The regulations further provide that facts which indicate that P does not purchase the T stock include that P merges into T, liquidates, or disposes of the T stock following the qualified stock purchase.

(3) Early private letter rulings suggested that the Service will disregard P in this context. See Ltr. Ruls. 8546110, 8542020, and 8539056. In each ruling, a corporation (P) was formed to acquire the T stock. In each, P borrowed funds, acquired T, and subsequently merged into T, with the debt secured by T's assets. In each, the Service disregarded P and treated the transaction as a redemption by T of its own stock to the extent of the borrowed funds, and a purchase by P's shareholders, to the extent of the equity contributed to P. Because in each case P was owned by a corporation, a Section 338 election was still available. If, however, P were owned by individuals, the implication is that a Section 338 election could not be made.

(4) An alternative would be for the individuals to form a new corporation (N), which in turn forms a subsidiary, P. P could purchase the T stock and merge into T. Even if P's existence is disregarded, the purchase would be treated as made by N which, as a corporation, could join in a Section 338(h)(10) election for T.

8. **Retaining an interest.**

What if shareholders of T decide to retain an interest in T? If so, attention may have to be paid to the form of the transaction.

**Example (1):** Corporation T has an agreed upon value, based on a Section 338(h)(10) election, of $100X. Its sole shareholder, Corporation S desires to retain a preferred stock interest with a value of $10X. X and S form P to which are contributed, respectively, $90X in cash and T stock with a value of $10X. X receives all of the P common and S receives qualifying P preferred. Thereafter, P purchases the remaining T stock from S for $90X.
Notwithstanding that P has supplied funds for 90 percent of the T stock, and S will recognize gain on the receipt of those funds, it is very possible that the Service would contend that, as to P, S and X, the overall transaction is one to which Section 351 applies. In other words, S may be treated as having transferred all of its T stock to P for P preferred stock and cash, and S and X may be regarded as a group of transferors who are in control of P immediately after the transaction. Thus, S's receipt of cash may be regarded as boot under Section 351(b), with the result that, as described above, P will not have accomplished a qualified stock purchase of T by reason of Section 338(h)(3)(A)(i) (basis determined in part by reference to transferor's) and (h)(3)(A)(ii) (stock acquired in Section 351 exchange). See Section III.D.2.c., supra.

This problem may be easily solved.

Example (2): The facts are the same as in Example (1) except that, after the acquisition, but as part of the plan, P merges downstream into T. In the merger, X's stock of P is exchanged for all of the common stock of T, and S's stock of P is exchanged for qualifying preferred stock of T described in Section 1504(a)(4). The transaction should be treated in part as a purchase by X of the T common from S (see Rev. Rul. 73-427, 1973-2 C.B. 301), and in part as an exchange by S of common stock for preferred stock in a recapitalization (see Rev. Rul. 78-250, 1978-1 C.B. 83.) If X is a corporation, the transaction should qualify as a qualified stock purchase. As noted, although the regulations do not expressly so provide, the requirements for a qualified stock purchase should be satisfied through a combination purchase and recapitalization of stock for non stock. See Section III.D.4. supra.

Even if the transaction is leveraged, the acquisition should qualify.

Example (3): The facts are the same as in Examples (1) and (2) except that X contributes only $30X and P borrows $60X. After S's transfer of $10X of T stock to P in exchange for P preferred, P purchases the remaining $90X and merges into T with X receiving T common stock (worth $30X) and S the P preferred (worth $10X). The Service likely would treat the transaction as a purchase by X of $30X of T common stock (Rev. Rul. 73-427, supra), a redemption by T of $60X of its own stock, and a recapitalization exchange by S of $10X of T common for preferred. (Rev. Rul. 78-250, supra.) See Ltr. Ruls. 8546110, 8542020, 8539056. Since, after the transaction, X would own all of the "countable" stock of T, which it acquired by purchase within 12 months, if X is a corporation, a qualified stock purchase should result. See Regs. §1.338-2(b)(5).

Problems may arise, however, if P is not owned by a corporate shareholder.

Example (4): The facts are the same as in Examples (2) and (3) supra except that X is not a corporation. After the merger of P into T, the Service would likely contend that the individual equity owners of P (i.e., X) purchased the T common, which would not count towards a qualified stock purchase.

What if S wants to retain "countable" stock in T which represents less than 20 percent of T before the transaction, but, because of the leverage, represents greater than 20 percent after the transaction?

Example (5): The facts are the same as in Example (3), i.e., X contributes $30X, S $10X of T stock, and P borrows $60X. However, instead of receiving T Section 1504(a)(4) stock in the merger, S receives convertible or voting preferred (or common stock), with a value of $10X. After the transaction, the countable T stock has a value of $40X, of which $30X was purchased by X, less than is necessary to make a Section 338(h)(10) election.

Is there a way to make this work?
Example (6): S and X form Newco 1 to which is contributed, respectively, $10X of T stock and $30X in cash in exchange for Newco 1 common stock. Newco 1 borrows $60X and contributes the proceeds along with X's cash to Newco 2, a newly formed wholly owned subsidiary. Alternatively, Newco 2 could borrow the $60X. With the $90X of cash, Newco 2 purchases the remaining 90 percent of T stock and does not merge into T. If the form is respected, a qualified stock purchase will have occurred since Newco 2 will have acquired 90 percent of T's stock from S in a Section 1001 transaction. Newco 2 will not have acquired that stock in a Section 351 exchange, since S will have transferred no property to Newco 2 in exchange for stock. See Rev. Rul. 84-44, 1984-1 C.B. 105.

In this structure, however, there is some risk that Newco 1 will be deemed to have made a "gain recognition election," and will thereby be taxed on the gain in the 10 percent of T that it holds. Since Newco 1 will have acquired that stock in a Section 351 exchange, it represents "nonrecently purchased stock" as to Newco 1. Since Newco 1 and Newco 2 are members of the purchasing group, arguably the deemed gain recognition election rule of Reg. §1.338(h)(10)-1(e)(4) and Prop. Reg. §1.338(h)(10)-1(d)(1) applies. See Section VIII.C.3.c., infra. On the other hand, since the S group will have been taxed on 100 percent of the gain, and S indirectly retains an interest in T, the additional level of tax liability may be viewed as inappropriate in this context.

Example (7): As an alternative, instead of receiving stock, S could receive options, convertible debentures, or similar instruments in the acquisition vehicle. Provided that these do not rise to the level of "stock," Section 351 would not apply to the acquisition. At the same time, however, S will have retained an interest in future growth of T.

E. S Corporations

Prior to The Small Business Job Protection Act of 1996 (the "1996 S Act"), the Service had ruled that P could not be an S corporation on the grounds that Section 1371(a)(2) provided that, for purposes of Subchapter C, an S corporation in its capacity as a shareholder is treated as an individual. Ltr. Rul. 88-18049. This position was reversed in Ltr. Rul. 92-45004. Similarly, see Ltr. Rul. 96-30005. (Also, for purposes of P's S qualification, momentary ownership of T prior to T's liquidation was disregarded. See also Ltr. Rul. 97-45004.) The Small Business, Job Protection Act of 1996 statutorily eliminated these issues.

1. Consequently, a variety of combinations involving C and S corporations are possible.

a. A C corporation can purchase the stock of an S corporation and join in a Section 338(h)(10) election. Continued ownership, however, by a corporate shareholder (P) will prevent New T from qualifying as an S corporation.

(1) As noted in III.C.1.b. supra, Old T's S qualification (and the QSSS qualification of its subsidiaries) continues through the acquisition date to encompass the deemed asset sale.

b. Similarly, an S corporation can purchase the stock of a C corporation and join in a Section 338(h)(10) election. Liquidation of T is no longer necessary to preserve P's S status. Also, for a 100 percent owned T, P can make a QSSS election subsequent to the Section 338(h)(10) election.

c. Further, an S corporation may purchase the stock of a second S corporation and join in a Section 338(h)(10) election. Again, a QSSS election should be available for new T subsequent to the Section 338(h)(10) election.
IV. PROCEDURE

A. Joint Election

The Section 338(h)(10) election is made jointly by P (or the common parent acting on its behalf) and, in the case of a consolidated subsidiary, the selling group (i.e., by a person acting on behalf of the common parent). In the case of a nonconsolidated subsidiary, the selling parent and, in the case of an S corporation, its shareholders must join in the election. Reg. §1.338(h)(10)-1(d)(2). Prop. Reg. §1.338(h)(10)-1(c)(1). The election, once made, is irrevocable. Reg. §1.338(h)(10)-1(d)(3). Prop. Reg. §1.338(h)(10)-1(c)(3).

1. Since consent of the seller is necessary to make a Section 338(h)(10) election (which only makes sense since the seller is agreeing to bear the tax liability), the buyer would be well advised to secure the seller's cooperation at an early stage, and make the election a subject of the stock purchase agreement. Similarly, if a Section 338(h)(10) election is desired by the seller (e.g., to cure a loss disallowance problem which would exist on a straight stock sale), the seller should secure the buyer's agreement to join in the election as part of the stock purchase agreement.

2. Later negotiations between seller and buyer could make the price of the election quite costly. For example, a seller later agreeing to the election would want compensation, both for the additional tax cost of the deemed asset sale as well as the tax cost of the compensation payment itself. A buyer later agreeing to the election would want compensation for the lost basis in assets (unless it could be convinced that the built-in loss rules of Section 382 rendered the higher historic basis worthless in any event), as well as the tax cost of the basis lost by the compensation payment itself.

3. Under the current regulations it is unclear whether all S shareholders, or only those who sell their stock in the qualified stock purchase, must join in the election. The Form 8023 suggests that only those who sell must join. The proposed regulation make clear that all S shareholders, even those who do not sell their stock, must consent to the election. Prop. Reg. §1.338(h)(10)-1(c)(2).

B. Form 8023

The regulations provide that the election is to be made on Form 8023, in accordance with the instructions. Reg. §1.338(h)(10)-1(d)(2), Prop. Reg. §1.338(h)(10)-1(c)(2).

1. Accordingly, all mechanics with respect to making the election are now contained in the form and the instructions, as described below.

2. Once the proposed regulations are made final, the form will generally need to be revised to reflect the changes made.

a. In addition, Prop. Reg. §1.338(h)(10)-1(g) provides that the Commissioner may exercise the information reporting authority granted in Section 338(h)(10)(C)(iii) to require submission of information in a tax reporting form.

b. The Preamble to the proposed regulations indicates that the Service and Treasury are considering requiring the information now submitted on Form 8023 concerning the amount and allocation of basis and selling price instead to be submitted by the purchaser and seller on their tax returns. In such case, implicitly, Form 8023 would be solely a form to make the election.
C. **Due Date**

The election is due by the 15th day of the ninth month beginning after the month in which the acquisition date occurs. Reg. §1.338(h)(10)-1(d)(2). Prop. Reg. §1.338(h)(10)-1(c)(2).

1. If the election is not timely filed, relief under Treas. Regs. §1.301.9100-IT-3T ("9100 relief") would be available, provided the standards for such relief are satisfied. See e.g., Ltr. Ruls. 9831009; 9831008; 9823056; 9823025; 9820019; 9814031; 9814026; 9813017; 9810017; 9810013; 9810004; 9804045; 9802014 (3 companies); 9801039; 9752043 (additional extension granted); 9751024; 9751021; 9747012 (additional extension granted); 9738005; 9738004; 9738003; 9737009 (invalid form filed); 9737008 (same); 9736008; 9734055. For regular §338(g) elections (generally involving foreign targets) see e.g., Ltr. Ruls. 9821042; 9729039, 9727022, 9725034 (wrong purchasing corporation identified on the form), and 9712012.

2. For a case where 9100 relief was denied, see Ltr. Rul. 9745005.

D. **Where to File**

1. Form 8023 is to be filed with the District Director for the Internal Revenue District where the headquarters of the purchasing corporation is located. If the purchasing corporation is a member of a consolidated group, the form is filed in the district where the headquarters of the common parent is located. If an affiliated, but not consolidated, group makes a qualified stock purchase through more than one member, the form is filed in the district of the headquarters of the member acquiring the largest percentage by value of the target stock in the qualified stock purchase.

   a. This filing place represents a change from prior practice. Form 8023-A was required to be filed with the Internal Revenue Service Center where the income tax return including the deemed sale gain would be filed.

2. For foreign purchasing corporations that file U.S. tax returns, Form 8023 is to be filed with the District Director for the Internal Revenue District having jurisdiction over the purchasing corporation. For foreign purchasing corporations that do not file U.S. tax returns, the Form 8023 is filed with the Assistant Commissioner (International). If U.S. shareholders make a Section 338 election on behalf of the corporation, as permitted by Reg. §1.338-1(g)(3), Form 8023 is filed with the District Director having jurisdiction over the single U.S. shareholder having the largest ownership percentage in the foreign purchasing corporation.

E. **Multiple Targets**

1. Like old Form 8023-A, Form 8023 allows a single form to be used for multiple targets with the same acquisition date that are in an affiliated group together both before and after the acquisition date. Form 8023, however, provides special rules for Section 338 elections for lower-tiered targets. For a lower-tiered target, the purchasing corporation of the directly purchased corporation is treated as the purchasing corporation, and the form should be filed with the District Director of that purchasing corporation.

   a. Previously, the form did not specify how elections were to be made for lower tier subsidiaries.

G. **Information Requested**

Among the information requested by Form 8023 is the following:
1. Identifying information with respect to the actual purchasing corporation, and, if a member of a consolidated group, its parent.

2. Identifying information with respect to the target corporation, and, if a Section 338(h)(10) election is made, the common parent of the selling group, the selling affiliate, or all S Corporation shareholders who sell their stock in the qualified stock purchase.
   a. Even if a Section 338(h)(10) election is not made, identification of the common parent is requested if T was a member of a consolidated group.

3. The acquisition date, and (new to this form) the percentage of T stock purchased during the 12-month acquisition period and on the acquisition date.

4. Information from P regarding amounts paid for recently purchased T stock, and a separate break-out of acquisition costs, T liabilities, and, if a Section 338(h)(10) election is not made, the tax on the deemed sale. In addition, the form requests P’s computation of AGUB, and a reporting of the amounts allocated to Classes I-III.
   a. Importantly, the form requests no information on Classes IV and V. Accordingly, taxpayers are not required to distinguish between these classes for this purpose.

5. Similar information is required for the selling consolidated group, selling affiliate, or selling S shareholders (as the case may be) with a computation of MADSP, and a separate break-out of selling costs and liabilities.
   a. With respect to S shareholders, it appears that this information is to be provided in the aggregate, and not shareholder by shareholder.

6. It is sometimes the case that the buyer and seller cannot agree on the information to be supplied on the form. For example, the amount of T liabilities may not be finally ascertained by the due date of the election, or the buyer or seller may have different views on the treatment of certain items. It is critical to note that the instructions confirm that the failure to supply any of the information described in 4. or 5 will not invalidate the election.
   a. Therefore, it would seem appropriate for buyers and sellers to make their best estimates of the numbers, perhaps submitting ranges for the various categories.
   b. The same analysis generally holds true for the reporting of the allocations to Class I-III assets. In this regard, however, the form asks whether the sales contract (or other written document) provided for an allocation of the price and, if so, whether the buyer (no question is asked of the seller) followed that allocation on the form.

7. The form is to be attached to the first return of the New Target and, if different, to the return of the purchasing corporation for the year that includes the acquisition date. Similarly, the form is to be attached to the selling group’s consolidated return, or the selling affiliate’s return for the year including the acquisition date. In the case of S Corporations, the form is to be attached to the final return of the corporation, with copies distributed to each electing S shareholder with his or her Schedule K-1 (presumably, to be attached to the return).
   a. Again, failure to satisfy this filing requirements will not invalidate the election.
   b. Also, unlike Form 8023-A, the form is to be attached to a return only when an election is made.

(1) Similarly, unlike Form 8023-A, Form 8023 does not ask for any information pertaining to the application of the consistency rules.
V. CONSEQUENCES OF THE ELECTION TO SELLER

A. In General

1. The current regulations, through a mixture of general principles and specific rules, treat the seller's side transaction generally as an asset sale by Old T while owned by the selling shareholder(s), followed a complete liquidation of Old T. See Reg. §1.338(h)(10)-1(a), (e)(2)(ii). Further, the consequences on the seller's side are often linked to consequences on the buyer's side.

2. The proposed regulations, while maintaining the same general model, attempt to tie the transaction more closely to the results that would obtain if the deemed transaction, in fact, had actually occurred. Further, the proposed regulations attempt to decouple the seller's results from those on the buyer's side.

3. In this section, we will review the principal elements of the seller's side transaction, pointing out, where relevant, changes and clarifications made by the proposed regulations.
B. **Deemed Sale**

1. **Current regulations.**

   In the consolidated return context, Old T is treated as having sold all of its assets in a single transaction at the close of the acquisition date, and while a member of the selling consolidated group. Reg. §1.338(h)(10)-1(e)(1). Thus, gain or loss on that sale is realized and recognized under usual tax principles. Realized losses are not subject to Section 267 (See Reg. §1.338-3(b)(3)). The results of that deemed sale are reported in the seller's consolidated return for the period that includes the acquisition date.

   a. If T is an S corporation or a nonconsolidated subsidiary, the sale is deemed to occur while T is owned by the S corporation shareholders or by the selling parent. Reg. §1.338(h)(10)-1(e)(1).

2. **Proposed Regulations.**

   a. The proposed regulations provide that Old T is treated as transferring all of its assets to an unrelated person in exchange for consideration that includes the assumption of, or taking subject to, liabilities in a single transaction at the close of the acquisition date. Prop. Reg. §1.338(h)(10)-1(d)(3).

   b. Further, the proposed regulations provide that, except as otherwise provided, other rules of law apply to determine the tax consequences to the parties as if they had actually engaged in the deemed transfer. Such other rules may characterize the transaction as a taxable transaction other than, or in addition to, a sale and purchase of assets. An example given in the regulations includes treatment of the transfer by an insurance company as an assumption re-insurance transaction. Prop. Reg. §1.338-1(a)(2). Similarly, if the Old T's assets include a partnership interest, that transfer would be governed by the rules of Subchapter K. See e.g. Section 708(b)(1)(B).

   c. Similar to the current regulations, the proposed regulations make clear that Old T realizes the gain from the deemed asset sale before the close of the acquisition date while Old T is a member of the selling consolidated group, (or owned by the selling affiliate or the S corporation shareholders). Prop. Reg. §1.338(h)(10)-1(c)(3).

   (1) As noted, when Old T is an S corporation, the proposed regulation make clear that its S election (and, if applicable, any QSSS elections of its subsidiaries) remain in effect through the acquisition date, including the deemed sale. Id.

C. **Price at Which Assets Deemed Sold**

1. **Current Regulations.**

   a. Under the current regulations, a formula specific to Section 338(h)(10) transactions must be used to determine selling price. Reg. §1.338(h)(10)-1(f). That formula determines fair market value by reference to P's basis in its T stock.

   b. The formula is generally the same as the regular aggregate deemed sales price (ADSP) formula set out in Reg. §1.338-3(d), but with the important exception that the tax liability from the deemed sale itself is not factored in (since this amount is paid by the sellers and not by P). Accordingly, no circular computation is required, and the formula is much simpler to apply.
c. Thus, the (h)(10) formula determines a modified ADSP ("MADSP") and is as follows (Reg. §1.338(h)(10)-1(f)(2)):

\[
\text{MADSP} = G + L + X
\]

- \(G\) is the grossed up basis of P's recently purchased stock;
- \(L\) is New T's liabilities as of the beginning of the day after the acquisition date (not including liabilities that were not liabilities of Old T). Reg. §1.338(h)(10)-1(f)(3); §1.338(b)-1(f). T's tax liability resulting from the sale is not included, as this generally would not be considered a liability of New T. Reg. §1.338(h)(10)-1(g); and
- \(X\) is other relevant items. These relevant items would include the adjustments required for events occurring subsequent to the acquisition date, e.g., receipt of contingent amounts, etc. Reg. §1.338(h)(10)-1(f)(5).

d. The general starting point for this computation is P's basis in T stock, the same general starting point as the determination of New T's asset basis. Thus, under the current regulations, items affecting P's stock basis would affect both basis and amount realized concomitantly.

(1) In light of this regime, the current regulations had to make an adjustment so that P's acquisition costs that are capitalized into its basis in the T stock are not taken into account in determining the seller's amount realized under the MADSP formula. See Reg. §1.338(h)(10)-1(f)(4)(i).

(2) Similarly, the regulations had to make clear that the selling group's (or selling shareholders') selling costs that are incurred in connection with the stock sale, and reduce the amount realized on that sale (and are not reflected in P's stock basis) reduce the amount realized under the formula. See Reg. §1.338(h)(10)-1(f)(4)(ii).

e. In applying the formula, T first determines the MADSP and then allocates that aggregate amount among the assets according to fair market values, using the residual method of allocation. Reg. §1.338(h)(10)-1(f)(1).
The residual allocation method is described more fully in Section VI.B.2.e and 3.c., infra.

2. Proposed regulations.
   a. The proposed regulations set out in a single section (Prop. Reg. §1.338-4) the rules for initially determining selling price (ADSP) applicable to both Section 338 (h)(10) and “regular” Section 338 elections.
   b. Further, the proposed regulations —
      (1) Decouple selling price determinations from basis determinations, and,
      (2) As will be seen more clearly in the discussion of contingent payments and contingent liabilities in Section VII below, rely heavily on general principles of tax law (or the uncertainties thereof) to determine tax consequences.
   c. Under the proposed regulations (as under the current regulations), Old T’s assets are deemed sold for a formula amount (ADSP), which amount is allocated among Old T’s assets (pursuant to Prop. Reg. §1.338-6) to determine the amount for which each asset is sold (and, consequently, gain or loss recognized). Further, specific rules are provided (in Prop. Reg. §1.338-7) to take into account, when otherwise required by general principles of tax law, increases or decreases in selling price occurring after New T’s first taxable year. Prop. Reg. §1.338-4(a).
   d. ADSP is defined as the grossed up amount realized on the sale to P of P’s recently purchased T stock, plus liabilities of Old T. Prop. Reg. §1.338-4(b)(1).
      (1) ADSP is initially determined at the beginning of the day after the acquisition date, with general principles of tax law determining the timing and amount of the foregoing elements of ADSP (i.e. amount realized and liabilities). Prop. Reg. §1.338-4(b)(2)(i).
      (2) ADSP is redetermined up or down as general principles of tax law require adjustments in those elements (e.g. an increase or decrease in amount realized for recently purchased stock or in liabilities) Prop. Reg. §1.338-4(b)(2)(ii).
         (i) Increases or decreases taken into account before the close of New T’s first taxable year are treated as if they occurred at the beginning of the day after the acquisition date, and, hence, are part of the initial computation. Id.
   e. Grossed up amount realized in defined as —
      (i) The amount realized on the sale to P of P’s recently purchased T stock (determined as if Old T were the seller and the installment method were not used, and not taking into account Old T’s shareholder’s selling costs);
      (ii) Grossed up by dividing the amount realized number by the percentage of T stock (by value) attributable to the recent purchased T stock; and
      (iii) Then subtracting from the grossed up number the selling shareholders’ costs, incurred in connection with their sale of the
recently purchased T stock to P, that reduced their amount realized. Prop. Reg. §1.338-4(e).

f. Liabilities are defined as under the current regulations to include—

(1) Liabilities of T (and the liabilities to which T’s assets are subject as of the beginning of the day after the acquisition date (other than liabilities that were not liabilities of Old T or liabilities to which Old T’s assets were subject); Prop. Reg. §1.338-4(d)(1); Reg., §§1.338-3(d)(3), 1.338(b)-1(f); and

(2) Only those liabilities of T that would be taken into account (here in amount realized) under general principles of tax law that would apply if Old T had sold its assets to an unrelated person for consideration that included that person’s assumption of, or taking subject to, the liability. Prop. Reg. §1.338-4(d)(1), (d)(2), Reg. §§1.338-3(d)(3), 1.338(b)-1(f)(1), (f)(2).

g. It is noted that there is only one ADSP formula. The distinction between its application to the “regular” Section 338 election and to the Section 338(h)(10) election lies in the definition of includible liabilities. Thus, since, in the latter case, it would be expected (and, indeed, the transaction documents would usually make clear) that the tax liability would be borne by a person other than T (i.e. by the selling consolidated group), this liability is excluded from the calculation, and no circular computation is necessary. See Prop. Reg. §1.338-4(d)(1).

D. Deemed Liquidation


a. For purposes of Subtitle A of the Code, Old T is treated as if, after the deemed sale, and while owned by the selling consolidated group (or the nonconsolidated parent or the S shareholders), it distributed all of its assets in complete liquidation. Reg. §1.338(h)(10)-1(e)(2)(ii).

b. Where Old T is a member of a consolidated return group or a nonconsolidated subsidiary, that liquidation could be governed by Section 332. As a result, under Section 381 Old T’s remaining NOL carryovers would be inherited by its parent, as would be Old T’s E&P, as adjusted for the deemed sale.

c. Where Old T is an S corporation, the deemed liquidation could be governed by Section 331, resulting in a recognition of gain or loss to the S shareholders. At the same time, the gain (or loss) recognized on the deemed asset sale would flow through to those S shareholders pursuant to Section 1366, resulting in an adjustment to the basis of the stock under Section 1367 to be applied against the deemed liquidating distribution. See Reg. §1.338(h)(10)-1(e)(2)(ii).

2. Proposed regulations.

a. Some may have thought that the current regulations conferred liquidation status to the transaction. Accordingly, the argument went, if S was a corporation (as in the case of a consolidated, or an affiliated but not consolidated, T), a Section 338(h)(10) election had to result in a Section 332 liquidation on the back end. Others may have thought that, if Section 332 could not have applied to the deemed liquidation (e.g. because T was insolvent or distributed assets were reincorporated), then a Section 338(h)(10) election could not be made. In either case, the link between the Section 338(h)(10) election and the liquidation
complicated the analysis in those cases where the two could be viewed as inconsistent.

b. The proposed regulations simplify this analysis by severing that link. Thus, rather than providing that Old T distributes its assets in complete liquidation, the proposed regulations provide that (before the close of the acquisition date, and after the deemed sale) Old T transfers all of its assets to members of the selling consolidated group, the selling affiliate, or the S corporation shareholders, and ceases to exist. The proposed regulations further provide that that transfer is treated for Federal income tax purposes as if it had actually occurred, taking into account surrounding transactions that actually or are deemed to occur. Prop. Reg. §1.338(h)(10)-1(d)(4), (d)(5).

Thus, that transfer could be (as it usually will be) a distribution in complete liquidation to which Section 332 (corporate seller) or 331 (S Corporation) applies, or it could be a distribution pursuant to a plan of reorganization (see Prop. Reg. §1.338(h)(10)-1(e), Example 3), a distribution in redemption, one of a series of liquidating distributions, or part of a circular flow of cash. See Sections VIII.D.1.b. and F.4.d.(i).

E. **No Gain or Loss on Sale of T Stock**

No gain or loss is recognized on the actual sale of the T stock by the selling consolidated group, the nonconsolidated parent, or the S corporation shareholders, as the case may be. Reg. §1.338(h)(10)-1(e)(2)(iv). Prop. Reg. §1.338(h)(10)-1(d)(5)(iii).

F. **Installment Reporting**

1. **In general.**

What if the consideration paid by P is, in part, P notes; is installment reporting available?

a. This question arises most frequently (and with some frequency) in transactions involving the acquisition of S Corporations.

(1) Likely, the inapplicability of the interest charge where the obligations held by the taxpayer do not exceed $5 million (Section 453A(b)(2)) makes installment reporting particularly attractive for S Corporation sellers.

b. As a policy matter, there should be no special restriction arising in the Section 338(h)(10) case. Thus, since the seller receives notes from the actual purchaser in the transaction (P), the income should be recognized, as in the usual case, when payment is received on the notes.

2. **Current regulations.**

a. Under the current regulations, a technical issue exists since the term "payment" includes "receipt of an evidence of indebtedness of a person other than the person acquiring the property from the taxpayer." Temp. Reg. §15A.453-1(b)(3). See also Section 453(f)(3). In a Section 338(h)(10) case, the "taxpayer" (i.e., the seller of the property) is deemed to be Old T, and the person "acquiring" the property is deemed to be New T. It is, of course, impossible to give to Old T notes of New T since (a) Old T does not actually sell the property and (b) New T does not exist until the day after the sale. Section 338(a)(2).
3. **Proposed regulations.**

   a. The proposed regulations specifically provide that, as in other asset sales, installment reporting is available in a Section 338(h)(10) transaction. Prop. Reg. §1.338(h)(10)-1(d)(8).

   (1) Nonetheless, various limitations still apply. See Sections 453(i) (recapture); 453(k)(2) (publicly traded property); 453(b)(2)(A)(1) (dealer dispositions); 453(b)(2)(B) (inventory), 453A(a)(1) (interest on deferred tax liability). The regulations also do not indicate how to allocate installment obligations among the assets of Old T (or subsidiaries of Old T).

   (i) In a direct asset sale, the Service has respected specific allocation of installment obligations and cash to various assets acquired. See Rev. Rul. 68-13, 1968-1 C.B.195.

   (2) Further, the Administration’s proposal to eliminate the installment method for accrual basis taxpayers, if enacted, would render this proposed regulation largely meaningless.

   b. In applying the installment sale rules, the proposed regulations treat Old T as receiving in the deemed asset sale New T installment obligations with identical terms to the P notes actually issued (thus eliminating, any zero basis concern on the use of P debt). The remainder of the consideration (other than liabilities) (including any gross-up amount) is treated as received in cash. Prop. Reg. §1.338(h)(10)-1(d)(8)(i).

   c. Further, Old T is treated as distributing in the deemed liquidation the “New T” installment obligations to those shareholders who actually received the P notes. General tax provisions apply to the receipt of these obligations. See e.g. Section 453(h) and the regulations thereunder. The Old T shareholders are treating as receiving the remainder of the proceeds of the deemed liquidation in cash. See Prop. Reg. §1.338(h)(10)-1(d)(8)(ii).

   d. These principles are illustrated in Prop. Reg. §1.338(h)(10)-1(e), Example (10).

VI. **CONSEQUENCES OF THE ELECTION TO BUYER**

A. **Treatment as a New Corporation**

   1. On the P side, New T is treated, for purposes of Subtitle A of the Code, as a new corporation, unrelated to Old T, which purchases the assets of Old T on the day after the acquisition date. Section 338(a)(2); Reg. §§1.338(h)(10)-1(e)(5); 1.338-2(d)(1). Prop. Reg. §1.338-1(a)(1),(b).

   a. Thus, subject to other applicable restrictions (such as those in the consolidated return regulations), New T may adopt any applicable taxable year or method of accounting without obtaining prior approval from the Commissioner. Reg. §1.338-2(d)(1)(ii), Prop. Reg. §1.338-1(b)(1)(ii).

   b. In addition, New T is not related to Old T for purposes of Section 168, and may make independent Section 168 elections. Reg. §1.338-2(d)(1)(i), Prop. Reg. §1.338-1(b)(1)(i). If New T is included in a consolidated return with P, New T’s first year Section 168 deduction, while subject to the applicable convention, should not be further limited by reason of that year being a short taxable year. See Reg. §1.168(d)-1(b)(5)(ii).
Similarly, New T is generally not related to Old T for purposes of the Section 197 anti-churning rules. See Prop. Reg. §1.197-2(h)(8).

See Ltr. Rul 9718006 (treatment as a new corporation for purposes of qualified REIT subsidiary rules of Section 856(i)(2); Ltr. Rul 9652008 (treatment as new corporation for purposes of utility normalization rules of Section 168).

c. These are some exceptions to this rule, however:

(1) Thus, New T and Old T are treated as the same corporation for purposes of—

(i) The rules applicable to employee benefit plans. Reg. §1.338-2(d)(2)(i), Prop. Reg. §1.338-1(b)(2)(i), (v), (vi);

(ii) The mitigation provisions (Sections 1311-1314), Reg. §1.338-2(d)(2)(ii), Prop. Reg. §1.338-1(b)(2)(ii);

(iii) Section 108(e)(5) (relating to the reduction of purchase money debt), Prop. Reg. §1.338-1(b)(2)(iii);

(iv) Certain tax credits, Prop. Reg. §1.338-1(b)(2)(iv); and


(2) Also, a Section 338(h)(10) election does not result in New T being treated as a new obligor for Section 1001 purposes. See Reg. §1.1001-3(e)(4)(F).

d. New T is generally treated as a continuation of Old T for purposes other than Subtitle A of the Code. See Reg. §1.338-2(d)(4), Prop. Reg. §1.338-1(b)(3). Thus, New T retains the following attributes of Old T:

(1) It keeps the same EIN. Reg. §1.338-2(d)(4)(iii), Prop. Reg. §1.338-1(b)(3)(iii);

(2) It continues to be liable for Old T’s tax liabilities, including the liability from the deemed sale and several consolidated return tax liability under Reg. §1.1502-6. Reg. §1.338-2(d)(4)(i), Prop. Reg. §1.338-1(b)(3)(i), §1.338(h)(10)-1(d)(3); and

(3) It is generally treated as the extension of Old T for FICA and FUTA purposes. Reg. §1.338-2(d)(2)(i), (d)(4)(ii); Prop Reg. §1.338-1(b)(3)(ii).

B. Basis

1. In general.

a. It is, of course, the deemed purchase which gives rise to basis revaluation.

b. Both the current and the proposed regulations treat New T as purchasing the assets of Old T for a formula amount, and then provide for the allocation of that amount to individual assets using the residual method of allocation.
c. As is the case on the seller’s side, the proposed regulations attempt to conform more closely Section 338(h)(10) acquisitions with actual asset acquisitions, by linking the results more closely with general principles of tax law.

d. Similarly, as above, the proposed regulations attempt to decouple the buyer’s basis determinations from the seller’s gain or loss determinations.

e. Further, to address the problem of the allocation of a “bargain purchase” (i.e. assigning to basis less than fair market value, perhaps by reason of a contingent purchase price or contingent liabilities) to assets with a rapid turnover (such as receivables and inventory, so-called “fast pay” assets), the proposed regulations modify the allocation classes.

2. Current regulations.

a. Aggregate basis amount.

(1) As noted, the aggregate basis amount (adjusted grossed up basis or AGUB) is tied to the aggregate deemed sales price amount (MADSP)

(2) AGUB is defined as the sum of--

(i) The grossed up basis in P’s recently purchased T stock;

(ii) P’s basis in nonrecently purchased T stock;

(iii) New T’s liabilities; and

(iv) Other relevant items.

Reg. §1.338(h)(10)-1(e)(5), 1.338(b)-1(c)

b. P’s grossed up basis in recently purchased T stock.

The “grossed-up basis” of the recently-purchased stock is that amount P would have paid for all of the T stock based on what P paid for the stock counted as part of the qualified stock purchase. Reg. §§1.338(b)-1(d)(2); 1.338(h)(10)-1(e)(4), 1.338-(b)-1(e).

c. Liabilities of New T.

(1) Liabilities of New T which increase basis include its liabilities and the liabilities to which its assets are subject, as of the beginning of the day after the acquisition date. The tax liability resulting from the deemed sale is not included in basis if a Section 338(h)(10) election is made. Reg. §1.338(b)-1(f)(1).

(2) To be included in basis, an obligation must be a “bona fide liability” of New T as of the beginning of the day after the acquisition date that would be includible in basis under “principles of tax law” that would apply if New T had acquired Old T’s assets from an unrelated party and assumed (or taken property subject to) its liabilities. Accordingly, if the amount of an Old T obligation is contingent or speculative, such that it would not be included in basis under general tax principles, it is not includible in the basis of New T’s assets as the beginning of the day after the acquisition date.

Reg. §1.338(b)-1(f)(1), (2).
(a) Increases or decreases in T's liabilities which occur before the close of New T's first taxable year are taken into account as of the beginning of the day after the acquisition date. Thus, if a contingent obligation then becomes fixed and determinable, the resulting obligation is treated as if it existed as of the beginning of the day after the acquisition date. See Reg. §§1.338(b)-1(g)(1), 1.338T(b)-3T(b)(1).

d. **Other relevant items.**

(1) "Other relevant items" which increase (or decrease) basis include basis adjustments resulting from events that occur after the close of New T's first taxable year. These include, changes (up or down) in basis-includible liabilities, the payment of a contingent purchase price for T stock, or a reduction in purchase price. Reg. §1.338(b)-1(g)(1), -3T.

(2) In addition, authority is conferred on the District Director (in connection with the examination of a return) to increase or decrease aggregate basis, and to allocate that increase or decrease among New T's assets, to insure that basis properly reflects the cost to P. Reg. §1.338(b)-1(g)(3).

e. **Allocation.**

The aggregate basis amount is allocated among New T's assets under the usual basis allocation rules. Reg. §1.338(h)(10)-1(e)(5), Temp. Reg. §1.338(b)-2T, -3T.
(1) **Classes.**

The current regulations divide New T's assets into five classes, as follows:

(i) **Class I assets.**

These are basically cash items. Thus, included are cash, demand deposits, and similar accounts in banks, S&Ls and similar depository institutions. In addition, the Service has authority to designate additional Class I items in the Internal Revenue Bulletin (I.R.B.). Temp. Reg. §1.338(b)-2T(b)(1).

(ii) **Class II assets.**

These are highly liquid, cash-like assets. Included are CDs, U.S. government securities, readily marketable stock or securities (as defined in Reg. §1.351-1(c)(3)), and foreign currency. Here too, the Service has authority to designate additional items in the I.R.B. Temp. Reg. §1.338(b)-2T(b)(2)(ii).

(iii) **Class III assets.**

Class III assets are all assets of New T other than those in Classes I, II, IV, or V. Temp. Reg. §1.338-2T(b)(2)(iii).

(iv) **Class IV assets.**

Class IV are all Section 197 intangible assets except those in the nature of goodwill and going concern value. Temp. Reg. §1.338(b)-2T(b)(2)(iv).

(v) **Class V assets.**

Class V assets are Section 197 intangibles in the nature of goodwill and going concern value.

(2) **Consecutive allocation.**

Aggregate basis is first reduced by the Class I assets. Temp. Reg. §1.338-2T(b)(1). Then, the remaining basis is assigned consecutively to the classes. Thus, the aggregate amount is assigned first to Class II assets, to the extent of the fair market values at the beginning of the day after the acquisition date of all assets in that class, then to Class III and IV assets (to the extent of their fair market values), with any residual or remaining basis being allocated to the Class V assets. Temp. Reg. §1.338(b)-2T(b)(2).

(i) If there is not enough basis to cover an entire class, the allocation within that class is in proportion to the fair market values of the class assets. Temp. Reg. §1.338(b)-2T(b)(2)(i).

(ii) The fair market value of an asset to be used for allocation purposes is the gross, and not the net, value of that asset. Temp. Treas. Reg. §1.338(b)-2T(a)(2).
(3) **Required residual method of allocation to goodwill.**

As a result of this approach, the regulations require that Section 197 intangibles are to be assigned basis based on use of the "residual method." Thus, P is not permitted to value such intangibles separately, nor to assign any premium in excess of the total value of New T's assets (including intangibles) on a pro-rata basis over all of New T's assets.

(i) The prescribed use of the residual method could work to the taxpayer's benefit, however, in the case where a bargain purchase is made (i.e., the total price paid is less than the fair market value of New T's assets). In that situation, application of the residual method precludes the Service from assigning basis to intangibles because there is no residual amount to be assigned to Classes IV and V.

(4) **Application to subsidiaries.**

This allocation regime similarly applies to subsidiaries of T, treating the stock of a subsidiary as a Class III asset. See Temp. Reg. §1.338(b)-2T(d), Example (1), (2); Reg. §1.338-2(b)(4), Reg. §1.338(b)-1(g)(2); Temp. Reg. §1.338(b)-3T(j); Example (3); Reg. §1.338(h)(10)-1(g)(2), Example (4); Reg. §1.338(h)(10)-1(f)(1)(ii). See Section VIII.E., infra.

3. **Proposed regulations.**

a. **In general.**

The rules for determining the AGUB are set forth in Prop. Reg. 1.338-5, the allocation rules are in Prop. Reg. §1.338-6, and the rule pertaining to subsequent adjustments are in Prop. Reg. §1.338-7.

b. **AGUB.**

(1) **In general.**

AGUB is defined similarly to the current definition (adjusted grossed up basis of recently purchased T stock, plus basis of nonrecently purchased stock, plus liabilities). The "other relevant items" category is eliminated. Prop. Reg. §1.338-5(b)(1).

(2) **Time and amount.**

As with ADSP, AGUB is initially determined as of the beginning of the day after the acquisition date, with the timing and amount of the elements determined and, if necessary redetermined, under general principles of tax law. Increases or decreases in the elements of AGUB taken into account before the close of New T's first taxable year are taken into account, and hence reflected in basis, at the beginning of the day after the acquisition date. Prop. Reg. §1.338-5(b)(2).

(3) **Grossed up basis.**

As under the current regulations (and unlike the proposed regulations treatment of ADSP), the starting point for the basis determination is P's basis in its recently purchased T stock. Unlike the current regulations,
P's acquisition costs are added after the gross up (i.e. acquisition costs themselves are not grossed-up). Prop Reg. §1.338-5(c).

(4) **Liabilities.**

The liability rules of Prop. Reg. §1.338-5 are very similar to those of the current regulations. Compare Prop. Reg. §1.338-5(e) with Reg. §1.338(b)-1(f). While more properly appearing in Prop. Reg. §1.338-7 (relating to subsequent adjustments), and arguably a change from the current regulations, Prop. Reg. §1.338-5 contains an example illustrating that liabilities are not taken into account (and hence are not reflected in basis) until economic performance (within the meaning of Section 461(h)) has occurred. See Prop. Reg. §1.338-5(b)(2)(iii), Example 2.

(5) **Adjustments.**

The proposed regulations also contain the rule in the current regulations allowing the District Director to make changes in the amount and allocation of AGUB to "properly reflect" the cost to P. Prop. Reg. §1.338-5(f).

c. **Allocation.**

(1) **In general.**

Like the current regulations, the proposed regulations provide for the residual method of allocation, based on gross fair market values, applicable to both selling price (ADSP) and purchase price (AGUB). Prop. Reg. §1.338-6(a)(2)(i).

(i) No specific allocation of transaction costs is permitted. Rather, these costs are treated as part of the ADSP or AGUB, and subject to the general allocation. Prop. Reg. §1.338-6(a)(2)(ii). Contrast Prop. Reg. §1.1060-1(c)(3).

(ii) Also, the proposed regulations reserve the authority for the Service to challenge the determination of the fair market value of any asset by any appropriate method, taking into account factors such as lack of adverse interests and independent valuation of goodwill. Prop. Reg. §1.338-6(a)(2)(iii).

(2) **Classes.**

The proposed regulations add two new classes to include short lived ("fast pay") assets, thus reducing the possibility that a "bargain purchase" (e.g. caused by contingent purchase price or contingent liabilities) will result in short term recognition of income to the buyer. The new classes are as follows.

(i) **Class I** – cash and general deposit accounts (savings and checking accounts) other than CDs held in banks, S&Ls and other depositories. The proposed regulations also provide that if Class I assets exceed AGUB, New T will immediately realize ordinary income in the amount of the excess. Prop. Reg. §1.338-6(b)(1). Similarly, is a deduction allowed to Old T for that same amount?
(ii) **Class II** – actively traded personal property (as defined in Section 1092(d)(1) and Reg. §1.1092(d)-1 (determined without regard to Section 1092(d)(3)), CDs, and foreign currency. This definition is slightly different than under the current regulations which focus on marketable stock and securities (whether the meaning of Reg. §1.351-1(c)(3).

(iii) **Class III** – new to the regulations, accounts receivable, mortgages, and credit card receivables from customers arising in the ordinary course of business.

(iv) **Class IV** – also new to the regulations, stock in trade, property properly included in inventory, and property held for sale to customers in the ordinary course of business.

(v) **Class V** - all assets other than those in Class I, II, III, IV, VI and VII.

(vi) **Class VI** - all Section 197 intangibles except goodwill and going concern value.

(viii) **Class VII** – goodwill and going concern value (whether or not qualifying as a Section 197 intangible).

(3) **General principles of tax law.**

As in other areas, the proposed regulations make clear that any ADSP or AGUB allocation is subject to other provisions of the Code, or general principles of tax law, as if the assets were transferred to, or acquired from, an unrelated person in a sale or exchange. Prop. Reg. §1.338-6(c)(2). Examples given include Section 1056(a) (limiting amounts allocated to athlete player contracts) and Section 197(f)(5) (relating to allocations to Section 197 intangibles arising from assumption - reinsurance transactions).

C. **Other Consequences**

1. **Consistency.**

   The Section 338(h)(10) election renders inapplicable the asset consistency rules of Section 338(e). Reg. §1.338-4(c)(2) (consistency called off if Section 338 election made for T) and Section 1.338-4(b)(2) (Section 338(h)(10) election treated as asset not stock acquisition for consistency purposes).

   a. At the same time, however, the general treatment of a Section 338(h)(10) election as an asset acquisition can invoke the consistency rules – and hence require a carryover basis for such acquisition – if the P group also acquires the stock of a higher tier corporation and does not make a Section 338 election. This result obtains because the gain from the Section 338(h)(10) election will tier up and influence the gain derived from the sale of the stock of the higher tier member. See Reg. §1.338-4(a)(6), (e)(2), Example (2).

2. **T's several tax liability.**

   Notwithstanding substantial arguments to the contrary, as noted, the regulations provide expressly that New T remains severally liable for consolidated return tax liability (including the tax on the deemed sale) attributable to periods in which Old T was a member of the
VII. ADJUSTMENTS TO BASIS AND SELLING PRICE – CONTINGENT PAYMENTS AND CONTINGENT LIABILITIES

A. Contingent Payments


a. In general.

The current Section 338(h)(10) regulations have a specific accounting regime for contingent payments (such as earn-outs and similar purchase price arrangements). Whether by design, or accident of history, this regime differs (particularly on the seller side) from the rules applicable to contingent payments in actual asset acquisitions.

b. Buyer’s side.

Thus, pursuant to Temp. Reg. §1.338(b)-3T(c)(1), a “contingent amount” is taken into account in calculating adjusted grossed up basis only at the time such amount becomes “fixed and determinable.” A “contingent amount” is defined as the amount of consideration to be paid for stock of T that is not fixed and determinable by the close of New T’s first taxable year. Temp. Reg. §1.338(b)-3T(b)(2). Once the contingent amount is taken into account, it is allocated among New T’s acquisition date assets under the usual residual allocation method provided in §1.338(b)-2T. See Temp. Reg. §1.338(b)-3T(d). Such allocation is subject to the limitation that an amount cannot be allocated to an asset in excess of its fair market value, as determined at the beginning of the day after the acquisition date. Presumably, the imputed interest rules of Sections 1274 and 483 apply. See Reg. §1.338(b)-3T(j). Rules are provided to account for the situation where the acquisition date asset has been disposed of (or depreciated) before the adjustment occurs. See Reg. §1.338(b)-3T(d)(2).

c. Seller’s side.

On the seller’s side, Temp. Reg. §1.338(b)-3T(b)(1)(ii) provides that, if the MADSP formula is used to determine sales price, that sales price is redetermined “to the extent required by general principles of tax law,” to take into account “adjustment events” occurring after the acquisition date. An “adjustment event” is defined in Reg. §1.338(b)-1(b)(1) to include an increase in the consideration paid for recently purchased stock. The regulations further provide that the change in the aggregate deemed sales price is taken into account for the taxable year in which the adjustment event occurs. Temp. Reg. §§1.338(b)-3T(h)(3), 1.338(b)-3T(j), Example (4). Also, since MADSP is a function of P’s stock basis, the timing of the increase in that stock basis should similarly govern the timing of the increase in the selling price and, hence, gain recognized.

(1) Thus, the Section 338(h)(10) regulations adopt an “open transaction” regime with respect to the receipt of contingent payments.

(2) Query how the later receipt of contingent payments is to be reported by S corporation shareholders.

(i) The approach that appears to be contemplated by the regulations is for the S corporation to be viewed as continuing for purposes of reporting additional asset sale gain. On this approach, additional S corporation returns would be filed, and K-1s issued, to report the receipt of the contingent payments, and the S
corporation shareholders would reflect such payments on their individual returns in the same manner as their original reporting of the noncontingent payments.

(ii) A second approach would be to view the right to the contingent payments as having been distributed in the deemed Section 331 liquidation of the S corporation. On this theory, gain may be recognized on that distribution, with the consequences that the transaction would now be closed for tax purposes. This approach is inconsistent, however, with the regime otherwise established for contingent payments applicable, for example, to consolidated targets. There appears to be no reason or language in the regulations to suggest that S corporations are to be treated differently in this regard.

2. Proposed regulations.

a. In general.

The proposed regulations, in accordance with the general theme, provide no special regime for contingent payments, and decouple consequences to the buyer from consequence to the seller.

b. Buyer's side.

Thus, Prop. Reg. §1.338-5(b)(ii) provides that AGUB is to be redetermined "at such time and in such amount" as would be required under general principles of tax law with respect to the elements of AGUB (e.g. an increase in the amount paid for T stock). The effect of redeterminations occurring after New T's first taxable year is set forth in Prop. Reg. §1.338-7.

(1) As under the current regulations, increases (or decreases) are allocated to New T's acquisition date assets, limited to acquisition date fair market values. Prop. Reg. §1.338-7(b).

(2) Similar rules are provided for cases in which the acquisition date asset has been disposed of (or depreciated) before the increase occurs. Prop Reg. §1.338-7(d).

c. Seller's Side.

Similarly, Prop. Reg. §1.338-4(b)(2)(ii) provides that ADSP is redetermined "as such time and in such amount" as would be required under general principles of tax law. Thus, for example, ADSP is redetermined because of an increase or decrease in the amount realized for recently purchased stock.

(1) Under general principles of tax law, the receipt of a contingent debt instrument would either be subject to installment reporting under Section 453, or would be subject to Reg. §1.1001-1(g). Under this latter provision, in general, the contingent payments must be valued, the transaction is closed, and the amount realized reported accordingly. A contingent payment transaction will be left open only in "rare and extraordinary cases" where the fair market value of the contingent payments is not readily
ascertainable. Accordingly, in general, amount realized is generally not affected by later receipt of contingent payments.

B. **Contingent Liabilities**

1. **Current regulations.**
   
a. **In general.**

   Similarly, the current regulations have a specific accounting regime for contingent liabilities. As a preliminary matter, this regime is applicable only to those liabilities that are not properly viewed as deductible liabilities of New T. Distinguishing, however, assumed capitalizable Old T liabilities from deductible New T liabilities is not so easy to do. See e.g. Ltr. Rul. (TAM) 9721002, FSA 1999-1068.

b. **Buyer’s side.**

   New T is awarded basis when the liability becomes “fixed and determinable.” Temp. Reg. §1.338(b)-3T(c)(1). As with contingent payments, that increase is then allocated over New T’s acquisition date assets, generally based on their fair market values on that date. Temp. Reg. §1.338(b)-3T(d)(1). If the original allocation already covered classes I-III, any additional basis will be allocated to Section 197 intangibles.

   (1) Here too, rules are provided to account for the situation where the acquisition date asset has been disposed of (or depreciated) before the adjustment occurs. See Reg. §1.338(b)-3T(d)(2).

c. **Seller’s side.**

   That payment may also have consequences to S. Since the MADSP formula is used, under Temp. Reg. §1.338(b)-3T(h)(1) once the liability becomes fixed, a recomputation of the gain may be necessary, taking into account the additional amount as sales proceeds. If original allocation went into classes IV and V, the additional proceeds would similarly be allocated to a sale of Section 197 intangibles. S, as a preliminary matter, may have to report the income in the return for the taxable year in which the item becomes fixed. Temp. Reg. §1.338(b)-3T(h)(1), (3).

   (1) If S (through T) is treated as receiving additional proceeds and, hence, must recognize additional gain, should S not be allowed a deduction for the additional amount (to the extent the liability was otherwise deductible)? Indeed, since S does not actually receive any additional payments, it seems inappropriate to treat it as having realized an additional amount for income purposes and not having paid out a like amount, which should be eligible for deduction.

   (i) S’s right to deduction could find support in Commercial Security Bank v. Comm’rr, 77 T.C. 145 (1981); James M. Pierce Corp. v. Comm’rr, 13 AFTR 2d 358, 64-1 USTC §9173 (8th Cir. 1964); Cooledge v. Comm’rr, 40 BTA 1235 (1939), and the philosophy behind Section 357(c)(3).

   (ii) See Ltr. Rul. 9125001 (TAM) specifically permitting a deduction to Old T. This TAM did not address the timing of that deduction.
2. Proposed regulations.
   a. In general.
   As with contingent payments, the proposed regulations provide no special
   regime for contingent liabilities. Similarly, those regulations decouple
   the buyer's results from those of the seller.
   b. Buyer's side.
   The same provisions as apply to contingent payments (Prop. Reg. §1.338-
   5(b)(2)(ii),-7) apply to contingent liabilities. Thus, if AGUB is
   redetermined, under general principles of tax law, because liabilities
   originally excluded from basis under Prop. Reg. §1.338-5(e) are
   subsequently taken into account, that increase is allocated as described
   above. As noted, the proposed regulations make clear that the basis
   increase occurs when the economic performance requirement is met, not
   when (as under the current regulations) the liability becomes fixed and
   c. Seller's side.
   Similarly, the same general provision (Prop. Reg. §1.338-4(b)(2)(ii),-7)
   apply to contingent liabilities. Thus, if amount realized is increased
   because a liability originally excluded from amount realized under Prop.
   Reg. §1.338-4(d) is subsequently taken into account, that increase is
   allocated as an offset to ADSP under Prop. Reg. §1.338-7.

   (1) Reliance on general principles of tax law, of course, imports all
   of the uncertainties of those principles. Accordingly, it is
   uncertain whether general principles require contingent
   liabilities to be valued and included in amount realized at the
   closing of the transaction. The proposed regulations suggest that
   they do. See Prop. Reg. §1.338-5(b)(2)(iii), Example (2) (last
   sentence).

   (2) Similarly, the proposed regulations are silent on the existence or
   timing of an offsetting deduction. The citation, however, to Reg.
   §1.461-4(d)(5) in Prop. Reg. §1.338-5(b)(2)(iii), Example 2,
   suggests that the Service believes (appropriately) that the
   deduction is taken into account concurrently with the income. If
   so, seller's side consequences should be academic (unless the
   taxpayer desires to include the amount realized as capital gain
   and the deduction as offsetting ordinary income).

VIII. OTHER ISSUES
A. The Problem of the Affiliated, Nonconsolidated T
   1. Where T is an affiliated, nonconsolidated corporation, the Section 338(h)(10) election may
      produce unanticipated results.
   2. Thus, upon the election being made, T is treated as having sold its assets and liquidating
      into its electing, selling parent (S). Since, however, T and S do not file a consolidated
      return, the tax liability from that sale (as well as T's liability from operations) is a liability
      of the separate corporation, T. Since T will be owned by the buyer when the return is filed
      and tax is paid, the liability is, economically, a liability of the buyer. Accordingly, even
though the election is one to which Section 338(h)(10) applies (and must be joined by the seller), the result is similar to that in the "regular" Section 338(g) case in that the buyer pays the tax. Well-informed buyers, therefore, should reduce the purchase price to take into account this assumed liability.

3. Further, the current regulations apparently do not contemplate that Old T's deemed sale gain under the MADSP formula will be computed by taking this tax liability into account. Contrast Reg. §1.338(h)(10)-1(f)(2), (g) with Reg. §1.338-3(d)(3), (8).

a. The proposed regulations appear to reach the opposite conclusion. See Prop. Reg. §1.338-4(d)(1).

4. While not usually the case in the Section 338(h)(10) context, it would seem that Old T's tax liability should be added to the basis of New T's assets. Cf. Reg. §1.338(h)(10)-1(e)(5).

a. Under the proposed regulations, in this case, basis inclusion is linked to inclusion in ADSP. See Prop. Reg. §1.338-5(e)(1) (last sentence).

B. Intercompany Transfers of T Stock

1. If, prior to the sale of T stock, that stock was transferred at a gain in an intercompany transaction, the deemed dissolution resulting from the Section 338(h)(10) election may cause that gain to be taken into account. As a result, the Section 338(h)(10) election could result in a double gain, one on the deemed sale of Old T's assets and a second on the earlier intercompany transfer of the Old T stock. See Reg. §1.1502-13(f)(5)(i).

2. The final intercompany regulations provide elective relief from this result. Thus, if the relief election is made, the owning member of the T stock may, notwithstanding the LDR rules, recognize a stock loss on the deemed liquidation of Old T as if Section 331 (rather than Section 332) applied to that liquidation. See Reg. §1.1502-13(f)(5)(ii)(C).

a. That loss may not exceed, however, the selling member's net gain on the intercompany transactions involving the Old T stock.

b. Similarly, the recognized loss may not exceed the loss that would otherwise be recognized if Section 331 actually applied to the deemed liquidation.

3. This relief is available, however, only if the election is made (and only if Old T was a member of the group throughout the period beginning with the first intercompany transfer and ending with the deemed Section 332 liquidation, i.e., the date of the qualified stock purchase.) Reg. §1.1502-13(f)(5)(ii)(A).

a. The details of that election are set forth in Reg. §1.1502-13(f)(5)(ii)(E). The election must be filed with the group's return for the year of the transaction.

4. When the intercompany transaction occurred in a taxable year beginning before July 12, 1995, elective transitional relief was available where (a) the Section 338(h)(10) transaction occurred on or after July 12, 1995 and (b) the election was made in the consolidated return for the year including July 12, 1995. Reg. §1.1502-13(f)(3). Accordingly, if the Section 338(h)(10) transaction occurred prior to July 12, 1995, or the transitional relief election was not timely filed, the transaction may be subject to the harsh double tax result of prior law. As to the election requirement, would "9100 relief" be available? Cf. Ltr. Rul 9834032.
C. **Cost of T Shareholders Selling Less Than 100 Percent of T**

1. If the selling T shareholders want to retain a piece of T, or own less than 100 percent to begin with, the Section 338(h)(10) election becomes more expensive.

2. For example, if S wants to retain 10 percent of T's pre-transaction value, nonetheless, Old T, while in the S group, recognizes gain as if 100 percent of its assets are sold. Reg. §1.338(h)(10)-1(g), Example (2). Prop. Reg. §1.338(h)(10)-1(d)(3). Thus, although S will receive only 90 percent of T's value in proceeds, S recognizes gain on 100 percent of the appreciation. Similarly, a nonconsolidated subsidiary will recognize gain on 100 percent of its assets.

   a. This same result obtains with respect to the shareholders of an S corporation T since 100 percent of the gain will flow through to the shareholders under Section 1366.

   b. To some extent, this additional tax to S is a prepayment of S's liability, since S will receive a basis step up in its retained stock at no additional tax cost. S's new basis will be equal to its fair market value determined by reference to the MADSP formula. Reg. §1.338(h)(10)-1(e)(2)(iii)-1(g), Example (2). See Prop. Reg. §1.338(h)(10)-1(d)(5)(i). Nonetheless, this acceleration in tax payment can be costly to S.

   (1) In the case of an S corporation T, the regulations similarly provide that, the basis of stock retained by the S shareholders is revalued to fair market value. Reg. §1.338(h)(10)-1(e)(2)(iii), Prop. Reg. §1.338(h)(10)-1(d)(5)(i). It would seem, however, that a similar result would be provided through the operation of Section 1367.

3. In the case of a consolidated T or a nonconsolidated subsidiary, if the seller only owned 90 percent of T to begin with, there is a double tax on the remaining 10 percent. Thus, as above, Old T recognizes the full gain.

   a. If the 10 percent is held by a person other than P, no gain or loss is recognized on the stock, and basis and holding period remain unchanged. Reg. §1.338(h)(10)-1(e)(3)(iii), -1(g), Example (3). Prop. Reg. §1.338(h)(10)-1(d)(6)(iii). Thus, a second level of tax would occur upon the sale of that T stock or the liquidation of T.

   (1) In addition, unless arrangements are otherwise in effect between the S group (or T where nonconsolidated) and the minority, the S group (or T) bears the minority's share of the corporate level tax.

   (2) Where S bears the full tax cost, the economics of the transaction are obviously skewed to S's detriment. In that case, the desirability of the Section 338(h)(10) election to S or P, as the case may be, and the amounts S or P are willing to pay for that election, may be seriously tested.

   b. If the 10 percent is held by an S corporation shareholder who does not otherwise participate in the sale to P, the results are similar to those which result in the consolidated case. Thus, T will recognize the full 100 percent of its gain, which will flow through to all of the S corporation shareholders under Section 1366, and basis will be adjusted under Section 1367 (and perhaps Reg. §1.338(h)(10)-1(e)(2)(iii)) and Prop. Reg. §1.338(h)(10)-1(d)(5)(i). See Prop. Reg. §1.338(h)(10)-1(d)(5).
c. If the 10 percent is held by P (or a member of the P group? See Reg. §§1.338(h)(10)-1(b)(2), 1.338-1(c)(7), Prop. Reg. §1.338-2(b)(2), (11)), the double tax occurs immediately, since P is deemed to have made a "gain recognition election" with respect to those shares. Reg. §1.338(h)(10)-1(e)(4); Reg. §1.338(h)(10)-1(g), Example (5). Prop. Reg. §1.338(h)(10)-1(d)(1). See generally Reg. §1.338(b)-1(e)(2), Prop. Reg. §1.338-5(d).

D. S is to Retain Certain Old T Assets

1. What if P doesn't want to buy, or S doesn't want to sell, certain assets of Old T? For example, assume S wants to keep the land owned by Old T since S believes that it will continue to appreciate rapidly. As part of the overall plan, T distributes the land to S, S sells the T stock and a Section 338(h)(10) election is made. What is the consequence of the distribution?

a. If clearly part of the overall transaction, it would seem that the distribution should be treated as part of T's Section 332 liquidation into S. If so, T would recognize no gain on the distribution (Section 337(a)), and S would take a carryover basis in the property (Section 334(b)(1)).

The Service has ruled that the distribution is part of the Section 332 liquidation. See e.g., Ltr. Ruls. 9738031, 9735038, 9434009, 9303006, 9137040, 9044063, and 8938036. In these rulings, T adopted a plan of complete liquidation prior to the stock sale and asset distribution, and P was obligated to purchase the T stock simultaneously with the distribution of the unwanted assets.

(1) In line with the model of the proposed regulations, treating the deemed transfer to shareholders as if it had actually occurred, and determining consequences by taking into account surrounding transactions (Prop. Reg. §1.338(h)(10)-1(d)(4)(i)), those regulations similarly make clear that a distribution made as part of a transaction agreed to by the parties that contemplates the distribution, stock sale and Section 338(h)(10) election will be treated as part of the Section 332 liquidation of Old T. In these circumstances a plan of complete liquidation is deemed adopted by Old T. See Prop. Reg. §1.338(h)(10)-1(e), Example 2.

b. Would the result be different if the distributed properties were dropped down by S to a controlled subsidiary after the stock sale (See Ltr. Rul. 9210041, supplementing Ltr. Rul. 9137040), or assets were dropped by Old T to a controlled subsidiary whose stock is distributed by T as part of the Section 332 liquidation (See Ltr. Rul. 9738031; distributed stock further distributed to Old T's grandparent)?

(1) It would seem that, here too, the model will prove quite helpful. Thus under the model (which delinks the Section 338(h)(10) election from the back end distribution), S's sale of the T stock to P will be eligible for a Section 338(h)(10) election. Accordingly, New T will take as its basis, and Old T will recognize as gain or loss, the amounts ordinarily determined under the Section 338(h)(10) regime with respect to those assets in T at the time of the stock sale. The treatment on the seller's side of the deemed distribution depends on general principle of tax law (and the uncertainties thereof). If, under those principles, the reincorporation causes a complete liquidation of Old T not to have occurred, assets not reincorporated could be viewed as distributed in a transaction to which Section 301 applies (with attendant Section 311(b) gain), and Old T's tax attributes may reside in the transferee corporation.
E. Treatment of T Subsidiaries

1. In line with the general abolition of the stock consistency rules of Section 338(f) (Reg. §1.338-4(a)(6)), the regulations no longer apply a consistency rule to Section 338(h)(10) elections. Thus, if Section 338(h)(10) treatment is desired for lower tier subsidiaries, it must be affirmatively elected.

   a. It would seem that a joint election is similarly required.

   b. If a Section 338 election is made for the lower tier subsidiary, no gain is recognized on the deemed sale of its stock. See Reg. §1.338(h)(10)-1(e)(2)(v); Reg. §1.338-3(c)(2). Prop. Reg. §1.338(h)(10)-1(d)(6), 1.338-4(h). Gain is recognized, however, if no Section 338 election is made for the subsidiary. See Reg. §1.338(h)(10)-1(e)(2)(v), Prop. Reg. §1.338(h)(10)-1(e), Example 1.

   c. If a Section 338(h)(10) election is made for T, can a regular Section 338 election be made for a lower tier subsidiary? It appears so. It also appears that the regular Section 338 election eliminates the gain recognized in the S group on the deemed sale of stock of the lower tier subsidiary. See Reg. §1.338-3(c)(2), 1.338(h)(10)-1(e)(2)(v), Prop. Reg. §1.338(h)(10)-1(e) Example 1.

   d. One could also make a regular Section 338 election for T and a Section 338(h)(10) election for Old T subsidiaries. Since, however, the regular election causes Old T to be disaffiliated for purposes of its deemed sale (Reg. §1.338-1(e)(2)(i), Prop. Reg. §1.338-10(a)(2)(i)), the sale of the stock of Old T's subsidiaries will not occur while they are members of the S group. Accordingly, the Section 338(h)(10) election will be governed by the rules applicable to nonconsolidated subsidiaries.

2. As indicated in VI.B.2.e.(4) supra, the consecutive basis allocation rules apply to subsidiaries of New T treating the stock of those subsidiaries as Class III assets. Thus, where a bargain purchase is made of T, the effect of that bargain will filter down to the assets of T's direct and lower tier subsidiaries. Further, the effect of the bargain is magnified if there is also a bargain element in the subsidiaries themselves.

   Example. T owns all of the stock of T1, which, in turn, owns all of the stock of T2. The value of T's assets (other than the stock of T1) is $4,000. The value of the stock of T1 is $1,000. The value of the assets of T1 (other than the stock of T2) is $1,100. The value of the stock of T2 is $100 and the value of its assets is $150. P purchases the T stock for $4,500 and P and S join in Section 338(h)(10) elections for T, T1, and T2.

   Assuming all assets are Class III (Class V under the proposed regulations), if all were held in T, the basis allocated to the T assets would be $3,428 ($4,000/5,250 X $4,500), the basis allocated to the T1 assets would be $942 ($1,100/5,250 X $4,500), and the basis allocated to the T2 assets would be $128 ($150/5,250 X $4,500). See Prop. Reg. §1.1060-1(b)(6). The tiering regime, however, gives the following results.

   The $4,500 purchase price of T is allocated pro rata to its other Class III assets ($4,000 / $5,000 X $4,500 = $3,600) and to its stock of T1 ($1,000 / $5,000 X $4,500 = $900). In turn, the $900 allocated to the stock of T1 is allocated pro rata to its other Class III assets ($1,100 / $1,200 X $900 = $825) and to its stock of T2 ($100 / $1,200 X $900 = $75). Finally, the $75 allocated to the stock of T2 is allocated to its $150 of assets, resulting in a 50 percent reduction from fair market value. Indeed, this tiering regime could result in Class II assets held by lower tier entities not being accorded full basis, whereas that result would not occur (and is not intended to occur) if those assets were held by T.

3. Similarly, the tier approach may skew the allocation depending on the location of liabilities.
Example: T owns all of the stock of T₁, which, in turn, owns all of the stock of T₂. The value of T’s assets (other than the T₁ stock) is $4,000. The value of the stock of T₁ is $1,250. The value of the assets of T₁ (other than the stock of T₂) is $2,000 and the value of the stock of T₂ is $250. Also, T₁ has liabilities of $1,000. The value of the assets of T₂ is $1,250, and T₂ has liabilities of $1,000. P purchases the T stock for $4,500 (again, a bargain purchase), and T and S join in Section 338(h)(10) elections for T, T₁, and T₂. Assuming all assets ($7,250) and liabilities ($2,000) are Class III (V) and are were held in T, the allocation (as set forth in Prop. Reg. §1.1060-1(b)(6)) would be as follows:

\[
\begin{align*}
T & \quad 4000/7250 \times 6500 \quad (4,500 \text{ plus } 2,000 \text{ liabilities}) = 3587 \\
T_1 & \quad 2000/7250 \times 6500 = 1793 \\
T_2 & \quad 1250/7250 \times 6500 = 1120
\end{align*}
\]

The tier allocation results are the following:

\[
\begin{align*}
T & = 4000/5250 \times 4500 = 3428 \\
T_1 & \text{stock} = 1250/5250 \times 4500 = 1072 \\
T_1 & \text{assets} = 2000/2250 \times 2072 \quad (1072 \text{ plus } 1000 \text{ liabilities}) = 1842 \\
T_2 & \text{stock} = 250/2250 \times 2072 = 230 \\
T_2 & \text{assets} = 230 + 1000 \text{ (liabilities)} = 1230
\end{align*}
\]

4. The results can become more dramatic when assets are of different recovery classes.

a. Example. Corporation T has two groups of assets, marketable securities with a value of $4,000 and a basis of $2,500, and accounts receivable with a basis and value of $4,000. P purchases the stock of T for $6,000 and P and S join in a Section 338(h)(10) election.

(1) Case 1. All assets are directly held by New T. $4,000 of basis is assigned to the securities, and $2,000 to the accounts receivable.

(2) Case 2a. The securities are held in a wholly owned subsidiary of New T (T₁) and the receivables in a second wholly owned subsidiary of New T (T₂). Section 338(h)(10) elections are made for each of T, T₁, and T₂. The basis of the securities is $3,000 and the basis of the receivables is also $3,000.

(3) Case 2b. A Section 338(h)(10) election is made for T and T₁, but not T₂. The securities have a basis $3,000 and the receivables keep their historic basis of $4,000. The deemed sale of the T₂ stock is a taxable transaction but, assumptively, that stock has a basis of $4,000 resulting in no gain (and, probably a disallowed loss) on the sale.

(4) Case 3. The receivables are directly held by New T. The securities are held by T₁. The proposed regulations are in effect and a Section 338(h)(10) election is made for T₁. The receivables take a $4,000 basis, and the securities a $2,000 basis.

(5) Case 3b. No Section 338(h)(10) election is made for T₁. The receivables take a $4,000 basis and the securities keep their historic basis of $2,500.

(i) As above, the results became even more skewed depending on the location of liabilities.
5. The drafters of the proposed regulations considered these issues, but made no changes at this time. The Preamble sets forth a framework for a potential model (the "look through approach"), and the potential drawbacks thereof. Comments are requested.

a. The proposed regulations do, however, contain an anti-abuse rule designed to prevent transfers of assets (and liabilities?) into and out of Old T in connection with the transaction from achieving taxpayer-desired results. See Prop. Reg. §1.338-1(c), See also Prop. Reg. §1.338(h)(10)-1(e) Example 4.

6. In the case of Section 338(h)(10) elections made for a chain of corporations, the proposed regulations clarify that the liquidations occur from the bottom up. See Prop. Reg. §1.338(h)(10)-1(d)(4)(ii), (e), Example 8.

F. Insolvency

1. If the liabilities of T exceed its assets, can a Section 338(h)(10) election be made and, if so, what are the consequences?

2. This uncertainty under the current regulations has been answered by the proposed regulations. See Prop. Reg. §1.338-3(b)(2)(ii) and (iii).

3. The proposed regulations made a distinction between the case where T is stand alone and where it is a subsidiary of a second corporation for which a Section 338(h)(10) election is made.

4. In the former case, Prop. Reg. §1.338-3(b)(2)(ii) provides that a purchase occurs only so long as more than a nominal amount is paid for the T stock.

   a. Example. Corporation T wholly owned by Corporation S, has assets of $1,000,000 and liabilities of $1,100,000. Corporation P pays S $1 for the stock of T. Under the proposed regulations, P has not purchased the T stock, and thus, can not join in a Section 338(h)(10) election for T.

   b. It is not clear that the result is correct under the statute. Section 338(h)(3) defines a "purchase" to included any acquisition of stock (with certain exceptions that are not herein relevant). In reaching this result, the Service must have concluded that P has not acquired "stock" in T, because whatever stock there is is held by T's creditors. See Helvering v. Alabama Asphalitic Limestone Co., 315 U.S. 179 (1942).

   c. In other contexts, however, stock ownership of an insolvent corporation has been respected. See Rev. Rul. 63-104, 1963-1 C.B. 172 (subsidiary placed in bankruptcy must continue to file consolidated returns with its parent); Section 382(l)(5) (shareholder of loss corporation under the jurisdiction of the court in a Title 11 or similar case recognized as shareholder for Section 382 purposes); cf. Helvering v. Southwest Consolidated Corp., 315 U.S. 194(1942).

   d. It would seem that the decoupling of the Section 338(h)(10) transaction from the consequences of the back end distribution should, as a policy matter, permit the purchaser to achieve basis benefit for the debt assumption.

      (1) This would be the result if P (or a subsidiary) acquired T's assets in a statutory merger in exchange for $1.

      (2) This result may also be illustrated by the following example.
(i) **Example.** The facts are the same as above except that, prior to the stock transfer, S contributes $300,000 to T (or forgives an equal amount of intercompany debt), and sells the T stock to P for $200,000. In this case, unless S's contribution is recast as a payment to P followed by P's contribution to T (which seems inappropriate, see Rev. Rul. 75-161, 1975-1 C.B. 114), P should be treated as having purchased the T stock (as $200,000 is not likely to been seen as nominal), and, therefore P and S can join in a Section 338(h)(10) election. S's contribution would, however, prevent the deemed dissolution of T from qualifying as a Section 332 liquidation. See Rev. Rul. 68-602, 1968-2 C.B. 135 (cited in the Preamble). Thus, P would have achieved basis revaluation, Old T's NOLs and other tax attributes would be eliminated, and any excess loss accounts in its stock restored to income, which seems to be the correct result.

5. Where T is a subsidiary of a second corporation for which a Section 338(h)(10) election is made, T stock would be considered purchased if “under general principles of tax law” the “New” second corporation is considered to own stock in T meeting the requirements of Section 1504(a)(2), even if no amount is allocated to the T stock in the deemed sale. Prop. Reg. §1.338(h)(10)-3(b)(2)(iii). In this regard, Rev. Rul. 63-104, supra could be cited for the proposition that the stock ownership requirements are satisfied.

a. **Example.** P purchases the stock of T for $4,000,000. Among T’s assets is stock of a subsidiary (T₁) with gross assets (including the stock of T₂) of $1,000,000 and liabilities of $1,100,000. T₁ owns all of the stock of T₂ with gross assets of $1,000,000,000 and liabilities of $999,999,999. A Section 338(h)(10) election for T allows P to join in a Section 338(h)(10) election for T₁ and therefore T₂. It is noted, however, that, as an insolvent company, the deemed dissolution of T₁ will not qualify under Section 332. Further, the bottom-up liquidation regime of the regulations results in all of the attributes of T₂, like those of T₁, being eliminated.