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Section 338(h)(10) & Appendix

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SECTION 338(h)(10)

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I. INTRODUCTION

The result of a section 338(h)(10) election is to treat the stock sale as if the target sold all of its assets in a single transaction and distributed the proceeds to its parent in complete liquidation. Part I of this outline provides a brief overview of section 338 and section 338(h)(10). Part II provides an example of a typical acquisition in which a section 338(h)(10) election might be made, and analyzes the results. Parts III-VIII provide a more detailed analysis of the operation and effect of section 338(h)(10).

Except as otherwise noted, in this outline "T" or "target" will represent the target corporation, "P", the "purchasing corporation" or the "purchaser" is the corporation that makes a qualified stock purchase of T, and "S" or the "seller" is a domestic corporation (unrelated to P) that owns T before the purchase of T by P.

A. Overview of Section 338

A general overview of section 338 is helpful to understand section 338(h)(10).

1. Operation of section 338

In general, section 338 operates as follows:

a. Purchase and election

(1) In one or more transactions occurring within a 12-month period (the "acquisition period"), the purchasing corporation ("P") must "purchase" at least 80 percent of the stock of a target corporation ("T"). The first date on which P has "purchased" at least 80 percent of T's stock is the "acquisition date."

(2) P must then make an election to have section 338 apply within 8½ months after the month in which the acquisition date occurs. (This period corresponds to the
time period for filing a corporate income tax return for "Old T," including extensions.) See sections 6072(b), 6081(a).

b. Deemed sale of assets

(1) If a qualifying purchase and election occur, T is treated as if it sold all of its assets in a single, fully taxable transaction.

(2) In this hypothetical sale, which takes place at the close of the acquisition date, T is both the seller and the purchaser.

(a) As the seller, T is characterized as "Old T," a corporation whose existence for tax purposes terminates on the acquisition date.

(b) As the purchaser, T is "New T," a corporation whose existence for tax purposes begins on the day after the acquisition date.

(3) The hypothetical selling price of the T assets is the "fair market value" of those assets as of the close of the acquisition date. The hypothetical purchase price is equal to P's basis in its "recently purchased" T stock, "grossed up" to reflect the value of any T stock not held by P on the acquisition date, plus P's basis in any "nonrecently purchased" stock, plus (or minus) any appropriate adjustments for liabilities and other items.

2. Consequences of the sale

a. As a result of the deemed asset sale, Old T (now owned by P) incurs all appropriate tax liabilities, and its tax attributes disappear.
b. As a result of the deemed asset purchase, New T holds the assets with a FMV cost basis.

c. The deemed asset sale by T does not affect the tax treatment of the actual sale of T stock by its shareholders. The selling shareholders of T recognize any gain or loss on the actual sale of the T stock.

d. Similarly, minority shareholders who retain their T stock are not deemed to engage in a sale of their Old T shares for New T shares even though they become shareholders in New T.

3. **Liquidation of T**

a. In contrast to prior law, there is no need to liquidate T in order to obtain a FMV cost basis for T's assets under section 338. The treatment described above obtains regardless of whether T is actually liquidated.

b. Indeed, an actual liquidation in the absence of a section 338 election will result in a carryover basis to P under section 334(b)(1). See Rev. Rul. 90-95, 1990-2 CB 67.

(1) Section 338 preempts the non-statutory rule of *Kimbell-Diamond Milling Co. v. Commissioner*, 14 T.C. 74 (1950), aff'd, 187 F.2d 718 (5th Cir. 1951) (stock purchase followed by a previously planned liquidation treated by court as a purchase of assets, with the result that the purchaser took a basis in the acquired assets equal to the cost of the stock).

(2) The combination of nonelection under section 338 and liquidation pursuant to a plan adopted within two years of the acquisition date, however, may trigger section 269(b), which allows the Treasury Secretary to disallow certain tax benefits if the principal purpose of
the liquidation is the evasion or avoidance of Federal income taxes.

4. **Consistency provisions**

   a. In accordance with the legislative purpose to prevent P from selectively stepping up the basis of acquired assets, the regulations under section 338 contain consistency rules.

   b. The former temporary regulations contained a complex set of consistency rules. In general, these rules required P (and its affiliates) to treat all acquisitions from T or T's affiliates consistently as either stock purchases or asset purchases.

   c. Following the Tax Reform Act of 1986, P.L. 99-514 ("TRA 86") and the repeal of the so-called General Utilities doctrine, the opportunity for abusive transactions was considerably narrowed. The final regulations reflect this by greatly simplifying the consistency rules and limiting their scope.

5. **Benefits of a section 338 election**

In general, a section 338 election is of economic value to the purchasing corporation only if the present value of future tax savings resulting from the "step-up" in basis of the T's assets exceeds the current tax cost of such a step-up.

   a. **TRA 86 substantially amended the corporate tax provisions dealing with distributions and liquidating sales. Conforming amendments were made to section 338.**

      (1) **The amendments greatly reduce the utility of section 338 as a mechanism to achieve a basis step-up in acquired assets.**

      (2) **To achieve a basis step-up under new section 338, the T corporation must recognize the full gain or loss inherent in its assets. Previously, under old**
section 338, the cost of basis step-up was limited to recapture and similar items.

(3) As a result, the present value of future tax savings (e.g., increased depreciation deductions) will rarely be greater that the current tax cost of the step-up. An election under amended section 338 will make economic sense only in limited situations, such as in the case of a foreign target or where the target corporation has sufficient loss carryovers to offset the section 338 gain.

b. However, section 338 has continued vitality under section 338(h)(10) inasmuch as this section provides for an asset basis step-up with only a single level of corporate tax.

B. Overview of Section 338(h)(10)

1. Basics of section 338(h)(10)

In the context of certain qualified stock purchases of a target corporation ("T"), the purchasing corporation ("P") and the seller (selling consolidated group, selling affiliate or S corporation shareholders) ("S") may make a joint election under section 338(h)(10) to treat the sale of T stock as if T sold all of its assets in a single transaction.

2. Consequences of a section 338(h)(10) election to S

Generally, for a T that is a member of a consolidated group:

a. No gain or loss will be recognized by members of the selling group on their sale of T stock (except as provided by regulations), but T will recognize gain or loss as if it had actually sold all its assets while included as a member of the selling group.

b. As a result, the tax on T's gain resulting from a section 338(h)(10) election is paid by
the selling consolidated group. Such gain can be offset by the losses, if any, of the selling group but not the purchasing group. As discussed in more detail below, any losses in excess of the gain remain with the selling consolidated group.

See Part V.B.1., below for consequences if T is a member of an affiliated nonconsolidated group or an S corporation.

3. **Consequences of a section 338(h)(10) election to P**

T's basis in its assets will be revalued to reflect the purchase price paid by P for the T stock.

4. **Scope of section 338(h)(10)**

a. As originally enacted, section 338(h)(10) was limited to the sale of stock of a target corporation that was a member of an affiliated group of corporations filing a consolidated return.

b. Regulations finalized in 1994 expanded the scope of section 338(h)(10) to include the sale of stock of a target: (1) that is a member of an affiliated group of corporations filing separate returns, or (2) that is an S corporation. See Treas. Reg. § 1.338(h)(10)-1(a),(c).

C. **Recently Proposed Regulations**

1. **In general**

a. Recently proposed regulations would revise all the regulations under section 338 (other than those dealing with international matters and stock consistency). Notice of Proposed Rulemaking REG-107069-97, 64 Fed. Reg. 43461 (August 10, 1999) (the "proposed regulations"). The proposed regulations would also revise the regulations under section 1060.
b. The proposed regulations would become effective for qualified stock purchases occurring after the date of publication of final regulations. Prop. Treas. Reg. § 1.338(i)-1.

2. Overview

a. The preamble to the proposed regulations (the "preamble") states that the proposed regulations are intended to clarify the treatment of, and provide consistent rules (where possible) for, both deemed and actual asset acquisitions under sections 338 and 1060. The changes made by the proposed regulations have four major components: (i) organization of the regulations; (ii) clarification and modification of the accounting rules applicable to deemed and actual asset acquisitions; (iii) modifications to the residual method mandated for allocating consideration and basis; and (iv) miscellaneous revisions to the current regulations.

b. A brief summary of some of the more significant provisions of the proposed regulations follows. These provisions are discussed in the order in which they appear in the proposed regulations. Some of these provisions are also discussed in more detail in other parts of this outline.

3. Organization of the regulations

The preamble states that the proposed regulations change the organization of the regulations in order to make the rules for all asset acquisitions more administrable and provide consistent treatment, when appropriate, for deemed and actual asset acquisitions.

4. Prop. Treas. Reg. § 1.338-1 -- General principles; status of old target and new target

a. The proposed regulations provide that if a section 338 election is made, 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. If a section 338(h)(10) election is made, old T is also deemed to liquidate following the deemed asset sale. Prop. Treas. Reg. § 1.338-1(a).

b. The proposed regulations provide that other rules of law apply to determine the tax consequences to the parties as if they had actually engaged in the transactions deemed to occur under section 338 and the regulations thereunder except to the extent otherwise provided in the regulations. Prop. Treas. Reg. § 1.338-1(b).

c. The proposed regulations include an anti-abuse rule. Under the proposed regulations, the Commissioner, for purposes of calculating and allocating the sales price and purchase price, has the authority under certain circumstances (a) to treat as not being part of T's assets those assets added to the pool of T's assets before the deemed asset sale and (b) to treat as being part of T's assets those assets removed from the pool of T's assets before the deemed asset sale. Prop. Treas. Reg. § 1.338-1(c).


a. Four definitions of terms already used in the current regulations have been added to the proposed regulations. These terms are acquisition date asset, deemed asset sale, deemed sale gain, and deemed sale return. The scope of some of these terms has been expanded from their usage in the current regulations.

b. Additionally, the definitions of certain terms have been modified.
c. In particular, the proposed regulations modify the definition of selling group to provide that a section 338(h)(10) election may be made for target notwithstanding that it was at some time during the year in which the acquisition date occurs the common parent of its affiliated or consolidated group, so long as it is not the common parent on the acquisition date. See Prop. Treas. Reg. § 1.338-2(c)(16).

6. Prop. Treas. Reg. § 1.338-3 -- Qualification for the section 338 election

A section 338 election may be made only with respect to a transaction that qualifies as a purchase within the meaning of section 338(h)(3).

a. The proposed regulations provide that a purchase of T stock occurs so long as more than a nominal amount is paid for the stock. Prop. Treas. Reg. § 1.338-3(b)(2)(ii).

b. However, the proposed regulations provide that stock in a T affiliate acquired by new T in the deemed asset sale of T's assets is considered purchased notwithstanding that no amount may be allocated to T's stock in the T affiliate. Prop. Treas. Reg. § 1.338-3(b)(2)(iii).

c. It is not clear whether Prop. Treas. Reg. § 1.338-3(b)(2)(iii) would allow the acquisition of an insolvent T affiliate to qualify as a purchase, or if it merely clarifies that the acquisition of a solvent T affiliate does not fail to qualify as a purchase simply because it is not allocated basis in the transaction.

d. Under section 338(h)(3)(A)(iii), the parties to a section 338 transaction must be unrelated in order for the transaction to qualify as a purchase. The statute is unclear as to when the relationship between the parties is tested. The proposed regulations provide that the relationship
between the purchaser and seller is tested immediately after the transaction. See Prop. Treas. Reg. § 1.338-3(b)(3)(ii).

Specifically:

(1) In the case of a single transaction, immediately after the purchase of the T stock.

(2) In the case of a series of acquisitions otherwise constituting a qualified stock purchase, immediately after the last acquisition in such series.

(3) In the case of a series of transactions effected pursuant to an integrated plan to dispose of T stock, immediately after the last transaction in such series.

7. Prop. Treas. Reg. §§ 1.338-4, 1.338-5, 1.338-6 and 1.338-7 -- Aggregate deemed sale price; various aspects of taxation of the deemed asset sale; adjusted grossed-up basis; allocation of aggregate deemed sale price adjusted grossed-up assets

The proposed regulations make several changes to the definition, calculation, allocation and other aspects of aggregate deemed sale price and adjusted grossed-up basis. A few of these provisions are discussed below.

a. The proposed regulations change the number and content of the asset classes. Prop. Treas. Reg. § 1.338-6(b) provides that basis is allocated to seven asset classes as opposed to five asset classes under the current regulations. The new asset classes are designed to put certain "fast pay" assets into a more senior classes than currently provided.

b. The proposed regulations remove the link in the current regulations between the calculation of the first element of ADSP and the purchaser's basis in recently purchased T stock. This change, combined with changes to the timing rules, results in the elimination
of "open-transaction" treatment that was provided in the current regulations.

c. The proposed regulations make clear that, old T's tax liability incurred on its deemed asset sale is deemed assumed unless the parties have agreed (or the tax or non-tax rules operate such that) the seller, and not T, will bear the economic cost of that tax liability.

d. Regarding the timing of taking liabilities into account, the proposed regulations provide that general principles of tax law apply in determining the timing and amount of the elements of ADSP and AGUB. Accordingly, the current rule in the regulations that liabilities are taken into account in calculating ADSP and AGUB, only when such liability becomes fixed and determinable is removed in the proposed regulations.

e. The "other relevant items" that are included in the calculation of MADSP are not included in the calculation of ADSP.

f. The proposed regulations provide that, for new T, the definition of AGUB is changed, such that when the P's basis in recently purchased stock is grossed-up, acquisition costs are no longer also grossed-up.

8. Prop. Treas. Reg. § 1.338(h)(10)-1 --Deemed asset sale and liquidation

a. Prop. Treas. Reg. § 1.338(h)(10)-1 describes the model on which taxation of the section 338(h)(10) election is based. Under the proposed regulations:

   (1) Old T is treated as transferring all of its assets by sale to an unrelated person.

   (2) Old T recognizes the deemed sale gain while a member of the selling consolidated group, or owned by the
selling affiliate, or owned by the S corporation shareholders (both those who actually sell their shares and any who do not).

(3) Old T is then treated as transferring all of its assets to members of the selling consolidated group, the selling affiliate, or S corporation shareholders and ceasing to exist.

(4) If T is an S corporation, the deemed asset sale and deemed liquidation are considered as occurring while it is still an S corporation.

b. The preamble states that the proposed regulations treat all parties concerned as if the transactions that are deemed to occur under section 338(h)(10) actually did occur, or as closely thereto as possible.

c. Old T generally may not obtain any tax benefit from the section 338(h)(10) election that it would not obtain if it actually sold the assets and liquidated. Prop. Treas. Reg. § 1.338(h)(10)-1(d)(9).

d. The current regulations provide that as a result of a section 338(h)(10) election old T is deemed to sell all of its assets and distribute the proceeds in complete liquidation. The proposed regulations do not mention the term "complete liquidation" but instead provide that old T is treated as if it transferred all of its assets to members of the selling consolidated group, the selling affiliate, or S corporation shareholders and then ceased to exist. Prop. Treas. Reg. § 1.338(h)(10)-1(d)(4).

e. The proposed regulations provide that when T is an S corporation, any direct or indirect subsidiaries of T which T has elected to treat as qualified subchapter S subsidiaries under section 1361(b)(3) remain qualified subchapter S subsidiaries through the close
of the acquisition date. However, the proposed regulations provide that no similar rule applies when a qualified subchapter S subsidiary, as opposed to the S corporation that is its owner, is the target the stock of which is actually purchased. Prop. Treas. Reg. § 1.338(h)(10)-1(d)(3).

f. The proposed regulations make the section 453 installment method available to old T in its deemed asset sale, as long as the deemed asset sale would otherwise qualify for installment sale reporting. For purposes of section 453, new T is considered to be the obligor on the installment obligation the purchasing corporation actually issued. Prop. Treas. Reg. § 1.338(h)(10)-1(d)(8).

g. The proposed regulations provide that, in the case of parent-subsidiary chains of corporations making section 338(h)(10) elections, the deemed asset sale at the parent level is considered to precede that at the subsidiary level. Prop. Treas. Reg. § 1.338(h)(10)-1(d)(3)(ii). The proposed regulations then provide, however, that the deemed liquidation of the subsidiary is considered to precede the deemed liquidation of the parent. Prop. Treas. Reg. § 1.338(h)(10)-1(d)(4)(ii).
II. EXAMPLE OF AN ACQUISITION WITH A SECTION 338(h)(10) ELECTION

A. Basic Facts

1. T Corporation is a wholly owned subsidiary of S Corporation, with which it files a consolidated return. T's balance sheet at the close of December 31, 1997, is as follows:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>2,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>5,000</td>
</tr>
<tr>
<td>Accts. Rec'ble</td>
<td>7,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>7,000</td>
</tr>
<tr>
<td>Land</td>
<td>2,000</td>
</tr>
<tr>
<td>Plant</td>
<td>9,000</td>
</tr>
<tr>
<td>Total</td>
<td>32,000</td>
</tr>
<tr>
<td>Accts Payable</td>
<td>7,000</td>
</tr>
<tr>
<td>Other Liabs.</td>
<td>15,000</td>
</tr>
<tr>
<td>Total Liabs.</td>
<td>22,000</td>
</tr>
<tr>
<td>Equity</td>
<td>10,000</td>
</tr>
<tr>
<td>Total</td>
<td>32,000</td>
</tr>
</tbody>
</table>

S has Net Operating Losses ("NOLs") of $30,000, of which $10,000 are attributable to T. In addition, S's basis in the stock of T is $10,000.

P Corporation is interested in purchasing T, and has conducted a valuation of the T assets listed above, plus intangible assets such as goodwill. Assuming that it could acquire the T assets with a FMV basis, P would be willing to pay no more than $50,000, as follows:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>2,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>7,000</td>
</tr>
<tr>
<td>Accts Rec'ble</td>
<td>7,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>9,000</td>
</tr>
<tr>
<td>Land</td>
<td>3,000</td>
</tr>
<tr>
<td>Plant</td>
<td>12,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>10,000</td>
</tr>
<tr>
<td>Total</td>
<td>50,000</td>
</tr>
</tbody>
</table>

Alternately, if P acquired the T assets with a carryover basis, P would be willing to pay less because such a purchase would not yield the tax benefits that a stepped-up basis would provide (e.g., higher depreciation, lower gain if the assets are disposed of). P has estimated that it
would be willing to pay no more than $43,000, as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>2,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>6,000</td>
</tr>
<tr>
<td>Accts Rec'ble</td>
<td>7,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>7,000</td>
</tr>
<tr>
<td>Land</td>
<td>1,500</td>
</tr>
<tr>
<td>Plant</td>
<td>11,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>8,500</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>43,000</strong></td>
</tr>
</tbody>
</table>

2. Thus, if P were also required to assume T's liabilities, then it would be willing to pay $28,000 if it could acquire the assets with a stepped-up basis ($50,000 less $22,000 of liabilities), or $21,000 if it could acquire the assets with a carryover basis ($43,000 less $22,000 in liabilities).

B. **Stock Acquisition Without Section 338(h)(10) Election**

If P agrees to purchase all the stock of T for $21,000, the results are as follows:

1. **Consequences to S**

S will realize gain of $11,000 ($21,000 received less S's basis in the T stock of $10,000). Under the circular basis adjustment rule, S cannot use the NOLs attributable to T to absorb this gain. Treas. Reg. § 1.1502-11(b). These NOLs, in any event, will be lost (to S) because P will succeed to them as the new owner of T (see below). S will be able to shield the entire gain, but it must do so with its other NOLs, reducing them from $20,000 to $9,000. Thus, S has no taxable income, cash of $21,000 and NOLs of $9,000.

2. **Consequences to P**

As noted, P will succeed to the NOLs of S that are attributable to T ($10,000). However, these NOLs will be subject to numerous restrictions (e.g., section 382 and the SRLY rules), which may significantly impair their utility. In addition, P will take a basis in the T stock of $21,000 and
the inside basis of the T assets will remain $32,000.

C. **Stock Acquisition With Section 338(h)(10) Election**

If P agrees to purchase all the stock of T for $28,000 and then P and S make a joint section 338(h)(10) election, the results are as follows:

1. **Consequences to S**

   As a result of the deemed sale, S will realize no gain on the sale of its T stock. Rather, T will realize gain equal to the modified aggregate deemed sales price ("MADSP") (see Part V.C., below) less T's inside asset basis. Under these facts, the MADSP is $50,000 ($28,000 grossed-up stock basis plus $22,000 of liabilities assumed). T's inside asset basis is $32,000, yielding a gain of $18,000, allocable to the individual assets as follows:

<table>
<thead>
<tr>
<th>Amount Adj'd</th>
<th>Rec'd.</th>
<th>Basis</th>
<th>Gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>2,000</td>
<td>2,000</td>
<td>0</td>
</tr>
<tr>
<td>Inventory</td>
<td>7,000</td>
<td>5,000</td>
<td>2,000</td>
</tr>
<tr>
<td>Accts Rec'ble</td>
<td>7,000</td>
<td>7,000</td>
<td>0</td>
</tr>
<tr>
<td>Equipment</td>
<td>9,000</td>
<td>7,000</td>
<td>2,000</td>
</tr>
<tr>
<td>Land</td>
<td>3,000</td>
<td>2,000</td>
<td>1,000</td>
</tr>
<tr>
<td>Plant</td>
<td>12,000</td>
<td>9,000</td>
<td>3,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>10,000</td>
<td>0</td>
<td>10,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>50,000</td>
<td>32,000</td>
<td>18,000</td>
</tr>
</tbody>
</table>

Because the deemed sale gain occurs while T is a member of the S group, the circular basis adjustment rule does not apply and S may use all of its NOLs which are attributable to T in offsetting this amount. S will be able to shield the entire gain, but its NOLs will be reduced from $30,000 to $12,000. Thus, S has no taxable income, cash of $28,000 and NOLs of $12,000.
2. Consequences to P

P does not succeed to the NOLs of S which are attributable to T. However, such NOLs would have been subject to various limitations in any event (e.g., section 382 and the SRLY rules). P will take a basis in the T stock of $28,000 and the inside basis of the T assets will increase to $50,000.

D. Summary

The following chart compares the results under both approaches:

<table>
<thead>
<tr>
<th>Cash to S</th>
<th>Taxable Gain to S</th>
<th>S's NOLs</th>
<th>T's NOLs available to P</th>
<th>P's Basis in the T Stock</th>
<th>Basis of T Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Without Election</td>
<td>21,000</td>
<td>0</td>
<td>9,000</td>
<td>10,000*</td>
<td>21,000</td>
</tr>
<tr>
<td>With Election</td>
<td>28,000</td>
<td>0</td>
<td>12,000</td>
<td>0</td>
<td>28,000</td>
</tr>
</tbody>
</table>

* NOLs subject to substantial limitations.

Therefore, by making a section 338(h)(10) election S is able to increase its post-transaction NOLs and the cash it receives. P is able to increase the basis of the T assets by $18,000, while paying only $7,000 more than if no election had been made.

The election clearly makes sense for S. However, in evaluating whether the election is beneficial for P, it will be necessary to determine, among other things, whether the basis increase is allocated to non-depreciable (or slowly depreciated) assets, or to assets that can be depreciated more quickly. Here, for instance, $10,000 of basis is allocated to goodwill. Under new section 197, the cost of such an asset is recoverable over 15 years. In contrast, by making the election P will forego T's $10,000 in NOLs. Even subject to the section 382 and SRLY limitations, the present value of such NOLs could exceed the present value of the goodwill deductions.

Under these facts S would probably accept a slightly
reduced purchase price if P were willing to make a joint 338(h)(10) election. The reduced purchase price would compensate P for the loss of the NOLs.

III. ELIGIBILITY

A. Basic Eligibility Rules

1. A qualified stock purchase ("QSP") and joint section 338(h)(10) election must be made for a "section 338(h)(10) target".

2. Section 338(h)(10) target

   a. Under Treas. Reg. § 1.338(h)(10)-1(a), a section 338(h)(10) target is defined as a domestic corporation that is:

      (1) a member of "selling consolidated group";

      (2) a member of a selling affiliated group filing separate returns; or

      (3) an S corporation.

   b. The section 338(h)(10) target must not be the common parent of the selling consolidated group.

      (1) This requirement makes sense since if P acquired the common parent of the selling group, all the gain recognized by the selling group would be included in T's final consolidated return for the entire group.

      (2) Economically, this liability would be borne by the P group not the selling consolidated group as contemplated by section 338(h)(10).

      (3) The preamble to the proposed regulations provides that a section 338(h)(10) may be made for T notwithstanding the fact that it was at some time during the year in which the acquisition date occurs the common parent of its affiliated or
consolidated group, so long as it is not the common parent on the acquisition date.

3. Seller requirements

a. P must acquire T in a qualified stock purchase from:

(1) A selling consolidated group;
(2) A selling affiliate; or
(3) S corporation shareholders.
Treas. Reg. § 1.338(h)(10)-1(d)(1).

b. Selling consolidated group

A selling consolidated group is a selling group that files a consolidated return for the period that includes T's acquisition date. Thus, T is a member of the selling consolidated group on the acquisition date. Treat. Reg. § 1.338(h)(10)-1(c)(3).

c. Selling affiliate

(1) A selling affiliate is defined as a domestic corporation that is not a member of a selling consolidated group and from which, P purchases an amount of T stock sufficient to satisfy the requirements of section 1504(a)(2). See Part III.B.1.a., below. On the acquisition date, the selling affiliate and T are affiliated (within the meaning of section 1504) but are not includible members of the same consolidated group. Treas. Reg. § 1.338(h)(10)-1(c)(4).

(2) Thus, a single member of the selling affiliated group must sell P an amount of stock sufficient to meet the requirements of section 1504(a)(2), see Part III.B.1.a., below. T stock sold to P by another member of the S affiliated group does not qualify for
nonrecognition of the gain on the stock sale.

d. **S corporation shareholder**

S corporation shareholders are the T shareholders if T is an S corporation immediately before T's acquisition date. Thus, if T is an S corporation, for T to be a section 338(h)(10) target, P can purchase no T stock before the acquisition date (since to do so would disqualify T from being an S corporation immediately before that date). Treas. Reg. § 1.338(h)(10)-1(c)(2).

4. **Purchaser requirements**

a. The purchaser must be a corporation. Individuals and partnerships cannot make a qualified stock purchase, and consequently cannot make a section 338(h)(10) election. Treas. Reg. § 1.338-2(b)(1).

b. Individuals and partnerships can get around this requirement by forming a new corporation ("Newco") to acquire the T stock. However, Newco must be considered for tax purposes as the purchaser. Facts that may indicate that Newco does not purchase the T stock include that Newco merges downstream into T, liquidates, or otherwise disposes of the T stock following the purported qualified stock purchase. Treas. Reg. § 1.338-2(b)(1).

c. The Small Business Job Protection Act of 1996 liberalized the rules relating to S corporations, it is now clear that an S corporation may make a qualified stock purchase.

**B. Qualified Stock Purchase ("QSP")**

1. **In general**

a. A QSP occurs when P, either in a single transaction or series of transactions within a 12-month period, acquires by "purchase" an
amount of stock meeting the requirements of section 1504(a)(2) -- i.e., at least 80 percent of the total combined voting power of all classes of T stock entitled to vote, and at least 80 percent of the total value of T stock (except nonvoting, nonparticipating, nonconvertible limited, preferred stock). Section 338(d)(3).

b. TRA 86 amended section 338(d) to follow section 1504. Although the statute refers only to section 1504(a)(2), the legislative history makes clear that other provisions of section 1504(a) apply as well. This is consistent with the purpose of conforming sections 332(b)(1), 338(d)(3) and 1504.

c. In Notice 87-63, the Internal Revenue Service (the "Service") announced that the regulations issued under sections 1504(a)(5)(A) and (B) (regarding the treatment of stock options and similar instruments in determining affiliation) would apply for purposes of section 338. Notice 87-63, 1987-2 C.B. 375.

2. **12-Month acquisition period**

a. **Definition**

The 12-month acquisition period is the 12-month period in which a qualifying stock purchase must occur. The period begins with the date of the first purchase of T stock included as part of the QSP. Section 338(h)(1).

b. Acquisition period for purchases from related corporation

Section 338(h)(1) states that the 12-month acquisition period will begin with the date of the "first acquisition by purchase of stock included in a qualified stock purchase." The parenthetical language states that "if any of such stock" was acquired by "purchase" from a related corporation, the
12-month period will begin with the date on which ownership of the "purchased" stock was first attributed under section 318(a).

(1) **Example**

S owns all of the stock of T. On January 1, 1997, P purchases 30 percent of the stock of S. On March 1, 1997, P purchases an additional 30 percent. Under section 318 attribution, March 1 is the date on which P is first considered to own T stock (P is deemed to own 60 percent of T at that time). On February 1, 1998, S is liquidated and P receives all of the T stock as a liquidating distribution. May P make a section 338 election with respect to its acquisition of T? P's 12-month acquisition period with regard to T commenced on March 1, 1997, the date when ownership of T stock was first attributed to P. Thus P's acquisition of the final 40 percent of the S stock on February 1, 1998, falls within the applicable 12-month acquisition period and P is eligible to use section 338 with respect to T.

(2) One important consequence of this acquisition period rule is that P may not include in a QSP any stock acquired from a related corporation if P acquires that stock more than one year after P is deemed to own the stock under section 318(a). Treas. Reg. § 1.338-2(b)(3).

3. **Acquisition date**

The term "acquisition date" means, with respect to "any corporation," the first day on which there is a "qualified stock purchase" with respect to its stock. Section 338(h)(2). Thus, if P purchases 30 percent of the stock of T on January 1, 50 percent on June 1, and the remaining 20 percent on July 1, the acquisition date is June 1 -- the day when a QSP of T stock was made.
4. **Purchase**

   a. **In general**

To qualify under section 338, P must acquire a qualifying 80 percent stock interest in T by "purchase." Section 338(h)(3)(A) defines the term "purchase" as "any acquisition of stock," subject to the following conditions:

1. The basis of the T stock in the hands of P is not determined (i) in whole or part by reference to the adjusted basis of such stock in the hands of T's former shareholders, or (ii) under section 1014(a) (property acquired from a decedent);

2. The T stock is not acquired in an exchange to which section 351, 354, 355 or 356 applies or in any other transaction described in the regulations in which the transferor recognizes less than all of its realized gain or loss; and

3. The T stock is not acquired from a person the ownership of whose stock would, under section 318(a) (other than paragraph (4) -- the option attribution provision), be attributed to P. **Cf. PLR 8345057** (Service ruled that P "purchased" stock from T shareholder that owned 45.7 percent of P).

4. Under the current regulations, it is not clear when the relationship between the parties should be tested. TAM 9742039 looked at the relationship both immediately before and immediately after the transaction. In TAM 9742039, S's stock would have been attributed to P for purposes of section 338(h)(3)(A)(iii) both immediately before and immediately after the transaction. It is not clear what the result would have been if S's stock
would not have been attributed to P immediately before the transaction but would have been attributed to P immediately after the transaction.

(5) The proposed regulations provide that the relationship between the purchaser and seller is tested immediately after the transaction. See Prop. Treas. Reg. § 1.338-3(b)(3)(ii). Specifically:

(a) In the case of a single transaction, immediately after the purchase of the T stock.

(b) In the case of a series of acquisitions otherwise constituting a qualified stock purchase, immediately after the last acquisition in such series.

(c) In the case of a series of transactions effected pursuant to an integrated plan to dispose of T stock, immediately after the last transaction in such series.

(6) In addition, the proposed regulations provide that a purchase of T stock occurs so long as more than a nominal amount is paid for the stock. Prop. Treas. Reg. § 1.338-3(b)(2)(ii). However, the proposed regulations provide that stock in a T affiliate acquired by new T in the deemed asset sale of T's assets is considered purchased notwithstanding that no amount may be allocated to T's stock in the T affiliate. Prop. Treas. Reg. § 1.338-3(b)(2)(iii).

b. Special rules for acquisitions from related corporations

(1) If P acquires at least 50 percent in value of the stock of S by "purchase," then the section 318(a) attribution
restriction will be ignored and P may "purchase" T stock from S. Thus, if P purchases 75 percent of the stock of S, which owns all of the stock of T, and S then liquidates under section 331, P will be treated as having purchased the 75 percent stock interest in T, even though P received the stock from a related party under section 318(a). Section 338(h)(3)(C)(i).

(2) Moreover, if P has made a QSP of S and has elected under section 338, then P may "purchase" T stock from the related corporation S without regard to the carryover basis restriction. For example, S owns 75 percent of the T stock. P purchases 100 percent of the S stock and makes a section 338 election as to S. S is subsequently liquidated into P in a section 332 liquidation. P is treated as purchasing the T stock held by S. Section 338(h)(3)(C)(ii).

5. Bootstrap purchases

a. If P purchases less than 80 percent of T's stock and as part of the same transaction T redeems stock sufficient to increase P's holdings to more than 80 percent, a question arises whether P has made a QSP.

b. The regulations resolve this issue and establish a clear rule for redemptions in connection with a QSP. Redemptions from unrelated persons generally count towards the QSP, while redemptions from persons related to P do not, except in limited circumstances.

c. Redemptions from persons unrelated to the purchasing corporation

(1) Redemptions of T stock from persons unrelated to P that occur during the 12-month acquisition period are taken into account in determining whether P has purchased, in the 12-month acquisition
period, sufficient T stock to satisfy the ownership requirements of section 338(d)(3). Treas. Reg. § 1.338-2(b)(5)(ii). Of course, redemptions occurring at any time prior to P's purchase of T stock (whether or not during the acquisition period) will indirectly increase P's percentage ownership and therefore count towards the QSP, so long as the redemptions are from persons unrelated to P. See Treas. Reg. § 1.338-2(b)(5)(iv), Ex. (3).

(2) The regulations state no limit on the size of the redemption. Treas. Reg. § 1.338-2(b)(5).

(3) Treas. Reg. § 1.338-2(b)(5)(iv) provides the following examples:

(a) P purchases 60 of the 100 outstanding shares of T stock, and T, within the acquisition period, subsequently redeems 25 shares from an unrelated party. The acquisition date is the date of the redemption, even though no purchase occurs on that date, because that is the first day on which the T stock purchased by P within the 12-month period satisfies the 80-percent ownership requirement (i.e., 60/75 shares), determined by taking into account the redemption of the 25 shares.

(b) P purchases 60 of the 100 outstanding shares of T stock and then, 13 months later, T redeems all the stock of an unrelated shareholder who owns 25 shares of T stock. There is no QSP because P has not satisfied the 80-percent ownership requirement within 12 months.
d. Redemption from the purchasing corporation or related persons

(1) General rule

For purposes of the percentage ownership requirements of section 338(d)(3), a redemption of T stock during the 12-month acquisition period from the purchasing corporation or from any person related to the purchasing corporation is not taken into account as a reduction in T's outstanding stock. Treas. Reg. § 1.338(2)(b)(5)(iii).

(2) Example

T redeems 30% of its stock (P's entire holding in T) on December 15 of Year 1 (such stock has been held by P for several years). On December 1 of Year 2, P purchases the remaining T stock from an unrelated shareholder. There is no QSP. For purposes of the 80-percent ownership requirement, the redemption of P's T stock on December of Year 1 is not taken into account as a reduction in T's outstanding stock.

(3) Exception

Redemptions from parties related to P are not taken into account for purposes of the 80-percent ownership requirement of a QSP except to the extent that P could have "purchased" such stock on the redemption date from the related party, within the meaning of section 338(h)(3)(C), and such stock would have been considered as having been acquired during the acquisition period under section 338(h)(1). Treas. Reg. § 1.338-2(b)(5)(iii). The regulations provide the following example:

On January 1 of Year 1, P purchases 60 of the 100 shares of X stock. On that
date, X owns 40 of the 100 shares of T stock. On April 1 of Year 1, T redeems X's T stock and P purchases the remaining 60 shares of T stock from an unrelated person. The redemption of the T stock from X (a person related to P) is taken into account as a reduction in T's outstanding stock. If P had purchased the 40 redeemed shares from X on April 1 of Year 1, all 40 of the shares would have been considered purchased during the 12-month period ending on April of Year 1 (24 of the 40 shares would have been considered purchased by P on January 1 of Year 1 and the remaining 16 shares would have been considered purchased by P on April 1 of Year 1). See Treas. Reg. § 1.338-2(b)(3). Accordingly, P makes a QSP of T on April 1 of Year 1. See Treas. Reg. § 1.338-2(b)(5)(iv), Ex. (6).

6. Going Public: "Busted" 351 and QSPs

a. A transaction that does not qualify for section 351 nonrecognition treatment due to the seller's binding commitment to sell the stock of the newly created company may qualify as a QSP.

b. Example

(1) **Facts:** S owns all of the stock of T and wants to sell the T stock to the public. S contributes the T stock to Newco ("N") in exchange for N stock. At the time of the contribution, S has a binding commitment to sell 51% of the N stock to an underwriter who will sell the N stock to the public.

(2) **Analysis:**

(a) Due to S's binding commitment to sell more than 20% of the N stock,
S will not be in "control" of N immediately after the transfer, and therefore the transfer will not qualify for section 351 treatment. See Rev. Rul. 79-70, 1979-1 C.B. 144. N will be deemed to have purchased the T stock in exchange for the money received upon the sale of the N stock to the public.

(b) This deemed sale will be a QSP as long as S and N are treated as unrelated parties. See TAM 9747001. Since S owns less than 50% of N at the conclusion of the transaction, N will not be treated as purchasing the T stock from a person whose stock would, under section 318(a) be attributed to the person acquiring such stock. Therefore, the purchase should satisfy the unrelated party requirement of section 338(h)(3)(A)(iii). See PLR 9845012, revised in PLR 199910033.

(c) S must own less than 20% of N after the transaction to avoid the application of the anti-churning rules of section 197(f)(9) (discussed in Part V.F.2.e., below).

(d) Even if S sells all the N stock, the anti-churning rules of section 197(f)(9) may apply to historically nonamortizable intangible assets (goodwill) in the hands of New T as a result of the momentary relationship between S, N and T. Section 197(f)(9) tests the relationship of the parties immediately before and immediately after the acquisition of the goodwill. Prop. Treas. Reg. § 1.197-2(h)(6)(ii).
(i) A similar issue arises in a creeping section 338(g) transaction.

(ii) For example, assume that P acquires 25 percent of the stock of T (a corporation that has pre-1993 goodwill), and within a month, P purchases an additional 56 percent of the stock of T. Because relatedness is tested immediately before and after the acquisition, the Service could argue that P cannot amortize T's goodwill, as P and T were related prior to the deemed asset acquisition.

(iii) However, the anti-churning rules should not apply, because P has made a qualified stock purchase within the allowable 12-month acquisition period, and thus should not be treated as related to T immediately before the acquisition of the goodwill.

(iv) Hopefully, the final Regulations under section 197, expected before the end of the year, will correct this problem.

(e) If N also sells stock to the public in the transaction it is possible that the transaction will qualify under section 351 because S sold N stock to a co-transferor. See Rev. Rul. 79-194, 1 C.B. 145. Under recently finalized Treas. Reg. § 1.351-1(a)(3) the public is treated as a transferor for stock issued by the corporation in a
"qualified underwriting transaction." A qualified underwriting transaction includes both "best efforts" and "firm commitment" underwritings.

(f) Therefore, if N plans to sell stock in the transaction, and the parties want to make a section 338(h)(10) election, they should make sure that the transaction does not satisfy section 351 for another reason. See TAM 9477001 (concurrent offerings by S and N could cause section 351 to apply, but did not in the ruling because of S's pre-existing commitment to sell non-voting preferred stock).

c. The proposed regulations contain a similar example, and provide that Newco's acquisition of T stock is a purchase within the meaning of section 338(h)(3). See Prop. Treas. Reg. § 1.338-3(b)(3)(iv), ex. 1.

7. Section 304 and OSPs

A sale of T stock to P may not be treated as a qualified "purchase" if P is controlled by the seller under section 304.

a. Example

A owns all of the stock of P and T. A sells the T stock to P for cash. A is treated under section 304(a)(1) as receiving a distribution in redemption of the P stock to which section 301 applies. The transaction is treated as if A had transferred the T stock to P in exchange for P stock in a section 351 transaction, and then P had redeemed the stock it was treated as issuing in the transaction. Under section 362(a) and Treas. Reg. § 1.304-2(a), P's basis in the T stock is determined by reference to A's adjusted basis in the stock. Further, stock owned by A would be attributed to P under
section 318(a)(3)(C). Thus, P is not considered to have acquired the T stock by purchase. See sections 338(h)(3)(A)(i) and (iii).

b. However, the regulations consider and reject the application of section 304 in the following circumstances. A owns 20 percent of T, and B (unrelated to A) owns 80 percent. A forms P and contributes its 20 percent holding in T to P in exchange for all of P's stock. As part of the same transaction, P purchases B's 80 percent holding in T. The regulations conclude that P has made a QSP of T and may elect under section 338. This is because B has not acquired or retained an interest in P, as required by sections 304(a)(1) and (c)(2)(B), and because A did not control T before the transaction. Treas. Reg. § 1.304-5(b)(3).

c. In addition, stock acquired in a section 304 transaction should be treated as being "purchased" to the extent that the transaction is treated as a section 302(a) exchange. See section 304(a)(1) (as amended by TRA 97). Section 304 provides special treatment only to the extent that the transaction is treated as a section 301 distribution.

8. Reverse subsidiary mergers and QSPs

a. Fact pattern

P wishes to purchase T stock and make a section 338(h)(10) election. P forms Newco ("N") for the sole purpose of acquiring all of the T stock by means of a reverse subsidiary cash merger. Prior to the merger, N conducts no activities other than those required for the merger. N merges into T and the T shareholders receive cash for their T stock. N stock is converted into T stock.

b. The existence of N is disregarded and P is considered to acquire the T stock directly
from the T shareholders for cash. The transaction will constitute a QSP of T. Treas. Reg. § 1.338-2(b)(2)(ii), ex. 2.

c. Stock acquired in a tax-free reverse subsidiary merger will not be considered to be purchased, and therefore will not qualify as a QSP.

9. **Circular ownership of T stock**

It is not clear how to treat stock of T owned by its wholly owned subsidiary X for purposes of determining whether P has made a QSP.

a. If P purchases all of the stock of T except the stock of T owned by X, should that stock be completely ignored?

b. In a letter ruling under section 338, the Service has described such stock as "issued and outstanding shares." PLR 8425120.

c. Should it be considered as purchased by P in proportion to P's percentage purchase of T? If it is "purchased," what is its basis for gross-up purposes? How is X's stock in T treated if T only owns 80 percent of X, and the other 20 percent is owned by an unrelated party?

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

If a section 338(h)(10) election is made for T, Old T is deemed to have sold its assets to New T. Under section 338(h)(3)(B), New T's deemed purchase of stock of another corporation is a purchase for purposes of section 338(d)(3). 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). Therefore, a section 338(h)(10) election can be made for T's subsidiaries.
11. **Effect of post-acquisition events**

a. **Post-acquisition elimination of T**

(1) P may make a section 338(h)(10) election even though T is liquidated on or after the acquisition date. If T is liquidated on the acquisition date, the liquidation is deemed to occur on the following day and immediately after New T's deemed purchase of assets. P may also make a section 338 election even though T is merged into another corporation, or otherwise disposed of by P provided that, under the facts and circumstances, P is considered for tax purposes as the purchaser of the T stock. Treas. Reg. § 1.338-2(c)(1).

(2) **Example**

On January 1 of Year 1, P makes a QSP of T. On that date, T owns the stock of T1. On March 1 of Year 1, T sells the T1 stock to an unrelated corporation (“X”). On April 1 of Year 1, P makes a section 338 election for T. Notwithstanding that the T1 stock was sold on March 1 of Year 1, the section 338 election for T on April 1 of Year 1, results in a qualified stock purchase by T of T1 on January 1 of year 1. Treas. Reg. § 1.338-2(c)(1) Ex. 2.

IV. **PROCEDURE FOR MAKING A SECTION 338(h)(10) ELECTION**

A. **Joint Election Required**

A section 338(h)(10) election is made jointly by P (or the common parent acting on its behalf) and:

1. In the case of a target that is a consolidated subsidiary, the selling consolidated group (i.e., by a person acting on behalf of the common parent); or
2. In the case of a target that is a nonconsolidated subsidiary, the selling affiliate; or

3. In case of a target that is an S corporation, the S corporation shareholders.

   a. Each shareholder who sells T stock in the QSP must consent to the section 338(h)(10) election and sign Form 8023. See Instructions to Form 8023.

   b. A shareholder who retains his or her shares, or who sells to a purchaser other than the QSP buyer, presumably is not required to agree to the section 338(h)(10) election, even though that election will have tax implications for the shareholder.

   c. The proposed regulations provide that all S corporation shareholders, selling or not, must consent to the making of the section 338(h)(10) election. See Prop. Treas. Reg. § 1.338(h)(10)-1(c)(2).

B. Timing of Election

The section 338(h)(10) election must be made not later than the 15th day of the 9th month beginning after the month in which the acquisition date occurs. Treas. Reg. § 1.338(h)(10)-1(d)(2).

C. Other Rules


2. If a section 338(h)(10) election is made for T, a section 338 election is deemed made for T. Treas. Reg. § 1.338(h)(10)-1(d)(3).

3. If a section 338(h)(10) election for T is not valid, the section 338 election for T also is not valid. Treas. Reg. § 1.338(h)(10)-1(d)(4).

4. The final regulations reduce the application of the stock consistency rules for the most part. Thus, a section 338(h)(10) election must be made for each acquired T separately. Application of
the stock consistency rules is limited to cases in which the rules are necessary to prevent avoidance of the asset consistency rules.

The consistency rules will most frequently apply in the context of section 338(h)(10) in a situation where a T subsidiary is purchased with a section 338(h)(10) election being made, and then, within a 12-month period, the same party acquires T itself. Under the consistency rules, P will have a carryover basis in the T subsidiaries assets unless P also makes a section 338(h)(10) election for the purchase of T. Treas. Reg. § 1.338-4. This rule makes sense since the T subsidiary's gain is taken into account in determining T's basis in the T subsidiary stock under Treas. Reg. § 1.1502-32.

5. Note that if a section 338(h)(10) is not made for T, a section 338(h)(10) election cannot be made for T's subsidiary -- without an election, there is no deemed purchase of the subsidiary's stock and can be no QSP.

V. CONSEQUENCES OF A SECTION 338(h)(10) ELECTION

A. Background

Basically, there were two alternative ways in which the regulations could have characterized the section 338(h)(10) transaction. The major differences between the two possible alternative characterizations were: (i) whether T's attributes, principally its net operating losses and E&P, would be retained and used by the selling consolidated group after the section 338(h)(10) transaction, and (ii) whether excess loss accounts would be triggered on the sale of the stock of target.

1. The first alternative (called the "liquidation approach") views the section 338(h)(10) transaction as a sale of assets followed by the distribution of the proceeds in complete liquidation under section 332.
2. The second alternative (called the "termination approach") views the section 338(h)(10) transaction as a sale of T's assets with T thereafter simply terminating as it does in a regular section 338 transaction.

3. The regulations adopt the first alternative (the liquidation approach) and reject the second alternative (the termination approach).

4. This was done apparently because it was perceived that Congress' intent was to parallel the results of an economically similar transaction, i.e., an actual sale of assets followed by a liquidation, and there was no compelling reason to force sellers to actually sell assets to obtain that result. Section 338 did away with requiring a liquidation to obtain a step-up; section 338(h)(10) did away with requiring an actual asset sale followed by a liquidation.

5. Moreover, the termination approach would permit a selling group to eliminate T's tax attributes. These attributes would remain in the selling group if T had actually sold assets and liquidated.

6. The proposed regulations do not mention the term "complete liquidation" but instead provide that old T is treated as if it transferred all of its assets to members of the selling consolidated group, the selling affiliate, or S corporation shareholders and then ceased to exist. Prop. Treas. Reg. § 1.338(h)(10)-1(d)(4).

7. The preamble to the proposed regulations states that the proposed regulations treat all parties concerned as if the fictions the section 338(h)(10) regulations deem to occur, actually did occur, or as closely thereto as possible; and, that this model should be used to help taxpayers answer any questions that are not explicitly addressed by the proposed regulations.

8. In addition, Prop. Treas. Reg. § 1.338(h)(10)-1(d)(9) provides that old T may not assert any provision in section 338(h)(10) or the regulations to obtain a tax result that would not be obtained
if the parties had actually engaged in the transactions deemed to occur because of the regulations and taking into account other transactions that actually occurred or are deemed to occur.

B. Consequences to Old T and its Shareholders

As a result of a section 338(h)(10) election, T is treated as "Old T", a corporation owned by T's current owners, who sells its assets to "New T" (owned by P) in a single transaction and then distributes the proceeds to its parent in complete liquidation. The consequences of a section 338(h)(10) election are as follows:

1. Recognize gain or loss as if T sold its assets

Old T must recognize gain or loss as if, while a member of the selling consolidated group (or owned by the selling affiliate or S corporation shareholders), it sold all of its assets in a single taxable transaction at the close of the acquisition date (but before the deemed liquidation). Treas. Reg. § 1.338(h)(10)-1(d)(1). See Part V.C., below for the determination of the deemed sale price.

a. Consequence if T is a member of a consolidated group

(1) Tax on any gain is paid by the selling consolidated group. Such gain can be offset by the losses, if any, of the selling group but not the purchasing group. Losses in excess of the gain remain with the selling consolidated group.

(2) Deferred gain or loss on intercompany transactions to T from another member of the selling consolidated group (i.e., transactions in which T is treated as the buying member) is taken into account. Treas. Reg. § 1.1502-13(c)(2).
b. Consequence if T is a member of an affiliated nonconsolidated group

(1) The regulations provide that New T (owned by P) remains liable for the tax attributes of Old T (including tax liabilities resulting from the deemed sale of assets). Treas. Reg. § 1.338(h)(10)-1(e)(5).

(2) Nothing in the regulations provide that S is liable for Old T's tax liabilities.

(3) Thus, unlike the result when Old T is a member of a consolidated group, in this case P is responsible for the tax liabilities of Old T.

c. Consequence if T is an S corporation

(1) If T is an S corporation immediately before T's acquisition date, the sale or exchange of Old T stock to P on the acquisition date does not result in a termination of the section 1362(a) election for the S corporation. Treas. Reg. § 1.338(h)(10)-1(d)(2)(iv).

(2) T files a final S corporation tax return that includes its activities through the close of business on the acquisition date, including gain or loss on the deemed asset sale.

(3) New T is not liable for the tax (except for possible section 1374 tax). Basis of the T shareholders in their T stock is adjusted under section 1366 and 1367 to reflect the T shareholder's share of gain on the deemed asset sale by T. The T shareholders recognize loss up to their basis in the T stock as permitted under section 1366.

(4) If any section 1374 tax is triggered by the deemed asset sale, that tax liability remains with New T.
(5) The proposed regulations provide that when T is an S corporation, any direct or indirect subsidiaries of T which T has elected to treat as qualified subchapter S subsidiaries under section 1361(b)(3) remain qualified subchapter S subsidiaries through the close of the acquisition date. However, the proposed regulations provide that no similar rule applies when a qualified subchapter S subsidiary, as opposed to the S corporation that is its owner, is the target the stock of which is actually purchased. Prop. Treas. Reg. § 1.338(h)(10)-1(d)(3).

d. Investment tax credit ("ITC") is recaptured (Treas. Reg. § 1.1502-3(f)(1)).

2. Consequence of sale of T stock

No gain or loss is recognized on the sale or exchange by the selling consolidated group (or the selling affiliate or an S corporation shareholder) of T stock included in the QSP. Treas. Reg. § 1.338(h)(10)-1(d)(2)(iv).

3. Deemed liquidation

a. In general

For purposes of Subtitle A of the Internal Revenue (the "Code") (Income Taxes), Old T is treated as if, while a member of the selling consolidated group (or owned by the selling affiliate or S corporation shareholders) it distributed all of its assets in complete liquidation. Treas. Reg. § 1.338(h)(10)-1(d)(2)(ii).

b. The proposed regulations do not mention the term "complete liquidation" but instead provide that old T is treated as if it transferred all of its assets to members of the selling consolidated group, the selling affiliate, or S corporation shareholders and

c. Consequence if T is a member of a consolidated group or is a nonconsolidated affiliate

(1) Deemed liquidation is governed by section 332.

(a) Do not recognize gain or loss.

(b) Attributes listed in section 381, such as net operating loss carryovers and Earnings and Profits ("E&P"), carry over from T to the transferee in the deemed liquidation.

(c) However, since the liquidation is deemed to occur after the deemed sale of T's assets, T's carryovers must be adjusted for the effects of the deemed sale.

(2) Gain or loss on intercompany transactions from T to another member of the selling consolidated group is not triggered but rather is inherited on the deemed liquidation. See Treas. Reg. § 1.1502-13(j)(2)(ii). The selling consolidated group also does not recognize gain attributable to any excess loss accounts as such amounts are eliminated. See Treas. Reg. § 1.1502-19(c).

d. Consequence if T is an S corporation

(1) Deemed liquidation is governed by section 331.

(a) S corporation shareholders are treated as receiving deemed liquidation proceeds as full payment in exchange for their stock. Recognize capital gain or
loss to the extent the deemed liquidation proceeds exceed or are less than the shareholder's basis in the stock.

(b) No double taxation should result because the basis of the T stock has been adjusted under section 1366 and 1367 to reflect the T shareholder's share of gain on the deemed asset sale by T.

(2) A section 338(h)(10) election can affect T shareholder even in absence of double taxation -- character of gain can vary depending on type of asset sold.

(3) Example: Individual A owns 100% of the stock of T, an S corporation. A's basis in the stock is $75. T has only one asset, inventory with a $50 basis and a $100 FMV. P wants to purchase T from A.

(a) Scenario 1: P purchases all of A's T stock for $100 with no section 338(h)(10) election.

Result: A recognizes $25 of capital gain because A's stock basis is $75, and the sale price is $100. P owns T, which has a $50 basis in its inventory.

(b) Scenario 2: P purchases all of A's T stock for $100 and the parties make a joint section 338(h)(10) election.

Result: T is treated as if it sold its assets (inventory) for $100, thus recognizing $50 of ordinary income. T's gain passes through to A, A recognizes ordinary income of $50. This amount is reflected in the basis of A's T stock, which rises to $125. On T's deemed liquidation, A recognizes a capital
loss of $25. P owns New T which has a $100 basis in its inventory.

(c) Therefore, although A recognizes the same amount of aggregate gain in both scenarios ($25), the tax results would be different because of the difference in tax rates between capital gains and ordinary income, and the limitation on deduction of capital losses.

e. **Other issues**

(1) If T adopts a plan of liquidation, a distribution of unwanted assets after the plan's adoption and prior to the sale of T stock should be treated as part of the deemed liquidation. [See PLR 9735038 and PLR 9434009.](#)

(2) If a plan of liquidation is not adopted prior to the distribution of assets, section 311(b) should apply to a distribution of unwanted assets prior to the stock transfer. The related gain would be deferred and would not be triggered by the subsequent section 338(h)(10) transaction. [See Treas. Reg. § 1.1502-13(j)(2); PLR 8821047.](#)

4. **Effect on minority shareholders**

a. If T is a member of a consolidated group or is a nonconsolidated affiliate

(1) The minority shareholders of T who do not sell or exchange their stock do not recognize gain or loss and retain their existing basis and holding period in T stock even though there is a deemed liquidation of T in the section 338(h)(10) transaction. [Treas. Reg. § 1.338(h)(10)-1(e)(3)(iii).](#)

(2) This results in a double tax on the shares held by the minority shareholders.
shareholders. Old T recognizes the full amount of gain or loss, and a second level of tax would occur upon the sale of the minority's T stock, or upon a liquidation of T.

b. If T is an S corporation

The nonselling T shareholders take into account their share of T's deemed asset sale gain or loss under sections 1366 and 1367, recognize gain or loss on T's deemed liquidation under section 331, and obtain a basis in their retained shares of T (now a C corporation) equal to FMV determined by applying the MADSP formula, described below at Part V.C. Treas. Reg. § 1.338(h)(10)-1(e).

5. Shares retained by the selling parent

To the extent the selling consolidated group or selling affiliate do not sell or exchange all of its T stock, no gain or loss is recognized on such stock, but holders of the retained stock receive a basis in the stock equal to the net FMV of the portion of New T's assets that such members would have received if T had actually been liquidated at the beginning of the day after the acquisition date. Treas. Reg. § 1.338(h)(10)-1(e)(2)(iii).

a. The reason for the adjustment in basis is that the selling consolidated group or T includes and pays tax on the full amount of gain on the deemed sale of T's assets.

b. This rule is not inconsistent with General Utilities repeal. So long as T's assets are subject to one level of corporate tax, the intent of TRA 86 appears satisfied. Therefore, a basis step-up is appropriate.

c. Such a stock basis step-up also is consistent with the fact that the buyer (P) will have a cost basis in both its acquired T stock and T assets.
C. Deemed Sale Price

1. MADSP formula

Treas. Reg. § 1.338(h)(10)-1(f)(1) provides that the deemed sale price of each asset is calculated by determining the modified aggregate deemed sales price ("MADSP") and then allocating the MADSP among Old T's assets in accordance with Temp. Treas. Reg. § 1.338(b)-2T.

a. The MADSP formula is:

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

- **G** = grossed-up basis of P's recently purchased T stock
- **L** = liabilities of New T as of the beginning of the day after the acquisition date
- **X** = other relevant items


b. Definitions

1. **Recently purchased stock** -- any T stock which is held by P on the acquisition date and which was purchased by such corporation during the 12-month acquisition period. Section 338(b)(6)(A).

2. **Nonrecently purchased stock** -- any T stock which is held by P on the acquisition date and which was not purchased by such corporation during the 12-month acquisition period. Section 338(b)(6)(B).
c. **Grossed-up basis** is determined as described below:

\[
P's\ basis\ in\ \text{(100\%\ of)}\ \text{recently purchased T stock} \times \frac{\text{percentage of recently purchased T stock (by value) held by P}}{100} = \text{grossed-up basis}
\]

When T has a single class of stock, grossed-up basis represents the amount P would have paid for all of the T stock based on the amount P paid for the stock counted as part of the QSP. Treas. Reg. § 1.338(b)-1(d)(2).

d. **Liabilities**

(1) Include the liabilities of New T and the liabilities to which its assets are subject, as of the beginning of the day after the acquisition date. Treas. Reg. § 1.338(h)(10)-1(f)(3).

(2) Liabilities do not include the tax liability resulting from the deemed sale imposed on Old T. Treas. Reg. § 1.338(h)(10)-1(g). This is appropriate in situations where Old T was a member of a consolidated group because the selling group, and not P, is liable for the tax. However, if Old T was an affiliated nonconsolidated corporation, this result is inappropriate because New T remains liable for the tax liability and therefore should be able to include it in its basis.

e. **Other relevant items include:**

(1) Reductions for P's acquisition costs incurred in connection with the qualified stock purchase that are capitalized in the basis of recently purchased T stock (e.g., brokerage commissions and any similar costs incurred by P to acquire T stock); and
(2) Reductions for selling costs of the selling consolidated group (or selling affiliate or S corporation shareholders) incurred in connection with the qualified stock purchase that reduce the amount realized on the sale of recently purchased T stock (e.g., brokerage commissions and any similar costs incurred by the selling group to sell T stock).


2. After the MADSP is determined pursuant to the above formula, the deemed selling price must be allocated to each asset. The allocation to specific assets generally is made using the method prescribed in Temp. Treas. Reg. § 1.338(b)-2T, i.e., first to Class I, then Class II, Class III, Class IV, and finally Class V assets. Treas. Reg. § 1.338(h)(10)-1(f)(1)(ii). See Part V.G., below.

3. The MADSP formula provides results that are similar to those in a bulk sale of assets.

4. If the selling consolidated group sells T stock in an installment sale, it is not clear whether it may report the section 338(h)(10) gain on the installment method. See Part VII.A., below.

5. Determination of MADSP -- Examples

The following examples are based upon the examples in Treas. Reg. § 1.338(h)(10)-1(g). In each of the examples, it is assumed, unless otherwise provided, that S owns all of the stock of T, and S and T file a consolidated return. On March 1, S sells its T stock to P for $80,000, and a section 338(h)(10) election is made for T.

a. Example 1: Simple transaction

(1) On March 1, T owns land with a $50,000 basis and $75,000 fair market value and equipment with a $30,000 adjusted basis, and $60,000 fair market value. T also has a $40,000 liability.
(2) The MADSP is $120,000 ($80,000 + $40,000 + 0). As explained in Part V.G., below, since both assets are of the same class, the MADSP will be allocated to the assets based on their relative FMV, therefore MADSP will allocated to each asset as follows:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Basis</th>
<th>FMV</th>
<th>Fraction</th>
<th>Allocable MADSP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td>50,000</td>
<td>75,000</td>
<td>5/9</td>
<td>66,677</td>
</tr>
<tr>
<td>Equipment</td>
<td>30,000</td>
<td>60,000</td>
<td>4/9</td>
<td>53,333</td>
</tr>
<tr>
<td>Total</td>
<td>80,000</td>
<td>135,000</td>
<td>1</td>
<td>120,000</td>
</tr>
</tbody>
</table>

Under Treas. Reg. § 1.338(h)(10)-1(e)(1), Old T has gain on the deemed sale of $40,000 (consisting of $16,667 of capital gain and $23,333 of ordinary income attributable to depreciation recapture).

(3) Under Treas. Reg. § 1.338(h)(10)-1(e)(2), S does not recognize gain or loss upon its sale of the Old T stock to P.

(4) P's basis in New T stock is P's cost for the stock, $80,000.

b. Example 2: P purchases less than all of T's stock

(1) The facts are the same as in Example 1, except that S sells 80% of the Old T stock to P for $64,000, rather than 100% of the Old T stock for $80,000.

(2) The consequences to P, T, and S are the same as in Example 1, except that:

(a) P's basis for its 80-percent interest in the New T stock is P's $64,000 cost for the stock.
(b) Under Treas. Reg. § 1.338(b)-1, the MADSP is $120,000. Grossed-up basis is calculated using the formula in Part V.C.2., above. The calculation is as follows:

<table>
<thead>
<tr>
<th>P's basis in recently purchased T stock</th>
<th>100%</th>
<th>=</th>
<th>grossed-up basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>percentage of recently purchased T stock (by value) held by P</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

\[ \frac{64,000 \times 100\%}{80\%} = 80,000 \]

\[ 80,000 + 40,000 = 120,000 \]

(c) Under Treas. Reg. § 1.338(h)(10)-1(e)(2), S does not recognize gain or loss with respect to the retained stock in T.

(d) Under Treas. Reg. § 1.338(h)(10)-1(e)(2)(iii), the basis of the T stock retained by S is $16,000 (i.e., $120,000 - $40,000 (the MADSP amount for the Old T assets over the sum of New T's liabilities immediately after the acquisition date) x 20% (the proportion of T stock retained by S)).

c. Example 3: Unrelated shareholder

(1) The facts are the same as in Example 2, except that K, a shareholder unrelated to T or P, owns the 20% of the T stock that is not acquired by P in the qualified stock purchase. K's basis in its T stock is $5,000.

(2) The consequences to P, T, and S are the same as in Example 2.
(3) Under Treas. Reg. § 1.338(h)(10)-1(e)(3), K recognizes no gain or loss, and K's basis in its T stock remains at $5,000.

d. Example 4: Target affiliate

(1) The facts are the same as in Example 1, except that the land is held by T and the equipment is held by Ti, a wholly owned subsidiary of T. Section 338(h)(10) elections are made for both T and Ti. The Ti stock has a fair market value of $60,000. Ti has no assets other than the equipment and no liabilities.

(2) The MADSP for T is $120,000, allocated $66,667 to the land and $53,333 to the Ti stock. Old T's deemed sale gain is $16,667 (the capital gain on its deemed sale of the land). Under Treas. Reg. § 1.338(h)(10)-1(e)(2), Old T does not recognize gain or loss on its deemed sale of the Ti stock.

(3) The MADSP for Ti is $53,333 (i.e., $53,333 + $0 + $0). On the deemed sale, Ti recognizes ordinary income of $23,333.

(4) Under Treas. Reg. § 1.338(h)(10)-1(e)(2), S does not recognize gain or loss upon its sale of the Old T stock to P.

6. Subsequent adjustments to MADSP

a. Subsequent adjustments may affect the price at which Old T was deemed to sell its assets. To the extent general tax law principles would require a seller in an asset sale to account for subsequent adjustments, T (or a member of the selling consolidated group in the event of an election under section 338(h)(10)) must take into account such subsequent adjustments in reporting income,

(1) For example, MADSP generally must be increased to take into account any additional payments made to the seller for recently purchased stock. If an increase (or decrease) in AGUB is specifically allocated to a contingent income asset (or other asset) (see Part V.E.5.j., below) then any redetermination of the fair market value of the asset is taken into account in making adjustments to the MADSP. Temp. Treas. Reg. § 1.338(b)-3T(h)(1)(ii).

(2) Presumably, although not dealt with in the regulations, if New T pays a contingent liability that would otherwise have been deductible by Old T if paid prior to the acquisition date, Old T will be allowed a deduction for such contingent liability on the theory that it is treated as continuing for such purpose and deemed to pay the contingent liability. See Commercial Security Bank v. Commissioner, 77 T.C. 145 (1981); James M. Pierce Corp. v. Commissioner, 326 F.2d 67 (8th Cir. 1964); Coolidge v. Commissioner, 40 B.T.A. 1235 (1939).

(3) In TAM 8741001 the Service ruled that certain contingent liabilities did not produce a deduction for Old T even though Old T included them in the ADSP (the equivalent of MADSP for section 338 elections) purchase price formula when they became fixed.

b. However, Treas. Reg. § 1.461-4(g)(1)(ii)(C) appears to suggest that if a purchaser expressly assumes a contingent liability, Old T is deemed to make payments with respect to the liability as the amount of the liability is included in the amount realized on the transaction by Old T.
7. The proposed regulations

a. In general

The proposed regulations remove the term MADSP from the regulations and extend the use of the term "aggregate deemed sales price" or "ADSP" generally applicable to section 338 transactions to section 338(h)(10).

b. ADSP formula

Prop. Treas. Reg. § 1.338-4(b)(1) provides that ADSP is the sum of:

1. the grossed-up amount realized on the sale to P of P's recently purchased T stock; and

2. the liabilities of old T.

c. Time and amount of ADSP

1. Original determination

ADSP is initially determined at the beginning of the day after the acquisition date of T. General principles of tax law apply in determining the timing and the amounts of the elements of ADSP. Prop. Treas. Reg. §1.338-4(b)(2)(i).

2. Redetermination of ADSP

ADSP is redetermined at such time and in such amount as an increase or decrease would be required, under general principles of tax law, for the elements of ADSP. Prop. Treas. Reg. §1.338-4(b)(2)(ii).

d. Grossed-up amount realized on the sale to P of P's recently purchased T stock

The grossed-up amount realized on the sale to
P of P's recently purchased T stock is equal to:

(1) the amount realized on the sale to P of P's recently purchased T stock determined as if old T were the selling shareholder and the installment method were not available and determined without regard to selling costs;

(2) divided by the percentage of T stock (by value, determined on the acquisition date) attributable to that recently purchased T stock;

(3) less the selling costs incurred by the selling shareholders in connection with the sale to P of P's recently purchased T stock that reduce their amount realized on the sale of the stock (e.g., brokerage commissions and any similar costs to sell the stock). Prop. Treas. Reg. § 1.338-4(c)(1).

e. Liabilities of old T

(1) The liabilities of old T are the 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 neither liabilities of old T nor liabilities to which old T's assets were subject). Prop. Treas. Reg. § 1.338-4(c)(1).

(2) In order to be taken into account in ADSP, a liability must be a liability of T that is properly taken into account 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 the person's assumption of, or taking subject to, the liability. Id.
Thus, ADSP takes into account both tax credit recapture liability arising because of the deemed asset sale and the tax liability for the deemed sale gain unless the tax liability is borne by some person other than T. Id.

For example, ADSP would not take into account the tax liability for the deemed sale gain when a section 338(h)(10) election is made for a target S corporation because the S corporation shareholders bear that liability. Id.

The time for taking into account liabilities of old T in determining ADSP and the amount of liabilities taken into account is determined as if old T had sold its assets to an unrelated person for consideration that included the unrelated person's assumption of, or taking subject to, the liabilities. Prop. Treas. Reg. § 1.338-4(c)(2).

(a) For example, if no amount of a T liability is properly taken into account in amount realized as of the beginning of the day after the acquisition date, the liability is not initially taken into account in determining ADSP (although it may be taken into account at some later date). Id.

(b) As a further example, an increase or decrease in a liability that does not affect the amount of old T's basis, deductions, or noncapital deductible items arising from the incurrence of the liability is not taken into account in redetermining ADSP. Id.
f. Comparison of MADSP under the current regulations and ADSP under the proposed regulations.

(1) The proposed regulations remove the link in the current regulations between the calculation of the first element of ADSP and the purchaser's basis in recently purchased T stock. This change, combined with changes to the timing rules, results in the elimination of "open-transaction" treatment that was provided in the current regulations.

(2) The proposed regulations make clear that, old T's tax liability incurred on its deemed asset sale is deemed assumed unless the parties have agreed (or the tax or non-tax rules operate such that) the seller, and not T, will bear the economic cost of that tax liability.

(3) Regarding the timing of taking liabilities into account, the proposed regulations provide that general principles of tax law apply in determining the timing and amount of the elements of ADSP. Accordingly, the current rule in the regulations that liabilities are taken into account in calculating ADSP only when such liability becomes fixed and determinable, is removed in the proposed regulations.

(4) The "other relevant items" that are included in the calculation of MADSP are not included in the calculation of ADSP.

D. Consequences to New T and its Purchaser

1. T is treated as New T for purposes of Subtitle A

T is treated, for purposes of Subtitle A of the Code, as a new corporation ("New T"), unrelated to Old T, which purchases the assets of Old T on the day after the acquisition date.


2. T is treated as a continuation of Old T for purposes other than Subtitle A

a. New T remains liable for the tax liabilities of Old T (including tax liabilities resulting from the deemed sale of assets). For example, New T remains liable for the tax liabilities of the members of any consolidated group that are attributable to taxable years in which those corporations and Old T joined in the same consolidated return. Treas. Reg. §§ 1.338(h)(10)-1(e)(5) and 1.1502-6(a).

b. New T is treated as the same corporation as Old T with respect to pension or other employee benefit plans as well as any other provision specified by the Service. Treas. Reg. § 1.338-2(d)(2).


d. Wages earned by employees of Old T are considered wages earned by such employees from New T for purposes of sections 3101, 3111, and 3301.

3. New T's basis in its assets will be calculated and allocated to its assets as described in Parts V.E. & G., below.

4. If P owns shares of nonrecently purchased stock (e.g., stock acquired more than one year before the QSP), it is deemed to have made a gain recognition election with respect to such shares.
E. Purchase Price in Deemed Sale Transaction

1. AGUB

New T's basis in its assets is determined pursuant to regulations as its "adjusted grossed-up basis" ("AGUB"). Treas. Reg. § 1.338(h)(10)-1(e)(5).

AGUB is very similar to MADSP (which determines the purchaser's basis), however, there are differences as described in Part V.E.2.a., below.

a. Determination of AGUB

Under section 338(b)(1) and (2), the T assets are treated as purchased by New T for an aggregate amount equal to:

(1) the "grossed-up basis" of P's "recently purchased" T stock, plus

(2) the basis of P's "nonrecently purchased" T stock, plus

(3) New T's liabilities as of the beginning of the day after the acquisition date, and

(4) other relevant items.

b. This aggregate amount is then allocated among New T's assets in accordance with Temp. Treas. Reg. §§ 1.338-2T, -3T.

(1) Subsequent adjustments (including contingent payments and liabilities, and reductions in payments and liabilities) are taken into account for basis purposes when they become fixed and determinable (or when the reduction occurs) and are allocated among New T's assets held on the acquisition date in accordance with the rules described at Part V.G., below.
(2) However, adjustment events that occur during New T's first taxable year are taken into account for purposes of determining AGUB and basis of T's assets as if they had occurred at the beginning of the day after the acquisition date.

2. Grossed-Up Basis

a. The sum of the grossed-up basis of P's recently purchased stock and the basis of P's nonrecently purchased stock will be exactly equal to the grossed-up basis for purposes of the MADSP formula.

(1) Recently purchased stock

(a) Where P only owns recently purchased stock in T, the gross-up is performed by using the same calculation as was used to determine grossed-up basis for purposes of the MADSP formula:

\[
P's \ basis \ in \ recently \ purchased \ T \ stock \times \frac{100\%}{percentage \ of \ recently \ purchased \ T \ stock \ (by \ value)} = \text{basis of recently purchased T stock held by P}
\]

(b) Where T only has one class of outstanding stock, P's grossed up basis per share in the recently purchased stock of T reflects the total price that would have been paid for all of the T stock (other than any nonrecently purchased stock) -- i.e., it will be equal to the average price per share paid by P times the number of shares outstanding (other than nonrecently purchased shares).
(c) **Example**

P purchases 90 percent of T's stock during the acquisition period for $900 and joins in making a timely section 338(h)(10) election. The grossed-up basis of P's stock in T (and T's new asset basis) equals $1000, determined as follows:

\[
\frac{900 \times 100\%}{90\%} = 1000
\]

(d) Where P also owns nonrecently purchased stock in T, the manner of calculating grossed-up basis of the recently purchased stock is modified to take into account the nonrecently purchased stock held by P. The calculation is as follows:

\[
100\% \text{ less percentage (by value of nonrecently purchased stock)} \times \frac{\text{basis of recently purchased T stock (by value) held by P}}{\text{percentage of recently purchased T stock (by value) held by P}} = \text{recently purchased T stock basis}
\]

(2) **Treatment of nonrecently purchased stock**

(a) **Mandatory gain recognition election**

If P owns nonrecently purchased stock on the acquisition date, then P is deemed to have made a gain recognition election with respect to that stock and will recognize gain (but not loss) with respect to that stock. Treas. Reg. § 1.338(h)(10)-1(e)(4) and Treas. Reg. § 1.338(b)-1(e)(3)(ii).

The result of the deemed gain recognition election is to treat the nonrecently purchased stock as
if P purchased the stock from itself on the acquisition date. Treas. Reg. § 1.338(b)-1(e)(2). P pays a tax on the deemed sale, but it steps up the basis of the nonrecently purchased stock in accordance with the following formula:

\[
\text{grossed-up basis in recently purchased T stock} \times \frac{\text{percentage (by value) of nonrecently purchased stock}}{100\% - \text{percentage in numerator}} = \text{new basis in purchased T stock}
\]

**Example**

P purchases 80 percent of T's stock for $8 million during the 12-month acquisition period. P holds an additional 10 percent of T's stock with a basis of $200,000 on the acquisition date. P and S make a section 338(h)(10) election for T.

The grossed-up basis for the recently purchased stock is $9 million.

\[
$8 \text{ million} \times \frac{100\% - 10\%}{80\%} = $9 \text{ million}
\]

Therefore, the new basis of the nonrecently purchased stock is $1 million.

\[
$9 \text{ million} \times \frac{10\%}{100\% - 10\%} = $1 \text{ million}
\]
P will recognize gain of $800,000. The amount the new basis of the nonrecently purchased stock ($1,000,000) exceeds the old basis of the nonrecently purchased stock = $800,000.

T will have a basis in its assets of $10 million. Grossed-up basis of recently purchased stock ($9 million) + basis of nonrecently purchased stock ($1 million) = $10 million.

(b) **Effect of election**

The effect of this formula is to step-up the basis of the nonrecently purchased stock to an amount equal to the basis it would have if it were recently purchased stock. Once T makes the deemed election, the grossed-up basis is the same as the grossed-up basis of the stock for purposes of applying the MADSP formula. See Part V.C.1.c., above. Treas. Reg. § 1.338(b)-1(e)(4).

3. **Liabilities** -- include the liabilities of New T and the liabilities to which its assets are subject as of the beginning of the day after the acquisition date.

a. In order to be included in the AGUB as of the beginning of the day after the acquisition date, the liability must be a bona fide liability of T that would otherwise be includible in basis as of that date "under principles of tax law" applicable to asset acquisitions in general. Treas. Reg. § 1.338(b)-1(f)(2)(i).

(1) If the taxpayer cannot establish that such liabilities were bona fide liabilities existing on the beginning of
the day after the acquisition date, such liabilities generally will not enter the determination of basis on the acquisition date. Treas. Reg. § 1.338(b)-1(f)(2). Cf. Webb v. Commissioner, 77 T.C. 1134 (1981), aff'd, 708 F.2d 1254 (7th Cir. 1983) (deduction of an assumed unfunded pension liability was allowed as paid under section 404 to the buyer in an asset acquisition). This rule would apply in the case of contingent or speculative liabilities.

(2) In addition, if a nonrecourse liability exceeds the value of the asset to which the liability is subject New T may not be able to include the liability in basis except as actually paid. See Estate of Franklin v. Commissioner, 545 F.2d 1045 (9th Cir. 1976).

(3) Further, Temp. Treas. Reg. § 1.338(b)-2T(c)(2) provides that if the amount of basis of an asset acquired in a sale or exchange is limited under a provision of the Internal Revenue Code or principles of tax law, then the amount of AGUB allocated to the asset is so limited. This rule would presumably apply if T's liabilities exceeded the value of its assets on the acquisition date (e.g., in the case of an acquisition of a solvent T with an insolvent subsidiary) or where T has a nonrecourse liability in excess of the value of collateral.

4. Other relevant items

Section 338(b)(2) provides that "other relevant items" are taken into account in determining the basis of T's assets. Unlike in determining MADSP, other relevant items do not include reductions for acquisition costs incurred by P in connection with the QSP that are capitalized in the basis of recently purchased T stock.
a. **Subsequent adjustments**

Treas. Reg. § 1.338(b)-1(g)(1) provides that increases (or decreases) due to adjustment events that occur after the close of New T's first taxable year are treated for this purpose as "other relevant items." See Part V.E.5., below.

b. **Adjustments by the Service**

Treas. Reg. § 1.338(b)-1(g)(3) provides that on audit the Service may increase or decrease AGUB, and allocate that increase or decrease among T's assets, to insure that the basis of T's assets properly reflect their cost to P.

c. **Flow-through of relevant item adjustment to subsidiary**

Treas. Reg. § 1.338(b)-1(g)(2) provides that if there is a "subsequent adjustment" to the AGUB of T that is allocated to the stock of a target affiliate, T-1, then the grossed-up basis of T-1 stock is adjusted and properly accounted for in the AGUB and basis of the assets of T-1.

5. **Subsequent adjustments to AGUB**

   a. **General**

AGUB must be redetermined to account for adjustment events that occur after New T's first taxable year. These adjustments must be made upon:

(1) the payment of contingent amounts for recently or nonrecently purchased stock,

(2) the change in a contingent liability of Old T to one which is fixed and determinable,

(3) reductions in the amounts paid for recently or nonrecently purchased stock, and
(4) reductions in liabilities of T (and liabilities to which its assets are subject) that were taken into account in determining adjusted grossed-up basis.

AGUB is redetermined only if such an adjustment would be required, under general principles of tax law, in connection with an actual asset purchase by New T from an unrelated person. Temp. Treas. Reg. § 1.338(b)-3T(1).

b. Contingent purchase price

Contingent purchase price that is not fixed and determinable by the close of New T's first taxable year is taken into account as an increase in AGUB (and in the bases of T's assets) when the payment becomes fixed and determinable. Temp. Treas. Reg. § 1.338(b)-3T(c)(1).

c. Contingent liabilities

A "contingent liability" is a liability of T at the beginning of the day after the acquisition date that is not fixed and determinable by the close of New T's first taxable year. Temp. Treas. Reg. § 1.338(b)-3T(b)(1). A contingent liability is taken into account as an increase in AGUB (and in the bases of T's assets) when the liability becomes fixed and determinable. Temp. Treas. Reg. § 1.338(b)-3T(c)(1).

d. Reductions of purchase price

A reduction after the close of New T's first taxable year of consideration paid for recently or nonrecently purchased stock is taken into account for purposes of calculating AGUB (and the bases of New T's assets) when the reduction in the consideration is paid. Temp. Treas. Reg. § 1.338(b)-3T(c)(2).
e. **Reductions of target's liabilities**

A reduction after the close of New T's first taxable year in a liability of T (or a liability to which one or more of its assets are subject) that has been taken into account in determining AGUB is taken into account for purposes of calculating AGUB (and the bases of New T's assets) when the reduction of the liability occurs. Temp. Treas. Reg. § 1.338(b)-3T(c)(2).

A reduction in a liability will not be taken into account if it is (i) includible in gross income as discharge of indebtedness income (or would be includible but for section 108(a)), (ii) due to a contribution of capital, (iii) due to the payment of a liability, or (iv) due to the discharge of a liability within the meaning of Treas. Reg. § 1.1001-2, i.e., the liability is included in New T's amount realized in connection with a sale or exchange. Temp. Treas. Reg. § 1.338(b)-3T(b)(2).

f. **Amount of increase or decrease in AGUB**

The amount of an increase (or decrease) in AGUB is the difference between (i) AGUB immediately before the increase (or decrease) and (ii) AGUB recomputed by taking into account the increase (or decrease). Temp. Treas. Reg. § 1.338(b)-3T(c)(3)

g. **Allocation of increases in AGUB**

Increases in AGUB are allocated among T's acquisition date assets in accordance with the general allocation rules set forth at Part V.G., below. Amounts so allocated are subject to the FMV and other limitations set forth at Part V.G., above, so that, once the FMV of all T's other assets on the acquisition date is exceeded, any excess may be allocated to intangible assets in the nature of goodwill or going concern value. Temp. Treas. Reg. § 1.338(b)-3T(d)(1).
h. Disposition or depreciation of acquisition date assets

If an acquisition date asset has been disposed of (or depreciated, amortized, or depleted) before an increase is included in the AGUB, the amount of the AGUB that would otherwise be allocated to the asset is treated under principles of tax law applicable when part of the cost of an asset is paid after the asset has been disposed of (or depreciated, etc.). Temp. Treas. Reg. § 1.338(b)-3T(d)(2). Thus, for example, an amount otherwise allocable to a disposed of capital asset may be deducted by New T as a capital loss. See Arrowsmith v. Commissioner, 343 U.S. 6 (1952).

i. Allocation of decreases in AGUB

The rule for allocation of decreases is similar to the one for increases, except that the decreases are allocated to T's acquisition date assets in the reverse of the order in which the AGUB was allocated. Temp. Treas. Reg. § 1.338(b)-3T(e)(1). Thus, decreases in AGUB are allocated first among T's acquisition date assets which are in the nature of goodwill and going concern value to the extent of their basis, and second, to T's other acquisition date assets in the reverse order of that set forth at Part V.G., above.

(1) The decrease is taken into account for purposes of calculating AGUB and the basis of T's assets when the reduction occurs. Temp. Treas. Reg. § 1.338(b)-3T(c)(2).

(2) Similar principles of tax law apply to amounts that would have been allocated to acquisition date assets that have been disposed of (or depreciated, etc.) as those that apply to increases. Temp. Treas. Reg. § 1.338(b)-3T(c)(2).
j. Special rule for allocation of increases (or decreases) to specific assets

Temp. Treas. Reg. § 1.338(b)-3T(g) provides a special rule for specifically allocating amounts of contingent payments to the basis of certain assets where the contingency directly relates to the income produced by a particular intangible asset (i.e., a "contingent income asset" such as a patent, copyright, or secret process) and not to other T assets. Temp. Treas. Reg. § 1.338(b)-3T(g)(1)(i).

(1) According to this rule, the increase (or decrease) is first allocated to such contingent income asset and then to other T assets.

(a) According to Temp. Treas. Reg. § 1.338(b)-3T(g)(2), the Service may apply the principles of Temp. Treas. Reg. § 1.338(b)-3T(g)(1) to reallocate an increase (or decrease) among some of T's assets in "appropriate cases" to the extent such allocation is necessary to reflect properly the consideration that relates to each of those assets.

(b) This special allocation rule is contrary to the residual approach, but provides the Service with authority to properly allocate basis to an asset whose value may be very difficult to ascertain on the acquisition date because the consideration given for that asset is contingent upon the future income produced by it.

(2) The amounts allocated to the contingent income asset are expressly subject to the FMV limitation and other limitations contained in Temp. Treas. Reg. § 1.338(b)-2T(c)(1) and (2).
(a) Solely for purposes of applying the FMV and other limitations to such assets, Temp. Treas. Reg. § 1.338(b)-2T(g)(1)(ii), as originally promulgated, stated that the FMV of the contingent income asset may be redetermined as of the time when the increase (or decrease) is taken into account.

(b) However, in connection with the promulgation of the section 1060 regulations issued in 1988 and amended in 1997, Treasury amended Temp. Treas. Reg. § 1.338(b)-3T(g)(1)(ii) to clarify that, for purposes of applying the FMV limitation of Temp. Treas. Reg. § 1.338(b)-2T(c)(1), the FMV of the contingent income asset is redetermined as of the day after the acquisition date, and taking into account only those circumstances which resulted in an increase (or decrease) in AGUB. See T.D. 8215 (July 15, 1988); T.D. 8711, (January 9, 1997).

(3) The proposed regulations would eliminate this item-specific adjustment rule. The preamble to the proposed regulations states that the rule was eliminated because it was determined that the usefulness of the rule was outweighed by its complexity.

6. The proposed regulations

a. Determination of AGUB

AGUB is the sum of:

(1) the grossed-up basis in P's recently purchased T stock;

(2) P's basis in P's nonrecently purchased T stock; and
(3) the liabilities of new T. Prop. Treas. Reg. § 1.338-5(b)(1).

b. **Time and amount of AGUB**

(1) **Original determination**

AGUB is initially determined at the beginning of the day after the acquisition date of T. General principles of tax law apply in determining the timing and amounts of the elements of AGUB. Prop. Treas. Reg. §1.338-5(b)(2)(i).

(2) **Redetermination of AGUB**

AGUB is redetermined at such time and in such amount as an increase or decrease would be required, under general principles of tax law, with respect to an elements of AGUB. Prop. Treas. Reg. §1.338-5(b)(2)(ii).

c. **Grossed-up basis in P's recently purchased T stock**

P's grossed-up basis of recently purchased T stock is equal to:

(1) P's basis in recently purchased T stock at the beginning of the day after the acquisition date determined without regard to the acquisition costs.

(2) Multiplied by a fraction, the numerator of which is 100 percent minus the percentage of T stock (by value, determined on the acquisition date) attributable to P's nonrecently purchased T stock, and the denominator of which is the percentage of T stock (by value, determined on the acquisition date) attributable to P's recently purchased T stock.
(3) Plus the acquisition costs the purchasing corporation incurred in connection with its purchase of the recently purchased stock that are capitalized in the basis of such stock. Prop. Treas. Reg. §1.338-5(c).

d. Liabilities of new T

(1) The liabilities of new T are the 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 neither liabilities of old T nor liabilities to which old T's assets were subject). Prop. Treas. Reg. §1.338-5(e).

(2) In order to be taken into account in AGUB, a liability must be a liability of T that is properly taken into account in basis under general principles of tax law that would apply if new T had acquired its assets from an unrelated person for consideration that included the assumption of, or taking subject to, the liability. Id.

(3) The time for taking into account liabilities of old T in determining AGUB and the amount of the liabilities taken into account is determined as if new T had acquired its assets from an unrelated person for consideration that included the assumption of, or taking subject to, the liabilities. Prop. Treas. Reg. §1.338-5(e)(2).

e. Comparison of AGUB under the current regulations and AGUB under the proposed regulations.

(1) Regarding the timing of taking liabilities into account, the proposed regulations provide that general principles of tax law apply in
determining the timing and amount of the elements of AGUB. Accordingly, the current rule in the regulations that liabilities are taken into account in calculating AGUB only when such liability becomes fixed and determinable, is removed in the proposed regulations. See Prop. Treas. Reg. § 1.338-5(e).

(2) The proposed regulations provide that, for new T, the definition of AGUB is changed such that when the P's basis in recently purchased stock is grossed-up, acquisition costs are no longer also grossed-up.

F. Effect of Section 197

1. In general

Section 197 was added to the Code by the Omnibus Budget Reconciliation Act of 1993, P.L. 103-66, 107 Stat. 312 (1993) ("OBRA93"). Section 197 governs the tax treatment of acquired intangible assets and allows a 15-year amortization period for any "amortizable section 197 intangible" that (i) is acquired after August 10, 1993, and (ii) "is held in connection with the conduct of a trade or business or any activity described in section 212." Section 197(c)(1).

2. Amortizable section 197 intangible

a. Section 197(c) defines the term "amortizable section 197 intangible" as referring to a section 197 intangible that is:

(1) acquired after the date of enactment of the statute (except for the special elections noted below), and

(2) held in connection with the conduct of a trade or business or an activity described in section 212. See Prop. Treas. Reg. § 1.197-2(d).
b. The term does not include any goodwill, going concern value, or any customer-based, supplier-based, workforce in place, or other similar intangible that is created by the taxpayer. However, this rule does not apply if the intangible is created in connection with a transaction involving the acquisition of assets constituting a trade or business or a substantial portion thereof. Section 197(c)(2). See Prop. Treas. Reg. § 1.197-2(e)(1).

(1) For goodwill or going concern value, a group of assets constitutes a trade or business or a substantial portion thereof if their use would constitute a trade or business under section 1060. Prop. Treas. Reg. § 1.197-2(e)(1).

(2) Whether or not the previous paragraph applies, a group of assets constitutes a trade or business or a substantial portion thereof if the assets include customer-based intangibles (see infra), or are acquired in a transaction (or series of related transactions) that involve the creation of customer-based intangibles. Prop. Treas. Reg. § 1.197-2(e)(2).

(3) The acquisition of a franchise, trademark, or trade name generally constitutes the acquisition of a trade or business or a substantial portion thereof. Prop. Treas. Reg. § 1.197-2(e)(3).

(4) A qualified stock purchase treated as an asset purchase under section 338(h)(10) constitutes the acquisition of a trade or business or a substantial portion thereof only if the direct acquisition of the assets of the corporation would have been treated as the acquisition of assets constituting a trade or business.
Whether acquired assets constitute a "substantial portion" of a trade or business is based on all the relevant facts and circumstances. Prop. Treas. Reg. § 1.197-2(e)(5).

c. A "section 197 intangible"

For purposes of section 197, acquired intangible assets generally can be grouped into four categories:

(1) intangibles that will always be treated as a "section 197 intangible" (goodwill; going concern value; workforce intangibles; information base intangibles; know-how intangibles, customer base intangibles, supplier base intangibles, licenses, permits, or other rights granted by a governmental unit; and franchises, trademarks or trade names);

(2) intangibles that will be treated as a section 197 intangible if there is a related direct or indirect acquisition of a trade or business (a covenant not to compete);

(3) intangibles that will be treated as a section 197 intangible only if acquired in connection with assets that constitute a trade or business (specialized computer software; any interest in a film, sound recording, video tape, book, or similar property; a contractual right to receive tangible property or services; any interest in a patent or copyright; and any right to service mortgage indebtedness secured by residential real property); and

(4) intangibles that will never be treated as a section 197 intangible (a financial interest, an interest in land; off-the-shelf computer software; an interest in a tangible property lease or a debt
instrument; a professional sports franchise; and certain transactional costs).

d. Applicability to section 338(h)(10) transactions

(1) Section 197 will apply to section 338(h)(10) deemed asset purchases if section 197 would have applied to a direct asset purchase.

(2) To determine whether section 197 would have applied to a direct asset purchase it is necessary to examine the situations in which section 1060 applies.

Section 1060 applies to any "applicable asset acquisition."

(a) An applicable asset acquisition is any transfer of assets constituting a trade or business in the hands of the seller or the purchaser, if the purchaser's basis in the acquired assets is determined wholly by reference to the consideration paid for such assets. Section 1060(c).

(b) Regulations define "assets constituting a trade or business" broadly as consisting of any group of assets (i) the use of which would constitute a trade or business for purposes of section 355, or (ii) to which goodwill or going concern value could under any circumstances attach. Temp. Treas. Reg. § 1.1060-1T(b)(2).

e. Anti-churning rules

Extensive anti-churning rules are intended to prevent pre-existing non-amortizable intangibles from being converted into section 197 intangibles in transactions where the
user does not change or where related parties are involved. A broad anti-abuse rule disqualifies any asset acquired in a transaction designed to avoid the effective date limitation. Generally, the anti-churning rules provide the following:

(1) An amortization deduction under section 197 may not be taken for an asset that, but for section 197, would not be amortizable if (1) it was acquired after August 10, 1993, and (2) either (i) the taxpayer or a related person held or used the intangible at any time on or after July 25, 1991, (ii) legal ownership changes but the user does not, or (iii) the taxpayer grants a former owner (who owned the intangible on or after July 25, 1991) the right to use the asset.

(2) The anti-churning rules do not apply to deductions otherwise allowable under section 1253(d).

(3) The anti-churning rules do not apply to the acquisition of any intangible by a taxpayer if the basis of the intangible in the hands of the taxpayer is determined under section 1014(a).

(4) For purposes of the anti-churning rules, a person is related to another person if (i) the person bears a relationship to that person which would be specified in sections 267(b) (and, by substitution, section 267(f)(1)) or 707(b)(1) if those sections were amended by substituting 20 percent for 50 percent, or (ii) the persons are engaged in trades or businesses under common control. See Prop. Treas. Reg. § 1.197-2(h)(6).

(5) In a section 338(h)(10) transaction, New T is generally not related to Old T for purposes of the section 197 anti-
G. Allocation of Purchase Price Among T's Assets

1. In general
   a. Section 338(b)(5) states that the deemed purchase price "shall be allocated among the assets of T corporation under regulations prescribed by the Secretary."
   

2. Method of allocation
   a. For asset acquisitions completed on or after February 14, 1997, Temp. Treas. Reg. § 1.338(b)-2T provides for basis allocation in the following order:

   (1) Class I -- cash, demand deposits and similar accounts in banks and savings and loan associations, and other items designated by the Service.

   (2) Class II -- certificates of deposit, U.S. government securities, readily marketable stock or securities, foreign currency, and other items designated by the Service.

   (3) Class III -- all assets of the target, other than Class I, II, IV, and V assets.

   (4) Class IV -- all section 197 intangibles, as defined in section 197, except those...
in the nature of goodwill and going concern value.

(5) Class V -- section 197 intangibles in the nature of goodwill and going concern value.

b. The allocation regulations prior to the 1997 amendments were identical to the newly amended regulations except that Classes IV and V were combined into a single class, Class IV. The 1997 amendments were made in response to the enactment of section 197 in OBRA93. The purpose of the amendments were to provide that goodwill and going concern value be assigned to a true residual class.

c. For asset acquisitions completed before February 14, 1997, the transition rules for the newly amended regulations provide that the taxpayer may choose whether to apply:

(1) the amended allocation method (see Part V.G.2.a., above);

(2) the allocation method in place before the 1997 amendment (see Part V.G.2.b., above); or

(3) the allocation method in place before the 1997 amendment, but treat all amortizable section 197 intangibles as Class IV assets.

d. The proposed regulations change the number and content of the asset classes and make other minor changes to the allocation of ADSP and AGUB. Prop. Treas. Reg. § 1.338-6(b) provides that basis is allocated to seven asset classes in the following order:

(1) Class I -- cash and general deposit accounts (including savings and checking accounts) other than certificates of deposit held in banks, savings and loan associations, and other depository institutions. If the amount of Class I
assets exceeds AGUB, new T will immediately realize ordinary income in an amount equal to such excess.

(2) Class II -- actively traded personal property within the meaning of section 1092(d)(1) and Treas. Reg. § 1.1092(d)-1. In addition, Class II assets include certificates of deposit and foreign currency even if they are not actively traded personal property. Examples of Class II assets include U.S. government securities and publicly traded stock.

(3) Class III -- accounts receivable, mortgages, and credit card receivables from customers which arise in the ordinary course of business.

(4) Class IV -- stock in the trade of the taxpayer or other property of a kind which would properly be included in the inventory of taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business.

(5) Class V -- all assets other than Class I, II, III, IV, VI, and VII assets.

(6) Class VI -- all section 197 intangibles, as defined in section 197, except goodwill and going concern value.

(7) Class VII -- goodwill and going concern value (whether or not the goodwill and going concern value qualifies as a section 197 intangible).

e. The allocation to assets within a class of assets is made based on the relative FMV of such assets. The FMV of an asset is the gross fair market value of the asset (i.e., fair market value determined without regard to mortgages, liens, pledges, or other liabilities). Temp. Treas. Reg. § 1.338(b)-
2T(a)(2). The proposed regulations provide that the Service may challenge a taxpayer's determination of the fair market value of any asset by any appropriate method and take into account all factors, including any lack of adverse tax interests between the parties. Prop. Treas. Reg. § 1.338-6(a)(iii).

f. All of the allocations are subject to the limitation that the basis allocated to each asset cannot exceed its FMV and any other limitation imposed on an acquisition of assets from an unrelated person (e.g., section 1056, relating to basis limitation on player contracts transferred in connection with a sale of a franchise).

g. Any excess over FMV is allocated to the next seriatim class of assets, with any residual excess allocated to "intangible assets in the nature of goodwill and going concern value."

The preamble to the regulations states that this residual approach was adopted because of the difficulty in valuing intangible assets in the nature of goodwill and going concern value.

3. **Specific lien rule**

The section 338 regulations reject the specific lien rule. All liabilities -- whether specific liens or general liabilities -- are included in AGUB and allocated under the method of allocation outlined in Part V.G.2., above.

a. The regulations under old section 334(b)(2) provided that amounts of secured liabilities subject to specific liens be allocated as basis to their respective collateral. This "specific lien rule" applied whether or not the amount of debt exceeded the value of its collateral and whether the debt was recourse or nonrecourse.

b. Generally, the specific lien rule could result in significant distortion in
allocating basis that was exacerbated by appropriate taxpayer planning. In order to allocate basis to particular depreciable assets, a taxpayer could incur indebtedness by pledging a particular asset prior to an acquisition. Allocating basis to a particular asset merely because it was pledged to obtain a debt arguably violated the spirit of the group asset purchase rules which allocate basis among all of the assets acquired based upon their relative FMVs ("pro rata rule").

4. Application to subsidiaries

a. This allocation method also applies to subsidiaries of T, treating the stock of a subsidiary as a Class III asset. See Temp. Treas. Reg. § 1.338(b)-2T(d), exs. 1 and 2.

b. If a section 338(h)(10) election is also made for a subsidiary of T ("T1"), the basis allocated to the T1 stock is allocated to T1's assets using the allocation method discussed in Part V.G.2.a., above.

5. Adoption of the residual approach -- policy overview

a. By adopting the residual approach, the regulations specifically reject and overrule the prior Service position, which allowed the separate valuation of and allocation of basis to goodwill through the use of a formula method in certain instances. See A.R.M. 34, 2 C.B. 31 (1920) and Rev. Rul. 68-609, 1968-2 C.B. 327. It was unclear under prior law as to when the formula approach was to be used in favor of the residual approach. Cf. Rev. Rul. 77-456, 1977-2 C.B. 102.

b. Critical to the application of the residual approach is the valuation of T's assets other than goodwill and going concern value. The Code does not mandate any particular method of valuing assets; however, the regulations refer to the price a willing buyer would pay
to a willing seller, neither being under compulsion to buy or sell. See, e.g., Treas. Reg. § 25.2512-1.

(1) In the case of a sale of an ongoing business, this standard does not provide much guidance on the allocation of basis to particular assets. Part of the value of the assets in place is their going concern value.

(2) It is unclear in the regulations whether the value of the assets in place is to be used or whether the scrap value of the assets is to be used for purposes of allocating basis to such assets. The section 338 regulations do not specifically address this issue.

(3) The mandatory adoption of the residual approach cuts two ways. In the case of a bargain purchase, taxpayers are generally benefited by not having to allocate basis to goodwill and going concern value (although since the enactment of section 197, this is of less importance). On the other hand, in the case of a premium purchase, more basis may be allocated to goodwill and going concern value than under the formula approach. Nonetheless, the policy in the regulations is clearly not to allow basis in an asset in excess of its FMV. While this places a great deal of pressure on valuations, there is no way to avoid such pressure completely. See A.P.B. Opinions Nos. 16 and 17, "Business Combinations" and "Intangible Assets," effective Nov. 1, 1970.

c. It may be argued that there is no such thing as a bargain or premium purchase. FMV by definition is what a willing buyer pays in an arms-length non-distress sale to an unrelated seller; thus, the purchase price constitutes FMV by definition. However, the application of this rule is unclear where the purchase
price of stock is being allocated to the underlying assets. Perhaps there is a different FMV for stock versus assets.

d. The preamble to the proposed regulations discusses the problems presented by the application of the residual method in the case of a bargain purchase. In particular, the preamble discusses the problem of gain recognition when assets that turn over quickly, such as accounts receivable and inventory ("fast pay assets"), are not allocated basis. To help fix this problem, the proposed regulations put these fast pay assets into more senior asset classes (Classes III and IV). See Part V.G.2.d.

6. Example 1 -- purchase price equal to FMV of assets

Corporation S owns all the stock of Corporation T. T's assets include the following:

<table>
<thead>
<tr>
<th>Asset</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$1,000</td>
</tr>
<tr>
<td>U.S Gov't Securities</td>
<td>$2,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>$2,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>$3,000</td>
</tr>
<tr>
<td>Goodwill and Going</td>
<td>$2,000</td>
</tr>
<tr>
<td>Concern</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$10,000</td>
</tr>
</tbody>
</table>

In addition, T has liabilities of $5,000. P purchases all of the stock of T from S for $5,000 and the assumption of T's liabilities.

The AGUB is $10,000, representing the grossed-up basis of the T stock ($5,000) + liabilities of New T ($5,000). Basis is allocated to T's assets using the residual approach of Temp. Treas. Reg. § 1.338(b)-2T. Basis is allocated first to Class I assets up to their FMV, and then to each following class up to its FMV, with any remaining basis allocated to Class V assets. Therefore, basis would be allocated as described below:
Result under the Temporary Regulations

<table>
<thead>
<tr>
<th>Asset</th>
<th>Class</th>
<th>FMV</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>I</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>U.S Gov't Securities</td>
<td>II</td>
<td>$2,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>III</td>
<td>$2,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>III</td>
<td>$3,000</td>
<td>$3,000</td>
</tr>
<tr>
<td>Goodwill &amp; Going Concern</td>
<td>V</td>
<td>$2,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
</tbody>
</table>

Since AGUB was the same as the FMV of the assets, each asset was allocated basis up to its FMV.

Result under the Proposed Regulations

The result would be the same under the proposed regulations except that (i) Inventory would be a Class IV asset; (ii) Equipment would be a Class V asset and (iii) Goodwill and Going Concern value would be a Class VII asset.

7. Example 2 -- Premium purchase

The facts are the same as in Example 1, except that P is willing to pay $10,000 for the T stock. Therefore, AGUB will be $15,000. The basis would be allocated as described above, each class up to its FMV, with the additional basis being allocated to the Class V assets.

Result under the Temporary Regulations

<table>
<thead>
<tr>
<th>Asset</th>
<th>Class</th>
<th>FMV</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>I</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>U.S Gov't Securities</td>
<td>II</td>
<td>$2,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>III</td>
<td>$2,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>III</td>
<td>$3,000</td>
<td>$3,000</td>
</tr>
<tr>
<td>Goodwill &amp; Going Concern</td>
<td>V</td>
<td>$2,000</td>
<td>$7,000</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>$10,000</td>
<td>$15,000</td>
</tr>
</tbody>
</table>
Result under the Proposed Regulations

The result would be the same under the proposed regulations except that (i) Inventory would be a Class IV asset; (ii) Equipment would be a Class V asset and (iii) Goodwill and Going Concern value would be a Class VII asset.

8. Example 3 -- Bargain purchase

The facts are the same as in Example 1, except P is only willing to pay $1,000 for the T stock. In this case, the AGUB of $6,000 would be allocated to the assets as described below:

Result under the Temporary Regulations

<table>
<thead>
<tr>
<th>Asset</th>
<th>Class</th>
<th>FMV</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>I</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>U.S. Gov't Securities</td>
<td>II</td>
<td>$2,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>III</td>
<td>$2,000</td>
<td>$1,200</td>
</tr>
<tr>
<td>Equipment</td>
<td>III</td>
<td>$3,000</td>
<td>$1,800</td>
</tr>
<tr>
<td>Goodwill &amp; Going Concern</td>
<td>V</td>
<td>$2,000</td>
<td>$0</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>$10,000</td>
<td>$6,000</td>
</tr>
</tbody>
</table>

Because the purchase was a bargain purchase, all assets do not receive basis equal to their FMV. The Class I and II assets is assigned basis up to their FMV. The Class III assets split the $3,000 basis available based on their relative FMVs. Therefore, the following formula is used to determine the basis for each Class III asset:

\[
\text{FMV of Asset of that Class} = \frac{\text{Combined FMV of all assets} \times \text{Purchase Price}}{\text{Asset Basis}}
\]

The result of this formula is to assign $1,200 basis to Inventory and $1,800 to Equipment. As there is no additional basis to allocate, T will have a $0 basis in its Class V assets.
### Result under the Proposed Regulations

<table>
<thead>
<tr>
<th>Asset</th>
<th>Class</th>
<th>FMV</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>I</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>U.S Gov't Securities</td>
<td>II</td>
<td>$2,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>IV</td>
<td>$2,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>V</td>
<td>$3,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>Goodwill &amp; Going Concern</td>
<td>VII</td>
<td>$2,000</td>
<td>$0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td>$10,000</td>
<td>$6,000</td>
</tr>
</tbody>
</table>

Under the proposed regulations, Inventory is a Class IV asset, and therefore is allocated its complete basis before Equipment, a Class V asset. As a result, Inventory is allocated $2,000 basis while Equipment is only allocated $1,000 basis.

### Example 4 -- Bargain purchase with subsidiary

The facts are the same as in Example 3, except that the Government Securities and Inventory are held by Tl, a wholly owned subsidiary of T for whom a section 338(h)(10) election is made. The FMV of the Tl stock is $4,000. AGUB would be allocated as described below:

### Result under the Temporary Regulations

#### Allocation of basis for T's assets

<table>
<thead>
<tr>
<th>Asset</th>
<th>Class</th>
<th>FMV</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>I</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>III</td>
<td>$3,000</td>
<td>$2,143</td>
</tr>
<tr>
<td>Tl stock</td>
<td>III</td>
<td>$4,000</td>
<td>$2,857</td>
</tr>
<tr>
<td>Goodwill &amp;</td>
<td>V</td>
<td>$2,000</td>
<td>$0</td>
</tr>
<tr>
<td>Going Concern</td>
<td></td>
<td>$10,000</td>
<td>$6,000</td>
</tr>
</tbody>
</table>

#### Allocation of basis for Tl's assets

<table>
<thead>
<tr>
<th>Asset</th>
<th>Class</th>
<th>FMV</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S Gov't Securities</td>
<td>II</td>
<td>$2,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>III</td>
<td>$2,000</td>
<td>$857</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td>$4,000</td>
<td>$2,857</td>
</tr>
</tbody>
</table>


Notice that the basis allocated to Inventory was reduced from $1,200 to $857 due to the Inventory being held by T1 instead of T. Although not present in this example, the effect of a bargain purchase is magnified if there is also a bargain element in the subsidiaries themselves.

Result under the Proposed Regulations

Allocation of basis for T's assets

<table>
<thead>
<tr>
<th>Asset</th>
<th>Class</th>
<th>FMV</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>I</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>V</td>
<td>$3,000</td>
<td>$2,143</td>
</tr>
<tr>
<td>T1 stock</td>
<td>V</td>
<td>$4,000</td>
<td>$2,857</td>
</tr>
<tr>
<td>Goodwill &amp;</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Going Concern</td>
<td>VII</td>
<td>$2,000</td>
<td>$0</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>$10,000</td>
<td>$6,000</td>
</tr>
</tbody>
</table>

Allocation of basis for T1's assets

<table>
<thead>
<tr>
<th>Asset</th>
<th>Class</th>
<th>FMV</th>
<th>Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S Gov't</td>
<td>II</td>
<td>$2,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>Securities</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inventory</td>
<td>IV</td>
<td>$2,000</td>
<td>$857</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>$4,000</td>
<td>$2,857</td>
</tr>
</tbody>
</table>

Under the proposed regulations, the basis allocated to Inventory was reduced from $2,000 to $857 due to the Inventory being held by T1 rather than T. This is a larger reduction than occurred under the temporary regulations because Inventory received its full basis under the proposed regulations when it was held by T.

VI. REPORTING REQUIREMENTS UNDER SECTION 338(h)(10)
A. Overview

1. Although a section 338(h)(10) election will allow a stock purchase to be treated as an asset purchase, the legislative history of the Omnibus Budget Reconciliation Act of 1990, which amended sections 338 and 1060, states that a section 338(h)(10) transaction should not be considered an

2. An applicable assets acquisition is any transfer of assets constituting a trade or business in the hands of the seller or the purchaser, if the purchaser's basis in the acquired assets is determined wholly by reference to the consideration paid for such assets. Section 1060(c).

3. Since a section 338(h)(10) transaction is not considered an applicable asset acquisition, the reporting requirements for applicable asset acquisitions do not apply to section 338(h)(10) transactions. Although these reporting requirements do not apply to section 338(h)(10) transactions, a knowledge of them is useful when considering the reporting requirements that do apply to section 338(h)(10) transactions.

4. Parties to an "applicable asset acquisition" must file an information statement (on Form 8594) stating:

a. The name, address, and taxpayer identification number of the seller and the purchaser, and the date of the purchase.

b. The total amount of consideration for the assets.

c. The amount of Class I assets and the aggregate fair market value of the Class II, III, IV, and V assets. The sum of the aggregate fair market values of the Class IV and V assets is reported on Form 8594 in the aggregate.

d. Whether the amount of Class I assets and the fair market values of Class II, III, IV and V assets were agreed upon in a sales contract or other written document signed by both parties.

e. The aggregate consideration allocated to each asset in Class I, II, III, IV, and V. As
stated above, the sum of the amounts allocated to Classes IV and V is reported on Form 8594 in the aggregate.

f. Whether the allocation of purchase price was provided for in a sales contract or other written document signed by both parties.

g. Whether there is a related covenant not to compete, employment or management contract, or similar arrangement with the seller (or managers, directors, owners, or employees of the seller). If so, the parties must state the maximum consideration (exclusive of interest) to be paid pursuant to such agreement.

B. Section 338(h)(10)(C)

1. Section 338(h)(10)(C) provides that "Under regulations. . . the purchasing corporation and the common parent of the selling consolidated group shall, at such times and in such manner as may be provided in regulations, furnish to the Secretary the following information:"

a. The amount allocated to goodwill and going concern value.

b. Any modification to the amount allocated to goodwill and going concern value.

c. Any other information the Secretary deems necessary to carry out the provisions of the section 338(h)(10).

2. The Service has yet to issue regulations under section 338(h)(10) pertaining to the reporting requirements. Notwithstanding the lack of regulations, the Service recently released Form 8023 "Elections Under Section 338 for Corporations Making Qualified Stock Purchases."
C. Form 8023

1. Who must file

The instructions to the form state that "If a section 338(h)(10) election is made for a target, Form 8023 must be filed jointly by the purchasing corporation and the common parent of the selling consolidated group (or the selling affiliate of S corporation shareholder(s))."

2. Requirements

a. The purchasing corporation must provide information regarding:

(1) Amount of consideration paid for recently purchased stock;

(2) Amounts (such as acquisition costs) capitalized in the purchasing corporation's basis in the recently purchased stock;

(3) The amount of New T's liabilities as of the beginning of the day after the acquisition date, that is, the amount taken into account to determine AGUB; and

(4) The amount of AGUB allocated to Class I, II and III assets respectively.

b. The seller must provide information regarding:

(1) The amount of consideration received for the recently purchased target stock;

(2) The selling costs of the selling consolidated group (or selling affiliates or S corporation shareholders) incurred in connection with the QSP that reduce the amount realized on the sale of the recently purchased stock (e.g., brokerage commissions or any similar costs
incurred by the selling group or shareholders to sell the target stock).

(3) New T's liabilities as of the beginning of the day after the acquisition date, (although the instructions to Form 8023 do not indicate that the seller must provide this information, Form 8023 provides a space for this information under the seller's statements, and therefore it is safe to assume that this information must be provided); and

(4) The amount of MADSP allocated to Class I, II and III assets respectively.

3. The preamble to the proposed regulations indicates that the Service and Treasury are considering whether the information regarding the amount and allocation of AGUB and ADSP currently submitted on Form 8023 should instead be submitted by the purchaser and seller separately on their income tax returns.

VII. OTHER ISSUES

A number of issues arise in the application of section 338(h)(10), including the following:

A. Use of the Installment Method

If P purchases T stock from S for a P note (in whole or in part) and both P and S join in making a section 338(h)(10) election, is T permitted to report its gain on the installment method under section 453? The answer is uncertain.

1. Operation of section 453

a. Section 453 applies only if there is an "installment sale" in which at least one payment is received after the year of sale. Section 453(b)(1).

b. Under the installment method, the gain recognized in a taxable year with respect to an installment sale is the proportion of the
payments received in the year which the total gain realized bears to the contract price. Section 453(c).

2. Problem with applying section 453 to section 338(h)(10) transactions

a. Under a literal reading of the statutes, the installment method is not available in a section 338(h)(10) sale because P has issued a note to S, and section 453(f)(3) requires that the note be the note of the person acquiring the property. In a section 338(h)(10) transaction the note is from P, while New T is deemed to receive the property. Therefore, the note is not the note of the person acquiring the property.

b. In addition, section 338(h)(10)(A) treats any sale of stock qualifying under its provisions as a sale of all of Old T's assets in a single transaction. If this is interpreted to mean that the target corporation is treated, for all purposes relating to the determination of gain or loss and timing of the recognition and reporting of gain, as having sold all of its assets for cash in an amount equal to the sum of the purchaser's basis in the stock and target liabilities, then section 453 would not be available. However, if this is interpreted to mean that the target corporation is deemed to receive the same consideration as was received by the selling shareholders, section 453 could still be available.

3. Arguments in favor of allowing use of the installment method for section 338(h)(10) transactions

a. Section 338(h)(10) treats a stock sale as a deemed asset sale followed by a deemed liquidation. Since the use of the installment method would be allowed if the transaction were structured as an actual asset sale followed by a liquidation, use of
the installment method should be allowed in a section 338(h)(10) transaction.

b. In the event that the seller in a section 338(h)(10) transaction receives a note as the purchase price for the target stock, the seller will have to recognize full gain at the time of the sale, before the seller has received the full purchase price. This will frequently be a problem in the context of sales of stock of S corporations because small closely held corporations frequently are unable to find purchasers who are willing, or able, to pay cash.


4. Recent developments

The Service recently issued final regulations under section 453 concerning installment obligations received from liquidating corporations. The Service received comments regarding the use of the installment method in section 338(h)(10) elections, but declined to address this issue because they felt it was beyond the scope of the regulations. See T.D. 8762 (January 27, 1998).

5. The proposed regulations make the section 453 installment method available to old T in its deemed asset sale as long as the deemed asset sale would otherwise qualify for installment sale reporting. For purposes of section 453, new T is considered to be the obligor of the installment obligation that P actually issued. See Prop. Treas. Reg. § 1.338(h)(10)-1(d)(8).
6. Merger of T into LLC to allow use of the installment method

a. By merging T into an LLC before the stock sale, the parties may be able to avoid the problems of applying the installment method to a stock sale treated as an asset acquisition.

b. Example

(1) Facts: S owns all the stock of T. S forms a wholly owned LLC and merges T into the LLC. S then sells 100 percent of the LLC interests to P, an unrelated party, in exchange for an installment note of P.

(2) Analysis:

(a) The default rule provides that a single-member LLC will be disregarded as an entity separate from its owner. As such, the merger of T into a single member LLC owned by the same person should be viewed as a liquidation of T. See PLR 9822037.

(b) Under section 332, S does not recognize gain or loss when T liquidates. Under section 337(a), T will not recognize gain or loss as a result of the liquidating distribution to S. Under section 334(b)(1), S takes a transferred basis and a tacked holding period in the assets received in the section 332 liquidation.

(c) LLC is disregarded as an entity separate from S. As a result, S is not treated as owning "interests" in LLC for Federal tax purposes, but rather is treated as owning LLC's assets directly. Thus, the sale of all of the interests in
LLC, a disregarded entity, to a single buyer should be treated as a sale of assets by S.

(d) Because P uses its own note to acquire the T assets, S can report the sale under the installment method.

B. Acquisition for Cash and Contingent Consideration

1. One technique to overcome a stalemate in which the buyer and seller cannot agree on the value of the business is to make part of the purchase price contingent. This way the sale can go through even though the parties have not agreed on the exact purchase price. Typically a portion of the consideration will be fixed and paid at the time of the acquisition. However, additional consideration will be payable subject to a formula based on the success of the business for a specified and limited period of time. The treatment of this contingent consideration under section 338(h)(10) is illustrated by the following example:

2. Basic Facts

   a. T Corporation is a wholly-owned subsidiary of S Corporation, with which it files a consolidated return. T's assets consist of equipment (a Class III asset) with a basis of $50 and a FMV of $75, and goodwill (a Class V asset) with a basis of $10 and an uncertain FMV.

   b. P agrees to acquire T's assets for $50 in cash and a note for $15. In addition, P and S agree to an earnout arrangement that will pay S one-third of T's annual net profit in excess of $20 for the five years after the acquisition.
3. **Effect of Section 338(h)(10) Election**

   a. As discussed in Part VII.A., above, it is not clear whether the installment method is available in a section 338(h)(10) sale.

   b. Even if the installment method is inapplicable, or if S elects out, the deemed asset sale rules follow the open transaction model.

   (1) As discussed in Part V.C., above, under Treas. Reg. § 1.338-1(f)(2), the deemed sale price of the assets (upon which gain or loss is calculated) is determined by reference to the MADSP formula. Under that formula, the relevant items are P's basis in T's stock and any liabilities assumed in the transaction. However, under current principles of tax law, P would not be able to include contingent payments in its basis of the T stock until such contingencies became fixed. Therefore, P's basis will reflect only the cash payment of $50 and the note of $15.

   (2) The MADSP is adjusted to account for subsequent events to the extent required by general tax principles. Temp. Treas. Reg. § 1.338(b)-3T(h)(1)(ii). Thus, once the contingent payments become fixed, the MADSP (and therefore the gain or loss on the deemed sale) must be adjusted. The gain or loss attributable to the adjustment is taken into income in the taxable year in which the adjustment occurs. Temp. Treas. Reg. § 1.338(b)-3T(h)(3).

   (3) Thus, the entire basis of an asset can be used to offset the portion of the deemed sale price allocable to such asset.
c. Assuming that the installment method does not apply or that S elects out of it, the consequences to S are as follows:

(1) The MADSP will be $65 ($50 in cash and $15 note). The earnout payments, though valued at $30, are contingent and under general tax principles would not be included in P's basis. Therefore, they are ignored until such payments are fixed.

(2) Because the FMV of the Class III asset ($75) exceeds the MADSP ($65), all of the MADSP is allocated to that asset and none to the Class V asset.

(a) As a result, S has a gain of $15 on the Class III asset (deemed sale price of $65 less basis of $50) and a loss of $10 on the Class V asset (deemed sale price of zero less basis of $10), for a total gain of $5.

(b) The first $10 in earnout payments is allocated to the Class III asset when received. Therefore, an additional $10 in gain would be recognized at that point.

(3) Any earnout payments in excess of $10 are allocated to the Class V asset when received. Until the amount received exceeded $10 (the asset's basis), the payments would not represent taxable gain. Only after the basis of the asset is recovered are the payments taxable.

d. On the buyer side, P would receive only $65 in basis in the T assets until the earnout payments were made.

4. Effect of the proposed regulations

a. Under the proposed regulations, the installment method would be available for the
transaction. For purposes of section 453, new T would be considered to be the obligor of the installment obligation that P actually issued. See Prop. Treas. Reg. § 1.338(h)(10)-1(d)(8).

b. If S elects out of the installment method, the proposed regulations would not follow the open transaction model of the current regulations.

c. "General principles of tax law will apply in connection with the contingent items." Prop. Treas. Reg. § 1.338-7(a). The preamble to the proposed regulations makes clear that the proposed regulations are intended to treat section 338(h)(10) stock sales like actual asset sales and to eliminate the special "fixed and determinable" rule in the current regulations. Temp. Treas. Reg. § 1.338-7(a).

C. Intercompany Transfers of T Stock

1. A section 338(h)(10) election raises the possibility of double taxation if prior to the sale of the T stock, that stock was transferred at a gain in an intercompany transaction. The deemed section 332 liquidation resulting from the section 338(h)(10) election may cause the deferred intercompany gain to be taken into account. Therefore, a section 338(h)(10) election could result in a gain on the deemed sale of T's assets and a gain on the prior intercompany transfer of the T stock. See Treas. Reg. § 1.1502-13(f)(5)(i).

2. However, the final intercompany regulations provide elective relief. See Treas. Reg. § 1.1502-13(f)(5)(ii)(C) and (E). The member of the group that owns the T stock may elect to treat the liquidation as if section 331 applied. Thus, that member will recognize a loss with respect to its T stock on the deemed liquidation of T. That loss is limited to the lesser of:

   a. the deferred gain on the intercompany transaction involving the T stock, or
b. the loss that would otherwise have been recognized had section 331 actually applied to the deemed liquidation.

3. In order to be eligible for the election, T must have been a member of the group from the time of the first intercompany transfer to the time of the deemed section 332 liquidation. Treas. Reg. § 1.1502-12(f)(5)(ii)(A).

4. The relief provision applies to transactions occurring in taxable years beginning after July 12, 1995. Treas. Reg. § 1.1502-13(l)(3) provides retroactive relief for any section 338(h)(10) sale that occurs after July 12, 1995, regardless of when the intercompany transaction occurred if the election was made in the consolidated return for the year including July 12, 1995.

5. It is not clear whether it is possible to obtain relief from the Service pursuant to Treas. Reg. § 301.9100-1 in the case of an untimely election. Cf. PLR 9834032 (One of Parent’s subsidiaries distributed stock of a second-tier subsidiary to parent, gain was deferred, second-tier subsidiary was then liquidated, Service granted corporate parent an extension to file an election under Treas. Reg. § 1.1502-13(f)(5)(ii)(E)).

D. Unwanted Assets

1. What if P doesn’t want to buy certain T assets (the “unwanted assets”)?

2. What are the consequences if, as part of an overall plan, T distributes the unwanted assets to S, S sells the T stock to P, and P and S join in making a section 338(h)(10) election?

   a. The Service has determined that if the distribution is part of the overall transaction, then the distribution is part of the section 332 liquidation. Therefore, T recognizes no gain on the distribution under section 337(a) and S takes a carryover basis in the property under section 334(b)(1). See PLRs 9738031, 9735038, 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.

b. What would be the result if after the distribution by T of the unwanted assets to S and the stock sale by S, S transferred the unwanted assets to a controlled subsidiary? Would this affect the deemed liquidation of T under section 338(h)(10)? In the context of an actual liquidation, the transfer of assets received in a liquidating distribution to a new corporation owned by the same shareholders could result in a determination that there was not in fact a "complete liquidation" of the presumably liquidated corporation. See Telephone Answering Service Co. v. Commissioner, 63 T.C. 423 (1974), aff'd without opinion, 546 F.2d 423 (4th Cir. 1976), cert. denied, 431 U.S. 914 (1977) ("TASCO") (no complete liquidation because new corporation was merely the "alter ego" of the liquidated corporation.)

c. It appears that the Service believes that the reincorporation of the unwanted assets could present a problem. See PLR 9210041, supplementing PLR 9137040 (Service rules that transfer of unwanted assets amounting to 3% of T's total assets to a controlled subsidiary will not cause liquidation to be taxable. However, the Service cited TASCO for this proposition, presumably indicating that the TASCO analysis could apply to a section 338(h)(10) deemed liquidation.)

d. However, Treas. Reg. § 1.338(h)(10)-1(e)(2)(ii) provides that Old T is treated as if "it distributed all of its assets in complete liquidation." Does this language trump the liquidation-reincorporation analysis of TASCO?

e. What would be the result if it were determined that the deemed liquidation was
not in fact a complete liquidation? Would the distribution be taxable? Would section 338(h)(10) still apply to the transaction?

f. What would be the result if T does not adopt a plan of liquidation prior to the stock sale? Apparently the distribution will not be part of the section 332 liquidation and T will recognize gain on the distribution under section 311(b). The related gain would be deferred and would not be triggered by the subsequent section 338(h)(10) transaction. See Treas. Reg. § 1.1502-13(j)(2); PLR 8821047.

g. Does it matter if the controlled subsidiary is a pre-existing active corporation or a new or inactive corporation?

h. In a recent ruling, PLR 9847027, the Service ruled that a section 338(h)(10) election could be made for a transaction in which a life insurance company transferred its entire life insurance business to its parent under a coinsurance agreement before its stock was sold. In PLR 9847027, a publicly trading holding company owned all the stock of a life insurance company ("S"), which owned all the stock of a second life insurance company ("T"). T would transfer its insurance business to S pursuant to a coinsurance agreement. T would then distribute to S all of its remaining assets other than its charter, licenses and minimum capital. Within 12 months of this distribution, S would sell all of the stock of T to an unrelated corporation ("P") or liquidate T. The Service ruled that the stock sale would constitute a QSP, and that S and P could make a section 338(h)(10) election. The Service further ruled that, if such an election were made, the transfer of the insurance business pursuant to the coinsurance agreement and the distribution of T's assets, together with T's deemed distribution of the sale proceeds, would constitute a section 332 liquidation. The ruling is significant because previously
the Service held the position that a coinsurance agreement prevents satisfaction of the complete liquidation requirement of section 332.

i. The proposed regulations do not mention the term "complete liquidation" but instead provide that old T is treated as if it transferred all of its assets to members of the selling consolidated group, the selling affiliate, or S corporation shareholders and then ceased to exist. Prop. Treas. Reg. § 1.338(h)(10)-1(d)(4). Thus, under the proposed regulations, the distribution of unwanted assets should not impact the application of section 338(h)(10) to the transaction.

j. The proposed regulations provide an example to illustrate the treatment of a distribution of unwanted assets prior to a transaction with a section 338(h)(10) election.

k. Example

S owns all of the outstanding stock of T. S and P agree to undertake the following transaction: T will distribute half of its assets to S, and S will assume half of T's liabilities. Then, P will purchase the stock of T from S. S and P will jointly make a section 338(h)(10) election with respect to the sale of T. The corporations then complete the transaction as agreed.

Under section 338(a), the assets present in T at the close of the acquisition date are deemed sold by old T to new T. Because S and P had agreed that, after T's actual distribution to S of part of the assets, S would sell T to P pursuant to an election under section 338(h)(10), and because T is deemed to have transferred all its assets to its shareholder, T is deemed to have adopted a plan of complete liquidation under section 332. T's actual transfer of assets to S is treated as a distribution pursuant to that
plan of complete liquidation. See Prop. Treas. Reg. § 1.338(h)(10)-1(e), ex. 2.

E. Effect of Section 338(h)(10) Election on State Taxes

1. State treatment of a section 338(h)(10) election is not uniform
   a. Some states have a similar election that will result in state tax treatment similar to the federal tax treatment.
   b. Some states will allow a similar election, but provide that the state tax liability remains with T and is not the responsibility of the selling consolidated group.
   c. Other states do not allow an election similar to section 338(h)(10) or a section 338 election at all.

2. A determination of the state tax implications of a section 338(h)(10) must be made before the purchase price is set.

F. Application of Section 338(h)(10) to an Insolvent Corporation

1. Can a QSP be made for an insolvent corporation?
   a. As discussed in Part III.B., above, a QSP occurs when P, either in a single transaction or series of transactions within a 12-month period, acquires by "purchase" an amount of stock meeting the requirements of section 1504(a)(2).
   b. Section 338(h)(3)(A) defines the term "purchase" as "any acquisition of stock" (with certain exceptions not herein pertinent).
   c. Therefore, it would appear that the acquisition of all of the stock of an insolvent T by P would be a QSP.
   d. However, it could be argued that since T is insolvent, its former stock ceased to exist
in a tax sense, and what "stock" there is is held by T's creditors. This argument is not convincing because insolvency does not bar consolidated return filing (which looks to stock ownership for eligibility), and a creditor in an insolvent corporation is not generally recognized as a shareholder under the Code. See, Helvering v. Southwest Consolidated Corp., 315 U.S. 194 (1942).

e. The proposed regulations provide that a purchase of T stock occurs so long as more than a nominal amount is paid for the stock. Prop. Treas. Reg. § 1.338-3(b)(2)(ii).

f. Therefore, under the proposed regulations a section 338(h)(10) election typically can not be made for an insolvent T. However, the proposed regulations provide that stock in a T affiliate acquired by new T in the deemed asset sale of T's assets is considered purchased notwithstanding that no amount may be allocated to T's stock in the T affiliate. Prop. Treas. Reg. § 1.338-3(b)(2)(iii).

g. It is not clear whether Prop. Treas. Reg. § 1.338-3(b)(2)(iii) would allow the acquisition of an insolvent T affiliate to qualify as a purchase, or if it merely clarifies that the acquisition of a solvent T affiliate does not fail to qualify as a purchase simply because it is not allocated basis in the transaction.

h. It is hoped that this ambiguity will be clarified when the regulations are issued as final regulations.

2. Assuming a QSP has been made, can a section 338(h)(10) election be made?

a. The regulations provide that, for purposes of Subtitle A, Old T is treated as if it distributed all of its assets in complete liquidation under section 331 or section 332. Treas. Reg. § 1.338(h)(10)-1(e)(2).
b. Section 332 has been interpreted to require that the liquidating subsidiary be solvent. See, e.g., Spaulding Bakeries, Inc. v. Comm'r, 27 T.C. 684 (1957), aff'd, 252 F.2d 693 (2d Cir. 1958); H.K. Porter Co., Inc. v. Comm'r, 87 T.C. 689 (1986); Rev. Rul. 68-602, 1968-2 C.B. 135.

c. Thus, the regulations can be read to preclude the application of section 332 if T is insolvent.

d. However, if the deemed liquidation is governed by section 331, it is still arguable that section 331 will not apply because a complete liquidation is not taking place because there will be no distribution to shareholders. See Rev. Rul. 56-387, 1956-2 C.B. 189.

e. Therefore, it is not clear what would be the result of a section 338(h)(10) election for an insolvent T.

f. The proposed regulations do not mention the term "complete liquidation" but instead provide that old T is treated as if it transferred all of its assets to members of the selling consolidated group, the selling affiliate, or S corporation shareholders and then ceased to exist. Prop. Treas. Reg. § 1.338(h)(10)-1(d)(4). Thus, under the proposed regulations, T's insolvency would not affect the availability of a section 338(h)(10) election (except as it impacts whether a QSP has been made).

VIII. PLANNING TO FIT WITHIN SECTION 338(h)(10)

A. Fact Pattern

S corporation owns 60 percent of T. Individual A owns the remaining 40 percent of T. S and A wish to dispose of the stock or assets of T. T's assets have a value of $100 and a zero basis. S and A have a zero basis in their T stock. The maximum rates apply to S, A and T.
B. **Example 1: Basic Asset Sale**

If T sells its assets to a corporate buyer and distributes the proceeds to S and A in liquidation, a double tax will be imposed.

1. T will pay $34 of tax at the corporate level. The remaining $66 will be distributed to S and A, proportionately, in liquidation of T.

2. S is left with after tax proceeds of approximately $26 ((60 percent of $66) x 66 percent). A is left with approximately $19 ((40 percent of $66) x 72 percent).

C. **Example 2: Stock Sale Without Section 338(h)(10) Election**

If S and A sell their stock to the same buyer, a single tax will be imposed at the shareholder level.

1. However, the T assets will not receive a stepped-up basis.

2. Therefore, the buyer is likely to pay only $66 for the T stock. The after tax proceeds received by S and A would be the same as in Example 1, above.

D. **Example 3: Stock Sale With Section 338(h)(10) Election**

However, assume that S first buys A's stock in T, and S and T then file consolidated returns. At a future date, S sells all of the T stock to a corporate buyer. S and the buyer make a section 338(h)(10) election.

1. S should be able to purchase A's stock based on T's after tax value. Accordingly, S should buy A's stock for $26 (40 percent of $66). A's after tax proceeds would be the same as above (approximately $19 ($26 x 72 percent).

2. Since the T stock and assets would receive a basis step-up in the hands of the buyer, the buyer should be willing to pay $100 for the T stock. Accordingly, S's after tax net proceeds would be $40 (($100 x 66 percent) - $26 (the price paid for A's stock)).
3. Thus, by acquiring A's stock in T, and fitting the subsequent sale of T stock within section 338(h)(10), P can realize approximately $14 in additional value.

4. Of course, step transaction principles must be considered. The acquisition of A's stock should occur as far in advance of the T sale negotiations as possible.
SECTION 338(h)(10) APPENDIX

December 3, 1999

Mark J. Silverman
Steptoe & Johnson LLP
Washington, D.C.

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Acquisition with Section 338(h)(10) Election (p. 5)

1. S owns 100% of the stock of T.

2. P purchases the stock of T from S. Should the parties make a section 338(h)(10) election?

3. The result of a section 338(h)(10) election will be a deemed sale of the T assets from Old T to New T, followed by a deemed liquidation of Old T under section 332.
Acquisition Period for Purchases from Related Corps. (p. 22)

1. S owns 100% of the stock of T.

2. On January 1, 1997, P purchases 30% of the stock of S.

3. On March 1, 1997, P purchases an additional 30% of the stock of S.

4. On February 1, 1998, S is liquidated, and P receives 100% of the T stock in the liquidating distribution.

5. May P make a section 338(h)(10) election with respect to its acquisition of T?
Scenario A

1. On January 1, 1997, P purchases 60% of the stock of T from B.
2. On June 1, 1997, T redeems all of the stock of T held by A.
3. June 1, 1997, is the acquisition date.

Scenario B

1. On January 1, 1997, P purchases 60% of the stock of T from B.
2. On February 1, 1998, T redeems all of the stock of T held by A.
3. P has not made a qualified stock purchase of T. The 80% ownership requirement was not satisfied within 12 months.
1. P owns 30% of the stock of T.
2. On December 15, 1996, T redeems the T stock held by P.
3. On December 1, 1997, P purchases the T stock held by A.
4. P has not made a qualified stock purchase of T. The redemption of P's T stock is not taken into account.
1. On January 1, 1997, P purchases 60% of X Stock.
3. Also on April 1, 1997, P purchases the T stock held by A.
4. P has made a qualified stock purchases of T on April 1, 1997.
1. S owns all the stock of T and wants to sell the T stock to the public.

2. S contributes the T stock to Newco ("N") in exchange for N stock. At the time of the contribution S has a binding commitment to sell 51% of the N stock to an underwriter who will sell the stock to the public.

3. Has N made a qualified stock purchase of T?
Going Public: "Busted 351s" and QSPs Continued (p. 29)

Would the results be any different if the facts were the same, but N also sold its stock to the public in a public offering?

Diagram:

1. N formed
2. T stock
3. N stock to Public

Legend:
- S
- N
- T
- Public

Arrow labels:
- (1) N formed
- (2) T stock
- (3) N stock to Public
1. A owns all the stock of P and T.
2. A sells the T stock to P.
3. A is treated as if A transferred T stock to P for P Stock and then redeemed the stock it was treated as issuing.
4. P's basis is determined by reference to A's adjusted basis. Therefore, P is not considered to have acquired her stock by purchase.
Reverse Subsidiary Mergers and QSPs (p. 33)

1. P forms Newco ("N") and contributes cash to N in exchange for N Stock.
2. N Merges into T, the T shareholder (S) receives cash for its T stock.
Circular Ownership of T Stock (p. 33)

1. S owns 60% of T stock. X owns the remaining 40% of T stock.
2. P purchases the T stock held by S.
3. Has P made a QSP of T?
1. On January 1, 1997, P makes a QSP of T. On that date T owns the Stock of TI.
2. On March 1, 1997, T sells the T1 stock to an unrelated corporation.
3. On April 1, 1997, P makes a section 338 election for T.
Consequences of a Section 338(h)(10) Election to the Shareholders of an S Corporation (p. 39)

1. Individual A owns 100% of the stock of T, an S corporation. A’s basis in the T stock is $75.

2. T has one asset, inventory with basis of $50 and a FMV of $100.

3. P wants to purchase T from A.
1. What is the MADSP?
2. What is the MADSP?
Determination of MADSP -- Example 3: Unrelated Shareholder (p. 50)

\[ \begin{array}{c}
\text{K} \\
\text{S} \\
\text{T} \\
\text{P} \\
\end{array} \]

- K
- S
- T
- P

80% 80% 20%

$64,000

\[ \begin{array}{lll}
\text{Asset} & \text{Basis} & \text{FMV} \\
\text{Land} & $50,000 & $75,000 \\
\text{Equipment} & $30,000 & $60,000 \\
\text{Liability} & $40,000 & \\
\end{array} \]

1. What is the impact on K?
Determination of MADSP -- Example 4: Target Affiliate (p. 50)

<table>
<thead>
<tr>
<th>Asset</th>
<th>Basis</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equipment</td>
<td>$30,000</td>
<td>$60,000</td>
</tr>
<tr>
<td>Liability</td>
<td>$40,000</td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>$50,000</td>
<td>$75,000</td>
</tr>
</tbody>
</table>
1. P purchases 90% of the T stock from S for $900.

2. The parties make a joint section 338(h)(10) election. What is the grossed-up basis of the T stock?
Treatment of Nonrecently Purchased Stock (p. 62)

1. P purchases 80% of the T stock from S within a 12 month period. P already holds 10% of the T stock with a basis of $200,000.

2. What is the grossed-up basis of the recently purchased stock and the nonrecently purchased stock?
Use of LLC's to Avoid Section 338(h)(10) Limitations (p. 94)

Facts

Corporation S owns all the stock of T. S forms a wholly owned LLC and merges T into the LLC. S then sells 100% of the LLC interests to P, an unrelated party, in exchange for an installment note of P.
Acquisition for Cash and Contingent Consideration (p. 96)

What is the MADSP? How is it allocated?
The Distribution of Unwanted Assets (p. 100)

Facts
Corporation S owns all the stock of Corporations T and T1. T operates businesses 1 and 2. Corporation P is unrelated to S. P wishes to acquire Business 1 but not any of the other assets owned by S.

Thus the following transactions take place.
• T adopts a plan of complete liquidation.
• T distributes Business 2 to S.
• S sells the T stock to P; S and P make a section 338(h)(10) election.

Questions
1. Does the sale of the T stock qualify for a section 338(h)(10) election?
2. What are the tax consequences of the distribution of Business 2 to S?
3. Does it matter when T’s plan of complete liquidation is adopted? What if T does not adopt a plan of complete liquidation?
4. What would be the result if after the distribution by T of Business 2 to S and the stock sale by S, S transferred the Business 2 to T1? Would this affect the deemed liquidation under section 338(h)(10)?

5. What would be the result if it were determined that the deemed liquidation was not in fact a complete liquidation?

6. What would be the result under the proposed regulations?

References

Treas. Reg. § 1.338(h)(10)-1(e)(2)(ii)
Treas. Reg. § 1.1502-13(j)(2)
Prop. Treas. Reg. § 1.338(h)(10)-1(d)(4)
Prop. Treas. Reg. § 1.338(h)(10)-1(e), ex. 2
PLR 9738031, PLR 9735038, PLR 9210041, PLR 9137040, PLR 9044063
PLR 8938036, PLR 8821047
Application of Section 338(h)(10) to the Purchase of an Insolvent Corporation (p. 104)

\[
\begin{array}{c}
\text{S} \\
\text{T} \\
\text{T1} \\
\text{T2} \\
\text{T3} \\
\text{P}
\end{array}
\]

\[
\begin{array}{c}
\text{Assets 1,000,000} \\
\text{Liabilities 900,000}
\end{array}
\]

\[
\begin{array}{c}
\text{Assets 10,000,000} \\
\text{Liabilities 6,000,000}
\end{array}
\]

\[
\begin{array}{c}
\text{Assets 1,000,000} \\
\text{Liabilities 1,000,001}
\end{array}
\]

\[
\begin{array}{c}
\text{Assets 100,000,000} \\
\text{Liabilities 99,900,000}
\end{array}
\]

T stock

$
Application of Section 338(h)(10) to the Purchase of an
Insolvent Corporation Continued (p. 104)

Facts

Corporation T owns assets with a value of $10 million and has liabilities of $6 million. Among the assets of T are all of the stock of T1 and T2. The assets of T1 have a value of $1 million and T1 has liabilities of $900,000. The assets of T2 have a value of $1 million and T2 has liabilities of $1,000,001. Among the assets of T2 is all of the stock of T3. The assets of T3 have a value of $100 million and T3 has liabilities of $99,900,000.

P purchases all the stock of T from S and attempts to join with S in a Section 338(h)(10) election with respect to T, T1, T2 and T3.

Questions

1. What are the results of this election?

2. Would the result be different if T2 had no liabilities, but rather had outstanding both common and preferred stock, both held by T, with the preferred stock having a liquidating preference of $1,100,000?

3. Would the result be different under the proposed regulations?

References

Treas. Reg. § 1.338(h)(10)-1(e)(2)(ii)
Treas. Reg. § 1.332-2(b)
Prop. Treas. Reg. § 1.332-3(b)(2)
Prop. Treas. Reg. § 1.338(h)(10)-1(d)(4)
Rev. Rul. 56-387, 1956-2 C.B. 189
Comm'r v. Spaulding Bakeries, Inc., 252 F2d 693 (2nd Cir. 1958)
S corporation owns 60% of the stock of T and individual A owns the remaining 40%. S and A wish to dispose of the stock or assets of T. T's assets have a value of $100 and a $0 basis. The parties are considering three possible alternatives.

Alternative 1: Basic Asset Sale

T assets $100 FMV

Alternative 2: Stock Sale
Alternative 3: Stock Sale with Section 338(h)(10) Election

Step 1: S purchases T stock from A.

Step 2: S sells the T stock to P and they make a joint section 338(h)(10) election.
# Elections Under Section 338 for Corporations Making Qualified Stock Purchases

**Section A-1—Purchasing Corporation**

1a Name and address of purchasing corporation

1b Employer identification number (see instructions)

1c Tax year ending

1d State or country of incorporation

---

**Section A-2—Common Parent of the Purchasing Corporation**

2a Name and address of common parent of purchasing corporation

2b Employer identification number (see instructions)

2c Tax year ending

2d State or country of incorporation

---

**Section B—Target Corporation**

3a Name and address of target corporation

3b Employer identification number

3c Tax year ending

3d State or country of incorporation

---

**Section C—Common Parent, Selling Affiliate, or S Corporation Shareholder**

(Complete only for a section 338(h)(10) election or if target was a member of a consolidated group.)

4a Name and address of common parent, selling affiliate, or S corporation shareholder of target corporation

4b Identifying number

4c Tax year ending

---

**Section D—General Information**

5a Acquisition date

5b What percentage of target corporation stock was purchased:

(i) During the 12-month acquisition period?

(ii) On the acquisition date?

<table>
<thead>
<tr>
<th>%</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
</table>

6 Was the purchasing corporation listed in Section A-1, above, a member of an affiliated group of corporations before the acquisition date?  

7 Was the target corporation a member of an affiliated group before the acquisition date?  

8 Is the target corporation or any target affiliate:

a A controlled foreign corporation?  

b A foreign corporation with income, gain, or loss effectively connected with the conduct of a trade or business within the United States (including U.S. real property interests)?  

c A qualifying foreign target under Regulations section 1.338-1(g)(1)(iii)?  

d A corporation to which section 936 applies?  

e A corporation electing under section 1504(d) or section 953(d)?  

f A domestic international sales corporation (DISC)?  

g A passive foreign investment company (PFIC)?  

h If the answer to item 8g is “Yes,” is the PFIC a pedigreed qualified electing fund?  

---

For Paperwork Reduction Act Notice, see separate instructions.

Cat. No. 49972Z

Form 8023 (Rev. 9-97)
### Section E—Purchasing Corporation’s Statement

<table>
<thead>
<tr>
<th>9a Stock price</th>
<th>9b Acquisition costs</th>
<th>9c Target liabilities</th>
<th>9d Income taxes on deemed sale</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>9e AGUB</th>
<th>9f Class I assets</th>
<th>9g Class II assets</th>
<th>9h Class III assets</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>10a Did the purchasing corporation and the seller(s) of target stock provide for an allocation of the deemed sales price in the sales contract or in another written document signed by both parties?</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>b If “Yes,” are the amounts reported on lines 9f, g, and h the amounts agreed upon in the sales contract or other written document?</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>c In connection with the purchase of target stock, did the purchasing corporation also purchase a license or a covenant not to compete, or enter into a lease agreement, employment contract, management contract, or similar agreement with any seller of target stock (or with any person affiliated with or related to any such seller)?</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
</table>

If “Yes,” attach a schedule to this form that specifies the type of agreement and the maximum amount of consideration (not including interest) to be paid under the agreement.

### Section F—Seller's Statement (Complete only for a section 338(h)(10) election)

<table>
<thead>
<tr>
<th>11a Stock price</th>
<th>11b Target liabilities</th>
<th>11c Selling costs</th>
<th>11d MADSP</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>11e Class I assets</th>
<th>11f Class II assets</th>
<th>11g Class III assets</th>
</tr>
</thead>
</table>

### Section G—Elections under section 338

12 Check here to make a section 338(h)(10) election for the target corporation listed in Section B on page 1

13 Check here to make a section 338 election (other than a section 338(h)(10) election) for the target corporation listed in Section B on page 1

14 If the box on line 13 is checked for the target corporation listed in Section B on page 1, check here to make a gain recognition election for that corporation

15 Check here if this form is filed to make a section 338 election for any target corporation, in addition to the one listed in Section B on page 1

Under penalties of perjury, I state and declare that I am authorized to make the election(s) on lines 12, 13, 14, or 15 on behalf of the purchasing corporation(s).

<table>
<thead>
<tr>
<th>Signature of Authorized Person for Purchasing Corporation(s)</th>
<th>Date</th>
<th>Title</th>
</tr>
</thead>
</table>

Under penalties of perjury, I state and declare that I am authorized to make the section 338(h)(10) election on line 12 on behalf of the common parent of the selling group, the selling affiliate, or S corporation shareholder.

| Signature of Authorized Person for the Common Parent, Selling Affiliate, or S Corporation shareholder | Date | Title |

(Applicable only if a section 338(h)(10) election is made.)
General Instructions

Purpose of Form
The purpose of Form 8023 is to permit elections to be made under section 338 for a corporation (the "target" corporation) if the purchasing corporation has made a qualified stock purchase (QSP) of the target corporation.

If a section 338(a) election is made for the target, the target is treated for purposes of Subtitle A of the Code as having sold all of its assets on the acquisition date and then as having purchased those assets as a new corporation ("new" target) on the day after the acquisition date. (For periods on or before the acquisition date, the target is sometimes referred to as the "old" target.) In addition, the target must recognize gain or loss on the deemed sale of its assets (the "deemed sale gain").

If a section 338(h)(10) election is made for the target, the target generally is treated as making the deemed sale and liquidating. The treatment of the target shareholders generally is consistent with the sale and liquidation treatment. A section 338(h)(10) election cannot be made for a target corporation unless it is acquired from a selling consolidated group, a selling affiliate (as defined in Regulations section 1.338(h)(10)-1(c)(4)), or an S corporation shareholder (or shareholders).

Who Must File
Persons making elections under section 338 must file Form 8023.

Generally, a purchasing corporation must file Form 8023 for the target. If a section 338(h)(10) election is made for a target, Form 8023 must be filed jointly by the purchasing corporation and the common parent of the selling consolidated group (or the selling affiliate or S corporation shareholder(s)).

When and Where To File
File Form 8023 by the 15th day of the 9th month beginning after the acquisition date to make a section 338 election for the target corporation. File Form 8023 with the District Director (Attention: Chief of Examination) for the Internal Revenue district where the main corporate office (headquarters) of the purchasing corporation is located (or, if the purchasing corporation is a member of a consolidated group, with the District Director (as identified above) of the common parent of the consolidated group). If an affiliated group that does not file consolidated returns makes its QSP of the target through more than one member, a section 338 election for the target is made by filing Form 8023 with the District Director (as identified above) of the affiliate that acquired the largest percentage (by value) of the target stock in the QSP (or, if there is more than one such affiliate, file Form 8023 with the District Director of any one such affiliate).

A copy of Form 8023 must be attached to the final income tax return of the old target, to the first income tax return of the new target, and to the income tax return of the purchasing corporation for its tax year that includes the acquisition date; but failure to do so will not invalidate a section 338 election. If a section 338(h)(10) election is made, a copy of Form 8023 is considered to be attached to the final income tax return of the old target if a copy of Form 8023 is attached to the income tax return of the selling consolidated group (or the selling affiliate) for the tax year of the seller that includes the acquisition date (or, in the case of a target that is an S corporation, attach Form 8023 to the final income tax return of the S corporation with additional copies distributed to each electing S corporation shareholder with his or her Schedule K-1 (Form 1120S)).

Election for Multiple Targets
One Form 8023 (rather than multiple Forms 8023) may be used for targets that each have the same acquisition date, were members of the same affiliated group immediately before the acquisition date, and are members of the same affiliated group immediately after the acquisition date. All of the information that would be required for the additional targets if a separate Form 8023 were filed must be provided for that target in schedules attached to the form. If a form is used to make an election under section 338 for more than one target, check line 15. In an attached schedule, provide the information requested in Sections A-1, A-2, B, C, D, E, and F for each target corporation other than the one shown in Section B of the form. In the schedule, also state which elections are made for each target (i.e., information corresponding to lines 12, 13, and 14 of Section G). Include the appropriate signature or signature attachment for each target. See Signature on page 3.

Some special instructions apply to section 338 elections for lower-tiered targets, whether one or more Forms 8023 are filed to make the elections. For example, if P purchases target A, target A owns target B, and P makes a section 338 election for target A, resulting in a deemed QSP of target B, these special instructions apply to make a section 338 election for the target B. To make an election for target B: (1) for purposes of completing and signing Form 8023 treat the purchasing corporation(s) of the directly purchased target as the purchasing corporation(s) of the lower-tiered target and (2) file Form 8023 with the District Director (as identified above) of the purchasing corporation of the directly purchased target.

Definitions
Qualified stock purchase. A QSP is the purchase of at least 80% of the total voting power and value of the stock of a corporation by another corporation during a 12-month acquisition period. Preferred stock (as described in section 1504(a)(4)) is not included in computing voting power or value. See section 338(h)(3) for the definition of "purchase."

Acquisition date. The acquisition date is the first day on which a QSP has occurred.

12-month acquisition period. In general, the 12-month acquisition period is the 12-month period beginning with the first acquisition by purchase of stock included in the QSP. See section 338(h)(1) for additional special rules.

Specific Instructions
Employer identification number. An employer identification number (EIN) must be included for each corporation identified in Section A-1, A-2, B, C or on attached schedules. An EIN is not required if the corporation does not have, and is not otherwise required to have, an EIN.

Country of incorporation. When identifying the country of incorporation, include political subdivisions, if any.

Tax year ending. The tax year ending date of any corporation is determined without regard to any QSP.

Section A-1. Purchasing Corporation
If more than one member of an affiliated group purchases stock of the target corporation listed in Section B or identified in an attached schedule, attach a schedule that lists which target stock was acquired by each purchasing corporation. Also provide the information requested on...
this Form 8023 and instructions for each purchasing corporation (other than the purchasing corporation listed in Section A-1).

Section A-2. Common Parent of the Purchasing Corporation
If the purchasing corporation is a member of a consolidated group, complete Section A-2.

Section C. Selling Shareholders
If Form 8023 is filed for a target corporation that is an S corporation and a section 338(h)(10) election is made for the target, the information requested in Section C must be provided for each shareholder who sells target stock in the QSP. Attach a schedule if necessary.

Line 4b. Identifying number. Enter the social security number (SSN) for an individual. Enter the EIN for a corporation.

Sections E and F. Purchasing Corporation's and Seller's Statements
If a section 338 election is made, the old target is deemed to sell all of its assets to the new target. Sections E and F concern the amount and allocation of the purchase price for this deemed sale. Do not file Form 8594, Asset Acquisition Statement Under Section 1060, for the deemed sale. Instead, provide the information requested in this form. The information in Section E is to be provided by the purchasing corporation. The information in Section F is to be provided by the selling consolidated group, selling affiliates, or selling S corporation shareholders. Complete Section F only if a section 338(h)(10) election is made. Failure to provide any of the information in Section E or F will not invalidate a section 338 election.

Lines 9 and 11. Line 9 concerns the determination and allocation of the new target's adjusted grossed-up basis (AGUB). The AGUB is the amount for which the new target is deemed to have purchased all of its assets from the old target. Line 11, to be completed only in the case of a section 338(h)(10) election, concerns the determination and allocation of the old target's modified aggregate deemed sale price (MADSP). The aggregate deemed sale price (ADSP) (if a section 338(h)(10) election is not made for the target) or MADSP (in the case of a section 338(h)(10) election) is the price at which the old target is deemed to have sold all of its assets to the new target. The ADSP or MADSP is allocated among the old target's assets, and the AGUB is allocated among the new target's assets. This allocation is done under a residual method that groups the assets into several classes and, beginning with Class I, allocates an amount to each asset in the class in proportion to its fair market value. Except in the last class (Class V), the amount allocated to any asset cannot exceed its fair market value. See Temporary Regulations section 1.338(b)-2T for application of the residual method, and Regulations sections 1.338-3 for special rules relating to the allocation of ADSP and MADSP.

Recently and nonrecently purchased stock. Target stock held by the purchasing corporation on the acquisition date is either recently purchased stock or nonrecently purchased stock. It is recently purchased stock if it was purchased within the section 338(h)(3) buy-sell agreement during the 12-month acquisition period. Otherwise it is nonrecently purchased stock. Target stock that is not held by the purchasing corporation on the acquisition date is neither recently nor nonrecently purchased stock.

AGUB. In general, the AGUB is the sum of (1) the grossed-up basis in the purchasing corporation's recently purchased stock, (2) the purchasing corporation's basis in its nonrecently purchased stock, and (3) the liabilities of the new target. In computing the AGUB, the basis of the recently purchased stock is "grossed-up" if any target stock is not held by the purchasing corporation on the acquisition date. The grossed-up basis is the product of (1) the basis of the recently purchased stock, times (2) a fraction, the numerator of which is 100% minus the percentage of target stock (by value) attributable to the nonrecently purchased stock and the denominator of which is the percentage of target stock (by value) attributable to the recently purchased stock. Special rules apply if there is nonrecently purchased stock and a section 338(h)(10) election or a gain recognition election is made. See Regulations section 1.338(b)-1 for rules about AGUB.

MADSP. MADSP is used if a section 338(h)(10) election is made for the target. In general, the MADSP is (1) the grossed-up basis in the purchasing corporation's recently purchased stock, plus (2) the liabilities of the new target, minus (3) both the acquisition costs capitalized in the purchasing corporation's basis in the recently purchased stock and the selling costs of the selling consolidated group (or selling affiliate or S corporation shareholders) incurred in connection with the QSP that reduce the amount realized on the sale of the recently purchased stock, MADSP generally will be the same as AGUB, except for reduction by the acquisition and selling costs. In computing the MADSP, the basis of the recently purchased stock is "grossed-up" if any target stock is not recently purchased stock (whether or not held by the purchasing corporation). The grossed-up basis is (1) the basis of the recently purchased stock, divided by (2) the percentage of target stock (by value) attributable to the recently purchased stock. See Regulations sections 1.338(h)(10)-1(f) and 1.338-3 for rules about MADSP. (In general, ADSP, used if a section 338(h)(10) election is not made for the target, is computed in the same manner as MADSP except that, for ADSP, the seller's selling costs are not subtracted. See Regulations section 1.338-3 for rules about ADSP.)

Time of computation. AGUB, ADSP, and MADSP are initially determined at the beginning of the day after the acquisition date, and are subject to subsequent adjustments (see Regulations section 1.338(b)-1 and Temporary Regulations section 1.338(b)-3T). Under the regulations, adjustment events that occur during the new target's first tax year are taken into account as if they had occurred at the beginning of the day after the acquisition date. For purposes of completing this form, you may, but need not, take into account these first year adjustments.

Line 9a. Enter the amount of the consideration paid for the recently purchased target stock. Include only amounts actually paid to the seller(s) of the target stock. Do not include other amounts that are also includible in the purchasing corporation's basis in the recently purchased target stock.

Line 9b. Enter any other amounts (such as acquisition costs) capitalized in the purchasing corporation's basis in the recently purchased stock.

Line 9c. Enter the amount of the new target's liabilities as of the beginning of the day after the acquisition date, that is, the amount taken into account to determine AGUB (see Regulations section 1.338(b)-1(f)).

Note: If a section 338(h)(10) election is not made for the target, this amount includes the amount of the old target's income tax liability on the deemed sale, which is separately shown on line 9d.

In order to be included in AGUB at the beginning of the day after the acquisition date, an obligation must be a bona fide liability of the target as of that date which is properly includible in basis under principles of tax law that would apply if the new target had acquired the old target's assets from an unrelated person and, as part of the transaction, had assumed or taken property subject to the obligation. Thus, the amount of an obligation of the target that, as of the acquisition date, is contingent or speculative is not initially included in AGUB.

Line 9d. Complete this line only if a section 338(h)(10) election is not made for the target. Enter the amount of the old target's income tax liability on the deemed sale of its assets. This amount is also included as part of the amount on line 9c.

Note: The new target's obligations to pay taxes on the old target's deemed sale gain increase the overall purchase price and cause this element of ADSP and AGUB to "gross-up" or "pyramide."

Lines 9f, g, and h. Enter the amount of AGUB allocated to Class I, II, and III assets, respectively. "Class I assets" are cash, and demand deposits and similar accounts in banks, savings and loan associations, and other similar depository institutions. "Class II assets" are certificates of deposits, U.S. government bonds, and similar debt instruments. "Class III assets" are accounts in banks, savings and loan associations, and other similar depository institutions.
securities, readily marketable stock or securities, and foreign currency. "Class III assets" are all assets other than Class I, Class II, and section 197 intangibles (whether or not amortizable) (see section 197).

Line 11a. Enter the amount of the consideration received for the recently purchased target stock. Include all amounts paid to the seller(s) of target stock, and do not subtract other amounts (such as selling costs) that can be subtracted from the purchase price in determining the seller's (or sellers') amount realized for the recently purchased target stock.

Line 11c. Enter the selling costs of the selling consolidated group (or selling affiliates or S corporation shareholders) incurred in connection with the QSP that reduce the amount realized on the sale of the recently purchased stock (e.g., brokerage commissions or any similar costs incurred by the selling group or shareholders to sell the target stock).

Lines 11e, f, and g. Enter the amount of MADSP allocated to Class I, II, and III assets, respectively. See the instructions for lines 9f, g, and h.

Section G. Elections Under Section 338

Line 14. Gain recognition election. If a gain recognition election is made for a target corporation, it applies to each "P" group member (that is, each corporation that, on the acquisition date, is a member of the affiliated group that includes the purchasing corporation and holds nonrecently purchased stock). See Regulations section 1.338(b)-1(e). If a section 338(h)(10) election is made for a target, a gain recognition election is deemed made by each P group member. If a gain recognition election is actually made (not deemed made) for a target corporation, attach a schedule providing the target corporation's name and the name, address, and EIN of each P group member holding nonrecently purchased target stock. The schedule must also contain the following declaration (or a substantially similar declaration):

"EACH CORPORATION HOLDING STOCK SUBJECT TO THIS GAIN RECOGNITION ELECTION AGREES TO REPORT ANY GAIN UNDER THE GAIN RECOGNITION ELECTION IN ITS FEDERAL INCOME TAX RETURN (INCLUDING AN AMENDED RETURN, IF NECESSARY) FOR THE TAX YEAR IN WHICH THE ACQUISITION DATE OF THE TARGET OCCURS."

The schedule must be signed on behalf of each P group member holding nonrecently purchased target stock by a person who states under penalties of perjury that he or she is authorized to act on behalf of the corporation.

A gain recognition election for the target also applies to any target affiliate that has the same acquisition date as the target and for which a section 338 election is made. Attach a schedule with the information requested above for each such target affiliate.

Signature

If the common parent of a consolidated group is the agent of the purchasing corporation under Regulations section 1.1502-77, the person authorized to sign the statement of section 338 election is the person authorized to act on behalf of that common parent.

If a QSP of a target corporation is made by two or more corporations that are members of the same affiliated (but not consolidated) group, Form 8023 must be signed by a person authorized to sign on behalf of each corporation.

If a section 338(h)(10) election is made for an S corporation, Form 8023 must be signed by each S corporation shareholder who sells target stock in the QSP.

Where multiple signatories are required, the signatures, dates, and titles (if applicable) of all signatories must be provided on a "SIGNATURE ATTACHMENT" to the form under the appropriate "declaration under penalties of perjury." (This is the statement that appears on the Form 8023 immediately above the relevant signature line). Write "See attached" in the signature area of the Form 8023.

Filing Rules for Foreign Purchasing Corporations

Unless otherwise specifically noted, the general rules and requirements in these instructions apply to foreign purchasing corporations.

Who must file. Generally, the purchasing corporation must file Form 8023. However, the U.S. shareholders of controlled foreign purchasing corporations described in Regulations section 1.338-1(g)(3) may make the section 338 election for the corporation. To take advantage of this special rule, complete Form 8023 and attach a statement to the form showing address, identifying number, and stock interest of each U.S. shareholder. The statement must be signed by each U.S. shareholder. When signing the statement, each U.S. shareholder must state under penalties of perjury that the stock interest for that shareholder specified in the statement is correct. Write "See attached" in the signature area of Form 8023. As an alternative to a jointly signed statement, the shareholder signatures may be shown on separate statements attached to Form 8023. If a U.S. shareholder is not an individual or does not have delegated authority to sign the statement, the person signing must state under penalties of perjury that he or she is authorized to sign the statement for the U.S. shareholder.

Copies. Each U.S. shareholder making the election must attach a copy of Form 8023 to Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations, and file the forms generally for the foreign purchasing corporation's tax year that includes the acquisition date; however, failure to do so will not invalidate a section 338 election.

When and where to file. Special rules may apply to foreign purchasing corporations or foreign targets. The time during which a qualifying foreign purchasing corporation may make a section 338 election for a qualifying foreign target is described in Regulations section 1.338-1(g)(1)(i).

Foreign purchasing corporations that file a U.S. income tax return must file Form 8023 with the District Director (Attention: Chief of Examination) for the Internal Revenue district having jurisdiction over the purchasing corporation. If the foreign purchasing corporation does not file a U.S. income tax return, it must file Form 8023 with the Assistant Commissioner (International) (Attention: Chief of Examination, CP:IN:D:C:EX:E), 950 L'Enfant Plaza, SW, Washington, DC 20224.

However, if U.S. shareholders of the foreign purchasing corporation make an election for the foreign purchasing corporation under Regulations section 1.338-1(g)(3), the Form 8023 must instead be filed with the District Director (Attention: Chief of Examination) for the Internal Revenue district having audit jurisdiction over the U.S. shareholder with the largest ownership percentage in the foreign purchasing corporation. If there are two or more U.S. shareholders with equally large ownership percentages, the shareholders may file the Form 8023 with the District Director (Attention: Chief of Examination) for the Internal Revenue district having audit jurisdiction over one of those U.S. shareholders.

Filing Instructions With Respect To Foreign Targets

Unless otherwise specifically noted, the general rules and requirements in these instructions apply to foreign targets.

A section 338 election will not be valid for a target that is a controlled foreign corporation, a passive foreign investment company, or a foreign personal holding company unless affected U.S. persons who own stock in these targets are notified, in writing, as set forth in Regulations section 1.338-1(g)(4).

Copies. In addition to the filing of the original Form 8023 and the attaching of copies to returns, as noted above, if a section 338 election is made for a foreign target for which a Form 5471 is filed, attach a copy of Form 8023 to the last Form 5471 for the old target and first Form 5471 filed by the new target. However, failure to do so will not invalidate a section 338 election.

Attachments. Attach a schedule listing the date of each purchase of foreign target stock, each purchaser's name, the percentage purchased by each purchaser, and the name and place of incorporation of any selling entities. If affected U.S. persons owning stock in the target are notified, attach a schedule
containing the name and EIN or SSN of each U.S. person.

**Paperwork Reduction Act Notice.** We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete and file this tax form will vary depending on individual circumstances. The estimated average time is:

- **Recordkeeping** .................. 14 hr., 7 min.
- **Learning about the law or the form** ........................................ 2 hr., 17 min.
- **Preparing and sending the form to the IRS** .................. 2 hr., 37 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. You can write to the Tax Forms Committee, Western Area Distribution Center, Rancho Cordova, CA 95743–0001. DO NOT send this form to this address. Instead, see **When and Where To File** on page 1.
### Asset Acquisition Statement

**Under Section 1060**

Attach to your Federal income tax return.

### Part I  General Information

To be completed by all filers.

1. **Name of other party to the transaction**
   - [ ] Buyer
   - [ ] Seller

2. **Date of sale**

3. **Total sales price**

### Part II  Assets Transferred

To be completed by all filers of an original statement.

<table>
<thead>
<tr>
<th>Assets</th>
<th>Aggregate Fair Market Value (Actual Amount for Class I)</th>
<th>Allocation of Sales Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Class I</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>Class II</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>Class III</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>Classes IV and V</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$</td>
<td>$</td>
</tr>
</tbody>
</table>

5. Did the buyer and seller provide for an allocation of the sales price in the sales contract or in another written document signed by both parties?  
   - [ ] Yes
   - [ ] No

   If "Yes," are the aggregate fair market values listed for each of asset Classes I, II, III, IV and V the amounts agreed upon in your sales contract or in a separate written document?  
   - [ ] Yes
   - [ ] No

6. In connection with the purchase of the group of assets, did the buyer also purchase a license or a covenant not to compete, or enter into a lease agreement, employment contract, management contract, or similar arrangement with the seller (or managers, directors, owners, or employees of the seller)?  
   - [ ] Yes
   - [ ] No

   If "Yes," specify (a) the type of agreement, and (b) the maximum amount of consideration (not including interest) paid or to be paid under the agreement. See the instructions for line 6.
### Part III  Supplemental Statement—To be completed only if amending an original statement or previously filed supplemental statement because of an increase or decrease in consideration.

<table>
<thead>
<tr>
<th>Class</th>
<th>Allocation of Sales Price as Previously Reported</th>
<th>Increase or (Decrease)</th>
<th>Redetermined Allocation of Sales Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Class I</td>
<td>$</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>Class II</td>
<td>$</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>Class III</td>
<td>$</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>Classes IV and V</td>
<td>$</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
<td>Total</td>
<td>$</td>
<td>$</td>
<td>$</td>
</tr>
</tbody>
</table>

8 Reason(s) for increase or decrease. Attach additional sheets if more space is needed.

9 Tax year and tax return form number with which the original Form 8594 and any supplemental statements were filed.
General Instructions
Section references are to the Internal Revenue Code unless otherwise noted.

A Change To Note
New temporary regulations under sections 1060 and 338 clarified the rules for allocating assets acquired after February 13, 1997. Under the new rules, all section 197 intangibles (other than goodwill and going concern value) are included in Class IV. Goodwill and going concern value are assigned to a new class, Class V. See “Class IV” and “Class V” under Definitions below.

Purpose of Form
Both the seller and buyer of a group of assets that makes up a trade or business must use Form 8594 to report such a sale if goodwill or going concern value attaches, or could attach, to such assets and if the buyer’s basis in the assets is determined only by the amount paid for the assets (applicable asset acquisition," defined below). Form 8594 must also be filed if the buyer or seller is amending an original or a previously filed supplemental Form 8594 because of an increase or decrease in the buyer’s cost of the assets or the amount realized by the seller.

Who Must File
Subject to the exceptions noted below, both the buyer and the seller of the assets must prepare and attach Form 8594 to their Federal income tax returns (Forms 1040, 1041, 1065, 1120, 1120S, etc.).

Exceptions. You are not required to file Form 8594 if any of the following apply:
1. The acquisition is not an applicable asset acquisition (defined below).
2. A group of assets that makes up a trade or business is exchanged for like-kind property in a transaction to which section 1031 applies. However, if section 1031 does not apply to all the assets transferred, Form 8594 is required for the part of the group of assets to which section 1031 does not apply. For information about such a transaction, see Regulations section 1.1031-7T(b)(4).
3. A partnership interest is transferred. See Regulations section 1.755-2T for special reporting requirements.

When To File
Generally, attach Form 8594 to your Federal income tax return for the year in which the sale date occurred. If the amount allocated to any asset is increased or decreased after Form 8594 is filed, the seller and/or buyer (whoever is affected) must complete Part I and the supplemental statement in Part III of a new Form 8594 and attach the form to the Federal tax return for the year in which the increase or decrease is taken into account.

Penalty
If you fail to file a correct Form 8594 by the due date of your return and you cannot show reasonable cause, you may be subject to a penalty. See sections 6721 through 6724.

Definitions
“Applicable asset acquisition” means a transfer of a group of assets that makes up a trade or business in which the buyer’s basis in such assets is determined wholly by the amount paid for the assets. An applicable asset acquisition includes both a direct and indirect transfer of a group of assets, such as a sale of a business.

A group of assets makes up a “trade or business” if goodwill or going concern value could under any circumstances attach to such assets. A group of assets could qualify as a trade or business whether or not they qualify as an active trade or business under section 355 (relating to controlled corporations). Factors to consider in making this determination include (a) any excess of the total paid for the assets over the aggregate book value of the assets (other than goodwill or going concern value) as shown in the buyer’s financial accounting books and records, or (b) a license, a lease agreement, a covenant not to compete, a management contract, an employment contract, or other similar agreements between buyer and seller (or managers, directors, owners, or employees of the seller).

The buyer’s “consideration” is the cost of the assets. The seller’s “consideration” is the amount realized.

“Fair market value” is the gross fair market value unreduced by mortgages, liens, pledges, or other liabilities. However, for determining the seller’s gain or loss, generally, the fair market value of any property is not less than any nonrecourse debt to which the property is subject.

The following definitions apply to applicable acquisitions after February 13, 1997. For transitional rules that apply to acquisitions before February 14, 1997, see Transitional Rules on page 4.

“Class I assets” are cash, demand deposits, and similar accounts in banks, savings and loan associations, and other depository institutions, and other similar items that may be designated in the Internal Revenue Bulletin.

“Class II assets” are certificates of deposit, U.S. Government securities, readily marketable stock or securities, foreign currency, and other items that may be designated in the Internal Revenue Bulletin.

“Class III assets” are all tangible and intangible assets that are not Class I, II, IV, or V assets. Amortizable section 197 intangibles are Class IV assets. Examples of Class III assets are furniture and fixtures, land, buildings, equipment, and accounts receivable.

“Class IV assets” are all amortizable section 197 intangibles, except for goodwill and going concern value. Amortizable section 197 intangibles include:
- Workforce in place,
- Business books and records, operating systems, or any other information base,
- Any patent, copyright, formula, process, design, pattern, know-how, format, or similar item,
- Any customer-based intangible,
- Any supplier-based intangible,
- Any license, permit, or other right granted by a governmental unit,
- Any covenant not to compete entered into in connection with the acquisition of an interest in a trade or a business, and
- Any franchise (other than a sports franchise), trademark, or trade name.

However, the term “section 197 intangible” does not include any of the following:
- An interest in a corporation, partnership, trust, or estate.
- Interests under certain financial contracts.
- Interests in land.
- Certain computer software.
- Certain separately acquired interests in films, sound recordings, video tapes, books, or other similar property.
- Certain separately acquired rights to receive tangible property or services.
- Certain separately acquired interests in patents or copyrights.
- Interests under leases of tangible property.
- Interests under indebtedness.
- Professional sports franchises.
- Certain transaction costs.

See section 197(e) for further information.
“Class V assets” are section 197 intangibles in the nature of goodwill and going concern value.

Allocation of Consideration
An allocation of the purchase price must be made to determine the buyer’s basis in each acquired asset and the seller’s gain or loss on the transfer of each asset. Use the residual method for the allocation of the sales price among the amortizable section 197 intangibles and other assets transferred. See Regulations section 1.1060-1T(d). The amount allocated to an asset, other than a Class V asset, cannot exceed its fair market value on the purchase date. The amount you can allocate to an asset also is subject to any applicable limits under the Internal Revenue Code or general principles of tax law. For example, see section 1056 for the basis limitation for player contracts transferred in connection with the sale of a franchise.

Consideration should be allocated as follows: (a) reduce the consideration by the amount of Class I assets transferred, (b) allocate the remaining consideration to Class II assets in proportion to their fair market values on the purchase date, (c) allocate to Class III assets in proportion to their fair market values on the purchase date, (d) allocate to Class IV assets in proportion to their fair market values on the purchase date, and (e) allocate to Class V assets.

Reallocation After an Increase or Decrease in Consideration
If an increase or decrease in consideration that must be taken into account to re-determine the seller’s amount realized on the sale, or the buyer’s cost basis in the assets, occurs after the purchase date, the seller and/or buyer must allocate the increase or decrease among the assets. If the increase or decrease occurs in the same tax year as